FOCUS

Top attorneys advise on downsizing tactics

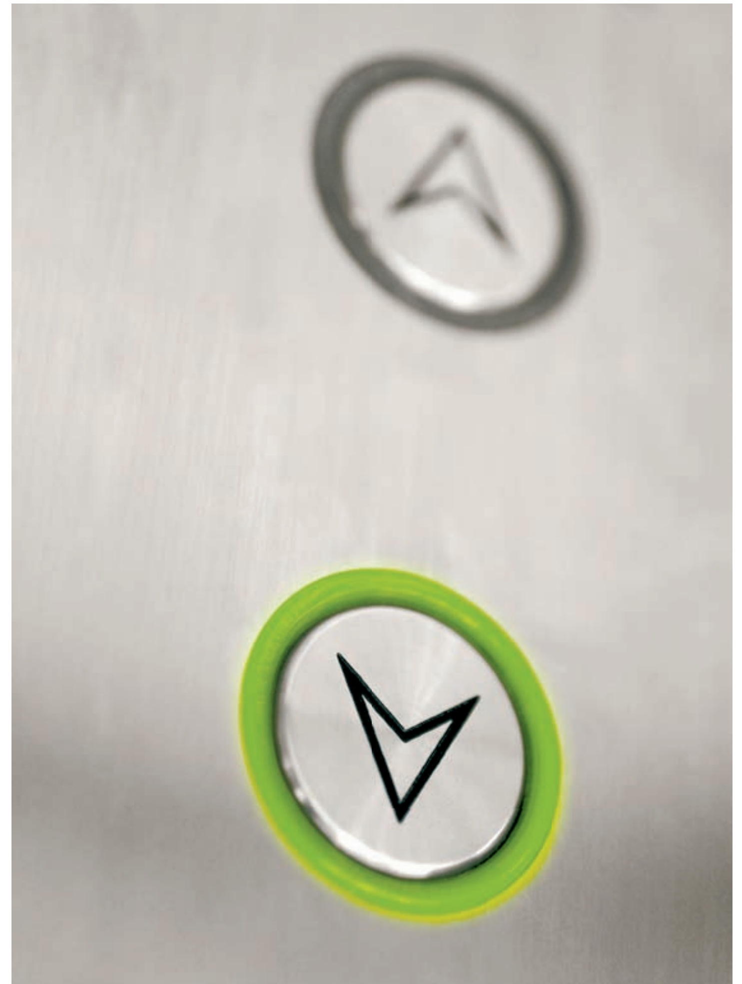
Ride It Down—Legally

By Ted Byrne

There's a fact of life, expansion's easy, contraction's hard. Chester County business lives on a ratchet … we can pop up, but there are teeth that keep us from dropping back—or at least it's really hard to take tiny steps down. It's the odd reader right now who has not contracted a business, is in the process of contracting, or who's not seriously considering a downsizing plan. Worse yet, virtually no one's sure that they've completed whatever downsizing they might need.

So I called the lawyers.

Over the past week, several distinguished regional legal business minds told me what a tactical downsizing plan can and probably shouldn't do. They donated thousands of dollars worth of billing time so that I could now write a book on the topic. But the way things are moving in the county, who has time for a book? What we need right now is an overview of the tactics you are *most likely* to feel are necessary and the red flags they can raise … the decisions that should first trigger a call to your counsel.



You've heard the cliché "Everything's negotiable!" right? Except for death and your electric bill, that seems sort of correct. Yes, it is odd that only the local deregulated electric utilities will never negotiate contracts in spite of their claims for price deregulation that they now exist in a competitive environment, but I digress. In other cases, there are walls to the negotiation tunnels. Or maybe there are hurdles. Or … or maybe hurdles inside of tunnels or …

Managers understand that there are two edges to the downsizing scissors. On the one side, they have a supply chain; on the other, market realities. And of course the regulatory, tax people, and lawmakers contribute to the sharpness of the slicing you can do.

