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EMPLOYER'S GUIDE TO RECOVERY OF WAGE OVERPAYMENTS

By John Shyer, Norma Studt, Kevin Kay and Aaron Safane*

Many jurisdictions have enacted statutes governing whether an employer may recover inadvertent overpayments from an employee's wages, including rules and regulations with respect to the amount and timing of repayment. However, not all jurisdictions have such statutes. Laws vary significantly in each jurisdiction making it impossible for global employers to adopt a uniform policy on wage deduction. With the goal of assisting employers with operations in multiple locations, this article focuses on employers' right to recover wage overpayments through the use of wage deductions in New York, Massachusetts, Illinois, Texas and California as well the United Kingdom and Germany.

United States

The Wage and Hour Division of the United States Department of Labor, the federal office responsible for enforcing the Fair Labor Standards Act (the FLSA), views overpayments to employees as a loan of the advanced wages. An opinion from the Wage and Hour Division of the United States Department of Labor interpreted the

FLSA to permit an employer to recoup an overpayment from an employee's paycheck, even when the employee did not expressly authorize such deduction.¹ However, employers in the United States are also subject to state regulation with respect to the recovery of overpayment of wages. As stated above, wage laws vary significantly from state to state. Some states have statutes that expressly permit recovery through wage deduction or that have been interpreted to allow such recovery under certain conditions. Other states have statutes or regulations that have been interpreted to prohibit recoupment through paycheck adjustment.

New York

On September 7, 2012, Governor Andrew Cuomo signed into law a bill that amends New York Labor Law Section 193, effective as of November 6, 2012, by expanding the categories of permissible wage deductions that employers may take with the consent of employees. Prior to the amendment, the New York State Department of Labor (NYSDOL) had narrowly interpreted New York Labor Law Section 193, thereby prohibiting

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private employers from deducting from an employee's wages, among other things, the repayment of inadvertent overpayments. The amendment to New York Labor Law Section 193 permits an employer to make deductions to recover inadvertent wage overpayments due to mathematical or other clerical errors. However, any such deductions will be subject to compliance with NYSDOL regulations. NYSDOL has not yet promulgated the regulations, but they will include the following:

- The size of the overpayments that may be recovered
- The timing, frequency, duration and method of any recovery or repayment
- Limitations on the periodic amount of any recovery or repayment
- A requirement that the employer provide notice to the employee prior to commencing any recovery or repayment
- A requirement that the employer implement a procedure that allows an employee to dispute the amount of any recovery or repayment or to delay commencing any recovery or repayment
- A requirement that the employer provide notice of the terms and content of its procedure to the employee prior to commencing such recovery

Until NYSDOL regulations are available, private employers with operations in New York should avoid deductions intended to recover wage overpayments. Private employers with operations in New York should also be aware that the amendment is set to expire three years after the effective date, and therefore, it is possible that the law may change again.

Massachusetts

The Massachusetts Wage Act generally prohibits employers from deducting wages from an employee's paycheck after such wages are earned, unless otherwise authorized or required by law. However, the Massachusetts Wage Act creates an exception for "valid setoffs" against wages. Massachusetts courts have held that a setoff is only valid when it is used

to recover a "clear and established debt." The state's attorney general's position has been, and the Massachusetts courts have held, that the following are all valid grounds for setoff: deductions for undisputed loans or wage advances, employee theft or misappropriation established through an independent proceeding with due process protections and a judgment in the employer's favor for the value of the employer's property. However, the courts have not directly addressed the topic of wage deductions for the recovery of a mistaken overpayment. Some commentators have speculated that deductions for mistaken overpayment of wages would likely meet the criteria for a valid setoff. However, in the absence of any specific authority permitting such deductions, employers with operations in Massachusetts should avoid deductions intended to recover wage overpayments.

Illinois

Pursuant to the Illinois Wage Payment and Collection Act, an employer may deduct overpayments from an employee's wages. If the overpayment is undisputed by the employee and is discovered before the employee's first regularly scheduled payday after such overpayment occurred, the employer may deduct the entire overpayment from the employee's next scheduled paycheck. However, if the undisputed overpayment is not discovered until after the next regularly scheduled paycheck, the employee must give express, written consent to a schedule of deductions for the repayment. Pursuant to the Illinois Wage Payment and Collection Act, such scheduled deductions may not exceed 15 percent of the employee's gross wages per paycheck. Importantly, employers in Illinois drafting such a written repayment agreement should include a provision stating that if, upon an employee's termination or resignation, the balance of the overpayment remaining to be repaid by the employee exceeds 15 percent of such employee's gross wages, that amount may be deducted from the employee's final compensation. Such a deduction is permitted under Illinois law, but only if such a provision was included in an agreement signed by the employee.

