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In-House Counsel: Protecting the Privilege in A Post-Yates Memorandum World

By Ty E. Howard and Todd Presnell

Internal investigations have always posed vexing issues for in-house counsel. Investigations arise in many different ways. They can involve relatively small, to bet-the-company risks. In-house counsel need to make difficult decisions on matters such as scope and purpose of the investigation, who will conduct the investigation, how costs will be controlled, and the work product that they will generate.

But perhaps the toughest issue pertains to protecting the attorney-client and other applicable privileges. By now, most counsel are familiar with the risks associated with attorneys, whether in-house or outside counsel, interviewing employees. To ensure that the company maintains its attorney-client privilege, and that they do not unintentionally create an attorney-client relationship with the employee, company counsel must give "corporate Miranda" or *Upjohn* warnings, which take their name from *Upjohn Co. v. United States*, 449 U.S. 383 (1981).

Privilege issues in internal investigations rarely end with an appropriate *Upjohn* warning. Further complications loom, including the effect of disclosure to a governmental agency, the effect of involvement of third-party contractors such as investigators and e-discovery personnel, the appropriateness of conditioning an employee's continued employment on participation and confidentiality, the viability of partial or selective waiver in your jurisdiction, and many others.

In-house counsel can now add one more complication: the Department of Justice's (DOJ) recently issued "Yates Memorandum." Taking its name from Deputy Attorney General Sally Yates, the memo is an update to the DOJ's Principles of Federal Prosecution of Business Organization, which are memorialized within the United States Attorney's Manual (USAM), the principal internal policy guide for DOJ attorneys across the nation. The Yates Memo actually marks just the latest

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Insider Trading Liability

By Jon R. Grabowski and Michael A. Sabino

In the wake of recent insider trading decisions issued by the U.S. Courts of Appeal for the Second and Ninth Circuits, the Supreme Court has granted certiorari to determine if proof of a close family relationship is enough to satisfy the personal benefit requirement laid out in previous decisions addressing tipper-tippee liability under Section 10 of the Securities Exchange Act of 1934. *See Salman v. United States*, cert. granted, __U.S.__ (No. 15-628) (Jan. 19, 2015). The forthcoming decision will undoubtedly set the table for all future insider trading actions brought by both the government and private parties, forcing individuals and firms to adjust their practices to the Court's holding in order to guard against exposure to potential insider trading liability.

Supreme Court Precedent

As first set forth in *Dirks v. S.E.C.*, the Supreme Court has long stood by its postulation of the elements necessary for a finding of tippee liability arising out of a corporate insider's breach of fiduciary duty. Specifically, under *Dirks*, the following elements must be satisfied for there to be a finding of tipper and tippee liability: 1) the corporate insider was entrusted with a fiduciary duty; 2) the corporate insider breached

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Privilege

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chapter in a long history of DOJ wrestling internally with how to treat the attorney-client privilege in the context of corporate investigations and credit for those businesses that cooperate with the government.

While the Yates Memo makes no formal changes to the DOJ's position on privilege with respect to cooperation credit for businesses, its practical implications could be far-reaching. To address those implications fully, a little history is in order.

The Yates Memo: A Genealogy

The Yates Memo is just the latest DOJ policy announcement related to the prosecution of business organizations over the last 17 years, and privilege issues have loomed large in each of the policy's iterations.

The Holder Memo (1999)

In 1999, then-Deputy Attorney General Holder issued the first official guidance related to prosecution of business organizations. The Holder Memo noted that many of the same factors that DOJ followed when considering whether to charge an individual (*e.g.*, sufficiency of evidence, likelihood of success at trial, deterrent, rehabilitative, and other consequences at trial) applied equally to the charging decision for business organizations. The Holder Memo also set out the following eight principles that prosecutors should consider when dealing with corporate targets: 1) The nature and seriousness of the offense; 2) The pervasiveness of wrongdoing within the corporation, including complicity or condoning by management; 3) The corporation's history of similar conduct and enforcement; 4) The timely and voluntary disclosure of wrong doing, *including, if necessary, waiver of the attorney-client privilege and the work product protection*; 5) Adequacy of the corporation's compliance program; 6) The corporation's remedial actions; 7) The collateral consequences to shareholders and employees; and 8) The adequacy of non-criminal remedies. Holder Memo, § II (emphasis added).

The Holder Memo noted that privilege waiver was not an "absolute requirement," but prosecutors could request a waiver in "appropriate circumstances" and could consider "the willingness of a corporation to waive the privileges when necessary to provide timely and complete information as only one factor in evaluating the corporation's cooperation." Holder Memo, § VI.B.

Thompson Memo (2003)

In 2003, the DOJ revised the Holder Memo in the wake of well-publicized corporate scandals such as Enron and WorldCom. The revisions were generally modest, but the pointed and skeptical tone toward corporate cooperation had a significant effect on attorney-client privilege issues.

The Holder Memo was advisory and characterized as guidance that should generally inform a prosecutor's charging decision. By contrast, the revised policy — authored by Deputy Attorney General Larry Thompson and known as the Thompson Memo — made consideration of the factors mandatory. The Thompson Memo also noted that the "main focus of the revisions" was "increased emphasis on and scrutiny of the authenticity of a corporation's cooperation." Thompson Memo, 1. While the revised policy retained the Holder Memo's language about attorney-client privilege waiver not being an "absolute

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The SEC Whistleblower Program

Part Two of a Two-Part Article

By Stephanie Korenman and Aegis J. Frumento

Last month, in Part One of this article (available at http://bit.ly/1Wq12Em), we examined the overall structure, operation and experience of the SEC's Whistleblower program over the first five years of its operation. In Part Two herein, we take a closer look at how the Office of the Whistleblower (OWB) processes Whistleblower claims, and we examine the claim decisions rendered through April 2016.

