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Why Employers Should Embrace ERISA Coverage of Their Severance Plans

Many employers say they do not want their severance arrangement or policy (hereinafter, a "severance plan") to be subject to ERISA, due to its burdensome requirements of having to draft and maintain a plan document and a summary plan description (SPD), preparing and filing Forms 5500 annual reports, and subjecting the severance plan to compliance with fiduciary standards. However, many change their minds after understanding that ERISA coverage provides for many advantages, and the related compliance requirements are not particularly onerous. This article discusses what causes a severance plan to be subject to ERISA, the consequences that result, and the advantages of ERISA coverage.

It Is Likely Your Severance Plan Is Already Subject to ERISA. Many employers believe that if their severance plan is maintained only pursuant to a policy and not a written "plan," it should not be subject to ERISA. It should be understood that it does not take much employer involvement for a policy to be an ERISA severance plan. In fact, severance plans are generally subject to ERISA. The seminal case concerning what subjects a severance plan to ERISA coverage was decided almost 40 years ago by the United States Supreme Court in *Fort Halifax Packing Co. v. Coyne*, 428 U.S. 1 (1987). At issue in *Fort Halifax* was whether a Maine statute that required employers to provide their employees with a one-time payment, when being terminated due to a plant closing, established an ERISA plan. The Supreme Court held that for an arrangement to be subject to ERISA, the administration of the arrangement must require "an ongoing administrative program to meet the employer's obligation." The court went on to state that the "requirement of a one-time, lump-sum payment triggered by a single event requires no administrative scheme whatsoever." Thus, for example, if a severance plan states that upon termination for any reason, employees will receive 2 weeks' pay as severance, that severance plan may not be subject to ERISA, depending on whether other factors exist. That is, the more conditions or limitations placed on the eligibility for severance, requiring employer discretion or calculation, the more likely there is an administrative scheme and the plan is subject to ERISA.

Specifically, courts have focused on the following two factors in determining whether an arrangement providing severance payments is an ERISA plan: (1) whether the severance payments made pursuant to the arrangement are subject to an "ongoing administrative scheme" for determining the eligibility to receive severance benefits and/or the calculation of such benefits; and (2) whether the employer is required to exercise discretion in determining the eligibility to receive the severance benefits. For example, in *Schonholz v. Long Island Jewish Med. Ctr.,* 87 F.3d 72, 76 (2nd Cir. 1996), the United States Court of Appeals for the Second Circuit held managerial discretion and a separate analysis of each terminated employee over an indefinite period of time requires an administrative scheme. Likewise, in *Whittemore v. Schlumberger Tech. Corp.,* 976 F.2d 922, 923 (5th Cir. 1992), the United States Court of Appeals for the Fifth Circuit held that the severance plan at issue was subject to ERISA because, unlike in *Fort Halifax*, it was not created with a particular closing in mind, but had been in existence for some time and required an administrative setup in order to make

severance payments to employees. That same court held in *Gomez v. Ericsson, Inc.*, 828 F.3d 367, 62 EBC 1560 (5th Cir. 2016) that administering employer paid COBRA coverage in a severance plan results in an administrative scheme. In *Deutsch v. Kroll Associates*, 30 EBC 1418 (S.D.N.Y. Feb. 20, 2003), a New York court held a severance arrangement was an ERISA plan because the arrangement required an ongoing administrative scheme to process the benefits of continuation of health and dental insurance coverage and 401(k) matching contributions over a six-to-twelve-month period. In *Bogue v. Ampex Corp.*, 976 F.2d 1319, (9th Cir. 1992), the United States Court of Appeals for the Ninth Circuit held that an administrative scheme exists where the plan requires ongoing, particularized, administrative, discretionary analysis as to whether an employee is owed severance. In that case the employer had to determine whether an employee was entitled to severance because the job offered by the acquirer of his employer was substantially equivalent to the job with the acquired employer.

Each of these cases demonstrates that employer severance plans that require the employer to determine when a terminated employee is eligible for benefits, the level of benefits, and include any continuation health coverage benefits will likely be an ERISA plan.

A Severance Plan That Is an ERISA Welfare Plan Is Not Overly Burdensome to Maintain. A plan that is subject to ERISA will be classified as either a pension benefit plan or a welfare benefit plan. Welfare benefit plans are subject to significantly fewer ERISA requirements than pension plans. According to Department of Labor regulations, for a severance plan to be a welfare benefit plan under ERISA, all of the following requirements must be met:

- The severance plan payment is not contingent, directly or indirectly, upon the employee retiring;
- The total amount of the payments to be made does not exceed two times the employee's annual compensation during the last full year of employment; and
- All payments must be made within 24 months following the employee's termination.

