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Supreme Court Rules that Dodd-Frank Does Not Apply to Whistleblowers Who Fail to Report to the Securities and Exchange Commission

On February 21, 2018, the United States Supreme Court issued a unanimous decision in *Digital Realty Trust, Inc. v. Somers*, No. 16-1276 (U.S. Feb. 21, 2018) holding that the anti-retaliation provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") do not protect individuals who report suspected securities law violations to company management, but not to the Securities and Exchange Commission ("SEC").

The Court's decision hinged on the definition of "whistleblower" set forth in Dodd-Frank. In particular, the Court held that, because the applicable statutory provision defines "whistleblower" as an individual who provides information "to the Commission," the statute is clear and conclusive. Thus, although the Court invalidated an SEC regulation that had extended Dodd-Frank's anti-retaliation protections to individuals who only reported potential securities laws violations to company management, and not to the SEC, the Court did not revisit the so-called Chevron doctrine, which demands judicial deference to the judgment of federal agencies charged with administering a particular statute.

Implications of the decision: *Somers* is significant because, among other reasons, Dodd-Frank has a generous framework for rewarding whistleblowers. Under Dodd-Frank, individuals whose reports result in successful SEC enforcement actions are entitled to up to 30% of the total monetary sanction, plus double back pay, with interest. A "whistleblower" under Dodd-Frank also has up to six years to sue an employer in federal court.

By comparison, "whistleblowers" under the Sarbanes-Oxley Act of 2002 ("SOX") can only recover back pay. And although SOX includes individuals who report suspected legal violations internally within its definition of "whistleblower," it requires plaintiffs alleging retaliation to file an administrative complaint within 180 days of termination – and to exhaust administrative remedies – before bringing suit in federal court. Like SOX, however, Dodd-Frank authorizes reinstatement and compensation for litigation costs, expert witness fees, and reasonable attorneys' fees.

That being said, *Somers* may turn out to be a pyrrhic victory for corporate in-house departments. If the only way to secure protected "whistleblower" status under Dodd-Frank is to report directly to the SEC, a company can expect more surprise inquiries from the SEC, and fewer opportunities to learn of a potential problem – and to resolve it – internally. Thus, from the perspective of risk and reputational management, *Somers* may prove to carry a significant downside.

Additionally, as the Court observed in *Somers*, the SEC is required to protect the identity of whistleblowers. This means that employers will often be unaware that an employee has made an SEC report. As a practical matter, when evaluating an internal report of suspected wrongdoing, companies should not assume that the reporting employee is

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not, in fact, a "whistleblower" under Dodd-Frank. Notably, once an individual qualifies as a "whistleblower" under Dodd-Frank by reporting suspected wrongdoing to the SEC, Dodd-Frank prohibits retaliation against him or her in connection with disclosures to persons or entities – including, but not limited to, the SEC itself. That is, the scope of Dodd-Frank's protective anti-retaliation provisions extends beyond actions that qualify someone as a whistleblower.

Indeed, *Somers* could incentivize employees to report suspected securities law violations to the SEC as quickly as possible, to avail themselves of Dodd-Frank's generous "whistleblower" anti-retaliation protections and other benefits. Also, Dodd-Frank rewards employees whose reports lead to successful SEC enforcement actions by the promise of cashing a percentage of the resulting monetary sanction; therefore, certain employees may prefer to skip an internal report altogether, and to report directly, and only, to the SEC. In this regard, however, it is worth noting that certain classes of employees, such as attorneys and accountants, are required by SOX to report suspected wrongdoing "up the ladder", starting with their immediate supervisors, and progressively up the chain of command, rather than directly to the SEC.

Finally, as the *Somers* litigation exemplifies, a suit by a former employee is seldom predicated on a single theory of liability. When Paul Somers sued Digital Realty Trust, Inc. in 2014, he sought damages for alleged retaliation and wrongful termination not only under Dodd-Frank, but also under Title VII, the California Labor Code, and California common law. Indeed, Somers' other causes of action continued to be litigated in the trial court at the same time as Digital Realty litigated its appeal from the trial court's Order denying its motion to dismiss Somers' claim under Dodd-Frank, which led to the recent Supreme Court's decision. In fact, while Digital Realty's appeal has now concluded, the trial court litigation based on Somers' other causes of action continues to this day.

Practical tips for corporate counsel:
The best way for a company to quickly and effectively resolve regulatory inquiries – or avoid them altogether – is to have real-time notice of possible wrongdoing. The legal and compliance departments of all SEC-reporting companies – especially of the larger, more departmentalized, and smaller but more budget-constrained companies – should implement internal procedures and audits designed to rapidly flag potential violations, rather than merely complying with the minimum compliance requirements mandated by laws like SOX. In this regard, retaining outside counsel experienced in conducting internal investigations and audits should be considered a necessary and cost-saving business measure.

Additionally, companies should look for ways to foster a culture of transparency and to encourage internal reporting. Management should consider implementing a system of internal rewards and bonuses for employees who flag potential problems that management resolves before the SEC commences an investigation. At the very least, companies should welcome feedback from its employees, including negative feedback, and should respond constructively rather than punitively.

