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PUBLISHED: APRIL 24, 2025

Supreme Court Decision Means Defense of ERISA Prohibited Transaction Claims Just Got More Difficult and More Protracted

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On April 17, 2025, the Supreme Court decided *Cunningham v. Cornell University*, unanimously holding that a plaintiff can state a valid claim under ERISA by merely alleging that a plan used "plan assets" to pay a service provider—regardless of whether the fees are necessary or reasonable. This decision is a significant victory for the plaintiffs' bar because it has removed a potential procedural roadblock to the dismissal of weak claims at the pleading stage.

ERISA prohibited transactions background

Section 406 of ERISA says it is a "prohibited transaction" for a plan to use plan assets to pay a service provider for services performed on behalf of the plan. Importantly, however, Section 408 of ERISA contains an exemption for services that are necessary for operating a plan, if the compensation paid by the plan ***is not more than reasonable***. The purpose and spirit of the rules are to prevent conflicts of interest creating financial entanglements that harm plan participants, while allowing plans to hire professionals to help service their plans.

Case background

Plaintiffs in the case are current and former Cornell University employees who participated in one of two of the University's defined contribution plans during 2010 to 2016. Each plan was a participant-directed plan with the value of the accounts dependent upon contributions, market returns, and plan expenses (including the fees paid to the plan's service providers).

In 2011, Cornell retained Teachers Insurance and Annuity Association of America-College Retirement Equities Fund (TIAA) and Fidelity Investments Inc. (Fidelity) to offer investment options to plan participants and to serve as recordkeepers for the retirement plans. Cornell compensated TIAA and Fidelity with fees from a set portion of plan assets.

In 2017, plaintiffs sued Cornell and other plan fiduciaries for allegedly engaging in a prohibited transaction by causing the plans to pay TIAA and Fidelity for recordkeeping services. Plaintiffs argue that paying TIAA and Fidelity for furnishing services to the plans was a prohibited transaction unless Cornell could prove an exemption. Plaintiffs also claimed the plans paid these service providers more than reasonable recordkeeping fees. The District Court dismissed the prohibited transaction claim because plaintiffs did not allege evidence of self-dealing or other misconduct.

The Second Circuit affirmed, holding that, because the exemption of ERISA Section 408 is incorporated into Section 406's prohibitions, plaintiffs must plead that a transaction was "unnecessary or involved unreasonable compensation" to survive a motion to dismiss. In reaching that conclusion, the Second Circuit split from the Eighth Circuit, which has held that no additional pleading requirements beyond section 406 apply to prohibited-transaction claims.

Plaintiffs appealed to the Supreme Court.

SCOTUS decision

The Supreme Court reversed the Second Circuit decision by holding that "reasonable compensation" is an "exemption" under section 408. Because it's an exemption, a plaintiff's initial complaint does not need to allege that the compensation was unreasonable. As a result, a plaintiff's complaint should not be dismissed if the complaint plausibly states a claim under Section 406 that the plan paid money to a service provider.

The question in *Cornell* was whether the exemptions in Section 408 impose ***additional*** pleading requirements for a plaintiff's prohibited transaction claim. The Court agreed with the plaintiffs, finding, the "[e]xcept as provided in [S]ection 408" language in Section 406(a) does not incorporate Section 408 exemptions as elements of Section 406(a) violations, and that Congress wrote the Section 408 exemptions "in the orthodox format of an affirmative defense" separate from the prohibitions. Therefore, once a plaintiff alleges that a prohibited transaction occurred, the burden shifts to the defendant to raise the affirmative defense that an exemption under Section 408 applies to permit the transaction.

Cornell argued that failing to incorporate Section 408's exemptions in a plaintiff's initial pleading would allow plaintiffs to get past the motion-to-dismiss stage too easily, thereby subjecting defendants to costly and time-intensive discovery. Such meritless litigation, Cornell contended, would harm the administration of plans and force plan fiduciaries and sponsors to bear most of the associated costs.

The Court acknowledged that these are serious concerns but emphasized it cannot overcome the statutory text and structure, noting that Congress "set the balance" in "creating [an] exemption and writing it in the orthodox format of an affirmative defense," so the Court must "read it the way Congress wrote it."

Therefore, at the pleading stage, it suffices for a plaintiff plausibly to allege only that a transaction occurred between a plan and a party in interest.

Key takeaways

The decision in *Cornell* has application beyond paying a plan's service providers. Section 406 lists five broad categories of prohibited transactions, for which one of the 21 exemptions in Section 408 might apply. For example, a sale of company stock by selling shareholders to an employee stock ownership plan is prohibited under Section 406 but is exempt under Section 408 if the purchase price does not exceed "adequate consideration."

The Supreme Court's holding potentially could lead to a surge in litigation against plan fiduciaries. After *Cornell*, a plaintiff can sue a plan's fiduciaries merely by alleging that the plan engaged in a transaction such as paying service providers—without even alleging they were paid too much—and get past a motion to dismiss. The fiduciaries then must plead the affirmative defense that the compensation paid was reasonable. While the plaintiff ultimately will still need to establish that the plan paid more than reasonable compensation in order to prevail on the merits, the Court's decision allows plaintiffs to more easily move beyond the pleading stage and engage in discovery and further proceedings—which will force plans to incur additional time and expense, and may incentivize defendants to settle claims to avoid the expense and risk of litigation.

The Court provided suggestions for pushback on the expected uptick in litigation. For example, Rule 7 of the Federal Rules of Civil Procedure gives a district court discretion to require a plaintiff to file a reply to a defendant's answer raising an affirmative defense. Thus, if a fiduciary's reply states that compensation paid to a service provider was reasonable, then the plaintiff may be required to plead specific, nonconclusory factual allegations showing the exemption does not apply. Rule 11 compels sanctions for frivolous lawsuits. And if a plaintiff cannot identify an injury resulting from an alleged breach, the court may dismiss the lawsuit for lack of standing. Though neither widely used nor often successful, these tools are available to litigants to consider as part of their defense strategy. Nevertheless, it is likely that *Cornell* will make defending lawsuits alleging prohibited transactions more protracted, and thus, more expensive.

Food for thought

While not widely adopted, one option for employers to reduce risk is to pay service providers without using plan assets. Plan service provider fees are typically a relatively insignificant portion of employees' total compensation package. If the employer pays service provider fees outside the plan, then there is no use of plan assets and no prohibited transaction. Other types of prohibited transactions generally do not have such an easy workaround.

Contact us

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