A severance plan that is categorized as a welfare benefit plan under ERISA is exempt from ERISA's minimum participation requirements and vesting standards, as well as minimum funding requirements and the requirement that plan assets be held in trust. These rules will apply if the plan is considered a pension plan.

If the severance plan is a welfare benefit plan, then ERISA's reporting and disclosure requirements, fiduciary responsibility provisions, and administration and enforcement provisions apply. The reporting and disclosure provisions require that eligible participants be provided an SPD. However, the plan document can be drafted to also serve as the SPD. And, if there are more than 100 eligible participants, a Form 5500 information report must be filed annually. This form is relatively easy to prepare, because it requires not much more than reporting the number of eligible participants at the beginning and end of the year, and the number receiving benefits during the year. It is also important to note that for this purpose any employee who might be eligible for severance upon termination of employment is considered eligible.

Under ERISA, persons and entities exercising authority or control over the management of a plan and/or the disposition of its assets are plan fiduciaries. ERISA plan fiduciaries have a duty to act in the best interest of plan participants and their beneficiaries. A fiduciary who fails to uphold this standard and, therefore, engages in a fiduciary breach, can be held personally liable for any losses sustained by the plan and/or its participants and beneficiaries. A breaching fiduciary may also be subject to other equitable and remedial relief, including removal as a fiduciary. ERISA's fiduciary duties ensure the people operating the plan take severance plan matters seriously and thoughtfully, and follow the terms of the plan document.

While being a plan fiduciary has risks if duties are breached, the availability of flexible plan designs and the fact the courts use an "arbitrary and capricious standard" in reviewing fiduciary decisions help mitigate that risk. The issue of mitigating risk is discussed below.

Mitigating Fiduciary Risk. A welfare benefit plan can be designed to provide the employer with flexibility to decide who is eligible for severance benefits. In fact, the plan can provide that severance will be paid only to eligible employees who have been notified that their termination makes them eligible for severance. Thus, not every termination without cause due to a reduction in force need qualify for severance, but only employees who are notified by the employer that they are eligible for severance will be entitled to benefits.

In the 2023 case of *Carlson v. Northrop Grumman Severance Plan,* the U.S. Court of Appeals for the Seventh Circuit, 67 F.4th 871 (7th Cir. 2023) approved this flexibility in severance plan eligibility for a welfare benefit plan. In that case, the court ruled that an employer can use its discretion to individually select which terminated employees will receive severance benefits, if it reserves the right to do so in the welfare benefit plan document. The employer's severance plan provided that employees regularly scheduled to work at least 20 hours a week who were terminated were entitled to severance benefits if the employee "received a cover memo, [to that effect] signed by a Vice President of Human Resources (or his/her designee)… addressed [to the individual] by name." After a series of layoffs, several terminated employees who did not receive severance benefits sued, claiming that their eligibility for benefits was established by the fact that they regularly worked more than 20 hours a week. They claimed the memo was not a requirement but merely a "ministerial document that verifies eligibility under the 20-hour standard." The district court ruled in favor of the employer, finding that the plan's language provided the employer's HR Department's discretion to choose whom, if anyone, is eligible for severance pay upon being laid off.

On appeal, the Seventh Circuit noted that "the Plan makes the receipt of severance benefits contingent on receipt of a HR Memo, which plaintiffs and the other class members did not get. Welfare-benefit plans under ERISA—unlike retirement plans—need not provide for vesting, and the terms of welfare-benefit plans are entirely in the control of the entities that establish them. When making design decisions, employers may act in their own interests." The court explained that this means employers can include a discretionary component in the plan's provisions that allows for individual determinations for severance benefits eligibility. Consequently, the court concluded that the severance plan was permitted to delegate the exercise of this discretion to its HR Department.

In addition to flexibility on the terms of eligibility, as approved in *Carlson*, if an ERISA severance plan provides the plan administrator the discretion to decide claims and interpret the plan's terms, courts will uphold the decisions of the plan administrator (such as those involving plan interpretation, eligibility, vesting and entitlement to benefits) unless the court finds that the administrator acted in an arbitrary or capricious manner in making the decision. Thus, under the "arbitrary and capricious" standard of review, a court will uphold administrative decisions, even if it finds that different decisions also might have been reasonable. This deference to the plan administrator significantly facilitates plan administration and guards against protracted litigation.

