Employer Update

Spring 2008

In This Issue

Supreme Court Authorizes Suits by Individual 401(K) Participants for Breach of Fiduciary Duty Under ERISA § 502(a)(2)

By Millie Warner and Jennifer Wolff

On February 20, 2008, the Supreme Court unanimously held that an individual 401(k) plan participant may sue a plan fiduciary under ERISA § 502(a)(2) to recover losses caused by a fiduciary breach that only affected the participant's individual account.

Background

Section 409 of ERISA imposes personal liability on plan fiduciaries to "make good to [the] plan any losses to the plan resulting from a breach" of fiduciary duty and to restore to the plan any profits derived from the fiduciary's improper use of plan assets.[1] ERISA § 502(a)(2) authorizes the Secretary of Labor, a participant, beneficiary, or fiduciary to bring a civil action to redress a breach of fiduciary duty under § 409(a) of ERISA.

The Supreme Court has consistently explained that it is "reluctant to tamper with an enforcement scheme crafted with such evident care as the one in ERISA," as the "[t]he federal judiciary will not engraft a remedy on a statute, no matter how salutary, that Congress did not intend to provide." *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134, 144, 147 (1985). Accordingly, because the text of ERISA § 409 provides for recovery by the plan, not by the participant who brings suit, the Supreme Court has found that, although a single participant may bring a civil action under ERISA § 502(a)(2), any recovery must "inure[] to the benefit of a plan as a whole." *Id.* at 140.

In *Massachusetts Mutual Life Insurance Co. v. Russell*, the Supreme Court held that a plan beneficiary could not bring an action for monetary damages against a plan fiduciary who had been responsible for the untimely processing of the beneficiary's benefit claim. *Id.* The plaintiff in that case brought suit under ERISA § 502(a)(2), alleging that she had been injured by her employer's improper termination of her disability benefits, even though her employer had later reinstated her benefits and paid retroactive benefits for the period in which she was not covered. *Id.* at 137. The Supreme Court rejected the beneficiary's claim. The Court explained that, based on the plain text of the statute, "recovery for a violation of § 409 inures to the benefit of the plan as a whole." *Id.* at 141. As a plaintiff could only recover losses on behalf of the entire plan under § 409, relief for an individual beneficiary was not available under that provision.

After the Supreme Court's holding in *Russell*, lower courts struggled to apply the Court's holding to claims alleging fiduciary breaches affecting only a subset of plan participants. While some courts allowed plaintiffs to proceed with claims for breach of fiduciary duty under § 502(a)(2) where the alleged breach did not harm all participants, it remained an open question whether a particular subset of participants could be too small to plausibly represent the "plan as a whole." *See, e.g., Milofsky v. Am. Airlines, Inc.*, 442 F.3d 311 (5th Cir. 2006); *In re Schering-Plough Corp. ERISA Litig.*, 420 F.3d 231 (3d Cir. 2005); *Steinman v. Hicks*, 352 F.3d 1101 (7th Cir. 2003); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995). This question was starkly presented in *LaRue v. DeWolff, Boberg & Associates*, in which a single participant sued for losses due to an alleged fiduciary breach exclusively affecting his individual 401(k) plan account.

LaRue v. DeWolff, Boberg & Associates

James LaRue participated in a 401(k) plan sponsored and administered by his employer, DeWolff, Boberg & Associates, Inc. ("DeWolff"). *LaRue v. DeWolff, Boberg & Associates*, 450 F.3d 570, 572 (4th Cir. 2006). Plan participants managed their own accounts by selecting from a menu of investment options. *Id.* LaRue claimed that in 2001 and 2002 DeWolff failed to execute his instructions for changes to the investments in his plan account, resulting in a loss of approximately $150,000 to his "interest in the plan." *Id.* LaRue claimed that DeWolff had breached its fiduciary obligations by failing to carry out his instructions and sought reimbursement of the resulting losses. *Id.* In his complaint, LaRue relied exclusively on ERISA § 502(a)(3) (which authorizes "appropriate equitable relief") for his requested relief. *Id.* at 572, 574. The defendants moved for judgment on the pleadings under Federal Rule of Civil Procedure 12(c), arguing that the monetary remedy sought by LaRue was unavailable under ERISA. *Id.* at 572. The district court agreed and granted judgment for defendants on the ground that LaRue's requested remedy was not available under ERISA.

LaRue appealed to the Fourth Circuit, and argued (for the first time) that defendants were liable for the $150,000 to his plan account under ERISA §§ 502(a)(2) and 409, which together make a fiduciary liable for "losses to the plan" resulting from breaches of fiduciary duties. *Id.* at 574. LaRue also argued, as he had in the district court, that he was entitled to recover the losses to his account as appropriate equitable relief under ERISA § 502(a)(3). *Id.* The Fourth Circuit rejected both bases of recovery and affirmed the district court's judgment.

Individual participants in a defined contribution plan may now bring claims under ERISA § 502(a)(2) for alleged fiduciary breaches that result in losses to an individual's account.

The Fourth Circuit held ERISA § 502(a)(2) does not permit a participant in a defined contribution plan to sue based on losses to the plan caused by a fiduciary breach when the losses affect only the participant's individual plan account. The court held that LaRue could not state a claim under § 502(a)(2) because "[r]ecovery under [§ 502(a)(2)] must 'inure[] to the benefit of the plan *as a whole*,' not to particular persons with rights under the plan." *Id.* at 573 (*quoting Russell*, 473 U.S. at 140) (emphasis added by Fourth Circuit). The court concluded that LaRue's suit would not benefit the plan as a whole for three reasons: (1) LaRue sought "recovery to be paid into his plan account, an instrument that exists specifically for his benefit"; (2) "[t]he measure of that recovery is a loss suffered by him alone"; and (3) "that loss itself allegedly arose as the result of [DeWolff's] failure to follow [LaRue's] own particular instructions, thereby breaching a duty owed solely to him." *Id.* at 574. The court explained that LaRue's suit was simply "different from a [§ 502(a)(2)] action in which an individual plaintiff sues on behalf of the plan itself or on behalf of a class of similarly situated participants," because, in that other kind of case, the remedy "does not *solely* benefit the individual participants." *Id.*

The Fourth Circuit also held that a participant in a defined contribution plan cannot sue under ERISA § 502(a)(3) to restore assets lost as a result of a fiduciary breach because such a suit does not seek "equitable relief" within the meaning of that provision. *Id.* at 576. In the court's view, LaRue's suit sought compensatory damages, which are not available under § 502(a)(3). *Id.* The court found that LaRue's argument that he was seeking equitable relief because he was suing a fiduciary to recover losses caused by a fiduciary breach was foreclosed by *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993) and *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204 (2002). *LaRue*, 450 F.3d at 576.

The Supreme Court

The Supreme Court rejected the Fourth Circuit's decision with respect to § 502(a)(2), finding that "although § 502(a)(2) does not provide a remedy for individual injuries distinct from plan injuries, that provision does authorize recovery for fiduciary breaches that impair the value of plan assets in a participant's individual account". 128 S. Ct. 1020, 1026 (2008). The Court distinguished its holding in *Russell* on two grounds. First, the Court explained that the type of misconduct alleged by LaRue fell "squarely within the category" of the "principal statutory duties" imposed by ERISA that "relate to the proper plan management, administration, and investment of fund assets." *Id*. at 1024. In contrast, the misconduct alleged in *Russell* (the delay in processing a benefit claim) fell outside these principal duties, and the plaintiff in *Russell* had received all the benefits to which she was contractually entitled. *Id*.

In light of *LaRue*, plan sponsors and fiduciaries may want to take certain actions to evaluate their potential exposure to claims of fiduciary breach.

Second, the Court explained that the emphasis in *Russell* on protecting the "entire plan" from fiduciary misconduct derived from the "former landscape of employee benefit plans," which had evolved in the years since *Russell* was decided. *Id*. at 1025.[2] Whereas "the defined benefit plan was the norm of American pension practice" when ERISA was enacted and when *Russell* was decided, "[d]efined contribution plans dominate the retirement plan scene today." *Id*. at 1025 (internal quotations and citations omitted). According to the Court, fiduciary misconduct with respect to a defined benefit plan would not affect an individual entitlement to a benefit unless the misconduct detrimentally affected the entire plan. *Id*. In contrast, "for defined contribution plans, . . . fiduciary misconduct need not threaten the solvency of the entire plan to reduce benefits below the amount that participants would otherwise receive." *Id*. "[W]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only to persons tied to particular individual accounts, it creates the kinds of harms that concerned the draftsmen of § 409." *Id*. For these reasons, the Court found that the "entire plan" language from Russell applied only to defined benefit plans, not to defined contribution plans. *Id*. at 1025.

Because the Court found that the Fourth Circuit erred in its interpretation of § 502(a)(2),[3] the Court declined to address the § 502(a)(3) question.

Consequences of *LaRue* and Outstanding Questions

As a result of the Supreme Court's holding in *LaRue*, individual participants in a defined contribution plan may now bring claims under ERISA § 502(a)(2) for alleged fiduciary breaches that result in losses to an individual's account. As the Court did not reach the § 503(a)(3) question, the law on remedies under § 503(a)(3) remains unchanged by the Court's opinion.

The Court's opinion also raised several questions, which the Court did not answer. One question is whether a participant is required to exhaust a plan's internal administrative review procedures before bringing suit for a breach of fiduciary duty under § 502(a)(2). The Court raised this question in a footnote, but did not decide it. *Id*. at 1024, n.3.

Another question raised by the Court's opinion is whether former participants who have cashed out of the plan have standing to sue for breach of fiduciary duty. The Court did not directly decide this issue, but stated in a footnote that, contrary to the respondents' argument that the case was moot because LaRue was no longer a participant in the plan, the case was not moot because ERISA includes in the definition of "participant" "a former employee with a colorable claim to benefits." *Id*. at 1026, n.6. The Court then cited to a Seventh Circuit opinion, which held that, based on the statutory definition of "participant," former participants who cashed out of the plan do have standing to sue under ERISA, as the prospect of winning a money judgment against the plan means that such former participants "may become eligible to receive a benefit" from the plan, as required in order to qualify as a "participant" under ERISA. *Id*. (*citing Harzewski v. Guidant Corp*., 489 F.3d 799, 804 (7th Cir. 2007)). The Supreme Court's position on this question is, however, unclear, as the Court also noted that LaRue's "withdrawal funds from the Plan may have relevance to the proceedings on remand." *LaRue*, 128 S. Ct. at 1026, n.6.

