409A INSIGHTS: INVOLUNTARY TERMINATION - Second Circuit Highlights Key Definitional Aspects in Soto v. Disney Severance Pay Plan

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04.05.2022

A recent decision of the Second Circuit Court of Appeals protects discretionary decisions by plan administrators and illustrates the application of the definition of an ?involuntary separation from service? under section 409A of the Internal Revenue Code (Section 409A). Beyond the context of this case, this definition is an important part of two useful exemptions from certain Section 409A restrictions.

Disability Termination. In 2016 and 2017, Nancy Soto suffered a severe stroke and other health problems. In December 2016, she was placed on a leave of absence and received short-term ? and later, long-term ? disability benefits. Soto remained in this status until January 2018 when Disney formally terminated her employment due to her inability to return to work. At this time, Soto was not deemed eligible for Disney?s Severance Pay Plan (the ?Plan?) because she did not experience a qualifying ?layoff.? Soto contended that she did experience a ?layoff.? She argued that (i) the Plan term was not ambiguous or, alternatively, (ii) the Plan administrator was arbitrary and capricious in its interpretation of an ambiguous term.

Key Definitions. Under the Plan, a ?layoff? was defined as an ?involuntary termination of employment? of an eligible employee, except for poor performance or misconduct. The Plan also specified that a ?layoff? would not include any involuntary termination that was not a ?separation from service? within the meaning of Section 409A.

Applicable Treasury Regulations under Section 409A define an involuntary separation from service as a separation from service ?? due to the independent exercise of the unilateral authority of the [employer] to terminate the [employee?s] services ? where the [employee] was *willing and able* to continue performing services.? (Emphasis added.) It is notable that the opinion cited the ?willing and able? aspect of the Section 409A definition. This aspect has significance for various Section 409A purposes, as discussed below. However, it may be less of a focus when drafting, due to other Section 409A

complexities and required plan and agreement language.

The court found that, under the Plan, the term ?layoff? was ambiguous. Thus, the Plan administrator?s discretion to interpret the term was relevant.

Effect of Disability Termination under Disney?s Severance Plan. While the Plan did not specify that a ?layoff? must be an *involuntary* separation from service under Section 409A, it did provide that the layoff must be an involuntary termination *and* a Section 409A separation from service. The Plan further stated that ??[i]t is intended that the Plan comply with the provisions of section 409A of the Code and the Plan shall be construed and applied by the Plan Administrator in a manner consistent with this intent. Any provision that would cause any amount payable to be included in the gross income of a[n] Employee under section 409A(a)(1) of the Code shall have no force or effect.? Through the lens of the Plan?s Section 409A language, the Plan administrator interpreted the Plan as providing benefits only on an involuntary separation from service within the meaning of Section 409A. Disney explained that the Plan was designed to conform to the ?short-term deferral? exemption under Section 409A. Satisfying this exemption excepts the Plan from many of Section 409A?s rules and is a method of avoiding tax penalties under Section 409A. Under applicable Treasury Regulations, if severance was available only if a Plan participant experienced an involuntary separation from service, and the possibility of forfeiture was substantial, the short-term deferral exemption would apply.

The court, quoting the Plan?s Section 409A interpretive language, concluded that, ?? the Plan Administrator is directed to interpret Plan terms in conformance with Section 409A and its exemptions from taxation.? As such, the court ruled that the Plan administrator was not arbitrary and capricious in determining that Soto (i) had not experienced a qualifying layoff since she was not ?willing and able? to return to work due to her disability and (ii) had not experienced a termination entitling her to Plan benefits.

Case Status. The Second Circuit panel found that the Plan administrator did not err in its interpretation of the term ?layoff.? In March 2022, Soto requested a rehearing by the full Second Circuit to review the decision. If the Second Circuit agrees to rehear the case, any subsequent analysis by the court will be instructive with regard both to drafting of Section 409A interpretive language and fine-tuning of definitions in plans and individual agreements providing benefits due to termination of employment.

Other Circumstances Where Involuntary Termination is Relevant under Section 409A. In assessing whether a particular amount of compensation is ?deferred compensation? under Section 409A (and therefore certain payment timing restrictions), the involuntary separation pay exemption may be available as an alternative to (or in addition to) the short-term deferral exemption noted above. Involuntary separation pay must be payable upon an involuntary separation from service, subject to certain dollar limits and time-based restrictions on the period of payment. These two exemptions can be helpful in structuring employment and change in control agreements. Where disability provisions appear in such agreements, careful drafting can preserve the availability of an applicable exemption and ensure Section 409A compliance to the extent an exemption does not apply.

For questions relating to Section 409A, including in the context of severance plans or agreements, please contact the authors.

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