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What a Savvy Employer Considers When Looking at Severance Arrangements

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This article explores the employee benefits issues that may arise under the Employee Retirement Income Security Act of 1974, as amended (ERISA), depending on the form and content of the severance arrangement. In addition, depending on how post termination health benefits are handled, this article looks at issues that may arise under the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended (COBRA). Here are a few matters for a severance-savvy employer to consider.

Does ERISA apply?

An employer's promise to provide severance benefits may be written or oral, formal or informal, and individual or group. Determining whether an ERISA plan already exists, or whether an employer wants its severance arrangement to be subject to ERISA, is an important consideration in determining an employer's obligation and liabilities associated with a severance arrangement.

There are significant advantages associated with a severance arrangement that is an ERISA plan as discussed in detail below. An employer, however, cannot unilaterally decide that the severance arrangement is an ERISA plan. Instead, an employer, when designing and administering a severance arrangement, can take definitive steps to ensure that the arrangement is treated as an ERISA plan.

Employers may assume that the first step to ensure the existence of an ERISA plan is to have a written plan document, which is required by ERISA. Surprisingly, this is not necessarily determinative as to whether an ERISA plan exists. Courts have held that ERISA plans can exist without a written plan document and vice versa.

Case law has provided the broad outlines of the nature of an ERISA-governed severance plan. An essential characteristic of ERISA severance plans is that, by their nature, they necessitate "an ongoing administrative scheme." Courts have looked at the following indicators when determining what constitutes an ongoing administrative scheme:

- The employer's discretion in determining (1) eligibility for benefits or (2) available plan benefits;
- The form of payment such as lump sums versus periodic payments;
- Any ongoing demand on the employer's assets such that there is an ongoing scheme to coordinate and control the distribution of benefits; and
- Calculations based on certain factors such as job performance, length of service, reemployment prospects, and so forth.

Severance plans or arrangements that normally do not require an ongoing administrative scheme, and therefore, do not implicate ERISA, are plans that have lump-sum payments that are calculated under a formula and are mechanically triggered by a single event (such as termination). Where severance payments are made over time (through payroll, for example) and/or additional benefits (such as continuation of benefits or outplacement services) are provided, the severance arrangement is likely subject to ERISA.

As a practical matter, whether severance arrangements are ad hoc or recognized in a formal plan document, they may end up providing ERISA-covered benefits. In a dispute, an employer generally prefers that ERISA applies because of ERISA's preemption of state laws. Preemption protects employers from state laws that may favor employees and generally limits the dispute to an ERISA claim for benefits, thereby avoiding the potential exposure to punitive, extra-contractual or special damages under state laws. In addition, ERISA's claim procedure, which provides a pre-litigation administrative process for dispute resolution, will apply if proper plan language is provided. If employees with a severance claim fail to faithfully follow the ERISA claims procedure, their lawsuits may be dismissed for failure to exhaust administrative remedies.

Typically, the plan document gives 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 follows the claim procedures and the claim is denied, the decision-making process of the employer (or its designee) if done properly, is given deferential treatment by a reviewing court. Moreover, in many cases, judicial review is limited to only those matters addressed in the administrative record of the claim. In other words, many federal courts would decline to consider factual matters that were not raised by the employee in the claim procedure process.

Another consideration for the savvy employer is that severance benefits are almost always considered to be "welfare" benefits. Welfare benefits, as opposed to pension benefits, are afforded an extremely low level of protection under ERISA. Essentially, the employer's exposure as to promised severance benefits is only as broad as its express contractual commitment to them. By appropriately documenting the benefits with "best practices" language (such as specifying that the amendment or termination of benefits may be done with or without advance notice), employers can take advantage of the opportunity afforded by the relatively thin protections provided by ERISA. On the other hand, poor or no documentation of a severance arrangement may leave an employer with difficult-to-prove assertions as to what severance commitments were actually made.

In summary, an ERISA-governed plan provides an employer with significant advantages in litigation. In addition, a severance arrangement subject to ERISA will enjoy the powerful benefits of ERISA preemption and the ERISA claims procedures.

How does a savvy employer prevent COBRA issues?

Sometimes, severance arrangements address a former employee's right to continue his or her employer-provided health plan coverage. A number of issues concerning COBRA may arise with post termination coverage under the employer's group health plan, if the severance arrangement is not drafted properly.

Generally, COBRA permits an employee to continue coverage in an employer's group health plan for up to 18 months after his or her date of termination, if the employee affirmatively elects COBRA coverage and pays the applicable premium. Neither COBRA nor any other federal law requires that an employer subsidize the cost of an employee's COBRA coverage premium. However, employers and employees may negotiate a severance arrangement providing that former employees may receive coverage for a period beyond 18 months after termination. In addition, a severance arrangement may provide that the employer will pay all or a portion of the COBRA premium for a specific period of time.

If an employer decides to pay for all or a portion of the COBRA premiums, the severance plan must specify how it will affect the former employee's coverage period under COBRA. Where severance arrangements are ambiguous when describing how the employer-provided coverage (whether through subsidies or extended coverage) will affect COBRA continuation coverage period, a dispute inevitably follows. For example, an ambiguous provision may provide something like "employer will pay 100 percent of the cost of continued coverage under the Plan for six months." 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 intended for the COBRA coverage, the arrangement should clearly state that the subsidized coverage is part of, and runs concurrently with, COBRA.

An employer may want to provide continuation coverage that extends beyond the 18 months required by COBRA. Employers, who have fully insured plans or stop-loss insurance, must contact their providers to make sure that such extended continuation coverage is available under the insurance policy or contract. Without prior approval by the provider, the employer may find itself self-insuring this extended coverage.

Additional considerations

The first thing for a savvy employer to remember about severance arrangements is that they are usually gratuitous benefits. No federal law mandates that employers provide severance arrangements for the benefit of their employees.

Second, depending on the job positions and industry at issue, severance arrangements can be all but mandated in order to attract and retain the best talent for the employer's needs.

Third, severance benefits may be required by a collective bargaining agreement, or by state or local laws. And recall that severance arrangements that also

provide for a release of claims under the Age Discrimination in Employment Act (ADEA) require compliance with the Older Workers Benefit Protection Act (OWBPA) in order to be legally enforceable.

Finally, Internal Revenue Code Section 409A may or may not apply. Depending on the form, amount, and distribution timing of severance benefits, employers may have to address 409A.

In perspective

An employer's attorneys have a number of legal compliance issues to consider when drafting severance arrangements. The failure to properly address these issues may result in an employer's unintended self-insurance of significant medical bills or litigation in unfavorable locations, such as state court. By identifying, documenting, and clearly describing how compensation and benefits are to be provided under a severance arrangement, savvy employers will be protected from such negative consequences. In addition, where litigation cannot be avoided, their attorneys will have a number of defenses should the former employee bring an action related to his or her severance benefits.

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