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

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Editor's Note: Part II of this article, discussing ramifications for privately held companies, will appear in the December issue.

Federal courts, administrative law judges, plus practitioners and corporations are all still coping with the fallout of the Sarbanes-Oxley Act of 2002, 18 U.S.C. § 1514 et seq. ("SOX" or the Act"). Enacted in the wake of the Enron and Arthur Andersen scandals, SOX is primarily about financial controls and transparency requirements for publicly traded companies. Yet the Act has broad ramifications for employment attorneys and human resource professionals, among other reasons because the Act's whistleblower provisions – SOX Section 806 (codified at 18 U.S.C. 1514A) – are in the nature of anti-discrimination employment law provisions. Moreover, Congress placed enforcement responsibilities for those provisions in the hands of the Occupational Safety and Health Administration (OSHA), an agency better known to employment attorneys than to corporate lawyers.

Section 806 provides:

(a) WHISTLEBLOWER PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES – No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 …, or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 …, or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in terms and conditions of employment because of any lawful act done by the employee –

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by –

(A) a Federal regulatory or law enforcement agency;

(B any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders. 18 U.S.C. § 1514A.

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Much has been written about Section 806's substantive protections. Consequently, and because of publicity surrounding SOX generally, together with images of prominent corporate officers being marched up and down courthouse steps (and sometimes off to jail), most publicly traded companies now have in place a whistleblower-protection policy. Such a policy, together with proper training and a meaningful complaint procedure, can go far towards insulating a company from whistleblower liability, at least if the message comes from the top that such policies and procedures reflect real corporate commitment. Indeed, at least one U.S. Court of Appeals has held that whistleblower claims alleging hostile environment harassment can be successfully defended using the *Faragher/Ellerth* standard adopted by the U.S. Supreme Court for sexual harassment cases. *See Williams v. Administrative Rev. Bd.* 376 F.3d 471, 478 (5th Cir. 2004). (Energy Reorganization Act whistleblower claim may be defeated by employer's policy and employee's failure to make complaint under that policy).

Although there are numerous issues relating to Section 806 and publicly traded companies, those are not this article's ultimate focus. Rather, this article addresses the question(s) of whether and when *privately held* companies may be liable under the Act's whistleblower provisions.

Many privately held companies believe they are *not* covered by SOX. That belief is well-founded as to the Act's provisions regarding auditor independence, enhanced financial disclosures, and other provisions which by their nature and terms apply only to publicly traded companies. Together with SOX document retention requirements, however, the Act's whistleblower protections appear broader.

The Law Regarding Publicly Held Companies And Private Subsidiaries

In *Gonzalez v. Colonial Bank*, 2004-SOX-39 (ALJ Aug. 20, 2004), the complainant's employer was a non-publicly traded company. The employer argued that it was not a covered employer under Section 806. The complainant had amended his complaint, however, to add his employer's publicly traded parent company as another respondent. He claimed that the parent and subsidiary were jointly managed, and that the parent's action affected his employment. Because the parent was a named respondent, and because Congress had intended to protect employees of subsidiaries of publicly traded companies, the ALJ denied the employer's motion for summary decision.

Other decisions are seemingly to the contrary. In *Powers v. Pinnacle Airlines, Inc.*, 2003-AIR-12 (ALJ Mar. 5, 2003), for instance, the complainant alleged she had been harassed and intimidated by the respondent in retaliation for having voiced concerns about flight and duty time under Federal Aviation Regulations. She further alleged that the respondent had violated Section 806 because she raised concerns regarding the accuracy of the respondent's on-time flight data and that data's fraudulent impact on shareholders. The ALJ dismissed the SOX complaint because the respondent was not a publicly traded company.

The complainant (Powers) attempted to cure this deficiency by naming Northwest Airlines, Inc., Pinnacle's parent, as a party. The ALJ, however, held that Powers could not "get around the fact that her Employer, Pinnacle, is not a publicly traded company by unilaterally adding another corporate entity that is publicly traded, *i.e.*, Northwest Airlines, Inc. as a respondent, after the investigation and determination by OSHA." The ALJ also found that adding Northwest as a respondent "ignores the general principle of corporate law that a parent corporation is not liable for the acts of its subsidiaries. In other words, the mere fact of a parent-subsidiary relationship between two corporations does not make one company liable for the torts of its affiliate. *United States v. Bestfoods, et al.*, 524 U.S. 51, 61 (1998). Nor has the complainant even alleged any facts that would justify piercing the corporate veil and ignoring the separate corporate entities."

