© Academy of Management Executive, 1992 Vol. 6 No. 4

Managing employee separations with the reward system

David B. Balkin, University of Colorado

Executive Overview

While executives in many companies find it necessary to reduce the size of their workforces, some are starting to rethink their approach. Instead of forcing certain employees deemed redundant to quit, more participative approaches are now being used to influence certain employees to leave the firm. The pivotal aspect of these voluntary workforce reductions is the reward system which can provide incentives for workers to quit. This article explains how employee separations can be managed through designing and administrating specific pay and benefit policies. It also shows that by using the reward system to make employee separations a participative decision, management can avoid the potential threat of unwanted litigation.

In My View

Making decisions that result in layoffs and discharge of employees are among the most painful and difficult ones that an executive will make in his or her career. Yet the restructuring of entire industries, such as banking, and the increased level of global competition is forcing executives to find ways to reduce the size of their workforces and run leaner organizations. The traditional top-down approach of selecting employees for discharge on a *fait accompli* basis is frequently being abandoned. A more participative approach that gives employees more control over their destiny is being used instead. Organizations that adopt this approach to outplacement try to develop policies that encourage the right employees to leave voluntarily instead of enduring the trauma of a discharge.

The reward system is the key driving force that makes this new approach to employee separations work effectively. By designing pay and benefits policies that support the need to manage the outflow of human resources, management can minimize the costs and unpleasantness associated with terminating employees. As additional legal barriers have been established that constrain management from firing a worker the costs associated with separations have increased.

This article seeks to explain how some organizations are designing their reward systems to manage downsizing. First, the legal constraints that are making it more difficult to force employees to quit will be identified. Next, key human resource outflow decisions are examined. Associated with each of these decisions are reward policies that encourage employees to leave voluntarily. Details of the administration of these reward policies are examined and examples of how these policies work are also provided.

Legal Environment for Employee Separations

The legal system that governs employee separations is becoming more protective of employee job rights in the United States. The result is that management is bearing more risk when deciding to discharge an employee. A combination of federal and state laws and court cases have weakened management's ability to decide to separate an individual from his or her job. The three cases where employer-initiated separations are being met with increasing legal resistance are retirements, layoffs, and dismissals.

Retirements
The Age Discrimination in Employment Act makes it illegal for an employer to force an employee to retire on the basis of age (only a few job categories, such as top management, are exempt from this law). Research indicates that the median retirement age in the United States is sixty three, and most employees postpone their retirement until they are close to sixty five because they are then entitled to full Social Security and Medicare benefits.[1] Employers who want some workers to retire early, before age sixty five, most likely will have to rely on the voluntary cooperation of the targeted employees.

Layoffs
The Worker Adjustment and Retraining Notification Act (WARN) requires that employers with 100 or more employees give sixty days advance notice to employees who will be involved in a layoff due to a plant closing or mass separation of fifty or more workers.[2] This law, passed in 1988, was enacted to facilitate workers' ability to find new work opportunities. The advance notice requirement, however, could negatively affect the firm's credit rating with bankers and suppliers as well as the perceived value of the stock. This makes layoffs costly.

Using layoffs to trim the workforce may also jeopardize a firm's ability to maintain a culturally diverse workforce and stay in compliance with EEOC regulations since many companies select workers for layoff based on seniority (last hired, first fired). A recent Supreme Court case requires firms that have seniority rules for layoffs to use them even if it reduces the number of women and minorities in that organization.[3] Since virtually all companies with unions have seniority provisions for layoffs, the loss of scarce minority employees could add to the cost of the layoff.

Dismissals
When an employee's behavior is inappropriate management may move to dismiss the employee. Not sustaining an adequate level of performance or some form of misconduct are examples of inappropriate behavior. The discharge is usually the result of several oral and written warnings and other disciplinary actions which failed to correct the employee's behavior. The case of gross misconduct such as theft, or physical assault, for example, is an exception and requires a more serious and immediate response from management.

A recent Supreme Court case requires firms that have seniority rules for layoffs to use them even if it reduces the number of women and minorities in that organization.