Up front, I discovered that everything ain't negotiable without spending an amazing amount of scarce time and money. As Roger Huggins, a partner at Gawthrop Greenwood, made clear, a lot of those things that are negotiable demand careful management in order to avoid exposing yourself to an annoying amount of scarce time and money as a result of some well-defined liabilities. Still,

as John Reed, a partner at Barley Snyder, puts it, if the daily burn rate is devouring your cash flow, it's time to put together a downsizing plan, review the one that you're using, or consider an add-on to the way you're dealing with resource, contract, and financial negotiations, wage contraction, and reductions in force.

General Negotiations

When it comes to downsizing a current relationship, what you are after are the leverage points. The wise manager has memorized comparative P/E financials: costs as a percentage of the whole and costs as a historical percentages have been calculated for every widget, worker, and wandering penny in the organization. The productive contribution of everything's been minutely analyzed, and the areas of lowest productivity are at the top of the cutting block. This isn't the place to review that management process. I'm considering it done. But the analysis has revealed any number of places leaking cash so that the burn rate is left to sizzle hotly.

They have to be plugged whether they're in the labor force, the executive office, the vendor contracts, or even in tax exposure. However, I'm guessing that you've also done an additional analysis. After ranking the least productive expenditures you make, you've further ranked them on the basis of do-ability. It's possible that the government's become your major partner in its first-claims upon sales taxes. Sorry, Charlie, nothing you can do there. They are up on your saddle along with wage withholding deposits, and no amount of bucking will hurl them off. If you have missed any of those payments, call your counsel or accountant, have a payment plan worked out immediately. Jeff Ouellet, an associate at Hartman Underhill & Brubaker, is firm in suggesting that failure to pay triggers personal … even criminal liabilities. They are among your top priority creditors.

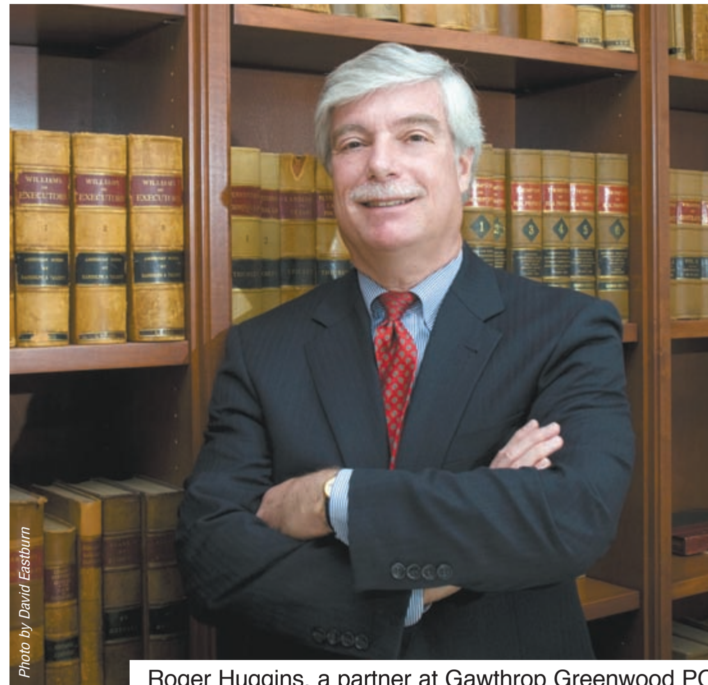


Photo by David Eastburn

Roger Huggins, a partner at Gawthrop Greenwood PC

Leverage Points

But that doesn't mean that all taxes are outside of the area of negotiations. Most municipalities, counties, state, and federal offices will work with business with respect to creating plans for unpaid tax liabilities. And everything, including interest and penalties, is negotiable. However, the real problem in this time of government downsizing and business distress is "in finding a tax authority," Roger Huggins notes, "who will take charge of your case." Cleary an area where one of your team of professional consultants can help. Team? You have a team? Sure your banker, accountant, insurance professional, and lawyer are always prepared to support you in these matters, but frankly, none of them likes surprises. The consensus of advice from the lawyers is that you keep everyone informed, including your creditors, so that when relief is needed, they needn't start from scratch.

