Basics of Drafting Enforceable Severance Agreements (for New Lawyers)

By Kelly M. Dougherty[1]

New employment lawyers will often face the task of negotiating and drafting a severance agreement (or separation agreement) on behalf of either an employer or employee. To be effective for your client and obtain a smooth transition, it is important to understand the context of the separation of employment, whether voluntary or involuntary, and to identify desired monetary and non-monetary terms early in the process. Further, under federal and Minnesota law, there are specific requirements for a valid release of claims. This article outlines the basics of drafting enforceable severance agreements and common mistakes to avoid.

A. Motivations for Entering Into a Severance Agreement

From an employer's perspective, the primary purposes of offering a severance agreement include: obtaining a release of claims from the employee; protecting company assets through non-solicitation, non-competition or confidentiality clauses; clarifying any payments or benefits the employee may receive as a result of the separation; and maintaining positive employee morale and positive public relations.

Employees may seek a severance agreement to: obtain payments or benefits as a result of the separation; ensure that non-competition, non-solicit and/or confidentiality clauses are narrow enough to allow the employee to obtain future employment; and to retain potential future claims against the employer.

B. Common Provisions of Severance Agreements

Severance agreements can govern various aspects of the employment relationship and termination. Common terms are outlined below.

1. Severance Payment

Severance agreements generally contain a clause describing the terms for severance payments in exchange for a release of claims. Although "severance pay" is not defined

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by statute, Minnesota courts have defined it as "[a] sum of money usually based on length of employment for which an employee is eligible upon termination."[2] The severance payment term in the contract will include information about the amount of the payment(s), applicable withholdings and payroll deductions, timing of the payment(s), whether payments will stop if employee finds another job, and tax implications.

Many employers tie the amount of severance to the length of employment. Others provide a base amount of severance to be paid to all employees, determined by a formula. Benefits and incentive compensation should also be considered when negotiating a severance agreement. Further, a separation agreement should address any employee compensation that is provided in stock options, bonuses or commissions.

2. An Employee's Release of Claims

a. Consideration

A severance agreement (and any releases contained in it) is only enforceable if supported by adequate consideration. The compensation paid to the employee as part of the severance agreement must be compensation to which the employee is *not already entitled*. Rather, the payment must be an additional payment of some kind.

Where an employee has only a contested right to a payment, the payment can constitute consideration.[3] This means that if an employee claims that he or she is owed unpaid wages or commissions and the employer disagrees or contests such claim, payment of an amount of contested money in exchange for a release of claims is valid consideration.

Further, the amount of consideration offered in exchange for a release of claims may be relevant in determining whether or not the employee signed the release "knowingly and voluntarily," as discussed below.[4]

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[2] *Ziemer v. GovDelivery, Inc*., Civ. No. A13-0644, 2013 WL 6725782, at *2 (Minn. Ct. App. Dec. 23, 2013) (citing *Carlson v. Augsburg Coll.,* 604 N.W.2d 392, 394–95 (Minn. Ct. App. 2000)).

[3] *Chappell v. Butterfield-Odin School Dist. No. 836*, 673 F. Supp. 2d 818, 832 (D. Minn. 2009) (citing *Warnebold v. Union Pac. R.R.*, 963 F.2d 222, 223–24 (8th Cir. 1992)).

[4] In a federal case in Minnesota involving a release of claims under Title VII of the Civil Rights Act, the Americans with Disabilities Act (ADA), and the Minnesota Human Rights Act (MHRA), the district court commented that "the adequacy of consideration is evidence—not *conclusive* evidence, but nonetheless *relevant* evidence—about whether a party acted knowingly and voluntarily in signing a release." *Chappell v. Butterfield-Odin School Dist. No. 836*, 673 F. Supp. 2d 818, 831 (D. Minn. 2009); *see also Mosley v. St. Louis Southwestern Ry.*, 634 F.2d 942, 946–47 (5th Cir. 1981) (declaring the need to examine an agreement with "the utmost scrutiny" when an employee releases a "substantial claim" for "insubstantial relief.").

b. Releases Under the ADEA and OWBPA

New employment lawyers must be familiar with the special requirements to obtain enforceable releases of claims under the Age Discrimination in Employment Act[5] (**"ADEA"**). The purpose of the ADEA is "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; [and] to help employers and workers find ways of meeting problems arising from the impact of age on employment."[6] The statute applies to individuals 40 years of age or older.[7] The ADEA contains specific requirements relating to waivers of claims arising under the statute, which are found in the Older Workers Benefit Protection Act (**"OWBPA"**).[8] "[T]he absence of even one of the OWBPA's requirements invalidates a waiver."[9]

In considering the validity of a release under the ADEA, the OWBPA requires that the release be "knowing and voluntary." The statute lists "minimum" requirements for defining an ADEA waiver for individuals, which must: (1) be written in a manner that can be clearly understood;[10] (2) not include rights and claims that may arise after the date on which the waiver is executed;[11] (3) specifically refer to rights or claims arising under the ADEA;[12] (4) be supported by consideration in addition to that to which the employee is already entitled;[13] (5) advise the employee in writing to consult an attorney before

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5 29 U.S.C. § 621 *et seq*.

