And You Thought the Bailout Was Bad: Employment Law Risks in the Current Financial Crisis

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As the current economic crisis escalates and governmental plans to provide billions of dollars to intervene in the capital markets take shape, financial institutions and other businesses are being forced to restructure their operations through merger, acquisition or reductions in force. The tough economic climate will also, no doubt, lead companies to reassess their benefit plans and executive compensation packages. However, employers must evaluate their own responses to these developments to ensure that they are complying with legal requirements and proceeding cautiously. There are several, critical employment law issues that must be taken into account in any organization's plan to address the new economic realities especially if reductions in force are a part of the organization's strategy.

Reductions in Force - Do You Have to Give Advance Notice? Federal and State WARN Requirements

The federal Worker Adjustment and Retraining Notification Act (WARN), and various state statutes based on WARN, require as much as 60- to 90-days' advance notice before certain layoffs can be implemented. These statutes compel back pay where proper notice is not given to affected employees and/or their union representatives, or to government officials, if the number of employees being let go exceeds statutory thresholds. Where a WARN notice is required but cannot be made, the anticipated savings may have to be offset by damages that would have to be paid in the absence of the required advance notice.

The WARN Act is highly complex, and it is often difficult to understand how it applies to a particular layoff situation. A close analysis of a layoff situation may reveal that no notice at all is, in fact, required when a company is about to budget for damages for not giving notice. There are also two exceptions to the obligation to provide notice in the current economic climate: the faltering company exception[1] and the unforeseeable business circumstances exception.[2]If either exception is applicable, however, a company must still give as much notice as it can, and the company must within the shortened notice give a statement of the basis for the shorter notice.[3]

The *faltering company exception* applies only to the shutdown of an employment site and not to the closing of a business unit within a site nor to mass layoffs. To invoke it, a company must demonstrate that: (1) it was actively seeking capital or business at the time notice would have been given (60 days prior to the shutdown); (2) there was a realistic opportunity to secure the capital or business; (3) the financing or business would have been sufficient to avoid or postpone the shutdown; and (4) giving notice would have precluded the employer from obtaining the capital or business.[4>] The employer bears the burden of proving the particular circumstances that trigger the exceptions.[5] In one recent case, a company did not qualify for the exemption because its single inquiry of a finance company did not demonstrate that it was "actively" seeking financing.[6] At least one court has held that coordinating a potential sale of the facility is not the same as seeking financing and denied application of the faltering company exception where the company was seeking a buyer rather than seeking financing.[7] Another company could not rely upon the exception because, while it satisfied the first three requirements, it did not demonstrate that notice would have prevented it from obtaining the financing it was seeking.[8]

The *unforeseeable business circumstances exception* refers, generally, to matters outside the employer's control.[9] The WARN Act regulations provide that an important indicator of a business circumstance that is not reasonably foreseeable is that the circumstance is caused by "some sudden, dramatic, and unexpected action or condition outside the employer's control." Examples of such circumstances include a client's sudden and unexpected termination of a contract, a strike at a major supplier, unanticipated and dramatic economic downturn, or a government-ordered closing of an employment site that occurs without prior notice.[10]

Courts, however, have been reluctant to apply this exception to a company whose financial condition was poor on the date normal notice would have been required, and the poor financial condition just got worse.[11] It remains to be seen whether the current financial crisis will be deemed to yield the sort of a dramatic economic downturn contemplated by this exception, but there clearly are strong arguments for its application.

Under the WARN Act, employers are liable for back pay for every day of violation, up to 60 days. The Third Circuit (unlike others) has interpreted this to mean up to 60 days of pay, rather than, simply, the pay the employee would have received for each of his/her workdays had the required notice been given.[12]

A growing group of states have also enacted WARN-like legislation:

- California (applies to facilities that have employed 75 or more within a year, and counts layoffs differently than federal WARN);[13]
- Connecticut (employer pays for health care for a period of time);[14]
- Illinois (applies to layoffs of as few as 25 employees);[15]
- Maine (requires severance pay);[16]
- New Hampshire (special notice if as few as 25 employees are laid off in the same week);[17]
- New Jersey (severance pay may be required if notice not given);[18]
- New York (effective February 1, 2009, applies to layoffs of as few as 25 employees, and requires 90 days' notice);[19]

- Tennessee (applies to employers of between 50 and 99 employees);[20]
- Wisconsin (applies to layoffs of as few as 25 employees);[21]
- Virgin Islands (requires 90 days notice).[22]

In addition to the supplementary WARN statutes listed above, an employer should review the requirements of each state for employment terminations.

