A. Introduction

Payment of large severance packages and retention bonuses by public companies in recent years has fueled popular resentment and spurred several legislative and regulatory changes to curb perceived abuses. Executive compensation proxy disclosure rules promulgated by the SEC in 2006 are beginning to have an effect on severance pay practices for executive officers as emerging practices for public companies are tending toward lower severance pay multiples.¹

Further changes to severance pay and retention bonus practices are likely as companies adjust to more exacting executive compensation disclosure requirements. It is becoming increasingly important for

¹Severance pay is usually expressed as a number of weeks of base salary for most rank and file employees or a number of months or even years of base salary (and, in some cases, base salary plus annual bonus) for officers and other executives. While two- to three-year severance packages for CEOs and other top executives are still relatively common, the emerging trend over the past several years has been toward significantly lower multiples.
employers to formulate cogent, rational policies regarding severance pay and retention bonuses and effectively articulate the rationale for providing these benefits.

This article examines various considerations that employers should take into account in designing appropriate severance and retention pay policies.

B. Reasons For Offering Severance Benefits And Retention Bonuses

There are numerous reasons for offering severance benefits and retention bonuses. While some of the underlying reasons for granting severance benefits and retention bonuses are similar, there are also some fundamental differences between the two.

1. Severance Benefits. Severance benefits are payable upon an employer’s termination of an employee’s employment or, in some cases, an employee’s voluntary resignation for “good reason.” These benefits are usually paid pursuant to the terms of an employment agreement, hiring letter, or a written severance plan or policy agreed to or implemented prior to the employee’s termination. It is not uncommon, however, for severance benefits to be paid to a departing employee on an ad hoc basis negotiated at the termination of employment. The most commonly cited reasons given for offering severance benefits include:

   a. Attracting Key Personnel. Ironically, one of the most frequently cited reasons for offering severance benefits is to attract key personnel. A severance package offered in connection with hiring a new executive can help demonstrate an employer’s confidence in the new executive and its commitment to the executive’s success with the company, while providing the executive with a safety net in case the relationship does not work out.

   b. Avoiding Litigation. Avoiding litigation is another commonly cited reason for providing severance benefits. In addition to direct litigation costs, litigation can be disruptive to an employer’s operations and demoralizing for its work force. By conditioning the payment of severance benefits on a departing employee’s execution of a well-designed waiver and release of employment-related claims, an employer can generally avoid most employment-related litigation. See below for a discussion on waivers and releases.

   c. Providing Compassionate Job Transition. Many companies provide severance benefits under broad-based severance arrangements to treat terminated employees with dignity and compassion. Such policies are not purely altruistic. Companies often provide broad-based severance benefits as part of an effort to cultivate the perception of providing a caring and respectful work environment that can significantly enhance a company’s employee recruitment efforts. Non-cash severance benefits, such as employer-paid COBRA benefits and outplacement services, often do more to enhance an employer’s standing as an employer of choice than cash severance.

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2 A “good reason” termination is a form of contractual constructive discharge in which the severance plan or employment agreement provides that an employee will be entitled to receive severance benefits if he or she quits due to an adverse change in the terms and conditions of employment, such as a demotion, reduction in salary, bonus opportunity or benefits, transfer of employment to a new location, or similar adverse change described in the severance plan or employment agreement. Typically only executive officers and other senior executives will be entitled to receive severance benefits upon a good reason termination.
2. **Retention Bonuses.** The primary purpose of retention bonuses is to encourage select employees with critical skills or knowledge to remain with the company when other retention incentives fail. Retention bonuses are frequently used in the following circumstances:

a. **Break Down Of Long-Term Incentive Compensation.** Long-term incentive arrangements are often used as a retention incentive as well as a mechanism for rewarding performance. Most long-term incentive arrangements condition payout on an employee’s continued employment with the company throughout the performance measurement period providing a retention incentive. Such long-term incentive arrangements often provide for partial payment in the event of termination of employment during the performance period due to death, disability, or termination by the employer without cause. In addition, such arrangements may also provide for an accelerated payout in the event of change of control. The prospect of forfeiting a potentially substantial long-term incentive payout creates a disincentive for an employee to leave. That disincentive disappears, however, if the employee believes that performance is likely to fall short of the minimum performance necessary to generate a long-term incentive payout or the payout is expected to be relatively small. Under these circumstances, a retention bonus may provide key employees with an incentive to remain with the employer.

b. **Underwater Stock Options.** Stock options also provide a retention incentive under normal conditions. Stock options typically require an employee to remain in continuous employment for several years before the option becomes fully exercisable. The employee will usually forfeit his or her unvested options at termination of employment. Moreover, vested stock options will usually remain exercisable for only a short period of time (typically 90 days) following an employee’s termination of employment. Forfeiture of unvested options coupled with an accelerated expiration of vested options creates a significant disincentive for employees to terminate their employment. Stock options will lose their retention incentive, however, if an employee ceases to value the stock options due to a substantial drop in the stock price below an exercise price for the stock option. If the employer is not able to restore the retention incentive of the stock options through new option grants or a repricing of outstanding options, a retention bonus may be appropriate to encourage the employee to remain with the company.

c. **Change Of Control Or Sale Or Disposition Of Company Or Business Unit.** An employer may be at substantial risk of losing key personnel due to personal insecurity arising from uncertainty in connection with a change of control of the employer or its sale or other disposition of a business unit. Employees critical to the operations of the employer or business unit may be tempted to start looking for other employment opportunities rather than face the prospect of working for new owners or a new management team. Retention bonuses are used in these situations to encourage employees who are critical to operations of the employer (or business unit) during this period of transition to remain with the company and keep them focused on enhancing the value of the business. Depending on when the retention period ends, it may also provide the purchaser with sufficient time to evaluate personnel and an opportunity to negotiate new employment terms with the employees it wants to retain.
d. *Plant Or Office Closing.* Retention bonuses are also often used in connection with the closing of a plant, office, or division to retain the personnel needed to effect an orderly winding down of operations.

