Missed Payroll in the Wake of Bank Collapse: Implications and Strategies

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In the wake of the recent news of bank failures, businesses—and their investors—are rightly concerned about the implications of a missed or delayed payroll. Let's look at those implications, and strategies for minimizing risk.

Obligation to Make Payroll

Under federal and most state laws, employers have both timing-of-pay and frequency-of-pay obligations. Under most of these laws, wages earned in a particular workweek must be paid on the regular pay day for the period in which such workweek ends. Under some of these laws, payment of certain kinds of wages (*e.g.*, overtime wages) can be delayed until the following regularly scheduled pay day, but only if the wages cannot be computed in time with reasonable diligence. Here, however, the issue is likely not one of computation—but of availability of funds.

Consequences

Employees who do not receive timely payment of wages can sue, and can seek not only their unpaid wages, but liquidated damages equal to 100% (and in certain states 200%) of the amount of wages not timely paid. In many jurisdictions, civil penalties and attorneys' fees are also available to prevailing plaintiffs in wage lawsuits. Unfortunately, the wage laws do not provide a defense based on lost access to payroll funds. In addition, while an employer may have rights or claims vis-a-vis their banks or insurers, the employer is the entity with responsibility for compliance with wage and hour laws, and third-party liability won't absolve the employer of its responsibility to make timely payroll.

Investor and Individual Liability

To what extent can an investor (*e.g.*, a private equity or venture firm) or an individual (*e.g.*, a director or officer) be liable to employees for unpaid or late-paid wages? The short answer is *it depends.* Employees and plaintiffs' lawyers may pursue different theories of liability depending on the jurisdiction, and most depend on an analysis of multiple considerations.

Federal Law

Under the Fair Labor Standards Act ("FLSA"), an employer is defined as "any person acting directly or indirectly in the interest of an employer in relation to an employee." It's possible for more than one entity or individual to be an "employer" of the same individuals under the FLSA, and all such "employers" are jointly and severally liable for wages—meaning any of them can be sued for the full amount of unpaid wages. To determine whether an individual or third party is an "employer" for purposes of FLSA liability, most courts apply a version of the "economic reality" test that considers whether the individual or third party (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/or (4) maintained employment records. None of the factors individually is dispositive, and the inquiry is fact specific.

The FLSA's definition of a "person" includes an individual, partnership, association, corporation, business trust, legal representative, or any organized group of persons. As such, a corporation, partnership, or limited liability company could be held liable for unpaid or delayed wages if it otherwise qualified as an "employer" under the FLSA.

While individual officers and directors can (depending on the facts) be deemed "employers" under the FLSA, many courts have held that individuals who are not directly involved in employment decisions and/or who do not have economic control over employees are not liable under the FLSA. By contrast, courts have found that individual defendants who are directly involved in employment decisions and/or who have economic control over the at-issue employees may be liable as "employers."

State Liability

As with all wage and hour issues, state laws may require a different analysis of individual or third-party liability. For example, under the Wage Orders of California's Industrial Welfare Commission, an individual or third party may be deemed an employer—or joint employer—if they "directly or indirectly, or through an agent or any other person, employs or exercises control over the wages, hours, or working conditions of any person." For a discussion on the consequences of a missed payroll under California law, see our blog here.

Separate and apart from whether individuals and third-parties can be held directly liable for wages as employers or joint employers, some states have statutes that allow employees to seek relief against shareholders. For example, under Section 630 of New York's Business Corporations Law, the top ten shareholders of a corporation (determined based on the fair value of their respective beneficial interests) are jointly and severally liable for amounts owed in respect of unpaid services performed in New York, including:

- wages;
- vacation, holiday, and severance pay;
- employer contributions to or payments of insurance or welfare benefits;
- employer contributions to pension or annuity funds; and
- other amounts due and payable for services rendered by the employee.

