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New York's Employment At-Will Doctrine Puts Private Company Compliance Personnel At Risk

Corporate governance failures in the last decade have focused attention on compliance and risk management functions at regulated businesses. Employees in those disciplines are sometimes under intense public scrutiny and have been regular enforcement targets. For example, the SEC recently pursued action against the general counsel of a broker-dealer for failure to supervise a trader involved in market manipulation.[1] The SEC brought the action even though the general counsel had recommended that the trader be fired and had been assured that the trader was being supervised.[2] The SEC's willingness to pursue compliance personnel even in the absence of culpability by them sends a very strong – and daunting – message.

While high-profile regulatory failures among privately-owned entities continue to make news,[3] and enforcement actions pressure compliance personnel to take a more muscular approach, in a recent case interpreting New York law, *Sullivan v. Harnisch*, the New York Court of Appeals relied on the state's at-will employment doctrine to deny protection from retaliation to a compliance officer who "blew the whistle" through internal reporting mechanisms.[4] The Court's decision leaves New York as an outlier jurisdiction based on its failure to recognize a public policy exception to its at-will employment law doctrine and risks further eroding public confidence in corporate governance at private, regulated institutions by sending the wrong message about the importance accorded by the law to internal compliance efforts.[5] Moreover, for compliance personnel at private

[1] *In the Matter of Theodore W. Urban*, SEC Initial Decision, File No. 3-13655 (9/8/2010).

[2] *Id.*

[3] *See, e.g.*, Ianthe Jeanne Dugan and Michael Rothfeld, *Peregrine's Vast Money Trail*, Wall Street Journal, July 20, 2012, at C1. (discussing the recent fraud at Peregrine Financial Group), *available at* http://online.wsj.com/article/SB10000872396390444097904577537182181098186.html?mod=googlenews_wsj.

[4] *Sullivan v. Harnisch*, WL 1580602 (N.Y. 2012).

[5] In light of recent publicity about governance failures, one might argue that there is little such risk because confidence is already very low. We suggest that the appropriate perspective is to recognize the fragility of the confidence that remains and address the circumstances that contribute to such failures.

companies, such as the plaintiff in *Sullivan*, New York law leaves them with a choice between, on the one hand, accepting the risk of termination for reporting suspicious activity and, on the other, accepting the risk of enforcement scrutiny concerning their failure to promptly respond to potential violations.

As discussed below, the implications of the *Sullivan* case can be far-reaching and undermine a company's compliance culture. To mitigate the concerns raised by the case, we suggest that private employers who employ compliance personnel in New York consider implementing anti-retaliation policies to set an appropriate tone at the top.

The New York At-Will Employment Doctrine

The New York at-will employment doctrine allows employers to terminate at-will, or non-contract, employees for any reason or for no reason at all, with very limited exceptions.[6] In *Sullivan*, the appellant was the chief compliance officer of a New York-based hedge fund. He was fired after internally objecting to stock sales by the fund's CEO, which he believed violated federal securities laws against "front-running," or trading ahead of customers.[7]

The Court of Appeals affirmed the lower court's decision that the appellant had no cause of action for wrongful termination since he was an at-will employee and his termination did not violate any constitutional requirement, statute or contract.[8] The Court also refused to extend a narrow exception to the at-will doctrine that protects lawyers working at law firms in comparable circumstances.[9] The Chief Judge, in dissenting from the Court's opinion, raised concerns that the strict application of New York's at-will employment doctrine would incentivize compliance personnel to ignore potential illegal behavior in order to protect their jobs.[10]

The New York at-will employment doctrine also denies compensation to employees in other roles who attempt to blow the whistle on potential legal violations. For example, the New York Court of Appeals dismissed a wrongful termination claim where an employee was terminated after internally disclosing accounting improprieties.[11] This precedent remains good law, a somewhat surprising result in light of the many accounting scandals in recent memory.

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[6] *Sullivan,* WL 1580602 (N.Y. 2012).

[7] *Id.*

[8] *Id*. (quoting *Murphy v. American Home Prods. Corp*, 448 N.E.2d 86 (N.Y. 1983)).

[9] *Id.*

[10] *Id*. (Lippman, J., dissenting).

[11] *Murphy*, 448 N.E.2d 86, 87 (N.Y. 1983).

The New York approach contrasts sharply with the law in neighboring states.[12] A public policy exception to Connecticut's at-will employment doctrine allows claims for wrongful discharge where employees are terminated in retaliation for insisting on compliance with state statutes.[13] The Massachusetts doctrine provides for a similar exception when an employer fires a person "for doing what the law requires,"[14] an exception that is interpreted to encompass potential whistleblowers.[15] New Jersey law is comparable, excepting cases in which an employee complains of behavior that actually constitutes a legal violation.[16]

Whistleblower Protection Laws

Some compliance officers who report violations may be protected from retaliation by state and federal whistleblower protection laws.

