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Key Employee Benefits Issues Affecting Severance Arrangements

The obligations and liabilities arising out of a terminated employment relationship and resulting severance arrangement raise a number of legal issues. Depending on the form and content of the severance arrangement, employee benefits issues may arise under the Employee Retirement Income Security Act of 1974, (ERISA) and § 409A of the Internal Revenue Code of 1986 (the Code). In addition, depending on how post-termination health benefits are provided, legal issues may also arise under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). This article highlights three issues that affect nearly every severance arrangement that practitioners specializing in labor and employment law must know.

Does ERISA Apply?

An employer's promise to provide severance benefits can take many different forms: written or oral, formal or informal, individual or group. The first step toward determining the obligations and liabilities associated with a severance arrangement is to determine whether an ERISA plan exists.

As discussed in detail below, there are significant advantages associated with a severance arrangement that is an ERISA plan. Although an employer cannot unilaterally decide that the severance arrangement is an ERISA plan, the employer can take definitive steps when designing and administering a severance arrangement to ensure that the arrangement is treated as an ERISA plan. The existence of a written plan document, although required by ERISA, is not necessarily determinative as to whether an ERISA plan exists. Courts have held that ERISA plans existed in the absence of a written plan document and vice versa.

In *Fort Halifax Packing Co. v. Coyne*, the U.S. Supreme Court held that only severance plans that "by their nature necessitate an ongoing administrative scheme" are covered by ERISA.[1] Courts have looked at the following indicators when determining what constitutes an "ongoing administrative scheme":

- the form of payment under the severance plan (such as lump sums versus periodic payments);
- the discretion of the company in determining (1) eligibility for benefits or (2) the benefits available under the plan;
- whether the delivery of severance benefits creates an ongoing demand on the employer's assets such that there is an ongoing scheme to coordinate and control the distribution of benefits; and
- the need to make calculations based on certain factors (such as job performance, length of service, re-employment prospects, and so forth).

Severance plans or arrangements that have lump sum payments calculated under a formula and mechanically triggered by a single event (such as termination) normally would not implicate an ongoing administrative scheme and thus will not be subject to ERISA. On the other hand, severance payments made over time (for example, through payroll) and/or additional benefits (such as continuation of benefits, outplacement services, and so forth) are likely to result in ERISA coverage.

As a practical matter, many severance practices, whether ad hoc or recognized in a formal plan document, end up providing benefits that are subject to ERISA. In a dispute, the employer would almost always prefer that ERISA apply because of ERISA's preemption of state laws. This pre-emptive effect protects the employer from generous state laws that may favor employees and generally limits the dispute to an ERISA claim for benefits (avoiding the potential exposure to punitive, extra-contractual, or special damages under state laws). In addition, with proper plan language, ERISA's claim procedure which provides a pre-litigation administrative process for dispute resolution will apply. If the employee with a severance claim fails to utilize the ERISA claims procedure, his or her lawsuit can often be dismissed for failure to exhaust administrative remedies.

The typical plan document would give the employer, in its capacity as plan administrator, the discretionary authority to interpret the plan's language and make decisions about the plan. If the employee properly follows the claim procedure and the claim is denied, the decision-making process of the employer (and/or the committee involved in the review process) is given deferential treatment by a reviewing court pursuant to *Firestone Tire & Rubber Co. v. Bruch*.[2] Moreover, in many cases, judicial review is limited to the matters already raised in the "administrative record." That is to say, many federal courts would refuse to look at factual matters not raised by the employee in the claim procedure process.

From a substantive standpoint, ERISA claims for severance benefits are almost universally within the realm of what ERISA considers to be "welfare" benefits (as opposed to pension). Welfare benefits are afforded an extremely low level of protection under ERISA: essentially, the employer's exposure is only as broad as its express contractual commitment. By properly documenting the benefits with "best practices" language (for example, specifying the ability to amend or terminate the benefits with or without advance notice), employers can take full advantage of the opportunity afforded by the low-level protections provided by ERISA. Conversely, the failure to document the "plan" often leaves the employer open to persistent arguments over what commitments actually constitute the plan.

Clearly, having an ERISA-governed plan provides the employer with many formidable weapons in litigation. A severance arrangement set up from the outset to be ERISA-governed will enjoy a more direct and efficient route to the significant benefits of ERISA pre-emption and the often helpful ERISA dispute resolution mechanisms.

Does § 409A of the Code Apply?[3]

The requirements of § 409A of the Code are potentially applicable to any severance arrangement, regardless of whether the arrangement is an ERISA plan. Also, because severance benefit payments that violate § 409A are subject to harsh tax penalties, § 409A should be considered when implementing any severance plan or arrangement.

Section 409A applies to any arrangement that provides for "deferred compensation." In general, an arrangement provides for deferred compensation when an employee has a legally binding right during a taxable year to compensation that, under the terms of the arrangement, is or may be payable to the employee in a later year.[4] A legally binding right is said to exist when the benefit is no longer subject to a substantial risk of forfeiture. In the context of a severance arrangement, a legally binding right to the compensation generally exists when the employee has separated from service and has satisfied any conditions of the severance arrangement.

Section 409A focuses on the timing of payments. In the case of a severance arrangement, the timing of payments can vary. Often, severance benefits are paid in a lump sum and in the same year that an employee separates from service. If this is the case, there is no deferred compensation. At other times, severance benefits are paid in a later taxable year or in a series of payments that begins in the same taxable year but continues into later years. In these instances, because the arrangement allows severance benefits to be paid in a subsequent taxable year, the arrangement provides for deferred compensation and is subject to § 409A.

