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Severance Plan Design: Legal and Practical Considerations Under ERISA and 409A

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Overview

• ERISA – Bruce Schwartz
  – Benefits and requirements of an ERISA severance plan
• 409A – Dana Hale
  – Implications of 409A on severance plans
  – How to structure an exempt arrangement
• Separation Issues – Ron Peppe
  – Common scenarios and best practices
ERISA Coverage of Severance Pay Benefits

• Courts and DOL regularly have held that severance pay plans are covered by ERISA.

• A ERISA-covered plan is established if a reasonable person can ascertain (1) the intended benefits, (2) a class of beneficiaries, (3) the source of financing, and (4) procedures for receiving benefits.

• Plans for certain one-time corporate events such as layoffs or facility closings may not be subject to ERISA.
ERISA Coverage Often is More Favorable to Employers

• Generally, statutory compliance for an ERISA-covered severance plan is neither complex nor burdensome.

• An employer may design a severance plan under ERISA that specifically provides an employer with the discretion to make determinations that affect an employee’s eligibility for benefits.

• The application of ERISA to severance pay benefits is more favorable to employers than state law.
Evidence of a Plan

• An employer cannot escape ERISA coverage by maintaining an informal or unwritten plan or merely by failing to comply with ERISA’s disclosure and reporting requirements.

• ERISA plan can be established from guidelines in internal policy statements or corporate manuals or by descriptions in employee handbooks or from employer’s consistent past practice of paying severance benefits to involuntarily terminated employees.
ERISA Requirements

• Plan must (1) be in writing, (2) include an amendment procedure and (3) provide a claims appeal process.
• Participants must be given a summary plan description.
• Subject to an exemption for plans with less than 100 participants, employer must file an annual report on Form 5500. DOL may impose a penalty of up to $300 per day for failure to file.
• Exempt from ERISA’s participation, vesting and funding rules.
• Subject to ERISA’s fiduciary standards in administering plan and paying out benefits.
Summary Plan Description Requirements

• Required to furnish SPD.
• Provide SPD to any employee who may be eligible to receive severance benefits under the plan upon termination of employment.
• If severance pay plan provides different benefits, a participant can be provided with a separate SPD that describes only the benefits applicable to that participant.
• Not acceptable “merely to place copies of the material in a location frequented by participants.”
• If certain conditions are met, SPDs may be distributed through electronic media.
Failure to Comply with ERISA

- Violation of ERISA’s reporting and disclosure requirements normally will not create a substantive right to benefits.
- Plaintiff may be entitled to a substantive remedy for benefits in situations where the employer has acted in bad faith, or has actively concealed a benefit plan or a change in the benefit plan, and the covered employees have been substantively harmed by virtue of the employer’s actions.
- A court may impose a civil penalty of up to $110 per day for failure to furnish documents.
- Participants, beneficiaries, plan fiduciaries and the DOL have the right to bring suit in federal district.
- In appropriate circumstances, attorney’s fees also may be awarded.
Permitted Company Discretion

- Employer may design a severance pay plan that specifically provides employer with discretion to make determinations that affect an employee’s eligibility for benefits.
- Only requirement is that such discretion must be stated in the plan terms.
- One court has held that nothing in ERISA prevents an employer from providing employees with benefits on a case by case basis — as long as that limitation is explicitly stated as part of the plan.
- Courts have stated that the exercise of permitted company discretion should be reviewed to determine only whether the company’s conduct was “arbitrary and capricious”.
Deviations From Plan Terms

• A deviation from a plan’s written terms for particular individuals does not prohibit the employer from again applying the written terms to other individuals.

• In other words, deviation from the written plan terms will not be treated as creating an amendment to the plan terms.
How Courts Treat Claims For Severance Pay Under ERISA

- Decision to deny severance pay is subject to ERISA’s fiduciary requirements.
- If plan expressly provides discretionary authority to determine benefit eligibility or interpret plan terms, decision will not be disturbed by a court, unless the denial was “arbitrary and capricious.”
- In determining whether a company decision is “arbitrary or capricious,” courts have considered (1) whether the interpretation of the plan was fair and reasonable in the context of the purposes of the plan and its terms, (2) whether the challenged interpretation departs radically from past practice, and (3) whether payment of severance pay under given circumstances would be a windfall.
- BUT if a plan does not include discretionary authority, a challenge to a benefit denial will no longer be accorded deferential review.
Advantage of Applying ERISA vs. State Law

The application of ERISA to a claim for benefits in almost all cases will be more favorable to employers than state law.

• Participant who sues for benefits is entitled only to the benefits – unlike state law, ERISA does not permit consequential or punitive damages or provide for tort remedies. (In egregious cases, a court may award attorney’s fees.)

• ERISA does not provide for jury trials and claims may be removed to federal court.

