

The Scope Of Whistleblower Protections Under Sarbanes-Oxley: Are Privately Held Companies Covered? – Part II

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Part I of this article appeared in the November issue of *The Metropolitan Corporate Counsel*. It featured a discussion of the pertinent portions of Sarbanes-Oxley as regards whistleblowers as well as whether and when certain privately held companies may be liable under the Act's whistleblower protections.

Ramifications For Privately Held Companies

OSHA's Final Rule governing procedures for handling SOX whistleblower complaints defines "employee" as "an individual presently or formerly working for a [publicly traded] company or company representative, an individual applying to work for a [publicly traded] company or company representative, or an individual whose employment could be affected by a publicly traded company or company representative." 29 C.F.R. §1980.101 (2005) (emphasis added).¹ The regulations further provide that "Company representative means any officer, employee, contractor, subcontractor, or agent of a company." 29 C.F.R. §1980.101.

The above-emphasized language indicates that a publicly traded company cannot retaliate against an individual who engages in SOX-protected activity and is employed by a privately held entity which contracts with a publicly traded company, especially if the publicly traded company can affect the terms and conditions of that individual's employment. In other words, where a publicly traded company functionally controls the contractor's personnel decisions, the contractor's employee can advance a SOX retaliation claim against the publicly traded entity.

OSHA's regulations further provide that: "a Respondent will not be liable for the adverse action taken against an employee of its contractor or subcontractor where the respondent did not act as an employer with regard to the employee." 69 Fed. Reg. 52104, 52107 (Aug. 24, 2004) (emphasis added). It follows that a publicly traded respondent may be held liable for retaliation against a contractor's employee if that respondent influences the contractor's personnel decisions.

The question remains whether a privately held company which contracts with a public company may be held liable under Section 806 for retaliating against its own employees.² The plain language of Section 806, together with OSHA definitions, appears to support this view. Cutting through, Section

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806 says that a "contractor" of a publicly held company cannot retaliate against an "employee." "Employee" is defined in the regulations to include "any individual presently or formerly working for a company or company representative." 29 C.F.R. §1980.101 (emphasis added). And that same section defines "company representative" to mean a "contractor of company." *Id.* (To close the loop, "company" is defined as "any company with a class of securities registered under . . . the Securities Exchange Act.") It is this approach which has led many informed practitioners to advise privately held companies that they, too, are covered by the SOX whistleblower provisions.

At least one case, *Morefield*, suggests that non-public companies (in that instance, an Exelon subsidiary) may be called to account for retaliatory action in violation of Section 806.

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Until recently, *Morefield* appeared to be the exception. That changed with *Kalkunte v. DVI Financial Services, Inc.*, 2004-SOX-56 (ALJ July 18, 2005). One respondent in that case, AP Services, provided crisis management and restructuring services to companies in financial distress. The other respondent, "DVI Financial, was a financial services company which had contracted with AP Services to provide leased employees to manage DVI through bankruptcy and dissolution. DVI was publicly traded, but AP Services was not. The complainant was employed by DVI. The chief protagonist as described in the complaint was a Mr. Toney, the President of AP Services who had been appointed by DVI's Board of Directors as temporary President and CEO of DVI upon filing for Chapter 11 protection. DVI was undisputedly a covered employer, but at issue was whether AP Services could be held liable.

After reviewing the facts and relevant law, the ALJ concluded that AP Services was a properly named respon-

dent because (1) it was a subcontractor or contractor, (2) it had assumed respondeat superior liability as to the complainant, (3) it was an agent under Section 806, and (4) the complainant could also be viewed as a third party beneficiary to the agreement between the respondents. The ALJ rejected AP Services' argument that it had to actually employ the complainant to be covered under the SOX, writing:

"DVI contracted to AP the power to determine how best to manage the corporation and its assets in light of the pending bankruptcy. . . . Included in those powers was the power to evaluate DVI's employees' value to the company and to terminate those who were no longer needed. . . . Mr. Toney, as CEO, had the authority to terminate anyone at DVI, and Ms. Clay [an AP Services employee brought to DVI to work on Human Resources issues] testified that she performed the duties of Chief Administrative Officer as part of her duties at DVI. Thus AP, through Mr. Toney and Ms. Clay, had the power to affect Ms. Kalkunte's employment."

Slip op. at 9 (record citations omitted).

Kalkunte, therefore, seemingly stands for the proposition that a privately held contractor may be sued under Section 806 by the employee of a publicly traded company. If that's so, then it must follow that a privately held contractor (of a publicly traded company) could be sued by its own employee – especially since the regulatory definition of "employee" appears to include any "individual whose employment could be affected by a contractor." 28 C.F.R. §1980.101.

"Not so," said the ALJ in *Minkina v. Affiliated Physician's Group*, 2005-SOX-19 (ALJ Feb. 22, 2005). There, the named employer was neither a publicly traded company nor a subsidiary of a publicly traded company. The complainant argued that the respondent was a contractor or subcontractor of various publicly traded companies, and therefore she should be considered a covered employee based upon Section 806's reference to "any officer, employee, contractor, subcontractor, or agent of such company." 18 U.S.C. 1514A(a). The ALJ held, however, that "this language simply lists the various potential actors who are prohibited from engaging in discrimination on behalf of a covered employer. It does not bridge the gap in this case which is created by the fact that the Complainant is not an employee of a publicly traded company. That is, while it is at least theoretically possible that a privately held entity such as APG could engage in discrimination prohibited by Section 806 when acting in the capacity as an agent of a publicly traded company in regard to an

employee of that company, there is nothing in the language of Sarbanes-Oxley or its legislative history that suggests that Congress intended to bring the employees of non-public contractors, subcontractors and agents under the protective aegis of Section 806." *Minkina*, Slip Op. at 6.

Confused? So is the case law to date. Which means that a prudent privately held contractor would be well-advised to assume it is covered by Section 806, and to act accordingly, even though the case authority is unclear. Moreover, many state laws have whistleblower protections covering private sector employees (publicly traded or otherwise) who complain about financial misconduct, at least to state officials. In California, for example, private employers are prohibited from retaliating against any employee who discloses information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information reveals a violation of any state or federal statute or regulation. Companies which violate California law are guilty of a misdemeanor punishable by a fine of up to \$5,000. Illinois law prohibits the same retaliatory conduct, as well as retaliation against an employee for refusing to participate in activity which would result in violation of any federal or state statute or regulation. Civil remedies available to Illinois whistleblowers include reinstatement, backpay and reasonable attorneys' fees. Whistleblower provisions in New York are in some ways broader, protecting not only employees who complain to government officials, but also those who complain to supervisors. The complaint, however, must involve conduct that violates a law or regulation and creates a substantial danger to the public health or safety. Moreover, the employee must first complain to a supervisor and afford the employer a reasonable opportunity to correct the wrongful conduct (before complaining to a public official). As in Illinois, employees in New York may obtain reinstatement, backpay and attorneys' fees.

Given varying state laws, as well as confusion under SOX Section 806, a broad view of financial whistleblower protection is advisable when crafting and applying corporate policies.

¹ Notably, the regulations promulgated under SOX do not define "employer," 29 C.F.R. §1980.101.

² Of course, the employee's conduct must be SOX-protected in the first instance. Section 806 on its face indicates it protects whistleblowing with regard to activity which the employee reasonably believes constitutes securities fraud. But Section 806 has been held to protect complaints about possible violations of banking and mail fraud laws as well. See, e.g., *Gonzalez v. Colonial Bank*, supra. Further analysis of Section 806's substantive protections is beyond this article's scope.

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