A Whistleblower claim must refer to an SEC enforcement action (either administrative or federal court) for which a Notice of Covered Action (a NoCA) was posted on the OWB website. Any claim must be made within 90 days of that posting. Rule 21F-10(b). That posting is the only notice to which a claimant is entitled, and Whistleblowers who missed the posting and filed late have had their claims summarily denied. *See* Whistleblower Award Proc. No. 2016-5, Exch. Act Rel. No 77368, at 3-4 (Mar. 14, 2016) ("A potential claimant's responsibility includes the obligation to regularly monitor the Commission's web page for NoCA postings and to properly calculate the deadline for filing an award claim."); *see also* Whistleblower Award Proc. No. 2014-3, Exch. Act Rel. No 71849, at 5 (Apr. 3, 2014).

Claim Determination

The Rules require OWB to make a preliminary determination as to each such claim, but only after the underlying case has become final beyond all appeals, and that may, of course, be long after the expiration of the 90 days. Moreover, unlike for Whistleblowers, the Rules impose no deadline on when OWB must make a preliminary determination. Once OWB issues a preliminary determination, the claimant has 60 days to accept or file objections to it. Alternatively, the Whistleblower may, within 30 days of the posting, request a copy of the material that OWB used in making the preliminary determination, and request a meeting with the OWB staff. OWB must provide the material, but may decline the meeting. Once OWB supplies the requested material (but not the meeting), the clock resets and the Whistleblower must file any objections within 60 days from then. Rule 21F-10e.

At some point — again undefined in the Rules — OWB's preliminary determination becomes a "proposed final determination" that is submitted to the Commission to be converted into a final order of the Commission. The latter will review a proposed final determination only if the applicant objects, or if a Commissioner requests a review within 30 days after OWB submits it. The Commission reviews proposed final determinations on the original papers — there will be no subsequent briefing or argument. In fact, the Rules do not provide for any notice to Whistleblowers of these end-game procedures, and there is anecdotal evidence that claimants, to their frustration, are told neither when OWB issues a proposed final determination nor when it submits it to the Commission.

If the Commission reviews a proposed final determination, it will issue a final order affirming or modifying it, often containing an explanatory narrative. Otherwise, a proposed final determination to which no objection is made and of which no Commissioner requests a review becomes a final order of the Commission automatically 30 days after OWB submits it. Rule F-10h.

OWB will then provide the claimant with a copy of the final order. Again, there is no deadline in the Rules, but OWB has consistently posted final award decisions on its website within days of issuance. The average time between a preliminary determination and a final order granting an award has been 128 days, ranging from a super-expedited 25 days to an almost year-long 338 days. The average number of days between preliminary determinations and final orders both granting and denying claims in each of the past few years has oscillated from 116 days in 2013, up to 142 days in 2014, down to 75 days in 2015, and back up to 261 days through April 2016.

Recent History

In the past five years, 103 substantive Whistleblower applications have gone through this process (at least 16 were added after Part One of this article went to press), and those cases reveal a few trends. Putting to the side those claims filed late, or where the information was provided before the passage of the Dodd-Frank Act on July 21, 2010, *see Stryker v. SEC*, 780 F.3d 163 (2d Cir. 2015) (discussed in Part One of this Article), recall that the Rules require an award to natural persons who: 1) voluntarily deliver to the SEC, 2) in proper form, 3) "original information," that 4) "leads to the successful enforcement" of an SEC administrative or judicial action in which the SEC obtains sanctions exceeding $1 million (that is, results in a posted NoCA). Rules 21F-2, 21F-3. Therefore, the simplest thing to say about the Whistleblower decisions is that winning claimants have run that gauntlet, while losing ones failed one or another of those tests.

A review of final orders — mostly denials — leads to the following observations:

Information must be given directly to the SEC. Information provided to other agencies — but not to the SEC — will not count, even if those other agencies thereafter do

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provide it to the Commission. This does not mean that it must be provided to the SEC *first*; only that, to be eligible for an award, it must be provided to the SEC directly.

Information must be provided in proper form. Claims have been denied expressly because information was not provided in the form required by Rule 21F-2(a)(2) — which refers to those provisions specifying the information requested in the "Tips, Complaints and Referrals" Form (the TCR).

Information merely regurgitated from public records will not be deemed "original." Whistleblower Award Proc. No. 2015-3, Exch. Act Rel. No 74815, at 2n.2 (Apr. 27, 2015) (*dicta*) ("information … largely copied from a third party's publicly available court filings" likely would not qualify as "original"); Final Orders relating to NoCAs 2011-78, 2011-200 and 2012-13 (Sept. 10, 2015). This appears to apply Rule 21F-4(b)(iii), which provides that "original" information cannot be "exclusively derived" from public records of which the Whistleblower is not the source. Information is not deemed to be "original" if it is not based on independent knowledge or analysis. Final Order relating to NoCA 2011-206 (Feb. 13, 2015).

A Significant Contribution?

Of course, the primary substantive criterion of a successful tip is whether the information led to the successful enforcement of an SEC action, and here, the redactions in the final orders render them not particularly instructive. Sometimes, simple timing explains the denial: A tip provided after the case had already settled, for example, is obviously of no value. But usually a denial incorporates Rule 21F-4(c)(1) to the effect that Whistleblower "information … [must be] … sufficiently specific, credible, and timely to cause the staff to commence an examination, *open* an investigation, *reopen* an investigation … , or to *inquire concerning different conduct* as part of a current examination or investigation … ." (Emphasis added.) Since all award claims presuppose a NoCA, and therefore the existence of an investigation, the question becomes one of contributory significance. The decisions simply say the information did not significantly contribute to the prosecution, or more precisely, it did not lead to the opening, reopening or redirection of an investigation or examination — that it was, in effect, old news. *See, e.g.*, Final Order relating to NoCAs 2013-51, 2013-50, 2013-48 and 2013-14 (May 8, 2015).

However, the most recent award made it clear that a significant contribution to an investigation that is already in process can also be rewarded, even one opened as a result of news stories, on the basis of Rule 21F(c)(2), which speaks not of opening, reopening or redirecting an investigation, but simply of providing information that "significantly contributes to the success" of an enforcement action. Whistleblower Award Proc. No. 2016-9, Exch. Act Rel. No. 77833 (May 13, 2016). Although few details of substantive significance are ever provided, those decisions at least suggest a substantive evaluation of the information.

