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Employment Law Update February 2012

PUBLISHED ON

February 1, 2012

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The Top Compensation Red Flags Lurking in Business Transactions

By: Jill Sebest Welch

Start-up companies seeking venture capital. Businesses positioning for an IPO. Owners looking to sell the company. What are the top compensation red flags uncovered during due diligence by investors and purchasers and their attorneys? When businesses make representations and warranties that they have operated the company in compliance with all laws, have they audited their compensation practices? Are companies at risk when they agree to indemnify the investor or buyer against claims made by government agencies or former employees? Are the non-compete agreements designed to protect a company's business interests assignable to the purchasing company?

Not only is it critical for business leaders to think about these employment related issues when conducting business transactions, it is also important to involve the company's human resources professionals or even outside employment counsel early in the due diligence process. Companies that take this proactive approach are better positioned for business transactions, including asset purchase agreements, stock purchases, and government contracts.

Representations and Warranties in Sales Agreements
Companies make representations and warranties in their sales agreements about a host of employment-related issues. For example:

• Seller has properly classified each employee as "exempt" or "non-exempt" under the FLSA or any state, local or foreign counterpart and properly compensated each "non-exempt" employee in accordance with the FLSA or such other applicable laws.

• Seller has properly classified each individual who provides services to the Company either as an "employee" or an "independent contractor" and properly effected any applicable employment and income tax withholdings with respect to such individual.

• Seller has maintained and currently maintains adequate insurance as required by applicable law with respect to workers' compensation claims and unemployment benefit claims.

• Seller has withheld and paid all required taxes and reported the amounts paid or owing to any employee, independent contractor, creditor, stockholder or other third party.

• No Company Benefit Plan provides benefits which are subject to taxation under Section 409 of the Code. Except as set forth in the attached schedule, Seller is not a party to or bound by any employment agreement, and the Shareholders have provided to the Purchaser true, correct and complete copies of each employment agreement.

These "reps and warranties" may be pro-forma, but do companies know whether these oft-requested statements are accurate? Have they performed an audit of their compensation practices prior to the sale to assess whether their employees are properly classified as exempt? Have they reviewed all independent contractor relationships to make sure that they meet the IRS test? Have
they reviewed employment agreements to know whether a non-compete covenant will survive the transaction and protect the purchaser? These compensation red flags are lurking in business transactions and business leaders and human resources professionals need to be able to spot and address them prior to the closing.

Attestations in Government Contracts

Government agencies are demanding similar assurances in their contracts with businesses and suppliers. For example, on December 1, 2011, the Department of Agriculture's Office of Procurement and Property Management issued a final rule that requires its contractors to attest that they and their subcontractors, to the best of their knowledge, are in compliance with all applicable labor laws. The rule will effectively add the clause to USDA contracts that currently exceed $150,000.

The Department warns that it will vigorously pursue action against any contractor that violates relevant labor laws while providing supplies and/or services under the government contract. This may include filing a claim under the False Claims Act. The Department has also vowed to cooperate with the enforcement of other agencies' labor laws as appropriate.

Top Red Flags In Today's Labor Climate

The time is now for business leaders and human resources professionals to recognize these red flags and their relevance to business transactions and to work proactively in the due diligence process. Recent improvements in the economy and an uptick in business transactions come at a time when federal and state government agencies are "upping the enforcement ante" on all of
these fronts.

1. The Company treats its employees as independent contractors

The United States Department of Labor ("DOL") is seeking over $15 million for a new multi-agency "Misclassification Initiative" that will strengthen and coordinate federal and state efforts to enforce labor violations that result from the misclassification of employees as "independent contractors." The DOL also aims to hire 107 employees to support field investigator training and conduct an additional 3,250 investigations to deter such violations in the future. Moreover, in September 2011, the DOL entered into a Memorandum of Understanding with the IRS to share information to reduce incidences of employee misclassification. Meanwhile, the IRS has already embarked upon an extensive random audit (of about 6,000 employers) on this issue and a review of the entire current system. At the state level in 2010, Pennsylvania enacted the Construction Workplace Misclassification Act was enacted which makes it both a civil and a criminal offense in Pennsylvania for a contractor to knowingly misclassify an employee as an independent contractor.

