

CUTTING EDGE EMPLOYMENT LAW COMPLIANCE ISSUES

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State Bar of Texas
7TH ANNUAL
ADVANCED IN-HOUSE COUNSEL COURSE
July 24-25, 2008
Dallas

CHAPTER 4

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CUTTING EDGE EMPLOYMENT LAW COMPLIANCE ISSUES

I. SOX COMPLIANCE AND BEYOND GROWING TRENDS IN CORPORATE COUNSEL LIABILITY

A. INTRODUCTION¹

In-house counsel continue to emerge as a target of regulators probing for wrongdoing in corporate America, regardless of whether those wrongdoings are perceived or real. For decades, in-house counsel have advised corporate clients on governance issues. However, recent headlines show that this advice and counsel role has yielded the growing potential for individual accountability and liability.

Stock option backdating scandals, boardroom leaks, the new rules regarding electronically stored information, and preservation of data relevant to existing or potential claims are some of the issues in-house counsel have been called upon to address. The potential liability and exposure for in-house counsel clearly has not bottomed out and appears virtually limitless. To date, numerous general counsel have lost their jobs, and many face or have faced criminal charges or have negotiated plea deals in criminal cases. For example, the former general counsel of a large publicly-traded company faces a maximum of 140 years in prison and more than \$10 million in fines arising out of the counsel's role in the company's stock option backdating scandal. Given estimates that a possible 2,000 publicly traded companies may have backdated stock options between 1996 and 2005, some observers speculate that more criminal charges are likely.

In this election year, the economy is among the foremost concerns in the minds of voters. As corporate scandals from the start of the decade, such as those associated with Enron and Worldcom, begin to fade in the collective consciousness, new tales of corporate misdeeds have risen to take their place. Growing concerns about the sub-prime mortgage collapse have led to an investigation of the mortgage industry by the FBI's economic crimes unit. The issue of corporate liability and accountability is global. In 2003, following the enactment of the Sarbanes-Oxley Act of 2002 ("SOX" or the "Act"), the Financial Reporting Council ("FRC"), the United Kingdom's independent regulator responsible for promoting confidence in corporate governance and financial reporting, revised

the UK's Combined Code on Corporate Governance ("Combined Code"). The Combined Code sets out best practices for corporate board composition and development, remuneration accountability, audit standards and relations with shareholders. All companies incorporated in the UK and listed on the Main Market of the London Stock Exchange are required under the exchange's Listing Rules to detail in their annual reports the measures taken to comply with the Combined Code. Non-UK companies listed on the Main Market are required to disclose the significant ways in which their corporate governance practices differ from the Combined Code. The FRC continues to revise the Combined Code (most recently in June 2006).

The Japanese legislature in June 2006 amended its Securities and Exchange Law to provide for a new legislative framework of internal controls and financial reporting. The legislation, informally referred to as J-SOX (in reference to the Sarbanes-Oxley Act after which it is modeled), requires all listed companies in Japan to strengthen their internal accounting controls to ensure accurate disclosure of financial information. J-SOX applies not only to companies listed on the Japanese stock exchanges, but also their subsidiaries, even if the subsidiaries do not operate in Japan.

However, according to a recent survey, despite world-wide efforts to strengthen corporate accountability, little has changed in the ethical culture of corporate America. According to a recent survey by the Ethics Resource Center ("ERC"), employees today are more likely to witness unethical corporate behavior such as conflicts of interest, abusive behavior and lying by company executives.² Fifty-six percent (56%) of the public and private sector employees surveyed said they had witnessed **at least one** violation of their company's corporate ethics policies or legal requirements.³ Compare this to the forty-three percent (43%) found in 2003, shortly after the passage of SOX.

Even more alarming, only forty-two percent (42%) of those who witnessed corporate wrongdoing reported it through company channels.⁴ The survey found this attributable to a feeling of futility by employees – that their reporting of misconduct would not make a difference – coupled with a fear of retaliation. The survey suggests the majority of corporate wrongdoing goes unnoticed by corporations and the causes of the wrongdoing remain uncorrected.

¹ We would like to acknowledge Mark Askanas of our San Francisco office and Richard Cino and Joseph Toris of our Morristown office for their work on the preparation of this portion of the paper.

² 2007 National Business Ethics Survey®, Ethics Resource Center.

³ *Id.*

⁴ *Id.*

The ERC survey revealed that more than one-third of employees who witnessed misconduct chose to address the situation themselves, rather than use established corporate channels.⁵ The reason for this? Two in five employees stated they would have had to report the misconduct to the person involved, and, shockingly, **one in four were unaware of any anonymous reporting mechanism used by their employer.** Even where employees who witnessed misconduct were aware of established hotlines for anonymous reporting, they used this option only three percent (3%) of the time.⁶

The survey also questioned the effectiveness of existing efforts by companies to address corporate ethics and accountability.⁷ The ERC found that most employer ethics and compliance programs addressed legal and regulatory demands and are designed in reaction to past problems.⁸ As a result, training focused on the types of conduct to avoid, rather than what employees should do to foster an ethical culture. While employers are likely to adopt a code of ethics that addresses disciplinary measures for infractions and establish a hotline for reporting suspected violations, they are less likely to implement vital program components such as training, adopt methods for evaluating the effectiveness of the code and training provided, and develop advice lines to assist employees in handling tricky ethical situations.

Based on the survey, the ERC concluded that the ethics risk landscape in corporate America was as “treacherous” as it was before the implementation of SOX, and the situation was “ripe” for another major corporate scandal. The ERC found only nine percent (9%) of companies have strong ethical cultures consisting of ethical leadership, supervisor reinforcement, peer commitment to ethics and embedded ethical values.⁹ This finding has remained virtually unchanged despite the widely-publicized corporate scandals and efforts, such as the enactment of SOX, to combat and prevent them.

To get an idea of in-house counsel’s potential exposure to personal liability for corporate malfeasance, one only need look to the headlines. In one incident, as a result of a corporate leak investigation, the general counsel and another in-house lawyer of a large corporation resigned and faced the real prospect of a criminal indictment because they knew of and, on one occasion, provided advice

regarding the legality of the type of techniques and surveillance being used to find the source of the leak.

It should be mentioned that the new Federal Rules of Civil Procedure regarding Electronically Stored Information also place a difficult responsibility on in-house counsel. In his role as gatekeeper, and not just advisor, the in-house counsel is responsible for interfacing with all facets of a company’s organizational structure, including Information Technology, to ensure that all Electronically Stored Information is located, gathered, reviewed and produced in litigation. The task can be monumental, with enough relevant e-mails in many types of litigation, including wage and hour class actions, to fill a warehouse.

B. SOURCES OF CORPORATE COUNSEL LIABILITY

1. Civil Liability

Title VIII of SOX, also known as the “Corporate and Criminal Fraud Accountability Act,” generally applies to publicly traded companies and provides whistleblower protection for employees of publicly traded companies who supply evidence and information of fraud or violations of SEC rules and regulations. The civil whistleblower protection provision, Section 806, provides that:

No publicly-traded company or its officers, employees, contractors, subcontractors, and agents may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee:

- (1) to provide information, or cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of sections 1341 (frauds and swindles), 1343 (wire, radio, and television fraud), 1344 (bank fraud), or 1348 (securities fraud), any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law, relating to fraud against shareholders when the information or assistance is provided to, or the investigation is conducted by,
 - (a) a federal regulatory or law enforcement agency;
 - (b) any member or committee of Congress; or
 - (c) a person with supervisory authority over the complaining employee, or other person with authority to

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

- investigate, discover, or terminate misconduct or
- (2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding relating to an alleged violation of sections 1341 (frauds and swindles), 1343 (wire, radio, and television fraud), 1344 (bank fraud), or 1348 (securities fraud), any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

A company also violates Section 806 if it threatens, restrains, coerces, blacklists, or in any other manner discriminates against an employee in the terms and conditions of employment because the employee engaged in protected conduct. The statute of limitations for filing a complaint with the Secretary of Labor for a violation of Section 806 is 90 days from the date on which the adverse employment action occurs.

SOX provides that if an employee prevails in a whistleblower action, he or she shall be entitled to all relief necessary to make him or her whole, including reinstatement, backpay with interest, and compensation for special damages sustained — litigation costs, expert witness fees, and reasonable attorney fees. One federal court held that “damages for reputational injury that diminished [an employee’s] future earning capacity” are potentially recoverable under the Act.¹⁰

Since SOX is a relatively new statute, there is little caselaw addressing the scope of the whistleblower protection afforded. Predictably, plaintiffs’ attorneys have alleged a wide range of protected activity by their clients. This includes complaints regarding fixing a supervisor’s personal car on company time, the quality of air in the company’s offices and refusal to participate in a random survey by a state insurance commission. While on their face, these issues would seem to have nothing to do with shareholder fraud, companies have nonetheless been forced to defend themselves against these claims — with the threat of plaintiffs’ potential reinstatement hanging over them.

2. Criminal Liability

SOX provides for criminal penalties for retaliation against certain whistleblowing activities. Importantly, this criminal provision includes **any individual or entity**, publicly traded or not (this goes beyond the Section 806 definition of covered entities). Section 1107 provides for the imposition of fines and/or imprisonment up to 10 years to “**whoever** knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.”¹¹

SOX also modified a number of other criminal statutes with application to other than publicly-traded companies. For example, in 2006, a church in Greenwich, Connecticut, approached a local attorney for advice after discovery of child pornography on a computer assigned to the church’s organist. The attorney advised the church to terminate the organist, and then the attorney destroyed the computer’s hard drive. At the time, the attorney was unaware the FBI had begun an investigation regarding the organist. The United States Attorney’s office subsequently filed criminal charges against the attorney. Among the charges in the indictment was violation of 18 U.S.C. § 1512(c)(1), a statute modified by SOX. This provision prohibits **anyone**, not just a publicly-traded corporation, from altering, destroying, mutilating or concealing a record, documents or other object with the intent to impair the object’s integrity and availability for use in an official proceeding. This is one of the first instances where an indictment has been brought under this provision of SOX.

SOX also created criminal penalties for either knowingly or willfully violating the Act’s financial certification provisions applicable to company CEOs and CFOs. SOX also enhanced existing criminal penalties for securities fraud violations, for altering or destroying records in federal investigations and bankruptcy, and for tampering with or altering corporate audit records. These criminal provisions underscore the need for comprehensive measures to ensure the integrity of a company’s financial information.

3. Attorney Obligations

SOX contains provisions related specifically to attorneys working for or on behalf of publicly-traded companies. As required by Section 307 of SOX, the SEC adopted stringent rules establishing standards for professional conduct for attorneys “appearing and

¹⁰ *Hanna v. WCI Communities, Inc.*, 348 F. Supp. 2d 1332 (S.D. Fla. 2004).

¹¹ *Id.* (emphasis added).

practicing before the SEC” in the representation of public companies. “Appearing and practicing before the SEC” is defined as:

- Transacting business with the SEC, including communications with SEC Commissioners, the SEC or its staff;
- Representing a public company in an SEC administrative proceeding or investigation, inquiry, information request or subpoena;
- Providing advice to a public company regarding the preparation of or requirements associated with any document the attorney knows or should know will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to the SEC; and
- Advising a publicly traded company that a statement, opinion or other writing must or need not be filed with or incorporated into any registration statement or other document filed with or submitted to the SEC Commissioners, the SEC or its staff, or that the company is not obligated to submit or file a registration statement or other document filed with or submitted to the SEC Commissioners, the SEC or its staff.

These regulations apply to in-house as well as outside counsel. They also apply to foreign attorneys to the extent those attorneys advise their clients on United States law.

At first glance, it may appear easy to determine whether an attorney is “appearing” or “practicing” before the SEC. Often, it is not so easy to make such a determination. Certain activities, such as representing an issuer at an SEC administrative hearing or investigation or responding to an SEC inquiry, information request or a subpoena, would clearly constitute “appearing and practicing” as they fit within the common sense understanding of the term. However, under the regulations, “appearing and practicing” also includes a number of activities that do not bring attorneys into such direct contact with the SEC.

For example, because the regulations cover providing advice regarding the preparation of any document the attorney knows or should know will be filed with, or submitted to, **or incorporated into** any document that will be filed with or submitted to the SEC, litigators who prepare audit letters concerning a company’s pending or anticipated legal proceedings which is incorporated into the company’s 10-K filing will likely be covered. Likewise, settlement agreements are often required to be attached to public filings to notify investors of the resolution of material

litigation. Therefore, these new regulations cover not only attorneys who deal directly with the SEC on behalf of their clients, but also those who prepare or assist in the preparation of SEC filings, prepare documents used as exhibits in SEC filings, advise clients regarding such filings and even those who supervise attorneys engaged in such activities.

The regulations require attorneys with knowledge of a company’s material violation of federal or state securities laws or a material breach of the company’s fiduciary duties to report these violations “up-the-ladder.” Materiality is determined on an objective, rather than subjective, basis. A violation is considered material when the attorney has credible evidence that would lead a prudent and competent attorney to believe it is reasonably likely that a material violation has occurred, is occurring or is about to occur. Attorneys with such information are required to report the material violation to the company’s chief legal counsel or chief executive officer. If the attorney reports a suspected material violation as required and the chief legal counsel or chief executive officer does not appropriately respond to the report, the reporting attorney is obligated under the SEC rules to submit his or her findings to the audit committee, a committee of independent auditors or the full board of directors.

The SEC regulations promulgated under Section 307 of SOX also authorize companies to establish a company-specific process for reporting suspected material violations. This can include the establishment of a “qualified legal compliance committee” (“QLCC”). The membership of a company’s QLCC must include at least one member of the company’s audit committee and two independent board members. If a company has a QLCC, an attorney may report suspected material violations to the QLCC in lieu of reporting “up-the-ladder.” The QLCC is then charged with formulating the company’s response to the suspected violation.

The regulations also allow an attorney to reveal confidential information related to his or her representation of the company to the extent the attorney reasonably believes necessary:

- To prevent the company from committing a material violation likely to cause substantial financial injury to the financial interests or property of the company or investors;
- To prevent the company from committing an illegal act; or
- To rectify the consequences of a material violation or illegal act in which the attorney’s services have been used.

In certain instances, the SEC rules may conflict with local state ethics rules, particularly where an

attorney is permitted or required to divulge confidential client information. In response to the SEC regulations, the American Bar Association amended the Model Rules of Professional Conduct – Model Rules 1.13 and 1.16, in particular – to mirror more closely the SEC regulations.

Furthermore, the regulations specifically state that attorneys complying in good faith with the regulations shall not be subject to discipline or otherwise be held liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.¹²

While the SEC has sought to place corporate counsel in the role of gatekeeper in corporate governance, it has recognized that counsel must be zealous advocates for their clients. The SEC claims the focus is not on marginal or fringe technical violations of SOX, but, rather, on serious misconduct, such as suborning perjury, manipulating internal corporate investigations or destroying documents. While this is encouraging, it remains to be seen whether the SEC's "bite" will be worse than its "bark".

4. Growing Areas of Concern: Stock Drop Cases

When discussing corporate governance, measures designed to guard against SEC violations and potential civil whistleblower liability may come to mind. However, in the past several years, plaintiffs' attorneys have found new ways to target companies suspected of corporate wrongdoing. At the beginning of the decade, following years of record growth, the stock market began to slide precipitously, causing the investing public great unrest. Today, analysts are debating whether the American economy is headed toward a recession. Investors looking to hold someone accountable for the decline in their portfolios have filed lawsuits against companies whose stock has declined, claiming the decline was attributable to corporate malfeasance in which in-house counsel either participated or should have known and prevented.

In addition to lawsuits under federal securities laws, publicly-traded companies that made company stock available to employees through Employee Stock Option Plans, matching programs under 401(k)'s or as part of 401(k) retirement investments are also seeing a rise in class-action lawsuits under the Employee Retirement Income Security Act ("ERISA"). The ERISA actions, which allege breaches of the company's fiduciary duty, are often filed as parallel actions to securities claims. To further complicate matters, criminal investigations or prosecutions against the company also frequently simultaneously occur.

The critical difference between the securities action and the ERISA action is that shareholders must prove *scienter* to succeed in the securities litigation, whereas employees whose retirement funds were invested in company stock through an employer-sponsored program only need to show the company breached a fiduciary duty in the ERISA litigation.

These ERISA lawsuits – referred to as "stock drop" actions – typically allege that the company-sponsored plan included company stock as an investment option and that the plan participants suffered losses due to the decline in stock value as a result of the company's financial issues. The lawsuits also allege a breach of fiduciary duty for the company's supposed failure to provide adequate information, including adequate financial information, to participants.

They also may allege that the corporation acted imprudently in failing to close company stock as an investment option or to divest the plan of company stock. Finally, they also may allege the plan fiduciaries had a conflict of interest and failed to retain independent fiduciaries or that fiduciaries improperly used insider information regarding the company's stock which ultimately resulted in devaluation.

It is common in corporations that in-house counsel is on corporate 401(k) and employee benefits' committees. Such a fiduciary role makes counsel a prime target for litigation.

C. DEVELOPING AN EFFECTIVE CORPORATE GOVERNANCE PROGRAM

According to the ERC's most recent survey, well-implemented corporate ethics and compliance programs help to decrease the level of misconduct and greatly increase the reporting of observed misconduct. However, the survey found only twenty-five percent (25%) of companies had such programs. The ERC based this determination on their finding that only one in four employees indicated:

- They are willing to seek advice about ethics questions that arise;
- They feel prepared to handle situations that could lead to misconduct;
- Employees are rewarded for ethical behavior;
- Their employer does not reward success obtained through questionable means; and
- They feel positively about their company.