6 29 U.S.C. § 621(b).

7 *Id.* § 631(a).

8 *See* 29 U.S.C. § 626(f)(1); 29 C.F.R. § 1625.22(a).

9 *Peterson v. Seagate US LLC*, No. 07-2502, 2008 WL 2230716, at *2 (D. Minn. May 28, 2008) (citing *Kruchowski v. Weyerhaeuser Co*., 446 F.3d 1090, 1095 (10th Cir. 2006)).

10 29 C.F.R. § 1625.22(b)(3)–(4); *see also Thormforde v. Int'l Bus. Machines Corp*., 406 F.3d 500 (8th Cir. 1999) (holding that a severance agreement was not written in a manner calculated to be understood when the terms "release" and "covenant not to sue" were used imprecisely in a confusing manner).

11 29 C.F.R. § 1625.22(c); *see also Budro v. BAE Sys. Info. & Elec. Sys. Integration, Inc*., Civ. No. 07–cv–351–SM, 2008 WL 1774961, at *5 (D.N.H. Apr. 16, 2008) (finding a waiver valid where it referred to claims the plaintiff "may now have or have had," which released past and present claims but not future claims).

12 29 C.F.R. § 1625.22(b)(6).

13 29 C.F.R. § 1625.22(d).

accepting the agreement;[14] (6) provide the employee with at least 21 days to consider the offer;[15] and (7) give an employee seven days to revoke his or her signature.[16]

When more than one employee is terminated or separates from the employer at the same time "in connection with an exit incentive or other employment termination program offered to a group or class of employees,"[17] the employer is required to make *additional disclosures* at the time of presenting the severance agreement in order for any resulting waiver to be deemed valid. In addition to the "knowing and voluntary" requirements listed in connection with individual separations above, for a group separation the 21-day consideration period is extended to a 45-day period to consider the employer's offer. In addition, an employer offering a group separation program must disclose the following information to each employee whom it asks to sign a waiver:[18] (1) the decisional unit; (2) eligibility factors for the program; (3) the time limits applicable to the program; and (4) the job titles and ages of all individuals who are eligible or who were selected for the program, and the ages of all individuals in the same job classifications or organizational unit who are not eligible or who were not selected.

c. Releases Under the Minnesota Human Rights Act

New employment lawyers must be familiar with the special requirements to obtain enforceable releases of claims under the Minnesota Human Rights Act (**"MRHA"**)[19]. The MHRA prohibits prospective waivers and requires that employees have the right to rescind their waiver fifteen (15) calendar days from the execution of the severance agreement.[20] Minnesota courts have applied the "knowing and voluntary" standard in determining whether a waiver under the MHRA is valid.[21] In one case, the court

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14 29 C.F.R. § 1625.22(b)(7); *see also American Airlines, Inc. v. Cardoza-Rodriguez*, 133 F.3d 111, 118 (1st Cir. 1998) (stating that to "advise" employees to consult an attorney means affirmatively to "caution," "warn," or "recommend" (citing Webster's Third New World International Dictionary 32 (1986))).

15 29 C.F.R. § 1625.22(e)(4).

16 29 C.F.R. § 1625.22(e)(5).

17 29 U.S.C. § 626(f)(1)(H).

18 *See* 29 U.S.C. § 626(f)(1)(H).

19 Minn. Stat. § 363A.01 *et seq.*

20 *See* Minn. Stat. § 363A.31.

21 *Somorra v. Marriott Corporation*, 812 F. Supp. 917, 922–23 (D. Minn. 1993) (citing *Danz v. Jones,* 263 N.W.2d 395, 398–99 (Minn. 1978) (noting similarity between the MHRA and Title VII and discussing Minnesota cases where Title VII principles have been used to construe the MHRA); *Hubbard v. United*

considered (1) whether the release was supported by adequate consideration; (2) whether the plaintiff had access to counsel; (3) the clarity of the release; (4) the length of time the plaintiff had to consider the release; (5) whether the plaintiff was able to negotiate any changes to the release and (6) the presence or absence of fraud, duress or other inequitable conduct.[22]

d. Releases Under the Fair Labor Standards Act

New employment lawyers should also be familiar with the requirements for releases of claims under the Fair Labor Standards Act (**"FLSA"**).[23] Releases of claims under the FLSA are typically held to be *unenforceable* unless approved by the U.S. Department of Labor (**"DOL"**) or by a court. The Eighth Circuit generally requires that settlements of FLSA claims have the approval of the DOL, or be found to be "fair" by the court.[24] As long as the court is satisfied that a settlement reached in adversarial proceedings represents a fair compromise of a bona fide dispute regarding the wages owed, the court will enter a stipulated judgment after scrutinizing the settlement for fairness.[25]