Another question, raised by Justice Roberts's concurrence, is whether a plaintiff may bring a claim under § 502(a)(2) when relief is otherwise available under § 502(a)(1)(B). Justice Roberts noted that § 502(a)(2) makes available "appropriate relief," and, in the context of § 502(a)(3), the Supreme Court has held that relief is not "appropriate" under that provision if another provision, such as § 502(a)(1)(B), offers an adequate remedy. *Id*. at 1027 (Roberts, J. concurring). Although the Court did not decide the issue, Justice Roberts pointed out that applying that reasoning to § 502(a)(2) "would accord with our usual preference for construing the 'same terms [to] have the same meaning in different sections of the same statute,' and with the view that ERISA in particular is a 'comprehensive and reticulated statute' with 'carefully integrated civil enforcement provisions.'" *Id*. (internal citations omitted).

Advice for Fiduciaries

In light of *LaRue*, plan sponsors and fiduciaries may want to take certain actions to evaluate their potential exposure to claims of fiduciary breach.

First, plan fiduciaries should be identified and the extent of fiduciary bonds and indemnifications should be reviewed. Since fiduciaries may be personally liable for plan losses, it is important for fiduciaries to be aware of the extent of their duties under the plan documents and those imposed by ERISA. Often plan sponsors provide fiduciaries with a bond and/or indemnification for damages resulting from certain types of breaches. This may be a good time for fiduciaries to review the amount of any bond that may have been purchased for reimbursement for damages incurred in their capacity as fiduciaries and the extent to which they may be indemnified.

Section 404(c) of ERISA limits fiduciary liability for certain investment losses in participant-directed account plans if certain requirements are met, including the requirement that the plan offers a diversified assortment of investments from which plan participants may choose. Plan sponsors and fiduciaries should review all of the requirements of, and ensure compliance with, ERISA § 404(c) as a preventative measure to decrease the potential for investment loss claims.

Finally, other individual account plans such as non-qualified deferred compensation plans should be reviewed as well. These non-qualified arrangements may be subject to or exempt from ERISA, and it will become increasingly important to be aware whether the *LaRue* decision may be extended so as to impose liability under these types of arrangements as well.

1 Section 409 also subjects plan fiduciaries to "such other equitable or remedial relief as the court may deem appropriate," including removal of the fiduciary.

2 Although the plan at issue in Russell was a disability plan, not a defined benefit plan, the Court in LaRue characterized the holding in Russell as emanating from logic that applied only to defined benefit plans, stating that "[t]he 'entire plan' language in *Russell* speaks to the impact of § 409 on plans that pay defined benefits." *LaRue*, 128 S. Ct. at 1025.

3 Although all of the justices agreed on the outcome of *LaRue*, they disagreed on the reasoning behind the Court's holding. Chief Justice Roberts, joined by Justice Kennedy, wrote a concurring opinion suggesting that it was "at least arguable" that the plaintiff's claim in *LaRue* "properly lies only under § 502(a)(1)(B) of ERISA," which authorizes a plan participant or beneficiary "to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan." *Id.* at 1026 (Roberts, J. concurring). Justice Thomas, joined by Justice Scalia, wrote a separate concurrence, disagreeing with the majority's reliance on "trends in the pension market" and the "concerns of ERISA's drafters," and instead finding that LaRue had a cognizable claim based on the "unambiguous text of §§ 409 and 502(a)(2)." *Id.* at 1028 (Thomas, J. concurring). According to Justice Thomas, losses to an individual account in a 401(k) plan constitute losses to the plan under ERISA because such losses diminish the plan's aggregate assets. *Id.*

New York Court of Appeals Rejects Fraudulent Inducement Claims Made By Terminated Employees

By Gary D. Friedman and Amanda G. Burnovski

The New York Court of Appeals, in its recent decision in *Smalley v. The Dreyfus Corp.*, 2008 N.Y. LEXIS 184 (N.Y. Feb. 12, 2008), rejected claims of fraudulent inducement made by several employees against their former employer. The Court of Appeals' decision in *Smalley* is important as it both reaffirms the strong doctrine of employment at-will in New York and casts serious doubt on the viability of fraudulent inducement claims in the employment context. The court held that, where plaintiffs alleged no injury separate and distinct from termination of their at-will employment, plaintiffs would not be allowed to bring fraudulent inducement claims to recover "what is at bottom an alleged breach of contract in the guise of a tort." *Smalley v. The Dreyfus Corp.*, 2008 N.Y. LEXIS 184, **5-6 (N.Y. Feb. 12, 2008). It is important that employers remember that while *Smalley* limits fraudulent inducement claims, these claims may still be brought successfully by employees who prove injury independent of the termination.

The plaintiffs in *Smalley* were comprised of a group of five former at-will employees of the Fixed Income Group of Dreyfus who all claimed that they either began or continued their employment with Dreyfus at a time when there were rumors regarding the potential merger of Dreyfus' parent company, Mellon Financial Corporation, and another financial management company, Standish Ayer & Woods. The plaintiffs claimed to have relied on assurances by Dreyfus, made over the course of the plaintiffs' employment, that rumors of the merger were untrue. In 2005, after Standish began to effect a merger of the Fixed Income Group of Dreyfus, every employee in the Fixed Income Group was terminated and the assets of the group were transferred to Standish. In response, the plaintiffs commenced an action in New York County Supreme Court for breach of contract, quantum meruit, defamation and fraud. *Smalley v. The Dreyfus Corp.*, 832 N.Y.S.2d 157, 158 (1st Dept. 2007). The Supreme Court dismissed all of the plaintiffs' claims and noted that the plaintiffs could not "masquerade breach of contract claims as fraud claims." *Id.* at 158.

The Appellate Division, in its review of the Supreme Court's decision, held that the dismissal of the fraudulent inducement claims was made in error and noted that "employment-at-will does not bar a cause of action for fraudulent inducement so long as the misrepresentation involved an existing fact and is not a promise as to future or continued employment." *Id.* at 160. Justice James M. McGuire issued a partial dissent affirming the dismissal of the claim for fraudulent inducement. He reasoned that the injury alleged by the plaintiffs was solely a result of the decision by Dreyfus to terminate their employment, and that none of the injuries claimed were independent of the termination of their employment. Justice McGuire acknowledged that the Court of Appeals had not yet addressed the issue, but provided that "in [his] view, the absence of such independent injury is fatal to plaintiffs' fraudulent inducement claim." *Id.* at 163.

In its February 12, 2008 opinion by Chief Judge Judith S. Kaye, the Court of Appeals reversed the Appellate Division and agreed with Justice McGuire, holding that the five employees – who all worked at-will – did not have a fraudulent inducement claim based on their employer's failure to tell them of a merger that ultimately cost them their jobs. The court provided, "New York law is clear that absent 'a constitutionally impermissible purpose, a statutory proscription, or an express limitation in an individual contract of employment, an employer's right at any time to terminate an employment at-will remains unimpaired." *Smalley*, 2008 N.Y. LEXIS 184 at **3 (internal citations omitted). The court also noted that it had repeatedly refused to recognize exceptions to, or pathways around, the principles of employment at-will and an employer's right to terminate an employee's employment for any reason or no reason at all. *Id.* at **4. In these passages, the Court of Appeals clearly reaffirms the strong doctrine of employment at-will in New York as set forth by the court in *Horn v. New York Times*, 100 N.Y.2d 85 (N.Y. 2003) (refusing to carve out an exception to the at-will doctrine and emphasizing the court's "strong disinclination to alter the traditional rule of at-will employment").

The Court of Appeals' decision in *Smalley* is important as it both reaffirms the strong doctrine of employment at-will in New York and casts serious doubt on the viability of fraudulent inducement claims in the employment context.

The *Smalley* court also provided that since "the length of employment is not a material term of at-will employment, a party cannot be injured merely by the termination of the contract – neither party can be said to have reasonably relied upon the other's promise not to terminate the contract." *Id.* at **5. The court emphasized: "Absent injury independent of termination, plaintiffs cannot recover damages for what is at bottom an alleged breach of contract in the guise of a tort." *Id.* at **5-6.

The plaintiffs, in an attempt to circumvent the at-will doctrine, relied on the Second Circuit's decision in *Stewart v. Jackson & Nash*, 976 F.2d 86 (2d Cir. 1982), where a law firm recruited an environmental law attorney by telling her that it had secured a large environmental law client, that she would work on that client's matters and that the firm was establishing an environmental law department, which she would head. Upon commencement of employment, the plaintiff learned that the firm was attempting to secure the client and that she would perform only general litigation work. When the firm terminated the plaintiff, she brought suit for damages. The Second Circuit allowed the plaintiff to raise a claim of fraudulent inducement against the law firm because "the firm's promises concerning the environmental law client and department were misstatements of present fact, and because the alleged injuries – thwarting her professional objective to specialize in environmental law and damaging her career potential – occurred well before plaintiff's termination and were unrelated to it." *Id.* Noting that *Stewart* was "fundamentally different" from the facts of *Smalley*, the Court of Appeals stated that "the core of plaintiffs' claim was that they reasonably relied on no-merger promises in accepting and continuing employment with Dreyfus, and in eschewing other job opportunities. Thus, the plaintiffs alleged no injury separate and distinct from termination of their at-will employment." *Id.* at **5.

It is important to note that that the Court of Appeals avoids "adopting or rejecting the Second Circuit's rationale [in *Stewart*]." *Id.* at **3. What remains unsettled from the court's opinion, then, is whether and to what extent fraudulent inducement claims may still be brought successfully by employees who prove injury independent to the termination, as the former employee did in Stewart, and has been done by other plaintiffs in the past. *See, e.g., Navigant Consulting, Inc. v. Kostakis*, 2007 U.S. Dist. LEXIS 74460, *10-17 (E.D.N.Y. Oct. 4, 2007) (denying motion to dismiss fraudulent inducement claim brought by former employee where he alleged that the compensation and career trajectory promised by his employer prior to his acceptance of employment were made with a "preconceived and undisclosed intention of never carrying them out" and where employee claimed damages "for loss of employment opportunities at [the firm at which he previously worked] (including his imminent promotion), loss of professional representation, diminution of earnings and earning capacity, and damage to career growth and potential"); *Doehla v. Wathne Ltd., Inc.*, 2000 U.S. Dist. LEXIS 9913 (S.D.N.Y. July 13, 2000) (denying motion to dismiss fraudulent inducement claim brought by former employee where "representations [made by new employer] about what his position would be and what he would be allowed to do were not true when they made them" and where former employee alleges damage to his career development as a highly-paid corporate chief executive, as he had turned down a "lucrative long-term contract to remain" his former employer's President and CEO).