These findings demonstrate the need for companies to have a commitment to ethical behavior and compliance at every level of the organization, from the Board of Directors/Trustees to upper level management to every employee. Many key

¹² See 17 C.F.R. 205.6(c).

governance principles are applicable to all organizations, large and small, profit and non-profit.

Similarly, the federal Criminal Sentencing Guidelines provide an excellent blueprint for an effective corporate compliance and ethics program. In evaluating a company's criminal culpability for conduct, the Guidelines look at several factors:

- 1) A company's involvement in or tolerance of criminal activity;
- 2) A company's prior history of misconduct;
- 3) A company's violation of an order;
- 4) A company's obstruction of justice;
- 5) **The existence of an effective compliance and ethics program by a company;** and
- 6) A company's self-reporting, cooperation, and acceptance of responsibility.

The Guidelines apply to **all organizations whether publicly or privately held and of whatever nature, including corporations, partnerships, labor unions, pension funds, trusts, nonprofit entities, and governmental units.**

1. Board of Director/Trustees' Composition and Conflicts of Interest

The Board of Directors/Trustees should consist of individuals who meet stringent independence criteria. A key factor in establishing the independence of Board members is to develop and implement a pragmatic conflict of interest policy. One of the keys to preventing corruption or the appearance of corruption within an organization is to ensure that those within the organization are not using their positions for personal benefit, and only for the benefit of the corporation.

A conflict of interest policy defines the types of relationships with outside companies and individuals that are prohibited. It contains a mechanism for the identification and reporting of potential conflicts and guidelines to assist in developing policies and procedures for addressing conflicts. A conflict of interest policy should address the unauthorized use of company assets and opportunities. This will ensure that the employees are acting in the company's interest, rather than their own, when in their official capacities. A policy also would likely reduce the chances that employees – particularly upper management – will act in their own interest rather than that of the company.

Board members should be financially literate and able to understand the organization's key risks and business issues. Additionally, Board members should understand the purpose of a corporate governance framework. The organization should provide all Board members with training on the overall purpose of the organization and how they are expected to conduct themselves regarding the business of the organization.

Compensation policies must be in line with the organization's overall strategies, goals and objectives. The creation of an active Compensation Committee, with access to external specialist resources, that takes into consideration remuneration differentials when establishing compensation awards can be vital.

2. Corporate Compliance and Ethics Program

Corporations should establish a separate and distinct Corporate Governance Committee responsible for handling corporate governance issues. The Committee must be fully aware of their duties and responsibilities as well as the scope of corporate governance issues within the organization. Likewise, the Committee should have access to external specialists to assist in fulfilling their responsibilities. The Federal Sentencing Guidelines set forth seven aspects that should be included in a corporate compliance and ethics program:

- 1) Organizational implementation of compliance standards and procedures reasonably capable of reducing potential criminal conduct;
- 2) Assignment of high-level personnel to oversee the compliance with such standards and procedures;
- 3) Due care in the delegation of authority to individuals whom the company knew or should have known had a propensity to engage in illegal activities;
- 4) Communication of standards and procedures, such as through mandatory training or dissemination of publications explaining what is required of company employees;
- 5) Systems for the monitoring, auditing and reporting of criminal conduct;
- 6) Enforcing the established standards through appropriate incentives to perform in accordance with the compliance and ethics program; and
- 7) Developing appropriate and consistent responses after an offense has been detected to prevent further similar conduct.

Companies that can demonstrate an effort to implement these steps can improve their chances of a more favorable outcome in federal criminal proceedings.

As a start, a Code of Ethics governing business practices and employees should be developed. A Code of Ethics should include, at minimum:

- A Statement of Principles outlining the company's business goals and corporate beliefs.

- Policies regarding the treatment of employees by the company, protection of whistleblowers and the interactions between employees in the workplace.
- Policies regarding the protection and prevention of unauthorized dissemination of confidential business information.
- Policies governing the retention and destruction of documents.
- Policies for identifying and addressing potential conflicts of interest.
- Policies for prohibiting employees from taking company opportunities for themselves.
- Policies requiring employees maintain accurate financial books and records for the company.
- Policies requiring compliance with applicable state and federal laws, rules and regulations, including the ADA, Title VII of the Civil Rights Act, State and local human rights laws, Fair Labor Standards Act, state wage payment and child labor laws, federal and state environmental regulations, OSHA and state workplace safety laws, anti-trust and fair business or trade practice laws.
- Policies requiring that the company and its employees conduct business practices and transactions with respect to federal securities regulations, anti-trust laws, accounting practices, fair business practices or governance regulations, including Sarbanes-Oxley, as well as other applicable laws.
- Policies regulating employee's personal use of company equipment.
- Policies prohibiting unfair competitive activities such as price fixing, kickbacks and boycotts.
- Policies regarding the appropriate collection and use of information regarding competitors.
- Policies prohibiting the use of insider information in the trading of securities.
- Policies prohibiting the use of company funds and assets for political contributions.
- Policies to provide a line of reporting or communication for an employee who wishes to report a suspected violation of law, public policy or company policy or practice and protecting the employee from retaliation.

3. Fulfilling Obligations Under the Compliance and Ethics Program and the Code of Ethics

A Code of Ethics must be dynamic and proactive. The organization should implement a process to review the policies and procedures set forth in the Code of Ethics to ensure that they comply with changes in the law. A knowledgeable workforce is

essential to maintaining compliance. Accordingly, the Code of Ethics should be made available to the public and the organization should conduct regular employee training to express expectations and employees' obligations under the Code of Ethics and Compliance and Ethics Program.

A program of routine self-evaluation is recommended. For example, the organization should conduct regular surveys to ensure that employees understand and adhere to the principles expressed in the Code of Ethics. Also, the corporation should establish a protocol for routine testing of the Compliance Program to ensure employee concerns are handled appropriately and efficiently. Since business partners (e.g., customers, lenders and vendors) likely maintain similar codes and programs, the company should establish a communication program to ensure its employees are aware of and in compliance with any obligations (for instance, insurance, billing, and record retention) imposed by its business partners.

In creating an effective Program, the company should identify and review legal problems encountered by it in the past and analyze the company's response to the problems identified. Any effective Code of Ethics and Compliance and Ethics Program must address legal problems facing other companies within the industry as these are useful indicators of issues that the company may soon face. A similar review should be conducted as to every distinct department and/or business unit within the company to account for any potential legal issues with respect to each department or unit. Finally, the Program should look towards the future with an effective business succession and catastrophe or continuity plan.

4. The Audit Committee

Having an independent Audit Committee is an important part of an effective risk management program. Under SOX, "independent" means a committee member not a part of the organization's control group and who does not receive collateral compensation from the organization. It is required that a financial expert, one with an expertise in accounting procedures, be included in the audit committee. The establishment of an Audit Committee seen to those outside the organization as being outside the control of management provides the organization with a layer of checks and balances otherwise unavailable. In addition, tort immunity available to non-profit organizations may be compromised if the dealings of the organization are based on the self-interest of the control group.

The Audit Committee should establish effective protocols and procedures to ensure that all internal and external audit activities are carefully coordinated to avoid omission and duplication. These protocols and

procedures should provide regular and ongoing comprehensive information to the Audit Committee to enable the committee to fulfill its oversight functions.

D. IMPORTANCE OF A CORPORATE COMPLIANCE AND ETHICS PROGRAM IN REDUCING LIABILITY AND IMPROVING YOUR ORGANIZATION

Despite the widespread attention given to corporate governance during the past several years, statistics indicate corporate ethics have not advanced much since the enactment of the Sarbanes-Oxley Act in 2002. The purpose of developing a Corporate Compliance and Ethics Program is to define the purpose, goals and beliefs of the organization, and to provide a mechanism for ensuring that the company and its employees work towards those goals and follow those beliefs. However, simply adopting a Corporate Compliance and Ethics Program is not enough. In order to be effective, companies must take appropriate steps to ensure that the Corporate Compliance and Ethics Program becomes integrated into the corporate culture.

An important aspect of any Corporate Compliance and Ethics Program is a procedure for reporting and addressing suspected violations of the Program and of applicable laws and policies. Employees must be aware of reporting mechanisms within the company and feel comfortable using them. Employee reports of suspected misconduct are valuable in rooting out unethical behavior within the organization before the misconduct has a chance to harm the company, its employees, investors or the public. Along with periodic reviews and updates of the Program and training, reports of suspected misconduct by employees help assess the effectiveness of the Compliance and Ethics Program.

When an employee reports suspected violations, it is the organization's obligation to investigate and take corrective action, if necessary. This enables the company to identify areas in which the Program is effective as well as areas where the company may need to focus greater attention, either in the form of new or revised policies and procedures or training. By investigating and addressing complaints of suspected misconduct, the company's employees will recognize that the organization is committed to upholding the tenets of the Compliance and Ethics Program and that it takes their concerns seriously.

In addition to the foregoing, an increased lack of trust of "big business" by the American public show that the benefits of adopting a Corporate Compliance and Ethics Program may outweigh the costs associated with its implementation. This is true especially when the organization considers not only the financial losses of potential lawsuits resulting from ethical breaches,

but also the potentially devastating effects of a corporate scandal.

Clearly, the world of corporate governance must grow and adapt as legislatures attempt to prevent potential widespread harm to the economy that may accompany a major corporate scandal. In the face of evolving corporate governance requirements and escalating costs associated with defending against suits alleging corporate impropriety, companies must develop appropriate compliance and ethics standards and procedures to ensure they are able to meet these challenges and continue to be profitable.

It is here, by serving the company, that in-house counsel can also protect and further their own position. An ethical culture which permeates all facets of the organization and is driven by senior management by mandate and example is counsel's most effective tool of prevention and preservation. In-house counsel's role is expected to be that of an activist, not just someone standing on the sidelines. It will be a demonstrated record of ethical activism that most effectively will protect in-house counsel and their client.

E. SOX LITIGATION¹³

Today, more than ever, "whistleblowers" – portrayed as courageous "Davids" taking on corporate or institutional "Goliaths" by reporting alleged corporate wrongdoings – occupy a prominent place in our national consciousness. The public has become increasingly aware of whistleblowing employees, the fallout from their reports of corporate malfeasance, and the threat of retaliation for engaging in whistleblowing.

According to a survey, North American companies expect to spend \$27.3 billion on legal compliance in 2006, with approximately one quarter of this amount attributable to SOX compliance issues.¹⁴¹

Years of media coverage of corporate fraud and wrongdoing have had their effect — a nationwide survey of over 1,000 jury-eligible adults conducted by Bowne DecisionQuest/MCCA, a jury consultant company, indicates a public distrust of corporations. The survey reveals that most potential jurors perceive corporations as dishonest, cold, and greedy. Further, many also believe that upper-level managers in even

¹³ We would like to acknowledge Mindy S. Novick and Nita Parikh of our Los Angeles office for their work on the preparation of this portion of the paper.

¹⁴ Laurence Arnold, *Billions Spent to Comply*, Bloomberg News, Mar. 5, 2006.

the largest corporations know “everything” that happens at corporate facilities, including at every plant, dock, and shipping station. Eighty percent of those surveyed felt corporations do not pay enough attention to employee opinions, and over 50% believe that complaining to management about work-related issues usually backfires.

Although few cases based on SOX have made their way to court thus far, the first cases are being heard in federal or state courts. As more cases move their way through the court system, we will have a better idea of how well these statistics foretell employee success in SOX cases.

1. COVERAGE BEYOND THE PUBLICLY TRADED COMPANY

One frequent area for litigation is whether a non-publicly traded subsidiary of a publicly traded company is the employer of the complainant. Recent decisions have found the non-publicly traded subsidiary is not a covered entity under SOX unless it was acting as an agent of the publicly held parent. Rao v. Daimler Chrysler, No.2:06- CV-13723 (E.D. Mich. May 14, 2007); Savastano v. WPP Group, PLC, 2007-SOX-34 (ALJ July 18, 2007). Indications that such a relationship did not exist include: (1) subsidiary acted and was run independently of the parent; (2) there was no overlap of officers; (3) the parent and subsidiary had separate offices and operations; (4) no officer and/or employee of the parent exerted control over the terms or conditions of complainant’s employment; (5) no officer or employee of the parent participated in the decision to hire or terminate the complainant.

SOX also provides for criminal penalties for retaliation against certain whistleblowing activities. Importantly, this criminal provision extends beyond the § 806 definition of covered entities to any individual or entity, publicly traded or not. Section 1107 provides for the imposition of fines or imprisonment up to 10 years to “whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense.” (Emphasis added.)

a. PROCEDURE FOR LITIGATING A SECTION 806 COMPLAINT

(1) INITIATING A COMPLAINT

To initiate a complaint under SOX, an employee who believes she has been retaliated against in violation of the Act may file a complaint of discrimination with the Secretary of Labor within 90 days after the alleged violation occurs. 29 C.F.R.

1980.103(a) and (d). No particular form of complaint is required, except that it must be in writing and should include a full statement of the acts and omissions, with pertinent dates, believed to be violations. 29 C.F.R. 1980.103(b). Typically, the complaint is in the form of a letter to the Secretary. Telephonic complaints are insufficient. Foss v. Celestica, 2004-SOX-4 (Jan. 8, 2004). The complaint is filed with the Occupational Safety and Health Administration (“OSHA”) area director responsible for enforcement activities in the geographic area where the employee resides or was employed, or with any OSHA officer or employee. 29 C.F.R. 1980.103(c). An administrative law judge then hears the complaint.

The 90-day limitations period begins once the complainant is aware or reasonably should be aware of the employer’s decision. See comment to 29 C.F.R. 1980.103, citing EEOC v. United Parcel Service, 249 F.3d 557, 561-62 (6th Cir. 2001).

A large percentage of cases are dismissed by OSHA on the basis of late filing.¹⁵ See also Sneed v. Radio One, Inc., 2007-SOX-18 (ALJ April 16, 2007) (time for filing complaint began to run from time complainant was advised she was being terminated, not from the time discussions about severance ended); Coppinger Martin v. Nordstrom, Inc., 2007-SOX-19 (ALJ April 4, 2007) (operative date for the running of the statute of limitations is the date the complainant is aware of the adverse employment action, not the date the complainant becomes aware of the causal connection between her protected activity and the adverse employment action, unless the complainant was lulled into inaction by the respondent.); Moldauer v. Canandaigua Wine Co., 2003-SOX26 (Nov. 14, 2003). See e.g., Rollins v. American Airlines, Inc., ARB No.04 140, ALJ No. 2004 AIR9 (ARB April 3, 2007) (complaint was timely if measured from date of termination letter but untimely if measured from date of letter giving employee choice of resignation, termination or reassignment; ARB held time ran from date of letter giving complainant choices).

¹⁵ In a study conducted by Richard E. Moberly, Assistant Professor of Law, Univ. of Nebraska College of Law, to be published in the William and Mary Law Review, Prof. Moberly concluded that 72 percent of cases are dismissed based on statute of limitations.

(2) INVESTIGATION BY OSHA

Upon receipt of the complaint in the investigating office, the Assistant Secretary will notify the named person or persons of the filing of the complaint, and of the substance of the evidence supporting the complaint. 29 C.F.R. §1980.104(a). This information may be redacted to protect the identity of any confidential informants. *Id.* Statements made in the course of the OSHA investigation are entitled to absolute privilege, including statements made to administrative agencies acting in a quasi-judicial capacity. Morlan v. Qwest, Inc., 2004 WL 1900368 (D. Or. Aug. 25, 2004).

Within 20 days of receipt of the notice, the respondent may submit to the Assistant Secretary a written statement and any affidavits or documents to demonstrate by clear and convincing evidence that it would have taken the same action even in the absence of the complainant's protected activity. 29 C.F.R. §1980.104(c). A copy of the notice is also sent to the SEC. 29 C.F.R. §1980.104(a).

A SOX complaint will be dismissed unless the complainant has made a *prima facie* showing that protected behavior or conduct was a contributing factor in the unfavorable personnel action alleged in the complaint. 29 C.F.R. §1980.104(b). The *prima facie* showing is determined based on information contained in the complaint, supplemented as deemed appropriate by OSHA, interviews with the complainant, and allegations of the existence of facts and evidence showing: (1) the employee engaged in a protected activity or conduct; (2) the named person knew or suspected, actually or constructively, that the employee engaged in the protected activity; (3) the employee suffered an unfavorable personnel action; and (4) the circumstances were sufficient to raise the inference that the protected activity was a contributing factor in the unfavorable action. *Id.* This *prima facie* showing may be made through either direct or circumstantial evidence. *Id.* OSHA regulations specifically state a complainant will satisfy his initial burden by showing that the action took place shortly after the protected activity. *Id.* As such, temporal proximity alone generally is sufficient to prove causation. However, the complainant must have been an employee at the time he alleges the adverse action took place. Alleged actions occurring after the termination of complainant's employment are not covered by SOX. See e.g.

Pittman v. Siemens AG, 2007-SOX-15 (ALJ July 26, 2007) (alleged slander of complainant by company two years after employment had ended was not an adverse employment action). In response, an employer must prove by clear and convincing evidence that any adverse action had no relation to the whistleblowing activity.

