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Financial reform law includes big cash incentives for whistle-blowers

A little-known provision in the huge package extends to the private sector a concept long applied to government contracts.

By David Savage, Los Angeles Times

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Reporting from Washington

The new financial reform law has what some lawyers call a secret weapon against fraud on Wall Street and in corporate America: the promise of a million-dollar jackpot to insiders who reveal an illegal scheme to the government.

Tucked in the massive bill is a provision that for the first time extends a concept long applied to government contracts to the private sector. It gives whistle-blowers a mandatory 10% — and as much as 30% — of what the government recoups in fines and settlements in financial fraud cases. These can include insider trading, false earnings reports and classic Ponzi schemes.

To claim a bounty, the whistle-blower must provide the Securities and Exchange Commission with "original information" that reveals the fraud and leads to a successful recovery.

"This is very significant and will have an immediate impact," said Erika Kelton, a Washington lawyer who has represented whistle-blowers. "It will motivate knowledgeable insiders to step forward and tell the enforcement agencies what they know. It is the secret weapon in this massive bill."

But some are worried about unintended consequences of the provision.

Some employees may see an incentive not to report a problem internally, but instead "to go to the SEC with it," said Martin Rosenbaum, a Minneapolis lawyer. After the collapse of Enron Corp. and the passage of the Sarbanes-Oxley Act, companies tried to keep problems in-house by setting up hotlines and encouraging employees to tell top management if they saw questionable conduct.

"Most people want their company to be strong and do the right thing," Rosenbaum said. "This has the potential to be a game changer," but not necessarily a good one, he said.

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Some management experts said they foresee a flood of new claims driven by aggressive law firms that represent whistle-blowers.

"I'm skeptical. This is the trend toward the informant-method of law enforcement," said Walter Olson, a scholar at the libertarian Cato Institute. "Congress sees this as free money, but do we want to live in a society with paid informants everywhere?"

He noted that the Internal Revenue Service has used similar bonuses to pay those who expose tax cheats.

Some corporate lawyers say the bounty provisions are the most important but least noticed parts of the new law. They have been overshadowed by the focus on new regulations for banks and the new consumer protection agency.

The whistle-blower provisions "will have a huge impact," said Leslie Caldwell, a management lawyer in New York.

"As people learn about this, they will see it's going to be very significant," Caldwell said. "There are a number of people in a large corporation who learn about things that could be considered violations of the securities law. Now, they have a huge motivation to come forward."

Goldman Sachs recently agreed to pay \$550 million to settle a suit brought by the SEC accusing the investment banking firm of misleading investors who bought mortgage-backed securities just as the housing market collapsed. Had the case arisen from a whistle-blower's tip under the new law, "it would mean at least \$55 million for the whistle-blower," Kelton said.

The idea of bounties for whistle-blowers goes back to the Civil War. Congress in 1863 said that private litigants who exposed fraud in military contracts could keep some of what was recovered.

Congress greatly expanded the False Claims Act in 1986 and offered rewards to whistle-blowers who exposed frauds in other government contracts. At first the targets were mostly Pentagon contracts. More recently the majority of the claims have involved healthcare programs.

Thanks to the act, which took effect the following year, the government has recouped \$24 billion since 1987. Of that amount, whistle-blowers have received nearly \$2.5 billion.

"This is the most successful fraud-recovery program ever. It brings money back to the taxpayers," said Stephen Kohn, executive director of the National Whistleblowers Center in Washington.

It was the massive Ponzi scheme run by Bernard Madoff in New York that convinced many of the need to extend the whistle-blower provisions to the world of financial frauds. Harry Markopolos, an outside investigator who tried to alert the SEC to Madoff's scheme, testified before Congress and urged lawmakers to empower whistle-blowers.

Signed by President Obama on Wednesday, the financial reform law for the first time extends the whistle-blower bonuses beyond government contracts to expose frauds in private companies that cheat their investors or their customers. Its proponents say the best way to expose a financial scheme is to offer a windfall to insiders who know about it.

"This is a not a get-rich-quick scheme for whistle-blowers," Kohn said. "Any time you are involved in a government investigation you are in for a long, drawn-out proceeding. But under this law, whistle-blowers win if they are right, and the government collects."

The new law states that the whistle-blower is entitled to receive at least 10% of what the government receives as a result of his or her tip, and more if the information was crucial to unraveling the fraud. Awards are triggered only when the government recovers at least \$1 million.

The largest awards in recent years have involved medicines and government-paid healthcare.

Last year, John Kopchinski, a Gulf War veteran and a former pharmaceutical salesman for Pfizer, was awarded a \$51.5-million whistle-blower reward for exposing problems with the drug Bextra. It was pulled from the market in 2005, and Pfizer paid a record \$2.3 billion in fines and penalties to the government.

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