Courts and various state laws have made it riskier for an employer to fire an employee without *just cause*. While employees under union contracts and government employees under civil service rules are protected from wrongful discharge, the majority of employees who are outside these jurisdictions, until recently, have had little recourse for wrongful discharge. Courts in forty states have now moved to extend protection of employees' job rights in the case of wrongful discharge.[4] For example, in California, plaintiffs have recently won large settlements for wrongful discharge that routinely exceeded one half million dollars.

Other states besides California are also awarding plaintiffs settlements that include damages as well as lost wages. For example, a plaintiff in Washington prevailed in a 1986 case and was awarded $102,000, of which $88,000 was for emotional distress.[5]

A successful tactic used in wrongful discharge cases is for the plaintiff's attorney to press for a jury trial composed of peers who are sympathetic to the dismissed employee's case. Not surprisingly the corporation's attorney may seek to avoid the

trial and negotiate an out-of-court settlement rather than risk a larger award that includes back pay and punitive damages from the jury (not many executives or managers are available for jury duty).

Courts in forty states have now moved to extend protection of employees' job rights in the case of wrongful discharge.

In 1987 Montana passed a state law making it unlawful to fire an employee without just cause. Other state legislatures are considering enacting a law similar to Montana's to protect employees' job rights. This change in the legal environment means that employers who seek to discharge a worker for poor performance or misconduct will need to provide a well-documented case for dismissal that is able to meet the burden of proof test required by courts. In many cases in the current legal environment, management may want to discharge an employee yet hesitate due to a lack of solid evidence or to avoid unwanted litigation. Even if management wins the case, attorney's fees and lost management time due to court appearances and depositions are expensive.

Managing Employee Separations With the Reward System

Legal risks associated with forcing employees to quit an organization have caused managers and executives to search for alternative ways to manage employee separations. Using a reward system is very effective in encouraging the "right" employees to leave a firm voluntarily thereby avoiding legal penalties. The reward system consists of the pay and benefits policies that govern how to compensate employees for their contributions. Management can fine tune the system to make it unattractive (in terms of foregone benefits and earnings) for employees to remain with the firm. The employee may rationally respond to the incentive and voluntarily quit the organization.

Exhibit 1 shows how pay policies are linked to specific types of separation decisions. Discussion follows showing how the reward system can be used to facilitate the decision and minimize the risk of litigation.

Early Retirements

Enticing senior employees who are close to retirement age to leave can significantly reduce fixed pay costs. Many times less expensive junior employees can replace higher cost senior workers. Early retirements allow a company to recruit outsiders who bring fresh ideas and new perspectives into the firm. It is illegal to force employees to retire, but an early retirement incentive package can make it financially attractive for senior employees to leave.

Typical retirement incentives may consist of accelerating the age requirement for retirement benefits, increasing years of service used to determine retirement

Separation Decision	Pay Policy
▶ Early Retirements	◀ Early Retirement Incentives ◀ Health Benefits Extension
▶ Voluntary Reduction in Workforce	◀ Voluntary Severance Plans ◀ Outplacement Benefits
▶ Dismissal for Poor Performance	◀ Strong Emphasis on Performance Contingent Compensation
▶ Sustain Functional Attrition Rates	◀ Retirement Plan Design ◀ Emphasis on Cash Compensation

Exhibit 1. Pay Policies That Facilitate Employee Separations.

income, and a lump sum of cash derived from a formula that ranges from one to four weeks of salary for each year of service. For example, an early retirement plan may add five years to an employee's age (so that a fifty five-year-old employee may qualify under an age fifty nine requirement for eligibility), five years are added to company service, and the cash equivalent of two weeks of salary for each year of service may be given as a lump sum. Health benefits are usually extended as an additional incentive so that the employee is covered until eligible for Medicare at age sixty five.

IBM announced an early retirement incentive plan to reduce its workforce in 1991. Employees with 30 years of service can qualify for full retirement benefits and receive a lump sum of one year's salary under the plan.[6] Age requirements are relaxed to allow more employees who meet the service requirements to retire early. Service credits are capped at thirty years. Employees who work additional years do not get credit in the calculation of retirement benefits.[7] As is typical of early retirement plans, there is an "open window" of several months when the employee can take advantage of the early retirement incentives.[8]

Early retirement incentives can result in significant workforce reductions. DuPont used early retirement incentives to reduce its workforce by ten percent and EXXON achieved a fifteen percent reduction with these inducements.[9]

Care must be taken when designing the incentive to avoid losing too many employees. Excess resignations may occur since all employees who meet the age and company experience requirements are eligible. Surveys can help predict how a given type of policy will affect senior employees' retirement decisions. If the survey indicates too few early retirements would result from the policy, the benefits may need to be enhanced. In this way the policy can be fine tuned to reach workforce reductions goals.

