

Should employers who maintain an ongoing practice of paying workers severance benefits implement a formal written ERISA plan to govern the award of severance?

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Following the Federal Reserve’s interest rate increases and the resulting volatility in the stock markets, economists and government officials continue to debate whether the country will experience a hard or soft landing, or no landing at all. While some sectors of the economy remain strong, others have begun to see layoffs. In the face of this uncertainty, employers facing the prospect of downsizing would be wise to take steps now to minimize the financial risks from litigation by workers who suffer loss of employment.

Employers planning reductions-in-force frequently seek to reduce their exposure to employment litigation by offering affected workers severance benefits in exchange for waivers of their employment litigation claims. While some businesses maintain formal policies governing their severance pay practices, others choose to provide discretionary severance benefits on a case-by-case basis. Employers in this latter group often are surprised to learn that offering workers severance pay on an ad hoc basis can itself lead to claims for additional severance benefits. Employees frequently have argued in litigation that an employer’s informal severance practice actually created a welfare benefit plan under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq. (“ERISA”).

In this article we discuss the legal standards courts apply in deciding whether an employer’s past practice of providing severance pay establishes an ERISA plan, and we offer practical suggestions for employers considering layoffs to mitigate the risk of unexpected liability for severance.

Background

Congress enacted ERISA in 1974 to set the standard for most retirement and welfare benefit plans established by private employers. *Id.* at § 1002(3). By enacting ERISA Congress sought to protect the interests of participants and their beneficiaries in

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receiving promised benefits. For this reason, ERISA empowers a participant or beneficiary of an employee benefit plan to bring a civil action to recover benefits due. 29 U.S.C. § 1132.

ERISA defines an employee welfare benefit plan as (1) any plan, fund, or program, (2) established or maintained (3) by an employer or by an employee organization, or by both, (4) for one of the purposes enumerated, (5) for participants or their beneficiaries. 29 U.S.C. § 1002(1). Factors (2) through (5) generally can be satisfied with respect to an ongoing informal severance pay practice. Courts, however, have struggled in determining whether Congress intended the words “plan, fund or program” to include an ongoing, informal severance pay practice.

In *Donovan v. Dillingham*, 688 F.2d 1367, 1372-73 (11th Cir. 1982) the Eleventh Circuit held that an employer established an ERISA plan if a reasonable person would be able to ascertain (1) the intended benefits, (2) the intended beneficiaries, (3) the source of financing and (4) the procedures for receiving benefits. In the years immediately after *Donovan*, the Supreme Court decided two cases that clarified the situations where employers established ERISA plans by making certain types of payments to employees upon termination of employment. In *Massachusetts v. Morash*, 490 U.S. 107, 119, (1989) the Supreme Court acknowledged that states traditionally regulated payment of wages, and therefore held that the vacation pay practice in that case did not fall within the scope of ERISA. In *Ft. Halifax Packing Co. v. Coyne*, 482 U.S. 1, 12 (1987) the Supreme Court held that a severance payment made as a “one-time, lump-sum” did not create the need for an administrative operation and thus did not constitute an ERISA plan. Following *Morash* and *Ft. Halifax*, courts nevertheless have continued to cite to *Donovan* in analyzing whether an informal practice to offer severance pay constituted an ERISA plan. See, e.g., *Grimo v. Blue Cross/Blue Shield*, 34 F.3d 148, 151 (2d Cir. 1994) (applying *Donovan*); *Baldo v. Zippo Mfg. Co.*, 48 Fed. Appx. 10, *11 (2d Cir. Oct. 4, 2002) (same).

Administrative Scheme

Courts in the Second Circuit have moved away from a strict application of the *Donovan* factors, focusing more on the frequency and “past practice” of making severance payments and the existence of an ongoing administrative scheme. In *Okun v. Montefiore Med. Ctr.*, 793 F.3d 277, 279 (2d Cir. 2015) the Second Circuit identified the following considerations to help courts determine whether there is an ongoing administrative scheme:

1. whether there is managerial discretion in the plan administration;
2. whether a reasonable employee would perceive an ongoing commitment by the employer to provide benefits; and
3. whether the employer was required to analyze the circumstances of each employee's termination separately.

In *Wimberly v. Automotivemastermind Inc.*, 2021 U.S. Dist. LEXIS 12344, 2021 WL 230299, at *7-8 (S.D.N.Y. Jan. 22, 2021), the U.S. District Court for the Southern District

of New York applied these factors to find that an offer of a lump sum amount to one employee as severance pay *did not* establish an ERISA plan. *Wimberly* arose out of the discharge of an employee who billed expenses to other persons' rooms while attending a sales conference for his employer Automotivemastermind Inc. ("aM"). When confronted about the hotel charges, the plaintiff refused to sign his warning and commenced a petition for pre-action discovery ("Petition") to discover the identity of his accusers and clear his name.

Shortly after plaintiff filed his Petition, aM terminated his employment. aM offered the employee six weeks of severance pay in exchange for dismissal of his Petition and his execution of a waiver and release of claims. The plaintiff refused, and instead claimed aM owed him severance under a "plan" which aM denied.

