Setting the Right Incentives
for Whistleblowers

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Authorship Declaration

"I hereby declare and confirm that this thesis is entirely the result of my own work except where otherwise indicated. I hereby acknowledge the supervision and guidance I have received from Dr. Martin Gelter. This thesis is not used as part of any other examination and has not yet been published."

10th of August, 2009

Maarten J.L. De Schepper
Introduction

Why are there so few corporate whistleblowers\(^1\)? Fraud, corruption and illegal practices\(^2\) within big corporations, banks, financial service providers, etc... have to a large extent contributed to the current crisis. Dozens, maybe even hundreds, of employees within these companies were aware of this misconduct or even actively participated.\(^3\) They had vital information and nonetheless decided not to divulge this to the authorities, that could have taken action and prevent further escalation, because of fear of the consequences.

This is not surprising as these consequences are often very substantial and can be seen as an immense loss in personal utility, ranging, for instance, from losing your income, your future career, your network of colleagues to personal attacks on your character, threats and potential incrimination. These are huge private disincentives for blowing the whistle.\(^4\)

This silence is a big cost for society however. When fraud, corruption and other illegal practices keep going on within companies, without this information getting out, there is

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\(^2\) For instance subprime mortgages fraud and falsified certifications.


\(^4\) “The alarms of whistleblowers would be unnecessary were it not for the many threats to the public interest shielded by practices of secrecy in such domains as law, medicine, commerce, industry, science and government. Given these practices, whistleblowers perform an indispensable public service; but they do so at great human cost” in Sissela Bok, *Secrets: on the Ethics of Concealment and Revelations*, New York, Pantheon books, 1982, p. 228.
a big utility loss for the ‘public’. Markets will fail, companies will unexpectedly
collapse, trust in the market will be severely reduced, etc.... In an economic view,
getting the whistleblower’s non-public negative information out means less information
asymmetry, less obstacles to bargaining, in the market. Which means it functions better,
reaching a more efficient allocation to the most productive activities.\(^5\)

Therefore society benefits when this negative information on corporate misconduct is
divulged. To get this information out, employee whistleblowing is one of the most
efficient channels, as employees are usually the lowest cost gatherers of this
information. As Hayek already established in 1945\(^6\), the cost of gathering the often very
diffuse relevant information is usually much cheaper for certain actors, like employees,
who gather this relevant information as a by-product of their normal work, than for the
relevant authorities. As, within corporations, these employees are the lowest cost
gatherers of information, the government cannot reach the same efficient results as by
collecting the information \textit{straight} from this source.\(^7\) To actually get this information
however the government should incentivize potential whistleblowers to divulge it. The
government is thus faced with a typical societal gain versus private loss problem,
turning around this private loss is the key to benefiting society.

Important hereby is that getting this information out can only be successfully done by
external whistleblowing. Giving information within the company about misconduct by
lower levels should be normal practice, as higher levels have an interest in this
information. While putting in specific structures and “internal commissions” for such

\(^7\) Jennifer Arlen, “The Potentially Perverse Effects of Corporate Criminal Liability”, \textit{The Journal of Legal Studies},
Vol. 2, No. 2, p. 835, (June, 1994); Robert Howse and Ronald J. Daniels, “Rewarding Whistleblowers: The Costs and
Benefits of an Incentive-Based Compliance Strategy”, \textit{Corporate Decision-Making in Canada} in Ed. Ronald J.
information streams is definitely sound company policy, it does not serve the same purpose as blowing the whistle externally.

Blowing the whistle externally is exposing corporate fraud to the relevant authorities, to the benefit of the public at large, divulging negative information that the public wouldn’t receive otherwise. Blowing the whistle internally on the other hand can exactly have to opposite effect and “work against the public interest in that they facilitate cover-ups and deprive the public of information about wrongdoing.” Therefore I will focus on external whistleblowing.

Another benefit to incentivizing employee whistleblowers worth mentioning, is that there is a higher deterrence effect to actually commit fraud, as potential frauds feel constantly monitored by their own employees. A possible benefit to a corporations’ shareholders is that whistleblowing leads to “better monitoring and control of managerial misconduct (agency cost) in large publicly-held corporations.”

The current regulation that should incentivize corporate whistleblowers is inadequate as relatively few blow the whistle. The focus in this regulation is too much on the protection against immediate retaliation by the employer. This current protection approach however is based on a very inaccurate view of the real cost and benefits to

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12 Cf. not. 5.
blowing the whistle. And I will show in this paper that hardly any rational employee\textsuperscript{13} will blow the whistle under the current “protection”. Therefore we have to set new incentives, the” right” incentives for whistleblowers. My thesis is that to induce potential employee whistleblowers to blow the whistle on corporate fraud we have to reincentivize them by enacting regulation focused on guaranteeing full compensation. Full compensation means that all the costs, economic and non-economic, they might incur due to their whistleblowing will be compensated.

To explicitly state what we have mentioned before the focus of this paper will be on corporate whistleblowers and more specifically on employee whistleblowers, as they are most often the lowest cost gatherers of information. Also important is to distinguish between whistleblowers and institutional ‘gatekeepers’, like lawyers and auditors.\textsuperscript{14}

**In the first chapter** I will go into a legal analysis of the existing regulation on whistleblowing, to provide the background for examining its flaws. I will focus mainly on the two leading national regulations, namely the Sarbanes-Oxley Act and the Public Interest Disclosure Act, although the diffuse continental approach will be shortly treated. These regulations will be confronted **in a second chapter** with the actual cost-benefit analysis a potential whistleblower will consciously or subconsciously go through. Thereby I will first discuss the costs, then the benefits and finally conclude how the current regulation fails to correctly assess these. **In the third and final chapter** I will propose my regulatory advice to reincentivize potential whistleblowers by compensating all their actual costs. Thereby I will first treat possible alternatives, such

\textsuperscript{13} Most cases are people who are motivated by revenge, or outside of the reach of their employer already fired, already burned in the business, nothing to lose type of whistleblowers.

as avoiding costs, mandatory whistleblowing, allowing insider trading on negative information and the bounty hunting approach, then I will propose my full compensation approach as a solution to reincentivizing potential employee whistleblower and finally I will formulate my regulatory advice. This will be followed by a short general conclusion.
1. A legal analysis of the existing regulation

The first step in this paper is analyzing, summarily, the currently enacted regulations to see where they fall short. Since very few employees blow the whistle on corporate fraud, the incentives currently on offer are in all probability faulty. Therefore the focus in this chapter will be on the incentives and counter-incentives these existing regulations foresee for blowing the whistle, as to compare them in the second chapter of this paper with the actual incentives the potential whistleblower is faced with.

First I will treat the Sarbanes-Oxley Act of the United States, the most prominent whistleblower regulation, which has a specific focus on corporate fraud. Then I will discuss the United Kingdom’s Public Interest Disclosure Act, which provides for whistleblowing in a much wider setting. Thirdly I will turn to the more diffuse continental civil law approach to whistleblower protection.

15 For now I will exclude the United States’ False Claims Act, as it has a very specific scope. It will however will be discussed in the third chapter.
1.1 The Sarbanes-Oxley Act

The most prominent piece of regulation on corporate whistleblowing is to be found in the United States’ Sarbanes-Oxley Act (SOX) 2002.\(^\text{16}\)

After the accounting scandals brought to light by the Enron, WorldCom, Tyco, Adelphia and several others in the early 2000’s, the United states Congress came to realize that current legislation, depending mostly on private litigation, such as class action lawsuits, did not effectively get the necessary information on corporate fraud out.

Therefore Congress adopted and passed the SOX in an attempt to fix this and several other corporate governance problems posed by the preceding scandals. This lead to a very *ad hoc* piece of legislation, made up of myriad provisions from previous proposals.

For the purpose of this analysis the focus will be on the key whistleblower section, section 806. This section attempts a coherent regulation of corporate whistleblowing, set on getting the information on corporate fraud, often readily available to employees, out to the public and to provide protection for the whistleblowers.

Section 806 provides for protection for the employee against retaliation by his employer, if the employer nonetheless retaliates compensation is PROVIDED FOR in division (C)(2).

What we see in this provision is that the regulators foresee that whistleblowers run a

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high risk of getting fired. This is of course the most direct threat an employer has. Nobody wants to keep a whistleblowing employee in “his team” as, for instance, he might uncover even more. This is the main retaliation the SOX focuses on. Congress tried to counteract this by assuring the whistleblower will get his former job back with the same seniority status and reimbursement for the immediate costs of being fired. These immediate costs being loss of wage and the interest on those. A third part of the relief is for other damages connected to the procedure of whistleblowing and an anti-discrimination law-suit.

The SOX also provides for relief of civil and criminal liability. Civil liability might be incurred, for instance, when there are gagging clauses in the employment contract. Criminal liability might be the consequence of initial complicity of the employee in the fraud. It also provides for the possibility to make a confidential complaint, protecting the identity of the whistleblower.

