FINANCIAL FRAUD LAW REPORT

VOLUME 3 NUMBER 2 FEBRUARY 2011

The FINANCIAL FRAUD LAW REPORT is published 10 times per year by A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207,

For subscription information and customer service, call 1-800-572-2797. Direct any editorial inquires and send any material for publication to Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 10 Crinkle Court, Northport, NY 11768, smeyerow@optonline.net, 631-261-9476 (phone), 631-261-3847 (fax). Material for publication is welcomed — articles, decisions, or other items of interest.

POSTMASTER: Send address changes to the Financial Fraud Law Report, A.S. Pratt & Sons, 805 Fifteenth Street, NW., Third Floor, Washington, DC 20005-2207. *ISSN 1936-5586*

Retaliation Claim by Investment Manager's Chief Compliance Officer Is Barred by New York's Employment-At-Will Doctrine

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The author examines a recent New York state appellate court decision finding that New York's employment-at-will doctrine bars a retaliation claim by the former chief compliance officer of an investment manager who claimed he was discharged after questioning a superior's alleged illegal securities trading activity.

New York is an "employment-at-will" state, which means that, generally speaking, employers are permitted to discharge employees without employment contracts for any reason or no reason at all, subject to a very limited number of exceptions. Recently, an intermediate New York state appellate court was asked to decide whether there should be an exception to the employment-at-will doctrine for an employee who claimed that his superior had retaliated against him by discharging him following his internal inquiries into the superior's alleged illegal trading activity, in violation of his firm's code of ethics.

Somewhat surprisingly, given the emphasis that federal and state governments have given to stamping out financial fraud over the past couple of years, the appellate court held that in this case such an exception to the employment-at-will doctrine did not exist, and, in the absence of a

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Published in the February 2011 issue of *The Financial Fraud Law Report*.

specific contractual provision protecting the employee from termination, his claim that he had an implicit contractual right not to be fired had to be dismissed.[1]

The court's decision left open the possibility that a similar claim based on specific contractual provision limiting such an employee's discharge would withstand a motion to dismiss. The ruling, however, would seem to be counter to the trend of whistleblower protection and the general public policy goal of limiting financial fraud by encouraging and protecting employees who attempt to investigate or disclose it. It remains to be seen whether the decision will lead to statutory or regulatory reform, or to a change in contractual provisions in the investment manager industry.

BACKGROUND

As the court explained, the corporate defendants, Peconic Partners LLC and Peconic Asset Managers LLC ("Peconic"), were institutional investment managers and registered investment advisors. Defendant William F. Harnisch was the majority owner and president of both companies, and maintained full management control over them. The business of Peconic was subject to the oversight of the U.S. Securities & Exchange Commission. Between September 28, 2008 and October 13, 2008, the plaintiff, Joseph Sullivan, was Peconic's chief compliance officer ("CCO") and chief operating officer, and held a 15 percent ownership interest in Peconic.

As mandated by federal law,[2] Peconic maintained a written code of ethics (the "Code") that all of its employees were required to follow. Section I.2 of the Code required the CCO, "on pains of termination," to "determine," when alerted, whether an employee or member of Peconic had engaged in any Code violation.

Peconic also disclosed to its current and prospective clients, and filed with the SEC, a document entitled Part II Form ADV that, among other things, outlined what controls were in place to ensure compliance with state and federal rules and regulations.

Peconic employees were permitted to maintain and manage proprietary securities accounts. All employees, however, were required to obtain consent from the CCO before engaging in any trades on their own behalf.

Proprietary trading was further restricted by the Form ADV and Code restrictions on taking advantage of investment opportunities that should first be accorded to clients.

According to the court, Peconic had staked large sums of its investors' capital on the fertilizer industry, mostly with Potash Corp. of Saskatchewan, Inc. and a related company, Mosaic Corp. Prior to September 2008, Harnisch personally held over $100 million in Potash stock, and his clients held approximately $60 million worth of the same stock.

On September 29 and 30, 2008, Harnisch allegedly sold two thirds (784,085 shares) of his Potash shares at $132 per share, without either pre-clearing the trades with Sullivan or notifying Peconic clients who owned holdings in Potash. Also allegedly in violation of the Form ADV and Code, these actions were taken without Harnisch making similar trades for the firms' clients. According to the court, upon learning of the sales, Sullivan blocked the October purchase of Potash shares with new client investment monies until he could determine why Harnisch had sold from his own accounts and not for Peconic clients.

