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SPECIAL EDITION 2018 - ISSUE 4, LABOR & EMPLOYMENT
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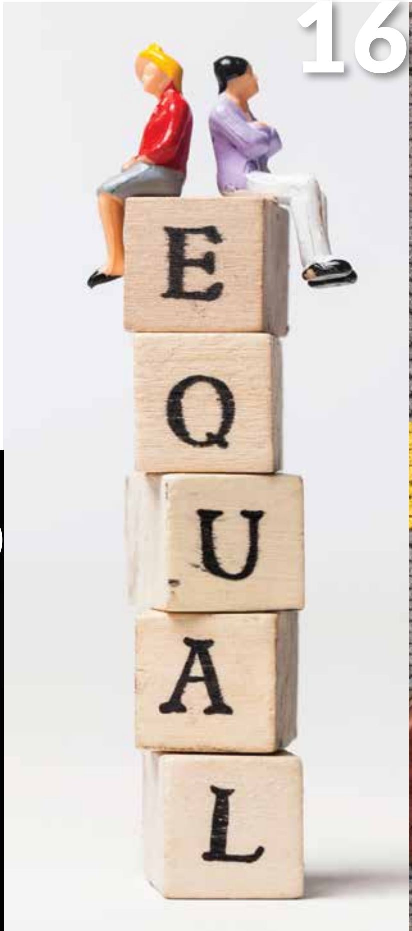

The
LEXIS PRACTICE ADVISOR Journal™

SPECIAL EDITION 2018 - Issue 4, Labor & Employment

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LETTER FROM THE EDITOR

Carrie Wright, Sr. Product Manager, Lexis Practice Advisor Labor & Employment and Employee Benefits & Executive Compensation

THIS SPECIAL EDITION FOCUSES ON Labor & Employment as well as Employee Benefits & Executive Compensation.
As reflected by the articles, these multifaceted practice areas span compliance, litigation, and transactional issues. Further, these dynamic practices closely entwine with major cultural and economic trends such as tax reform, pay equality, artificial intelligence, and the "me too" movement.

2018 has been coined the year of AI. Not surprisingly, many companies are contemplating how to leverage machine learning and robots to streamline their processes. In doing so, they may unwittingly open themselves up to liability. The article on counseling employers about introducing these disruptive technologies discusses the potential legal risks and provides insight on how careful planning can minimize potential exposure.

The treatment of women at work is another hot-button topic. Beyond the decades-old federal Equal Pay Act, states and cities are expanding their existing protections as well as adopting new laws to finally close the persistent gender wage gap. The article and checklist on conducting pay equity and wage and hour audits explain how to evaluate an employer's compensation practices to identify any shortcomings that the employer should correct.

As women become more vocal about their workplace experiences, their stories may corroborate the claims of plaintiffs in employment discrimination and harassment lawsuits. The article on "me too" evidence will help you effectively navigate the thorny evidentiary and strategic issues that this type of proof presents.

On the Employee Benefits & Executive Compensation front, employers need to understand how to avoid discrimination and retaliation claims arising out of their administration of benefit plans. The article on ERISA's protections for employees asserting their rights to plan benefits explains how employers can avoid infringing these rights and prevent claims under the statute.

The longstanding trend of companies terminating their pension plans in favor of 401(k) or other defined contribution plans has not slowed down. One of the perpetual issues when winding up a retirement plan is locating missing participants who are owed a plan benefit. In December 2017, the PGBC finalized rules to streamline its missing participant program for defined benefit plans and open the program for the first time to terminating defined contribution plans. The article on locating missing participants covers these developments as it guides plan administrators on handling missing participant issues for terminating and ongoing plans.

This journal issue kicks off with an overview of how the new tax reform law impacted benefits and compensation issues. Most notably, the legislation eliminated the performance-based compensation exemption to the $1 million cap on the deduction allowed for compensation paid to covered executives by public corporation under I.R.C. § 162(m). The extent to which public companies will alter their executive compensation packages remains to be seen considering recent trends emphasizing pay-for-performance among compensation committees, proxy advisory firms, and shareholders.

The Lexis Practice Advisor Journal and the Lexis Practice Advisor online offering provide how-to information about the most important issues facing employers, which helps you get your work done better and faster. Please enjoy this special edition of the Lexis Practice Advisor Journal.

Our mission

The Lexis Practice Advisor Journal™ is designed to help attorneys start on point. This supplement to our online practical guidance resource, Lexis Practice Advisor®, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 850+ seasoned attorney authors, the Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

LABOR DEPARTMENT RESUMES OPINION PROGRAM, REISSUES 17 RESCINDED LETTERS

THE U.S. DEPARTMENT OF LABOR (DOL) HAS REISSUED 17 opinion letters originally issued in January 2009 during the last few weeks of the Bush administration but later withdrawn by the Obama administration "for further consideration." The Obama administration subsequently discontinued the practice of issuing opinion letters, opting instead to issue general guidance documents.

On June 27, 2017, the DOL announced the reinstatement of the opinion letter process, stating that the letters "will benefit employees and employers as they provide a means by which both can develop a clearer understanding of the Fair Labor Standards Act (FLSA) and other statutes."

The 17 reissued letters, dated Jan. 5, 2018, and designated as FLSA 2018-1 through FLSA 2018-17, address a wide range of issues arising under the FLSA. The letters provide case-specific guidance on actual workplace issues raised by employers, employees, or their representatives.

Among the reinstated opinions are:

- FLSA2018-1, finding that on-call hours of ambulance personnel are not compensable under the FLSA
- FLSA2018-8, finding that client service managers at an insurance company are exempt administrative employees under the FLSA
- FLSA2018-11, finding that bonuses paid to non-exempt equipment operators for each day worked at an oilfield services company must be included in the operators' regular rate of pay

Each letter emphasizes that the opinion is based "exclusively on the facts and circumstances" provided in the submitted request.

Members of the public can access existing opinion letters or submit a request for agency guidance, including an opinion letter, at https://www.dol.gov/whd/opinion/.

- Lexis Practice Advisor Attorney Team

RESEARCH PATH: *Labor & Employment > Wage and Hour > FLSA Requirements and Exemptions > Articles*

D.C. COURT LIFTS RULEMAKING NOTICE DEADLINE BUT HOLDS EEOC TO REVISION REQUIREMENT

JUDGE JOHN BATES OF THE U.S. DISTRICT COURT FOR THE District of Columbia has partially vacated his December 2017 order, AARP v. EEOC, 2017 U.S. Dist. LEXIS 208965 (D.D.C. Dec. 20, 2017), setting an August 2018 deadline for the Equal Employment Commission (EEOC) to give notice of proposed rulemaking aimed at revising two regulations governing employer-sponsored wellness programs.

However, the order, issued on January 18, AARP v. EEOC, 2018 U.S. Dist. LEXIS 27317 (D.D.C. Jan. 18, 2018), reaffirms the court's earlier ruling vacating portions of the regulations as of January 1, 2019, in the absence of action by the EEOC and requires the EEOC to provide a status report on its rulemaking process by March 30.

The regulations, 81 Fed. Reg. 31,126 and 81 Fed. Reg. 31,143, which allow employers to require employees to disclose health information in order to be eligible for financial incentives tied to participation in wellness programs, were challenged by the American Association of Retired Persons (AARP) in a suit brought on behalf of its members. The AARP contended that the rules are inconsistent with requirements in the Americans with Disabilities Act and the Genetic Information Nondiscrimination Act that disclosure of health information to an employer be voluntary. Specifically, the AARP argued, employees who would not otherwise disclose health information would be forced to do so in order to obtain reductions in health coverage costs of up to 30%, as permitted by the regulations.

Finding that the EEOC failed to justify its adoption of the 30% incentive figure, Judge Bates ordered the agency to reconsider the regulations "in a timely matter," but left them in place, finding that to vacate them would likely cause "widespread disruption and confusion."

For more information on wellness programs, see

> IMPLEMENTING COMPLIANT WELLNESS PROGRAMS

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > Health Plans and Affordable Care Act > Practice Notes*

Subsequently, the AARP moved for vacatur of the regulations. Judge Bates granted the motion, but he set an effective date of January 1, 2019, and ordered the EEOC to issue a notice of proposed rulemaking by August 2018.

In his most recent order, in addition to lifting the August 2018 deadline and ordering a status report, Judge Bates rejected the EEOC's request that he clarify that he "is not retaining jurisdiction over this matter," stating instead that the case will be deemed closed as of January 2, 2019.

- Lexis Practice Advisor Attorney Team

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > Health Plans and Affordable Care Act > Articles*

SUPREME COURT TO RULE ON CONSTITUTIONALITY OF TRAVEL RESTRICTIONS

THE U.S. SUPREME COURT IS EXPECTED TO RULE LATER this year on the constitutionality of President Donald J. Trump's most recent executive order restricting the entry of certain foreign nationals into the United States.

The high court agreed on January 19 to review a ruling by the U.S. Court of Appeals for the Ninth Circuit enjoining enforcement of the executive order. Trump v. Hawaii, 199 L. Ed. 2d 620 (2018).

At issue is Proclamation 9645, entitled "Enhancing Vetting Capabilities and Processes for Detecting Attempted Entry Into the United States by Terrorists or Other Public Safety Threats," 82 Fed. Reg. 45161. The order, signed by President Trump on September 24, 2017, seeks to restrict citizens of Chad, Iran, Libya, North Korea, Syria, Venezuela, and Yemen from entering the United States because of deficiencies in the countries' "identity-management and information-sharing capabilities, protocols, and practices."

The state of Hawaii filed suit on October 17 in the U.S. District Court for the District of Hawaii, seeking an injunction against enforcement of the order. The court granted the injunction. The government appealed; the Ninth Circuit affirmed in part, limiting the injunction to "persons who have a credible bona fide relationship with a person or entity in the United States." Hawaii v. Trump, 878 F.3d 662 (9th Cir. 2017).

Acting on a petition by the federal government, the Supreme Court stayed the injunction pending further proceedings in the Ninth Circuit or the government's filing of a petition for writ of certiorari.

For more information on the travel ban, see

> **THE CHANGING IMMIGRATION LAWS UNDER THE TRUMP ADMINISTRATION: A NEW ERA FOR U.S. IMMIGRATION**

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Articles*

The government filed its petition on January 5, arguing that both the U.S. Constitution and federal law "confer on the President broad authority to suspend or restrict the entry of aliens outside the United States when he deems it in the Nation's interest" and that the injunction is overly broad. Opposing review, the state of Hawaii argued that the president exceeded his authority by issuing an order "that purports to ban over 150 million aliens from this country based on nationality alone" and that the Ninth Circuit acted properly in enjoining application of the order.

A decision is expected before the high court adjourns at the end of June.

- Lexis Practice Advisor Attorney Team

RESEARCH PATH: *Labor & Employment > Business Immigration > Employment Eligibility Verification > Articles*

UNION MEMBERSHIP IN THE UNITED STATES

ON JANUARY 19, 2018, THE DEPARTMENT OF LABOR (DOL) released its annual report on the status of union membership in the United States, showing that for calendar year 2017, the union membership rate was unchanged from 2016, holding at 10.7%. The actual number of employees who were union members in 2017 increased by 262,000 workers to 14.8 million. By comparison, in 1983, when the DOL first started reporting such data, the union membership rate was 20.1%, nearly double the 2017 rate, and total union membership was 17.7 million workers.

For more information on union membership and organization, see

> **UNDERSTANDING THE LANDSCAPE OF UNION ORGANIZING AND UNION CAMPAIGNS**

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Practice Notes*

If only private-sector employment is considered, the 2017 union membership rate drops to 6.5%, demonstrating the strength of organized labor's influence in the public sector, where more than 34% of the workforce is unionized—more than five times the rate in the private sector. Stated another way, in the public sector workforce, consisting of nearly 21 million workers, 7.2 million employees are unionized; in the private sector workforce, consisting of nearly 117 million workers, 7.6 million employees are organized. The occupations with the highest rate of unionization are teachers, police officers, and firefighters.

The statistics show that unionized employees enjoy a substantially higher median weekly wage than non-unionized employees: $1,041 versus $829.

- Bender's Labor & Employment Bulletin, Volume 18, Issue 3

RESEARCH PATH: *Labor & Employment > Labor-Management Relations > Union Organizing and Representation > Articles*

FINANCIAL FIRMS REVISITING APPROACH TO RESTRICTIVE COVENANTS

MANY BUSINESS OWNERS UTILIZE SOME FORM OF restrictive covenant when hiring employees. Whether it is to protect trade secrets or customer lists or to ensure that sensitive information remains confidential, employees routinely execute agreements barring them from competing with their former employer, soliciting their former employer's clients, or taking certain information with them when they leave.

While the enforcement of these covenants varies across jurisdictions, financial advisors and wealth management firms have chosen in the past to take a different tack. Instead of trying to restrict wealth managers from taking their clients with them when they moved to new firms, these firms voluntarily joined the broker protocol, which permitted wealth managers to take certain client information with them when they left and allowed managers to solicit their clients to join them at their new firms. Wealth management firms believed that competition for the managers and their clients was a good thing.

The good times may be coming to an end. A recent article in the New York Times noted that Morgan Stanley, UBS, and Citibank withdrew from the broker protocol last year. If other brokerages, especially the larger ones, follow suit, clients may see their advisors subject to increased restrictions upon departing. This usually means one thing: litigation. While post-employment restrictions are subject to various levels of enforcement, the threat of litigation and its attendant costs will surely chill the liberal movement of wealth managers from one firm to another.

- *Bender's Labor & Employment Bulletin, Volume 18, Issue 3*

For more information on the Broker Protocol and issues employers should consider when hiring from competitors, see

> BEST PRACTICES TO REDUCE LITIGATION RISKS WHEN HIRING FROM A COMPETITOR

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Restrictive Covenants > Practice Notes*

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Restrictive Covenants > Articles*

Richard Lieberman DYKEMA GOSSETT PLLC

2017 Tax Act Impact on Employee Benefits and Executive Compensation

THE TAX REFORM LEGISLATION ENACTED IN LATE 2017, known as the Tax Cuts and Jobs Act (Pub. L. No. 115-97) (the Tax Act), made relatively few far-reaching and substantive changes in the area of executive compensation and employee benefits. These changes, summarized in this article, primarily focus on (1) the non-deductibility of excessive employee compensation by publicly held corporations under I.R.C. § 162(m), (2) a new tax deferral option for certain qualified equity grants by private corporations, (3) the imposition of a new excise tax on excessive compensation paid by tax-exempt organizations, and (4) a few adjustments to existing tax-advantaged benefits provisions. However, from an executive compensation and employee benefits perspective, what may be most significant about the Tax Act is what was left out. The original legislative proposals introduced in both houses of Congress would have effectively eliminated the continuing use of non-qualified deferred compensation (NQDC) arrangements. Although the implications of the Tax Act are relatively few in the employee benefit and executive compensation area, the changes that were made are significant, albeit for limited audiences. The new rules described below are generally effective for tax years beginning after December 31, 2017.

Changes to Section 162(m) Deduction Limit

Section 162(m) provides that no deduction is allowed to a publicly held corporation for compensation paid to certain covered employees in excess of $1 million. Prior to the Tax Act, an exception to the disallowance of a deduction for excessive compensation applied to qualified performance-based compensation or compensation payable on a commission basis. To qualify as performance-based compensation, the corporation had to maneuver through a labyrinth of conditions to ensure that such incentive compensation arrangements were solely conditioned on the achievement of performance criteria established and certified by a duly constituted compensation committee and approved by company shareholders.

Impact of the Tax Act on Section 162(m)

The Tax Act substantially amends Section 162(m) by (1) significantly expanding the definition of covered employee, (2) eliminating the performance-based compensation exception (other than for grandfathered arrangements), and (3) broadening the limitation's application to corporations required to report under the Securities Exchange Act of 1934 (the Securities Act). Pub. L. No. 115-97, § 13601.

UNDER THE NEW RULES, ONCE A COVERED EMPLOYEE, ALWAYS A COVERED EMPLOYEE. FOR EXAMPLE, AN OFFICER WHO IS ONE OF THE THREE HIGHEST COMPENSATED OFFICERS DURING 2018 WILL REMAIN A COVERED EMPLOYEE, EVEN IF SHE NO LONGER QUALIFIES AS ONE OF THE THREE HIGHEST REMUNERATED OFFICERS IN A SUBSEQUENT YEAR.

Expanded Definition of Covered Employee

Under Section 13601 of the Tax Act, the universe of potential covered employees has been greatly expanded. Under prior law, the term included the chief executive officer (CEO) of the corporation and the four highest compensated named executive officers for the taxable year, other than the chief financial officer (CFO). (The CFO was excluded because of a technical conflict between the Internal Revenue Code and Securities and Exchange Commission rules. I.R.S. Notice 2007-49, 2007-1 C.B. 1429.)

A covered employee now includes:

- Any individual serving as the principal executive officer or principal financial officer during the tax year
- The three highest compensated named executive officers for the tax year, other than the principal executive officer and the principal financial officer
- Any individual who was a covered employee for a tax year beginning after December 31, 2016

I.R.C. § 162(m)(3).

Importantly, the time for identifying covered CEOs and CFOs no longer occurs as of the close of the year. Instead, the determination is now made continuously throughout the year. Thus, for example, a former CFO, interim CFO, and replacement CFO could all become covered employees in the same tax year. Further, the covered employee designation sticks to and remains with an individual throughout his or her life (and even thereafter, as I.R.C. §162(m)(4)(F) now provides that "[r]emuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee.")

Under the new rules, once a covered employee, always a covered employee. For example, an officer who is one of the three highest compensated officers during 2018 will remain a covered employee, even if she no longer qualifies as one of the three highest remunerated officers in a subsequent year. Moreover, she continues to be classified as a covered employee after her separation from service and even after death. Therefore, if in retirement she exercises options resulting in a gain exceeding $1 million, her former employer would not be permitted a corresponding deduction for the excess amount (as was allowed under prior law).

In view of the stickiness of the covered employee designation, publicly held corporations must be keenly aware that severance pay, deferred compensation, and other post-separation remuneration may be subject to the deduction ceiling. In this regard, they may look to design severance and other post-separation related plans to spread payments over multiple years to avoid, or at least mitigate, the effect of the cap.

Elimination of Performance-Based Compensation Exception

The Tax Act eliminates the nearly quarter-century-old exception to Section 162(m) allowing for the deduction of qualified performance-based compensation and commissions, including non-discounted stock options and stock appreciation rights. Many companies relied extensively on this exception and organized their incentive compensation programs around the rule's qualification requirements. A narrow transition rule permits companies to continue to deduct performance-based compensation over the $1 million threshold if it is paid under a written binding contract in effect on November 2, 2017, so long as the terms of the contract are not modified in any material way after that date. Pub. L. No. 115-97, § 13601(e)(2).

Some commenters have suggested that publicly held corporations will now revert to non-equity-linked forms of compensation, such as straight cash bonuses. For instance, according to news reports, covered employees at Netflix will now be paid straight cash bonuses regardless of company performance. On the other hand, publicly held corporations may wish to retain their existing performance-based compensation arrangements. The popularity of pay-for-performance principles among boards of directors, proxy advisory firms, and shareholders to appropriately incentivize executives is unlikely to wane. Objectively administered performance-based compensation models have become an integral tool for structuring executive compensation arrangements. Moreover, those companies that continue to emphasize incentive-based pay will have a freer hand since the administrative burdens of complying with Section 162(m)'s qualified performance-based compensation conditions are no longer applicable.

Of course, corporations continuing to rely on performance-based grants as a substantial element of total compensation may need to retain certain governance practices, regardless of their loss of tax relevance. For example, the NYSE and NASDAQ, as well as other exchanges, require listed corporations to maintain an independent compensation committee with the responsibility for setting executive compensation or making recommendations to the board regarding executive compensation. Moreover, disclosing such arrangements to shareholders and seeking their preapproval remains a best practice in shareholder relations that should not be lightly discarded.

Expanded Application of Section 162(m)

Finally, the universe of corporations subject to Section 162(m) has expanded under the Tax Act. The definition of publicly held corporation has been broadened to include any corporation required to file reports under Section 15(d) of the Securities Act. Previously, the rule applied only to issuers of registered common equity securities. This means that companies not listed on any securities exchange or that have not crossed the size threshold of Section 12(g) of the Securities Act, but which issue equity or debt securities to the public in an offering registered with the SEC, are now subject to Section 162(m). As a result, many private equity firms along with certain foreign entities that are publicly traded in the United States using an American Depository Receipt (e.g., Alibaba Group Holding Ltd.) will now find that compensation paid to covered employees in excess of $1 million dollars is no longer deductible for U.S. federal tax purposes.

Tax Deferral Election for Qualified Equity Grants

New I.R.C. § 83(i) allows certain individuals to elect to defer recognizing income on qualified stock options and restricted stock units (RSUs) for up to five years. The new rule evolved from a 2016 Senate bill sponsored by Senators Mark Warner and Dean Heller, the Empowering Employees Through Stock Ownership Act (SB3152), and a companion House bill (HR5719). The purpose was to provide an extended deferral period of up to seven years for employees who exercise options to buy the stock of private companies to ease the tax burden arising from equity grants covering shares that are not publicly traded. Although the bills had bipartisan support, Congress failed to act on them until the material portions of those bills were included in Section 13603 of the Tax Act.

Historical Treatment of Options and RSUs

Under long-standing rules, if a non-qualified stock option (NQSO) does not have a readily ascertainable fair market value at the time the option is granted (which is usually the case), the grant of the NQSO is generally not subject to tax until the option is exercised. Upon exercise, the option holder will generally be subject to tax on the spread between the fair market value of the shares received and the exercise price (also known as the strike price) of the NQSO.

The obvious problem for employees of private companies is the illiquid nature of private company stock. Since a public market does not generally exist, an employee exercising an NQSO usually cannot make a cashless exercise and must go out of pocket for the federal and state taxes imposed on the

Related Content

For an overview of the rules governing the executive compensation deduction limitation under I.R.C. § 162(m), as amended by the 2017 tax reform legislation, see

> IRC SECTION 162(M): NAVIGATING TAX DEDUCTION LIMITATIONS FOR EXECUTIVE COMPENSATION

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Employment Agreements > Practice Notes*

For more information on the important legal and tax considerations when developing executive compensation arrangements for tax-exempt organizations, including new excise tax rules enacted under the 2017 tax reform legislation, see

> EXECUTIVE COMPENSATION ARRANGEMENTS FOR TAX-EXEMPT ORGANIZATIONS

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Employment Agreements > Practice Notes*

For guidance in the drafting and negotiation of executive compensation agreements from the employer's perspective, see

> UNDERSTANDING, DRAFTING, AND NEGOTIATING EXECUTIVE COMPENSATION AGREEMENTS ON BEHALF OF EMPLOYERS

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Benefits and Perquisites > Practice Notes*

THE TAX ACT IMPOSES A NEW COST ON EXCESSIVE EXECUTIVE COMPENSATION AND SEVERANCE BENEFITS PAID BY TAX-EXEMPT ORGANIZATIONS FOR TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 2017.

receipt of private company shares. A similar problem exists for stock-settled RSUs. RSUs are typically taxed on the fair market value of the award as it becomes vested (i.e., no longer subject to a substantial risk of forfeiture). However, even if a stock-settled RSU award is settled upon vesting, the grantee must come up with the cash for the associated taxes. This can also be a cashflow issue for the company because it will need to withhold and remit income and employment taxes at the time of the NQSO exercise or stock-settled RSU vesting, but it is not transferring any cash to the grantee from which it can withhold those amounts.

The new Section 83(i) election is designed to alleviate, or at least postpone, the foregoing dilemma. As further described below, if the grantee timely makes a Section 83(i) election, the income tax, but not the employment tax, owed at the time of exercise or vesting will be deferred (the deferred amount). The deferred amount will ultimately be subject to income tax at ordinary rates along with employment taxes. However, any appreciation above the deferral amount will be taxed as capital gain, similar to the tax consequences of a Section 83(b) election. Although it is possible for the deferral period to expire before the maximum five-year deferral, the deferral period nonetheless allows for more time during which a liquidity event could occur or other source of funds become available.

Conditions for Section 83(i) Elections

Pursuant to new I.R.C. § 83(i), if qualified stock is transferred to a qualified employee who makes an election with respect to such stock, income that would have previously been recognized upon exercise (or vesting for RSUs) is deferred for five years, or earlier upon any of the following events:

- The first date the qualified stock becomes transferable (including becoming transferable to the employer)
- The date the employee first becomes an excluded employee
- The first date on which any stock of the corporation issuing the qualified stock becomes readily tradeable on an established market
- The date on which the employee revokes the deferral election

The term qualified stock means the stock of a corporation that is the employer of the qualified employee making the election if all of the following conditions are met:

- The stock is received in connection with the exercise of an option or in settlement of an RSU.
- The option or RSU was granted by the corporation for the performance of services by the employee during a calendar year in which the corporation:
  - Did not have readily tradeable stock on an established market for any preceding year
  - Had a written plan under which at least 80% of all of the company's employees in the United States were granted stock options or RSUs with the same rights and privileges to receive qualified stock
- The employee does not have a right to sell the stock to the corporation at the time of the option exercise or RSU vesting.

I.R.C. § 83(i)(2).

Whether the granted options or RSUs have the same rights and privileges is determined by reference to the qualified employee stock purchase plan (ESPP) rules under I.R.C. § 423(b)(5). Although the company must have a broad-based plan in place, these rules do not require the company to grant an equal number of shares to all employees, although the number of shares available to each employee must be more than a de minimis amount.

Eligible Employees

The employees eligible to make the new Section 83(i) election are those who are customarily employed for at least 30 hours per week, excluding any individual who:

- Is a 1% owner or was at any time during the 10 preceding calendar years
- Is or has been at any time the CEO or CFO of the corporation (or a spouse, child, grandchild, or parent of such an individual)
- Is one of the four highest compensated officers of the corporation for the taxable year in which the option is exercised or RSU vests, or any of the 10 preceding taxable years

The Time for Making a Section 83(i) Election

Analogous to the making of a Section 83(b) election, the new Section 83(i) election must be made no later than 30 days after the option exercise or RSU vesting date (or an earlier date upon which the award becomes taxable because the employee's rights in the stock become transferable). The Section 83(i) election is made in a form and manner similar to a Section 83(b) election.

Limitations and Restrictions

It should be noted that, although the rights granted under new Section 83(i) are available for grants of incentive stock options under I.R.C. § 422 and stock issued pursuant to a qualified ESPP under I.R.C. § 423, an employee's Section 83(i) election will negate the preferential tax treatment otherwise afforded such options or stock.

Finally, the new deferral election is generally not available if any stock of the issuing corporation is readily tradable on an established securities market at any time before the election is made. The deferral election is also not available if the issuing corporation bought back any outstanding stock in the preceding calendar year, unless not less than 25% of the total amount the company bought back is stock for which a Section 83(i) deferral election is in effect and the buyback's eligibility criteria are made on a reasonable (non-discretionary) basis.