The main disincentive the SOX foresees is the fear of immediate retaliation, to counteract this the main incentive offered is a reinstatement in his previous employment. The effectiveness of these provisions however in convincing employees to blow the whistle is put in serious question by the drop\(^\text{17}\) in whistleblowers after the SOX enactment. While this may be due to other circumstances,\(^\text{18}\) no big leap forward seems to have taken place. Recent cases, as for instance the collapse of Madoff’s Ponzi scheme, have shown that still many employees in the know, are not convinced to blow the whistle after the SOX.


\(^{18}\) Some say this is because less fraud is taking place, however, others state that corporate fraud has risen since the enactment of the SOX in 2002, see Anita Hawser, “Corporate Fraud on the Rise Despite SOX”, Global Finance, Jul/Aug 2007 issue, available at http://findarticles.com/p/articles/mi_qa3715/is_200707/ai_n19510836/, last visited on August 2, 2009.
1.2 The Public Interest Disclosure Act

The second most important piece of legislation regulating whistleblowing is the United Kingdom’s Public Interest Disclosure Act (PIDA) of 1998\textsuperscript{19}, which amends the Employment Rights Act (ERA) of 1996.\textsuperscript{20}

The origin of the PIDA is quite different from the SOX. Preventable disasters\textsuperscript{21} set the process to creating this act in motion. The view being that these disasters could have been prevented if whistleblowing had occurred.

This has provided for a much larger protection where employee whistleblowing of corporate fraud was only a minor part under a much larger umbrella. Because of the focus on “heroics”, like preventing malpractice that endangers human lives on a large scale, the protection for whistleblowers in the PIDA is, potentially, much larger than in the SOX. It states in amended Section 47 B 1) of the ERA “A worker has the right not to be subjected to any detriment by any act, or any deliberate failure to act, by his employer done on the ground that the worker has made a protected disclosure.”\textsuperscript{22}

If the whistleblower is subjected to a detriment the PIDA provides for compensation. Even compensation for moral damages is implied. The possibilities of this clause seem to be open ended and the problem of incentivizing the whistleblower solved. On top of that the PIDA provides relief for criminal and civil liability. However no real possibility for confidentiality is present.

\textsuperscript{22} For this paper’s analysis, making a protected disclosure would mean blowing the whistle on corporate fraud.
If the potential whistleblower does not expect to be subjected to any (uncompensated) detriment for blowing the whistle, any benefit, be it as simple as a clear conscious should be enough to make him blow the whistle.

However this clause has been open ended given its high soaring goal of preventing disaster. Therefore much is left to the interpretation of the courts. Its real implementation in the past 10 years provides a very different view on the incentives offered to potential whistleblowers, leading Lewis to conclude: “PIDA 1998 has not adequately protected whistleblowers”

As mentioned the main remedy provided for detriments that have been incurred by the whistleblower is compensation. However to get this compensation the whistleblower has to prove the detriment was due to “retaliatory intent”.

The burden of proof for this intent is put very high. For example in London Borough of Harrow v. Knight, a burden of proof is put on the whistleblower to show that the disclosure has caused the employer to cause him detriment. A “but for” test was not accepted as sufficient. So even if the detriment would not have happened “but for” the disclosure, this is not regarded as sufficient causation.

The very strict interpretation of the link of causation goes even further in the case Bolton School v. Evans: “it seems to us that the law protects the disclosure of wrongdoing, or anticipated wrongdoing, which is covered by Section 43B. It does not

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25 That is the section describing which disclosures qualify for protection.
protect the actions of the employee which are directed to establishing or confirming the reasonableness of that.‘

Therefore only the retaliation directly linked to the disclosure itself will be protected. This means that while looking for more proof that fraud is going on, the unauthorized checking of e.g. the books of the corporation, would on itself be a reason for firing not caused by the actual disclosure. As breaching a certain duty or authorization while checking whether there is actual fraud taking place is very likely, one can easily see how an employer can find another ground for firing the whistleblower. Combined with the high burden of proof for retaliatory intent it renders the protection offered in Section 47 B almost useless.

So while the compensation offered for any detriment seems to take away all possible disincentives, and induces blowing the whistle, the very restrictive interpretation almost completely counteracts this. The result being that in most cases only immediate retaliation costs, associated with being fired, wage-cuts or being demoted, have any chance of passing the causation threshold. This being the main cost, disincentive, perceived to be immediately linked to the act of whistleblowing.

While this paper focuses on the PIDA itself, the impact of the process of creating the PIDA and the actual act itself has a far wider reach than just the United Kingdom. Other commonwealth countries have been inspired by the PIDA while creating their own

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27 In casu firing on basis of strong suspicion that he had unauthorized access to the schools computer network, while preparing his whistleblowers case, was seen as not sufficiently linked to the actual disclosure.
whistleblowing regulation. For instance several states in Australia\textsuperscript{29} have done so, and it has also found application in Canadian state laws\textsuperscript{30}. Furthermore the PIDA has been the main inspiration for both the New Zealand\textsuperscript{31} (2000) and the South African\textsuperscript{32} (2000) Protected Disclosure Acts. Therefore we should not underestimate the importance of the creation of this legislation and its application in the United kingdom.

1.3 Protecting employee whistleblowers through labour law and human rights

The legislation treated so far is rooted in the common law legal system, the continental civil law tradition has taken quite a different “route” to whistleblower protection. As labour law and the protection against discrimination offered to employees is far more elaborate than in for instance the US and the UK the necessity of specific whistleblower regulation is less pronounced. Direct retaliation, like firing an employee, is much more unlikely to take place.

Therefore these legal systems rely mostly on a combination of labour law and human rights to protect corporate whistleblowers. Blowing the whistle is a “right” of the

\textsuperscript{29} The key elements are the same as the PIDA: protection from detriment and compensation if detriment is nonetheless incurred and relief of criminal and civil liability. However the problems are parallel too; the narrow focus is on immediate detriment linked to being fired, wages cut or demotion, see Lindy Annakin, A. J. Brown, et al., “Whistleblowing in the Australian Public Sector: Enhancing the theory and practice of internal witness management in public sector organisation”, Chapter 11, available at http://epress.anu.edu.au/anzsog/whistleblowing/mobile_devices/ch11s03.html, last visited July 24, 2009.

\textsuperscript{30} As in the State of Manitoba. This act is specifically interesting because it says explicitly that reinstatement is the main option and that only if this fails compensation is to be given “to the complainant in an amount not greater than the remuneration that the board considery would, but for the reprisal, have been paid to the complainant” in 28(3) (Manitoba’s) Public Interest Disclosure (Whistleblower Protection) Act, S.M. 2006, c. 35, Bill 34, 5th session, 38th Legislature, enacted December 7, 2006. Further mentioning direct financial loss as a result of the whistleblowing procedure. Showing again the focus on direct retaliation and the immediate financial losses coming from it.

\textsuperscript{31} (New Zealand’s) Protected Disclosures Act 2000, Public Act 2000 No. 7, Date of assent 3 April 2000.

employee, therefore he enjoys protection of that right. He cannot be discriminated against for exercising this right on the work floor under labour law and in general due to human rights such as freedom of speech.

In countries like Belgium, Germany and France this “network” of labour laws and human rights is used to protect whistleblowers. The main protection offered is the protection against being fired and protection against discrimination. However the outcome of this is very unpredictable as no coherent system is put forward. Steps are taken to develop specific legislation e.g. for government employees, specific types of fraud or to incorporate a real “right of whistleblowing”. The focus of all these specific regulations however is still heavily on internal procedures.

Civil liability is sometimes covered by seeing whistleblowing as a right of the employee, no contract clause can gag this “right”. Criminal liability is an even more difficult issue, whistleblowers should count on attenuating circumstances as witnesses in criminal law.

The biggest incentive in this diffuse protection approach is the protection of employment and anti-discrimination much in the same sense of other workplace

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33 E.g. the Belgian law of the 11th of June 2002, concerning protection against violence, harassment and sexual impropriety in the workplace and articles L. 1132-3-11324 French Code de Travail.
34 For instance Freedom of Speech.
35 Flemish federal state, government employees have the additional benefit of being under the protection of an Ombuds, who has to makes sure whistleblowing employees are not caused any detriment. However he has very limited powers to actually do so; Decree of the 7th of May 2004 (B.S. 11th of June 2004).
36 France’s Law against corruption of 13 November 2007, (Loi no. 2007-1598) only applicable to fraud by civil servants. There is however a proposal to do the same for financial markets, see proposition du rapport Anton Mattei-Vivien; Council of Europe, Civil Law Convention on Corruption, ETS 174, 4.XI.1999.
37 A proposal to change the law in Germany (Entwurf zu § 612a BGB) includes employee whistleblowing as a specific right. Proposal available at: http://www.bundestag.de/ausschuesse/a10/anhoerungen/a10_81/16_10_849.pdf, last visited July 20, 2009.
38 Entwurf zu § 612a BGB (cf. supra) still treating external whistleblowing as a real ‘last resort’ measure; Flemish Decree of 7th of May 2004 (cf. supra).
discrimination and harassment. The actual outcome is however even more unsure as no specific regulation exists in most cases, which seriously devaluates this incentive.