Sometimes a highly valued employee may take advantage of the early retirement program. The impact of losing a valued employee can be minimized by developing policies that allow the firm to retain the skills of that individual as a temporary consultant until a suitable replacement is hired and trained.

Surveys can help predict how a given type of policy will affect senior employees' retirement decisions.

Ann Howard recently studied AT&T's early retirement program and found that there were no performance differences between those employees who took the early retirement offer and those that did not.[10] This suggests that organizations that use these programs to reduce their workforces lose employees who are just as talented as those who choose to stay. The key difference was that those who left reported lower levels of job satisfaction and greater financial security than those who stayed. This indicates that the financial and psychological costs of retiring were lower for the employees who opted for the early retirement program.

Management needs to administer the early retirement program so that eligible employees do not think that they are being coerced to leave. This may result in litigation. Lower performance ratings for senior employees or circulating a rumor of a major layoff—calculated to encourage senior employees to leave—could be construed as coercive management action. A former employee sued IBM for age discrimination and was awarded $315,000 in compensating damages by a jury because the plaintiff claimed he was pressured to take an early retirement against his will.[11] Evidence that the plaintiff introduced to convince the jury of age discrimination included having his job reclassified after voicing some reservations about taking early retirement and receiving a warning that the next performance evaluation would be unsatisfactory.

To avoid exposure to age discrimination management needs to treat early retirement programs on a voluntary basis both in the letter and the spirit of the

policy. This means being sensitive to the needs of senior employees who have vested a significant number of years of their lives in a company and want to leave with a sense of appreciation and conviction that the personal investment was worthwhile.

Voluntary Reduction in Workforce
When business is in decline, large cuts in the workforce may be necessary. Companies in newer and highly volatile industries such as computers and electronics may have few employees close to retirement age. Cost savings from early retirements would be modest. A voluntary reduction in workforce can help avoid the legal problems and psychological pain associated with a layoff. The key to getting employees to quit voluntarily is to provide a voluntary severance pay package as indicated in Exhibit 1.

The voluntary severance plan is sometimes called a *buy-out* and it consists of a lump sum of cash representing several years of earnings provided to employees who voluntarily resign. The plan can be used in conjunction with early retirement incentives to motivate a significant number of a firm's workforce to quit. The buy-out is particularly attractive to a business that provides a "lifelong employment policy" to its employees or one that cares deeply about the psychological contract between the company and its workforce. Recently IBM used a voluntary severance plan to reduce the workforce at its Boca Raton, Florida plant. Employees willing to resign were given the equivalent of two years salary. Using a reward system allowed IBM to avoid a layoff which it has taken pride in for many years.

Herman Miller, an office furniture manufacturer, designed a policy called the "silver parachute" which provides financial security to all employees in the event of a hostile takeover. In most companies this privilege is usually reserved for top executives and called a golden parachute. Under the silver parachute policy at Herman Miller, if within two years of a hostile takeover, an employee's job is terminated, the employee with two years of work experience is entitled to one year's salary as severance pay. Employees with five years of work experience are eligible to receive two and one half years of salary.[12] Employees may also use this benefit if they quit voluntarily due to the hostile takeover. This policy is derived from the overall company philosophy at Herman Miller which tries to foster mutual trust and teamwork between employees and management.

Outplacement benefits complement the voluntary severance plan by providing resources for employees to make the transition into a new job with a different organization. Job location assistance from professional career counselors, office space and clerical support to conduct a job search, and training in job search skills such as interviewing and resume preparation, are a few examples of outplacement services.

Outplacement assistance is expensive. It can average several thousands of dollars per employee. Of course the benefits of outplacement frequently outweigh its management costs which is why there has been a rapid increase in the number of firms that use this service.[13] It is often beneficial to demonstrate social responsibility to the stakeholders, especially to the public and remaining employees. By assisting departing workers with their transition to a new job the firm maintains its image in the community as a good corporate citizen.[14] In addition the remaining employees' anxiety levels are reduced as they view the firm as being a fair employer despite their regrets about the departing employees.

