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Prohibited Transactions Post-Cunningham v. Cornell University

Catherine L. Reagan

Last year, in *Cunningham v. Cornell University*, 604 U.S. 693 (2025), the Supreme Court resolved a circuit split on pleading standards for prohibited transaction (PT) claims under the Employee Retirement Income Security Act of 1974 ("ERISA"). This article provides an overview of how that decision has affected motions to dismiss those claims.

Transactions described by the PT statute, ERISA §406(a), 29 U.S.C. § 1106(a), occur frequently in the ordinary course of administering ERISA-governed plans, but prudent fiduciaries endeavor to have such transactions fall under one of the statutory exemptions under ERISA §408(b), 29 U.S.C. §1108(b). Before *Cunningham*, the Second, Third, Seventh, and Tenth Circuit U.S. Courts of Appeal required plaintiffs alleging a PT claim under ERISA §406(a) to plead that an exemption under ERISA §408(b) does not apply. The Eighth and Ninth Circuits held that it was sufficient to allege that a plan fiduciary caused the plan to enter into a transaction with a party-in-interest to state a PT under ERISA §406(a). In a rare unanimous decision, the Supreme Court sided with the Eighth and Ninth Circuits.

In *Cunningham*, the Supreme Court clarified that to plead a PT claim under ERISA §406(a) plaintiffs do not need to anticipate and plead around statutory exemptions under ERISA §408(b), because they are affirmative defenses and, thus, they are left for the defendant to raise and prove. In litigation, plaintiffs bear the burden of proof and must plead sufficient factual allegations to plausibly allege each of their claims. If plaintiffs fail to plausibly allege a claim, defendants can move to dismiss that claim—ending the litigation early. However, again, defendants have the burden to prove any affirmative defenses. The Supreme Court responded to concerns raised by the Respondents, Cornell University, and *amici* (friends of the court) that this would allow frivolous PT claims to advance past the pleading stage to discovery (which can be prohibitively expensive). In so doing, the Supreme Court acknowledged "[t]hese are serious concerns but they cannot overcome the statutory text and structure [of ERISA §406(a) and §408(b)]." The Supreme Court noted that plaintiffs are still

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required to establish Article III standing under the U.S. Constitution. (To establish standing in federal courts, a plaintiff must plausibly allege (1) they have suffered an injury in fact, (2) that there is a causal connection between that injury and defendants actions, and (3) it must be likely, not speculative, that the injury will be redressed by a favorable decision. *Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992).) The Supreme Court also noted that courts have other tools to limit meritless litigation, such as by bifurcating the issues and through less commonly used procedures that require the plaintiff to file a reply to affirmative defenses plausibly alleged in an answer. At first, practitioners were concerned that the ruling in *Cunningham* would make it harder to dismiss meritless PT claims; however, over the last year, we have seen courts continue to dismiss these claims.

What is a Prohibited Transaction?

The PT statute covers many transactions that ERISA plans enter into with service providers. The language in the statute is very broad in prohibiting ERISA plan fiduciaries from engaging in specified transactions, including "furnishing of goods, services, or facilities" between a plan and a "party in interest." ERISA §406(a). A "party in interest" with respect to an employee benefit plan includes both a plan fiduciary as well as any "person providing services to such plan." ERISA §3(14), 29 U.S.C. §1002(14). To determine whether service providers are parties-in-interest to a plan, courts look at whether the entities (or their affiliates) were service providers *at the time of the transaction*. This statute does not govern transactions with new service providers, but would include renewed services or new services from an existing provider. Further, the plan fiduciary must be acting in their fiduciary capacity when causing the plan to enter the transaction—they cannot be solely wearing their plan sponsor/settlor hat.

As noted above, there are statutory exemptions under ERISA §408(b). To fall under the most common exemption, described in ERISA §408(b)(2), the plan fiduciary needs to show that (i) the arrangement is reasonable; (ii) the services are necessary for operation of the plan; and (iii) the plan pays no more than reasonable compensation for those services.

