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FINPRO Focus

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Dodd-Frank's Whistleblower and Clawback Provisions: Potential Effects on D&O Exposures

Similar to the Sarbanes-Oxley Act of 2002 (SOX), the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) has many provisions aimed at corporate governance, financial reform regulatory enforcement, and a myriad of other issues impacting directors & officers (D&O) exposures. With a mission containing objectives that include "to promote the financial stability of the United States…and other purposes," Dodd-Frank has moved towards the center of the D&O radar. Particularly noteworthy from a D&O perspective are the whistleblower protection and compensation clawback provisions.

The whistleblower protection provision of Dodd-Frank (Title IX, Subtitle B, Section 922) is especially notable as the provision establishes a potential bounty to individuals reporting "original information" to the Securities and Exchange Commission (SEC) regarding securities violations within their company(ies). If eligible, such whistleblowing activities could yield an award of 10 percent to 30 percent of the monetary sanctions imposed in an action, subject to a minimum sanction of $1 million. Under Dodd-Frank, employees with information are in the position to consider two choices: Report allegations to their audit committee's hotline in an attempt to fix the issue, or report to the SEC and collect at least 10 percent of $1 million. Some experts forecast a torrent of whistleblower activity; however, the SEC still needs to establish a new office and staff it appropriately to receive, review, and enforce the program. Clearly this is no easy task, even with a $452 million fund.

The whistleblower incentive concept is not unprecedented in the regulatory arena. The Dodd-Frank program is a broader, heartier version of the SEC's "Insider Trading Bounty Program," which paid total bounties of under $160,000 from 1989 to 2009. The False Claims Act of 1863 and the Tax Relief and Health Act of 2006 also provide for bounties to whistleblowers. To illustrate, a single whistleblower will collect a $96 million award for her involvement in a $750 million payment from a large pharmaceutical and health care company to settle an investigation of manufacturing deficiencies, under a 2002 False Claims Act lawsuit. This extremely large award underscores the fact that federal whistleblowing incentive programs have been in existence for some time and have the potential for significant economic consequences for companies.

Final rules under Dodd-Frank—expected in April—will hopefully balance the incentive program with more language encouraging corporations to further strengthen internal reporting procedures. To this end, while the SEC is not contemplating an actual requirement to utilize internal company procedures before reporting into the whistleblower program, it is considering two other incentives to report internally:

1. determining the size of the award along the 10 percent to 30 percent scale would be partially based upon whether the employee reported it under an internal program; and
2. using the date of an internal report as the official date on which original information was reported to the SEC, thus potentially accelerating the award time line for the whistleblower.

Corporations' ongoing quest for better internal controls and continuous self-improvement is now somewhat weighed down by a form of negative reinforcement—avoiding increased SEC investigation activity and the related time, expense, and distraction to the business.

As expected, there is substantial retaliation protection for whistleblowers. In addition to a potentially 10-year statute of limitations for filing retaliation claims, whistleblowers who suffer retaliation could be eligible for reinstatement, two times base pay, and attorney's fees and costs.

Dodd-Frank's whistleblower protection provision calls attention to the whistleblower exception to a D&O

policy's insured versus insured exclusion, among other policy provisions. Other components of a policy's coverage, including but not limited to the definition of loss and coverage for investigations, should be carefully reviewed as the Dodd-Frank whistleblower provision and investigations gain momentum.

Dodd-Frank's compensation "clawback" provision, technically known as "Recovery of Erroneously Awarded Compensation" (Title IX, Subtitle E, Sec. 954), builds on similar provisions established by SOX. It requires a company to:

1. disclose of its policies on incentive-based compensation based on financial information that is required to be reported under the securities laws; and
2. establish a policy to recover (claw back) any amount of incentive-based compensation paid to any current or former executive that exceeds the amount which would have been paid under an accounting restatement in the three years prior to the date on which the company was required to prepare the restatement.

A company that fails to comply with these requirements risks being de-listed from its exchange.

Under SOX, incentive compensation of CEOs and CFOs could be recouped within 12 months following an accounting restatement involving misconduct. Dodd-Frank, however, widens the net.: It applies beyond CEOs and CFOs to any current or former "executive officer", removes the requirement for misconduct, and extends the clawback period to three years. With misconduct out of the way, a strict liability standard draws near; if there is a restatement, for any reason the company must clawback compensation. And Dodd-Frank allows for SEC enforcement as well as private actions via derivatives.

Companies will have to establish procedures to comply with Dodd-Frank's clawback provision. Doing so will be difficult in the short-term, however, as there are still a number of issues to be clarified, such as the beginning of the three-year period, definition of "executive officer," and definition of incentive-based compensation. To add complexity to the challenge for policyholders, all of these issues have some nexus to D&O policies:

- Who is the insured, vis a vis who are the executive officers subject to the Dodd-Frank clawback?
- What issues are likely to arise under a D&O policy with respect to claims arising in the clawback process?

These and other questions will see answers with greater clarity as case law develops. We expect that evolving case law and rules under Dodd-Frank will shed more light on how D&O policies would need to be amended.

Clearly, the whistleblower and clawback provisions of Dodd-Frank affect directors and officers and raise concerns as to the coverage provided by their D&O liability insurance programs. Policyholders and brokers need to pay particular attention to a D&O policy's insured versus insured exclusion, personal conduct exclusions, the definition of loss, and investigation coverage, among others. This is an especially fluid process with a new law, and Marsh's claims advocates and client advisors are available to discuss Dodd-Frank further as we monitor the developments and the issues they present.

To learn more about the Dodd-Frank Act, its whistleblower or clawback provisions, or to discuss your company's D&O exposures in detail, please contact your local Marsh representative or:

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