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webinar

Executive Compensation Basics | A Webinar Series

Anatomies of Severance and Release Agreements

Webinar 4 of 4

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Agenda

- Provisions Typical of Release Agreements (Separation Agreements and Severance Agreements)
- Terms and Provisions That Can Lead to Trouble or Avoid Trouble
- Employee Benefits/Tax Concerns
- Employment Concerns

Provisions Typical of Release Agreements

- ERISA severance plan vs. severance policy
 - Benefits of an ERISA severance plan:
 - *ERISA preemption over state law claims*
 - *Federal jurisdiction in the event of a dispute*
 - *Application of federal contract law principles*
 - *Can provide discretion to employer to decide who receives severance pay, how much is paid, and other conditions to payment*

Provisions Typical of Release Agreements

- Introductory Provisions
 - Set the context of the release agreement
 - Identify specific facts leading to, or relevant to, the release agreement
 - Identify the purpose of the release agreement
 - Typically include provisions that:
 - *Identify and define the parties*
 - *Identify any disputes, including administrative or court proceedings, and ensure capture of all pending claims*
 - *Identify significant events or facts (e.g., termination date, reason for termination, etc.)*

Provisions Typical of Release Agreements

- Monetary Provisions – to avoid disputes, include details
 - Form of payment – check, direct deposit, wire transfer
 - Allocation of payment(s) – payable to individual, attorney, beneficiary
 - Timing of payment(s) – lump sum or installments
 - W-2 wages or 1099 compensation?
 - *Focus is on the nature of the payment and claim(s) being resolved*
 - *Severance pay is reportable on Form W-2*
- Stock/Equity Provisions
 - Confirm when options can be exercised and when other equity grants will be paid

Provisions Typical of Release Agreements

- Other Non-Monetary Consideration
 - Can be anything of value
 - Examples of non-monetary consideration:
 - *Outplacement assistance*
 - *Benefits continuation/COBRA*
 - *References and recommendations*
 - *Waiver of amounts due from employee to employer*
 - *Loan forgiveness*
 - *Retention of company property*

Provisions Typical of Release Agreements

- Dismissal of Pending Charges, Suits, Etc.
 - Should cover all pending charges and lawsuits, except:
 - *Unemployment compensation claims*
 - *Workers' compensation claims*
 - *Any other claims that cannot be released as a matter of law*
 - Consider whether partial or structured payment may be warranted, particularly where the dismissal is not entirely within the control of the individual
 - Certain agencies may not automatically grant an individual's request to dismiss or withdraw a charge or claim

Provisions Typical of Release Agreements

- Waiver and Release of Claims
 - Consider whether the waiver should identify specific statutory or common law claims rather than a general waiver, keeping in mind the most common claims brought by current and former employees:
 - *Discrimination*
 - *Retaliation*
 - *Wage and hour claims*
 - *Breach of contract*
 - *Common law claims*
 - Cannot waive the right to cooperate with government agencies in their investigations, but can waive right to recovery through such actions
 - Cannot waive the right to challenge the release under the OWBPA and cannot waive certain claims as a matter of law (to be addressed later)

Provisions Typical of Release Agreements

- Restrictive Covenants:
 - Covenants not to compete
 - Non-solicitation of customers or clients
 - Non-solicitation of employees, vendors, etc.
 - Confidentiality
- Check state law to determine whether restrictive covenants are enforceable under the circumstances
 - Consideration to support covenants
 - Geographic and temporal scope are reasonable
 - Protectable interest exists
 - Equitable considerations

Provisions Typical of Release Agreements

- Non-Disparagement, Cooperation, References, and Recommendations (“play nice” provisions)
 - Non-disparagement provision is significant given the ease with which one can disparage another through social media and online activities
 - Non-disparagement provisions typically are one-sided or limited as employers cannot monitor their employees’ activities
 - Cooperation provisions should be catered to the individual, including whether out-of-pocket costs will be covered, whether time will be compensated, limitations on type of activity, etc.
 - References and/or recommendations should be carefully controlled to ensure compliance with provision

Provisions Typical of Release Agreements

- Choice of Law and Choice of Venue
 - Both provisions are important for enforcement and in the event a dispute arises under the release
 - Ensure the parties (and in some cases the conflict at issue) have a sufficient nexus to the venue selected by the parties
 - Law varies from state to state on whether a court will honor a choice of law and/or choice of venue provision
 - Determine how specific the choice of venue provision should be