While *Smalley* is certainly a win for the employment at-will doctrine, it is important for employers to bear in mind that fraudulent inducement claims may still be successfully brought by former employees under the doctrine set forth in *Stewart*.

Ninth Circuit Says ERISA Does Not Bar State Laws Mandating Employer Funded Health Care Benefits

By Mark Jacoby and Daniel J. Venditti

The availability of affordable health insurance in the United States continues to be an issue of great concern for many Americans. The desire to make health care more widely available and more affordable has prompted a few state and local legislatures to enact laws that require employers to fund their employees' health care. These laws mandate that employers meet predetermined health care spending levels, or pay an amount to the local government to fund public access to health care. The State of Maryland, Suffolk County, New York, and the City of San Francisco have enacted laws with similar requirements. *See* Md. Code. Ann., Lab. & Empl. §§ 8.5-101 through -107 ("Maryland Fair Share Act"); Suffolk County Fair Share for Health Care Act, Suffolk County, N.Y. Reg. Local Law §§ 325-1 to -7 (2005) ("Suffolk County Fair Share Act"); San Francisco Health Care Security Ordinance, codified as City and County of San Francisco Administrative Code, Sections 14.1 to 14.8 ("San Francisco Ordinance"). Each of these laws, however, has come under attack as encroaching on the provisions of the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. §§ 1001-1961 ("ERISA"), which preempt state laws that "relate to" employee benefit plans.

In the past year, federal courts ruled that ERISA preempts both the Maryland and the Suffolk County Fair Share Acts. *See Retail Indus. Leaders Ass'n v. Fielder*, 475 F.3d 180 (4th Cir. 2007); *Retail Indus. Leaders Ass'n v Suffolk County*, 497 F. Supp. 2d 403 (E.D.N.Y. 2007). The San Francisco Ordinance is broader in scope than the Maryland and Suffolk County Fair Share Acts. San Francisco's law applies to employers with as few as twenty employees, while the Maryland and Suffolk County laws were so-called "Walmart laws" targeting only the largest retailers in those jurisdictions. The three laws, however, are similar in structure because each requires employers to spend a certain amount on their employees' health care, and each provide alternative spending methods intended to allow employers to meet their obligations ostensibly without interfering with the administration of ERISA plans.

The Ninth Circuit Court of Appeals recently held in *Golden Gate Restaurant Association v. City and County of San Francisco*, 512 F.3d 1112 (9th Cir. 2008), that ERISA most likely does not preempt the San Francisco Ordinance. It is noteworthy that the Ninth Circuit's ruling in *Golden Gate* was not a final determination on the merits by that Court that the San Francisco Ordinance is lawful. The court below had held that the Ordinance was preempted, and the Ninth Circuit's decision stayed the lower court's judgment pending appeal. Nevertheless, in granting the stay, a unanimous panel agreed that there was a "strong likelihood" that San Francisco would succeed on appeal. In reaching that conclusion, the Court ruled, at least on a preliminary basis, that the Ordinance did not "relate to" ERISA plans and thus was not preempted by ERISA. Although the stay decision was not a final ruling on the matter by the Ninth Circuit, it is highly likely that the Ninth Circuit will rule the same way in finally deciding the appeal. If the Ninth Circuit does uphold the San Francisco Ordinance, it would create a split between the

Ninth and Fourth Circuits, setting the stage for Supreme Court review of this important question.

Background

ERISA preempts "any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. § 1144(a). A state law "relates to" an employee plan by "referring to" or having a "connection with" such a plan. *Cal. Div. of Labor Standards Enforcement v. Dillingham Constr., N.A., Inc.*, 519 U.S. 316, 324-25 (1997); *Shaw v. Delta Air Lines, Inc.*, 463 U.S. 85, 96-97 (1983). A state law "refers to" an ERISA plan if the law "acts immediately upon ERISA plans" or if "the existence of ERISA plans is essential to the law's operation." *Dillingham*, 519 U.S. at 325. A state law has an impermissible "connection with" an ERISA plan if the effect of the state law is to require employers to structure their employee benefit plans in a particular way or to provide specific benefits. If different states were to adopt inconsistent requirements, it would interfere with ERISA's goal of establishing a uniform administrative scheme for the processing of claims and disbursements of benefits. *See Engelhoff v. Engelhoff*, 532 U.S. 141, 148 (2001); *Dillingham*, 519 U.S. at 325.

States may, however, create incentives that influence employers to make particular decisions regarding the health care they provide. *See Dillingham*, 519 U.S. at 334; *N.Y. State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 659-62 (1995). In Travelers, the Supreme Court held that ERISA did not preempt a New York statute that required hospitals to collect surcharges from patients covered by a commercial insurer but not from patients insured by a Blue Cross & Blue Shield plan. This form of "indirect economic influence" was found to be permissible because it did not bind plan administrators to any particular choice. Although Blue Cross & Blue Shield plans became more attractive to plan administrators under the New York law because they did not have an associated surcharge, administrators remained free to select other insurance plans if they chose. *Travelers*, 514 U.S. at 659-64.

The Golden Gate decision is important because it is the first time a court has permitted a state or local mandated employer health care spending law to remain in effect.

The analysis by the Ninth Circuit in *Golden Gate* is directly at odds with that of the Fourth Circuit in *Fielder* regarding whether the mandatory health care spending laws impermissibly require employers to increase their contributions to ERISA plans, or merely increase the possibility that employers will be influenced to do so.

The Maryland Fair Share Spending Act

The Maryland Fair Share Act, Md. Code. Ann., Lab. & Empl. §§ 8.5-101 *et seq.*, required employers with at least 10,000 employees to spend an amount equal to or greater than eight percent of the total wages that they pay to employees in the State on "health insurance costs." Md. Code. Ann., Lab. & Empl. §§ 8.5-102, 8.5-104(b). Covered employers falling below the eight percent threshold were required pay the State the difference between the eight percent and what they actually spend on health insurance costs. The Maryland Fair Share Act defined "health insurance costs" as "the amount paid by an employer to provide health care or health insurance to employees in the State to the extent the costs may be deductible by an employer under federal tax law." Such costs include "payments for medical care, prescription drugs, vision care, medical savings accounts, and any other costs to provide health benefits as defined in § 213(d) of the Internal Revenue Code." Md. Code. Ann., Lab. & Empl. §§ 8.5-101(D).

In *Fielder*, a retail trade association sued the Maryland Secretary of Labor seeking a declaration that ERISA preempted the Maryland Fair Share Act. Both the district court and the Fourth Circuit agreed that the law "related to" employee benefit plans and was therefore preempted. Maryland had argued that the statute did not violate ERISA because, under the statutory definition of "health care expenditure," covered employers could satisfy their spending requirements in one of three ways that did not implicate an ERISA plan or the administration of an ERISA plan: (i) by contributing to health savings accounts for their employees; (ii) by funding on-site first aid facilities; or (iii) by paying the State the difference between what they actually spend on health care and the eight percent minimum amount.

The Fourth Circuit rejected Maryland's argument, reasoning that none of the alternative options advanced by the State provided employers with a meaningful way to increase their health care spending other than raising their contributions to ERISA plans. Making additional contributions to employee health savings accounts was not a viable option because such accounts are available only under limited conditions, which greatly reduced the number of employees who could potentially benefit from the increased spending. On-site medical clinics are exempt from ERISA only if they are limited to "the treatment of minor injuries or illness or rendering first aid in case of accidents occurring during working hours," and the Court doubted that this type of facility would be a serious means by which employers would increase spending to comply with the act. *Fielder*, 475 F.3d at 196 (quoting 29 C.F.R. § 2510.3-1(c)(2)). Finally, the Fourth Circuit agreed with the district court that a rational employer would not choose to pay money to the State rather than offer the same amount of money to their employees in the form of additional health care benefits. Thus, because the Maryland Fair Share Act left "employers no reasonable choices except to change how they structure their employee benefit plans," it had a "connection with" such plans and was preempted by ERISA. *Id*. at 197.

The Suffolk County Fair Share Act

In 2007, Suffolk County, New York enacted local legislation requiring large retail employers to make minimum "health care expenditures" for their employees. Covered employers could satisfy the Suffolk County Fair Share Act by (i) contributing to an ERISA plan; (ii) paying into health savings accounts; (iii) reimbursing employees for health-care expenses; (iv) funding the operation of an on-site health clinic; or (v) contributing to a public health center. N.Y. Reg. Local Law §§ 325-2. The same retail trade association that successfully challenged the Maryland Fair Share Act sued the County of Suffolk, arguing that ERISA also preempted the Suffolk County Fair Share Act. Finding that the requirements of the Suffolk County Fair Share Act were substantially similar to the Maryland Fair Share Act, the district court adopted the reasoning of the Fourth Circuit, agreeing that the only realistic option for employers under the County legislation would be to increase funding of their ERISA plans. *Retail Indus. Leaders Ass'n v. Suffolk County*, 497 F. Supp. 2d 403, 417-18 (E.D.N.Y. 2007).

The ruling may well stimulate other state or local legislative bodies to adopt similar legislation, even as a Presidential election campaign is underway in which all of the candidates are speaking of federal legislation to make adequate health care more universal in this country.

The San Francisco Health Care Security Ordinance

Similar in concept to the Maryland and Suffolk County Fair Share Acts, but much broader in coverage, the San Francisco Ordinance imposes health care spending obligations on all but the smallest employers in that jurisdiction. City and County of San Francisco Administrative Code, §§ 14.1(b)(3), 14.3. Specifically, the San Francisco Ordinance requires that employers with as few as twenty employees "make required health care expenditures to or on behalf of their covered employees each quarter." "Required health care expenditures" are calculated by multiplying the number of hours paid for every covered employee during the quarter by the applicable "health care expenditure rate," which varies depending on the size of the employer. *Id*. §§ 14.1(b)(8), 14.3; OLSE Regulations Implementing the Employer Spending Requirement of the San Francisco Health Care Security Ordinance (HCSO) ("OLSE Regulations"), Reg. 5.2(A)(1)-(2).

