SETTLEMENT AND SEPARATION AGREEMENTS
Ohio Counsel of School Board Attorneys
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The purpose of this session is to provide attendees with practical advice regarding negotiating severance agreements. Subject of course to the ongoing input of the audience, I will focus on the interplay between the plaintiff and defense viewpoints on various key issues in negotiating these agreements.

These materials will serve as resources for attendees, particularly on some of the more substantive issues, providing legal background beyond what we will have time to cover in the program itself. They focus on issues that are common to all employers, but we will also discuss issues that may come up specifically in the school district context.

I. TAX ISSUES IN SETTLEMENT AND SEVERANCE AGREEMENTS[1]

One of the biggest issues in any settlement or severance negotiation is how and when the monies will be paid out, and what each party's obligations are to taxing authorities. Tax laws and regulations often trip up settlement negotiations because employment lawyers are not typically tax lawyers.

A. Are employment settlements generally taxable?

The short answer is yes. More specifically, it depends on how the settlement is allocated among the various types of damages. The following table shows the different types of damages and whether they are taxable as income to the Employee:

Type of Damage	Taxable to the Employee?	Source[2]
Lost wages/back pay and front pay	Yes	26 U.S.C. § 104(a)(2); *Commissioner v. Schleier*, 515 U.S. 323 (1995).
Compensatory damages for emotional distress, pain and	Yes	26 U.S.C. § 104(a)(2)

[1] The materials on tax and unemployment issues were prepared by Chris Royer at the firm of Elfkin, Klingshirn, Royer & Torch, with whom I have presented on this topic (and others), and a terrific plaintiff's lawyer. Some of the highlighted issues will not be the focus of Board lawyers, but I find it helpful to be educated of the other side's concerns.
[2] IRS Publication 525 also provides useful information on what is, and is not, taxable income.

Type of Damage	**Taxable to the Employee?**	**Source[2]**
suffering (NOT associated with personal physical injury and NOT including medical expenses from emotional distress)		
Compensatory damages for emotional distress, pain, and suffering (associated with personal physical injury)	No	26 U.S.C. § 104(a)(2)
Medical expenses associated with emotional distress	No	26 U.S.C. § 104(a)(2)
Punitive damages **EVEN IF ASSOCIATED WITH PHYSICAL INJURY**	Yes	26 U.S.C. § 104(a)(2)
Damages arising from a personal physical injury or sickness	No	26 U.S.C. § 104(a)(2)
Liquidated damages (such as FLSA, FMLA, ADEA)	Yes	*Commissioner v. Schleier*, 515 U.S. 323 (1995) (where liquidated damages are punitive in nature, they are taxable under 26 U.S.C. § 104(a)(2)).
Attorneys' fees and costs of suit associated with employment discrimination claims	No	26 U.S.C. § 62(a)(20); (e)

B. If all of the settlement is taxable anyway, why should we fight over allocating the amounts in the settlement agreement?

Even though all of the components of a settlement may be taxable, the way they are reported to IRS determines how taxes must be paid, and in what amount. Allocating the payments in the settlement agreement may also help both parties if, for some reason, the IRS conducts an audit and tries to challenge the way the payments are reported and taxed.

If there is no allocation in the agreement, then the IRS is more likely to try to treat all of the settlement as taxable, which is detrimental to both sides. For example, if all of the settlement is determined to be wages, then both the Employee and the Employer may be assessed penalties and interest associated with FICA taxes and the Employer's matching obligation.

When a settlement agreement expressly allocates the settlement proceeds among various types of damages, the allocation is generally binding for tax purposes, as long as the agreement is entered into by the parties in an adversarial context; at arm's length; and in good faith.[3]

An express allocation will be disregarded only where the facts and circumstances surrounding the payment indicate that the payment was intended to be for a different purpose.

C. What are the various ways to report these amounts, and what implications does each have?

There are two reporting mechanisms for the typical components of an employment settlement: Form W-2 and Form 1099-MISC. Within Form 1099-MISC, there are two further choices: Box 3 or Box 7. Box 3 is for "other income," including taxable damage awards. Box 7 is for "non-employee compensation" over $600.

