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2007

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Employees may be your biggest asset, but they can also be your biggest liability. With lawsuits booming, ignore HR at your own peril

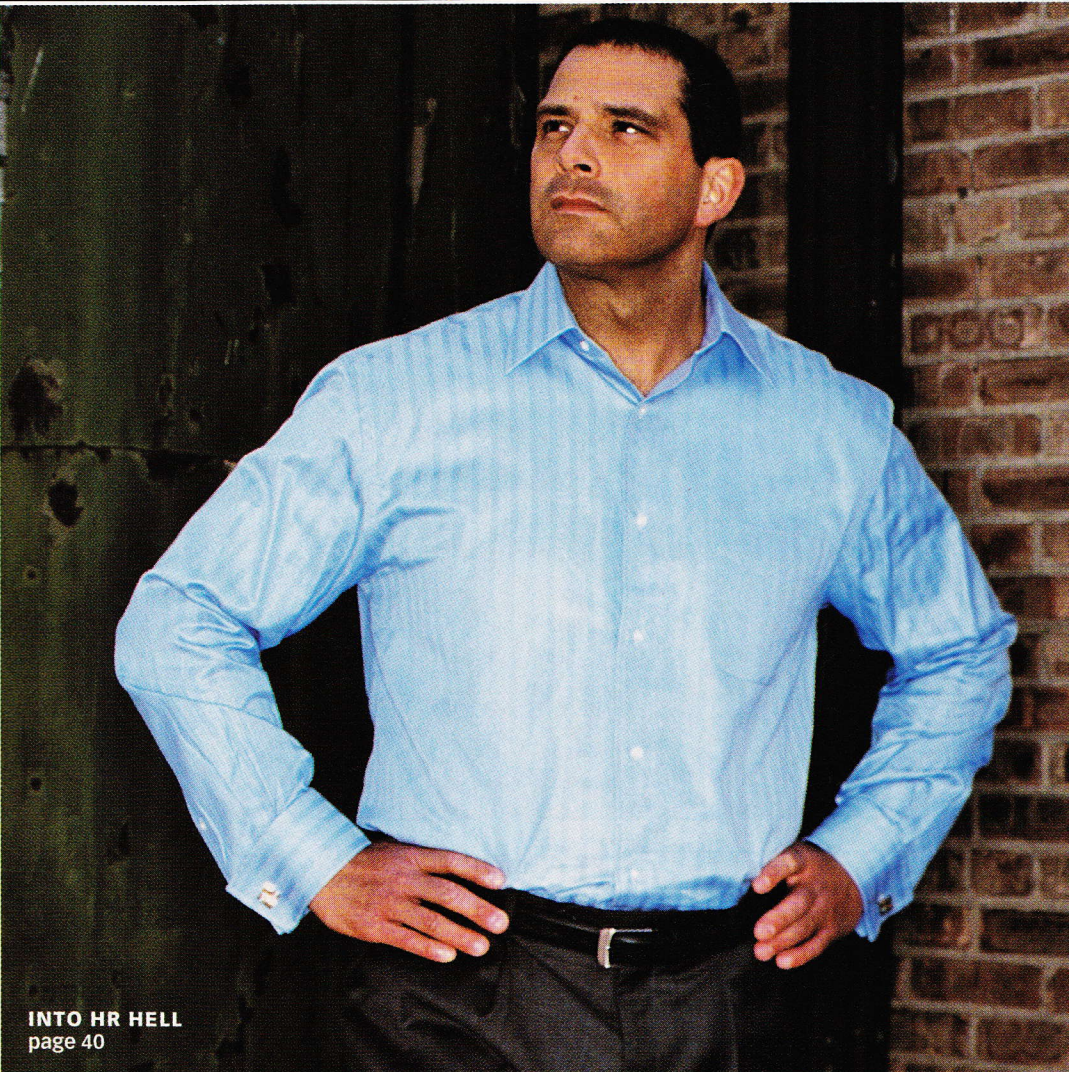
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Cover 3D illustration by Roger Kenny

PAUL ELLEDGE; ILLUSTRATION BY GERARD DUBOIS

BLIND

Five H.R. Mistakes You Can't Afford to Make

BY AMY BARRETT

TO THOSE OF US who haven't made it our profession, "human resources" has that ring to it—the ring of something that can be ignored, handed off to a chief financial officer or, worse, another employee who's already wearing five different hats. "In small businesses, no one gets up every morning and thinks about HR issues," says Daniel Blake, an employment attorney in the Boston office of Bulkley, Richardson & Gelinas. After all, drafting policies to handle allegations of harassment, keeping on top of health insurance regulations, and writing noncompetes aren't the sorts of things that get the entrepreneurial juices flowing.