The administration of voluntary severance plans must be performed as carefully as early retirement incentives. Management must construct the program to avoid losing too many employees with critical skills. Restricting eligibility of the buy-out to employees in a specific division or location is one way to do this.

Endnotes

[1] B. Rossen and T.H. Jerdee, "Managing Older Workers' Careers," in K. Rowland and G. Ferris (Eds.), *Research in Personnel and Human Resources Management*, Vol. 6, (Greenwich, CT: JAI Press, 1988).

[2] R.G. Ehrenberg and G.H. Jakubson, "Advance Notification of Plant Closing: Does it Matter?" *Industrial Relations*, 28, 1989, 60-71.

[3] Firefighters Local 1784 v. Stotts, 104 U.S. 2576 (1984).

[4] J. Hoerr, "What Should Unions Do?" *Harvard Business Review*, 69(3), 1991, 30-45.

[5] J.W. Hunt, *The Law of The Workplace* (Washington D.C.: BNA, 1989).

[6] M. Kolbasuk, McGee "Can IBM Retain its Full Employment Policy?" *Management Review*, 80(9), 1991, 22-25.

[7] M. Rowland, "IBM's Cadillac of Retirement Plans," *New York Times*, July 21, 1991, F14.

[8] P.B. Grant, "The 'Open Window'–Special Early Retirement Plans in Transition," *Employee Benefits Journal*, 16(1), 1991, 10-16.

[9] R. Tomasko, "Downsizing: Layoffs and Alternatives to Layoffs," *Compensation and Benefits Review*, 23(4), 1991, 19-32.

[10] A. Howard, "Who Reaches for the Golden Handshake?" *Academy of Management Executive*, 2, 1988, 133-144.

[11] M. Beck, "Old Enough to Get Fired," *Newsweek*, December 9, 1991, 64.

[12] M. Moskowitz, "Companies That Put Perks in Every Pot," *Business and Society Review*, 69, 1989, 26-29.

[13] V.M. Gibson, "The Ins and Outs of Outplacement," *Management Review*, 80(10), 1991, 59-61.

[14] D.H. Sweet, "Outplacement," in W.F. Cascio (Ed.), *Human Resource Planning and Placement* (Washington, DC: Bureau of National Affairs, 1989).

[15] W.H. Mobley, *Employee Turnover: Causes, Consequences, and Control* (Reading, MA: Addison-Wesley, 1982).

[16] D. Odermann, "Four Steps to a Successful 401(k) Plan," *HR Magazine*, 36(8), 1991, 44-46.

About the Author

David B. Balkin is an associate professor of management at the College of Business Administration at the University of Colorado at Boulder. His primary research and writing focuses on strategic pay issues and human resource management in high technology firms. His recent work has appeared in *Academy of Management Journal*, *Strategic Management Journal*, and *Industrial Relations*. He is coauthor with Luis Gomez-Mejia of *Compensation, Organizational Strategy, and Firm Performance* (South-Western, 1992).

that moderate turnover can be positive for the firm. Innovation is increased and the organization's adaptability in responding to jolts from the external environment is also improved.[15]

Examining the design of the reward system is important in increasing attrition rates to an optimum level. Many companies use the benefits package as "golden handcuffs" that lock employees into the firm for a long time. Vacation, retirement, severance pay, sabbatical leaves, and so on may be tied to company service. Employees become extremely security conscious and reluctant to leave for other opportunities after they build up tenure in a firm.

Other organizations use the retirement benefit to make it difficult for employees to leave without losing a portion of the retirement investment. For example, an organization that uses an Employee Stock Ownership Plan (ESOP) for employee retirement may find employees hesitant to leave when it means selling their shares on the open market at less than book value. By designing the pay mix so that cash compensation consists of a relatively large portion of an employee's total earnings, employees can "take the money and run" if an attractive job opportunity becomes available.

Employee mobility is further enhanced if the retirement plan can vest easily and be rolled over into another employer's plan with minimum transaction costs. For example, faculty movement between universities is facilitated when the TIAA-CREF retirement plan is offered to faculty. Faculty who quit and are under TIAA-CREF are immediately vested. They can then take the full value of their employer's retirement contribution with them as long as their new employer offers TIAA-CREF for retirement. Other plans (such as a state employee retirement plan) may require an employee to have five years of tenure when changing jobs (under the cliff vesting schedule of ERISA) before having access to the employer's retirement contribution. Universities need to manage their faculty attrition rates since low turnover could lead to intellectual stagnation.