• If a severance plan is properly drafted, decisions will be reviewed by a court only to determine whether the decision is “arbitrary and capricious” (or an “abuse of discretion”).

• Any state law that “relates” to any employee benefit plan covered by ERISA is preempted by the federal law. Traditional state law grounds for enforcing payment of severance benefits are preempted.

• Courts have rejected claims seeking to enforce payment of severance benefits which are based upon common law theories of fraud or breach of contract, or even based upon state wage collection statutes.
Application of Other Laws

- Although ERISA preempts state laws, the various federal employment discrimination laws (age, sex, race, disability, etc. discrimination) continue to apply to severance pay determinations whether made in accordance with the written terms of a severance plan or made at the employer’s discretion.
Section 409A
409A Implications to Severance Arrangements

• What is 409A?
• What if a plan is covered by 409A?
• How to avoid 409A
  – STD
  – Involuntary Termination
• Good reason issues
• Definition of separation
• Release issues
• Substitution issues
What is Section 409A of the American Jobs Creation Act?

- Sweeping legislation enacted in response to Enron, other corporate scandals governing NQDC
- NQDC - legally binding right in one year to receive taxable compensation/benefits in a later year
- Governs the time and form of elections and payments
- Severance paid pursuant to a plan or agreement (which can include employment agreement, COC, offer letters, etc.) is generally considered NQDC, absent a special exception
What if Severance is Covered by 409A?

- Agreement/plan must specify form and timing of pay
- Cannot change form or timing except limited circumstances (12-month / 5-year rule)
- Must pay on-time, in correct form
- Top 50 “Key Employee” severance must be delayed six-months post-term (public companies only)
  - Generally top 50 highest paid (> $165k, adjusted annually)
- Failure to comply: 20% penalty to employee + interest
How to Keep From Being Covered by 409A

• Short-term Deferral Rule
  – Exempt if payment must be made by March 15\textsuperscript{th} of the year following the year right to payment vests (e.g., lump sum 30 days after term)

• Involuntary Termination
  – 2X pay, up 2X the §401(a)(17) limit ($255,000 for 2013, or $550,000)
  – Paid within two years after year of separation
Benefits of Being Exempt from 409A

• No delay for Key Employees
• Can change form and timing of payment (as long as payment is still exempt)
  – E.g., lump sum payment to installments w/in two-year period
• No penalty if get payment wrong (within certain parameters)
Good Reason Issues

• Voluntary termination for “good reason” may still fall under Involuntary Termination exemption, if:
  – Material negative change to relationship (e.g., change in authority, duties, compensation, location)
  – Amount of severance pay is same as involuntary
  – Employee gives notice and opportunity to correct

• Safe harbor exists
• Lose exemption if don’t comply
Separation Under 409A

• 409A defines a separation from service
  – occurs when the level of services is expected to be no more than 20% of the level of services provided during the preceding 36-month period
  – Being on payroll alone does not count
• Separation is trigger for distribution of deferred comp
• Service as IC or consultant may be continued service under 409A
Release Issues

- Recent IRS guidance says payment upon release of claims can be problematic if employee can control year of payment (even indirectly)
- Example: payment begins on next payroll date after receipt (and irrevocability) of release of claims by employer
  - Termination date: Nov. 15th
  - Release due back within 45 days / paid bi-weekly installments
  - Employee can ensure payment in subsequent year by holding onto release until Jan 1st
- Remedy:
  - Specify that if benefits could be paid in more than one taxable year depending on when the employee signs the release, the benefits will automatically be paid in the later year, regardless of when the employee signs the release
Substitution Issues

- Can’t substitute payment of amounts that are exempt from 409A to offset or avoid payments that are subject to 409A
- E.g., can’t forfeit separation pay promised in employment agreement in favor of new agreement paying same amount in different form or at different time
- Okay to pay additional amounts at different time or in different form
Separation Issues
Separation Issues

• Some severance payments are lump sum, some are periodic payments, BUT

• Many companies simply continue an employee on the payroll for “administrative simplicity”

• It is important to clearly specify the separation date AND to no longer treat the former employee as an employee
Examples of Common Scenarios

• Tell employee he/she is terminated, but leave him/her on the payroll

• Put the employee on “leave”

• Call the employee a “consultant” or “independent contactor”
Risks:

• Claims for continued benefits

• Worker’s compensation claims

• Misclassification issues for “independent contractors”

• Effectiveness of release for claims arising AFTER actual separation date
Best Practices:

- Establish clear separation date in the written agreement
- Specify payment method
- Specify that benefits end
- Review all benefit plans for definition of “employee”
- Rather than continue health benefits, specify whether company will pay or contribute to COBRA premiums as part of cash settlement
- Do NOT allow work after the separation date
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