Final orders of denial have recently shifted to a more strictly procedural determination: that a tip did not contribute to a case because the prosecuting staff never got it. In a few instances, the Commission coupled such a procedural determination with a substantive assessment that the information could not have led to a successful enforcement action anyway. The bulk of the more recent denials, however, is based simply on the fact that the Office of Market Intelligence (OMI) (*see* Part One of this article) disposed of the TCR with "no further action" and did not pass it on to the enforcement staff prosecuting the case.

This is problematic. OMI is responsible for routing relevant information to those responsible for pending investigations. If OMI does not do that, and the enforcement staff remains ignorant of the TCR information, then of course the TCR information cannot actually contribute to the case. The recent decisions conclude in that event the Whistleblower is not entitled to an award — *regardless of the TCR's substantive merit*.

Those final orders that do grant awards are useful mostly for clues on how percentages are determined. OWB has suggested in public statements that in making preliminary determinations of awards, the default starting point is 20%, the exact middle of the Act's range of percentages. From there, certain negative factors will tend to push the percentage toward the minimum 10%, and others will tend to pull the percentage up toward the maximum 30%. The significance of the information provided must inevitably be a factor, but its impact is almost impossible to gauge from the decisions, which describe information only in general terms and are so redacted that even the correlating NoCA is often unascertainable. The most that can be gleaned is that the more detailed and better documented the information is, and the more involved the Whistleblower is during the investigation, the greater the impact it should have in supporting a higher award.

Delay in reporting is clearly a significant factor in pushing the percentage recovery down toward the 10% minimum. Conversely, quick action despite exposing oneself to a personal risk of retaliation tends to pull the award percentage up toward the 30% maximum. Indeed, a compliance officer (usually ineligible for an award), whose employer failed to act on his internal reports of rule violations, earned himself a $1.6 million award by promptly reporting out to the SEC despite a clear risk of retaliation by his employer. And in the most recent award, the Commission specifically identified the Whistleblower's inability to find employment "significantly

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Joint Employment And the Contingent Worker

By Robert G. Brody and Katherine M. Bogard

In today's global economy, many companies are staffing through employee brokers, leases, or temporary agencies, franchises and other non-traditional arrangements. For instance, in 2013, the U.S. Bureau of Labor and Statistics estimated that 2,673,800 workers were employed in the temporary help services industry. Many of these contingent arrangements result in third parties, such as the temporary staffing agency, employing the workers — not the company on whose behalf the work is being performed (the "putative joint employer," *i.e.*, where the temp is assigned). For instance, this is a common relationship that exists within the catering world in large metropolitan cities, such as New York City or alternatively in manufacturing distribution hubs, such as Memphis, TN. These arrangements generally allow the putative joint employer to minimize or even avoid functions such as recruiting, screening, hiring, paying workers, and complying with labor and employment laws. This avoidance, however, often comes with significant risks.

Over the last few years, government agencies have reacted to this trend by increasingly finding that both companies are employers and as such, both are jointly and severally liable for any issue involving the employees. The National Labor Relations Board, Title VII of the Civil Rights Act of 1964, as amended, and the Occupational Safety and Health Administration (OSHA) have long been on board with this outcome. Not one to be left out, the federal Department of Labor (DOL) recently issued instructive administrative guidance on this exact issue.

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DOL Guidance

The DOL guidance focuses on the joint employer provisions already existing in both the Fair Labor Standards Act (FLSA) — the federal wage and hour watchdog) and the Migrant and Seasonal Agricultural Worker Protection Act (MSPA). Although the MSPA is not applicable to many employers, the DOL nonetheless used its joint employer provisions to establish the DOL's joint employer analysis. The guidance focuses on the fact that because the word "employ" is defined so broadly by the FLSA and MSPA ("to suffer or permit to work") that a wide range of companies related to the employment of workers might be considered joint employers. Next, the guidance introduces the two main categories of joint employment that determine what legal test is used in the analysis — horizontal or vertical joint employment.

Horizontal Joint Employment

Horizontal joint employment exists where an employee has a relationship with two companies that are related or associated with each other such that they both employ the worker. The focus is the relationship that the two companies have with each other (*e.g.*, two restaurants that share employees) rather than either employer's relationship with the employee.

According to the DOL guidance, the horizontal joint employer factors are:

- Who owns the potential joint employers (*i.e.,* does one employer own part or all of the other employer (*e.g.*, parent subsidiary relationship) or do they have any common owners)?
- Do the potential joint employers have any overlapping officers, directors, executives, or managers?
- Do the potential joint employers share control over operations (*e.g.*, hiring, firing, payroll, advertising, overhead costs)?
- Are the potential joint employers' operations intermingled (*e.g.*, is there one administrative operation for both employers, or does the same person schedule and pay the employees regardless of which employer they work for)?
- Does one potential joint employer supervise the work for the other?
- Do the potential joint employers share supervisory authority for the employee?
- Do the potential joint employers treat the employees as a pool of employees available to both of them?
- Do the potential joint employers share clients or customers? and
- Are there any agreements between the potential joint employers regarding the workers?

Although not every factor must be met, the more factors that are present, the more likely a finding of joint employer.

Vertical Joint Employment

Vertical joint employment exists where the employee has a relationship with one employer, but is paid by the other entity. The focus is the relationship between the two companies and then the employee's different relationships with each of the two companies (*e.g.*, staffing agencies or labor providers). Vertical joint employment is most common for contingent workers.

For vertical joint employment to be found under the DOL guidance, two companies generally have an agreement or arrangement whereby one company supplies employees to the other (the latter being the putative joint employer since the employee actually performs work for this entity). However, before beginning the joint employer analysis, be sure the workers are not actually employees misclassified as independent contractors. If this is the case, you will never get to a joint employer analysis, but rather merely an employer analysis. If

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this concept makes no sense to you, seek counsel to make sure you have not fallen into this trap.