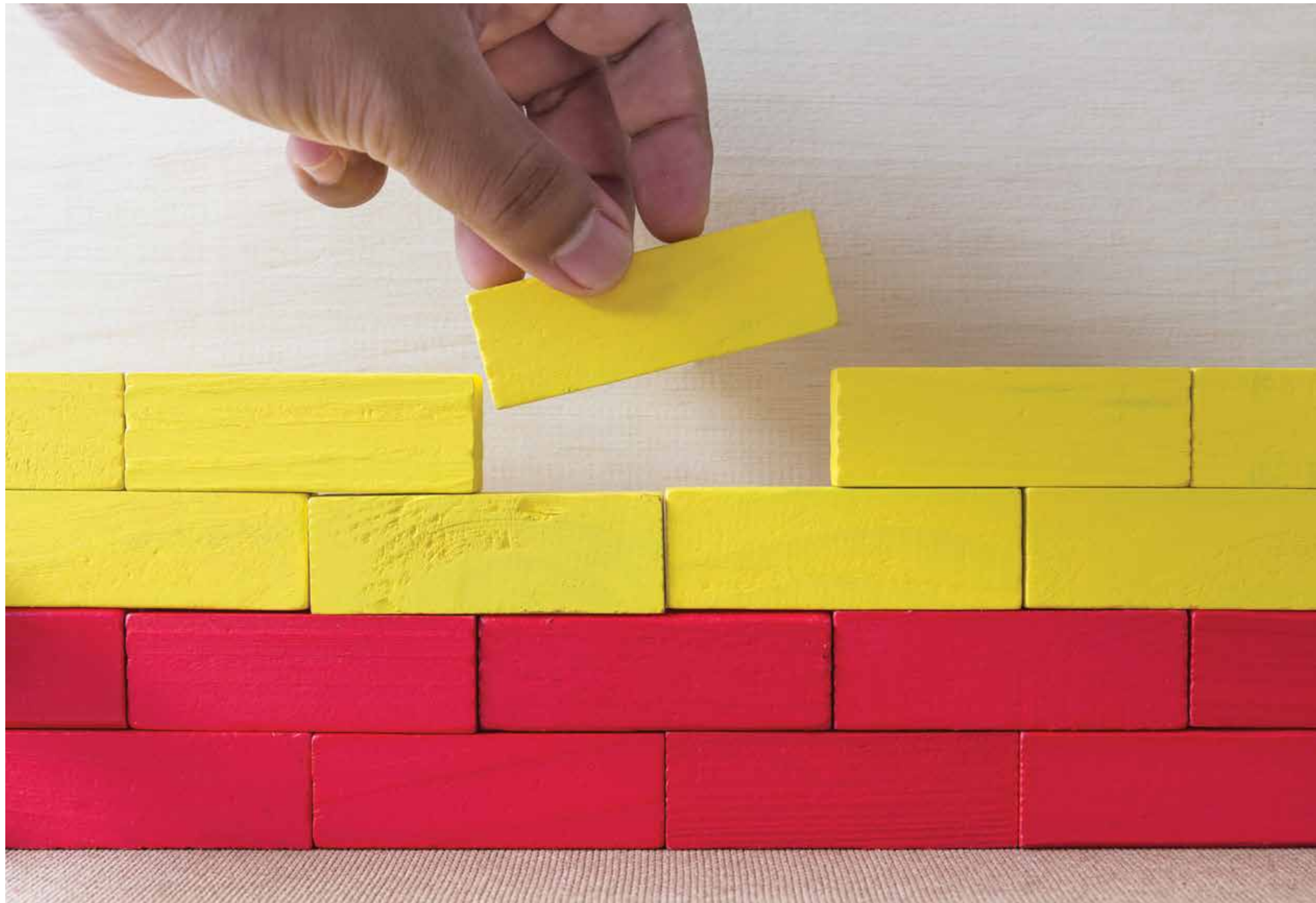
Reporting and Notice Requirements

The new rule imposes several reporting and notice requirements on applicable issuing corporations. First, if a corporation has stock outstanding on January 1 of any calendar year for which a Section 83(i) election is in effect (referred to as deferral stock) and the company purchases any of its outstanding stock during that year, it is required to report on its return for that year the total dollar amount of its outstanding stock so purchased, along with any other information that may be required in future regulations.

Second, any corporation that transfers qualified stock to a qualified employee is required to take the following actions at the time the employee becomes eligible to make a Section 83(i) election:

- Certify to the employee that such stock is qualified stock
- Notify the employee that he or she may be eligible to defer income by making a Section 83(i) election and about the consequences for making such an election

The notice requirement applies to stock attributable to options exercised or RSUs settled after December 31, 2017. Penalties apply if an employer fails to provide the required notice: $100 for each failure to provide timely notice, up to $50,000 for any calendar year.



The Good and the Bad of Qualified Equity Grants

In addition to lessening the tax burden imposed on recipients of private company stock, the 2016 Empowering Employees Through Stock Ownership Act was designed to create incentives for private companies to broaden the base of employee-shareholders. Whether new I.R.C. § 83(i) will accomplish that goal is not at all clear. For private tech corporations particularly, and other startup corporations that seek to use equity-linked compensation to attract and retain talent while minimizing cash compensation prior to a liquidity event such as a sale, merger, or IPO, qualified equity grants represent a powerful new talent acquisition and retention tool.

For the vast majority of privately owned corporations, however, the value of a Section 83(i) election may be more limited. First, the requirement to offer options or RSUs with the same rights and privileges to at least 80% of all U.S. employees may result in too great a broadening of the shareholder base from the perspective of many legacy shareholders, especially in closely held and family-controlled corporations.

Second, with the exception of private corporations with a short liquidity event timeline, the Section 83(i) election merely delays the inevitable income tax consequence, with no impact on the time for payment of employment taxes. Although there is a time value of money benefit associated with the deferral period, it remains inevitable for employees of private corporations having longer-term horizons that, at some point, they will have to go out of pocket to pay both the income and employment taxes associated with the exercised options or vested RSUs.

Excise Tax on Excessive Compensation Paid by Exempt Organizations

The Tax Act imposes a new cost on excessive executive compensation and severance benefits paid by tax-exempt organizations (EOs) for taxable years beginning after December 31, 2017. First, EOs are subject to a 21% (the corporate rate) excise tax on any remuneration paid to covered employees in excess of $1 million. The term covered employee for this purpose means any employee (including any former employee) of an EO if the employee is one of the five highest compensated employees of the organization for the taxable year or was a covered employee of the EO for any preceding taxable year beginning after December 31, 2016. (An exception is provided for remuneration paid to a licensed medical professional (including a veterinarian) that is for the performance of medical or veterinary services by that professional.)

Second, EOs are also now subject to a golden parachute regime similar to I.R.C. §§ 280G and 4999, but irrespective of any organizational change in control. The Tax Act imposes a 21% excise tax on excess severance payments to highly compensated covered employees (using the I.R.C. § 414(q) threshold ($120,000 for 2018)). The tax applies to payments that are conditioned upon a separation from service that exceed the individual's average compensation over the preceding five years (the base amount), but only if the total amount of such severance payments exceeds three times the covered employee's base amount. I.R.C. § 4960. Pub. L. No. 115-97, § 136 02.

Other Tax Act Effects on Employee Benefits

The Tax Act changed some of the rules governing less high-profile matters as well, including the following:

- **Retirement plans.** Qualified plans are another area that escaped dramatic changes in some legislative proposals, such as dramatic reduction of pre-tax deferrals. The main change affecting retirement plans is to provide relief to participants who have an outstanding plan loan at the time of a distribution arising due to a termination of employment. In this situation, plans typically reduce the participant's plan benefit by the amount owed under the loan. That offset amount is a taxable distribution (and subject to an early withdrawal penalty for younger participants) unless the individual makes a rollover to another eligible plan or IRA (out of pocket for the remaining loan balance). The Tax Act extends the time for rolling over the offset amount from the usual 60 days to the due date (with extensions) for filing the participant's tax return for the distribution year. Pub. L. No. 115-97, § 13613.
- **Fringe benefits.** The income exclusion for employer-paid qualified moving expense reimbursements under I.R.C. § 132(g) has been suspended through 2025 for reimbursements received after December 31, 2017. As a result, employees who are reimbursed for moving expenses will now have to report such reimbursements as income subject to both income and employment tax, at least through 2025. Pub. L. No. 115-97, § 11048. Similarly, the Tax Act suspends through 2025 the income exclusion transportation fringe benefit for reimbursement of up to $20 per month for qualified bicycle commuting previously permitted under I.R.C. § 132(f). Pub. L. No. 115-97, § 11047.
- **Deductions for employee benefits.** Certain employer deductions for employee benefit expenses have been cut or reduced:
  - Expenses incurred to provide a qualified moving expense reimbursement and any qualified transportation fringe benefit (not just bicycle commuting reimbursements) are no longer deductible, unless paid to ensure the safety of an employee. In addition, there is a reduction to 50% for the deduction allowable for on-premises employee eating facilities eligible as an excludible fringe benefit under I.R.C. § 132(e). Also, beginning in 2026, the deduction available for providing employee meals for the employer's convenience (eligible for income exclusion under I.R.C. § 119(a)) will also be eliminated. Pub. L. No. 115-97, § 13304.
  - The rules for employee achievement award deductions under I.R.C. § 274(j) are now restricted to awards consisting of tangible personal property, excluding cash, gift certificates, and other cash equivalents; vacations; meals; and tickets or vouchers for services and events. Pub. L. No. 115-97, § 13310.
- **Volunteer award program limits.** The Tax Act increased the annual amount that may be contributed to a length-of-service award program for bona fide firefighting and emergency responder volunteers under I.R.C. § 457(e)(11) to $6,000 (up from $3,000), subject to adjustment for inflation. Pub. L. No. 115-97, § 13612.
- **Affordable Care Act.** In a larger development, only tangentially related to employee benefits, the Tax Act essentially eliminates, as of 2019, the Patient Protection and Affordable Care Act's (ACA) individual mandate, which penalizes individuals who do not obtain qualifying health insurance coverage, either through an ACA exchange or otherwise. This could lead to fewer insurers offering individual coverage on the ACA exchanges, leaving employers back in the position of being the sole source of affordable health insurance options for their employees. On the other hand, it may be less likely that an applicable large employer that fails to offer qualifying coverage will incur an employer shared responsibility penalty if fewer of its employees opt for exchange coverage. Pub. L. No. 115-97, § 11081.

The Dog That Didn't Bark: Nonqualified Deferred Compensation Unchanged

As originally proposed in the initial House bill and the Senate Conference Committee markup, I.R.C. § 409A (and I.R.C. §§ 457A, and 457(f)) would have been repealed, and NQDC would have been made taxable to employees and other service providers when vested, (i.e., when no longer subject to a substantial risk of forfeiture). Moreover, substantial risk of forfeiture was narrowly defined to cover only payments conditioned on the future performance of substantial services. Notwithstanding the complexity of Section 409A and the substantial penalties for non-compliance, under current tax law those rules permit a wide variety of compensation arrangements to defer taxation on vested amounts until payment is actually or constructively made. The proposals went further yet and would have defined NQDC to include non-qualified stock options and stock appreciation rights. As a result, the tax deferral for NQDC, including elective deferrals, supplemental executive retirement plans, stock appreciation rights, non-qualified stock options, and other arrangements would have essentially been eliminated under the now rejected proposals. This would have been a hugely disruptive change resulting in a massive reassessment of existing and future compensation arrangements across public and private companies of all sizes. L

Related Content

For assistance in the drafting and negotiation of executive compensation agreements from the executive's perspective, see

> UNDERSTANDING, DRAFTING, AND NEGOTIATING EXECUTIVE COMPENSATION AGREEMENTS ON BEHALF OF EXECUTIVES

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Benefits and Perquisites > Practice Notes*

For a discussion on the tax issues associated with grants of equity-based compensation, see

> TAX RISKS OF EQUITY-BASED COMPENSATION

RESEARCH PATH: *Employee Benefits & Executive Compensation > Incentive and Equity-Based Compensation > Equity-Based Compensation > Practice Notes*

For an analysis of the basic types of equity and equity-based compensation awards, see

> UNDERSTANDING TYPES AND TAXATION OF EQUITY COMPENSATION

RESEARCH PATH: *Employee Benefits & Executive Compensation > Incentive and Equity-Based Compensation > Equity-Based Compensation > Practice Notes*

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RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Employment Agreements > Practice Notes*


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CONDUCTING **PAY EQUITY AUDITS**

This article provides advice and guidance to employers regarding how to ensure compliance with equal pay laws, particularly the Equal Pay Act of 1963 (EPA).

ALTHOUGH THE EPA HAS BEEN IN EFFECT FOR 50 YEARS, it gained renewed momentum with the Obama administration's creation of the National Equal Pay Enforcement Task Force, composed of members of the Equal Employment Opportunity Commission (EEOC), the Department of Justice, the Office of Personnel Management, and the Department of Labor. The task force has aggressively pursued employers who have violated the EPA's requirements and has collected significant amounts of money for victims of sex-based wage discrimination. While it remains to be seen what efforts the current White House administration takes concerning equal pay, the momentum has continued with state equal pay legislation. Several states have amended their equal pay laws to broaden their scope beyond what the EPA requires.

Virtually all employers must comply with the EPA and many, depending on their size and the state in which they are located, must also comply with other federal and state laws regarding equal pay. To limit exposure for equal pay violations, employers should adopt policies and procedures that satisfy the EPA and other federal and state requirements and help them meet their equal pay obligations and/or existing audit requirements.

Understanding the EPA

The EPA amends the Fair Labor Standards Act and generally requires employers to pay equal wages to men and women who perform work requiring substantially equal skill, effort, and responsibility, under similar working conditions (i.e., physical surroundings and hazards) within the same establishment.

Substantially equal does not mean identical. In evaluating whether two positions are substantially equal, you should disregard minor or insubstantial differences in work and should look to the overall job content rather than job title. Thus, employees who spend significant amounts of time on different tasks do not perform substantially equal work, while employees who spend a little time on different incidental tasks do. Additionally, wages is not limited to an employee's regular rate of pay; it also includes overtime pay, bonuses, stock options, life insurance, vacation, holiday pay, and any other similar payments and benefits.

Employers nonetheless retain their right to pay employees differently as long as the reason is not sex-based and does not violate other anti-discrimination laws. Thus, pay differentials are permitted when based on seniority, merit, quantity or quality of production, or another factor other than sex. When an employer must correct a wage difference, the EPA requires the employer to increase the wage of the lower-paid employee. In other words, an employer may not reduce the wages of the higher-paid employee(s) to equalize pay.

The EPA applies to non-exempt employees as well as exempt administrative, executive, professional, and outside sales employees; however, it does not apply to other exempt employees (e.g., computer professionals).

EEOC Guidance

In 2016, the EEOC published a new fact sheet[1] that highlights the agency's interpretation of the EPA. As noted, the EPA prohibits employers from paying unequal wages to men and women who perform jobs that require substantially equal skill, effort, and responsibility under similar working conditions in the same establishment. The EEOC's fact sheet summarizes its interpretation of each of these factors:

- **Skill.** Skill is measured by factors such as an employee's experience, education, ability, and training to perform a job. It is important to distinguish between the skills required for the specific job and the skills of the employee in general. An employee may have skills in a certain area, but if those skills are not relevant to the job (e.g., a graduate degree in an unrelated field), they should not be considered in the employer's analysis.
- **Effort.** The amount of physical or mental exertion needed to perform a job.
- **Responsibility.** The degree of accountability required in performing a job. Note, however, that minor differences in responsibility will not justify a pay differential (e.g., turning off the lights at the end of the work day).
- **Working conditions.** Working conditions refer to both (1) physical surroundings (e.g., temperature, fumes, and ventilation) and (2) hazards.
- **Establishment.** An establishment is a distinct physical place of business rather than an entire business consisting of several places of business. However, in some circumstances, physically separate places of business may be treated as one establishment (e.g., if a central administrative unit hires employees, determines their compensation, and assigns them to separate work locations, the separate work sites can be considered part of one establishment).

1. Facts About Equal Pay and Compensation Discrimination, https://www.eeoc.gov/eeoc/publications/fs-epa.cfm.

Understanding Other Equal Pay Laws

In addition to the EPA, an employer's pay practices must also comply with other federal and state laws, some of which are discussed briefly below. Although this article primarily focuses on EPA compliance, you should evaluate the employer's pay practices under all applicable laws and recommend corrective action that minimizes the employer's full range of liability.

Federal Laws

In addition to the EPA, sex-based wage discrimination is also illegal under Title VII of the Civil Rights Act of 1964 (Title VII); thus, employees with EPA claims may also have Title VII claims. Title VII also prohibits wage discrimination based on race, color, religion, and national origin. Additionally, the Age Discrimination in Employment Act of 1967 (ADEA) and the Americans with Disabilities Act of 1990 (ADA) prohibit wage discrimination based on age and disability. Only employers with the requisite number of employees must comply with Title VII, the ADEA, and the ADA (i.e., 15 employees for Title VII and the ADA; 20 for the ADEA).

Federal Regulations and Guidance

In 2016, as part of the government's renewed focus on the issue of equal pay, the Office of Federal Contract Compliance Programs (OFCCP) issued updated guidance on sex discrimination. The EEOC also put forth an equal pay data rule, which the Office of Management and Budget (OMB) later indefinitely stayed. The OFCCP guidance and the stayed EEOC equal pay data rule are addressed below.

OFCCP Guidance

The OFCCP rule updates its prior guidance on sex discrimination, which had last been updated in 1970, to bring it up to date with current law.[2] The rule also specifically:

- Prohibits sex-based wage discrimination and promotes fair pay practices (such as not denying opportunities for overtime work, training, higher pay, or higher-paying positions based on a person's sex)
- Allows employees to recover lost wages any time a federal contractor pays compensation that is the result of discrimination and not just when the decision to discriminate is made
- Prohibits discrimination on the basis of sex as to fringe benefits, such as medical insurance, life insurance, and retirement benefits, as well as profit-sharing, bonuses, and leave
- Requires federal contractors to give men and women equal access to jobs and workforce development opportunities unless they can meet the high bar of demonstrating that such requirements are a bona fide occupational qualification

2. *See* 41 C.F.R. §§ 60-20.1–20.8, OFCCP's Sex Discrimination Final Rule – Fact Sheet, https://www.dol.gov/ofccp/SexDiscrimination/SexDiscrimFinalRuleFactSheet_JRFQA508c.pdf, and OFCCP Sex Discrimination FAQs, https://www.dol.gov/ofccp/SexDiscrimination/sexdiscrimination_faqs.htm.

WHILE THE EQUAL PAY DATA RULE REQUIREMENTS WERE MEANT TO HELP EMPLOYERS EVALUATE THEIR OWN BUSINESS PRACTICES AND PREVENT PAY DISCRIMINATION, THEY WERE ALSO AIMED AT HELPING THE EEOC AND OTHER ENFORCEMENT AGENCIES IDENTIFY AND INVESTIGATE PAY DISCRIMINATION.

The EEOC's Equal Pay Data Rule (Indefinitely Stayed by the OMB

The EEOC's equal pay data rule would have required employers with 100 or more employees to submit pay data by sex, race, and ethnicity on their EEO-1 Reports. Specifically, under the rule, employers were scheduled to provide:

- **Summary pay data.** Employers were scheduled to provide aggregate data on pay ranges. Specifically, employers were to count the number of employees they had in each of 12 EEO-1 pay bands for each of 10 job categories. After tallying the total number of employees in each pay band by job category, employers would then enter this information in the report based on the sex and ethnicity or race of the employees. For example, an employer could report that it had 11 employees who are white women in the Professionals job category in pay band 7.
- **Aggregate hours worked data.** Employers were also scheduled to submit the aggregate hours worked by tallying the total number of hours worked by all of the employees in each pay band.

On August 29, 2017, the OMB stayed the EEOC's equal pay data rule. The pay data and hours worked information was initially due on March 31, 2018; now it is uncertain if the OMB will reinstate these reporting requirements.

While the equal pay data rule requirements were meant to help employers evaluate their own business practices and prevent pay discrimination, they were also aimed at helping the EEOC and other enforcement agencies identify and investigate pay discrimination. Therefore, if the OMB lifts the stay on these reporting requirements, it is very likely that the risk of potential equal pay claims for employers will increase, making it more important than ever that employers monitor and, if necessary, correct their pay practices to prevent any such claims.

State Laws

Many states have equal pay laws that may govern an employer's pay practices, and those states have begun to renew their focus on pay discrimination. While some states' equal pay laws closely mirror the EPA, several states, including California, Delaware, Maryland, Massachusetts, New York, and Oregon, have amended their equal pay laws to broaden their scope, while other states have similar legislation pending. As a result of the states' increased

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For more information on the Equal Pay Act, see

> HEEDING THE EQUAL PAY ACT

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For the unique requirements of the various state equal pay laws, see

> THE WAGE AND HOUR RETALIATION AND DISCRIMINATION LAWS COLUMN OF WAGE AND HOUR STATE PRACTICE NOTES CHART

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For guidance on analyzing the employer's obligations under Title VII, see

> COMPLYING WITH TITLE VII

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For a discussion of the employer's obligations under the Age Discrimination in Employment Act (ADEA), see

> ADDRESSING THE ADEA'S MANDATES

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For an analysis of the employer requirements under the Americans with Disabilities Act, see

> AMERICANS WITH DISABILITIES ACT: EMPLOYER REQUIREMENTS AND REASONABLE ACCOMMODATIONS

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > The ADA and Disability Management > Practice Notes*

For details on preserving the attorney-client privilege and work product, see

> PRESERVING THE ATTORNEY-CLIENT PRIVILEGE AND WORK PRODUCT PROTECTION DURING INVESTIGATIONS

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SOME STATES HAVE BEGUN TO EXPAND EQUAL PAY LAWS BEYOND PAY EQUALITY BASED ON SEX. FOR EXAMPLE, CALIFORNIA HAS EXPANDED ITS LAW TO PROTECT RACE- AND ETHNICITY-BASED PAY DIFFERENTIALS.

attention to equal pay matters, it is essential that you keep abreast of any developments in your clients' state(s) to ensure that they make all necessary changes to their pay policies and audit procedures to avoid potential liability. Several of the most significant recent developments in states' equal pay laws are briefly summarized below.

Bona fide factor. Most of the equal pay amendments modify the EPA's exception that permits employers to pay employees unequally if the differential is based on any factor other than sex. The amendments generally state that such pay differentials must be based on a bona fide factor other than sex (i.e., a factor that is job-related with respect to the particular position and consistent with business necessity, such as education, training, or experience). This updated standard makes it easier for an employee to allege a prima facie case of wage disparity. Also, unlike under the EPA's standard, it allows employees to claim that a neutral factor produced a wage differential that disparately impacts employees based on their sex and that the employer did not adopt an alternative business practice that would serve the same purpose without resulting in the wage differential.

Comparable and substantially similar work. Some states have also expanded equal pay protections beyond what the EPA provides by requiring equal pay not only for substantially equal work, but also for comparable or substantially similar work. For example, California requires equal pay for employees who perform substantially similar work and Massachusetts requires equal pay for employees who perform comparable work.

Expanded protections. Some states have begun to expand equal pay laws beyond pay equality based on sex. For example, California has expanded its law to protect race- and ethnicity-based pay differentials.

Geographical scope. The state equal pay amendments vary as to the reach of the protections. California and New York, for example, have eliminated the requirement that an employee show that he or she was not being paid at the same rate as an employee of the opposite sex at the same establishment for equal work. Instead, employees need only show that they are not being paid at the same rate for substantially similar work and working conditions (California) or for equal work and similar working conditions (New York). In other words, the comparison need not be between employees working at the same location. However, California's law provides no geographic restriction whatsoever, whereas in New York, employees can only compare themselves to others in the same geographic region, which can be no larger than the same county.

Pay transparency provisions. In addition to expanding the scope and coverage of existing equal pay laws, several states have also amended their equal pay laws to include pay transparency provisions. These provisions prohibit employers from restricting employees' ability to discuss their wages with coworkers. There are exceptions to this rule in some states. For example, in New York there may be limitations imposed on the ability of certain employees with access to employee wage information (such as human resources staff) to disclose employee wage information.

Salary history information. Another type of equal pay law that has been gaining momentum is those that prohibit employers from inquiring about an applicant's salary history. These laws are meant to ensure that any past wage discrimination is not perpetuating so that employees do not continue to be underpaid as their careers progress. Massachusetts was the first state to bar employers from forcing prospective employees to divulge how much they were making at their previous jobs. Several other states including California, Delaware, Maine, and Oregon have also passed similar laws, as well as several cities including New York City, San Francisco, and Philadelphia (although Philadelphia has stayed enforcement of its law until a lawsuit about its constitutionality is resolved).

Steps for Auditing the Employer's Equal Pay Practices

This section provides step-by-step guidance to help you audit an employer's equal pay practices to ensure they are in compliance with the EPA. You should modify these steps, as necessary, to ensure compliance with any applicable state laws as well.

Step 1: Identify the Audit Scope

Before beginning the audit, you should develop an understanding with the employer of what departments, positions, and locations the audit will address. You should also lay the groundwork for protecting the audit from disclosure.

- **Establish parameters of the audit.** Meet with the employer to determine the parameters of the audit. Determine whether any state or local equal pay laws apply and which protected categories the employer will analyze. If a company-wide audit is cost-prohibitive or not otherwise possible, consider audits that target specific high-risk facilities, departments, or positions; more limited audits are less costly and time consuming and often more palatable for employers. While targeted audits are effective, they have shortcomings that you should discuss with the employer before a decision is made. Although the scope of the audit should be set at the very outset, you should continue to assess whether it makes sense to enlarge the scope based on information revealed during the audit.
- **Take steps to preserve the attorney-client privilege and work product.** Use an engagement letter (for outside counsel) or memorandum (for in-house counsel) to establish that the scope of the audit includes providing legal advice and/or assistance in defending against anticipated litigation.

Any assessment of an organization's pay system should include an evaluation of the pay rates of all employees. When determining which employees to compare, you must ensure that the employees at issue perform equal, substantially similar, or comparable work. This typically requires substantially similar skill, effort, and responsibility, and the performance of those responsibilities under similar working conditions. You must compare pay rates by using one uniform period of time, most likely the actual or projected yearly wage, as employees tend to care most about their yearly income. Unless the pay system and/or the factors considered in determining rate of pay are complex, you need not use a compensation expert or consultant to evaluate an employer's pay system.

