

**CALPELRA Annual Conference
November 3, 2016**

**SEVERANCE AND LAST CHANCE AGREEMENTS:
HOW TO NEGOTIATE AND DRAFT AGREEMENTS
THAT COMPLY WITH THE LAW AND
PROTECT YOUR AGENCY**

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**WHEN AND WHY SHOULD EMPLOYERS
USE SEVERANCE AGREEMENTS**

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EEOC Scrutiny of Broad Waivers in Settlement Agreements

- EEOC has been attacking employer agreements containing waivers and releases.
- EEOC has been filing more lawsuits against employers based on the alleged illegality of their agreements with employees.



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- **1997:** EEOC stated that employment agreements that attempt to inhibit participation with the EEOC violate anti-retaliation provisions of statutes the EEOC enforces.
 - ✓ The Sixth Circuit Court of Appeals rejected this argument that an agreement containing an impermissible “charge-filing ban” was retaliatory, and instead found that, while the provisions might have been unenforceable, it did not constitute unlawful retaliation.



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- **2009:** EEOC seemingly softened its position by telling employees that provisions in severance agreements prohibiting filing a charge or participating in an EEOC investigation are “invalid and unenforceable” rather than unlawful.
- **2013-2016:** In its Strategic Enforcement Plan for 2013-2016, EEOC illustrated a renewed interest in waiver and release agreements. The Plan set forth a goal of preserving employees’ access to the legal system, in part, by targeting overly broad waivers or settlement provisions that prohibit filing charges with EEOC or providing information to assist in an EEOC investigation.



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- **Today:** EEOC is again contending that agreements purportedly infringing on the right to file a charge are not only unenforceable, but are also unlawful.



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- In recent lawsuits, EEOC has taken issue with a variety of language/provisions in the agreements, including:
 - ✓ Releases with broad language attempting to release an employee's ability to file a charge;
 - ✓ Barring employees from assisting others in bringing claims against the employer;
 - ✓ Obligating employees to assist the employer with an investigation or lawsuit;



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- ✓ Non-disparagement clauses that purportedly prevent the employee from making negative statements about the employer to the Commission;
- ✓ Confidentiality provisions that prohibit disclosure of such information as wages, benefits, personnel information and the skills, abilities, and duties of employees; and
- ✓ Requiring an employee to pay the employer's attorneys' fees for breaching the agreement.



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- Need to Evaluate ADEA waiver considering totality of circumstances. In a June 2016 District Court case (*Romero v. Allstate*) the court emphasized that there is no one factor that will ensure that an agreement is a valid waiver of federal ADEA claims. The court instead looked at the totality of the circumstances, rather than a checklist. However, a checklist would include:
 1. The clarity and specificity of the release language
 2. The plaintiff's education and business experience
 3. The amount of time the plaintiff had for deliberation about the release before signing it
 4. Whether plaintiff knew or should have known his rights upon execution of the release



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

5. Whether plaintiff was encouraged to seek, or in fact received benefit of counsel
6. Whether there was an opportunity for negotiation of the terms of the agreement
7. Whether the consideration given in exchange for the waiver and accepted by the employee exceeds the benefits to which the employee was already entitled by contract or law

However, the court looks beyond these factors at the totality of the circumstances to determine if a waiver is "knowing and voluntary."



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- Recommended Actions: The following steps can help reduce the risk that an employer's severance agreement becomes an EEOC target or is found to violate federal law:
 - ✓ Ensure employment agreements neither explicitly nor implicitly prohibit employees from filing a charge or complaint with EEOC or from participating in agency investigations under federal laws that EEOC enforces. E.g., do not include the word "charges" or language such as "complaints before administrative agencies" in the releases. But can include a waiver and release for recovery of personal relief (monetary damages, reinstatement from an administrative action).