Because liability is joint and several, employees can elect to recover from only one, a few or all of the top ten shareholders, though shareholders that pay more than their pro rata share are entitled to contribution from the other shareholders.

Under the New York law, to seek relief from the top ten shareholders, plaintiffs must:

- first give written notice to the applicable shareholder(s) that they intend to hold such shareholder(s) liable within 180 days of the termination of the services performed in New York (or, if within such time period the employee demands an inspection of the corporation's records to determine the top ten shareholders, within 60 days of being granted such inspection);
- seek to recover the amounts owed from the corporation and obtain a judgment against the corporation that remains unsatisfied prior to commencing an action against the shareholder(s); and
- commence such action within 90 days after the judgment against the corporation is unsatisfied.

The requirement that the employee first obtain a judgment against the corporation is of particular importance because it has the effect of limiting the potential for shareholder liability to situations in which the corporation is insolvent or bankrupt. In all other contexts, the corporation should generally be able to satisfy the claim directly without the need to shift the liability to its shareholders. Similar relief is available against the ten members of a limited liability company with the largest percentage ownership interest, under Section 609 of New York's Limited Liability Company Law.

California also has unique laws that could implicate a company's directors and officers. For example, under Section 558.1 of the California Labor Code, an "owner, director, officer, or managing agent" of an employer may be held personally liable for violating or causing a violation of any provision of the Labor Code relating to minimum wages or hours and days of work in any Wage Order of the Industrial Welfare Commission. California courts have held that the key inquiry for liability under Section 558.1 is whether the individual had "personal involvement" in violating a labor statute or causing the violation. In 2021, the Court of Appeal held that a company's owner was not liable because her involvement in the operation and management of the business was "extremely limited" and "she did not participate in the day-to-day operational/management decisions of the company."

Employee Benefits Considerations

Missed payroll can impact employee benefit plans. First, employee contributions (*e.g.*, to health or 401(k) plans) will need to resume when payroll resumes. Employees can miss out on 401(k) and similar deferral opportunities if payroll does not resume by year-end. Second, employers that are unable to make matching or other employer contributions should consider whether the plan can be amended to cut off the employer's obligation. Third, employers should contact their insurers to ensure there are no gaps in coverage. If employers are resorting to manual adjustments to payroll or moving to new providers, they should confirm that employee contribution elections are implemented correctly. If any employees' benefit elections are missed, employers should discuss with counsel the available options to correct the error.

Avoiding Section 409A Issues

If pay is delayed beyond March 15, 2024, employers can be exposed to adverse tax consequences under Section 409A of the Internal Revenue Code. To avoid this tax, the employer will need to make payment as soon as practicable and establish either (a) that it was "administratively impracticable" to make the payment earlier and the impracticability was unforeseeable, or (b) that earlier payment would jeopardize the employer's ability to continue as a going concern.

Practical Considerations

Employers that no longer have access to their payroll accounts should, of course, be actively seeking alternative sources of funds to make payroll (*e.g.*, from cash reserves in other accounts, credit lines, etc.).

As with so many other workplace issues, early and open communication with impacted employees—combined with frequent updates as to the status of remediation efforts—is a key strategy that can help to create and maintain trust and minimize the risk of legal claims. Employers that have lost access to their payroll accounts and will miss a payroll as a consequence should immediately notify employees of the development and the plan to make payroll on the next possible date. In that communication, the employer should designate a contact person or team to field questions from employees, and that contact person/team should respond to all employee inquiries in real time. Employers should send regular updates to impacted employees (e.g., every 24 hours) as to when they expect to make payroll. Assuring employees that they will be paid notwithstanding the circumstances—and keeping them well-informed as to timing—should help alleviate what is likely the primary concern in most workers' minds, particularly for those who rely on a predictable payroll to meet their financial obligations.

As with all wage and hour and benefits issues, state law may require a different or more nuanced approach. Employers with multi-state operations must consider both federal and state law in devising a strategy to address a missed payroll.

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