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A CLIENT ALERT FROM PAUL HASTINGS
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Global Workplace: Outperforming the Markets – and the Competition

Overview

This monthly newsletter from the Paul Hastings Employment Law practice discusses major employment law issues facing employers due to the economic downturn.

We've seen the downturn of 2008 carry over into 2009, with increasing pressure on employers to manage their workforces and benefit plans in ever more proactive ways.

Our articles this month cross the spectrum, from subtle WARN Act operational issues to improvements to consider in executive compensation. Follow the links below to read articles regarding recent developments in the employment sector. For more information on our Global Employment Law practice, click here.

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Managing Pay Equity Risks During the Downturn

BY KENNETH W. GAGE AND JON A. GEIER

In-house labor and employment lawyers have much to keep them busy these days. In addition to their day jobs, counseling in-house clients and managing outside counsel, most have been working late nights and weekends on the large-scale workforce reductions that are grabbing headlines daily. Working closely with senior management, human resources, and outside counsel, they advise on selections procedures and the development of appropriate decisional units, evaluate risk with adverse impact analyses, and carefully draft releases, all to minimize the litigation risk presented by departing employees. The litigation risks of workforce reductions are not exclusively found among the departing employee population, however. Workforce reduction decisions can have an indirect albeit material impact on potential pay discrimination claims of the employees who remain. The recently passed Lilly Ledbetter Fair Pay Act (the "Ledbetter Act"), as well as the proposed Paycheck Fairness Act (the "PFA") legislation, which is a priority on the Democrats' legislative agenda, will dramatically change the legal landscape for pay discrimination claims. And employers will be well served to evaluate their pay practices, particularly after large-scale workforce reductions.

The New Pay Equity Legal Landscape

First, the Ledbetter Act, signed by President Obama on January 29, 2009, overturns the Supreme Court's 2007 holding in *Ledbetter v. Goodyear Tire & Rubber Co.*, 550 U.S. 618 (2007), and codifies the so-called "paycheck rule." The new law practically eliminates any statute of limitations for discriminatory compensation claims under any of the primary non-discrimination laws, including Title VII, the ADEA, and the ADA. Now, simply by alleging that a portion of their most recent paycheck was tainted by a prior discriminatory decision, regardless of how long ago that decision was made, employees can bring discriminatory compensation claims, as long as that claim is brought within 300 days of the last paycheck. The Ledbetter Act is expressly made retroactive to cases pending as of May 28, 2007. Employers defending such claims, therefore, may be forced to explain decisions made many years prior by people no longer employed and, possibly, no longer alive.

The PFA materially amends the Equal Pay Act of 1963 (the "EPA"). If passed, the PFA will permit plaintiffs to bring opt-out class actions under Rule 23 of the Federal Rules of Civil Procedure, instead of the typically smaller opt-in collective actions currently permitted by the EPA. It also adds race and national origin as protected characteristics under the EPA, broadens substantially the employees whom a plaintiff can allege are comparators for purposes of proving pay discrimination claims, allows for uncapped compensatory and punitive damages, and sharply limits the affirmative defenses previously available to employers under the EPA.

These changes likely will lead to an increase in the number and scale of pay discrimination lawsuits in the coming years. To read more about the Ledbetter Act and the PFA, and their consequences, follow this link to read other client alerts on these subjects.

RIFs and Pay Equity Risks

A large-scale workforce reduction can meaningfully alter risk of pay discrimination claims in two ways. First, the remaining employee population will likely have changed dramatically, so prior pay equity analyses may well be meaningless. Depending upon the eligibility factors used to select employees for reduction, large numbers of higher-paid white males may have left the workforce or, alternatively, large numbers of lower-paid, less-experienced employees comprised largely of women and minorities may have been severed. Most likely, the workforce reduction will have effected different changes in different departments and functions across the company. Unlike the effects of ordinary attrition and hiring on a compensation analysis, the effects of a large-scale workforce reduction can be massive. In light of the anticipated new emphasis on pay equity, a refreshed diagnostic of employee compensation is

likely necessary, both to understand current risk and to potentially develop a remediation strategy to reduce or eliminate that risk.