Provisions Typical of Release Agreements

- Arbitration Provision
 - In determining whether an arbitration provision should be included, consider:
 - *Confidentiality*
 - *Cost*
 - *Finality*
 - *Speed of process*
 - Arbitration is not always cheaper, faster, and more predictable than litigation
 - Carve out equitable proceedings to enforce restrictive covenants
 - Take into account recent Supreme Court decisions, NLRB decisions, and state law decisions in determining enforceability

Provisions Typical of Release Agreements

- Return of Company Property
 - Provision should require that all company property be returned, including confidential, proprietary information in hard or electronic form (including all copies)
 - Examples of property should be specific to the employer:
 - *Laptops, flash drives, external drives, disks, security devices, etc.*
 - *Handheld devices and cell phones*
 - *Key cards*
 - *Clothing*
 - *Equipment*
 - *Samples*

Provisions Typical of Release Agreements

- Offset of Severance Pay by Amounts Owed to the Company
 - Typical examples include:
 - *Shortages*
 - *Tuition or education reimbursement*
 - *Relocation expenses*
 - *Employee loans*
 - Offsets relating to deferred compensation may result in adverse taxation under Section 409A of the Internal Revenue Code

Provisions Typical of Release Agreements

- Acknowledgments, Non-Admission, and Non-Admissibility
 - Individuals can acknowledge:
 - *All compensation/wages have been paid (including accrued vacation, expense reimbursement, etc.)*
 - *No pending claims*
 - *Provided all leave under the FMLA and other leave laws*
 - *No claims assigned to third parties*
 - *Ongoing contractual obligations (e.g., existing confidentiality agreement, restrictive covenants, etc.)*
 - Employers generally will deny any liability or wrongdoing
 - All parties agree that the release, or the fact of its presentation by a party, is not admissible in any proceeding to demonstrate liability or as an admission of liability

Provisions Typical of Release Agreements

- Confidentiality of the Release
 - The release typically should provide that its terms are confidential and not to be disclosed to third parties, with limited exceptions:
 - *Employees: attorneys, accountants, immediate family members*
 - *Employers: attorneys, accountants, consultants, executives, and others within the organization with a need to know*
 - Consider whether to limit confidentiality to certain provisions of the release
 - Consider including a liquidated damages provision in the event of breach, but enforceability may be questionable
 - Consider including examples of types of communications that are forbidden (discussions on social media sites, blogs, chat rooms, etc.)

Provisions Typical of Release Agreements

- Miscellaneous
 - Successors and assigns provision
 - *Include such a provision for enforceability in the event of a merger, acquisition, etc.*
 - Notice provision
 - *Identify the individuals/positions to receive notice pursuant to the release*
 - Survival and “blue pencil” provisions
 - *To protect enforceability in the event one or more provisions are deemed unenforceable*
 - *Blue pencil provision recognizes that a court may modify a restrictive covenant if deemed overly broad*
 - State-specific provisions
 - *E.g., California Civil Code Section 1542*
 - Integration provision
 - *Memorializes the fact that the agreement is a stand-alone agreement*

Employee Benefits/Tax Concerns Agenda

- How does Section 409A affect severance benefits?
- Postemployment benefits

Code Section 409A

- “Deferred compensation” arises where an employee has a legally binding right in one year to receive compensation in a later year
- Severance compensation to be paid under a severance plan or severance agreement (which can include employment agreements, change in control agreements, offer letters, etc.) is generally considered deferred compensation, unless an exception exists

Code Section 409A

- If severance compensation is considered deferred compensation, and no exception applies:
 - Severance pay can be subject to the 409A six-month delay for key employees
 - The agreement must specify the payment date for severance pay
 - Reimbursements for certain benefit coverage, taxes, and other amounts must meet the Section 409A timing requirements

Code Section 409A

- If the Section 409A rules are not met:
 - Deferred compensation is included in income when no longer subject to a substantial risk of forfeiture
 - Penalty tax to executive of 20% of amount included in income
 - Interest is assessed on the tax underpayments (at underpayment rate plus 1%)

Separation from Service

- Distribution trigger for Section 409A deferred compensation
- Impacts when six-month delay period starts
- Can be difficult to determine when separation from service occurs if separation is not complete

Separation from Service

- The Section 409A regulations define when there has been a separation from service. General rule:
 - A separation from service occurs when the level of services is reduced to a level expected to be no more than 20% of the level of services provided during the preceding 36-month period
 - Service as a consultant/independent contractor after termination of employment is considered continued service for purposes of Section 409A

