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Client Alert

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Privately Held Subsidiaries of a Public Company and Their Employees May Be Liable Under the Sarbanes-Oxley Act

The Administrative Review Board of the U.S. Department of Labor broke new ground in a Sarbanes-Oxley Act ("SOX") whistleblower case brought by an employee of a privately held subsidiary of a public company. The Board held that a private subsidiary or its employees may be covered by SOX under an agency theory of liability. Moreover, the Board ruled that it did not matter that the employee did not believe that anything fraudulent had occurred, because SOX applies to a disclosure of any conduct that the employee reasonably believed violated a Securities and Exchange Commission ("SEC") rule, and not just fraud. Finally, the Board applied a low standard for causation, concluding that a terminated employee need prove only that retaliation was a "contributing factor" in the discharge decision. *Klopfenstein v. PCC Flow Techs. Holding Inc.*, DOL ARB, No. 04-149, 5/31/06.

Complainant Keith Klopfenstein was employed as Vice President of Strategic Operations for Flow Products, Inc. ("Flow"), one of a number of private business entities owned by PCC Flow Technologies Holdings, Inc. ("Holdings"), a non-public company. Holdings was wholly-owned by a publicly traded corporation, Precision Castparts Corp. ("PCC"). In late 2002, Klopfenstein noticed that balance sheets for Flow showed substantially more prepaid inventory in transit overseas than shipping documents reflected. Klopfenstein did not believe that any fraud was involved, but said he thought the data should be corrected, because it could affect the accuracy of Flow's financial statements. His subordinate, whom he had asked to investigate the imbalance, reported it to Allen Parrott, Flow's Vice President of Finance.

Klopfenstein asserted that he became concerned when, despite assurances, the Flow finance department did not correct the discrepancy. He began adding a footnote in his weekly inventory reports to management concerning the discrepancy. Not long after, Debbie Kramer, a PCC employee, was assigned to reconcile the inventory imbalances and determine what had occurred. At around that same time, Flow's CFO stated that the inventory imbalances were a "large exposure" that needed to be addressed. Outside auditors had also spotted the inventory imbalances as a problem to be corrected. To avoid any material misstatement of its accounts, Flow made adjustments to correct the balances and write off any differences.

Kramer's investigation, however, continued. In the course of her review, she discovered violations of PCC's revenue recognition policy, which applied to all subsidiaries. Parrott initiated another investigation and ultimately wrote a report concluding that Klopfenstein was responsible for those policy violations, and also blaming Klopfenstein for the inventory imbalances. Klopfenstein denied most of the accusations, admitting to only one practice that violated policy, which, he claimed, was an improvement. Wayne Robbins, President of Holdings and Executive Vice-President of PCC, made the decision to discharge Klopfenstein, based on the Parrott report and on Klopfenstein's admission of a policy violation.

Klopfenstein filed a SOX claim naming Holdings and Parrott as the only respondents. An administrative law judge ("ALJ") dismissed the case after a hearing, finding that neither Holdings nor Parrott were subject to SOX, because Holdings was a private company and neither respondent was an agent of PCC.

The Board reversed that decision and remanded the case for further factual findings. The fact that PCC, the publicly traded company, was not named as a respondent did not matter, the Board said, "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 company." *Id.* *8. Whether a private "subsidiary or its employee is an agent of a public parent for purposes of SOX . . . should be determined according to principles of the general common law of agency." *Id.* In this case, the Board noted, there was evidence suggesting an agency relationship, including commonality of officers for PCC and Holdings (the decision-maker Robbins held positions with both companies); the involvement of PCC officers and employees in Holdings' investigation; and, as to Parrott, that he conducted his investigation at the direction of managers for Holdings and PCC.

The Board also reversed the ALJ's finding that, in any event, Klopfenstein had not established that his discharge was retaliatory. The ALJ had applied a standard that required Klopfenstein to prove that he was terminated "because of" his activity, or "based on" it. According to the Board, however, the correct standard is "whether protected activity was a *contributing* factor," which is "any factor which alone or in combination with other factors, tend to affect the outcome of a decision." *Id.* *10. This standard, the Board stated, is a lesser burden for the complainant than the "significant, motivating, substantial or predominant factor standard" that has been applied in other contexts. Thus, a SOX complainant is not required to prove that the reason given for his termination was pretextual – only that there was a retaliatory motive that contributed, at least in part, to the discharge decision.

The Board provided some further guidance in sending the case back to the ALJ. The Board noted that it did not matter that others may have raised the alarm about the same issue before Klopfenstein did, nor that he did not think the inventory imbalances were fraudulent. The problems with internal inventory controls were "not clearly outside the realm covered by SOX," the Board reasoned, and the ALJ should determine whether Klopfenstein had a "reasonable belief" that the deficiencies were a "violation" of an SEC rule or regulation. Klopfenstein had cited to SEC Rule 13a-15a, which requires public companies to maintain "disclosure controls and procedures" and "internal control over financial reports," as the basis for his alleged "reasonable belief." Lastly, the Board noted that the ALJ should determine whether, "in light of his position," what Klopfenstein did was sufficient to "express" his alleged concern. To be protected activity, the Board said, the information communicated "must include expression of a concern and not just its existence."

EDITORS' COMMENT: The *Klopfenstein* case likely will have a profound and expansive affect on plaintiffs' ability to successfully assert SOX violations. Businesses should be aware of the potential for SOX claims involving private companies and their employees, where there is ownership by a public company. Further, employers subject to SOX should keep in mind that under this decision, "whistleblowing" about deficiencies in internal controls or procedures that are merely sloppy or incompetent, rather than fraudulent, may form the basis for a SOX claim, if there is some relationship to an SEC rule or regulation. Companies subject to SOX should review their whistleblower policies in light of *Klopfenstein*, to assure that such policies adequately cover associated private entities and are not limited merely to disclosures of fraudulent activity.

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