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Supreme Court Sets Low Bar for ERISA Prohibited Transaction Claims – *Cunningham v. Cornell* **Gallagher**

On April 17, 2025, the U.S. Supreme Court reversed the 2nd Circuit's dismissal of an Employee Retirement Income Security Act (ERISA) based excessive fee claim, *Cunningham v. Cornell* (US 2025). Large universities with ERISA governed 403(b) plans have frequently been the subject of this type of litigation. The ruling extends the long history of this case, which was originally brought in 2016. The decision addresses a split in the circuit courts regarding prohibited transaction claims, and what plaintiffs must plead to survive a summary dismissal motion.

Facts

Cornell University sponsors two ERISA-governed 403(b) plans (the Plans). Between the Plans, asset holdings are well over \$3 billion, with tens of thousands of participants. The Plans offered approximately 300 investment options throughout the period in question, including fixed annuities, variable annuities, and mutual funds. Plaintiffs represented a class of current and former participants in the Plans, making a number of claims that have become customary for ERISA excessive fee lawsuits.

However, the Supreme Court focused specifically on Plaintiffs' claim that the plan administrator engaged in a prohibited transaction due to unreasonable recordkeeping fees. The District Court dismissed the claims, and Plaintiffs appealed that dismissal to the 2nd Circuit Court of Appeals. The 2nd Circuit had not previously addressed the issue of what a plaintiff must plead to allege a claim based on a violation of the prohibited transaction rules. Ultimately, the circuit court affirmed the District Court's dismissal.

Prohibited Transaction Claims

Both ERISA and the Internal Revenue Code contain restrictions against certain prohibited transactions between a plan and a related party. In particular, ERISA prohibits the "furnishing of goods, services, or facilities between the plan and a party in interest." However, a separate part of ERISA contains an exemption for "[c]ontracting or making reasonable arrangements with a party in interest for office space, or legal,

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accounting, or other services **necessary for the establishment or operation of the plan**, if no more than **reasonable compensation** is paid therefor." (Emphasis Added.)

Consequently, paying service provider expenses from plan assets will technically create a prohibited transaction. However, the payment is exempted from the prohibited transaction rules if (1) the services provided are necessary to run the plan, and (2) the amount of the expense is reasonable. This exemption allows plan sponsors to pay service providers from plan assets. Overwhelmingly, plan sponsors use plan assets to pay for those services, rather than paying plan service providers directly.

Plaintiffs took the position that a complaint needs only to point out that service providers were hired for a fee to create a valid prohibited transaction claim. If this were the pleading standard to state a valid complaint, nearly every ERISA-governed plan would be susceptible to a prohibited transaction lawsuit. While the fiduciaries could raise a defense that the fees were reasonable and necessary, the plaintiff would not have to plead that fees were unreasonable to bring the claim and survive a motion for summary judgment.

This issue has created a split in the Circuits. In addition to the 2nd Circuit, the 3rd, 7th, and 10th Circuits have all ruled that the prohibited transaction and the exemption must be read together. Consequently, plaintiffs must plausibly plead that the services were unnecessary, or the fees were unreasonable, or there was some form of self-dealing. However, the 8th and 9th Circuits have ruled that a plaintiff can survive a summary dismissal motion merely by pleading that a service provider was paid from plan assets. Given this history, the Supreme Court agreed to hear the Cornell case.

Once a case survives the summary dismissal motion, it proceeds to the discovery stage. This process can be very expensive and time consuming for fiduciaries and plan sponsors. The pressure to settle the case becomes intense. Defendants frequently conclude that it will cost less to settle the case even though they are certain they would win if the case proceeded to trial. Consequently, winning a motion for summary dismissal can be crucial for a fiduciary defendant.

Supreme Court Ruling

The Supreme Court gave a brief and unanimous opinion in favor of Plaintiffs that did not stray from the specific issue relating to pleadings for prohibited transaction claims. The Court cited precedent that when a statute has exemptions laid out apart from the

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original prohibition (as ERISA does), courts have historically ruled that the exemption constitutes an affirmative defense. Demonstrating the elements of that defense becomes “entirely the responsibility of the party raising” them. Consequently, the prohibited transaction exemptions do not impose any pleading requirements for excessive fee claims.

The Court points out that ERISA contains 21 statutory exemptions to prohibited transactions, in addition to hundreds of regulatory exemptions. Requiring plaintiffs to plead and disprove all potentially relevant prohibited transaction exemptions would be “impractical,” particularly when they turn on facts solely in the fiduciary’s possession. Of course, demonstrating merely that plan assets were used to pay a service provider will not by itself result in a successful fiduciary claim. The Court stresses that defendants can raise the services exemption as an affirmative defense. However, in order to proceed past a motion for summary dismissal, plaintiffs only need to plausibly plead the fundamental requirements of the prohibited transaction itself.

Future of Prohibited Transaction Claims

Defendants in *Cornell* contended that a ruling in favor of Plaintiffs would result in an “avalanche of meritless litigation.” Such meritless litigation burdens plan administrators and sponsors and discourages adoption of employer sponsored retirement plans. The Supreme Court acknowledged that these are serious concerns. But ultimately, they do not outweigh the statutory text and structure.

However, the Court raised a number of existing tools that district courts can use to screen out meritless claims before discovery. For example, if fiduciaries file a response to the claim pointing out that services were necessary and fees were reasonable, district courts can require plaintiffs to reply with “specific, nonconclusory factual allegations” showing the exemption does not apply. Claims can also be dismissed if they do not show a specific injury. Courts can also expedite or limit discovery as necessary to mitigate unnecessary costs. Perhaps most importantly, courts can discourage baseless lawsuits by assessing a defendant’s attorney’s fees against the plaintiff. A concurring opinion joined by Justices Alito, Thomas, and Kavanaugh encouraged district courts to “strongly consider” those options.

Gallagher Insight

Defendant’s concern is very real that the ruling will result in even more excessive fee claims and make it easier for plaintiffs’ attorneys to succeed beyond summary

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judgment. We can expect that ERISA fiduciary breach lawsuits will nearly always feature a prohibited transaction claim going forward. Hopefully, district courts will take seriously the mitigating steps suggested by the Supreme Court.

Having said that, the decision does not change the steps that retirement plan fiduciaries should be taking now to build a proper defense. In fact, following a prudent process and documenting why any decision was made as well as the factors considered is perhaps more crucial than it has ever been. In particular, plan administrators should confirm that all services provided to the plan are necessary, and the fees are reasonable. As always, your Gallagher consultant is here to help you follow and document the needed fiduciary actions.

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