

# Strategic Redesign of the Severance Package

## Protecting Companies and Employees Against an Economic Crisis

Organizational restructurings, reductions in force and company-paid severance benefits are common business practices in both the strong economy of the not-too-distant past and the current economic crisis. Reducing corporate expense is a high priority for most companies today, and the significant cost of compensation and benefits has resulted in heightened scrutiny of employee benefits across the board. While most compensation and benefits plans undergo a periodic review and update, it has become increasingly evident that companies typically leave severance unexamined, and the structure and characteristics of severance programs and packages have thus changed very little since the inception of the severance benefits concept in the early 1930s.

Originally intended to provide financial support during the unemployment period to reduce the impact of job loss, severance practices vary between and within companies yet share fundamental features. The standard severance package

### QUICK LOOK

- ➔ A severance payment acts in some way as an intangible and generally unarticulated benefit.
- ➔ Most companies expect to disburse separation benefits on a yearly basis even under the strongest economic conditions.
- ➔ Integration of alternative funding sources into a separation benefits package allows organizations to reduce short-term costs while ensuring quality benefits for terminated workers.

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is a fixed sum determined formulaically based on employees' job levels, pay rates and tenures, and without regard to the probable length of time it might take each separated employee to find new employment. While the national average severance benefit is equal to two weeks of salary for each year of service, a six-month benefit is not uncommon, and a benefit can often amount to a full year's worth of pay. As many organizations are reducing expenses by reducing headcount, severance costs are soaring, thus it remains an area of growing concern.

Many companies are considering decreasing severance benefits offered to employees, yet simply reducing an employee's benefits allotment does nothing to alter a fundamentally inefficient structure. Because severance payments are managed by human resources, and state unemployment taxes by finance, it is rare that an organization calculates and understands the true cost of separation benefits pay.

Many employers believe that severance plays a critical role in upholding employee morale, maintaining company reputation, attracting talent and mitigating the risk of litigation, yet are unclear as to how their company's severance plan achieves these internal goals or what its fundamental value proposition is. Because a reduction in force is, at best, considered an unhappy event and rarely part of the company's business plan, management has been reluctant to apply the same disciplined analyses to severance that are applied to other compensation and benefits programs, hence this remains a vastly inefficient area ripe for improvement. HR professionals charged with implementing a program to add bottom-line value can do so with one that is highly efficient and provides meaningful support to severed employees. By addressing the four fundamental questions below, companies can establish

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a strategic cost-saving alternative to traditional severance that better aligns employer and employee needs.

### 1. What is the real purpose of displaced worker compensation?

One goal of any organization's benefits programs should be aligning the needs of employees with those of the organization. A recently reported 96 percent of employers pay severance in exchange for a release and waiver from the terminated employee. This payment also acts in some way as an intangible and generally unarticulated benefit. Is the payment a reward to the terminated employee for service to the company? Is it to provide income protection during the unemployment period? Is it to attract and retain employees? Is it to improve internal morale during tough times? Is it to maintain the company's reputation? A severance determination formula, which most companies use to calculate awards, in some fashion addresses these questions. Only 59 percent of companies report having a formal severance policy in place, yet even without a formal policy, employers

must consider precedents already set when determining future awards. In times of economic crisis when companies are forced to slash costs, headcount reductions are often among the initial steps taken to immediately reduce cash expenditures. Recent reports indicate 2008-2009 reductions reach well into the millions, and with many of the companies performing these layoffs lacking a formal separation benefits policy, it is unclear which goals are actually achieved through the severance offered.

The most appropriate purpose of severance is to provide protection to the employer against litigation and income protection during the unemployment period to the employee. While many employees appreciate the protection a severance policy offers in the case of a reduction in force, it is the rare individual who accepts or retains a job because of that same policy. And while employers may believe that a severance policy improves morale, it is not uncommon for the retained employees to be discouraged by increased workloads and diminished bonuses. Therefore, any

available funds to improve morale are best invested in programs other than severance.

## 2. What is the best approach for a displaced employee benefits plan?

Severance is lightly regulated and very rarely required by law, therefore policies and payment procedures adopted by organizations may be changed at any time. Because restructuring and reductions in force are such common components of the modern business environment, most companies expect to disburse separation benefits on a yearly basis even under the strongest economic conditions. The country's 8.9-percent unemployment rate indicates the permanent loss of millions of jobs during the past 14 months. Companies have been forced to look at reducing severance awards due to the large number of employees displaced. Where significant cost cutting is required to effectively meet market and operational challenges, continuing to provide a quality severance benefit is increasingly difficult.

An alternative solution to shrinking severance awards is integrating alternative funding sources into the separation benefits package. Rather than spending additional dollars or decreasing award amounts, by using other available resources to fund severance, employers can provide greater numbers of employees with more generous benefits.

Unemployment insurance (UI) is one such resource rarely considered by employers when determining the size of a severance benefit. UI is a nationwide, state-administered program intended to provide temporary financial assistance to people following job loss. These benefits are fully funded using

taxes paid by employers to state and federal governments based on a company's employee population, theoretically to provide UI assistance to all workers the company may potentially displace. State UI is currently available to most separated workers for 39 weeks, depends on weekly reporting and active job-seeking, and ceases upon re-entry into the workforce. While all involuntarily displaced employees have access to state UI, only approximately half of the country's eligible unemployed people claim these funds. Because the IRS mandates all employers must continue to pay taxes into

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the UI system, those employers who fund state UI and pay severance to employees who choose not to claim UI are effectively wasting money. Requiring employees to file for UI funds and integrating those dollars into the company-provided separation benefits package allows companies to use spent funds already put into place to protect unemployed

workers, and effectively offer more generous benefits.

