PROTECTING PRIVATE EQUITY INVESTORS FROM WAGE-HOUR CLAIMS

As private equity firms prepare to make follow-on investments in businesses impacted by the COVID-19 pandemic, or make new investments in or acquire distressed companies, there has never been a better time to increase their vigilance against wage and hour claims. These claims, many of which arise from what can only be described as "tricks and traps" for the unwary, pose serious risks not just to a portfolio company but to individual managers of a portfolio company, affiliated companies and, in New York, shareholders.

Specifically, would-be private equity investors or acquirers should: (a) strengthen their due diligence on wage-hour claims; (b) keep the investment vehicle used by the private equity firm as legally separate from the portfolio company where possible and ensure portfolio company directors and managers stay within their assigned roles; and (c) anticipate possible adverse changes in the law that could expand liability to agents and shareholders.

I. Wage Claim Risks to Portfolio Companies

Hidden wage-hour liabilities in portfolio companies can greatly reduce the value of an investment. Wage violations are extremely common. In one two-year period, the U.S. Department of Labor found that 84% (eighty-four percent) of the full-service restaurants it investigated had committed violations.[1] In 1993, plaintiffs filed 1,457 federal wage-hour cases annually. Today they file over 8,000 annually. If a private equity investor does not find wage-hour law violations in the target company, they are probably not looking hard enough.

Wage-hour claims are expensive because the statute of limitations under the Federal Fair Labor Standards Act ("FLSA") is three years in the case of "willful" violations (and almost all violations are considered "willful") and six years under New York law. Unless the employer had a "good faith" belief that it was following the law (a difficult standard to prove in this context), liquidated damages equal to 100% of the wages owed will be added to the total damages. Moreover, if the plaintiff prevails, the employer will have the displeasure of paying not just its own attorneys, but the plaintiffs' attorneys. Collective actions under the FLSA (in which plaintiffs can obtain permission from a court to send written invitations to all similarly situated employee to join the case) are easily brought.

As such, wage-hour claim due diligence and plans for compliance going forward should be high on the list of any investor in or purchaser of a company. In the current economic environment, employers may be particularly tempted to cut corners or take legal risks by, for example, classifying emplyoees as exempt when their exempt status is a close call. However, there is no "pandemic defense" to wage-hour claims. Private equity firms should also be looking for failure to give proper notices under The Worker Adjustment Retraining and Notification Act (the so-called "WARN Act") which has already spurred a class action lawsuit against the Hooters restaurant chain.

II. Risks to Individual Managers/Directors and to Parent Companies

One of the dangers of wage-hour claims is the ease with which individual liability can be imposed upon managers of a company who under wage laws are deemed "employers." The same is true of affiliated companies. Adherence to the formalities of corporate separation and making clear distinctions between director and officer duties will protect individuals and affiliated companies from ultimate liability and, just as importantly, will increase the likelihood that lawsuits against them are dismissed early in the case.

[1] "Wage Theft in Restaurants," *N.Y. Times*, Editorial (3/12/2018).

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A company does not have to necessarily be the one that pays an employee or issue him or her a Form W-2 to be considered an "employer" under the FLSA. Separate entities can be held jointly and severally liable for wage-hour claims if they comprise a "single employer" with another entity or "jointly" employ an employee. The U.S. Court of Appeals for the Second Circuit determines whether an entity is an "employer" by asking whether the putative employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records.[2] No single one of these factors is decisive and they do not all have to be satisfied for an entity to be considered an "employer."

In assessing whether an individual is liable as an "employer," the Second Circuit looks to the *Carter* Test, but considers two additional factors: (1) the scope of the individual's "operational control;" and (2) the individual's "potential power."[3] Put simply, this means that, in a wage-hour lawsuit, a court will ask if a person or company had the power to control terms and conditions of employment and whether the use of that power had some relationship to the plaintiff's employment in light of the totality of the circumstances.

If it sounds expensive for lawyers to analyze the facts of a situation to determine if one company is the "employer" of another company's employees or to determine if an individual manager had sufficient "operational control" to be held personally liable for unpaid wages, it is. Because so many factors play into the determination of employer status, large amount of information are required and precedent in other cases is of little use. Consequently, it is difficult for an employer to win summary judgment on such issues.

In California, private equity firm Ensign Group learned this lesson the hard way when it was sued in a class action wage-hour lawsuit by employees of a nursing care center it owned.[4] Ensign Group owned a "cluster" of companies that together operated the care center. Among the facts the court pointed to in holding that Ensign could be held liable for the care center's wage hour violations were:

- All the companies shared the same corporate address;
- An Ensign Group staff person recruited the care center's employees; and
- A "seamless flow" of corporate officers between Ensign and its clusters with Ensign employees and former employees serving as secretary, president, and treasurer of these "cluster" of companies.

As a result, a court of appeals revived a class action lawsuit that had been dismissed and sent it back for further proceedings. If Ensign Group had been more careful about keeping its various operations separate, the lawsuit might have been dismissed.