In the context of severance agreements, a Minnesota court is unlikely to allow a purported release of FLSA claims to result in the dismissal of an employee's FLSA claim. Attorneys drafting severance agreements in Minnesota should consider including a provision by which the employee represents that he or she has been paid all wages owed to him or her, including any overtime pay, or choose to allocate a specific portion of the severance payment to a release of FLSA claims. This could be viewed as an offset to any amount deemed owed for unpaid wages in a subsequent FLSA action. The danger of this approach, however, is that a court may later determine that the actual damages are greater than the specific dollar amount listed in the severance or settlement agreement, placing the employer at risk for additional damages and penalties.

e. Other Laws and Regulations

Press Int'l, 330 N.W.2d 428, 441 (Minn. 1983) (based on "substantial similarities in the language and purposes of the two statutes," the Minnesota Supreme Court has "applied principles developed in the adjudication of claims arising under Title VII" to MHRA cases)).

[22] *Chappell v. Butterfield-Odin School Dist. No. 836,* 673 F. Supp. 2d 818, 829 (D. Minn. 2009) (citing *Alexander v. Gardner–Denver Co*., 415 U.S. 36, 52 n. 15 (1974); *Wallin v. Minn. Dep't of Corr.,* 153 F.3d 681, 689 (8th Cir. 1998)).

[23] 29 U.S.C. §§ 201 *et seq*.

[24] *See McInnis v. Ecolab Inc*., Civ. No. 11-02196, 2012 WL 892187, at *1-3 (D. Minn. Feb. 17, 2012).

[25] *See id*. at *4.

Close attention should also be given to releases of claims under Family Medical Leave Act, the Americans with Disabilities Act, the Equal Pay Act of 1963, the Employee Retirement Income Security Act of 1974 (ERISA), and Title VII of the Civil Rights Act of 1964 (Title VII). Releases of claims under these laws require similar language and processes to releases under the ADEA.

3. Assignment of Intellectual Property, Non-Disclosure of Confidential Information, Restrictive Covenants, and Return of Company Property

Employers seeking to protect company information upon and employee's separation can include various provisions to this effect.

For example, an employer may require, as a condition of the severance package, that the employee assigns, transfers or sells the intellectual property the employee created as a member of the company to the company.

Employers can also include a provision in which the employee promises not to disclose any company information to third parties. This includes proprietary information, trade secret information or otherwise confidential information.

To prevent unfair competition and to protect trade secrets, confidential business information, as well as the goodwill of customers, employers can include a "non-compete" or a "non-solicitation" provision that prevents the employee from competing with the employer, or from soliciting its customers or employees for a period of time. The parameters of such a provision, however, cannot be broader than is necessary to protect the employer's legitimate business interest. Courts often view restrictive covenants as partial restraints on trade and construe them narrowly.

Employers routinely require employees to return company information and company property, such as laptops, vehicles, and cell phones. In such a provision, the employer should specify the date by which the employee must return the property and the consequences that will result if the employee fails to do so.

4. Pro-Employee Terms

Certain provisions that can be included in a severance agreement are advantageous primarily to the employee. These include some provisions that assist the employee in finding employment after severance occurs. For example, it is common for an employee to request a favorable reference letter, limit the information that can be disclosed to prospective employers inquiring about the employee's past work history, seek a copy of his or her personnel record, or seek indemnification for any civil damages, penalties, or fines against the employee in relation to the employee's work with the employer.

C. Pitfalls to Avoid

Even after a new employment lawyer understands the mechanics of drafting a severance agreement, there are special issues to watch for that could impact the legal rights of each party.

1. Avoidance of Interference with Protected Rights

Employers and their attorneys must be careful to avoid interfering with employees' protected rights under federal law, interfering with employees' right to file charges with the Equal Employment Opportunity Commission (**"EEOC"**), and provisions that the National Labor Relations Board (**"NLRB"**) have determined constitute unfair labor practices.