Pursuant to the Illinois Wage Payment and Collection Act, in the event that the employee does not agree to an overpayment deduction, the employer may still withhold the amount in question from the employee's paycheck, provided that the employer notifies the Illinois Department of Labor in writing on the date the payment is made. Such written notice must state (i) the amount that is being withheld, (ii) the date it is withheld and (iii) the reasons for which the payment is being withheld. Once the Illinois Department of Labor receives such notice from the employer, it will complete an investigation within 30 days and thereafter render a judgment. Employers in Illinois should note that the acceptance by the employee of a disputed paycheck does not constitute acquiescence by the employee to the deduction. If the employer is ordered to repay the employee, then the employer must pay within 15 days of the Department of Labor's determination.

Texas

Texas Labor Code Section 61.018 permits an employer to withhold part of an employee's wages if it (i) is ordered to do so by a court of competent jurisdiction, (ii) is authorized to do so by state or federal law or (iii) has written authorization from the employee to deduct part of the wages for a lawful purpose.

Texas Labor Code Section 61.018 has been interpreted to permit an employer to recover a wage overpayment through deductions from an employee's wages after receiving the employee's voluntary prior written consent, specifying the amount and timing of such deductions. In the absence of such written authorization by the employee, an employer with operations in Texas should avoid such deductions.

California

The Division of Labor Standards Enforcement, the entity responsible for enforcing the California Labor Code, has stated that, in general, an employer may lawfully recover a wage overpayment through deductions from an employee's wages provided (i) the deductions are specifically and voluntarily authorized by the employee

in a signed writing, (ii) no such deductions are made from the employee's final paycheck and (iii) any such deduction does not cause the employee to earn less than the minimum wage. In the event that the employee does not agree to the deductions to recover a wage overpayment, an employer with operations in California should avoid such deductions.

Europe

United Kingdom

The UK Employment Rights Act 1996 (the Act) protects workers from unauthorized deductions from their wages by their employers. For these purposes, "worker" is defined to include not only an employee but also any individual who has entered into a contract to perform services personally for the employer, unless such individual is carrying on a profession or business and the employer is such individuals' client or customer.

The Act provides that an employer may make deductions where (i) the deduction is required or authorized by statute, (ii) the deduction is required or authorized by a provision in the worker's contract or (iii) the worker has given his or her prior written consent to the deduction.²

Deductions made to reimburse the employer with respect to overpayment of wages or expenses do not come under the unlawful deductions regime. Employers therefore can make such deductions, even when overpayment was accidental, without the need to gain prior written consent or without authorization in the worker's contract. Employers are, however, advised to include a provision in the worker's contract allowing for such deductions to be made, as this will give the employer both contractual authorization and statutory justification for the deductions.

Germany

If an employer in Germany inadvertently overpays salary or other remuneration to an employee, it has, in principle, a repayment claim against such employee based on unjustified enrichment, pursuant to Sec. 812

para. 1 of the BürgerlichesGesetzbuch (the German Civil Code or BGB). In accordance with the court rulings of the Federal Labor Court, such a repayment claim is based on unjustified enrichment. For example, a repayment claim may be established if the employer has simply made a calculation error or erroneously believed that it was obliged to make the payment under collective labor agreements. In such cases, however, the employer has a burden of production and proof that it made the overpayment in error.

If the employer had actual knowledge that it was not required to make the excessive payment, the employer cannot make a repayment claim based on unjustified enrichment.³ A repayment claim is also precluded if the employee is “enriched,” which under the BGB means that the employee has already innocently spent the payment.⁴ However the employee has the burden of production and proof with regard to the affirmative defense of enrichment, and such a defense will fail if the employee knew that there was no lawful basis for the payment to him.⁵

In principle, the employer’s repayment claim is due at the time of the overpayment, even if the employer does not know of the existence of such claim at the time of the overpayment. In addition, an employer’s repayment claim may be further precluded through contractual or collectively agreed restrictions on the permissible recovery period.

Conclusion

Employers with operations in jurisdictions that either do not permit deductions from an employee’s wages for recovery of an overpayment or that do not have clear guidance on the issue should adopt a policy for other methods of recoupment. One such alternative method of recovery where the overpayment is not in dispute is to contract for the employee to repay the employer through means other than payroll deductions. Any such written agreement should specify (i) the reason for the repayment, (ii) the amount of the repayment and (iii) the timing of the repayment. In jurisdictions where there is no clear authority for deductions to recover a wage overpayment and such overpayment is in dispute, an employer may be required to commence a civil action to recover the unpaid debt. ■

Endnotes

¹ Opinion Letter, Wage and Hour Div., U.S. Dep’t of Labor, FLSA2004-19NA (Oct 8, 2004), available at http://www.dol.gov/whd/opinion/FLSANA/2004/2004_10_08_19FLSA_NA_recoup.pdf.

² The Act does not apply to the following circumstances, and an employer may deduct amounts from an employee’s wages pursuant to the following exemptions: (1) deductions relating to taking part in an industrial action; (2) deductions made pursuant to the direction of a statutory authority; and (3) deductions for amounts payable to a third party pursuant to a written agreement or contractual provision. If an employer wishes to make deductions from wages for any reason that is not one of the listed exemptions, it should include a well-drafted clause in the contract with the worker to allow for such deduction. If done properly, this should render any future deductions lawful.

³ Sec. 814 BGB.

