Crafting Settlement Agreements and Releases in the Employment Context

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The following presentation provides practice pointers on preparing a legally enforceable, clear and complete settlement agreement and release in the employment context. The legal requirements for releasing claims arising under specific statutes are covered, as well as tax treatment issues and the employee's obligation to reimburse third-party payers.

I. Checklist for the Employment Lawyer

In crafting a settlement agreement in an employment case, attorneys on both sides should consider whether to include the following provisions:

- Comprehensive release of all claims that have accrued as of the effective date of the agreement as to all parties or potential parties;
- Dismissal (with prejudice, when available) of pending claims, complaints or litigation OR a covenant not to sue if the settlement is reached pre-litigation;
- How the settlement proceeds will be paid and when; in particular, the agreement should be clear as to whether severance pay will be provided in a lump sum or over time;
- Confidentiality clause – be specific about what may or may not be disclosed and to whom; consider a clawback and/or fee-shifting provision, or other enforcement mechanism, if one side violates confidentiality;
- Non-disparagement clause;
- Prohibition on re-applying for employment with the employer and related entities;

- Return of property (uniform, keys, phone, computer equipment, etc.) or documents by the employee to the employer;
- Continued effectiveness of prior agreements between the employee and employer – such as a non-competition agreement, non-disclosure agreement, non-solicitation agreement, agreement as to ownership of work product;
- Express agreement regarding what information will be provided as an employment reference to prospective employers (including provision of a letter of reference);
- Agreement regarding how the termination (or demotion, transfer, retirement or resignation) will be characterized to third parties and in the employer's records;
- Impact on benefit plans, including who will pay for premiums if benefits continue;
- Impact of the employee's future employment on the employer's obligations (for instance, an agreement to continue benefits might automatically terminate if the employee obtains other employment that provides benefits);
- Whether the employer will need future services or cooperation from the employee (for example, the employer may be involved in on-going litigation in which testimony from a departing employee is needed);
- Express waiver by the employee's attorney if the settlement encompasses a claim for which statutory attorney's fees are available and the employee's attorney is receiving fees under the settlement agreement;
- Tax treatment of the settlement payment (addressed in greater detail below);
- Reimbursement of collateral payments (addressed in greater detail below);
- Legal requirements for releasing specific claims (addressed in greater detail below).

The above checklist is intended to be a starting point. It is impossible to provide a comprehensive list of every provision that might be required in the employment context. Settlement agreements involving high-level executives may address additional topics such as stock ownership, golden parachutes, and resignation from the company's Board of Directors. Sometimes the parties include non-monetary provisions in their resolution, such as outplacement services, training, or relocation. Attorneys should consider what other provisions are needed in a settlement agreement to protect the attorney's respective client and to clarify any ambiguity in the relationship between the parties going forward.

II. Legal Requirements for Releasing Specific Claims

A. Age Discrimination in Employment Act Claims

A release or waiver of a claim under the Age Discrimination in Employment Act, 29 U.S.C. §§ 623-34 (ADEA), is valid and enforceable only if it meets the requirements of the Older Workers Benefit Protection Act (OWBPA), the pertinent portion of which is found at 29 U.S.C. § 626(f)(1). *See also* 29 C.F.R. § 1625.22 (regulations implementing the OWBPA).[1] The OWBPA requires that the waiver of an ADEA right or claim be knowing and voluntary, as evidenced by the following:

1) The waiver is part of an agreement that is written in a manner calculated to be understood by the employee, or by the average individual eligible to participate in the settlement;

2) The waiver specifically references ADEA rights or claims;

[1] Note that the U.S. District Court for the Western District of Kentucky has rejected the argument that the OWBPA requirements should be extended to age discrimination claims brought under the Kentucky Civil Rights Act, KRS Chap. 344. *Willett v. Insight Commc'ns Co.*, No. 3:07-CV-58-S, 2007 U.S. Dist. LEXIS 61383 (W.D. Ky. Aug. 20, 2007).

3) The waiver does not encompass rights or claims arising after the date on which the waiver is executed;

4) The waiver is provided in exchange for consideration in addition to anything to which the individual is already entitled;

5) The employee is advised in writing to consult with an attorney prior to executing the agreement;

6) The employee is given a period of either 21 or 45 days, depending on the circumstances, to consider the agreement;

7) The agreement provides a 7-day revocation period to the employee and is not effective or enforceable until that period has elapsed; and

8) In certain circumstances, specific workforce information is provided to the employee.

