MorrisonCohen LLP
Law Firm to the Middle Market®

Morrison Cohen's Cross-Disciplinary Approach To Employment Law Considerations In Distressed Situations

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INTRODUCTION

There is one common denominator across each and every company in the United States today: employees. Whether the company is a two-person start up or a multi-national enterprise, all companies employ someone. When a company is in financial distress, the rights afforded by various laws to these employees and the anxiety levels of these employees become of paramount concern to owners and management. It is critical that you (i) remain cognizant of the key employee issues that you will face, and (ii) have representation that specializes in employee-related issues in distressed situations.

MORRISON COHEN'S INTEGRATED PLATFORM

Morrison Cohen offers a suite of services for distressed companies – including stand-alone and portfolio companies – to address the liability of officers and directors for employee related claims and the duties owed by those controlling the organization to employees, critical employment and benefit plan issues, the interplay of various federal and state enforcement and employee protection regimes within the bankruptcy code, and the structuring of retention and incentive plans.

Morrison Cohen has an integrated legal services platform that combines lawyers from multiple disciplines to ensure that our clients are not represented solely by restructuring lawyers or by employment lawyers, but by a dedicated and experienced team of lawyers with direct experience handling employment issues in distressed situations.

Morrison Cohen attorneys have real-world experience in the areas most likely to affect distressed companies. Our attorneys can guide you through any employment issues, including:

- Fiduciary Liability For Unpaid Wages, Vacation Pay, Severance, Expense Reimbursements

- Handling Employee Compensation and Benefit Plans When a Company is in Distress

- Interplay between Bankruptcy and Reductions in Force, WARN Act and EEOC issues; and

- Key Employee Retention and Incentive Plans.

> “Unpaid wage claims are a veritable mine field for officers and directors of a distressed company.”

Fiduciary Liability for Unpaid Wages, Vacation Pay, Severance, Expense Reimbursements

While it is always preferable to just pay employees, it is not uncommon for a cash-strapped company that is reliant on a bank advancing monies to make payroll each cycle to question whether it can make payroll. As such, one of the first, and perhaps most critical questions that a distressed company may face is: “What happens if I cannot pay my employees?”

Unfortunately, there is no easy answer to this question. Officer and director liability for unpaid wages will depend on the location of the employee. As such, when a distressed company has employees in multiple jurisdictions, there are multiple legal frameworks that could be at issue.

For example, if a company registered in Delaware has offices in Delaware, New York, and California, the officers of the company are potentially subject to three separate, and oftentimes dissimilar, legal frameworks in determining their own liability.

In this example:

- New York imposes personal liability for unpaid wages on the ten (10) largest shareholders of a corporation (or members of an LLC).
    - An officer or manager with active involvement in running the business may also face criminal liability for knowingly not paying wages.
- Delaware imposes personal liability on officers and agents of a corporation who knowingly permit the corporation to violate the wage statute.
    - Delaware, however, 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.

Similar questions arise in the distressed context in connection with payment of vacation pay, severance, and employee expense reimbursements. We can advise your board and managers of strategies to minimize that risk both in and out of bankruptcy.

Handling Employee Compensation and Benefit Plans When a Company is in Distress

Compensation Reductions

The first step to handling employee compensation issues when a company is in distress is to make certain that the company's employee handbook and any agreements with employees permit the company to change employees' compensation rates and structures. If any of the employees are union members whose employment with the company is subject to the terms of a collective bargaining agreement, such agreement must be carefully analyzed, as it often imposes a notice obligation on the company and grants the union a consent right before any material changes to compensation or other terms or conditions of covered employment may be made. In addition, the Bankruptcy Code contains special provisions concerning collective bargaining agreements. In preparing a compensation reduction strategy, the company must take care to avoid disparate treatment of, or disparate impact on, protected groups of employees. 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.