C. **ERISA Coverage**

Severance and retention arrangements are offered in a wide array of forms including: unwritten, informal policies; term sheets and written agreements covering individual employees; and more formal written plans or programs covering multiple employees (ranging from a few officers to thousands of rank and file employees). In structuring these arrangements, employers should consider whether ERISA applies to the benefits being offered and how the structure of the arrangement may affect that determination.

1. **Advantages of ERISA Coverage.** On balance, there are certain advantages to having ERISA apply to these arrangements, including:
   a. Preemption of state law (including causes of action based on failure to pay wages, fraud, and so forth);
   b. Access to federal courts;
   c. ERISA claims administration, which requires exhaustion of administrative claims before an employee can file a lawsuit;
   d. No right to punitive or extracontractual damages; and
   e. Arbitrary and capricious standard of review by the courts. Although a court would review benefit denials under an arbitrary and capricious standard of review, the courts are required to take into account any conflict of interest that arises when an employer acts as the plan administrator and the payor of the benefit claims. *Metropolitan Life Ins. Co. v. Glenn*, 128 S.Ct. 2343 (2008).

2. **Disadvantages Of ERISA Coverage**
   a. An ERISA plan must comply with ERISA’s reporting (Form 5500) and disclosure (summary plan description) requirements. Compliance with these requirements should not be difficult. ERISA imposes minimal Form 5500 reporting requirements for unfunded severance plans. Many employers combine the formal plan document and the summary plan description into a single document that they provide to eligible employees.
   b. An ERISA plan must establish a formal claims procedure and provide employees with an opportunity to request a meaningful review of any benefit denial.
   c. An employee may be awarded attorneys’ fees in a suit for benefits.

3. **Determining Whether ERISA Applies.** In determining whether ERISA applies, two questions must be answered: (1) whether the benefits offered constitute either “welfare” or “pension” benefits and (2) whether the benefits are provided under a “plan, fund, or program.”

   a. **Welfare Or Pension Benefits**
      
      i. **Severance Benefits.** Depending on the terms of the arrangement, severance benefits may qualify either as pension benefits or welfare benefits. Section 3(2)(A) of ERISA defines the term pension
plan in part as “any plan, fund, or program . . . to the extent that by its express terms or as a result of surrounding circumstances such plan, fund or program provides – (i) retirement income to employees, or (ii) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond.” 29 U.S.C. §1002(3)(2)(A).

Although severance benefits may be viewed as a deferral of income to termination of covered employment, the Department of Labor (“DOL”) has issued regulations providing that a severance arrangement will not be treated as a pension plan if the following requirements are met:

(1) Payment under the arrangement is not directly or indirectly contingent upon the employee’s retirement;

(2) The total amount of the payments is not greater than twice the employee’s annual compensation for the year immediately prior to the year in which the termination of employment occurs; and

(3) The payments are completed within 24 months of the employee’s termination of employment. 29 C.F.R. §2510.3-2(b).

If the severance pay is not treated as a pension benefit, it should be treated as a welfare benefit. Section 3(1) of ERISA defines the term welfare plan as

any plan, fund, or program which . . . was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 302(c) of the Labor Management Relations Act of 1947 (the “LMRA”) (other than pensions on retirement or death, and insurance to provide such pensions).

Section 302(c)(6) of the LMRA includes “holiday, severance or similar benefits.” See also 29 C.F.R. §2510.3-1(a)(3) (describing benefits provided under section 302(c) of the LMRA that constitute welfare benefits).

ii. Retention Benefits. The status of retention benefits under ERISA is much more ambiguous. Retention arrangements will typically provide for a lump-sum payment to an employee who remains employed through the date the bonus is earned. While many retention arrangements will also provide for payment if the employer terminates the employee’s employment without cause or if the employee quits for good reason, payment of a retention bonus is generally not conditioned on an employee’s termination of employment. DOL regulations provide that a pension plan does not include bonuses unless the bonuses are “systematically deferred to termination of employment or beyond.” 29 C.F.R. §2510.3-2(c). Accordingly, it would appear that retention bonuses should not be treated as either welfare or pension benefits regulated by ERISA.

The court in Orgeron v. Sea Mar Management, LLC, 2008 U.S.Dist. LEXIS 25953 (W.D.La. Mar. 29, 2009), agreed, stating that the retention bonus payment in that case “is a one-time lump-sum payment to current employees.” The court concluded that the retention bonus arrangement did not provide for a deferral of compensation. Although the court in Orgeron quoted the definition of welfare plan from ERISA, it did not expressly state that the retention bonus did not constitute a welfare benefit. Rather the court ultimately held that the retention bonus arrangement did not require any ongoing administrative scheme