



ERISA Considerations For Severance Pay Policies Checklist

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This Checklist outlines the advantages and disadvantages of maintaining a formal severance pay policy and of the policy complying with the Employee Retirement Income Security Act of 1974 (ERISA).

FORMAL SEVERANCE PAY PLAN

When employers implement a severance pay policy, many decide to adopt a formal, written employee benefit plan with ongoing administrative requirements.

ADVANTAGES

Under a formal severance pay plan, the employer does not necessarily have to treat all employees exactly the same. Employers have discretion to set eligibility criteria. Certain employees can be excluded and different benefit formulas can apply to different job levels if the plan does not discriminate against employees in protected classes.

The advantages to a formal severance pay plan are that:

- The plan sets clear expectations for employees if their jobs are eliminated or they are terminated for reasons beyond their control. Therefore it serves as an employee morale and retention tool.
- A written plan provides consistency among the entire corporate and human resources philosophy, values and benefits package.

- The company can be protected through legally binding separation agreements and/or releases (see *Standard Document, Separation and Release of Claims Agreement* (www.practicallaw.com/0-503-8253)).
- All similarly-situated employees are treated equitably. Therefore a formal plan helps to shield the company from discrimination suits. Individually-negotiated benefits expose the company to potential liability for all kinds of discriminatory benefits claims.
- The company's reputation in the labor market is elevated, especially for future recruiting.
- It is easier for the employer to monitor whether all legal requirements are met (for example, Internal Revenue Code Section 409A compliance and Employee Retirement Income Security Act of 1974 (ERISA) requirements).

DISADVANTAGES

The disadvantages to a formal, written severance pay plan are that the plan:

- Is less flexible.
- Is standardized and therefore subject to less individual negotiation.
- Requires more administration.

Also, if the plan covers a group that extends beyond a select group of management or highly compensated employees (a top hat plan) and the plan is intended to avoid the requirements of an ERISA pension plan:

- Benefits may not exceed twice the employee's annual compensation in the year before the year of termination.
- Payments must be made within 24 months of employment termination.

INFORMAL SEVERANCE PAY POLICY

Some employers do not set out the terms of their severance benefits in writing. Even if they do put severance terms in writing, some written policies fail to meet ERISA's reporting and disclosure requirements. These "informal" severance policies have both advantages and disadvantages.

ADVANTAGES

The advantages to an informal severance policy are that it:

- Allows employers to retain the flexibility to change or eliminate severance, because no expectations have been set (although ERISA plans can preserve this flexibility also).
- Provides the ability to negotiate benefits on an individual, case-by-case basis.
- Is quickly adaptable for changes in the economy and for a range of circumstances, from individual separations to mass layoffs.
- Works better for negotiated benefits for executives, small companies and companies with infrequent involuntary terminations.

DISADVANTAGES

An informal severance policy has several disadvantages:

- It can invite discrimination claims unless there is a rational business reason for distinguishing between different employees.
- It does not work well in mass layoff situations or where there are frequent departures because negotiating with each employee takes time and runs the risk of unsubstantiated differences.
- Unless the informal policy provides only lump sum severance with no ongoing administration, the informal policy may become a "de facto plan" or even an ERISA-governed plan (see Compliance with ERISA). Depending on the facts, courts have held that informal severance policies are actually de facto, binding ERISA severance pay plans based on:
 - oral representations;
 - the existence of a fund or account from which benefits are paid;
 - the actual payment of benefits;
 - the employer's past practices;
 - reasonable expectations of employees; or
 - the intentions of the employer.
- The employer must always reserve the right, in every piece of communication, to terminate or amend the policy, otherwise employees may be able to claim benefits that the employer does not want to give.

COMPLIANCE WITH ERISA

Although complying with ERISA is not required for severance benefits, employers often do not have a choice. Many

severance plans and policies are governed by ERISA regardless of whether the employer intends for them to be. The US Supreme Court has held that if a policy provides more than just a one-time, lump sum payment to a group of employees and requires an ongoing administrative scheme, it is most likely governed by ERISA (*Fort Halifax Packing Co., Inc. v. Coyne*, 482 U.S. 1 (1987)).

In addition, numerous courts have found that where an employer handles its severance matters informally, the employer's past practices provide the basis on which a terminated employee or group of employees may make a claim for the same severance benefits. This type of claim rests on two conditions that:

- The employer's past practices have established an ERISA plan.
- The benefit levels previously paid by the employer must be paid to the terminated employees now claiming benefits because the employer has not expressly reserved its right to reduce them.

If the severance benefits are later determined to be subject to ERISA and the requirements of ERISA have not been satisfied, the company and plan fiduciaries could be subject to various penalties including civil and criminal penalties for violation of ERISA's reporting and disclosure requirements (see *Practice Note, ERISA Fiduciary Duties: Overview: Penalties for Breaching Fiduciary Duties* (www.practicallaw.com/5-504-0060)).

There are advantages and disadvantages for an employer if its severance benefits comply with ERISA.

ADVANTAGES

The advantages are that:

- ERISA's preemption provisions ensure that ERISA provides the exclusive remedy for any claims for severance pay under the plan. All state law claims relating to the plan are preempted, including claims for constructive discharge and punitive damages. Because many state laws provide substantive remedies or requirements that are more onerous than those imposed by ERISA, this is a significant advantage.
- No jury trial is available in actions to remedy ERISA violations.
- ERISA's mandated detailed claims procedures encourage the employer and the employee to resolve potential disputes without litigation. Generally a participant must exhaust his administrative remedies before filing a suit for benefits in state or federal court.
- If the plan includes language giving the employer full administrative discretion, a court must give the employer's decisions a more deferential standard of review. Therefore if an employee's claim for severance benefits is denied and the employee files suit under ERISA, a court should not review the administrator's decision on a de novo basis.



DISADVANTAGES

In exchange for ERISA's protections, certain disadvantages apply to a severance plan:

- It must comply with ERISA's administratively burdensome requirements.
- The benefits must be set out in writing.
- Claims for severance benefits must be subject to a formal claims procedure.
- The employer may be required to file a Form 5500 for the severance benefits.
- The benefits must be described in a summary plan description.
- The plan has less flexibility in how it is operated, although the employer can:
 - preserve the right to change benefits under the plan; or
 - determine that some employees will receive zero benefits.

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