⁴ Sec. 818 para. 3 BGB.

⁵ Sec. 819 para. 1, 820 para. 1 BGB.

NEW SAY-ON-PAY RULES IN THE UK

By Sarah Gadd

Out With the Old...

To date, the UK “say-on-pay” rules have been relatively light-weight. Under the existing rules, UK incorporated companies that are listed on the Financial Services Authority’s Official List are required to publish a directors’ remuneration report annually and submit that report to an advisory shareholder vote. Crucially, the vote has only ever been advisory, and the UK Companies Act 2006 actually prohibits a director’s remuneration being made conditional on a shareholder vote. In light of the recent economic crisis and various reports on the divergence between escalating executive pay and downward pressure on employee wages, these rules have been criticised as being ineffective. In particular, the advisory nature of the shareholder vote, the confusing way that information in the remuneration reports is presented and low shareholder activism have come under fire.¹

In With the New...

The UK government has now published draft amendments to the UK Companies Act 2006 (the Companies Act) that embody the new UK say-on-pay regime. The new regime is due to come into effect in October 2013.

Under the new rules, the annual remuneration report must comprise two separate parts:

- A remuneration policy report that will be subject to a binding shareholder vote at least every three years.
- A remuneration implementation report that will be subject to an annual advisory shareholder vote and must include a single figure for how much each director was paid in the previous year.

In addition, the prior prohibition on making executive pay conditional upon a shareholder vote will be removed from the Companies Act.

What Information Should the New Reports Include?

The “policy report” essentially will be a forward-looking document setting out the company’s remuneration proposals for the next three years. An ordinary resolution (requiring over 50 percent of shareholder votes) will be required to approve the policy report and the company will only be able to make payments in line with that report. If the company wishes to make any payments which are not envisaged in the approved report, a separate shareholder resolution will be required to approve the payment.

The policy report will have to include the following information:

- Whether the opinions of the employees were obtained regarding the proposed remuneration and detail on how their opinions were sought.
- Whether any element of the remuneration is subject to a claw-back.
- Details of any director severance packages, including an explanation of how each element of pay will be dealt with when determining the severance package, whether there is a distinction between good and bad leavers, and how performance will be taken into account.

While this is a significant expansion of the current requirements, the new rules have not gone as far as some earlier reports had proposed. For example, in respect of severance packages, the government had considered requiring a specific shareholder vote to approve the value of any cash, shares or other benefits received by a director on termination of service in excess of one year’s basic salary. In addition, affected companies will be relieved that the new rules require a binding vote on the policy report every three years (not annually), will not extend to non-board executives and will not require employee representatives to sit on the board’s remuneration committee — all



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suggestions made during the debate on reforming say-on-pay in the UK.

Where the policy report is not produced for a particular year or if a policy report is voted down by the shareholders, the last approved report will continue to apply until a new report is approved.

The “implementation report” will be a retrospective report that explains how the remuneration policy has been implemented in the past year. This report must be produced annually and submitted to an advisory shareholder vote. The implementation report therefore will be similar to the existing remuneration report although it is required to include the following new information:

- A single figure of remuneration for each director.
- More detailed information about the performance conditions for annual bonuses, options and long-term incentive plans (LTIPs) and how the company performed against those targets.²
- Details of how any termination packages have complied with the company’s remuneration policy.
- A chart comparing company performance (using total shareholder return) with chief executive officer (CEO) remuneration.
- Details of how shareholders voted on the company’s policy and implementation reports at the previous annual meeting (including the percentage of abstentions, reasons for significant dissent and any action taken by the remuneration committee in response); this measure appears to be targeted at increasing shareholder activism.

Which Companies Will Be Affected?

The rules will apply to the reporting of board director remuneration at UK-incorporated companies that are listed on the “Official List” maintained by the Financial Services Authority. This will include UK-incorporated companies listed on a recognized European market or on NYSE or NASDAQ. This means

that the new rules will not apply to non-UK incorporated companies listed on the London Stock Exchange.³ The rules also will not apply to UK companies listed on the London Stock Exchange’s alternative investment market (AIM). However, the government is clearly hoping that investor pressure will lead to such companies voluntarily adopting similar disclosure and voting practices.

When Will the New Rules Come into Effect?

The government has indicated that the new rules will come into effect for companies with fiscal years ending on or after October 1, 2013. The first companies to be affected by the new rules generally will be companies with December 2013 year-ends. These companies will be required to comply with the new rules when preparing the 2013 year-end report, and the 2014 annual meeting will be required to include the advisory vote on the implementation report and the binding vote on the policy report.⁴

What Are the Risks of Breaching the Rules?

Any contractual obligation to make a payment to a director that falls outside the scope of an approved remuneration policy report will not be enforceable. If any remuneration is paid to a director in breach of the new rules, that remuneration will be recoverable by the company from the receiving director and from the directors who authorised the relevant payments. The new rules therefore envisage an increase of shareholder activism to monitor and enforce compliance with the new rules.

What About Existing Remuneration Agreements?