**Conclusions of the legal analysis**

Current regulation focuses on the immediate retaliation by the employer as the main disincentive. Getting fired, reduction of wage or instant demotion are seen as the main costs, next to possible criminal or civil liability.

Therefore incentives, benefits, offered by the whistleblower protection focus on prohibiting this immediate retaliation and only if this fails the reinstatement or the compensation of the immediate loss of wage. Relief for criminal and civil liability is also provided for in most cases.

We shall see in the next part covering the actual cost benefit analysis of a potential employee whistleblower goes through that this protection approach is hardly sufficient to incentivize blowing the whistle.
2. Costs and benefits of blowing the whistle

As mentioned in the previous part, my hypothesis about the flaws in the current whistleblowing regulation is that it does not accurately reflect the real cost-benefit analysis that the potential employee-whistleblower goes through. If dozens, sometimes even hundreds of employees know that fraud is being committed and none of them come forward with this information, this has to be because in reality the costs for the whistleblower currently outweigh the benefits. To more clearly point out where the faults in the current approach lie and to provide a framework for devising recommendations in the third chapter of this paper, I will treat the factors of this cost-benefit analysis here.\(^{39}\)

The goal here is to show that the cost and benefits are much more varied than previously taken in account. Total private benefits should outweigh total private costs. If not the employee cannot reasonably be expected to blow the whistle.

\(^{39}\) I will not treat the Protection of Identity here as it is directed at avoiding incurring any costs on the balance and only has a limited applicability. It will however will be discussed in the third chapter.
In this chapter I will treat the possible costs associated with blowing the whistle in the first section, and the benefits that the employee whistleblower, in the current regulatory landscape, can possibly expect, in the second section. Finally I will point out in my conclusion where the current regulation falls short. This will be the groundwork to investigate in the final part of this paper what regulation could be enacted to tip the balance back in favor of blowing the whistle.

2.1 The costs

In this section I will treat the costs associated to blowing the whistle, splitting them up, for analysis purposes, in economic and non-economic costs.

2.1.1 The economic costs

The economic costs that will be described here are, in principle, objectively verifiable and consist of past, current and/or future monetary losses.

2.1.1.1 Immediate monetary costs

These are the costs that can very easily be monetarized and therefore can be easily calculated. It is not surprising that current regulation that includes compensation usually include one or more of these, as they are the easiest to provide relief for.
Loss of employment, reduction of wage

This one is foreseen by almost all existing regulations and even in the patched up legislation and juridical elaborations in countries were no such specific regulation is present. Clearly firing the employee is the most direct threat and most easily executed by the employer, next to discriminating the employee by reducing his wage. Justly so, providing a remedy against this cost is necessary. Loss of wage and employment and all the financial difficulties it entails are a clear disincentive to blowing the whistle. It is an immediate cost to the whistleblower.

Costs of making the complaint and possible ensuing juridical procedures.

Lawyer fees, expert fees and other procedural fees come at a great cost. These might be associated with the procedure of blowing the whistle and/or a later lawsuit against the (former) employer. If this is to be carried by the whistleblower this would also be a clear monetary cost to him. Again most whistleblower “protection” systems foresee this.

Loss of invested capital in the company

Although this is not always the case, the reality of the ENRON, WorldCom, Tyco etc... collapses have shown that the employees suffered very high losses on invested capital.

The growing\textsuperscript{40} prevalence of performance based compensation schemes paid in options and stock, combined with company related pension funds mean employees often have a very large part of their capital invested in the company.\textsuperscript{41} Blowing the whistle might make these ‘investments’ evaporate as the company takes a big hit on the stock market or even worse when it completely collapses.\textsuperscript{42} This loss of capital is also a clear

\textsuperscript{40} Now put into question because of its role in providing perverse incentives for fraud, exposed by those scandals.


\textsuperscript{42} Hamdani and Kraakman foresee this cost in the setting of monitoring by outside directors; “Rather, the problem is that by diligently performing their gatekeeping duties, directors must automatically—and permanently—destroy the
monetary cost to the whistleblower. It would be a very valuable tool for the (fraudulent) employer to tactically increase these as to bind\textsuperscript{43} the potential employee-whistleblower, reducing his incentives to blow the whistle. Therefore it should be taken into consideration by any legislation focusing on incentivizing potential whistleblowers, this is not the case so far.

2.1.1.2 The loss of human capital

One of the most important costs to the potential whistleblower and absent in all of the existing regulations is the loss of human capital. Whistleblower often experience a very strong negative reputational effect. Their careers are virtually over. Maybe an at first unexpected result, but nonetheless in practice a very real one, is that whistleblowers rarely get re-employed by the other companies in the industry.\textsuperscript{44} And even if he would stay in the same job or be reinstated in that job, chances are high that he will not get any further in his career.

The phenomenon that potential future employees will refuse a whistleblower is called blacklisting, the whistleblower is put on the “black list” of the “not to be employed”.\textsuperscript{45} Although he has done the right thing, he is considered to be a disloyal employee and a potential liability for future employers. Who would want to have the whistle blown on

\textsuperscript{43}Lisa K. Meulbroek, “Company Stock in Pension Plans, How Costly is it?”, \textit{op. cit.}.
\textsuperscript{44}“The lawyer of James Bingham, a whistleblower in the Xerox case, sums up Jim’s situation as: “Jim had a great career, but he’ll never get a job in Corporate America again.”” in I. J. Alexander Dyck, Adair Morse and Luigi Zingales, “Who Blows the Whistle on Corporate Fraud?” (October 1, 2008), \textit{op. cit.}, p. 24.
his own company? Partly this fear and partly the informal boycott by the “old boys” network of the industry make a further career in this field almost impossible.

Another factor contributing to this exclusion is the possible collapse of a fraudulent company will make any working experience there heavily suspect.

This means that his career is virtually dead. This is often event the most important cost to the corporate whistleblower as especially in the fields of finance and banking much weight is given to the future career prospects. Two labour economics techniques used in corporations contribute heavily to this: the first technique being “screening contracts” linked to very upward sloping wage profiles and the second technique being the use of “tournament style compensation”.

The first technique means that employees are screened in categories of initial low and initial high productivity employees by offering a very low wage (W1) in the beginning and only if they get promoted a much higher wage (W2) in a following period. This can be seen as a prolonged “probation” period and can be spread over many years. This screens beginning employees, as the ones that don’t expect to be good enough to get promoted will refuse to work foreseeing only low wage W1. High productivity level employees who do see a very high probability (Pr) that they will get promoted will want to work there as they consider their future much higher wage too. In a simple two period equation this would mean a high productivity worker will take his combined wage to be W= W1 + Pr(W2). This means that they will not be satisfied if someone offers him compensation for W1. Therefore compensation for the current lost wage is

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48a. No matter how virtuous the motives, whistleblowers often are committing career suicide.” In Phillip G. Clampitt, Communicating for managerial incentives, SAGE, 2004, p. 75.
not sufficient. An example would be junior employees working for a very low beginners wage as they expect promotion within a few years.

The other element is the use of tournament models\textsuperscript{50} where the motivation to exert effort is the possibility of a much higher wage in the future. This will motivate employees to exert a very high effort, much higher than their current wage justifies. The more unlikely, the more luck involved in getting promotion, the more the wages in the future have to be exorbitantly high to motivate the lower level employees, to keep aiming for them. This is said to be one of the reason for the extreme wages managers of big corporations receive, not so much to motivate them in their current job, but to motivate those below them in the hierarchy to exert much more effort than they actually get paid for. So employees in these big corporations will not take their current wage as enough compensation as they have been aiming and working to reach a much higher wage in the future. An example would be junior associates in an investment bank working themselves to death to climb up higher in the hierarchy in the hope to one day reach the highest cadre, with exorbitant wages, which can be a very unlikely prospect.

Both techniques have the same result however that current wage is hardly a good measure for most employees willingness to accept. They are willing to work for a lower current wage, being underpaid, in the hope of future payoffs of their career-investments. On top of that many employees will develop skills, often with great trouble, that are industry specific, that won’t be any use outside of his current career. This will pay-off only as long as they stay in the industry. \textit{“High levels of firm- or industry-specific human capital, particularly when the costs of such investment are borne principally by}

employees in return for future compensation, increase the vulnerability of employees to retaliation"51

This means that blacklisting has a huge impact on the investments an employee has made over the years in his career. Blacklisting often ends all further prospects of working in this field and moving up. All his specific invested education and work experience is liquidated, the years of underpaid work almost valueless. It’s not only his immediate wealth that is on the line here but his whole potential future earnings. This liquidation of invested human capital52 might even turn out to be the biggest costs to the potential corporate whistleblower.

2.1.2 The non-economic costs

These are the subjective non-monetary losses associated with blowing the whistle, hard to evaluate but nonetheless a real cost to the whistleblower.

