

## Chapter 6

# Severance plans

Severance benefits ordinarily take the form of cash payments made by an employer to an employee whose employment is involuntarily terminated because of circumstances beyond the employee's control. In many industries and in many parts of the country, providing severance benefits to involuntarily terminated workers has been commonplace for a long time, and the custom of providing severance pay pre-dates ERISA by many years. Although severance payments often are no longer made as a matter of course, severance policies still remain a very common feature of employer-provided benefit packages.

Yet in spite of their long history and their relative simplicity when compared with pension or group health plans, severance plans remain one of the most misunderstood and litigation-prone types of employee benefit arrangements. At least four factors have contributed to this phenomenon:

1. the wide variety of reasons for paying severance, which leads to great diversity in how plans are structured
2. the fact that a subtle and easily-misunderstood test developed in the courts determines whether a severance pay policy is governed by ERISA or by state law
3. a widespread but mistaken belief that maintaining an unwritten or informal severance policy can prevent the application of ERISA to an employer's severance practices
4. the fact that under certain circumstances, a severance plan may be covered under ERISA as either a welfare benefit plan or a pension benefit plan.

This chapter discusses each of these points in turn, beginning with an overview of the variety of reasons employers adopt severance arrangements, and the resulting diversity in plan types.

## Varieties of severance arrangements

---

The reasons employers offer severance pay vary. Some employers adopt severance policies only on an "as needed" basis to provide income continuation to a specific group of employees who are terminated because of an event that is already in the works, such as the discontinuation of a product line. Other employers establish uniform and broad-based severance policies well before they anticipate a need to implement them, in part as a way of reassuring current and prospective employees that they will have some protection from unanticipated job loss. Still other employers use severance pay as a "*quid pro quo*" for a terminated employee's release of claims against the employer, especially in the context of a reduction in force. There also are employers – particularly sole proprietors and family-owned companies – that make the amount of grants of severance pay based on various factors such as custom, a

sense of loyalty, and other considerations which may not have been articulated or communicated to employees.

Given the differing reasons for adopting severance policies, severance arrangements range from informal practices to relatively formal employee benefit plans with significant ongoing administrative requirements. A less formal severance arrangement may consist of nothing more than an employer's custom of providing terminated employees with a small cash gift, or an *ad hoc* decision to make a modest payment to a terminated employee on a one-time basis.

A more formal severance arrangement typically will provide terminated employees with either a lump-sum monetary payment, or payment in installments over time. Severance payments may be made from the employer's general assets or from a trust fund. The amount of the benefit payments generally will be calculated using an established formula that applies upon the occurrence of one or more pre-established events. Criteria used to calculate the amount of an individual's benefit often include the employee's length of service and rate of compensation. The employer may limit the class of employees eligible for benefits (for example by distinguishing between full-time and part-time employees, or by eligibility criteria based on location), as well as the circumstances under which they may become eligible for benefits (for example, plant closings or reductions in force).

## Coverage of severance plans under ERISA

---

Severance benefits are among the types of benefits that can be subject to the requirements imposed by ERISA. In fact, in some cases, there may be two bases on which a severance benefit plan can be covered under ERISA. The first and more obvious basis is that severance benefits are one of the categories of benefits described in Section 302(c) of the Labor Management Relations Act of 1947 (LMRA). ERISA defines welfare benefit plans to include plans that provide any of the benefits described in Section 302(c) of the LMRA, subsection (6) of which includes "pooled vacation, holiday, severance or similar benefits." As discussed in Chapter 1, **Overview of employee benefits law**, courts have ruled that because of the reference in Section 302(c) to "severance . . . benefits," ERISA's reference to "any benefit described in Section 302(c)" must have been intended to include severance benefits. Furthermore, judicial decisions also provide support for the proposition that severance benefits may come within the meaning of the phrase "benefits in the event of . . . unemployment."

The second reason severance arrangements can fall within ERISA's mandates is that severance benefits arguably result in a deferral of compensation to or beyond the termination of employment. In such cases, the arrangement may fall within ERISA's definition of a pension plan.

The issue of whether a given severance arrangement is covered by ERISA tends to be determined most often by whether the arrangement is a "plan, fund or program" that meets the definition of a plan under Section 3(1) of ERISA. A funded severance pay plan ordinarily is governed by ERISA regardless of its terms. An unfunded severance pay arrangement is quite likely to be subject to ERISA if there is any ongoing administrative process for determining whether, when, and in what amount severance benefits are due. Likewise, an unfunded severance arrangement is likely to be subject to ERISA if there is any possibility that discretionary judgment might be applied to determine whether, when, or in what amount severance benefits are due.

