

Client Alert



A report for clients and
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Tip of the Month: Best Practices for Compensation Audits

Recent changes in the legal and economic landscape have significantly heightened the risk that employers' compensation systems will come under attack. Congress has passed the Lilly Ledbetter Fair Pay Act ("Ledbetter"), which effectively waives the statute of limitations for compensation discrimination claims under the majority of federal employment statutes. The law increases a plaintiff's ability to recover for compensation discrimination, by placing into issue each and every decision impacting pay, starting from the date of initial hire, rather than just those decisions that occurred within statutory filing period. The law has made the issue of pay equity a hot button issue. Plaintiffs' attorneys and government regulators are primed for attack.¹

The Obama administration also has brought the specter of increased EEOC and OFCCP enforcement activity, as well as the possibility of additional pro-employee legislation in the pay discrimination arena. Of note is the Paycheck Fairness Act ("PFA"), which, if passed in its current form, would substantially amend the Equal Pay Act of 1963 and make it significantly easier for employees to establish unlawful pay discrimination. The PFA broadens the categories of employees that plaintiffs can claim as comparators for purposes of showing pay inequity; it sharply curtails the affirmative defenses available to employers; it makes it easier for plaintiff's attorneys to bring large class-action lawsuits, and it permits uncapped compensatory and punitive damages. It also allows the OFCCP to use a simplistic and often inaccurate "pay grade methodology" when identifying federal

contractors unjustly investigated and make it more difficult for them to defend against agency audits.

Coupled with these legal developments have been a rash of company layoffs, rising unemployment, and an increasing number of employees and former employees who face difficult financial plights. All of these forces make employee compensation discrimination lawsuits more likely. Conducting internal audits to identify disparities in compensation that might be subject to legal challenge, and appropriately addressing such disparities, is one of the best ways to prevent pay discrimination lawsuits and to place your organization in the most favorable position should they occur. This Tip of the Month provides guidance for in-house counsel and human resources executives when undertaking such audits.

A. The Purpose of a Pay Equity Audit

Preventive pay audits help ensure fairness in pay rates among similarly situated employees, which serves to maintain good workplace morale potentially averting employee lawsuits. Such audits enable an organization to assess its susceptibility to a claim of systemic, pattern or practice discrimination, which may be brought by the EEOC, OFCCP or private litigant(s) in either an individual or class action context. Preventive audits also enable an organization to anticipate its vulnerabilities and fix them in advance of any regulatory or private employee challenge. For federal contractors, they also serve to meet the OFCCP compliance requirement that contractors regularly evaluate their compensation systems to determine any sex, race, or ethnicity-based disparities. If a legal challenge should occur, the information learned during the audit, and any ameliorative steps taken by the employer to fix problems uncovered during the audit, will be of critical assistance in defending and ultimately defeating such a challenge.

¹ For more information on the Ledbetter Act see our Client Alert at http://www.proskauer.com/news_publications/client_alerts/content/2009_01_28_c/res/id=sa_PDF/17399-President%20Obama%20Set%20To%20Sign%20Ledbetter%20Fair%20Pay%20Act-ca.pdf.

To be effective, however, it is imperative that the audit results be statistically sound, legally defensible, and, to the maximum extent possible, shielded from disclosure by the attorney-client privilege. The following is a list of tips for conducting these audits.

B. Best Practice Tips

1. Identify the Factors that Influence Compensation.

Before conducting any audit, it is important to identify the legitimate (i.e., nondiscriminatory) factors that influence employee compensation in your organization. Such factors typically include “job-related” characteristics such as job title; pay grade/band; function; type of work performed; level of responsibility; sector or personnel area; and geographic location. They also may include “productivity-related” characteristics, such as: time in current job; direct measures of performance – e.g., performance scores or sales results; and indirect measures that may be correlated with performance – e.g., education level, pre-hire experience, and company seniority.

Also important is the identification of whether the compensation variables are universal across the organization, or whether they differ by business unit, geographic location, or other factors. There may be one business unit where a certain educational degree is a critically important factor affecting compensation (e.g., the finance unit at a company might routinely offer \$25,000 more in starting salary to an employee who has an MBA). In another unit, the same educational degree may have little or no effect on compensation (e.g., in a creative writing department, an employee who earned an MBA early in his or her career but then switched careers to become a writer may not receive any added compensation at all for the MBA). The more accurately the employer can identify and understand the variables affecting compensation up front, the more accurate the results of the statistical analysis will be.

2. Review Compensation Policies and Procedures.

Another important preliminary step is to identify and review all of the organization’s policies and practices that bear on employee compensation. These will include topics such as pay grade/band structure; quartile charts, grids, or matrices used for setting percentage increase amounts; standards for merit and other increases, bonuses, commissions, and any other forms of compensation; and performance evaluations. It is important that the employer’s written policies be consistent with the factors that have been identified as influencing compensation. Additionally, the more the employer has documented the legitimate factors that it considers relevant to compensation, the easier it will be for it to defend use of those factors in its statistical analyses.

