Legal Backgrounder

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When Enough Is Not Enough:
Two Court Rulings Complicate Corporate Compliance Efforts

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In the shadow of billion dollar settlements, exhaustive and expensive internal investigations, costly shareholder derivative suits, and the constant need to stay competitive in a global marketplace, companies in recent years have spent significant resources developing detailed and complex compliance programs to mitigate potential risks associated with the kaleidoscope of United States *and* foreign laws. But, as if the compliance challenges facing companies were not already difficult, two recent court decisions could make the task even more daunting. In *United States v. Kellogg Brown & Root, Inc.*[1] and *Asadi v. G.E. Energy, LLC,*[2] the U.S. Court of Appeals for the Fifth Circuit has arguably made it tougher for companies to avoid government scrutiny and potential liability, despite robust compliance. While the issues decided in the two cases are very different, both present potentially significant compliance challenges for companies in every industry sector.

Kellogg Brown & Root, Inc. The first case involved the federal Anti-Kickback Act ("AKA") 41 U.S.C. §§ 51-58 [now codified at 41 U.S.C. §§ 8701-07], and a contract between Kellogg Brown & Root, Inc. ("KBR") and the U.S. Army to provide logistics services in Iraq, Afghanistan, and Kuwait. A criminal investigation revealed that KBR employees accepted kickbacks in the form of meals, event tickets, golf outings, etc., in exchange for favorable treatment on certain subcontracts on the KBR projects. Two of the KBR employees who received the gifts pled guilty to federal criminal charges brought under the AKA's criminal provisions.

The civil litigation commenced when private individuals brought a *qui tam* suit against KBR alleging the same kickback scheme. The government intervened in the case and filed its own civil complaint, alleging that KBR violated the AKA's civil provisions, specifically Section 55(a)(2) which provides for vicarious liability in connection with "any person whose employee, subcontractor or subcontractor employee" provides, accepts, or charges a kickback. However, Section 55(a)(1) refers only to "any person who knowingly engages in conduct" prohibited by the Act. Section 55(a)(1) permits double damages, but Section 55(a)(2) permits a civil penalty only in the amount of the kickback.

KBR moved to dismiss arguing, *inter alia*, that the government failed to state a claim for civil liability under the AKA because Section 55(a)(1) does not permit vicarious liability, and because the complaint failed to allege sufficient facts to attribute the employees' conduct to KBR. The district court granted KBR's motion to dismiss, finding that the plain language of Section 55(a) indicates that corporate vicarious liability does not extend to violations of Section 55(a)(1), and further stating that because the United States did not sufficiently allege that KBR employees were acting for the corporation's benefit, imputation of vicarious liability was not appropriate.

[1] No. 12-40447 (5th Cir. July 19, 2013)
[2] No. 12-20522 (5th Cir. July 17, 2013)

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On appeal, the Fifth Circuit reversed the district court's decision, holding that the federal government can recover enhanced penalties from companies under the AKA even in the absence of any evidence that the company had actual knowledge of or benefited from its employees' or subcontractors' wrongful conduct. Specifically, the court decided that the "any person" language of the statute potentially allows for vicarious liability and potential enhanced penalties for the company, even based on the acts of its employees and/or subcontractors committed without the company's authority or knowledge.

Although KBR argued that the government must allege that an employee acted with intent to benefit his employer and was of managerial level acting within the scope of his employment before the government may state a claim imputing liability to the employer, the court disagreed. It declined to vary from the "common law norm" of permitting vicarious liability for employee actions taken under apparent authority. Thus, the decision suggests that a company can be found liable based solely on its employees' knowledge and actions.

G.E. Energy, LLC. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") was at issue in the second case. The plaintiff, Khaled Asadi, was working in the Kingdom of Jordan for G.E. Energy, LLC (a subsidiary of General Electric, "GE"), when he allegedly learned about GE's hiring of a woman closely associated with a senior Iraqi official in order to gain favor with that official in negotiating a lucrative joint venture agreement. Concerned that this alleged conduct violated the Foreign Corrupt Practices Act ("FCPA"), he reported the matter to his supervisor. Shortly thereafter, he was given a negative performance evaluation and eventually was terminated.

Asadi sued GE under the whistleblower protection provisions of Dodd-Frank, alleging that his termination was in retaliation for his whistleblowing activity. GE moved to dismiss the complaint, arguing that the relevant provisions of Dodd-Frank did not apply extraterritorially, that Asadi's termination was not related to his alleged whistleblowing activity, and that, even if it was, he was not a "whistleblower" at all under Dodd-Frank because he did not provide his information to the Securities and Exchange Commission ("SEC"). The district court agreed with the first argument, holding that Dodd-Frank's whistleblower protections do not apply outside of the United States, and granted GE's motion.

