Supreme Court Puts To Rest the Pleading Standard in ERISA Prohibited Transaction Cases And Opens The Door To More Litigation

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Over the past two decades, a lot of (very expensive) ink has been spilled in courts around the country in ERISA litigation cases regarding a single question: how much does a plaintiff need to say in a complaint alleging that a prohibited transaction has occurred, to survive an early motion to dismiss? The question seems very academic, at first, but the answer has significant implications for sponsors and fiduciaries of employee benefit plans.

On April 17, 2025, a unanimous Supreme Court weighed in, resolved a split between federal circuit courts and put the issue to rest, concluding that plaintiffs alleging violations of ERISA's prohibited transaction provisions need not plead facts to show that service provider arrangements are unreasonable, but rather that it is the burden of defendants to plead and prove that arrangements between plans and service providers are reasonable and no more than reasonable compensation is paid for those services. Unfortunately for employee benefit plan sponsors and fiduciaries, the decision will make it easier for plan participants to sue and impose greater pressure on fiduciaries to settle. The case is *Cunningham v. Cornell University,* — S.Ct. –, 2025 WL 1128943 (Apr. 17, 2025).

Plaintiffs in *Cornell* are participants in the university's 403(b) plans. They alleged that the university engaged in a prohibited transaction in violation of ERISA §406(a)(1)(C) by agreeing to pay excessive recordkeeping fees. That section provides:

> "Except as provided in [ERISA §408]: (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect –
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> (C) furnishing of goods, services, or facilities between the plan and a party in interest.

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A "party in interest" includes, among others, a person providing services to a plan. (ERISA §3(14)(B).) Together, these statutes provide that transactions between plans and persons providing services to plans are prohibited, *except* as provided in ERISA §408, which describes exemptions to the prohibited transactions described in §406.

Litigants typically point to ERISA §408(b)(2)(A) in support of their claim that service provider agreements are exempt from §406. That section provides:

> The prohibitions provided in [ERISA §406] shall not apply to any of the following transactions:
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> Contracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.

Although the language of the statute seems clear, courts have struggled for years to believe that it means what it says, especially in the context of agreements between plans and service providers. Did Congress actually mean to prohibit *any* transaction between a plan and a service provider? After all, employee benefit plans are complex. As a practical matter, they rely on several specialized service providers to function. Does it make any sense that Congress would have prohibited agreements with service providers when plans cannot reasonably exist without them?

Litigation attorneys and judges view the question this way: do plaintiffs need to plead facts that would enable the court to find the transaction is *not* exempt from §406? Or does the defendant bear the burden of proving the service provider contract is reasonable? The answer to the question has enormous, real-world and high dollar consequences. Defendants in litigation frequently file motions to dismiss at the outset of litigation matters. A successful motion to dismiss (once final) means that a defendant can avoid the substantial costs associated with discovery, expert witness expenses, trial preparation and trial.

In recent years, some courts have refused to accept that Congress really intended that a plaintiff can allege little more than a fiduciary entered into an agreement with a service provider to overcome a motion to dismiss, and thereby force a defendant to incur the costs of full-blown litigation. As one court stated, "it would be nonsensical to read [§406(a)(1)] to prohibit transactions for services that are essential for defined contribution plans, such as recordkeeping and administrative services." *Albert v. Oshkosh Corp.,* 47 F.4th 570, 585 (7th Cir. 2022).

Conversely, other courts have felt no need to wring their hands over what Congress might have intended, since the plain language of the statute gives them no reason to do so. Those courts have reasoned that it is for Congress, and not the courts, to decide who is responsible for pleading and proving that a service provider contract is or isn't reasonable: "… even assuming § 408(b)(2) 'require[s] a fiduciary to plead reasonableness as an affirmative defense' …, the concern 'that putting employers to the work of persuading factfinders that their choices are reasonable makes it harder and costlier to defend … ha[s] to be directed at Congress, which set the balance where it is.[Citation omitted.] Congress has already set the balance here." *Buglielski v. AT&T Services, Inc.,* 76 F.4th 894, 907 (9th Cir. 2023).

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Shortly after the Ninth Circuit decided *AT&T*, the Second Circuit Court of Appeals reached the opposite conclusion in *Cunningham v. Cornell Univ.*, 86 F.4th 961 (2nd Cir. 2023) – the precursor to the Supreme Court decision. The Second Circuit concluded that the §408 exemptions were not true "affirmative defenses," and that reading §406 "in isolation from its exemptions … would encompass a vast array of routine transactions the prohibition of which cannot be consistent with that statutory purpose. To the contrary, if all payments by plan fiduciaries to third parties in exchange for plan services were presumptively prohibited, then the plan would be severely compromised." *Id.* at 976.

As foreshadowed above, the Supreme Court disagreed. Justice Sonia Sotomayor, writing for a unanimous Court, held that "… the [§408] exemptions are 'written in the orthodox format of an affirmative defense. [Citation omitted.] Understood as affirmative defenses, the … exemptions must be pleaded and proved by the defendant who seeks to benefit from them." *Cornell,* 2025 WL 1128943 at *5.

Justice Samuel Alito wrote a separate concurring opinion, which was joined in by Justices Thomas and Kavanaugh – essentially to note that while the decision is correct, he didn't have to like it: "Unfortunately, this straightforward application of established rules has the potential to cause – and, indeed, I expect it will cause – untoward practical results … In this case, for example, Cornell set up a plan under which employees could invest in [the plans' investment funds] and then those companies provided the recordkeeping services for their own funds, as they customarily do. There is nothing nefarious about any of that. Yet under our decision that is all that a plaintiff must plead to survive a motion to dismiss. And, in modern civil litigation, getting by a motion to dismiss is often the whole ball game because of the cost of discovery. Defendants facing those costs often calculate that it is efficient to settle a case even though they are convinced that they would win if the litigation continued."

Justice Sotomayor suggested that courts in cases where plaintiffs file "barebones" prohibited transaction claims may require plaintiffs to file a reply to defendants' answers – a type of pleading allowed by Federal Rule of Civil Procedure 7. *Id.* at *8. (Justice Alito echoed that suggestion and took it one step further: "District courts should strongly consider utilizing this option – and employing the other safeguards that the Court describes – to achieve 'the prompt disposition of insubstantial claims.'")

It is too soon to say whether courts will require plaintiffs to file detailed replies to defendants' answers. It is certainly not part of most courts' way of doing things – our litigators have never seen that procedure used. The Court's "suggestion" may cause plaintiffs' attorneys to file cases in courts not known for being "business friendly." In the meantime, we expect to see an uptick in prohibited transaction claims against ERISA fiduciaries.

Download the Supreme Court's opinion. (https://www.supremecourt.gov/opinions/24pdf/23-1007_h3ci.pdf)

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