They are, however, exactly the sorts of things that can turn into big expensive headaches if not handled properly. Attorneys say employment-related litigation is booming. Jury awards have ballooned. The median award in an employment case was \$276,711 in 2005, up from about \$150,000 in 1999, according to Palm Beach Gardens (Fla.)-based Jury Verdict Research, which tracks and analyzes litigation. Then there are attorneys' fees, which San Francisco law firm Littler Mendelson estimates at about \$95,000 for employment suits that settle just before trial. The tab

TYPOGRAPHY BY SI SCOTT; DIGITAL ENHANCEMENT BY JOE CALVIELLO/BW



for cases that make it to trial: \$250,000 and up. Add fines and penalties from government agencies such as the Labor Dept., and HR issues suddenly seem a lot less boring.

It's not just the money. It's the time and aggravation. Few entrepreneurs have in-house counsel, and without one, "the owner will be the one to spend their time with this huge distraction," says Rebecca Klemm of Washington (D.C.)-based Klemm Analysis Group, which in 2005 did a study for the Small Business Ad-

ministration on the impact of litigation on small companies. Many business owners surveyed in Klemm's research said they became less trusting of employees after a suit. Angela Murray, who with husband Francis owns amusement park Happy Tymes Family Fun Center in Warrington, Pa., says her company's experience with a sexual harassment claim by a former employee was "horrendous," and that the stress of the case gave her

heart palpitations. Says Murray: "It felt like they were attacking me personally."

What follows are five HR hot spots that entrepreneurs need to pay close attention to—right now.

NONCOMPETE NICETIES

What makes an effective noncompete agreement? Stephen Skertich found out the hard way. In 2001, Skertich bought Pro Med Staffing, an Orland Park (Ill.) nurse staffing company with about \$3 million in sales.

He drew up noncompete agreements for his six employees, a standard practice in the staffing business. In 2006, when one of his scheduling managers bolted to a competitor, Skertich was glad he'd taken precautions—especially after nurses who had been using Pro Med to find work switched to the competitor. But when Skertich consulted with his attorney, he learned his noncompetes probably wouldn't hold up in court.

They were too broad, limiting neither time period nor geography. "Even though we hadn't been hurt that badly this time, I realized next time it could certainly be worse," says Skertich. His new noncompetes run for one year and cover seven nearby counties.

As Skertich discovered, the devil is in the details. States differ in their approaches to noncompetes. In California, they are practically unenforceable; in other states, such as Illinois, they can work just fine. But all courts frown on overly broad agreements. Your noncompetes will be stronger if they apply to employees whose specific expertise—close ties to customers, knowledge of trade secrets—means their defection could cause real damage. If you are in a state where noncompetes are hard to enforce, consider other ways to cultivate loyalty among key employees. When hiring, ask candidates if they are subject to anyone else's noncompetes—potentially saving you from a court battle or from having to ditch someone you've invested in.

E-MAIL EXASPERATIONS

It's scary to think that your company's own e-mails could work against you in the event of a lawsuit. But recent Supreme Court actions mean business owners have reason to be particularly uneasy if they suspect that incriminating e-mails have been deleted.

In December, 2006, the Supreme Court tightened the rules that govern civil cases in federal court. The new guidelines require attorneys for both sides to meet early in the process to discuss how they will handle electronic evidence. That might not sound like a big deal, but the result is that courts will be less inclined to forgive those who don't move aggressively to preserve electronic evidence, such as computer files

and e-mail. "A judge's tolerance of mistakes is going to be reduced," says Robert Owen, an attorney in the New York office of Fulbright & Jaworski. If a company drops the ball, "it will be easier for the other side to stir up the judge on this issue."

And it could have costly ramifications. The most sobering example predates the Supremes' tightening of the screws: Laura Zubulake sued UBS Warburg in an employment discrimination case in 2002, and an issue arose as to the preservation of some UBS e-mail. Two years later, in a key ruling, the judge told the jury that they could assume missing e-mails would have been unfavorable to UBS. The jury found that UBS had discriminated against Zubulake and awarded her \$29 million in damages.

Meeting your own obligations in regard to electronic files is relatively straightforward. The tricky part is that you need to start saving electronic files when you have reason to believe you may be involved in litigation—not when you're actually sued (or bring a suit). You don't have to save

everything under the sun—you just need to show you've made a reasonable, good-faith effort to preserve relevant information.

