To many, the Employee Retirement Income Security Act of 1974, as amended, (“ERISA”) brings to mind broad-based corporate pension and health care plans covering scores of employees. In reality, ERISA can apply to benefit plans of nearly every shape and size, including those established under individual employment agreements. In this edition of Tax Advisor Weekly, we examine a case from a federal court in Pennsylvania that underscores the need for careful drafting of employment agreements to avoid unintentionally subjecting them to the provisions of ERISA.

**Individual Employment Agreements Can Create ERISA Plans**

In *Zgrablich v. Cardone Industries, Inc.*, 61 EBC 2650 (E.D. Pa. 2016), the Federal District Court for the Eastern District of Pennsylvania was tasked with deciding whether a terminated executive’s state-law claims for breach of contract, involving a severance provision included in his employment agreement, were subject to complete preemption under ERISA. The plaintiff’s employment agreement provided for continuation of the executive’s annual salary for a period of five years in the event his employment with the defendant was terminated “without cause.” The plaintiff claimed that he was terminated without cause, but the company disagreed and denied his claim for severance benefits.

Although the plaintiff filed his action in state court, the company removed the case to federal court, arguing that the severance portion of the employment agreement created an employee pension benefit plan governed by ERISA. The executive argued that the federal court lacked subject matter jurisdiction over what was clearly a state-law contract claim grounded in a breach of his employment agreement and moved that the case be remanded to state court. Because ERISA was designed to provide an exclusive framework of rights, duties and remedies for claims involving ERISA-governed plans, if the employment agreement created an ERISA plan, the plaintiff’s state-law breach-of-contract claims would be preempted, and the case would remain in federal court.

The court reiterated the standard articulated in *Donovan v. Dillingham*, 688 F.2d 1367 (11th Cir. 1982), that, in deciding whether the severance provisions of an employment agreement constitute an ERISA plan, a court must determine whether “from the surrounding circumstances a reasonable person could ascertain the intended benefits, a class of beneficiaries, the source of financing and the procedures for receiving benefits.” The court went on to address the well-established requirement under *Fort Halifax Packing Co. v. Coyne*, 482 U.S. 1 (1987), that ERISA severance plans require the establishment and maintenance of a separate and ongoing administrative scheme. An administrative scheme must involve some level of subjective discretion on behalf of the plan’s administrators in determining an individual employee’s eligibility for, and level of, benefits.

In *Zgrablich*, the plaintiff argued that an “individual one–person employment agreement” could not constitute a “plan” under ERISA. The court, unconvinced, noted that the plaintiff would receive benefits under the agreement only if he were terminated “without cause” — a criterion the court found sufficiently subjective — and, furthermore, benefits would cease in the event the plaintiff breached any of the restrictive covenants in the agreement. This, the court found, required the employer to maintain an “ongoing administrative apparatus” to assess the employee’s initial and continuing eligibility under the plan. The court held that the employment agreement did create an ERISA plan and, accordingly, that the plaintiff’s claims were preempted.

**ERISA Coverage of Severance Agreements**

The *Zgrablich* decision sets the bar for what constitutes an “administrative scheme” strikingly low. In the court’s view, the
simple continuation of salary payments for a single employee based on a determination that such employee’s termination was “without cause,” subject to their ongoing compliance with restrictive covenants, created an ERISA–governed plan.

Other courts have taken a different view. At the extreme, the Eighth Circuit Court of Appeals held that an individual severance agreement cannot create a “plan” under ERISA as a matter of law. (Dakota, Minnesota & Eastern Railroad Corporation v. Schleffer, 52 EBC 1916, 1918 (8th Cir. 2011)) While most circuit courts allow for the possibility that individual agreements can constitute ERISA plans, they require a much higher level of administrative discretion than what was present in Zgrablich. See, e.g., Duggan v. Hobbs, 99 F.3d 307, 310 (9th Cir. 1996).

Most courts have found that determining whether an employee was terminated “for cause” does not require a level of discretion sufficient to implicate ERISA when the contested payments are “a simple mechanical mathematical calculation.” (Young v. Am. Junkie River N., LLC, 58 EBC 1511, 1513 (N.D. Ill. 2014)) In Delaye v. Agripac, the Ninth Circuit Court of Appeals found that determining whether a single employee was terminated “without cause,” and therefore entitled to continued pay and benefits, did not “rise to the level of an ongoing administrative scheme.” (39 F.3d 235, 237 (9th Cir. 1994))

The result is usually the same even when the employer is required to monitor the employee’s compliance with restrictive covenants following termination. In Cantrell v. Briggs & Veselka Co., the Fifth Circuit Court of Appeals rejected a company’s claim that determining whether former employees breached non-compete clauses created an administrative scheme, finding “nothing discretionary or complex about reducing each payee’s amount” in the event of a breach. (56 EBC 1872, 1877 (5th Cir. 2013))


Interestingly enough, the same court that decided Zgrablich previously found that a “retirement agreement” that provided for the post–employment continuation of medical benefits did not create an ERISA plan. (Coggins v. Keystone Foods, LLC, 111 F. Supp. 3d 630 (E.D. Pa. 2015)) Noting that the retirement agreements were “closely analogous” to severance agreements, the court followed the Angst decision and held that the retirement agreements represented the continuation of an existing plan, not the creation of a new one. Although the severance agreement in Zgrablich specifically provided for the “continuation of the Executive’s then annual salary,” the same court reached the opposite conclusion.