EEOC Scrutiny of Broad Waivers in Settlement Agreements, cont'd

- ✓ Include a severability clause.
- ✓ Alternatively (or in conjunction with a general disclaimer) include disclaimers in specific provisions that state that the limitations of the provisions do not inhibit the employee's right to file a charge with EEOC.



SPECIFIC PROVISIONS IN SETTLEMENT AGREEMENTS

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Settlement Terms for Consideration

Compensation

- Back Pay
- Front Pay
- Damages for physical or emotional injuries
- Cash Settlement
 - ✓ Timing of payment – lump sum or prorated
- Benefits
 - ✓ Health
 - ✓ Retirement
 - ✓ Other

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Settlement Terms, cont'd

Modifying the Notice of Discipline

- Strike Language
- Causes of Action
- References to Specific Allegations

Removing the Notice of Discipline

- Notice/Working Files/Supporting Docs



Settlement Terms, cont'd

Excluding the Settlement Agreement from the personnel file

- Sealing
- Destruction after certain period



Settlement Terms, cont'd

Withdrawal v. Removal – What's the difference?

- Withdraw adverse action v. cleanse the file
- Impact on notice/progressive discipline
- Future use of file documents
- Impact on providing information to other prospective employers
- Risks of not providing information to prospective employers



Settlement Terms, cont'd

Withdrawing adverse action in exchange for waiver of back pay

- Terminated/suspended employee returns to work
- Impact on service credits and other benefits
- Post/bid rights
- Seniority



Settlement Terms, cont'd

Transfer to another unit, supervisor, or position.

Practicalities –

- Transferee concerns
- Seniority
- Minimum qualification requirements



Settlement Terms, cont'd

Rejection during probation –

- Mandatory or permissive right to return to previous position

Rights affected by voluntary resignation

- Unemployment Insurance
- Other



Settlement Terms, cont'd

Agreement not to seek reemployment. If hired, grounds for dismissal.

- Waiver of appeal rights
- Time limit



Settlement Terms, cont'd

Non-Disparagement Provisions

- By employee? Mutual?

Exceptions

- Testifying truthfully under oath per subpoena or court order
- Participating in legitimate investigation



Settlement Terms, cont'd

Provisions for Employer's Response to Reference Inquiries

- Dates of employment
- Job Titles
- Salary
- Other information



Settlement Terms, cont'd

Confidentiality Clauses

- Settlement Agreement is public record, subject to disclosure under Public Records Act
 - ✓ *Register Division of Freedom Newspapers v. County of Orange* (1984) 158 Cal. App 3d 893
 - ✓ *Sanchez v. County of San Bernardino* (2009) 176 Cal. App. 4th 516
- Employee? Mutual?
- Disclosure to spouses, accountants and other professionals



Settlement Terms, cont'd

Resignation in Lieu of Dismissal – Considerations

- No challenge to Unemployment Insurance
- One contact for all employment verification inquiries
- Seal records
- No challenge to retirement application
- Resignation letter



Settlement Terms, cont'd

Layoffs

- ADEA and OWBPA – 45-days consideration
- Notice required of names and ages of others eligible for layoff in classification



Settlement Terms, cont'd

Standard Waiver Language

- Limited to Notice of Discipline conduct
- All prior incidents in workplace
- Specific items waived or not
 - ✓ Existing grievances, EEO claims, DFEH complaints, etc.
- No waiver of workers' compensation
- Civ. Code 1542 general release
- ADEA language
 - ✓ 21-day consideration – waiver permissible
 - ✓ 7-day revocation period – no waiver



Settlement Terms, cont'd

Standard Waiver Language

- No admission of wrongdoing
- Voluntary Agreement
- Consultation with Atty/Rep
- No reliance on verbal terms
- Entire agreement



Settlement Terms, cont'd

Settlement Conferences

- Clear settlement authority required
- Authority of Atty/Rep to bind parties
- Resolve conflicts between multiple parties in advance
- Right to request new judge/mediator – may be waived



TAXATION OF SETTLEMENTS



Taxation of Settlements

- Legal Principle: Origin of the Claim Test
 - Payment in satisfaction of a claim is a substitute for the item alleged in the claim.
 - Not based upon calculation of that claim, but what forms the basis for the claim.