2. The Company classifies all of its workers as "exempt" from overtime rules

Wage and hour cases under the federal Fair Labor Standards Act ("FLSA") and Pennsylvania's counterpart, the Pennsylvania Minimum Wage Act ("PMWA"), have proliferated against companies across Pennsylvania and other states. Recent trends in this litigation focus on the alleged misclassification of employees in jobs such as customer service representatives, account representatives, mortgage loan officers, and assistant managers. Companies may put all of their employees or supervisors on "salary" and never record hours worked or pay them overtime. While this may be an easier pay practice to administer, simply calling an employee "salaried" does not make him/her exempt from minimum wage and overtime requirements, and it puts companies at significant risk for legal action, including expensive class action litigation. This is a risk that purchasers do not want to assume.

3. Section 409 Compliance

The Code Section 409A requirements affect more than what we typically think of as deferred compensation. They also pertain to separation pay and other post-termination benefits, and give rise to a number of concerns that exist with current employment agreements that provide for severance benefits. These concerns surface in business transactions, particularly those that may trigger payout of severance or may result in termination of employment agreements.

The regulations do provide some very useful exceptions, which permit companies to structure severance plans and employment contracts to avoid the application of Section 409A. These exceptions cover (1) short term deferrals; (2) involuntary termination; (3) good reason termination; (4) reimbursement of non-taxable benefits under an employment contract and certain incidental post-employment benefits such as outplacement services, moving expenses and the like that do not exceed the limitation of elective deferrals under Code Section 402(g); and (5) in kind benefits. Employment agreements need to be analyzed to determine if either an exception applies or if 409A compliance revisions are needed.

4. Assuming the Seller's Non-Compete Agreements Will Protect The Buyer

The assumption that a non-compete covenant between an employee and the selling company is automatically assignable and inures to the benefit of the purchasing company may not be correct, and a review of employment and non-compete agreements as part of due diligence is important. This is a matter of state law, and in Pennsylvania, whether non-compete agreements are assignable depends on whether the agreement includes an express assignment provision and the type of transaction -- a stock purchase agreement or an asset purchase agreement. These are a few of the employment issues commonly raised during the mergers and acquisitions due diligence process. Increasingly, they are surfacing in routine business transactions as well. Human resources professionals who recognize these issues and are involved early in the process can better position their company for a successful transaction.

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EEOC Warns Against Use of Criminal Records to Deny Employment

By: Joshua L. Schwartz

In a settlement likely to have long-lasting implications for employers nationwide, Pepsi Beverages Company has agreed to pay $3.13 million to resolve charges stemming from its policy against hiring applicants who had been arrested and/or convicted of certain minor offenses. The Equal Employment Opportunity Commission ("EEOC") determined that Pepsi's policy adversely affected over 300 black applicants, in violation of Title VII of the Civil Rights Act. Pepsi will also provide job offers and training to many of these applicants. The Pepsi investigation is part of a nationwide EEOC crackdown on hiring policies that can hurt black and Hispanic applicants. The "use of arrest and conviction records to deny employment can be illegal," according to the EEOC, "when it is not relevant for the job," because it can limit opportunities for minorities with higher arrest and conviction rates. The agency has indicated that it "hope[s] that employers with unnecessarily broad criminal background check policies take note of this agreement and reassess their policies to ensure compliance with Title VII."

Pennsylvania employers are already prohibited from having blanket policies regarding criminal background checks. Under Pennsylvania law, Title 18 section 9125, an applicant's convictions may be considered only to the extent to which they relate to the available position, and employers must notify applicants if their criminal background played a role in the decision not to hire them.

The Pennsylvania Human Relations Commission has opined that employers "must be able to show that inquiry into conviction is substantially related to an applicant's suitability to perform major job duties" and that the criminal background check is, thus, required by "business necessity." The EEOC's statements surrounding the Pepsi settlement potentially takes this constraint nationwide.

Given these developments, employers should ensure that hiring practices conform to some "relevance" standard for criminal background disqualifications. The EEOC has stated, for example, that a recent theft conviction may be relevant to a bank teller position, while a years-old drunk driving conviction is likely not relevant to a clerical position. Employers should take steps to ensure that those in charge of hiring have access only to aspects of an applicant's criminal background deemed relevant to a given position or that criminal background checks are not performed until late in the hiring process after a conditional offer is made. An individualized analysis should then be undertaken to ensure that the age and circumstances of the conviction, the available position, and any interim conduct suggesting rehabilitation of the applicant are adequately taken into account.

