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RETENTION AGREEMENTS OR SEVERANCE PAY ARRANGEMENTS: WHAT'S THE DIFFERENCE AND WHAT ARE THE CONSIDERATIONS?

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**Mary K. Samsa**

*As the economy continues to rebound and the United States again starts to see more movement in the employment market, employers are once again revisiting their severance pay and retention policies and developing an underlying rationale for whether or not to provide these benefits and if so, how broadly among their workforce. However, it has become apparent that not everyone really understands the difference between severance arrangements and retention agreements and when one should be used instead of the other. Each accomplishes a different purpose and understanding the fundamental differences between the two will allow professionals to make an educated decision regarding which option is best for a given organization depending on its existing circumstances.*

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IS CEO PAY RELATED TO COMPANY PERFORMANCE?

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**David M. Schmidt**

*Most companies attempt to establish CEO Award pay relative to the size of the company as measured by revenue. Yet as data indicates, revenue rank did not stand out as being closely related to compensation rank, particularly when compared with profit measures like net income. Indeed, there is virtually no correlation between revenue rank and realized compensation rank as confirmed by the flat line in the graph above. This article analyzes the data and concludes that profitability is often the key driver in compensation.*

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THE HR ABCS FOR PRIVATE COMPANIES: MAXIMIZING ENTERPRISE VALUE WHILE EVALUATING POTENTIAL CAPITAL EVENTS, INCLUDING AN IPO

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*A recent EY study found that institutional investors support IPOs that come to market well prepared. Companies must consider the non-financial, HR-related factors that are important to investors pre- and post-IPO, such as talent retention and recruitment, sound HR infrastructure including HR risk management and internal controls, board of directors (BOD) governance / composition and quality of management remuneration systems, as well as proper corporate governance practices. Since only a fraction of organizations contemplating a potential IPO actually go public, many companies need to become IPO ready while also preserving their flexibility to pursue other capital event alternatives that may arise. This article discusses how companies can identify human resources improvement areas through an HR diagnostic to maximize shareholder value up through and beyond a possible capital event date.*

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# Retention Agreements or Severance Pay Arrangements: What's the Difference and What Are the Considerations?

Mary K. Samsa, McDermott Will & Emery LLP\*

While both retention agreements and severance pay arrangements offer financial protection for certain employees within an organization, there are inherent differences between the two types of arrangements and why an organization would choose to use or offer one versus the other. The following article will evaluate at a high level the rationale for each arrangement, various legal/other considerations to be aware of and potential structures seen with respect to each type of arrangement specifically in a change in control situation.

## RATIONALE FOR USING OR OFFERING ONE ARRANGEMENT VERSUS ANOTHER

As a general matter, retention arrangements are normally viewed as a limited-purpose compensation device for active employees. In most instances, these retention devices are intended to provide a financial incentive to the employee to prevent such employee's voluntary termination when he/she is considered crucial or critical to a particular aspect of the ongoing operations of the employer. As such, most retention arrangements are offered as a means of protecting the interests of the employer against the adverse consequences of pre-

mature termination of employment by key employees.

Employers generally consider retention arrangements during times of uncertainty (such as when the employer is embarking on a new strategic direction, the employer is entering into a major corporate transaction, or other departures make it likely that key employees will consider looking for employment elsewhere). In those situations, employers look to structure the retention arrangements to provide only as much compensation as is considered strictly necessary for the desired purpose.

Therefore, retention arrangements tend to be more individually designed (i.e., on an

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employee-by-employee basis) for the particular target employee who is raising the concern. Employers, as a result, can be much more selective for purposes of who it offers retention arrangements to and simply focus on those employees considered most crucial to the ongoing operations. Importantly, although retention arrangements are most commonly used for key executive, they do not have to be limited to members of senior management and can have a broader applicability to the workforce depending on what is the ultimate desired purpose.