Assuming the workers are not employees, the next step is to perform an economic realities test. The key is whether the worker is economically dependent on the putative joint employer. The MSPA sets forth a seven-factor economic realities test although different jurisdictions and different agencies use different versions of this same idea:

1. Who directs, controls, or supervises the work performed?
2. Who controls employment conditions (*e.g.*, pay rate, schedules)?
3. What is the permanency and duration of the relationship (*i.e.*, the more definite/full-time the relationship between employee and putative joint employer, the more likely a joint employer finding)?
4. Is the nature of the work repetitive and rote (*i.e.*, the more repetitive, rote, and unskilled the work, the more likely a joint employer finding)?
5. Is the work integral to the putative employer?
6. Is the work is performed on premises? and
7. Who performs administrative functions commonly performed by employers?

Again, although not every factor must be met, the more factors that apply, the more likely a finding of joint employment.

NLRB Joint Employer Standard

For over 30 years, the National Labor Relations Board (NLRB) has found two entities joint employers if they shared or co-determined matters governing the essential terms and conditions of employment — and actually exercised this power. Where one entity had direct and immediate control over various aspects of employment over the other entity's employees, including such things as supervision, scheduling, hiring, firing or directing those employees, these entities would be joint employers. However, after *Browning-Ferris Industries of California, Inc.*, the NLRB now considers whether an employer has exercised control over terms and conditions of employment indirectly through an intermediary, or even if it has reserved the authority to do so. In other words, if an employer has the ability to exercise control, but did not use that authority, it can be found a joint employer. This standard vastly expands the range of employers that could be subject to joint employer status and could expose them to significant monetary damages for the actions of the other joint employer. This type of joint employment is a hot topic in the franchisor/franchisee world, and is currently pending before the NLRB in the *McDonald's USA, LLC* case.

Despite these significant ramifications, the *Browning-Ferris* decision is limited in its scope. The NLRB's decision was fact-specific. The case centered on the employer's (BFI's) use of Leadpoint, a temporary staffing agency. The NLRB found that BFI was the joint employer with Leadpoint. It relied on the indirect and direct control BFI possessed over the essential terms and conditions of employment of Leadpoint's workers and BFI's reserved authority to control these terms and conditions. This case was the traditional temporary employment agency case. However, in the *McDonald's* case, the NLRB is trying to expand *Browning-Ferris* to apply to a franchising relationship. The NLRB's underlying theory is that McDonald's' alleged indirect ability to control franchisees through technology offerings creates the joint employer relationship. If the NLRB prevails, the world of franchising could be turned upside down!

Joint Employer Liability Under Title VII

Title VII of the 1964 Civil Rights Act generally prohibits employers from discriminating against employees on the basis of sex, race, color, national origin and religion. The practical concern in the joint employer arena is if a primary employer makes racially insensitive comments about its employees, will the joint employer be liable?

Most recently, in *Faush v. Tuesday Morning*, the U.S. Court of Appeals for the Third Circuit adopted the ERISA joint employer test from the U.S. Supreme Court's *Nationwide Mutual Insurance Co. v. Darden* decision. In *Faush*, the plaintiff was employed by a staffing agency and assigned to work at the defendant (the putative employer), where he claimed he was subjected to racially discriminatory comments and terminated because of his race. He brought an employment discrimination suit under Title VII against the putative employer. The key factors used to make the joint employer determination were: whether the skills used at both companies were similar; the source of the instrumentalities and tools used by the employee was the putative employer; the work was performed at the putative employer's business; the duration of the relationship between the parties was ongoing; and the putative employer had the right to assign additional projects to the employee. Weighing all these factors (no single factor is dispositive), the court determined there was enough evidence of joint employment to defeat the putative employer's summary judgment motion.

In another civil rights case, the U.S. Court of Appeals for the Fourth Circuit, in *Butler v. Drive Automotive Industries,* adopted a similar test to *Faush*, but it considered 11 factors. In that case, the plaintiff was hired by a temp agency to work at Drive Automotive, where she claimed she was subjected to verbal and physical sexual harassment and was terminated as a result of her complaints to both companies. The factors considered are similar to those in the Third Circuit test, but the court noted that the first four factors (who had authority to hire and fire employees; day-to-day supervision of the employee, including

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disciplining the employee; who furnished the equipment used by the employee; and the actual workplace used by the employee) were the most important. The element of control over the employee remained the "principal guidepost" in the analysis. Weighing these factors, the court found that Drive Automotive was a joint employer and therefore subject to Title VII liability.

Joint Employers Under Wage And Hour Laws

While the federal DOL created guidelines to address the joint employer situation, wage and hour case law also addresses this concern. The federal Fair Labor Standards Act (FLSA) generally establishes minimum wage, overtime pay, record-keeping, and youth employment standards for private sector and government employees. If one employer fails to properly pay employees for overtime, the joint employer could be liable for that overtime pay. In today's world, these cases can involve immense liability and are probably the fastest growing area of litigation.

In this context, many courts have cited the U.S. Court of Appeals for the Ninth Circuit's opinion in *Bonnette v. California Health and Welfare Agency* as the foundational test for FLSA joint employer liability. In that case, the court addressed the issue of whether a state welfare agency was a joint employer of domestic in-home caregivers, and found that they were, based on the level of control they possessed. The test examines whether the putative employer had the power to hire and fire the employees, supervise and control employee work schedules or conditions of employment, determine the rate and method of payment, and maintain employment records.

The U.S. Court of Appeals for the Second Circuit originally adopted those four factors, but has since added six additional factors in a 2003 case, *Zheng v. Liberty Apparel*. Among the additional factors, the key ones are whether the employee used the putative employer's premises and equipment, the transferability of a contract (for the employees) among multiple putative employers, and the degree of supervision from the putative employer. In that case, the plaintiffs were factory workers employed by contractors doing business at the same factory. When one of those employees was not paid thousands of dollars in alleged wages, the employee sued the contractors and Liberty Apparel as joint employers. Because the district court had exclusively considered the four *Bonnette* factors, the Second Circuit remanded the case so the additional factors could also be considered. As in the Title VII context, these multifactor tests are fact-specific and could produce variable outcomes. The tests leave judges with broad discretion.