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Pennsylvania Employer Withholding of Employee Local Earned Income Taxes Became Mandatory on Januar

By: Dara C. Bachman

As of January 1, 2012, Act 32 makes it mandatory for employers with places of business in Pennsylvania to withhold local earned income taxes for all employees who live or work in the Commonwealth. If an employer willfully or negligently fails to withhold such taxes, the employer may be held liable for such taxes. In order to ensure compliance (and avoid employer tax liability), all employers with Pennsylvania locations must:

1. Complete an Employer Registration Form and file it with the proper tax collection district for all locations where the employer does business. If an employer has operations in multiple locations, it may elect to only file in one tax collection district by filing a Notice of Intention to File Combined Returns and Make Combined Payments with each district where it is required to file an Employer Registration Form.

2. Obtain signed Residency Certification Forms from each employee. After obtaining such form from each employee, an employer will need to be sure to obtain an updated Residence Certification Form each time an employee moves. For new employees, this form should be completed as an attachment to each new employee's W-4. The form should be kept with the employer's records in the event the employer's withholding is under review in the future.

3. Determine the proper withholding tax for each new employee. This will be the greater of the nonresident tax of the political subdivision where the employee works or the employee's resident tax. In order to make an accurate determination, employers need to take into account all of the locations where an employee works and decide in which location the employee would be subject to tax.

4. File the employer's returns and send payment of withheld taxes to the proper tax collection district. This requirement may be quarterly or monthly. Most notably, an employer must file monthly if it has multiple locations but elects to only file its withholding information in one tax district (as explained above).

5. By the end of February of each year, submit a W2-R Annual Reconciliation Form along with individual withholding statements for each employee with the proper tax collection office for the calendar year. This individual withholding can be reflected on each employee's W-2, and production of the W-2 will satisfy the requirement to produce withholding statements. Because this law became mandatory on January 1, Employers who are not already in compliance with this new law should move quickly. Additional information and forms can be found at www.newpa.com. If you have any questions with these requirements, you should contact your attorney and accountant as quickly as possible to avoid incurring any liability under Act 32.

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New Service Provider Disclosure Rules Heighten Responsibilities Of Retirement Plan Fiduciaries

By: David J. Ledermann

**** Due to a recent revision issued by the DOL, there have been updates to the information in this article. Please click here to read about the changes.**

Unfortunately, many retirement plan fiduciaries have not been fully aware of the compensation their plan service providers receive, the sources of such compensation or how that compensation is determined. While plan fiduciaries have long been considered duty-bound to obtain and evaluate information about service provider compensation, there was no commensurate duty on the part of service providers to disclose such information. The regulations promulgated by the Department of Labor under Section 408(b)(2) of ERISA mandate such service provider disclosures going forward. The import of these disclosures to plan fiduciaries will be a heightened responsibility to evaluate and to act upon the information provided.

Prior to April 1, 2012, retirement plan sponsors and plan committees will begin to receive these newly-required disclosures from plan service providers, which information it will be their duty to evaluate. Under the regulations, plan service providers must make written disclosures to their clients concerning the providers' services, compensation and fiduciary status. These regulations are a response to a widely held, and undoubtedly accurate, perception that plan fiduciaries find it exceedingly difficult to understand how, and how much, service providers are compensated and whether conflicts of interest may exist in the underlying arrangements to which a service provider is party.

Fiduciary Obligations in Handling Plan Service Provider Arrangements

Fiduciaries of retirement plans under ERISA are obligated to act prudently in the selection of plan service providers. Part of this obligation is a requirement that only "reasonable" contracts be put in place for the provision of services to a plan. Failure to ensure that such contracts are reasonable will implicate the responsible plan fiduciary in a fiduciary breach and a prohibited transaction under ERISA, resulting in financial liability to plan participants and regulatory penalties.

For these reasons, the plan sponsor, committee or other fiduciary empowered by the plan sponsor to engage a service provider must ensure that the service provider receives no more than reasonable compensation for the services to be provided, including in connection with the plan's investments. In performing this function, the fiduciary must evaluate information beyond the amount of fees directly expended by the plan for services, to encompass the total compensation received by a service provider. The fiduciary must consider compensation to the service provider from all sources in connection with its provision of services to the plan, including from revenue sharing arrangements and marketing fees paid by third parties, such as mutual funds.