Example: $100,000 settlement of a gender-discrimination claim where the plaintiff was terminated. Plaintiff's attorney's fee is $40,000. Of the remaining $60,000, $20,000 is allocated to wage loss and $40,000 is allocated to emotional distress.

Here's how each amount could be reported:

1. For the wage loss portion: W-2 or 1099/Box 7

   This decision should be made in consultation with the Employee's tax advisor because it can depend greatly on his or her financial circumstances.

   a. If reported on W-2: the Employer will treat the payment as if it were a payroll check, and will deduct applicable taxes and withholding for Social Security and Medicare (FICA taxes). The Employer will also have to remit the matching taxes.

      The Employee will receive a check for an amount that is less than the $20,000, and the Employer will send him or her a W-2 at the end of the year.

   b. If reported on Form 1099-MISC, Box 7: the Employer will cut a check to the Employee in the full amount of $20,000. The Employer will not deduct any state, federal, or FICA taxes from this payment, and it will not remit any matching FICA taxes. At the end of the year, the Employer will send the Employee a 1099 with $20,000 reported in Box 7.

2. For the emotional-distress damages portion: The only choice here is for the Employer to report this portion in box 3 of Form 1099-MISC. This box is for "other income" and is

[3] *E.g., Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff'd* 121 F.3d 393 (8th Cir. 1997); *Robinson v. Commissioner*, 102 T.C. 116, 127 (1994), *aff'd in part, rev'd in part and remanded on other grounds* 70 F.3d 34 (5th Cir. 1995); *Threlkeld v. Commissioner*, 87 T.C. 1294, 1306-1307 (1986), *aff'd* 848 F.2d 81 (6th Cir. 1988).

specifically designed for taxable damage awards, such as emotional distress resulting from non-physical injury.

The Employee will receive a check for the full amount of $40,000, and the Employer will send him or her a Form 1099 with $40,000 reported in box 3.

D. Is the Employee subject to higher federal withholding on the wage portion of the settlement, if it is paid in one lump-sum?

If the amount of the wage-loss portion of the settlement is more than the Employee's normal earnings, and the Employer is paying this amount as one lump-sum payment (i.e., not over time), the Employee could be subject to higher federal withholding than he or she usually had when receiving regular paychecks.

This is often because Employers use payroll services that do one of two things: (1) treat the payment as a "supplemental payment" and tax it at a flat rate; (2) or treat the payment as if the Employee earns this larger amount in every pay period, which would push him or her into a higher tax bracket, and therefore result in more withholding.

The rate of withholding for wage-loss payments is a very common sticking point because Employees are dismayed when more federal withholding is deducted and, given the usually acrimonious relationship between the parties at this point, may be distrustful of the Employer.

Employers, for their part, often resist agreeing to tax the wage-loss portion of a settlement at the federal rate applicable on the Employee's last day worked, consistent with the Employee's W-4, fearing some negative consequence from the IRS.

The IRS regulations state that an employee's remuneration may consist of regular and supplemental wages.[4] Supplemental wages are those that are usually paid without regard to a payroll period, and include payments for back pay. Overtime pay can be either supplemental or regular wages.

Because most wage-loss portions of settlements will be supplemental wages, the amount of the payment and other factors determine how withholding is calculated. If a payment falls under the definition of "supplemental payment" and is $1 million or more, it must be taxed at a flat rate.[5] If a supplemental payment is less than $1 million, the Employer may generally choose to withhold at a flat rate of 28 percent, or calculate withholding based on what is called the "aggregate method."[6]

If the following conditions are **not met**, the Employer **must** withhold based on the aggregate method, and cannot calculate withholding based on a flat 28 percent: (1) income tax has been withheld from the Employee's regular wages during the calendar year of the payment, or the

[4] 26 C.F.R. § 31-3402(g)-1(a)(1)—(i).
[5] *Id.* (a)(2).
[6] *Id.* (a)(7).

preceding calendar year; and (2) the payment is not made concurrently with regular wages, or is separately stated on the Employer's payroll records.[7]

Otherwise, if the above conditions are met, then the Employer may choose between withholding at a flat rate and calculating withholding based on the aggregate method.