The availability of flexible eligibility requirements, as well as the arbitrary and capricious standard of review, significantly mitigate fiduciary risk for ERISA-covered severance plans.

Advantages of an ERISA-Covered Plan, in General. There are other advantages to a severance plan being subject to ERISA, regardless of whether it is a pension or a welfare plan. These advantages include the following:

- Preemption of State Laws. ERISA generally preempts state law; therefore, it can invalidate state law claims, such as breach of contract, bad faith and intentional infliction of emotional distress. Additionally, employers who conduct business in more than one state can rely on the consistency of federal law (ERISA) in operating their severance plan arrangements, rather than having to be concerned about compliance with varied state laws.
- Written Plan Requirement. ERISA requires that the terms of employee benefit plans be set forth in writing. This means that ERISA plan documents must specifically and clearly identify eligible participants, the circumstances under which benefits are payable, and how a participant's benefit is determined. In addition, the plan must contain administrative information regarding the employer's right to amend or terminate the plan, a claims and review procedure (discussed further in the next paragraph), and the identity of the plan administrator and fiduciaries. This precludes claims from employees based on informal or even verbal severance plans and provides one place to look to govern the severance benefits.
- Claims Procedures. A participant in an ERISA plan must follow the plan's administrative procedures when making a claim for benefits under the plan. ERISA requires two levels of internal administrative review, both of which must be completed (or exhausted) before an individual may bring a claim in court. Through these procedures, claims and disputes can often be resolved without becoming public.
- The Availability of a Shorter Statute of Limitations. An ERISA plan can provide for an internal period by which a benefit claim must be brought, regardless of whether a state law statute of limitations provides for a longer period of time, provided it is reasonable. This is because, as noted above, ERISA preempts state law. This is an advantage by providing one uniform time by which claims must be brought and precluding claims that would have a longer limitations period. It also avoids an employer that does business in multiple states having to comply with multiple state statutes.
- Jury Trials. Courts have held that in many types of ERISA cases, there is no right to a jury trial; rather, a federal judge familiar with the federal ERISA statute decides the case. It is generally advantageous to have a judge familiar with ERISA case law decide the matter, as opposed to jurors unfamiliar with it.
- Punitive Damages and Attorney's Fees. Monetary awards meant to punish bad behavior, known as punitive damages, are generally not available under ERISA. However, ERISA does provide for the award of attorneys' fees and court costs, at the discretion of the court.
- Avoiding Code section 409A. Because severance plans generally pay an employee in the future for services rendered in the past, they are deferred compensation plans under Internal Revenue Code section 409A (409A), unless an exception is met. The details of 409A are beyond the scope of this article. However, the important thing to understand is that if a plan is subject to 409A and fails to meet its requirements either in the plan document or in operation there are drastic tax consequences for the employees. In summary, the deferred compensation is subject to income tax to the extent vested (not subject to a substantial risk of forfeiture), plus there is an additional 20% federal tax and interest at a rate that is 1 percentage point higher than the normal rate for unpaid taxes from the date of vesting.
- Code section 409A Exemption. A severance plan that is an ERISA welfare benefit plan can be written to be exempt from 409A. First, if the plan pays the benefit within 2 1/2 months of the end of the year in which the employee's right to the benefit vests (or the end of the employer's fiscal tax year if longer), the plan will not be considered deferred compensation under the short-term deferral exception to 409A. On the other hand, if the severance plan does not pay within the short-term deferral period, it can still be exempt from 409A if it

only pays on an involuntary termination; the benefit payable is paid within 2 years of the termination date; and the benefit does not exceed the lesser of 2 times 1) the amount of compensation that can be considered under a qualified plan (currently $360,000) or 2) the employee's base salary at the end of the year prior to termination. This last part of the equation is very similar to the test to be a welfare benefit plan under ERISA. This is an advantage to know that a simple mistake in operating the plan will not cause the draconian 409A tax consequences for participants.

Conclusion. If an employer treats a severance plan as not subject to ERISA and a court determines it is subject to ERISA, the employer could face penalties for failing to provide an SPD or file annual Forms 5500. Rather than trying to avoid ERISA, the employer should consider the many advantages of ERISA coverage. And, as explained above, complying with ERISA is not overly burdensome and has many advantages.

If you have questions about ERISA or non-ERISA severance plans, please contact us.