**\$172
MILLION**

Amount the Labor Dept. collected in back wages in 2006

HARASSMENT HASSLES

In the summer of 2001, after about six months on the job at Happy Tymes, a 15-year-old girl quit, claiming another employee had sexually harassed her. She lodged a complaint with the Equal Employment Opportunity Commission and the Pennsylvania Human Relations Commission and also filed a lawsuit.

Co-owner Angela Murray was floored. She'd considered Happy Tymes, an operation run by four family members, three other full-time workers, and about 50 part-timers, to be a true family operation. Murray says there was a poster on a wall near the employee coat rack explaining that harassment of any kind was not tolerated and that the sign also told employees who to contact with any problems.

Happy Tymes attorneys tried to have the case dismissed, using what has become a standard defense: If a company has a well-known policy and an effective procedure for handling harassment and an employee does not use that system to complain, the company should not be liable. The employee said she never saw the poster, and a judge said a trial was needed to determine, among other things, if the employee really knew about the policy. (The employee, through her mother, declined to comment on the case.) Two days after the trial started, the parties reached a confidential settlement.

Harassment issues are particularly tricky for small companies, where long hours and an informal culture are common. Title VII of the Civil Rights Act of 1964 prohibits

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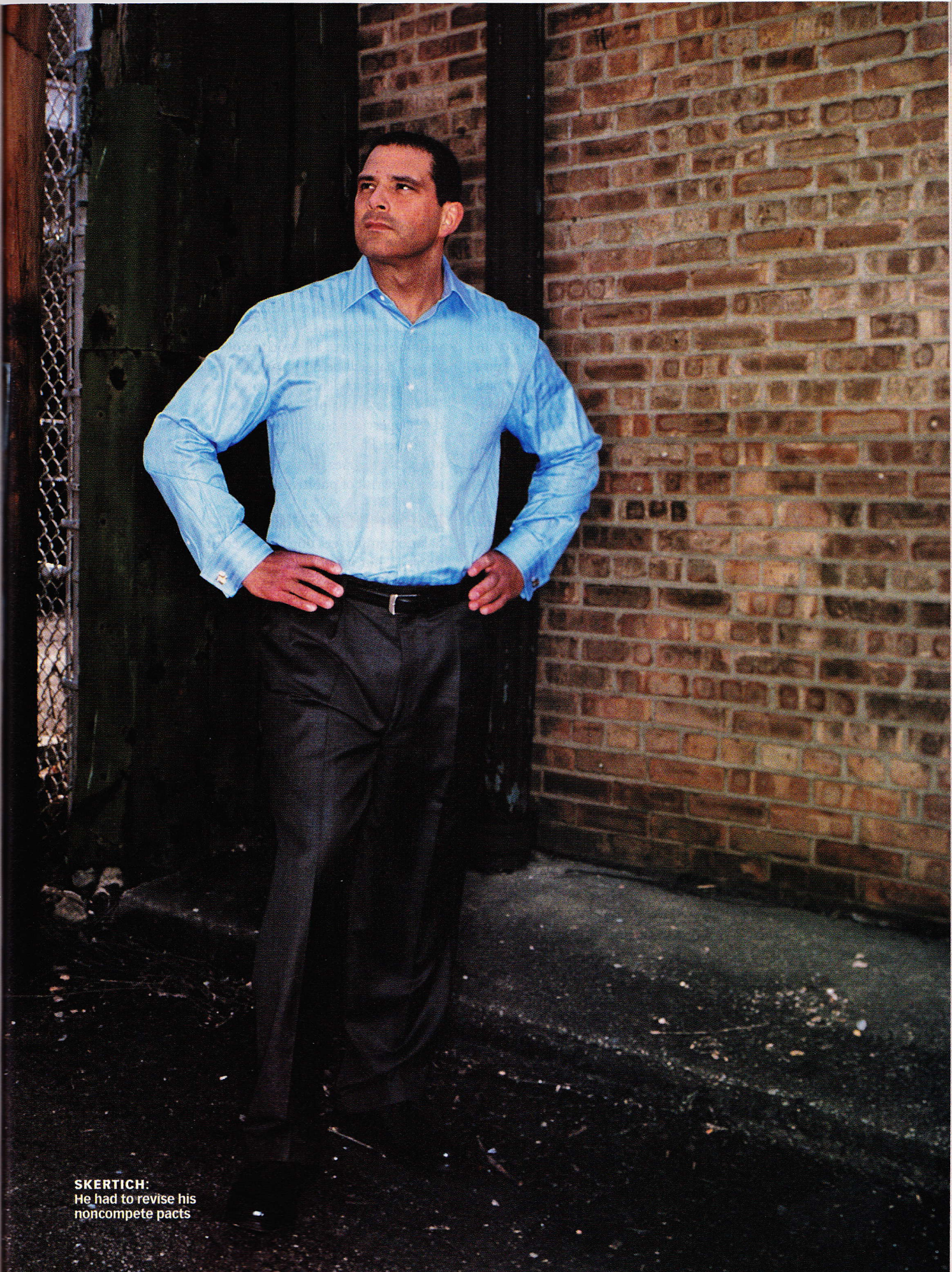
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PAUL ELEDGE