Additionally, retention arrangements normally have a finite period of time to which they apply and then expire. That applicable time period correlates to the time period during which departure by the key employees would create the greatest operational risk to the employer. In most instances, the target employee is offered an amount of money to stay put until a given date.

On the other hand, severance pay arrangements tend to be more broad-based compensation devices for certain active employees. Severance pay arrangements typically are intended to provide protection against the adverse consequences of premature, involuntary termination of employment

by the employer, but also provide funds to the employee that will assist him/her in transitioning to employment with another employer.

Unlike retention arrangements, a severance pay arrangement is intended to benefit the employee, not the employer, by protecting the employee from economic hardship resulting from unexpected termination of employment caused by the employer. In many instances, entitlement to severance pay is triggered via application of an employment agreement, offer letter or a corporate severance pay plan that exists prior to the employee's termination event. Notwithstanding this, it is not unusual for severance benefits to be negotiated with an employee at the termination of employment to ensure an amicable parting of the ways and mitigate the potential for any employment-related litigation.

Severance pay arrangements often are established before a period of employment uncertainty, particularly in connection with a restructuring or other major corporate transaction. In other words, when an employer can reasonably predict that the elimination of positions and other forms of involuntary employment terminations are likely, the employer frequently considers some form of severance pay protection for employees.

Unlike retention arrangements which typically address a finite period of time for a specific employee, severance pay arrangements are normally structured to provide uniform compensation protection for classes of covered employees which provide protection for an indefinite period or a longer period during which involuntary employment terminations are considered most likely to occur. Severance pay arrangements can range from a broad-based severance plan covering the entire workforce to individual severance agreements with only a few, select executives. In most instances, severance pay is structured as a period during which base salary (or average weekly compensation) is continued, and therefore is inherently linked to compensation.

## LEGAL AND OTHER CONSIDERATIONS

### **Making Appropriate Distinctions from an Employment Law Standpoint**

As a general matter, federal law does not require that all employees be treated equally or similarly under these types of arrangements. However, prudence does require employers to scrutinize these arrangements from an optics standpoint and evaluate whether decisions made by the employer as to who will receive an arrangement

and who will not can possible be viewed by an outside observer as discriminatory. Employers may, and often do, create distinctions among employees in different employment classifications, and indeed many employers make distinctions among employees within the same employment classification. But, as alluded to above, employers should be careful, however, not to discriminate between employees on the basis of a status or classification protected under Title VII of the Civil Rights Act of 1964 or other applicable employment discrimination laws (such as race, ethnicity, gender, age and religion).

### **Clear and Enforceable Documentation**

The retention and/or severance pay arrangements should be articulated in written documents that expressly describe the terms and conditions upon which the employee can and will receive the underlying pay. The written document should be signed by both parties. The employer will want to establish the conditions under which these amounts would be paid (i.e., what must be satisfied or agreed to as a condition precedent), and both the employees and the employer want these arrangements to ultimately be enforceable. Because severance pay arrangements are

generally designed to be salary continuation over a period of time, it is normally recommended that continuing payments be conditioned on a well-designed general release and waiver of employment-related claims (which equally contain any applicable restrictive covenants to the employee). In the event the terms of the general release and waiver is violated by the employee, the employer will have the ability to cease making continuation payments under the arrangement. Such a structure provide significant protection to the employer in the event of violation by the employee, whereby the same protection is not as easily afforded where severance pay in made in a single lump sum amount.

### **Ensure No Conflict or Overlap With Any Other Contractual Promises**

If an employer chooses to use both retention agreements and severance pay arrangements, it is critical to ensure that neither arrangement duplicates the benefits and purpose of the other arrangement where an employee could be required to be paid under both (unless that was expressly intended). Additionally, some employers establish and maintain a Severance Pay Plan for its entire workforce but also enter into separate arrangements with executives where if such ar-

rangements are not expressly excluded from the Severance Pay Plan, the employer could be required to pay certain individual with separate agreements twice. As such, it is important to confirm that no employee who is covered by the retention and/or severance pay arrangements is already covered under a similar arrangement. Specifically, where similar arrangements are already in place, the relationship of those arrangements must be clarified—does one offset the other, or do both apply? Equally, is the intent that different eligibility standards apply to the different arrangements? These and many other issues would need to be addressed and synchronized if similar arrangements already exist for certain employees.