Note that some “grandfathering” will be permitted under the new rules. Certain payments made under agreements dated before June 27, 2012, will not be covered by the new recovery rules, even if they are inconsistent with the company’s remuneration policy. Note, however, that agreements amended since that date will not be protected by the grandfathering exemption.

Next steps

Assuming that the new rules are implemented next October, affected companies should prepare to make considerable adjustments to their annual reporting procedures to ensure that they are complying with these new rules.

While the government has produced only draft rules so far, it is anticipated that some amendments will be made to these rules in the coming months to address certain issues. In particular, the definition of “remuneration payment” in the draft rules is limited to payments for accepting and carrying out the office of director, which could in theory enable companies to split an executive director’s remuneration into a small director fee (which would have to be disclosed in the remuneration report) and larger payments for other services which (at least in theory) would not require disclosure. It is anticipated that the final rules will rectify this issue. It is also not clear at this stage whether certain share awards that vest or are exercised after termination of a director’s service are captured in the disclosure rules, and this question may also be addressed in a future draft of the rules.

In the meantime, affected companies should consider preparing suitably flexible remuneration policy reports to apply from 2014 onwards. A company should make its policy sufficiently flexible to ensure that future implementation reports can demonstrate full compliance with the policy while ensuring that key shareholders support and will approve the proposed policy. ■

Endnotes

- ¹ For more background on the current rules and the momentum for reform see our earlier article [“Recent Developments in Say-On-Pay in the US and the UK”](#) in *Working World Issue 14*.
- ² These new disclosure obligations will be particularly concerning insofar as they relate to annual cash bonuses as the performance conditions attaching to executive bonuses are often deliberately obscure.
- ³ Thus, some companies may consider redomiciling outside the UK to avoid the new rules.
- ⁴ Note that all companies will be required to produce a policy report in the year that the rules are first applicable (*i.e.*, 2014). Companies cannot simply delay complying with the rules for three years.



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401(K) PLANS WITH EMPLOYER STOCK — WATCH YOUR SPD DISCLOSURE

By Robin Struve

Recent case law developments in the US have increased the potential ERISA fiduciary liability for US public companies that sponsor 401(k) plans and other individually-directed tax-qualified plans with a company stock investment fund among the investment alternatives. Most cases involving company stock funds have focused on the prudence of maintaining the employer stock fund during a period when such employer stock was declining. However, a recent US Sixth Circuit Court of Appeals case, *Dudenhoefer v. Fifth Third Bancorp*, No. 11-3012, 2012 WL 3826969 (6th Cir. Sept. 5, 2012), adds a new angle to plaintiffs' arguments by finding that incorporation of public filings made with the US Securities and Exchange Commission (SEC) into the plan's Summary Plan Description (SPD) was a fiduciary act, and that such SEC filings, if misleading, could serve as the basis for a breach of fiduciary duty claim.

The lower court in *Dudenhoefer* found that the alleged misrepresentations and omissions in the SEC filings, which were incorporated by reference and not actually included in the SPD, were not made in an ERISA fiduciary capacity since such communications were not required under ERISA. As a result, the lower court found that the SEC documents could not serve as the basis of a claim by plaintiffs, who alleged that the defendants, as ERISA fiduciaries, breached their duty of loyalty by providing misleading information about the company stock investment. However, the Sixth Circuit Court of Appeals overturned the lower court's decision and held that, by incorporating SEC filings into the SPD, the defendants had intentionally intertwined the SEC filings with an ERISA fiduciary communication (the SPD) and had thus engaged in fiduciary conduct, as the SEC filings were fiduciary communications. As a result, the ERISA plan fiduciaries could breach their duty of loyalty if the SEC filings, in fact, contained material misrepresentations or omissions.

Most public companies satisfy their required securities law prospectus disclosure by including and incorporating such disclosure in the SPD. However, those companies that do so should be aware of the increased risk to ERISA fiduciaries post-*Dudenhoefer*. Any company that has employer stock as an investment alternative in its 401(k) plan or other individually directed defined contribution plan should review the plan's SPD to make sure that the SPD does not inadvertently create additional risk and liability to ERISA fiduciaries by incorporating information from SEC filings that may contain misrepresentations or omissions of pertinent information.

Such risk could be alleviated by separating the required ERISA SPD disclosure from the required SEC prospectus information. Providing two communications regarding the same plan, however, would be impractical and cumbersome. Instead, companies may place the required SEC prospectus disclosure in a separately identified section at the end of the SPD. Such disclosure should also specifically note that it does not form a part of the SPD and it is being made solely by the company and is not being made by the plan administrator or any other fiduciary. Clear labeling of the SEC disclosure material as non-ERISA fiduciary communications should address the court's concerns in *Dudenhoefer* while allowing companies to satisfying both their SEC and ERISA disclosure requirements in one document. ■

PROSPECTUS DIRECTIVE SUMMARY

By *Stephen Brown*

It is unlawful for a public offer of transferable securities to be made in the UK unless a prospectus, approved by the Financial Services Authority (FSA) or another authority in the European Economic Area (EEA) has been issued, or an exemption applies. The Prospectus Directive, originally implemented in 2005, regulates the preparation of prospectuses throughout the EEA. This summary is intended to clarify the applicability of the Prospectus Directive to a company's grant of stock-based awards to its employees and others in the UK.