Fortunately, employers can ensure that these tests will not have to be applied by having officers, directors, and parent companies "stay in their lanes" so clearly that allegations of "employer" status are not even plausible:

- A private equity firm should allow the board of directors of the portfolio company to manage it. In particular, a private equity firm should not have one of its employees (ostensibly acting as a "representative" of the portfolio company board) set up a direct line with the portfolio company managers and tell them what to do, bypassing the portfolio company board.

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[2] *Carter v. Dutchess Cmty. Coll.*, 735 F.2d 8 (2d Cir. 1984).
[3] *See, e.g., Irizarry v. Catsimatidis*, 722 F.3d 99, 106, 109 (2d Cir. 2013).
[4] *Castaneda v. Ensign Grp., Inc.*, 177 Cal. Rptr. 3d 581, 584–85 (2014).

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- Private equity firms should not "lend" their employees to portfolio companies or have their employees directly supervise portfolio company employees.

- Portfolio company directors should stick to acting as directors and not get involved in day-to-day management. The one bright line rule in this sphere is that directors are not, by their mere status as directors, considered "employers" under wage-hour laws. That is because, individual directors (while many may think otherwise) have no formal authority to do anything on behalf of a corporation or, on their own authority, to force any corporate agent to take any action. If directors step outside of their assigned roles, however, and become too closely involved in management, they put themselves at risk for potential wage-hour claims.

III. Risks to Shareholders Under New York Law

Additionally, New York law imposes joint and several liability (along with the employing entity itself) for unpaid wages on the ten largest shareholders of a corporation, and ten largest unitholders of a limited liability company.[5] Importantly, this also applies to entities formed outside of New York with respect to work performed within New York state.

"No problem," some purchasers may say. "We will simply have a corporation own 100% of the shares and have indirect parent companies in turn own that corporation. That way we will not be one of the ten largest shareholders. In fact, we will not be shareholders at all."

It is sound strategy that has worked. Where a plaintiff attempted to apply BCL §630 to the shareholders of an employer/corporation's shareholders, Justice Ramos of the Commercial Division of New York County Supreme Court rejected the plaintiff's attempt. In *Local 1181-1061 v. Wayzata Opportunities Fund, LLC*, 2016 WL 3646988 (N.Y. Sup. June 30, 2016), the plaintiff union represented employees of three bus companies (collectively "Atlantic Companies"). Atlantic Express Transportation Corp. ("Atlantic Express") was the sole owner and holding company of the Atlantic Companies. After the union and its employees obtained a judgment for unpaid wages against the Atlantic Companies in a proceeding before the National Labor Relations Board, Atlantic Express and the Atlantic Companies declared bankruptcy. The employees collected only a small fraction of their claims in bankruptcy.

The union then sued the ten largest shareholders of Atlantic Express, the holding company, under BCL §630. The court granted the defendant shareholders' motion to dismiss on several grounds, including the fact that the defendants were shareholders, not of the Atlantic Companies, who had employed the plaintiffs, but rather of the holding company, Atlantic Express. The Court wrote: "The complaint is subject to dismissal for the additional, independent reason that none of the defendants are alleged to have been shareholders of the Atlantic Companies. . . . As discussed above, BCL §630 'must be strictly construed' and nothing contained in the statute extends liability beyond the shareholders of the Atlantic Companies, as the entity for which the employees performed their services."[6]

In *Local 1181*, the Court discussed a decision of the New York Appellate Division, *Pope v. Halloran*, 76 A.D.2d 770, 772–73, 428 N.Y.S.2d 957, 960 (1st Dep't 1980). The dissenters in that 3-2 decision argued that liability should attach to the shareholder of a parent corporation that wholly-owned the corporation that employed the plaintiff employees because the shareholder exercised "control" over the employer. Justice Ramos, in rejecting the plaintiffs' efforts to invoke the dissenting opinion, stated in *Local 1181* that "the First Department majority dismissed the complaint based upon the plaintiff's failure to give

[5] *See* N.Y. Business Corp. L. §630 ("BCL §630).

[6] *Local 1181*, 2016 WL 3646988 at *5 (citations omitted).

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timely notice, without addressing - and, therefore, implicitly rejecting - the dissenters' contention that 'control is the key,' not ownership of the corporation."[7]

In other words, while BCL §630 could not more clearly state that it imposes liability on the ten largest shareholders of the employer only, in the Appellate Division there were two votes in favor of disregarding the law. The dissenters said, in effect, that while the statute may *say* that only the actual shareholders of the company are liable, our preferred policy is that those who exercise control over wage payments should be liable for these wages.

Given this history, how much trust can a private equity investor or purchaser of a target company have that a New York court will apply BCL §630 as written if the target company goes bankrupt and wipes out large wage claims of employees? All the more reason, in New York especially, to be absolutely certain that the target company has paid its employees every penny that they are owed.

In summary, while the risks of wage-hour claims to private equity investors area substantial, strict attention to corporate formalities can make them much more manageable and less expensive to address.

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[7] *Local 1181*, 2016 WL 3646988 at *6.

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