On October 1, 2008, Mosaic released a disappointing third quarter earnings report. By the market opening on the next day, its stock price had dropped more than 15 percent. On October 2, 2008, Peconic sold half of the shares of Potash stock held in client accounts (230,000 shares) at an average price of $103 per share. Peconic's clients were estimated to have lost $6,670,000 by not having their Potash stock sold at the same time that Harnisch sold his personal Potash shares. Harnisch thereafter allegedly sold the remaining shares of Potash held in his personal accounts (243,900 shares) on October 6, 2008, without selling any of the remaining 229,965 shares of Peconic's clients' Potash stock.

Sullivan claimed that after reviewing Harnisch's September 29 and 30 Potash sales against Peconic's October 2 trading activity on behalf of clients, he believed, in his professional judgment, that Harnisch had engaged in "front running," a practice specifically forbidden by Peconic's SEC Form ADV and its Code, as well as its compliance manual.

On October 6, 7, and 8, 2008, Sullivan questioned Harnisch about the apparent front running, and Harnisch allegedly refused to provide Sullivan with any explanation. On October 10, 2008, when all the data necessary to complete the review of the Potash trades would have become available, Harnisch, according to Sullivan's complaint, summarily terminated the employment of Sullivan and nonparty Daniel Otmar, the deputy compliance officer; wiped out all of Sullivan's computer data, including Peconic's trading logs; and expelled Sullivan from Peconic's partnership.[3]

Sullivan brought suit against Peconic on November 10, 2008, alleging a claim for retaliatory firing as well as claims regarding the defendants' refusal to pay Sullivan the value of his ownership interest in Peconic. Included in the original complaint were the names of four corporate investors set forth as part of the allegations that Harnisch had breached his fiduciary duty to the Peconic clients by his September 29 and 30 Potash trades. After the original complaint was filed, copies were released to the media. The defendants subsequently moved to strike the names of the clients, and the motion was granted in an order entered February 6, 2009. The court specifically stated, in relevant part, "The information is prejudicial as there is no denial that Peconic's client information is deemed confidential and protected by the Peconic companies."

Sullivan filed an amended complaint on March 10, 2009, that asserted nine causes of action, including the following five causes of action: breach of implied contract of employment (second), tortious interference with Sullivan's contractual relationship with Peconic and third parties (third), fraud (fourth), conspiracy to defraud (fifth), and breach of fiduciary duties (eighth).

In their answer, the defendants alleged 10 counterclaims, including that the plaintiff had damaged the defendants because Sullivan's complaint had identified certain clients in violation of Sullivan's continuing obligation of confidentiality, and then Sullivan had disseminated the complaint publicly. Certain of those clients, it was alleged, subsequently withdrew their funds from Peconic accounts.

After cross-motions to dismiss certain of the causes of action and the counterclaims, the trial court dismissed the first counterclaim, and denied the defendants' motion to dismiss the five causes of action noted above.

While acknowledging an employer's right to terminate an at-will employee under normal circumstances, the trial court found that, at this pre-discovery stage, an "express limitation" to the at-will discharge rule might result from the language found both in the Peconic handbook prohibiting retaliation, and also from the Code language specifically requiring the CCO to report complaints to the SEC.

THE APPELLATE RULING

In its decision on appeal, the intermediate appellate court explained that it was "axiomatic" in New York that "where an employment is for an indefinite term it is presumed to be a hiring at will which may be freely terminated by either party at any time for any reason or even for no reason."[4] Moreover, the appellate court continued, absent "a constitutionally impermissible purpose, a statutory proscription, or an express limitation in the individual contract of employment, an employer's right at any time to terminate an employment at will remains unimpaired."

The appellate court acknowledged that the Peconic code of ethics required that each person report to the CCO all purchases and sales in any security in which the person had any beneficial interest, and required that each employee pre-clear trades with the CCO. Additionally, the Code (as well as the Form ADV) required the CCO to report to the chief operating officer and the president, following the receipt of any employee trading information, any apparent violation of the reporting requirements of the Code.

The appellate court then ruled: "As hard as the result may seem, however, nothing in either document protects the CCO from being terminated, even though the Code authorized Sullivan to make his complaint to the SEC." In the appellate court's view, courts should not "infer a contractual limitation on the employer's right to terminate an at-will employment absent an express agreement to that effect which is relied upon by the employee."