Even where the total compensation a service provider receives appears objectively reasonable, the arrangements under which the compensation is earned may reflect conflicts of interest in which the service provider is enmeshed. For example, a plan's recordkeeper or broker-dealer who receives direct compensation from the plan and indirect compensation from an investment company, even though reasonable in the aggregate, may be suggestive of a relationship between the service provider and the investment company that is not necessarily conducive to the plan participants' best interests. Part of the fiduciary's responsibility is to know how the plan's service providers are compensated, including by way of indirect payments, and to be alert to the possibility of conflicts of interest that may adversely impact the plan.

Service Providers and the New Disclosure Regime

The new disclosure regulations apply to providers of services to ERISA retirement plans, including defined benefit and defined contribution plans under Internal Revenue Code Sections 401(a) and (k), as well as Section 403(b) plans of certain tax-exempt organizations. Included are providers of ERISA fiduciary services, registered investment advisers, recordkeepers and brokerage firms, and others providing such plan-related services, whether they are compensated directly by the plan or otherwise. In addition, individuals or firms that provide accounting, actuarial, auditing, appraisal, banking, custodial, insurance, investment advisory, legal, recordkeeping, brokerage and third party administration services to a plan for which the service provider expects to receive indirect compensation are covered by the new disclosure regulations. For purposes of the regulations, "indirect compensation" includes payments received by the service provider in connection with the plan, other than payments directly from the plan or from the plan sponsor.

The information each service provider must disclose includes a description of the services being provided in sufficient detail to permit the responsible plan fiduciary to understand the appropriateness of the service and whether it is being delivered as expected. If the service provider will be acting as an ERISA fiduciary or as a registered investment adviser, such status must be affirmatively stated in the disclosure. Finally, the service provider must disclose its compensation, including any non-monetary items of value received and payments going to affiliates and subcontractors of the service provider. Commissions or incentive pay based on the placement of business with the plan, or charged against the plan's investments, must be broken out and reported to the plan fiduciary. Disclosure must also be made of any amounts the plan must pay if the arrangement with a service provider is terminated.

Plan recordkeepers are subject to additional disclosure requirements intended to enable fiduciaries to fully understand how these service providers are compensated, including disclosures concerning rebates and credits from offerors of proprietary investments, and an estimate of how much the recordkeeper would charge for its services absent such factors. This information is intended to facilitate evaluation of the reasonableness of the recordkeeper's fees and the potential for conflicts of interest involving the recordkeeper. Investment provider disclosures must inform the fiduciary concerning any commissions payable in connection with a plan's investments, redemption fees, surrender charges, operating expenses and items such as wrap fees and mortality expense charges.

Heightened Demands on Fiduciaries Resulting from New Disclosure Rules

In meeting its obligations to act prudently in selecting service providers and to ensure that only reasonable contracts with providers are made, the fiduciary in receipt of these service provider disclosures must analyze the information provided in the disclosures. A prudent selection process may further entail issuing requests for proposals to prospective service providers or the benchmarking of fees within a peer group of similarly sized plans. The process should ultimately result in determinations of whether (i) the services being provided are necessary and appropriate; (ii) service provider fees are reasonable; and (iii) there exist conflicts of interest that need to be managed or eliminated.

April 1, 2012 is the current deadline by which existing covered service providers must provide these newly-required disclosures. Going forward, as new service providers are engaged, the regulations require that the disclosures be provided reasonably in advance of the time of the engagement so as to afford the fiduciary enough time to evaluate the information. Any change in the information that has been disclosed must be supplied within 60 days of such change. In the case of a service provider who fails to furnish the required disclosures, a plan fiduciary must actively seek the information required to be disclosed and may be obliged to report the service provider to the Department of Labor, and perhaps to terminate the service provider's contract, in order to avoid incurring regulatory penalties.

Plan fiduciaries should consult experienced benefits counsel concerning the disclosures and the implementation of an appropriate process for evaluating and selecting plan service providers. Agreements offered by service providers often include provisions that a prudent fiduciary should reject and which counsel can identify. The engagement of knowledgeable advisers is deemed evidence of a prudent process in cases involving judicial scrutiny of fiduciary conduct.

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