## 3. What innovative and tested solution can provide the same level of legal protection to the employer, realize significant cost savings and maintain employee morale?

Nearly three-quarters of recently downsized companies have executed significant force reductions with the intent of affecting immediate cash flows. Additional cost-reduction strategies implemented, including the reduction of other employee benefits like medical coverage, pension and company 401(k) matches, have reportedly damaged levels of employee trust and resulted

in decreased levels of engagement. Layoffs continue to occur across all industries and in all regions to various degrees. Cost-reduction strategies like benefits reductions, which negatively affect employee morale, serve only to help organizations solve current cash challenges, yet neither effectively keep companies competitive nor protect them against adverse retention effects.

As discussed, integration of alternative funding sources into a separation benefits package allows organizations to reduce short-term costs while ensuring quality benefits for terminated workers. An innovative option adopted by many organizations to achieve these goals is the Supplemental Unemployment Benefit (SUB) plan, a structured program tailored to companies seeking severance cost reductions and broad flexibility in separation benefits administration. SUB plans have been administered by companies for more than 50 years to reduce the financial burden of severance while maintaining a quality benefit equal to a worker's predisplacement income during the unemployment period.

The primary feature of a SUB plan is the integration of state UI benefits into the severance offering. Offsetting an individual's company-paid separation benefit by the amount of state UI awarded allows a company to reduce its financial obligation to the separated employee and, more importantly, can afford the employer the ability to either increase employees' benefits allotments by adding those saved funds to the total of the benefits amount, or reinvest saved funds into other areas of the business. Because cash savings generated by a SUB plan allow an employer to reinvest in ongoing operations and retained employees, it supports those terminated and those who remain, while allowing an organization to efficiently restructure and thus remain competitive during a downturn.

Another feature of a SUB plan that presents a significant savings opportunity to employers and

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employees is the reduction of employment taxes owed by both to the government. Using state UI as a severance-benefit offset allows a company to reduce its FICA and FUTA tax obligations because funds are disbursed to terminated employees as SUB pay benefits rather than as severance wages. Under the typical severance agreement, FICA and FUTA taxes are paid by workers and by employers on all severance wages. Under a SUB plan, payments are reclassified from wages to benefits by the IRS, and the IRS no longer requires payment of these taxes, saving the employer and employee combined approximately 15 percent.

Separation benefits paid under a SUB plan are governed by the Employee Retirement Income Security Act (ERISA) and allow an employer to require a signed release and waiver prior to disbursement. Employers can therefore maintain legal protections yet can realize considerable cost savings and provide terminated employees with income protection during their periods of unemployment.


#### 4. How might an organization establish a new strategy for displaced worker benefits that better supports immediate and longer-term goals?

A good number of organizations feel that recently implemented cost-cutting initiatives have done little to appropriately address the long-term recovery needs of the organization. Attraction, retention, motivation and legal protection reportedly remain the overall goals in severance program design; headcount reductions with fixed-sum payments do little to meet these goals over the long term.

In the same way as a SUB plan addresses immediate cash-flow needs, an additional structural component of the program, critical to its proper administration, allows the SUB plan structure to efficiently and fully satisfy long-term strategic needs of a downsizing company. To properly administer a SUB plan, a company must ensure all displaced employees are eligible for SUB pay by verifying each has applied for and is receiving state UI. By tracking the unemployment period this way, the company guarantees compliance

with the tax code as appropriate under a SUB plan, and ensures terminated employees take full advantage of funds already paid to provide unemployment income protection. In 44 states, employees affected by a force reduction are able to collect company-funded state UI either immediately or only one week after receiving a lump-sum severance payment. By failing to monitor the unemployment status of terminated workers, employers are unable to manage employees' use of the state UI benefit. Additional long-term severance cost savings are achieved when an employer ceases payment of benefits to an employee who has obtained new employment in the same way all states cease disbursement of UI. This component provides meaningful cost savings to the employer, ensures that the separation benefit fulfills the original intent of severance by acting as a financial bridge between employment opportunities, and helps maintain company reputation as it provides flexible and equitable benefits to all employees affected by a reduction in force.

Recent dramatic labor force changes have cost companies billions of unnecessary dollars in severance costs. While not a widely known structure, SUB plans have been in place in many companies for many years, and the flexibility of a SUB plan's structure allows for changes to occur as often as necessary to support a company's goals for employee benefits. While it seems logical to fully examine and overhaul separation benefits programs during times of corporate distress, even during periods of relative economic stability, business needs continually evolve, positions are eliminated and employees displaced. Having in place an ongoing plan that efficiently

supports these transitions eliminates the need for a quick plan change in a crisis situation and allows companies to save funds over the long-term during the normal course of business. Flexibility and variability are necessary components of a company's separation benefits program to ensure the correct balance between the needs of the modern employee population and a corporation strategically and efficiently managing resources. Adoption of an innovative solution that integrates all available resources is critical to address immediate financial needs and establish a more solid platform for growth. 

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