Private sector firms may also manage employee attrition rates by redesigning retirement benefit plans. For example, the 401 (k) plan, which allows employees to save a portion of their earnings on a tax-deferred basis, can be fully or portionally matched by the employer. Most employers place restrictions on their plan contributions by having vesting requirements that range between four and seven years of employment.[16] By allowing employees to vest immediately in their 401 (k) plan, it is feasible for employees to leave without forfeiting the employer's contribution. This money can then be rolled over into their new employer's 401 (k) plan. While few employers currently allow their employees to vest immediately, employers who want a steady inflow of new employees with fresh perspectives may want to rethink their retirement plans to remove impediments for employees who want to leave.

Conclusion

The reward system can be a valuable asset in managing employee attrition or layoffs in the current legal environment. It is, however, only one of several systems that can be used. Other approaches that complement the use of the reward system include employee development (retraining workers with obsolete skills), proactive human resource planning (hiring part-time workers, subcontract employees or college interns to protect full-time employees from layoffs) and a progressive discipline procedure for employee misconduct. By rethinking the reward system design to include the sometimes forgotten goal of employee separations, management can convert many forced resignations into voluntary separations—a more socially responsible and legally defensible way to conduct business.

Endnotes

[1] B. Rossen and T.H. Jerdee, "Managing Older Workers' Careers," in K. Rowland and G. Ferris (Eds.), *Research in Personnel and Human Resources Management*, Vol. 6, (Greenwich, CT: JAI Press, 1988).

[2] R.G. Ehrenberg and G.H. Jakubson, "Advance Notification of Plant Closing: Does it Matter?" *Industrial Relations*, 28, 1989, 60-71.

[3] Firefighters Local 1784 v. Stotts, 104 U.S. 2576 (1984).

[4] J. Hoerr, "What Should Unions Do?" *Harvard Business Review*, 69(3), 1991, 30-45.

[5] J.W. Hunt, *The Law of The Workplace* (Washington D.C.: BNA, 1989).

[6] M. Kolbasuk, McGee "Can IBM Retain its Full Employment Policy?" *Management Review*, 80(9), 1991, 22-25.

[7] M. Rowland, "IBM's Cadillac of Retirement Plans," *New York Times*, July 21, 1991, F14.

[8] P.B. Grant, "The 'Open Window'–Special Early Retirement Plans in Transition," *Employee Benefits Journal*, 16(1), 1991, 10-16.

[9] R. Tomasko, "Downsizing: Layoffs and Alternatives to Layoffs," *Compensation and Benefits Review*, 23(4), 1991, 19-32.

[10] A. Howard, "Who Reaches for the Golden Handshake?" *Academy of Management Executive*, 2, 1988, 133-144.

[11] M. Beck, "Old Enough to Get Fired," *Newsweek*, December 9, 1991, 64.

[12] M. Moskowitz, "Companies That Put Perks in Every Pot," *Business and Society Review*, 69, 1989, 26-29.

[13] V.M. Gibson, "The Ins and Outs of Outplacement," *Management Review*, 80(10), 1991, 59-61.

[14] D.H. Sweet, "Outplacement," in W.F. Cascio (Ed.), *Human Resource Planning and Placement* (Washington, DC: Bureau of National Affairs, 1989).

[15] W.H. Mobley, *Employee Turnover: Causes, Consequences, and Control* (Reading, MA: Addison-Wesley, 1982).

[16] D. Odermann, "Four Steps to a Successful 401(k) Plan," *HR Magazine*, 36(8), 1991, 44-46.

About the Author

David B. Balkin is an associate professor of management at the College of Business Administration at the University of Colorado at Boulder. His primary research and writing focuses on strategic pay issues and human resource management in high technology firms. His recent work has appeared in *Academy of Management Journal, Strategic Management Journal,* and *Industrial Relations*. He is coauthor with Luis Gomez-Mejia of *Compensation, Organizational Strategy, and Firm Performance* (South-Western, 1992).