Overview

Non-assignable stock options do not fall under the Prospectus Directive because they typically are not transferable securities. Therefore, stock options do not require an exemption.

Other types of award, such as restricted stock units (RSUs) and long-term incentive plan (LTIP) awards, restricted stock and stock appreciation rights (SARs) may fall within the scope of the Prospectus Directive's applicability. Where securities are allocated free of charge, *e.g.*, gifted, (and there is no element of choice on the part of the recipient), there is no "offer of securities to the public" within the meaning of the Prospectus Directive, therefore such allocations would fall outside the scope of the Prospectus Directive.¹ However, in the unusual situation where the intended recipient of the free shares does have a choice whether to accept the shares, it is likely that this will be an "offer" and that the Prospectus Directive would apply. Even if the Prospectus Directive covers such awards, there may be an exemption that applies to these types of awards, which means that a prospectus would not be required.

There are four main exemptions to the requirements of the Prospectus Directive:

1. Where the total consideration for the offer of securities is less than €5 million (when aggregated with all other non-exempt offers of the same securities made into the EEA over the last 12 months).
2. Where the offer is made to less than 150 persons in each EEA member state.
3. Where (a) the company/issuer is a company with its head or registered office within the EEA, or not in the EEA but has securities listed on an EEA regulated market (in either case, an EEA Company), and (b) the issuer has issued an employee information document.
4. Where, in the case of a company that is not an EEA Company, (a) the European Commission (the EC) has formally agreed that the market on which the securities are listed has a legal and regulatory framework that is equivalent to an EEA regulated market (an Equivalent Market) and (b) the issuer has issued an employee information document.

Exemptions three and four together are referred to as the "Employee Share Scheme Exemption." Exemption four currently is not available because the EC has not yet formally agreed that any non-EEA regulated market is equivalent to an EEA-regulated market. Note that the Employee Share Scheme Exemption will not be available if the plan in question allows non-employees (such as consultants) to participate.



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Table of Main Exemptions (In Order of Usefulness) to Prospectus Directive for Various Companies and Awards

Type of Award Issuer	Non-Transferable Stock Options	Free Shares ²	Non-Transferable RSU/LTIP ²	Non-Transferable SAR	Restricted Shares with Purchase Price	Employee Stock Purchase Plan (ESPP) ³
UK Private Company	Not caught by Prospective Directive (PD) Arguably, PD does not apply if shares not negotiable on a capital market.					
UK PLC	Not caught by PD	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Exemption 1 & 2 (But note caps for both) Share Scheme Exemption	Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption
US NYSE/NASDAQ⁴	Not caught by PD	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Exemption 1 and 2 (But note caps for both) Share scheme Exemption	Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption
EEA Company (HQ in EEA, or HQ outside of EEA but with securities listed on EEA regulated market)	Not caught by PD ²	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Exemption 1 and 2 (But note caps for both) Share Scheme Exemption	Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption
Non-EEA Company but with shares listed on an Equivalent Market NB: the Share Scheme Exemption will only apply once EC has agreed market is an Equivalent Market	Not caught by PD	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Probably not caught by PD ² Exemption 1 & 2 Share Scheme Exemption	Exemption 1 and 2 (But note caps for both) Share Scheme Exemption	Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption

Type of Award Issuer	Non-Transferable Stock Options	Free Shares ²	Non-Transferable RSU/LTIP ²	Non-Transferable SAR	Restricted Shares with Purchase Price	Employee Stock Purchase Plan (ESPP) ³
UK Company listed on AIM	Not caught by PD	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2t	Probably not caught by PD ² Exemption 1 & 2	Exemption 1 and 2 (but note caps for both)	Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption
Non EEA Company listed on AIM	Not caught by PD	Probably not caught by PD, provided there is no element of choice on the part of the recipient (see above)	Probably not caught by PD ² Exemption 1 & 2	Probably not caught by PD ² Exemption 1 & 2	Exemption 1 and 2 (but note caps for both)	P Not caught by PD if drafted as an option Exemption 1 & 2 (But note caps for both) Share Scheme Exemption

Endnotes

- ¹ There is still a risk that the FSA could deem the offer of free shares to be disguising 'hidden consideration', *i.e.*, shares offered in lieu of remuneration the employee would otherwise receive. Therefore they would be within the scope of the Prospectus Directive, unless one of the four exemptions applies.
- ² There is an argument, not accepted by all commentators, that giving free shares as a "gift" is not an "offer" and therefore is excluded from the PD and an exemption is not required.
- ³ There are a number of ways of constructing an ESPP. To fall outside of the PD, it is necessary that the ESPP is constructed as an option plan rather than simply a saving scheme linked to the automatic purchase of shares at the end of the savings period.
- ⁴ As noted above, exemption four currently is not available because the EC has not yet formally agreed that any non-EEA regulated market is equivalent to an EEA-regulated market. ■

BCE Group Highlights

Latham's BCE group frequently produces thought leadership and webcasts that may be of interest. A selection of recent offerings appear on the BCE Practice page at <http://www.lw.com/practices/BenefitsCompensationAndEmployment>.