The *Peconic* appellate court observed that New York's highest court, the Court of Appeals, in *Wiener v. McGraw Hill, Inc.*,[5] found that a cause of action for breach of an employment contract was sufficiently stated by a security guard who was able to point to specific language in the employee handbook that stated that the employer would "resort to dismissal for just and sufficient cause only, and only after all practical steps toward rehabilitation or salvage of the employee have been taken and failed."[6]

On the other hand, the appellate court in the *Peconic* case noted, four months later, in *Murphy v. American Home Prods. Corp.*,[7] the Court of Appeals rejected the claim of a discharged, at-will employee who had reported accounting improprieties but who was relying only on an implied covenant of good faith to support his breach of contract claim.[8] As the appellate court in the *Peconic* case pointed out, the Court of Appeals in *Murphy* made clear that it believed that any changes in what it viewed as a public policy matter should be made by the New York legislature.[9]

The *Peconic* appellate court also noted that the at-will doctrine had been reaffirmed by the New York Court of Appeals in *Sabetay v. Sterling Drug*.[10] There, the plaintiff allegedly had refused to participate in illegal activities and was terminated. He argued that since the personnel manual enumerated seven grounds for termination, and also required an employee to refrain from illegal and unethical activity, there was an implied promise that he could not be terminated for any other grounds. The Court of Appeals held that because there was no express limitation on the employer's unfettered right to terminate at will, all the breach of contract causes of action had to be dismissed. The Court of Appeals observed that statements in the manual and employment application requiring employees to adhere to company rules "merely suggest standards set by [the employer] for its employees' performance of their duties that, without more, cannot be actionable."[11]

The appellate court in *Peconic* stated that the "only retreat" from the employment-at-will doctrine by the Court of Appeals had been reached in *Wieder v. Skala*[12] — a case that the appellate court in *Peconic* stated was "sui generis." In *Wieder*, an associate at a law firm claimed that he had been discharged for insisting that the firm report unethical conduct of another associate at the same firm, which conduct included numerous alleged misrepresentations and acts of malpractice against clients and acts of forgery of checks drawn on the firm's account. The Court held that the associate had stated a valid claim for breach of contract based upon an implied-in-law obligation in his relationship with the law firm. It reasoned that intrinsic to the relationship between the associate and the law firm was an unstated but essential compact that in conducting the firm's legal practice, both the associate and the firm would do so in compliance with the prevailing rules of conduct and ethical standards of the legal profession. The firm's alleged insistence that the associate, as an attorney in its employ, act unethically and in violation of Code of Professional Responsibility DR l-103(A) amounted to nothing less than a frustration of the only legitimate purpose of the employment relationship:

> [I]n any hiring of an attorney as an associate to practice law with a firm there is implied an understanding so fundamental to the relationship and essential to its purpose as to require no expression: that both the associate and the firm in conducting the practice will do so in accordance with the ethical standards of the profession. Erecting or countenancing disincentives to compliance with the applicable rules of professional conduct, plaintiff contends, would subvert the central professional purpose of his relationship with the firm — the lawful and ethical practice of law.[13]

The *Peconic* court observed that *Wieder* had not been applied to a business or profession other than the practice of law.[14] Indeed, it added, it had in the past specifically declined to extend the *Wieder* exception to an auditor employed by a brokerage house.[15] In that case, the *Peconic* court noted that *Wieder* was grounded in the "unique characteristics of the legal profession," although *Wieder* did leave open the potential for a cause of action for breach of express contract based upon a provision in the defendant's employment manual that specifically provided that an employee who reported wrongdoing would be "protected against reprisals." The *Peconic* court noted, however, that such language, express or otherwise, did "not appear in the Peconic handbook."

Thus, the *Peconic* court ruled, the second cause of action asserted by the plaintiff, for breach of implied contract, should have been dismissed, because it was based on the erroneous premise that the company's "speak out" policy itself protected an at-will employee such as Sullivan. Notwithstanding his employment responsibilities, and the conflict posed, "he did not have either an express or implied right to continued employment." The *Peconic* court acknowledged that "some may disagree," but it stated that absent extension of the *Wieder* exception by the Court of Appeals, or action by the legislature, the existing precedent mandated this result.

It should be noted that the *Peconic* court decided that the third cause of action for tortious interference with advantageous and prospective advantageous business relations should not be dismissed. That cause of action alleged that by terminating Sullivan and by threatening parties that did business with Peconic, Harnisch had interfered with Sullivan's relations with Peconic, as well as with the third parties. The language of the cause of action appeared to suggest that the business relations with Peconic encompassed not only Sullivan's employment with Peconic, but also his ownership interest in the company. The *Peconic* court ruled that, to the extent the third cause of action asserted claims concerning the ownership interest, as well as claims concerning the alleged interference with other third parties, it could stand. However, the *Peconic* court decided that any claims for damages based on loss of employment could not be sustained.