With respect to relationship redefinitions, what you want to look for, Roger Huggins says, are the leverage points of negotiable areas. Ken Rollins, an associate at Rhoads & Sinon, agrees and adds that almost all relationships can be prioritized among the secured and those that are *relatively* unsecured. (From the lawyers' standpoint, everything is secured to some degree, and it is the lawyer's job in most cases to redefine those relationships.) An attorney will look at your list of least productive inputs and outputs and rearrange them in terms of priority and non-priority relationships. Wages, taxes, and secured liabilities can be easily discovered. Among liabilities, there are those to landlords, equipment lessees, and vendors that are secured by contract as are some contractually secured relationships with customers, which could become messy should the current downturn become complicated by an abrupt inflationary surge.

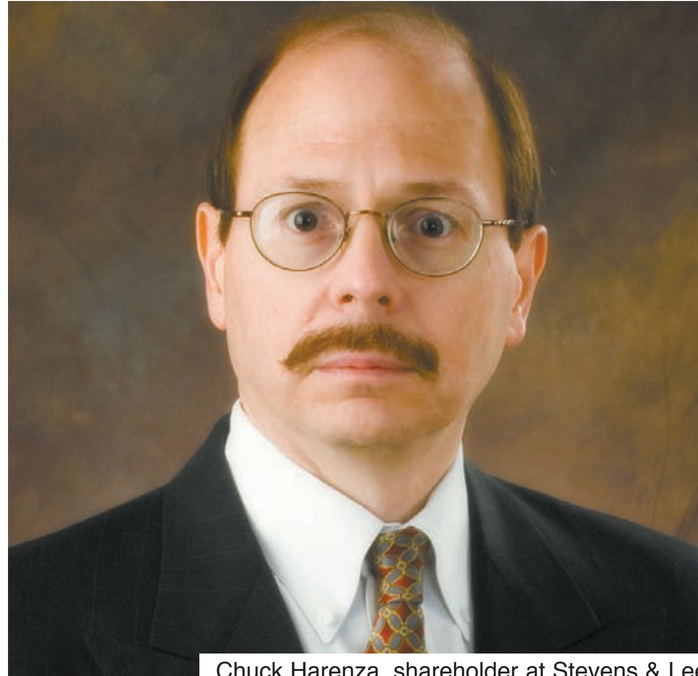
Takebacks, as Ken Rollins observes, are a particularly good area for renegotiation. Here a former owner will frequently be anxious to make adjustment in cash flows in order to preserve the integrity of what many of those sellers see as a major component of their long-term retirement. Many financial relationships are surrounded by covenant shells of varying thickness. But as Ken Rollins adds, even when they're strongest, creditors rarely want to actually take possession or accept titles in lieu of bankruptcy, and there are even some opportunities to negotiate beyond payment holidays and interest-only payments. In some cases, creditors have been known to renegotiate principal outstanding. However, most will prefer to revisit the terms of agreements with firms that are managing forcefully toward a reasonably expected recovery situation. Still, legally protected and secured relationships move to the bottom of the pile of most easily downsized areas.

Wages

Wages are a particularly interesting area with respect to unilateral moves on the part of an employer. It seems a reality, Roger Huggins points out, that case law has resulted in the 20 percent barrier. Suppose a well-meaning employer tells a manager that her salary will have to be cut by 25 percent as a result

of market conditions. Suppose that the employer is totally honest and that he wants the manager to stay on … that he is sincere in his offer of continued employment. The lawyers are unanimous in their conclusion that the manager will be eligible to collect unemployment. Ted Brubaker, partner at Hartman Underhill & Brubaker, points out that precedent indicates that unilateral contractions of wages beyond 20 percent will be the equivalent to the "constructive discharge" of the employee from the job she occupied. She can indeed be offered the job with the new remuneration. But for practical purposes, courts will very readily side with an employee's decision to leave and to file for UC instead. If you are considering the need to contract wages or other well-defined components of an employee's remuneration, talk first with counsel.