Thought Leadership

A Useful Tool for Global Employers: A Look at Short-time Work in Germany

Employment Law Strategist publishes article by Latham analyzing “short-time work” in Germany.

Reform, Reform, Reform — The Latest Developments in The UK Government's Efforts to Cut Back Red Tape in Employment Law

Reforms to existing UK employment law are designed to give firms more flexibility and confidence in managing their workforce and reduce red tape.

Rules of Engagement: Building Relationships with Your Shareholders Through Effective Communication

Shareholder engagement can help build valuable relationships with institutional investors that will pay dividends in the future.

Pay Design Issues to Consider in Planning for 2012 Year-End and 2013 Pay Decisions

The most important issue of 2012 was pay-for-performance alignment and experts say it will continue to dominate in 2013.

California Limits Employer Access to Employee/Applicant Social Media

California became the third state to enact legislation protecting social media users from employers and universities.

Employee Incentive Plans for Executives in Bankruptcy Cases Denied

The bankruptcy court has denied company motions to establish employee incentive plans for key executives in two recent cases.

2013 Proxy Season Update — Five Key Executive Compensation Considerations

Five important issues public companies should consider in preparing 2013 proxy statements.

In Brief: UK

UK PENSIONS RIGHTS TRANSFERRING ON AN ASSET SALE

By Catherine Drinnan and Kathryn Ramsden

A recent UK High Court decision has confirmed that some rights to enhanced early retirement and redundancy provisions derived from UK pension plans transfer on an asset sale to a buyer. This decision likely will have profound implications for transactions involving asset transfers in the UK, as well as UK outsourcing transactions. This decision is currently being appealed to the UK Court of Appeal.

Background

The Acquired Rights Directive,¹ as implemented in the UK in the Transfer of Undertakings (Protection of Employment) Regulations 2006² (TUPE), provides that the employment of employees who are “assigned” to a business (or to a service in the context of outsourcing), transfers to the business buyer when that underlying business is transferred. The employees transfer *automatically*, on the terms and conditions of employment and with an entitlement to receive the same benefits that applied to them immediately prior to the transfer, and the employees transfer with all their accrued service and any outstanding employment-related liabilities. In other words, if the business seller has not paid the employees’ wages, or if it discriminated against them prior to the transfer, the business buyer inherits those liabilities from the moment of transfer. TUPE is designed to allow employees to follow their work and to protect them from being disadvantaged as a consequence of the business sale.

The principle that employees’ terms, conditions and benefits are unchanged by a TUPE-transfer is subject to an exception in relation to “old age, invalidity or survivors’ benefits” under occupational pension plans.³ TUPE does not transfer those rights and obligations to a business buyer. It does, however, impose minimum obligations on the business buyer to provide pension benefits that, at the very least, involve the business buyer providing the transferring employees with access to a defined contribution pension plan and matching the employees’

contributions to that plan up to a value equal to 6 percent of the employees’ salaries.

Rights relating to personal pension plans, being insurance-based pension arrangements with external providers such as stakeholder and group personal pension plans, do not fall within this TUPE exception, and therefore when employees who participate in personal pension plans TUPE-transfer to a business buyer, they are entitled to have those arrangements continued (or replicated).

The focus of the recent UK case, and therefore of this article, is on the occupational pension plan carve-out from TUPE.

Instinctively, it is not easy to think of benefits provided by pension plans that are anything other than “old age, invalidity or survivors’ benefits,” but this case concerned rights in relation to enhanced early retirement benefits. It also has relevance for enhanced redundancy benefits.

The Case

The recent High Court case concerned a business sale that involved the TUPE-transfer of a number of employees who were, immediately prior to the transfer, actively accruing benefits in the seller’s UK defined benefit pension plan. As their employment automatically transferred to the business buyer, those employees became deferred members of the seller’s pension plan, *i.e.*, their benefits were frozen until they reached retirement age under the plan.

The sale agreement provided for a price adjustment in the event that the transfer of the employees also resulted in the transfer of liabilities in relation to the seller’s UK defined benefit pension plan. The buyer claimed that certain rights under the pension plan that provided for benefits other than “old age, invalidity and survivors’ benefits” had transferred, and therefore, that the purchase price should be reduced accordingly. The seller argued that no such rights transferred, and therefore, there should be no change to the purchase price.



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The pension plan provided for defined benefit pension benefits upon a person's retirement at the age of 65. It also provided that, from early retirement (which could be taken from age 55), the employee member was entitled to a so-called "bridging pension," a regular income payable from the date of early retirement until the employee member reached the plan's normal retirement age (aged 65). This "bridging pension" was only available for active members of the plan (*i.e.*, those who were actively accruing benefits in the plan at the time of early retirement). Active members were not automatically entitled to this bridging pension — this was subject to the employer exercising its discretion to grant them this benefit.