This investigational framework places a low burden of proof on the complainant and a high burden upon a responding employer. Despite the low burden of proof, companies that comply with their own rules and policies for dealing with allegations of wrong-doing by an employee and that document performance issues will be able to defeat a complainant's claim. In Grove v. EMC Corp., 2006 SOX-99 (ALJ July 2, 2007), the ALJ found that complainant's protected activity actually prolonged his employment as the employer avoided taking action for otherwise terminable offenses. It was only when the complainant refused to cooperate with the company's investigation of his complaint and stopped working that he was discharged. The ALJ found that complainant's exercise of protected activity was not a contributing factor in his termination.¹⁶

If the complainant has not made a *prima facie* showing, OSHA will notify the complainant and no investigation will take place. *Id.* OSHA also will decline to investigate a complaint if the employer demonstrates by clear and convincing evidence that it would have taken the same unfavorable personnel action in the absence of the complainant's protected activity. 29 C.F.R. §1980.104(d). If the complainant passes the "gatekeeper" initial review, the Assistant Secretary will conduct an investigation. *Id.* The investigation will be conducted in any manner that will protect the confidentiality of any person who provides information on a confidential basis. *Id.*

If, following its investigation, the Assistant Secretary has reasonable cause to believe the named entity has violated SOX, and preliminary reinstatement is warranted, the Assistant Secretary will notify the named entity. *Id.* The Assistant Secretary

¹⁶ The ALJ found that complainant "had blown the whistle, and [respondent was ready to listen. However, over the next several weeks, [complainant] swallowed the whistle and decided not to cooperate...." *Id.* At slip op. 27.

will provide notice of the substance of the relevant evidence developed through the investigation, including any witness statements, either redacted or summarized to protect the identities of confidential informants. *Id.* The named entity has ten (10) business days from the receipt of such evidence to submit a written response, meet with investigators to present statements from witnesses, and make legal and factual arguments in support of its position that any adverse action was nonretaliatory. *Id.* This ten-day period may be extended by agreement, in the interest of justice, between the Assistant Secretary and the named entity. *Id.*

(3) INITIAL DECISION AND PRELIMINARY ORDER

Under the regulations, OSHA is required to conclude its initial investigation and issue written findings within 60 days of the filing of the complaint. 29 C.F.R. §1980.105(a). In practice, the investigation is rarely concluded in this period of time. In 2005, the average number of days for OSHA to complete an investigation was 127, slightly down from 130 days in 2004.¹⁷ If the Assistant Secretary concludes there is reasonable cause to believe a SOX violation has occurred, he shall include a preliminary order providing relief to the complainant along with the initial findings. *Id.*

The preliminary order shall include all relief necessary to make complainant whole, including, where appropriate: reinstatement with the same seniority the employee would have had but for the adverse action; back pay with interest; and compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney's fees. *Id.* An order of reinstatement is effective immediately upon receipt of the findings and preliminary order. 29 C.F.R. §1980.105(c).

The Assistant Secretary will also notify the parties if it determines no violation has occurred. 29 C.F.R. §1980.105(b). A copy of this notice is also sent to the Chief Administrative Law Judge, U.S. Department of Labor, along with a copy of the original complaint. *Id.*

(4) APPEAL TO THE OFFICE OF ADMINISTRATIVE LAW

The parties have 30 days from receipt of the initial findings and preliminary order to file written objections or request a hearing with the Chief Administrative Law Judge. 29 C.F.R. §1980.106(a).¹⁸ If no objections ~~are~~ filed within this period, the findings and preliminary order will become the final decision of the Secretary, not subject to judicial review. 29 C.F.R. §1980.105(c); §1980.106(b)(2).

The date of the filing of objections is based upon the date of the postmark, facsimile transmittal, or e-mail. 29 C.F.R. §1980.106(a). Copies of the objections also must be sent to all parties of record, the OSHA official who issued the findings and order, and the Associate Solicitor, Division of Fair Labor Standards. *Id.* The timely filing of objections stays all aspects of the preliminary order other than an order of reinstatement. 29 C.F.R. §1980.106(b).¹⁹ To obtain a stay of an order of reinstatement, the named person may file a motion with the ALJ seeking a stay of a preliminary order of reinstatement. *Id.*

Before the filing of objections or the preliminary order becoming final, the Assistant Secretary may withdraw his findings or preliminary order and substitute new findings or preliminary order. 29 C.F.R. §1980.111(b). The date of the receipt of the substituted findings or order will begin a new 30-day objection period. *Id.* Additionally, at any time prior to the filing of objections, a complainant may withdraw his or her complaint, subject to approval by the Assistant Secretary. *Id.*

¹⁸ A request by the named party for attorney's fees based on an allegation the complainant filed a frivolous complaint or filed the complaint in bad faith must also be made to the ALJ within this 30-day period. 29 C.F.R. § 1980, 106(a).

¹⁹ Absent prejudice to the respondent by the improper service, failure of a complainant to timely serve the respondent with a copy of his objections and request for hearing does not necessarily warrant a dismissal of the complaint. See *Richards v. Lexmark Int'l, Inc.*, 2004-SOX-49 (Oct. 1, 2004); see also *Lerbs v. Buca Di Beppo, Inc.*, 2004-SOX-8 (Dec. 30, 2003) (noting that SOX regulations were not jurisdictional and therefore were subject to equitable considerations, including tolling, when the complainant failed to timely serve respondent with a request for an ALJ hearing due to inadequate instructions in the ALJ determination letter).

¹⁷ Statistics compiled by OSHA.

Neither the dismissal of the complaint without an investigation nor the determination to investigate is subject to ALJ review. 29 C.F.R. §1980.109(a).

A hearing before the ALJ is conducted in accordance with the rules of practice and procedure for administrative hearings before the Office of Administrative Law Judges. 29 C.F.R. §1980.107(a). Hearings are expeditious and the review is *de novo* on the record. 29 C.F.R. §1980.107(b). The ALJ has broad discretion to limit discovery. The ALJ may, for example, limit the number of interrogatories, document requests or depositions. *Id.* Formal rules of evidence do not apply. 29 C.F.R. §1980.107(d). Rules or principles designed to assure the production of the most probative evidence will be applied, and the ALJ may exclude evidence that is immaterial, irrelevant, or unduly repetitious. *Id.* The Assistant Secretary and the SEC may appear as *amicus curiae* at the hearing. 29 C.F.R. §1980.108. The scope of the OSHA investigation does not establish boundaries of the factual inquiry permitted in the subsequent adjudication by an ALJ. Morefield v. Exelon Services, Inc., 2004-SOX-2 (Jan. 28, 2004). While new violations may not be raised after 90 days, the statute and the regulations provide for both discovery and a *de novo* hearing regarding the protected activities and the reasons for the adverse action regardless of OSHA's findings. *Id.*

If the ALJ concludes the named entity has violated the Act, she will issue an order providing all relief necessary to make the employee whole, including all remedies available to the Assistant Secretary. 29 C.F.R. §1980.109(b). An order of reinstatement or lifting a stay of reinstatement becomes effective upon receipt of the decision by the named person. 29 C.F.R. §1980.109(c). If the ALJ determines the complaint was frivolous or brought in bad faith, she may award the named entity a reasonable attorney's fee not to exceed \$1,000. 29 C.F.R. §1980.109(b).

(5) PETITION FOR REVIEW BY THE ADMINISTRATIVE REVIEW BOARD

Either party may seek review of an ALJ decision by filing a written petition for review with the Administrative Review Board within ten (10) business days after the date of the

ALJ's decision. 29 C.F.R. §1980.110(a). All provisions of the ALJ's order are stayed upon a filing of a petition for review with the ARB, except an order of reinstatement or lifting a stay of reinstatement. 29 C.F.R. §1980.109(c). The petition for review must identify the findings, conclusions or orders to which exception is taken. 29 C.F.R. §1980.110(a). Any exception not specifically pled will be deemed to have been waived by the parties. *Id.* At the time the petition is filed with the ARB, the petition must be served on all parties of record, the Chief ALJ, the Assistant Secretary of OSHA and the Associate Solicitor, Division of Fair Labor Standards. *Id.*

If no petition is filed, the ALJ's decision will become the final order of the Secretary. 29 C.F.R. §1980.110(a). The ALJ's decision will also become the final decision of the Assistant Secretary unless the ARB accepts the case for review within 30 days of the filing of the petition. 29 C.F.R. §1980.110(b). If the case is accepted for review, the ALJ's decision will be inoperative unless and until the ARB issues an order adopting the decision, except that a preliminary order of reinstatement will be effective while the ARB conducts its review, unless the ARB stays the order. *Id.* The ARB will determine the terms under which any briefs are to be filed, and its review is under the substantial evidence standard. *Id.*

The ARB shall issue a final decision within 120 days of the conclusion of the hearing, which concludes the proceedings before the ALJ. 29 C.F.R. §1980.110(c). As with the Assistant Secretary and the ALJ, if the ARB finds the named party has violated the Act, it may order any remedy necessary to make the complainant whole. 29 C.F.R. §1980.110(d). If the ARB determines that no violation has occurred, upon the request of the named person, the ARB may award a reasonable attorney's fee not to exceed \$1,000. 29 C.F.R. §1980.110(e).

Within 60 days after the issuance of a final order by the ARB, any person affected or aggrieved by the order may file a petition for review with the United States Court of Appeals for the circuit in which the violation allegedly occurred, or the circuit in which the complainant resided at the date of the violation. 29 C.F.R. §1980.112(a).

(6) WITHDRAWAL, DISMISSAL AND SETTLEMENT

At any time prior to the filing of objections to the findings and preliminary order, a complainant may withdraw his or her complaint, subject to approval by the Assistant Secretary. 29 C.F.R. §1980.111(a). At any time prior to the findings or order becoming final, either party may withdraw its objections, subject to approval by either the ALJ or the ARB, depending on where the matter is then located. 29 C.F.R. §1980.111(c). The parties also can agree to settle at any time prior to a final decision. 29 C.F.R. §1980.111(d). Settlements are subject to the approval of the body having jurisdiction of the action at the time. *Id.* Any such settlement will constitute the final order of the Secretary. 29 C.F.R. §1980.111(e).

(7) ADR AGREEMENTS

With respect to inclusion of SOX whistleblower claims in alternative dispute resolution agreements, the few courts which have considered the issue have found agreements enforceable. Kimpson v. Fannie Me Corp., No.1:06-CV-00018 (D.D.C. Mar. 31, 2007) (employee had consented to arbitration but SOX was not included in the list of statutes covered by the agreement because it had not yet been passed; relying on statement in the agreement that “any claims involving rights protected by federal statute”, the court held the arbitration agreement was binding); Green v. Service Corp., Int’l, No. 4:06-CV-00833 (S.D. Tx. June 30, 2006) (company could compel arbitration even after defending in administrative proceedings at DOL); Boss v. Salomon Smith Barney, Inc., 263 F. Supp. 2d 684 (S.D.N.Y. 2003) (court noted the Act does not prohibit such resolution of claims).

(8) ENFORCEMENT OF ORDERS AND AGREEMENTS

Whenever any person has failed to comply with a preliminary order of reinstatement, a final order, or the terms of a settlement agreement, the Secretary or the person on whose behalf the order was issued may file a civil action seeking enforcement in the U.S. district court where the violation occurred. 29 C.F.R. §1980.113.

b. PROCEEDING IN FEDERAL COURT: A “SECOND BITE” OF THE APPLE

If, after 180 days from the filing of the complaint, the matter has not proceeded to a final decision on OSHA’s initial determination, an appeal to an ALJ, or an appeal to the ARB, and there is no showing that the delay is the result of bad faith, the complainant may bring an action at law or equity for *de novo* review in the appropriate federal district court. 29 C.F.R. §1980.114(a). This is significant since, on a practical basis, many SOX complaints do not proceed to a final decision within 180 days. A complainant’s ability to proceed in federal court after the expiration of the 180- day period is not premised on a showing of good faith, but only that any delay in a final determination was not a result of the complainant’s bad faith. Collins v. Beazer Homes USA, Inc., 2004 WL 2023716 (N.D. Ga. Sept. 2, 2004).

A complainant is not required to exhaust administrative remedies prior to bringing an action in federal court, as long as 180 days have passed since the filing of the complaint. See Hanna v. WCI Communities, Inc., 2004 WL 2931133 (S.D. Fla. 2004). The complainant must file notice of such action with the ALJ or the ARB, depending on where the proceeding is pending, 15 days before filing in the district court. 29 C.F.R. §1980.114(b). The notice must be served upon all parties to the proceeding, the Assistant Secretary of OSHA and the Associate Solicitor, Division of Fair Labor Standards. A party can only proceed in federal court against those parties named as respondents in the complaint filed with the DOL. Hanna v. WCI Communities, Inc., 2004 WL 2931133 (S.D. Fla. 2004).

The 180-day provision makes the Sarbanes-Oxley Act unique. It permits an employee to file an action in U.S. district court after an initial decision has been made by OSHA if more than 180 days have elapsed from the filing of the complaint. The Act refers to a final decision of the “Secretary,” while the regulations refer to a final decision of the ARB. The comments to 29 C.F.R. §1980.114(a) indicate the DOL believes that preclusion would bar a federal action instituted after the ARB issued a final decision, as the parties would have had the opportunity to litigate all claims. Fed. Reg. Vol. 69, No. 163:52111. However, one court has held that the findings and preliminary order were not preclusive. Hanna v. WCI Communities, Inc., 2004 WL 2931133 (S.D. Fla. 2004).

In Collins v. Beazer Homes USA, Inc., 334 F. Supp.2d 1365, 1373 (N.D. Ga. 2004), the complaint was filed with the DOL in October 2002. On May 20, 2003, the plaintiff filed a complaint in federal court asserting claims under SOX. Id. at 1371-2. Two days later, the DOL issued a preliminary finding that the complainant had not shown a violation under the Act. Id. at 1371. The district court found it had jurisdiction over plaintiff's claims because the DOL did not issue its findings until after 180 days from the filing of the initial complaint.²⁰ Id. at 1374. If the DOL's failure to issue a decision within 180 days was attributable to bad faith on the part of the plaintiff, it would not have jurisdiction over the plaintiff's claims. However, the court found the delay was attributable primarily to extensive settlement negotiations between the parties. Id. at 1374. While the DOL's file suggested the delay may have in some part been caused by plaintiff's failure to cooperate with investigators and her misrepresentations regarding representation by counsel, the court concluded the mere suggestion of bad faith, absent a greater showing, does not defeat jurisdiction. Id. at n.8.

2. PRACTICAL DIFFICULTIES WITH SOX AND OTHER WHISTLEBLOWER PROTECTION STATUTES

a. WHISTLEBLOWERS CAN BE WRONG

One of the most widely misunderstood elements of whistleblower laws is that a whistleblower generally does not have to be correct: the complained-of activity need not actually be a violation of a rule, regulation, or policy. The complainant need only have a "reasonable belief" that the activity is illegal or a violation. Thus, an employee may accuse her employer of wrongdoing erroneously but still be entitled to whistleblower protection and damages if she can show retaliation by the employer for her complaint about a believed violation of an identifiable law, rule, regulation or policy, and that her belief is objectively reasonable. Grove v. EMC Corp., 2006-SOX-99 (ALJ July 2, 2007); Johnson v. Stein Mart, Inc., No. 3:06-CV-00341 (M.D. Fla. June 20, 2007).²¹ Moreover, whistleblowing need not be the sole

²⁰Because [the DOL] failed to issue findings within 180 days and there was no showing of bad faith, jurisdiction [of the district court] in this case is proper."

²¹ For a comprehensive review of the law to date on what constitutes protected activity see Deremer v. Gulfmark Offshore, Inc., 2006-SO-2 (ALJ June 29, 2007).

reason for an adverse employment action to support a complaint.

b. INVESTIGATING SUPERVISORS AND HIGH-LEVEL OFFICERS

Often, in a Sarbanes-Oxley internal complaint situation, an accused is a high-level officer, or even the CEO of the company. To avoid an uncomfortable internal investigation that may seem biased, a law firm or accounting firm should be retained to conduct the investigation.

However, a company should be aware that if a lawyer or law firm is retained to investigate, they become fact witnesses in the event of subsequent litigation, and will likely be unable to serve as litigation counsel. Therefore, a company should use one law firm for potential litigation and advice and another for the investigation. Additionally, using a lawyer to investigate a complaint does not mean the findings will be protected by the attorney-client privilege or the work product doctrine. This is particularly true if the company intends to rely upon the investigation in any litigation.

c. ALL COMPLAINTS MUST BE INVESTIGATED

Section 301 of the Sarbanes-Oxley Act mandates that the Audit Committee of a covered entity's Board of Directors establishes procedures for the receipt, retention, and treatment of confidential, anonymous complaints regarding accounting, internal auditing controls, or auditing matters. Although employment lawyers long have recommended that employers investigate all complaints, this is imperative for complaints under the Act which reach well beyond whistleblowing. Companies covered by Sarbanes-Oxley are subject to government investigations and to criminal penalties for securities law violations separate and apart from any related whistleblower claim by an employee. Even if a complaint by a whistleblower is settled or quickly resolved, a complete investigation must be conducted to ensure that the various reporting and internal control requirements of Sarbanes-Oxley are effective.

3. PRACTICAL CONSIDERATIONS TO PREPARE FOR AND ADDRESS WHISTLEBLOWER COMPLAINTS

Given the broad impact of SOX and other whistleblower protection laws, companies increasingly are developing and implementing ethics and compliance programs (a somewhat amorphous term). These programs are generally understood to include

many components, including: a code of ethics, company policies and procedures (i.e., anti-harassment and discrimination policies and complaint procedures in employee manuals), training and education programs, and effective monitoring of workplace conduct. A Compliance Program informs all employees, not just upper management, that they are expected to act in an ethical and appropriate manner.

There are many reasons to develop and implement a corporate Compliance Program.²² First, Sarbanes-Oxley mandates that publicly-traded companies develop and implement a code of ethics to address financial reporting, accounting, and auditing practices, and general business conduct. NASDAQ and the NYSE have promulgated similar requirements for listed companies. In particular, § 406

²² Companies that implement Compliance Programs may face reduced sentences for corporate wrong doing under the Federal Criminal Sentencing Guidelines. No company or organization, for-profit or not-for-profit, is exempt from the reach of the Guidelines. The implementation of an effective Compliance Program is one factor considered by the government to lower "culpability scores" under the Guidelines. More particularly, a company's culpability under the Guidelines is generally determined by: 1) a company's involvement in or tolerance of criminal activity; 2) a company's prior history of misconduct; 3) a company's violation of an order; 4) a company's obstruction of justice; 5) the existence of an effective compliance and ethics program by a company; and 6) a company's self-reporting, cooperation, and acceptance of responsibility. The Guidelines apply to all organizations whether publicly or privately held, and of whatever nature—corporations, partnerships, labor unions, pension funds, trusts, nonprofit entities, and governmental units.

