What's A Signature Worth? Negotiating Employee Severance Pay Packages

By Severance Pay Attorneys Jessica Juarez and Albert G. Stoll, Jr.

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A. Severance Agreements Generally:

A severance agreement is a contract between the employer and the employee which specifies the terms of an employee's termination. Severance agreements are called by different names. They are also known as severance packages, transition agreements or separation agreements. A severance agreement may be offered to a worker or executive who is fired, resigns, or is laid off. Generally an employee is offered a sum of money beyond what is already owed to them in exchange for signing a release of all claims. A release of all claims prevents a former employee from suing the company at a future date.

Generally the objective of a severance agreement is to provide a complete separation between the employee and the employer. Severance agreements are voluntary. A high level executive may be offered a set amount of severance pay at the time of hire. Lower level employees are most commonly offered severance when an employer predicts that an employee may assert a labor and employment law claim.

The amount of severance pay is negotiable. There are difference sources of potential recovery for an employee who is negotiating a severance package. The money in a severance package may be payment for past service, money for an agreement not to compete or solicit an employer's customers, money for signing a release, money for confidentiality, and/or cooperation with an ongoing lawsuit.

A viable discrimination claim may result in a source of money to include in a severance package. If a person was terminated to make way for a younger person, they have an age discrimination claim. A termination in violation of an employee's employment agreement creates a breach of contract claim. Alternatively, a termination based on a good faith disagreement over business strategy would be less likely to create an additional source of severance pay.

For highly paid executives, the amount of severance is greater if the termination is without cause, by the executive with good reason, or upon a change of control. The amount of severance is generally less if an executive was legitimately terminated "for cause" or if an executive leaves for other than a defined "good reason."

B. Request All the Documents:

The first step in negotiating severance is finding all of the documents that may govern the negotiation and shed light onto an employee's legal claims. For example an executive employee may already have a contract that provides for one year of severance pay without a release requirement.

Former employees have the right to access all payroll and time-keeping records, paystubs, daily and/or weekly time reports, timecards, payroll histories, personnel file(s), performance evaluations, documents relating to any discipline, any documents signed by the employee, and other similar work place documents. Pursuant to California Labor Code section 226(f) an employer must provide employment documents within 21 days of a request, or the employer owes the worker a penalty in the amount of $750.

Before a company lets an executive go, the employer should read all the documents related to an executive's compensation. Any documents that govern an executive's employment are going to be integral to the ultimate severance package that is negotiated. There may be an offer letter, term sheet, employment agreement, change of control agreements, executive retirement agreements, or an ERISA severance plan document, where a form 5500 is filed. An offer letter that is not integrated into an employment contract may provide for an offer of severance that does not require a release of all claims. There may be multiple pre-existing agreements that create different buckets of severance pay.

The lawyer for the executive should also review any pre-existing severance plan, deferred compensation plan, short and long term incentive plans, and commission plans and make sure they understand what their client is owed. The parties may not remember what was agreed to initially. For example, there may be accelerated vesting if an executive leaves because of a disability.

C. De Facto ERISA Severance Plans:

A de facto ERISA severance plan is a practice or precedent of giving severance which has essentially created a severance plan by default. Here the employer has all of the obligations and none of the benefits of an actual ERISA severance plan. For example, a company that has given the last eight people who were let go; one week of severance pay per year of service, may have created a de facto ERISA severance plan.

D. Offers of Severance:

When an employer is making an offer of severance they should take care to explain to the employee what they will receive without signing the severance agreement, and what additional money they will receive if they do sign the severance agreement. An offer of severance should not give an employee the incorrect impression that if they do not sign off on the severance agreement they will not get their vacation or COBRA benefit. An employee is legally entitled to vacation pay, past due wages and COBRA without signing a release. An employer is not entitled to hold onto the vacation pay until all of the terms of the severance agreement are signed.

E. Key Severance Agreement Terms

Generally an employer is not going to pay severance without getting a release. However it does happen where employers offer severance without a release requirement. This may be because the company is worried if they require a release the departing employee may go see a lawyer.

1. Defense indemnification and contribution: Is the company taking care of the employee or executive going forward, in terms of directors and officers liability insurance, defense and indemnification? Is there a cooperation provision? An ex-employee needs to retain their right to a defense and indemnification should a lawsuit arise after their departure. An ex-employee should not waive any of their rights under any existing agreements and equity plans.

2. Counter claims against former colleagues: If the departing employee is in a situation where they are likely to get sued buy a subordinate for discrimination it is in the company's and employee's interest to maintain the right to make a counter claim in any subsequent discrimination lawsuit that may arise.

3. Mutual releases of claims: Is a company going to release claims it may have against the departing employee? This is a point of negotiation. If the parties want a final separation then waivers of claims should be mutual. If a departing employee is guilty of malfeasance they are less likely to secure a mutual release. If the departing employee uncovered illegal activities and the company is trying to dismiss them, the release will likely be mutual. A company may demand an exception to a mutual release for any illegal activity by the employee.

4. Non-disparagement clauses: A non-disparagement clause should not be written in a way that prohibits the employee from engaging in ordinary business communication that is made in good faith. An ex-employee who goes to work for a competitor should not be prohibited from selling his new employer's product. However it is reasonable to prohibit an ex-employee from saying, "I worked there, and I know their products are poorly made." This clause should be mutual.