This article also addresses PTs under ERISA §406(b). PT claims under ERISA §406(b) involve transactions between the plan and a fiduciary. Under §406(b), plan fiduciaries shall not (1) deal with plan assets in their own interest or account, (2) act (in any capacity) in a transaction on behalf of a party with interests adverse to a plan, or (3) receive consideration for their personal account from any party dealing with a plan in a transaction involving plan assets.

Types of Prohibited Transaction Litigation

PT claims arise in a variety of cases. We have traditionally seen these claims in retirement plan litigation involving Employee Stock Ownership Plans ("ESOPs"), excessive recordkeeping fees, use of funds in forfeiture accounts, and pension risk transfer cases. There are certainly other types of cases where PT claims are alleged, including disputes between plan fiduciaries and service providers, but the categories listed here are the most common.

We are also seeing an increase in PT claims in the health and welfare area, including voluntary benefit cases and excessive fee litigation related to Pharmacy Benefit Managers (PBMs); however, this article focuses on retirement plan litigation. For a discussion of recent PBM litigation, read our article *Employees of JPMorgan May Proceed with Their Lawsuit Over High Drug Costs in Health Plan* (https://www.truckerhuss.com/newsletter/jpmorgan-employees-high-drug-costs-lawsuit/), by Mary Powell.

Excessive Fee Cases Post-Cunningham. We have seen waves of class action excessive fee litigation for defined contribution plans. This litigation focuses on breach of fiduciary duty claims for alleged failure to prudently select and/or monitor (i) investment funds that allegedly performed poorly and (ii) recordkeepers that allegedly received excessive direct and indirect compensation. The PT claims were not the focus of this litigation before *Cunningham*, but thereafter we are seeing increased focus on the PT issues in these cases because those claims are more difficult to dismiss. That said, courts are still willing to dismiss PT claims under certain circumstances, as exemplified by the following two cases:

> ***Fleming v. Kellogg Company*, 2025 WL 4053174 (W.D. Mich. Dec. 8, 2025).** In *Fleming v. Kellogg*, the district court dismissed the PT claim challenging that plan's recordkeeping fees. The district court held that collecting a contractually predetermined fee is not a fiduciary act triggering ERISA's PT rules. The district court relied on the Fifth Circuit's decision in *D.L. Markham DDS, MSD, Inc. 401(K) Plan v. Variable Annuity Life Ins. Co.,* 88 F.4th 602, 609–10 (5th Cir. 2023), which held that entities not already providing services to the plan at the time of contracting are not parties-in-interest under ERISA §406(a). In *Fleming*, the court held the recordkeeper was not a party-in-interest at the time it contracted around the challenged transaction. There is an appeal pending in this case.

> ***Peeler v. Bayada Home Healthcare*, 2026 WL 208630 (W.D.N.C. Jan. 27, 2026).** In *Peeler v. Bayada*, the district court dismissed the PT claim for lack of Article III standing. The district court held the complaint allegations only provided a "speculative basis" for inferring the plaintiffs suffered an actual loss because of the payments for advisory services. The plaintiffs' allegations failed to draw a meaningful comparison between the advisory fees incurred by the Plan and the alleged comparator plans. Plaintiffs in *Peeler* did not allege that the value of their individual accounts declined because of these advisory fees; therefore, there was no harm alleged and the plaintiffs did not have standing for these claims.

Pension Risk Transfer Cases Post-Cunningham. Another common type of case where PT claims are alleged is pension risk transfers. When plan sponsors want to terminate all or part of a defined benefit plan, one option is to transfer the pension liabilities outside the ERISA plan to an annuity provider that then will provide the benefits to participants. Plaintiffs in these types of cases often allege breach of fiduciary duty claims, arguing that the plan fiduciary acted imprudently when selecting what they describe as a risky annuity provider, and that the participants suffered harm because they lost protections under ERISA. In pension risk transfer cases, PT claims have been brought against plan sponsors, plan fiduciaries, independent fiduciaries (hired to evaluate the transaction), and annuity service providers.

