

Change of Control Severance Agreements for Hospital Employees



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During this age of integration, severance agreements are being used by hospitals to keep key employees in place during transitions. The agreements are most common for executives who may no longer be needed after the transitions have been completed.

These agreements are not perks for key employees, but retention tools to help ensure a smooth transition, if and when a change of control occurs. The possibility of such change creates risks and uncertainty, which could otherwise lead to the distraction or departure of the employees to the detriment of the hospitals and their patients.

Change of control severance agreements have a double-trigger, meaning that severance benefits are payable only if a change of control occurs *and* the employee's employment is involuntarily terminated by the hospital or its successor.

Change of control severance agreements are designed to prevent the employees from having personal interests that conflict with the hospitals' interests, thus ensuring the best future for the hospitals' patients.

The Boards try to get key employees to remain at the hospitals and to cooperate fully with changes of control, even though the employees may lose their jobs afterwards.

Regardless of whether it is contractually required, hospitals sometimes pay some form of severance when they terminate loyal employees without cause. It is worth noting that, if a hospital needs to replace one of its key employees, it may have to offer severance plans to candidates in order to attract qualified replacements.

It is also worth considering that severance agreements may help keep employees at the hospital even if there is no change of control.

Terms

Hospitals often provide severance pay for a year or more to former employees. Some add a lump-sum amount in place of incentive compensation that the employee could have earned. In addition, they may add cash payments for benefits that would have been provided. Severance is traditionally paid over time, but is sometimes paid in lump sums when termination follows a change of control. Hospital severance plans with double-trigger features may pay severance even if an employee is offered a similar job in the new organization.

Severance agreements usually require the covered employees to sign a general release of all claims, which protect the hospitals from expensive litigation. The releases can have significant value to the hospital, especially for any worker who is in a protected class of employees. Therefore, the terms do not provide a private benefit to any employee without also providing important benefits to the hospital.

Before finalizing any severance agreement, the Boards must determine that the proposed severance terms are in the best interests of the patients, the community and their charitable mission.

Considerations

Hospital Boards often ask compensation consultants to help determine terms that will be fair market value. The consultants may then issue opinion letters that can help protect against excise taxes under Internal Revenue Code section 4958.

The issuer of an opinion letter will analyze the terms of the severance agreements to determine whether they are reasonable based on all of the facts and circumstances. In this process, they will consider the employee's key roles, tenure, job performance, current cash compensation and benefits. They will also consider compensation comparability data, the potential costs to the hospital, the potential benefits to the hospital, and severance pay plan practices of other healthcare providers.

The methodology that severance agreements use to determine payout amounts varies among employers in the health care industry.

The resulting cash compensation and benefits for each covered employee, taken as a whole, should not exceed fair market value and reasonable compensation for their services. Carefully consider each employee's overall value to the hospital and its patients. Also consider the costs and disruption that could be incurred if the employee voluntarily left during a major transition such as a change of control,

or if they brought legal action against the hospital following a termination.

The issuer of an opinion letter may state that he or she is assuming that the employees will continue to perform their duties satisfactorily for the remainder of their employment.

Final Tips

Severance agreements can help hospitals terminate employees following a change of control without treating them unfairly. To warrant offering such a plan, the Boards must believe that the employees' continued service would be needed if and when a major change occurs. Carefully consider the employee's experience and knowledge of the hospital and the local community. Any severance pay (with or without a change of control) should support the tax-exempt organizations charitable mission.

Legal counsel should draft the agreements and the compensation professional will want to be sure he or she understands the terms before issuing an opinion letter. Separately, qualified professionals should address the financial statement treatment and the tax treatment.

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