Step 2: Conduct the Audit

In assisting an employer to ensure that its pay systems do not raise any equal pay issues, you should consider its performance evaluation system, compensation system, job descriptions, training programs, and other factors that influence the employer's pay rates. You must identify the various factors the employer considers in deciding how and what to pay its employees, such as length of service, years of experience in the industry, education, and geography, and you should assess whether sex, or any other protected category, factors into pay rate decisions. When analyzing employees' compensation, you will need to make sure that you compare similarly situated employees who perform like duties, even if their titles or positions do not reflect that. If you are conducting a company-wide audit, refine the audit procedures and analysis as you go and modify as needed.

More specifically, you should do the following:

- **Conduct a statistical analysis.** An employer can most effectively assess a pay rate and the impact of sex and/or other protected categories, if any, on that rate by performing a statistical analysis of male employees versus female employees. You can conduct this analysis in several ways—and, depending on its complexity, you may want to involve a compensation consultant or statistician—but the effect should be to separate out and compare the rate of pay for men and women based purely on position and grade. If a disparity exists, consider whether other factors explain the disparity such as seniority, experience, expertise, employment history, or any other neutral factors that are not based on sex or any other protected category.

NON-ROUTINE ADJUSTMENTS TO EMPLOYEE STATUS OR PAY ENGENDER RISK BECAUSE THEY SIGNAL DEFICIENCIES IN THE EMPLOYER'S WAGE AND HOUR COMPLIANCE.

- **Assess performance review procedures.** Similarly, analyze job evaluation systems to ensure the employer applies them consistently and does not tend to favor certain individuals over others. Conduct this analysis by reviewing all of the factors used in determining rate of pay and assessing if the employer applies them uniformly. Make sure that the employer evaluates all positions in the same grade and/or category using similar benchmarks and scoring rubrics. A significant disparity between rates of pay among those in the same grade and position may trigger further analysis to ensure the decision-maker did not consider sex or any other protected category as a factor in setting the rate of pay.
- **Analyze compensation factors.** Assess what employee contributions and/or qualifications the employer uses or values in determining employee raises and bonuses. You can obtain this information through interviews of and/or questionnaires provided to decision-makers or by simply requiring decision-makers to submit explanations of what factors they considered in deciding raise and bonus amounts. In conjunction with this assessment, evaluate whether all positions allow employees to exhibit those qualifications or provide those contributions for purposes of earning pay raises and bonuses.
- **Ascertain prevalence of women, minorities, and older workers.** Evaluate any data the employer maintains regarding the demographics of its workforce to determine if women, minorities, and/or older workers tend to occupy certain positions and/or grades in the company. If so, analyze whether the preponderance of women, minorities, and older workers in certain roles impacts their pay relative to their male, non-minority, and younger counterparts. Try to limit any comparisons to employees within the same grade, department, or position and with similar experience. If pay disparities do exist among employees performing equal work, look for factor(s) other than sex or any other protected category that would explain the pay differential. For instance, perhaps the males have more seniority than female employees in these like positions, which would account for the difference in pay rates.

Step 3: Present Your Findings to the Employer

Depending on the scope of the audit, you may present your findings and recommendations on an interim basis or at the conclusion of the audit. You and the employer should carefully consider if, and to what extent, you should provide a written report of the audit results, keeping in mind that despite efforts to protect communications and documents as privileged and/or attorney work product, your report, in whole or in part, may ultimately be deemed discoverable. If you provide a written report to the employer, also provide specific written instructions about maintaining confidentiality, including limiting distribution of the report and information contained in it to those who need to know.

Step 4: Take Remedial Actions

At the conclusion of the audit, the employer should address any unjustified disparities. This may entail a subsequent evaluation of an employee's rate of pay to determine if any reasonable basis justifies the disparity. If not, the employer must raise the affected employee's rate of pay to a level comparable to those performing equal work.

Non-routine adjustments to employee status or pay engender risk because they signal deficiencies in the employer's wage and hour compliance. Therefore, employers should give honest, brief, and general reasons for pay adjustments flowing from the audit. For example, an employer might say that the adjustment is the result of ongoing compliance efforts or, if appropriate, allows the employer to keep pace with competitors or the job market.

Step 5: Consider Future Best Practices

In addition to regular assessments of its compensation systems, the employer should also follow these best compliance practices:

- **Be transparent.** Advise the employer to share how it establishes each employee's rate of pay and how raises/bonuses are awarded so that employees understand differentials in pay. Handbooks may be helpful to lay out general compensation policies, but the factors considered when determining who should receive a bonus may change from year to year. Instead, the employer may want to provide an annual distribution to all employees detailing how it will determine discretionary and non-discretionary bonuses for that year. You should also recommend that the employer hold one-on-one meetings with each employee specifically to discuss the employee's set rate of pay and how to reach individual targets to increase compensation. The employer can hold these meetings in conjunction with annual evaluations or at the discretion of the employer when it considers an employee for a raise or bonus.
- **Elicit employees' views.** Solicit feedback from employees regarding their perception of pay rate differentials to determine whether employees perceive differences based on sex or any other protected category. Feedback acquired anonymously will provide the most useful insights. The employer can provide questionnaires regarding employee perception during employee evaluation periods or during any other time when it assesses the current compensation system. The employer should consider making changes to its evaluation system based on feedback and/or useful employee recommendations to demonstrate to employees that their feedback has significance.
- **Provide training.** Counsel the employer to include compensation determination in the employer's regular Equal Employment Opportunity (EEO) training, particularly any individual training offered to managers, supervisors, or others involved in determining compensation, raises, and bonuses.
- **Make sure job descriptions are current.** The employer should regularly update position qualifications, skills, and duties when necessary to accurately reflect current practice and characterization. The employer should also ensure that all job descriptions are completely sex-neutral unless a specific component of the position would require otherwise. L

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RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes*



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Wage and Hour Self-Audits Checklist

This checklist identifies the main risk categories for wage and hour self-audits. To avoid potentially significant liability for wage and hour violations, employers should consider wage and hour self-audits to identify and close compliance gaps.

In conducting a wage and hour self-audit, you should consider the following issues:

Preserve the Attorney-Client Privilege/Work Product

Audits often involve the production of documents that would normally be discoverable in a federal or state Department of Labor investigation or wage and hour litigation. Consequently, you should take steps to establish and preserve the attorney-client privilege and work product, to the extent possible, from the outset of the audit.

Evaluate Employer's Wage and Hour Policies and Procedures

Ensure that the employer's policies and procedures comply with applicable federal and state law and that the employer uniformly implements them.

Ensure Employer Corrected Previously Identified Shortfalls

Confirm that the employer corrected compliance gaps identified in prior audits.

Confirm Accuracy of Employee Classifications

In assessing whether the employer has correctly classified employees as exempt or non-exempt for overtime purposes, consider the following:

- **Duties.** Do exempt employees meet all requirements of the executive, administrative, professional, outside sales, computer employee, or highly compensated employee exemption? In evaluating the classification of employees, you should:
  - ✓ Review job descriptions and actual duties to ensure that the job descriptions reflect the work being performed by employees
  - ✓ Examine job descriptions to ensure they are accurate, up to date, and justify the applicable exemption –and–
  - ✓ Evaluate each exemption on a case-by-case basis and avoid decisions based solely on job descriptions and/or titles

- **Compensation amount.** Confirm that exempt employees earn at least $455 per week on a "salary basis" to ensure that the federal exempt salary basis and threshold is satisfied. Salary basis means an employee regularly receives a set amount of compensation each pay period regardless of the quality or quantity of the employee's work, although certain types of deductions are permissible (see the section below entitled "Deductions"). Note the following:
  - ✓ This requirement does not apply to outside sales employees, teachers, and employees practicing law or medicine. Note that not all states (e.g., California) have adopted each of these exceptions to the salary basis rule.
  - ✓ Exempt computer employees may be paid at least $455 on a salary basis or on an hourly basis at a rate not less than $27.63 an hour. Confirm that state law does not require a higher rate. In California, for example, computer professional employees must be paid a salary of at least $90,790.07 annually ($7,565.85 monthly) or an hourly wage of at least $43.58 for every hour worked.
  - ✓ Exempt highly compensated employees must be paid at least $100,000 annually. Note that not all states (e.g., California) recognize the highly compensated employee exemption.
  - ✓ On November 22, 2016, a federal district court judge in the U.S. District Court for the Eastern District of Texas issued a nationwide preliminary injunction barring enforcement of the U.S. Department of Labor's (DOL) overtime expansion rule in Nevada v. United States DOL, 218 F. Supp. 3d 520 (E.D. Tex. 2016). That rule would have, among other things, raised the salary threshold to $913 per week ($47,476 yearly) on December 1, 2016. Consequently, the DOL's overtime expansion rule did not take effect as scheduled. Then on August 31, 2017, the same federal district court judge in the Eastern District of Texas struck down the DOL's overtime expansion rule in Nevada v. United States DOL, 2017 Dist. LEXIS 140522 at *28 (E.D. Tex. Aug. 31, 2017).
  - ✓ Confirm that the salary paid to employees classified as exempt satisfies the salary threshold of certain states that maintain thresholds greater than the federal $455 weekly salary threshold requirement.
- **Deductions.** Ensure exempt employees regularly receive a predetermined amount of compensation for every workweek in which they perform any work regardless of the hours, quality, or quantity of work. Confirm that the employer only makes the following proper deductions:
  - ✓ For absences of one or more full days not for sickness/disability
  - ✓ For absences of one or more full days for sickness/disability if made according to a bona fide plan, policy, or practice of providing compensation for salary loss
  - ✓ Offsets for amounts employees receive as jury or witness fees/military pay
  - ✓ Penalties for infractions of major safety rules
  - ✓ For disciplinary suspensions of one or more full days
  - ✓ Days not worked in the first/last week of employment
  - ✓ For leave under the Family and Medical Leave Act
- **Safe harbor policy.** Confirm the employer has a safe harbor policy and procedures to address improper salary deductions. If an employer has made improper deductions from salaries, it will not jeopardize employee exemptions so long as the employer clearly communicates a policy that prohibits improper deductions and provides a complaint mechanism; reimburses employees for improper deductions; makes a good-faith commitment to comply in the future; and does not willfully continue to make improper deductions.

Evaluate Independent Contractor Classifications

The worker is more likely to be deemed an employee if:

- ✓ The worker's services form an integral part of the employer's business
- ✓ The relationship has a longer term or more permanent character
- ✓ The worker did not invest much in facilities and equipment
- ✓ The company exercises control over how, when, and where the worker performs the work
- ✓ The worker does not have any opportunity for profit and loss beyond the hourly compensation or salary received by the worker
- ✓ The worker is prohibited by the employer from providing services to another company –and–
- ✓ The worker does not use initiative, judgment, or foresight to compete for business in the open market

Review Employer Internship Programs

In January 2018, the DOL announced its withdrawal from using the previous six-factor test for unpaid internship programs that had been used under the Obama administration. The new test, which has been adopted by the Second, Sixth, Ninth, and Eleventh Circuits, is known as the "primary beneficiary" test.

- **Primary beneficiary test.** The primary beneficiary test is flexible, and no single factor is determinative. Accordingly, whether an intern or student is an employee under federal law necessarily depends on the unique circumstances of each case. The test considers the following seven non-exhaustive factors to weigh and balance:

1. The extent to which the intern and the employer clearly understand that there is no expectation of compensation. Any promise of compensation, express or implied, suggests that the intern is an employee and vice versa.
2. The extent to which the internship provides training that would be similar to that which would be given in an educational environment, including the clinical and other hands-on training provided by educational institutions
3. The extent to which the internship is tied to the intern's formal education program by integrated coursework or the receipt of academic credit
4. The extent to which the internship accommodates the intern's academic commitments by corresponding to the academic calendar
5. The extent to which the internship's duration is limited to the period in which the internship provides the intern with beneficial learning
6. The extent to which the intern's work complements, rather than displaces, the work of paid employees while providing significant educational benefits to the intern –and–
7. The extent to which the intern and the employer understand that the internship is conducted without entitlement to a paid job after the internship

Evaluate How the Employer Calculates and Pays Wages

You should consider the following issues:

- **Minimum wage and overtime.** Determine if the employer pays non-exempt employees minimum wage and overtime according to applicable federal and/or state law. In particular:
  - ✓ Confirm that the employer includes all applicable payments in calculating the regular rate and overtime pay (e.g., non-discretionary bonuses, shift differentials, and other payments) and/or lawfully excludes additional payments from such calculations.
  - ✓ Confirm that deductions for the benefit or convenience of the employer (e.g., uniforms) do not reduce an employee's rate of pay below minimum wage.
  - ✓ Consider whether special requirements for overtime pay apply (e.g., for hospital workers, non-exempt salaried employees, piecework, multiple jobs, and job/day rates).
  - ✓ Advise the employer to consider participating in the DOL's pilot Payroll Audit Independent Determination (PAID) program. Employers that participate in the PAID program to resolve non-compliant overtime and minimum wage practices will not be subject to civil penalties or liquidated damages under the FLSA.
- **Compensatory time.** Determine whether the employer provides compensatory time to non-exempt employees in lieu of overtime. Note the following:
  - ✓ Only public employers (i.e., a state, a political subdivision of a state, or an interstate governmental agency) may lawfully provide compensatory time in lieu of overtime pay.
  - ✓ Private sector employers must pay overtime when employees work more than forty hours in a week. However, there may be a limited exception for validly implemented "time-off plans," which provide time off in the same pay period at the time-and-one-half rate.
- **Deductions.** Evaluate the propriety of the deductions that the employer makes. In particular:
  - ✓ Confirm that the state in which the employer operates permits deductions from employees' wages. (For example, California prohibits employers from deducting from wages unless done so under certain circumstances set forth in Cal. Labor Code § 224.)
  - ✓ If the state does permit wage deductions and permits them for the benefit or convenience of the employer (e.g., uniforms), confirm that such deductions do not reduce an employee's rate of pay below minimum wage.
  - ✓ Ensure the employer is not making impermissible deductions from exempt employees' salary basis pay. (See the section above entitled "Compensation amount.")

Determine Whether All Hours Worked Are Recorded and Paid

Your analysis should encompass the following:

- **Timekeeping system.** Ensure the employer's timekeeping system allows for the accurate recording and calculation of hours worked.
- **Compensable time.** Confirm that non-exempt employees record all hours worked including, for example, pre- and post-shift work; compensable training, travel, and meeting time; reporting time; work performed at home; on-call time; waiting time (if engaged by the employer to wait); and any time worked during an employee's otherwise non-compensable meal and break times. Confirm that the employer pays the employees for such time.
- **Rounding.** Determine whether the employer complies with applicable rounding rules. Federal law permits employers to round employee time to the nearest quarter hour. That is, employers may round down—and not count as hours worked—one to seven minutes of work. Employers must round up—and count as a quarter hour of work time—eight to 14 minutes of work. Rounding is permissible where it is used in such a manner that it will not result, over a period of time, in failure to compensate employees properly for all the time they have actually worked.
- **Meals and breaks.** Confirm that non-exempt employees accurately record non-compensable meal and break times and that they do not perform work at such times. Under federal law, breaks of thirty minutes or more need not be compensable. Employers, however, must pay employees for breaks of twenty minutes or less and include such time in overtime calculations.
- **Off-the-clock policies/procedures.** Determine if the employer has policies and procedures in place that prohibit and prevent off-the-clock work. Determine whether there is a procedure for reporting off-the-clock work.

Review the Employer's Provisions for Nursing Mothers

You should consider the following issues concerning breastfeeding mothers:

- **Location and time for breaks.** Be sure the employer provides non-exempt nursing mothers reasonable breaks and a place to express milk (other than a bathroom). Federal law does not require breaks for exempt employees.
- **Exemption from requirements.** If the employer does not provide breaks or private location for nursing mothers to express milk, determine whether it is exempt from such requirements because it has fewer than fifty employees and can establish undue hardship. Note that state law, however, may also impose lactation break requirements.
- **Similar treatment of employees.** Generally, breaks to express milk are not compensable under federal law. However, if an employer provides compensated breaks, the employer must compensate an employee who uses break time to express milk in the same way that it compensates other employees for break time.
- **Relieved from work.** Determine whether nursing mothers are completely relieved from work when taking breaks to express milk. If not, the employer must compensate the time as work time.

Confirm Compliance with Child Labor Restrictions

The employer must comply with the following federal restrictions for non-agricultural jobs:

- **Minors age 18 or older.** No restrictions on jobs or hours.
- **Minors age 16 and 17.** May perform any job not declared hazardous by the Secretary of Labor, and are not subject to restrictions on hours.
- **Minors age 14 and 15.** May generally work outside school hours in various non-manufacturing, non-mining, nonhazardous jobs listed by the Secretary Labor in regulations published at 29 C.F.R. Part 570 under the following conditions:

✓ No more than three hours on a school day, eighteen hours in a school week, eight hours on a non-school day, or forty hours in a non-school week

✓ They may not begin work before 7 a.m. or work after 7 p.m., except from June 1 through Labor Day, when evening hours are extended until 9 p.m.

✓ Permissible work for 14- and 15-year olds is limited to those jobs in the retail, food service, and gasoline service establishments specifically listed in the Secretary of Labor's regulations

✓ Those enrolled in an approved Work Experience and Career Exploration Program (WECEP) may work up to twenty-three hours in school weeks and three hours on school days (including during school hours)

Evaluate the Employer's Recordkeeping Practices

Is the employer maintaining at least the following records?

- Personal information (employee's name, home address, occupation, sex, and birth date if under 19 years of age)
- Hour and day when workweek begins
- Total hours worked (each workday and each workweek)
- Total daily/weekly straight-time earnings
- Regular hourly pay rate for week when overtime is worked
- Total overtime pay for the workweek
- Deductions from or additions to wages
- Total wages paid each pay period
- Date of payment and pay period covered
- Specific information for homeworkers, employees working under uncommon pay arrangements, employees to whom lodging or other facilities are furnished, and employees receiving remedial education

Determine Whether Industry-Specific Requirements Apply

Does the employer comply with all wage and hour requirements applicable to its industry (e.g., agriculture, automobile dealers, restaurants, construction, garment, government contractors)?

Related Content

For additional information on worker classifications, see

> CONDUCTING AN AUDIT ON EXEMPT/NON-EXEMPT EMPLOYEE CLASSIFICATIONS

RESEARCH PATH: *Labor & Employment > Wage and Hour > Claims and Investigations > Practice Notes*

For a discussion of best practices in conducting pay equity audits, see

> PAY EQUITY AUDITS AND BEST PRACTICES

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes*

For a detailed look at the Fair Labor Standards Act's (FLSA) child labor restrictions, see

> NAVIGATING THE FLSA'S CHILD LABOR RESTRICTIONS

RESEARCH PATH: *Labor & Employment > Wage and Hour > FLSA Requirements and Exemptions > Practice Notes*

To obtain an overview of the FLSA's records maintenance requirements, see

> UNDERSTANDING RECORDS MAINTENANCE AND RETENTION REQUIREMENTS UNDER THE FLSA

RESEARCH PATH: *Labor & Employment > Wage and Hour > FLSA Requirements and Exemptions > Practice Notes*

For information on the various states' wage and hour requirements, see

> WAGE AND HOUR STATE PRACTICE NOTES CHART

RESEARCH PATH: *Labor & Employment > Employment Litigation > Class and Collective Actions > Forms and Guidance*

For a sample lactation break time policy, see

> LACTATION/BREASTFEEDING POLICY

RESEARCH PATH: *Labor & Employment > Attendance, Leaves, and Disabilities > Attendance and Time Off > Forms and Guidance*

Review the Employer's DOL Posters and Notices

Has the employer satisfied all applicable posting and notice requirements, including industry-specific requirements? Many states and cities also require employers to post certain notices advising employees of their wage and hour rights, in addition to providing employees with written notices upon hire and when the employer changes certain terms and conditions of employment (e.g., pay rate, pay day, pay period). Confirm that all such posting and notice requirements are met. See Complying with Federal Wage and Hour Poster and Notice Requirements. For state wage and hour poster requirements, see Wage and Hour State Practice Notes Chart.

Determine State Wage and Hour Requirements Applicable to the Employer

Federal and state law may significantly differ in many areas and employers must generally comply with the provisions most protective to employees. You should:

- Determine whether and to what extent the employer complies with applicable state wage and hour requirements
- Ensure the employer's wage and hour policies/procedures reflect applicable state law requirements

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RESEARCH PATH: *Labor & Employment > Wage and Hour > Policies and Procedures > Checklists*

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Locating Missing Retirement Plan Participants

This article addresses the steps that plan sponsors and fiduciaries must take to locate and notify missing participants in qualified defined contribution and qualified defined benefit plans regarding benefits that are due to them under the plan.

PLAN ADMINISTRATORS ARE OBLIGATED UNDER THE Employee Retirement Income Security Act (ERISA) to conduct a diligent search to locate missing participants and beneficiaries. The fact that participants and beneficiaries cannot be located poses a problem for plan administrators in active plans when a distribution is required and in terminated plans for which the plan administrator must liquidate the benefit trust. Recently, the Pension Benefit Guaranty Corporation (PBGC) opened its missing participant program to terminating defined contribution plans and other previously excluded defined benefit plans. This article summarizes guidance regarding missing participants, provides an overview of the revised PBGC program, and offers tips for plan administrators to handle (and avoid) missing participant issues.

Missing Participant Issues in Qualified Plans

Missing participants (which term includes beneficiaries and alternate payees with accrued benefits as used in this article) become an acute issue for qualified retirement plan sponsors, administrators, or other fiduciaries in several circumstances, such as:

- The plan is being terminated and all assets are being liquidated.
- A plan participant terminated employment and is due a distribution under the plan.
- A plan participant must take a required minimum distribution under the rules of I.R.C. § 401(a)(9).

- Payments are being made for plan corrections under the Employee Plans Correction Resolution System.
- A plan distribution was made and a check for the benefit payment was returned or remained uncashed until it was no longer eligible to be presented for payment.

LOCATING MISSING PARTICIPANTS IS PARTICULARLY IMPORTANT IN ERISA-GOVERNED PLANS BECAUSE IT IMPLICATES THE FIDUCIARY DUTIES OF RESPONSIBLE PARTIES.

While it may seem unlikely that a participant would not remain vigilant about his or her retirement benefits, there are a variety of reasons individuals become missing participants. Such reasons include:

- **No updated address.** In keeping with the trend of increased workforce mobility, a participant may terminate employment and fail to provide the employer or plan with a new address.
- **Participant unable to locate the plan.** As a result of corporate transactions, the sponsor of the plan of which a participant previously was a member may change, or the plan may be merged into another plan. Thus, the participant may not know how to locate the plan.
- **Participant dies.** The participant dies but no beneficiary comes forward.

Locating missing participants is particularly important in ERISA-governed plans because it implicates the fiduciary duties of responsible parties. To assist plan fiduciaries in these efforts, the Department of Labor (DOL) and the PBGC have provided detailed guidance on steps to take to locate missing participants in both defined contribution plans (DC plans) and defined benefit plans (DB plans). This guidance is summarized in the following sections.

Missing Participants in Terminating Defined Contribution Plans

When terminating a defined contribution plan, the plan sponsor and plan fiduciaries must notify participants that the plan is being terminated and benefits are being distributed. This requirement implicates ERISA § 404(a)'s prudent man standard of care for plan fiduciaries. ERISA § 404(a) (29 U.S.C. § 1104). While the decision to terminate a plan is a settlor decision and not a fiduciary decision, the fiduciary responsibility provisions of ERISA govern the implementation of plan termination, including steps to locate missing participants, and the choice of distribution options for a missing participant's account balance. DOL Field Assistance Bulletin 2014-01 (Aug. 14, 2014) (FAB 2014-01).

Further, the IRS has ruled that in the context of a terminating plan, all of a plan's assets must be distributed as soon as administratively feasible after plan termination. Rev. Rul. 89-87; Prop. Treas. Reg. § 1.412(b)-4(d)(1).

DOL Field Assistance Bulletin 2014-01

FAB 2014-01 sets forth guidance on what the DOL considers reasonable efforts to locate missing participants when terminating defined contribution plans such that if such efforts are taken, the terminating plan's fiduciary duties will generally be deemed satisfied. Under earlier guidance, the DOL required that plan fiduciaries utilize the Social Security Administration's and the IRS's address forwarding services to locate plan participants or beneficiaries. Those programs were discontinued given expanded internet search options.

FAB 2014-01 requires that the following actions be taken to locate missing participants in a DC plan (in no particular order):

- **Use certified mail.** Certified mail is an easy way to find out, at little cost, whether a participant or beneficiary can be located in order to distribute benefits. The DOL has provided a model notice that may be used for mailings made to locate missing participants and beneficiaries. The model, which relates to terminated defined contribution plans, need not be followed and use of other notices will satisfy the safe harbor.
- **Check related plan and employer records.** The plan sponsor should check the employer records and the records of another of the employer's plans, such as the group health plan, for address and beneficiary information. Where there are privacy concerns, the plan fiduciary engaged can request that the employer or other plan fiduciary contact or forward a letter to the missing participant or beneficiary.
- **Check with the designated plan beneficiary.** Try to identify and contact any individual that the missing participant designated as a beneficiary to find updated contact information for the missing participant. If this raises privacy concerns, the plan fiduciary can request that the designated beneficiary contact or forward a letter to the missing participant or beneficiary.
- **Use free electronic search tools.** Plan fiduciaries must make reasonable use of internet search tools that do not charge a fee to search for a missing participant or beneficiary. The DOL has identified these services to include internet search engines, public record databases (such as those for licenses, mortgages, and real estate taxes), obituaries, and social media.

The above list is required for any distribution regardless of the participant's account balance. However, if taking all those steps does not yield results, the plan fiduciary must make a cost-benefit analysis, weighing the facts and circumstances, to determine whether further steps are necessary.

When determining whether further steps are necessary, the plan fiduciary must take into account:

- The size of participant's account balance
- The cost of further search efforts

DOL FAB 2014-01 lists the following as possible additional search methods:

- Internet search tools
- Commercial locator services
- Credit reporting agencies
- Information brokers
- Investigation databases
- Analogous services that may involve charges

Distributing Accounts on Behalf of Missing Participants Who Cannot Be Located

Because all assets must be distributed for a terminating plan, if none of the fiduciary's search efforts are successful, the fiduciary's next step is to decide how to distribute the account on behalf of the missing participant. Prior to the expansion of the PBGC missing participant program, the main approach was to follow the safe harbor distribution rules for terminating individual account plans (e.g., 401(k) plans) under 29 C.F.R. § 2550-404a-3 and the safe harbor for automatic rollovers of mandatory cashout distributions, as contemplated by FAB 2014-01. Now, the PBGC program, described further below, is also available.