To calculate withholding using the aggregate method:

a. if the payment is paid concurrently with wages for a payroll period: the supplemental payment is added to the regular wages to be paid. Withholding is calculated based on this single payment, taking into consideration the Employee's W-4.

b. if the payment is not paid concurrently with wages for a payroll period: the supplemental wages are added to wages paid within the same calendar year for the last payroll period, if any. Withholding is determined based on this amount, taking into consideration the Employee's W-4. The amount withheld from the regular wages that were paid earlier is subtracted to arrive at the amount of withholding from the supplemental payment.

E. Why is it important for the attorneys' fees in an employment discrimination case to be paid separately?

In 2004, Congress amended the tax code to provide tax relief for contingent attorney-fee payments in "employment discrimination" cases. This relief came in the form of an "above-the-line" adjustment for the amount of the attorneys' fees, meaning that the amount is not factored into the Employee's adjusted gross income on his or her Form 1040, so it is not subject to tax.

Note that the term "employment discrimination" is very broad, and covers a wide swath of cases, including overtime under FLSA, discrimination under Title VII and related federal statutes, and claims under analogous state statutes, including public-policy claims.[8]

II. UNEMPLOYMENT ISSUES IN SEVERANCE AND SETTLEMENT AGREEMENTS

There are many issues relating to unemployment that can complicate settlement and severance negotiations, and dealing with these issues appropriately in the written agreement is of paramount importance to both Employees and Employers.

A. Parties to a settlement or severance agreement may not agree that an Employee will waive his or her right to unemployment compensation.

Although it may be tempting to try to negotiate a waiver of the right to unemployment benefits to avoid some of the complications that unemployment can pose in settlement and severance

[7] *Id.* (a)(6).

[8] 26 U.S.C. § 62(e).

contexts, the Unemployment Compensation Act provides that "no agreement by an employee to waive his right to benefits is valid."[9]

Thus, any negotiations must address only the issue of whether the employer will contest a claim, and other issues that could affect the employee's unemployment compensation, such as those addressed in the sections that follow.

B. Certain payments to employees are offset from unemployment compensation, which can affect the timing and characterization of settlement or severance payments.

Weekly unemployment compensation benefits are reduced by certain types of payments, including "remuneration in lieu of notice"; retirement or pension payments; and "separation or termination pay."[10] Notably, however, Social Security payments are no longer offset from unemployment compensation.[11]

"Remuneration in lieu of notice" is a "continuation of wages for a designated period after termination of employment."[12] This type of payment is generally made when the employer does not give the employee required or customary notice before dismissal, including payments required under the WARN Act. It is considered wages for the designated period, is subject to employer contributions, and is considered "remuneration" for purposes of the employee's weekly claim.

"Separation pay" includes payments made to employees "in return for their agreeing to a separation from employment."[13] However, according to ODJFS guidance on fact-finding for this issue, severance pay is not deductible in certain circumstances:

> *Severance pay is not deductible when payment(s) is made beyond a reasonable period of time (regardless of whether the employee requested the payments be deferred) after the separation date, allowing for final accounting and payroll processing. A "reasonable period of time" is based on the employer's pay schedule. If claimant is paid bi-weekly, consider two weeks a reasonable period of time. If claimant is paid monthly, consider 30 days a reasonable time and so forth.*[14]

It is not clear whether "back pay" is considered to be "earnings" for offset purposes, or for overpayment purposes. Overpayment is discussed in Section D. In one section of its *UC Law Abstract*, the Unemployment Compensation Review Commission states that back pay is "earnings" and is deductible:

> *An award of back pay is considered earnings. An overpayment order should be issued if*

[9] Ohio Rev. Code Ann. § 4141.32(A).
[10] *Id.* § 4141.31(A)(1), (3), (4).
[11] *Id.* § 4141.312(B).
[12] Ohio Adm. Code § 4141-9-08.
[13] *Id.* § 4141-30-01.
[14] Unemployment Compensation Policy Guide, Non-Monetary Issues, Non-Separation, Deductible Income. A copy of this is attached to these materials.