Second, large-scale workforce reductions often result in the downgrade and demotion of some employees, very often without any immediate decrease in compensation. As a consequence, you have employees working shoulder to shoulder, in the same job title (or at least arguably performing the same work), working at the same level of performance, earning drastically different salaries. And to the extent incentive compensation is derived from base salary, the earnings gap grows even greater. In the past, few employers have reduced the pay of an employee moving to a lower-paid position, and many have not even "red-circled" such an employee. As discussed below, such policies will need to be rethought.

What Should an Employer Do?

In order to assess the risks of a pay discrimination claim in the aftermath of a reduction in force, here are some suggestions that employers should consider:

- Conduct a proactive pay diagnostic under the attorney-client privilege
  - Create reasonable measurement groups of employees doing similar types of work
  - Develop data reflecting legitimate business-related factors that explain pay at the employer
- Consider remediation strategies to "start the clock over" and to reduce the risk of previously barred claims given new life by the Ledbetter Act
- Review and strengthen documentation of compensation decisions
- Review current pay policies and practices, including
  - Setting of pay upon hire, promotion, or demotion
  - Develop a tool to identify appropriately paired comparators for making such pay decisions
  - Specifically consider a policy that will lower the pay of employees suffering a demotion to a lower-paid job classification; alternatively, consider red-circling such employees to inhibit future salary growth
- Use of compa-ratio/rate range penetration type tools and their interface with the performance management system
  - Reconsider the use of broadbanded pay grade or level systems
  - If retaining such systems, consider an expanded use of market-based pay surveys to benchmark your company's pay for specific jobs
- Develop mandatory written exception process to document any deviation from existing pay policies or guidance

There is no "one size fits all" solution to address pay equity issues. Policy and practice changes, and remediation strategies, are dependent upon an employer's circumstances, pay philosophy, and available data. Privilege issues are very thorny and counsel should be involved from the inception of the project.

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Washington's New Limits on Executive Compensation

BY MARK POERIO

In last week's stimulus legislation that the President just signed, a mere ten pages address executive compensation. They nonetheless impose dramatic restrictions. This alert describes these restrictions and recommends actions employers should now take to implement them, whether or not they are participating in the Treasury Department's Troubled Asset Relief Program ("TARP").

Immediate action is critical for all TARP recipients, because the new restrictions apply immediately, notably imposing limits on how much TARP recipients may pay certain executives as bonus and severance. Employers that are outside the TARP face less onerous and more indirect issues, but they should take action right away to best position their executive compensation disclosures for public scrutiny.

Executive Compensation Provisions of the Stimulus Bill

Section 7001 of the American Recovery and Reinvestment Act of 2009 ("ARRA") expands and restates the executive compensation restrictions that the federal bailout program imposes through Section 111 of last October's Emergency Economic Stabilization Act of 2008 ("EESA"). The Section 7001 restrictions apply to any entity that receives financial assistance under the TARP, including those that already have received assistance. These entities (collectively, "TARP recipients") must comply with Section 7001.

The principal features of Section 7001 are summarized below in Appendix A. These new restrictions take effect immediately and apply for so long as a TARP recipient is subject to any TARP obligations ("TARP Period"), but not when the federal government merely holds warrants to purchase stock of the TARP recipient. Note that, for purposes of these rules, the term "senior executive officer" ("SEO") means a TARP recipient's CEO, CFO, and next three highest-paid executives, as determined under SEC proxy disclosure requirements (whether or not those requirements apply to the TARP recipient).

Action Items for TARP Participants

As a threshold matter, TARP recipients may withdraw entirely from the TARP by repaying the assistance they have received. This is worth considering, for those who are able, if the TARP's onerous limitations seem likely to jeopardize the TARP recipient's future financial success (such as by causing the best talent to leave).

Any TARP recipient that remains or becomes subject to TARP must establish a "Board Compensation Committee" of independent directors, subject to action by the full board of directors if (i) the TARP recipient's common or preferred stock is not registered under the Securities Exchange Act of 1934, and (ii) the TARP recipient has received less than $25 million of TARP assistance. Regardless of who acts, Section 7001 requires a review of employee compensation plans, and at least semiannual meetings to discuss and evaluate them in light of any risks they pose to the TARP recipient.

Further, the Board Compensation Committee should expect to be held accountable for the TARP recipient's compliance with the Section 7001 requirements summarized in Appendix A. As a practical matter, the committee will probably be the TARP recipient's Compensation Committee. Aside from the foregoing, an immediate challenge (perhaps in the form of a "bet-the-company" challenge) will be to

address the potential loss of executive talent that may quickly follow from the ARRA's one-two punch in the form of severe limits on incentive compensation, and an outright prohibition on severance pay, in each case for certain top executives only during the TARP Period.