The San Francisco Regulations expressly provide that a "covered employer has discretion as to the type of health care expenditure it chooses to make for its covered employees." OLSE Regulations, 4.2(A). However, the Regulations define "health care expenditures" to include the same options that the Fourth Circuit and Eastern District of New York found to be unrealistic and difficult to implement. To comply with the Ordinance, employers could: (i) pay health insurance premiums; (ii) contribute to self-insured and/or self-funded insurance programs; (iii) contribute to a health benefit flexible spending account, a health savings account, a health reimbursement account, a medical spending account, or similar account; (iv) reimburse covered employees for the purchase of health care services; (v) pay for the direct delivery of health care services for covered employees; or (vi) pay the City of San Francisco directly to fund membership in a public health care program or to establish and maintain medical reimbursement accounts for covered employees. OLSE Regulations, 4.2(A).

In the *Golden Gate* case, 512 F.3d at 1120-25, the Ninth Circuit ruled that ERISA most likely does not preempt the San Francisco Ordinance. The Ninth Circuit reasoned that the alternative payment options in the San Francisco Ordinance are not problematic and that they permit employers to comply with their spending obligations without impacting their administration of ERISA plans:

> Any employer covered by the Ordinance may fully discharge its expenditure obligations by making the required level of employee health care expenditures, whether those expenditures are made in whole or in

> part to an ERISA plan, or in whole or in part to the City. . . . The Ordinance also has no effect on 'the administrative practices of a benefit plan,' unless an employer voluntarily elects to change those practices.

512 F.3d at 1121. In the Ninth Circuit's view, the fact that employers faced with an obligation to spend a required amount on health care would be motivated to adopt or change their ERISA plans rather than make those payments to the City did not make the legislation unlawful. Because the Ordinance did not bind plan administrators to any particular choice regarding the provision or administration of benefits, it was not preempted. Although the Ninth Circuit believed the San Francisco Ordinance appropriately left discretion to employers in selecting from various non-ERISA payment options, the Court did not expressly discuss whether those options are practical or realistic, which was a primary concern for the courts in the Fourth Circuit and the Eastern District of New York in striking down the Maryland and Suffolk County Fair Share Acts.

Conclusion

The *Golden Gate* decision is important because it is the first time a court has permitted a state or local mandated employer health care spending law to remain in effect. While the ruling is not a final one by the Ninth Circuit, it certainly foreshadows the likely decision by this Court when it takes up the merits of the appeal in a few months. The ruling may well stimulate other state or local legislative bodies to adopt similar legislation, even as a Presidential election campaign is underway in which all of the candidates are speaking of federal legislation to make adequate health care benefits more universal in this country. In all events, if the Ninth Circuit does sustain the legality of the San Francisco Ordinance on appeal, this will set up a clear conflict between the Fourth and Ninth Circuits which may prompt the Supreme Court to weigh in on the ERISA preemption issue which has been raised by the enactment of state and local mandatory employer health care spending laws.

International Employment Law

Update On Current German Employment Law Issues

By Mareike Pfeiffer and Andreas Mauroschat

According to a recent survey among 1,200 top managers from six European countries, Germany was considered to be one of the economically most competitive countries in the world, second only to China[1]. Moderate and flexible terms of employment were considered a material aspect for this favorable assessment.

To many observers this may come as a surprise, as Germany's employment law system frequently is perceived to be rigid and over-regulated. This may be reason enough to take a look at whether some recent developments in German labor and employment law may support such favorable findings.

Anti-Discrimination Law and Litigation

The Anti-Discrimination Act (the "Act") was introduced in August 2006, implementing relevant European regulations in Germany. The Act significantly extends the previous anti-discrimination law in some aspects, *e. g.*, race and religion, and established additional duties of the employer to prevent discrimination, including organizational measures and a duty to train employees in internal workshops and seminars. Even more importantly, the Act specifically introduced a liability of the employer for abstract damages in case of discriminating acts in the company. The Act does not define limits or ranges for the amount of such damages with the exception of damages for discriminatory non-hiring which are limited to three (hypothetical) monthly salaries.

In view of the above, there were fears that the Act could trigger a wave of anti-discrimination litigation and result in considerable additional costs for employers. These fears have not materialized so far: According to recent survey data, 94.3% [2] of the

Continued on page 11

UK Pensions Update – Potential Conflicts and Financial Demands of UK Pension Trustees in Deal Situations

By Joanne Etherton

The UK Pensions Regulator was set up under the Pensions Act 2004 and is the regulator of work-based pension plans in the UK. It has powers to investigate pension plans and to take action to protect the security of members' benefits, including anti-avoidance powers where it considers that an employer is deliberately attempting to avoid its pension obligations.

The law requires that most occupational pension plans in the UK are set up as trusts and that at least one-third of the trustees are nominated by the plan members. The other trustees are nominated by the sponsoring employer and tend to be drawn from management, although some employers are now choosing to appoint independent professional trustees.

Trustees of defined benefit ("DB") pension plans in the UK have a duty to monitor the financial strength and prospects of the plan's sponsoring employer as well as the employer's willingness to continue to fund the plan's benefits. Some of these duties are similar to those of trustees of DB plans maintained in the United States, while others are quite different. If there are changes in what is known as the "employer covenant" (i.e. the employer's legal obligation to the plan and its financial position, both current and prospective) which the trustees think could have a negative impact for the UK pension plan they may seek (possibly substantial) financial compensation from the employer. Additionally, the UK Pensions Regulator may seek to look to the wider corporate group of the plan sponsor to fund any pension deficit (similar to joint and several responsibility among a US plan sponsor's ERISA "control group", but applicable in wider circumstances).

This trustee obligation is one of various measures aimed at protecting employees' DB plan benefits. It requires trustees to have a proactive role in regularly carrying out an objective assessment of the sponsoring employer's financial strength and the implications for the plan of any significant corporate transactions relating to the sponsoring employer, another employer participating in the plan or the wider corporate group. There are also requirements for sponsoring employers and trustees to notify the UK Pensions Regulator when certain specified corporate or scheme related events occur (similar to ERISA's "reportable events" requirements).

UK pension plan trustees expect to be involved at the time of corporate transactions impacting the sponsoring employer (or its wider corporate group) and may demand significant financial compensation. In dealing with these issues, potential conflicts of interest of the plan trustees need to be carefully managed.

Accordingly, many trustees are now seeking to agree on an information sharing protocol with the employer whereby the sponsoring employer agrees to provide the trustees with regular financial updates and, potentially, advance notice of certain events which could impact on the covenant. This need for sharing of corporate and financial information brings to the fore the issue of potential conflicts of interest in trustee boards – particularly the trustees nominated by the sponsoring employer – and the whole question of how the trustee board is constituted.

The management of conflicts of interest by trustees of UK pension plans is a hot topic at the moment and the UK Pensions Regulator issued, for consultation, draft guidance on the topic at the end of February 2008.

Acute conflicts of interest can arise where a trustee is privy to employer information relevant to the pension plan. In this situation there can be a direct conflict between the trustee's duty to share information with fellow trustees and the trustee's duty of confidentiality to the employer. Options for dealing with this situation include the employer waiving the confidentiality duties (on the basis that the trustees have signed a confidentiality agreement), the trustee being absolved in some way from sharing employer information in specified circumstances or the trustee in question having to resign as a trustee.

While more details on these and other UK pension related issues will be forthcoming in future issues of Employer Update, the key points to note are:

1. UK pension plan trustees are taking a more active interest in the corporate group within which their sponsoring employer operates and may start seeking information, for example, on transactions relevant to a US parent company if they think it could have an impact on the UK company or pension plan;
2. Failure to keep the trustees informed could lead to UK Pensions Regulator involvement or additional security (in the form of cash, charges or guarantees) being requested by the trustees; and
3. Trustees who have relevant corporate information gained in their capacity as managers or executives at the corporate level need to consider how to manage any potential conflicts between the interests of the company and their role as trustees acting in the best interests of pension plan members.

If there are UK DB plans in a company's corporate group or a company is considering a corporate transaction, consider the following:

(1) Are there procedures in place to assess whether any current or future corporate transaction could have an impact on UK pension plans of group subsidiaries and to provide information to the trustees to enable them to comply with their obligations?

(2) How is the trustee board of the UK pension plan constituted and how are conflicts of interest currently being managed?

German Employment Law

Continued from page 10

companies have never been involved in a discrimination dispute until November 2007 and only 0.1% to 0.3% [3] of all employment lawsuits brought before first instance courts from the introduction of the Act until April 2007 were related to the Act.

This situation could change dramatically depending on the outcome of a currently pending court case in which a woman of Turkish origin has sued her employer, a major German insurance company, for damages in the amount of EUR 500,000 based on alleged gender and national origin discrimination. This is the highest anti-discrimination claim ever filed in Germany. Most legal experts believe, however, that the claim is unlikely to succeed.

The moderate impact of the Act may be based on the fact that many employers have trained their staff to avoid critical situations, in particular in connection with hiring processes, and have screened their pension and benefit schemes for compliance with the Act.

Opt-out of Collective Agreements

In Germany, the material terms of employment (in particular working hours and salaries) are frequently regulated by collective agreements. Employers bound by a collective agreement must meet such terms and conditions at minimum. Traditionally, collective agreements are negotiated between employers' associations and labor unions and are applicable to all member companies within a Federal State or region. Since such agreements are naturally not tailor-made to fit the economic situation of an individual employer, the collective agreements have in the past frequently resulted in considerable cost pressure for some employers.

The introduction of the Anti-Discrimination Act has so far not resulted in the expected wave of litigation. The outcome of the currently pending highest anti-discrimination claim ever filed in Germany may dramatically change this situation.

As a result, since the early 1990s, there has been an increasing trend of companies withdrawing from the collective agreement coverage. Labor unions have reacted to this trend by consenting to opt-out provisions in collective agreements which allow employers to regulate adequate working hours and salaries by agreement with their works council. While we have frequently seen opt-out provisions allowing flexible adjustment of working hours or a reduction of annual bonuses, opt-out provisions relating to the amount of the base salaries are not as frequent in most industries. There are, however, certain industries, *e.g.*, the chemical industry, in which applicable collective agreements allow a salary opt-out for all bound employers subject to union consent.[4]

Going forward, we expect that an increasing number of employers will be able to use the option to define adequate terms and conditions of employment for their enterprise by individual agreement with their works council.

