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## News

### Whistleblowers

## DOL Review Board Revives VP's SOX Case, Gives Guidance on Liability, Protected Activity

In its first significant ruling in a Sarbanes-Oxley Act whistleblower case, the Labor Department's Administrative Review Board May 31 revived the claims of a fired vice president of a private subsidiary of a publicly held Texas company (*Klopfenstein v. PCC Flow Techs. Holdings Inc.*, DOL ARB, No. 04-149, 5/31/06).

Finding an administrative law judge erred in not using the common law theory of agency to determine whether Keith Klopfenstein properly identified defendants, the ARB resurrected Klopfenstein's claim against PCC Flow Technologies Holdings. The ARB also said that an alleged SOX whistleblower is protected even if they are not the first to raise an issue about potential wrongdoing or they do not necessarily believe they are reporting "fraud" under the Securities Exchange Act.

"[W]e do not interpret the Act to require a complainant to name a corporate respondent that is itself 'registered under § 12 [of the Securities Exchange Act] 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," the ARB said in quoting the statute and setting out the standard for determining what entities are covered under SOX.

Instead, the ARB said that when determining whether a subsidiary or employee is an agent of the public parent company for purposes of the SOX, those determinations should be made "according to principles of the common law of agency."

### Alleged Financial Improprieties

Klopfenstein was employed by PCC Flow Technologies (known as Flow Products), which is a limited partnership owned by the defendant PCC Flow Technologies Holdings. Holdings is owned by the publicly traded corporation Precision Castparts Corp., and it was PCC officials who terminated Klopfenstein.

As vice president of strategic operations, Klopfenstein discovered a discrepancy in the in-transit inventory balances at Flow Products. The balances reflected substantially more prepaid inventory in transit from overseas than other documents showed, and Klopfenstein theorized that the discrepancy allowed the company to overstate its assets on the balance sheets. A write-down to correct the discrepancy could have a significant impact on income, Klopfenstein determined.

A subordinate that Klopfenstein asked to investigate the discrepancy was assured by the finance department that the problem was being addressed. After hearing no initial response to his findings, Klopfenstein became concerned that the finance department would not correct the discrepancy so he began documenting the discrepancies and raising the concerns at management meetings.

The company's finance department ultimately performed a "true-up" that wiped the discrepancy from its balance sheet and started fresh, alleging that fixing the discrepancy would result in a "massive material misstatement" on the company's books. An employee from PCC's finance department was brought in to reconcile the adjustment and remained with the company for four months.

At the same time Klopfenstein was alleging the potential improprieties, he was the subject of another company investigation accusing him of changing shipping dates to alter the company's balance sheets; he ultimately was terminated based on that investigation.

After a Labor Department investigator found no merit to Klopfenstein's claims, his allegations of SOX violations were heard by ALJ C. Richard Avery, who ruled in July 2004 that Klopfenstein was not protected by SOX because he failed to name the publicly traded parent company as the defendant (133 DLR A-1, 7/13/04 [link](#)).

### Applied Agency Analysis

In reversing the ALJ and remanding the case, the ARB said that the ALJ should rely on an agency analysis in determining whether Holdings or its vice president Allen Parrott was acting on behalf of the public company when Klopfenstein was terminated. That analysis, the ARB said, includes determining "the manifestation" by the parent company that it wanted the agents to act for it, asking whether the agent accepted the undertaking and also evaluating the understanding between the parties that the parent company was in control.

"The function of the ALJ is to ascertain whether these factual elements are present," the ARB explained. "The ALJ did not do so in this case, however, possibly because he did not begin by examining the legal standard for identifying the existence and scope of an agency relationship."

In its ruling, the ARB signaled that it was likely that an agency relationship existed between PCC and Holdings, noting there were overlapping officers and the involvement of PCC officers and employees in the investigation that took place at Holdings. These facts, the ARB said, "make more probable that Holdings was PCC's agent."

Although reversing on the question of the SOX coverage, the ARB also spoke to the merits of Klopfenstein's allegations, providing direction on what is considered protected activity.