Of less immediate concern, though worthy of immediate attention, are three issues arising from other Section 7001 requirements, namely:

- Designing the company-wide "luxury expense" policy that Section 7001 requires – see Appendix "A" for more information.
- Best positioning the TARP recipient for the "Say on Pay" advisory vote that shareholders are permitted to make – see Appendix "A" for more information.
- Anticipating compliance with the Secretary of the Treasury's obligation to review – for inconsistency with Section 7001, the TARP, or the public interest – all bonuses, retention awards, and other compensation paid before ARRA's enactment to the TARP recipient's SEOs and next 20 most highly compensated employees; with the Secretary being authorized to seek reimbursements from the TARP recipient and the subject employees.

Action Items for Non-TARP Employers

Those outside the TARP program face less Herculean challenges with respect to executive pay. Nonetheless, they should be proactive because today's new TARP limitations evidence Washington's deepening fixation on executive pay as a primary – and effective – means for placating an American public that blames Wall Street greed and excess for today's financial meltdown. Governmental and shareholder activism seem ready to boil over further in 2009.

"Say on Pay" seems destined to pass in 2009, for implementation in 2010 proxy statements. Public companies consequently should position in 2009 for proxy statement disclosures that respond to the issues that are currently inflaming shareholders, Congress, proxy advisors, and the general public. A few of the notable issues that come to mind for attention early in 2009 are the following:

- Excessive emphasis on short-term incentive compensation, or other compensation structures that pose a risk to long-term corporate success.
- Sizable out-of-the-money stock option awards.
- Inadequate loyalty protections, during and after employment.
- Excessive or risk-free severance.
- Excessive change in control benefits.
- Unjustifiable perquisites.
- Tax gross-ups, especially for golden parachute liabilities.

APPENDIX "A" – ARRA SECTION 7001 REQUIREMENTS

General Standards

During the TARP Period, each TARP recipient must:

- exclude incentives for its SEOs to take unnecessary and excessive risks to the value of the TARP recipient;
- prohibit any compensation plan that would encourage manipulation of the reported earnings of such TARP recipient to enhance the compensation of any of its employees;
- have the right to recover any bonus, retention award, or incentive compensation that is both (i) paid to an SEO or any of the next 20 most highly

compensated employees, and (ii) based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate; and

- prohibit the payment, to an SEO or any of the next five most highly compensated employees, of any golden parachute payment – which Section 7001 defines broadly to include any payment for departure from a company for any reason, except for payments for services performed or benefits accrued.

One-third Limit on Incentives

A TARP recipient must not, during the TARP Period, provide anyone identified in the table below, with any bonus, retention award, or incentive compensation; provided that they may receive long-term restricted stock that does not vest during the TARP Period, that has a value not greater than one-third of the individual's total annual compensation, and that is subject to other terms and conditions that the Secretary of the Treasury may determine.

TARP Assistance Level	Individuals Subject to Bonus Limit*
Below $25 million	Highest-compensated employee
Over $25M; below $250M	Five highest-compensated employees
Over $250M; below $500M	SEOs plus the 10 next most highly compensated
Over $500M	SEOs plus the 20 next most highly compensated

** **Note:** The Secretary may increase the number of those subject to the limit.*

***Exception:** The foregoing limit does not apply to any bonus that is required to be paid pursuant to a written employment contract executed on or before February 11, 2009.*

Luxury Expenditure Policy

Section 7001 of the ARRA requires that the Board of Directors of each TARP recipient establish a company-wide policy regarding excessive or luxury expenditures, according to Treasury rules that may include excessive expenditures on –

- entertainment or events;
- office and facility renovations;
- aviation or other transportation services; and
- other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or similar measures in the normal course of business.

CEO and CFO Certifications

The CEO and CFO of each TARP recipient (or their equivalents) must certify to compliance with Section 7001's requirements in annual SEC filings, or to the Secretary of the Treasury if the TARP recipient's securities are not registered with the SEC.