> ***Piercy v. AT&T*, 2025 WL 2505660 (D. Mass. Aug. 29, 2025), R&R adopted (Sept. 30, 2025).** In *Piercy v. AT&T*, the district court dismissed all PT claims. The district court held that ERISA §406(a) claims challenging the engagement of the independent fiduciary failed because that entity had not provided services to the plans before it was retained for this transaction, and therefore was not a party-in-interest. Similarly, ERISA §406(a) claims challenging the selection of the annuity provider failed because the annuity provider was not a party-in-interest to the plan. The district court found further that the ERISA §406(b) claims challenging the plan sponsor's decision to transfer pension liabilities to the annuity provider failed because the plan sponsor was acting as a settlor, not as a fiduciary. The plan sponsor had given the independent fiduciary discretion to select the annuity provider. *See also, Dempsey v. Verizon Commns*, 2026 WL 72197 (S.D.N.Y. Jan. 8, 2026) (dismissing all PT claims brought under both ERISA §§406(a) and (b) for the same reasons in *Piercy*).

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***Doherty v. Bristol-Myers Squibb*, 2025 WL 2774406 (S.D.N.Y. Sept. 29, 2025).** In *Doherty v. Bristol-Myers Squibb*, the district court dismissed the ERISA §406(a) claims against the *plan fiduciaries* premised on the purchase of annuities from the annuity provider, because the annuity provider was not a party-in-interest at the time of the transaction. The district court allowed ERISA §406(a) claims to continue based on transactions between the plan and the *independent fiduciary* related to the purchase of annuities, because that entity was a party-in-interest at the time of the transaction.

The district court also allowed the ERISA §406(b) claims against the plan fiduciaries to survive. The plaintiffs alleged that the plan sponsor used plan assets to purchase annuities from an allegedly risky annuity provider in order to maximize corporate profits (through cheaper premiums) "jeopardizing the interests" of participants. The district court acknowledged that the decision to terminate the plan is a settlor decision; however, the selection of the annuity provider implementing that decision was a fiduciary function. Unlike in *Piercy*, here the plan sponsor retained control over the selection of the annuity provider, the independent fiduciary only made the recommendation.

Practice Tip for Pension Risk Transfers: For plan sponsors that are considering a pension risk transfer, having the independent fiduciary select the annuity provider (as opposed to recommend one) adds a layer of protection insulating the plan sponsor from the fiduciary duties of implementing the settlor decision to transfer pension liability.

Forfeiture Cases Post-Cunningham. In cases involving the use of forfeiture funds, plaintiffs often allege that the plan fiduciaries caused the plan to enter into a PT when forfeiture funds are used to offset employer contributions. The majority of courts addressing these types of claims have held intra-plan transfers from the forfeiture accounts to individual participant accounts are not the type of transactions prohibited by ERISA §406(a), because money does not leave the plan and it is used for the benefit of the participants. Any benefit plan sponsors receive from the use of forfeitures to offset employer contributions is incidental, not a direct payment from the plan to the employer. While there are still some outlier cases that allow PT claims to proceed beyond a motion to dismiss, the vast majority of cases, even post-*Cunningham,* have dismissed these claims. Compare *Becerra v. Bank of America*, 2025 WL 3032922 (W.D.N.C. Aug. 12, 2025) (allowing PT claims to survive), with *Estay v. Ochsner Clinic Foundation et al*, 2026 WL 809570 (E.D. La. Mar. 24, 2026) (dismissing claims because this is not a transaction under ERISA §§406(a) or (b));*Gardner-Keegan v. W.W. Grainger, Inc.*, 2026 WL 194772, at *11 (N.D. Ill. Jan. 26, 2026) (same)*; Tillery v. WakeMed Health & Hosps*., 2026 WL 125784, at *8 (E.D.N.C. Jan. 15, 2026) (same)*; Brown v. Peco Foods, Inc*., 2025 WL 3210857, at *9 (S.D. Miss. Nov. 14, 2025) (same); *Polanco v. WPP Grp. USA, Inc.,* 2025 WL 3003060, at *10 (S.D.N.Y. Oct. 27, 2025) (same).