Courts have not applied uniform standards when resolving the issue of ERISA coverage of severance plans. At least one court has found a “plan” where the employer had an ongoing administrative process for compliance with a state statute. Courts have applied ERISA to a variety of arrangements, including a voluntary separation plan, when the terms were disclosed in a series of meetings with employees and there was an ongoing need to determine eligibility for plan benefits.

On the other hand, one court found that an ERISA-covered plan did not exist where an employer had a custom of simply paying employees one week of pay for each year of employment upon termination. Furthermore, where a single payment is made upon termination (regardless of the reason for termination), courts are more likely to find that there is neither an exercise of discretion nor any ongoing administration requirement, and thus no ERISA-governed plan. Another court held that a severance arrangement that included a one-time \$75,000 lump-sum payment and the ability to continue coverage under the employer’s group health plan did not entail sufficient administrative involvement to establish a plan. (This was the case, in part, because the administrative requirements for the continued health coverage did not amount to establishing a new medical plan, but instead were simply a function of employer’s existing health plan).

The payment of a one-time, lump-sum severance payment requiring no exercise of administrative or discretionary functions typically does not implicate ERISA. Likewise, offers of “stay-on” bonuses to employees who remain with an employer through a certain date are generally not ERISA-governed plans. Individual employment agreements that provide for severance payments also are not ERISA plans (although it is possible to have an ERISA-governed plan that covers only one employee). It is possible, however, for an employment contract to require an employer to pay severance independently of (and potentially in addition to) any benefits due under an ERISA-governed severance plan.

Furthermore, the mere fact that an employer has offered severance benefits in the past, or has made a decision to extend such benefits in the future, is not necessarily sufficient to establish the existence of a plan. The question of whether or not a plan has been established is largely circumstantial. For example, ERISA has been held to apply to a plan that was cast as a confidential severance pay policy distributed only to corporate officers and employee relations staff managers, even though the plan purported to provide nothing more than a flexible and general guide for officers and managers in exercising their discretion to award severance pay on elimination of an employee’s position.

## **Treatment as welfare plans, pension plans or payroll practices**

---

An ERISA-governed plan that provides participants or other beneficiaries with severance or similar benefits, but does not provide retirement benefits, is an employee welfare benefit plan. Severance plans that are welfare plans are exempt from many of ERISA’s strictures, including its minimum participation and vesting standards. Such plans are also exempt from the Act’s minimum funding requirements, and are not subject to ERISA’s general requirement to hold plan assets in trust.

While most severance plans are “welfare benefit plans” under ERISA, certain design features of severance plans, including the amount of the benefits provided under a plan, the payout period, and/or the conditions for receiving those benefits may cause the arrangement to be characterized as a “pension plan” under ERISA.

Severance plans are similar to pension plans that both provide benefits (usually cash payments) to workers following termination of employment. In some cases, a severance plan will have more of the characteristics of a pension plan than a welfare plan. In such situations, the plan may be considered to provide retirement benefits. If so, the plan will be subject to significantly more rigorous reporting, disclosure and fiduciary requirements under ERISA.

The substance of a severance plan will determine whether it is treated as a welfare plan or a pension plan under ERISA. While the plan document (or summary plan description) may characterize the payments as early retirement or special early retirement benefits, the plan may still be a welfare plan (rather than a pension plan) if benefits are payable only upon an employee's involuntary termination by reason of a plant shutdown or similar event.

A severance plan will be treated as a pension plan (and therefore subject to ERISA's more stringent fiduciary, reporting and disclosure requirement) if the principal effect of the arrangement is to evade ERISA's standards applicable to pension plans. Under the applicable DOL regulations, a severance plan will be treated as a pension benefit plan if:

- the payment of benefits is contingent on the employee's retirement
- or
- the total amount of the payments exceeds twice the employee's annual pay during the year immediately preceding the employee's termination
- or
- all payments are not completed within 24 months of termination.

In contrast to the less stringent requirements imposed on welfare plans, a severance plan that is considered to be a pension plan will be subject to ERISA's minimum participation and vesting standards. Such plans also may be subject to ERISA's minimum funding requirements, and be required to hold assets of the severance plan in trust. Furthermore, severance plans falling within ERISA's definition of a pension plan also may be required to meet applicable federal tax qualification requirements in order to avoid unfavorable tax consequences to employees.

## **Conditioning benefits on retirement**

If a severance plan makes payment of benefits contingent on an employee's retirement, the plan will be deemed a pension plan under ERISA. A severance plan that provides a pension-type benefit (or payment in lieu of benefits under the employer's retirement plan) will be subject to treatment as a pension plan. The use of age and service requirements for eligibility can cause a severance plan to be treated as providing pension benefits. For example, a severance pay arrangement was found to be contingent on retirement where benefits were available only to employees between 60 and 65 years of age, and employees who opted to receive benefits waived their rights to future employment with the employer. Likewise, a severance plan that conditioned eligibility on completing 10 years of service and reaching age 65 also was subject to treatment as a retirement plan.