"Say on Pay" Advisory Shareholder Votes

During the TARP Period, each TARP recipient must permit a separate, advisory shareholder vote for approval of the compensation of the TARP recipient's executives – as disclosed pursuant to SEC rules, including the compensation discussion and analysis (aka CD&A), the compensation tables, and any related material). In keeping with general "Say on Pay" legislative proposals, the vote is purely advisory, will not overrule any board decision, will not create or imply any additional fiduciary

duty of the board, and will not limit the opportunity for shareholders to make other proxy statement proposals relating to executive compensation.

Note: *Other executive compensation restrictions remain in effect.*

Section 7001 of the ARRA does not affect the excise tax and tax deduction limitations that the EESA instituted. Further, the ARRA leaves intact the executive compensation guidelines that the Treasury Department released this past February 4th. Another round of Treasury Regulations is nevertheless expected within a few weeks.

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Managing Redundancies in the People's Republic of China

BY K. LESLI LIGORNER

In July 2007, when the Employment Contracts Law ("ECL") was promulgated, few employers focused on Article 41, the provision regarding mass layoffs. Business was booming and companies were bulking up with new hires. Thoughts of layoffs in the People's Republic of China ("PRC") were virtually nonexistent. Those thoughts were just as distant in the PRC when the ECL took effect on January 1, 2008.

It is no secret that the tides have turned. Both domestic and multinational companies ("MNCs") in the PRC are feeling the effects of the global economic crisis and engaging in or considering workforce reductions. This article examines how companies are handling the issue of whether and how to conduct redundancies in the PRC.

Grounds to Terminate Are Limited in the PRC

As a threshold matter, it is important for employers to understand that employers may only terminate an employment contract for a reason that is specifically enumerated in the

law.[1] Deciding to make an employee's position redundant in order to reduce overhead and labor costs does not in and of itself constitute a valid basis to terminate staff.

The Definition of and Requirements for a Mass Layoff

As an initial step in deciding whether to conduct a mass layoff as defined by the ECL, the employer will need to assess the number of staff it intends to make redundant and whether that number will trigger the mass layoff procedures. Article 41 of the ECL defines a mass layoff as the dismissal of at least 20 employees or 10% or more of the "total number" of the employer's workforce.[2]

If an employer does believe that it will reach the threshold of a mass layoff, then advance planning is essential. The ECL creates an increased administrative burden with respect to conducting a mass layoff, which reflects the law's goal of encouraging longer-term employment relationships and discouraging dismissals. Employers should understand that they cannot terminate employees as soon as the decision to conduct the layoff is made. Rather, the employer should plan that the process will take at least 40-60 days and work backward to plan for a smooth transition period. This 40-60 day time frame is based on the employee consultation procedure built into Articles 4[3] and 41 of the ECL and the need to submit a workforce reduction plan to the local labor authorities in advance of any unilateral termination.

The employer must also consider whether the basis for the planned terminations falls under one of the categories set out in Article 41. Staff reductions may only be supported by one of the grounds set forth in either the Labor Law or the ECL; namely, restructuring pursuant to the Enterprise Bankruptcy Law;[4] serious operational or production difficulties;[5] a change in production method or automation of a business process through technical innovation, and a suitable alternative cannot be agreed upon with the employee despite consultation; or another major change in the objective circumstances of the employer that were relied upon at the time of the conclusion of the employment contracts, rendering them unable to be performed (for example, where there is a departmental reorganization and the employee's original job no longer exists).[6]

If the employer's situation does fall under one of these grounds, then it must consider its list of employees and whether any of those employees are subject to protection from termination.[7] Contrary to the way in which many MNCs carry out the selection process, the ECL prescribes specific provisions for the retention of employees without regard to employee performance or job function. Rather, the ECL provides specific preferences with respect to who may be made redundant: employees (a) with comparatively longer-term fixed-term employment contracts, (b) with open-ended employment contracts, and (c) who are the sole wage earners in the household and support an elderly person or a

[1] *See, e.g.,* ECL, arts. 39-41. Notably, out of concern for rising unemployment rates, on February 11, 2009, citing new rules from the State Council, government media reported that any layoff, no matter how many staff members are involved, must be reported to the state-controlled labor union. AFP, Feb. 12, 2009.

[2] ECL, art. 41.

[3] According to Article 4 of the ECL, employers must communicate decisions on material matters that affect the material terms and conditions of employment to the employees. A reduction in force clearly falls under this notification requirement.