Employee Benefit Plans

Companies typically reserve the right to modify and terminate their benefit plans in the governing plan documents, although any proposed plan modification or termination must be reviewed for compliance with the governing documents and applicable laws. Just as with compensation reductions, companies must carefully review any collective bargaining agreements to which they are party to ensure that any contemplated benefit plan change does not violate the company's obligations under such agreements. Defined contribution retirement plans (such as 401(k) plans) of distressed companies are often "frozen" to prevent the accrual of new employer funding liabilities and "closed" to new employees, but such plans remain responsible for maintaining and paying out previously accrued retirement benefits. When freezing and closing a retirement plan, the company must consider whether such act will constitute a partial plan termination, requiring immediate full vesting of affected participants (in a complete plan termination full vesting is always required). 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 would also require full vesting of all plan benefits.

Sponsors of defined benefit pension plans must contend with various additional issues even after they have frozen and closed their plan: continuing annual funding obligations (including yearly funding liability fluctuations caused by changes in actuarial assumptions and investment performance) and premium payment obligations to the Pension Benefit Guaranty Corporation (PBGC), PBGC and participant notices, funding-based benefit restrictions, and the potential that the PBGC may force an involuntary termination of a severely underfunded plan. Sponsors wishing to terminate their underfunded single employer pension plan must consider how they will satisfy the resulting accelerated plan funding liability, and sponsors of underfunded multiemployer pension plans (union pension plans to which a company contributes pursuant to a collective bargaining agreement) may incur a substantial withdrawal liability when they stop or reduce their pension contributions. Significantly, 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 single-employer plan underfunding liability or multiemployer plan withdrawal liability.

We have counseled distressed companies through these issues and can work with your compensation advisors, benefit plan providers and HR personnel to help your company successfully navigate the regulatory waters.

Reductions in Force

WARN Act

While it may be tempting to lay off all your employees in order to avoid personal liability, this may not be a sound strategy.

The Federal Worker Adjustment and Retraining Notification Act requires any company with more than 100 employees to provide workers with 60 days' advance notice of any mass layoffs. Failure to provide this notice may lead to personal liability for officers and directors of the company.

Not to be outdone, the majority of states have enacted their own "mini-WARN acts" to protect persons employed in their state. The thresholds and notice provisions under the mini-WARN acts all vary (New York, for example, requires 90-day notice for any business larger than 50 full time employees). Personal liability may attach under these mini-WARN acts.

The reach of the WARN Act and the mini-WARN acts is long and may, in certain circumstances, not be limited to the employees' direct employer. Class actions are often commenced not only against the employer, but also against private equity owners of the company. We can both advise on these matters and litigate claims brought in bankruptcy, other federal, and state courts.

EEOC Issues

Financial distress also tends to highlight interpersonal and management issues. Where employees recognize that they are at risk of potential job loss, they are more likely to look to extra-judicial means for protecting their paychecks.

One potential scenario faced by companies in distress is the increase in frequency of complaints to the Equal Employment Opportunity Commissions ("EEOC"), which is the first stop in any employee's litigation regarding the "fairness" of their termination. An EEOC investigation can complicate even the most routine reduction in force by providing employees with the ability to challenge a company's decision making process. Even where a company acted in accordance with the

Bankruptcy, however, introduces an entirely new set of issues to the EEOC process. Two key issues that arise in a bankruptcy are (1) whether damages owed to an employee for alleged EEOC violations are dischargeable in a chapter 11, and (2) whether the injunction in a confirmed plan of reorganization can stay an EEOC investigation for conduct that occurred before or during the bankruptcy case.

We have faced these issues on behalf of clients and, because of our interdisciplinary approach to employment law in distressed and bankruptcy situations, have developed key strategies for using the bankruptcy process to mitigate the risk of loss related to EEOC complaints as well as similar state agency process.

Key Employee Retention and Bonus Plans

Companies in distress often face the existential threat of losing key and valued employees without whom the company cannot hope to recover. We believe that devising retention and bonus plans for companies in distress must take into consideration the potential bankruptcy of the company. Our approach works to create plans that can be put in place before a filing that will enable the key workforce to continue in employment free from the uncertainty that that always affects a workforce once a company files.