ESOP Cases Post-Cunningham. PT claims are quite common in ESOP cases; however, even before *Cunningham*, these types of claims often survived a motion to dismiss. PT claims in ESOP cases focus on transactions to buy stock from the plan sponsor (on behalf of the ESOP plan) or to sell stock (owned by the ESOP) to a third-party buyer. These transactions often involve the owners, board of directors, and other parties-in-interest to the ESOP. The plan sponsor often hires an independent fiduciary to evaluate the transaction. There are specific exemptions for the purchase and sale of employer securities for ESOPs under ERISA §408(e), so long as the transaction is for adequate consideration. Plaintiffs still must allege a concrete injury to establish Article III standing. *Dyer v. Green*, 2025 WL 4056746, at *5 (D. Mass. Nov. 26, 2025) (alleged harm was too speculative because it was based on future loss if the plan is terminated or the company is sold).

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***Dalton v. Freeman*, 2025 WL 3771345, at *2 (E.D. Cal. Dec. 31, 2025).** In *Dalton v. Freeman*, an ESOP case, the district court made the plaintiffs file a reply to the answer, relying on *Cunningham*. While plaintiffs did not have to plead around the affirmative defense under ERISA §408 in their complaint, they had to respond to the factual allegations supporting that affirmative defense in the answer by putting forward "specific, nonconclusory factual allegations showing the exemption does not apply." This is one of the first ERISA cases post-*Cunningham* where we have seen the district court require a reply to an answer under Federal Rules of Civil Procedure 7(a)(7). Plaintiffs filed their reply in January 2026, and according to the parties' joint status update the case is moving into the next phase of litigation—discovery.

Final Comments

One way plan fiduciaries can protect themselves from PT claims is by performing requests for proposals ("RFPs") to evaluate the costs of services offered by other providers, and to document that the fees plans are paying are consistent with the fees paid by other employers of similar size and benefit offerings. This helps support the plan fiduciaries' position that the amount they are paying their service provider is no more than reasonable, when factoring in both direct and indirect compensation.

While the RFP process does not prevent plaintiffs filing a new lawsuit, by going through a prudent process plan fiduciaries can establish support for their position that an exemption applies, which will facilitate a defense on the merits in the event of litigation alleging PT claims.

If you have questions about the legal landscape of PT claims post-*Cunningham* and how best to defend against such claims, please contact us.

Why Employers Should Embrace ERISA Coverage of Their Severance Plans

Scott E. Galbreath

Many employers say they do not want their severance arrangement or policy (hereinafter, a "severance plan") to be subject to ERISA, due to its burdensome requirements of having to draft and maintain a plan document and a summary plan description (SPD), preparing and filing Forms 5500 annual reports, and subjecting the severance plan to compliance with fiduciary standards. However, many change their minds after understanding that ERISA coverage provides for many advantages, and the related compliance requirements are not particularly onerous. This article discusses what causes a severance plan to be subject to ERISA, the consequences that result, and the advantages of ERISA coverage.

It Is Likely Your Severance Plan Is Already Subject to ERISA. Many employers believe that if their severance plan is maintained only pursuant to a policy and not a written "plan," it should not be subject to ERISA. It should be understood that it does not take much employer involvement for a policy to be an ERISA severance plan. In fact, severance plans are generally subject to ERISA. The seminal case concerning what subjects a severance

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plan to ERISA coverage was decided almost 40 years ago by the United States Supreme Court in *Fort Halifax Packing Co. v. Coyne*, 428 U.S. 1 (1987). At issue in *Fort Halifax* was whether a Maine statute that required employers to provide their employees with a one-time payment, when being terminated due to a plant closing, established an ERISA plan. The Supreme Court held that for an arrangement to be subject to ERISA, the administration of the arrangement must require "an ongoing administrative program to meet the employer's obligation." The court went on to state that the "requirement of a one-time, lump-sum payment triggered by a single event requires no administrative scheme whatsoever." Thus, for example, if a severance plan states that upon termination for any reason, employees will receive 2 weeks' pay as severance, that severance plan may not be subject to ERISA, depending on whether other factors exist. That is, the more conditions or limitations placed on the eligibility for severance, requiring employer discretion or calculation, the more likely there is an administrative scheme and the plan is subject to ERISA.