### Protected Activity Questions

"[C]ontrary to the Respondents' arguments, we do not believe that activity is protected only when the complainant is the first to raise the issue, or when the communications relate to published information, or when the complainant believes he is reporting 'fraud,'" the ARB said. "SOX protection applies to the provision of information regarding not just fraud, but also 'violation of ... any rule or regulation of the Securities and Exchange Commission.' "

The ARB said that a complainant "need not express a concern in every possible way or at every possible time in order to receive protection," as long as the actual communications provide enough information that links the actions to a covered activity.

In Klopfenstein's case, the ARB suggested that his concerns about in-transit inventory suggested, at a minimum, incompetence in Holding's internal controls that could affect the accuracy of its financial statements. These complaints, the ARB said, represented "communications thus related to a general subject that was not clearly outside the realm covered by the SOX, and it certainly is possible that Klopfenstein could have believed that the problems were a deficiency amounting to a 'violation.' "

The ARB also scolded the ALJ for failing to apply the SOX contributing factor standard when determining causation, noting the ALJ "applied some higher standard--it is not clear which

one."

The ALJ, the ARB said, should have applied the contributing factor standard. In addition, the ARB clarified that an alleged whistleblower does not have the burden to show pretext, even if it is helpful to do so.

"Because, in examining causation, the 'ultimate question' is whether the complainant has proven that protected activity was a contributing factor in his termination, a complainant need not necessarily prove that the respondent's articulated reason was a pretext in order to prevail," the ARB concluded.

Judges A. Louise Oliver, Wayne C. Beyer, and M. Cynthia Douglass joined in the decision.

#### **Attorneys: Ruling 'Very Significant.'**

Attorneys who closely watch the emerging SOX whistleblower case law called the decision "very significant" and said that the ruling should hopefully clarify significant areas of dispute among ALJs.

"The ARB provided guidance on a key issue that has split ALJs, whether raising a concern about a violation of any SEC rule or regulation is protected conduct," plaintiff's attorney Jason Zuckerman told BNA June 9.

Zuckerman, of the Law Office of Jason M. Zuckerman in Washington, D.C., said that some ALJs had held that an employee who raises a concern to management about a violation of an SEC rule does not engage in protected conduct unless the issue implicates fraud against shareholders. That view, Zuckerman said, was rejected by the ARB.

Pointing to the ARB's suggestion that employees need only demonstrate that protected activity was a "contributing factor" in the employer's decision instead of the more daunting burden of "motivating factor," Zuckerman said "if ALJs will simply apply the plain meaning of SOX, corporate whistleblowers will have robust protection."

Agreeing with the significance of that finding, Klopfenstein's attorney, Marc E. Grossberg, told BNA June 9 that "protecting shareholders is served whether it is fraud or incompetence" and that employees should be protected even if they do not allege "fraud." Grossberg and Stephen F. Fink--of Thompson & Knight in Houston--represented Klopfenstein.

Reacting to the ruling, Grossberg said he was "pleased with the decision" and said he was "confident now that the law has been clarified, we expect the ALJ to rule in our favor, and we can get the relief we requested."


#### **ALJs 'Implicitly and Explicitly' Divided**

Management attorney Connie M. Bertram of Winston & Strawn in Washington, D.C., agreed that the ruling "may be the most significant ruling yet" on SOX and said that the ARB provided greater direction on the question of what was protected activity.

Saying ALJ's were "implicitly and explicitly" divided over what was necessary to show protected activity, Bertram said the ARB's ruling would likely answer many of the questions that have been raised by the differing rulings by the ALJs. Although cautioning that not needing to prove "fraud" does not mean that the alleged violation still needs to be connected to something reportable to the Securities and Exchange Commission, she said the guidance was welcomed by attorneys on both sides.

Bertram also praised the guidance on what test should be used in determining whether a private subsidiary of a public company was covered by SOX.

"The ALJs had been very divided on the proper way to analyze this issue, with some ALJs suggesting an alter ego analysis while others suggested a piercing the corporate veil analysis," said Bertram. By pointing specifically to the Restatement on Agency, the ARB has given attorneys a much clearer sense of how to plead a case and also how to defend an action, Bertram said.

*Text of the decision appears in Section E.*  

*By Michael R. Triplett*

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