The *Wimberly* plaintiff asserted that aM had a plan within the meaning of ERISA because two former aM employees allegedly received offers of severance upon termination of their employment. Unpersuaded the *Wimberly* court reasoned that this fact alone does not establish an ongoing administrative program because aM's offers of severance, to the plaintiff and the two other employees were based on a simple arithmetical calculation, obviating any need for managerial discretion or ongoing administrative efforts.

Then relying on *Ft. Halifax*, the *Wimberly* court found that there was no ongoing commitment to provide benefits considering the one-time nature of the severance offer. Moreover, the complaint allegations supported that aM and its managers made an ad hoc determination that a severance payment in exchange for the release of all claims would facilitate a speedy dissolution of their relationship with the plaintiff and his pending Petition.

Employment Agreements

In contrast with *Wimberly*, other courts have held that arrangements affecting only one employee may establish an ERISA plan. For example, in *Thomas v. Command Alkon Inc.*, 2023 U.S. Dist. LEXIS 89149, *9 (E.D. Pa. May 22, 2023) the court found that an employment agreement providing severance if the employee resigned for good reason was an employee benefit plan with an administrative scheme subject to ERISA.

In *Thompson*, the employee worked with Libra Systems, Inc. which was purchased by Command Alkon in November 2020. During the sale negotiations, Libra's owners insisted that Command Alkon enter into an employment agreement with Thompson for a fixed period. Command Alkon agreed to that offer. The employment agreement also provided Thompson severance pay if her employment ended prior to the fixed period for good reason.

Before the end of the fixed period, Thompson asserted that she had good reason to terminate her employment. Thompson sought severance pay, but the employment agreement provided for severance pay only if she executed a waiver and release of claims. Thompson did not execute a waiver and release, but still claimed entitlement to

severance in the amount of \$467,424.62.

The *Thompson* court reasoned that there was an administrative scheme, because Thompson's eligibility to collect severance pay was set forth in the employment agreement, which turned on whether she resigned with good reason, and Command Alkon exercised managerial discretion in categorizing the circumstances of the termination of the employment agreement. Although the employment agreement applied only to Thompson, the court cited various cases in sister circuits which support the proposition that contracts with one employee can constitute an ERISA plan, provided that an "administrative scheme" is established.

Tips to Avoid Liability

Employers should consider whether their past practices for paying severance inadvertently has crossed the legal threshold for the creation of an ERISA plan. If the past practice has established an ERISA plan, employers may have unwittingly subjected themselves to ERISA's reporting and disclosure obligations which come with penalties for non-compliance. For example, ERISA requires that the plan be in writing, 29 U.S.C. § 1102(a)(1), that participants be given summary plan descriptions, *Id.*, § 1024(b)(1); 29 C.F.R. §§ 2520.102-2, 25.20.102-3, that a claims procedure be established, 29 U.S.C. § 1133(1); 29 C.F.R. § 2560.503-1(b), that a plan administrator make certain documents available for examination by plan participants and beneficiaries, 29 U.S.C. § 1024(a)(1); 29 C.F.R. § 2520.104(b)(1), and that the administrator file a Form 5500 with the U.S. Department of Labor. *Id.*; see also 29 C.F.R. § 2520.103-1. An employer's failure to file a Form 5500 may result in a civil penalty of up to \$1,000 per day from the date of noncompliance. 29 U.S.C. § 1132(c)(1). If a violation of ERISA's reporting and disclosure requirements is deemed willful, the employer may be subject to criminal liability, including a fine of not more than \$5,000 for an individual or \$100,000 for non-individuals and up to one-year imprisonment. *Id.* at § 1132(c)(2); see also 29 U.S.C. § 1131.

An employer with an ongoing practice of paying severance to terminated workers and which thereby risks subjecting itself to ERISA should consider implementing a written plan and otherwise complying with ERISA's requirements. First and foremost, such an employer demonstrates its adherence to and respect for the law. Further, such an employer avoids the risk of incurring penalties and costly enforcement actions by the U.S. Department of Labor which enforces ERISA's requirements. Similarly, by having a written plan an employer may improve its employee relations by awarding of benefits to workers who experience loss of employment.

An employer with a written plan also may control the circumstances when severance will be paid through careful drafting. For example, employers can preclude an award of severance pay if the employer terminates employment upon a sale of the business or upon outsourcing a business unit, where the buyer or a contractor offers comparable employment to the worker following termination. An employer may preclude or reduce an award of severance where the employer provides its workers pay in lieu of notice under the WARN Act or similar state laws. An employer also can preclude the employees with individual employment agreements from "double dipping" so that they do not receive

severance both under the plan and under their individual agreements. A plan may preclude severance pay for employees terminated “for cause” or who voluntarily resign. Finally, a plan may require as a condition to an award of severance that the employee first sign a release of all claims against the employer.

Armed with a written plan, employers also benefit from ERISA’s preemption of state law. Thus, employers can avoid claims for liquidated damages under state wage payment statutes, or for punitive damages under the common law. ERISA also allows employers to draft clauses according to their broad discretion in interpreting their plans, and courts have upheld such clauses absent interpretations deemed arbitrary and capricious.

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