Although the standard is applied inconsistently by the courts, it is clear that the creation of an ERISA plan requires the creation of an “administrative scheme.” The Fifth Circuit’s recent opinion in Gomez v. Ericsson, Inc., 828 F.3d 367 (5th Cir. 2016), sets out some of the specific features commonly found in severance agreements that can create an administrative scheme. The Gomez court found that an administrative scheme can exist when the plan contains discretionary elements, including eligibility determinations, calculations of payment amounts, provision of additional services beyond the severance payment (such as insurance) and determining whether “good reason” exists to qualify an employee’s voluntary termination for severance benefit eligibility.

All of these decisions highlight the fragmented jurisprudence of ERISA preemption in the context of severance arrangements. Although the Zgrablich case represents the minority view, it would support the application of ERISA to individual employment agreements many employers previously thought exempt from its provisions. Some may welcome ERISA coverage — as did the employer in Zgrablich. ERISA limits the remedies available to employees, requires the exhaustion of administrative remedies before proceeding to court, and provides the fiduciary with broad administrative discretion under the “arbitrary and capricious” standard of judicial review established in Firestone Tire & Rubber Co. v. Bruch, 489 US 101 (US 1989). ERISA coverage of a severance arrangement for top management may prove helpful, particularly as employers navigate through old challenges such as enforcement of restrictive covenants and new challenges such as Dodd–Frank clawbacks.

Alvarez & Marsal Taxand Says:

ERISA–governed plans come with costs and benefits to the employer. While there may be some compliance tasks involved, for some companies, access to more business–friendly federal courts, the potential for a deferential standard of review, and limited
employee remedies can make ERISA well worth the price of admission. Either way, ERISA coverage has its consequences. Employers need to remain cognizant of the law and its requirements in order to ensure that any adoption of an ERISA pension or welfare benefit plan is intentional. The Alvarez & Marsal Compensation and Benefits team is here to assist you in designing a benefit plan tailored to achieve your company’s goals.

Disclaimer

The information contained herein is of a general nature and based on authorities that are subject to change. Readers are reminded that they should not consider this publication to be a recommendation to undertake any tax position, nor consider the information contained herein to be complete. Before any item or treatment is reported or excluded from reporting on tax returns, financial statements or any other document, for any reason, readers should thoroughly evaluate their specific facts and circumstances, and obtain the advice and assistance of qualified tax advisors. The information reported in this publication may not continue to apply to a reader’s situation as a result of changing laws and associated authoritative literature, and readers are reminded to consult with their tax or other professional advisors before determining if any information contained herein remains applicable to their facts and circumstances.

About Alvarez & Marsal Taxand

Alvarez & Marsal Taxand, an affiliate of Alvarez & Marsal (A&M), a leading global professional services firm, is an independent tax group made up of experienced tax professionals dedicated to providing customized tax advice to clients and investors across a broad range of industries. Its professionals extend A&M’s commitment to offering clients a choice in advisors who are free from audit–based conflicts of interest, and bring an unyielding commitment to delivering responsive client service. A&M Taxand has offices in major metropolitan markets throughout the U.S., and serves the U.K. from its base in London.

Alvarez & Marsal Taxand is a founder of Taxand, the world’s largest independent tax organization, which provides high quality, integrated tax advice worldwide. Taxand professionals, including almost 400 partners and more than 2,000 advisors in 50 countries, grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.


Related Issues:

DOL Takes Narrow View of 'Top Hat' Plan Status [4]

Many companies maintain “top hat” plans to provide supplemental pension benefits to their top–paid employees. A recent brief filed by the Secretary of Labor in pending litigation suggests that sponsors of such plans may want to rethink the population that is allowed to participate in such plans.
Employment Tax Considerations for Restricted Stock Units That Vest on Retirement

A common provision in many restricted stock unit awards is that vesting will accelerate when a participant becomes eligible to retire, after having reached a certain age and/or completed a minimum number of years of service. One aspect of “retirement vesting” that can be overlooked is the timing of the employment tax obligations.

Latest Trends in Compensation Practices at the Top U.S. Oil and Gas E&P Companies

Alvarez & Marsal’s Executive Compensation and Benefits Practice recently released its 2017 study on compensation practices in the oil and gas exploration and production (E&P) industry. Our study analyzed the total value of CEO and CFO compensation packages, annual and long–term incentive pay practices, and the prevalence and value of change in control benefits to which these executives are entitled.

Source URL: https://www.alvarezandmarsal.com/insights/individual-employment-agreements-under-erisa

Links

Authors:
James Deets, ideets@alvarezandmarsal.com, +1 214 438 1017
Brian Cumberland, bcumberland@alvarezandmarsal.com, +1 214 438 1013
J.D. Ivy, jivy@alvarezandmarsal.com, +1 214 438 1028