



Electronic Dispatch

Employee Benefits Law Information Memo

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DOES YOUR SEVERANCE PAY POLICY OR PRACTICE COMPLY WITH ERISA?

Many employers have established severance pay policies or practices that provide severance payments to terminated employees if certain requirements are satisfied. These policies or practices vary in formality, with some being unwritten, some being reflected only in employee handbooks, and some being incorporated in a plan document. Severance pay policies or practices generally are subject to the requirements of the Employee Retirement Income Security Act ("ERISA"), and there have been numerous employers that have failed to comply with those requirements with respect to their severance pay policies or practices. Such noncompliance could result in substantial monetary penalties and other ERISA sanctions.

This noncompliance issue often arises when a former employee who has been involuntarily terminated gets in a dispute with his or her employer over severance payments, and the employer finds itself in a weaker bargaining position to resolve the dispute because of its noncompliance with ERISA (e.g., because the employer is concerned that the noncompliance issue might be brought to the attention of the United States Department of Labor). To avoid these types of problems, nongovernmental employers should assume that their severance pay policies or practices (even if they are unwritten or informal arrangements) are subject to the requirements of ERISA and should comply with those requirements unless an applicable ERISA exemption is identified.

What Are Some of the More Important Total Exemptions From the Requirements of ERISA That Could Apply?

Among the more important total exemptions from the requirements of ERISA that could apply to a severance pay policy or practice are:

- Governmental Plan Exemption – Plans maintained by the United States government, the government of a state or political subdivision of a state, or any agency or instrumentality of the foregoing, are completely exempt from ERISA.
- Church Plan Exemption – Church plans that satisfy certain requirements under ERISA and the Internal Revenue Code are completely exempt from ERISA.
- "Fort Halifax" Exemption – The United States Supreme Court, in Fort Halifax Packaging Co. v. Coyne, held that if an arrangement provides for a one-time payment and does not create a need for an ongoing administrative program for processing claims and paying benefits, it is not subject to ERISA. The case law since this decision was issued has expanded this exemption to include certain non-lump sum arrangements, but the parameters of this exemption are still evolving and are far from clear. If an employer has a one-time severance pay arrangement that provides a lump sum payment and requires little administration (e.g., a lump sum severance payment that is offered pursuant to a one-time termination incentive program that is easy to administer), an employer generally should be able to structure the arrangement to satisfy the requirements of the "Fort Halifax" exemption. To the extent a severance pay arrangement offers more than a lump sum or requires significant or ongoing administration, an analysis should be made as to whether it still would qualify for the "Fort Halifax" exemption.

What Happens If a Severance Pay Policy or Practice Does Not Qualify For One of the Total Exemptions From the Requirements of ERISA?

If a severance pay policy or practice does not qualify for one of the total exemptions from the requirements of ERISA, the policy or practice generally will be subject to ERISA's reporting, disclosure, fiduciary, and administration requirements. The ERISA reporting and disclosure requirements for a severance pay plan include:

- the need to have a written plan document;
- a requirement to distribute summary plan descriptions and to prepare summaries of material modifications (certain plans with fewer than 100 participants at the beginning of a plan year, and certain plans maintained for a select group of management or highly compensated employees, are exempt from this requirement);

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- a requirement to file annual Form 5500-series reports (certain plans with fewer than 100 participants at the beginning of a plan year, and certain plans maintained for a select group of management or highly compensated employees, are also exempt from this requirement) — a failure to satisfy this requirement could result in a penalty of up to \$1,100 a day for each day such failure continues; and
- the need to make certain plan documents available for inspection and copying.

How Should a Severance Pay Policy or Practice Be Structured To Satisfy the ERISA Severance Pay Requirements?

A severance pay policy or practice that is subject to ERISA usually will be an ERISA welfare benefit plan, but also could be an ERISA pension plan. A “safe harbor” from ERISA pension plan status is available under United States Department of Labor regulations if:

- payments are not contingent, directly or indirectly, upon an employee’s retirement from the work force (this requirement generally will not be satisfied if the employees to be benefited are primarily over the employer’s general retirement age, which for some employers is as low as age 55);
- the total amount of such payments does not exceed twice the employee’s annual compensation during the year immediately preceding the termination of his or her employment; and
- all payments to the employee generally are completed within 24 months of his or her termination of employment.

If an employer has a severance pay policy or practice that is subject to ERISA, it is important to satisfy the “safe harbor” described in the preceding paragraph. Failure to satisfy the “safe harbor” would result in the applicable employer having to satisfy the onerous ERISA pension plan requirements (which would require, among other things, the need to satisfy trust and benefit distribution requirements that would greatly complicate the administration of the severance pay arrangement).

What Are Some of the Major Advantages and Disadvantages of Structuring a Severance Pay Policy or Practice To Be An ERISA Severance Pay Plan?

Among the more important advantages of structuring a severance pay policy or practice as an ERISA severance pay are: (1) the right to have a favorable judicial standard of review if litigation arises (this assumes the plan has reserved the plan administrator’s right to construe ambiguous or uncertain terms); (2) the preemption of state law claims; (3) the right to have claims tried in federal courts rather than state courts; and (4) the limited rights of recovery that claimants will have (a claimant generally will be able to recover the benefits permitted by the terms of the plan and possibly attorney’s fees, but not extra-contractual damages or punitive damages). Among the more important disadvantages of structuring a severance pay policy or practice as an ERISA severance pay plan are: (a) the need to comply with the ERISA requirements described earlier in this memo; and (b) an inability to structure the plan so that it primarily covers participants who are of retirement age.

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