Finally, companies should regularly consider negotiated, rather than one-sided, terminations. Regardless of the precise meaning of "whistleblower" under Dodd-Frank or SOX, most states read a common law exception into an employer's otherwise unfettered right to terminate employees at will on the basis of the state's public policy, which is commonly drawn from statutes designed to protect the public. Thus, although the Supreme Court opted for textual analysis of the applicable Dodd-Frank provisions, statutory intent may still play a role in how courts analyze employer liability, albeit indirectly. Finally, when entering into separation agreements with employees, any release and non-disclosure clauses should be analyzed by counsel with expertise both in employment and securities/financial industry laws. ■

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Federal Circuit to Analyze Whether Converse's Garment Design Is Entitled to Trade Dress Protection

In February 2018, the Federal Circuit heard a trademark infringement claim over an iconic sneaker, Converse's Chuck Taylor All Stars. The famous canvas sneaker has been manufactured and sold by Converse for close to 100 years, and since 1949, the basic design of the sneaker has remained the same. In fact, 60% of all Americans own or have owned at least one pair of these sneakers in their lifetime (www.chucksconnection.com/history1.html).

Trade dress – which is similar to a trademark – consists of all the various elements that are used to promote or identify a product or service. For a product, trade dress may be the packaging, the displays, and even the aesthetic design of the product itself (i.e., a product's total image or overall appearance), and may also include features such as size, shape, color or color combinations, texture, and graphics. For a service, trade dress may be the decor or environment in which the service is provided – e.g., the distinctive decor of McDonald's® or Starbucks®. As with other types of trademarks, trade dress can be registered with the U.S. Patent and Trademark Office (USPTO), and receive protection from the federal courts. Trade dress is entitled to protection if it is distinctive, either inherently or through acquired distinctiveness (i.e., secondary meaning, which arises when consumers have come to identify a trademark with a certain product over time).

Converse filed a complaint in the U.S. International Trade Commission ("ITC"), in an attempt to block rival shoe companies from making sneakers that allegedly look like the iconic Chuck Taylor. (*Converse Inc v. ITC*, case number 16-2497.) Converse claims that Wal-Mart Stores Inc., Skechers USA Inc., New Balance and dozens of others have been copying the Chuck's key elements — namely, a rubber "bumper" running around the front, a toe cap, and stripes around the sides of the sole. Converse believes those elements combine to form a trade dress that is protected by trademark law.

In June 2016, the ITC rejected Converse's claims and dismissed the complaint. Notwithstanding the fame and longevity of Converse's sneaker design, the ITC held the shoe lacked the kind of "secondary meaning" necessary, pointing to numerous look-alike shoes sold over the years without opposition, and thus Converse owned no protectable rights to be infringed. The ITC ruled that the company's supposedly unique "midsole" design for the Chuck Taylor had in fact been widely used by other shoemakers for more than eight decades: "We find that substantial record evidence of use of the [design] by multiple third parties from the 1920s to the present provides strong circumstantial proof that at least a significant percentage of the average consumers of [Chuck Taylors] associated the [design] with multiple sources other than (or in addition to) Converse."

Converse appealed the ITC's decision to the Federal Circuit, claiming that the ITC's focus on similar shoes was misplaced. Walmart, Skechers and New Balance countered by claiming that Converse's use was never substantially exclusive, and that Converse has always competed with shoes from other sources bearing the design that Converse now attempts to claim exclusively its own.

This case highlights an important issue in intellectual property law, especially as it relates to the fashion and apparel industry: protection for garment designs in the United States, which has been a hot-button issue for many years. Fashion designers and manufacturers have been seeking some level of IP protection for their designs for decades, but neither copyright nor patent law has been useful in protecting IP in the fashion industry, leaving companies like Converse to attempt to apply trademark law when they believe they are being imitated.

It further highlights another very important aspect of trademark law: widespread use of a trademark or trade dress by third parties can severely weaken, or even invalidate, rights in a trademark. This is why trademark owners must be vigilant and take the necessary precautions to enforce and protect their trademark rights against others at all times. Failure to do so can result in a loss of those rights, much like Converse appears to have lost those rights – for now.■

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New Jersey's Appellate Division Finds That Lienholder Not Entitled to Disbursement of Surplus Funds

On February 15, 2018, in *MD Sass Municipal Finance Partners, C., LLC v. Cesar Melendez*, the New Jersey Appellate Division affirmed the Mercer County Chancery Division's holding that a lienholder who did not pursue its own foreclosure, but instead took assignment of a tax sale certificate, was not entitled to surplus funds from the foreclosure of the tax sale certificate.

On February 27, 2004, Arnold N. Kimmel ("Kimmel") sold commercial property in Trenton, New Jersey to defendant Carmen Natal-Melendez ("Natal-Meledez"). The sale was subject to a purchase money mortgage held by Kimmel. However, Natal-Meledez defaulted on the loan and in March 2009 Kimmel instituted a foreclosure action. But Kimmel did not pursue the foreclosure or obtain a final judgment.

