

SEVERANCE BENEFITS

Overview

Severance benefits provide pay and sometimes other services to employees while they seek new employment. Usually, employers give severance benefits to employees whose jobs are eliminated, but some employers provide benefits to employees who retire, resign voluntarily, or are fired for cause. The promise of severance benefits can help an employer retain workers during unstable periods when future job loss is possible. Additionally, some employers feel that severance benefits reduce the chance that former employees will sue them for wrongful termination or other employment-related claims. Most employers that offer severance benefits have written policies, but other employers tailor benefits to individual situations.

Practical and Legal Considerations

Scope and Purpose

The majority of employers offer severance benefits to at least some of their departing employees. The most common severance benefit is cash, either as a lump sum or as a continuation of salary for a certain length of time. However, some employers offer continued health insurance, life insurance, pension contributions, or other benefits to terminated employees. The larger the employer, the more likely it is to offer severance benefits and the more generous the benefits are likely to be.

Most employers provide benefits that are tied directly to length of service, with a week's pay for each year of service being the most common formula. A maximum dollar amount usually is placed on the total benefit an employee can receive.

Some employers offer severance benefits only to managers or other salaried employees. Another common restriction is a minimum service requirement so that only employees with significant service records are eligible for benefits.

Generally, severance pay is provided to employees who are terminated before retirement age through no fault of their own, such as a reduction-in-force due to decreased demand, economic pressure, or new technology.

Some employers pay severance benefits only in cases of mass terminations. Employers should clearly define whether employees are entitled to severance benefits when they retire, resign voluntarily, are discharged for cause, or are terminated because the employer closes down altogether. Another situation to address in a severance benefit policy is layoffs-usually, employers do not want to pay severance benefits to employees whose departure from the payroll is only temporary. Some employers pay severance to employees terminated for cause to reduce the likelihood of a wrongful discharge lawsuit.

Employers also should consider whether severance benefits should be "funded"-that is, whether a separate fund be earmarked to pay severance benefits. Otherwise, the employer must pay benefits out of general revenues as needed. Especially if severance benefits are extensive or widely available, it is wise to estimate anticipated severance package costs and allocate the money to cover them as a separate budget item.

Legal Pointers

Tax, ERISA, and state law implications employers should consider in drafting severance policies are discussed below. Legal issues surrounding release of claims also are discussed.

Tax Aspects

Severance payments made to employees are subject to federal income tax and in some cases are considered wages subject to federal employment taxes, including income tax withholding, social security, Medicare, and unemployment tax. Employers usually can deduct severance payments as ordinary and necessary business expenses.

Payments to employees in connection with involuntary separations are treated as supplementary wage payments and are subject to federal withholding. However, payments made in connection with a voluntary separation, the settlement of litigation, or the early termination of an employment contract are taxable only to the individual, and the employer need not withhold federal taxes.

ERISA

In most cases, severance plans are not regulated by the Employee Retirement Income Security Act as pension plans. ERISA-covered pension plans must comply with the law's reporting, disclosure, fiduciary, participation, vesting, and funding standards. Most severance plans are considered welfare plans under ERISA and must comply only with the law's reporting, disclosure, and fiduciary standards. Severance plans are classified as welfare plans if:

- payments are not contingent on the employee retiring;
- maximum benefits are limited to two years of the employee's annual rate of compensation, including fringe benefits; and
- all payments are completed within two years of the employee's separation.

State Laws

Some state laws require severance pay in certain circumstances. Employers should check for any applicable state law on severance benefits.

Release of Claims

Often, employers require employees receiving severance packages to sign a waiver stating that they release all employment-related claims they might have had against the employer, such as gender or age discrimination or workers' compensation claims. These releases are no guarantee that the employee will not succeed later in maintaining a lawsuit, but they do give some protection against future litigation. Generally, if a terminated employee signs a waiver and then decides to sue the employer later, the former employee must offer to return severance payments and pursue his or her claim in a timely manner. Waivers of rights under the federal Age Discrimination in Employment Act in particular must follow specific regulatory guidelines for wording and timing.

Policy Pointers

Items an employer should consider in developing a severance benefit package include:

Written or informal policy - Written severance benefit policies make administration more uniform, but they require the employer to make an up-front commitment to paying benefits to the stated classes of employees. An informal, ad hoc policy allows employers to award severance benefits selectively and tailor them to each departing employee's needs.

Eligible employees - The policy should state clearly which categories of employees are eligible for benefits: management, salaried, or hourly employees. Different levels of benefits can be assigned to different categories of employees. The policy also should address what events entitle employees to severance pay: involuntary termination, voluntary termination, retirement, layoff, plant shutdown, or sale of part or all of the employer's business. In cases of sale or takeover, employers should specify that employees are not entitled to severance benefits as long as they keep their jobs with the new employer. Most policies require a minimum amount of service, such as one year or more, before an employee is eligible for benefits upon termination.

Payment method - Most employers pay severance benefits as a lump sum immediately upon termination of employment. Others make periodic payments that mimic salaries, known as "salary continuation." Sometimes, employees are allowed to choose their preferred payment form.

Benefits formula - "Years of service" is the most common method for determining the amount of severance benefits. Severance policies should state how many weeks of pay the employee is entitled to per year of service, such as one week of salary per year served, and whether the employee will receive credit for partial years of service. Salary typically is defined as base pay only, not including bonuses, commissions, or overtime. The policy should specify a maximum number of weeks to be paid, such as 26 weeks, or a maximum dollar amount so that the severance benefit liability is not infinite. A minimum number, such as two weeks, also can be established. Other methods for calculating benefits include the reason for termination, the employee's age, or the employee's salary and grade level. Executives frequently negotiate severance benefits into their individual employment contracts.