SKERTICH:
He had to revise his
noncompete pacts



8,650

The number of harassment and intimidation cases against small companies filed with the EEOC in 2006

discrimination, including harassment based on factors such as sex or race, and is enforced by the EEOC. It covers employers that have at least 15 employees or full-time equivalents. (Other federal laws prohibit discrimination based on age or disability.) Someone who wants to bring a claim under the federal law is required to file with the EEOC before going to court. In 2006, the EEOC and its state and local counterparts received 8,650 charges of harassment or intimidation, including those brought under Title VII, at small companies. But because some states and cities have additional laws, many covering companies with fewer than 15 people, the actual number of accusations is higher. Pennsylvania's law, for example, applies to companies with only four employees.

To protect your company, make sure you know the federal, state, and local laws. "Companies don't pay attention to their county or state laws, and they are shooting themselves in the foot," says Charles Krugel, a Chicago labor and employment lawyer. Then you'll need a policy that includes a process for handling complaints. At least two people, preferably a man and a woman, should be available to employees who need to report a problem. Include the policy in your company handbook and instruct employees annually about it. If you

employ many people who speak another language, make sure to translate the policy for them. And document everything. Then have employees state, in writing, that they understand the policy (Happy Tymes now does this as part of every employee's orientation). Record any prob-

lems reported as well as the actions taken to resolve it.

Be aware that you can't turn a blind eye even if the complaining employee asks you to not to follow up on his grievance. That will be no excuse if a second worker complains and there is evidence that you ignored a known problem. "We see a lot of problems where employees complain to their supervisors and those supervisors don't do anything," says Anna Park, regional attorney in the EEOC's Los Angeles office. That wipes out the possibility of a good defense and raises the risk of punitive damages.

EXEMPTION ENIGMAS

Salaried employees don't get overtime pay, right? You may think so, but it's not always the case. And if you're wrong and the Labor Dept. comes knocking, it'll be demanding back pay for your employees and possibly slap you with fines as well. In 2006 the Labor Dept. collected almost

Litigation Inoculation

Insurance you may want to cover employee suits

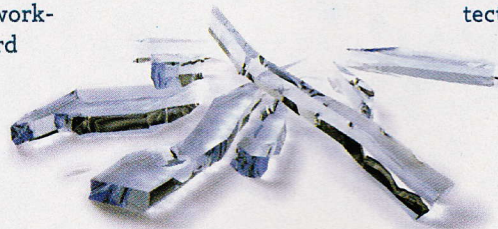
No matter how carefully you try to protect yourself from employee lawsuits, the unexpected happens. That's where insurance comes in. Standard liability policies don't cover employee-related litigation. Nor do they cover problems arising from botched benefits administration. Rather, employment practices liability insurance (EPLI) can help pay for damages incurred as part of a lawsuit. Benefits missteps can be covered by a rider to your existing liability policy.

Employment practices liability insurance covers companies for the legal costs and damages associated with harassment, discrimination, or wrongful termination cases brought by current or former employees or job applicants. Any company with at least 15 employees—the size at which Title VII kicks in—and even some with fewer workers should have EPLI, says Richard Betterley, president of Betterley Risk Consultants, a Sterling (Mass.) insurance consultant. That's especially true if you operate in a plain-

tiff-friendly state such as California, or if you're covered by state or local anti-discrimination laws. Still, there are drawbacks. Many policies restrict which attorneys you can use to handle your case. And EPLI is pricey: Annual premiums for a \$1 million policy with a \$10,000 deductible on a 100-person company can range from \$4,000 to \$10,000, depending on the state and your company's rate of employee turnover. Insurers will also look at a company's internal employment policies, so solid anti-harassment rules, for example, can lower your premium. Shop around for the best price, and be sure that you understand exactly what the policy covers before you buy it. Some policies, for example, also cover suits by temporary or contract employees.

A rider attached to your standard liability policy may help cover missteps with the law known as COBRA, as well as administrative problems with benefits such as disability and life insurance. About \$200 a year pays for a \$500,000 in coverage with a \$1,000 deductible.

Unfortunately, you won't find policies to protect against mistakes in figuring out who should get overtime pay or losses arising from unworkable noncompete agreements. All the more reason to avoid those two situations in the first place.