Severance plans that condition eligibility on factors that will result in benefits under the plan being paid (primarily or entirely) to former employees who also meet the criteria for benefits under the terms of the employer's retirement plan also may cause the severance plan to be contingent on retirement. Such plans will be treated as providing pension benefits (with all of the attendant additional reporting and administrative requirements).

## **Limits on benefit amounts and payment periods**

For a severance plan to avoid treatment as a pension plan, the total amount of benefits provided to the employer may not exceed an amount equal to twice the employee's annual compensation for the year immediately preceding the termination of his or her employment. For purposes of this limitation, the term "annual compensation" is the total of all compensation that would have provided to the employee had he or she worked the full year. This includes not only salary, bonuses and other cash payments, but the cash value of all benefits having a monetary value.

Additionally, in order for a severance pay plan not to be deemed a pension plan, all payments must be completed within 24 months of termination of service. There is, however, one exception to this rule. If the employee is terminated as part of a "limited program of terminations," the payments must be completed within 24 months after the employee reaches his or her normal retirement age or 24 months after termination, whichever is later. A "limited program of terminations" is a program that, when begun, is scheduled to end on a certain date or upon the occurrence of certain specified events and under which the employees who are to be terminated are specified in advance, provided that the program is in writing, contains sufficient information to demonstrate that all required conditions have been met, and is available to DOL.

## **Potential problems in administering severance plans**

---

### **Informal establishment of severance plans**

It is not uncommon for employers to fail to set out the terms of their severance benefit plans in writing (or in a written document sufficient to meet ERISA's reporting and disclosure standards). Plans that are unwritten, or that do not formally spell out all required terms, are often referred to as "informal plans." The employees' rights under an informal plan, including any conditions for eligibility, will be determined applying general principles of law to the facts and circumstances. The written terms of the plan (or the lack of them) may well limit the employer's ability to modify, amend, or terminate the plan.

When determining whether or not a severance plan has been created informally, courts first look to any written representations that promise or limit benefits. Courts then consider all other evidence that would indicate the presence or absence of an informal plan. Such evidence includes internal or distributed documents, oral representations, existence of a trust or account to fund benefits, the payment of benefits, the reasonable understanding of employees, and the employer's intent. Oral representations by the employer's management may be evidence of a plan (except to the extent they contradict written terms of a plan). Moreover, in the absence of a

more formal plan document, the existence and terms of a severance plan may be inferred from references or descriptions in employer handbooks. However, evidence that an employer considered adopting a severance program will not, in and of itself, demonstrate that such a policy was actually implemented.

## **Failure to meet ERISA's administrative requirements**

Notwithstanding ERISA's requirement that severance plans be in writing, some severance plans are poorly documented or not reduced to writing at all. In those circumstances, courts will look to a number of factors to identify the employees who are eligible for severance benefits. These factors include the extent of the employer's procedural violations of ERISA, treatment of similarly situated workers, and whether a triggering event (such as reduction-in-force) has occurred.

When a plan is not formally documented, in addition to potential questions regarding the employees' eligible for benefits, the amount of benefits (including the means for calculating that amount) may also be in dispute. For example, if the terms of the severance plan are inadequately documented (or altogether absent), any decision to deny a claim for benefits could be seen as self-serving or subject to a conflict of interest.

Likewise, the failure to comply with ERISA's procedural requirements can have significant implications. Issues such as the deference given to the plan administrator's decision and the enforceability of any administrative exhaustion requirement may be affected by a failure to comply with the Act's requirement for reasonable claims procedures. If the employer's procedural violations demonstrate a disregard for ERISA's mandates, they may factor significantly in a court's determination of whether the employer has acted improperly in denying benefits. In such cases, the circumstances surrounding the benefit denial may adversely affect the level of deference given to the plan administrator's interpretation of the plan's provisions. Procedural violations that can substantively change the relationship between the employer and employee include the failure to distribute a summary plan description (keeping the arrangement "secret") and failure to advise a claimant of his or her rights to appeal (potentially alleviating any duty to exhaust those appeal rights before suing).