According to the United States Sentencing Commission, an effective ethics and compliance program must require the organization to "exercise due diligence to prevent and detect criminal conduct" and "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law." United States Sentencing Commission, Guidelines Manual, §8B2.1 (a) (Nov. 2005). Examples of "due diligence" cited by the Sentencing Commission include: (1) the governing authority must have knowledge of the content and operation of the program and must exercise reasonable oversight of its implementation and effectiveness; (2) high-level personnel must be charged with putting an effective program in place; (3) individuals within the company must be designated to oversee the day-to-day operation and must have the resources to oversee the program; and (4) the company must ensure the program is being followed and is effective, and must publicize a system for anonymous reporting and obtaining guidance on questionable conduct without fear of retaliation. United States Sentencing Commission, Guidelines Manual, §8B2.1 (a).

of Sarbanes-Oxley requires each covered publicly-traded entity to adopt, or explain why it has not adopted, a "code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions." The NASDAQ and NYSE requirements for a code of ethics extend to all employees of covered entities.

Even if not required by SOX, NASDAQ, or the NYSE, Compliance Programs make good business and practical sense and are likely to improve company image both internally and externally. A recent study revealed that companies emphasizing ethics as an important management strategy were two times more likely to be among the top financial performers.

4. PROGRAM PREPARATION, PUBLICATION AND TRAINING

In preparing policies in connection with a Compliance Program, companies should keep the following points in mind:

- Policies should include examples of the types of activities that are prohibited.
- Policies should describe the consequences employees will face for violating the policies.
- Policies should encourage all employees, including management, to report concerns regarding any violations or suspected violations.
- Policies should include a reporting procedure that is easy to use and that identifies the individuals, by title, who should receive such reports. The individuals must be management level and trained to gather all information and conduct a thorough investigation. The procedures should allow complaints to be lodged with someone other than direct supervisors.
- Policy language should assure that investigations of Sarbanes-Oxley complaints will be undertaken in an independent manner.
- Policies should allow for alternative or multiple means of reporting complaints (Sarbanes-Oxley requires an anonymous method). Employers considering an outside hotline should research options, obtain vendor references, verify reputation and independence, and insure procedures are followed for documenting and forwarding calls to the correct location and individuals while maintaining confidentiality.
- Policies should assure that all complaints will be taken seriously, investigated promptly, and result in appropriate corrective action.
- Policies should state that, where a report is not made anonymously, it will be kept

confidential to the extent possible and in accordance with the law, but should advise that absolute confidentiality cannot be guaranteed.

- Policies should include language indicating the company will not retaliate against an employee who, in good faith, makes a report or who assists in an investigation or claim regarding alleged violations, and reiterate that retaliation against an employee will not be tolerated by management, other employees, agents, contractors, or subcontractors of the company.
- The policy language should be unambiguous and easily understandable.

Once developed, Compliance Program policies must be disseminated and communicated. Employers should incorporate training into all new employee orientations and train current employees on an annual basis. Such training should review the Compliance Program in its entirety. Employers should consider interactive training methods, such as live training combined with online training through the employer's intranet or a third-party provider, and supplemental written materials should be provided for future reference. The employer should keep attendance and participation records for each training session.

Other considerations are also important:

- Ideally, the policy should be a separate chapter in the employee handbook provided to every employee.
- Receipt and understanding of the policy should be documented in writing and retained for every employee.
- The policy should be redistributed and reviewed at training sessions. Training also should review conduct that is both required and prohibited and behavior that is considered appropriate and inappropriate.
- **BE PROACTIVE AND USE COMMON SENSE.**

II. WAGE AND HOUR COMPLIANCE – PREEMPTING WAGE AND HOUR COLLECTIVE ACTIONS²³

A. INTRODUCTION

Paying employees for services rendered: every business must do it, and it is in many ways the most important element of the employer-employee relationship. This year marks the 70th anniversary of

one of the most far-reaching federal laws enacted during the New Deal, the Fair Labor Standards Act of 1938 (the “FLSA”).²⁴ The FLSA generally requires payment of a minimum wage per hour worked, plus premium pay of at least time-and-a-half for hours worked beyond 40 in a workweek.²⁵ Even though the FLSA and numerous state-law counterparts have been on the books for decades, the laws continue to present severe compliance challenges for employers, giving rise to the most frequently filed employment-law class and collective actions in the federal courts today,²⁶ as well as very substantial state-court class action litigation.²⁷

One of the most common wage and hour claims in large, multi-plaintiff lawsuits involves employees who allegedly are not exempt from the overtime requirements of the FLSA claiming they have not been paid for all the hours worked. This so-called “off-the-clock” claim can arise in several ways. *First*, a claim can focus on normal work duties performed outside the usual work schedule, with employees contending their supervisors either pressured them not to record all hours worked or altered time records to omit work time. *Second*, employees may seek compensation for tasks the employer has regarded as non-compensable. *Third*, employees may contest their employer's time-keeping procedures, contending the procedures short-change the employees' wages. This article briefly discusses each of these issues.²⁸

²⁴ 29 U.S.C. §§ 201-219.

²⁵ *See id.* §§ 206(a), 207(a)(1). These rules are subject to dozens of exemptions set forth in, among other places, subsections (a) and (b) of section 13 of the FLSA. 29 U.S.C. § 213(a)-(b).

²⁶ *See* Michael Bologna, *Class Action Fairness Act Had Little Impact on 2007 Filings of Workplace Suits*, Daily Lab. Rep. (BNA), Jan. 22, 2008, at A-6.

²⁷ The FLSA provides an opt-in mechanism for workers to join a lawsuit. *See* 29 U.S.C. § 256(b). Where a court certifies the plaintiffs are similarly situated and authorizes notice to other potentially similarly-situated workers, the case is called a “collective” action. *See id.* § 256. Claims under state wage and hour laws, by contrast, are ordinarily brought as “class” actions in which, upon certification of the class, all class members are covered by the lawsuit unless they take the step of opting out of the case.

²⁸ Although this article focuses on federal law, a number of states have wage-hour laws that differ significantly from the FLSA. Employers must comply with all applicable laws, including federal, state, and local statutes, regulations, and ordinances.

²³ We would like to acknowledge Paul DeCamp of our Washington, D.C. Region office and Cary G. Palmer of our Sacramento office for their work in the preparation of this portion of this paper.

B. EMPLOYEES SEEKING UNPAID WAGES ON TASKS ORDINARILY COMPENSATED

One important type of off-the-clock claim concerns alleged non-payment for the performance of job duties the employer ordinarily regards as compensable work. Many cases arise where employees allege their supervisors directed them not to record all of their working hours²⁹ or altered employees' time cards to reflect fewer than actual hours worked.³⁰ The legal principle is that so long as an employer knows or has reason to know an employee is performing services for the employer, the employer must compensate the employee for that time.³¹ In these disputes, the focus is generally on whether the employees worked the hours alleged; if they worked the hours, and if the employer had actual or constructive knowledge of the work, the employees are entitled to be paid for the unrecorded time.

C. EMPLOYEES SEEKING COMPENSATION FOR ORDINARILY UNCOMPENSATED TASKS

Another significant type of off-the-clock claim involves time spent on tasks that are not part of an employee's core job duties and that the employer does not ordinarily treat as compensable work, calling into question the very notion of what it means to "work." One variant of this claim addresses matters occurring at the beginning or end of shifts, presenting the issue of what precise events start and stop the workday. A related challenge addresses an employer's practice of treating various types of activity or inactivity, whether during or outside the normal workday, as uncompensated.

²⁹ See, e.g., Michael R. Triplett, *Federal Judge OKs \$53.3 Million Settlement With Albertson's Over "Off-the-Clock" Claims*, Daily Lab. Rep. (BNA), Mar. 26, 2007, at A-9 (discussing settlement involving roughly 7,000 workers alleging, inter alia, they were required to perform uncompensated work).

³⁰ See, e.g., *Coca-Cola to Pay \$14 Million to Settle Wage Suit*, Daily Lab. Rep. (BNA), Feb. 22, 2007, at A-10 (discussing settlement in case where the workers alleged, inter alia, time record alteration).

³¹ See *Chao v. Gotham Registry, Inc.*, 2008 U.S. App. LEXIS 1327, at *15 (2d Cir. Jan. 24, 2008). The Second Circuit held an employer must pay for overtime hours worked by employees who failed to follow a policy requiring pre-approval for work beyond the normal schedule. The court concluded the employer could not deny payment based on its policy where it had reason to know that the overtime work was being performed, notwithstanding the lack of pre-approval, and the employer failed to take adequate steps to prevent that work from occurring. See *id.* at *10-26.

1. When Does the Workday Begin and End?

The Supreme Court has long held tasks "performed either before or after the regular work shift, on or off the production line" must be treated as work "if those activities are an integral and indispensable part of the principal activities" of an employee's position.³² In 2005, the Court issued a unanimous decision in *IBP, Inc. v. Alvarez*,³³ concluding that "during a continuous workday, any walking time that occurs after the beginning of the employee's first principal activity and before the end of the employee's last principal activity" is compensable.³⁴ The Court's endorsement of the continuous workday rule, including compensation for many otherwise noncompensable tasks occurring between the workday's first and last principal activity, underscores the importance of determining exactly when the workday starts and concludes.

a. Donning and Doffing Protective Gear, Clothing, and Uniforms

Whether time spent putting on ("donning") and removing ("doffing") protective gear, clothing and uniforms is compensable working time depends on the nature of the specific items. In *Alvarez*, the Court read its precedent as establishing the rule that donning and doffing "specialized protective gear" are compensable activities.³⁵ In *Alvarez*, the workers at a meat producer's facility wore "outer garments, hardhats, hairnets, earplugs, gloves, sleeves, aprons, leggings, and boots," and many employees also wore "chain link metal aprons, vests, plexiglass armguards, and special gloves."³⁶ The parties did not dispute the lower court's determination that these items constituted "unique protective gear," the donning and doffing of which were compensable.³⁷

Where protective gear is not unique or specialized, courts are split on the compensability of donning and doffing. In *Gorman v. Consolidated Edison Corp.*,³⁸ the U.S. Court of Appeals for the Second Circuit concluded that the time workers at a nuclear power station spent donning and doffing "a helmet, safety glasses, and

³² *Steiner v. Mitchell*, 350 U.S. 247, 256 (1956).

³³ 546 U.S. 21 (2005).

³⁴ *Id.* at 37.

³⁵ *Id.* at 30 (citing *Steiner*, 350 U.S. at 256).

³⁶ *Id.*

³⁷ *Id.* at 32.

³⁸ 488 F.3d 586 (2d Cir. 2007), petition for cert. filed, No. 07-1019 (U.S. Jan. 30, 2008).

steel-toed boots” was not compensable work because these duties involved “generic protective gear” and thus were not “integral” to the workers’ principal activities.³⁹

In *Spoerle v. Kraft Foods Global, Inc.*,⁴⁰ by contrast, a federal court in Wisconsin held that the time meat processing workers spent donning and doffing “a hard hat or bump-cap, steel-toed shoes or sanitation boots, ear plugs, hairnet and beard net, safety glasses, a freezer coat (if necessary), gloves, plastic gloves, paper frock or plastic apron, sleeves, slickers (for employees that work in wet areas) or a cotton frock” was compensable.⁴¹ The court dismissed *Gorman* as “truly bizarre,”⁴² holding instead that “[b]ecause plaintiffs need to put on the equipment in order to perform their job safely, their doing so is ‘an integral and indispensable part’ of a ‘principal activity.’”⁴³ Under this analysis, donning and doffing any necessary protective gear may be compensable.

For unionized employees, Section 3(o) of the FLSA deems noncompensable “any time spent in changing clothes or washing at the beginning or end of each workday which was excluded . . . by the express terms of or by custom or practice under a bona fide collective-bargaining agreement.”⁴⁴ Significant questions arise, however, regarding the definition of “clothes,” including whether the term includes personal protective equipment or employees’ non-protective uniforms. The U.S. Department of Labor (“DOL”) has taken the position, since *Alvarez*, that “the ‘changing clothes’ referred to in Section 3(o) applies to putting on and taking off the protective safety equipment typically worn by employees in the meat packing industry . . . such as mesh aprons, sleeves and gloves, plastic belly guards, arm guards, and shin guards.”⁴⁵ Similarly, in *Anderson v. Cagle’s, Inc.*,⁴⁶ the Eleventh Circuit concluded Section 3(o) authorized a

poultry processor’s practice of not paying for donning and doffing “various articles of protective clothing, including smocks, hair/beard nets, gloves, and hearing protection.”⁴⁷ The court considered these items to be “general protective clothing” that “fit squarely within the commonly understood definition of ‘clothes.’”⁴⁸

Other courts have concluded non-protective articles of clothing do not meet the definition of “clothes” under Section 3(o). In *Hoyt v. Ellsworth Cooperative Creamery*,⁴⁹ a federal court in Wisconsin considered creamery workers who were required to change into and out of “sanitary/safety uniforms consist[ing] of clean pants, a clean shirt, a hairnet and a hard hat” at their employer’s facility.⁵⁰ The court held that because the uniforms were, *inter alia*, job-related and for the employer’s benefit, donning and doffing these items did not constitute “changing clothes.”⁵¹ In *Lemmon v. City of San Leandro*,⁵² a federal court in California likewise concluded police patrol officer uniforms and related gear are not “clothes” for purposes of Section 3(o) because of the special “gravitas” associated with the uniform, which thereby enhances officer safety, and because the uniform benefits the employer.⁵³

b. Security Checks

Most courts have treated time spent passing through security checks as non-compensable. In *Gorman*, for example, the court held the 10-30 minutes a day that nuclear power station employees spent passing through security screening, including waiting in line at a vehicle entrance, swiping an employee card, and undergoing handprint analysis, were similar to travel and not integral to the employees’ principal activities.⁵⁴ Similarly, in *Bonilla v. Baker*

³⁹ 488 F.3d at 594.

⁴⁰ No. 3:07-cv-00300-bbc, 2007 U.S. Dist. LEXIS 95037 (W.D. Wis. Dec. 31, 2007).

⁴¹ *Id.* at *3, *8-9.

⁴² *Id.* at *10-11.

⁴³ *Id.*

⁴⁴ 29 U.S.C. § 203(o).

⁴⁵ Wage and Hour Opinion Letter FLSA2007-10 (May 14, 2007).

⁴⁶ 488 F.3d 945 (11th Cir. 2007), *petition for cert. filed*, No. 07-910 (U.S. Jan. 4, 2008).

⁴⁷ *Id.* at 955-56.

⁴⁸ *Id.*

⁴⁹ No. 07-cv-386-jcs, 2008 U.S. Dist. LEXIS 2042 (W.D. Wis. Jan. 10, 2008).

⁵⁰ *Id.* at *3-4.

⁵¹ *Id.* at *15-17.

⁵² No. C 06-07107 MHP, 2007 U.S. Dist. LEXIS 90278 (N.D. Cal. Dec. 7, 2007).

⁵³ *Id.* at *16, *20.

⁵⁴ *Gorman v. Consol. Edison Corp.*, 488 F.3d 586, 591, 593-94 (2d Cir. 2007), *petition for cert. filed*, No. 07-1019 (U.S. Jan. 30, 2008).

Concrete Construction, Inc.,⁵⁵ the Eleventh Circuit concluded that time construction workers on an airport project spent passing through a federally-required security checkpoint before proceeding to the tarmac was neither integral nor indispensable to their job duties and did not benefit the employer, and thus was non-compensable.⁵⁶ The court also held that time spent before and after the checkpoint riding in employer-provided vehicles to the work site was non-compensable.⁵⁷

c. Checking E-mail, Voice Mail, and Assignments at Home

At least one court has held that checking e-mail at home, and other related activities, can be a principal activity for purposes of the continuous workday, thereby rendering commuting time after the first principal activity and before the final principal activity of the workday compensable as well. In *Dooley v. Liberty Mutual Insurance Co.*,⁵⁸ a federal court in Massachusetts considered an insurance company's automobile damage appraisers. While at home at the start or end of each workday, the employees must check their e-mail and voice mail, make various telephone calls, download their assignments for the following day, and perform other work-related tasks. The employer paid for these tasks if the employees reported spending time on the duties.⁵⁹ The employees, however, also sought compensation for the time spent driving from home to their first appointment of the day and from their last appointment back home. The court agreed the driving time was compensable because the employer required the employees to perform the various tasks before and after driving, rendering the tasks principal activities.⁶⁰

Dooley serves as a caution for any employer that requires, informally expects, or permits non-exempt employees to perform tasks such as checking or responding to e-mail and voice mail, and logging onto the computer network away from the workplace and outside of normal

working hours that these may be compensable principal work.

2. When Must Employers Pay for Time Not Spent on Core Job Duties?

Several common situations may constitute exceptions to the continuous workday rule or involve activity outside the workday. These scenarios concern time spent not on principal activities or other clearly productive work, but, rather, on what may appear to be non-productive endeavors. Employers must be aware of the rules that govern whether and how to compensate employees for lectures, meetings, and training programs, travel, breaks and meals, preparation time, waiting time, and paid time off.

a. Lectures, Meetings, and Training Programs

The DOL's regulations provide that "[a]ttendance at lectures, meetings, training programs and similar activities need not be counted as working time" where four conditions are met.⁶¹ *First*, attendance must be "outside of the employee's regular working hours."⁶² *Second*, attendance must be "in fact voluntary."⁶³ *Third*, the event must not be "directly related to the employee's job."⁶⁴ *Fourth*, the employee must "not perform any productive work during such attendance."⁶⁵ Where all four conditions are met,

⁶¹ 29 C.F.R. § 785.27; *see also* U.S. Department of Labor, Wage and Hour Division, Field Operations Handbook ("FOH") § 31b17. The Department has also issued regulations specifically addressing certain training activities by public employees. *See* 29 C.F.R. § 553.226.