In Advance of a Workforce Reduction, Employers May Wish to Establish an ERISA-Governed Severance Plan

The current economic crisis may lead employers to consider reductions in force. Employers that are considering reductions in force and providing severance payments to laid-off employees may wish to consider establishing a severance plan governed by the Employee Retirement Income Security Act (ERISA). One advantage in having an ERISA-governed severance plan is that it provides many protections to employers who are sued by employees in connection with severance benefits. Under such a plan, an internal “claims procedure” would need to be exhausted prior to an employee being able to proceed to court. Pursuant to the terms of an ERISA-governed severance plan, an employer may construe ambiguous terms in its sole discretion as long as its determination was not found to be arbitrary and capricious. A court has recently held that a claims administrator could have a conflict of interest if it was also the payor of benefits and that this fact might need to be taken into account in determining whether a claims decision was arbitrary or capricious. However, it is still widely believed that the standard of review in an ERISA-governed plan will be superior to that of a plan that is not governed by ERISA. Another advantage of an ERISA-governed severance plan is that the claims brought in state court could be removed to federal court. This is critical because many state laws regarding severance pay are more favorable to employees than federal law. This advantage takes on added importance for employers with operations in multiple states.

In order to establish an ERISA-governed severance plan, an employer will need to prepare a plan document and a summary plan description (these may found in the same document). The summary plan description will need to be distributed to eligible plan participants (generally those who would be eligible to participate in the plan in the event of an eligible termination of their employment). The employer will also need to file Form 5500 annual reports with the government. A valid plan must provide for an ongoing administrative scheme, so, ideally, its provisions should be used for more than a single workforce reduction. It is permissible for the plan to provide some discretion to an employer to provide greater benefits than the formula-based benefits contained in the plan so a plan is no bar to employer flexibility.

It should be noted that once the steps have been taken to develop an ERISA-governed severance plan, compliance with ERISA’s rules must be taken seriously. Failure to timely file Form 5500s can result in a $1,000 per day penalty imposed by the Department of Labor, and a failure to distribute summary plan descriptions can lead to a $110 per day penalty. Nonetheless, the advantages of maintaining an ERISA-governed plan should outweigh the administrative requirements imposed on employer-plan sponsors.

Additional Considerations for Implementing Reductions in Force

Reductions in force often breed litigation. Employers should be prepared to train managers and use other precautions (such as vetting of decisions by senior HR and legal personnel) to ensure not only that improper factors were not considered in making layoff decisions but that, to the extent possible, each such decision is defensible. It may be advisable to perform disparate impact analyses to determine whether layoff decisions are disproportionately affecting any protected classes of employees and, if so, whether the decisions are justified and explainable. In some instances, to avoid age discrimination claims (as well as to protect morale and ensure continued productivity), it may be wise to offer older employees the opportunity to bump back to lower-paying jobs they successfully performed in the past, rather than include them in the termination program.

Employers typically require employees to sign release agreements in return for the receipt of severance payments in both voluntary and involuntary layoff programs. However, the law of releases has been changing rapidly, so employers should not rely on the release agreements they used even just a year or two ago. Releases are subject to many requirements under both federal and state law, and they are too often successfully challenged by employees who choose to sign the release, accept the severance pay, and sue anyway, using the severance pay itself to fund their lawsuit. However, "tender back" provisions may themselves invalidate the release. In addition, the Older Workers Benefit Protection Act (OWBPA) contains strict, but complicated, disclosure requirements, that will invalidate a release if the employer does not strictly comply. Employers are well advised to involve counsel early to help draft these disclosures and "get it right."

Consider the Unenforceability of Noncompete Agreements Following a Layoff

In some instances, noncompete agreements will not be enforceable where an employee is laid off through no fault of his or her own.[23] Thus, employers who hope to rely on such agreements should carefully review them with counsel, and perhaps make strategic decisions regarding who should be laid off or whether additional consideration should be offered to ensure continued enforceability of and compliance with noncompete agreements after the layoff.

Employers Planning to Cut Back on Benefits Should Do So with Care

As the economic noose tightens, employers are bound to consider cutbacks in benefits and impose greater cost sharing with employees. In the health plan arena, employers have, for years, been passing along a greater share of the costs to employees. This cost sharing has generally been in the area of higher premiums, deductibles and co-pays under medical plans. An economic downturn is certain to accelerate this trend, even in the face of employee resistance to further cost-sharing. Employers may also look to retirement plans and reductions in future plan benefits.

One area where employers will likely accelerate cutbacks is retiree health care and other retiree benefits. Rising costs of post-retirement benefits have caused employers that offer such benefits to expend about one-third of their total medical spending on these benefits. What was once a staple of large employers is now offered by less than one in three employers today. These crippling expenditures will surely make these benefits the subject of fierce bargaining in negotiations with union representatives. This is because workers without these benefits spend a significant percentage of their retirement income on medical care, especially those retiring before government benefits kick in at 65. Legal battles are commonly waged between employers and unions over the terms of collective bargaining agreements, with unions arguing that employers cannot change the benefits for retirees even after existing collective bargaining agreements expire on account of the language contained in expired agreements. And unions have been able to prevail in some of these fights.