[4] *See* PRC Enterprise Bankruptcy Law (Trial Implementation), effective June 1, 2007, art. 2.

[5] For SOEs, the Ministry of Finance defines such difficulty as cessation of production or losses for three continuous months. PRC law provides no guidance for other types of business entities.

[6] *See* ECL, art. 41; *see also* Labor Law, art. 27.

[7] *See* ECL, arts. 41, 42.

minor.[8] Hence, deciding who is eligible for a workforce reduction requires careful investigation and inquiry in order to ascertain who fits into these categories.

Employers should further be wary of potential discriminatory grounds on which they select employees for termination, although enforcement of the anti-discrimination laws has been historically weak. PRC law protects employees from discrimination on the following grounds: carriers of infections pathogens (*i.e.*, Hepatitis B), disability, ethnicity, gender, marital status, pregnancy, race, religion, and rural workers.[9]

Moreover, Article 42 contains additional categories of employees who are protected from dismissal in a redundancy situation:

1. employees who have been exposed to occupational disease hazards and have not undergone a pre-departure occupational health checkup, or are suspected of having contracted an occupational disease and are being diagnosed or under medical observation;

2. employees who suffer from occupational disease or who have been confirmed as being totally or partially unable to work;

3. employees suffering from an illness or non-work-related injury and the medical treatment period has not expired (depending on an employee's service years with the employer and service years in the workforce, the medical treatment period may last from 3-24 months);

4. employees who are pregnant, on maternity, or in the nursing period (which is one year measured from the baby's birth date);

5. employees who have been working continuously for the employer for at least 15 years and are less than five years away from the legal retirement age.[10]

Once the employer determines that its workforce reduction will fall squarely under Article 41, it must then engage in the initial consultation process with the trade union (to the extent that one exists in the company) or all of the employees. The employer must provide the employees with at least 30 days' written notice of the workforce reduction and explain the circumstances behind the proposed layoffs. The employer must then consider the opinions of the labor union or the employees. Proactive engagement with the company's labor union, if handled correctly, should facilitate the process, as should open communication with the employees who are targeted for the layoff as well as those who are not.

In planning for the communication of the layoff plan to the employees, employers should carefully consider the nature of their workforce and how they propose to communicate this news. Depending on the number of staff involved, conducting meetings with smaller groups of employees may, for example, create less opportunity for large numbers of disgruntled crowds of employees to gather. Employers should also think about the safety

[8] *See* ECL, art. 41.

[9] The PRC Labor Law, effective January 1, 1995, prohibits discrimination based on ethnicity, race, gender, and religion. The PRC Employment Promotion Law, effective January 1, 2008, prohibits discrimination based on gender, physical disability, infectious pathogen carriers, and rural workers. The PRC Law on Protection of Women's Rights prohibits discrimination against women based on marital status, pregnancy, maternity leave, and breast-feeding leave. The PRC Law on the Protection of Disabled Persons, amended April 24, 2008 and effective July 1, 2008, prohibits employers from discriminating against "disabled persons" in employment.

[10] The legal retirement age for male and female blue collar workers is 55 and 50, respectively, and for male and female white collar workers is 60 and 55, respectively.

and welfare of those individuals who will physically deliver the message to the employees.

Assuming that the employer chooses to go forward with the mass layoff, it must then submit a workforce reduction plan ("Plan") to the labor authorities. The Plan should include, at a minimum, the applicable information to demonstrate the legal basis for the mass layoff; the number of employees affected; the schedule for the layoffs; details of the severance payments; and consideration of the union or employees' input. Although the ECL is ambiguous with respect to whether approval of the Plan from the labor authorities is required, in practice, an employer will find it difficult to proceed without receiving that approval.

What If the Company Does Not Meet the Definition of a Mass Layoff or Does Not Want to Proceed with a Mass Layoff, but Still Wants to Reduce Headcount or Labor Costs?

Given the bureaucratic hurdles in connection with mass layoffs, companies should consider whether immediate layoffs make the most economic sense, in light of high costs of separation packages and future recruitment and retraining costs. As unemployment rates continue to rise and present a challenge for China this year,[11] the PRC government is actively encouraging employers to consider and implement other remedial measures that fall short of redundancies, such as reduced hours, shortened workweeks, wage reductions, and furloughs or forced shutdowns.[12]

Employers may also consider approaching individual employees under Article 36 of the ECL which provides that an employer and employee may terminate the employment contract upon mutual agreement. Using this approach, employers must consult with individual employees, which may be more time-consuming, but which also may result in the execution of signed settlement agreements and releases and does not require government reporting. Employers should anticipate meeting some resistance from the employees and the need for employees in the PRC to negotiate their separation packages.