\$172 million in back wages for more than 246,000 employees, 3.6% more than they hauled in the previous year. They levied \$7.9 million in penalties.

There are three main categories of employees who are not generally entitled to overtime: administrative, professional, and executive. These categories are also known as exemptions, and none is clear-cut. The exemption for administrative employees requires that those workers have decision-making authority, such as the ability to negotiate contracts or order major items. The professional exemption covers those with advanced degrees or certification, but only if they're using that training in their work. A certified public accountant working on your factory floor is probably not exempt. And the executive exemption typically covers those who are in senior management—managing the entire company or running a business unit. “These are such fine lines,” says Shannon Farmer, an employment attorney with Philadelphia-based Ballard Spahr Andrews & Ingersoll. “This is such a trap.”

Labor Dept. audits usually come in response to an employee complaint. Those audits can reach back two or three years, and, painful as they are, rarely are a one-time occurrence. Farmer has one client, a computer software company with 120 employees—it declined to be identified because it'll likely be audited again—that was found to have misclassified 18 employees as exempt in 2004. “I remember my assistant saying you have something from the Labor Dept. and thinking it was some sort of survey,” the CEO says of the audit notification. “I was floored.” The company shelled out \$24,000 in back pay, \$7,000 for a consultant to provide data that Labor wanted, plus \$25,000 in attorneys' fees. The company was audited again in 2006, when one hardware specialist was found to be misclassified. This time, the company owed \$6,000 in overtime and got fined \$1,100 because it wasn't paying overtime fast enough.

Simple managerial missteps can make an otherwise exempt employee nonexempt. If you dock an employee's wages for a few hours because they missed work, or deduct money from a paycheck to compensate for a lost company cell phone, you risk losing the exemption for the employee. By docking the employee's pay, you're stating that the pay is directly tied to the quality of their work—and therefore not “guaranteed” as is required for an exempt employee.

If you have any doubts at all about how your employees are classified, get an employment attorney who knows this stuff cold. Companies that provide outsourced HR services, such as

Administaff and ADP TotalSource, will help clients properly classify workers. They may also help with the paperwork in the event of an audit (but not pay any back wages you owe). These companies also handle other HR matters, but that brings their fee to 1% to 4% of payroll.

COBRA CONUNDRUMS

The good news: You're able to offer health insurance to your employees. The bad news: Your insurance obligations continue even after your workers leave. COBRA, the 1986 Consolidated Omnibus Budget Reconciliation Act, is to thank for this odd state of affairs. Fire an employee, and you need to offer to continue coverage for 18 months, although you don't have to pay for it. Other changes can entitle someone to COBRA for up to three years: a divorce, if it causes a spouse to lose coverage, or a birthday, if it makes a child ineligible for coverage as a dependent. If you fire someone or they tell you they have just finalized their divorce, you have 44 days to provide a COBRA notice to them and the affected family members.

When Exhibit Design Consultants, a 35-person Grand Rapids (Mich.) company that makes exhibits for trade shows, laid off one of its employees in 2001, CEO Timothy Morris says the employee went through an exit interview, had her rights under COBRA explained to her, and was mailed a letter explaining COBRA. But she went to court, contending she was not notified of her COBRA rights. (*BusinessWeek SmallBiz* was unable to reach the employee for

comment.) While Morris contends he may have been able to prove his company handled the termination properly, he says he didn't have the time and money for a court battle. The court entered a judgment in his employee's favor, but the two sides settled and the insurance company reinstated coverage. If your carrier won't reinstate coverage, you can find yourself on the hook for any employee health-care bills that would have been covered.

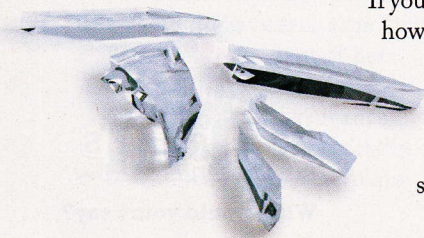
To avoid these sorts of headaches, document everything. If you send a letter, get a return receipt. If you try to reach a worker at home, save the phone record. There's also software, such as that made by *cobra Solutions*, that helps track changes in the law and generates notifications, but it'll run \$670 to get started plus \$375 annually.

Some insurers will notify employees for you, but you need to specify this in your contract. Third-party administrators (or TPAs), such as Minneapolis-based Ceridian, also provide this service. But if you fail to notify the insurance company or TPA of a change in an employee's status, you're on the hook. And when it comes to employment law, that's the last place you want to be.

—With additional reporting by Susann Rutledge

\$276,711

The median jury award
in an employment case



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