Introduction of Minimum Wages

Traditionally, any initiatives to introduce a statutory nationwide minimum wage have been refused by German governments. The discussion has, however, been reopened lately with the left wing parties and the labor unions in particular speaking in favor of such proposals. Two Federal States have filed applications with the German Federal Council requesting a nationwide minimum wage of EUR 7.50 per hour by statutory law.[5] These applications have been refused so far, but it is possible that the political situation may change soon.

At the moment, a minimum wage exists only for the building industry and related industries and, as of 2008, for the mail services sector. However, such minimum wage arrangements for specific industries are facing legal and practical problems: The introduction of the minimum wage for the mail services sector has been declared ineffective by a regional court, emphasizing *inter alia* the constitutional rights of the competitors of Deutsche Post AG. In addition, it appears that the labor union and employers' associations competent for the building industry will not come to an agreement on the extension of the collective minimum wage agreement for the building industry which will expire in August 2008.

Putting an end to a long-lasting debate, Germany may soon follow the example of most other European countries which have already introduced a statutory nationwide minimum wage.

Less Flexibility for Forfeiture Provisions in Bonus Schemes

In October 2007, the German Federal Labor Court held that a provision in a bonus scheme stipulating without further detail that a granted bonus must be forfeited if notice of termination is given prior to a certain date is not sufficiently clear and, thus, ineffective[6]. The Federal Labor Court stated that the employer should, *inter alia*, have distinguished between different amounts of bonus payments when determining the forfeiture date. The court expressly left the question open as to whether a bonus amounting to more than 25% of the total annual remuneration may be subject to forfeiture at all.

This decision will have a material impact on the design of company bonus schemes and employment agreements, since comparable forfeiture clauses had been standard practice in Germany, in particular in the banking industry. Employers will need to analyze their existing bonus schemes and individual bonus grants for compliance with the new requirements.

Reduction of Downsizing Risks by Statutory Settlement Option?

A material risk for employers in connection with downsizing and restructuring activities in Germany has always resulted from the fact that in case of an unfair dismissal the employer is not obliged to pay a severance or other penalty but to reinstate the employee. The reinstatement obligation includes the obligation to pay all salaries which have accrued as of the date of the unfair dismissal. In practice, the reinstatement risk is therefore a sword of Damocles for the employer and complicates reliable cost projections for downsizing and restructuring efforts. As a consequence, employers are frequently willing to settle unfair dismissal claims in court for payment of a severance although there is no general obligation of an employer to pay severances under German law.

In an effort to mitigate such risk, a new provision was introduced in the German Termination of Employment Act in 2004 under which employers may offer a severance payment in an amount of at least half a monthly salary for each year of service with the company subject to the condition that the employee who was made redundant does not file a suit against the termination. However, the legislature's effort to reduce employers' risks fell short of the target and the new provision has not become relevant in practice, since it has proven to be ineffective in avoiding court cases: Employees frequently would rather take the offered amount as a base line and try to negotiate a higher amount in court. It remains to be seen whether the legislature will eventually follow the example of other European countries and replace the reinstatement principle by a severance obligation in case of unfair dismissals.

Conclusion

There are numerous promising signs that German labor and employment law is becoming more flexible and offers employers options to find adequate and competitive solutions for their enterprises. Opt-out clauses in collective agreements and initial efforts of the legislator to reduce the restraints of termination protection law for employers may serve as examples. However, recent developments such as the introduction of the Anti-Discrimination Act and the new requirements for bonus forfeiture clauses illustrate that it still remains a highly regulated and technical field. The frequently proposed fundamental reform and simplification has, so far, not been politically achievable.

Coming back to the favorable assessment of Germany as an investment location, it appears to be fair to conclude that while the German labor and employment law system has come a long way to provide more flexibility to employers, there is still room for further reforms and deregulation.

1 *Handelsblatt* dated January 2, 2008, p. 1; US companies rate Germany as the number one investment location in Western Europe, see *V. AmCham Business Barometer 2007*, AmCham Germany and Boston Consulting Group, www. AmCham.de; see also cover story of *The Economist* dated August 18, 2005: "Germany's surprising economy".

2 *Personalmagazin* 02/08, p. 42-43; *Frankfurter Allgemeine Zeitung* dated January 21, 2008, p. 13.

3 *Press release* dated June 27, 2007, of the Higher Labor Court Baden-Württemberg; Federal Equal Treatment Office, in *Personalmagazin* 02/08, p. 42.

4 Wolf Dieter Heinbach, "Ausmaß und Grad der tarifvertraglichen Öffnung" in IAW-Report 2/2005, p. 49 et seq.; Wolf Dieter Heinbach in *IAW-News* 2/2006, p. 4.

5 Print matters of the Federal Council *BR-Drs. 517/07* and *BR-Drs. 634/07*.

6 *Neue Zeitschrift für Arbeitsrecht* 2008, p. 40-45.

Internal Revenue Service Limits Section 162(m) Performance-Based Compensation Exception to Exclude Payment Upon Involuntary Termination

By Steven Margolis

In two recently released rulings, the Internal Revenue Service ("IRS") announced that incentive-based compensation that could have been paid upon an executive's termination of employment without "cause" or for "good reason" – regardless of whether the performance goal was attained – does not meet the qualified performance based compensation exception under Internal Revenue Code Section 162(m) and the regulations. Private Letter Ruling 200804004, released on January 25, 2008, runs contrary to prior private letter rulings which directly acknowledged that a termination without cause or for good reason was similar to a termination due to death, disability or change in control, and payment made upon such termination would not disqualify the plan or arrangement from the qualified performance-based compensation exception under Section 162(m).

On February 21, 2008, the IRS released Revenue Ruling 2008-13 in support of PLR 200804004. This Revenue Ruling confirmed the new IRS position on the application of the $1 million compensation limitation under Internal Revenue Code Section 162(m), but it provides transition relief under which the new IRS position will not apply to employment agreements, contracts or plans if (i) the performance period for the compensation begins on or before January 1, 2009, or (ii) the compensation is paid pursuant to such arrangements in effect (without respect to future renewals or extensions, including any automatic renewals or extensions) on February 21, 2008.

These new rulings call into question the deductibility of all payments intended to qualify for the performance-based exception where the underlying plan or arrangement allows payment upon a termination without cause or for good reason or due to retirement.

Background

Statutory Law. IRC Section 162(m) generally provides that compensation in excess of $1,000,000 paid to any "covered employee"[1] of a publicly held corporation is not deductible by the corporation. However, IRC Section 162(m)(4)(C) exempts from such limit certain performance-based compensation that will not be paid unless the applicable performance goals are satisfied. Further, Treas. Reg. Section 1.162-27(2)(2)(v) provides that "compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the [performance goal requirements]." That is, if an amount is paid prior to the attainment of the performance goal because of the employee's death, disability or a change in control, the amount is not deductible, but the underlying plan or arrangement would still otherwise qualify for the performance-based exception.

Prior Rulings. In both 1999 and 2006, the IRS issued rulings which expanded the payment circumstances in Treas. Reg. Section 1.162-27(2)(2)(v). In PLR 199949014, the IRS addressed whether a restricted stock agreement which provided that shares would immediately become fully vested if an executive was terminated by the company without cause, or upon a termination by the executive for good reason, would qualify for the Section 162(m) performance-based exception. The IRS concluded that a termination by the company without cause and a termination by an executive with good reason are both involuntary terminations similar to terminations as a result of death, disability or change in control. Similarly, in PLR 200613012, the IRS concluded that compensation paid under a company's annual and long term bonus plan upon the attainment of performance goals would be considered a performance-based exception under Section 162(m)(4)(C), even though the compensation could be paid upon the executive's termination by death, disability, by company without cause, or by the executive for good reason or due to the executive's retirement.

If a plan allows for payment of performance-based compensation upon a termination by the company without cause or by the executive for good reason or due to retirement, without regard to whether the performance-based conditions have been satisfied, then any payment under the plan will not be considered performance-based compensation that is deductible under Section 162(m).

PLR 200804004

The facts in PLR 200804004 are substantially the same as in the two prior private letter rulings. In this case, an employment agreement provided that if the executive's employment was terminated by the company other than for cause or by the executive for good reason, the performance goals would be "deemed to be achieved at target and the award shall vest at termination to the extent such awards would have become vested in accordance with the regular vesting schedule had Executive's employment continued for a period of two years following Executive's termination date."

Without distinguishing either PLR 199949014 or 200613012, the IRS ruled that if the payment of compensation is only nominally or partially contingent upon attaining a performance goal, none of the compensation payable under the grant of award is considered performance-based. The ruling is consistent with the specific wording in the regulations, but at odds with the prior private letter rulings. This means, if a plan or arrangement allows for payment of the performance-based compensation upon a termination by the company without cause or by the executive for good reason or due to retirement, without regard to whether the performance-based conditions have been satisfied, then no such payment will be considered performance-based compensation that is deductible under Section 162(m).

Revenue Ruling 2008-13 and Transition Relief

Revenue Ruling 2008-13 reaffirms the new IRS position set forth in PLR 200804004. However, this new position will only apply prospectively. Specifically, Revenue Ruling 2008-13 does not apply to arrangements that otherwise qualify for the performance based compensation exception under Internal Revenue Code Section 162(m) if either:

- the performance period for the compensation begins on or before January 1, 2009, or
- the compensation is paid pursuant to the terms of an employment contract as in effect (without respect to future renewals or extensions,

including any automatic renewals or extensions) on February 21, 2008.

Action Items

While PLR 200804004 technically only applies to the taxpayer that requested it, Revenue Ruling 2008-13 applies broadly. This ruling signifies the IRS's new position on this type of arrangement, and publicly traded corporations should be prepared to comply with this ruling within the timeframe of the transition relief.

The transition relief in Revenue Ruling 2008-13 does two important things. First, it covers prior awards so that the deductibility of such awards is not in question. Second, it provides many employers nearly two years to amend their plans (longer, in some cases where long-term employment contracts are in place).