The *Peconic* court also found that the trial court had not erred in refusing to dismiss the fourth, fifth, and eighth causes of action for fraud, conspiracy to defraud, and breach of fiduciary duty, respectively. The *Peconic* court observed that the defendants argued that these claims were but an alternative way for plaintiff to plead his meritless claim of wrongful discharge, and they relied on case law that held that the employment-at-will doctrine could not be "circumvented by casting the cause of action in terms of tortious interference with employment."[16]

According to the *Peconic* court, however, these three causes of action alleged more than conduct resulting in the wrongful termination of Sullivan's employment. In the fourth cause of action for fraud or attempted fraud, for instance, Sullivan alleged, among other things, that the defendants represented that he was a 15 percent owner of Peconic and was entitled to 33 1/3 percent of the profits, but that the defendants never intended to provide him with his entitlement.

Likewise, in the fifth cause of action, Sullivan alleged that the defendants conspired to defraud him of his ownership and management of the companies (as well as his employment and career). In the eighth cause of action, Sullivan alleged that Harnisch had breached his fiduciary duties against Sullivan, a co-member of the limited liability companies, by expelling Sullivan and, among other things, denying him his share of due profits and ownership interests.

Thus, the *Peconic* court found, all three of these causes of action sought compensation for property rights that arose, at least in part, from something other than a claim of wrongful discharge, and should not be dismissed. To the extent they raised such claims, they remained viable, but the *Peconic* court cautioned that any claims relying on the argument that Sullivan was wrongfully discharged could not be entertained.[17]

CONCLUSION

The appellate ruling in the *Peconic* case is a notable decision. Whether it is likely to lead to statutory or regulatory change of course remains to be seen. The message it sends to chief compliance officers — and other employees who believe they have found unlawful conduct — is quite straightforward, however. It is: Be careful.

NOTES

1 *Sullivan v. Harnisch*, No. 115092/08 (1st Dep't Dec. 21, 2010).

2 *See, e.g.*, 17 CFR 275.206(4)-7.

3 Sullivan did not allege that he made any complaint to the SEC or any other government agency.

4 *See, e.g., Wieder v. Skala*, 80 N.Y.2d 628 (1992); *Murphy v. American Home Prods. Corp.*, 58 N.Y.2d 293 (1983).

5 57 N.Y.2d 458 (1982).

6 *Id*. at 460.

7 58 N.Y.2d 293 (1983).

8 *Id*. at 304-05.

9 *Id*. at 301-02.

10 69 N.Y.2d 329 (1987).

11 *Id*. at 336.

12 80 N.Y.2d 628 (1992).

13 *Id*. at 636.

14 *See, e.g., Haviland v. J. Aron & Co*., 212 AD2d 439, 440-41 (1st Dep't 1995), *lv denied* 85 N.Y.2d 810 (1995) (plaintiff, who claimed to have been fired for refusing to breach confidentiality of clients, was hired as a broker and not a lawyer, and any services rendered to employer were not sufficient to bring claim within narrow exception of *Wieder*); *see also Horn v. New*

York Times, 100 N.Y.2d 85 (2003) (plaintiff physician's duties as Associate Medical Director arose not solely from her knowledge as a physician, but also in furtherance of her responsibilities as part of corporate management).

[15] *See Mulder v. Donaldson, Lufkin and Jenrette*, 208 A.D.2d 301 (1st Dep't 1995).

[16] *See, e.g., Barcellos v. Robbins*, 50 AD3d 934 (2d Dep't 2008), *lv denied* 11 N.Y.3d 705 (2008).

[17] The *Peconic* court also ruled that the trial court had erred in dismissing the first counterclaim. It noted that, in granting that part of the motion, the trial court observed that Sullivan was an at-will employee and that fiduciary duties did not exist between an employer and an at-will employee. The trial court further held that the defendants "failed to allege a binding confidentiality agreement." According to the appellate court, this determination was inconsistent with its prior order in which it found that Peconic's client information was confidential, and directed that the names of the clients should be stricken from the complaint. According to the appellate court, it was "premature" for the trial court to determine that the obligation to keep the identities confidential did not apply to an at-will employee, especially in view of the confidentiality provision of the firm's code of ethics, which appeared to apply to all employees, and which specifically recited, "Client and Client account information is also confidential and must not be discussed with any individual whose responsibilities do not require knowledge of such information."