State whistleblower protections vary widely. New York is "on one end of the spectrum of employee protection;"[17] that is, it provides very little. For example, New York Labor Law §740 protects an employee from retaliation for internally reporting a violation, but only if the violation creates "a substantial and specific danger to the public health or safety . . . ."[18] The misconduct asserted in *Sullivan* would likely not meet this standard.

The federal Sarbanes-Oxley Act of 2002 does contain robust civil and criminal whistleblower protections,[19] covering both internal and external reporting. However, Sarbanes-Oxley only covers employees of public companies. As discussed in *Sullivan*, the Sarbanes-Oxley protections were not available to the whistleblower in that case. On a related note, the U.S. Court of Appeals for the First Circuit recently held, in a case of first impression, that the Sarbanes-Oxley protections do not cover employees of private

[12] *See, also,* Kevin Rubinstein, *Internal Whistleblowing and Sarbanes-Oxley Section 806: Balancing the Interests of Employee and Employer*, 52 N.Y.L SCH. L. REV. 637, 641 (2007/08) ("many state laws recognize whistleblowing as one type of public policy exception to [the] employment-at-will doctrine") (internal quotation marks and citations omitted).

[13] *See Sheets v. Teddy's Frosted Foods, Inc.*, 427 A.2d 385 (Conn. 1980); *Magnan v. Anaconda Industries, Inc.*, 479 A.2d 781 (Conn. 1984).

[14] *Smith-Pfeffer v. Superintendent of the Walter E. Fernald State School*, 533 N.E.2d 1368 (Mass. 1989).

[15] *Smith v. Mitre Corp.*, 949 F.Supp. 943, 949-50 (D. Mass. 1997).

[16] *Tartaglia v. UBS Painewebber Inc.*, 691 A.2d 1167 (N.J. 2008).

[17] Rubinstein, *supra* note 12, at 643.

[18] N.Y. Labor Law § 740 (McKinney 2006).

[19] Section 806 and 1107 of the Sarbanes-Oxley Act of 2002, respectively.

contractors or subcontractors who provide services to and report information about a public company.[20]

The federal Dodd-Frank Wall Street Reform and Consumer Protection Act includes whistleblower protections, but these provisions do not apply to internal reporting. Section 922 of the Dodd-Frank Act provides a cause of action for employees who are terminated in retaliation for providing information about securities violations to the SEC, assisting in an SEC investigation or proceeding or making legally required public disclosures.[21] But section 922 would not appear to protect those who, like Sullivan, only raise suspicions internally.

Last year the SEC also approved rules under Section 922 establishing a new bounty program. The rules require a monetary award to be paid to a whistleblower who reports information to the SEC that results in a successful enforcement action.[22] This program also does not benefit employees who only report internally, such as Sullivan, and the rules generally exclude compliance personnel from receiving awards. Exceptions to the exclusion of compliance personnel apply where: (i) the conduct reported is reasonably likely to cause substantial financial injury to the firm or its investors, (ii) an internal cover-up is underway, or (iii) the compliance employee's internal report of violations is ignored for 120 days.[23] Despite these exceptions, compliance personnel must eventually report suspected violations to the SEC to be considered for monetary rewards, and compensation is dependent on the ultimate success of the SEC's enforcement action.

The interplay between the Dodd-Frank Act's bounty and anti-retaliation rules, recent enforcement efforts and the New York employment at-will doctrine as interpreted by *Sullivan* could lead to increased direct reporting to the SEC by compliance personnel. These individuals may bypass internal reporting functions for fear of retaliation by management or to protect themselves from enforcement scrutiny in case a violation is discovered by authorities before the matter is externally reported. This course of conduct would preclude compliance personnel from participating in the SEC bounty program (unless the substantial financial injury or internal cover-up provisions apply), but it would afford them section 922's anti-retaliation whistleblower protection. If New York law provided the protection for internal reporting via an exception from the at-will employment doctrine, or if a company provides contractual protections as discussed below, compliance personnel might decide to

[20] *Lawson v. FMR LLC*, No. 10-2240 (1st Cir. Feb. 3, 2012), *available at* http://www.ca1.uscourts.gov/cgi-bin/getopn.pl?OPINION=10-2240P.01A.

[21] Dodd-Frank Wall Street Reform and Consumer Protection Act § 922 (2010).

[22] 17 C.F.R. § 240.21F (2012).

