BLOG

Unanimous Supreme Court Decision Makes It Easier for Prohibited Transaction Claims to Survive a Motion to Dismiss

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Lawsuits targeting retirement plans for allegedly paying excessive fees to service providers, including recordkeepers, show no signs of slowing down. As we previously posted, some courts required plaintiffs asserting prohibited transaction claims in such cases to make some initial detailed allegations that the arrangement at issue between the plan and the service provider was improper because it was unnecessary or involved unreasonable compensation. On April 17, 2025, the U.S. Supreme Court unanimously held in *Cunningham v. Cornell University* that those lower-court decisions set the bar too high. As a result, the permissive pleading standard announced in this case may increase the already steady stream of excessive fee litigation.

BACKGROUND

Excessive fee lawsuits commonly assert at least two claims: (1) plan fiduciaries breached their fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), as amended, when they agreed to pay providers excessive fees to provide certain services to plans; and (2) these service provider arrangements are prohibited transactions. The prohibited transaction claims were at issue in *Cornell*.

Two applicable sections of ERISA apply to prohibited transaction claims:

- **Section 406** of ERISA contains the prohibited transaction rules. A transaction is generally prohibited if it involves the “furnishing of goods, services, or facilities between the plan and a party in interest,” including a service provider like a recordkeeper, unless all of the elements of a prohibited transaction exemption are satisfied. Because Congress was concerned about the significant harm that could come to a plan as a result of these prohibited transactions, Section 406 provides a *per se* prohibition on these transactions, including transactions that are undertaken in good faith and at arm’s-length. Bad intent or harm to the plan are not required for these transactions to constitute a prohibited transaction.
- **Section 408** of ERISA contains the prohibited transaction exemption rules. ERISA Section 408 offers numerous exemptions to the *per se* prohibited transaction in Section 406 of ERISA, including an exemption for transactions involving necessary services for which the plan pays reasonable compensation.

To attempt to have these cases dismissed at the outset, ideally before engaging in expensive and onerous discovery, plan fiduciary defendants typically file a motion to dismiss arguing that the plaintiffs failed to plausibly allege facts supporting each element of a prohibited transaction claim.

Plaintiffs, plan fiduciaries, and courts have disagreed over what exactly plaintiffs must allege to overcome a defendant's motion to dismiss such claims. Before the U.S. Supreme Court weighed in, several federal appellate courts had agreed with plan fiduciary defendants that it is not enough for a plaintiff to simply allege the barebone elements of a prohibited transaction under ERISA Section 406. According to those courts, more details must be required in order to state a claim upon which relief may be granted because otherwise a plaintiff could overcome a motion to dismiss simply by alleging that a plan had an arrangement with a service provider, despite the ubiquity and need for such arrangements.

The Second Circuit Court of Appeals ("Second Circuit") in *Cornell* concluded that surviving a motion to dismiss requires the plaintiffs to plead facts showing that a prohibited transaction exists because a service provider arrangement was "unnecessary or involved unreasonable compensation." In other words, the Second Circuit held plaintiffs must negate the exemption in ERISA Section 408 to plead a Section 406 prohibited transaction claim.

On appeal to the U.S. Supreme Court, the plaintiffs argued that Congress drew a clear line between ERISA Sections 406 and 408. Thus, the plaintiffs asserted that pleading only the elements in Section 406 (and not overcoming the ERISA Section 408 exemption) should be sufficient to withstand a motion to dismiss.

THE U.S. SUPREME COURT'S DECISION

The U.S. Supreme Court lowered the bar for plaintiffs to survive a motion to dismiss by concluding that ERISA Section 408's exemption for reasonable compensation for necessary services is an affirmative defense, meaning that a court cannot dismiss a plaintiff's case at the outset for failing to address it. The justices relied on precedent holding that, when interpreting a statute, exemptions that are set apart from prohibited conduct and "expressly refe[r] to the prohibited conduct as such" are generally defenses on which defendants bear the burden of demonstrating they apply. According to the Supreme Court, because ERISA Section 408's exemptions are set apart from the prohibited transaction rules set forth in ERISA Section 406, they are defenses for which defendants bear the burden of demonstrating they apply. Moreover, the Court explained there is no basis for requiring plaintiffs to address one, but not all, of the numerous exemptions listed in ERISA Section 408 and associated regulations, and that requiring plaintiffs to anticipate and negate *all* possible defenses in each case would be unfair to the plaintiffs.

As Justice Samuel Alito noted in a concurring opinion, "the Second Circuit tried to formulate a rule that would weed out plainly unmeritorious suits at the pleading stage. The court attempted to achieve an admirable goal, but established pleading rules do not allow that workaround."

Thus, the justices determined that to withstand a motion to dismiss, plaintiffs need only plead the basic elements of ERISA Section 406—that the fiduciary: (1) caused the plan to engage in a transaction (2) that the fiduciary knows or should know constitutes a furnishing of goods and services (3) between the plan and a party in interest.

The Court acknowledged plan fiduciaries' "serious concerns" that litigation would multiply and discovery costs would mount if plaintiffs could overcome a motion to dismiss with a "barebones" complaint imply alleging that a plan knowingly contracted with a service provider. As Justice Alito noted in his concurring opinion, "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."

But those arguments, the Court reasoned, could not overcome ERISA's plain text. Further, the Court pointed out that trial judges have means to limit baseless lawsuits, such as (1) requiring plaintiffs to respond immediately when defendants assert an exemption in a motion to dismiss (2) dismissing cases when the plaintiffs cannot plausibly overcome such exemptions, and (3) awarding fees, shifting costs, and applying sanctions. Some have hypothesized that the case was assigned to Justice Sonia Sotomayor because she was a former trial judge who would have an appreciation for how to deal with these types of lawsuits in real life. Justice Alito also noted that "[p]erhaps the most promising . . . is the suggestion, offered by the Solicitor General, that a district court may insist that a plaintiff file a reply to an answer that raises one of the [ERISA 408] exemptions as an affirmative defense."

KEY TAKEAWAYS

The U.S. Supreme Court's decision resolves a split among the Circuit Courts of Appeals and provides clarity on an important issue in ERISA litigation, but not the kind of clarification that plan fiduciaries sought. The ruling may embolden prospective plaintiffs in parts of the country where courts had previously imposed a higher bar to plead prohibited transaction claims.

The ruling underscores the importance of establishing a prudent process for monitoring service provider fees to ensure that such fees are reasonable in light of the market and the scope of services provided. Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice or your Winston relationship attorney for further information.

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