When the waiver of ADEA rights or claims is sought as part of a reduction-in-force, exit incentive or other employment termination program offered to a group or class of employees, the individuals from whom the ADEA waiver is sought must have 45 days to consider the agreement and must be provided specific information in writing about the termination program and the individuals affected by the program, as set forth in 29 U.S.C. § 626(f)(1)(H). The implementing regulations provide additional guidance on meeting these requirements. 29 C.F.R. § 1625.22(f) If the settlement is between the employer and a single employee, the period for considering the agreement is reduced to 21 days. 29 U.S.C. § 626(f)(1)(F)(i).

When the waiver does not meet the OWBPA requirements, it is not enforceable. That is, the risk to the employer of not complying with the OWBPA is that the employee may bring suit against the employer under the ADEA. *Oubre v. Entergy Operations, Inc.*, 522 U.S. 422, 426-27

(1998) ("The statutory command is clear: An employee 'may not waive' an ADEA claim unless the waiver or release satisfies the OWBPA's requirements."). This is true even if the employee accepted a payment or incentive in exchange for the non-compliant waiver. Thus, the employer cannot attempt to enforce the non-compliant waiver on a theory of ratification, equitable estoppel or release and satisfaction:

> The OWBPA sets up its own regime for assessing the effect of ADEA waivers, separate and apart from contract law. The statute creates a series of prerequisites for knowing and voluntary waivers and imposes affirmative duties of disclosure and waiting periods. The OWBPA governs the effect under federal law of waivers or releases on ADEA claims and incorporates no exceptions or qualifications. The text of the OWBPA forecloses the employer's defense, notwithstanding how general contract principles would apply to non-ADEA claims.

Id. at 427; *see also Howlett v. Holiday Inns, Inc.*, 120 F.3d 598, 603 (6th Cir. 1997) (rejecting the defense of ratification and declining to require that plaintiffs repay some part of the consideration received for the non-compliant ADEA waiver).

The downside for the employer of failing to comply with the OWBPA requirements is steep: the employer may face further litigation from employees who already received severance pay or a settlement payment, and the employer is unlikely to recoup any portion of the amounts previously paid. As noted by the Sixth Circuit, there is little reason for employers not to comply "in light of the relative ease with which employers could avoid such complications by complying with the OWBPA." *Howlett*, 120 F.3d at 603.

B. Fair Labor Standards Act Claims

Congress specifically made the ADEA subject to the enforcement provisions of the Fair Labor Standards Act, 29 U.S.C. §§ 201-262 (FLSA). *See* 29 U.S.C. § 626(b). Even prior to passage of the OWBPA, waivers of ADEA claims arguably were subject to the requirement in the FLSA that a "make-whole" payment by the employer in exchange for a waiver by the

employee be supervised by the Secretary of Labor. *Id.* § 216(c).[2] With passage of the OWBPA, supervision by the Secretary is no longer necessary when seeking a waiver of ADEA claims. When a waiver of FLSA claims is sought, however, the employer must ensure that the employee's acceptance of a settlement payment in exchange for a waiver is "informed and meaningful." *Woods v. RHA/Tenn. Group Homes, Inc.*, 803 F. Supp. 2d 789, 800 (M.D. Tenn. 2011).

Questions about the enforceability of a waiver of FLSA claims generally arise in the context of resolution agreements between the employer and employee without involvement of the U.S. Department of Labor (DOL).[3] When a conciliation agreement is reached in a DOL investigation or enforcement action, the DOL supervises the payment of back wages to individual employees, and Form WH-58 is used to obtain the employees' release.[4] If an employer attempts to resolve a FLSA claim with a single employee or group of employees – outside of a court-supervised settlement or DOL investigation – the employer must take certain precautions to ensure the enforceability of the release. The Portal-to-Portal Act of 1947 amended the FLSA to resolve the questions surrounding the enforceability of compromises and

[2] The Sixth Circuit, however, rejected the need for the Secretary's oversight when certain circumstances are present. In *Runyan v. Nat'l Cash Register Corp.*, 787 F.2d 1039, 1044 (6th Cir. 1986), the court held that employers and employees could in good faith resolve ADEA disputes without agency involvement when the underlying facts, such as the employer's motive for terminating an employee, are the subject of a bona fide dispute.