In October 2010, MD Sass Municipal Finance Partners, V., LLC ("MD Sass") filed a complaint for foreclosure of a tax sale certificate on the same property. Final Judgment was entered in favor of MD Sass, setting the total amount to be satisfied at sheriff's sale of $28,449.63. Kimmel and MD Sass then entered into an agreement whereby Kimmel received an assignment of the tax sale certificate in return for paying the redemption amount, plus an additional premium, to MD Sass.

Kimmel then purchased the property at the sheriff's sale for $105,000.00, leaving a surplus of $72,473.46. Kimmel subsequently sold the property for $195,000.00, realizing $118,018.74, which was still not enough to satisfy the Natal-Melendez mortgage. He then applied to the Chancery Division for disbursement of the surplus funds pursuant to *R*. 4:64-3 and *R*. 1:34-6(15). The Chancery Division judge denied the motion on the basis that Kimmel was not entitled to the surplus funds because he "voluntarily chose to forego his own foreclosure action rather than redeem [MD Sass's] tax sale certificate and proceed to judgment." Finding that the tax sale foreclosure extinguished Kimmel's lien on the property, the trial court concluded that Kimmel "is neither a judgment creditor [nor] a lienholder with regard to the property."

The Appellate Division agreed and held, "[i]t is generally acknowledged that surplus funds take on the character of the land, at least with respect to junior encumbrancers whose liens existed at the time of the foreclosure." Kimmel, having obtained the tax lien, foreclosed it, sold the property and abandoned his own mortgage foreclosure, was not entitled to the surplus funds because he was neither a judgment creditor nor a lienholder. Accordingly, the Appellate Division reasoned that "[Kimmel's] failure to pursue the foreclosure on the note to Natal-Melendez precluded any opportunity to obtain a judgment and a lien on the property, and thus a right to the surplus funds." The Appellate Division panel concluded that Kimmel's sole remedy was to pursue Natal-Melendez for a money judgment under the Note.■

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The Duties of Lenders in New Hampshire During a Foreclosure Sale

As a general rule, the relationship between a lender and borrower in New Hampshire is not a fiduciary one, but rather contractual in nature. There is, however, one exception to this rule and that is one of the foreclosure mortgagee. *See First NH Mortgage Corp. v. Greene*, 139 N.H. 321, 323 (1995), *Wheeler v. Slocinski*, 82 N.H. 211, 212 (1926). In this situation, the New Hampshire Supreme Court has held that mortgagees executing a power of sale to a duty that is "essentially that of a fiduciary" under the "often-repeated rule that a mortgagee executing a power of sale is bound by both the statutory procedural requirements and by a duty to protect the interests of the mortgagor through the exercise of good faith and due diligence." *Murphy v. Financial Development Corp.*, 126 N.H. 536, 540-541 (1985).

The policy behind imposing such a fiduciary duty on a foreclosing mortgagee is to curb the possibility that a mortgagee-bank might act in its own self-interest at the expense of the mortgagor borrower: a policy echoed by the New Hampshire Supreme Court in *Murphy*, 126 N.H. at 540-541. The mortgagor has the right to have the proceeds of the sale first credited against the mortgagor's debt.

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Carrols Equities Corp. v. Della Jacova, 126 N.H. 116, 119 (1985). The mortgagor then has the right to receive "all the proceeds of the sale above the amount necessary" to repay the debt in full. *Wheeler*, 82 N.H. at 212. As a result, the mortgagor has an interest in maximizing the price at which the property is sold.

On the other hand, the foreclosing mortgagee, however, has no reason to promote that interest; it "has the right to sell the property for the payment of the mortgage debt," *Id.*, but it has no incentive to obtain a higher price. The mortgagor's interest is also not protected by the purchaser at a foreclosure sale, who seeks to purchase the property as cheaply as possible, and who has the right to do so. *Id.* at 214.

Accordingly, the interests of the mortgagor and the purchaser are directly adverse to one another, especially when the mortgagee is the potential purchaser. *See Murphy*, 126 N.H. at 541 (recognizing the "conflicting interests involved" when a foreclosing mortgagee occupies "dual role[s] as seller and potential buyer at the foreclosure sale"); *Wheeler*, 82 N.H. at 214 (noting that "[t]he situation created by the statute authorizing the mortgagee to buy…permit[s] the exercise of personal interest conflicting with fiduciary duty"). Moreover, the mortgagee's ability to control the sale heightens the risks to the mortgagor's interest. Accordingly, foreclosure under power of sale presents the mortgagee with an opportunity to profit at the mortgagor's expense by buying-in at less than fair value (perhaps even by manipulating the circumstances of the foreclosure sale itself) and then reselling the property at a higher price.

So what is the take away? All foreclosures in New Hampshire must be done in a commercially reasonable manner taking into account both the interests of lender and borrower. ■

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