Another consideration is if the entity seeking to conduct a layoff is a representative office. Representative offices must hire PRC nationals through a staffing agency, which adds an extra layer of complication because the representative office may not unilaterally terminate an employee whom it identifies as redundant and is seconded through a staffing agency. Rather, the representative office must reach an agreement with any affected individual, unless the representative office is closing, which provides an independent legal basis for the dismissal. These same concerns also apply for companies that hire any staff through a staffing agency.

Ensuring Compliance with Severance Calculations

Staff who are laid off are entitled to severance.[13] The ECL has increased the complexity in calculating severance compensation. Generally, an employee should receive severance based on the number of consecutive years worked with the employer at the rate of one month's average monthly wage for each year of service. The employee's "average monthly wage" is based on the

[11] *See* http://news.xinhuanet.com/english/2009-02/07/content_10778188.htm, *last visited* 14 Feb. 2009.

[12] *See, e.g.*, Circular Regarding the Report of Mass Layoffs by Employers, issued by the Shanghai Bureau of Human Resources and Social Security, Jan. 8, 2009 at reply for receipt of report (encouraging company to use such remedial measures in "Solemn Statement" in order to avoid layoffs).

[13] *See* ECL, art. 46(4); *see* Circular of MLSS on Printing and Distributing the Provisions on Personnel Reduction Due to Economic Reasons in Enterprises, effective Jan. 1, 1995, art. 4.

employee's total wages for the twelve months immediately preceding the employee's termination, including all cash payments such as commissions, allowances, bonuses, subsidies, etc.[14] In addition, employers must round up any partial period of employment of six months or more to one year, thereby entitling the employee to a month of wages. Any period of less than six months entitles the employee to one-half of his/her monthly wage.[15]

The ECL further imposes a cap on the amount of required severance. The ECL limits the severance amount to (a) three times the average "monthly wage" of employees for the previous year in the city where the employer is located, and (b) for no more than 12 years of work. These caps are tending to assist employers to negotiate packages with highly paid employees because the caps tend to be so much lower than the employee's average monthly wage.[16]

Nonetheless, the caps on severance do not apply to severance entitlements that accrued prior to the ECL's effective date of January 1, 2008. The calculation of severance for service that accrued prior to January 1, 2008 depends on the applicable local regulations.

Calculating severance accurately and paying it timely is critical. If an employer fails to pay the full severance amount to a dismissed employee, it could face penalties of 50% of the overdue amount.[17] In reaching agreements with employees on separation packages, employers should also pay attention to annual leave entitlements and the issue of required cash-outs and company policy.

In sum, employers should tread carefully in the realm of mass layoffs. Due consideration of measures short of layoffs should be considered, particularly in light of the increased administrative burden under Article 41 of the ECL and the PRC government's discouragement of laying off staff before alternative arrangements are endeavored. Nonetheless, the option of reaching mutual agreements with employees remains a steadfast approach, although it generally requires employers to offer significantly larger packages than those required by statute.

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[14] *See* Implementing Regulations to Employment Contracts Law, effective 18 Sept. 2008, art. 27.

[15] *See* ECL, art. 47.

[16] At present, for example, the cap in Beijing is RMB9,966/month and in Shanghai RMB8,676/month.

[17] *See id.* art. 85.

New COBRA Subsidy Requires Prompt Action by Employers and Plan Administrators

BY ERIC KELLER AND ETHAN LIPSIG

The stimulus legislation, the American Recovery and Reinvestment Act (the "Act"), signed by President Obama on Tuesday creates a taxpayer-funded COBRA[18] subsidy that imposes new notice, election and reporting requirements that require prompt action by employers and plan administrators. Employers that charge at least a portion of the COBRA premium – virtually all employers who provide COBRA coverage -- do not have the option of offering COBRA without the subsidy. Consequently, virtually every employer that provides COBRA health coverage will have to take steps to implement the Act's COBRA subsidy provisions.