With non-union employees, employers generally find it easier to cut back on retiree medical benefits, which are generally "non-vested" and therefore legally unprotected. However, even non-union workers, feeling economic pressure, may legally challenge these cuts. Some employees have been able to mount successful court challenges to prohibit employers from cutting such benefits based on the language contained in written plans or other documents that, the employees claim, create contractual promises to continue to offer such benefits. Often these cases center around whether an employer has sufficiently "reserved the right" to make subsequent plan changes in plan documents. For example, in 2004, in *Abbruscato v. Empire Blue Cross and Blue Shield*,[24] the U.S. District Court for the Southern District of New York held that a 1987 summary plan description vested retirees in lifetime life insurance benefits where there was no "reservation of rights" language in the SPD, even though a reservation of rights existed in subsequent SPDs. A similar result was more recently obtained in a case dealing with retiree medical benefits in *Bland v. Fiatallis North America, Inc*.[25] Accordingly, irrespective of whether benefit cuts are currently contemplated, employers should examine the language of any legal documents that touch on such benefits to assess whether any legal obstacles may hinder their right to make future benefit cuts.

In the retirement plan arena, future cuts in accrued benefits are generally permissible. However, employers must take care to follow the notice requirements contained in ERISA and the Internal Revenue Code to avoid a challenge to the validity of these cuts by either employees or government agencies.

Potential Employer Liability Because of Retirement Savings Shortfalls

The current economic crisis may create retirement savings shortfalls that go beyond those that could potentially result from employers reducing plan benefits. Currently, the most prevalent retirement plans are defined contribution plans under which participants are permitted to direct their own plan investments. To the extent that stock market performance is below expected levels, retirement plan savings will suffer. Additionally, however, the crisis may make investors of all stripes more conservative. If retirement plan participants move their plan assets from the stock market to safer, historically lower yielding investments, this too, could, over time, erode the sufficiency of retirement plan savings.

For both of these reasons, employers should revisit the adequacy of their plan investment education efforts. Employers have a legal obligation to educate employees about plan investments and their relative risks and potential returns if they wish to avoid liability for participant investment decisions. ERISA section 404(c) creates a roadmap that employers must follow to assure that investment risk is not transferred from the participants to the employer. Many employers have not recently reviewed their 404(c) compliance strategies, and there is concern that employers could be vulnerable to legal challenge in the event of underperformance. These lawsuits could be grounded in either: (1) disappointing returns of certain equity-related investments; or (2) over-allocation by plan participants in safer, low-yielding investments.

The requirements necessary to comply with ERISA section 404(c) are not difficult to meet, but they do require dissemination of updated plan investment information as well as data that gives participant-investors the tools to make informed plan investment decisions.

Executive Compensation May Be at Risk

Tax rules permit income to be deferred by an executive if a promise to pay has been made, but only if this obligation is unfunded and subject to the claims of company creditors. Many types of executive pay are provided pursuant to unfunded promises, such as supplemental executive retirement plans (SERPs), excess benefit plans, arrangements to defer pay and/or bonuses and long-term incentive plans. Employers that are in danger of insolvency may not be able to fully meet their obligations to pay executives what has been promised to them. Executives, on their own, may buy insurance from an insurer, to insure an employer's obligations, but such insurance was tough to come by even before this financial crisis. Now, it may be nearly impossible to procure.

There may be one way to assuage jittery executives, but only if action is taken by December 31 of this year. Under Internal Revenue Code section 409A, employers have only through year-end (December 31, 2008 is the end of a transition period) to offer employees the right to change the timing of deferred pay distributions. A payment that would otherwise be made well after the end of this year can be changed to be paid at another time after 2008. For example, a payment scheduled to be paid in five years could be changed to be made in January 2009. Employers must of course act quickly if they wish to take advantage of this "transition rule" that may be eagerly sought by company executives.

Option Exchange Programs

After the dot-com bust earlier in this decade, many companies allowed their employees to participate in an option exchange or re-pricing program, when the exercise price of outstanding stock options greatly exceeded the fair market value of the company's stock. The option exchange or re-pricing program was implemented primarily to address employee retention and to reduce overhang, which is generally the dilutive effect of stock options on a company's outstanding stock.

With the current financial crisis and a change in the accounting rules, which provide for significantly lower expense charges than under prior rules, employers may want to consider an option exchange program. A company considering an option exchange program would need to assess whether the option exchange program will likely achieve the retention and reduction of overhang goals. In addition, the company should also consider the following: the accounting impact of the program, whether the equity plans allow for option exchanges, the tender offer rules and, the impact on non-U.S. employees.