Psychological pressure

"Usually the whistleblower is not fired outright. The organization’s goal is to disconnect the act of whistleblowing from the act of retaliation, which is why so much legislation to protect whistleblowers is practically irrelevant. The usual practices is to

52 Id., p. 536.
demoralize and humiliate the whistleblower, putting him or her under so much psychological stress that it becomes difficult to do a good job”.53

Retaliation by the employer and even fellow employees can be very indirect and subtle. For instance workplace harassment and threats devised to make a potential whistleblower, or one in the process of blowing the whistle, lose faith in his whistleblowing and the possibility of bringing it to a good end.54

This building up of psychological pressure might even be as subtle as silent social ostracism,55 excluding the employee in question from any social gatherings, e-mails, carpools and giving him ‘the silent treatment’. Other nuisances might be transferring him to other locations, giving him a closet for office56, increased scrutiny, investigation of his personal backgrounds to detract from his statements, etc…57

All these psychological harassments are very difficult to successfully prove and be protected against, as we can see in general harassment in the workplace lawsuits. The government cannot credibly protect the whistleblower from this psychological stress. On top of that whistleblowers are, quite often, at first branded as ‘crazy’ even by the authorities they report to.

This all together can have devastating effects of the whistleblower and those close to him58, and it is a serious cost to consider for any potential whistleblower.

Reinstating the whistleblower in his previous job could lead to a continuation of this subtle daily torture, this might even turn out to be a strong additional disincentive.

56 C. Fred Alford, Whistleblowers: broken lives and organizational power, op. cit., p. 32.
**Breaking loyalty and trust**

The people he denounces are not only his employer, who is “the hand that feeds him”, but also his colleagues and business relations, who have often become friends. It is therefore very difficult to come forward on an emotional level too, leading to added psychological stress. Perceived duty of loyalty to ones friends and “benefactors” is a very strong value, and breaking it is often seen as a social wrong.\(^{59}\) Considering that the “moral duty to divulge” is to the benefit of a very abstract “public”, the action of divulging is directly detrimental to people he knows and cares for. This on its own might be enough to offset that “ethical” duty. Therefore one should take this in account to correctly asses the non-economic costs the potential whistleblower faces.

2.1.3 Civil and criminal liability

Obviously if whistleblowers can still be sued according to ‘gagging clauses’ or other provisions in their employment contract this would amount to another cost. A breach of contract is very likely as many contracts include confidentiality clauses and “*all contracts of employment involve an implied "duty of fidelity" which requires honest, loyal and faithful service and forbids competition with the employer*”\(^{60}\)

Criminal liability for complicity is another possible cost. Often fraud is incrementally done step by step. However what starts out as a minor manipulation, might soon turn out to be large scale fraud. To avoid employees suddenly being caught in a web of fraud, so they still dare to come out and blow the whistle, they should be convinced by giving them relief of complicity. If not *the “leaders” of the crime within the* 

\(^{59}\) Pamela H. Bucy, “Private Justice”, *op. cit.*, p. 54.

Corporations have a strong incentive to induce other employees to engage in wrongdoing so as to immunize them against becoming whistleblowers. Otherwise who would blow the whistle on himself? “If this isn’t provided for in whistleblowing legislation, this would be another potential cost for the whistleblower.

2.2 The currently available benefits

In this section I will treat the benefits, currently associated to blowing the whistle, splitting them up, for analysis purposes, in those meant specifically to offset the economic costs and other benefits.

2.2.1 Benefits to offset the economic costs

Protection from being fired or demoted and reinstatement

This by far the least realistic benefit included in existing regulation. Although very prevalent, it is almost completely devoid of any realism. Regaining employment at your former seniority level or protection from dismissal are quite a poisoned benefit, as it puts you in an environment that is, in all probability, quite hostile to you. Psychological pressure would build up, chances of ever advancing in the firm are almost negligible, social ostracism hardly inconceivable.

Not only on the psychological and the career advancement level this is quite an unrealistic measure, but also considering the risk of collapse of the fraudulent company.

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It would mean rejoining or staying on in a company in serious trouble, maybe even on the verge of collapse or already in bankruptcy. The higher the importance of the fraud, the more important the information for the public, the higher the risk of collapse and complete uselessness of regaining or keeping your employment.

The employee will be put in a situation he doesn’t want and the employer is stuck with an employee he doesn’t want. This “benefit” is therefore quite counterproductive, nonetheless it is found in almost all regulations. As mentioned before the focus of current regulation on this unrealistic “protection of current employment” could be seen as an additional disincentive for the potential whistleblower.

**Compensation for loss of wage**

This is a necessary compensation as this counteracts one of the immediate wealth effects of immediate retaliation by dismissal or by reduction of wage.

But the loss of the regular wage is often only a very small part of the actual loss if there are significant performance based elements\(^{62}\) to the wage. And very inadequate if screening contracts and tournament models are applied\(^{63}\), making the current (low) wage a bad measure of the value lost by the employee.

**Costs of making the complaint and possible ensuing juridical procedures are compensated**

A clear benefit, offsetting the cost associated with pursuing the procedure of blowing the whistle. A necessary provision in any whistleblowing regulation, and provided for in both the PIDA and the SOX.

\(^{62}\) E.g. Bonuses, stock, stock options.  
\(^{63}\) Cf. *supra*
2.2.2 Other benefits

**Having fulfilled a moral duty**

This moral duty has played its part in the discussions leading up to the SOX and the PIDA and it was even proposed to make it into a legal duty. While the moral duty to blow the whistle might be more significantly felt in situations with a health or catastrophic disaster risk, posing a direct threat to co-workers, clients and bystanders,\textsuperscript{64} the public duty of responsibility is a lot less swaying in cases of corporate fraud. No clearly defined duty exists as such. On top of that, as mentioned before, this duty is to the abstract “public”, while divulging information on corporate fraud is hurting yourself and your immediate circle of friends, coworkers and business relations.

While there are people with very high ethical standards that would gladly risk it all for the public good, this should not be overestimated. “Lone rangers” are a rare breed. Only rarely will an ethical benefit like this convince the potential whistleblower when he is faced with the list of costs described above.

**Compensation for psychological stress**

Currently a very rare benefit. This is partly due to the difficulty in proving causality and partly due to the underestimation of these types of subjective costs in whistleblowing. They are hard to evaluate and therefore quite often ignored.\textsuperscript{65}

However this lack of compensation for, or even acknowledgement of, an often very real cost for the whistleblower is only adding to the disbalance in current regulations.

\textsuperscript{64} Robert Howse and Ronald J. Daniels, “Rewarding Whistleblowers: The Costs and Benefits of an Incentive-Based Compliance Strategy”, op. cit., p. 532.

**Revenge**

Controversial, but an important driving force behind some whistleblower cases is revenge.\(^{66}\) Revenge is apparently “very sweet” to some disgruntled (ex-)employees. This leads to a much higher willingness to bear costs just to get back at their employer or co-workers. Often cases driven by revenge are offered as exemplary whistleblowing cases\(^{67}\), leading to a very unbalanced estimation of what motivates the average employee whistleblower. Therefore while not being an incentive the government can influence, better left to the private motivation of the whistleblower, it remains nonetheless and important factor to analyze correctly the cost-benefits in a specific case.

### 2.2.3 Loss of civil and criminal liability

As we have seen in the cost section, often clauses in the contract and criminal liability prevent the whistleblower from blowing the whistle.

For civil liability this benefit is present in almost all systems. Explicitly the case in application of the SOX and PIDA and implicitly in the continental protection by considering whistleblowing a protected right of the employee.

Criminal complicity\(^{68}\) should be exonerated too. This is the case in the application of the PIDA and the SOX, but not explicitly in the continental systems. It should be generalized as not only does this offset this potential cost for the employee whistleblower, but the loss of criminal liability might be an additional incentive to come

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\(^{68}\) Although one can see that there should be limits to this. Once we are not talking about complicity anymore but about being a main perpetrator, we should switch to big reductions of liability, but not complete exoneration. As this could provide perverse shelter to high scale corporate fraud criminals.
forward. The additional incentive being that one can clean his own slate by blowing the whistle.69

2.2.4 A dilutor of these benefits: possible failure of procedure

In the calculation of the benefits of blowing the whistle the probability of success also plays an important role. If the chance is high that the complaint will be ignored or discarded, taking the risk of blowing the whistle is very unappealing as the costs could be incurred without any of the benefits. Therefore the authorities should do their utmost to make the whistleblower procedure as responsive and efficient as possible.70

Any government trying to reincentivize whistleblowers should take in account that this is a very important factor. A possible equation to represent this would be: Expected benefit $E(B) = Pr.(B)$ and the Excepted incentive $E(I) = (Probability\ of\ success) \ (Benefits) – Costs;$ $E(I) = Pr.(B) – C.$ If the whistleblowing procedure has a high probability of success close to 1, the full benefits will be taken in account. If on the other hand probability is low due to consistent failure of the authorities this will be closer to 0, seriously diluting the benefits. This means that reincentivizing whistleblowers by heightening only the benefits will still be unconvincing if the responsiveness of the authorities is low.

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69 This might be an even bigger incentive if the fear exist that the fraud will be uncovered and therefore all implicated feel that they are on the verge of potential prosecution. This could create a race to blow the whistle. Although this is not “ethically correct” it could contribute greatly to undermining collusive agreements and bringing the fraud out much faster.