[23] *Id.*

report internally instead, giving the company an opportunity to respond to the issue before the SEC gets involved.

There are other federal and state laws that protect whistleblowers, but those anti-retaliation provisions generally focus on assisting in the enforcement of a specific statute. For example, Section 3730(h)(1) of the False Claims Act, as amended in 2009, protects from retaliation persons who undertake "lawful actions done…in furtherance of an [FCA] action," or "other efforts to stop 1 or more [FCA] violations." Also, Section 7623 of the tax code provides for a bounty program for information related to "punishment [of] persons guilty of violating the internal revenue laws or *conniving* at the same" (emphasis added). Rules adopted by the Internal Revenue Service under that Section provide that "the IRS will protect the identity of the whistleblower to the fullest extent permitted by the law."[24]

Negative Effects on Compliance

The failure of the New York Court of Appeals to recognize a public policy exception for the protection of whistleblowers under New York's at-will employment doctrine, together with the gaps in federal and state whistleblower protections, is inconsistent with the various pressures on companies to improve their compliance and risk management functions. It is well documented that employees who fear retaliation report fewer instances of misconduct. When retaliation can take the form of termination, the chilling effect can be expected to be even more significant. This may lead to fewer internal investigations designed to ferret out illegal activity – investigations that often yield remedial initiatives and benefits that go beyond the original subject of the investigation. As discussed above, it may also lead to more reporting to the SEC that bypasses internal reporting procedures.

Private and Public Solutions

Given the current at-will employment doctrine in New York, private companies should consider developing their own carefully crafted policies and practices to ensure that compliance personnel are protected from retaliatory termination. Express non-retaliation policies contained in employee manuals or other company documents represent one way to achieve this goal. The Appellate Division in *Sullivan* pointed to New York precedent holding that provisions in employee manuals can establish employment contracts between employers and employees.[25] For example, the Court of Appeals upheld a wrongful termination cause of action where an employer's personnel handbook required "just and sufficient cause" for termination, as well as "rehabilitative efforts" on behalf of the employer.[26] Additionally, in *Mulder v. Donaldson*, the Appellate Division held a wrongful

[24] Internal Revenue Manual Section 25.2.2.11.

[25] *Sullivan v. Harnisch*, 915 N.Y.S.2d 514, 518-21 (N.Y. App. Div. 2010)

[26] *See Weiner v. McGraw-Hill*, 443 N.E.2d 441 (N.Y. 1982).

termination claim for breach of contract existed where the employee manual of a brokerage indicated that employees reporting misconduct and accounting irregularities would be protected from "reprisals."[27] Indeed, many companies now rely on explicit disclaimers precisely to avoid any implications that corporate policies and manuals create employment contracts.

While the Court of Appeals in *Sullivan* did not mention the above precedents, it noted that Sullivan's employer did not have a non-retaliation policy.[28] Of course, employees should only be protected for good faith claims, but carefully crafted protections do not, in our view, create unreasonable risk to employers as the experience with public company policies has shown. A properly tailored approach would indicate the company's commitment to best practices and the protection of whistleblowers. It may also foreclose legislative or regulatory action that may address the issue with less finesse than companies would accomplish on their own.

While the New York employment at-will doctrine may shield an employer from liability for retaliatory employment actions taken against compliance personnel, such actions run substantial risks of attracting regulatory attention, and in some cases, damaging publicity. From a longer-term perspective, such actions are likely to undermine a culture of compliance and therefore carry a risk of facilitating compliance failures down the road.

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In sum, the impact of the New York at-will employment doctrine on compliance programs for privately-owned regulated entities should not be underestimated, and the *Sullivan* case creates a default rule that is out of step with current realities. Privately-owned companies in New York that have already taken steps to improve the independence of compliance departments and the vigor of their compliance programs should now take a hard look at how they protect their compliance personnel from retaliation.

[27] *Mulder v. Donaldson Lufkin and Jenrette*, 623 N.Y.S.2d 560, 564 (N.Y. App. Div. 1995).

[28] *See Sullivan*, WL 1580602 (N.Y. 2012) ("[The plaintiff's] claim says that Sullivan was fired because he 'spoke out' about 'manipulative and deceptive trading practices,' and that his dismissal violated 'a company policy to prohibit retaliation' for such conduct. The complaint, however, does not identify any statement of this 'company policy'; it infers the existence of the policy from Peconic's obligations under the securities laws and the firm's own Code of Ethics to avoid improper transactions, and from Sullivan's duty as Chief Compliance Officer to see that those obligations were performed.").

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Corporate Governance” or “Executive Compensation and ERISA” under the “Practices” section of our website at http://www.clearygottlieb.com.

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