For example, employees have a right to file charges with the EEOC if they believe a violation of one of the EEOC-enforced statutes has occurred. Agreements barring interaction with the EEOC effectively penalize employees who are entitled to engage in activity protected under one or more EEOC-enforced statutes. Thus, courts have found that agreements that restrict an employee's right to file a charge with the EEOC to be retaliatory.[26]

The NLRB, like the EEOC, is wary of broad provisions in severance agreements that reasonably give an employee the impression that the employee is prohibited from saying anything negative about the employer and restricts the employee from participating in protected activity. The NLRB takes the position that these clauses have the potential to chill an employee's exercise of protected rights.[27] The NLRB has determined that certain provisions, particularly confidentiality provisions, constitute an unfair labor practice under Section (8)(1) of the NLRA.[28] Therefore, new lawyers should be careful to guard against including language in severance agreements that may violate the NLRA, even in the private sector.

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[26] *See, e.g.*, *EEOC v. Board of Governors*, 957 F.2d 424 (7th Cir. 1992) (finding unlawful retaliation where a collective bargaining agreement allowed the termination of an administrative grievance proceeding upon the filing of a charge with EEOC); *EEOC v. Cosmair, Inc.*, 821 F.2d at 1089 (finding unlawful retaliation where the filing of a charge with the EEOC provoked the termination of payments to which one was otherwise entitled); *EEOC v. U.S. Steel Corp.*, 671 F. Supp. 351, 358 (W.D. Pa. 1987) (finding invalid a provision allowing the reclassification of pension benefits of persons who file charges or otherwise participate in EEOC proceedings).

[27] *See, e.g., Metro Networks, Inc. & Am. Fed'n of Radio & Television Artists, Philadelphia Local, Afl-Cio*, 336 NLRB 63 (2001) (holding that it is unlawful for an employer to offer a severance agreement that would prohibit the employee from voluntarily assisting other employees with regard to any matter that would arise under the NLRA).

[28] 29 U.S.C. § 158 (a)(1) (stating "[I]t shall be an unfair labor practice to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7 of section 157 of this title").

2. Intersection of Minnesota Unemployment Law and Severance Agreements

Employers must be careful not to circumvent an employee's ability to gain unemployment compensation, or an agency's ability to collect thorough information from the employer regarding employees' claims for unemployment benefits. An employee in Minnesota may not waive his or her right to unemployment benefits.[29] This includes a waiver in a severance agreement. In addition, employers cannot obstruct or impede an employee's application for unemployment insurance benefits or agree not to contest employees' claims for unemployment benefits.[30]

Aside from considerations of what the parties can agree to in the separation agreement itself, an important issue is whether a severance payment offsets or delays unemployment compensation benefits. In Minnesota, an employee receiving post-termination payments is normally ineligible for unemployment compensation for as long as he is receiving payments.[31]

Employers and employees should be aware of how the wording and timing of a separation agreement can affect the employee's eligibility for unemployment benefits. Compensation that is characterized as consideration for the employee's promise not to bring claims against the employer, as opposed to consideration for past years of service, is less likely to be construed as "wages" or "back pay" that must be deducted from unemployment benefits. Further, treating post-termination compensation as 1099 income rather than W-2 income suggests the payment is for something other than lost wages. Or, the separation agreement might characterize the compensation as "front pay" and allocate it to a period of time untouched by unemployment benefits. Finally, employees should apply for unemployment benefits as soon as possible after termination since they are entitled to the benefits while in the process of negotiating a severance agreement with the employer. Keep in mind, however, that employers and employees who intentionally misrepresent or conceal material facts in an effort to obtain unemployment benefits for the employee are subject to criminal and administrative penalties.[32]

3. Taxation Considerations of Severance Pay

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[29] Minn. Stat. § 268.192, subd. 1.

[30] *See* Minn. Stat. § 268.192, subd. 1a.

[31] *See* Minn. Stat. § 268.085, subd. 3(b).

[32] *See* Minn. Stat. §§ 268.182, 268.184.

New lawyers should also be aware of the tax issues involved in severance agreements. As a general rule, severance pay and other payments received for involuntary termination of employment are wages for federal tax purposes.[33] The characterization of payments in a severance agreement will determine which specific payments are taxed at which rate. Attorneys who do not consider allocating portions of the payment to specific purposes may cause the client to unnecessarily pay taxes on severance agreement payments.

D. Conclusion

By understanding the various laws that impact severance agreements and considering the specific employment situation at hand, a new lawyer can draft an enforceable and fair severance agreement and help their client obtain a smooth transition during a difficult life change.

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[33] *See U.S. v. Quality Stores, Inc*., 134 S. Ct. 1395 (2014); *Abrahamsen v. United States,* 44 Fed. Cl. 260 (1999) (holding that income and FICA taxes withheld on payment received from resource reduction programs were not excludable from gross income as personal injury damages). *See also* Rev. Rul. 90-72, 1990-2 C.B. 211 (unemployment compensation benefits) and Rev. Rul. 73-166, 1973-1 C.B. 411 (strike payments).