## **Discrimination issues**

Employers may design their severance plans to limit eligibility to certain classes of employees, including employees who are eligible only by making affirmative elections under the plan (though severance plans that are treated as pension plans may be limited in this ability). For example, a severance pay plan may limit eligibility for benefits to those employees whose employment is terminated through no fault of their own. In cases where this is the plan's purpose, the administrator (provided he or she applies and interprets the plan's terms on a reasonable and consistent basis) could deny a claim for benefits to employees who are discharged for cause. Such situations could include an employee terminated for repeated violations of the employer's rules, or failure to perform his or her job duties; an employee terminated when his employer discovered that he had falsified his application for employment using a college transcript showing a degree the employee had not earned; or an employee who violated his employer's sexual harassment policy.

On the other hand, discriminating between older and younger workers in paying severance benefits may run afoul of the ADEA. Under regulations issued by the Equal Employment Opportunity Commission (EEOC), an employer may offer additional benefits, such as increased severance pay, to older employees if there is a reasonable basis to conclude that those benefits will counteract problems related to age discrimination, and the offer of additional benefits will not accomplish practices prohibited by the ADEA.

Under proper circumstances, older workers may waive their ADEA rights in consideration of certain enhanced early termination benefits. Such waivers are subject to the stringent requirements to meet the “knowing and voluntary” standard imposed on such waivers by the Older Workers Benefit Protection Act (OWBPA).

Employers that deny severance benefits to employees who are eligible for retirement, while offering payments to (younger) terminated employees who are not retirement eligible, may be accused of discriminating on the basis of age, unless the payments are made pursuant to an employee benefit plan that qualifies under the ADEA’s benefit plan exception. Denial of severance benefits based on eligibility for retirement is too closely related to age to be a reasonable factor other than age that could allow denial of severance benefits without violating the ADEA. (Such treatment would likely make the plan subject to treatment as a pension plan, rather than a welfare plan.) Thus, an employer’s policies providing that, in the event of plant closings, severance benefits would not be provided to employees eligible for retirement or early retirement would constitute illegal age discrimination. A severance pay plan that denies benefits to employees over age 55 and eligible for early retirement, but which pays severance benefits to employees under age 55 with vested pension rights, also violates the ADEA.

On the other hand, an employer usually does not violate the ADEA when it pays lump sum distributions to younger employees from its pension fund in conjunction with a facility closure. The distributions from the employer’s pension fund are not designed to replace the lost income resulting from lay-off, but rather to pay those employees not eligible for retirement the amounts already due them under the terms of the pension fund. Because the pension-eligible older employees may opt to receive pension payments, they are not treated adversely.

Moreover, severance plans may condition benefits on the employee’s meeting certain terms and conditions. Examples of such conditions include non-disparagement provisions and releases (including those with covenants not to sue). While such waivers are permissible conditions for severance benefits under ERISA, their effectiveness may be affected by other statutes or regulations, including (as discussed above) the “knowing and voluntary” requirements imposed on such waivers by the OWBPA.

## **Amendment and termination of severance plans**

---

ERISA generally provides no guarantee of vested rights under welfare plans, including those severance plans that are welfare plans. Thus, the extent to which an employee’s right to severance benefits is vested is strictly dependent on the applicable plan documents. Because welfare benefits generally do not vest, an employer usually will not be found to have violated ERISA by amending, reducing, or

eliminating benefits under that plan unless an examination of the plan document establishes that the employer granted vested benefits.

## Severance plans and Code Section 409A

---

The American Jobs Creation Act of 2004 added a new provision to the Internal Revenue Code, Section 409A, that can impose punitive tax consequences on employees who participate in a “nonqualified deferred compensation plan.” Section 409A is discussed in greater detail in Chapter 10, **Nonqualified deferred compensation plans**. Severance plans generally meet the definition of a “nonqualified deferred compensation plan” under Section 409A. However, the IRS has published regulations that exempt severance plans from coverage under Section 409A if the plans satisfy certain conditions. One such condition is that the plan may not provide for or pay benefits in the case of a voluntary separation from employment (except in the case of a “window program,” as discussed below). The remaining conditions set limits on the amount of severance pay and on the payment period. The regulations generally exempt such arrangements where the entire amount of payments does not exceed two times the service provider’s annual compensation or, if less, two times the limit on annual compensation that may be taken into account for qualified plan purposes (\$245,000 for calendar year 2009), each for the calendar year before the year in which the service provider separates from service, and provided further that the arrangement requires that all payments be made by no later than the end of the second calendar year following the year in which the service provider terminates service. These limitations generally are consistent with the safe harbor under which severance plans may be treated as welfare plans under the applicable Department of Labor regulations, and should allow most of these arrangements to avoid coverage under Section 409A.

The proposed regulations also exempt so-called “window programs” from coverage under Section 409A if certain criteria are met. A “window program” is a program that encourages voluntary termination of employment during a limited period of time by offering financial incentives over and above any post-employment benefits to which an employee would otherwise be entitled.