Six-Month Delay for Specified Employees

- If a “key employee” of a public company receives deferred compensation upon separation from service, there must be a six-month payment delay
- A “key employee” of a public company is:
 - An officer having annual compensation greater than \$165,000 for 2012 and 2013 (up to 50 employees)
 - An employee who is a 5% owner
 - An employee who is a 1% owner and has annual compensation greater than \$150,000

Flexibility in Structuring Severance Pay

- If no existing severance agreement is in effect at the time of termination, the parties can structure severance pay to be paid on specified payment dates without a six-month delay
 - The severance payments cannot be a replacement for forfeited deferred compensation

Exceptions to Section 409A Deferred Compensation

- Short-term deferral exception
- Separation pay exception
- Expense reimbursement within a limited period of time after separation from service
- *De minimis* amounts up to \$17,500 (indexed to the Section 402(g) limit)

Short-Term Deferral Exception

- Payments made within a short period after vesting
 - Payments made within 2½ months after the end of the year in which the severance pay vests (no substantial risk of forfeiture)
 - For example, March 15 after year of involuntary termination of employment
- Where more than one payment is made under the agreement, the agreement generally should provide that each payment is treated as a separate payment for purposes of Section 409A

Separation Pay Exception

- Severance payments:
 - On account of involuntary termination of employment
 - 2X pay, capped at 2X the Section 401(a)(17) limit (\$260,000 for 2014, or \$520,000)
 - Paid within two years from year of separation

Involuntary Termination

- In the severance pay context, both the short-term deferral exception and the severance pay exception require involuntary termination of employment
- “Good reason” termination may constitute involuntary termination
 - Must require actions taken by the employer that result in a material negative change in employment relationship
 - Notice and cure period

Involuntary Termination

- An agreement generally will not meet the severance pay exception or short-term deferral exception if severance pay can be paid for other reasons, even if the termination is actually an involuntary termination
 - The existence of a “walk right” provision may cause the entire severance agreement to be subject to Section 409A
- Plans that provide payment upon an involuntary termination are aggregated for purposes of the Section 409A rules
 - This means that all severance arrangements for an employee must be analyzed together for purposes of Section 409A

Postemployment Benefits and Reimbursements

- Exclusions from Section 409A:
 - Reimbursements of COBRA premiums may be made for COBRA period
 - Certain outplacement benefits
 - Moving expenses and loss on sale of primary residence
 - Nontaxable benefits
- Any reimbursements and tax gross-ups need to be paid within an allowable period under Section 409A

Payments Contingent on a Release

- If payments are subject to Section 409A, the payment date must be specified and the employee must not be able to designate, directly or indirectly, the calendar year of payment
- Issue arises if agreement provides that payment will not be made until an employee signs and does not revoke a release of claims
- IRS Notice 2010-6 takes the position that the following language violates Section 409A:
 - Payment shall be made within 60 days following separation from service, subject to the employee signing a release, and not earlier than expiration of the revocation period for the release

Payments Contingent on a Release

- Solution:
 - Specify a fixed payment date (e.g., the 60th day following the termination date), or
 - Specify that where release delivery and nonrevocation period span two years, payment will commence in the second year

Postemployment Benefits and Reimbursements

- Continued participation by a former executive in the active employees' health plan at active rates creates discrimination issues for a self-insured health plan under Section 105(h)
 - If employer reimburses the COBRA premiums in a taxable payment, employer should be able to avoid application of Section 105(h)
- Affordable Care Act (ACA) regulations (not yet issued) will impose discrimination requirements on insured health plans

Postemployment Benefits and Reimbursements

- Timing issues where employer provides subsidized COBRA for a period after termination of employment and former employee wants to purchase insurance coverage through an ACA exchange (Exchange Coverage) at the end of the COBRA subsidy period.
- An election for Exchange Coverage can be made (i) within 60 days of the loss of employer coverage or (ii) if COBRA coverage is in effect, within 60 days after COBRA coverage is no longer in effect for reasons other than non-payment of premiums.

Postemployment Benefits and Reimbursements

- An employee who does not elect Exchange Coverage within 60 days of the loss of employer coverage because he has subsidized COBRA coverage may find himself having to pay for COBRA coverage from the end of the subsidy period until the next open window for Exchange Coverage.