To the extent there are pay practices that are not memorialized in writing, consider documenting them and updating them as they arise in the future. Some common events that affect compensation but which often are not properly memorialized in writing include:

- An employer might decide to eliminate the job position of a group of employees and transfer them into different available positions. To the extent the available positions are within a lower salary grade, the employer might decide not to reduce the pay of the transferred employees, despite the fact that their pay may appear “off the charts” when compared to other employees in that lower salary grade.
- An employer might premise base salaries for certain job positions on market studies as to what comparable employees are making elsewhere. Periodically, the company may make adjustments to the salaries of employees in specific job positions so as to remain competitive and retain talent. If such adjustments are not made to the salaries of employees in job positions that, while different in kind, are substantially similar in terms of skills required, level of responsibility and other factors, a statistical pay disparity may result and be subject to future challenge.

The above practices are common; but all too often, they are handled on an ad-hoc basis and are not memorialized in the type of formal writing that could be used to explain resulting statistical pay disparities. Especially in light of Ledbetter, it is in the employer’s interest to invest the time up front to document these practices in a manner that can inform future proceedings.

3. Be Prepared For Possibly Harmful Audit Results.

Before embarking on an audit project, the employer must be prepared for the possibility that the audit will uncover statistically significant compensation differences among protected and unprotected employee groups. These discrepancies may be isolated among a handful of individual comparator employees, or in certain job groups, or within certain geographical or business units. They also may be present across the organization as a whole. Such results do not mean that the company has engaged in discrimination. Cultural and historical factors have resulted in compensation disparities between males and females, and minorities and non-minorities, in society at large into the present day.

Nonetheless, such statistical results *may* be an indication that discrimination has occurred – either unintentionally or intentionally – at some past point in time. Under Ledbetter, a female or minority employee can challenge a single discriminatory compensation decision that occurred decades

ago but which results today in the employee being paid less than a similarly situated male or nonminority employee. It may be impossible for the employer to defend the pay discrepancy at issue because the supervisor who made the pay decision is no longer with the company or is otherwise unavailable, and there are no documents or other evidence to rely upon. There may be a perfectly legitimate explanation for the present-day pay disparity despite the unfavorable statistical results.

Depending on the statistical results of the audit, pay adjustments may be advisable for only a handful of employees, or they may be warranted on a larger, systemic scale. Before starting any pay audit, therefore, it is critical that you obtain the buy-in from the high-level decision makers who will have to approve the resources for any such compensation fixes. Knowing about inexplicable pay disparities and failing to correct them is worse than not knowing.

4. Use an Experienced Outside Attorney.

In order to maximize the opportunity to protect audit results from disclosure under the attorney-client privilege, it is imperative to retain outside counsel to conduct the audit. Courts have held that if there is evidence that the audit was performed for general business purposes (such as for determining whether a compensation system is working correctly and fairly, or to assist the company in planning and establishing salaries, etc.), the audit materials may not be privileged and may not in fact be protected from disclosure.

Nevertheless, there are many ways to try to maximize the chance that your audit results, or at least parts of them, will remain confidential and shielded from disclosure, including by engaging outside counsel to conduct the audit for purposes of providing legal advice in connection with an assessment of litigation risk and/or compliance with EEO laws. The engagement letter with outside counsel should reflect the privileged nature of the audit. Other steps, including treating all communications about the audit as attorney-client privileged, limiting internal disclosure and discussion of audit results, and carefully planning the extent and content of any written reports on the audit, can assist in protecting the audit as privileged and confidential.

5. Ensure Use of Proper Statistical Technique.

To ensure a statistically sound analysis, it is critical for your counsel to engage and work with a qualified statistician. The most common approach to an audit of compensation is a multiple regression analysis. In a multiple regression analysis, a “neutral” model is developed that includes certain “variables” that are assumed to affect a given “outcome.” In

a pay audit, the “outcome” is typically the proposed pay rate for the following year (that tentatively has been decided but not yet put into effect). The “variables” are the neutral factors that have been identified as playing a role in predicting salary. In the process of incorporating the variables, the model tests and confirms that each variable does in fact, from a statistical standpoint, have an influence on compensation. In this way, the statistical analysis itself can help to identify the factors that influence pay at a given organization.

Statistics can be powerful descriptive tools, but generated improperly, they will be meaningless and potentially harmful. Improper technique can result in inaccurate and misleading results. By working closely with an expert statistician who is experienced in conducting pay equity audits, you will maximize the reliability of your results.

6. Document Information Learned during the Audit.

Finally, an audit of compensation often will result in company human resources performing some investigative work to determine the propriety of certain individuals’ pay that cannot be explained by the data. The company should document the results of such investigative efforts so that it does not have to reinvent the wheel every year.

C. Conclusion

Pay equity audits are not just for government contractors anymore. Any organization wishing to be proactive in its risk management is wise to consider such audits in light of the Ledbetter Act. The above summary outlines just a few of the important steps an organization should take when deciding to conduct a pay equity audit. Proskauer’s Government Relations and Contract Compliance Practice Group routinely assists companies with such audits. Please contact one of the lawyers listed below or your Proskauer relationship attorney for assistance in this area.

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