Correct Treatment of Employment-Related Settlement Payments

- Determine the character of the payment and the nature of the claim;
- Determine whether payment constitutes gross income;
- Determine whether payment is wages for employment tax purposes;
- Determine the appropriate reporting for the payment and any attorneys' fees (Forms 1099 or W-2)



What is the Payment For?

- Back pay (other than lost wages for personal physical injury)
 - Compensation up to the date of settlement/court award that would have been earned, but for employer's wrongful conduct
 - Taxable as wages, Rev. Rul. 78-336
- Front pay
 - Compensation for remuneration that would have been received after the date of settlement/court award but for employer's wrongful conduct
 - Taxable as wages (except in TX, LA and MS)



What is the Payment For?

- Emotional Distress (from discrimination, injury to reputation)
 - Taxable as non-wage income, Treas. Reg. 1.61-14(a)
- Emotional Distress (attributable to personal physical injury or physical sickness)
 - Non-taxable
- Interest
 - Taxable as interest, *Brabson v. U.S.*, (10th Cir. 1996)
- Costs
 - Taxable as non-wage income, IRC section 62(a)(2)



What is the Payment For?

- Personal Physical Injury or Personal Physical Sickness
 - Non-taxable, IRC section 104(a)(2)
 - IRS: observable bodily harm, such as bruising, cuts, swelling or bleeding
- Punitive Damages
 - Taxable as non-wage income, IRC section 104(a)(2)



Attorneys' Fees

- Attorneys' Fees (No fee-shifting statute)
 - Taxable as income, *Comm'r v. Burks*, (S. Ct. 2005)
- Attorneys' Fees (Fee-shifting statute)
 - Taxable as income to employee, *Green v. Comm'r*, (2007)
 - Tax court not bound by California Supreme Court that under state law the fees belonged to the attorney
 - Open question whether these are wages
- Attorneys' Fees (relating to non-taxable award)
 - Non-taxable to claimant
 - But, no deduction for allowed for attorneys' fees § 265(a)(1)



Reporting of Payments to IRS

- Back pay and Front Pay - Form W-2 to employee
- Personal Physical Injury or Physical Sickness– none
- Punitive Damages – Form 1099-MISC to employee
- Emotional Distress (non-personal physical injury) – Form 1099-MISC
- Emotional Distress (personal physical injury) – None
- Costs – Form 1099-MISC

- Attorney's Fees (No fee-shifting statute)
 - For employee: Form W-2 or Form 1099-MISC
 - For attorney: Form 1099-MISC, Box 14
- Attorney's Fees (Fee-shifting statute)
 - For employee: Form W-2 or Form 1099-MISC
 - For attorney: Form 1099-MISC, Box 14



Reporting Payments to Attorneys

Examples in Treasury Regulation § 1.6045-5:

- Joint Payees - Example 1:
 - Defendant settles wage claim for \$300,000.
 - One check payable jointly to plaintiff and attorney in the amount of \$200,000 (withholding taxes of \$100,000).
 - Check in the amount of \$200,000 is delivered to the attorney.
 - Attorney retains \$100,000 for fee.
 - Defendant must report the following:
 - \$300,000 on Form W-2 to Plaintiff
 - \$200,000 on Form 1099 to Attorney.



Taxation of Settlement Payments Deductions for the Employee

Attorneys' Fees

- Deduct as an above-the-line deduction if attorneys' fees paid in connection with any action involving a claim of unlawful discrimination. IRC § 62(a)(20)(a number of federal, state or local laws including the ADEA).
- Deduct as an above-the-line deduction if attorneys' fees paid in connection with any aspect of the employment relationship. IRC § 62(e)(18).
 - *Reminder: no deduction for fees' if recovery is tax-exempt.*
- If neither, then deduction allowed under either the deduction can be a miscellaneous itemized deduction, subject to 2% floor.