unemployment compensation benefits were paid during the period covered by the award . . . .[15]

However, in another section of the *Abstract*, the Commission says that settlement payments in exchange for an agreement not to sue are "non-deductible" in certain situations:

> *Agreements not to sue. The Review Commission generally views a standard agreement not to sue an employer as an agreement to a separation, and any payment conditioned on signing that agreement is still deductible separation pay.* ***Where the individual already has pending legal action against the employer, the Review Commission is more likely to view the conditioned payment as non-deductible settlement pay.***

The issue of deductions and offsets arises most often in the severance context, where payments are made over time. If an employee applies for Unemployment and is already receiving benefits at the time the parties agree to a severance, the payments under the agreement will create complications for his or her weekly claims. ODJFS will stop payments and, in some cases, force the employee to "re-open" the benefits claim.

C. The Ohio Department of Job & Family Services will allocate severance or separation payments, unless the parties address this issue in the agreement.

If the parties' severance agreement allocates the payments to weeks in which the Employee claims benefits, the benefits will be reduced by the amount of the severance payments.[16] If the parties do not allocate the payments to particular weeks, then ODJFS will allocate the payments based on the employee's weekly wage, until the total amount of the severance is exhausted.[17]

The allocation rules can cause particular problems where a severance is paid as a lump sum, and the parties do not address the allocation of the payment in the agreement. In this situation, the parties should include an allocation in the agreement.

D. If ODJFS finds that an Employee received benefits, but should not have for some (non-fraud-related) reason, it will assess an overpayment, and require the Employee to pay back benefits received.

Because unemployment compensation is subject to "overpayment" and re-payment, it is imperative that issues that could impact an Employee's benefits be addressed precisely in any settlement or severance agreement.

Under the Ohio Revised Code, ODJFS has a certain amount of time to assess an overpayment and order re-payment: within six months after the Employee's benefits determination becomes final, or within three years after the Employee's benefit year ends, whichever is later.[18] However, this limitations period does not apply to cases involving "retroactive payment of

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[15] OHIO UNEMPLOYMENT COMPENSATION REVIEW COMMISSION, *UC LAW ABSTRACT*, available at www.web.ucrc.state.oh.us.
[16] OHIO REV. CODE ANN. § 4141.31(A)(5). *See also* OHIO UNEMPLOYMENT COMPENSATION REVIEW COMMISSION, *UC LAW ABSTRACT*, available at www.web.ucrc.state.oh.us.
[17] *Id.* (6).
[18] OHIO REV. CODE ANN. § 4141.35(B)(1)(a).

remuneration."[19] Although there appears to be no limitations period for these types of cases, ODJFS may not assess an overpayment or demand repayment unless the agency is notified of the retroactive payment with six months of the date the Employee received it.

A "retroactive pay award" is defined in the regulations as "any adjustment in the amount of remuneration paid to an individual as the result of the resolution of a dispute as to the remuneration for services" provided by the Employee during the base period, as long as this amount was not used to determine the Employee's application for unemployment benefits or the amount due for a weekly claim.[20]

Like severance/separation payments, these payments may be allocated by agreement, or by ODJFS if there is no agreement.[21]

To avoid a settlement or severance payment being considered "retroactive payment of remuneration," the parties must include language characterizing the payment accordingly.

III. VALIDITY (OR NOT) OF NO-REHIRE CLAUSES

Employers often want an agreement to specify that the employee cannot be rehired by the employer – "yes, we will pay you to sign this release, IF you agree we never have to take you back." There is case law support for the validity and enforceability of such clauses or, more specifically, that such provisions constitute a legitimate nondiscriminatory reasons for a refusal to subsequently hire the employee. *E.g., Jencks v. Modern Woodmen of America*, 479 F.3d 1261 (10th Cir. 2007) (holding that employer's reliance on a former employee's waiver of any right to reemployment or reinstatement in settling a Title VII claim constituted a legitimate and nondiscriminatory reason for the employer's decision not to consider the former employee for a subsequent position). While these provisions are not conclusively enforceable, and clients who want them should be advised as such, there seems no reason not to include them if desired.

