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Supreme Court Establishes Lower Pleading Standard for Prohibited Transaction Claims

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In a unanimous decision, the U.S. Supreme Court ruled in *Cunningham v. Cornell University* that plaintiffs can satisfy the requirements for pleading prohibited party-in interest transactions under ERISA section 406(a) without alleging facts disproving the availability of a statutory exemption for such transactions, such as where no more than reasonable compensation is paid for necessary services. No. 23-1007 (U.S. Apr. 17, 2025). As a result, plaintiffs may be able to withstand motions to dismiss such claims even where the underlying pleadings are found insufficient to sustain a fiduciary breach claim based on the same conduct. Recognizing the risks posed by potentially frivolous claims proceeding into discovery, the Supreme Court coupled its ruling with specific advice as to how district courts can mitigate these risks.

Lower Court Proceedings

As explained in a previous post, the case was brought by participants in two Cornell University retirement plans, who alleged that plan fiduciaries breached their fiduciary duties of prudence and loyalty and caused the plans to engage in prohibited transactions by: (i) offering certain investment products in the plans; (ii) failing to monitor and offer appropriate investment options; and, relevant here, (iii) failing to monitor and control recordkeeping fees paid to a third-party service provider. Plaintiffs’ prohibited transaction claim regarding recordkeeping fees was brought under section 406(a) of ERISA, which provides that a fiduciary may not cause a plan to enter into certain transactions with a party in interest if he knows or should know that the transaction constitutes a furnishing of goods or services. Section 408 of ERISA contains various exemptions for otherwise prohibited transactions, including one in subsection (b)(2) permitting contracts between plans and service providers for necessary services for no more than reasonable compensation.

The district court dismissed or granted summary judgment to defendants on all but one of plaintiffs’ claims, which the parties later resolved through a settlement. The Second Circuit affirmed. With respect to the prohibited transaction claim based on the plans’ recordkeeping fees, the Second Circuit held that to survive a motion to dismiss, plaintiffs must plead that a transaction “was unnecessary or involved unreasonable compensation” such that it was not exempt under ERISA section 408(b)(2). In so holding, the Second Circuit took a position like that of the Third, Seventh, and Tenth Circuits, which all have required plaintiffs to plead something more than the bare elements of a prohibited transaction claim, such as allegations of self-dealing. Its ruling conflicted, however, with a ruling in the Eighth Circuit that the availability of a statutory exemption is an affirmative defense not properly considered at the pleading stage.

The Supreme Court’s Opinion

The Supreme Court, in a unanimous opinion written by Justice Sotomayor, reversed and remanded the Second Circuit’s decision. The Court resolved the existing circuit split by holding that plaintiffs need only plausibly allege the basic elements of a prohibited transaction claim to overcome a motion to dismiss. The Court held that section 406(a)(1)(C)’s prohibition on a furnishing of services between a plan and a party in interest is “categorical,” and does not carve out transactions that are necessary or for reasonable compensation. Relying primarily on ERISA’s structure, the Court found that the statutory exemptions are affirmative defenses for which defendants bear the burden of proof, and thus do not impose any additional pleading requirements. Accordingly, the Court rejected Cornell’s argument (embraced by the Second Circuit) that the exemptions are incorporated into section 406.

In so ruling, the Court took note of the "serious concerns" that requiring plaintiffs to plead merely that the plan contracted with a service provider would lead to "an avalanche of meritless litigation" and subject defendants to costly discovery in every case. But the Court concluded that these concerns could not overcome ERISA's text and structure, which provide the exemptions in the "orthodox format of an affirmative defense." The Court stated these concerns could be mitigated by other procedural safeguards, such as: Article III's injury-in-fact requirement; the district court's ability to require plaintiffs to reply to an answer under Federal Rule of Civil Procedure 7; and the district court's ability to impose attorneys' fees or sanctions. In a concurring opinion joined by Justices Thomas and Kavanaugh, Justice Alito recognized that "untoward practical results" were likely to flow from the Court's decision, and suggested that the potential requirement of replies to answers under Rule 7 was "[p]erhaps the most promising" of the alternative safeguards available.

Proskauer's Perspective

As both the Supreme Court's opinion and the concurrence acknowledged, the pleading bar set in *Cunningham* gives rise to increased risks of litigation and higher settlement costs to any plan that outsources plan management services to a third-party provider. And, as Justice Alito recognized, it "remains to be seen" whether the Court's suggested procedural safeguards will "adequately address" these concerns. Until now, Rule 7 has not been commonly invoked in ERISA cases, but the Court's invitation will likely prompt an increased resort to that procedural device. In the face of this lower pleading standard, courts must be prepared to more aggressively manage litigation so that the ability to plead a bare-boned prohibited transaction claim does not become a cudgel to extract unwarranted settlement payments.

District courts might also wish to consider permitting early, targeted discovery on the reasonableness of the fees paid to service providers, as a means of facilitating early motions for summary judgment. Conceivably, a trend in this direction could work to the advantage of plan sponsors and fiduciaries, in that it could lead to surgical discovery approaches to address other discrete factual issues, such as whether the plaintiffs have satisfied Article III's injury-in-fact requirement; or whether, notwithstanding any procedural imprudence alleged, there was no basis for a claim because the challenged decisions were objectively prudent.

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