⁶² 29 C.F.R. § 785.27(a).

⁶³ *Id.* § 785.27(b); *see also id.* § 785.28 (attendance "is not voluntary in fact if the employee is given to understand or led to believe that his present working conditions or the continuance of his employment would be adversely affected by nonattendance").

⁶⁴ *Id.* § 785.27(c); *see also id.* §§ 785.29 ("Where a training course is instituted for the *bona fide* purpose of preparing for advancement through upgrading the employee to a higher skill, and is not intended to make the employee more efficient in his/her present job, the training is not considered directly related to the employee's job even though the course incidentally improves his skill in doing his regular work."), 785.31 ("[A]n employer may establish for the benefit of his employees a program of instruction which corresponds to courses offered by independent *bona fide* institutions of learning. Voluntary attendance by an employee at such courses outside of working hours would not be hours worked even if they are directly related to his job, or paid for by the employer.").

⁶⁵ *Id.* § 785.27(d).

⁵⁵ 487 F.3d 1340 (11th Cir.), *cert. denied*, 128 S. Ct. 813 (U.S. 2007).

⁵⁶ *Id.* at 1345.

⁵⁷ *Id.* at 1333.

⁵⁸ 307 F. Supp. 2d 234 (D. Mass. 2004).

⁵⁹ *See id.* at 239-40.

⁶⁰ *Id.* at 242.

these activities are not compensable work time. If any one of these conditions is not satisfied, however, the employer must treat this time as hours worked.

Questions about the compensability of this type of activity arise in a number of contexts.⁶⁶ For example, in recent years, the DOL's Wage and Hour Division ("WHD"), which enforces and interprets the FLSA, has issued opinion letters addressing scenarios such as the following:

- A restaurant provided English language lesson materials to its employees. The employees expressed an interest in taking the materials home for further study and to share with their relatives outside of normal working hours. WHD determined that the time the employees voluntarily spend at home studying the materials, which were similar to English proficiency courses available at community colleges, is not work.⁶⁷
- A county asked whether time police recruits spent typing their class notes constituted working time. During months of academic and firearms training, the recruits took notes in class, and thereafter they prepare a typed notebook. The recruits typed at home after class, and one purpose of this typing is to prepare for the job requirement of typing police reports. WHD concluded that the typing was not voluntary and that the training is directly related to the recruits' job. Thus, the time is compensable.⁶⁸

b. Travel

Whether time an employee spends traveling from one location to another is compensable depends on the specific facts relating to that travel. A number of general rules apply,⁶⁹ and among those that arise most frequently are the following:

⁶⁶ See, e.g., Joyce E. Cutler, *Security Guards, Inter-Con Reach \$4 Million Overtime Settlement*, Daily Lab. Rep. (BNA), Sept. 24, 2007, at A-1 (discussing settlement involving approximately 1,600 workers alleging that they were not compensated for mandatory pre-shift meetings).

⁶⁷ See Wage and Hour Opinion Letter FLSA2006-5 (Mar. 3, 2006).

⁶⁸ See Wage and Hour Opinion Letter FLSA2006-2NA (Jan. 17, 2006).

⁶⁹ See generally 29 C.F.R. §§ 785.35-.41 (addressing travel time); FOH §§ 31c00-31c10 (same).

First, ordinary commuting to and from work, outside the employee's normal working hours, is generally not compensable working time.⁷⁰

Second, time spent going from home to work and back, outside normal working hours, on a special one-day assignment in another city is compensable, at least to the extent that the time in transit exceeds the employee's usual commuting time.⁷¹

Third, time spent traveling during the employee's normal working hours, such as travel from job site to job site,⁷² or travel after the first principal activity of the day, is compensable working time.⁷³

Fourth, travel that keeps the employee away from home overnight is working time if the travel is during the employee's normal working hours, including during those same hours on days, such as weekends, when the employee does not ordinarily work.⁷⁴

Fifth, any actual work an employee performs while traveling is compensated.⁷⁵

Certain issues, however, remain unsettled. For example, there has been significant litigation regarding whether commuting from home to work after an employee engages in some amount of work at home is compensable because it is part of the continuous

⁷⁰ See 29 C.F.R. § 785.35 ("An employee who travels from home before his regular workday and returns to his home at the end of the workday is engaged in ordinary home to work travel which is a normal incident of employment. This is true whether he works at a fixed location or at different job sites. Normal travel from home to work is not worktime.").

⁷¹ See 29 C.F.R. § 785.37.

⁷² See, e.g., Michelle Amber, *Home Health Care Firm to Pay \$2.2 Million for Travel Time, Expenses Under Settlement*, Daily Lab. Rep. (BNA), Dec. 3, 2007, at A-13 (discussing case where home health workers sought compensation for traveling between the homes of clients during the workday).

⁷³ See 29 C.F.R. § 785.38.

⁷⁴ See 29 C.F.R. § 785.39. Employers should note that although WHD has adopted an "enforcement policy" that "time spent in travel away from home outside of regular working hours as a passenger on an airplane, train, boat, bus, or automobile" is not compensable working time, *id.*, that is not the same as a regulatory provision defining such time as not compensable, and the policy may not be binding on employees asserting a private right of action under the FLSA.

⁷⁵ See 29 C.F.R. § 785.41.

workday, or not compensable because it is the type of travel generally deemed not working time under the Portal-to-Portal Act. Cases have reached conflicting results.⁷⁶

There is also uncertainty regarding the status of time spent commuting in an employer-owned vehicle. Under a 1996 law, the time an employee spends traveling in an employer-owned vehicle is not part of the employee's principal activities where the use of the vehicle "is within the normal commuting area for the employer's business or establishment and the use of the employer's vehicle is subject to an agreement on the part of the employer and the employee or representative of such employee."⁷⁷ On the other hand, the Washington Supreme Court has interpreted that state's law as requiring compensation for time employees spend commuting in a company vehicle, at least where the employer exercises some amount of control over the use of the vehicle.⁷⁸

c. **Breaks and Meals**

The general federal rule is that rest periods of less than 20 minutes are compensable.⁷⁹ These short breaks are considered primarily for the

employer's benefit because they "promote the efficiency of the employee."⁸⁰ Where a "regular rest period of known duration" exceeds 20 minutes, the waiting-time rules (discussed below) apply.⁸¹

Bona fide meal periods, by contrast, are not considered working time. The employee must have sufficient time to eat the meal, ordinarily at least 30 minutes, and the employee must be completely relieved of work duties during this time.⁸² Under "special conditions" a meal period of less than 30 minutes may be sufficient, although this depends on the facts of each case.⁸³ WHD applies "special scrutiny" to meal periods of less than 20 minutes.⁸⁴

The federal rules are fairly well known and familiar to employers, and they do not ordinarily lead to significant disputes. Substantial litigation, however, arises from the fact that approximately 18 states have their own rules governing breaks, meals, or both, and some of these rules differ greatly from federal law.⁸⁵ California is the most notable example, where there have been some exceptionally large awards, including an \$87 million settlement⁸⁶ and a \$172 million verdict.⁸⁷

⁷⁶ Compare *Lemmon v. City of San Leandro*, No. C 06-07107 MHP, 2007 U.S. Dist. LEXIS 90278, at *23-24 (N.D. Cal. 2007) (holding that although time police officers spend at home donning their uniforms before coming to work is compensable working time, their subsequent commute to work is not compensable), with *Dooley v. Liberty Mut. Life Ins. Co.*, 307 F. Supp. 2d 234 (D. Mass. 2004) (holding that where auto damage appraisers engage in undisputedly compensable work tasks at home such as checking e-mail and voice mail, returning telephone calls, and preparing their laptop computers before driving to their first appointment or after returning from their last appointment, the time spent driving from home to the first appointment and from the last appointment to home is compensable).

⁷⁷ 29 U.S.C. § 254(a). See, e.g., *Adams v. United States*, 471 F.3d 1321, 1325-28 (Fed. Cir. 2006) (holding that "merely commuting in a government-owned vehicle is insufficient; the plaintiffs must perform additional legally cognizable work while driving to their workplace in order to compel compensation for the time spent driving," and that the employees in that case failed to show that they worked while driving).

⁷⁸ See *Stevens v. Brink's Home Sec., Inc.*, 169 P.3d 473 (Wash. 2007) (concluding that technicians were "on duty" while driving company trucks because the employer prohibited them from using the trucks for personal business; required them to remain available to assist at other job sites while en route; and prescribed rules regarding, inter alia, carrying passengers, parking, and locking the vehicles).

⁷⁹ See 29 C.F.R. § 785.18; FOH § 31a01.

⁸⁰ 29 C.F.R. § 785.18.

⁸¹ See FOH § 31a01(b).

⁸² See 29 C.F.R. § 785.19(a); FOH § 31b23. Not all courts follow the rule that an employee must be completely relieved of duty, focusing instead on whether the "predominant benefit" of the meal period went to the employer or the employee. See generally Federal Labor Standards Legislation Committee, Section of Labor and Employment Law, American Bar Association, *The Fair Labor Standards Act 484-86* (1999) (collecting cases); 2007 Cumulative Supplement 508-09 (2007) (same).

⁸³ See 29 C.F.R. § 785.19(a); FOH § 31b23.

⁸⁴ See FOH § 31b23(b).

⁸⁵ See, e.g., Conn. Gen. Stat. § 31-51ii; N.Y. Labor Law §§ 162(3)-(5).

⁸⁶ See Joyce E. Cutler, *California Court OKs \$87 Million Settlement of UPS Drivers' Suit Alleging Missed Breaks*, Daily Lab. Rep. (BNA), Apr. 19, 2007, at A-4 (discussing settlement on behalf of class of 23,362 workers alleging missed meal and rest breaks); see also *Mortgage Firm Settles Overtime, Wage Claims of 506 Loan Consultants for \$13.6 Million*, Daily Lab. Rep. (BNA), Jan. 29, 2007, at A-7 (discussing settlement of claims including, inter alia, missed meal periods).

⁸⁷ See Michael R. Triplett, *Judge Declines to Gut Wal-Mart Verdict; Dispute Likely to Move to Appeals Court*, Daily Lab. Rep. (BNA), Dec. 12, 2006, at A-1 (discussing trial court's refusal to set aside \$172 million verdict,

d. Preparation

Preparatory activities are generally not compensable unless they are an integral and indispensable part of an employee's principal duties or required by the employer's rules, collective bargaining agreements, industry custom, or laws. For example, oiling machinery prior to its use, counting money in the till before working, arranging furniture or distributing materials prior to a meeting, and wiping tables before taking food orders are examples of activities that are likely to be compensable preparatory activities.

Recent class actions, however, allege that time spent preparing to deliver services is compensable. One of the challenges in defending these types of cases is ascertaining the amount of time employees actually have spent on preparatory time because these activities often are alleged to have occurred off the clock and away from the employer's premises. Requiring employees to certify on time records that they have recorded all hours worked is essential to guard against these types of claims.

e. Waiting Time

Employees who are "on call" (also called "stand-by time") must be compensated for their time if the employer's control over the employee is such that the employees cannot use the time effectively for their own purposes.⁸⁸ Determining whether on-call time is controlled and therefore compensable, or uncontrolled and therefore unpaid, depends on the facts of each situation and the jurisdiction in which the employee works.

A variety of factors affect whether restrictions on an employee's movements and activities transform on-call time into work. These factors include: (1) whether the employee must remain on the employer's premises; (2) whether there are excessive geographical restrictions on the employer's premises; (3) whether the frequency of calls is unduly restrictive; (4) whether a fixed response time is unduly restrictive; (5) whether the employee can trade on-call responsibilities with another employee; and (6) the extent to which the employee engages in personal activities during on-call periods.⁸⁹

including \$115 million in punitive damages, awarded to roughly 116,000 workers).

⁸⁸ See 29 C.F.R. § 785.17.

⁸⁹ *Berry v. County of Sonoma*, 763 F.3d 1174 (9th Cir. 1994); see also California Division of Labor Standards Enforcement, Opinion Letter, 1993.03.31.

As technological advances improve an employer's ability to predict the ebb and flow of staffing needs, the issue of compensable on-call time is certain to be increasingly scrutinized by plaintiffs' attorneys through class actions. For example, some retailers are considering installing scheduling software to monitor the number of customers present in a store and using that data to determine whether to call more employees into work. Such a system is likely to require a number of employees to be subject to an immediate call to work in the event of a surge in shoppers. Careful consideration of the factors that govern whether an employee is "waiting to be engaged" or "engaged to wait" are necessary before implementing such practices.

f. Paid Time Off

The issue with periods of time where the employee is receiving pay, but not performing work, such as for vacations, holidays, or illness, is not whether that time is compensable, but, rather, under what circumstances an employer's payment for the time must be factored into the employee's regular rate for purposes of calculating overtime.⁹⁰ The regulations expressly provide that pay in lieu of taking a paid holiday or vacation is not "compensation for working," and need not be included in the regular rate.⁹¹

One issue dividing courts is whether cashing out an employee's unused paid time off, where that balance includes time available for sick days, requires including that compensation in the employee's regular rate. In *Featsent v. City of Youngstown*,⁹² the Sixth Circuit held that payments made to police officers for the non-use of sick leave need not be included in the employees' regular rate, concluding such

⁹⁰ Section 7(e)(2) of the FLSA excludes from compensation that must be factored into the regular rate "payments made for occasional periods when no work is performed due to vacation, holiday, illness, failure of the employer to provide sufficient work, or other similar cause." 29 U.S.C. § 207(e)(2).

⁹¹ See 29 C.F.R. § 778.219(a); see also Wage and Hour Opinion Letter FLSA2006-18NA (July 24, 2006) (concluding that payments for cashing out an employee's unused floating holiday time, akin to vacation time, need not be included in the regular rate); Wage and Hour Opinion Letter FLSA2004-2NA (Apr. 5, 2004) (concluding that cash-out of unused vacation time need not be included in the regular rate).

⁹² 70 F.3d 900 (6th Cir. 1995).

payments “are similar to payments made when no work is performed due to illness, which may be excluded from the regular rate.”⁹³ By contrast, in *Acton v. City of Columbia*,⁹⁴ the Eighth Circuit concluded that payments to firefighters to buy back unused sick leave were includable in the regular rate because “the primary effect of the buy-back program is to encourage firefighters to come to work regularly over a significant period of their employment tenure” and, thus, the payments “constitute remuneration for employment.”⁹⁵ The court in *Acton* acknowledged, but declined to follow, *Featsent*.

Employers also should be aware of two other issues. *First*, if employers significantly restrict employees’ freedom during paid time off, the restrictions may end up converting that time into compensable work. This concern is most likely to arise in the context of an employer’s efforts to manage employees who are on paid sick leave.⁹⁶

Second, where employers pay salaried non-exempt employees on a fluctuating workweek basis, employers may charge absences against a paid time off bank. However, where an employee exhausts paid time off, the employer must not deduct absences from the employee’s salary. In other words, the deduction rules applicable to salaried exempt employees do not apply to non-exempt employees working a fluctuating workweek, and the employee must receive the guaranteed salary.⁹⁷ Failure to abide by this rule could, among other things, negate the fluctuating workweek, thereby potentially entitling employees to substantial unpaid overtime.

⁹³ *Id.* at 905.

⁹⁴ 436 F.3d 969 (8th Cir. 2006).

⁹⁵ *Id.* at 976-80.

⁹⁶ *Cf.* Wage and Hour Opinion Letter FLSA2002-10 (Nov. 1, 2002) (concluding that an employer’s policy requiring employees on paid sick leave to remain at their residence and available by telephone, and to contact the employer before leaving home, did not convert the paid time off into hours worked).

⁹⁷ *See* Wage and Hour Opinion Letter FLSA2006-15 (May 12, 2006) (stating that absences may not lead to deductions from fluctuating workweek wages, but “an employer may take a disciplinary deduction from an employee’s salary for willful absences or tardiness or for infractions of major work rules, provided that the deductions do not cut into the required minimum wage or overtime compensation”).

D. OTHER POLICIES TO WATCH CAREFULLY

1. Rounding

The DOL recognizes that time clocks will not always reflect the time an employee actually is engaged in compensable work. The DOL by regulation thus permits employers to round time in some circumstances.⁹⁸ In general, rounding to the nearest five minutes, tenth of an hour, or quarter hour is permissible under federal law and many state laws so long as the practice is likely to even out in the long run.⁹⁹

Although sanctioned by the DOL and many state labor departments, rounding practices still present the risk of class action litigation. The federal regulation uses the term “for enforcement purposes,” which likely precludes the DOL from pursuing an administrative action if an employer complies with the terms of the regulation. However, it is still possible the regulation could be challenged as incompatible with the FLSA and, therefore, have limited value in a judicial action under the FLSA for unpaid wages.

Strict tardy policies may also create class action exposure for employers who use rounding practices. Employers who use rounding should proceed with caution in adopting and administering tardy policies that discipline employees for being late within the rounding period. Discipline in these circumstances may undermine the concept of neutrality upon which rounding is premised. For example, if an employer rounds to the nearest quarter hour, any punch time between 6:53 a.m. and 7:07 a.m. will be counted as work commencing at 7:00 a.m. If an employee’s shifts starts at 7:00 a.m. and he or she is identified as tardy for any punch between 7:00 and 7:07, the rounding practice is arguably no longer neutral. This is the type of system-wide practice upon which class action litigants rely when seeking to establish commonality for class certification.

