Management Alert

Sox Whistleblower Reach Expands

An Administrative Review Board of the U.S. Department of Labor recently expanded the rights of plaintiffs to obtain relief under the "Whistleblower" provisions of the Sarbanes-Oxley Act of 2002 (SOX). In *Klopfenstein v. PCC Flow Technologies Holdings, Inc. and Allen Parrott*, ARB No. 04-149, ALJ No. 04-SOX-11(ARB May 31, 2006), the Administrative Review Board expanded the reach of the SOX Whistleblower protection statute (18 U.S.C.A.§1514A), reversing and remanding a case appealed from an ALJ.

The ARB opinion holds that employees of subsidiaries of public companies may be entitled to SOX Whistleblower protection, suggesting both that subsidiaries themselves may be covered by the jurisdictional language of the statute, and that the subsidiaries can be deemed "agents" of their covered parent corporations. The panel also indicated that, at least under some circumstances, employees of a private subsidiary can be agents of a public parent, thus exposing such employees to SOX liability. Finally, in connection with its remand, the panel stated that a SOX complainant need not show that his or her protected activity was a primary, or even significant cause of the unfavorable personnel action, but only that it was a contributing factor.

FACTS

This case involves some finger-pointing and assigning blame between Klopfenstein, a Vice President of Operations, and Parrott, a Vice President of Finance, over responsibility for accounting irregularities in connection with in-transit inventory in Flow Products, Inc. (Flow), a wholly-owned, indirect subsidiary of PCC Flow Technologies Holdings, Inc. (Holdings), which in turn is a wholly-owned subsidiary of Precision Castparts Corp. (PCC),
a public company clearly covered by SOX. Both Klopfenstein and Parrott were officers and employees of Flow, and reported to officers of Holdings on a regular basis.

Klopfenstein became aware of a discrepancy in in-transit inventory balances in November, 2002. These problems raised issues under PCC's revenue recognition policy, which in turn meant that there was a strong possibility that the outside auditors would label it a "material misstatement," which would need to be publicly disclosed as such in documents filed with the SEC. Klopfenstein and his subordinate first reported the problem to Parrott and other members of Flow's finance department. When the problem persisted, Klopfenstein included it in weekly reports to his managers at Holdings.

Members of the finance department investigated the problem, and Parrott wrote a report characterizing the problem as "an unauthorized change in establishment procedure… directed by Keith Klopfenstein… not disclosed to senior management." The matter of responsibility for this problem was discussed and further investigated by Holdings' head of Human Resources, during which time Klopfenstein was given opportunity to tell his side of the story. In the end, however, Klopfenstein was terminated by the president of Holdings. Klopfenstein filed a SOX complaint with OSHA shortly thereafter, naming Holdings and Parrott as defendants. His complaint contended that the reasons given by the company and set forth in Parrott's report were a pretext for its real motivation, which was his "persistent reporting of the in-transit inventory discrepancy."

OSHA initially determined that the complaint lacked merit. Klopfenstein then requested a hearing. The respondents' motion for summary decision was denied, but after a two-day hearing in 2004, an ALJ ruled for the respondents, holding that neither of them was subject to the Whistleblower provisions of SOX, and that Klopfenstein "failed to establish a case for retaliation under the Act." Klopfenstein appealed.

COVERAGE

The first issue discussed by the panel was whether Holdings, a non-public subsidiary of a public company, and Parrott, an officer-employee of a non-public subsidiary, are covered by SOX. In what is probably the most note-worthy pronouncement of this opinion, the panel distinguished its decision in *Flake v. New World Pasta Co.*, ARB No. 03-126, ALJ No. 2003-SOX-18 (ARB Feb. 25, 2004) from the present case, holding that the respondent company in the *Flake* case did not have a public parent, whereas here, it did, stating:

"… we do not interpret the Act to require a complainant to name a corporate respondent that is itself 'registered under §12 or… required to file reports under §15(d),' so long as the complainant names at least one respondent who is covered under the Act as an 'officer, employee, contractor, subcontractor or agent' of such a company." (Opinion, p. 13)

The panel stated that because of its remand on the agency question, it does not reach the question of whether a non-public subsidiary of a public parent could be covered by SOX. But it seems to have gone out of its way to hold that question open.