70 Some authorities like the SEC have a very bad track record in evaluating whistleblower complaints. As recently has been put in the spotlight by the failure to listen to the Madoff whistleblower Harry Markopolos, but also in case like Dynegy, Equity Funding of America, etc…
Conclusions of the CBA for current regulation

It is clear from this rudimentary framework for the cost-benefit analysis a potential employee whistleblower goes through, that none of the current regulatory alternatives take these in account correctly.

Loss of employment is a cost that is foreseen in all existing whistleblowing regulations. The PIDA provides to most realistic solution, in explicitly mentioning compensation as a solution for job loss. However the focus is still on keeping the employee in his previous employment. The SOX and the continental systems focus completely on keeping the whistleblower in the same job, by offering him protection or by reinstating him, as we have seen before this is not a convincing solution. His previous job is usually no longer a viable employment for an employee that blew the whistle.

Immediate monetary costs like loss of wage and reduction of wage are provided for in the PIDA and in to a lesser degree in the SOX and are usually compensated in anti-discrimination lawsuits on the continent. As such this is not problematic. However as we have seen this wage is only part of pay the employee receives. Even more problematic is that no compensation for invested capital in the company is provided for under any of the regulations. With the increased importance of stock, stock options and bonuses in corporations this is a considerable flaw in current regulation.

However the most problematic fault in current regulation is that it completely ignores the loss of invested human capital. No regulation has taken in account this cost, which for an employee might be the most significant. Basically the employee has to start back from near zero, often in a completely unrelated field. Compensation for only his current wage will be a very unconvincing incentive put in this perspective.
Next to this non-economic costs are as a rule severely underestimated by current regulation. As one of the most common consequences of whistleblowing is psychological harassment, this contributes strongly to making the current approach undercompensatory.

The complete lack of any compensation for invested capital and invested human capital, together with the lack of attention paid to non-economic damages makes the current Cost-Benefit Analysis for a potential whistleblower severely unbalanced in favor of not blowing the whistle.

A main benefit in the current protection approach: protection of employment, reinstatement, is no serious incentive to tip this balance, not even with the compensation of lost wage. The consequence is that hardly any rational employee would blow the whistle on his fraudulent corporation.

“Given these costs, however, the surprising part is not that most employees do not talk: it is that some talk at all.”

The ones that do are very much the exception often fueled by revenge or an overdeveloped sense of public duty. In general most whistleblowers are either freed from most of the above mentioned costs\textsuperscript{72} or quite quirky individuals.\textsuperscript{73}

Therefore future regulation should more accurately reflect the real CBA the potential whistleblower goes through and try to tip the balance in favor of blowing the whistle. This will be treated in the next chapter of this paper.

\textsuperscript{72}Having already taken up another employment for instance, or having already squandered their chances of any future successful career in the industry through some other way.

3. The right incentives for whistleblowers

The right incentives should tip the balance back in favor of blowing the whistle. This requires a new reincentivizing regulation. In this chapter I will work up to my proposed solution for reincentivizing whistleblowers, based on the full compensation of all the economic and non-economic costs an employee whistleblower incurs, making the whistleblower “whole” again.

Changing the balance can be done in two ways. Although they can be complementary. You can avoid or reduce costs on the negative side of the balance on the one side and/or add or expand benefits on the positive side. The first ‘avoiding costs’ is the main goal of the current protection approach or anti-retaliation approach, while the second ‘adding benefits’ is part of a compensation approach.

While some provisions of the current protection approach bent on “avoiding costs”, still have an important role to play, the focus of new regulation should shift to a full compensation approach.

In a first section I will treat the ways to avoid costs on the negative side that should be applied by future regulation. These rules are in part already provided for in existing regulation and could be seen as the lowest cost approach to tipping the balance.

Complementary to these however there is a need for more benefits to tip the balance. This will be treated in the second section starting by treating why the perverse benefit offered by mandatory whistleblowing is not a solution. Then the reason for the need for more compensation on the benefit side will be represented graphically, as to illustrate why they are the key to reincentivizing whistleblowers. Following that I will treat two

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74 Or in the case of the PIDA, at least a completely new interpretation and application of the existing regulation.
proposed ways of offering this compensatory benefits, one being the lift of the
prohibition on insider trading on negative information and the other being the institution
of a “bounty” for the whistleblower. And explain why they fall short in incentivizing
potential whistleblowers. Concluding with my own approach to providing the necessary
compensatory benefits to reincentivize potential whistleblowers: the full compensation
approach. Focused on making the whistleblower “whole” again.

I will conclude this chapter in a third section by summarizing my findings in
recommendations for future regulation.

3.1 Avoiding costs

Avoiding incurring costs is often the easiest way to convince a whistleblower to come
forward. This goal of protecting the whistleblower from incurring any costs is the main
idea behind current regulation. However this protection from costs approach is limited
in its applicability as avoiding the costs often can’t be guaranteed. Nonetheless it
remains the focus of the SOX, PIDA and the diffuse continental system.

A typical failed attempt to protect the whistleblower from incurring costs is the
protection of his employment. Either due to anti-discrimination regulation or mandatory
reinstatement. The drawbacks of this rule have been mentioned above. There is simply
no way the government can protect the whistleblower from all the pressure, abuse and
loss of career opportunities he would suffer if he stays at his former employer. This is
where the protection approach is shown at its weakest. It is just unfeasible in most cases
to offer the protection from ‘any’ detriment or from ‘any’ discrimination. Therefore the
focus on unattainable goals like these should be removed, and be replaced by the more credible guarantee of compensation of the incurred costs.

This doesn’t mean that all of the protective provisions should be thrown overboard, in fact it is often the cheapest cost avoiding regulation. Protection however should remain within the situations the government can actually control, therefore it should be limited to protection of identity and protection from civil and criminal liability. Protection by the government from any detriment is just unrealistic and can only provide for unconvincing incentives. Except for the two rules that will be treated here I see no place in future regulation for the protection approach.

3.1.1 Protection of identity

Guaranteeing the confidentiality\(^75\) of a whistleblower complaint could be the cheapest cost avoiding rule. This is a typical transfer of information from the lowest cost gatherer to the government agency, significantly lowering their costs of discovery of the fraud. It also makes this information near costless to obtain, as confidentiality is to be attained with minimal extra costs to the government.

A confidential complaint by an employee to the public authorities, could severely heighten their chances of uncovering the fraud, without the employee incurring any of the costs.\(^76\) When, but only when, protection can actually prevent the employer from finding out, virtually none of the costs are incurred and the benefit of having fulfilled a moral duty might be enough incentive to blow the whistle.

\(^{75}\) This is something different than anonymous tips, and is often defined as confidentiality, as his identity will be known by the agency he blows the whistle to, but will be confidential, and should therefore remain unknown to his employer. Anonymous tips might lead to a stream of fake complaints and would be hard to distinguish between the credible and incredible.

\(^{76}\) It could encourage potential whistleblowers who are not certain they could prove the fraud to blow the whistle anyways as they do not incur the cost of unsuccessfully blowing the whistle.
However in most cases perfect confidentiality is unlikely. It may not prove so hard to find out which employees were able to blow the whistle, or the whistleblower might be put in terrible dilemma if his co-workers suffer under the employer’s suspicion.\textsuperscript{77} On top of that the active aid of the whistleblower is often necessary to actually get to the depth of the fraud as he is usually a first rank witness. If the whistleblowers job is threatened by the following risk of severe financial problems or collapse of the employer then protection might fall short in avoiding his costs to begin with.

So protection of identity should be an option available to the whistleblower. However it should not be a mandatory first step, as the potential whistleblower himself should have the possibility to assess whether government confidentiality is likely to be sufficient in his case. It should definitely not exclude the option for the whistleblower to have recourse to the benefits of the compensation regulation, when costs are incurred due to imperfect protection or discovery by the employer. Full compensation, \textit{cf. infra}, should still be provided to the whistleblower.

One of the possible costs that remain even with protection of identity is criminal liability. The whistleblower may later be prosecuted after the fraud is uncovered.

Therefore this too should fall under the loss of criminal liability or severe reduction of this liability that should be available to all whistleblowers as will be treated in the next section.\textsuperscript{78}


\textsuperscript{78} This could be done by, after the uncovering of the fraud by government agencies and the start of a criminal procedure, divulging his role in the process to the prosecutor under confidentiality.
3.1.2 Loss of civil and criminal liability

As mentioned in the previous chapter, clauses in the contract prohibiting whistleblowing, or prohibiting it de facto, should be null and void. It is clear that no contract should be allowed to detract from whistleblowing as it is in the interest of the state and the “public”. Therefore the whistleblower should be protected from civil liability.

Protection from criminal liability, especially when the whistleblower is only complicit to steps along the way is a very good way to reduce the costs for the whistleblower. And even when this involvement is somewhat more substantial, serious mitigation of liability should be introduced.79 Considering that otherwise the employer could otherwise immunize himself from whistleblowing by bloodying the hands of the employees involved,80 it is necessary even in cases of active participation to offer these reductions, and this type of whistleblower should not be exempted from the other benefits coming from whistleblowing.