⁹⁸ *See* 29 C.F.R. § 785.48(b) (“‘Rounding’ practices. It has been found that in some industries, particularly where time clocks are used, there has been the practice for many years of recording the employees’ starting time and stopping time to the nearest 5 minutes, or to the nearest one-tenth or quarter of an hour. Presumably, this arrangement averages out so that the employees are fully compensated for all the time they actually work. For enforcement purposes this practice of computing working time will be accepted, provided that it is used in such a manner that it will not result, over a period of time, in failure to compensate the employees properly for all the time they have actually worked.”).

⁹⁹ *See also* California Division of Labor Standards Enforcement, Enforcement Policies and Interpretations Manual § 47.2.

Employers should also consider whether records will withstand an audit from a labor agency seeking to determine whether the rounding actually evens out for employees in the long run. Practices that favor employers are unlikely to pass muster.

Employers who use rounding should audit their records periodically to determine whether their practices comply with federal and state regulations. Internal and external audits can detect if the rounding system in place does not satisfy the “evening out” component contemplated by law. If an audit shows that employees systematically lose more time than they gain, further investigation is warranted to determine the likely cause and to ascertain appropriate modifications to policies and/or practices.

2. Recordkeeping

Understanding and complying with wage and hour laws is only part of an employer’s safety net in the quest for protection from wage and hour class actions. An employer often must take a third step: maintaining records to demonstrate compliance. Failure to collect and to maintain accurate records about employee work hours, workdays, workweeks, regular pay, overtime pay, other compensation, and other required information can seriously affect an employer’s ability to defend itself in a wage and hour class action and often is used to argue *per se* violations of law.

Most employers are aware of federal and state requirements to maintain timekeeping and payroll records and to make good-faith efforts to maintain those records; however, if records disappear, an employer could be subject to an evidentiary inference that the missing records would have been adverse to the employer’s position. The employee may be entitled to a presumption that the records would have supported the employee, which the employer must then negate. The adverse inference may apply even where the employer has not acted maliciously or intentionally.¹⁰⁰

Even where an adverse inference is not made, employers may have extreme difficulty defending claims in the absence of accurate records reflecting each employee’s pay, hours worked, and the like. Generally, plaintiffs’ evidence is given every favorable inference and “the employer cannot be heard to complain that the damages lack the exactness and

precision of measurement that would be possible had [it] kept records.”¹⁰¹

In California and throughout the nation, the explosion of wage and hour class litigation, and class litigation over meal periods in particular, has forced many employers to exercise greater care in maintaining records, including records of how company policies regarding timekeeping have been communicated to the workforce. Some potential strategies to minimize exposure for these claims include:

- *Policies.* Adopt written policies requiring employees accurately to record work time, not to work “off the clock,” and to take meal and rest breaks.
- *Ongoing Educational Campaigns.* Establish a recordkeeping system that demonstrates employees have been notified of company policies regarding off-the-clock work and meal and rest breaks.
 - ✓ Signed acknowledgment of policies.
 - ✓ Periodic reminders in paychecks.
 - ✓ Postings.
- *Complaint Procedure.* Provide a complaint procedure, which is outside immediate management and provides for prompt investigation and resolution of complaints.
- *Certifications.* Have employees acknowledge on each timesheet that the hours reflected are accurate and all meal and rest breaks have been taken in accordance with the employer’s policy.
- *Schedule and Track Meal Periods.* Include time in/time out section for meal periods on time cards (required in some states).
- *Prevention.* Sound an alarm on time clocks when employees attempt to clock back in early from a meal break.
- *Participatory Fixes.* Supervisors should not adjust time and should resist the temptation to fix mis-punches and errors without the participation and acknowledgement of the employee.
- *Training.* Provide information to managers and supervisors about wage and hour requirements and the importance of compliance.
- *Voluntary Payment of Penalties.* Automatic payment of meal period penalties by timekeeping/payroll systems based on time punches.

¹⁰⁰ See, e.g., *Zubulake v. UBS Warburg LLC*, 229 F.R.D. 422, 431 (S.D.N.Y. 2004) (“In this circuit, a ‘culpable state of mind’ for purposes of a spoliation inference includes ordinary negligence.”).

¹⁰¹ *Rivera v. Ndola Pharmacy Corp.*, 497 F. Supp. 2d 381 (E.D.N.Y. 2007) (plaintiff’s testimony alone was sufficient even though she filed false income tax returns in the past).

- *Discipline.* Discipline employees for engaging in or allowing uncompensated work.
- *Compliance Audits.* Conduct internal or external compliance reviews.

A California decision demonstrates how several of these strategies may not only enhance compliance with wage-hour requirements, but also may be used as tools to defeat class certification. In *Bell v. Superior Court*,¹⁰² the plaintiffs sought to certify a class of drivers who claimed, *inter alia*, denial of meal and rest breaks. The trial court declined to certify the proposed class. Although the plaintiffs asserted through declarations that the employer had a common practice of imposing tight delivery schedules that did not allow drivers to take breaks, the employer submitted evidence showing it had written policies requiring drivers to take breaks. The employer also submitted declarations from drivers indicating they took, or were permitted to take, breaks, and witnessed other drivers taking breaks, including the named plaintiffs. In addition, the employer submitted evidence showing that drivers were trained to take breaks and were only scheduled work for 10 hours within a 12-hour workday, which permitted the employees to take breaks at their discretion. On this evidence, the appellate court affirmed the denial of certification, concluding there was “no uniform policy or practice forbidding or preventing breaks and that any driver who did not take the necessary breaks did so for reasons which require independent adjudication.”¹⁰³

In *White v. Starbucks Corp.*,¹⁰⁴ the plaintiff worked for Starbucks for 11 days and then quit and sued, claiming a host of wage-hour violations, including an alleged failure to comply with California’s meal and rest break rules. Starbucks introduced evidence of its policy requiring employees to take meal and rest breaks and that it regularly communicated that policy to the plaintiff and other employees. Granting the employer’s motion for summary judgment, the court concluded the California Supreme Court would require only that an employer *offer* breaks, *not* require the taking of breaks. Because the plaintiff admitted he made the decision to skip meals and was not forced to forgo breaks by the employer, the district court concluded the alleged break claims failed.¹⁰⁵

Bell and *White* demonstrate that written policies directing employees to take meal and rest breaks, and a practice of training employees and supervisors about those policies, may be important factors for courts

evaluating whether sufficient commonality exists for class treatment. Preparing, implementing and distributing lawful and effective break policies are relatively simple and inexpensive means to guard against future claims.

E. CONCLUSION

Wage and hour class and collective actions remain extremely problematic for all employers, in all industries. Creative plaintiffs’ attorneys are constantly exploring new bases for such cases and expanding targeted industries and defendants. As a result, implementing lawful policies is only the first step to guard against such actions; employers should develop proactive strategies to minimize the risk of class and collective litigation.

III. TRADE SECRET PROTECTION COMPLIANCE¹⁰⁶

A. INTRODUCTION

A loss of confidential business information would be a serious problem for most companies. Companies seeking to guard against the loss of confidential business information are exploring new ways to enforce and execute protective agreements with employees. Supplement Executive Retirement Plans (“SERPs”), options with clawback provisions (agreements to pay employees who do not compete, drafted to take advantage of the employee choice doctrine), and deferred compensation plans with penalty provisions may provide protection even in states that generally do not enforce “standard” noncompetes. In addition to denying employees benefits in the event they compete, carefully drafted documents may enable employers to recover from their former employees the consideration paid for the agreement.

B. NONCOMPETE PROVISIONS

Although many jurisdictions previously hostile to noncompete agreements now seem to be taking a less rigid stance,¹⁰⁷ other states are maintaining their

¹⁰⁶ We would like to acknowledge Stephanie Adler of our Orlando, Florida office and A. Robert Fischer of our Stamford, Connecticut office for their work on the preparation of this portion of this paper.

¹⁰⁷ See, e.g., *In re AutoNation, Inc. and Auto M. Imports North, Ltd. d/b/a Mercedes-Benz of Houston-North*, 228 S.W.3d 663 (Tex. 2007) (holding that Texas employees can be bound by choice of forum provisions); *Carr v. Entercom Boston, LLC*, 23 Mass. L. Rep. 169 (Mass. Super. Ct. Oct. 16, 2007) (rejecting plaintiff’s argument that a right-of-first refusal clause operated as a noncompete provision in the broadcasting industry, a provision that otherwise would be prohibited under Massachusetts law).

¹⁰² 69 Cal. Rptr. 3d 328 (Ct. App. 2007).

¹⁰³ *Id.* at 347-48.

¹⁰⁴ 497 F. Supp. 2d 1080 (N.D. Cal. 2007).

¹⁰⁵ See *id.* at 1085-89.

aggressive stance against restrictions on competition. For example, Oregon recently passed legislation that will make it more difficult for employers to restrict employees from leaving to work for a competitor. Under that new law, a noncompete in the employment context is voidable and may not be enforced by an Oregon court unless various restrictions are satisfied.¹⁰⁸

C. SERPs

Supplemental Executive Retirement Plans (“SERPs”), also known as “Top Hat Plans,” are an “employee pension benefit plan” within the meaning of the Employee Retirement Income Security Act (“ERISA”).¹⁰⁹ SERPs can be an effective tool to restrain post-employment by providing for the forfeiture of benefits in the event a former employee violates noncompetition or confidentiality restrictions, or the like.

Such plans are exempted from the substantive requirements of ERISA with respect to participation and vesting, benefit accrual and funding, and fiduciary duty.¹¹⁰ Accordingly, SERPs are governed only by the enforcement provisions of 29 U.S.C. §§ 1131 - 1145 of ERISA.¹¹¹ As ERISA does not provide for substantive rules to control the form or content of SERPs, they are guided by a body of federal common law comprised of basic principles of contract law and interpretation as

developed by the courts.¹¹² ERISA preempts all state law that may relate to a claim or benefit under such plan; thus, such claims must be brought under ERISA instead of state law. ERISA’s preemption of state law claims is particularly important in states hostile to noncompetes.¹¹³

ERISA does not provide “nonforfeitability protection” to top hat plans.¹¹⁴ *Bigda v. Fischbach* addresses this issue squarely:

[S]ince top hat plans are exempt from the nonforfeitability provisions of ERISA . . . plaintiff has no cause of action under ERISA to challenge the forfeitability provision in his benefits plan.

. . . .
Courts use federal common law to “fill in the interstices of ERISA’s statutory scheme” The failure of ERISA to provide nonforfeitability coverage to top hat plans is not an “interstice” because it is the result of a deliberate decision to let executives use their positions of power to negotiate such protection for their plans on their own Since ERISA intentionally omits top hat plans from its nonforfeitability protection, federal common law may not be used to create nonforfeitability protection under ERISA.¹¹⁵

D. STOCK OPTIONS WITH CLAWBACK PROVISIONS

A stock option agreement, granting either incentive stock options (“ISO”)¹¹⁶ or non-qualified stock options (“NQSO”),¹¹⁷ may contain a clawback or

¹⁰⁸ See Or. Rev. Stat. § 60.047(2)(e). Key provisions of the statute include: (1) employees considered “non-exempt” cannot be subject to noncompetition agreements; (2) employees must be informed about a noncompetition agreement at least two weeks prior to the first day of work; (3) employer needs to have a “protectable” interest in order to enforce a noncompetition agreement; (4) a noncompetition provision may not be enforced against an employee whose median household income is less than approximately \$61,000 for a family of four; and (5) the duration of noncompetition cannot exceed two years.

¹⁰⁹ 29 U.S.C. § 1001 *et seq.*

¹¹⁰ 29 U.S.C. §§ 1051(2), 1081(a)(2) and 1101(a)(1).

¹¹¹ See, e.g., *Kemmerer v. ICI Americas, Inc.*, 70 F.3d 281 (3d Cir. 1995) (holding that retired executives had an ERISA-based right to enforce the plan’s payment schedule); *Rockney v. Blohorn*, 877 F.2d 637 (8th Cir. 1989) (“An employer may be sued by participants in these plans to redress violations of ERISA or to enforce the terms of the plans”); *Bigda v. Fischbach Corp.*, 898 F. Supp. 1004 (S.D.N.Y. 1995) (noting that the enforcement provisions of ERISA apply to top hat plans, and holding that ERISA preempts state law causes of action regarding these plans); *Carr v. First Nationwide Bank*, 816 F. Supp. 1476 (N.D.Cal. 1993) (“[I]t is clear that plaintiffs may enforce the terms of the Bank’s Top Hat Plan under 29 U.S.C. § 1132 and that federal common law of contract principles govern.”).

¹¹² See, e.g., *Healy v. Rich Products Corp.*, 981 F.2d 68 (2d Cir. 1992) (referring to principles of contract interpretation, rather than ERISA, to determine the meaning of the term “vested” as applied to the Plans); *Carr*, 816 F. Supp. at 1485-87.

¹¹³ See, e.g. California Business and Professions Code § 6600: “Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”

¹¹⁴ See 29 U.S.C. § 1051; *Bigda*, 898 F. Supp. at 1016-17.

¹¹⁵ *Bigda*, 898 F. Supp. at 1016-17.

¹¹⁶ A “statutory stock option,” is the umbrella term for incentive stock options, guided by Internal Revenue Code (“Code”) Section 422 and Code Section 423 stock purchase plan option. A Section 423 stock purchase plan allows for employees to purchase stock at up to a fifteen percent discount, and purchasers receive favorable tax treatment if the plan meets certain rules. The term “statutory stock option” is also synonymous with “qualified stock option.”

¹¹⁷ From the employer’s perspective, an important advantage of the ISOs is that they offer the company a means to attract and keep talent without draining cash flow by paying higher

forfeiture provision, enabling the employer to strip the employee of his or her right to exercise the option. A clawback provision may also allow the employer to recover any net gains on stock option exercises made before or after the employee leaves the company in the event the employee violates a provision in the option agreement.¹¹⁸

Clawback provisions have been invoked to impose harsh judgments for poor behavior. In *Phansalkar v. Andersen Weinroth & Co., L.P.*,¹¹⁹ Rohit Phansalkar, a former investment banker of former-employer Andersen Weinroth & Co, L.P., was required to forfeit \$4.4 million dollars for breaching his fiduciary duties.¹²⁰ Not only was Phansalkar required to forfeit

salaries. See David Johnson, *Employee Stock Options and Related Equity Incentives*, The National Center for Employee Ownership (NCEO), ¶ 10 2005, <http://www.nceo.org/library/equity.html>.

¹¹⁸ However, clawback provisions are not always enforced. For example, it is unlikely a Massachusetts court would enforce a clawback provision to require a former employee to disgorge net gains in the event of subsequent competition, particularly where the employee was terminated involuntarily and without cause. In *Kroeger v. The Stop & Shop Companies, Inc.*, 13 Mass. App. Ct. 310 (1982), plaintiff-former executive at defendant grocery store chain negotiated a deferred compensation agreement which provided for monthly benefits to plaintiff upon retirement and a continuing relationship as a consultant, provided that he not work for a competitor as defined in the agreement. Within six months of plaintiff's involuntary termination, he found employment with a competitor. *Id.* at 314. In determining whether plaintiff was entitled the benefits under the agreement, the Court also considered "shall the employee be made to forfeit money which he has in fact earned?" *Id.* at 319. With regard to this issue, the Court noted:

Particularly in the case of retirement benefits which an employee has earned, courts should avoid forfeiture of those rights where possible. We are of opinion that, when an employee is discharged in circumstances involving no misconduct by the employee, the employee's deferred compensation benefits should not be forfeited to the extent those benefits have been earned, even though the employee violates a valid postemployment restriction.

Id. at 320-21.

¹¹⁹ 344 F.3d 184 (2d Cir. 2003).

¹²⁰ *Id.* at 200-02; see also *Design Strategies, Inc. v. Davis*, 384 F. Supp. 2d 649 (S.D.N.Y. 2005) ("[T]herefore, the

all compensation awarded to him after the date of his disloyalty to his former employer, but all investment opportunities received by the employee were considered a form of compensation subject to forfeiture.¹²¹ Further, even Georgia, a state widely known for its staunch policies against forfeitures and noncompete agreements,¹²² now recognizes a policy exception that is applicable to forfeiture provisions that do not restrict the former employee from working elsewhere, but instead act as a condition precedent to the receipt of stock certificates.¹²³

Although clawback provisions often have been enforced, they may contravene wage and hour laws in those states which have adopted a broad definition for earned "wages." For example, in *International Business Machines Corp. v. Bajorek*¹²⁴ and *International Business Machines Corp. v. Martson*,¹²⁵ both the Ninth Circuit and the Southern District of New York, respectively, rejected the argument that enforcement of a clawback provision is akin to the unlawful violation of the wage payment laws. The finding in these cases hinged on the definition of "wages" as adopted by the applicable state, which, notably, did not include stock options and other forms of stock option payment.

However, the statutory definition of "wages" is not always the end of the inquiry. For instance, Pennsylvania courts, which refer to a definition of "wages" similar to the statutory definition in New York, have nevertheless determined that most types of payments to an employee from an employer fall within the definition of "wages," including bonus payments,

Court interprets *Phansalkar* to require forfeiture of salary earned during a period of disloyalty, but not during periods of loyal employment that may follow the period of disloyalty").

¹²¹ *Phansalkar*, 344 F.3d at 200-02. The case was remanded to determine the benefit that was derived by the employee from employer-derived opportunity to invest in stock, and to determine appropriate remedy as to stock options received in the employee's name. See also *Olander v. Compass Bank*, 363 F.3d 560, 562-53 (5th Cir. 2004) (concluding the former executive was required to forfeit the profits from stock sales derived from the option agreement).