The panel went on to examine the agency question. It stated that whether a subsidiary or an employee is an agent of a public parent is a factual question, to be determined according to "principles of the general common law of agency." It went on to observe that overlapping officers between the parent and subsidiary, and involvement of the parent's officers in investigating the conduct of a subsidiary employee, suggest the establishment of an agency relationship. With respect to Parrott, the panel observed that the fact that he was asked by officers of PCC, or by officers of Holdings who were in turn instructed by PCC, to perform certain functions was an important factor in determining whether or not an agency relationship existed. The panel instructed the ALJ to make fact findings consistent with these agency law principles on remand.

MERITS

The panel observed that to prevail on the merits, a SOX plaintiff must prove: 1) unfavorable personnel action; 2) protected activity (whistleblowing); 3) knowledge (did respondents know of Klopfenstein's protected activity?); and 4) causation.

Several interesting issues were discussed by the panel in connection with the merits. First, the panel stated that protected activity extends beyond reporting fraud, to "violation of… any rule or regulation of the Securities and Exchange Commission." It extends also when the complainant is not the first one to raise the issue. Additionally, complainant need not raise the issue "in every possible way or at every possible time" (Opinion, p.17).

The panel then stated that the ALJ had applied the wrong legal standard in determining causation. Under SOX, the appropriate standard is whether the protected activity was a **contributing factor** to the termination, not the more rigorous standard of "significant, motivating, substantial or predominant" cause (Opinion, p. 18). According to the panel, because "mixed motive" analysis applies, moreover, a complainant is not required to prove that the respondent's articulated reason for its action is pretextural. Rather, the complainant can prevail via other evidence, "including temporal proximity between a protected act and an unfavorable action" (Opinion, p. 19 n. 21, citing, *inter alia, Desert Palace v. Costa*, 539 U.S. 90, 100-102 (2003)).

IMPLICATIONS

This case broadens the scope of SOX whistleblower protection by articulating two different avenues by which a non-public subsidiary of a public parent may be subject to the Act. It also clarifies that SOX's whistleblower protection scope goes beyond fraud to cover the reporting of alleged incompetence that could affect the accuracy of the financial statements. While not ruling on this issue, the panel's remand language suggests a more inclusive than exclusive interpretation. Similarly, on the issue of causation, all that is required is that the whistleblowing be "a contributing factor."

The panel's analysis is favorable for SOX complainants, not only with regard to coverage but also with regard to causation. The panel's mixed motive analysis (that protected conduct need not be "the" motivating factor or "the determining" factor) is not altogether surprising. That has been the law for some time under Title VII, as amended by the Civil Rights Act of 1991. What is surprising is the panel's pretext analysis. In disparate treatment (intentional) discrimination cases, including retaliation cases, the plaintiff can prevail either by using direct evidence or by using the indirect method of proof, whereby the defendant's articulated reason for its action is shown to be pretextual. In *Desert Palace*, the Supreme Court held that pretext could be established by showing that the defendant's articulated reason is false (or by raising a question of material fact in this regard) without any additional quantum of proof being required. That holding, of course, did not excuse the plaintiff from having to prove pretext. Yet, the ARB panel's opinion appears to do this under SOX. The panel suggests that SOX complainants can prevail, absent direct evidence of retaliatory animus and without proving pretext, merely by showing "temporal proximity between a protected act and an unfavorable action." Courts have long held under Title VII and other anti-discrimination laws that temporal proximity alone is insufficient to prove retaliatory causation.

Thus, assuming that the panel's opinion accurately states the law of retaliation under SOX, that law appears to be broader - more favorable for employees - than retaliation analysis under Title VII.

All of this means that suggestions of a SOX whistleblower action by a disgruntled employee must be taken very seriously, regardless of the setting in which they arise.

Seyfarth Shaw is uniquely positioned to help evaluate such situations with a team of lawyers possessing excellent credentials on both the labor and employment and the corporate and securities side.

If you have any questions or need additional information, please contact the Seyfarth Shaw LLP attorney with whom you work or any Corporate attorney on our website at www.seyfarth.com.

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