Consequences

Legally, if the temporary staffing agency and the location at which the contingent employee is assigned or franchisor and franchisee are joint employers, both companies are held jointly and severally liable. Practically, many employers have agreements with temp agencies/staffing companies stating that the agencies are responsible for compliance with all labor and employment laws. Assuming that the agreement is enforceable, the putative employer would be able to turn to the other employer, if any liability is found against the putative employer. But if one employer goes out of business, the other one will be left holding this very expansive bag.

Therefore, it is important for putative employers that choose to employ contingent workers to understand the risks associated with such employment relationships and to negotiate an arrangement that adequately protects the putative employer. For instance, if a putative employer determines that it can benefit from contingent workers services without controlling the assignments, pay and other indicators of an employment relationship, it should closely scrutinize its contract with the temporary staffing agency to make sure that is clear. But in a practical sense, this is a difficult task, as the putative employer more times than not is the only entity in the position of directing and supervising the contingent workers' day-to-day work.

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his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; 3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and 4) the tippee still used that information to trade in a security or tip another individual for personal benefit. *See Dirks v. S.E.C.*, 463 U.S. 646 (1983).

However, the murmurings of discord between the Second and Ninth Circuits raise issues regarding what may constitute a personal benefit under the existing case law. In *United States v. Newman*, 773 F.3d 438 (2d Cir. N.Y. 2014), cert. denied, __U.S.__, 136 S. Ct. 242 (2015), the Second Circuit took a narrow approach in addressing this element, holding that the government had to prove that a tippee knew the tipper received a personal benefit in exchange for the disclosure. Significantly, that tribunal ruled that "personal benefit" has to extend beyond a mere casual friendship between tipper and tippee. On the other hand, a subsequent Ninth Circuit decision, *U.S. v. Salman, supra*, 792 F.3d 1087 (9th Cir. 2015), now under High Court review, addressed circumstances in which a personal or familial relationship between a tipper and insider was sufficient to satisfy the "personal benefit" requirement.

The Second Circuit in *Newman* reiterates that liability for insider

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trading exists under either the "classical" or the "misappropriation" theories. The classical theory states that a corporate insider violates Section 10and Rule 10b-5 by his own trading in the corporation's securities on the basis of material, nonpublic information. *See Chiarella v. United States*, 445 U.S. 222, 230 (1980). In contradistinction, yet intersecting with the classical theory, the misappropriation theory encompasses those outside the executive suite who do not have a fiduciary or special relationship to a corporation or its shareholders, yet are in possession of material, non-public information about the firm. When these ostensible outsiders trade on that information to their gain, they fall under the gamut of tipper-tippee liability on the theory that, essentially, they misappropriated knowledge that does not belong to them. *See United States v. O'Hagan*, 521 U.S. 642, 652-53 (1997).

Tipping liability reaches situations where the insider or misappropriator in possession of material nonpublic information (the "tipper") does not himself trade, but discloses the information to an outsider (a "tippee"), who then trades on the basis of the information before it is publicly disclosed. *See Newman*, 773 F.3d at 446. This was seized upon by the Second Circuit in *Newman*, which pointed to Supreme Court *dicta* holding that "[t]he tippee's duty to disclose or abstain is derivative from that of the insider's duty," and, because "the tipper's breach of duty requires that he personally will benefit, directly or indirectly, from his disclosure, a tippee may not be held liable in the absence of such benefit." Thus, in *Newman*, the tribunal held that "a tippee may be found liable only when the insider has breached his fiduciary duty … and the tippee knows or should know that there has been a breach." *Id*. (internal quotation omitted).

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Second Circuit Limits

In *Newman*, the Second Circuit overturned the conviction of two individuals charged with insider trading. Significantly, this decision sets forth the outer boundary at which the court will uphold tippee liability by holding that, *inter alia*, the existence of a casual friendship alone does not satisfy the personal benefit requirement of insider trading liability.

Relying upon the Supreme Court's holding in *Dirks*, the *Newman* defendants argued that the government failed to present sufficient evidence that the tippers received either a direct or indirect "personal benefit" from the disclosure. *See Dirks v. S.E.C.*, 463 U.S. at 662. Specifically, they asserted that innocuous career advice given to one tipper did not rise to the level necessary to satisfy the "personal benefit" leg of the analysis laid out in *Dirks*. The defendants further claimed that the government did not offer any evidence that the insider giving the tip received any sort of personal benefit at all.

The appellate court based its reversal upon two findings. The first was that the government failed to meet its evidentiary burden to establish that the tippee knew of the insider, and that the tipper derived a personal benefit from giving the tip. *See Newman*, 773 F.3d at 448. The second finding, more procedural in nature, was that the district court had committed harmful error by failing to instruct the jury regarding the government's burden of proof of those two allegations. *Id*. at 450.

Newman revitalized the "personal benefit" analysis of *Dirks*, holding that the prosecution must prove each of the following elements beyond a reasonable doubt: 1) the corporate insider was bound by fiduciary duty to the corporate issuer; 2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to the tippee (b) in exchange for a personal benefit; 3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and was divulged for personal benefit; and 4) the tippee nonetheless used that information to trade in the security or tip another individual for his own personal benefit. *Id*. at 450.

Citing *Dirks*, the Second Circuit reiterated that "a breach of confidentiality is not fraudulent unless the tipper acts for personal benefit, that is to say, there is no breach unless the tipper 'is in effect selling information to its recipient for cash, reciprocal information, or other things of value for himself.'" The district court's failure to include an "in exchange for personal benefit" instruction, coupled with the government's dearth of evidence on the subject, proved to be the fatal blow to upholding the convictions. *Id*.