Specifically, employers and plan administrators will need to promptly:

- Identify employees who were covered by the plan and who lost coverage due to an involuntary termination of employment (other than for gross misconduct) on or after September 1, 2008, and their plan covered spouses and dependents ("qualified beneficiaries").
- Of these individuals, identify who is receiving COBRA coverage as of the date of enactment of the Act. Those who aren't will be eligible for a special election opportunity described below.
- Implement administrative procedures to permit high income earners to opt out of the subsidy in lieu of paying it back through increased taxes imposed by the Act.
- Determine whether to implement the optional opportunity to elect different COBRA coverage.
- Develop and provide notices required by the Act.
- Coordinate the employer's payroll and human resources functions to implement systems for obtaining the federal subsidy.

The remainder of this Client Alert describes the key provisions of the COBRA subsidy.

Effective Date

The COBRA subsidy applies to premiums paid for a period of COBRA coverage that begins after the date of the Act's enactment, February 17, 2009. A "period of coverage" is the monthly or shorter period with respect to which the premiums are charged for coverage. Therefore, monthly premiums payable for coverage beginning in March would be eligible for the subsidy.

The Act anticipates that plan administrators may not be able to timely notify all eligible qualified beneficiaries of the premium subsidy before March 1, 2009. If an eligible qualified beneficiary pays the full COBRA premium for the first or second period of coverage beginning after the date of enactment of the Act (e.g., monthly periods of coverage for March and April 2009), the plan administrator must either credit the subsidized portion of the premium against future COBRA premiums or refund the subsidized portion within 60 days.

Eligibility for Subsidy

Qualified beneficiaries are eligible for the subsidy if they (i) lose health plan coverage

[18] The subsidy is also available for continuation coverage provided under state law that provides coverage comparable to COBRA, such as California's Cal-COBRA. The subsidy is not available for COBRA coverage provided under health flexible spending accounts provided under a cafeteria plan.

due to involuntary termination (other than termination for gross misconduct) of employment during September 1, 2008 through December 31, 2009 and (ii) are eligible for and elect COBRA continuation coverage. As discussed below under "Tax Consequences of Subsidy", the subsidy phases out for higher income former employees.

Note: The Act does not define involuntary termination of employment. But, as described below, an employer must attest that each qualified beneficiary for whom it requests government reimbursement was involuntarily terminated. In addition, as described below, the plan administrator must notify each qualified beneficiary who is eligible for the subsidy. The determination of whether an employee's termination was involuntary can be complicated by questions such as constructive discharge or an agreement between the employer and the employee to terminate employment.

Amount of the Subsidy

The Act treats eligible qualified beneficiaries as paying the full COBRA premium if such individual pays at least 35% of the premium that the individual would otherwise be required pay but for the Act. If an employer subsidizes the cost of COBRA coverage, it appears that the 35% will be applied against the portion paid by the employee and the employer paid portion will be disregarded because the employee would not have been required to pay that portion. For example, if the COBRA premium is $500, the employer pays $400 and the employee is required to pay $100, then the employee will be treated as paying the full premium if the employee pays $35 and the employer's tax-funded subsidy will be limited to $65 rather than the full $465 paid by the employer. Employers considering implementing subsidized COBRA as part of reductions in force or other programs should consider redesigning them in light of the subsidy.

Duration of Subsidy

The subsidy is available for the earliest of 9 months, the expiration of the maximum COBRA coverage period applicable to the qualified beneficiary or the date the qualified beneficiary becomes eligible for Medicare or coverage under any other group health plan.[19] The Act requires a qualified beneficiary to notify the plan providing COBRA if he or she becomes eligible for Medicare or other group health coverage. Qualified beneficiaries who fail to provide notice are subject to a penalty equal to 110 percent of the amount of the subsidy provided after their eligibility for the subsidy terminates, unless the failure to notify is due to reasonable cause and not willful neglect.

Tax Consequences of Subsidy

The subsidy generally is excludible from the gross income of the qualified beneficiary, but this exclusion phases out ratably if the former employee's modified adjusted gross income for the taxable year is between $125,000 and $145,000 ($250,000 and $290,000 in the case of a joint return). Tax credits may not be used to offset this liability. The Act defines "modified adjusted gross income" as adjusted gross income" determined under Section 62 of the Internal Revenue Code ("Code") increased by any amount excluded under Code Sections 911, 931 or 933.