5. Employees over 40 years of age: Under the Age Discrimination in Employment Act of 1967. There are mandatory terms that must be provided when a person over 40 is waiving age discrimination claims. If the severance agreement is in conjunction with a company lay off the employee must be given 45 days to consider the agreement. For layoffs the employee must give given a listing of all the people in their job category who were affected by the layoff and whether or not they were terminated. The release cannot waive future claims. There must be a seven day period to revoke the agreement. The employee must be advised in writing to consult with an attorney. A company that hopes to secure a valid release of an age discrimination claim should consult with an attorney.

6. Characterization of the separation: Is the departure a resignation, retirement or termination? There are multiple ramifications to both the employer and employee when negotiating how to characterize the employee's departure. When the parties change the real reason for the termination there may be ramifications with unemployment insurance, deferred compensation plans, equity plans, stock options, references, benefits and COBRA. For example when a medical doctor is let go for cause a hospital may be required to report that fact to the medical board. From the employers point of view how the departure is characterized is not just a point of negotiation, there are other issues to consider.

7. Employee references: Will a reference be provided? An employee may propose a letter of reference and negotiate over what it will say. Alternatively, the company and employee may agree upon a company contact for all references. The parties may agree to a verbal script that verifies the employment, duties and what was done well buy the ex-employee. Both the company and the employee may be just as concerned about how the departure will appear to the public. Generally both sides want a characterization of the departure they are both comfortable with. If the relationship is contentious, the parties may simply agree to a clause that requires the ex-employer to give a neutral, name and date of service response to any future inquiry.

8. Payment for past service: Prior to negotiating a severance agreement all vacation, commissions, and wages should have already been paid in accordance with state law. The employee is not required to sign a release to obtain past wages and vacation time owed. It is a good idea to note in the severance agreement that all past wages and vacation time have been correctly calculated and paid.

9. Business expenses: A provision that all business expenses have been paid and submitted. There should not be any open issues once the agreement is signed.

10. Return of company property: A severance agreement may have a provision requiring the employee to represent that they have returned all company property. The agreement should confirm that the smart phone, laptop, pager, all confidential and proprietary information and any copies the departing employee may have had are all returned.

11. Non-compete or non-solicitation agreements: If there is existing non-compete or non-solicitation agreements they should be incorporated by reference into the severance agreement. The terms of existing non-compete agreements may be negotiated at termination, especially if the agreements are over broad or unenforceable.

12. Annual bonus: An employment agreement may set forth how a bonus is to be paid out upon departure. Many bonuses are paid out in the first quarter of the next year. Does the employee executive get a pro-rata bonus on target for the year of termination? If that is not in the employment agreement already, a pro-rata bonus for the current year may be able to be negotiated into the severance package.

13. Taxes on deferred compensation: With highly paid executives it is a good idea to consult with a tax attorney to insure that the terms of a severance package do not result in tax penalties under IRS Code Section 409(a). A clause may be included in the severance agreement stating that the parties agree to cooperate in good faith to resolve any future 409(a) issues that may arise. There may also be a savings clause related to section 409(a), that states the party's intent was to comply with section 409(a) and if they got it wrong to read the agreement as though the intent was to comply with section 409(a).

14. Lump sum payment or salary continuation: There are pros and cons to each. If a restrictive covenant is in place salary continuation keeps more leverage over a departing executive. An ongoing income stream is a good incentive to keep a person in compliance with a restrictive covenant. From a cash flow standpoint a company may prefer salary continuation. If a sale or acquisition of a company is imminent a lump sum payment may be better.

15. Additional terms and benefits: These may include, accelerated vesting, extended exercise period for stock options, continued benefits, payment of COBRA cost, tax gross ups that comply with 409A restrictions, and transition services such as attorney fees or relocation expenses.

An extended exercise period for stock options may be very valuable to a departing executive. Normally an incentive stock option expires three months after termination of employment. If the company is private the executive may have very little basis on which to make a decision about whether or not to exercise their options. An executive may be better off negotiating a two year extension and potentially benefiting if the company is successful and sold.

16. Unemployment benefits: What affect does severance pay have on a person's ability to obtain unemployment benefits? If the employee intends to apply for unemployment insurance the severance should be paid in one lump sum. This will allow the employee to claim zero income for unemployment insurance purposes. The severance payment should come before what is deemed the employee's termination date. When a severance payment comes after the termination date; the money may be deemed income that prevents an unemployment insurance claim.

In order for a person to qualify for unemployment insurance, they must be terminated through no fault of their own. Whether or not a company will agree not to contest an employee's unemployment insurance claim may or may not be able to be negotiated depending on the circumstances of the termination.

F. Conclusion:

It is a myth that severance pay is only for highly paid executives. If a company understands that a terminated employ has a legitimate wrongful termination claim for retaliation or discrimination, they may be motivated to negotiate significant severance pay in exchange for a release of all claims. Even when an employer is not impressed with an employees potential claims they may be motivated to offer severance in exchange for a release of claims and avoid an expensive wrongful termination lawsuit. Finally, an employer may simply offer severance pay as a "thank you" for a job well done and may or may not require that a release be signed.

By attorney Jessica Juarez 415-762-1383 or jessica@stoll-law.com
and attorney Albert G. Stoll, Jr. 415-762-0039 or astoll@stoll-law.com