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Say Hello to Smart Goodbyes

Best severance practices help morale and reduce legal risks.

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As the economic sky takes on a less comforting hue, the anxious thoughts of employers everywhere naturally turn to finding the right talent and the right-sized work force to weather the oncoming storm.

Federal and state laws can provide certain baseline requirements for mass layoffs and plant closings, but often employers go further to establish plans or programs—or to enter into individual agreements—promising severance payments to those who depart. A recent survey of U.S. companies shows that four out of five have established severance practices.

These employers typically do so with the best intentions, but they often incur unnecessary costs and risks of litigation—often because of little-understood aspects of the Employee Retirement Income Security Act of 1974, which governs employee benefit plans, including severance benefits. These costs and risks are largely self-inflicted; with careful planning, they can be avoided or minimized.

Smart Severance

Smart severance is worthy of employer attention because the success of most businesses depends on retaining the right talent. Poor severance practices can give the best employees the incentive to be the first out the door, especially when an economic downturn affects their employer.

It is human nature for employees to feel insecure when the media are filled with tales of low profits, layoffs, takeovers, and reductions in force. In this anxiety-riddled environment, employees who have well-understood severance protections are likely to be less anxious, more focused on the business at hand, and more likely to ride out the volatility. On the other hand, employees who sense job risk and have only uncertain (or no) severance protections are more likely to have a wandering eye. If retaining the best talent is a tool for survival in uncertain times, poor severance practices can be a threat.

A best practice is the following:

First, provide your best talent with specific, easily understood severance protections. Ad hoc, unwritten practices or customs do not suffice. Consider a severance plan (or plans) or a series of individually designed agreements. In all cases, terms can be customized to the need. For example, if a takeover is the primary employee concern, a change-in-control protective plan may suffice.

Second, consider announcing a severance plan or policy that promises minimum severance protections to all staff. The cost is easy to quantify, and the employer may—and should!—reserve discretion to change eligibility and benefits any time, prospectively.

The Power of ERISA

A make-it-up-as-we-go severance practice is a bad practice. Informal, inconsistent practices spawn avoidable litigation risks. They produce workplace lore of the worst kind ("I hear John got three years!") that can corrode employee morale, increase uncertainty, and cause problems in any subsequent litigation.

Just because an employer's practices are unwritten and informal does not mean that they are unenforceable; they can often create a legal obligation. The result could be an ERISA-covered plan without many of the employer protections that a carefully crafted plan can provide.

An informal practice that results in something that a court deems to be an ERISA plan exposes an employer to expensive but uncertain liabilities under ERISA. Employees can claim benefits at levels based on past employer practices (albeit random ones), as well as win attorney fees and costs. The employer can be liable for penalties for failing to report an ERISA plan it did not know it had. In such circumstances, ERISA becomes a sword for employees, when a proper plan would have enabled the employers to use ERISA as a time-tested shield.

The solution is to consider providing severance benefits through a formal ERISA severance plan, with carefully documented administration.

ERISA generally applies to severance plans, programs, and practices that essentially involve an ongoing administra-

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tive scheme. By contrast, the Supreme Court has pointed out in *Fort Halifax Packing Co. v. Coyne* (1987) that "one-time, lump sum payment triggered by a single event requires no administrative scheme."

For employers, then, the design of their severance plans carries with it the potential to structure them to fall within ERISA or outside it. After a comprehensive analysis of applicable ERISA cases, the seminal treatise on this subject concludes that "when ERISA coverage is potentially available, employers ought generally to embrace it."

Here are some of the different areas that illustrate why a written ERISA plan is typically more desirable than informal non-ERISA practices:

• *Employer's right to reduce benefits:* Under a written ERISA plan, benefits are easy to modify if the plan contains an express provision authorizing this. Under an informal practice, this is uncertain because of the absence of written reservation of this authority.

• *Disclosure to employees*: A written ERISA plan requires disclosure of material plan terms, which cannot only avoid misunderstandings but in the process help to retain employees. An informal practice does not (unless the practice is deemed an ERISA plan), in which case the employer may face undesired employee anxiety, lost productivity, and turnover.

• *Exposure to claims:* In an ERISA plan, exposure is limited to the terms and conditions of the plan, and only after exhaustion of plan remedies. Under an informal practice, exposure can be based on past practice and be open-ended under state tort law.

• *Applicable law:* ERISA plans are governed by ERISA; informal practices may be subject to dispute about whether state law or ERISA controls.

• *Judicial standard:* Under ERISA, the employee must normally show the employer acted arbitrarily or capriciously to establish liability. Without ERISA, the review is *de novo*, which is more favorable to the employee.

• *Decision-makers*: Federal judges handle ERISA cases, based on a wealth of generally predictable ERISA case law. The alternative can be a state court jury, which tends to favor employees, with applicable law varying from state to state.

DOWNSIZING WITH FORETHOUGHT

ERISA is not, of course, a panacea for all downsizings or severance practices. It is merely a vehicle for mitigating some benefits-related litigation risks.

In an economic downturn, a broader source for litigation risks comes from the process that an employer follows to effectuate reductions in force. Although business exigencies often force employers to move with a frenetic pace in a RIF, rushed decisions tend to exacerbate risks of employment-related claims, while well-organized programs tend to defuse risks. Consequently, an ad hoc ill-conceived downsizing should be avoided.

An employer who wants or needs to downsize its work force must first decide whether to start with a voluntary early retirement program, resorting to a second-step involuntary reduction-in-force if needed, or whether to start with an involuntary RIF.

Beginning with an involuntary RIF obviously permits the employer to reach its desired employee complement more quickly, but it increases significantly the number of individuals who may sue.

In contrast, offering a voluntary early retirement program may reduce the number of potential plaintiffs. Moreover, because voluntary exit programs (such as an early retirement program) typically involve enhanced severance benefits conditioned on the broadest possible release of employee claims, employers may target eligibility for a voluntary plan to select employee populations (such as older workers). Finally, an employer can structure the voluntary program in a way to reject an application to retire from the most talented eligible employees, ensuring that the program does not result in a brain drain.

The best employer practice should include the following steps: Begin any downsizing effort by carefully considering all objectives, alternatives, and constraints. Carefully plan the shape, eligibility rules, and implementation of the program, and ensure that accountability for an effective and well-received program rests with capable professionals. Consider starting with a voluntary RIF when time permits, and ensure that the program's incentives are calibrated to ensure success. In designing any RIF, be careful to have an eye for more than cash severance, paying significant attention to outplacement and post-employment alternatives to employee benefits such as health plans, retirement, loans, and stock awards.

In sum, an economic downturn places a premium on thoughtful programs by which employers address employee concerns about severance practices. The stakes get even higher, in terms of liability risks, when employers wrestle with reducing their work force.

As a general matter, the best employers will proceed with forethought that both secures the best talent and right-sizes a work force in the most effective and humane way possible.

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