¹²² See, e.g., *A. L. Williams & Assoc. v. Faircloth*, 259 Ga. 767 (1989) ("The settled public policy of this state is that forfeitures are not favored").

¹²³ See *Milhollin v. Salomon Smith Barney, Inc.*, 272 Ga. App. 267 (2005). An example may be where the employee is terminated for cause.

¹²⁴ 191 F.3d 1033 (9th Cir. 1999).

¹²⁵ 37 F. Supp. 2d 613 (S.D.N.Y. 1999).

equity interests, stock options, and other equity-based plans.¹²⁶

Despite these challenges, forfeiture provisions in stock option arrangements offer employers a tool for setting standards of employee conduct and recovering an employee's net gains in the event of a violation of those standards.

E. EMPLOYEE CHOICE DOCTRINE

The employee choice doctrine ("ECD") allows an employer to condition an employee's receipt of benefits on the employee's compliance with a restrictive covenant. The doctrine "assumes that an employee who voluntarily leaves his employment makes an informed choice between forfeiting his benefits or retaining the benefits by avoiding competitive work."¹²⁷ The ECD has long been used by New York Courts¹²⁸ as a vehicle for enforcing post-

¹²⁶ See *Scully v. U.S. WATS, Inc.*, 238 F.3d 497 (3d Cir. 2001); *Gautney v. Amerigas Propane, Inc.*, 107 F. Supp. 2d 634 (E.D. Pa. 2000) ("Courts have uniformly held that the [Pennsylvania Wage Payment Collection Law] creates a statutory remedy on behalf of employees for the recovery of wages and benefits owed to them by contract but wrongfully withheld by employers"). But see *Kafando v. Erie Ceramic Arts Co.*, 764 A.2d 59 (Pa. Super. Ct. 2000) (concluding that amounts paid under a gainsharing program were not "wages," as the bonuses were not related to work performance and were dependent entirely on the employer's earnings).

¹²⁷ *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 N.Y.2d 84 (1979).

¹²⁸ Pennsylvania courts may also be enforcing forfeiture provisions without an inquiry into the reasonableness standard. In *Fraser v. Nationwide Mutual Insurance Co.*, 334 F. Supp. 2d 755 (E.D. Pa. 2004), the court assessed the forfeiture provision under general contract principles. Of importance, the court noted:

Nationwide's protectable interest is the stake Nationwide has in providing an incentive to dissuade former employees from competing with Nationwide for a limited period of time after leaving Nationwide's employ. Rather than "pure financial gain at the expense of restricted competition," the forfeiture-for-competition provision does not restrict competition in the sense that it carries the threat of injunction, but rather offers a monetary benefit upon compliance with its terms.

.....

The reasonableness of this particular forfeiture-for-competition provision is highlighted by its conditional nature: Fraser could either abide by the conditions required to receive the deferred compensation or not, it was his choice. In that regard, it would be overly

employment restrictions linked to stock option or deferred compensation arrangements.¹²⁹ Therefore, many stock option plans and deferred compensation plans condition benefits upon compliance with the restrictive covenants contained in the plan, and are thus designed for an employee's automatic forfeiture of benefits upon resignation and breach of the agreement.¹³⁰

Pursuant to the ECD, a court "will enforce a restrictive covenant without regard to reasonableness if the employee has been afforded the choice between not competing (and thereby preserving his benefits, such as stock, stock options or other types of deferred compensation) or competing (and thereby risking forfeiture)."¹³¹ Therefore, an employee who voluntarily resigns and subsequently violates his or her post-employment obligations may waive all legal right to deferred benefits — regardless of whether the noncompete agreement is reasonable.¹³² Conversely, the ECD does not apply to situations in which the employee is involuntarily terminated without cause or constructively discharged, although a forfeiture provision is typically enforceable under the ECD if the employee is discharged for cause.¹³³

Morris v. Schroder Capital Management International has made it more difficult for employees

simplicistic to state that the provision operated to Fraser's detriment in the form of \$346,000.00 of forfeited compensation. It is more probable that Fraser recognized the loss of \$364,000 as the opportunity cost of accepting other employment, and chose to compete because it was more economically advantageous to do so.

Id. (Footnote omitted). In this context, and because the court determined the restrictive covenant was otherwise enforceable, as Nationwide had a legitimate interest in offering a conditional incentive program, the court concluded that the forfeiture-for-competition provision was valid and enforceable. *Id.*

¹²⁹ *Morris v. Schroder Capital Mgmt. Int'l*, 859 N.E.2d 503 (S.D.N.Y. 2006), *aff'd*, 481 F.3d 86, 88 (2d Cir. 2007).

¹³⁰ See *infra* Section VI.

¹³¹ *Lucente v. I.B.M.*, 310 F.3d 243, 254 (2d Cir. 2002).

¹³² See *id.*

¹³³ See, e.g., *Cray v. Nationwide Mutual Insur. Co.*, 136 F. Supp. 2d 171, 179 (W.D.N.Y. 2001); *Morris*, 481 F.3d at 89 (2d Cir. 2007); *Post v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 48 N.Y. 84 (1979) (holding that such forfeiture-for-competition clauses will not be enforced "where the termination of employment is involuntary and without cause").

to challenge forfeiture provisions linked to restrictive covenants by requiring employees to meet the test of constructive discharge when arguing involuntary termination.¹³⁴ Coupled with enforcement without an inquiry into the “reasonableness” of the restriction, the rigorous standard of constructive discharge¹³⁵ provides a powerful disincentive for departing employees to engage in prohibited activity, such as noncompetition and nonsolicitation, misappropriation or disclosure of confidential or other proprietary information, and employee raiding.

F. DEFERRED COMPENSATION PLANS

Deferred compensation is a mechanism by which a portion of the employee’s income is paid out at a date after which that income is actually earned.¹³⁶ Two types of deferred compensation plans exist: qualified and nonqualified deferred compensation (“NQDC”) plans. Deferred compensation plans may take a variety of forms, including life insurance plans, excess-benefit plans, top hat plans, severance plans, deferred bonuses, vested trusts, rabbi trusts, secular trusts, stock options, phantom stock, stock appreciation rights, and gold, silver, tin, and pension parachutes. Similar to the ECD discussed above,¹³⁷ deferred compensation plans also

serve as a vehicle for imposing restrictions on employee conduct; however, in states that do not adopt the ECD, the inquiry into the enforcement of such forfeiture provisions in such plans also includes an analysis as to “reasonableness.”

For example, in *Briggs v. R. R. Donnelley & Sons Co.*,¹³⁸ the District Court for the District of Massachusetts, applying Illinois law, rejected plaintiff’s argument that the “Cancellation of Benefits” provision in a deferred compensation plan, which provided for the forfeiture of employee contributions in the event the employee began working for a competitor within three years of his termination, operated as a “bar contrary to public policy because the monies forfeited are for the most part plaintiff’s own contributions to the deferred compensation account.”¹³⁹ In so concluding, the court noted that “[o]nce invested in the Plan by plaintiff, however, these monies were not unlike other employee benefits. Cases considering the validity of employee benefit forfeiture provisions have consistently applied a test of reasonableness. Even where such provisions have been found to be invalid, public policy has not been the basis for such determination.”¹⁴⁰

Accordingly, as the court determined, “the reasonableness of the covenant in restraint of trade depends upon the particular facts of the case,”¹⁴¹ thus, given that the defendant corporation operated throughout the United States and had customers worldwide, the court upheld the covenant even though it lacked a geographic limitation.¹⁴² Moreover, in ultimately concluding that the covenant was reasonable and valid, the court pointed out that:

Unlike the more common covenants prohibiting competitive employment, the covenant at bar left plaintiff with a choice of competing and forfeiting benefits of the Plan or not competing and retaining the Plan’s benefits. While such a covenant restrains trade, it does so by providing an inducement for compliance rather than by imposing a ban on noncompliance. Although this distinction is conceptually subtle, it underlies the reasonableness of the covenant.¹⁴³

¹³⁴ 859 N.E.2d 503 (N.Y. 2006), *aff’d*, 481 F.3d 86 (2d Cir. 2007). “Constructive discharge occurs when the employer, rather than acting directly, deliberately makes an employee’s working conditions so intolerable that the employee is forced into an involuntary resignation.” *Id.* at 507 (citing *Pena v. Brattleboro Retreat*, 702 F.2d 322, 325 (2d Cir. 1983) (internal quotation marks omitted)).

¹³⁵ *See Morris*, 859 N.E.2d at 507 (“Under the constructive discharge test, the actions of the employer in creating the intolerable workplace condition must be deliberate and intentional, *see Whidbee v. Garzarelli Food Specialties, Inc.*, 223 F.3d 62, 73 (2d Cir. 2000), and the atmosphere in the workplace must be so intolerable as to compel a reasonable person to leave (*id.*; *but see e.g. Petrosino v. Bell Atl.*, 385 F.3d 210, 231 (2d Cir. 2004) (finding no constructive discharge where an employee’s promotion opportunities were reduced, but the employee retained her job title, pay, and seniority); *Lumpkin v H.E.L.P. USA*, 2005 U.S. Dist. LEXIS 6227, *13-16, 2005 WL 839669 at *5 (E.D.N.Y. 2005) (finding no constructive discharge where plaintiff retained the same salary and pay grade after his transfer to a lower position within the organization, even if the transfer was subjectively regarded as a demotion)). The constructive discharge test is not met if the employee is simply dissatisfied with a change in his job assignments (*see Stetson v. NYNEX Serv. Co.*, 995 F.2d 355, 360 (2d Cir. 1993); *Pena*, 702 F.2d at 325-326)).

¹³⁶ *See* I.R.C. §§ 401-425 (2005). Qualified plans include profit-sharing or 401(k) plans.

¹³⁷ *See supra* Section V.

¹³⁸ 446 F. Supp. 153 (D. Mass. 1978).

¹³⁹ *Id.* at 155, 157.

¹⁴⁰ *Id.* at 157 (internal citations omitted).

¹⁴¹ *Id.* at 156-57.

¹⁴² *Id.* at 157.

¹⁴³ *Id.* at 158 (citing references omitted).

Accordingly, the plaintiff former employee was not entitled to the return of the \$23,715.13 in contributions to his deferred compensation account.¹⁴⁴

G. SUING FOR RECOVERY OF CONSIDERATION

In addition to protecting its confidential business information, an employer may be able to recoup the amount paid for such protection, or the consideration paid, in the event its employees ignore or challenge post-employment restrictions. The mechanisms for recovering paid consideration are based in equity, and include unjust enrichment and rescission.

Equitable considerations may provide the employer with an avenue for recovering the paid consideration. As one commentator noted:

At the time of enforceability of the restrictive covenants contained in the parties' agreement [are] subjected to judicial review, the employer has generally provided the employee with the full value of the consideration that the employee bargained for in reaching their overall agreement. Nevertheless, at that same point in time, the employee has only provided the employer with part of the consideration to their overall agreement. As a result, if at the time the terms of the restrictive covenant are first subject to judicial review, the court determines that those terms are unreasonable and hence unenforceable, the employee will be unjustly enriched. Therefore, the employer will suffer a hardship that is cognizable in equity, unless the employer receives appropriate restitution for the consideration that has already been paid to the employee.¹⁴⁵

However, courts have not always applied equitable principles to recover paid consideration, particularly where a public policy is at issue. For instance, although the decision in the *New Jersey v. Norris, McLaughlin & Marcus*, demonstrates that New Jersey

courts may apply equitable principles to recover paid consideration, the court ultimately was unwilling to extend the doctrine to the instance where the underlying agreement violated a public policy against noncompetition.¹⁴⁶ Thus, in states with strong policies against noncompetition agreements, such as California or Georgia, equitable principles may not be useful in recovering paid consideration.

Rescission may also provide the employer with another tool for recouping its paid consideration, and returning the parties to status quo.¹⁴⁷ Rescission is "abrogation or undoing of [a contract] from the beginning, which seeks to create a situation the same as if no contract ever had existed."¹⁴⁸ **Rescission** entitles the party to a return of the **consideration** paid as well as any additional sums necessary to restore him to the position occupied prior to the making of the contract.¹⁴⁹ Similar to other equitable considerations, however, rescission may not be possible in circumstances where the party has already substantially performed the contract,¹⁵⁰ where the contract does not

¹⁴⁶ 588 A.2d 1287 (N.J. Super Ct. App. Div. 1991), *rev'd*, 128 N.J. 10 (1992); *see also Haight, Brown & Boonesteel v. Fitzgerald*, 285 Cal. Rptr. 845 (Cal. Ct. App. 1991), *reh'g denied*, No. 2020824, No. S020824, 1991 Cal. LEXIS 5862, at *1 (Cal. Dec. 19, 1991) (refusing to consider waiver, unclean hands or in *pari delicto* where agreement violated public policy).

¹⁴⁷ *See First Equity Inv. Corp. v. United Serv. Corp.*, 386 S.E.2d 245, 248 (S.C. 1989).

¹⁴⁸ *Gov't Employees Ins. Co. v. Chavis*, 176 S.E.2d 131, 135 (S.C. 1970) (citing references omitted).

¹⁴⁹ *See Bank of Johnson v. Jones*, 139 S.E. 190, 196 (S.C. 1927).

¹⁵⁰ *See Lenel Sys., Int'l, Inc. v. Smith*, 810 N.Y.S.2d 792, 795 (Sup. Ct. Monroe County 2005), *aff'd*, 824 N.Y.S.2d 553 (4th Dep't 2006) ("In actions at law for rescission, the plaintiff must mak[e] allowance for benefits received. If the option agreements were just part of a much larger employment package memorialized in multiple agreements, part of the consideration of their issuance was, unquestionably, [defendant former-employee's] multi-year service to Lenel which has already been performed. The question of rescission under [this] scenario, therefore, is not as simple as suggested by [plaintiff employer], which would have the court consider the option agreements in a vacuum. If indeed [the noncompetition provision in the stock option agreement] read in the broader context of the complete employment package offered to and enjoyed by [defendant], rescission is now impossible because of [defendant's service record with [plaintiff company]].").

¹⁴⁴ *Id.* at 155, 158.

¹⁴⁵ Samuel Damren, *The Theory of "Involuntary" Contracts: The Judicial Rewriting of Unreasonable Covenants Not to Compete*, 6 Tex. Wesleyan L. Rev. 71, 82 (1999); *see also McMullen v. Hoffman*, 174 U.S. 639, 655 (U.S. 1899) ("Where a contract, although it be illegal, has fully executed between the parties so that nothing remains thereof for completion, if the plaintiff can recover from the defendant moneys received by him without resorting to the contract, the court will permit a recovery in such case"); *Ellie, Inc. v. Miccichi*, 358 S.C. 78, 95 (S.C. Ct. App. 2004), *reh'g denied*, No. 3741, 358 S.C. 78 (2004) ("**Rescission** entitles the party to a return of the **consideration** paid as well as any additional sums necessary to restore him to the position occupied prior to the making of the contract").

provide for this remedy,¹⁵¹ or where the contract is based on illegal grounds.¹⁵²

However, the recovery of paid consideration may be inapposite to recouping damages under the contract. Take, for instance, a clawback provision — it is invoked by turning to the plain language of the agreement as a mechanism for returning any net gains realized by way of the agreement. Therefore, unlike rescission, enforcement of the clawback provision hinges not on the cancellation of the agreement, but on its enforcement. In this regard, recovery by way of a clawback provision appears to be contradictory to rescission; and, so, a plaintiff is often forced to choose *either* remedy. This point was discussed by the court in *Hustad v. Edwin K. Williams & Co. – East*.¹⁵³

The breach of a dependent covenant gives the injured party the right to rescind the contract, or to treat it as broken and to recover damages for a total breach. The injured party must, however, elect between these two remedies as they are mutually exclusive. If the contract is rescinded, it is as though it had never existed, but if the remedy sought is damages for its breach the injured party necessarily thereby recognizes and affirms the initial validity and enforceability of the contract. Even though the breach terminates the contract so that the injured party is no longer obligated to perform that which was to be performed in consideration of the contract, those provisions thereof which, in contemplation of the very breach that occurred, expressly provide for the rights and duties of the respective parties upon termination, should be given effect. Otherwise, such provisions would be totally meaningless.¹⁵⁴

Moreover, equitable considerations would permit a plaintiff to doubly recover under the very same agreement — by simultaneously invalidating it by way of rescission and recover damages per its contractual

language.¹⁵⁵ Accordingly, it would seem, then, that return of net gains due to breach of the agreement would typically preclude return of the very consideration supporting recovery under that agreement.¹⁵⁶

Despite the above issues of double or contradictory recovery, a party seeking return of the consideration would likely **not** be precluded from recovering other damages that do not necessarily rest on the agreement. Indeed, courts have found that damages for unjust enrichment or misappropriation of trade secret information, for example, are not inconsistent with the remedy of rescission.¹⁵⁷ Thus, in instances where recovery is not premised on the contract, it may be possible for an employer to recover **both** damages and paid consideration.

H. CONCLUSION

Employers have recourse against an employee's misconduct through SERPs, clawback provisions, the ECD, and deferred compensation arrangements with forfeiture provisions. Careful drafting in such compensation arrangements will allow an employer to recover at least some of the employee's net gains connected with his or her misconduct. Further, equitable principles may afford the employer with bases for recovering paid consideration under the agreement. Therefore, despite some state opposition to noncompete provisions, employers are not without remedy.

¹⁵¹ See *Rainbow Home Improvement Co. v. Williams*, 379 So. 2d 628 (Ala. Civ. App. 1980) (noting that partial rescission may only occur where the contract is divisible).