IV. OLDER WORKERS BENEFIT PROTECTION ACT (OWBPA) REQUIREMENTS FOR A VALID RELEASE OF FEDERAL AGE CLAIMS

The Older Workers' Benefit Protection Act ("OWBPA"), codified at 29 U.S.C. § 626(f) as an amendment to the Age Discrimination in Employment Act ("the ADEA"), sets forth requirements for a valid release that are unique among discrimination laws. If the waiver of a person's ADEA rights is requested in connection with a layoff affecting only one employee, the OWBPA imposes the following requirements that the waiver:

1. be in writing and understandable by the employee affected or by the average employee entitled to participate;
2. specifically refer to ADEA rights or claims;
3. not waive rights or claims that may arise after the waiver is executed;

[19] *Id.* (b).
[20] OHIO ADM. CODE § 4141-9-14(A).
[21] *Id.* (C).

4. be in exchange for valuable consideration;
5. advise the individual in writing to consult an attorney before signing the waiver; and
6. provide the employee at least 21 days to consider the agreement and at least seven days to revoke the agreement after signing it.

Most lawyers practicing in the area and many employers and employees are aware of this "21/7" requirement and it does not frequently present significant practice issues. If, however, the waiver is requested in connection with an ***"exit incentive" or "other termination program"*** offered to a group or class of employees, the OWBPA requires that the waiver:

1. provide the employees at least ***45 days*** to consider the agreement and at least seven days to revoke the agreement after signing it; and

2. include written notice, drafted in a manner to be understandable by the average employee entitled to participate, of

    - any class, unit, or group of individuals covered by such program, any eligibility factors for such program, and any time limits applicable to such program; and

    - the job ***titles and ages of all individuals eligible or selected for the program***, and the ages of all individuals in the same job classification or organizational unit who are not eligible or selected for the program.

There are surprisingly few cases concerning the waiver requirements applicable to exit incentive or other termination programs. Importantly, "exit incentive or other employment termination program" is defined very broadly: "A 'program' exists when an employer offers additional consideration for the signing of a waiver pursuant to an exit incentive or other employment termination (e.g., a reduction in force) to ***two or more employees***." 29 C.F.R. § 1625.22(f)(1)(iii)(B) (emphasis added).

Once an employer concludes it has an exit incentive or other employment termination program, the issue becomes which employees should receive the written notice; otherwise stated, which employees constitute the ***decisional unit*** entitled to information about the program? The decisional unit is "that portion of the employer's organizational structure from which the employer chose the persons who would be offered consideration for the signing of a waiver and those who would not be offered consideration for the signing of a waiver."

29 C.F.R. §1625.22(f) provides a variety of examples. For example, if the employer seeks to eliminate ten percent of the employees in a particular facility, the decisional unit would be any of the employees in that entire facility. If, however, the employer sought to eliminate half of the employees in its keyboard department, the decisional unit would only be the keyboard department. 29 C.F.R. § 1625.22(f)(3)(iii).

The few cases on this issue have helped to somewhat clarify the issue of the decisional unit and what information should be included on the notice. Clearly there is no safe harbor of being overinclusive. *See, e.g., Burlison v. McDonald's Corp.*, 455 F.3d 1242 (11th Cir. 2006) ("In order to evaluate their claims, employees need appropriate data to conduct meaningful statistical

analyses. In the discrimination context, the data must permit employees and their attorneys to make meaningful comparisons to determine whether an employer engaged in age discrimination. The data must allow the Appellees to consider whether anything suggests that older employees in their unit were unjustifiably terminated in favor of younger ones. ***Extending the information requirement beyond a decisional unit will in reality only obfuscate the data and make patterns harder to detect.***"); *Kruchowski v. Weyerhaeuser Co.*, 446 F.3d 1090 (10th Cir. 2006) ("Defendant failed to provide the correct, mandated information when it informed plaintiffs that the "decisional unit" included all salaried employees of the Mill. Because the information defendant provided did not meet the strict and unqualified requirement of the OWBPA, the Release is ineffective as a matter of law."); *Pagliolo v. Guidant Corp.,* 483 F. Supp. 2d 847 (D. Minn. 2007) ("The Court finds that Guidant violated the OWBPA by failing to disclose the decisional unit. The Court finds that listing nearly all United States-based employees in Exhibit B does not disclose the decisional unit in a manner calculated to be understood by the average individual eligible to participate in the Severance Plan.");