In light of these rulings, employer should take the following steps to ensure compliance:

- Review all employment agreements, equity and bonus plan award agreements and other arrangements intended to qualify for the performance-based exception under IRC Section 162(m) to determine if they contain the prohibited payment provisions.
- Determine when existing employment agreements, plans and arrangements that may be "grandfathered" under the transition relief will become subject to the new rules, *e.g.*, when does the initial term of an employment agreement without regard to any extension, and take appropriate action to amend such arrangement as necessary to comply with the new rulings.
- For new employment agreements, plans and arrangements entered into after February 21, 2008, draft such arrangements so as to comply with the new rulings.
- Check with your accountants and other advisors regarding the impact on anticipated future deductions and any public filings or public disclosure documents.

If you have any questions on the application of PLR 200804004 and Rev. Rul. 2008-13, please contact Andrew Gaines (andrew.gaines@weil.com (212-310-8804)), Michael Kam (michael.kam@weil.com (212-310-8240)), Michael Nissan (michael.nissan@weil.com 212-310-8169)), Amy Rubin (amy.rubin@weil.com (212-310-8691)) or Steven Margolis (steven.margolis@weil.com (212-310-8124)).

1 For IRC Section 162(m) purposes, "covered employee" generally means a corporation's chief executive officer and its three most highly compensated officers (other than the chief executive officer) whose compensation is required to be disclosed for purposes of the Securities Exchange Act of 1934.

Enforceability of Class Arbitration Waiver Clauses

By Jeffrey S. Klein, Nicholas J. Pappas and Jason E. Pruzansky

Employers frequently adopt mandatory pre-dispute arbitration policies to achieve quick, inexpensive and confidential resolution of employment claims. However, the Supreme Court's decision in *Green Tree Fin. Corp v. Bazzle*, 539 U.S. 444 (2003), raised the specter of a chilling impediment for employers – the unanticipated potential for classwide arbitration arising out of an individual employment dispute. In *Bazzle*, the Supreme Court recognized the possibility that even where an arbitration agreement makes no mention of class actions or the possibility that non-parties to the arbitration agreement might be permitted to assert claims for relief, an individual claim could be transformed into a class action within the context of arbitration.

Prior to *Bazzle,* most courts refused to allow individuals to seek class certification within an arbitration except where the arbitration agreement expressly authorized individuals to maintain class actions.[1] However, following the *Bazzle* decision, a number of arbitration panels and courts have wrestled with the question of whether an arbitration clause silent on the availability of the class action procedure could be construed either to allow or to preclude class actions.[2]

Many employers have responded to *Bazzle* by crafting arbitration agreements that expressly prohibit class arbitration, in an effort to protect themselves from the unexpected expense, risk, and lack of procedural safeguards, including full appellate rights, inherent in class arbitration. Additionally, employers have sought to steer clear of class arbitration due to the less predictable adherence by arbitrators to precedent and the risk that the parties to the arbitration will be forced to select arbitrators from panels that are less experienced than judges in class action procedures. While numerous courts have enforced provisions barring class arbitration,[3] courts in California recently have found that under certain circumstances such provisions are unconscionable, and, therefore, render the entire arbitration agreement unenforceable.

In this article, we provide a general overview of the legal framework that courts have applied in deciding whether to deny enforcement of arbitration agreements under the law of unconscionability. We then analyze a recent California appellate court decision which denied enforcement of an arbitration agreement due to unconscionability, in part because of the inclusion of a class action waiver clause. We also propose ways employers might draft their arbitration programs or agreements to protect against such unanticipated risks. Finally, we highlight legislation that is currently pending in Congress that would amend the Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2000) ("FAA"), by limiting the enforceability of predispute arbitration agreements in the employment context.

Law of Unconscionability

Under the FAA, an arbitration agreement "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The Supreme Court has held that, under § 2, a court may refuse to enforce an arbitration agreement where a party has demonstrated the applicability of a generally available contract defense, such as unconscionability. *See Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996)("[g]enerally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2"). Under the FAA, a court may refer to state contract law when evaluating whether an arbitration agreement is unconscionable.[4] Although there is no universal definition of "unconscionable,"[5] numerous courts have explained that so-called "procedural unconscionability" involves "bargaining naughtiness in the formation of the contract, i.e., fraud, coercion, undue influence, misrepresentation, inadequate disclosure." *Rudolph v. Topsider Bldg. Sys.*, 2007 U.S. Dist. LEXIS 54403, at *11 (D. Haw. 2007). Likewise, various courts have explained that so-called "substantive unconscionability" involves "the harsh, oppressive, and one sided terms of a contract, i.e., inequality of the bargain." *Tillman v. Commer. Credit Loans, Inc.*, 629 S.E.2d 865, 870 (N.C. Ct. App. 2006).

The court held that if the trial court concludes, based on these factors, that a class arbitration is likely to be "a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations, it must invalidate the class arbitration waiver...

Most jurisdictions require a showing of *both* procedural and substantive unconscionability in order to render an arbitration agreement unenforceable,[6] while others only require a showing of one or the other to invalidate an arbitration agreement.[7] Other courts will use a sliding scale. Under this approach, where there is a greater degree of substantive unconscionability, a lesser degree of procedural unconscionability will be necessary for an agreement to be found unenforceable.[8]

Gentry v. Superior Court

The California Supreme Court recently announced a specific test to be applied in determining whether an arbitration agreement may be found unconscionable due to its inclusion of a class action waiver provision. Though the persuasive value of this case outside of California remains to be seen, employers should take note of this precedent and assess their current arbitration programs under the California standards.

In *Gentry v. Superior Court*, 42 Cal. 4th 443 (2007), the defendant employer moved to compel the plaintiff to arbitrate a claim to be paid overtime wages under a broad arbitration agreement which also included a class action waiver clause. *Id.* at 451-52. The Court did not address the merits of this motion, but instead remanded the case back to the trial court to analyze four issues which would govern the enforceability of the arbitration agreement, and the class action waiver clause as follows:

1) the size of the potential individual recovery;

2) the potential for retaliation against members of the class;

3) whether absent members of the class may be ill-informed about their rights;

4) "other real world obstacles" to the vindication of class members' rights via individual arbitration.

Id. at 463. The court held that if the trial court concludes, based on these factors, that a class arbitration is likely to be "a significantly more effective practical means of vindicating the rights of the affected employees than individual litigation or arbitration, and finds that the disallowance of the class action will likely lead to a less comprehensive enforcement of overtime laws for the employees alleged to be affected by the employer's violations, it must invalidate the class arbitration waiver..." *Id*. The court remanded the case to the court of appeals with directions to remand to the trial court to determine whether the disputed class arbitration waiver at issue was void. *Id*. at 473. As of the writing of this article, the trial court has not decided whether or not to require arbitration of the dispute.

Murphy v. Check 'N Go of California, Inc.

In the first published decision to apply the *Gentry* factors in the context of a motion to compel arbitration, the Court of Appeals of California in *Murphy v. Check 'N Go of California, Inc*., 156 Cal. App. 4th 138 (Cal. Ct. App. 2007) affirmed a trial court's order denying an employer's motion to compel arbitration in a wage and hour dispute thereby allowing the employee to proceed with her individual and class action claim in state court. The plaintiff in *Murphy*, Lisa Murphy, worked for the defendant payday lending company for eight years ending in 2005. *Id*. at 141. For the last seven of those eight years she held the position of "salaried retail manager." *Id*. In February 2006, Murphy filed suit on behalf of similarly situated retail managers claiming that the defendant misclassified its salaried retail managers as exempt under California labor laws thereby denying them time and one half overtime compensation. *Id*. The defendant responded to the lawsuit by filing a motion to compel arbitration based on an arbitration agreement contained in a "Dispute Resolution Agreement." *Id*. at 142.

In opposing defendant's motion to compel arbitration, plaintiff asserted that the arbitration agreement which she signed, was delivered to her office along with the regular company mail and that the company required all employees to sign the agreement and return it to company headquarters. *Id*. Plaintiff stated that no one explained the agreement to her nor did the company inform her that she had the ability to opt out or otherwise revise the agreement. *Id*. The agreement to arbitrate covered virtually all claims arising from or relating to plaintiff's employment including claims that the arbitration agreement itself "is substantively or procedurally unconscionable." *Id*. Under the agreement, arbitration of a claim is mandatory if elected by either party to the dispute. *Id*. In bold print, the class action waiver clause read: "you and we agree that an arbitration firm may not arbitrate a [claim] as a class action or a representative action and may not otherwise consolidate the [claim] with the claims of others." *Id*.

The California courts have shown that courts may look with disfavor upon a dispute resolution program that requires as a condition of employment, that employees arbitrate all their claims on an individual basis and also to waive their rights to assert class actions, whether in a judicial or arbitral setting.

Citing to the public policy considerations and factors set forth in *Gentry*, the appellate court affirmed the trial court's decision finding the class action waiver clause unenforceable. *Id*. at 148-49. The plaintiff in *Murphy* submitted testimony from her counsel declaring that "class members would have difficulty securing legal representation for individual cases because of the relatively small sums involved, and [pointing out that] class actions are necessary to deter employers like defendant from misclassifying their employees." *Id*. at 148. The court found this evidence (which was unrebutted by the defendant) properly supported the trial court's finding that the class action waiver provision had the effect of an "exculpatory clause" by making it "very difficult for those injured by unlawful conduct to pursue a legal remedy." *Id*. at 147-49. Finding the arbitration agreement "permeated" by unconscionability,[9] the court refused to sever the class action waiver clause from the rest of the agreement thereby rendering the *entire* arbitration agreement unenforceable. *Id*. at 149. As a result, the court denied the defendant's motion to compel arbitration effectively permitting the plaintiff to continue pursuing both her individual and class action claim in state court.

Drafting Considerations

In view of the *Gentry* and *Murphy* cases, employers both in California and other jurisdictions should review their arbitration programs and assess how their programs addresses the availability of a class actions in arbitration. The California courts have shown that courts may look with disfavor upon a dispute resolution program that requires as a condition of employment, that employees arbitrate all their claims on an individual basis and also to waive their rights to assert class actions, whether in a judicial or arbitral setting.[10]

Although full waivers of the right to assert class actions may, in particular circumstances and in various jurisdictions, violate unconscionability principles, employers may wish to consider implementing arbitration programs which maximize their ability to avoid class actions in arbitration. There are at least two ways this can be accomplished through careful drafting of the arbitration agreement.