If an arrangement is subject to § 409A, it must be structured and administered in a way that either (1) complies with the requirements of § 409A or (2) satisfies an exception under § 409A. In general, to comply with § 409A, a *written* document must provide for and be administered in accordance with a number of requirements, including the following:

- allow payment of deferred compensation only after an employee's separation from service, death, or disability, or at a specified time or pursuant to a fixed schedule;
- preclude acceleration of the timing of payment;
- require an election to defer compensation for a particular year to be made before that year begins; and
- limit an employee's rights to defer payment beyond the times specified by the arrangement when compensation is deferred.

In practice, most severance arrangements will be designed and administered in order to fit within a § 409A exception. The regulations provide two valuable exceptions that a severance arrangement may use: the short-term deferral exception and the separation pay plan exception. Under the short-term deferral exception, an employee must be paid all severance benefits no later than two and one-half months following the end of the taxable year (in most cases, March 15) during which the employee acquired the legally binding right to the severance benefits.[5]

To take advantage of the separation pay plan exception, the severance arrangement must:

- provide for payment only upon an involuntary separation from service (or participation in a window program);
- provide for payment no later than the end of the second taxable year of the employee following the year of the separation from service; and
- limit the amount of the severance benefit to the lesser of two times the employee's annual compensation or two times the limit on compensation set forth in § 401(a)(17) of the Code.[6]

How to Prevent COBRA Issues When Drafting a Severance Arrangement

Severance arrangements often address a former employee's right to continue his or her employer-provided health plan coverage following separation from service. If not properly drafted, a number of issues concerning COBRA may arise in dealing with post-termination coverage under the employer's group health plan.

In general, COBRA permits an employee to continue coverage in an employer's group health plan for up to 18 months from employee's date of termination by electing COBRA coverage and paying the applicable premium. COBRA does not require that an employer subsidize the cost of an employee's COBRA coverage

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premium. Notwithstanding these rules, employers and employees may negotiate severance provisions where former employees may receive coverage for a period beyond 18 months after termination or where the employer will pay a portion (or all) of the COBRA premium for a specified period of time.

When employers decide to pay for all or a portion of the COBRA premiums, the severance plan must be clear as to how it will affect the former employee's coverage period under COBRA. All too often, severance arrangements are ambiguous when describing how the employer-provided coverage, whether through subsidies or extended coverage, will affect COBRA continuation coverage. For example, a provision that says, "Employer will pay 100 percent of the cost of continued coverage under the Plan for six months" without clear language as to the impact on COBRA continuation coverage is problematic. The former employee may argue that this extended coverage is not part of COBRA and that the 18-month COBRA period begins after the six-month period. If the employer's subsidy is for COBRA coverage, it should be clear in the arrangement that this subsidized coverage is part of and runs concurrently with COBRA.

Occasionally, employers provide continuation coverage extending beyond the 18 months required by COBRA. In these cases, employers who have fully insured plans or stop-loss insurance must contact their providers to make sure such extended continuation coverage is covered under the insurance policy or contract. If the arrangement is not approved by the provider, the employer may find itself self-insuring this extended coverage.

Conclusion

Attorneys have a number of legal compliance issues to consider when drafting severance arrangements. Included among these are employee benefits concerns that must be addressed. The failure to properly account for these issues may result in tax penalties, excise taxes, and/or litigation in unfavorable locations (that is, in state court). By simply identifying, documenting, and clearly describing how compensation and benefits are to be provided under a severance arrangement, employers will be protected from such negative consequences and will provide their attorneys with a number of defenses in litigation should the former employee bring an action related to his or her severance arrangement. **TFL**

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Endnotes

[1]482 U.S. 1, 18, 19 (1987).

[2]489 U.S. 101 (1989)

[3]Readers should note that this column is intended only to provide a general informational summary of § 409A and is not intended to be relied upon for purposes of determining compliance with that § 409A.

[4]Treas. Reg. § 1.409A-1(b)(1).

[5]Treas. Reg. § 1.409A-1(b)(4).

[6]Treas. Reg. § 1.409A-1(n).

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the protection afforded to ISPs under the statute. This is especially so in light of the court's emphasis that, even under a theory of willful blindness, an ISP must be shown to be willfully blind to specific instances of infringement.

Finally, although the Second Circuit failed to clarify the law and created something of a circuit split with the Ninth Circuit, its examples of the "something more" required to constitute the right and ability to control suggest that something *much* more than the ability to block access is required. As long as an Internet service provider is not purposefully and actively inserting itself in dictating the content of the materials of its users, it seems unlikely it would forfeit safe harbor protection by reason of the right and ability to control. **TFL**

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Endnotes

[1]*See* www.youtube.com/watch?v=dG5Qk-jB0D4 (last visited April 25, 2012) for both an example of the type of video clips at issue in the *Viacom* case and the classic referenced scene (be forewarned: the scene is not for the faintheart).

[2]17 U.S.C. § 512.

[3]*See Viacom Int'l Inc. v. YouTube Inc.,* 718 F. Supp. 2d 514 (S.D.N.Y. 2010).

[4]*See Viacom Int'l. Inc. v. YouTube Inc. et al.,* F.3d 2012 WL 1130851 (2d Cir. April 5, 2012).

[5]17 U.S.C. § 512(c).

[6]*Id.* at §§ 512(c)(1)(A), et seq.