Oftentimes, and even if a plan has been put in place prior to a bankruptcy filing, companies in distress need to develop management compensation plans that they will seek to get approved once the company has filed for bankruptcy protection most commonly through a key employee incentive program (KEIP) for managers or a Key Employee Retention Program (KERP) for rank and file employees.

KEIPs

As a result of changes in the bankruptcy law, a debtor can no longer adjust compensation for its executive and management teams solely based on their willingness to remain with the debtor through the bankruptcy case. Given this, debtors have created the KEIP, which ties managers' bonus compensation to productivity and performance-based goals.

For a KEIP to pass the minimum bankruptcy standards, it must be truly incentivizing and not a disguised retention plan – meaning that the incentive targets cannot be "softballs." The targets must require management to stretch to meet their performance goals. If the goals are easily achievable or inevitable, courts will deny the KEIP.

Structuring a Key Employee Incentive Plan for Officers and a Key Employee Retention Plan for rank and file is an exercise in both transactional law and litigation.

KEIP targets are often the product of negotiation with the company and its professionals, the company's lenders – who will be financing these payments, the official committee of unsecured creditors (a statutory body of creditors that is appointed to represent the interests of creditors in chapter 11 cases), and the United States Trustee (which is the United States Department of Justice's bankruptcy watchdog).

Additionally, given the requirement of court approval, KEIP plans are often litigated. Even in cases where there is complete agreement, the courts will want to examine the proposed targets to confirm that the targets motivate executives to drive results, as opposed to just compensating management for continued attendance.

Having a KEIP denied is a temporary setback and is certainly frustrating to management. An interdisciplinary approach to KEIP structure devised by professionals knowledgeable about the market is critical to successful design, approval, and implementation of a KEIP.

KERPs

Given that the bankruptcy law's restriction on retention plans apply only to management-level employees, a KERP is, at least facially, easier to implement in a bankruptcy case. 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.

Morrison Cohen's approach to creating KEIPs and KERPs always looks forward to take into consideration what the company will want to do with its workforce after the bankruptcy case is over. The team works with management to transition the plans into new post-bankruptcy incentive or bonus plans and or to provide a roadmap for reductions in force.

Modifying Existing Deferred Incentives and Code Section 409A

If, in lieu of or in addition to adopting new retention arrangements, a company wishes to restore or enhance its pre-bankruptcy employee incentives, it must take care not to violate Section 409A of the Internal Revenue Code ("Section 409A"), 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 payment for his or her deferred compensation. Deferral elections that do not comply with Section 409A, or deferred compensation payments other than in accordance with six specified trigger events (an employee's separation from service, pursuant to a fixed time or schedule, a change of ownership or effective control, death, disability and an employee's unforeseeable emergency) will violate Section 409A and result in, at a minimum, a 20% penalty tax on the affected employee. Some of the more common techniques used to restore or enhance a company's pre-bankruptcy incentives, which also implicate Section 409A, include the extension or repricing of stock options or other stock rights, delay, acceleration or other change in the payment schedule of previously deferred compensation, and pre-funding of deferred compensation arrangements. These techniques must be carefully structured in order to avoid unintended and potentially disastrous tax consequences.

We counsel clients daily on all aspects of Section 409A compliance and can advise your board and managers on restructuring your company's deferred compensation arrangements in a manner that avoids, or minimizes to the maximum possible extent, the associated adverse tax consequences.

Conclusion

Understanding and navigating employment law issues is critical to any company involved in distressed situations.

Morrison Cohen's Bankruptcy & Restructuring Practice Group and its Employment Law Practice Group have worked together to fashion an interdisciplinary approach to distressed situations that recognizes that financially fatigued companies need more than just bankruptcy and restructuring expertise and employment law expertise, they need restructuring employment law expertise. Morrison Cohen can advise you on how to minimize exposure of boards, officers, and equity sponsors and take full advantage of the bankruptcy or workout process to maximize employee productivity and comfort during times of distress

To Learn More

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