An employer considering a re-pricing program must wish to consider whether the exchange of stock options should be for restricted stock, restricted stock units or cash, rather than for stock options, if overhang is the prevailing concern. However, those types of exchanges may have an impact on disparate factors such as employee tax planning and employee retention as well as company cash flow. In addition NYSE and NASDAQ have implemented rules requiring shareholder approval for option exchange programs. If the company's plan does include the express authority, shareholder approval must be sought in order for the company to offer an option exchange program. Further, an option exchange program will be subject to the tender offer rules, which require extensive disclosure of the program to the public, and the costs associated with such offers are not insignificant. Finally, if the company has participants outside of the U.S., the company will also need to consider the effect an option exchange program will have on those employees under their local laws

Conclusion

With the uncertainty that surrounds the recent economic downturn and financial system turmoil, companies will no doubt explore several cost-saving options. Many of the options being considered (layoffs, severance plans, changes in benefits, etc.) involve critical employment law issues that should not be ignored.

Employers facing dire economic circumstances also should keep in mind their fiduciary obligations to employees. State wage and hour laws may impose personal liability on business owners and executives if payroll is delayed or defaulted. Federal law imposes both civil and criminal penalties for failure to deposit payroll taxes and employee benefit plan contributions. And benefit plan fiduciaries may have an obligation to communicate accurately and timely with employees and beneficiaries, if a plan will be terminated or underfunded.

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[1] *See* 29 U.S.C. § 2102(b)(1).

[2] 29 U.S.C. § 2102(b)(2).

[3] 29 U.S.C. § 2101(b)(3).

[4] 29 U.S.C. § 2102(b)(1).

[5] 20 C.F.R. § 639.9.

[6] *In re APA Transport Corp. Consolidated Litigation*, 2008 WL 3982469 (3d Cir. Aug. 9, 2008).

[7] *Local 397, Int'l Union of Elec., Salaried, Mach. & Furniture Workers v. Midwest Fasteners, Inc.,* 763 F. Supp. 78, 83 (D.N.J. 1990).

[8] *Childress v. Darby Lumber, Inc.*, 357 F.3d 1000 (9th Cir. 2004).

[9] 20 C.F.R. § 639.9(a).

[10] 20 C.F.R. § 639.9(b)(1).

[11] *See, e.g., Childress v. Darby Lumber Co.*, 126 F. Supp. 2d 1310, 1319 (D. Mont. 2001), *aff'd*, 357 F.3d 1000 (9th Cir. 2004); *Paperworkers v. Alden Corrugated Container Corp.*, 901 F. Supp. 426 (D. Mass. 1995).

[12] *United Steelworkers of Am. v. North Star Steel Co.*, 5 F.3d 39 (3d Cir. 1993).

[13] Cal. Lab. Code §§1400 – 1408.

[14] Conn. Gen. Stat. §§31-51n, 31-51o, 31-51s.

[15] 820 Ill. Comp. Stat. 65/1 *et seq*.

[16] 26 Me. Rev. Stat. Ann. §625-B.

[17] N.H. Rev. Stat. Ann. 282-A:45-a.

[18] N.J. Stat. Ann. § 34:21-1.

[19] N.Y. Senate Bill S8212, to be codified at N.Y. Lab. Law §§ 860 *et seq*.

[20] Tenn. Code Ann. §§ 50-1-601, 50-1-602, 50-1-603.

[21] Wis. Stat. §109.07

[22] 24 V.I. Code Ann. §471 *et seq.*

[23] *Borne Chem. Co., Inc. v. Dictrow*, 85 A.D.2d 646, 445 N.Y.S.2d 406 (2d Dept. 1981) (relying on oft-cited *dicta* from *Post v. Merrill Lynch Pierce, Fenner & Smith, Inc.*, 48 N.Y.2d 84, 89, 397 N.E.2d 358, 360-61 (1979), where the court said, in relevant part: "[T]he State c limited restraints on an employee's employment mobility where a mutuality of obligation is freely bargained for by the parties. An essential aspect of that relationship, however, is the employer's continued willingness to employ the party covenanting not to compete. Where the employer terminates the employment relationship without cause, however, his action necessarily destroys the mutuality of obligation on which the covenant rests as well as the employer's ability to impose a forfeiture....").

[24] 2004 U.S. Dist. LEXIS 18286 (S.D.N.Y. 2004) (on remand from *Abbruscato v. Empire Blue Cross & Blue Shield*, 274 F.3d 90, 98 (2d Cir. 2001)).

[25] 2005 U.S. App. LEXIS 4264 (7th Cir. 2005).

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