

CLIENT ALERT

Supreme Court Clarifies ERISA Prohibited Transactions Pleading Standard

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The Supreme Court's unanimous opinion in *Cunningham v. Cornell University*,¹ holding that plaintiffs asserting ERISA² prohibited transactions claims need not plead around ERISA's prohibited transaction exemptions ("PTEs"), will make it harder for defendants to escape breach of fiduciary duty claims at the pleading stage. Resolving significant disagreements among lower courts that have been accumulating for years, the Court held that, to survive dismissal, a plaintiff must plead only that the plan fiduciaries: (1) caused a plan to engage in a transaction that (2) they knew or should have known would constitute a direct or indirect furnishing of goods, services, or facilities (3) between a plan and a party in interest. Because the Court held that the applicability of PTEs is an affirmative defense for which the burden of proof falls on the defendant, and many routine plan activities are technically prohibited transactions that are permissible because they satisfy one or more of ERISA's PTEs, this ruling opens wide avenues for bare bones complaints to edge past the motion to dismiss bar and proceed to discovery. Although

¹ No. 23-1007 (April 17, 2015).

² The Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 *et seq.*

the Court suggested some possible procedural routes for resolving such claims early, it remains to be seen whether, in practice, defendants will be able to use those tools to defeat meritless complaints.

Key Takeaways:

- **Setting the Pleading Bar Low:** The Court’s ruling will be seen as a win for ERISA plaintiffs, who often expect seven- or eight-figure settlements once they get past a motion to dismiss.
- **More Prohibited Transaction Claims:** Prohibited transaction claims, which had been largely an afterthought in breach of fiduciary duty litigation, may become the main event in complaints going forward.
- **Defendants Must Be Proactive to Utilize Procedural Tools Beyond 12(b)(6) Motions:** Defendants will need to take a fresh approach to responding to complaints with prohibited transaction allegations. The Court suggested pleading affirmative defenses in detail and using Rule 7’s mechanism for requiring a reply to an answer as one option that has not been commonly used so far. Other options, such as phased discovery and early summary judgment motions, may also be effective tools.
- **Impact on Number of New Complaints Unclear:** Although many commentators have opined that this decision will open the floodgates for ERISA class actions, the reality is that those gates have been open for quite some time. Plaintiffs’ lawyers do not appear to have been holding back waiting for this decision. Whether there will be *more*, rather than just *different*, complaints filed is an open question. And the number of complaints that survive dismissal at the pleading stage is certain to increase.

Analysis

The plaintiffs, a group of current and former Cornell University employees, brought ERISA breach of fiduciary duty claims against the fiduciaries of Cornell’s 403(b) plan, including a prohibited transaction claim in connection with recordkeeping services with both Fidelity Investments (“Fidelity”) and Teachers Insurance and Annuity Association (“TIAA”). *Id.* at 4. The plaintiffs alleged the plan fiduciaries engaged in a prohibited transaction by hiring TIAA and Fidelity to provide recordkeeping and administrative services, as they were both parties in interest because they were plan service providers. *Id.* Additionally, the plaintiffs alleged that the plans paid both Fidelity and TIAA “substantially more than reasonable” recordkeeping fees. *Id.* The district court’s dismissal of Plaintiffs’ prohibited transaction claim was affirmed by the Second Circuit, which held that plaintiffs must affirmatively plead that a transaction was “unnecessary or involved unreasonable compensation”—in other words, that the allegedly prohibited transaction did not fall within one of ERISA’s PTEs—to survive dismissal. The Second Circuit reasoned that the PTEs (in § 1108) are incorporated into the prohibited transaction provision (§ 1106 (a)(1)(C)). *Id.* at 4-5.

The Supreme Court reversed, holding that a plaintiff only needs to allege the elements of a prohibited transaction as explicitly listed in the provision itself, and need not plead facts suggesting that none of ERISA’s PTEs apply. *Id.* at 1.

Plaintiffs Need Not Plead a Transaction Was Unnecessary or Involved Unreasonable Compensation.

The Court emphasized that § 1106(a)(1)(C) is categorical, and any transaction that satisfies its three elements—(1) “caus[ing a] plan to engage in a transaction” (2) that the fiduciary “knows or should know . . . constitutes a direct or indirect . . . furnishing of goods, services, or facilities” (3) “between the plan and a party in interest”—is presumptively unlawful. *Id.* at 6. Because there is no reference in this provision to necessity of transactions or reasonable compensation, which are discussed in the PTE section of ERISA, plaintiffs need not allege these elements. *Id.* Rather, the Court concluded that PTEs are affirmative defenses that must be raised by the defendant, who bears the burden of proving that they are satisfied. *Id.* at 7. The Court acknowledged that a defendant who can meet that burden will ultimately defeat a prohibited transaction claim, but concluded that, at the pleading stage, a plaintiff need only plead facts suggesting that a prohibited transaction occurred. *Id.*

In response to the defendants’ arguments that plaintiffs’ interpretation would result in “an avalanche of meritless litigation,” the Court acknowledged that allowing plaintiffs to “too easily get past the motion-to-dismiss stage” was a “serious concern[],” but ultimately held that the statute’s text and structure was definitive. *Id.* at 14.

Defendants Should Leverage Other Procedural Tools to Resolve Meritless Claims Early.

The Court tried to end on an “all is not lost for defendants” note. It suggested district courts can use “existing tools” like Rule 7 to compel plaintiffs to file a reply with “specific, nonconclusory factual allegations,” that could be used to screen out meritless claims. *Id.* The Court also encouraged careful application of the Article III standing requirements, stating that courts “must” dismiss suits that allege a prohibited transaction but fail to identify an injury. *Id.* at 15. The Court further noted that claims proceeding past the motion-to-dismiss stage are still subject to district courts’ discretionary authority to expedite or limit discovery to mitigate unnecessary costs, and that district courts may impose Rule 11 sanctions where plaintiffs lack a good-faith basis for their claims in the face of an obviously applicable exemption. *Id.* Finally, the Court also cited cost shifting as a tool to ward off meritless ERISA litigation. *Id.*

Although standing challenges and other efforts to use these types of procedural tools so far have not been particularly effective for defendants faced with prohibited transaction claims, it is possible that the Court’s endorsement of these tools will make them more useful. Employers who find themselves on the receiving end of prohibited transaction claims should be prepared to avail themselves of the entire procedural tool kit to minimize or avoid expensive discovery about threadbare claims.

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