Other benefits - Cash is the most common type of severance benefit, but many packages include continued medical benefits, life insurance, pension credits, or disability insurance. Outplacement services also can be provided, particularly in cases of mass terminations. These services include: job counseling and referral, resume preparation, retraining assistance, and access to computers, printers, facsimile machines, copy machines, voice mail, and telephones for terminated employees to use in their job search. A relatively uncommon benefit is mortgage deficit assistance.

Payment termination - Some employers stop severance payments, continued insurance benefits, or both when the recipient finds new employment. A few employers attempt to recover severance payments if they rehire terminated employees who received benefits.

Model Policies

This section includes two model severance policies:

Severance Benefits: Standard Policy - This model policy provides benefits only to employees terminated involuntarily as a result of reductions-in-force. A lump-sum payment is offered, based solely on years of service.

Severance Benefits: Expansive Policy - This model policy provides benefits to employees terminated for a variety of reasons. In addition to a choice of a lump-sum payment or salary continuation, other benefits are offered.

Severance Benefits: Standard Policy

Eligibility - Full-time employees who are terminated due to reductions-in-force or corporate restructuring receive a lump-sum severance payment with their final paycheck. Employees must have worked for EMPLOYER for a minimum of one year to receive benefits. Benefits are not available to employees in any other circumstances, including but not limited to voluntary termination, temporary layoff, retirement, or termination for cause. If EMPLOYER sells part or all of its operation and an employee retains a job with the new owner, the employee is not eligible for severance benefits from EMPLOYER. Severance benefits also are not available if termination results from acts beyond the employer's control, such as fire, flood, explosion, bombing, or earthquake.

Benefit calculation - Employees with at least one year of service receive one week's pay per year worked. A partial year is rounded up to a complete year if days of service equal or exceed half the total service days for that year. The maximum number of weeks paid as severance benefits is 26. "Pay" is base salary only and does not include overtime, bonuses, or commissions. EMPLOYER withholds the usual federal taxes from the severance payment.

Waiver - To receive severance benefits, the employee must sign a statement waiving all future legal claims against EMPLOYER.

Severance Benefits: Expansive Policy

Eligibility - Full-time and part-time employees may receive severance benefits if they are terminated due to reductions-in-force, corporate restructuring, poor performance, sale or takeover of EMPLOYER, or refusal to relocate. Employees who quit voluntarily or are discharged for felonious conduct are not entitled to severance benefits. If EMPLOYER sells part or all of its operation and an employee retains a job with the new owner, the employee is not eligible for severance benefits from EMPLOYER. Severance benefits also are not available if termination results from acts beyond the employer's control, such as fire, flood, explosion, bombing, or earthquake.

Benefit calculation - Hourly employees entitled to severance benefits receive one week's pay for each year or partial year of service. The minimum amount of severance pay is one week's pay, and the maximum is 26 weeks' pay. Salaried and management employees entitled to severance benefits receive two weeks' pay for each year or partial year of service. The minimum amount of severance pay is two weeks' pay, and the maximum is 52 weeks' pay. "Pay" is base salary only and does not include overtime, bonuses, or commissions. EMPLOYER withholds the usual federal taxes from the severance payment. Employees can choose to receive severance pay as a lump sum with their final paychecks or in equal installments on their regular paydays.

Insurance benefits - Employees entitled to severance benefits also can continue to receive medical, dental, life, and long-term disability insurance for which they and their dependents are enrolled on the day they are notified of their termination. Terminated employees must continue to pay the regular employee contributions to these plans. These insurance benefits are available for one year and cease if the employee finds a new job offering insurance benefits.

Outplacement benefits - A counselor conducts classes for employees terminated due to reductions-in-force or corporate restructuring. The classes cover skills assessment, resume preparation, and job-search strategies. EMPLOYER contacts other employers in the area and maintains a bulletin board advertising their vacancies. For a minimum of three months, these terminated employees have free use of office space with personal computers, Internet connection, telephones, a fax machine, and a photocopier.

Waiver - To receive severance benefits, the employee must sign a statement waiving all future legal claims against EMPLOYER.

Policy Support Document

This section includes a model waiver that employers can require employees to sign to receive severance benefits. To protect against claims under the Age Discrimination in Employment Act, be sure to allow 21 days for employees to consider the waiver, and advise employees in writing to consult an attorney about it. Keep a record of when the waiver is distributed to the employees and when the employees sign it. Ask them to sign it before a company representative, such as an HR staff member. For the waiver to be effective against ADEA claims, allow for a seven-day revocation period after the employee signs the waiver. The waiver must state that it is not effective or enforceable until after the seven days. Employers should keep in mind that the enforceability of waivers of ADEA claims is an area of law that is frequently litigated. The model waiver below is not intended to substitute for legal advice and employers are advised to consult an attorney to execute the most effective waiver of ADEA claims.

Waiver of Employment-Related Claims

Waiver - In consideration of the attached severance benefits [attach a copy of the severance policy], I release EMPLOYER and all EMPLOYER'S officers, directors, and employees from all legal claims that I might raise against EMPLOYER now or in the future concerning my employment with or termination from EMPLOYER, including, but not limited to, claims under the federal Age Discrimination in Employment Act, as amended.

I acknowledge that I have had at least 21 days to read this waiver, and EMPLOYER advised me in writing to consult with an attorney to review it. EMPLOYER has offered me no promise or inducement to sign this waiver, which I do voluntarily, acknowledging my full responsibility for and understanding of it. I understand that I may revoke this waiver for seven days after signing it by delivering a written revocation to the representative of EMPLOYER who has signed below. This agreement is not effective or enforceable until after the seven-day period.

Employee signature: _____

Employee name: _____

Date: _____

HR representative signature: _____

HR representative name: _____

Date: _____

Source: BNA