[3] This presentation does not address the enforceability of arbitration agreements that forbid collective actions under FLSA. That subject has been intensely litigated since the Supreme Court's decision in *Stolt-Nielsen S.A. v. Animal Feeds Int'l Corp.*, 130 S. Ct. 1758 (2010) (holding that a party may not be compelled under the Federal Arbitration Act to submit to class arbitration unless there is a contractual basis for concluding that the party agreed to do so).

[4] On Form WH-56, "Summary of Unpaid Wages," the DOL investigator will list all of the employees whom the investigator has determined are due back wages, the period for which back wages are due, and the amount of the gross back wages due. Once the employer has signed the Form WH-56, the DOL investigator will send the employer Form WH-58, "Receipt for Payment of Lost or Denied Wages, Employment Benefits, or Other Compensation." The employer fills out a Form WH-58 for each employee to whom the employer is offering back wages, and presents the form to the employee at the time a back-wage check is tendered. The employee must sign and date the form, which includes a release of future claims against the employer, in exchange for the back wages payment.

waivers, among other things. 29 U.S.C. §§ 251-262. The statute provides that any action to enforce the FLSA may be resolved, in whole or part, if: (1) the employer and employee have a bona fide dispute as to the amount owed to the employee; (2) the compromise does not result in payment to the employee of less than minimum wages or of less than the statutory overtime rate; and (3) the employer does not obtain the employee's agreement to the compromise agreement through fraud or duress. If the compromise meets these criteria, a waiver of liquidated damages is also permitted. *Id.* § 253(a), (b), (c).

Confusion arises, however, from the proposition that a "compromise" under the FLSA is not enforceable if it results in payment of less than the full amount of back wages owed to the employee. From the employer's perspective, there is no compromise if it is required to pay the employee the full amount due. As one federal court explained:

> Settlement of an action under the FLSA stands distinctly outside the practice common to, and accepted in, other civil actions. As commanded in *Lynn's Food*, [679 F.2d 1350 (11th Cir. 1982),] settlement of an FLSA action requires review and approval by the district court or the Department of Labor. . . . *Hydradry*[, 706 F. Supp. 2d 1227 (M.D. Fla. 2010),] explains that an employee cannot relinquish or modify a claim under the FLSA except in exchange for "full compensation"; the employer is unconditionally obligated to pay the full amount owed.

Moreno v. Regions Bank, 729 F. Supp. 2d 1346, 1348 (M.D. Fla. 2010). In *Moreno*, the court agreed that the proposed settlement of plaintiff's FLSA claim was reasonable, yet refused to approve the settlement agreement because it contained a broad "pervasive release" of unknown claims. The court could not value the unknown claims and thus determined that the employer might be receiving a windfall. *Id.* at 1352. For that reason, the settlement agreement was rejected by the *Moreno* court.

While several U.S. Courts of Appeal have addressed the enforceability of a private settlement agreement of a FLSA claim, the Sixth Circuit's position is unclear. The decision in

Runyan, 787 F.2d 1039, is often cited as a "middle position," in which the Sixth Circuit indicated that a settlement of an ADEA claim would be enforceable if the employee's release was "knowing and voluntary." *See Martinez v. Bohls Equip. Co.*, 361 F. Supp. 2d 608, 628 (W.D. Tex. 2005). As the *Martinez* court noted, the Sixth Circuit "refrained, however, from specifically stating that it viewed purely private compromises under the FLSA as permissible." *Id.* at 629. The *Martinez* decision provides a thorough review of the development of law surrounding the enforceability of FLSA releases. At the conclusion of its review, the *Martinez* court held as follows:

> Therefore, the Court holds that, according to the language of the FLSA, its amendment by the Portal-to-Portal Act of 1947 and the Fair Labor Standards Amendments of 1949, and its interpretation of the case law, parties may reach private compromises as to FLSA claims where there is a bona fide dispute as to the amount of hours worked or compensation due. A release of a party's rights under the FLSA is enforceable under such circumstances.

Id. at 631. In the Sixth Circuit, an argument that private settlement agreements of FLSA claims are enforceable has not been foreclosed.[5]

III. Reimbursement of Collateral Payments and the Medicare Secondary Payer Act

Generally speaking, the parties do not need to address in their settlement agreement whether the plaintiff/employee is required to reimburse a third party for collateral payments, such as unemployment insurance benefits, workers' compensation benefits and Social Security income benefits. The employee's counsel, however, should determine whether reimbursement is required in order to provide accurate legal guidance to the employee on how much of the settlement proceeds the employee will retain.