First, employers may implement an arbitration program that requires arbitration of individual employment disputes, prohibits arbitration of class action claims, but which expressly allows employees wishing to assert class action claims to assert those claims in court. Thus, an aggrieved employee must assert any individual claims in arbitration, but if the employee wishes to assert a class action claim, both his individual claim and the class action claim must be asserted in court. The NASDAQ and New York Stock Exchange have similar arbitration policies in place to resolve disputes with their employees. *See* NASDAQ, Inc., Code of Arbitration Procedure § 10000; NYSE, Inc., Arbitration Rules § 600; *see also* NASD Code of Arbitration Procedure for Industry Disputes § 13000.

Alternatively, employers also might consider implementing a program that provides for arbitration of individual claims only where both parties agree at the time of the dispute to having the claim heard by an arbitrator. However, as with the first option described above, even under this procedure employers may wish to prohibit an employee who has consented to the individual arbitration of his dispute from amending his claim to include any class action claims, or from consolidating his claims with claims of other employees. Again, in cases where the employee wishes to assert a class action, the arbitration program should require the employee to assert his claim in court.

Arbitration Fairness Act of 2007

In addition to monitoring the increasing volume of litigation over arbitration in the employment context, employers also should stay abreast of legislative activities in this area. The recent developments in the case law has caused some legislators to seek certain changes in the FAA, which has governed arbitration law since 1925.

The Unites States Senate currently is considering a bill to amend the Federal Arbitration Act by limiting the enforceability of predispute arbitration agreements in employment disputes. *See* Arbitration Fairness Act of 2007 (S. 1782). Under S. 1782, "no predispute arbitration agreement shall be valid or enforceable if it requires arbitration of (1) an employment, consumer or franchise dispute; or (2) a dispute arising under any statute intended to protect civil rights or to regulate contracts or transactions between parties of unequal bargaining power."

The proposed bill defines a "predispute agreement" as "any agreement to arbitrate disputes that had not yet arisen at the time of the making of the agreement." An "employment dispute" includes any "dispute between an employer and employee arising out of the relationship of employer and employee as defined by the Fair Labor Standards Act." Employers with unionized employees should note that the bill would not bar the enforcement of arbitration clauses contained in collective bargaining agreements. The House of Representatives is currently considering a companion bill to S. 1782. *See* H.R. 3010.

1 *See, e.g., Glencore, Ltd. v. Schnitzer Steel Prods. Co.*, 189 F.3d 264, 266 (2d Cir. 1999); *Am. Centennial Ins. Co. v. Nat'l Cas. Co.*, 951 F.2d 107, 108 (6th Cir. 1991); *Weyerhaeuser Co. v. Western Seas Shipping Co.*, 743 F.2d 635, 637 (9th Cir. 1984).

2 For a comprehensive analysis of *Bazzle's* effect on the law concerning the availability of the class arbitration procedure in arbitration, *see* P. Christine Deruele & Robert Clayton Roesch, *Gaming the Rigged Class Arbitration Game: How We Got Here And Where We Go Now*, Metro. Corporate Counsel, Aug. 2007, at 9, Sept. 2007, at 5.

3 *See, e.g., Walther v. Sovereign Bank* 872 A.2d 735 (Md. 2005); *Strand v. U.S. Bank Nat. Ass'n ND*, 693 N.W.2d 918 (N.D. 2005).

4 *See Skirchak v. Dynamics Research Corp.*, 508 F.3d 49, 58 (1st Cir. 2007) (under the FAA, "[t]he enforceability of employer-imposed arbitration agreements depends on the governing state's contract law..."); *Circuit City Stores, Inc. v. Adams*, 279 F.3d 889, 892 (9th Cir. 2002).

5 *Zapatha v. Dairy Mart, Inc.*, 381 Mass. 284, 293 (Mass. 1980) ("[T]here is no clear, all-purpose definition of 'unconscionable,' nor could there be...").

6 *See, e.g., Ting v. AT&T*, 319 F.3d 1126, 1148 (9th Cir. 2003); *Armendariz v. Found. Health Psychcare Servs., Inc.*, 6 P.3d 669, 690 (Cal. 2000) ("The prevailing view is that [both procedural and substantive unconscionability] must be present in order for a court to exercise its discretion to refuse to enforce a contract or clause under the doctrine of unconscionability.").

7 *See, e.g., Bank One Acceptance Corp. v. Hill*, 367 F.3d 426, 433 n.4 (5th Cir. 2004).

8 *See, e.g., Armendariz*, 6 P.3d at 690 ("The more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.").

9 The court found the agreement "permeated" by unconscionability after determining that "at least two aspects of the arbitration agreement [were] unconscionable: (1) the provision for arbitrator determinations of unconscionability issues; and (2) the class action waiver." *Id.* at 149.

10 *See also Skirchak v. Dynamics Research Corp.*, 508 F.3d 49 (1st Cir. 2007)(affirming decision not to enforce arbitration agreement based on unconscionability due to class action waiver clause).

New Jersey Plant Closing Law Imposes New Potential Severance Pay Obligations on Employers

By Lawrence J. Baer and Philip F. Repash

Introduction

On December 20, 2007, New Jersey enacted the Millville Dallas Airmotive Plant Job Loss Act (the "New Jersey Act"), which imposes significant new obligations in addition to the federal law on which it is modeled, the Worker Adjustment and Retraining Notification Act, 29 U.S.C. § 2101, *et seq.* (the "WARN Act"). New Jersey is the sixteenth state to enact a state law analog to the federal WARN Act. Because the New Jersey Act substantially departs from the WARN Act by imposing new obligations and potential penalties – including mandatory severance pay – all New Jersey employers would be wise to familiarize themselves with the requirements of this new law.

Because the New Jersey Act substantially departs from the WARN Act by imposing new obligations and potential penalties – including mandatory severance pay – all New Jersey employers would be wise to familiarize themselves with the requirements of this new law.

By way of background, the WARN Act was enacted by the U.S. Congress in 1988 in the wake of numerous plant closings and mass layoffs in the 1970s and 1980s in an effort to soften the hardships imposed by such dislocations on employees. The WARN Act, among other things, requires employers to provide affected employees with 60 days' advance written notice of a mass layoff or plant closing to allow affected employees time to transition, including time to seek alternative employment. The New Jersey Act was enacted to address perceived shortcomings in the WARN Act following the 2004 closure of the Dallas Airmotive's plant in Millville, New Jersey that resulted in the loss of more than 200 jobs.

Scope of the New Jersey Act

The New Jersey Act applies to employers of 100 or more full-time employees at an "establishment" in New Jersey. An establishment is defined as "a single place of employment which has been operated by an employer for a period longer than three years." N.J. Sta. § 34: 21-1. An establishment "may be a single location or a group of contiguous locations, including groups of facilities which form an office or industrial park, or separate facilities just across the street from each other." *Id.* Temporary construction sites, however, are excluded from the definition of an establishment. The New Jersey Act defines "termination of employment" as a "layoff of an employee without a commitment to reinstate the employee to his previous employment within six months of the layoff." *Id.*

The New Jersey Act is triggered on the occurrence of any of three possible events: (1) a mass layoff; (2) a termination of operations; or (3) a transfer of operations. A "mass layoff" is defined as "a reduction in force" resulting "in the termination of employment at an establishment during any 30-day period for 500 or more full-time employees or for 50 or more of the full-time employees representing one third or more of the full-time employees at the establishment." *Id.* A "termination of operations" is defined as "the permanent or temporary shutdown of a single establishment" that during any continuous 30-day period results in the termination of employment of 50 or more full-time employees, subject to certain exceptions, including a termination of operations due to a fire, flood, natural disaster, national emergency, or act of war.[1] *Id.* Finally, a "transfer of operations" is defined as "the permanent or temporary transfer of" an "establishment" to another location, whether inside or outside of the state of New Jersey, that during any continuous 30-day period results in the termination of employment of 50 or more full-time employees. *Id.*

Like the WARN Act, the New Jersey Act also requires an employer to look backward and forward 90 days in determining whether a mass layoff, a termination of operations, or a transfer of operations has occurred. If the terminations of employment of two or more groups of employees at an establishment occur within a 90-day period that, in tandem, meet or exceed the requisite number of terminations necessary to trigger the notice requirements under the New Jersey Act (although each such termination by itself would not), the notice requirements still apply. The sole exception to this requirement is where the employer can demonstrate that the cause of the terminations for each such group is separate and distinct from the causes of the terminations of the other group or groups.

The New Jersey Act's Severance Pay Requirements

Like the WARN Act, the New Jersey Act requires employers to provide affected employees with 60 days' advance written notice prior to a mass layoff, a termination of operations or a transfer of operations. However, unlike the WARN Act, the New Jersey Act provides that if an employer fails to provide anything less than the *full* 60 days' advance notice, the employer must pay severance "equal to one week of pay for each full year of employment" for each affected employee. N.J. Sta. § 34: 21-2(b). The New Jersey Act provides no cap on the amount of such severance pay an employer could owe. For example, if an employer provides 59 days' advance notice to an affected employee (one day less than required by law), and the affected employee was continuously employed by the employer for 30 years, the employer could be obligated to pay 30 weeks of severance pay to the affected employee under the New Jersey Act. By contrast, under the WARN Act, the employer under this scenario would only owe the affected employee a single day of back pay and benefits. The rate of severance pay under the New Jersey Act is determined as follows: (a) the average regular rate of compensation received during the affected employee's last three years of employment with the employer or (b) the final regular rate of compensation paid to the affected employee, whichever rate is *higher*.

The onerous nature of the New Jersey Act is further evidenced by the fact that the severance pay requirements are "in addition to any severance pay provided by the employer pursuant to a collective bargaining agreement or for any other reasons," which would seemingly include additional severance obligations under employment contracts or various other employment policies or plans relating to the termination of employment. Although the New Jersey Act does permit an offset for the amount of back pay provided to an affected employee pursuant to the WARN Act (up to 60 days' pay), no additional credits or offsets are contemplated, including any payments made pursuant to an existing company severance plan.

[I]f an employer provides 59 days' advance notice to an affected employee (one day less than required by law), and the affected employee was continuously employed by the employer for 30 years, the employer could be obligated to pay 30 weeks of severance pay to the affected employee under the New Jersey Act. By contrast, under the WARN Act, the employer under this scenario would only owe the affected employee a single day of back pay and benefits.