Can the subsidiary of a publicly traded company be held liable under Section 806 for retaliatory conduct *by the subsidiary*? At least one case – *Morefield v. Exelon Services, Inc.*, 2004-SOX 2 (ALJ Jan 28, 2004) – appears to say "yes." In *Morefield,* both the corporate parent and a subsidiary were named respondents. The complainant had been employed by the privately held subsidiary, and there was no evidence that the subsidiary's employment decisions (either generally or with regard to the complainant) had been controlled by the publicly held parent. The ALJ nonetheless denied motions to dismiss the subsidiary from the case, stating:

"The publicly traded entity is not a free-floating apex. When its value and performance is based, in part, on the value and performance of component entities within its organization, the statute ensures that those entities are subject to internal controls applicable throughout the corporate structure, that they are subject to the oversight responsibility of the audit committee, and that the officers who sign the financials are aware of material information relating to the subsidiaries. A publicly traded corporation is, for Sarbanes-Oxley purposes, the sum of its constituent units; and Congress insisted upon accuracy and integrity in financial reporting at all levels of the corporate structure, including the non-publicly traded subsidiaries. …" *Morefield*, Slip op. at 5-6.

Relying on legislative purpose and intent, the ALJ reasoned more broadly: "[I]t does not serve the purposes or policies of the act to take too pinched a view of this remedial statute when it comes to protecting those in an organization who can address the concerns Congress sought to correct." *Id.* at 4.

However, *Klopfenstein v. PPC Flow Technologies Holdings, Inc.*, 2004-SOX-11 (ALJ July 6, 2004), appears to say "no." There, the ALJ considered whether the complainant's failure to name a publicly traded company as a respondent should result in dismissal of the complaint. The complainant was employed by a limited partnership, which was owned by a holding company. Neither the limited partnership nor the holding company was publicly traded. The holding company in turn was owned by a corporate parent, which was publicly traded. For unexplained reasons, the complaint named only the holding company and the limited partnership's vice president for finance. The vice president had investigated some of the complainant's business practices at the holding company's request, but made no recommendations as to what should be done.

The holding company moved to dismiss, arguing that SOX covers only publicly traded companies. The ALJ agreed with the complainant that employees of non-public subsidiaries of publicly traded companies can be covered by Section 806, citing *Morefield v. Exelon Services*, *supra.* The ALJ also found that, had the complainant named the publicly traded parent, the commonality of management and purpose would likely have sufficed to support whistleblower protection. Because the complainant had only named a subsidiary of the parent, however, which subsidiary was neither the complainant's employer nor a publicly traded company, the ALJ dismissed the complaint. According to the ALJ: "Despite the apparent legislative intent to attach liability to publicly traded companies who surround themselves by other entities under their control, it does not seem the Act provides a cause of action directly against such subsidiary alone." *Klopfenstein*, Slip op. at 12. Notably, the ALJ also rejected the complainant's argument that the holding company was an agent of the parent company. And the ALJ further found that the individually named vice president of finance was not a proper party to the action because he was not an officer, employee, contractor, subcontractor, or agent of the publicly traded parent.

Klopfenstein seemingly stands for several propositions, not all of which are altogether consistent. For one, the case seems to say that a parent can, under some circumstances, be liable for its retaliatory conduct against a subsidiary's employee. For another, the case seems to say that a publicly traded parent cannot "contract out" its retaliatory conduct by having the dirty work done by a subsidiary. Yet in the next breath the case says that the subsidiary will not be held liable; the employee must proceed against the publicly traded parent (or at least against both entities).

A few common threads run through the case law. First, where the publicly held parent is a named respondent, and where the parent has exercised control over the employing subsidiary's personnel decisions, an employee of the subsidiary may proceed under the 806. Second, where the employee works for a subsidiary and the alleged wrongdoer is the publicly traded parent, failure to name that publicly traded parent will likely foreclose a SOX whistleblower action. *See Powers v. Pinnacle*, *supra*; *Klopfenstein*, *supra*.

But the case authority to date seems irreconcilable in some regards. *Powers v. Pinnacle*, *supra*, says that the employee of a non-publicly traded subsidiary claiming retaliation by that subsidiary is not protected by Section 806. Conversely, *Morefield v. Exelon*, *supra*, allowed the employee of a subsidiary to pursue a claim alleging retaliation by that subsidiary. Granted, a publicly traded parent (Exelon) was named as a respondent in *Morefield*. But it was not alleged that Exelon had controlled the subsidiary's personnel actions or that Exelon itself had been the retaliating decision-maker.

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