Kim Smith, a partner with Hartman Underhill & Brubaker, makes it clear that non-payment of any wage will open the employer to a civil suit. Of course the ability to contract an employee's wages at all may be further hampered by a collective bargaining contract, a formal personal employment contract, or an implied contract that initially described the employee's job description and remuneration during the hiring process. This might be reinforced by the employee manual. Again, before considering any substantial change in the totality of an employee's remuneration, it will be useful to talk with counsel. Incidentally, a unilateral change in wages or salary may trigger complications with respect to bonuses, commissions, and a host of benefits including health care and pension contributions or vesting relationships. As Ted Brubaker reminds us as the federal government is discovering there are pesky problems with that word bonus, "A discretionary bonus is not discretionary if it is paid annually at the same amount." It's best to review the decisions with counsel rather than igniting a bomb's fuse. (See "Bonus!" at business2businessonline.com.)


Chuck Harenza, shareholder at Stevens & Lee

Reductions In Force

In many cases, reductions in wages accompany reductions in force. And here, *as with wage reductions*, the various pieces of anti-discrimination legislation need to be considered first. Legal counsel will remind you that there are protected groups. In most cases, the threat of retaliatory suit is highest with respect to age discrimination. Labor attorneys have considerable experience in this area and can easily help shape a reduction in salary or force that constructively respects the intentions of those laws. However, they are easily violated unintentionally and can be costly to defend against at a later date.

Employees in Pennsylvania are "at will" of their employers. Still, even beyond the matrix of anti-discrimination legislation, a jungle of legal vines has grown about the hands that sign the payroll checks. Mark Smith, a partner at Barley Snyder, reminds us that there are strict laws governing the notice of larger layoffs or plant closings. And of course collective bargaining contracts are the first relationships that must be revisited with care. Joe Hofmann, a shareholder at Stevens & Lee, also notes that the Pennsylvania wage payment and collection act is a statute that lays a quasi contractual status over at will employment relationships and allows employees who are not paid wages according to understandings to make claims against employers. It allows them to recover court and attorney fees and allows them to go personally after certain corporate officers. Personal employment contracts come immediately after. With respect to those personal contracts, all restrictive covenants and particularly the non-compete clause demand close attention. Kim Smith concludes it is probable that courts will find them inapplicable to employees who have been terminated in a downsizing. Violations of long company traditions with respect to, say, seniority termination, may be grounds for action on the part of a terminated employee.

In order to avoid any of this or other messiness that may arise with respect to the benefits I'm about to discuss, Chester County employers frequently offer some sort of conditional severance packages. These are paid conditional to the employee signing a release from future claims. First off, properly done, a reduction in force will in all probability trigger nothing but the most easily defensible claims and consequently require no compensatory severance package. And secondly, even if paid, some may still expose the employer to liability if the accompanying documentation and/or the strategy of the workforce reduction are not competently executed. Once again, these are tactics best prepared in cooperation with counsel. An additional warning. An employer who, as a result of some form of sympathy with the plight of his severed employee, offers a severance package may open him or herself up to special liability down the line. It is very useful to have counsel review all severance relationships with respect to employer exposure.

Benefits

Benefits offer some of the nastier resistance to workforce reduction, particularly since

their impact is unexpected by the business. How will the employer treat outstanding vacation time? As a lump payment? What about outstanding commissions? Bonus agreements? Sick, personal, or family leave time? Kim Smith is clear that these are all areas where the legalities are strong with cautions.

How about pension rights? Chuck Harenza, a shareholder at Stevens & Lee, reminds us that here in central Pennsylvania, we still have a lot of old line manufacturing firms that have defined benefit plans. What about the complexity of vesting claims? Jeff Ouellet warns that in some cases, vesting periods may be accelerated by layoffs and consequently employer savings unrealizable at best, or an exposure to a lump of contribution may be required at worst. John Reed agrees and adds that it is particularly difficult to unwind defined benefit plans quickly, especially when elements of it may be drilled deeply into collective bargaining agreements or employee manuals. Moreover, changes in the scale of any pension plan could trigger difficulties with respect to the covenants established with plan administrators. And Ted Brubaker reminds that pension plan contribution schedules may make an employer liable for a contribution well after an employee has been discharged.

