

# Memorandum

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## SEC Brings Another Enforcement Action Based on Severance Agreements that Remove Financial Incentives for Whistleblowing

August 23, 2016

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For the second time within one week, the Securities and Exchange Commission (“SEC”) instituted and settled cease-and-desist proceedings last week against an issuer for allegedly violating the SEC’s whistleblower protection provisions under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).<sup>1</sup> As in the enforcement action the SEC initiated against BlueLinx Holdings Inc. on August 10, the issuer subject to the cease-and-desist order – Health Net, Inc. (the “Company”) – allegedly included provisions in its severance agreements with employees that removed “the critically important financial incentives that are intended to encourage persons to communicate directly with the Commission staff about possible securities law violations.”

According to the SEC, starting in August of 2011, the Company included a clause in its severance agreements that specified that, while not prohibited from participating in a government investigation, the former employee was prohibited from filing an application for or accepting a whistleblower award from the SEC pursuant to Section 21F of the Exchange Act. In another provision, the Company’s severance agreements allegedly provided:

[N]othing in [the agreement’s Waiver and Release of Claims] precludes Employee from participating in any investigation or proceeding before any federal or state agency or government body . . . [H]owever, while Employee may file a charge and participate in any proceeding, by signing this Release, Employee waives any right to bring a lawsuit

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<sup>1</sup> Securities and Exchange Commission, *In the Matter of Health Net, Inc.*, Release No. 78590, File No. 3-17396 (Aug. 16, 2016); see also Securities and Exchange Commission Press Release, [“Company Punished for Severance Agreements That Removed Financial Incentives for Whistleblowing”](#) (Aug. 16, 2016). For information regarding the August 10, 2016 enforcement action against BlueLinx Holdings, Inc., see [“SEC Brings Enforcement Action For Violation of Its Whistleblower Protection Provision”](#) (Aug. 16, 2016).

against the Company, and waives any right to any individual monetary recovery in any such proceeding or lawsuit or in any proceeding brought based on any communication by Employee to any federal, state, or local government agency or department.

In June of 2013, the Company allegedly removed from its severance agreements the language that expressly prohibited employees from applying for whistleblower awards pursuant to Exchange Act Section 21F and added language to its agreements indicating that nothing in the agreement “shall be construed to impede the employee from communicating directly with, cooperating with or providing information to any government regulator.” The Company, however, allegedly “retained restrictions in the Waiver and Release of Claims that removed the financial incentive for its former employees who executed that agreement to communicate with Commission staff concerning possible securities law violations at Health Net.” Specifically, according to the SEC, the agreements stated that “by signing this Release, Employee, to the maximum extent permitted by law . . . waives any right to any individual monetary recovery . . . in any proceeding brought based on any communication by Employee to any federal, state or local government agency or department.”

As acknowledged in its cease-and-desist order, the SEC was unaware of any instances in which:

1. a former employee of the Company who executed a severance agreement did not communicate directly with SEC staff regarding potential securities law violations; or
2. the Company took any action to enforce an employee’s waiver of the right to receive monetary recovery for providing information to the SEC or otherwise prevented an employee’s communications with the SEC.

Nonetheless, in both the Company’s 2011 and 2013 agreements, explained the SEC, the Company unlawfully removed critical financial incentives under the SEC’s whistleblower protection provisions. According to the SEC, “[s]uch restrictions on accepting financial awards for providing information regarding possible securities law violations to the Commission undermine the purpose of Section 21F and Rule 21F-17(a), which is to ‘encourag[e] individuals to report to the Commission,’ . . . and violate Rule 21F-17(a) by impeding individuals from communicating directly with the Commission staff about possible securities law violations.”<sup>2</sup>

The Company agreed to settle the charges against it without admitting or denying the SEC’s findings. In addition to a \$340,000 penalty, the Company agreed to “make reasonable efforts” to contact its former employees who signed severance agreements from August of 2011 through October of 2015, provide them with a link to the SEC’s order and notify them that the Company “does not prohibit former employees from

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<sup>2</sup> Rule 21F-17 provides that “[n]o person may take any action to impede an individual from communicating directly with the Commission staff about a possible securities law violation, including enforcing, or threatening to enforce, a confidentiality agreement . . . with respect to such communications.”

seeking and obtaining a whistleblower award” from the SEC pursuant to Exchange Act Action 21F. The Company further agreed to certify and provide evidence of its compliance with this undertaking.

### **Significance of the Action**

Along with the actions the SEC brought against KBR last year and against BlueLinX earlier this month, the Health Net action reflects a trend of SEC enforcement against issuers for including provisions in their agreements with employees that, in the view of the SEC, have the effect of hindering employees from reporting potential securities law violations to the SEC.<sup>3</sup> These enforcement actions underscore that the SEC will scrutinize contractual provisions that impede, in any way, the ability of employees to communicate with the SEC – regardless of whether the issuer has ever enforced these provisions.

In light of these recent enforcement actions, issuers are reminded that they should review employment, separation, and other agreements containing confidentiality provisions and amend them, if necessary, to ensure that they do not violate Rule 21F-17. Of particular note, as observed in the SEC’s recent actions, these agreements should not:

- contain a blanket prohibition from disclosing confidential information;
- require employees to provide notice to or obtain consent from the company or its legal department prior to disclosing confidential information to the SEC; or
- remove financial incentives in the form of whistleblower awards for providing information about suspected securities law violations to the SEC. Notably, in the Health Net action, the SEC suggests that requiring an employee to waive, “to the maximum extent permitted by law,” any right to monetary recovery based on communication with a government agency is equally objectionable.

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<sup>3</sup> For more information regarding the enforcement action against KBR, see Simpson Thacher & Bartlett LLP, [“The SEC Brings Its First Enforcement Action Involving Confidentiality Provisions That Have the Potential to Silence Employees From Reporting Suspected Misconduct to the SEC”](#) (Apr. 3, 2015).

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at +1-212-455-3815 or [yafit.cohn@stblaw.com](mailto:yafit.cohn@stblaw.com), **Andrew M. Kofsky** at +1-212-455-7437 or [andrew.kofsky@stblaw.com](mailto:andrew.kofsky@stblaw.com), **Daniel J. Venditti** at +1-212-455-7387 or [daniel.venditti@stblaw.com](mailto:daniel.venditti@stblaw.com), or any other member of the Firm's Public Company Advisory Practice or Labor and Employment Practice.

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