Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 43 – The Advantages and Requirements for Severance Plans Subject to ERISA

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Megan Monson: Welcome to the Lowenstein Sandler Podcast Series. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, SoundCloud or YouTube. Now, let's take a listen.

Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld, and I'm an associate in Lowenstein Sandler's Executive Compensation Employment and Benefits group. I'm joined today by two partners in my group, Andy and Megan.

Andy Graw: Thank you, Jessica. I'm Andy Graw, Chair of the Group. Happy to be here.

Megan Monson: I'm Megan Monson. I'm a partner in our Practice Group as well.

Jessica Kriegsfeld: Today's discussion will focus on severance plans, including when severance plans will be subject to ERISA and some requirements associated with compliance with ERISA. This episode will also discuss deferred compensation considerations for severance plans and other notable consideration for companies adopting severance plans. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you wish to adopt a severance plan. To begin, what's the purpose of a severance plan?

Megan Monson: So often companies will adopt a severance plan to provide protection typically for senior management or key leaders of the company in the event of a termination without cause. Sometimes it also covers a resignation for good reason, and that they will get some sort of benefits, whether it's salary continuation, COBRA coverage, a variety of things subject to execution and non-revocation of a release of claims. Often companies will adopt these types of arrangements as ways for management to feel that they are protected against those type of termination situations beyond their control, and it can be used as a retention tool to attract and retain some of those key employees.

Jessica Kriegsfeld: When are severance plans subject to ERISA?

Andy Graw: That's a great question, Jessica. It's not always easy to know when severance plans or policies are subject to ERISA. ERISA is the Employee Retirement Income Security Act of 1974, federal law that governs pension and welfare plans. And although a lot of people would not think of severance as a pension plan, ERISA does under certain circumstances. A severance plan can either fall into a pension plan category or a welfare plan category, or it could be outside the scope of ERISA entirely for various reasons. We'll get into, in a little bit, why it's actually better often to be subject to ERISA. So under ERISA, a pension plan exists generally for a severance plan unless the severance plan provides benefits for a period of less than two years and less than two times the person's annual compensation, which most severance plans would do. They're not going to provide benefits payable at retirement.

They're not designed to provide for benefits that usually exceed two years pay. So, most severance plans are going to fall under this exception, and when they fall under this exception, they're then treated as welfare plans. And that's important because welfare plans are subject to ERISA but not subject to the more onerous requirements that a pension plan would be required to abide by. For example, there's no funding requirement, there's no minimum participation or eligibility requirements, there's no vesting requirements, and all those are very important for purposes of maintaining a severance plan. The company wants to be able to choose who's going to be eligible for severance, what the requirements for severance are, how long severance would be provided for, and they certainly don't want to have to fund severance benefits. They want it payable out of their general assets. So, falling under this welfare plan category of ERISA is really critical.

And then there's a whole another exception for severance arrangements that can be considered to be outside of ERISA because they don't have an administrative practice that's ongoing. So, it's not considered to be a, quote, "plan" in the first instance. So, if a policy, for example, when a handbook provides for severance, there can be an argument, a good argument that it's just an administrative practice and therefore not under ERISA at all. But like I said, there are good reasons to be subject to ERISA, and that'll be the subject of, I think, what we're going to talk about very shortly.

Megan Monson: And one other thing I'll mention on the severance plans themselves is that you can have an ERISA plan even if the policy's not in writing depending upon what the terms are and how it's being administered. So, it is important to be aware of all of the things that Andy just mentioned, even if you don't have a written policy as ERISA could still apply.

Andy Graw: That's a great point, Megan, because there's actually been some court cases, rather dated ones now, but because everyone knows to put their severance plans in writing, but you don't want a court deciding what your severance policy or plan is based on past practice. It's very important to have the plan terms or policy terms in writing to avoid a court stepping in and deciding what your terms are.

Jessica Kriegsfeld: If the severance plan is subject to ERISA, what does that mean?

Megan Monson: So, Andy's touched on a couple of these items so far, but there are a host of requirements, some documentary, some in practice that plans need to follow when they are subject to ERISA. The first being that there needs to be a formal plan document and a summary plan description. Summary plan description is what describes the plan's terms in ways that participants can understand. Sometimes for a severance plan it will be combined with the formal plan, but there are requirements under ERISA of things that need to be in that document. ERISA plans are also subject to reporting requirements such as filing annual 5500s. If it is considered a welfare plan and there's less than a hundred participants, they may not need to file, but again, that's something to be aware of, in particular, because an employer who sponsors an ERISA covered severance plan but that doesn't comply with ERISA, maybe subject to taxes and penalties, though on the 5500 aspect, if they are required to file them and don't, they could be penalized for up to $2,259 per day for failing to file the report. So, the ramifications can be significant.