### **Overall Amount and Reasonableness**

As previously discussed, in retention agreements, the game plan is normally to pay as much compensation as is considered strictly necessary for the desired purpose and no more. The amount must be high enough to give the employee pause in walking away from it but the amount must also be reasonable enough to not be considered a waste of corporate assets. Compensation consultants can be extremely valuable to identifying similarly situated executives and retention ve-

hicles used by other employers in successful keeping key members of their team in place.

The largest challenge in establishing severance pay arrangements is identifying what the right “dollar amount” is for a given employee. Although most broad-based severance pay plans covering large portions of an employer’s workforce typically provide a simple “base salary” equivalent, as higher level executives factor into this, the question becomes whether solely providing a base salary replacement is enough to “keep the executive whole” in the event of a loss of position. Many employers will evaluate whether to also provide compensatory items such as the following: (1) annual incentive pay (forfeiture, pro-rata or the whole award simply paid at target), (2) long-term incentive award, if any (forfeiture, pro-rata at target over the performance period or deemed earning of the entire award at target); (3) vesting of equity awards. The value of these awards can substantially increase the underlying severance cost but fairness dictates at least evaluating whether the above awards need to be seriously factored into the severance pay amounts to ensure consistency in replacement income. There is no requirement or absolute way of handling this, but the market trend, at

least for the higher level executives, appears to require consideration of at least the annual incentive pay.

Equally, because of the longer term associated with severance payment, it is somewhat typical to continue providing coverage under the employer’s group medical plan (including dental, vision, drug and other ancillary coverages) during the severance period. This coverage period can offset the COBRA period, unless the agreement expressly states that the COBRA election period immediately follows the severance continuation period. Other benefits, including long-term disability and life insurance coverage, as well as retirement benefit contributions and coverages, typically end as of any termination date. Some arrangements provide for additional payments in lieu of these coverages, and some of these coverages can be transitioned directly to the employee to continue (such as supplemental life insurance coverage).

Severance pay may be offset (but is not required to be offset) by income earned from a subsequent employer. The continuation of group health benefits coverage should end when the former employee is eligible for the similar coverage under a group health benefits plan of a subsequent employer.

## Affordability

To what extent can the employer afford these retention agreements and severance pay arrangements? In this regard, projections should be made of the most likely scenario and the worst-case (*i.e.*, most expensive) scenario. It is worth reiterating that different amounts can be provided to different employees, if necessary to make the overall arrangements affordable.

## POTENTIAL ARRANGEMENT STRUCTURES IN CHANGE IN CONTROL SITUATIONS RETENTION AGREEMENTS

### Who is Targeted for Eligibility?

Normally in a change in control situation, an employer will be focusing its attention on offering retention agreements to those specifically identified employees who without their continued employment the proposed change in control would not be successfully completed, or whose loss is likely to cause material loss in value to the organizational due to compromised pre-change in control operations.

### Length of Retention Period

Retention benefits are, in most instances, payable in single, lump sum payments so long as the eligible employee remains with the employer until

a specified date after the effective date of the change in control. That “appropriate” period of time fluctuates from employee to employee (depending on their role and responsibilities with respect to integration) and truly depends on a realistic transition period to ensure success (for example, ninety (90) days following the effective date or six (6) months following the effective date). Regardless, voluntary termination of employment by the employee before that designated date would result in forfeiture of the retention benefit. On the other hand, an involuntary termination of employment by the employer before that designated date could result in a prorated payment of the retention bonus, which is how most employers handle this particular situation.