[5] *But see McConnell v. Applied Performance Techs., Inc.*, No. C2-01-1273, 2002 U.S. Dist. LEXIS 27598, at **18-19 (S.D. Ohio Mar. 18, 2002) (voiding the portion of a release in a settlement agreement that purports to waive FLSA claims).

The Kentucky Unemployment Compensation Benefits statute provides that when an individual "has received benefits in weeks for which [the individual] later receives a back pay award, [the individual] shall, in the discretion of the secretary [of the Education and Workforce Development Cabinet], either have such sum deducted from any future benefits payable to him under this chapter or repay the Office of Employment and Training, Department of Workforce Investment, for the fund a sum equal to the amount so received by him." KRS 341.415(1). The statute expressly refers to a "back pay award," rather than a settlement, and it is unclear whether the state agency would require repayment when the employer and employee resolve a claim for back pay through a negotiated settlement. Counsel for the employee should make a determination of the employee's repayment obligations to avoid an unnecessary recoupment action by the state agency.

The Kentucky Workers' Compensation Act includes an exclusivity provision, KRS 342.690, and a subrogation provision when a third party may be liable for the employee's injury, KRS 342.700. Research did not reveal any authority discussing whether a workers' compensation award must be repaid because of a settlement or award on other employment-related claims. Based on the principles behind the workers' compensation statute, it is unlikely that the employee would be required to repay benefits received in the settlement of another type of employment claim.

Counsel for employers and employees should be aware of the requirements of the Medicare Secondary Payer Act, 42 U.S.C. § 1395y(b)(7)-(8), which requires liability insurers, and in some instances, their insureds, to submit claims information to the Centers for Medicare and Medicaid Services (CMS) when a settlement, judgment, award or other payment to a Medicare beneficiary compensates the beneficiary, or results in a release of claims by the

beneficiary, for medical expenses, bodily injury or emotional distress. The statute provides a "coordination of benefits" process that allows CMS to recoup payments made on behalf of the Medicare beneficiary for medical expenses that are being covered by another liability policy as a result of the settlement, judgment, award or other payment. *See, e.g., Hadden v. United States*, 661 F.3d 298, 302-04 (6th Cir. 2011) (rejecting plaintiff's argument that he should not be required to repay Medicare in full after compromising his claim for medical expenses in a personal injury action brought against the party primarily responsible for those expenses).

Employers and their liability carriers are more likely to raise compliance with the Medicare Secondary Payer Act during settlement negotiations because penalties for non-compliance are imposed on insurers and policyholders. *See* 42 U.S.C. § 1395y(b)(7)(B). Best practice is to request information from the plaintiff at the outset of the litigation so that the employer and liability carrier are aware of their reporting obligations. Medicare beneficiaries should cooperate in providing information. Compliance with the Medicare Secondary Payer Act may result in delay during the settlement process, and thus counsel for employers should determine whether the Act is implicated early in settlement discussions.

IV. Tax Treatment of the Settlement Proceeds

Tax treatment of the settlement proceeds received by a plaintiff on an employment claim often is the subject of great controversy during settlement negotiations. Defendants, or employers, tend to take a conservative view and routinely issue a Form 1099-MISC to the plaintiff and his/her attorney for the settlement payment and often insist on treating some portion of the settlement as lost compensation, which is subject to withholding and issuance of a Form W-2. Plaintiffs, on the other hand, believe that they can avoid tax liability – that is, avoid having

the settlement proceeds treated as income by the IRS – if they characterize the payment in the settlement agreement as related to a personal injury, bodily harm and/or emotional distress. *See Comm'r v. Schleier*, 515 U.S. 323 (1995) (establishing two requirements that must be met for an award in an employment discrimination case to be excluded from the taxpayer's gross income). As time has gone on, the tax implications of settlements in employment cases have become clearer, and the areas in which there is some room for argument with the IRS are more narrow.[6] Three distinct propositions have emerged, as explained below.

