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Employee Benefit Plan Review

U.S. Supreme Court Opens Door to Increased ERISA Litigation

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The U.S. Supreme Court has issued a unanimous opinion that could lead to an increase in litigation for prohibited transaction claims under the Employee Retirement Income Security Act of 1974, as amended (ERISA).

Background

The decision in *Cunningham v. Cornell University*, revived a class action in which Cornell University employees alleged that Cornell's retirement plan paid unreasonable recordkeeping fees.

Specifically, the lawsuit alleged that payments made to the plan's service providers – the Teachers Insurance and Annuity Association of America and Fidelity Investments Inc. – constituted prohibited transactions under ERISA because the fees charged for investment management and recordkeeping were too high. The district court granted Cornell's motion to dismiss the prohibited transaction claims, and the U.S. Court of Appeals for the Second Circuit affirmed the dismissal.

The key issue on appeal was the relationship between two sections of ERISA: Section 406, which sets out transactions that are prohibited under the statute, and Section 408, which lists exemptions to those prohibitions. The case provided the Supreme Court an opportunity to resolve a widening circuit split on the pleading standard for a prohibited transaction claim.

After hearing oral argument on January 22, 2025, the Supreme Court, in a majority opinion written by Justice Sonia Sotomayor and a concurring opinion by Justice Samuel Alito (which Justices Clarence Thomas and Brett Kavanaugh joined), unanimously reversed the decision of the Second Circuit and remanded the case for further proceedings.

The Supreme Court's Opinion

The majority opinion clarified the pleading standard for a prohibited transaction claim, holding that a plaintiff is required to allege only the elements specified in Section 406(a) of ERISA – "no more, no less." This means that, to survive a motion to dismiss, a plaintiff can simply allege that there was a transaction with any party in interest. The majority rejected arguments that Section 406(a) incorporates the exemptions set forth in Section 408 of ERISA, which would have required plaintiffs to plead facts beyond the mere existence of a service provider relationship, such as self-dealing, fraud, or an intent to benefit the party in interest. Instead, a plaintiff does not need to address these exemptions in pleading a prohibited transaction claim because the exemptions are considered "affirmative defenses" that "defendant fiduciaries bear the burden of pleading and proving."

Given that defendants benefit from the exemptions, Justice Sotomayor emphasized that it is not a plaintiff's burden to plead and prove the "myriad" of Section 408 exemptions. Requiring a plaintiff to plead the exemptions "would be especially illogical" according to the majority, given that "several of the [Section 408] exemptions turn on facts one would expect to be in the fiduciary's possession."

The majority acknowledged the "serious concerns" that this pleading standard could potentially increase the costs and burdens of litigation for plan sponsors and fiduciaries of ERISA plans. However, Justice Sotomayor suggested certain "existing tools" for lower courts to use "to screen out meritless claims before discovery."

First, under Rule 7 of the Federal Rules of Civil Procedure, district courts can require a plaintiff to file a reply to a defendant's answer to rebut any Section 408 exemption, and, if the reply fails to plausibly rebut the defense, the defendant may then move for judgment on the pleadings.

Second, district courts can dismiss any lawsuit that fails to identify an injury from the transaction, meaning there would be no injury if reasonable compensation is paid to the service provider.

Third and finally, where an exemption clearly applies, Rule 11 sanctions, as well as ERISA's fee-shifting provision, will serve as a deterrent to meritless litigation. Given these safeguards, the majority was satisfied that there would not be a significant increase in litigation involving prohibited transaction claims.

In a concurring opinion, Justice Alito, joined by Justices Thomas and Kavanaugh, agreed that the text of ERISA does not require plaintiffs to negate the exemptions set forth in Section 408 because "it is black letter law that a plaintiff need not plead affirmative defenses." However, this "straightforward application" of the text has the potential and likelihood to cause "untoward practical results," because it will allow lawsuits to advance to discovery based on allegations of routine, innocuous conduct. Defendants then must weigh the burden and expense of discovery, "often calculat[ing] that it is efficient to settle a case even though they are convinced that they would win if the litigation continued."

Plan sponsors are encouraged to review and, if necessary, tighten their procedures for distributing plan information to participants.

Justice Alito encouraged district courts to adopt the relatively uncommon procedural mechanism of requiring plaintiffs to file a reply to an answer that raises one of ERISA's prohibited transaction exemptions as an affirmative defense. Specifically, Justice Alito noted that "[d]istrict courts should strongly consider utilizing this option," along with the other safeguards recommended by the majority to help weed out meritless lawsuits.

As noted in the concurring opinion, the extent to which these procedures will be adopted and implemented by lower courts remains to be seen.

Impact of the Decision

The Supreme Court's decision substantially changes the pleading standard for prohibited transaction claims under Section 406(a) of ERISA, which could alter the landscape of litigation for ERISA plans.

Now, merely alleging that a fiduciary approved a transaction with a "party in interest" for payment, such as a routine arrangement with recordkeepers, investment managers, or plan consultants, could be sufficient under the pleading standard to survive a motion to dismiss. In turn, this could lead to increased litigation and costs for fiduciaries and plan sponsors of ERISA plans. Plan sponsors are encouraged to review and, if necessary, tighten their procedures for distributing plan information to participants.

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