Employment Alert: Salary Deferral Arrangements May Be Void under Massachusetts Wage Act, Even for Top Executives

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Wage Act

Recently, in *Stanton v. Lighthouse Financial Services, Inc.*, the U.S. District Court for the District of Massachusetts held that a salary deferral arrangement in an employment contract was void under the Massachusetts Wage Act ("Wage Act" or the "Act"). This decision is an important reminder that the Wage Act sweeps broadly, and that deferred salary provisions are problematic for several reasons.

In *Stanton*, the plaintiff, John Stanton, was the company's co-founder and its President. The company was a start-up that provided payment processing services and did not have sufficient cash flow to pay wages on a current basis. Faced with this reality, Stanton and the company's CEO entered into employment agreements, which provided that salary may be deferred at the election of the board of directors for the first year of employment, but must be paid before the distribution of any profits of the corporation. These agreements were mutually negotiated with the help of corporate counsel. The company continued to struggle financially. In fact, the CEO withdrew money from his 401(k) account to pay for basic operating expenses of the company.[1] Just over 14 months after entering an employment agreement, Stanton left the company without having received the majority of his salary.

Stanton sued the company and the CEO individually for various claims. One of the claims was for violation of the Wage Act, which provides that employers must pay wages to an employee within six or seven days following the end of the pay period in which the wages were earned.[2] The Act allows an aggrieved employee to recover treble damages, attorney fees, and costs. In *Stanton*, the parties disagreed as to whether the President of the company could bring a claim under the Wage Act. The company argued that he was not an employee because he could be sued as an employer under the Act.[3] The Court reasoned that a person can be both an employer and an employee for purposes of the Wage Act. Here, the President was subordinate to the board of directors, at least in terms of receiving his pay, and as such he was an employee and could bring a claim under the Wage Act. Further, the President's salary constituted wages under the Act because the deferral arrangement did not make his pay contingent on any individual performance criteria and was a deferral of base wages, not of a bonus. As such, the President could sue the company and the CEO under the Act for unpaid wages. Indeed, *Stanton* reveals that the Wage Act reaches even the highest-ranking employees in an organization, not just rank-and-file employees who lack bargaining power.

The *Stanton* case also makes clear that salary deferral arrangements may result in liability under the Wage Act. The Wage Act itself specifies that no person can exempt themselves from the Act by special contract. Here, the Court examined an arrangement to defer all base compensation at the discretion of the board of directors, and found that such a provision runs afoul of the Act's special contract prohibition. While some forms of deferred compensation are permissible, arrangements that defer base salary at the employer's discretion are very likely unlawful. Indeed, there is a tension between deferred compensation arrangements entered into by employees for their benefit and those that leave wage deferral decisions in the employer's hands.

IRC Section 409A

Deferred salary arrangements may also trigger unexpected tax implications under Section 409A of the Internal Revenue Code of 1986, as amended ("409A"). If salary is earned by an employee in one year but may not be received by the employee until a later year, such deferred salary is very likely deferred compensation subject to 409A. Among other requirements, any deferred compensation subject to 409A must comply with certain requirements related to the timing of the deferral election and payment. For example, as a general rule, an election to defer salary must be in place by December 31 of the year before the salary is earned, and the arrangement must specify when payment will be made in accordance with 409A. In any case, an open-ended discretionary option to defer salary is not permissible under 409A. Failure to comply with such requirements with respect to the deferred salary could require the employee to currently include such salary in income, even if the employee has not yet received it. In addition, a 20% excise tax would be imposed on the deferred salary and there may be interest penalties if income is not timely recognized. Employers should pay close attention to the personal income tax implications of deferred compensation arrangements because affected employees would likely look to employers to make them whole.

Conclusion

As *Stanton* indicates, malformed deferred compensation arrangements can create significant employer liability under the Wage Act. They also can result in personal income tax exposure under 409A. Start-up organizations are particularly at risk for Wage Act violations because executive pay is often deferred until the company is financially stable. In these situations, careful drafting of the deferral arrangement can make all the difference.

Action Items for Employers:

Employers should:

- Work with experienced counsel to develop plans that comply with the law while also reflecting the realities of the workplace.
- Review existing compensation arrangements to be sure they

comply with the Wage Act and 409A.

- Contact a Mintz Levin Employment, Labor and Benefits attorney with any questions, and look for further information from us regarding developments in this area of law.

Endnotes

[1] Although not the focus of this advisory, withdrawing funds from a 401(k) account to pay for business expenses raises prohibited transaction and plan qualification issues under the Employee Retirement Income Security Act of 1974 and Internal Revenue Code of 1986.

[2] The number of days within which an employer must pay wages after a pay period depends on the number of days an employee works during a work week. Pay periods may be weekly, bi-weekly, or in some cases semi-monthly or monthly.

[3] The company also argued that startup co-venturers should be treated like co-operative associations, which are exempt from the Act. The Court did not find the two types of organizations sufficiently analogous to extend the Act's exemption to startup co-venturers.

For assistance in this area, please contact one of the attorneys listed below or any member of your Mintz Levin client service team.

Thomas M. Greene
(617) 348-1886
TMGreene@mintz.com

Adelita C. Press
(617) 348-1659
ACPress@mintz.com

Joel M. Nolan
(617) 348-4465
JMNolan@mintz.com