Ninth Circuit Imposes Liability

In *Salman*, the defendant allegedly traded upon inside information purportedly obtained through the close relationship he had with his brother-in-law, Michael Kara. Michael had obtained material, nonpublic information from his brother, Maher, a member of Citigroup's healthcare investment banking group. Michael was also alleged to have traded for his own account, as well as tipping Salman. The tribunal found the evidence was clear that "Salman knew full well that Maher Kara was the source of the information." Moreover, "Michael and Maher Kara enjoyed a close and mutually beneficial relationship," and "Salman was aware of the Kara brothers' close fraternal relationship." *Salman*, 792 F.3d at 1090.

Much like its Second Circuit brethren in *Newman*, the Ninth Circuit

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in *Salman* correctly focused upon *Dirks* and its "personal benefit" requirement as an element necessary to impose liability for insider trading. Yet the western appellate court reached a markedly different result. The *Salman* panel chose to emphasize that portion of *Dirks* wherein the Supreme Court ruled that insider trading liability also "comes into existence where the insider makes a gift of confidential information to a trading relative or friend." *Id.* at 1092, quoting *Dirks v. S.E.C.*, 463 U.S. at 664. Thus, applying the Supreme Court's maxims as articulated in *Dirks*, the tribunal accordingly held that Maher's disclosure of confidential information to his brother, with awareness that the latter intended to trade on it, "was precisely the gift of confidential information to a trading relative that *Dirks* envisioned." *Id.*, internal quotations omitted. The Ninth Circuit declared that its ruling flowed logically from the critical facts that the Kara brothers had a "close fraternal relationship, Salman was well aware of that relationship, and thus Salman could have readily inferred Maher's intent to benefit Michael." *Id.*

Providing the utmost level of clarity, the *Salman* court distinguished itself from the circumstances in *Newman*, observing that the nature of the relationship between the *Newman* tipper and tippee was far more nebulous than the relationship present in *Salman*. Employing its sister court's language, the Ninth Circuit declared as follows:

> The Second Circuit held that [the] evidence was insufficient to establish that either [tippers] received a personal benefit in exchange for the tip. It noted that although the "personal benefit" standard is "permissive," it "does not suggest that the Government may prove the receipt of personal benefit by the mere fact of a friendship, particularly of a casual or social nature." Instead, to the extent that "a personal benefit may be inferred from a personal relationship between the tipper and tippee, … such an inference is impermissible in the absence of proof of a meaningfully close personal relationship that generates an exchange that is objective, consequential, and represents at least a potential gain of a pecuniary or similarly valuable nature."
>
> *Salman*, 792 F.3d at 1093, citing *U.S. v. Newman*, 773 F.3d at 452.

Based upon the Supreme Court's granting certiorari in *Salman*, one can logically infer that the Justices wish to clarify the evidentiary burden of the government in pursuing an insider trading case, specifically in satisfying the "personal benefit" element as found in the *Dirks* formulation. Given that the Second Circuit refuses to recognize that a casual friendship can satisfy the personal benefit element of the *Dirks* test, but at the same time the Ninth Circuit decrees that evidence of a close, familial relationship is sufficient to impose liability, it will be up to the Supreme Court to choose between these two divergent approaches or even affirm or amend its own prior extrapolations, as found in *Dirks*, in order to resolve this internecine controversy.

Corporate Liability

While insider trading, as a species of securities fraud, is prosecuted under Section 10 and Rule 10b-5 of the Securities Exchange Act of 1934 (*see* 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5, respectively), Section 20 of the 1934 enactment (15 U.S.C. § 78t) authorizes both the government and private litigants to pursue those who "control" the primary violator. This is "control person" liability, and it possesses the uncanny ability to assess damages against those higher up in the corporate chain of command for neglecting to supervise, let alone aid and abet, those malefactors engaged in insider trading. If the claimant is first able to establish the liability of the primary violator, and then prove the "control" by a secondary actor, then liability shall also attach against the "control person." To be sure, "control person" includes business entities, as well as individuals.

Given this potential for exposure to meaningful liability, those individuals and/or firms likely deemed "control persons" in a corporate setting must endeavor to establish practices that minimize the risk of liability in the context of a Section 20 action. While there is no fool proof methodology for avoiding control person liability, there are numerous active and passive steps a corporation, its directors, and its upper management may implement as strong countermeasures against eventualities of employee misbehavior. For example, a firm may protect material, non-public information with any number of physical and electronic safeguards. Taking a more proactive approach, a firm may also choose to monitor the trading activity of its employees and/or the shares of the firm itself for irregularities that may indicate the presence of misuse of inside information, by the employees themselves or their confederates.

Most importantly, however, a firm and its executives must strive to educate its employees regarding the risks of sharing confidential information with others, including close family and friends, the very persons the employee is most likely to trust with company secrets. Particularly in light of the Supreme Court's decision to grant certiorari in *Salman*, and the expected ruling as to how a family or other personal relationship might equate the "personal benefit" element of the *Dirks* test, the employee may expose the corporation to control person liability by a simple slip of the tongue when speaking in confidence to a family member or close friend about their work day.

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Whistleblowers

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due" to his whistleblowing as a factor. Whistleblower Award Proc. No. 2016-9, Exch. Act Rel. No. 77833, at p. 4 (May 13, 2016).

THE PROGRAM'S EFFECTIVENESS

How "effective" the Whistleblower Program has been depends on one's view of its objective. The SEC's official statements all focus on how many tips the program has developed, and the Whistleblower program surely generates many TCRs. The total 15,000 tips (Whistleblower and others) that OMI evaluates each year yield about 1,000 investigations and about 800 actual proceedings. *See* SEC FY 2017 Congressional Budget Justification at p. 62 (http://1.usa.gov/1SPD2nr). Using those same proportions of proceedings-to-tips, TCRs alone appear to have resulted in about 1,000 proceedings since the program began. So, if the objective of the Whistleblower program is merely to increase the number of leads and cases, then perhaps the program can be deemed to some extent effective.

