



# Be Careful With Severance Plans

Insights

11.01.09

*(Benefits Update, No. 4, November 2009)*

The current financial crisis and economic downturn have caused many employers to implement layoffs and reductions in force. In an effort to reduce the harsh economic impact of a sudden job loss, and in an effort to mitigate the negative employee relations issues that can result from downsizing, many employers offer affected employees separation pay or severance. Many of these arrangements are not formalized and simply consist of continuation of payroll for a specified period of time following termination of employment.

But some employers prepare written policies relating to severance or even adopt a formal severance plan with specific rules for participation and benefits. Regardless of how these severance arrangements are designed and implemented, you should be aware of several tricky compliance issues that may have been overlooked in the rush to deal with such a sudden economic slowdown, and the practicalities of significant employee reductions. As the end of the year approaches and we look forward to better times, now is the right time to consider the compliance issues that come with the adoption of a severance arrangement.

## Does ERISA Apply?

The first step is to determine whether a particular severance arrangement is governed by the Employee Retirement Income Security Act (ERISA). If the severance plan is subject to ERISA, it will likely be required, among other things, to prepare and submit a completed Form 5500, make available a compliant Summary Plan Description or SPD to participants; and establish proper procedures for participants to appeal adverse claim determinations.

While most employers are well aware of ERISA's application to retirement plans and group health plans, many are surprised to learn that some severance arrangements are considered "welfare plans" under ERISA and, are therefore, subject to ERISA's reporting and disclosure requirements, as well as the rules for processing and determining claims. Because not every severance arrangement is covered by ERISA, many employers overlook its potential application when they are implementing or designing a severance plan. The application of ERISA, though not necessarily a bad thing for employers, can be a source of problems if you are not aware of the various requirements that must be met if a severance plan is subject to ERISA.

The U.S. Supreme Court set the standard for determining whether the payment of severance pay is a "plan" under ERISA, in *Ft. Halifax Packing Co. v. Coyne*. The Court held that a one-time, lump-sum severance payment triggered by a plant closing did not create an ERISA plan because it did not create the need for an "ongoing administrative scheme." In other words, simple ministerial payroll practices that do not require some type of discretionary administration are not plans subject to ERISA.

The determination of whether a particular arrangement creates an "ongoing administrative scheme" requires an analysis of the terms of the plan and how the plan is administered. The less discretion and administration required to implement the plan the greater the likelihood that the severance plan is really a payroll practice and, therefore, not subject to ERISA. Moreover, if the plan is implemented just once for a single occasion, it is unlikely that a court will find that ERISA applies.

Courts have examined a number of factors to determine if a particular severance arrangement includes an "ongoing administrative scheme." These factors include the following:

- the amount and form of payments under the plan;
- the level of discretion in determining eligibility for participation and benefits;
- the length or term of the plan (i.e., indefinite versus a single event only); and
- the level of administration.

It's difficult to set forth a specific safe harbor for employers to utilize to avoid ERISA's application other than to look back to the *Fort Halifax* case and note that a single, lump-sum severance payment related to a one-time event was not subject to ERISA. But as mentioned previously, the application of ERISA is not necessarily a bad thing. ERISA gives deference to the decisions of the Plan Administrator concerning benefits and eligibility under a well drafted severance plan and courts will only overturn such decisions if they are found to be arbitrary or capricious. Moreover, claimants are not entitled to a jury trial in litigation brought under ERISA. ERISA would also provide the exclusive remedy for participants to resolve disputed claims since ERISA preempts all state laws, including state wage-payment laws that may provide employees and participants with expanded claims for damages.

On the other hand, an ERISA plan is subject to greater administrative requirements, which likely will add to the cost of the plan. And there are significant penalties for failing to comply with the requirements of ERISA. These include civil penalties (up to \$110 per day) for failing to provide required documents to participants upon request and (up to \$1,100 per day) for the failure to file a Form 5500 annual report. Willful violations of ERISA's reporting and disclosure requirements are subject to criminal sanctions as well.

Be sure to review any severance arrangement carefully to determine if the arrangement is an ERISA plan. If it is, comply with ERISA's reporting and disclosure requirements, including filing the Form

5500. For plans adopted for the calendar year 2009, the Form 5500 would normally be due in July 2010. If the severance plan is unfunded and has less than 100 participants, a Form 5500 need not be filed. Generally, every employee who would be entitled to benefits as a result of a qualifying termination must be counted as a participant.

### **The Accidental Retirement Plan**

When adopting severance arrangements be careful not to accidentally create a pension plan by mistake. Under ERISA, if payments under the severance arrangement are contingent directly or indirectly upon retirement, the total amount of payments exceeds two times the employee's annual compensation, and all payments are not completed within 24 months after termination, the plan will likely be considered a pension plan. If the severance arrangement is determined to be a pension plan, it will be subject to various funding, vesting and trust requirements that are not imposed on welfare plans.

Further complications involve Section 409A of the Internal Revenue Code, which applies to most deferred compensation arrangements. Certain severance arrangements can be considered a form of deferred compensation. This means that you must take care to ensure that the arrangement either complies with 409A's requirements, or meets one of its exceptions. The consequences of violating Section 409A are significant. Individual recipients who receive payments under a plan that is subject to Section 409A and does not comply with 409A's requirements may have to pay income tax on the amount deferred, interest and an additional tax of 20%. Employers may find themselves exposed to these taxes under the employment tax reporting and withholding requirements.

### **Our Advice**

Carefully review your severance packages and determine whether they are subject to ERISA. We can help if you're unsure. For any arrangement determined to be an "ERISA Plan," make sure that the plan meets ERISA's various requirements and that proper procedures are in place to ensure continued compliance. You should also review the terms of each severance plan to see if Section 409A applies. For severance plans adopted this year, there may still be time to ensure compliance.

### ***Related People***





**William D. Wright**

Partner

610.230.2137

Email