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## *Labor and Employment Alert*: Avoiding Traps in Terminations and Common Separation Agreement Pitfalls


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Unfortunately, sometimes an employer needs to end an employment relationship. In many situations, it is in the best interests of the parties to enter into an agreement that defines the terms of the separation. Whether called a "separation agreement," "severance agreement," "retirement agreement" or any other name, the issues remain the same.

When drafting a separation agreement, it is clearly important to define the business terms involved with the employment termination, including:

- the final date of employment;
- the timing and amount of severance payments;
- whether the individual will be allowed to continue to participate in the company's benefits for any period of time after the termination, and at what cost;
- any post-termination covenants like non-compete and non-solicitation provisions;
- the obligation to return all company property;
- whether the company will require a release of claims from the individual; and
- any other business terms.

However, we regularly see separation agreements that overlook important legal requirements creating potential risks for the company. The remainder of this alert describes some of the most commonly missed legal requirements. It is important that careful consideration be given when using such agreements, so that the employer accomplishes its business objectives without concern of unintended legal consequences.

## Internal Revenue Code Section 409A

Section 409A applies to "deferred compensation" which is very broadly defined. Because severance benefits are provided after termination in connection with the employee's prior work, these benefits can be subject to Section 409A. If a severance benefit is subject to, but does not comply with, Section 409A, the employee faces immediate income tax on the total present value of the severance (even if payments would be spread over time) plus a 20% excise tax and a complicated penalty interest tax. Individuals who incur these adverse tax consequences regularly ask their employer to cover that expense, especially if the taxes are triggered by non-compliant drafting by the employer. Fortunately, most severance arrangements can be structured to fall within one of two exceptions or can be drafted to comply with Section 409A's rules.

The "short-term deferral" exception generally exempts amounts that are paid no later than March 15th of the calendar year following the calendar year in which the employee's right to the severance benefit became vested. For example, if an employee is terminated in calendar year 2017, as long as all severance payments are made on or before March 15, 2018 and the employee did not have a vested legal right to the payment before 2017, the severance payments would be exempt from application of Section 409A.

The "involuntary separation pay" exception generally exempts severance payments that (1) are payable only in connection with the employee's involuntary termination or participation in an early retirement window, (2) do not exceed two times the employee's annual compensation (but such compensation is capped at the qualified retirement plan compensation limit, $270,000 for 2017); and (2) are paid by the last day of the second year following the employee's termination of employment.

In drafting a separation agreement, attempts should be made to fit all or a portion of the severance payments under one or both of these exceptions to Section 409A. To the extent that any portion of the proposed severance payments will not fit within one of these exceptions, it is necessary to ensure the separation agreement is drafted to comply with all of the requirements of Section 409A. Common errors include failing to define the termination date properly, not imposing the 6-month payment delay required for certain highly compensated employees of publicly traded companies, and not defining when the severance payments will start.

## Continuation of Employee Benefits

It is quite common that separation agreements allow the former employee to continue to participate in some or all of the employer's employee benefit plans for some period of time following termination of employment. However, before including such provisions in a separation agreement, it is important to review the eligibility provisions of the employer's employee benefit plans. Many plans require that an individual be employed for a certain number of hours per week in order to be eligible. To the extent that the benefit plan does not allow participation by former employees, there are three important traps to navigate.

First, insurance coverage may be unavailable. If the plan is fully self-insured without stop loss coverage, this issue is avoided. But for fully insured or partially insured benefits, there have been numerous cases where courts found that an employer was bound by its promise of benefits to the former employee, but the insurer was bound only by its insurance contract which excluded former employees. This leaves the employer in the uncomfortable position of fully self-insuring the liability. For example, if the former employee were to die during a period during which he or she is promised continuation of group life insurance benefits, it is very likely that the insurer would deny the claim for benefits and the employer would have to pay the death benefits to the beneficiary from the employer's general assets. Before promising extended insurance coverage, it is critical that the employer get an insurance rider from the carrier (or knowingly self-insure the benefit).

Second, providing the coverage may create a breach of fiduciary duty. An ERISA plan must be administered in accordance with the terms of the plan. The DOL frequently finds that the failure to follow the plan terms is a breach of the plan administrator's fiduciary duties and potentially a prohibited transaction. To the extent that an exception is desired, either an amendment should be made to the plan or a parallel plan should be created so that this issue is avoided.

Third, most employee benefits must be offered on a non-discriminatory basis and there are adverse tax consequences if pre-tax post-termination benefits are offered to highly paid former employees that are not offered to their lower paid counterparts. For example, benefits could become taxable to participants and premiums could lose their pre-tax status. There are two potential solutions to eliminate the potential adverse tax consequences. One solution is to offer extended coverage that is consistent with COBRA continuation coverage that is offered to all former employees. This would require limiting the continuation benefit to group health, dental and vision benefits for no more than 18 months. Alternatively, the tax discrimination consequences are avoided if the continued benefits are provided on an after-tax basis.

## Limits on Non-Disclosure

Many separation agreements include a non-disparagement provision that prevents the former employee from making any negative statements regarding the employer. In addition, some of these provisions contain standard language that requires the former employee to waive his or her right to communicate with government agencies or to collect whistle blower compensation. Recently, some government agencies, including the Securities Exchange Commission (SEC) and Equal Employment Opportunity Commission (EEOC), have taken the position that such language in a separation agreement applies impermissible restrictions on the former employee with respect to whistle blower activities. Any provision restricting the former employee's ability to communicate with government agencies contained in the separation agreement should be carefully reviewed.

## Obtaining a Valid Release of Claims

In most cases, when entering into a separation agreement, an employer wishes to receive from its former employee a release for all potential claims for liability arising from the employee's employment relationship with the employer. In drafting this release, it is important to make certain that the release is valid under applicable law and would not later be determined by a court to be null and void and of no effect. If the release were later invalidated, the employer would have made severance payments to the former employee under the separation agreement and would still be subject to claims for liability, such as, for example, claims for age discrimination. In drafting a valid release, it is necessary to both (1) include provisions that are required for release of claims under certain laws, such as, the Age Discrimination in Employment Act; and (2) exclude provisions that are impermissible, such as, the waiver of rights to cooperate with government agencies, such as the SEC and the EEOC. With respect to the Age Discrimination in Employment Act, if the former employee, at the time of termination of employment, is age 40 or older, the employee must be given a specified period of time to consider the separation agreement, be given an opportunity to consult with legal counsel (21 days for a single termination and 45 days if more than one individual is terminated as part of the same decision process) and be given 7 days to revoke any acceptance of the separation agreement.

## Conclusion

Careful drafting and awareness of these potential traps can enable an employer to accomplish its business objectives without triggering unintended legal consequences. If you have questions about your severance agreements, contact your Vorys attorney.