Postemployment Benefits and Reimbursements

- Example: Assume that a severance plan provides subsidized COBRA coverage for six months post-employment, and an employee's employment is terminated in October 2014. For Exchange Coverage starting in 2015, it is anticipated that the proposed open enrollment window will be November 15, 2014–February 15, 2015.
 - The former employee will not be able to elect Exchange Coverage at the end of the six-month subsidized COBRA period (April 2015) and, instead, will have to wait for the next annual enrollment window, or the date on which his COBRA coverage ends, to elect Exchange Coverage.
 - The employee could drop subsidized COBRA coverage early and elect Exchange Coverage during the open window for 2015 Exchange Coverage, but he would need to understand the interplay between the Exchange Coverage rules and COBRA rules to know to do that.

Postemployment Benefits and Reimbursements

- Employers may want to review their treatment of post-termination continuation coverage, think about how it could affect eligibility to enroll in Exchange Coverage, and review communications to help terminating employees understand these rules.
- Employers may also consider providing a lump-sum payment or monthly payments to terminating employees as part of the severance package, instead of subsidizing or reimbursing COBRA coverage.
 - Before changing the form of payment in an existing arrangement, the implications under Section 409A should be considered.

Coordination of Severance Agreement with Other Benefit Plans

- Health plan
 - If benefits continue past COBRA period, make sure the insurance policy or stop loss coverage covers the former employee
- Life and disability insurance
 - Group LTD coverage usually cannot continue after termination of employment
 - Group life insurance usually cannot continue after termination without special arrangements with insurer
 - Providing cash in lieu of continued coverage is preferable for employer

Coordination of Severance Agreement with Other Benefit Plans

- Section 401(k) plan
 - Coverage ends at termination date
 - Salary deferral contributions cannot be made from severance pay paid after termination of employment
- Nonqualified deferred compensation plans
 - Six-month delay for key employees of a public company under Section 409A

Coordination of Severance Agreement with Other Benefit Plans

- Equity plan
 - Vested stock options can usually be exercised for a limited period of time after termination of employment
 - Check terms of restricted stock, restricted stock units, and performance share units
- Separation from service rules for health, Section 401(k), and equity plans are usually different from the Section 409A separation from service rules

Miscellaneous Employment Concerns

- Age Discrimination in Employment Act (ADEA), as amended by the Older Worker Benefit Protection Act (OWBPA)
 - Requires the inclusion of certain provisions to waive age-discrimination claims to validly waive an age claim
 - The failure to include each provision can be fatal to the release
 - *Knowing and voluntary waiver:*
 - Written in a manner calculated to be understood by the individual
 - References rights under ADEA
 - Waiver excludes claims arising after the date of execution
 - Waive rights or claims only exchange for consideration in addition to that to which the individual is entitled
 - Individual is advised to consult with an attorney before execution
 - 21 days to consider; 7 days to revoke

Miscellaneous Employment Concerns

- Age Discrimination in Employment Act (ADEA), as amended by the Older Worker Benefit Protection Act (OWBPA)
 - If the waiver is in connection with an exit incentive or other employment termination program, then:
 - *45 days to consider; 7 days to revoke; and*
 - *Must include a group data report that identifies:*
 - Class, unit, or group of individuals covered by such program
 - Eligibility factors for such program
 - Time limits applicable to such program
 - Job titles and ages of all individuals eligible or selected for the program
 - Ages of all individuals in same job classification or organizational unit not eligible or selected for the program

Miscellaneous Employment Concerns

- Claims That Cannot Be Waived as a Matter of Law:
 - State unemployment compensation claims
 - State workers' compensation claims
 - Certain whistleblower claims
 - Claims for vested benefits under ERISA
 - Wage and hour claims (e.g., FLSA)
 - FMLA claims
 - NLRA claims

Miscellaneous Employment Concerns

– Improper Drafting Can Lead to Potential Litigation, Including:

- *Breach of Contract Claims*
- *Failure to Comply with the ADEA/OWBPA*
- *Retaliation – EEOC’s Perspective*
- *Interference with Rights Under the EEOC or NLRA*
- *Failure to Obtain Court or Government Approval*
 - FLSA, state wage and hour claims
 - Workers’ compensation

Miscellaneous Employment Concerns

- EEOC is Targeting Release Agreements That May “Chill” the Exercise of Protected Activity
 - *EEOC v. CVS (N.D. Ill. 2014)*
 - *EEOC is challenging employer’s use of release agreements that condition the payment of severance benefits on the waiver of certain protected rights, including:*
 - The ability to bring a charge before the EEOC
 - The ability to cooperate with an EEOC investigation
 - The ability to communicate with the EEOC
 - The EEOC’s position is troubling, because the release being challenged is similar to releases used by many employers.
 - Employers should ensure they have appropriate language in their releases that clearly preserves the individual’s right to engage in protected activity.



Questions?

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