Allocation of Damages

- Payment may be made on account of multiple claims
 - Allocation must be made
 - Based on all facts and circumstances
 - Terms must be consistent with the true substance of the underlying claims
- IRS is Not Bound by Allocation Made between Parties
- To respect the allocation in the settlement, IRS considers:
 - Whether there was a bona fide adversarial settlement
 - Whether terms are consistent with substance of the claims



LAST CHANCE AGREEMENTS

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WHEN AND WHY SHOULD EMPLOYERS USE LAST CHANCE AGREEMENTS

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Last Chance Agreements

Definition: a formal, written agreement between an employer and an employee that allows the employee to remain employed despite significant misconduct, provided that employee meets certain conditions.



Last Chance Agreements, cont'd

- Pros:
 - ✓ Cost-effective process: avoids the final expense associated with otherwise going through a full-blown termination hearing/process
 - ✓ Provides a private forum and direct means to avoid termination
 - ✓ Win-win scenario: employee gets second chance and employer avoids hassle, expense and uncertain outcome of disciplinary process



Last Chance Agreements, cont'd

- Cons:
 - ✓ LCAs become problematic if not drafted carefully
 - ✓ Employees may allege disparate treatment if employer refuses to provide LCA to all employees facing discipline for similar misconduct in future



Last Chance Agreements, cont'd

Cases Involving LCAs:

- *Lanigan v. City of Los Angeles*, 199 Cal.App.4th 1020 (2011)
 - ✓ If entered into voluntarily and without coercion, a LCA that waives a police officer's statutory rights in exchange for settlement of a proposed disciplinary action is generally permissible.



Last Chance Agreements, cont'd

- Facts
 - ✓ First Misconduct - Proposed termination for harassment and failure to follow orders
 - ✓ LCA - 22-day suspension without pay, signed letter of resignation held in abeyance until LCA violated
 - ✓ Second Misconduct - Lanigan was later charged with providing false information and failing to cooperate with an officer. The LAPD sustained the complaint and, in accordance with the LCA, accepted Lanigan's already-executed resignation without affording him pre or post-termination rights under POBRA.



Last Chance Agreements, cont'd

- Why the LCA was enforceable:
 - ✓ Well-drafted and comprehensive – the terms were clear and the possibility of automatic resignation was fully disclosed and summarized.
 - ✓ Repeated misconduct was clear-cut.
 - ✓ No procedural unfairness or surprise (such as coercion).



Last Chance Agreements, cont'd

- ✓ Had an opportunity to negotiate the terms with his attorney and acknowledged in writing that his agreement was voluntary.
- ✓ Could not argue that the LCA had an overly harsh result as the LCA allowed Lanigan the substantial benefit of keeping his job.
- ✓ Court was untroubled by the fact that the LCA had no expiration date.



Last Chance Agreements, cont'd

- *Walls v. Central Contra Costa Transit Authority*, 653 F.3d 963 (9th Cir. 2011).
 - ✓ LCA failed to contain waiver of *Skelly* rights, and court held that the employee had not knowingly waived his rights to a pre-termination hearing by signing LCA and public employer thus violated his due process right by not providing such a hearing prior to termination.



Last Chance Agreements, cont'd

- The court found:
 - ✓ That it was not clear that the phrase “immediate and final termination” used in the context of an LCA necessarily signaled that the termination would take effect without a hearing or process of any kind; and
 - ✓ That it was certainly not clear Walls knew and understood when he signed the LCA that he was waiving his right to due process in the form of a pre-termination hearing. Neither did he acknowledge or understand that he would thereafter be treated as an at-will employee.



Last Chance Agreements, cont'd

- Action Item
 - ✓ *Walls* allows for the waiver of due process, including the waiver of pre-termination *Skelly* hearings. However, it also stresses the importance of public employers correctly drafting a LCA and clearly identifying the specific rights that are to be waived by the employee and the specific consequences of further misconduct.