On appeal, the 5th Circuit affirmed the district court's dismissal, but focused not on the extraterritorial issue, but on whether the plaintiff met the definition of "whistleblower" under Dodd-Frank. Concluding that he did not, the appellate court explained that because the plaintiff made his report internally and not to the SEC, he was not a whistleblower under Dodd-Frank because the statute provides a cause of action only for individuals who provide information to the SEC. In so holding, the court ignored several contrary district court decisions, and refused to defer to an SEC regulation which, at least, arguably provides for a broader definition of "whistleblower." The regulation, issued on May 25, 2011, specifically states that an individual may be a whistleblower even though they never report to the SEC, so long as they make disclosures that are "required or protected under the Sarbanes-Oxley Act of 2002." The court nevertheless held that the text of the Dodd-Frank statute itself requires that report be made to the SEC.

Mixed Outcome for Defendants, Definitively Challenging Results for Corporate Compliance. While the result in *Asadi*, if not *KBR*, was a positive one for the company defendant, both decisions, for different reasons, present potentially significant challenges for corporate compliance efforts going forward. The obvious problem with the *KBR* holding is that it seems to allow, for the first time, the government to penalize corporate defendants for AKA violations committed by their employees or subcontractors, even without evidence of corporate complicity. This will likely lead to not only increased pressure on compliance and ethics training programs, but also to a nearly impossible risk management environment in which it is hard to imagine how a company can absorb enough risk to eliminate exposure under the AKA (and similar laws). If a company can be held liable not only for its own actions, but also for an employee's illegal conduct that was outside the scope of employment and that the company neither authorized nor knew about, no amount of hiring screening, training, auditing, or internal control can adequately control the risk.

The *Asadi* decision, while, again, good for the company defendant on the surface, creates a narrowing of the Dodd-Frank definition of "whistleblower" in a way that clearly incentivizes employees to bypass internal corporate reporting mechanisms completely and go straight to the SEC, thus depriving the company of an opportunity to investigate and discover the alleged wrongdoing on its own.

Indeed, while GE's argument in the *Asadi* case was successful in the Fifth Circuit, it actually runs contrary to the position taken by GE and several other large companies during the SEC's rule-making process. At that time, GE, Google, Microsoft, Northrop Grumman, and others urged the SEC to include a provision in the regulations that would require whistleblowers to report wrongdoing internally before approaching regulators. While this position made perfect sense, the regulation that was ultimately adopted appears to have created a contradiction, or at least, an ambiguity between the statute and the regulation as identified by the Fifth Circuit, with the former clearly defining a whistleblower as one who reports to the SEC, and the latter apparently providing for a more expansive definition.

The problem here is two-fold. First, it is always in a company's best interests to discover wrongdoing on its own, and then, if necessary, report it to the regulators. Unfortunately, the decision in *Asadi* provides an obvious incentive to employees to go straight to the SEC, completely bypassing their company's internal reporting mechanism. Second, already overburdened regulators are not equipped to investigate every single allegation of wrongdoing. To the extent that the goal is to uncover and remedy corporate wrongdoing in the quickest, least expensive way possible, the system works better when whistleblowers have an incentive to report internally. This is especially the case if the regulator waits (or fails) to inform the company of the alleged wrongdoing. Thus, wrongdoing could be continuing while the government evaluates a course of action to the detriment of the company and the public policy rationale underpinning the law. Thus, requiring whistleblowers, at least under Dodd-Frank, to report directly to the SEC in order to qualify for whistleblower status, seems likely to encourage the opposite of good corporate citizenship and perhaps significantly increase any penalty because the "illegal activity" was not immediately stopped and mitigated.

As compliance challenges for companies continue to grow in scope and complexity, these two Fifth Circuit decisions do not help. Although appeals to the U.S. Supreme Court are likely, it is Congress that can have the last word. Specifically, the language of each of the relevant statutes at issue in these cases could be revised in a way that lends some common sense to the policy challenges at issue.

Congress could change the Anti-Kickback Act to clearly provide for enhanced penalties only where the company defendant had knowledge of and benefited from the violation. Imposing more expansive vicarious liability in this context is too onerous, and is simply not fair. As for Dodd-Frank, restricting whistleblower status to only those who report to the SEC may narrow the number of actual whistleblowers and, therefore, reduce the number of suits that are filed. But, as discussed above, the perverse incentive to report everything to the SEC first simply does not promote effective compliance. The definition of whistleblower in the statute should be clarified, thus removing the ambiguity that now arguably exists between the statute and the regulation.

The lesson from these decisions for corporate compliance operations is that enough is not enough. Until the Supreme Court reviews these decisions or Congress acts to clarify the law, companies must continue to do their best to implement effective compliance programs, which include policies and procedures that have the unequivocal support of senior management, effective training programs about how to operate legally and ethically (especially on government contracts), an anonymous violation reporting system, and well-drafted agreements with the entire supply chain that highlight the company's expectations in responding to compliance issues and attempts to mitigate the risk. A company that fails to take heed could face significant

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penalties (criminal, civil, debarment, *qui tam* actions, shareholder derivative suits, media scrutiny, etc.) under the various laws for which the Fifth Circuit's opinions could be extended.

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