Equally serious are the ramifications of cancellation of health care benefits. The collapsing of health care savings accounts on a large scale involves new and frequently uncharted areas since these instruments are so relatively new. But even traditional health care programs can cause serious concern to counsel. John Reed explained that under recent legislation, terminated employees can, as they always could, apply for COBRA protection of their benefits for a period of time. But now the employee is responsible for paying 35 percent of the employer's cost of that plan, and the employer will pay the additional 65 percent. However, once the ex-employee makes that 35 percent contribution, the employer can deduct full relief for that remaining 65 percent payment as a tax credit deduction from his or her next payroll tax deposit to the U.S. Treasury. Or should that deposit not be large enough, the employer can immediately apply for a tax return for the remainder.

Before considering any of this with respect to an HSA, talk to your lawyer and insurance professional.

Golden Lining

As an aside, there is a golden lining to the economic uncertainty and the employer's benefit burdens. Employers have been under increasing pressure to share the costs of these programs with formerly resistant employees. So employers have generally eaten double-digit increases in health care benefit costs without passing on the largest share in terms of withholding, copays, and deductibles. That's ended as the full employment economy has collapsed. Now employees are sufficiently happy to have any benefits that they are increasingly accepting the burden of 20 to 25 percent of the plan costs, and some employers are reaching 30 percent. Moreover, employees are routinely accepting jumps in copays and deductibles in order to allow the employer to "hold the line" on benefit cost increases. And resistance to increasing the burden of insuring family members beyond the worker is also dissipating in this climate. More Chester County employers are cleansing their rolls of family members who could be insured at their own places of work, albeit at a higher rate. In each of these cases, employers have discovered legal counsel is educated and ready to help in crafting the new relationships.

Boards have also found this an attractive environment in which to find savings in executive compensation. Chuck Harenza, who specializes in benefits and executive compensation, saw a 20 percent reduction in CEO bonus payments between 2007 and 2008. There was an additional 10 percent reduction in performance payments. And the steepest decline was in discretionary cash rewards of some 47 percent. And Joe Hofmann added that there is a continuing trend for firms to outsource executive jobs (along with benefits and pay) as Chester County firms continue to embrace the services of professional employee organizations. However, he is quick to note that commonwealth legislation needs augmentation to maximize the attraction of these PEOs to area firms.

Downsizing tactics have led many county managers to reconsider outsourcing *and* insourcing alternatives. Some of these, say, bookkeeping and treasury management, may result in the need for new contractual relationships. But just as some firms have moved these very relationships out of house, some others have discovered that new killer computer applications have allowed them to move back with fewer employees and lower expenses than they traditionally absorbed.

Basically then downsizing is not as seamlessly encouraged as expansion is here in Chester County. The tactic demands identifying leverage points within existing relationships, and particularly identifying those relationships that are secured by personal guarantees. It is Ken Rollins's experience that "the lender who is owed the most will be willing to negotiate the most." However, it's becoming increasingly the case that firms are afraid of their bankers, particularly when they are closely held. However, in Pennsylvania, Roger Huggins points out that the strength of commitments secured by personal guarantees don't mean as much since it is difficult to collect against a single spouse when the pledged assets are jointly owned. Frequently there is no practical ability to collect on that debt, and hence the borrowing firm has a leverage point for renegotiation. All of which means identifying those with contractual protections that are willing to negotiate in order to protect more than they might lose in a bankruptcy court. Or it might mean rethinking the entirety of the inputs to your process and plotting out which might be most easily downsized and how that action will affect all of the other flashpoints along your supply and sales chains.

Regardless, if you have not approached the managerial exercise of downsizing, either in fact or theory—you're the odd manager in today's environment. But there's a final warning that you need to consider. Downsizing for most of you is a temporary event. As you build it either on paper or in reality, make certain that it's accompanied by another tactic.… For every downsizing tactic, remember to have a clear grasp upon its … *escape plan.*