ERISA plans also are required to have certain participant disclosure requirements and distribute that information to participants in the plan. The plan has to have a proper claims procedure. Again, that's a requirement of ERISA and it sets forth what that is, but they need to have an administrator and a certain process if there are any disputes with respect to the plan. One of the other key things is by sponsoring an ERISA plan, there will be folks that are considered fiduciaries, and what that means is they have to run the plan in the interest of participants and beneficiaries, the exclusive purpose of providing benefits and paying plan expenses. And by being a fiduciary, there are a number of different requirements that you need to be aware of. You have to act prudently and in the best interest of the participants in the plan, follow the plan terms, avoid conflicts, pay benefits as required, and a couple of other things that aren't applicable to severance plans.

If a severance plan is considered a pension plan for ERISA purposes, another way it can potentially get out of having to file Form 5500s is whether if it can be considered a top hat plan, and then it will also be exempt from some of the other ERISA requirements that Andy mentioned such as some of the minimum funding standards. We've talked about top hat plans on a prior episode, so we're not going to get into detail on that here, but that's something to be aware of if you do have a severance plan that's considered a pension plan for ERISA purposes of ways to try to work around some of those more complex requirements.

Jessica Kriegsfeld: What are the benefits of an ERISA severance plan?

Andy Graw: Having a severance plan be subject to ERISA is actually a good thing from an employer's standpoint. There's a knee-jerk reaction by employers that they don't want to have a plan that's subject to ERISA because the general thought is that they'd subject to a whole array of problems and obligations associated with compliance with ERISA. However, the benefits of having a severance plan and

maintaining it under ERISA are important to understand. For example, when ERISA applies to a severance plan, if there's any dispute over the benefits provided by the plan, it's the terms of the plan that control. So, it is again, very important to have the terms under which severance is provided to be set forth in writing and be very clear. That does not eliminate discretion on the part of the employer. You want the discretion to be built into the plan certainly, but having a plan that's subject to ERISA doesn't eliminate the ability for an employer to have discretion over determining much severance will be provided, for example.

If there's a dispute over benefits, then ERISA requires that the participant go through an administrative claims procedure before going to court. That's a critical advantage to an employer that maintains a plan, any kind of a health welfare or pension plan, and it's the same for a severance plan as well. It requires a participant who disputes a claim to go through an administrative claims procedure that's essentially run internally by the company, so it forces the participant to set forth all of their arguments for why they're entitled to the benefit. The employer or a committee of the employer or some other fiduciary needs to then assess the claim and make a determination on it. If it's denied, the participant has an appeals process, again, internal, and all this takes place before the participant can go to court.

If the participant does go to court to pursue the claim because of ERISA, they would not be entitled to state or common law remedies because ERISA preempts state laws. That leaves them with the remedy of the benefit that they were allegedly entitled to under the terms of the plan itself. Unitive damages are not available under ERISA, but would be outside of ERISA, potentially under state laws or even if the individual sued under common law. So those are really significant advantages for an employer maintaining an ERISA plan. Also, if a participant does sue and if they went to state court, the employer has the ability because ERISA is a federal law, to remove the case to federal court where the courts will usually better analyze federal laws including ERISA. It's best to be in federal court anyway if you're an employer.

So those are some pretty important reasons why an employer would be very advantaged by having a severance plan that's subject to ERISA. On the contrary or to the opposite effect, what are the negatives? Megan touched on a number of those. But in comparison, in my view, the positives of being subject to ERISA outweigh the negatives. Probably the biggest negative is having to file that 5500 if you have a severance plan for which more than a hundred employees are eligible, but even that is not a very onerous requirement because it's a welfare plan where benefits are payable out of general assets. That means that you don't have to do an audit report for the 5500, which would be the most difficult part of a 5500. Instead, it's a short form filing essentially, and other than the obligation to have to fill it out and file it, it's not that onerous a requirement.

Megan Monson: Yeah, I agree with everything you said, Andy. And I think part of it is planning upfront. So, when you're adopting these plans, making sure the documentation is done properly, and that covers a majority of your requirements under ERISA, subject to some of the furnishing documents to participants and potentially the

5500 filing. And I've found that many companies that do adopt these plans also aren't typically giving them out to a lot of employees, so they may very well fall under that hundred participant threshold, and they don't even need to do the 5500 filings.

Andy Graw: Right. And sometimes severance plans are set up just for particular reductions in force, a plant closing for instance, or some other reduction in workforce. And even in those situations, having a plan subject to ERISA has its advantages as I've listed out, and the downsides are just not that significant in my view.

Jessica Kriegsfeld: Are there any deferred compensation considerations to keep in mind when creating a severance plan?