But if the program's goal is to reward and incentivize Whistleblowers who facilitate prosecuting *high-quality* cases, then it has not lived up to its press. The vast majority of TCRs ultimately prove useless. Despite the SEC having commenced 4,000 proceedings in the past five years, it only posted 762 NoCAs, implying that 80% of its cases resulted in sanctions of less than the $1 million minimum threshold for a Whistleblower award. And despite 1,000 cases having perhaps been opened as a result of TCRs, no more than 21 NoCAs have yielded Whistleblower awards. Thus, perhaps as many as 98% of the cases that result from TCRs do not yield the dollar minimum required for an award. And if we conservatively assume that Whistleblower awards to date relate to TCRs filed in and prior to 2013, then less than one-half of one percent of all TCRs yield awards. That means there is a 99.5+% statistical probability that a Whistleblower will get nothing.

The vast majority of TCRs ultimately prove useless.

And yet, OWB blatantly hypes the amounts awarded to Whistleblowers. It is true that the largest award to date appears to be up to $35 million, and that the next largest award was as much as $14 million. However, only four other awards appear to have exceeded $1 million each, aggregating at most $9.9 million among them. See Whistleblower Award Proc. No. 2016-9, Exch. Act Rel. No. 77833 (May 13, 2016) ($3.5 million); Whistleblower Award Proc. No. 2016-4, Exch. Act Rel. No 77322 (Mar. 8, 2016) ($1.8 million); Whistleblower Award Proc. No. 2015-5, Exch. Act Rel. No 75477 (Jul. 17, 2015)($3 million); Whistleblower Award Proc. No. 2015-2, Exch. Act Rel. No 74781 (Apr. 22, 2015) ($1.6 million). But the SEC has only awarded $62 million to all 28 Whistleblowers to date. SEC Press Release 2016-88 (May 13, 2016). Therefore, the remaining 22 award winners shared all of $3.1 million — an average of $140,909 each.

CONCLUSION

Putative Whistleblowers are highly unlikely to retire from a TCR, and so-called "SEC Whistleblower Attorneys" had better have paying practices doing something else. Why the Whistleblower program has been so ineffective at ferreting out high-dollar cases inevitably calls for speculation, so this is ours. Cases involving fraud in the offering of securities are still the bread-and-butter both of SEC enforcement (as reflected in NoCAs and other notices of enforcement actions) and of tips (as seen in the TCR statistics), but they are visible, easy to unravel, and generally do not lead to high-dollar cases. Whistleblowers are most needed when the illegal conduct is obscure.

Cases involving arcane internal accounting fraud, Foreign Corrupt Practices Act (FCPA) violations, internal broker-dealer and investment adviser rule violations, and trading and pricing schemes stand out in the NoCAs as being particularly vulnerable to Whistleblowing, but only if they occur at a firm large enough to warrant a multi-million dollar sanction. This suggests that the successful Whistleblower likely will be an insider at a large institution, who can explain and document ongoing obscure violations, but who is neither actively participating in them nor in such a senior management or compliance role that he or she is disqualified from receiving a bounty for reporting them. The program's results so far show that such Whistleblowers may be rarer than Congress imagined. (*Note: For a full list of citations, kindly contact the authors.*)

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Privilege

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requirement," it ushered in a new era in which fear of being labeled uncooperative — and the charging and sentencing implications attendant to such a stigma — led to more waivers requested and more waivers obtained.

McCallum Memo (2005)

Criticism of the Thompson Memo and its erosive effect on the attorney-client privilege grew over the next two years. In response, DOJ issued a memorandum from then-acting Assistant Attorney General Robert McCallum, titled "Waiver of Corporate Attorney-Client and Work-Product Protections." The one-page McCallum Memo directed U.S. Attorneys and other DOJ department heads to establish a written review process in their districts or divisions, a directive apparently designed to ensure supervisory approval before requesting a privilege waiver.

Whatever the intent, the McCallum Memo did nothing to quell

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criticism of the DOJ waiver policy. That criticism grew louder as the late U.S. Sen. Arlen Specter (R-PA) introduced legislation to prohibit waiver of the attorney-client privilege as a prosecutorial consideration. *See* 152 Cong. Rec S11439 (Dec. 7, 2006). Equally important, abuse of a related aspect of the policy came to light in *United States v. Stein*, 435 F. Supp. 2d (S.D.N.Y. 2006). In a series of rulings, the *Stein* court eventually dismissed indictments against KPMG employees after finding that prosecutors violated the employees' Fifth and Sixth Amendment rights by coercing KPMG to condition its payment of employees' legal fees on the employees' willingness to cooperate with the government.

McNulty Memo (2006)

In December 2006, the DOJ changed course with the McNulty Memo. Written by then-Deputy Attorney General Patrick McNulty, the memo explicitly superseded and replaced the Thompson and McCallum Memos. With respect to privilege waivers, the revamped policy created a two-tiered system distinguishing between "purely factual information, which may or may not be privileged, relating to the underlying conduct" (Category I) and "attorney-client communications or non-factual attorney work product" (Category II). McNulty Memo § VII.B.2.

The new policy set out a cumbersome procedure, including a multi-factor balancing test, for line prosecutors to obtain privilege-waiver approval when they had a "legitimate need" for the information to carry out their duties. *Id*. Once a prosecutor performed that balancing test, the memo required a further two-step process: For Category I information, the prosecutor must obtain written authorization from the U.S. Attorney, who must consult with the Assistant Attorney General before granting the request. For Category II information, the prosecutor must complete the first step, but also obtain written approval from the Deputy Attorney General — the DOJ's second in command.

Filip Memo (2008)

Less than two years later, Deputy Attorney General Mark Filip issued his own eponymous memo that again changed DOJ's privilege-waiver policy in the context of corporate investigations. Amid several modest changes, the Filip Memo explicitly prohibited prosecutors from requesting attorney-client communications or non-factual attorney work product (the McNulty Memo's "Category II information"). The only exceptions were if defendants asserted an advice-of-counsel defense or where counsel-corporation communications were in furtherance of a crime.