Notice Requirements

Prior to the first termination of any affected employee's employment in connection with a mass layoff or the termination or transfer of operations, a covered employer must provide at least 60 days' advance notice to (a) the New Jersey Commissioner of Labor and Workforce Development, (b) the chief elected official of the municipality where the establishment is located, (c) each employee whose employment is to be terminated, and (d) any collective bargaining representatives of employees at the establishment. N.J. Sta. § 34: 21-2(a). The required notice under the New Jersey Act mandates that an employer provide more information than required under the WARN Act. Such notice must include the following information:

1. A statement of the number of employees whose employment will be terminated in connection with the mass layoff or transfer or termination of operations of the establishment, the date or dates on which the mass layoff or transfer or termination of operations and each termination of employment will occur;
2. A statement of the reasons for the mass layoff or transfer or termination of operations;
3. A statement of any employment available to employees at any other establishment operated by the employer, and information regarding the benefits, pay and other terms and conditions of that employment and the location of the other establishment;
4. A statement of any employee rights with respect to wages, severance pay, benefits, pension or other terms of employment as they relate to the termination, including, but not limited to, any rights based on a collective bargaining agreement or employment policy;
5. A disclosure of the amount of the severance pay which is payable to any employee pursuant to the New Jersey Act; and
6. A statement of the employees' right to receive information, referral and counseling regarding (a) public programs that may make it possible to delay or prevent the transfer or termination of operations or mass layoff; (b) public programs and

(b) ... benefits to assist the employees; and (c) employee rights based on law.

On March 20, 2008, the Commission of Labor and Workforce Development made available a revised form that must be used by employers to comply with the notice requirements set forth above.[2]

Private Right of Action

The New Jersey Act also provides aggrieved current and former employees with a private right of action to sue their employers in New Jersey Superior Court either individually or on behalf of other employees similarly affected by an alleged violation of the New Jersey Act. If an action is commenced on behalf of other affected employees, the plaintiff must inform the Department of Labor and Workforce Development, which will notify each affected employee of the lawsuit. Pursuant to the New Jersey Act, successful plaintiffs are entitled to compensatory damages, including lost wages and benefits and the recovery of the costs of the action, including reasonable attorneys' fees. Any award of compensatory damages for lost wages is, however, capped at the amount of severance pay required under the New Jersey Act.

Governmental Rapid Response Team

The New Jersey Act provides for the creation of a governmental rapid response team, whose "purpose is to provide appropriate information, referral and counseling, as rapidly as possible, to workers who are subject to plant closings or mass layoffs." N.J. Sta. § 34: 21-5. Unlike the WARN Act, employers subject to the New Jersey Act must provide the governmental response team onsite access to affected employees during working hours to, among other things, advise affected employees of their legal rights under the law, including with respect to wages, severance pay, benefits, and pensions, and the availability of public programs or benefits (such as unemployment compensation benefits and job training) for which the affected employees may be eligible. The New Jersey Act goes still further. It also provides that the government response team "shall offer to meet with the representatives of the management of the establishment to discuss available public programs that may make it possible to delay or prevent the transfer or termination of operations, including economic development incentive and workforce development programs." Further, the response team is charged with seeking "to facilitate cooperation" between management and employees to most effectively utilize available public programs that "may make it possible to delay or prevent the transfer or termination of operations or to assist employees if it is not possible to prevent the termination." Because the New Jersey Act has only recently been enacted, it is unclear at this time what the full scope of the governmental response team's authority will be "to meet" and "facilitate cooperation" with employers to delay or prevent a mass layoff or plant closing.

Conclusion

As the foregoing makes clear, New Jersey employers would be well-advised to plan any reduction-in-force or plant closing sufficiently in advance to ensure compliance with the significant new obligations imposed under the New Jersey Act and to avoid the stringent costs for non-compliance.

---

1 Notably, although the New Jersey Act does adopt the WARN Act's natural disaster exception to the 60 days' notice requirement, it does not adopt other key WARN Act exceptions on which employers have relied, including the faltering business and unforeseeable business circumstances exceptions.

2 This form is available at http://lwd.dol.state.nj.us/labor/forms_pdfs/lwdhome/Legal/Layoff-NotificationForm2_31208REVDD6.pdf

Second Circuit Heightens Employers' Duty to Prevent the Performance of Unauthorized Overtime Work

By Jonathan Shiffman

In *Chao v. Gotham Registry Inc.*,[1] The United States Court of Appeals for the Second Circuit recently held that employers must make every effort to affirmatively prevent their employees from performing overtime work if they intend to avoid paying overtime wages for that work. Writing for the Court, Judge Richard J. Cardamone said Gotham Registry Inc. ("Gotham"), raised a "question of first impression in this Circuit" regarding an employer's duty to pay overtime wages for work performed in violation of that employer's employment policies when the employer was not physically present to monitor the employee's activities. The Court ruled that merely having a policy that prohibits overtime without prior approval is not enough, even if the employer is not present to monitor or provide such approval on a real-time basis. Instead, "to forestall unwanted work," the employer must "adopt all possible measures to achieve the desired result." Under this standard, the Court ruled, Gotham's efforts were insufficient.

The defendant-employer, Gotham, ran a temporary nurse staffing service which made it difficult to control its employee-nurses' day-to-day schedules. According to the Court, hospitals made requests to Gotham to fill nursing vacancies, and nurses who accepted those requests reported directly to the Hospital. Nurses signed in and out of the Hospital on timesheets that were forwarded to Gotham. Gotham managers were not allowed on Hospital premises and did not supervise the nurses.

In *Gotham Registry*, the Secretary of Labor sued Gotham to enforce a consent decree in which the Company admitted that its nurses were employees and not independent contractors, and therefore were entitled to overtime pay under the Fair Labor Standards Act. After entry of the consent decree, Gotham promulgated an overtime policy which required its nurses to obtain advance approval to work more than 40 hours in any particular week. The policy warned: "If you fail to do so, you will not be paid overtime for those hours." Despite this policy, hospital staff would frequently ask nurses to work extra hours, and nurses would sometimes accede to those requests and work overtime hours without obtaining Gotham's approval. Gotham refused to pay overtime pay for those hours, unless the hospital agreed to reimburse it for those extra costs. Alleging that Gotham's practices deprived nurses of more than $100,000 in pay due under the FLSA, DOL filed a petition to hold the Company in civil contempt of the earlier consent judgment. The U.S. District Court for the Southern District of New York denied the petition, finding that the nurses were not entitled to overtime pay, and DOL appealed to the Second Circuit.

Employers must "adopt all possible measures" to prevent unauthorized overtime.

Gotham's primary argument before the Court was that, because it had a policy requiring pre-approval of overtime hours, and because its managers were not present in the hospitals to prevent nurses from working unauthorized overtime hours, it did not "suffer or permit" the nurses to perform that work and therefore was not liable for the nurses' compensation under the FLSA. In support, it cited the Ninth Circuit's opinion in *Lindow v. United States*,[2] which held that "an employer may insulate itself from overtime claims by notifying its employees that overtime is not expected, so long as the employees can complete their duties within regular hours and are under no pressure to perform overtime."

The Court rejected that argument. First, it noted that *Lindow* was distinguishable because the nurse employees were in fact under pressure from the hospital to perform overtime work, and "*Lindow's* rationale does not extend to employees whose jobs require them to on occasion work beyond regular hours." Moreover, to the extent nurses "elect[ed] to work overtime without any compulsion to do so," the Court "declined to follow *Lindow*." Reviewing Supreme Court precedent, it found that liability under the FLSA's "suffer or permit" standard "does not turn on whether the employee agreed to work overtime voluntarily or under duress." Instead, the Court found, the proper standard is employer knowledge: "an employer who knows of an employee's work may be held to suffer or permit that work." Moreover, the Court found that there was a "presumption" of knowledge based on the fact that employers have "the power to prevent work [they do] not wish performed," and that, to rebut that presumption, employers must "adopt all possible measures" to prevent unauthorized overtime.

According to the Court, Gotham failed to meet this rigorous standard. Gotham failed to take a number of steps which would have helped prevent unauthorized work. For example, Gotham did not "keep a daily, unverified tally of its nurses' hours and reassign shifts later in the week that could result in overtime." It did not "refuse to assign any shifts to nurses who habitually disregard[ed] Gotham's overtime rule." And it did not "discipline nurses who violated the [overtime] rule." Since it failed to take these, or similar, steps, Gotham failed to overcome the presumption that it had the power to prevent unauthorized overtime, and therefore it "suffered or permitted" the nurses to work overtime. On the other hand, because the law on this issue had been unclear (among other reasons), the Court declined to hold Gotham in contempt of the consent decree.

The *Gotham* decision is an important precedent establishing that employers must take rigorous steps to prevent unauthorized work if they wish to avoid liability for unpaid overtime. Promulgating a policy requiring preapproval of overtime is not enough. Employers must also proactively enforce that policy, discipline violators, and remain ever vigilant of its employees' weekly hours and work demands.

1 514 F.3d 280 (2d Cir. 2008).

2 738 F.2d 1057 (9th Cir. 1984).

Employer Update is published by the Employment Litigation Practice Group and the Executive Compensation and Employee Benefits Group of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, (212) 310-8000, http://www.weil.com.

Boston
James L. Messenger
617-772-8329
james.messenger@weil.com

Dallas
Yvette Ostolaza
214-746-7805
yvette.ostolaza@weil.com

Frankfurt
Britta Grauke
+49-69-21659-665
britta.grauke@weil.com

Andreas Mauroschat
+49-69-21659-619
andreas.mauroschat@weil.com

Houston
Melanie Gray
713-546-5045
melanie.gray@weil.com

London
Joanne Etherton
+44-20-7903-1000
joanne.etherton@weil.com

Peter Van Keulen
+44-20-7903-1095
peter.vankeulen@weil.com

Miami
Edward Soto
305-577-3177
edward.soto@weil.com

New York
Jeffrey S. Klein
212-310-8790
jeffrey.klein@weil.com

Gary D. Friedman
212-310-8963
gary.friedman@weil.com

Andrew L. Gaines
212-310-8804
andrew.gaines@weil.com

Mark A. Jacoby
212-310-8620
mark.jacoby@weil.com

Michael K. Kam
212-310-8240
michael.kam@weil.com

Michael Nissan
212-310-8169
michael.nissan@weil.com

Nicholas J. Pappas
212-310-8669
nicholas.pappas@weil.com

Lawrence J. Baer
212-310-8334
lawrence.baer@weil.com

Steven M. Margolis
212-310-8124
steven.margolis@weil.com

Washington, DC
David A. Hickerson
202-682-7105
david.hickerson@weil.com

www.weil.com