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INSIGHT: Distressed Companies Should Prepare for Employee Rights Realities

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Employees' legal rights are a paramount concern for companies in financial distress. Morrison Cohen attorneys say companies should be aware of key employee issues and have representation that specializes in these issues.

When a company is in financial distress, the rights afforded by various laws to employees and the anxiety levels of these employees become of paramount concern to owners and management.

It is not uncommon for a cash-strapped company to question what happens if it cannot meet payroll. Failure to pay employee wages can subject officers, directors, and owners to personal liability, and in some cases, criminal sanction. Who is liable and for what, such as, unpaid vacation, reimbursable expenses, and severance, is, state-law specific and the laws are inconsistent.

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The scope of liability also depends on where the employee is located and the corporate form of the employer. New York, for example, imposes personal liability for unpaid wages on the 10 largest shareholders of a corporation (or members of an LLC).

Delaware imposes personal liability on officers and agents of a corporation who knowingly permit the corporation to violate the wage statute but does not impose similar liability on members of an LLC. California provides that any employer (which includes owners, directors, officers, and managing agents) who willfully fails to pay wages is personally liable.

Reductions in Force—WARN Act Exposure

Federal and state laws deal harshly with companies as well as their officers and directors that without adequate notice fire employees wholesale. The federal WARN Act requires that companies with more than 100 employees provide workers with 60 days' advance notice of any mass layoffs.

The majority of states have also enacted their own WARN acts. The thresholds and notice provisions under state WARN acts vary (New York requires 90-day notice for businesses larger than 50 full time employees). There are exceptions to the notice requirements, but they must be scrutinized carefully. Class actions are often commenced not only against the employer, but also against private equity owners of the company.

Employee Compensation and Benefit Plans

Compensation Reductions

When a distressed company wants to make changes to employee compensation, it is subject to applicable federal and state wage and hour laws. Collective bargaining agreements covering an organized workforce must be carefully analyzed, as they often impose a notice obligation on the company and prohibit unilateral action regarding compensation, changes in which are a mandatory subject of collective bargaining.

In preparing a compensation reduction strategy, the company must take care to avoid disparate treatment of (or disparate impact on) employees in protected classes. The company must also consider the impact of any reductions in compensation on employee morale—a poorly structured compensation reduction strategy could undermine the company's employee retention goals and lead to damaging personnel departures.

Retirement Benefit Plans

If permitted under the applicable agreement, defined contribution plans may be "frozen" to prevent the accrual of new employer funding liabilities and "closed" to new employees, but these plans remain responsible for maintaining and paying previously

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accrued benefits. When freezing and closing a retirement plan, the company must consider whether doing so will constitute a partial plan termination, which may require immediate full vesting of affected participants.

Additionally, frozen plans that have not received any employer contributions for a number of years may be deemed to be terminated by the IRS, which requires full vesting of all plan benefits.

Sponsors wishing to terminate their underfunded single employer pension plan must also consider how they will satisfy the resulting accelerated plan funding liability, Affiliates with a sufficient degree of common ownership or other indicia of affiliation with a pension plan sponsor may be held jointly and severally liable for the sponsor’s plan underfunding or withdrawal liability.

Collective bargaining agreements must be scrutinized to ensure that any contemplated benefit plan change does not violate the company’s obligations under them, and the impact of plan underfunding must analyzed because the company may incur substantial withdrawal liability when there is an event of withdrawal resulting from the cessation to contribute or a significant reduction in pension contributions.

Key Employee Retention and Bonus Plans

Distressed companies often face the existential threat of losing employees who are critical to any recovery effort. These companies will look to develop compensation plans that will incentivize employees and bolster morale. To the extent that these plans are going to be implemented through a bankruptcy filing, there are numerous additional factors to consider.

As a result of changes in the bankruptcy law, a debtor can no longer adjust compensation for its executive and management teams solely to incentivize retention. These plans (called Key Employee Incentive Plans) must require management to meet performance goals. If the goals are easily achievable or inevitable, a court may find the plan is a disguised retention plan.

Even in cases where there is complete agreement, the courts will want to examine the proposed targets to confirm that the KEIP is not compensating management solely for remaining with the company.

The bankruptcy law’s restriction on retention plans apply only to management-level employees, non-management retention plan, or a KERP, is facially easier to implement. However, a KERP is still the product of intense negotiations between the stakeholders, and in the absence of consensus will be the subject of litigation.

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Deferred Incentives

If a company wishes to use deferred compensation incentives, it must take care not to violate Section 409A of the Internal Revenue Code, which limits how and when employees can elect to defer compensation, prohibits employers or employees from accelerating the payment of deferred compensation, and restricts when an employee can receive deferred compensation.

Deferral elections that do not comply with Section 409A, or deferred compensation payments other than in accordance with specified trigger events will result in, at a minimum, a 20% penalty tax on the affected employee.

While there are strategies for enhancing this tax treatment, these techniques must be carefully structured in order to avoid unintended and potentially disastrous tax consequences.

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