Specifically, courts have focused on the following two factors in determining whether an arrangement providing severance payments is an ERISA plan: (1) whether the severance payments made pursuant to the arrangement are subject to an "ongoing administrative scheme" for determining the eligibility to receive severance benefits and/or the calculation of such benefits; and (2) whether the employer is required to exercise discretion in determining the eligibility to receive the severance benefits. For example, in *Schonholz v. Long Island Jewish Med. Ctr.,* 87 F.3d 72, 76 (2nd Cir. 1996), the United States Court of Appeals for the Second Circuit held managerial discretion and a separate analysis of each terminated employee over an indefinite period of time requires an administrative scheme. Likewise, in *Whittemore v. Schlumberger Tech. Corp.,* 976 F.2d 922, 923 (5th Cir. 1992), the United States Court of Appeals for the Fifth Circuit held that the severance plan at issue was subject to ERISA because, unlike in *Fort Halifax*, it was not created with a particular closing in mind, but had been in existence for some time and required an administrative setup in order to make severance payments to employees. That same court held in *Gomez v. Ericsson, Inc*., 828 F.3d 367, 62 EBC 1560 (5th Cir. 2016) that administering employer paid COBRA coverage in a severance plan results in an administrative scheme. In *Deutsch v. Kroll Associates*, 30 EBC 1418 (S.D.N.Y. Feb. 20, 2003), a New York court held a severance arrangement was an ERISA plan because the arrangement required an ongoing administrative scheme to process the benefits of continuation of health and dental insurance coverage and 401(k) matching contributions over a six-to-twelve-month period. In *Bogue v. Ampex Corp.,* 976 F.2d 1319, (9th Cir. 1992), the United States Court of Appeals for the Ninth Circuit held that an administrative scheme exists where the plan requires ongoing, particularized, administrative, discretionary analysis as to whether an employee is owed severance. In that case the employer had to determine whether an employee was entitled to severance because the job offered by the acquirer of his employer was substantially equivalent to the job with the acquired employer.

Each of these cases demonstrates that employer severance plans that require the employer to determine when a terminated employee is eligible for benefits, the level of benefits, and include any continuation health coverage benefits will likely be an ERISA plan.

A Severance Plan That Is an ERISA Welfare Plan Is Not Overly Burdensome to Maintain. A plan that is subject to ERISA will be classified as either a pension benefit plan or a welfare benefit plan. Welfare benefit plans are subject to significantly fewer ERISA requirements than pension plans. According to Department of Labor regulations, for a severance plan to be a welfare benefit plan under ERISA, all of the following requirements must be met:

- The severance plan payment is not contingent, directly or indirectly, upon the employee retiring;

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- The total amount of the payments to be made does not exceed two times the employee's annual compensation during the last full year of employment; and
- All payments must be made within 24 months following the employee's termination.

A severance plan that is categorized as a welfare benefit plan under ERISA is exempt from ERISA's minimum participation requirements and vesting standards, as well as minimum funding requirements and the requirement that plan assets be held in trust. These rules will apply if the plan is considered a pension plan.

If the severance plan is a welfare benefit plan, then ERISA's reporting and disclosure requirements, fiduciary responsibility provisions, and administration and enforcement provisions apply. The reporting and disclosure provisions require that eligible participants be provided an SPD. However, the plan document can be drafted to also serve as the SPD. And, if there are more than 100 eligible participants, a Form 5500 information report must be filed annually. This form is relatively easy to prepare, because it requires not much more than reporting the number of eligible participants at the beginning and end of the year, and the number receiving benefits during the year. It is also important to note that for this purpose any employee who might be eligible for severance upon termination of employment is considered eligible.

Under ERISA, persons and entities exercising authority or control over the management of a plan and/or the disposition of its assets are plan fiduciaries. ERISA plan fiduciaries have a duty to act in the best interest of plan participants and their beneficiaries. A fiduciary who fails to uphold this standard and, therefore, engages in a fiduciary breach, can be held personally liable for any losses sustained by the plan and/or its participants and beneficiaries. A breaching fiduciary may also be subject to other equitable and remedial relief, including removal as a fiduciary. ERISA's fiduciary duties ensure the people operating the plan take severance plan matters seriously and thoughtfully, and follow the terms of the plan document.