There just is not a lengthy body of cases to guide attorneys in advising clients in this area. As demonstrated by the cases, courts do not hesitate to invalidate releases. *See also Peterson v. Seagate US LLC*, 2008 U.S. Dist. LEXIS 42179 (D. Minn. May 28, 2008) (invalidating releases because the information presented in the OWBPA notice was inaccurate and presentation of the applicable job titles and codes was confusing); *Faraji v. FirstEnergy Corp.*, 2007 U.S. Dist. LEXIS 16092 (N.D. Ohio Mar. 7, 2007) (finding a release invalid because the company failed to disclose the termination program's eligibility factors on the OWBPA notice).

V. MUTUALITY: DRAFTING AROUND COMMON AREAS OF DISAGREEMENT

It is a common pattern – the employer's counsel drafts an agreement, requiring *the employee* to release claims and promise confidentiality and confidentiality. The employee's counsel responds requesting mutuality of one or more of those provisions. The employer is generally not unwilling to entertain the concept of mutuality, but asserts that it is not quite apples and apples.

With respect to the release, the employer's view is that there is a greater likelihood of "latent liability" arising from the employee's actions – the termination itself is generally the worst thing that the employer can do to the employee, but the employee may have committed acts against the employer's interest that the employer has at the time of entering into the agreement not yet discovered.

With respect to nondisparagement, the employee generally needs only to control his or her own communications, whereas the employer does not want to be bound to controlling every communication of every non-management employee. We will discuss these issues during the session. What follows are some sample provisions that have been used to address the employee's desire for mutuality while giving the employer protection against its concerns.

Release

Employer, releases and discharges Employee from any claim, demand, action, or cause of action, known or unknown, which arose at any time from the beginning of time to the date Employer executes this Agreement, and waives all rights relating to, arising out of, or in any way

connected with Employee's employment with Employer, the cessation of that employment, including (without limitation) any claim, demand, action, cause of action or right, including claims for attorneys' fees, ***provided that this release of Employee is not intended to and will not release him from any claims arising in whole or in part from violations of law on his part.***

OR

The Board, on behalf of itself and its representatives, forever releases Teacher from, and covenants not to bring suit or otherwise institute legal proceedings against him arising in whole or in part from, all claims arising from events occurring prior to the execution of this Agreement that the Board now has or may have or that the Board may hereafter have of any nature whatsoever, be they common law or statutory, legal or equitable, in contract or tort, under federal, state or local law including but not limited to claims arising out of Teacher's employment with the Board and/or the termination of that employment, ***provided that with respect to Teacher's conduct related to any such claim he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Board and he had no reason to believe such conduct was unlawful***. The Board hereby waives all rights to assert a claim for damages available under any such laws, including but not limited to attorney fees, damages, or injunctive relief.

Confidentiality

Except as otherwise required by law, the Parties agree to keep the terms of this Agreement completely confidential and not to disclose any information concerning the Agreement or the facts and circumstances underlying it to anyone other than the Parties' attorneys as is reasonably necessary, provided that, if any Party makes a disclosure to any such person and such person makes a disclosure that, if made by the Party, would breach this paragraph 4(a), such disclosure will be considered to be a breach of this paragraph 4(a) by the Party. The confidentiality provisions of this Agreement are of the utmost importance to the Parties and the Parties agree that the confidentiality provisions are a material part of this Agreement. ***For purposes of this paragraph only, "the Parties" shall be defined as Employee and Employer's administrators and Board members.***

Nondisparagement

The Parties agree that Employee and ***Employer's administrators and Board members*** will refrain from any publication, oral or written, of a defamatory, disparaging, or otherwise derogatory nature pertaining to the other Party and/or its Related Persons.

OR

Employer that it will not ***direct, encourage, assist, or ratify*** any statements or representations that disparage, demean, or impugn Employee to any person or entity, including without limitation any statements impugning Employee's personal or professional character.