Megan Monson: Absolutely. So, in addition to having to work through all of the ERISA aspects and analysis that both Andy and I have touched on, you also need to think about things from a deferred comp standpoint, and this is really going to require looking at things on a case-by-case basis. But generally, if an employee has a legally binding right in one year to receive payment of compensation in another year, it will be considered a deferral of compensation, and those payments could be subject to Section 409A of the Internal Revenue Code. We've had other episodes of this podcast focusing on the ins and outs of Section 409A in greater detail that we're not going to get into today, but generally, a plan that pays benefits on a termination of employment may be treated as deferred compensation subject to 409A if severance benefits are paid over more than one year.

So, there's a couple of different considerations to think about. A severance arrangement could be structured to be exempt from or required to comply with 409A. Often for severance plans, they tend to be structured in a way that would allow them to be exempt from 409A, and there's two typical ways to do this. So, the first would be structuring the payments to meet the short-term deferral exception, meaning the severance payments will all be paid out within two and a half months following the year of termination. So that works well if you're going to have payments made in a lump sum or a short-term severance arrangement. Another way to structure it would be to meet what they call the separation pay exception under 409A. You can meet the separation pay exception under 409A allowing for severance to be exempt from 409A if it meets a couple of requirements. The first being that all of the payments must be made no later than two years following the calendar year in which the employee was terminated.

Often this is a pretty easy requirement to satisfy since most severance obligations aren't going to continue for more than 24 months after termination, and that's even on the longer side. The other requirement is that the termination has to be due to an involuntary termination of employment. Now, that's a term of or under 409A, but it typically will cover terminations without cause and certain resignations for good reason. And this is another key piece, the amount of the severance cannot exceed two times the lesser of the employee's annualized base salary or an annual limit under the internal revenue

code, which was for 2024, $345,000. So, in short, if you have a pretty highly compensated employee, as long as they're not getting payments that exceed that threshold and they're paid in less than two years, you could fall under the separation pay exception. Another key piece to mention is oftentimes, especially for people who are getting larger severance packages, the short-term deferral exception and the separation pay exception will be layered together so it requires careful analysis to make sure that the arrangement is not subject to 409A. If it is, again, we're not going to get into detail in that today, there are ways severance could be structured to comply with 409A, but there are more complexities involved in doing so, so if it's possible to meet one of these exceptions, it's a little bit easier from an employer's perspective. One other item to mention is that certain post-termination benefits under a severance plan may also be exempt from 409A, so we don't have to worry about those purposes of looking at the types of payments and when they're being made.

Andy Graw: One thing I'd add to that, Megan, is that the separation pay exception, as you mentioned, can work together with the short-term deferral exception called stacking. But you can use the separation pay exception to the extent that the severance does not exceed two times that 401A17 limit, so in total $690,000 for 2024. If it exceeds that amount, then the excess amount would be deferred compensation under 409A. That can lead to a whole another set of circumstances involving key employees and requiring key employees to wait six months to receive severance pay under 409A. There's also a podcast episode dealing with that, so I would recommend to our listeners that they hear the podcast involving the six-month delay role and get a sense of what that's like.

Megan Monson: Yeah. No, those are all great points, Andy. And I think really all of the things we've talked about so far really emphasize the reason to consult with counsel when you're adopting these type of arrangements because navigating 409A can be complicated. Navigating ERISA can also be complicated, so making sure to have things set up properly when a plan is being adopted can help eliminate a lot of the risks that an employer would take on or failing to comply with all of these different requirements.

Jessica Kriegsfeld: Andy, are there any other considerations to be aware of?

Andy Graw: There's many when it comes to severance. A few that come to mind are that listeners should be aware that severance usually should be conditioned on release from the recipient, and then that release has to comply with various state law rules as well as federal age discrimination requirements. They should also keep in mind the impact that severance can have on other company benefits, so they should consider in drafting a severance arrangement whether or not the severance will be taken into account as compensation for that purpose. Should also consider whether or not the severance is provided while the person is on say, garden leave versus whether it's provided after separation from service. We could do a whole subject on that as well. That will also dovetail into the release condition, and when you get the release and whether to get it re-executed at the end of the person's garden leave period.

All these are complicated design issues for severance that employers should carefully consider and certainly talk to counsel about. There's a corollary to 409A called Section 457A of the code, which affects certain employers that are generally subject to foreign tax rules, or at least gain some advantages that are outside of the US tax laws. Again, that's a whole another topic of discussion, but severance can be subject to 457A, so it's also important for employers to be aware of that. Again, another reason to really engage counsel when creating these arrangements to not run afoul of these potential pitfalls.

Jessica Kriegsfeld: As you heard today, severance plans can be a useful tool for employers looking to provide deferred compensation benefits to certain key employees. However, care must be taken to ensure compliance with the relevant requirements of ERISA and Section 409A. This episode is intended to be a high-level overview but is by no means an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next episode of Just Compensation.

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