While being a plan fiduciary has risks if duties are breached, the availability of flexible plan designs and the fact the courts use an "arbitrary and capricious standard" in reviewing fiduciary decisions help mitigate that risk. The issue of mitigating risk is discussed below.

Mitigating Fiduciary Risk. A welfare benefit plan can be designed to provide the employer with flexibility to decide who is eligible for severance benefits. In fact, the plan can provide that severance will be paid only to eligible employees who have been notified that their termination makes them eligible for severance. Thus, not every termination without cause due to a reduction in force need qualify for severance, but only employees who are notified by the employer that they are eligible for severance will be entitled to benefits.

In the 2023 case of *Carlson v. Northrop Grumman Severance Plan,* the U.S. Court of Appeals for the Seventh Circuit, 67 F.4th 871 (7th Cir. 2023) approved this flexibility in severance plan eligibility for a welfare benefit plan. In that case, the court ruled that an employer can use its discretion to individually select which terminated employees will receive severance benefits, if it reserves the right to do so in the welfare benefit plan document. The employer's severance plan provided that employees regularly scheduled to work at least 20 hours a week who were terminated were entitled to severance benefits if the employee "received a cover memo, [to that effect] signed by a Vice President of Human Resources (or his/her designee)… addressed [to the individual] by name." After a series of layoffs, several terminated employees who did not receive severance benefits sued, claiming that their eligibility for benefits was established by the fact that they regularly worked more than 20 hours a week. They claimed the memo was not a requirement but merely a "ministerial

document that verifies eligibility under the 20-hour standard." The district court ruled in favor of the employer, finding that the plan's language provided the employer's HR Department's discretion to choose whom, if anyone, is eligible for severance pay upon being laid off.

On appeal, the Seventh Circuit noted that "the Plan makes the receipt of severance benefits contingent on receipt of a HR Memo, which plaintiffs and the other class members did not get. Welfare-benefit plans under ERISA—unlike retirement plans—need not provide for vesting, and the terms of welfare-benefit plans are entirely in the control of the entities that establish them. When making design decisions, employers may act in their own interests." The court explained that this means employers can include a discretionary component in the plan's provisions that allows for individual determinations for severance benefits eligibility. Consequently, the court concluded that the severance plan was permitted to delegate the exercise of this discretion to its HR Department.

In addition to flexibility on the terms of eligibility, as approved in *Carlson*, if an ERISA severance plan provides the plan administrator the discretion to decide claims and interpret the plan's terms, courts will uphold the decisions of the plan administrator (such as those involving plan interpretation, eligibility, vesting and entitlement to benefits) unless the court finds that the administrator acted in an arbitrary or capricious manner in making the decision. Thus, under the "arbitrary and capricious" standard of review, a court will uphold administrative decisions, even if it finds that different decisions also might have been reasonable. This deference to the plan administrator significantly facilitates plan administration and guards against protracted litigation.

The availability of flexible eligibility requirements, as well as the arbitrary and capricious standard of review, significantly mitigate fiduciary risk for ERISA-covered severance plans.

Advantages of an ERISA-Covered Plan, in General. There are other advantages to a severance plan being subject to ERISA, regardless of whether it is a pension or a welfare plan. These advantages include the following:

