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## Highlights

A recent Ontario court case may impact the way employers wish to deal with disability insurance coverage for terminated employees.

## Hewitt

The Hewitt Research Advisory is a regular Hewitt newsletter designed to provide a detailed overview of specific legislative and regulatory developments in Canada relating to human resources.

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## Disability of Terminated Employees Risky for Employer

A recent court case has caught the attention of the media and many employers. The case is *Egan v. Alcatel Canada Inc.*, [2006] O.J. No. 34, a decision of the Ontario Court of Appeal.

The *Egan* case deals with the issue of an employer's liability for disability coverage when a terminated employee becomes disabled within the reasonable notice period. Alcatel was held liable for the full 12 months of Egan's disability, even though a court awarded only nine months' reasonable notice, because Alcatel did not continue Egan's disability insurance during the reasonable notice period.

***Hewitt Comment:*** *The Egan case is not a departure from past approaches. In fact, it reinforces and validates the advice given by prudent advisors for many years. The most radical thing about Egan is simply that it makes explicit a risk that employers have always run implicitly, and perhaps without realizing it: the risk that a terminated employee may become disabled within the common law notice period and that the employer, not having continued insurance coverage, will be directly liable for the employee's disability benefits. Now that the risk is "out in the open," employers can be proactive in taking steps to minimize its potential impact.*

### Case summary

Egan, a senior marketing director with Alcatel, was dismissed in a mass termination in July, 2002. She had been with Alcatel for 21 months and was paid 12 weeks' salary as statutory notice and severance pay. She did not accept a further settlement offer, or sign a release. Her benefits, including her disability insurance coverage, terminated at the end of the 12-week statutory notice period.

Egan did not find a new job within the 12-week statutory notice period. In November, 2002, she obtained a medical certificate stating that she had been fully disabled from working since October 1, 2002. Her disability lasted 12 months. Egan applied for benefits under Alcatel's disability insurance policy, but was turned down because her coverage had ended in September, at the end of the statutory notice period and before the disability began.

Egan sued for wrongful dismissal and for disability benefits. At trial, the judge ruled that she was entitled to nine months' reasonable notice of dismissal. This was a longer notice period than would be usual for a 21-month employee because Alcatel had induced Egan to leave a competitor with whom she had 20 years' service. However, the trial judge declined to award disability benefits. Both Egan and Alcatel appealed.

The appeal court ruled that Egan was entitled to full compensation throughout the entire common-law reasonable notice period of nine months. This included entitlement to all benefits coverage throughout, not just for the statutory portion of the greater common-law notice period. If Alcatel had met that obligation, Egan would have received disability benefits, since her disability began before the end of the common-law notice period. Because Alcatel had not met its obligation to continue benefits coverage throughout the common-law notice period, it was directly liable to Egan for her loss.

Egan was awarded her full salary up to the date her disability began, a period of three months, and then damages for the amount of disability benefits she would have received during her 12 months of disability. However, if Egan had received disability benefits directly from the insurer, they would not have been taxable to her. Damages being taxable, the court grossed up the amount of damages so that her after-tax income would be the same as the amount she would have received from the disability insurer if her coverage had been maintained.

## **Hewitt Commentary**

### **The employer's obligation on termination**

*When terminating an employee, an employer is legally obligated to provide full compensation – including all benefits – throughout the entire common-law notice period, not just the shorter statutory notice period. This is an implied term of every employee's contract, unless a contract (such as an individual employment contract or a collective agreement for unionized employees) contains explicit terms for notice or payment upon termination.*

*The employer's obligation for disability benefits coverage throughout the entire common-law notice period creates challenges in several ways. The duration of the notice period coverage varies by each employee's situation, and if the employee disputes the amount offered by the employer in lieu of working notice, the notice period could ultimately be determined by a judge. Employers are also running an unknown financial risk since they cannot know ahead of time whether or when an employee will become disabled, how severe the disability will be or how long it will last. And employers are running this unpredictable risk without the usual claims management tools to mitigate the cost impact of an employee's disability.*

*Additionally, many disability insurance policies provide tax-free benefits to the employee. In order for the employee to receive the same real benefit from taxable damages as from tax-free benefits, the amount of damages must be higher than the amount of benefits the insurer would have paid. Thus, the damages may be grossed up, as they were in the Egan case, making the cost to the employer even higher.*

*In short, these situations can end up being extremely expensive.*

### **Disability coverage challenges**

*Most group disability insurance policies limit coverage to the period of “active employment” (which typically includes the statutory notice period), so employers may have believed that that was the extent of their obligation. However, the Egan case makes clear that the employer’s obligation to the employee goes to the end of the common-law notice period, whether or not the employee is “actively employed” during that time and regardless of whether insurance coverage is available.*

*Some disability insurance for the full notice period has been available, but it has tended to be on a case-by-case basis, often at expensive rates compared to regular employee group insurance coverage. Insurers are reluctant to extend coverage primarily because the notice period is regarded as a high-risk time for disability claims. Employers who do not seek disability insurance coverage for terminated employees have actually been self-insuring against the risk of disability during the full notice period - either knowingly or unknowingly.*

### **Managing the risk**

*To lessen the chance of disputes, and to protect the employer if a disputed termination does arise, there are several ways to explicitly manage the disability benefits cost risk:*

- *Give an employee working notice instead of pay in lieu of notice; benefits coverage will continue throughout the notice period. Even if the employer has underestimated the length of the notice period and the employee ultimately gets more by suing, the employer will have protected itself from loss for a portion of the notice period.*
- *Enter into a settlement and obtain a release from the employee if working notice is highly undesirable. These releases generally cover all matters arising from the employment and the termination. This normally prevents an employee from coming back for more money in the event that he or she later becomes disabled.*
- *Avoid playing “hard ball”. It is only in a disputed termination without working notice, where the employee does not sign a release, that the employer remains at risk. Recognizing this risk can motivate employers to reach a reasonable settlement with the terminated employee.*
- *If a settlement truly is not possible, consider seeking insurance coverage against disability during the reasonable notice period. Whether to seek wide-scale insurance or case-by-case insurance, and if the latter, how long to wait before deciding that a termination is “disputed,” are matters that employers may want to address on a policy basis.*

- *If a terminated employee does claim disability, employers need to be proactive and involved in the case as they would with a regular employee. If the insurer is involved, expect diligent review and assessment. If the employer is self-funding the risk, take appropriate steps to substantiate the need for disability benefits.*
- *Communicate to new hires the conditions under which benefits will end in the event of termination, and re-communicate/re-state current policy clearly to existing employees. This communication may enable employers to end benefit coverage prior to the end of the common-law notice period.*

### **About Hewitt Associates**

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