Last Chance Agreements, cont'd

- *Farahani v. San Diego Community College Dist.*, 175 Cal. App. 4th 1486 (2009) (depublished).
 - ✓ The LCA entered into by a college professor was ruled unenforceable because it purported to waive statutory procedural protections that were enacted for the benefit of the teaching profession and the public at large.



Last Chance Agreements, cont'd

- *Farahani* (cont'd)
 - ✓ Part of the court's reasoning was based specifically on provisions of the *California Education Code* that define procedural rights in faculty disciplinary matters. But the reasoning in the opinion appears to affect the entire practice of entering into any "last chance" agreement or other side agreement between a public employer and an employee, where the employee purports to waive statutory procedural protections.
 - ✓ In particular, the decision follows the general principle, codified in *California Civil Code*, section 3513, that purported waivers of the protections of statutes enacted for a public purpose are extremely narrowly construed. Section 3513 provides: "Anyone may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement."



Last Chance Agreements, cont'd

- LCAs and Drug and Alcohol Cases - When LCAs arise from an employee's substance abuse, other legal issues are implicated
 - ✓ Americans with Disabilities Act
Alcoholism may be classified as a disability under the ADA if it *substantially limits* participation in a major life activity.
 - ✓ Cal. Fair Employment and Housing Act
Alcoholism may be classified as a disability under the FEHA if it merely *limits* such participation (more general standard than federal counterpart).



Last Chance Agreements, cont'd

- ✓ Cal. Labor Code Section 1025
 - Requires private employers who employ 25 or more employees to “reasonably accommodate” any employee who wishes to voluntarily enter and participate in an alcohol or drug rehabilitation program
“Reasonable accommodation must not impose an “undue hardship” on employer.
 - However, employers are not prohibited from taking action against an employee “who, because of the employee’s current use of alcohol or drugs, is unable to perform his or her duties, or cannot perform the duties in a manner which would not endanger his or her health or safety or the health or safety of others.”



Last Chance Agreements, cont'd

- Testing
 - ✓ The employer's right to conduct drug and alcohol testing on employees is limited by, and must be balanced against, the employee's right to privacy.



Last Chance Agreements, cont'd

- Structure: employers should be specific about the types of misconduct that will result in termination and explain that unexcused failures will result in termination. The following are some examples of potential LCA provisions:
 - ✓ That the problem employee attend counseling sessions or successfully complete a substance abuse program;
 - ✓ That the employee will be subject to unannounced drug and alcohol testing for a certain period of time (e.g. two years);
 - ✓ That the employee will be terminated either for failure to participate in unannounced testing, or for a positive test result;
 - ✓ That the employee must maintain an exemplary attendance record without any unverified absences.



Last Chance Agreements, cont'd

- Helpful Practice Pointers (to ensure enforceability)
 - ✓ The employee must have (i) retained competent counsel that reviewed the contract during negotiations and (ii) entered into the agreement voluntarily and without coercion;
 - ✓ The employer must tender sufficient consideration;
 - ✓ State the term (duration) of the LCA (i.e., 6 months – the duration of employment);
 - ✓ Specify the consequences for a breach (i.e. termination)
 - Have employee provide a signed **Letter of Resignation** that will be held in abeyance and given immediate effect in event of a breach;



Last Chance Agreements, cont'd

- Helpful Practice Pointers (cont'd)
 - ✓ Clearly describe the type of employee misconduct that will constitute a breach and trigger the LCA's consequences;
 - Have employee acknowledge that a repeat of misconduct will merit those consequences;
 - Keep LCA problem specific – e.g., if LCA was a result of employee's treatment of coworkers, don't draft language proscribing future absenteeism/tardiness;
 - ✓ Describe the process that will be conducted if a later-terminated employee denies a breach (e.g., investigation, final and binding determination by a decision-maker after consideration of investigation).



QUESTIONS

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