Charging Plan Accounts for Missing Participant Search Expenses

If the plan fiduciary determines that a search method that involves costs is warranted, an additional decision to consider is whether to charge the participant's account for such fees. The DOL permits the charge to individual participants in the case of charges related to distributions and the accounts of separated vested participants, so long as the amount and nature of the charges are prudent. DOL Field Assistance Bulletin 2003-03 (May 19, 2002). If participant accounts will be reduced for search fees, you should make sure the plan terms and the plan's fee disclosures are consistent with this practice.

PBGC Missing Participants Program for DC Plans

The PBGC developed a program over 20 years ago to locate and preserve benefits for missing participants in most terminating single-employer defined benefit plans, pursuant to ERISA § 4050. The Pension Protection Act of 2006 authorized the PBGC to establish a more expansive program available to defined contribution and other plans not covered by the former program. After consulting with the DOL and IRS and issuing proposed rules in 2016, the PBGC issued final rules for its revised and expanded program. The new program is applicable for plan terminations on and after January 1, 2018 and is set forth in revised Part 4050 of C.F.R. Title 29.

DC Plan Eligibility and Optional Participation

The program is generally open to most qualified DC plans (whether single-employer, multiple-employer, or multiemployer) and plans treated as individual account plans, including applicable 403(b) plans, but excluding non-ERISA plans (e.g., non-electing church plans). However, the program is specifically limited to terminating plans and is not available for ongoing plans.

Unlike for defined benefit plans, participation by DC plans is optional. In addition, DC plan fiduciaries can decide whether to participate as either a transferring plan or notifying plan:

- Transferring plans send the PBGC funds equal to the amount of the missing participant's distributable account balance at the termination of the plan (the so-called benefit transfer amount) so that the PBGC can pay the benefit to the missing participant if and when they are located. Under an all-or-nothing rule, a transferring plan must transfer funds for all of the plan's missing participants.
- Notifying plans make other arrangements for the benefit amounts (such as a rollover to an IRA pursuant to FAB 2014-01) but enlist the PBGC's assistance in helping to locate the missing participants. Notifying plans send the PBGC information on the entity responsible for providing the benefit to share with the participant (or other eligible claimant) once found.

In addition, missing participants will be added to the PBGC's publicly available unclaimed pension benefit database, which will now be unified for DB and DC plans participating in the PBGC program. This searchable database incorporates names of missing participants and plan information, such as the plan name, type, and termination dates and company name and address.

Importantly, the program is available not only for missing participants who cannot be located, but also for participants who (1) do not make a distribution election after receiving notice or (2) do not accept a lump sum payment. The program is only available for participants who are missing. Non-acceptance of a lump sum includes the failure to cash the distribution check by any applicable cash-by date that is at least 45 days after issuance of the check (or, in the absence of a cash-by date, by the check's stale date under the UCC or state law, as applicable).

Generally, the requirements to participate in the DC plan program are:

- **Diligent search.** Conduct a diligent search for all missing participants that cannot be located (or, for a notifying plan, those for whom information will be provided to the PBGC), conducted in accordance with FAB 2014-01, as described in the discussion above, not more than nine months before making the missing participant filing (discussed below).
- **Obtaining a PBGC case number.** Request a case number by emailing the PBGC per the missing participant filing instructions.
- **Missing participant filing.** File a completed missing participants form (Form MP-200 and appropriate schedule) with the PBGC to provide relevant plan and participant information, benefit amount and beneficiary information for transferring plans, and responsible entity information for notifying plans, all in accordance with the applicable instructions (the PBGC website has draft forms and instructions, including drafts of Form MP-200 and Missing Participants Program Filing Instructions for DC Plans).
- **Transfer of funds and fees (for transferring plans).** Send the benefit transfer amount to the PBGC as provided in the missing participant instructions to cover the cost of providing the benefit and, if applicable, an administration fee (expected to be $35 per missing participant with benefits over $250).
- **Supplemental information.** Respond to any PBGC request for supplemental information relating to the missing participants within 30 days.

Missing Participants in Terminating Defined Benefit Plans

Upon the termination of a defined benefit pension plan which is subject to Title IV of ERISA (i.e., a PBGC-insured plan), a plan sponsor must fully distribute all plan assets before the defined benefit plan can be terminated. Title IV contains extensive rules for terminating DB plans, including requiring covered plan administrators to either procure an irrevocable commitment from an insurer to provide for a missing participant's benefit or transfer the benefit liability to the PBGC. The PBGC established its missing participants program to facilitate, monitor, and ensure compliance with these obligations.

In 2017, the PBGC issued final regulations to open the program to other DB plans previously excluded from coverage as well as to DC plans. In addition, the procedures for single-employer DB plans were significantly simplified. The PBGC's final rulemaking restructures C.F.R. Part 4050 in four subparts that address different types of plans:

- Single-employer DB plans
- DC plans, discussed earlier in this article
- Certain DB plans not covered by ERISA Title IV (small professional services DB plans)
- Multiemployer DB plans

The following section provides an overview of the new program for DB plans, applicable for plan terminations on and after January 1, 2018. The program is limited to the context of terminating plans and is not available to ongoing plans having missing participants, even where a distribution is required. Separate rules apply for DB plans experiencing a distress termination that are not fully funded.

PBGC Missing Participants Program for DB Plans

Under the program, the PBGC either accepts a transfer of missing participant pension benefits from terminated DB plans to pay the distributees once located or helps connect missing participants with the insurance company responsible for their annuity contracts, as well as monitors the program and audit compliance.

Another significant change for the new program is to explicitly treat certain unresponsive individuals as missing participants, instead of as individuals who cannot be located. Specifically, the definition of missing now includes individuals who:

- Cannot be located after a diligent search
- Are subject to a mandatory cash-out lump-sum distribution and do not respond to the distribution notice
- Are subject to a mandatory cash-out lump-sum distribution and do not accept payment or are deemed not to by failing to cash the distribution check by any applicable cash-by date that is at least 45 days after issuance of the check (or, in the absence of a cash-by date, by the check's stale date under the UCC or state law, as applicable)

Missing participants are also added to the PBGC's unclaimed pension benefit database, which is publicly available and will be unified for both DB and DC plans participating in the PBGC program. The searchable database lists missing participants' names, as well as plan information, including plan name, type, termination dates, company name and address.

DB Plan Mandatory Participation and General Requirements

DB plans that are PBGC-insured are required to follow the program rules during the termination process for all missing participants (including participants deemed to be missing because they fail to respond to a distribution notice or accept a mandatory lump-sum distribution). This means that for each missing participant at the close-out of the plan, they must either transfer the applicable benefit transfer amount (based on the value of the accrued benefit) to the PBGC or procure an annuity for the missing participant and convey information about the annuity provider to the PBGC. Unlike for transferring DC plans, there is no all-or-nothing rule, so different missing participants can be treated differently.

PLAN ADMINISTRATORS WHO ARE UNABLE TO LOCATE PARTICIPANTS AND BENEFICIARIES TO PROVIDE NOTICES, PLAN INFORMATION, AND PLAN BENEFITS MUST MAKE A DILIGENT EFFORT TO LOCATE THESE INDIVIDUALS TO FULFILL THEIR FIDUCIARY OBLIGATIONS.

The preceding paragraph does not apply to small professional services DB plans (having 25 or fewer participants) (SPS plans), which are not PBGC-insured. The program for these plans is optional under rules similar to DC plan participation discussed earlier.

Generally, the requirements for DB plans are:

- **Diligent search.** Conduct a diligent search for all missing participants that cannot be located (or, for a notifying SPS plan, those for whom information will be provided to the PBGC) not more than nine months before making the missing participant filing under new rules (described below).
- **Determining benefit transfer amount or purchasing annuity for each missing participant.** For plans transferring funds to the PBGC for any missing participant, the benefit transfer amount is a present value of the individual's benefit, determined as explained below. For all other missing participants, the plan must purchase an irrevocable commitment from an insurer to provide the benefit to the missing participant.
- **Missing participant filing.** File a completed missing participants form (Form MP-100 and appropriate schedule(s)) with the PBGC to provide relevant plan and participant information; benefit amount, form, and beneficiary information (for benefits transferred to the PBGC); and insurance company information (for reporting annuities to the PBGC), all in accordance with the applicable instructions (the PBGC website has draft forms and instructions, including drafts of Form MP-100 and Missing Participants Program Filing Instructions for Single-Employer DB Plans).
- **Transfer of funds and fees (if applicable):** For any benefit transfer amounts, DB plans must convey the funds to the PBGC as provided in the missing participant instructions and, if applicable, pay an administration fee (expected to be $35 per missing participant with benefits over $250).
- **Supplemental information:** Respond to any PBGC request for supplemental information relating to the missing participants within 30 days.

Related Content

For guidance on identifying employee benefit plans and programs that are subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA), see

> **IDENTIFYING ERISA EMPLOYEE BENEFIT PLANS**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Retirement Plans > ERISA and Fiduciary Compliance > Practice Notes*

For a discussion on the various fiduciaries of employee benefit plans under ERISA, including their duties and obligations, see

> **FUNDAMENTALS OF ERISA FIDUCIARY DUTIES**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Retirement Plans > ERISA and Fiduciary Compliance > Practice Notes*

For the steps that plan sponsors and fiduciaries must take to locate and notify missing participants when terminating qualified defined contribution and qualified defined benefit plans, see

> **LOCATING MISSING PARTICIPANTS WHEN TERMINATING DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Retirement Plans > ERISA and Fiduciary Compliance > Practice Notes*

For an explanation of the potential employer liability and notice obligations under ERISA when there is a cessation of operations at a facility that results in the termination of employment of retirement-plan-eligible employees, see

> **ERISA § 4062(E): SUBSTANTIAL CESSATION OF OPERATIONS LIABILITY FOR DEFINED BENEFIT PLANS**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Retirement Plans > ERISA and Fiduciary Compliance > Practice Notes*

Diligent Search Requirement

In order for a terminating DB plan to utilize the PBGC's missing participant program, and before it can distribute funds to terminate, the plan administrator must perform a diligent search for each missing participant who cannot be located.

The new program substantially modifies this requirement for conducting a diligent search, modelling the new rules on the DOL's FAB 2014-01. For DB plans, the required method depends on whether the missing participant's benefit is valued at over $50 per month:

- **Commercial locator method for benefits over threshold.** The DB plan must engage a commercial locator service that, as a minimum, uses information from a database maintained by a consumer reporting agency. Many companies specialize in helping plan administrators locate lost participants.
- **Records search method for benefits under threshold.** Undertake all of the following, to the extent reasonably feasible and affordable:
  - Search plan records
  - Search plan sponsor and employer records
  - Search records of other employee benefit plans in which the missing participant participated
  - Contact any identified beneficiaries of the missing participant
  - Conduct internet searches, such as through search engines, network databases, public record databases, and social media websites

29 C.F.R. § 4050.104.

Missing Participants Filings

For the new program, the applicable version of Form MP replaces the Schedule MP that DB plans filed with the PBGC for a standard plan termination prior to 2018. Form MP-100 for single-employer DB plans, Form MP-300 for SPS DB plans, and Form MP-400 for multiemployer DB plans, are all available with corresponding instructions and Excel templates in draft form on the PBGC website. Similar to the Schedule MP attachments, the new forms contain:

- Schedule A for providing information on annuities the plan purchased for one or more missing participants
- Schedule B for providing information about benefit transfer amounts to the PBGC

Filers may use Excel templates furnished by the PBGC in lieu of completing the schedules.

Additional forms must be provided that are related to the termination of the plan and not specifically to missing participants, and thus are outside the scope of this article.

Best Practices in Administering Qualified Plans

Plan administrators who are unable to locate participants and beneficiaries to provide notices, plan information, and plan benefits must make a diligent effort to locate these individuals to fulfill their fiduciary obligations. Some of this work can be done in advance of a distribution event based on returned mailings sent to a participant or beneficiary. Conducting a diligent search has been facilitated by the increased resources available via the internet and through readily available commercial locator services. The following list offers missing participant best practices to help responsible parties fulfill their fiduciary duties and facilitate plan administration.

- Adopt a policy to identify and locate missing participants that is designed and implemented in a consistent and nondiscriminatory manner, and in accordance with ERISA § 404(a) requirements.
- Consult any third-party administrators to confirm that they have, and that they implement, a reasonable missing participant's policy and are following appropriate procedures.
- Review the plan for records on a regular basis to identify retirees with deferred vested benefits, as well as terminated vested participants, and consider periodic communications to verify accurate mailing addresses.
- Keep accurate records of all efforts to locate missing participants and instruct third-party service providers to do the same.
- Document reasons for using more expensive search services (if plan assets will be used to pay for such services).
- Monitor forfeitures resulting from failure to locate missing participants (where the plan allows this) and consider modifying or using newer locator procedures if the number of forfeitures increases.
- Periodically review data by comparing plan records to a database such as the Social Security Death Index or the National Change of Address database.
- In the context of a business transaction, like a merger or acquisition, request information regarding missing participants and beneficiaries and verify that participant and beneficiary lists are readable or transferable to the acquiring sponsor's information systems or those of its vendor.
- In the context of a change in recordkeepers or vendors, verify that the successor third-party service provider has access to complete participant and beneficiary lists.
- Include a reminder on all plan communications (e.g., summary plan description and annual notices) for participants to update their contact information, with easy-to-follow instructions.

Read the complete Practice Note on locating missing plan participants in the Employee Benefits and Executive Compensation module of Lexis Practice Advisor.

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RESEARCH PATH: *Employee Benefits & Executive Compensation > Retirement Plans > ERISA and Fiduciary Compliance > Practice Notes*


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COUNSELING EMPLOYERS ON THE LEGAL IMPLICATIONS OF **ARTIFICIAL INTELLIGENCE AND ROBOTS IN THE WORKPLACE**

This article provides guidance and best practices for counseling employers on the legal implications of integrating artificial intelligence (AI) and robots into their workplaces.

Reductions in Force Due to Artificial Intelligence and Robotics

Thanks to recent technological advances, AI algorithms and robots are developing the sophistication to displace human employees, causing many employers to engage in mass layoffs and reductions in force. For instance, Goldman Sachs recently laid off nearly 600 equity traders whose work has largely been supplanted by automated trading programs and a team of computer engineers.[1]

As employers continue to pursue disruptive technologies like AI and robotics that can reduce workforces, unions and employees will mount legal challenges in an effort to protect their positions. To ensure employers can implement these technologies with minimal repercussions, you should assess their risks and liabilities and help them put together a strategic plan. Consider the following measures to avoid liability from layoffs caused by AI and robotics.

- **Request a seat at the table to discuss integrating robotics and AI automation.** Counsel your human resources and in-house counsel contacts to request a seat at the table when their organization discusses how to integrate robotic and AI automation into the workplace. With your help, your contacts can assist their organization with strategic plans that implement new technologies while limiting the company's exposure.
- **Consider a voluntary ADEA-compliant termination plan.** Before recommending that an employer carry out an involuntary reduction in force (RIF), encourage it to adopt a voluntary termination strategy, such as offering employees separation agreements that release the employer from all claims in exchange for a monetary sum. Be sure to adhere to applicable state and federal laws, such as the Age Discrimination in Employment Act (ADEA) and the Older Workers Benefit Protection Act (OWBPA) when separating employees age 40 and over. Additionally, encourage employees to consult with an attorney before accepting the offer to minimize the risk that the separated employee will be able to subsequently invalidate the agreement on the grounds of coercion or duress.
- **Ensure compliance with the Worker Adjustment and Retraining Notification Act (WARN Act) and any state applicable mini-WARN Acts.** Once the employer has completed any voluntary separations, you should assess what must be done to comply with the forthcoming RIF. The Worker Adjustment and Retraining Notification Act (WARN), 29 U.S.C. § 2101 et seq., requires businesses that have 100 or more full-time employees (or 100 or more employees, including part-time, who work at least 4,000 hours per week, excluding overtime) to issue 60 days' advance written notice of a plant closing or mass layoff to (1) the affected non-union employees, (2) the representative of affected unionized employees, (3) the state or entity designated to carry out rapid response activities, and (4) the chief elected official of the unit of local government where the closing or layoff will occur. 20 C.F.R. § 639.6. A mass layoff is defined as either a reduction during any 30-day period of (1) 500 or more employees or (2) 50 or more employees, provided they constitute at least 33% of the employees at the worksite. 29 U.S.C. § 2101(a)(3)(A)–(B). Many state laws impose additional WARN Act-like obligations, including California (Cal. Lab. Code §§ 1400–1408), Illinois (820 Ill. Comp. Stat. 65/1 to 65/99), New York (N.Y. Lab. Law § 860 et seq.), and New Jersey (N.J. Stat. Ann. § 34:21-1 to -7).
- **Determine whether reductions or plant closings are subject to mandatory bargaining.** Reductions of unionized employees or plant closings may require additional obligations. For instance, employers may need to bargain regarding the implementation of AI and robotics, since some federal circuit courts and the National Labor Relations Board (NLRB) have held that implementing new technologies and automation that affect the terms and conditions of union jobs is a mandatory bargaining subject.[2] Thus, instruct employers to notify the union of the changes well before implementing them so that the union has time to bargain over the decision to make, and the effects of, the operational change. Communications between the employer and the union should be in writing to create a record that the employer met its obligation to bargain in good faith under 29 U.S.C. § 158(d) of the National Labor Relations Act.
- **Encourage employers to communicate the positive aspects of automation.** Another important consideration when implementing technological advances is the effect it has on workplace morale. If the employer is not downsizing as a result of automating, or is only conducting limited layoffs, it should assure employees that its technological advances do not foretell a RIF. Indeed, AI can have the effect of enhancing jobs rather than replacing them, such as when automation replaces repetitive manual work and frees up employees to do higher-level strategy work.

1. See Nanette Byrnes, As Goldman Embraces Automation, Even the Masters of the Universe Are Threatened, MIT TECHNOLOGY REVIEW (Feb. 7, 2017). 2. See, e.g., Renton News Record, 136 N.L.R.B. 1294, 1297–98 (1962); NLRB v. Columbia Tribune Publ'g Co., 495 F.2d 1384, 1391 (8th Cir. 1974); Newspaper Printing Corp. v. NLRB, 625 F.2d 956, 964 (10th Cir. 1980).

The Risks of Using AI for Screening and Hiring

Another way employers may utilize AI is to filter large pools of job applicants. For example, some employers use computer software programs to auto-screen resumes as a human recruiter would. Such programs use machine learning, algorithms, and/or natural language processing to identify the best candidates for employment. Similarly, employers can use an AI-powered recruiting assistant that allows applicants to communicate through messaging apps. One such program uses natural language processing to analyze data an applicant provides and then asks the applicant additional questions to help fill gaps in the applicant's data. The applicant can also ask the virtual recruiting assistant questions. Other computer programs search social media to find information to fill the gaps in candidates' profiles and then rank the candidates. Certain employers also have candidates play neuroscience-based computer games and use the results to determine which candidates to interview.

Some employers even use AI for conducting interviews. For instance, an employer might ask a candidate to record answers to interview questions, and a computer program would then analyze the interview (utilizing machine learning, algorithms, and/or natural language processing) for key words, the speed of speech, body language, or other relevant predictors of a candidate's qualifications and future successes. The computer program would generate a report with suggestions that could then be used to determine whether a candidate should move on in the employer's recruitment process.

While a sophisticated AI screening system may be able to eliminate unqualified candidates, system limitations and inherent biases may lead to employment discrimination lawsuits. Consider taking the steps below to limit exposure resulting from using AI in the screening and hiring process.

- **Ensure employers use proper and relevant data when developing AI systems to assist with screening and hiring.** Make certain that the employer inputs appropriate data into its AI algorithm to avoid unintentionally discriminating against job candidates. Though an AI system itself does not have any biases, the information humans choose to use in the system may be biased, and the computer-generated results could perpetuate these biases. Accordingly, failing to use a proper data set for AI can cause the algorithm to disproportionately factor in applicants' protected characteristics and/or represent certain populations, resulting in disparate impact claims.[3]

  Thus, data should only include information that is in line with business necessity and relevant to a particular skill or trait for the particular job. For example, an AI system could analyze data regarding the skills that have made previous employees successful and pattern match to find applicants with these characteristics. Data should not include characteristics such as gender, religion, race, marital status, or whether someone has children. It should include information from all populations, not a select few.

  Note that even data that is seemingly facially neutral could lead to an unintentional disparate impact. For example, (1) using data such as the distance an applicant lives from the potential job site could reflect the different ethnic or racial profiles of the surrounding towns and neighborhoods; (2) using the reputation of the colleges/universities from which an applicant obtained a degree could have a disparate impact on a protected class if equally qualified members of the protected class graduate from these colleges/universities at a substantially lower rate than those not in the protected class; or (3) using an AI system that screens applicants based on a hiring manager's previous hiring decisions could recreate the historical bias of that hiring manager if the hiring manager's decisions previously disfavored a particular protected class, and the AI codes this bias into the system.[4]

3. See EXECUTIVE OFFICE OF THE PRESIDENT, Big Data: A Report on Algorithmic Systems, Opportunity, and Civil Rights (May 2016), p. 14; Roger W. Reinsch and Sonia Goltz, *The Law and Business of People Analytics: Big Data: Can the Attempt to be More Discriminating be More Discriminatory Instead?*, 61 St. Louis L.J. 35, 40–42 (2016). 4. See *Data-Driven Discrimination at Work*, Pauline T. Kim, 58 Wm. & Mary L. Rev. 857, 863, 873 (2017); Sofia Granaki, *Autonomy Challenges in the Age of Big Data*, 27 Fordham Intell. Prop. Media & Ent. L.J. 803, 826 (2017); Solon Barocas & Andrew D. Selbst, *Big Data's Disparate Impact*, 104 Calif. L. Rev. 671, 682, 689, 722 (2016); Federal Trade Commission, Big Data: A Tool for Inclusion or Exclusion? (January 2016), p. v.

IF THE EMPLOYER IS CONCERNED THAT ITS BIG-DATA SCREENING ALGORITHMS WILL CAUSE A DISPARATE IMPACT, ENCOURAGE THE EMPLOYER TO SUPPLEMENT THE AI FILTER BY SCREENING JOB APPLICATIONS MANUALLY.

- **Utilize AI instead of human intelligence to reduce the risk of certain human biases**. Although AI filtering systems risk perpetuating human biases, as discussed above, these same applications, when used properly can actually prevent humans from selecting an applicant for an interview based on conscious or subconscious biases. For example, a subconscious racial or ethnic bias could unintentionally influence a human's decision to select or not select an applicant for an interview based on the applicant's name.[5] An AI system would not likely use an applicant's name when deciding whom to select for an interview as it is unlikely that an AI system would distinguish race from an applicant's name. Similarly, AI systems could eliminate the human bias that would subconsciously influence a human to select or not select an applicant based on a particular appearance and eliminate the possibility of a hiring manager selecting applicants who share his or her gender, race, or other protected characteristic. To the extent possible, advise the employer to use an AI filter that is simple enough for the human resources department to easily understand, implement, and, if necessary, defend in litigation.
- **Use screening filters specific to the position the employer seeks to fill.** Ensure that the employer tailors any AI screening system to the particular job the company seeks to fill. A screening filter used to select appropriate applicants for a finance position in New York will not be effective for filling a manufacturing job in Omaha, since the characteristics the employer seeks—such as employment history, education levels, resume phrases, and other unprotected categories—will vary from job to job. Accordingly, the employer should customize the search criteria to different job openings to avoid hiring a candidate who is ill-suited for the role.
- **Review with employers any voice-recognition programs to ensure compliance with disability and ethnicity/national origin issues.** Similarly, voice-recognition software that utilizes AI to screen oral interviews may not be able to distinguish between a poor interviewer or unqualified candidate and an interviewee with a speech disability, mental disability, or native accent. Filtering out candidates on the basis of these protected characteristics is likely to result in disability or national-origin claims.
- **Encourage employers to supplement AI use by personally screening applications.** If the employer is concerned that its big-data screening algorithms will cause a disparate impact, encourage the employer to supplement the AI filter by screening job applications manually. This way, in the event of litigation, the employer can testify to an individualized, unbiased selection process.

Health and Safety Issues Concerning Robots and Artificial Intelligence

Robotics and AI raise novel issues and concerns for employers regarding employee safety. There are currently no Occupational Safety and Health Administration (OSHA) standards specifically for the robotics industry. However, OSHA highlights general standards and directives applicable to employers utilizing robotics.[6] OSHA also provides guidelines for robotics safety.[7]

Under the Occupational Safety and Health Act (OSH Act), a covered employer utilizing robotics—like any other employer the OSH Act covers—must conduct a "hazard assessment" in which it reviews working environments for potential occupational hazards. 29 C.F.R. § 1910.132(d). An employer that identifies a hazard must implement a "hazard control" in the following order of preference: hazard elimination, hazard replacement, engineering controls, administrative controls, or personal protective equipment. With this legal framework as background, consider taking the following actions to mitigate the risk of employee exposure to hazards and legal actions associated with robots:

- **Enlist the assistance of an OSHA-trained attorney to assist at the outset of implementation.** As demonstrated above, the intersection between robotics operations and the law is complex, so you should advise employers to consult an attorney with expertise in workplace health and safety issues. Together, the OSHA-trained attorney and the company can develop an employee health and safety plan that minimizes the risk of a

5. See Anupam Chander, *Reviews: The Racist Algorithm?*, 115 Mich. L. Rev. 1023, 1029 (2017). 6. See Robotics, Standards, Occupational Safety and Health Administration, Safety and Health Topics. 7. See Guidelines for Robotics Safety, OSHA Instruction STD 01-12-002 (1987).

workplace accident while creating a defense against employee claims if an incident were to occur.

- **Have the employer develop a basic understanding of the robot's potential hazards and preventive measures the employer can take.** Due to the complexity of sophisticated robots, the employer's managers and supervisors are unlikely to understand their inner workings. As a result, it may be difficult for employers to identify and eliminate their potential hazards. Accordingly, have the employer train its management staff on the robot's decision-making processes; what actions the robot could take and under what circumstances it would take such actions; and how to eliminate the hazard should the robot malfunction, such as the steps for shutting it down.
- **Know whom to contact when a robot misbehaves.** Unlike human errors, which can be addressed through discipline and retraining, when the root cause of a workplace accident involves the logic of a robot, such traditional methods are not applicable. Rather, the employer may need to consult highly trained engineers to understand why the robot malfunctioned and correct the robot's performance. If doing so is not feasible, the employer could replace a manufacturing line entirely, but due to the significant cost and disruption to the business this would cause, an employer should only order a complete replacement as a last resort.

Dangers of Artificial Intelligence in Wearable Technology

From the Apple Watch to the Fitbit, wearable technology is becoming increasingly prominent in modern life. In the workplace, using AI to catalog and assess employee data can be a significant boon for employers, which can use AI systems to track worker movements to identify and rectify inefficiencies. Nevertheless, privacy and data security concerns abound when employers utilize such technology.