The business buyer in this case argued that the right to a bridging pension was not an "old age, invalidity or survivors' benefit," and therefore it was not within the occupational pensions carve-out from TUPE, and consequently that the liability to provide this benefit TUPE-transferred to it when the business was sold — and the UK High Court (the Court) agreed. The Court found that enhanced early retirement benefits were not "old age" benefits (even though they were dependent on the member being of a certain age, as these early retirement benefits were only available to members who were 55 or older), and therefore, the obligation to provide them transferred to the business buyer under TUPE.

The Court also found that even a discretionary right — being only a right to be considered for early retirement benefits — transferred and had a value for the purpose of the purchase price adjustment.

Key Principles

The key principles emerging from the Court's judgment were:

- Rights and obligations concerning benefits provided by occupational pension plans that do not relate to any of (i) the member being over normal retirement age (usually 65), (ii) incapacity to work, or (iii) survivors' benefits (*e.g.*, widow's pension) are capable of transferring on a business sale or an outsourcing transaction under TUPE.
- The obligations concerning these benefits will transfer to the business buyer only where the plan itself does not provide

these benefits (*i.e.*, where the plan makes a distinction between the rights of active members and the rights of deferred members). If the plan treats active and deferred members in the same way, the business buyer will not also be liable to provide these benefits (subject to an unresolved point regarding future service, see Points Not Considered below).

- Discretionary rights — the right to be considered for a benefit — will transfer to the business buyer. It is not clear how this will work in practice (see Points Not Considered below).
- A benefit that is not an old age benefit when it is provided earlier than normal retirement age will become an old age benefit when the member reaches normal retirement age. In other words, the liability of the business buyer to provide an early retirement pension will cease when the member turns 65.
- The liability of the business buyer is limited to the difference between the benefits provided by the pension plan to active and deferred members.

Points Not Considered

Because the facts of this case were considered in the context of a commercial dispute about a purchase price adjustment, rather than a claim by transferring employees for their bridging pension from the business buyer, a number of questions were left undecided by the High Court judge, including:

- *How will this work in practice?* Here, the seller's pension plan provided the members with the right to apply and be considered by the seller for a bridging pension from the age of 55. The plan stated that whether the member actually became entitled to receive the bridging pension depended on whether the employer exercised its discretion to grant that request. In the context of a TUPE transfer, does that discretion remain with the business seller, or does it pass to the new employer, given that the new employer (the business buyer) will be the party obligated to fund that benefit?
- *How is a discretionary right valued?* On the facts of this case, the plan actuary used a number of assumptions when calculating the value of the plan's deficit. Some of those assumptions concerned

the statistical possibility that a portion of the plan's members would retire early and would be granted discretionary early retirement benefits. The Court found that these assumptions enabled the value of the discretionary rights that transferred with the TUPE-transferring employees to be determined but the judgment does not include details of the calculation.

- *Does the right to accrue additional service transfer under TUPE? Should the calculation of "final salary" or "career average" earnings take account of earnings after the TUPE-transfer?* These points were not relevant to the facts of the case, but would be relevant to both a buyer and seller in the context of a business sale. If employment with the business buyer is relevant to the value of the employee's pension benefits connected to the seller's occupational pension plan, this could have significant cost implications for both buyer and seller where the pension plan provides for benefits other than old age, invalidity or survivors' benefits.
- *What happens with benefits that are brought forward by early retirement, but which the plan would have had to pay at normal retirement age?* Some UK pension plans provide, for example, that a member is entitled to a lump sum payment when he retires, and the value of that lump sum payment is not changed when the member retires early. Where the early retiring employee has transferred to a business buyer under TUPE, this case makes it clear that the business buyer will become liable to make that lump-sum payment. However, the pension plan will receive a windfall from this arrangement, because the member will no longer be entitled to that lump sum payment when they reach normal retirement age and therefore the plan will not have to pay anything out. Does this mean that the business buyer could become entitled to have that lump-sum payment reimbursed by the pension plan when the member reaches normal retirement age?

Implications

The Court's decision emphasizes the importance of thorough diligence in the context of buying a business in the UK or

contracting to receive services in the UK that could involve the transfer of employees under TUPE. Where a business seller's occupational pension plan treats active and deferred members differently with respect to benefits that are not "old age, invalidity or survivors' benefits," the business buyer could inherit liability to provide the benefits lost by any active member of the pension plan who transfers into the buyer's employment under TUPE.

Where due diligence reveals that such a retirement liability will transfer under TUPE, the business buyer may wish to seek an indemnity in respect of this risk or consider a purchase price reduction. A purchase price adjustment such as the one in this case would provide the buyer with an immediate commercial benefit. A purchase price reduction would, however, be based on assumptions such as the number of potentially eligible transferring employees who will remain in the buyer's employment until they are eligible for early retirement benefits and how many will apply for early retirement. This raises the possibility that the assumptions could be too conservative with the ultimate cost borne by the buyer if employees start to retire in a manner that exceeds the purchase price reduction assumptions. Arguably, an indemnity may be the safer option, provided that the indemnity is still valid by the time the employees reach early retirement age, and provided that the seller is still "good for the money" at that time.