Although this might look like rewarding criminals, one can see that often those severely implicated are in the best position to gather enough proof of fraud and blow the whistle. Existing schemes protecting and compensating complicit witnesses from within criminal organizations show however that even in case of “heavy” criminals this has already been applied.

Conclusion

Protection of identity and loss of civil and criminal liability, already goes a long way to clearing the negative side of the whistleblowing balance in quite some cases and they

79 Cf. supra
should be part of any future whistleblowing regulation. However as the chances are high that confidentiality is just not sufficient, it can only exist next to a more elaborate incentivization on the benefit side.

3.2 Adding benefits

If costs are not to be avoided the whistleblower will experience a drop in his utility, his utility curve takes a drop due to the costs associated to whistleblowing.

The protection approach cannot credibly guarantee the avoidance of costs in most case, therefore the option of compensation has been included in all regulation. However this is treated as subsidiary to the actual protection approach, and is due to this perspective severely limited. The compensation is usually focused on the immediate consequences of direct retaliation by the employer as this is the clearest failure of the ‘governmental’ protection offered to the whistleblower. As treated in the second chapter, this makes the current approach very undercompensatory.

In this section I will first treat the flaws in the proposed mandatory whistleblowing solution, then there will be a graphical illustration why future regulation should focus on compensatory benefits. Following that the two compensation approaches proposed the literature will be treated to show the flaws in their incentivization and I will propose my own proposition to switch to a full compensation approach to tip the balance back in favor of blowing the whistle.
3.2.1 Adding a perverse benefit: mandatory whistleblowing or the stick approach

Tipping the balance can be done by adding benefits to induce whistleblowing (carrots) but can also be done by adding costs to not blowing the whistle (sticks). This stick can be introduced in the form of mandatory whistleblowing, making not blowing the whistle a criminal offense.

On a cost-benefits analysis of a potential whistleblower this would translate in an extra ‘benefit’ in favor of blowing the whistle, namely loss of the specific criminal liability for remaining silent.

The cost-benefit analysis, this the added ‘benefit’ of mandatory whistleblowing would be avoiding a specific criminal liability for remaining silent. This stick approach is appealing to some, because of the costless multiplication of sticks. This theory states that while carrots have to be handed out each time, the threat of one stick can induce many to comply. In casu the threat of criminal liability for remaining silent can induce many to actually blow the whistle with hardly any added procedural costs for the government or any payment of compensation.

The problem of this mandatory whistleblowing approach is that it does carry a big cost, not carried by the government but by all employees. The real cost would be put on the shoulders of every employee, who will have to continuously be on his toes for possible fraud. This would mean that actually uncovering a fraud, means automatically incurring a cost. As either he blows the whistle and runs the risk of incurring the abovementioned costs or he

doesn’t blow the whistle and runs the risk of being criminally liable for his silence. Therefore as soon as an employee due to his diligence finds out about a fraud he has to pick the lesser of two evils.\textsuperscript{83} This would have the perverse consequence that employees would try not to uncover anything, staying away as far as possible from any suspect practices.\textsuperscript{84} This would make discovery of fraud by employees more unlikely.

On top of that the atmosphere within the corporation that such a regulation would create would be stifling, some even compare it to the culture of denouncement often associated with totalitarian states.\textsuperscript{85}

A sense of paranoia would strike as every employee who uncovers the slightest suspect irregularity would declare it, just to avoid any possibility of criminal liability. Leading to an uncontrollable stream of groundless complaints.

In conclusion, the main problem with mandatory whistleblowing is that it would put an unacceptable burden on every employee, which would probably lead to avoidance behavior by those that in other circumstances would be potential whistleblowers.

\textsuperscript{83} While this is an acceptable burden for professional monitoring bodies/gatekeepers with a clear public role and job description, e.g. auditors, this is a burden we cannot put unto every employee.

\textsuperscript{84} Reinier H. Kraakman, Gatekeepers: The Anatomy of Third-Party Enforcement Strategy, \textit{op. cit.}, p. 60.

\textsuperscript{85} "Governments as diverse as Nazi Germany, the Soviet Union and the McCarthy-era United States persuade their citizenry that informing on friends and neighbors was a patriotic duty. Accompany the encouragement to inform was the threat that one who failed to inform would be viewed as no less guilty than the wrongdoer." in Henry Ordower, James Fisher et al., “Privatizing Regulation: Whistleblowing and Bounty hunting in the financial services industries”, \textit{Dickenson Journal of International Law}, Vol. 19, p. 130, (2000).
3.2.2 Adding compensatory benefits

3.2.2.1 The need for higher compensatory benefits

Once incurred the costs of blowing the whistle are a drop in the utility of the employee. Not only does he lose immediate wealth being wage, invested capital and the immediate wealth associated to the costs of the whistleblowing procedure, he also loses career perspectives.

Career perspectives is to be operationalized as the future perspectives he would normally have in his career. These would specifically include loss of invested human capital due to blacklisting and loss of the opportunity to do his job without unnecessary psychological pressure.

Blowing the whistle makes both drop. Both his immediate wealth and his career perspectives take a big hit.

Graph. 1.

However current regulation focuses on protection for immediate retaliation and if this fails provides only compensation for the immediate consequences. Therefore current
regulation focuses on counteracting only the drop in immediate wealth. The idea being that the biggest disincentive for the whistleblower is this immediate retaliation. (black arrow Graph 2).

Graph. 2.

They will focus their compensation on getting the curve back from the perceived new (light blue) utility curve to the old (dark blue) utility curve. Monetary compensation would amount to the path described by the black arrow. However the real immediate wealth loss is often higher (yellow arrow) considering the loss in invested capital that is not compensated (cf. supra). But more importantly it almost completely overlooks the career perspective loss (Blue arrow in Graph 1).

This helps to explain why a very significant part of the whistleblowers seem to be people who have already lost most of their “career perspectives” due to other circumstances. Other than being just purely disgruntled employees they are faced with a different kind of drop in utility curve, for which the compensation currently on offer can be sufficiently incentivizing.

Nonetheless for most potential employee whistleblowers the current compensation is insufficient. To counteract this, we should put the whistleblower in a situation where blowing the whistle makes him as well off, back on the old utility curve or even better off, on a higher utility curve. Since the career perspective part can hardly be influenced by government

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86 Be it by protecting him from being fired, paying compensation or reinstating him in his job.
regulation in a free market economy,\textsuperscript{87} heightening the immediate wealth (red arrow Graph 3) is the only way to put the employee whistleblower on the same, or higher, utility curve. This should be done by developing a present value of those lost career perspectives.

It is clear that the compensation that should be offered (Red arrow Graph 3) is far higher than in current regulation (Path of black arrow Graph 2)

Graph. 3.

To conclude, this clearly demonstrates the need of shifting to more comprehensive compensatory benefits. Different approaches have been proposed to achieve this compensation. In the next section I will first treat the two most championed in the literature and then will propose my own full compensation approach.

\textsuperscript{87}The simplifying protection approach, e.g. in the SOX, implies that they government thinks it can, by for instance reinstating the employee at his former seniority level. This has been shown to be unrealistic in the second chapter.
3.2.2.2 Providing for higher compensatory benefits

At first in this part we will treat two proposals from the literature that provide for higher compensatory benefits to corporate whistleblowers and why they are flawed. These proposals are: allowing insider trading on a certain type of negative information and generalizing the bounty approach of the False Claims Act. As these two proposals are flawed in providing potential corporate whistleblowers with enough incentives, I will propose my own approach in the last section, the full compensation approach.

3.2.2.2.1 Allowing insider trading on a certain type of negative information

This important concept in the literature suggests that lifting the prohibition on insider trading on a certain type of negative information will provide for the necessary compensation for whistleblowers. It leaves the compensation of the whistleblower up to the market and is therefore an appealing idea. While the idea had been proposed by others, the seminal theory on using insider trading on negative information to incentivize whistleblowers has been developed by Macey. In this section I will shortly discuss why this theory is flawed as a general way to incentivize whistleblowers.

The distinction between insider information on positive and negative information has been defended by several authors. I do not disagree with the fundamental difference

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between those two types of insider trading.\textsuperscript{91} Lifting the ban on prohibition on insider trading on negative information is a powerful concept and could possibly be operationalized to help combat corporate fraud.

However it is not the same as providing for a general whistleblowing regulation. It is definitely not “analytically and functionally indistinguishable” to whistleblowing as response to corporate pathologies such as fraud and corruption.\textsuperscript{92} And certainly not, even when properly regulated, a “superior substitute” to whistleblowing.\textsuperscript{93}

To get to the conclusion that they are analytically and functionally indistinguishable, Macey admits that not all types of negative information will do. It has to be information that otherwise would remain non public, it should not constitute just foreknowledge. It should basically be narrowed down to the same information that would also be the basis for whistleblowing,\textsuperscript{94} information not on a regular downturn in for instance profits, but on fraud, corruption and illegal practices. Another important addition is that it has to be narrowed down to a certain type of whistleblower, only rank and file employees, as higher echelon employees, managers, etc. would have the perverse incentive to produce irregularities if they would be allowed to trade on them. So those who are in the position to produce the negative information are not allowed to blow the whistle to prevent this.