Additionally, if an organization first enters a period of assessing strategic options (i.e., before the letter of intent is signed), one of which may be a change in control, then in that situation, the employer may structure two separate retention arrangements and periods: (1) one would compensate the employee for staying through the expected strategic assessment period, and (2) the second would compensate the employee for staying through the effective date of the transaction itself (i.e., the close of the change in control).

### Retention Amount

A typical, market supportable retention incentive amount for an executive employee normally falls in the range of 20% to 40% of annual base salary; however, this amount, although expressed as an annualized amount, would be prorated for any retention period of less than one year. If the total retention period (for example, from January 1, 2015 through December 31, 2015 as the strategic assessment period) were twelve (12) months and the annualized retention amount were 30% of base salary, an eligible executive employee with a salary of \$200,000 would be eligible to earn a retention bonus of \$60,000 for staying through the entire initial twelve (12)-month retention period.

### SEVERANCE PAY ARRANGEMENTS

#### Who is Targeted for Eligibility?

Normally in a change in control situation, an employer will be offering severance protection to key employees who, without this protection, are likely to start looking for another position (particularly in a difficult job market), regardless of any protection currently provided in the form of an overall corporate severance policy.

### The Use of Double Triggers for Severance Entitlement

Unlike retention benefits where it is understood that the payment will be due at some time in the future, severance pay is a contingency and is provided to assist the employee in transitioning to a new employment position in the event he/she is involuntarily terminated without cause by the employer. Consequently, most employers attempt to structure severance pay with the use of double triggers in the change of control context such that a large compensatory payment is not triggered and due to an employee simply because the change in control occurred even though nothing regarding the employee's position has truly changed. As such, it is recommended that in order for a severance entitlement to be triggered, both a change in control would have to occur AND the employee would have to suffer a termination event coinciding with or as a result of the change in control event.

The most common double trigger is related to an involuntary termination of employment by an employer following a change in control (whether do to consolidation of staff, elimination of duplication of positions or determinations that the employee is not a good cultural

fit). However, to ensure that such second trigger is actually related to the change in control itself, most organizations place a time restriction on when such a second trigger (i.e., termination event) must occur with respect to the change in control in order for it to actually “trigger” a severance entitlement. In other words, if a change in control occurs and then three (3) years later an employee is “involuntarily terminated without cause” due to reorganizations within the employer having nothing to do with the change in control, unless an outer time limit restriction has been placed on such second trigger, this employee may be able to claim severance entitlement three (3) years after the actual change in control event. Consequently, the most common way to draft the double trigger is typically to provide that if a change in control occurs AND the employee is involuntarily terminated without cause within twelve (12) months of the effective date of the change in control, THEN those two events together will

trigger a severance entitlement. Drafting is the key here to protecting the employer and limiting their liability solely to events which are directly related to the change in control. Note that there are many ways to draft the underlying timeframe for the second trigger, but the above is the one most commonly utilized in these arrangements.

Additionally, some employers also like to permit higher level executives the ability to trigger their own termination event when the surrounding circumstances impacting their employment have the effect of “involuntarily terminating” them. This is normally referred to as a voluntary termination by the executive with good reason. In most instances, “good reason” generally refers to a material reduction in position, duties, responsibilities, reporting relationship, or total compensation opportunity, or any relocation of the employee to a principal office that is at least 50 miles from the current principal office. In other words, the circumstances spe-

cifically impacting the executive have such a material negative impact on his/her position (in most instances comparable to a demotion from the prior position) that it will be treated and deemed to be an involuntary termination by the employer. This can also be used as the second trigger (termination event) in the double trigger situation.

## CONCLUSION

This high-level summary outlines some, but not all, of the various administrative and legal issues which need to be evaluated before offering a severance agreement or Policy arrangement. The key concept to keep in mind is that there are differences but understanding those differences allows an organization effectively manage its costs but protect its greatest resource—its employees. Always consult with your legal and tax professional before putting pen to paper and retention agreement or severance arrangement.