This case will also be relevant to sellers and buyers of UK companies, as the company may have employees who transferred into its employment under TUPE prior to the currently-envisaged sale who have these enhanced early retirement or redundancy rights. ■

Endnotes

¹ Council Directive 2001/23/EC of 12 March 2001 on the approximation of the laws of the Member States relating to the safeguarding of employees' rights in the event of transfers of undertakings, businesses or parts of undertakings or businesses.

² SI 2006/246.

³ "Occupational" pension plans are plans particular to the employer, and governed by trust deed and rules.



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ADDITIONAL MEDICARE TAX WITHHOLDING REQUIRED IN 2013

By Robin Struve

Effective beginning January 1, 2013, under the Patient Protection and Affordable Care Act, US employers will be required to withhold an additional 0.9% percent Medicare tax on amounts paid to employees in excess of US\$200,000. However, individuals are liable for the additional 0.9 percent Medicare on amounts over a certain threshold depending on their filing status:

Filing Status	Threshold Amount
Married, filing jointly	US\$250,000
Married, filing separately	US\$125,000
Single	US\$200,000
Head of household (with qualifying person)	US\$200,000
Qualifying widow(er) with dependent child	US\$200,000

Employers are not required to withhold based on the employee's filing status (even if that status is known) or on wages paid by other employees, but are required to withhold on Medicare taxable amounts paid to an individual by the employer over US\$200,000. All other aspects of Medicare tax withholding remain the same, such as the types of wages and compensation subject to Medicare taxes, the individuals subject to Medicare tax withholding and the manner of withholding. The employer's Medicare tax obligations also remain unchanged, as the additional Medicare tax is applicable only to individuals. ■

CHANGES TO US PAYROLL TAXES IN 2013

By Carol Samaan



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Effective January 1, 2013, the portion of the Social Security payroll tax paid by US employees will increase. Under the American Taxpayer Relief Act of 2012, certain US payroll tax cuts previously in effect have expired as of December 31, 2012. Under the Federal Insurance Contributions Act (FICA), 12.4% percent of an employee's earned income (up to an annual limit) must be paid into Social Security, and an additional 2.9 percent must be paid into Medicare.

The 2012 payroll tax cut had reduced the employee's share of Social Security taxes by 2 percent, from 6.2 percent to 4.2 percent of employee wages earned during 2012. Effective January 1, 2013, the employee's Social Security tax rate will increase again to 6.2 percent. The employer's Social Security tax rate will remain unchanged at 6.2 percent.

In addition, the 2013 Social Security wage base, which limits the covered wages subject to the Social Security tax, has increased to US\$113,700, up from the 2012 wage base of US\$110,100. As in prior years, there is no limit to the wages subject to the Medicare tax. ■

In Brief: Hong Kong

PROPOSED PATERNITY LEAVE LEGISLATION

By Jane Ng

The Hong Kong Special Administrative Region government has welcomed a Labour Advisory Board recommendation for legislation enabling fathers working in the private sector to take three days of paid paternity leave. The draft legislation is expected to be introduced this year, although there is not yet an official timeframe for implementation. A similar provision was enacted last year, enabling eligible government employees to take five days of paid paternity leave. That scheme, which became effective on April 1, 2012, and saw 1,315 paternity leave applications in its first six months, has led to pressure for equivalent rights to be granted to fathers working in the private sector.

Although the full details of the private sector paternity leave have not yet been finalized, many commentators expect that it would operate in a manner similar to the system in place for maternity leave under ss. 12A-15C of the Employment Ordinance (Cap. 57). It is likely that fathers would be entitled to paid leave if they have been employed continuously for at least 40 weeks immediately before the expected or actual date of childbirth, and the daily pay level during the paternity leave would be equal to 80 percent of the average daily wages earned by the employee in the previous 12 months. Some commentators have called for the paternity leave to be extended to fathers of children born out of wedlock and to fathers of children born overseas.

Hong Kong employers have resisted the proposed reforms, with the Federation of Hong Kong Industries criticising the consequent increase in labour costs. However, the government has estimated that Hong Kong's wage bill will increase by as little as 0.02 percent as a result of the reforms. The adverse impact of the proposed legislation on employers has been projected to be minimal partially as a result of Hong Kong's birth rate, which is one of the lowest in the world. In addition, many private sector employers already provide paternity leave to employees voluntarily, with one recent Labour Department survey estimating that the number of organisations providing paternity leave to employees has increased from 16 percent in 2006 to 38.7 percent in 2012.

Even if the proposed reforms are implemented, Hong Kong will not compare favourably with many other countries around the world and in the region. Most regimes in Europe have paternity leave policies significantly more generous than the Hong Kong proposal, and even within Asia, the Philippines allows for seven days of paid paternity leave. The Singaporean government has also discussed plans to legislate on mandatory paternity leave. Therefore, both internal and external forces may even cause pressure on the Hong Kong government to let those in the private sector receive the same five-day paternity entitlement enjoyed by government employees. ■



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