\textsuperscript{91} “We could define information as negative when disclosure leads to a decrease of the stock price and positive when it leads to an increase. The economic basis for distinguishing between insider trading on positive and insider trading on negative information lies in the effect on the dissemination of information. Typically, insiders are willing to tell that they have worked successfully and that their decisions have proved to be the right ones (ex ante). They are very likely to disclose positive information for reputational reasons, career ambitions, special monetary rewards such as bonuses, or simply to boost their self-esteem. (To a small extent, disclosing positive news may be delayed in order to decrease volatility.) For the same reasons, insiders have strong incentives not to disclose negative information. They will receive less pay, for example because stock options are worth less, their value on the job market decreases, they may be subject to social sanctions for being an unsuccessful manager or worker etc. According to our intuition, the incentive structure suggests that positive information reaches the market sooner than negative information. Where information is published fairly quickly, insider trading can do little to enhance the information flow. To pay insiders for disseminating positive information, by allowing them to trade, makes little sense. They would disclose the information anyway. The opposite is true for negative information” in Kristoffel Grechenig, “Positive and Negative Information – Insider Trading Rethought”; op. cit., p. 4.


\textsuperscript{93} Id., p. 1903.

\textsuperscript{94} Id., p. 1913.
This makes the group of potential whistleblowers smaller than in the existing regulation. The chance that those who are not in any position to produce the information, do actually find this information in the normal course of their work is a lot smaller. Making discovery less likely.

On top of that the rank and file employees that would actually find out would be allowed to trade, but won’t necessarily be able to do so successfully because of lack of capital.

This brings us to the biggest problem with this approach, the claim that “Insider trading on the basis of information about an on-going fraud necessarily leads to the exposure of that fraud”\footnote{Id., p. 1914.} Since the insider traders are willing to undersell, the credibility of their negative information would rise.

However insider trading on negative information about an ongoing fraud does not necessarily get the information out. This would mainly happen when somebody has an interest in the price of the shares dropping because of his use of underselling techniques or put options.

Those who actually already own shares might just be happy to sell them at current market value to get their money’s worth out of it. They might even spread this information to their friends and associates so they can dump their shares too. However they have no interest in spreading this information to the public.\footnote{Relying on just a price-change to transfer this information correctly is very unlikely due to the inherent information asymmetry in the market.} Selling the tip to for instance an investment bank might be another way of getting your money’s worth out of it, without divulging this to the public. Even stronger the insider trader in question has all reason to conceal that he is doing so on basis of insider information as this would engender a “insider trading tax”, as investors will anticipate losses when trading against
someone with inside information and will calculate this in the price they are willing to pay.97

So only in case of underselling or put options would the trader have a specific interest in the price dropping. However underselling and put options are complex procedures and require significant funding in order for them to give a credible signal to the market.

No normal run of the mill employee will be able to do this. Tipping off a trader98 in hope of getting a reward is about the best they can expect. This engenders another problem: the value of the negative information has to be clear and very large to convince a potential insider trader/whistleblower to come forward. It’s very hard to assess this value beforehand, let alone for a regular rank and file employee. This is a problem it shares with the bounty hunting compensation treated in the next section.

Even if divulging the information would be beneficial to the public, if it does not have a clear and high value on which the whistleblower/insider trader could capitalize he will not be incentivized to divulge.

Two cases used by Macey to illustrate his insider trading on negative information approach actually highlight these problems. In both the case of Ronald Secrist (leading to Dirks vs. SEC99) and the case of Ted Beatty (Dynegy collapse) these insiders did not trade on the information themselves but tipped off those who could. In both cases neither of them made any money from this tip.100 Ted Beatty was even completely impoverished due to blacklisting, suffered severe threats and even had a break-in in his house.101 Important to note is that even the underselling of Dynegy stock by a hedge

98 And this would require finding one and convincing him of the value of your tip.
100 Both were disgruntled (ex-)employees.
101 And to top it all off, because of his dire situation after he had tipped his friend at the hedge fund in question, he engaged in some private insider trading on 8000 dollars worth of put-options, however he lost 2400 dollars on that as
fund did not prove credible enough to the market as the stock kept on rising, only a publicized class action lawsuit against Dynegy brought it down.

While the information eventually got out, these two cases are hardly a precedent that will incentivize future generations of whistleblowers. While in some specific cases the insider trading on negative information would incentivize whistleblowers to come forward, because of the problems described above in most cases it would not.

3.2.2.2.2 Generalizing the bounty approach of the False Claims Act

Another proposal in the literature to incentivize whistleblowers is the bounty approach, made popular due to the success of the US False Claims Act. It is very appealing as the private loss of the “whistleblower” is directly compensated by part of the societal benefit of his actions.

The US Federal False Claims Act is directed against government contractors, who, in short, falsely makes fraudulent claims for payment by the government, or don’t deliver what they should thereby defrauding the government.104 They are liable to pay three times the damages sustained by the government.

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104 This is currently most applied in health care fraud.
times the government’s damages plus a civil penalty ranging from 5,500 to 11,000
dollar per false claim.\(^\text{105}\)

It is unique in the provision for whistleblowers included in § 3730 B stating that: “A
person may bring a civil action for a violation of section 3729 for the person and for the
United States Government. The action shall be brought in the name of the Government”.

This is what they call the Qui tam\(^\text{106}\) provision, private action in name of the
government. In return those whistleblowers “receive at least 15 percent but not more
than 25 percent of the proceeds of the action or settlement of the claim, depending upon
the extent to which the person substantially contributed to the prosecution of the
action.”\(^\text{107}\) That is if the government supports their claims, if the government didn’t
support their claim during the proceedings the percentage ranges from minimum 25 tot
max 30 percent. All reasonable procedural expenses, fees, and costs are awarded against
the defendant. So when a private person\(^\text{108}\) blows the whistle by starting his own civil
action under the False Claims Act he gets a percentage of the award, a “bounty”. That is
why it is sometimes compared to the institution of bounty hunting.\(^\text{109}\)

It is currently one of the most successful whistleblowing legislations in existence,
remitting billions of dollars to the American taxpayer. It success is due to the incentives
it gives to potential whistleblowers as the average petitioner under False Claims gets a
bounty of around 1 million dollars. An overwhelming benefit that tips the balance. On
top of that due to the high gains, specialized law firms are jumping at the opportunity to
help file Qui tam lawsuits.

\(^{105}\) There is a separate but similar regulation for tax fraud, as it is specifically excluded from the False Claims Act. It
is to be found in Section 7623 of the US Internal Revenue Code.

\(^{106}\) Latin: *qui tam pro domino rege quam pro se ipso in hac parte sequitur*, meaning “(he) who sues for the king (the
government) as for himself in this case.”

\(^{107}\) § 3730. (d).

\(^{108}\) Irrespective of him being an employee, a private investigator, etc…

\(^{109}\) Henry Ordower, James Fisher et al., “Privatizing Regulation: Whistleblowing and Bounty hunting in the financial
services industries”, *op. cit.*; William E. Kovacic, “Whistleblower Bounty Lawsuits as Monitoring Devices in
This makes the idea of generalizing the bounty hunting approach to compensation for all whistleblowers very appealing. However there are some serious flaws in this generalization.

The biggest problem with generalizing this approach is that there is a significant difference in what type of damage is done and therefore a difference in the calculation of the whistleblowers’ bounty. One could say the damage done in case of False Claims is purely to public revenues, the public budget is harmed. However “laws regulating financial markets address actions that may inflict no direct damage to governmental revenues but nevertheless do both public and private harms.”

This makes it very hard to calculate a percentage on.

How would one value the public harms? How could undermining the market by generating information asymmetry and undermining confidence in government and market be calculated? And calculating the private harm done would be an aggregate of many thousand stakeholders’.

It is not possible that a percentage on the money the government recovers from a direct false claim can be translated in a percentage of the benefits to the abstract public from uncovering corporate fraud.

A problem adding on to this, which also applies to the False Claims in general, is that only a specific type of fraud gets discovered, that is, highly quantifiable, high profile schemes that would almost certain give a huge pay-off. Especially since he has to convince a lawyer of the size of the bounty too. As mentioned above however in corporate fraud cases the pay-off is rarely this clear.

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110 Id., p. 140.
111 How would we define and calculate the benefit to the public of uncovering a fraud that leads to the collapse of the corporation in question.
So there is a big problem of undercompensation in case of less high profile cases or less quantifiable cases "this feature also reduces incentives for socially beneficial whistleblowing, "112

The procedure of *Qui tam* also requires a certain bounty-hunter mindset, the potential whistleblower has to be a very motivated person that has the initial means and perseverance to mount a civil action lawsuit against the company, knowing that the expected pay-off will be huge and would provide a benefit big enough to counter any costs he might incur during the process. Not every potential employee whistleblower is cut out for this.