¹⁵² See *Rahmani v. Resorts Int'l Hotel, Inc.*, 20 F. Supp. 2d 932 (E.D. Va. 1998) (“[E]ven if Virginia law governed, the plaintiff would not have fared better because the contracts in question would be considered gambling contracts, which are illegal or immoral and thus absolutely null. Hence, under Virginia’s common law, neither **rescission** nor restitution would be available because with regard to such contracts [Virginia] law simply leaves the litigants in the plight in which they have seen fit to place themselves without undertaking to balance benefits or burdens”).

¹⁵³ 321 So. 2d 601 (Fla. App. 4th Dist. 1975).

¹⁵⁴ *Id.* (Internal citations omitted).

¹⁵⁵ See *Bhushan v. Loma Alta Towers Owner’s Association, Inc.*, 148 Fed. Appx. 882 (11th Cir. 2005) (“[A] plaintiff cannot simultaneously claim the benefits of a contract and repudiate its burdens and conditions. This rule makes good sense because to permit a plaintiff to retain the money that she got under a release, and to also repudiate same . . . would allow her to divide or separate the transaction by accepting the favorable part and rejecting what was unfavorable to her.”) (internal marks and citations omitted).

¹⁵⁶ *But see Dean Cowan v. Outpatient Partners, Inc.*, No. 6:04-cv-28-Orl-22JGG, 2004 U.S. Dist LEXIS, at *5 (M. D. Fl. Apr. 1, 2004) (considering breach of a noncompete covenant that was part of a purchase and sale agreement, and including the amount of paid consideration in the damage estimate for purposes of determining jurisdiction).

¹⁵⁷ See *Rhone-Poulenc Agro, S.A. v. DeKalb Genetics Corp.*, 345 F.3d 1366 (Fed. Cir. 2003) (awarding rescission of a genetic testing agreement and awarding damages based on punitive damages, unjust enrichment, trade secret misappropriation and patent infringement claims).

IV. RETALIATION PROHIBITION COMPLIANCE – THE “GROWTH AREA” IN DISCRIMINATION CASES

A. INTRODUCTION

Retaliation cases have always been among the more difficult of the cases to defend under Title VII and the other federal and state discrimination statutes. Last year and this year, the U.S. Supreme Court has issued two important decisions in the retaliation law arena that make these cases even more problematic. Moreover, retaliation cases have had the greatest percentage increase of charges filed with the Equal Employment Opportunity Commission in the most recent two years in which the EEOC has published statistics. (Appendix A)

B. *Burlington Northern v. White*, ___ U.S. ___, 126 S. Ct. 2405, 165 L. Ed 2d 345, U.S. LEXIS 4895, 98 FEP Cases 385 (2006)

1. Holding

- a. “The anti-retaliation provision does not confine the actions and harms it forbids to those that are related to employment or occur at the workplace.”
- b. “[T]he [anti-retaliation] provision covers those (and only those) employer actions that would have been materially adverse to a reasonable employee or job applicant,” meaning that, “the employer’s actions must be harmful to the point that they could well dissuade a reasonable worker from making or supporting a charge of discrimination.”
- c. “By focusing on the materiality of the challenged action and *the perspective of a reasonable person in the plaintiff’s position*, we believe this standard will screen out trivial conduct while effectively capturing those actions that are likely to dissuade employees from complaining or assisting in complaints about discrimination.” (Emphasis added).

2. The Court’s Reasoning

- a. Actionable events are not limited to those that are related to employment or occur at the workplace.
- b. The substantive provisions of Title VII and the anti-retaliation provisions of Title VII differ in purpose:
 - (1) The substantive provisions require that there be discrimination with respect to “compensation, terms, conditions, or privileges of employment.
 - (2) The anti-retaliation provision has no such limiting language. It just prohibits

“discrimination” because an employee engages in protected opposition activity.

- c. The difference is important.
 - (1) The substantive provisions “seeks a workplace where individuals are not discriminated against because of their racial, ethnic, religious, or gender-based status.
 - (2) The anti-retaliation provision “seeks to secure that primary objective [non-discrimination in the workplace] by preventing an employer from interfering (through retaliation) with an employee’s efforts to secure or advance enforcement of the Act’s basic guarantees.”
- d. The actions must be likely to dissuade a reasonable worker from filing a claim or testifying.
 - (1) The anti-retaliation provision does not protect against all retaliation, just that which produces an injury or harm.
 - (2) It must be “materially adverse”, *i.e.*, “it might well have ‘dissuaded a reasonable worker [under the particular circumstances of the case – “context matters”] from making or supporting a charge of discrimination, and not a “trivial harm”.
 - (3) The test is probably not purely objective. The materiality inquiry focuses not just on what the employer did but also “the perspective of a reasonable person in the plaintiff’s position.”

3. Key Points

- a. Adverse actions not restricted to those that occur in the workplace.
- b. Financial loss is not required.
- c. Petty slights are not materially adverse.
- d. “Context matters.” The standard focuses on a reasonable person in the plaintiff’s circumstances, not just a hypothetical reasonable person.

4. Sufficiently Adverse Cases

- a. *Pryor v. Wolfe*, No. 05-21067, 2006 WL 2460778 (5th Cir. Aug. 22, 2006) (unpublished) (persuasive authority only, 5th Cir. R. 47.5.4)
 - (1) *Pro se* Plaintiff claimed employer withheld wages for hours worked after he filed an EEOC charge, where the employer claimed that payment was delayed.

- (2) Holding: “[D]eprivation of earned compensation would almost certainly ‘dissuade[] a reasonable worker from making or supporting a charge of discrimination.’”
- b. *Harris v. Fresenius Medical Care*, No. H-04-4801, 2006 WL 2065313 (S.D. Tex. July 24, 2006) (Rosenthal, J.)
- (1) After filing an internal complaint of discriminatory failure to hire to a full time position, Plaintiff (part time employee) alleged retaliatory acts of: (a) not being scheduled for enough hours; (b) being scheduled to work on Saturdays which conflicted with her religious beliefs; (c) having the supervisor treat Filipino employees better (including with respect to the difficulty of patients assigned; and (d) being given a negative job reference to a prospective employer.
 - (2) Only the negative job reference implicitly found to be an adverse employment action.
 - (3) No pretext issue on the failure to assign hours; no causal connection on having to work Saturdays (job requirement for full time employees); and the remaining alleged acts were not the kind to “dissuade[] a reasonable from making or supporting a charge of discrimination” (scheduling of lunch breaks, letting Filipino employees speak a language other than English among themselves, and the assignment of patients).
- c. *Jones v. Griffin*, No. H-04-4719, 2006 WL 2253133 (S.D. Tex. Aug. 3, 2006) (Smith, Magis. J.)
- (1) After filing an EEOC charge, Plaintiff alleged he was retaliated against by being denied a promotion when assuming 80% of the duties of a retired employee in a higher pay grade.
 - (2) “Viewed in light of most favorable to Jones, there is a real possibility that a reasonable person could have found the challenged action materially adverse.”
 - (3) Failure to promote claim failed, though, because no pretext on why Plaintiff was not promoted (unable to perform certain tasks previously performed by retiree).
 - (4) Also, negative comments in an appraisal consistent with prior appraisals and, therefore, not a “hostile reaction” and no causal connection between the EEOC charge and the appraisal.
- d. *Monroe v. Corpus Christi Indep. School Dist.*, No. C-05-412, 2006 WL 2092436 (S.D. Tex. July 26, 2006) (Owsley, Magis. J.)
- (1) Not receiving an interview which precluded an applicant for a promotion the ability to be promoted is an “adverse employment action.”
 - (2) But, Plaintiff failed to show a causal link (slight deviation from interview selection practice was *de minimis* – and comparators were also African-American) and failed to show pretext (employer “engages in equal employment opportunity practices through a neutral selection procedure”).
- e. *Moore v. City of Philadelphia*, No. 03-1465, 2006 WL 2492256 (3d Cir. Aug. 30, 2006)
- (1) Rent the movie *Serpico*. After complaining of racial mistreatment of African American officer, several white officers were subjected to adverse acts, including: (a) a change of demeanor and treatment; (b) receipt of less desirable assignments; (c) job transfer; (d) increased scrutiny while on sick leave; (e) assault; (f) failure to give a court notice; (g) intervention on behalf of an ex-wife in a contentious child custody dispute; and (h) termination.
 - (2) “Materially adverse” actions
 - (a) Having weapon stripped, duties changed and ordered to have a psychiatric examination for a threat to shoot a supervisor “for what he does to us where the supervisor had threatened to make the officer’s life a “living nightmare”.
 - (b) Being threatened, assaulted and laterally transferred after brother threatened to shoot the supervisor and the supervisor threatened to “kick [the brother’s] ass.
 - (c) Being “falsely disciplined” for contacting a supervisor at his beach house on a holiday weekend, and having the supervisor become involved in the child custody dispute.
 - (3) “These three police officers have sought to recover for a long, unpleasant experience working at the Philadelphia Police Department. We find that a jury might well believe that their supervisors made their lives the ‘living nightmare’

one supervisor promised as payment for opposing unlawful discrimination.”

f. *Randolph v. Ohio Department of Youth Services*, 453 F.3d 724 (6th Cir. 2006)

- (1) Plaintiff alleged that, after complaining about sexual harassment by inmates, and later, sexual assault, she was retaliated against by being placed on administrative leave and then terminated, notwithstanding her later reinstatement with 70% back pay.
- (2) “[T]he termination and concomitant loss of income constitutes a materially adverse action under Title VII, notwithstanding Randolph’s later reinstatement with back pay.”

g. *Mickelson v. New York Life Ins. Co.*, No. 05-3049, 2006 WL 2468302 (10th Cir. Aug. 28, 2006)

- (1) After filing both an internal complaint and an EEOC charge, Plaintiff complained she was retaliated against in several respects.
- (2) Refusal to allow to return to work from FMLA leave on a part time basis, leading her to exhaust her FMLA leave earlier than she would have otherwise which led to her termination was sufficiently adverse action.
- (3) Failure to promote or transfer (no positions open), having to use her vacation time to study for the bar (same as her prior two times off to study for the bar), and a “derogatory” email complaining about Plaintiff’s unruly conduct in a meeting insufficiently adverse to deter a reasonable employee.

h. *Kessler v. Westchester County Dep’t of Soc. Svcs*, No. 05-2582-CV, 2006 WL 2424705, (2nd Cir. Aug. 26, 2006)

- (1) After filing charges of discrimination with the state discrimination agency and the EEOC, the Plaintiff alleged he was retaliated against by being transferred to a less desirable job and stripped of responsibilities, notwithstanding the fact that his pay grade remained the same.
- (2) Found to be sufficiently adverse to defeat summary judgment.

5. Insufficiently Adverse Action Cases

a. *Harris v. Fresenius Medical Care*, No. H-04-4801, 2006 WL 2065313 (S.D. Tex. July 24, 2006) (Rosenthal, J.)

- (1) Scheduling of lunch breaks, letting Filipino employees speak a language

other than English among themselves, and the assignment of patients.

- (2) “[N]ot materially harmful employment actions that would have ‘dissuaded a reasonable worker from making or supporting a charge of discrimination.’”

b. *Sabzevari v. Reliable Life Ins. Co.*, No. 03-3240, 2006 WL 2336909 (S.D. Tex. Aug. 10, 2006) (Miller, J.)

- (1) Plaintiff alleged that a denial of a transfer from Beaumont to Austin was retaliation for filing an EEOC charge.
- (2) Not a materially adverse act, where a change in working conditions are minor and the difference is based on the subjective preference of the employee – “[m]ere idiosyncrasies of personal preference are not sufficient to state an injury.”

c. *Molina v. Equistar Chemicals, L.P.*, No. C-05-327, 2006 WL 1851834 (S.D. Tex. June 30, 2006) (Jack, J.)

- (1) Plaintiff, already on a written performance plan, was given a last chance agreement after he filed an EEOC charge because his performance continued to be problematic. Plaintiff chose to resign when given the LCA and alleged that the LCA was retaliation for filing an EEOC charge.
- (2) Court quoted *Burlington* that “[a]n employee’s decision to report discriminatory behavior cannot immunize the employee from those petty slights or minor annoyances that often take place at work and that all employees experience.”

d. *Lynch v. Baylor University Medical Center*, No. 3:05-CV-0931-P, 2006 WL 2456493 (N.D. Tex. Aug. 23, 2006)

- (1) On the same day as filing an internal complaint of discrimination, the Plaintiff also filed an EEOC charge. When learning of the EEOC charge, the employer denied the employee the ability to pursue her internal complaint through the employer’s grievance procedure. Plaintiff claimed that this denial was in retaliation for filing the EEOC charge.

- (2) Court finds that this action would not have dissuaded a reasonable employee from making a charge of discrimination.

e. *Tomanovich v. City of Indianapolis*, No. 05-1653, 457 F.3d 656 (7th Cir. Aug. 8, 2006).

- (1) After the employee filed an EEOC charge, the employer updated a notice of unacceptable performance and several months later fired the employee. The employee claimed both were acts of retaliation.
 - (2) Questionable whether the updated notice (given when employee did not show for a meeting to review his performance after the original notice) is a “materially adverse employment action” (the termination clearly was).
- f. *Mickelson v. New York Life Ins. Co.*, No. 05-3049, 2006 WL 2468302 (10th Cir. Aug. 28, 2006)
- (1) Failure to promote or transfer (no positions open), having to use her vacation time to study for the bar (same as her prior two times off to study for the bar), and a “derogatory” email complaining about Plaintiff’s unruly conduct in a meeting.
 - (2) Actions insufficiently adverse to deter a reasonable employee.
- g. *Reis v. Universal City Develop. Partners*, No. 6:06-cv-613-Orl-19JGG, 2006 WL 2054178 (M.D. Fla. July 21, 2006)
- (1) Plaintiff – with congenital heart problems – alleged that a denial of a lateral transfer into an inside position was retaliation.
 - (2) Found not to be “materially adverse.”
- h. *Martin v. Merck & Co., Inc.*, No. 5:05 cv 0028, 2006 WL 2468518 (W.D. Va. Aug. 28, 2006)
- (1) Plaintiff was removed from the relief operator position during the first shift and forced either to rotate between the first and second shifts or work solely on the newly-created third shift.
 - (2) The plaintiff testified that this schedule change presented a hardship because of a dog that could not be left alone at home. The court dismissed this out of hand because the employer gave her the option of working the third shift which, the Court said, would have permitted her to be available for dog care.
 - (3) "I find that the minor inconvenience Martin suffered as a result of being removed from her relief operator position fails to meet the materiality requirement."
- i. *Higgins v. Gonzales*, No 06-2556 (8th Cir., March 20, 2007)
- (1) After complaining about sporadic off-hand comments about Native Americans, the plaintiff (a former assistant U.S. attorney) allegedly failed to receive mentoring, was given the “cold shoulder,” and was transferred to a similar position 100 miles away.
 - (2) The Eighth Circuit, in its first application of *Burlington Northern*, found the lack of mentoring and personality conflict to be trivial harms that were not materially adverse. It further found that the transfer resulted in no diminution in job benefits, job duties, job responsibilities or job prestige.
- j. *DeHart v. Baker Hughes Oilfield Operations, Inc.* No. 05-21087, 100 FEP Cases 88 (5th Cir Jan 19, 2007) (unpublished)
- (1) Employee received a written warning for alleged insubordination, for being argumentative, and for excessive absenteeism.
 - (2) Held not to be “adverse employment action[s]” because “there were colorable grounds for the warning.”
 - (3) The Fifth Circuit also noted that the employee did, in fact, file a charge several weeks after receiving the written warning and could not have, therefore, been “dissuaded...from making or supporting a charge of discrimination.”

6. Considerations Moving Forward

- a. Do not ignore the other prongs of the *prima facie* case. That plaintiffs may now sue over actions less than ultimate employment actions in no way eliminates the obligation to demonstrate that the plaintiff engaged in protected conduct or that such conduct motivated the employer’s actions.
- b. “Context matters” also helps define alleged adverse acts as petty or normal workplace annoyances.
- c. *CBO West, Inc. v. Humphries*, ___ U.S. ___, 128 S.Ct. 1951, 2008 U.S. LEXIS 4516 (May 27, 2008)
 1. Holding: 42 U.S.C. § 1981 encompasses retaliation claims.
 2. The Court’s Reasoning: Because of the similarity between §1981 and §1982 (the latter of which the Court had previously found encompassed claims of retaliation and which also derived from the 1866 Civil Rights Act) and because the federal appellate courts’ consistent

interpretation of §1981 as encompassing retaliation claims, there was no reason to overturn prior precedent construing § 1982.

3. Key Points

- a. § 1981 has a longer statute of limitations than Title VII and the parallel Texas discrimination statute.
- b. Unlike Title VII and the parallel Texas discrimination statute, there are no limitations on the amount of punitive damages and pain and suffering damages available to a plaintiff.

APPENDIX A

RANK	2006	RANK	2007	RANK	% CHANGE
1	Race (27,238)	1	Race (30,510)	1	Retaliation (+18.2%)
2	Sex (23,247)	2	Retaliation (26,663)	2	Age (+15.4%)
3	Retaliation (22,555)	3	Sex (24,826)	3	Pregnancy (+14.0%)
4	Age (16,548)	4	Age (19,103)	4	Disability (+13.9%)
5	Disability (15,575)	5	Disability (17,734)	5	Religion (+13.3%)
6	Sexual Harassment (12,025)	6	Sexual Harassment (12,510)	6	National Origin (+12.8%)
7	National Origin (8,327)	7	National Origin (9,396)	7	Race (+12.0%)
8	Pregnancy (4,901)	8	Pregnancy (5,587)	8	Sex (+6.8%)
9	Religion (2,541)	9	Religion (2,541)	9	Sexual Harassment (+4%)
10	Equal Pay (861)	10	Equal Pay (818)	10	Equal Pay (-5%)

* Source:

<http://www.eeoc.gov/stats/charges.html>