Privacy Issues

Consider the following measures to guard against privacy claims:

- **Ensure that employer monitoring does not violate employees' reasonable expectation of privacy.**
  - **Monitoring employee locations.** Few courts have considered employers' right to monitor employees' locations via GPS while using employer-owned property and vehicles, but thus far courts have not found that tracking employees' location in public areas violates their privacy rights.[8] Some states, such as Connecticut, Conn. Gen. Stat. § 31-48d, require businesses to obtain worker consent before monitoring the location of employees. You should research state and local privacy laws and advise employers accordingly. Additionally, consider distributing an employee privacy policy providing notice of the employee tracking; the business reasons for doing so; the ways in which the employer will safeguard the employee's data; and the limits on the employee monitoring, such as only tracking movements in public areas during working hours. Be sure to obtain an employee acknowledgment consenting to the monitoring.
  - **Monitoring electronic and telephonic communications.** Similarly, if employers are monitoring employee telephonic or electronic communications or website usage via wearable technology, employers must make sure that such monitoring complies with federal, state, and local privacy and other laws.

    To protect an employer's right to access and monitor employee communications, employers should have clear written policies informing employees that they should not have any expectation of privacy in their use of company electronic systems and that the employer will monitor communications on company electronic systems.
- **Ensure compliance with the Health Insurance Portability and Accountability Act (HIPAA) and other relevant medical privacy laws.** If employers utilize wearable technology to collect and store health information—such as to help the employer configure an employee wellness plan—you must counsel employers on compliance with HIPAA, 110 Stat. 1936 et seq., and other relevant state privacy and electronic surveillance laws. These laws typically place limits on what data employers can collect and use and require employers to provide notice to employees regarding what personal information the employer will obtain, how the employer will use that information, and with whom the employer will share the information. Be sure the employer honors its obligations under these laws and takes all the necessary steps to protect its employees' privacy.

Data Security Issues

Whenever employers gather data, including via wearable technology, they must consider the risk of data breaches and how to prevent them. As this area of law is continually evolving, ensure that the employer consults with an attorney who is well-versed in cybersecurity issues. You should also determine whether the employer has appropriate safeguards in place to prevent unauthorized intruders from obtaining private, personal employee data. For instance, IT departments should mask data collected so that it cannot be linked to a specific user and should use encryption. Additionally, consider implementing regular audits to ensure the employer's data security protocols are legally compliant and up-to-date.

Integrating AI into the Practice of Law

The amount of data that parties produce in discovery in today's employment litigations can be staggering. Compounding this problem, attorneys are expected to review this data efficiently—quickly and at a low cost. The faster and more accurately a lawyer can locate useful information, the better and more cost-effectively the attorney will be able to develop his or her case. Because AI can analyze a larger quantity of information more thoroughly than humans can, and in a fraction of the time, attorneys are turning to AI more and more as a key component of their legal practices. Consider taking advantage of recent developments in AI in your own practice in the following ways:

- **Cull through e-discovery.** AI technology used in the legal profession includes machine learning and natural language processing. In e-discovery, attorneys often utilize predictive coding, a process that uses algorithms to distinguish relevant

8. See, e.g., Elgin v. St. Louis Coca-Cola Bottling Co., 2005 U.S. Dist. LEXIS 28976, at *7–11 (E.D. Mo. 2005); Gerardi v. City of Bridgeport, 2007 Conn. Super. LEXIS 3446, at *17–20 (Super. Ct. Dec. 31, 2007).

Related Content

For more information on voluntary separation programs and alternatives to reductions in force (RIFS), see

> ALTERNATIVES TO REDUCTIONS IN FORCE (RIFS)

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Agreements > Executive Separation Agreements & Severance Plans > Practice Notes*

For a discussion of drafting separation agreements, see

> SEPARATION AGREEMENTS: DRAFTING AND NEGOTIATION TIPS (PRO-EMPLOYER)

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > Claims and Investigations > Practice Notes*

For information on state laws concerning RIFs, see

> THE MASS LAYOFF AND PLANT CLOSING LAWS COLUMN IN INVESTIGATIONS, DISCIPLINE, AND TERMINATIONS STATE PRACTICE NOTES CHART

RESEARCH PATH: *Labor & Employment > Investigations, Discipline, and Terminations > Discharge and Layoffs/RIFs > Practice Notes*

For an overview of requirements under the Worker Adjustment and Retraining Notification Act (WARN Act), see

> WARN ACT COMPLIANCE CHECKLIST

RESEARCH PATH: *Labor & Employment > Investigations, Discipline and Terminations > Discharge and Layoffs/RIFs > Checklists*

For best practices on drafting policies concerning employee privacy when using electronic devices, including a sample policy, see

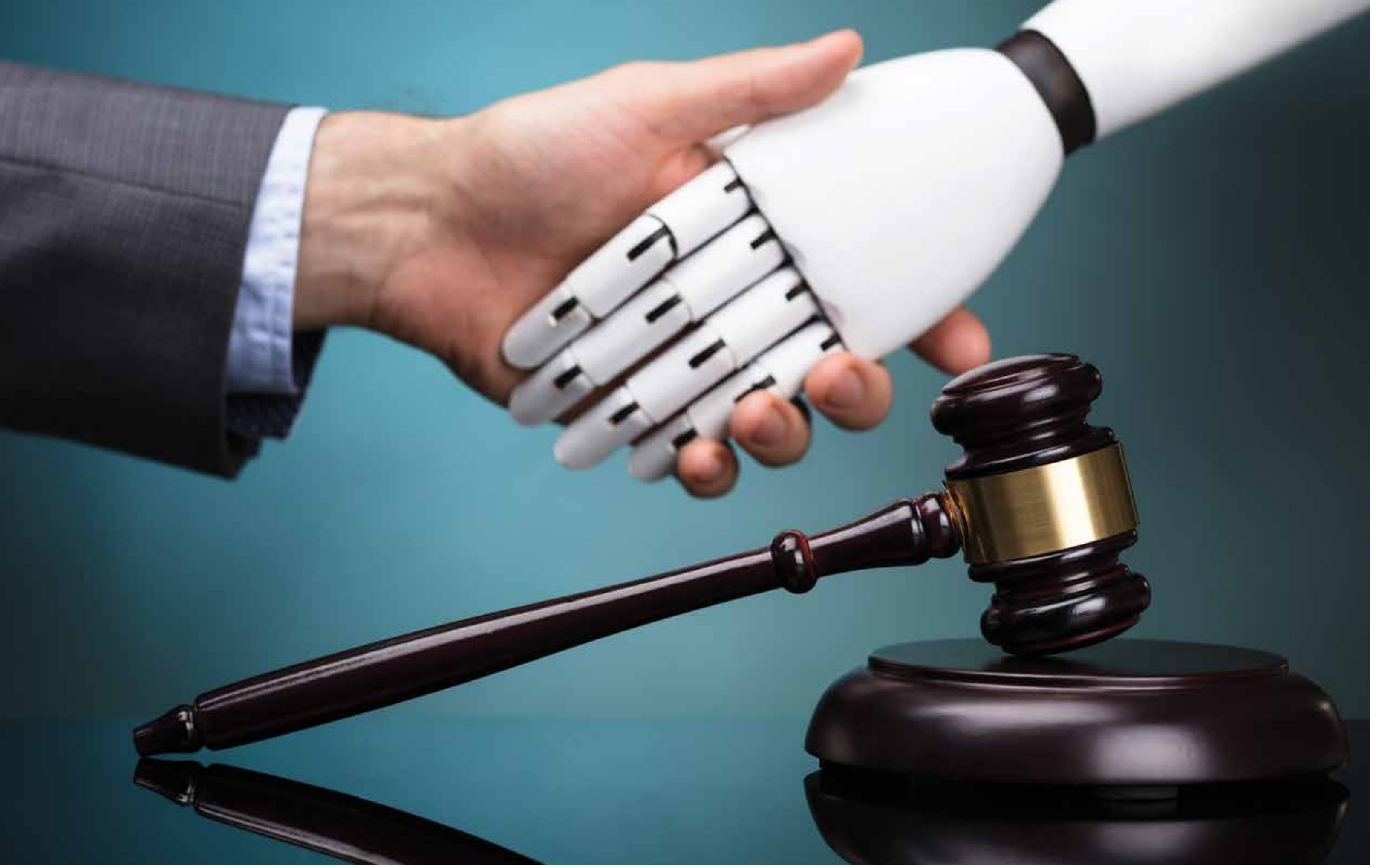
> CREATING POLICIES ON COMPUTERS, MOBILE PHONES, AND OTHER ELECTRONIC DEVICES

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Practice Notes*

For more information on the risks of wearable technology, see

> UNDERSTANDING EMPLOYMENT PRIVACY ISSUES UNDER FEDERAL LAW

RESEARCH PATH: *Labor & Employment > Privacy, Technology and Social Media > Monitoring and Testing Employees > Practice Notes*



from non-relevant documents. This process usually involves an attorney expert on the subject matter reviewing a sample set of documents (known as a seed set) from the whole set of documents and coding the documents for relevance, privilege, or other issues. The computer program then analyzes the determinations the attorney made on the seed set and learns how to select relevant documents from the larger pool of documents. Among other organizational tools, algorithms can rank documents in the order of relevance or use concept clustering, which groups together documents that share certain combinations of words. This type of AI can be extremely useful to attorneys involved in employment discrimination or wage and hour litigation. For it to be effective, however, attorneys must be properly trained in how to use AI. For example, the attorneys coding a sample set of documents should be experts on the subject area. If the initial set of documents is not coded accurately, then the data the AI tool produces may not be accurate.

- **Streamline contract review.** AI can similarly be used in contract review. Software learns from contracts as they are uploaded into a database and then compares these contracts to those inputted by the attorney or end user. The software can then produce a report recommending changes to the attorney's contract based on this comparison. L

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RESEARCH PATH: *Labor & Employment > Investigations, Discipline, and Terminations > Discharge and Layoffs/RIFs > Practice Notes*


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Admissibility of "Me Too" Evidence

Introduction

In early Fall 2017, the #MeToo campaign exploded into a movement across social media demonstrating the prevalence of sexual assault and harassment in the workplace. Countless public revelations of sexual misconduct allegations against Hollywood producer Harvey Weinstein and other well-known powerful men ignited the movement, exposing the cover-up and tolerance of sexual harassment, and even assault, in some workplaces as a longstanding cultural norm that must be addressed and changed. In the present social, political, and legal climate, the phrase "me too" has more powerful cultural and personal resonance than ever before. While the phrase holds cultural significance in today's society, it has long held legal significance in the litigation of discrimination and harassment claims. "Me too" evidence is often used in civil litigation to show that others have experienced the same actions and claims as those alleged by a plaintiff. Finding such evidence, establishing its admissibility, and using it effectively confounds both plaintiff and defendant employment lawyers. But it can be an effective litigation tool—for either party.

Admissibility of "Me Too" Evidence in Federal Courts

Most sexual harassment and discrimination claims rely on circumstantial evidence. Direct evidence can be elusive in such cases, where eyewitnesses and incriminating documents are rare. For these reasons, "me too" evidence—other instances of discrimination or harassment against other employees by the alleged harasser or the same employer—may be proffered by the plaintiff in an effort to show a pattern or practice of misconduct to prove, or at least bolster, discrimination or harassment claims.

Whether such "me too" evidence is admissible or even relevant to the claims brought by a plaintiff turns on many factors, including the very facts of the discrimination and harassment.

The admission of "me too" evidence in federal courts also depends on where it falls under the Federal Rules of Evidence. Fed. R. Evid. 404(b)(2) provides that evidence of a crime, wrong, or other act "may be admissible for another purpose, such as proving motive, opportunity, intent, preparation, plan, knowledge, identity, absence of mistake, or lack of accident." Because motive, intent, and state of mind are directly at issue in employment discrimination claims, "me too" or propensity evidence may be properly admitted under Fed. R. Evid. 404(b)(2) under certain circumstances. Other relevant parts of the Federal Rules of Evidence with respect to "me too" or propensity evidence include Fed. R. Evid. 401 (Test for Relevant Evidence) and Fed. R. Evid. 403 (Excluding Relevant Evidence for Prejudice, Confusion, Waste of Time, or Other Reasons).

Despite the Federal Rules of Evidence, the federal courts, including the U.S. Supreme Court, offer little guidance as to when "me too" evidence is admissible. In *Sprint/United*

Management Co. v. Mendelsohn,[1] the plaintiff, Ellen Mendelsohn, was terminated from her employment as part of a reduction in force. Mendelsohn sued her employer, Sprint/United Management Co. (hereinafter Sprint), alleging that she was selected for layoff because she was over 40 years old. In support of her age discrimination claim, Mendelsohn sought to admit testimony from five other employees who claimed they were subject to discrimination and harassment based on their ages—over 40. In seeking to exclude the evidence, Sprint argued that the witnesses were not similarly situated to the plaintiff. They did not share the same supervisor, and the alleged discriminatory conduct against the five witnesses was remote in time from Mendelsohn's termination. For these reasons, the trial court refused to admit the evidence. The U.S. Court of Appeals for the Tenth Circuit reversed, holding that while a "similarly situated" limitation on admissibility was appropriate in a discriminatory discipline case, it was not per se grounds for exclusion of evidence if there was a company-wide policy of discrimination.

The Tenth Circuit then reviewed and determined that Mendelsohn's proposed "me too" evidence was relevant. As a result, the appellate court reversed the trial court and remanded the case for a new trial with instructions to admit the challenged testimony. The U.S. Supreme Court disagreed. The Court found that the Tenth Circuit should have remanded the case to the trial court for a further explanation of its findings and, absent an abuse of discretion, deferred to the trial court's judgment respecting the evidentiary issues. In so finding, the Court stated: "We conclude that such ['me too'] evidence is neither *per se* admissible nor *per se* inadmissible."[2] In other words, whether evidence of discrimination (or harassment) by other supervisors is relevant and admissible in an individual case is "fact based and depends on many factors, including how closely related the evidence is to the plaintiff's circumstances and theory of the case."[3]

Following *Mendelsohn*, one district court delineated a four-factor test to use when considering the admission of "me too" evidence.[4] The test considers (1) whether past discriminatory or retaliatory behavior is close in time to the events at issue in the case, (2) whether the same decision-maker was involved, (3) whether the witness and the plaintiff were treated in the same manner, and (4) whether the witness and plaintiff were otherwise similarly situated.[5] Similarly, a few years later in *Griffin v. Finkbeiner*,[6] the U.S. Court of Appeals for the Sixth Circuit outlined factors to consider in determining the admissibility of "me too" evidence, mirroring the *Hayes'* court's test.

OTHER FEDERAL COURTS HAVE ALSO FOUND THAT "ME TOO" EVIDENCE MAY BE RELEVANT IN CERTAIN CIRCUMSTANCES, BASED ON THE FACTS AND THEORY OF THE CASE.

Other federal courts have also found that "me too" evidence may be relevant in certain circumstances, based on the facts and theory of the case. For example, in *Goldsmith v. Bagby Elevator Co.*, the U.S. Court of Appeals for the Eleventh Circuit rejected the defendant-employer's argument that the district court abused its discretion in admitting evidence of discrimination and retaliation against the plaintiff-employee's coworkers.[7] The court found this "me too" evidence was admissible to prove the coworkers' intent to discriminate, relevant to a claim of hostile work environment, and "probative of several issues raised by [the defendant] either on cross-examination or as an affirmative defense."[8]

In *Quigley v. Winter*,[9] the defendant-landlord in a sexual harassment case argued that the district court erred in admitting the testimony of the defendant's former tenants that the defendant also subjected them to sexual harassment. The defendant claimed the testimony of the three tenants was irrelevant because there was no evidence the plaintiff-tenant knew the women or observed any of the events to which they testified.[10] In reaching its decision, the U.S. Court of Appeals for the Eighth Circuit reviewed the Supreme Court's guidance in *Mendelsohn* that the admissibility of "me too" evidence "is fact-based and depends on many factors, including how closely related the evidence is to the plaintiff's circumstances and theory of the case."[11] The Eighth Circuit rejected the defendant's argument, finding that the trial court "properly performed its gatekeeping function" by carefully analyzing the admissibility of the testimony and excluding other witnesses whose testimony was more remote in time.[12]

Recently, a Virginia district court denied an employer's motion in limine to exclude "me too" evidence, finding that "there is no rule that would exclude evidence of other employees simply because the plaintiff has not proven that they qualify as comparators under *McDonnell Douglas*.[13] The court also observed that "[r]elevance and prejudice under Rules 401 and 403 are determined in the context of the facts and arguments in a particular case, and thus are generally not amenable to broad *per se* rules."[14]

1. 552 U.S. 379 (2008). 2. 552 U.S. at 381. 3. 552 U.S. at 388. 4. Hayes v. Sebelius, 806 F. Supp. 2d 141 (D.D.C. 2011). 5. 806 F. Supp. 2d at 144–45. 6. 689 F.3d 584 (6th Cir. 2012). 7. 513 F.3d 1261, 1285 (11th Cir. 2008). 8. 513 F.3d at 1285–87. 9. 598 F.3d 938, 951 (8th Cir. 2010). 10. 598 F.3d at 951. 11. 598 F.3d at 951 (quoting *Mendelsohn*, 552 U.S. at 388). 12. 598 F.3d at 951. 13. Emami v. Bolden, 241 F. Supp. 3d 673, 688 (E.D. Va. 2017); *see* McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973). 14. 241 F. Supp. 3d at 688.

Related Content

For an overview on the application of Title VII to sexual harassment and discrimination claims, see

> **COMPLYING WITH TITLE VII**

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes*

For a discussion on protected status harassment issues in the workplace, see

> **EXAMINING HARASSMENT CLAIMS**

RESEARCH PATH: *Labor & Employment > Discrimination and Retaliation > EEO Laws and Protections > Practice Notes*

For a sample complaint that alleges claims of sexual harassment, see

> **SEXUAL HARASSMENT AND EMOTIONAL DISTRESS COMPLAINT (WITH JURY DEMAND)**

RESEARCH PATH: *Labor & Employment > Employment Litigation > Discrimination and Retaliation > Forms*

Admissibility of "Me Too" Evidence in California

In California, the admissibility of "me too" evidence can be more expansive. In *Pantoja v. Anton*,[15] the plaintiff, Lorraine Pantoja, worked as a legal secretary for attorney Thomas J. Anton and his firm, Thomas Anton & Associates. Following her employment termination, Pantoja sued for race and sex discrimination, as well as sexual harassment. Pantoja claimed her supervisor inappropriately touched and slapped her, referred to his employees as "my Mexicans," and, among other things, asked for a back massage. At trial, Pantoja attempted to introduce the testimony of witnesses who had experienced the same and similar behavior from the supervisor. But the trial court excluded the evidence since Pantoja had not personally witnessed the other alleged acts of harassment and discrimination. After the jury found for the employer, the plaintiff appealed. The California Court of Appeal reversed and held evidence that the supervisor had harassed other employees outside the plaintiff's presence could have shown the supervisor harbored a discriminatory intent based on gender and would allow the jury to evaluate the credibility of the defendant and his witnesses who denied the discrimination and harassment.

While the *Pantoja* court expanded the admissibility of "me too" evidence, the California Court of Appeal in *Hatai v. Department of Transportation*[16] held that such evidence is subject to some limits. In *Hatai*, the plaintiff, Kenneth Hatai, initially alleged that he was discriminated against by his supervisor because of his Asian race and Japanese national origin. At the time of trial, Hatai sought to expand his claims by arguing that his supervisor, an Arab, discriminated against all employees who were not of Arab descent. The Department of Transportation moved in limine to exclude any evidence that the supervisor had discriminated against non-Asians, arguing that the discrimination against employees of non-Arab descent was not the claim Hatai had pled. The trial court agreed, and limited the "me too" evidence to employees subject to alleged anti-Asian discrimination. The appeals court agreed, holding that the evidence of anti-Arab discrimination or harassment was not sufficiently related to Hatai's anti-Asian and anti-Japanese claims. The court distinguished its prior ruling in *Pantoja* because the "me-too" evidence in *Pantoja* came from individuals who were within the same protected classes alleged by the plaintiff. However, the court also observed that evidence of discrimination against protected classes different from the plaintiff's may be admissible in other contexts, such as where favoritism of one protected class has an adverse effect on other protected classes.

Conclusion

"Me too" evidence can significantly impact either party's likelihood of prevailing in employment discrimination and harassment actions. As employment discrimination and harassment cases increase, especially in today's political and social climates, "me too" evidence must be considered by both plaintiffs' and defense counsel:

- Keep in mind the basics of admissibility of any evidence. "Me too" evidence is relevant if it has a tendency to make it more or less likely that an employer acted with discriminatory intent. If other employees claim they suffered from discrimination and harassment, is it more likely than not that the plaintiff did as well? Does the relevance of such evidence outweigh the danger of undue prejudice to the defendant? Be prepared to offer a careful step-by-step analysis on the admissibility or inadmissibility of the evidence.

15. 198 Cal. App. 4th 87 (2011). 16. 214 Cal. App. 4th 1287 (2013), overruled on other grounds, Williams v. Chino Valley Independent Fire Dist., 61 Cal. 4th 97 (2015).

- Be specific on the evidence you want admitted or excluded. An attempt to admit or exclude broadly defined evidence is not compatible with *Mendelsohn* or the cases that followed.
- Use laser-focused discovery to learn specific facts and expected witnesses.
- Look at pattern and practice issues. These can raise "me too" evidence.
- Defendants can look at "not me too" evidence. Defendant can rebut plaintiffs' "me too" evidence by showing the plaintiff was the only one to complain or allege discrimination and harassment, and such policies and behavior did not pervade the workplace.
- Defendants need to consider the undue prejudice and confusion arguments. Admitted "me too" evidence of other employees could confuse the jury and result in a trial within a trial where the defendant is forced to defend or produce evidence regarding someone other than the plaintiff.

Of course, whether a trial court will consider, or how it will rule on, "me too" evidence is still unsettled. With the #MeToo movement in full force, expect "me too" evidence to be raised in the future.

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RESEARCH PATH: *Labor & Employment > Employment Litigation > Discrimination and Retaliation > Articles*

Marc E. Bernstein PAUL HASTINGS LLP

SEPARATION AGREEMENTS: DRAFTING AND NEGOTIATION TIPS FOR EMPLOYERS

This article addresses initial preparations for drafting a separation agreement and common terms that employers ordinarily should include, or at least consider including, in separation agreements.

WHEN TERMINATING AN EMPLOYEE'S EMPLOYMENT, THE employer often requests that the departing employee execute a separation agreement. In doing so, the employer seeks to obtain a comprehensive and defensible release of all real or perceived claims that the employee may legally waive in exchange for payments and/or benefits to which the employee is not otherwise entitled, which will be the consideration for the agreement. As the employer's attorney, you must ensure that the separation agreement is comprehensive, valid, and enforceable so that the employer can successfully avoid litigation and other risks stemming from the termination.

Initial Preparations for Drafting a Separation Agreement

If possible, the employer should have the separation agreement prepared in advance so that it is available for distribution to the employee at the time of the termination. The earlier you become involved in separation discussions, the more valuable you will be to the employer during the preparation and negotiation of a separation agreement.

Once involved, you should review the relevant employer policies and documents relating to the specific termination at issue—whether related to a layoff or a one-off termination—to ensure that the separation agreement is consistent with them. The documents that you should review ordinarily include:

- Employment agreement or offer letter
- The severance plan (if the employer has one)
- The employee handbook
- Ancillary agreements between the employer and employee, such as a stand-alone restrictive covenant agreement

Any of these documents may contain formulaic separation payments based upon position and years of service, partial incentive payments, payment for accrued sick or vacation days, and outplacement. Agreements specifically between the employer and the employee may also contain non-standard severance terms, such as continued vesting of incentive compensation, bonus payments, and restrictive covenants that often remain in effect following termination.

You should also consult with the employer's managers and decision-makers to understand the reasons for the termination and anticipate any actionable issues that may arise—such as alleged discrimination, retaliation, federal Fair Labor Standards Act (FLSA) issues, whistleblower activities, or breach of contract claims—and any special business risks, needs, or concerns. In conjunction with these discussions, you should review relevant personnel and disciplinary documentation about the employee.

If the termination may involve multiple employees or a plant closing, you should ascertain the applicability of the federal Worker Adjustment and Retraining Notification Act and any state analogs and ensure that the employer has provided any required notice.

Understanding and Negotiating Common Provisions in Separation Agreements

This section addresses the most essential clauses in a separation agreement. In addition, this section discusses some provisions that employees may propose during the course of negotiations.

Release of Claims

The release of claims provision is perhaps the most important part of a separation agreement. This provision provides that the employee—broadly defined to include the individual and his or her heirs, representatives, and agents—will dismiss and waive all potential or pending causes of actions, claims, charges of discrimination, complaints, etc., against the employer, whether known or unknown—broadly defined to include the company, its affiliates, employees, agents, representatives, and assigns.

In drafting the release language, you should avoid legalese and describe in plain language understandable to a non-lawyer that the employee is giving up his or her right to bring various claims in exchange for the consideration provided.

If a claim is pending before a court or administrative body, you should specify the case or charge number of the claim that the employee will withdraw or stipulate to dismiss with prejudice.

Enumerating Released Claims

To ensure that the release broadly covers all types of claims that an employee may bring under federal, state, and local law, the release should state that the employee releases all claims against the employer "to the extent permitted by law," including claims alleging unlawful discrimination, breach of contract, tort claims including without limitation negligence, and claims for the non-payment of wages. You should also list the main employment statutes "without limitation," including the following:

- Title VII of the Civil Rights Act of 1964
- The Pregnancy Discrimination Act
- The Equal Pay Act of 1963
- The Age Discrimination in Employment Act of 1967
- The Americans with Disabilities Act of 1990
- The Family and Medical Leave Act of 1993

Consult state and local law regarding which relevant claims the employer must list in the release or language that employers must use for employees to waive certain claims. For example, a waiver of claims under the Minnesota Human Rights Law requires that the employer provide the employee 15 days to revoke the separation agreement after the employee signs it. Minn. Stat. § 363A.31.

Older Workers Benefit Protection Act (OWBPA)

If the employee is at least 40 years old, you will want the employee to release age discrimination claims under the Age Discrimination in Employment Act (ADEA). To execute such a release, the release must comply with OWBPA.

OWBPA requires that the employer provide specific information and consideration periods to an employee from whom it seeks a waiver of ADEA claims. For example, under OWBPA the release regarding an individual termination should (1) explicitly release ADEA claims, (2) not release future ADEA claims, (3) specify the consideration for the release, (4) advise the employee to consult with counsel, (5) provide the employee at least 21 days to consider the release, and (6) provide seven days to revoke the release after signing.