Although the False Claims Act has proven to be a great piece of legislation,113 its applicability is limited in cases of corporate fraud. And the cases of exposure of fraud not necessarily the most socially beneficial ones. I think however more countries should consider this regulation when working with direct damage to public funds. However it cannot provide a sufficient incentivization for most potential corporate whistleblowers.

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112 Bruce Kobayashi and Larry Ribstein, "Outsider Trading as an Incentive Device", *op. cit.*, pp. 70-71.
113 Especially since its amendment of 1986.
3.2.2.2.3 The full compensation approach: making the whistleblower “whole” again

The approach I propose to tipping the balance back in favor of blowing the whistle is the full compensation approach. To counteract all the costs on the negative side of the balance, the regulation should provide monetary compensation for all economic and non-economic costs. Thereby putting the whistleblower on his original utility curve again. To this end I propose providing for a direct claim for compensatory damages against his (fraudulent) employer. This claim could be brought as soon as his status as a whistleblower is recognized by the relevant authorities.

**Strict liability**

This should be under a regime of strict liability for the employer, with a strong presumption of causality of costs in favor of the whistleblower. This presumption would turn around the burden of proof as soon as there is an indication that the cost has been incurred due to his blowing the whistle. The strict liability would make the employer compensate for all costs incurred due to consequences of blowing the whistle, also those that are not strictly his fault, such as loss of earning potential due to blacklisting and psychological pressure caused by fellow employees. Considering that the employer’s fraudulent actions have put the whistleblower in this precarious situation to begin with this is not unreasonable.

This regime would offer the highest degree of certainty for a successful full compensation of the whistleblower.

In case of collapse of the employer or (temporary) insolvency a government fund specifically assigned to this purpose could provide for the compensation. As the

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114 Making of course the abstraction that any fraud within the corporation is attributed to the corporation as a legal entity.
whistleblower incurs his private costs for the benefit of the public, the government should prevent that they are uncompensated, not in the least to safeguard the incentives for future whistleblowers.

**Making the whistleblower “whole” again**

The new regulation instating this specific claim right should expressly mention that all economic costs, especially including loss of invested capital and invested human capital, and non-economic costs, especially due to psychological stress, have to be fully compensated, as to make the whistleblower whole again.

For valuing the cost/damages that the employer should compensate, the courts can use the techniques developed in tort law cases. As the main goal of tort law, at least according to the legal view\(^{115}\), also is to make the victim whole again.

In economic terms, in tort law, harm is seen as a downward shift in the victim’s utility.\(^{116}\) The victim should be brought to the original utility curve. The victim should be “made whole again”. When repair is impossible, e.g. permanently deteriorated health, monetary compensation is in order. Therefore “The principal purpose underlying tort damage awards is the compensation of the victim for his loss”.\(^{117}\) Full compensation has been the main approach\(^{118}\) in awarding damages in tort law cases.

\(^{115}\) The view on Tort law here is strictly the one followed by most law scholars and courts, the law and economics perspective on torts, which mainly focuses on liability and future incentives for level of care and the right deterrence is not implied here. Since full compensation of the whistleblower is the goal, and the only forward looking idea to incentivize future potential whistleblowers, the current legal way of looking at compensatory damages goal as to make the victim whole again suits perfectly.


\(^{118}\) Second Restatement of Torts, § 901 cmt. a. (1979).
“That sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation.”¹¹⁹

The same idea of putting the whistleblower back on his original utility curve is the goal of the full compensation approach. As repair is hardly possible, for instance the failure of reinstatement, the compensation should take place in immediate wealth. (See Graph 3 section 3.2.2.1.)

As society has an interest in making victims of torts whole again, it too has an interest of making the whistleblower whole again, since he blows the whistle to the benefit of society, the public. Letting him bear private costs/harm for this seems unreasonable from that perspective. As society can’t repair or prevent these costs in most cases, they have to be compensated.

**How to value the full compensation**

Applying the full compensation approach to economic losses such as loss of wage, including benefits such as bonuses, and loss of invested capital, at its value before the negative information was made public, should not provide any serious problems. Calculating losses like these are the easiest valuations in tort law cases as clear (price) information is available. The same goes for the costs of procedure and legal representation.

However as we have seen the biggest flaw in monetary damage calculation in current regulation is its lack of attention for the **human capital loss**. Existing tort law cases however provides techniques for this too, that can be used by analogy. In accident

caused injury the loss of future employment potential, earning power, is often calculated and compensated. Loss of future earnings and career could easily be applied by analogy to cases of blacklisting. Which also has a crippling effect on the future earning potential of the whistleblower.

Many techniques can be used to calculate loss of earning power based for instance on age-related earning within the industry, market projections, possible productivity increases, etc… But Slesinger makes a convincing case for using a multifactor economics approach: “Though there are a variety of tools to help develop parameters, the calculations have one common objective – to restore the plaintiff or decedent to an economic whole. Thus, attempts are made to estimate what would have been the earning power, potential or horizon had no the tort occurred. The projection of earning power and not actual earnings, as it is this power which has been impaired or destroyed. In estimating the earning potential, economists examine a variety of magnitudes such as past earning records, non-contributory fringe benefits, promotion potential, productivity records and non-market related values such as the value of household services performed by the individual for his family.”

These valuations of loss of earning potential have been consistently been done by courts, even for minor impairing injuries, there is no reason why they couldn’t adapt this to apply for loss of earning potential due to the effects of blacklisting.

Compensating for non-economic damages have a long standing record in (common law) tort law in general. Damages for psychological stress and suffering have been

awarded countless times based on expert assessments and the circumstances of the case. Awards are made for non-economic harms ranging from the standard “pain and suffering” to emotional distress, mental anguish, loss of enjoyment of life, humiliation, depression, etc… Applying this to the consequences of the psychological and social pressure in the case of whistleblowers should provide no significant problems. However they should, as they are now, be awarded in a case-by-case way, as no general rule can be created to value these in economic terms. The courts should bear in mind that the goal of the regulation is to fully compensate the whistleblower for his costs, under compensation would have terrible disincentivzing effects for future whistleblowers.

Therefore the full compensation approach, focusing on making the whistleblower whole again, has powerful precedents in current tort law cases. Keeping in mind that the true incentive here is to convince future whistleblowers, the awarded compensation should at all costs not be undercompensatory. This compensation of full cost should take away the negative side of the cost-benefit analysis as much as possible, leaving the potential employee whistleblower the choice to follow his own conscious.


125 There is a view in (Tort) Law and Economics that this should nonetheless be done, but this is based on optimal incentives for level of care and insurance, specific to torts. However from the light of strict corrective justice, making the victim whole again, the case-by-case approach is always superior. As it is the most likely to make the whistleblower in concreto whole again. As only this is playing in the proposed full compensation approach, case-by-case valuations are the best way of approaching the non-economic costs of whistleblower.
3.3 Concluding regulatory advice

Whistleblowing regulation should change its focus from providing protection to fully compensating the whistleblowers.

This can be done by instituting a direct claim for the whistleblower against the employer. This would be under a regime of strict liability for the employer, with strong presumptions of causality in favor of the whistleblower. The compensation provision should specifically mention:

- Compensation for lost current wages
- Compensation for loss of invested capital
- Compensation for loss of invested human capital, the loss of future earning potential
- Compensation for any reasonable costs incurred for the procedure of blowing the whistle and for the full compensation lawsuit
- Compensation for non-economic damages, such as psychological stress

However part of the protection approach is still valid in case in which the government can actually guarantee the protection, therefore two provisions should definitely be included in future whistleblower regulation:

- Possibility of protection of identity by offering confidentiality
- The relief of criminal and civil liability

However no amount of regulation can reincentivize corporate whistleblowers if the authorities fail to react properly to whistleblowing complaints. Lack of responsiveness to these complaints,
leading to a higher probability of failure for the whistleblower, acts as a dilutor of the incentives offered by the full compensation regulation. Therefore existing or created agencies for accepting whistleblowing complaints should continuously be monitored and evaluated for their responsiveness by the government.

**Final conclusion**

My proposal for reincentivizing whistleblowers is to change the current focus on the protection of the whistleblower, which mostly can’t be guaranteed by the government, to a full compensation approach. The real costs and benefits of the whistleblower have shown us that current regulation does not provide convincing incentives. The lack of compensation for loss of invested capital, loss of future earnings potential due to blacklisting and the lack of compensation for non-economic loss, such as psychological stress, make it very unappealing for a potential employee whistleblower to come forward.

This can only be successfully solved by providing for compensatory benefits. However the currently proposed compensation schemes, expanding the bounty hunting approach or lifting the prohibition on insider trading on a specific type of negative information, generally would not accurately incentivize potential employee whistleblowers.

Therefore I propose a new approach: the full compensation approach. This approach focuses on compensating for all of the whistleblowers costs and is linked to a strict liability for the defrauding employer. Leaving the cost of compensation to the party responsible for putting the whistleblower in his precarious situation, would correctly attribute these costs to the wrongdoer.
If regulation provides full compensation for all the potential employee whistleblower’s costs, that would enable him to choose to fulfill his moral duty by divulging his negative information.
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