The Yates Memo is silent regarding privilege, and ostensibly does not alter DOJ's policy toward privilege waiver.

In addition, the Filip Memo provided that a corporation's cooperation credit no longer depended on the waiver of privilege and work-product protections. Instead, such credit turned on the willingness and sufficiency of the corporation's disclosure of relevant facts to aid the government's investigation.

Coincidentally, on the same day the Filip Memo was released, the U.S. Court of Appeal for the Second Circuit issued a unanimous opinion affirming the district court's decision in *Stein* to dismiss criminal charges against former KPMG employees. *United States v. Stein*, 541 F.3d 130 (2d Cir. 2008). The court upheld the district court's ruling that the U.S. Attorney's Office violated the employees' Sixth Amendment rights by requiring KPMG to condition paying the employees' legal fees on the employees' cooperation. *Id*.

Yates Memo (2015)

The Filip Memo's changes remained undisturbed until Sept. 9, 2015, when Deputy Attorney General Yates issued a new memorandum revising DOJ's policy in corporate investigations. The Yates Memo set out "six key steps" intended to enhance DOJ's effort to identify culpable individuals in corporate cases, specifically: 1) To qualify for *any* cooperation credit, a company must disclose all relevant facts about culpable individuals. 2) Criminal and civil investigations will focus on individuals from the start. 3) Criminal and civil investigators should routinely communicate. 4) Absent extraordinary circumstances, DOJ will not release individuals from liability as part of a corporate resolution. 5) Corporate cases should not be resolved unless individual cases can be resolved before the statute of limitations. 6) In civil cases, attorneys should focus on individuals and determine whether to bring suit regardless of ability to pay.

The first step has received the most attention because it now makes full disclosure of all relevant facts a threshold for any credit, rather than just one of several factors. Likewise, the sixth step constitutes an aggressive counterpart to the first step, establishing that inability to pay will not insulate individuals from civil enforcement. Several of the other steps do not mark a change in DOJ policy and appear to be directed internally to DOJ lawyers.

The Yates Memo is silent regarding privilege, and ostensibly does not alter DOJ's policy toward privilege waiver. The only mention of privilege is an indirect reference that companies seeking cooperation credit must cooperate completely "within the bounds of the law and legal privileges." Yates Memo, § 1.

Two months after release of the policy, Yates addressed privilege issues more specifically in a speech, noting that "there is nothing in the new policy that requires companies to waive attorney-client privilege or in any way rolls back protections

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that were built into the prior factors." Remarks by Sally Yates to American Banking Association and American Bar Association Money Laundering Enforcement Conference, Nov. 16, 2015, Washington, DC. ("11/16/15 Yates Speech"). She continued: "Facts are not [privileged]. If a law firm interviews a corporate employee during an investigation, the notes and memos generated from that interview may be protected, at least in part, by attorney-client privilege or as attorney work product." In that situation, Yates noted that a company need not turn over the protected material with an important caveat: "[T]o earn cooperation credit, the corporation does need to produce all relevant facts – including the facts learned through those interviews — unless identical information has already been provided." 11/16/15 Yates Speech.

Yates's remarks and privilege analysis did little to allay concerns that the Yates Memo may be encouraging, if not requiring, waivers indirectly just as the prior policies did so directly.

Status of the Privilege Now

Despite assurances that the DOJ is not altering its stance toward privilege waiver, the Yates Memo and Ms. Yates' public remarks raise several thorny, unanswered questions:

1. Can you provide all relevant facts without a privilege waiver? The decision on whether a company should cooperate is now more complicated. Given the "all-or-nothing" policy in the first step, companies must consider carefully whether they can meet that standard. It is not clear, for example, how this policy would affect a company that turns over what it believes are all of the relevant facts, but has a good-faith disagreement with the DOJ over an individual's culpability. If, based on that disagreement, the company does not accede to the DOJ's view of the case, will it still be eligible for cooperation credit?

The breadth of required disclosure also implicates the privilege. Put simply, the DOJ's "facts are not privileged" statement is overly simplistic and does not solve the matter. Indeed, while the Yates Memo focuses solely on non-privileged information, it is easy to envision how a disagreement over privilege could jeopardize a company's ability to receive cooperation credit.

One clear effect of the Yates Memo is that in-house counsel must give … greater thought to their Upjohn warnings and when to secure separate counsel for individual employees.

2. What are the implications for potential partial or selective waiver? It appears that the DOJ now takes a rather formalistic view toward privilege waiver, one that courts may not follow in collateral matters that put cooperating companies at risk. For example, it appears the DOJ would expect that, after privileged employee interviews, a company would segregate in some way the "pure facts" from other information obtained and disclose the former. But even if that were done, the privilege still protects the underlying communication from which the company obtained those facts, and separating pure facts from employees' communications to corporate counsel is, at best, difficult.

As a result, it appears that the Yates Memo effectively requires a *de facto* waiver. While one may characterize that waiver as a partial waiver (waiving it for purposes of just one particular subject), such waivers create an inherently slippery slope and the scope of the waiver can be subject to various and potentially damaging interpretations. Likewise, to the extent the waiver is a selective waiver (waiving for purposes of just one party, the DOJ), this characterization is of little help, as the majority of courts do not recognize selective waiver.

3. How does the new approach affect* Upjohn *warnings and providing counsel to individual employees? One clear effect of the Yates Memo is that in-house counsel must give even greater thought to their *Upjohn* warnings and when to secure separate counsel for individual employees. Given the policy's focus on individuals, many employees may want separate representation before deciding whether to cooperate with an internal investigation.

In turn, investigations will be slowed, and company counsel may be limited in what they can learn absent a joint-defense agreement, which could prove difficult to obtain. Moreover, while the contours of an *Upjohn* warning remain unchanged, those warnings will take on enhanced meaning. Counsel usually try to balance an appropriately robust *Upjohn* warning with a facilitating approach that does not chill an employee from providing information. A more conservative, formal approach to the content of the *Upjohn* warning and interviewing employees may be required, which in turn could result in less information obtained.

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