Releases in connection with a termination program have different requirements. For example, to obtain an ADEA waiver from an employee terminated as part of a termination program the employer must also provide the employee:

- A longer time period to consider waiving his or her potential ADEA claim (45 days, as opposed to 21 days for an individual termination)
- Additional documentation regarding those employees who were selected and not selected for termination

Mutual Release

The employer should avoid agreeing to a mutual release of claims because the employer may not know of causes of action it may have against the employee, such as claims for fraud, theft or conversion, violations of restrictive covenants, or other compensable claims that have not come to light.

Non-waivable Claims

When drafting the release, note the following:

- Releases of claims under the FLSA may require Department of Labor or judicial supervision. To protect against future wage claims, you should consider adding recitals to the release that, to the employee's knowledge, the employee has received all compensation owed to him or her.
- The separation agreement may not contain language that purports to prevent an employee from filing charges with the Equal Employment Opportunity Commission (EEOC) or another administrative agency. You may, however, include a recital that the employee waives his or her entitlement to any damages resulting from any EEOC or other agency charge that he or she (or any third party) may file.
- In most states, the separation agreement cannot include a waiver of claims for workers' compensation and unemployment compensation. The agreement can contain a recital that the employee has reported to the employer any work-related injuries.

Last Date of Employment

You should specify the effective date of the employee's termination.

Benefits

You should specify the last day of the employee's eligibility for medical coverage and other benefits including, inter alia, dental coverage, life insurance, or participation in the employer's retirement plan. You should also enumerate any vested and accrued benefits to ensure that the employer does not overlook any required benefit payments.

Consolidated Omnibus Reconciliation Act (COBRA)

The agreement should explain that the employee may be eligible for continued health benefit coverage under COBRA and that, if the employee elects COBRA, the employee will bear the expense of such continuing coverage.

Consideration

The separation agreement must be supported by consideration beyond that which the employee is already entitled. The departing employee often will request additional separation compensation. In responding to a request for more separation pay, your initial research regarding the employee and the circumstances of his or her termination will prove indispensable.

Additionally, providing or extending certain benefits may bridge the gap between what the employer is willing to provide consideration-wise and what the employee seeks. Some examples that may arise include:

- **Outplacement benefits.** If the employer's initial offer did not include outplacement benefits, then including them in the separation agreement may be a relatively inexpensive way to increase the value of the package. On the other hand, the employer may have offered outplacement benefits that the employee does not want. If so, the employer should consider paying the cash equivalent for such services upon request.
- **Health benefits.** Many departing employees will worry over the loss of health coverage. Assuming the cost of the employee's share of the COBRA payments for a period of time may provide a relatively inexpensive way to boost the cost of the separation package while ameliorating the employee's concerns over health benefits.

Method of Separation Payments

The separation agreement should specify whether the employer will pay the consideration in one lump-sum payment or over a period of time.

If the separation agreement provides for a future stream of payments, you should discuss with the employer whether the agreement should provide that these payments will cease if the employee finds new employment. You will also need to consider I.R.C. § 409A (Section 409A) implications.

Brief Introduction to Section 409A

Section 409A generally provides that most deferred compensation plans, which may include separation agreements, must comply with various rules regarding the timing of deferrals and distributions. Deferred compensation generally occurs for Section 409A purposes when compensation is paid in a different tax year than the year in which the employee first vested in the right to be paid. Section 409A was added to the Internal Revenue Code in 2004, in part as a response to the practice of opportunistic executives at Enron Corporation accelerating the payments under their company's deferred compensation plans to access money before the company went bankrupt. Note that Section 409A also applies to independent contractors and imposes a six-month delay rule on non-exempt severance payable to certain officers of public companies.

Section 409A Penalties

The penalties for violating Section 409A apply primarily to the employee, although the employer has W-2 reporting and tax withholding obligations. The penalties for an employee include (1) the full amount of the severance pay (even if it is to be paid over several years) becomes taxable, except to the extent it is exempt from Section 409A; (2) the employee pays an additional 20% penalty tax on the severance pay; and (3) the employee may also have to pay additional interest.

Related Content

For additional guidance on separation agreements specifically tailored for executives, see

> DRAFTING COMMON PROVISIONS IN AN EXECUTIVE SEPARATION AGREEMENT

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Separation Agreements & Severance Plans > Practice Notes*

For detailed advice on meeting the waiver requirement set out in the Older Workers Benefit Protection Act, see

> COMPLYING WITH THE HEIGHTENED WAIVER REQUIREMENTS UNDER THE OLDER WORKERS BENEFIT PROTECTION ACT

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Separation Agreements & Severance Plans > Practice Notes*

For a detailed discussion on the application of the non-qualified deferred compensation rules of Section 409A of the Internal Revenue Code, see

> SECTION 409A AND SEVERANCE ARRANGEMENTS

RESEARCH PATH: *Employee Benefits & Executive Compensation > Nonqualified Deferred Compensation > Practice Notes*

THE EMPLOYER SHOULD GENERALLY REQUIRE THAT THE EMPLOYEE PAY THE EMPLOYER LITIGATION FEES AND LIQUIDATED DAMAGES, WHICH ARE PREDETERMINED MONETARY DAMAGES FOR VIOLATING THE AGREEMENT, FOR MATERIAL BREACHES OF THE AGREEMENT, SUCH AS BREACHES OF NON-DISPARAGEMENT OR CONFIDENTIALITY CLAUSES.

Complying with Section 409A

The first way to avoid the negative implications of Section 409A is to ensure that any payments meet the short-term deferral exemption. This exemption is generally available if the employer pays the severance payments within two and one-half months after the end of the year in which the termination occurs. Note that a Section 409A violation could occur if the employer has a preexisting obligation, such as under an employment agreement, to pay severance over a longer period and then accelerates payment to occur within that two and one-half month period.

A second safe harbor for separation pay exists for payments that do not exceed the lesser of either two times the employee's annual compensation or twice the compensation limit in I.R.C. § 401(a)(17)—set at $275,000 in 2018. The termination must be involuntary and the employer must pay the separation pay by no later than December 31 of the second year following termination of employment.

You should also consider including provisions stating that although both the employer and the employee intend the agreement to comply with Section 409A, the employer and the employee agree that the agreement will be interpreted in a manner to comply with Section 409A. In addition, if any provision of the agreement is found not to comply with Section 409A, the parties will cooperate to execute any necessary amendments to accomplish compliance with Section 409A.

Tax Withholding

You should state in the agreement that applicable tax withholding (and other authorized or required deductions) will be deducted from the separation payment(s) made to the employee.

Confidentiality of Separation Agreement

You should include a clause stating that the employee agrees not to tell anyone about the separation agreement and not to provide any information in the separation agreement to anyone, other than his or her attorney, financial advisor, close family members, or as legally required. The agreement should also state that if the employee tells anyone on this list about the agreement, the employee must simultaneously instruct them to maintain the confidentiality of the terms of the separation agreement.

Confidentiality of Proprietary Information

The agreement should contain the employee's promise to keep the company's proprietary information confidential. You may define proprietary information simply as any confidential non-public information of the employer. This provision should state that the employee may disclose such information only if required by law. This clause should also state that the employee agrees not to use the employer's proprietary or confidential information to harm or damage the employer.

You should determine if the employee previously signed a confidentiality agreement at the outset of or during employment that may contain much or all of this content. If so, this provision should incorporate by reference that previous agreement.

Return of Company Property

The agreement should memorialize that the employee will return all company property, including electronic devices, documents, and electronic data by no later than a specified date.

Restrictive Covenants

The employer may want to incorporate in the separation agreement new or existing restrictive covenants, such as non-disclosure, non-solicitation, non-competition, and provisions concerning the ownership of work product and intellectual property. Examine existing policies and agreements to determine which restrictions may apply to the employee and carefully review state law to determine the extent of enforceability.

Non-Disparagement

This provision is designed to protect the employer from disparagement by the former employee. An example of this clause is a statement that:

> The employee shall not make any statements or take any actions that disparage, hold out to public embarrassment, or ridicule, the Company, its services, products, management, employees, image, tradecraft, practices, office environment, culture, or otherwise harms its reputation. This paragraph shall not prevent [employee's name] from making truthful statements in response to a subpoena or under oath in the course of an investigation conducted by the EEOC or another government administrative agency.

Carve-out Relating to Administrative Agencies

To reduce the risk that administrative agencies will take issue with the confidentiality, non-disparagement, or similar clauses, you should include a disclaimer that such provisions do not preclude the employee from filing an administrative charge or otherwise communicating with or reporting possible violations of law or regulation to any federal, state, or local government office, official, or agency.

Mutual Non-Disparagement

While an employee may request a mutual non-disparagement provision, the employer should reject this request. First and foremost, it is impractical for the employer to monitor and filter comments made by its myriad employees. Further, if the employer has to provide evidence to a court, administrative, or regulatory body in a matter relating to the employee, such a restraint may impede forthright disclosures about the employee's performance or conduct.

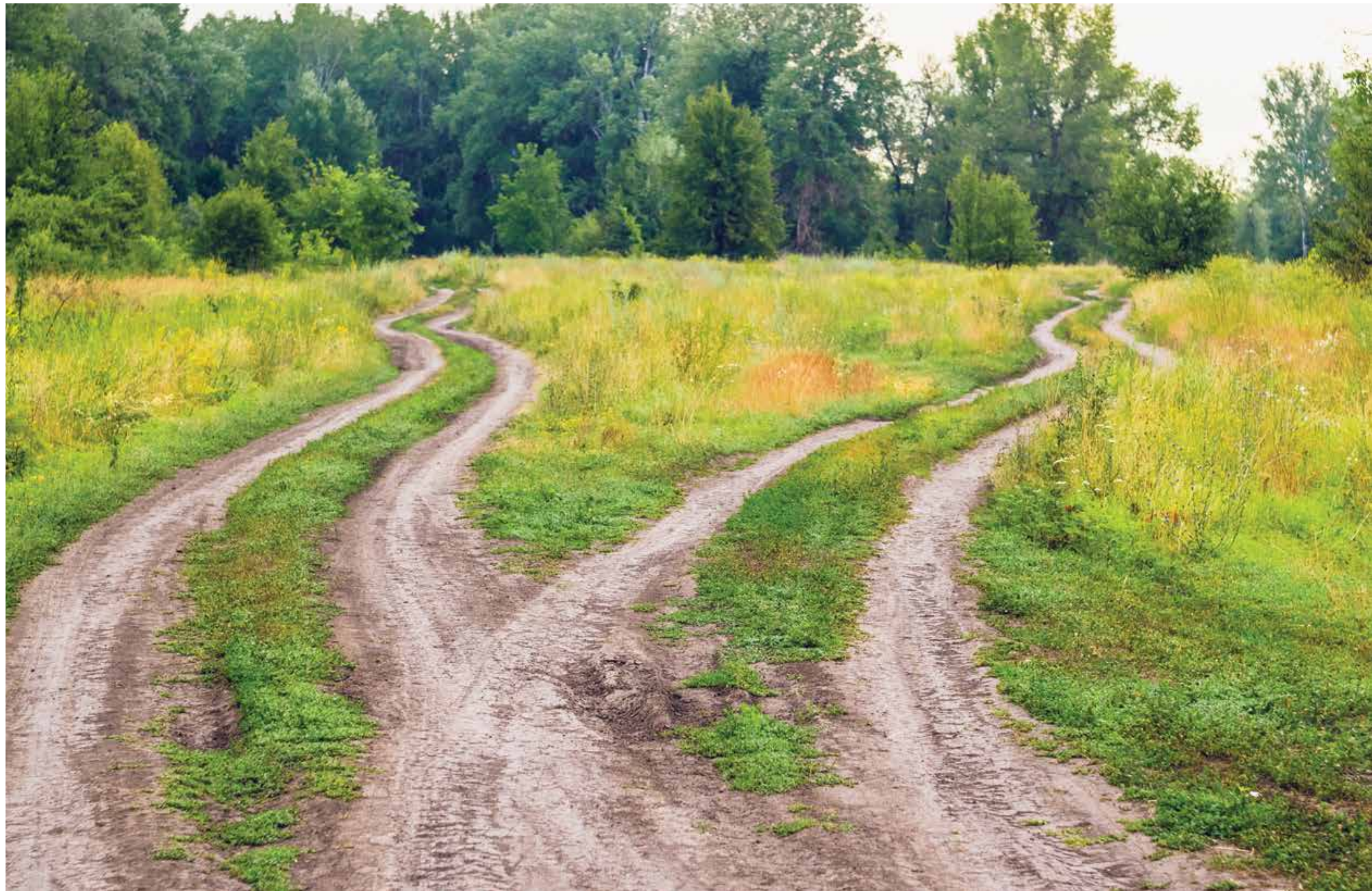
Job References

Job references, if any, should be in writing. Agreeing to an oral reference inevitably leads to "he said, she said" issues. If the employer agrees to provide a specific reference letter, the employer should have the employee agree in writing to the exact terms of the reference. The employer must also ensure that the reference is accurate and provide the reference exactly as written.

No-Rehire Provisions

This clause states that the employee will not apply for re-employment and waives the right to be hired again by the employer. It may foreclose future retaliation suits against the employer for denying a future application.

The EEOC discourages no-rehire clauses. The courts, however, generally have upheld such provisions. See, for example, Jencks v. Modern Woodmen of Am., 479 F.3d 1261 (10th Cir. 2007); Salerno v. City Univ. of N.Y., 2005 U.S. Dist. LEXIS 3825 (S.D.N.Y. Mar. 8, 2005). But see Golden v. Cal. Emergency Physicians Med. Group, 782 F.3d 1083 (9th Cir. 2015) (remanding employment litigation settlement agreement to district court to determine whether a no-rehire provision it contained violated the Cal. Bus. & Prof. Code § 16600 prohibition against restraints on the practice of a profession); Reyes, et al. v. HIP at Murray Street, LLC, et al.,



Related Content

For an overview on how to use bargaining power and leverage to negotiate favorable separation agreements for executives, see

> **STRATEGIES FOR NEGOTIATING EXECUTIVE SEPARATION AGREEMENTS FOR EXECUTIVES**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Separation Agreements & Severance Plans > Practice Notes*

For a sample annotated executive separation agreement with practical guidance and drafting notes, see

> **EXECUTIVE SEPARATION AGREEMENT (PRO-EMPLOYER)**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Separation Agreements & Severance Plans > Forms*

For state-specific separation agreements, see

> **INVESTIGATIONS, DISCIPLINE, AND TERMINATIONS STATE EXPERT FORMS CHART**

RESEARCH PATH: *Labor & Employment > Investigations, Discipline, and Terminations > Discharge and Layoffs/RIFs > Forms*

No. 1:15-cv-00238 (S.D.N.Y. Jan. 6, 2016) (rejecting proposed settlement agreement because the agreement's no-rehire provision was inconsistent with the purposes of the FLSA). Courts have also specifically held that a no-rehire provision/policy does not in itself constitute retaliation. See, for example, Jencks, 479 F.3d at 1263; Franklin v. Burlington Northern & Santa Fe Ry., 2005 U.S. Dist. LEXIS 3288 (N.D. Tex. Mar. 3, 2005), aff'd by 2006 U.S. App. LEXIS 8267 (5th Cir. Apr. 5, 2006).

Cooperation

The employer should generally require the employee to cooperate reasonably in any ongoing or future litigation, investigation, or criminal/legal matter. The employer often offers indemnification for the employee's expenses and attorney's fees. The employer should typically not agree to pay the employee for time spent cooperating.

The employer may also request that the employee inform it of any subpoenas or summons related to the employer that the employee receives within a prescribed time period (e.g., within three business days of receipt).

Liquidated Damages and Litigation Fees

The employer should generally require that the employee pay the employer litigation fees and liquidated damages, which are predetermined monetary damages for violating the agreement, for material breaches of the agreement, such as breaches of non-disparagement or confidentiality clauses. The liquidated damages provision will give teeth to the agreement and encourage ongoing compliance by the employee. Don't set the liquidated damages amount too high, as courts will reject unreasonable liquidated damages provisions.

Integrated Document

You should include an integration provision stating that the agreement reflects the complete agreement of the parties. The integration provision bars reliance by the employee on oral representations or agreements outside of the separation agreement.

The integration provision may, however, result in the unintended effect of superseding and extinguishing ongoing restrictive covenants or other agreements that the employer may want to continue to enforce against the employee. To avoid extinguishing these agreements you should include a carve-out in the integration clause that preserves these obligations.

Choice of Law/Choice of Venue

This provision permits the selection of the controlling law and jurisdiction, including arbitration, regarding an allegation of material breach of the separation agreement by either party.

Severability

You should include a paragraph regarding the severability of the agreement, which means that if one paragraph is deemed unenforceable, the rest of the agreement remains enforceable.

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RESEARCH PATH: *Labor & Employment > Employment Contracts > Waivers and Releases > Practice Notes*

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Guidance for Employers on **ERISA Discrimination, Retaliation, and Whistleblower Claims**

This article discusses aspects of Section 510 of the Employee Retirement Income Security Act (ERISA) ([29 U.S.C. § 1140]()), which prohibits interference with benefits and retaliation for the exercise of rights under ERISA and ERISA employee benefit plans. The prohibition applies to employee pension benefit plans and employee welfare benefit plans, to vested and unvested benefits, and to actions affecting a single individual or multiple individuals. By virtue of Section 510, employees should be able to claim benefits and exercise their rights under the law without fearing their employer's interference or reprisal.

Competing Principles in Section 510 Litigation

ERISA Section 510 prohibits discrimination (including discharge, fine, suspension, expulsion, or discipline) against any ERISA employee benefit-plan participant or beneficiary, for exercising any right under the provisions of the plan. Section 510 claims lie at the intersection of many well-established and often competing policies. Since these policies are explicitly and implicitly considered by courts at all stages of litigation, you should recognize them to help litigants better frame their legal arguments.

Factors against the Robust Application of Section 510

Several factors weigh against a robust application of Section 510. Historically, the law has not required employers to sponsor employee benefit plans. Outside of the collective bargaining context, if an employer chooses to sponsor a plan, it has broad discretion to establish the plan's terms and only marginally narrower discretion to amend those terms on a prospective basis. This is particularly true of welfare benefits because, at least prior to health care reform and with the exception of a few

Internal Revenue Code limits, the law did not prescribe levels of participation or benefits.

In addition, ERISA itself is indicative of public policy favoring employer-sponsored plans. Courts are often reluctant to impose costs and expenses that disincentivize employers from sponsoring plans.

The employment-at-will doctrine is also lurking in the background of many Section 510 cases. This doctrine militates against courts second-guessing employment-related decisions. Federal and state comity is also a consideration since employment relationships are traditionally governed by state law.

Finally, courts recognize societal norms allowing companies to operate their businesses efficiently and to maximize profits. This factor can be particularly important when adverse employment actions are taken to control costs during a downturn in a company's financial fortunes.

Factors for the Robust Application of Section 510

On the other hand, there are factors favoring a robust application of Section 510. ERISA is the law of the land. Its primary purpose is to ensure that employers' benefit-related promises are kept. Despite the free hand that employers have in setting the terms of their plans, Congress clearly intended that employers keep the promises they have made.

Moreover, Section 510 is an integral component of the statutory scheme enacted to accomplish this goal. Without Section 510, employers could interfere with employees' opportunities to obtain promised benefits through adverse employment actions. That would undermine all of ERISA's participation, vesting, and benefit accrual requirements.

Of course, notions of fundamental fairness to employees require that employers' benefits-related promises be kept.

Types of Claims under Section 510

Section 510 authorizes:

- Interference claims
- Retaliation claims
- Whistleblower claims

For each type of claim, the alleged unlawful action must be a discharge, fine, suspension, expulsion, discipline, or discrimination. These actions must affect the employment relationship. It is not enough to show that a benefit plan has been changed in a way that disadvantages a participant or merely that a benefit claim was denied.

Interference Claims

Section 510 prohibits adverse employment actions that are taken to interfere with plan participants' and beneficiaries' earned or promised benefits. These are the most common types of claims under Section 510.

While the concept of interference claims can be simply stated, complexities arise from the need to analyze specific

. . . A RETALIATION CLAIM MIGHT ARISE IF AN EMPLOYEE'S EMPLOYMENT IS INVOLUNTARILY TERMINATED AFTER HE OR SHE FILES A CLAIM FOR REIMBURSEMENT OF SUBSTANTIAL MEDICAL EXPENSES UNDER A GROUP HEALTH PLAN.

adverse employment actions taken in the context of complex, multifaceted employment relationships. Plaintiffs must establish that employers specifically intended to interfere with their rights under employee benefit plans or ERISA. In the more common cases that do not involve direct evidence of discrimination, plaintiffs must also establish that their employers' proffered legitimate reasons for having taken adverse employment actions are merely pretexts for unlawful discrimination.

For example, interference claims might arise due to:

- A termination of employment shortly before a participant would become vested or qualified to receive supplemental or early retirement benefits under a pension plan
- A change in employment status (e.g., layoffs, outsourcing positions to a contractor, reclassifying employees as independent contractors or from full-time to part-time) related to workforce restructurings or a company's financial distress
- A failure to hire or maintain benefits in connection with a company merger or acquisition
- A misrepresentation about the possibility of an impending early retirement window program to an employee who terminates employment prior to implementation of the program

Retaliation Claims

Section 510 prohibits adverse employment actions taken against participants and beneficiaries in retaliation for their exercise of rights under an employee benefit plan or ERISA.

For example, a retaliation claim might arise if an employee's employment is involuntarily terminated after he or she files a claim for reimbursement of substantial medical expenses under a group health plan. For example, in [Kross v. Western Electric Co., 701 F.2d 1238, 1242–43 (7th Cir. 1983)](), a claim that an employer discharged an employee in order to avoid paying medical and dental expenses was found to be cognizable under Section 510.

Whistleblower Claims

Section 510 prohibits adverse employment actions taken against individuals who have given information, have testified, or are about to testify in any inquiry or proceeding related to ERISA. For example, a whistleblower claim might arise if an employee experiences a change in employment status after raising possible violations of law relating to an ERISA plan.

Section 510 also prohibits discrimination against employers contributing to multiemployer plans for exercising rights under ERISA or giving information or testifying in any inquiry or proceeding before Congress relating to ERISA.

Proving Violations of Section 510

Generally, it is very difficult to make and prove a Section 510 claim. To state a Section 510 claim, a plaintiff may show direct evidence that the employer had specific intent to violate ERISA. In the absence of such direct evidence, courts have applied a shifting burden analysis similar to that applied in Title VII employment discrimination cases. For instance, in Dister v. Continental Group, Inc. 859 F.2d 1108, 1111-12 (2d Cir. 1988), the court adopted the burden shifting paradigm of McDonnell Douglas Corp. v. Green, 411 U.S. 792 (1973) for discriminatory discharge claims under Section 510.

Elements of a Section 510 Claim

Section 510 is not a model of statutory draftsmanship. In George v. Junior Achievement of Cent. Ind., Inc., 694 F.3d 812 (7th Cir. 2012), the U.S. Court of Appeals for the Seventh Circuit referred to it as "a mess of unpunctuated conjunctions and prepositions." Due to these shortcomings and the fact that Section 510 allows three types of claims, there is a lack of uniformity in the language courts use when pronouncing the elements of Section 510 claims. Litigants should reference the leading decisions of the relevant circuit court of appeals for the applicable formulation of a Section 510 claim.

Direct Evidence

Plaintiffs may prove their Section 510 claims through the use of direct or indirect evidence. Direct evidence consists of the proverbial smoking gun.

For example, in a case decided by the U.S. Court of Appeals for the Third Circuit, Gavalik v. Continental Can, 812 F.2d 834 (3rd Cir. 1987), an employer systematically laid off employees to prevent them from vesting under its pension plan. This liability avoidance program used a scattergraph to identify and target particular employees tied to unfunded pension liabilities. A liability avoidance tracking system or "red flag" system was put in place to ensure that targeted employees were not inadvertently called back to work. The Third Circuit had no trouble finding that this program was direct evidence of discrimination.

Another example of a case involving direct evidence of discrimination is Lessard v. Applied Risk Mgmt., 307 F.3d 1020 (9th Cir. 2002). In that case, parties to a company asset sale structured the purchase agreement to require employees on leave to return to active, full-time status for their employment to transfer to the buyer after the closing. Other employees' employment transferred automatically. After finding that the purchase agreement facially discriminated against employees on leaves of absence, the Ninth Circuit Court of Appeals reversed the lower court's grant of summary judgment for the company on the employees' Section 510 claims.

Indirect Evidence

If claims are based on indirect evidence, courts apply the familiar burden-shifting paradigm developed in cases under Title VII of the Civil Rights Act of 1964. Initially, plaintiffs must demonstrate, by a preponderance of the evidence, a prima facie case of unlawful discrimination under Section 510 consisting of the following elements:

- **Prohibited conduct.** The plaintiff must demonstrate prohibited conduct. Prohibited conduct is a discharge, fine, suspension, expulsion, discipline, or discrimination. These are referred to collectively herein as adverse employment actions. The most common actions are termination of employment and changes in status such as demotions, transfers, or reclassifications.
- **Specific discriminatory intent.** Discrimination must be a motivating factor for the adverse employment action; however, discrimination need not be the sole motivating factor. Plaintiffs must show specific evidence, not speculative and conclusory allegations, to prove specific intent. This is the linchpin of all Section 510 claims.
- **Loss of entitled right or benefit under employee benefit plan.** Plaintiffs must show a loss of an entitled right or benefit under an employee benefit plan. An entitled right is broader than a vested right because it can encompass rights to future contributions and welfare benefit rights.

If plaintiffs establish a prima facie case, defendants may offer legitimate reasons for taking adverse employment actions, which usually fall into one of the following categories:

- Employee misconduct
- Poor job performance
- Workplace restructuring
- Economic hardship and reduction of expenses

Finally, plaintiffs must demonstrate that proffered legitimate reasons are pretexts for unlawful discrimination or retaliation. Case law is instructive in determining how to make this showing. The following factors can be relevant, depending on the facts underlying the claims:

Related Content

For a discussion on the roles of fiduciaries of employee benefit plans under the Employee Retirement Income Security Act (ERISA), see

> **FUNDAMENTALS OF ERISA FIDUCIARY DUTIES**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > ERISA and Fiduciary Compliance > Practice Notes*

For an overview on the preemption provision of ERISA, see

> **ERISA PREEMPTION**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > ERISA and Fiduciary Compliance > Practice Notes*

For guidance in identifying employee benefit plans and programs that are subject to regulation under ERISA, see

> **IDENTIFYING ERISA EMPLOYEE BENEFIT PLANS**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > ERISA and Fiduciary Compliance > Practice Notes*

For more information on the Patient Protection and Affordable Care Act (ACA) whistleblower provisions and regulatory procedures, see

> **UNDERSTANDING THE WHISTLEBLOWER PROVISIONS OF THE ACA**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > Health Plans and Affordable Care Act > Practice Notes*

For a description on the shared responsibility rules for applicable large employers under the ACA, see

> **EMPLOYER SHARED RESPONSIBILITY MANDATE UNDER THE ACA**

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > Health Plans and Affordable Care Act > Practice Notes*

THE PATIENT PROTECTION AND AFFORDABLE CARE ACT DRAMATICALLY CHANGED THE WAY THAT HEALTH INSURANCE COVERAGE IS PROVIDED IN THE UNITED STATES. AMONG OTHER THINGS, THE ACA REQUIRES EMPLOYERS OF A CERTAIN SIZE TO OFFER HEALTH COVERAGE TO THEIR FULL-TIME EMPLOYEES OR BE AT RISK FOR EXCISE TAXES.