- Preemption of State Laws. ERISA generally preempts state law; therefore, it can invalidate state law claims, such as breach of contract, bad faith and intentional infliction of emotional distress. Additionally, employers who conduct business in more than one state can rely on the consistency of federal law (ERISA) in operating their severance plan arrangements, rather than having to be concerned about compliance with varied state laws.
- Written Plan Requirement. ERISA requires that the terms of employee benefit plans be set forth in writing. This means that ERISA plan documents must specifically and clearly identify eligible participants, the circumstances under which benefits are payable, and how a participant's benefit is determined. In addition, the plan must contain administrative information regarding the employer's right to amend or terminate the plan, a claims and review procedure (discussed further in the next paragraph), and the identity of the plan administrator and fiduciaries. This precludes claims from employees based on informal or even verbal severance plans and provides one place to look to govern the severance benefits.
- Claims Procedures. A participant in an ERISA plan must follow the plan's administrative procedures when making a claim for benefits under the plan. ERISA requires two levels of internal administrative review, both of which must be completed (or exhausted) before an individual may bring a claim in court. Through these procedures, claims and disputes can often be resolved without becoming public.
- The Availability of a Shorter Statute of Limitations. An ERISA plan can provide for an internal period by which a benefit claim must be brought, regardless of whether a state law statute of limitations provides for

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a longer period of time, provided it is reasonable. This is because, as noted above, ERISA preempts state law. This is an advantage by providing one uniform time by which claims must be brought and precluding claims that would have a longer limitations period. It also avoids an employer that does business in multiple states having to comply with multiple state statutes.

- Jury Trials. Courts have held that in many types of ERISA cases, there is no right to a jury trial; rather, a federal judge familiar with the federal ERISA statute decides the case. It is generally advantageous to have a judge familiar with ERISA case law decide the matter, as opposed to jurors unfamiliar with it.
- Punitive Damages and Attorney's Fees. Monetary awards meant to punish bad behavior, known as punitive damages, are generally not available under ERISA. However, ERISA does provide for the award of attorneys' fees and court costs, at the discretion of the court.
- Avoiding Code section 409A. Because severance plans generally pay an employee in the future for services rendered in the past, they are deferred compensation plans under Internal Revenue Code section 409A (409A), unless an exception is met. The details of 409A are beyond the scope of this article. However, the important thing to understand is that if a plan is subject to 409A and fails to meet its requirements either in the plan document or in operation there are drastic tax consequences for the employees. In summary, the deferred compensation is subject to income tax to the extent vested (not subject to a substantial risk of forfeiture), plus there is an additional 20% federal tax and interest at a rate that is 1 percentage point higher than the normal rate for unpaid taxes from the date of vesting.
- Code section 409A Exemption. A severance plan that is an ERISA welfare benefit plan can be written to be exempt from 409A. First, if the plan pays the benefit within 2 1/2 months of the end of the year in which the employee's right to the benefit vests (or the end of the employer's fiscal tax year if longer), the plan will not be considered deferred compensation under the short-term deferral exception to 409A. On the other hand, if the severance plan does not pay within the short-term deferral period, it can still be exempt from 409A if it only pays on an involuntary termination; the benefit payable is paid within 2 years of the termination date; and the benefit does not exceed the lesser of 2 times 1) the amount of compensation that can be considered under a qualified plan (currently $360,000) or 2) the employee's base salary at the end of the year prior to termination. This last part of the equation is very similar to the test to be a welfare benefit plan under ERISA. This is an advantage to know that a simple mistake in operating the plan will not cause the draconian 409A tax consequences for participants.

Conclusion. If an employer treats a severance plan as not subject to ERISA and a court determines it is subject to ERISA, the employer could face penalties for failing to provide an SPD or file annual Forms 5500. Rather than trying to avoid ERISA, the employer should consider the many advantages of ERISA coverage. And, as explained above, complying with ERISA is not overly burdensome and has many advantages.

If you have questions about ERISA or non-ERISA severance plans, please contact us.

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Editor: Nicholas J. White, nwhite@truckerhuss.com (mailto:nwhite@truckerhuss.com)

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SAN FRANCSICO

135 Main Street, 9th Floor
San Francisco, California 94105-1815

LOS ANGELES

15760 Ventura Blvd, Suite 910
Los Angeles, California 91436-3019

PORTLAND

329 NE Couch St., Suite 200
Portland, Oregon 97232-1332

Tel: (415) 788-3111
Fax: (415) 421-2017
Email: info@truckerhuss.com (mailto:info@truckerhuss.com)
Website: www.truckerhuss.com (https://www.truckerhuss.com)

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