First, when the employee is seeking lost compensation in the litigation, some portion of the settlement should be treated as wages (or back pay). For the amount treated as wages, the employer is required to withhold standard FICA deductions and income tax and to send the withheld amounts to the appropriate federal authority. The U.S. Tax Court has made clear that the nature of the claims settled determines the tax treatment of the settlement proceeds: "Where damages are received pursuant to a settlement agreement, the nature of the claim that was the basis for the settlement determines whether the damages are excludable under section 104(a)(2) [of the Internal Revenue Code]." *Hennessey v. Comm'r*, 97 T.C.M. (CCH) 1756 (2009). Thus, characterizing the settlement proceeds as something other than back wages will be disregarded when it is clear from the complaint and discovery that the plaintiff was seeking lost compensation in the lawsuit.[7]

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[6] *See generally* Robert W. Wood, *Tax on Employment Settlements Addressed by IRS*, 11 J. Tax Prac. & Proc. 51 (2009-2010).

[7] The IRS has indicated in a guidance memo that the characterization of the settlement proceeds must be consistent with the relief available for the claims resolved by the settlement. Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements, PMTA 2009-035 (Oct. 22, 2008), *available at* http://www.irs.gov/pub/lanoa/pmta2009-035.pdf. According to the IRS website, this memo provides an authoritative legal opinion on the subject matter to assist IRS personnel in administering their programs. It may not be cited or used as precedent. In the memo, the IRS states that in reviewing the tax implications of a settlement, it looks to whether the characterization of the settlement is "consistent with the true substance of the underlying claims." *Id.* at 10. If the terms are consistent with the claims and the settlement is a good-faith, arm's length

Second, unless the employee suffered an actual physical injury, no part of the settlement proceeds is exempt from gross income. The Internal Revenue Code § 104(a)(2) excludes from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness." 26 U.S.C. § 104(a)(2). Thus, amounts attributable to emotional distress, humiliation, mental anguish, embarrassment, and similar injuries suffered by plaintiffs in employment cases must be included in the employee's gross income. If the payment relates to a ***physical*** injury or sickness, it can be excluded.[8] In employment disputes, damages for physical injuries are often not available. As noted previously, the exclusive remedy for a physical injury that occurs at work is found in Kentucky's workers' compensation statute, KRS 342.690. Thus, employees face an uphill battle in convincing the IRS that some or all of a settlement of an employment dispute is not includible in gross income.

Third, the employee should expect to report as part of his/her gross income the portion of the settlement proceeds allocated as attorney's fees, even if the payment is made separately to the attorney, and the amount is not included on the employee's Form 1099-MISC. In *Comm'r v. Banks*, 543 U.S. 426 (2005), the Supreme Court held that a taxpayer must include in gross income the entire amount of a judgment or settlement, including the portion paid to an attorney as a contingent fee. The Court left open the question of whether an award of fees pursuant to a statutory fee-shifting provision is excludible from the plaintiff's income. *Id.* at 439. Because the

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resolution of an adversarial proceeding, the IRS will defer to the parties' allocation of the settlement payment between back pay and other compensatory damages. *Id.*

[8] The IRS guidance memo states that "the taxpayer must demonstrate that the amount was received on account of personal physical injuries or physical sickness, or as reimbursed expenses for medical treatment for emotional distress" to be excluded. PMTA 2009-035, at 5.

case being heard by the Court involved a fee paid solely on the basis of a contingency fee arrangement, the Court declined to address the issue of statutory fees.

The American Jobs Creation Act of 2004 amended the Internal Revenue Code to allow a taxpayer to deduct from gross income attorney's fees and court costs paid by, or on behalf of, the taxpayer in connection with a claim of unlawful discrimination or retaliation for protected activity. 26 U.S.C. § 62(a)(20). Thus, while the attorney's fees would be includible as ***gross*** income, the deduction would subtract the fees out for purposes of computing ***adjusted gross*** income. The end result is that the attorney's fees, whether awarded by the court pursuant to a statutory fee-shifting provision or paid by the plaintiff pursuant to a private contingency fee agreement, are included in gross income, but may be deducted if the criteria of § 62(a)(20) are met.

V. Conclusion

Resolving employment disputes is a complex matter in which a number of variables may arise. Employment law practitioners must be knowledgeable about the interplay between the settlement of the employment dispute and other legislative and regulatory schemes, such as the Medicare coordination of benefits provision and the federal tax laws, in order to provide accurate and complete legal advice and to protect their clients from future litigation or unforeseen consequences.