- **Strength of the employer's evidence supporting its proffered legitimate reason for taking adverse employment action.** For example, if an employer asserts that an employee was terminated for failure to meet job requirements, a human resources file documenting multiple instances of the employee's shortcomings can be powerful evidence against a claim of pretext. Also, an employer's position can be bolstered by showing that it followed established, written policies and procedures. Conversely, an employer's inconsistent explanations for taking adverse employment actions, demonstrated history of treating an affected group worse than others, or administering punishment that is disproportionate to the alleged offense, may bolster a claim of pretext.
- **Temporal proximity of the exercise of an employee benefit right to the adverse employment action.** Close proximity may support a finding of pretext; a significant lapse of time may undermine a claim of pretext.
- **Cost savings to the employer resulting from an adverse employment action.** Plaintiffs must show more than an employer's knowledge of cost savings. Rather, cost savings must be the reason for an adverse employment action. Courts are more likely to find that cost savings have probative value if the alleged discrimination affects a class of individuals rather than a single employee. The size and health of the business can also be factors in determining whether cost savings were truly the motivation for an adverse employment action.
- **Contingencies and the length of time before an individual could enjoy a purportedly wrongfully denied benefit.** For example, if an individual would have to work a lengthy period of time to become entitled to supplemental pension benefits or would have to wait a number of years after termination of employment to receive them, courts will be less inclined to find that a proffered reason is a pretext.
- **Treatment of similarly situated individuals.** If an employer took no action or less severe action against similarly situated individuals accused of similar actions in the past, that may be used to show that a more severe sanction against an employee, such as termination of employment, was a pretext for unlawful discrimination.
- **Awareness of adverse impact.** An important consideration is whether the individual who made the decision to take adverse employment action was aware of the plaintiff's participation in a plan or the implications of the action to the plaintiff's rights and interests in a plan.
- **Unlawful discrimination preventing benefit eligibility.** The participant or beneficiary must be eligible for benefits under the terms of a plan in the absence of unlawful discrimination.

Special Issue with Whistleblower Claims

Anti-retaliation provisions exist in a number of federal statutes, declaring unlawful the discharge or discriminatory treatment of employees who file charges alleging that their employers' actions violate those statutes, or who otherwise initiate or participate, assist, or testify in investigations or proceedings brought under those statutes against their employers. Anti-retaliation provisions are often drafted with sufficient breadth so that they can also be construed as whistleblower provisions that protect the employee who reports violations affecting the employee, as well as other workers or the public.

The federal appeals courts are split about whether unsolicited internal complaints concerning ERISA violations are protected activities under Section 510. The Fifth, Seventh, and Ninth Circuit Courts of Appeals have concluded that these complaints are protected activities, whereas the Second, Third, Fourth, and Sixth Circuit Courts of Appeals have concluded that these complaints are not. The Department of Labor has written amicus curiae briefs consistently urging that informal complaints are protected activities under Section 510.

The split among the courts has developed due to conflicting interpretations of the ambiguous phrases "given information" and "any inquiry or proceeding." The courts that broadly construe the whistleblower provision interpret these terms to encompass more than the giving of testimony in a formal context. For these courts, protected activity can include informal, oral complaints to a supervisor or human resource administrator. No formal proceeding need be underway at the time of the complaint; the complaint itself can be viewed as the first step of an inquiry or proceeding. These courts reason that any other construction would give employers a perverse incentive to discharge potential whistleblowers because doing so would prevent the occurrence of a formal inquiry or proceeding.

By contrast, the courts that narrowly construe the whistleblower provisions often compare them to the whistleblower provisions of the Fair Labor Standards Act. This comparison tends to result in the courts focusing on whether there is an inquiry or proceeding under the circumstances, regardless of the level of formality involved. Under this analysis, unsolicited internal complaints fall outside the protections of Section 510. If the employer is merely a passive recipient of information, no inquiry (let alone proceeding) can be said to exist. Only the employer can initiate an inquiry—either by asking questions of the employee or conducting a more formal investigation.

Remedies

Depending on the type of adverse employment action involved, affected employees could justifiably seek reinstatement to their positions, back pay, front pay, restitution of forfeited benefits, payment of benefits wrongfully denied, service credit for vesting or entitlement to supplemental benefits, restoration of seniority, and other remedies available in wrongful discharge and discrimination cases.

However, ERISA Section 502 is the exclusive enforcement mechanism for Section 510 claims. As a practical matter, Section 510 claims are brought under ERISA § 502(a)(3) (29 U.S.C. § 1132(a)(3)). Thus, the remedies available to plaintiffs include injunctions and "other appropriate equitable relief," but generally not monetary damages.

Nevertheless, in Cigna v. Amara, 563 U.S. 421 (2011), the U.S. Supreme Court identified several types of equitable relief that may actually be meaningful to participants and beneficiaries. In addition to injunctions, participants and beneficiaries could seek equitable relief in the form of reformation of a plan's terms, a surcharge (e.g., an order requiring fiduciaries to abide by the terms of a reformed plan's terms), and estoppel. The Court described a surcharge as "'monetary' compensation for a loss resulting from a trustee's breach of duty, or to prevent the trustee's unjust enrichment." Cigna v. Amara, 563 U.S. at 441. In effect, the Court provided a roadmap for bringing equitable claims under Section 502(a)(3). Notably, courts have also recognized reinstatement and, in some circumstances, restitution, as equitable remedies in the employee plan context.

Courts have discretion to award reasonable attorney's fees and costs to either party to an action under ERISA Section 510. A fee claimant need not be a prevailing party to be eligible for attorney's fees; it is sufficient to have some success on the merits.

Section 510 Litigation Relating to the Patient Protection and Affordable Care Act

The Patient Protection and Affordable Care Act (ACA) dramatically changed the way that health insurance coverage is provided in the United States. Among other things, the ACA requires employers of a certain size to offer health coverage to their full-time employees or be at risk for excise taxes. The ACA may prove to be very fertile ground for Section 510 claims.

Employer Shared Responsibility Provisions of the ACA

The ACA's shared responsibility provisons apply to applicable large employers, meaning employers with an average or 50 or more full-time employees or full-time equivalents in the preceding calendar year. For this purpose, a full-time employee is a common law employee who averages at least 30 hours of service per week during a month. Part-time employees'

SECTION 510 HAS BEEN ON THE BOOKS FOR OVER 40 YEARS. AN AMPLE BODY OF CASE LAW HAS DEVELOPED FROM WHICH WE CAN IDENTIFY BEST PRACTICES TO AVOID OR DEFEAT SECTION 510 CLAIMS.

hours are aggregated to create full-time equivalent figures to determine whether the 50-employee threshold has been satisfied and whether an employer is thus subject to the ACA shared responsibility requirements.

Covered employers must either pay or play. That is, if they do not offer minimum essential health care coverage to substantially all of their full-time employees (those who work 30 hours or more on average per week), they may be subject to excise tax penalties. The pay-or-play mandate is sometimes referred to as a free rider surcharge or a free rider penalty.

Predictably, many employers have tried to avoid or minimize their exposure to these excise taxes. Whether employers are trying to avoid being subject to the ACA, or to avoid or minimize excise taxes triggered by failures to make offers of coverage or adequate offers of coverage, the ACA's structure incentivizes them to take adverse employment actions against their employees. These actions include discharges, reductions in hours to achieve part-time status, and coercive transitions to independent contractor status.

Dave & Buster's Litigation

The hospitality industry is among the hardest hit by the ACA's employer shared responsibility mandates. These businesses tend to have large numbers of hardworking but low-paid and unskilled employees. The cost of health coverage provided on ACA-compliant terms can equal or exceed many of these employees' salaries and wages. Fearing skyrocketing human resource expenses, many hospitality businesses view the ACA as an existential threat and have reacted by taking preemptive measures designed to lessen the ACA's impact on their businesses. In Marin v. Dave & Buster's, Inc., 159 F. Supp. 3d 460 (S.D.N.Y. 2016), the employer allegedly violated Section 510 by cutting employee hours to deny them health benefits.

Maria De Lourdes Parra Marin sued her former employer, Dave & Busters, Inc., for discrimination under Section 510. The class action complaint was filed on behalf of approximately 10,000 hourly employees whose hours were allegedly involuntarily reduced, resulting in a loss of coverage under the company's health plan or an offer of "inferior" health coverage.

The complaint alleged several communications by managers and company executives that could be used to show specific intent under Section 510 and sought "to obtain appropriate equitable relief" for acts of discrimination under Section 510. The class action complaint specifically sought:

- Reinstatement of employees to their prior full-time positions
- Restoration of rights to participate in the company's plan that complies with the requirements of the ACA
- Being made whole for:
  - Loss of wages and benefits, with interest, from the date of the reduction of hours and benefits
  - Costs of health insurance obtained to replace coverage under the company's plan
  - Reimbursement for out-of-pocket costs for medical claims to the extent that they would have been paid as if they had continued to participate in the company's plan
- Reasonable attorney's fees and costs

Dave & Buster's filed a motion to dismiss for failure to state a claim under Section 510. In denying the motion, the court found that the complaint alleged intentional interference with current health care coverage that was motivated by concern about future costs and was supported by factual allegations. The reduction in hours "affected [Ms. Marin's] employment status, her pay and the benefits she had and to which she would be entitled." Accordingly, the court concluded that "the complaint states a plausible and legally sufficient claim for relief, including, at this stage, [Ms. Marin's] claim for lost wages and salary incidental to the reinstatement of benefits."

Based on what we can discern from the pleadings and the court's ruling on the motion to dismiss, the plaintiffs will likely attempt to establish their claims on the basis of direct evidence of discrimination under Section 510. Perhaps the company will claim that its fiduciary obligation to its shareholders and disclosure obligations under securities law could not be reconciled with the constraints of Section 510. The subtext of such a claim is that the company should not be singled out for punishment just because it was honest and forthright (perhaps to a fault) about its actions.

On December 1, 2017, the court rejected a proposed settlement of this matter.

Best Practices for Avoiding and Defeating Section 510 Claims

Section 510 has been on the books for over 40 years. An ample body of case law has developed from which we can identify best practices to avoid or defeat Section 510 claims. Happily, most of these best practices comport with best practices that have been

advocated by human resources professionals when dealing with employment matters:

- To the extent possible, separate human resources personnel and functions from ERISA plan administration.
- Limit human resources personnel's access to plan-related information (ignorance can be bliss in this context).
- Maintain clear written employment policies and procedures with sanctions for violations that are commensurate with the severity of the offenses, and apply them consistently.
- Carefully document workplace incidents, disciplinary measures, performance reviews, etc., over the course of time.
- Avoid providing different, inconsistent explanations for adverse employment actions.
- Avoid linking an adverse employment action with any rights under an ERISA plan, so that specific intent to interfere is not manifest (i.e., avoid creating a smoking gun).
- Allow as brief a period as possible between a final decision to modify benefits (such as offering an early retirement window) and implementation of that modification, and develop a uniform, fiduciary-compliant approach to dealing with benefit-related inquiries during that period.
- Include employer-friendly provisions in your ERISA plan documents (e.g., expressly acknowledge ERISA status; require exhaustion of claims procedures; and reserve discretionary authority to amend and terminate the plan, construe plan terms, and make findings of fact and other administrative determinations).
- Consult with labor and employment counsel to develop standard waiver and release of claims language to be signed by departing employees.
- Conduct exit interviews with departing employees and communicate rights under plans.
- When contemplating changes to employee benefit plans:
  - Consider how various cohorts of employees will be impacted (e.g., hourly versus salaried, long-term versus short-term).
  - Document legitimate, non-discriminatory business reasons for making the changes (e.g., as part of a multifaceted and business-wide cost-cutting program in response to adverse business conditions). L

Brian Murray is a partner at Baker and Hostetler LLP. He has a depth of experience counseling small private companies to large publicly traded corporations on diverse employee benefit and executive compensation matters across a multitude of industries, including pharmaceuticals, food and beverage, and financial services. Brian has also been heavily involved in employee benefits matters in mergers, acquisitions, and dispositions, as well as the consolidation and restructuring of employee benefit plans and arrangements after closings. He wishes to thank Dan McClain, an associate in the Cleveland office of Baker and Hostetler, for his assistance.

RESEARCH PATH: *Employee Benefits & Executive Compensation > Health and Welfare Plans > ERISA and Fiduciary Compliance > Practice Notes*

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Partnership and LLC Equity Compensation

This article addresses fundamental considerations in structuring equity compensation for general and limited partnerships, as well as limited liability companies (LLCs) that are classified as partnerships for federal income tax purposes.

IT SUMMARIZES THE EQUITY-BASED ARRANGEMENTS USED by entities taxed as partnerships to provide key service providers the opportunity to become true equity owners of the business. (Synthetic equity arrangements, such as phantom equity and other cash-settled programs linked to equity appreciation, are not discussed here in detail.)

For simplicity, although this article generally uses the term partnership, the information is equally applicable to all entities classified as a partnership for federal income tax purposes, including general partnerships, limited partnerships, and LLCs.

Special Partnership Compensation Considerations

There are several issues that are important to understand when advising clients on equity compensation matters for partnerships. Many of these issues are unique to partnership equity compensation, primarily because of the different tax regime applied to entities taxed as partnerships compared to entities taxed as corporations. For tax purposes, a partnership is a pass-through entity, meaning that income tax is generally not imposed at the entity level. Instead, a partnership's income, gain, loss, deduction, or credit (tax items) are allocated to its partners based on a method agreed to among the partners in the partnership agreement. The partners are liable for paying income tax on their distributive shares of the partnership's tax items as reported on their respective income tax returns. Importantly, partners are subject to tax on their distributive shares of a partnership's tax items (a tax reporting concept) regardless of whether the partnership makes

distributions of cash to its partners (an economic concept). As such, it is necessary to distinguish between a partner's distributive (or allocated) share of the partnership's tax items and distributions of partnership cash.

An equity interest in a partnership can be either a capital interest or a profits interest (including profits interests treated as so-called applicable partnership interests under new tax rules discussed further below). There are also synthetic forms of equity (e.g., phantom equity) that provide the appearance, but not the substance, of true ownership. Partnerships may consider synthetic equity alternatives due to the relatively higher costs and complexity of administering an incentive program that involves true equity interests.

Incentive Effect Considerations

When designing an equity compensation program, it is imperative at the outset to identify the organizational objectives. These will impact the choice of award type and the terms of the award. From a talent management viewpoint, the primary reason partnerships grant equity compensation is to attract, incentivize, and retain key service providers. By offering a service provider an equity stake, the partnership is able to align the economic interests of its existing partners with key service providers.

Vesting

To strengthen the incentive and retention effects of equity grants, partnerships (like corporations) typically subject the award to vesting restrictions, which can incentivize service providers to remain with the business over a designated period of time (if vesting is time-based) or to enhance performance (if vesting is performance-based), or both. On the other hand, extended vesting periods or unrealistic performance standards can diminish the perceived value of an equity award.

Capital Contribution Requirement

The partnership will also need to determine whether service providers will be asked to contribute cash or other property to receive an equity interest in the partnership or whether the equity grant will be entirely compensatory. A service provider who is required to contribute cash or other property to the partnership will have skin in the game due to having capital at risk. The psychological effect of having capital at risk tends to incentivize performance in a manner consistent with a well-designed program's objectives.

Partner Status

Some service providers highly value receiving equity compensation because of the value attributed to being a business owner. Although becoming a business owner has important psychological benefits, the change in status from employee to partner has real economic consequences, not all of which are positive, as discussed later in this article.

Voting, Redemption Rights, and Transfer Restrictions

Partnerships often impose restrictions on equity awards that are intended to primarily serve a compensatory purpose. These restrictions are usually set forth in a partnership agreement that establishes the rights and obligations of the partners and may also be included in a separate equity award agreement.

Voting rights. Compensatory equity arrangements commonly restrict voting and management rights to allow existing owners to retain control of the business. Frequently, however, there will be negotiated exceptions for certain types of significant decisions for which the parties agree that award recipients should have a say or be able to act to preserve the value of their equity rights. Of course, voting restrictions must comply with the law of the state in which a limited partnership (or LLC) is organized.

Transfer restrictions. Almost all partnership equity awards are subject to transfer restrictions, as businesses often desire to control, or at least limit, the acquisition of its equity by unaffiliated third parties.

Redemption or buy-back rights. The partnership (or the other partners) typically has a right to redeem or acquire a service provider's partnership interest at an established price based on the occurrence of specified events (e.g., a separation from service after vesting in all or a portion of the interest). This is especially important for partnerships that are closely held and do not want inactive partners or passive investors. Such provisions should be clear about how the transfer restriction will operate, including how the transferred interest will be valued upon disposition, whether transfer is optional or mandatory, the time period in which the transfer is permitted to occur, and terms of payment (e.g., payment partially in cash and partially with an installment obligation).

Right of first refusal. For partnership agreements that permit partners to sell their interests to third parties, the partnership (and/or other partners) may also have a right of first refusal providing the remaining partners (or the partnership) with a first option to acquire any interests that a partner proposes to sell to a third party (usually at the same price and on substantially the same terms as the proposed sale).

Types of Partnership Equity Compensation

Partnership equity compensation can take the form of either capital interests or profits interests.

Capital Interests

For federal tax purposes, a capital interest in a partnership is a distinct type of equity interest. Specifically, a capital interest is defined as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." Rev. Proc. 93-27. That determination is made at the time of receipt of the partnership interest.

Similar to grants of equity in a corporation, partnership capital interests can vest immediately, over a period of time, or be based on performance. They can also be issued subject to restrictions, including transfer restrictions, redemption and buy-back rights, and rights of first refusal.

Tax Treatment of Capital Interest Grant

The tax treatment of an award of a compensatory capital interest in a partnership is governed by I.R.C. § 83 and turns on whether the interest is vested at the time of grant.

Vested capital interest. A service provider awarded a capital interest that is fully vested upon grant will immediately include as taxable compensation an amount equal to the excess of the fair market value of the capital interest over the amount paid, if any, for the interest (generally referred to as the spread).

Unvested capital interest. A service provider awarded a capital interest that is subject to a vesting provision (i.e., the interest is subject to a substantial risk of forfeiture) is not subject to tax upon grant (unless the service provider makes a Section 83(b) election). Instead, as the interest vests, the service provider will be subject to tax on the spread.

In either case, the partnership generally deducts an amount equal to the compensation reported by the service provider. That deduction is allocated to the existing partners as provided for in the partnership agreement.

Given that a capital interest is taxable on the spread at the time the award vests, consideration should be given to how the recipient would be expected to pay the tax. Since transfer and other restrictions limit the marketability of a vested capital interest, the award recipient may not have sufficient liquidity to pay the federal and state income tax imposed on the spread. To minimize the financial burden on the award recipient, some partnerships combine the award of a capital interest with another cash-settled incentive such as a bonus payment or arrange for a loan.

Holding periods are important for recipients of unvested capital interests. To obtain the preferential federal tax rate associated with long-term capital gains, an individual must hold a capital asset for a period greater than 12 months. The holding period for an unvested capital interest generally does not begin to run until the interest vests, and even then, full vesting may occur over an additional period of years. If the holder disposes of the interest (or a portion thereof) within 12 months of vesting, he or she would not qualify for long-term capital gain treatment. Although a recipient of an unvested capital interest could accelerate the holding period by making a Section 83(b) election, such an election is not without potentially adverse economic consequences if the value of the interest declines since the tax paid on the grant date value cannot be recouped.

A similar issue must be addressed when granting a compensatory option to acquire a capital interest in a partnership. To avoid being taxed on the spread at the time the option is exercised, many optionees delay exercise until there is clarity regarding the timing of a capital transaction. Since the holding period cannot start until the option is exercised, many award recipients would not qualify for the preferential long-term capital gain rate because the subsequent disposition of the capital interest often occurs within 12 months of the exercise date. Such grants of compensatory partnership options are rare, however. Profits interests are more common and more highly valued by key talent.

Other Tax Consequences of Capital Interests

A partner's distributive share of tax items from a partnership is taxable as either ordinary income or loss, or capital gain or loss, depending on the character of the tax item in the hands of the partnership. A guaranteed payment made to a partner is treated as ordinary income subject to self-employment tax. The partnership is allowed a deduction equal to the amount of any guaranteed payments, which is passed through to its partners.

When a partner eventually disposes of a capital interest, he or she will generally recognize a capital gain equal to the net proceeds from the sale less the capital interest's basis. However, in some instances, all or a portion of the gain can be recharacterized as ordinary income if certain hot asset rules apply pursuant to I.R.C. § 751.

Related Content

For an examination of the non-qualified deferred compensation rules under I.R.C. § 409A, see

> UNDERSTANDING NONQUALIFIED DEFERRED COMPENSATION ARRANGEMENTS AND INTERNAL REVENUE CODE SECTION 409A

RESEARCH PATH: *Employee Benefits & Executive Compensation > Nonqualified Deferred Compensation > Practice Notes*

For information on the 2017 tax reform legislation, see

> 2017 TAX ACT IMPACT ON EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

RESEARCH PATH: *Employee Benefits & Executive Compensation > Nonqualified Deferred Compensation > Practice Notes*

For an overview of the rules governing the executive compensation deduction limitation under I.R.C. § 162(m), as amended by the 2017 tax reform legislation, see

> IRC SECTION 162(M): NAVIGATING TAX DEDUCTION LIMITATIONS FOR EXECUTIVE COMPENSATION

RESEARCH PATH: *Employee Benefits & Executive Compensation > Employment, Independent Contractor, and Severance Arrangements > Executive Employment Agreements > Practice Notes*

Profits Interests

For federal tax purposes, a profits interest in a partnership is another type of distinct equity interest. By definition, a profits interest is a partnership interest other than a capital interest. Rev. Proc. 93-27, Rev. Proc. 2001-43.

The simplest way to distinguish a profits interest from a capital interest is to ask whether, in a hypothetical liquidation of the partnership on the grant date, the recipient would be entitled to receive anything of value. If so, then the interest is a capital interest and the spread is taxable to the recipient, as discussed above. If not, then the interest is a profits interest, the receipt of which is not treated as a taxable event for either the recipient or the partnership. In other words, if the recipient of the interest only has a right to share in future profits (i.e., profits arising subsequent to the grant date) and in the future enterprise value (i.e., the fair market value of the partnership arising subsequent to the grant date), the interest is a profits interest.

Rev. Proc. 93-27 provides that if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the IRS will not treat the receipt of that interest as a taxable event for the partner or the partnership. However, that revenue procedure does not apply, and the receipt of a profits interest will be taxable to the recipient, if any of the following are true:

- **Certain income stream.** The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- **Disposition within two years.** Within two years of receipt, the recipient disposes of the profits interest.
- **Publicly traded partnership.** The profits interest is a limited partnership interest in a publicly traded partnership within the meaning of I.R.C. § 7704(b).

Rev. Proc. 2001-43 provides an important clarification regarding the time for determining whether an unvested interest is a profits interest or a capital interest. The required determination is made at the time the interest is granted, regardless of whether it is vested or unvested at that time, provided that, if the interest is to be treated as a profits interest, all of the following must be true:

- **Treated as partner.** The partnership and the recipient treat the recipient as the owner of the partnership interest from the date of its grant, and the recipient takes into account the distributive share of partnership tax items associated with the interest in computing the recipient's income tax liability for the entire period during which the recipient has the interest.
- **No deductions.** Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest.
- **Compliance with Rev. Proc. 93-27.** All other conditions of Rev. Proc. 93-27 are satisfied.

Thus, a profits interest must not violate the safe harbor requirements. For example, if a profits interest must be disposed of upon a change in control, which occurs prior to expiration of the two-year holding period, the interest would be reclassified as a capital interest carrying the corresponding tax consequences.

Traps to Avoid

Unless the award agreement provides otherwise, most recipients of profits interests are subject to the provisions of the partnership agreement in the same manner as holders of capital interests. If the partnership agreement provides for final liquidating distributions to be made in accordance with the partners' positive capital balances (in order to have economic effect), the recipient of a profits interest would not receive any proceeds from the hypothetical liquidation of the partnership on the grant date because the recipient would not have a capital account balance as of that date.

Many current partnership agreements, however, do not provide for liquidating distributions to be made in accordance with the partners' positive capital account balances. Instead, these agreements provide for liquidating distributions to be made in the same manner as non-liquidating distributions. In the view of many investors, distributing liquidation proceeds according to the partners' positive capital account balances may interfere with the deal economics, which is of higher importance to them than complying with the economic effect requirement. Such provisions can create a serious tax issue for recipients of a profits interest.

As discussed above, the holder of a profits interest must not participate in the proceeds from a hypothetical liquidation on the grant date. However, if liquidation proceeds are distributed according to the agreement's general distribution provision, an award recipient may be hypothetically entitled to receive something of value following a hypothetical liquidation of the partnership on the grant date. The receipt of anything of value on that date would cause the interest to be classified as a taxable capital interest.

This issue can easily be avoided by building a distribution threshold or similar distribution hurdle into the partnership agreement. A distribution threshold provision requires that a minimum amount of cumulative distributions would be made with respect to other interests before the holder of a newly granted profits interest would receive a distribution arising from the hypothetical liquidation. The threshold merely provides a mechanism to avoid the unintended reclassification of a non-taxable profits interest into a taxable capital interest.

Other Tax Consequences of Profits Interests

As with capital interests, profits interests result in partnership allocations that are taxable at either ordinary income or capital gain rates, depending on the characterization of the income or gain to the partnership, and guaranteed payments received by a partner are taxed as ordinary income. Upon the redemption or sale of a profits interest, the holder will have a short-term or long-term capital gain, depending on how long the interest was held. In some instances, all or a portion of the gain can be recharacterized as ordinary income if certain hot asset rules apply pursuant to I.R.C. § 751.

IF A PROFITS INTEREST IS AN APPLICABLE PARTNERSHIP INTEREST, THE GAIN OR LOSS REPORTED BY ITS HOLDER IS SUBJECT TO A SPECIAL HOLDING PERIOD.