To avoid this, the Act permits qualified eligible qualified beneficiaries to irrevocably elect to waive the COBRA subsidy for all periods of coverage. The legislative history states that each qualified beneficiary must separately waive the subsidy.

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19 The following types of group health plan are disregarded for this purpose: (i) coverage that consists of only dental, vision, counseling, or referral services (or combination of any of these), (ii) coverage under a health flexible spending account or health reimbursement arrangement, or (iii) coverage consisting of treatment at an on-site medical clinic maintained by the employer and that consists primarily of first-aid services, prevention and wellness care.

Reimbursement

The U.S. government will reimburse an employer for the 65 percent of the COBRA premium. To obtain this reimbursement, the employer must claim it as a credit against its payroll tax (income tax and FICA withholding) liability. If the credit exceeds that liability, the Treasury will reimburse the employer directly. To qualify for reimbursement, the employer must furnish reports containing information the Treasury may require for such reimbursements, including an attestation of the involuntary termination of employment of each covered employee, the amount of payroll taxes offset for a reporting period and the estimated offsets for the next reporting period, the tax identification numbers of the covered employees, the amount of the subsidy reimbursed with respect to each covered employee and qualified beneficiaries, and a description of whether each subsidy reimbursement is for coverage of one individual or two or more individuals.

Notification

Plan administrators are required to provide notices to two groups of eligible qualified beneficiaries within 60 days after the enactment of the Act. The first notice must go to all eligible qualified beneficiaries who currently have COBRA continuation coverage and the second notice must to any qualified beneficiary who does not currently have COBRA continuation coverage but is eligible for the special enrollment period described below. The notices must advise these individuals of the availability of the subsidy and its conditions, the requirement to notify the employer if the individual becomes eligible for Medicare or another group health plan, the penalty for failing to do so as well as other information required by the Act.

Plan administrators will also need to update the qualifying event notice furnished qualified beneficiaries to reflect the COBRA subsidy.

Violation of the Act's notification requirements is a violation of COBRA's notification requirements.

The Act directs the Department of Labor to provide model notices for plan administrators to use within 30 days after the enactment of the Act.

Special Election Opportunity

The Act provides a special 60-day election opportunity for qualified beneficiaries who are eligible for the subsidy but who did not elect COBRA or who are no longer enrolled in COBRA as of the date of enactment of the Act. The 60-day election period ends 60 days after the notice is provided to the qualified beneficiary of the special election opportunity. The special election opportunity does not extend the period of COBRA coverage beyond the original maximum required period, and any COBRA coverage elected pursuant to this special election opportunity begins on the date of enactment and does include any period prior to that date. If a qualified beneficiary eligible for the subsidy elects COBRA during the special election opportunity, the period beginning on the date of the qualifying event and ending with the day before enactment of the Act is disregarded for purposes of determining if the qualified beneficiary had a 63-day significant break in coverage for purposes of applying pre-existing condition exclusions.

Optional Opportunity to Elect Different COBRA Coverage

Generally, COBRA only requires the employer to offer the same type of coverage that the qualified beneficiary had before qualified beneficiary experienced a qualifying event. The Act, however, permits (but does not require) an employer to allow qualifying beneficiaries eligible for the subsidy to elect a different COBRA coverage. If an employer elects to offer this option, the employer must provide the qualified beneficiary with an election notice and allow an election period of not less than 90

days.

This option is subject to the following restrictions:

- The COBRA premium for the different coverage may not exceed the COBRA premium for the coverage in which the qualified beneficiary was enrolled in prior to the qualifying event.
- The employer must be offering the different coverage to its active employees at the time the qualified beneficiary elects the different coverage.
- The different coverage cannot be limited to dental, vision, counseling or referral services (singly or in any combination) and cannot be a health care flexible spending account or an on-site medical facility providing primarily first aid, prevention or wellness care.

Adjudicating Denials of COBRA Subsidy

The Act provides for expedited review by the Secretary of Labor or Health and Human Services (in consultation with the Secretary of Treasury) of premium subsidy denials. Such reviews must be completed within 15 business days after receipt of the individual's application for review. The Secretary's determination upon review is de novo and is the final determination

Conclusion

While the new COBRA subsidy is funded by taxpayers, plan administrators and employers a responsible for administering the subsidy. They will need to take prompt action to comply with the Act.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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