Applicable Partnership Interests

The tax reform legislation enacted in late 2017, known as the Tax Cuts and Jobs Act (Pub. L. No. 115-97), added new I.R.C. § 1061, which impacts the tax treatment accorded to a special type of profits interest referred to as an applicable partnership interest. These rules apply when the following conditions are met, subject to the limitations discussed further below:

- **Interest issued for performance of services.** An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or is held by) a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business (defined below).
- **Interest in an applicable trade or business.** The interest is in an entity that conducts activities on a regular, continuous, and substantial basis that consist, in whole or in part, of raising or returning capital, and either (1) investing in (or disposing of) specified assets or (2) developing specified assets. Importantly, the activity does not actually have to rise to the level of a trade or business as that term is generally used in the Internal Revenue Code.
- **Investment or development of specified assets.** The specified assets are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options, derivative contracts with respect to any of the foregoing, and partnership interests in partnerships having an interest in any of the foregoing.

SPECIAL HOLDING PERIOD FOR APPLICABLE PARTNERSHIP INTERESTS

If a profits interest is an applicable partnership interest, the gain or loss reported by its holder is subject to a special holding period. Specifically, gains passed through to a service partner from the sale of a partnership's portfolio investments, in addition to gains related to the disposition of the applicable partnership interest itself, qualify for long-term capital gain treatment only if held by the partnership or partner, respectively, for more than three years. As a result, gain associated with an applicable partnership interest will be classified as short-term capital gain subject to tax at ordinary income rates unless the new three-year holding period requirement is satisfied.

A special rule applies for the sale of an applicable partnership interest to a related party. For such transactions, all or a portion of the resulting gain will be characterized as short-term capital gain to the extent portfolio assets of the partnership do not separately satisfy the three-year holding period requirement. A related person is a member of the transferring partner's family (within the meaning of I.R.C. § 318(a)(1)), or any person who performed a service within the disposition year or the preceding three calendar years in any applicable trade or business in which or for which the transferring partner performed a service.

LIMITATIONS ON WHAT QUALIFIES AS AN APPLICABLE PARTNERSHIP INTEREST

The three-year holding period associated with applicable partnership interests is not as broadly applicable or impactful as may initially appear. The special holding period does not apply to:

- Income or gain attributable to any asset not held for portfolio investment on behalf of third-party investors. This carve-out is subject to forthcoming regulatory guidance.
- A partnership interest held, directly or indirectly, by a corporation. Commentators have questioned whether this limitation applies to both C corporation and S corporations. Such a literal interpretation would appear self-defeating since an individual could avoid the special holding period requirement by establishing a single-member LLC classified as an S corporation to hold her investment. Although the failure to define corporation appears to be a drafting oversight, it is not clear whether the omission can be remedied using technical corrections or regulations rather than by a statutory amendment.
- A partner holding a capital interest in a partnership, regardless of whether the partnership is engaged in an applicable trade or business.

Employment Status and Benefits Issues

Individuals who perform services on behalf of a partnership and receive either (1) vested capital interests (and, presumably, non-vested capital interests for which a Section 83(b) election has been made) or (2) profits interests (whether vested or unvested) must be treated as partners for tax purposes from the date of grant. That is, under long-standing IRS policy, a service provider cannot be treated as both a partner and an employee of the same partnership simultaneously. This has several important consequences.

First, due to the pass-through nature of partnership taxation, partners report and pay income tax on their distributive share of partnership tax items (reported on Schedule K-1 to Form 1065) on their separate tax returns, regardless of whether the partnership makes an economic (cash) distribution to the partners. As noted previously, this can result in a timing issue, where a partner must currently pay tax on partnership tax items while receiving a distribution of the corresponding cash in a subsequent tax year. The income recognized in the current year is added to the partner's basis in his or her partnership interest, thereby avoiding a second tax on the same income when later distributed. Most partnerships address the timing issue by including a provision in the partnership agreement allowing for a so-called tax distribution, which is simply an advance against future distributions that are used by the partners to pay current tax.

In addition, partners are not considered employees covered by payroll (FICA) tax, unemployment insurance, or wage withholding rules. Instead, they are taxed as self-employed individuals, who are generally subject to self-employment tax under I.R.C. § 1402(a). The self-employment tax liability is generally equal to the combined employee and employer portions of FICA taxes for employees, although an above-the-line deduction for half the amount is usually available. Also, since there is no withholding by the partnership, partners must make quarterly estimated tax payments. Further complicating the tax situation, partners are often required to file income tax returns in each state in which the partnership has income tax nexus. In most states, the partnership is required to withhold and remit tax on behalf of non-resident partners.

Also, a service provider's status as a partner adversely affects eligibility for certain tax-favored employee benefit plans and arrangements, such as tax-free employer-paid health and life insurance benefits and pre-tax health plan premium, FSA, and HSA contributions.

Considerations for Compensatory Partnership Equity Arrangements

The foregoing is a brief overview of the primary issues involved when designing partnership equity compensation plans. Before embarking on a compensatory equity plan, a partnership should carefully consider its driving compensation goals (e.g., incentivizing performance and talent retention), its goals for (and the effects of) creating partner-service providers, the specific terms of the plan and interests (e.g., vesting, redemption rights, and transfer restrictions), and the tax and securities law consequences for equity-based compensation. In some cases, partnerships may find that a synthetic equity or other cash-based incentive programs may be a suitable alternative. L

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RESEARCH PATH: *Employee Benefits & Executive Compensation > Incentive and Equity-Based Compensation > Equity-Based Compensation > Practice Notes*

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Recourse for Trade Secret Misappropriation under the **Federal Defend Trade Secrets Act**

THE DEFEND TRADE SECRETS ACT OF 2016 (DTSA), 130 STAT. 376, allows U.S. employers to protect against and remedy misappropriation of trade secret information in federal court. Before the enactment of the DTSA, in the absence of diversity jurisdiction, employers seeking redress had no choice but to sue in state court. While most states have adopted and codified some version of the Uniform Trade Secrets Act (UTSA), which provides uniform definitions and remedies for trade secret misappropriation, these laws nevertheless tend to differ from state to state both in the text of the laws themselves and in their application. Bringing suit under the DTSA allows a party to avail itself of the federal courts, which can be advantageous since federal courts often are more adept at addressing highly complex technical issues arising in trade secret cases.

Bringing a claim under the DTSA can be a double-edged sword, however, as it can make a case that an employer wishes to keep in state court (for any number of strategic reasons, including taking advantage of more employer-friendly laws or procedures) removable to federal court by the defendant. As a result, employers should think strategically before including a claim under the DTSA, particularly where the employer may prefer to remain in state court.

The DTSA Does Not Preempt Existing State Trade Secret Law

While the DTSA provides trade secret owners with a new federal cause of action, it does not preempt existing state trade secret law regimes. As a practical matter, this means that a trade secret owner can bring parallel state and federal claims for trade secret misappropriation in federal court.[1]

Because state trade secret laws may provide slightly different relief than the DTSA, it is important to consider bringing concurrent state and federal trade secret claims to avail the employer of all potential causes of action. When considering filing dual claims under the DTSA and state trade secret law, be cognizant that the definition of trade secret in the DTSA and state trade secret laws may differ.

1. See, e.g., Panera, LLC v. Nettles, 2016 U.S. Dist. LEXIS 101473, at *4, *10 n.2 (E.D. Mo. Aug. 3, 2016) (noting that, for purposes of analyzing plaintiff's likelihood of success at preliminary injunction stage, the court's analysis focused on the state trade secrets claim, but stating that an analysis under the DTSA would "likely reach a similar conclusion").

Statutory Definitions: DTSA vs. UTSA

Before bringing a claim pursuant to the DTSA (or state or common law), it is important to understand the definitions of key terms to ensure the employer has a viable claim.

Definition of Trade Secret

A trade secret is generally any commercially valuable information that is not publicly known where reasonable effort is taken to preserve its confidentiality. The DTSA's definition of trade secret is broad, allowing a wide range of proprietary information to fall under its protection.

Trade secret is defined as:

> All forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if:
>
> (A) The owner thereof has taken reasonable measures to keep such information secret.
>
> (B) The information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.

18 U.S.C. § 1839(3).

This definition is not significantly different from the definition for trade secret in the UTSA and contains the familiar requirements of the UTSA that the trade secret "derives independent economic value, actual or potential, from not being generally known," and that the trade secret owner has undertaken reasonable efforts to keep the information secret.

The UTSA definition of trade secret, which is the basis for the definition of trade secret in most state trade secret statutes, is set forth below:

> Trade secret means information, including a formula, pattern, compilation, program, device, method, technique, or process, that:
>
> (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use
>
> (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy

Unif. Trade Secrets Act § 1(4).

Although minor, the differences in the definition of "trade secret" between the DTSA and UTSA are not necessarily insignificant, and litigants have already attempted to exploit these differences. For example, in RF Micro Devices, Inc. v. Xiang, 2016 U.S. Dist. LEXIS 91284, at *10–13 (M.D.N.C. July 14, 2016), the defendant successfully argued that a guilty plea to a criminal charge of misappropriation could not establish liability under a state civil trade secret statute with a different definition of trade secret.[2] Thus, be sure to argue that the trade secrets at issue meet the definition of trade secret under all applicable statutes.

Definition of Misappropriation

The definition of misappropriation under the DTSA does not differ from the definition for this term under the UTSA, and is as follows:

> Misappropriation is defined in detail as follows:
>
> (A) Acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means –or–
>
> (B) Disclosure or use of a trade secret of another without express or implied consent by a person who:
>
> (i) Used improper means to acquire knowledge of the trade secret
>
> (ii) At the time of disclosure or use, knew or had reason to know that the knowledge of the trade secret was
>
> (I) Derived from or through a person who had used improper means to acquire the trade secret
>
> (II) Acquired under circumstances giving rise to a duty to maintain the secrecy of the trade secret or limit the use of the trade secret –or–
>
> (III) Derived from or through a person who owed a duty to the person seeking relief to maintain the secrecy of the trade secret or limit the use of the trade secret –or–
>
> (iii) Before a material change of the position of the person, knew or had reason to know that
>
> (I) The trade secret was a trade secret.
>
> (II) Knowledge of the trade secret had been acquired by accident or mistake.

2. The distinction relied upon by the court in *R.F. Micro Devices, Inc.* between the DTSA and UTSA was subsequently eliminated when 18 U.S.C. § 1839(3)(B) was amended on May 11, 2016, by striking the phrase "the public" and inserting "another person who can obtain economic value from the disclosure or use of the information." See Defend Trade Secrets Act of 2016, 130 Stat. 376.

18 U.S.C. § 1839(5); Unif. Trade Secrets Act § 1(2).

Drafting a DTSA Complaint

When filing suit under the DTSA, it is very important to explain in the complaint why the allegedly misappropriated information qualifies for trade secret protection. It is not enough to simply call something a trade secret in a complaint under the DTSA. Rather, a plaintiff must plausibly allege—at least in general terms—how the information qualifies as a trade secret. Where a plaintiff fails to do so, the complaint is susceptible to dismissal with prejudice.[3]

It is, however, necessary to be guarded about how much information about the allegedly misappropriated trade secret the employer discloses during court proceedings. Thus, it is important to balance two important considerations. On the one hand, put a sufficient amount of detail into the complaint to (1) state a claim, (2) show that the allegedly misappropriated information qualifies as a trade secret, and (3) survive a motion to dismiss. On the other hand, limit the amount of detail regarding the employer's trade secret in the pleadings, as public disclosure of a trade secret may cause the information to lose its protected trade secret status. This is an integral yet often difficult balance to strike.

The DTSA makes finding this balance easier by allowing employers to maintain the secrecy of allegedly misappropriated trade secrets during court proceedings. Specifically, the DTSA states:

> [A] court may not authorize or direct the disclosure of any information the owner asserts to be a trade secret unless the court allows the owner the opportunity to file a submission under seal that describes the interest of the owner in keeping the information confidential.

18 U.S.C. § 1835(b).

Under this provision, the DTSA gives trade secret owners an opportunity to identify what information is subject to trade secret protection and why that information should be shielded from public disclosure. Thus, if trade secret owners make a proper submission, they then have a tool at their disposal to protect trade secret information from disclosure during court proceedings.

Related Content

For a listing of state trade secret laws, see

> NON-COMPETES AND TRADE SECRET PROTECTION STATE PRACTICE NOTES CHART

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Practice Notes*

For assistance in drafting non-compete and trade secret protection clauses and documents, see

> NON-COMPETES AND TRADE SECRET PROTECTION STATE EXPERT FORMS CHART

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Forms*

For a chart tracking key federal court Defend Trade Secrets Act of 2016 (DTSA) decisions in several circuits, see

> DEFEND TRADE SECRETS ACT (DTSA) CASE TRACKER

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Practice Notes*

For more information on the statutes that protect trade secrets and what constitutes misappropriation of a trade secret, see

> TRADE SECRET FUNDAMENTALS

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Practice Notes*

DTSA Statute of Limitations

There is a three-year statute of limitations for claims under the DTSA. This period begins when "the misappropriation . . . is discovered or by the exercise of reasonable diligence should have been discovered." 18 U.S.C. § 1836(d). The DTSA generally applies to trade secret misappropriation that occurred on or after the date of the enactment of the Act (May 11, 2016) or began before the Act's enactment and continued after the Act took effect.[4]

3. See, e.g., Raben Tire Co., LLC v. McFarland, 2017 U.S. Dist. LEXIS 26051, at *5–7 (W.D. Ky. Feb. 24, 2017) (finding plaintiff's failure to set forth in the complaint any measures it took to protect the allegedly misappropriated trade secret information from disclosure was fatal to plaintiff's claims and dismissing the complaint with prejudice); but compare Mission Measurement Corp. v. Blackbaud, Inc., 216 F. Supp. 3d 915, 921 (N.D. Ill. 2016) (explaining that "at the pleading stage, plaintiffs need only describe the information and efforts to maintain confidentiality of the information in general terms," and that "trade secrets need not be disclosed in detail in a complaint alleging misappropriation for the simple reason that such a requirement would result in the public disclosure of the purported trade secrets") (internal citations omitted). 4. See, e.g., Adams Arms, LLC, v. Unified Weapon Sys., Inc., 2016 U.S. Dist. LEXIS 132201, at *17–19 (M.D. Fla. Sep. 27, 2016) (finding that a trade secret owner may recover under the DTSA when the misappropriation occurs both before and after the effective date if the entire misappropriation is within the three-year limitations period).

DTSA Civil Seizure

The DTSA provides for an ex parte civil seizure mechanism. Civil seizure is a preventative tool employed prior to a finding of misappropriation by which a court may "issue an order providing for the seizure of property necessary to prevent the propagation or dissemination of the trade secret that is the subject of the action."[5] Using this tool, an employer aware of a potential misappropriation of its trade secrets may quickly prevent further dissemination of that information during the pendency of a formal DTSA case. Following issuance of a seizure order, the court must hold a seizure hearing where the party who obtained the seizure order has the burden to prove the facts underlying the order.

Civil seizure may be ordered only in "extraordinary circumstances" and requires a showing that:

- An order pursuant to Fed. R. Civ. P. 65 or other equitable relief would be inadequate because the party to which the order would be issued would evade, avoid, or otherwise not comply with such an order.
- An immediate and irreparable injury will occur if seizure is not ordered.
- Harm to the applicant from denial of a seizure order (1) outweighs the harm to the person against whom seizure is ordered and (2) substantially outweighs the harm to any third parties harmed by such seizure.
- The applicant is likely to succeed in showing that the information is a trade secret and that the person against whom the order is issued (1) misappropriated the trade secret by improper means or (2) conspired to use improper means to misappropriate the trade secret.
- The person against whom the order will be issued has possession of the trade secret and any property to be seized.
- The application describes with reasonable particularity the matter to be seized and, to the extent reasonable under the circumstances, the matter's location.
- The person against whom seizure is ordered would destroy, move, hide, or otherwise make such matter inaccessible to the court if on notice.
- The applicant has not publicized the requested seizure.

18 U.S.C. § 1836(b)(2)(A)(ii).

Only a handful of such requests have been made under the DTSA. As of this writing, we have not identified any request for civil seizure that a court has granted.[6] Cases where an employee used external digital storage devices and/or cloud storage services to store misappropriated trade secrets may be candidates for use of the civil seizure mechanism, especially if it is clear that the employee may not fully comply with a temporary restraining order (TRO) or preliminary injunction. Regardless of the form of the misappropriated trade secret, to make civil seizure effective, be prepared to quickly explain to the court what information was stolen, who stole it, and where it is being kept. A well-developed trade secret asset management plan—in which an employer takes proactive steps to identify, value, secure, and protect its trade secrets—will greatly assist in this process.

Seizures under Fed. R. Civ. P. 65

Where the extraordinary circumstances required for a DTSA civil seizure order are not present, litigants seeking redress for trade secret misappropriation have another option in Fed. R. Civ. P. 65. Under Rule 65, a judge may grant a seizure request as part of a TRO or preliminary injunction related to allegations of trade secret theft under the DTSA and thus potentially avoid the extraordinary circumstances requirement of the DTSA civil seizure provision.[7]

Other Remedies under the DTSA

The DTSA also provides for several remedies other than seizure upon a finding that a party misappropriated a trade secret. For instance, a court may grant an injunction to prevent any actual or threatened misappropriation, provided that the injunction does not "prevent a person from entering into an employment relationship," and that any conditions placed on employment are based on "evidence of threatened misappropriation and not merely on the information the person knows."[8] Where appropriate, an injunction under the DTSA may require affirmative actions to protect the trade secret.[9] Further, in "exceptional circumstances that render an injunction inequitable," the court may condition future use of the trade secret on the payment of a reasonable royalty.[10]

Following a finding of misappropriation, a court may also award damages.[11] Where the trade secret is willfully and maliciously misappropriated, a court may award exemplary damages of up to double the damage amount already awarded.[12] A court may also award attorney's fees where the misappropriation or claim of misappropriation was in bad faith or where a party makes or opposes a motion to terminate an injunction in bad faith.[13]

5. 18 U.S.C. § 1836(b)(2). 6. See, e.g., OOO Brunswick Rail Mgmt. v. Sultanov, 2017 U.S. Dist. LEXIS 2343, at *4–5 (N.D. Cal. Jan. 6, 2017) (denying request for DTSA civil seizure order). 7. See, e.g., Magnesita Refractories Co. v. Mishra, 2017 U.S. Dist. LEXIS 10204, at *1 (N.D. Ind. Jan. 25, 2017) (court granted a TRO ordering seizure of a former employee's personal laptop because there was a strong likelihood that the employee was conspiring to steal the employer's trade secrets contained on the laptop, and the seizure needed to be carried out immediately to prevent the impending harm). 8. 18 U.S.C. § 1836(b)(3)(A)(i). 9. 18 U.S.C. § 1836(b)(3)(A)(ii). 10. 18 U.S.C. § 1836(b)(3)(A)(iii). 11. 18 U.S.C. § 1836(b)(3)(B). 12. 18 U.S.C. § 1836(b)(3)(C). 13. 18 U.S.C. § 1836(b)(3)(D).

REGARDLESS OF THE FORM OF THE MISAPPROPRIATED TRADE SECRET, TO MAKE CIVIL SEIZURE EFFECTIVE, BE PREPARED TO QUICKLY EXPLAIN TO THE COURT WHAT INFORMATION WAS STOLEN, WHO STOLE IT, AND WHERE IT IS BEING KEPT.

Inevitable Disclosure Doctrine Unavailable

By requiring actual evidence of threatened misappropriation, the DTSA explicitly rejects the inevitable disclosure doctrine under federal trade secret law.

Inevitable disclosure is a common law doctrine by which a court can prevent a former employee from working for a competitor of his or her former employer where doing so would require the employee to depend upon his or her former employer's trade secret information.[14]

Notwithstanding that the DTSA proscribes application of the inevitable disclosure doctrine in a federal claim for trade secret misappropriation, trade secret plaintiffs can still allege misappropriation under the inevitable disclosure doctrine pursuant to a state law cause of action where the state common law allows application of the doctrine. Thus, because some states have adopted (or at least not rejected) the inevitable disclosure doctrine and some have not, the choice of jurisdiction is very important for trade secret plaintiffs alleging misappropriation under the DTSA with a pendent state trade secret claim under a theory of inevitable disclosure.[15]

Whistleblower Provision and Notice Provision

As discussed above, the remedies for employers suing former employees for trade secret misappropriation under the DTSA include punitive damages and attorney's fees. To take advantage of these remedies, however, an employer must advise its employees of the existence of the whistleblower immunity in any contract or other employment agreement entered into after the enactment of the DTSA.[16] As such, employers should strongly consider updating their employment policies and agreements going forward to include either the required notice or a cross-reference to a policy document that includes a statement about the DTSA's whistleblower immunity.

The DTSA also includes a safe harbor for whistleblower employees that provides for immunity from criminal or civil liability under any federal or state trade secret law for disclosure of a trade secret in confidence to an attorney or governmental official "solely for the purpose of reporting or investigating a suspected violation of law," or in a filing in a lawsuit made under seal.[17] Employers should be acutely aware of the notice provision within the whistleblower immunity section of the statute because compliance with this notice provision may affect whether an employer can seek certain remedies under the statute.

14. See, e.g., PepsiCo, Inc. v. Redmond, 54 F.3d 1262, 1269–71 (7th Cir. 1995) (upholding injunction preventing former PepsiCo manager from working for Quaker Oats Company because, notwithstanding the fact that he did not take any physical trade secret information, he would inevitably rely on his knowledge of PepsiCo's trade secrets in his new position). 15. Compare EarthWeb, Inc. v. Schlack, 71 F.Supp.2d 299, 311 (S.D.N.Y. 1999) (The doctrine of inevitable disclosure thus rewrites the employment agreement and "such retroactive alterations distort the terms of the employment relationship and upset the balance which courts have attempted to achieve in construing non-compete agreements.") with Payment Alliance Intern., Inc. v. Ferreira, 530 F.Supp.2d 477, 482 (S.D.N.Y. 2007) (enforcing restriction against work for a competitor and noting factors to consider in determining whether there is a risk of inevitable disclosure). 16. 18 U.S.C. § 1833(b)(3). 17. 18 U.S.C. § 1833(b).

Sample Notice Language

Below is sample notice language that employers may consider including in employment agreements entered into after enactment of the DTSA:

> **Defend Trade Secret Act Trade Secret Disclosure Notice**
>
> NOTICE is hereby given that this agreement does not affect any immunity under 18 U.S.C. § 1833(b)(1) or (2). For the purposes of these subsections only, which are reproduced below, individuals performing work as contractors or consultants are considered to be employees.
>
> (1) An individual shall not be held criminally or civilly liable under any federal or state trade secret law for the disclosure of a trade secret that (A) is made (i) in confidence to a federal, state, or local government official, either directly or indirectly, or to an attorney; and (ii) solely for the purpose of reporting or investigating a suspected violation of law; or (B) is made in a complaint or other document filed in a lawsuit or other proceeding, if such filing is made under seal.
>
> (2) An individual who files a lawsuit for retaliation by an employer for reporting a suspected violation of law may disclose the trade secret to the attorney of the individual and use the trade secret information in the court proceeding, if the individual (A) files any document containing the trade secret under seal; and (B) does not disclose the trade secret, except pursuant to court order.

Overseas Application

The terms of the Economic Espionage Act (EEA), which the DTSA modified, allow employers to use the DTSA to address trade secret misappropriation where the theft occurred outside of the United States. Specifically, the EEA includes a provision indicating that the law applies to conduct occurring outside of the United States if:

1. The offender is a citizen or permanent resident of the United States.
2. The offender is a United States corporation.
3. An act in furtherance of the offense was committed in the United States.

18 U.S.C. § 1837.

The option to apply the DTSA to overseas conduct will be immensely valuable because overseas trade secret theft continues to proliferate. The increased threat of trade secret theft overseas is a result of the lack of strong intellectual property protection in many foreign countries. Overseas application will be especially useful to address economic and corporate espionage originating in China.[18] Compounding this threat is the reality that significant structural and institutional impediments undermine effective IPR enforcement in China, including a lack of coordination among government agencies, insufficient resources for enforcement, local protectionism, and a lack of judicial independence.[19]

18. See Office of the National Counterintelligence Executive, *Foreign Spies Stealing US Economic Secrets in Cyberspace*, Oct. 2011, at i-ii (stating that "Chinese actors are the world's most active and persistent perpetrators of economic espionage"). **19.** U.S. Int'l Trade Comm., *China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy*, Nov. 2010, at xiii, https://www.usitc.gov/publications/332/pub4199.pdf.

THE DTSA'S ABILITY TO ADDRESS TRADE SECRET MISAPPROPRIATION OVERSEAS IS VALUABLE WHETHER THE THEFT OCCURS IN CHINA OR ANOTHER COUNTRY WITH WEAK IP PROTECTIONS.

The DTSA's ability to address trade secret misappropriation overseas is valuable whether the theft occurs in China or another country with weak IP protections.

The DTSA at the International Trade Commission

The DTSA may also become the trade secret statute of choice to remedy trade secret misappropriation through a Section 337 investigation before the International Trade Commission (ITC). The ITC is a quasi-judicial administrative agency with the authority to address unfair trade practices related to imports, including the authority to exclude articles from importation into the United States. A complaint in a Section 337 investigation related to trade secret misappropriation generally must show:

> (1) Importation of an article into the United States related to an unfair method of competition or unfair act, the threat or effect of which is to
>
> (a) Destroy or substantially injure an industry in the United States
>
> (b) Prevent the establishment of such an industry
>
> (c) Restrain or monopolize trade and commerce in the United States

19 U.S.C. § 1337(a)(1)(A).

Notably, in a Section 337 investigation, there is no requirement that the alleged trade secret theft take place in the United States.[20] Additionally, Section 337 investigations move very quickly, and the ITC typically reaches a final adjudication within 16 months of initiating the investigation. Thus, where an employer has been the victim of trade secret misappropriation overseas and the theft relates to articles being imported into the United States, strongly consider bringing a DTSA action before the ITC. L

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RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Articles*

20. See Tianrui Group Co. v. ITC, 661 F.3d 1322, 1332 (Fed. Cir. 2011).

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"All of us at LexisNexis are proud to help veterans by providing them and their representatives the tools and resources they need to address military service and discharge records that prevent veterans from accessing vital care and services," said Kermit Lowery, vice president of Legal Research Solutions at LexisNexis Legal & Professional and a retired assistant judge advocate in the U.S. Army Judge Advocate General Corps.

The initiative is part of Lexis' ongoing Pro Bono Task Force work to support military veterans. The content is especially valuable to veterans who suffer post-traumatic stress disorder (PTSD) or traumatic brain injuries (TBI), but have been unable to access services provided by the Veterans Administration because of inaccuracies in their service records.

"Any veteran suffering from PTSD and TBI has legitimate health concerns, and they should be treated as such," Lowery said. "For those facing challenges getting the care and services they need based on their discharge status, if we can help them and their legal advocates to open up access to those services where warranted, we feel we are doing the right thing by the men and women who serve our country."

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