Publications

A Victory for Plan Fiduciaries: In Cunningham v. Cornell University, the Second Circuit Clarifies the Pleading Standard for Prohibited Transaction Claims

ATTORNEYS & PROFESSIONALS

Sean Abouchedid
sabouchedid@groom.com
202-861-6605

William Delany
wdelany@groom.com
202-861-6643

Ross McSweeney
rmcsweeney@groom.com
202-861-6625

Paul Rinefierd
prinefierd@groom.com
202-861-9383

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For years, courts have struggled with the appropriate standard to apply to ERISA prohibited transaction claims at the pleading stage. Setting the pleading standard too low exposes employers to significant litigation risk, and potentially discourages employers from offering or maintaining benefit plans. Enterprising plaintiffs' firms have made that fear a reality by filing a barrage of barebones complaints challenging 401(k) plan fees and stock purchase transactions involving employee stock ownership plans, or ESOPs. Part of the strategy is surviving the pleading stage and leveraging the prospect of expensive discovery to extract settlements. The Supreme Court has recognized as much in *Fifth Third Bancorp v. Dudenhoeffer*, directing lower courts to engage in a "careful, context-sensitive scrutiny" and "weed[] out" implausible ERISA claims.

In *Cunningham v. Cornell University*, a case that involved a 403(b) defined contribution plan, the Second Circuit addressed the pleading standard necessary to sufficiently allege a party-in-interest prohibited transaction claim. The Second Circuit issued a well-reasoned opinion that may have significant implications for ERISA prohibited transaction claims at the pleading stage. The Second Circuit embraced a position that plan fiduciaries and their counsel have advanced for years: plaintiffs alleging a prohibited transaction under ERISA section 406 must do more than merely allege facts that the transaction meets the technical elements of a party-in-interest transaction. Rather, the plaintiff must also plead plausible facts showing that ERISA section 408's statutory exemptions do not apply.

1. Background

The complaint in *Cunningham* alleged, among other things, a claim that the defendants engaged in a party-in-interest prohibited transaction in violation of ERISA section 406(a)(1)(C) by causing the plan to pay fees to the plan recordkeepers, which is a standard contractual arrangement necessary for the operation of the plan. Section 406(a)(1)(C) provides that, "[e]xcept as provided in [ERISA section 408]," a plan fiduciary "shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect . . . furnishing of goods, services, or facilities between the plan and a party in interest."

The district court dismissed those prohibited transaction claims, however, on the basis that the plaintiffs failed to plead the absence of one of the exemptions under ERISA section 408. That section—which is referenced in the first clause of Section 406(a)—provides several exemptions to what would otherwise be prohibited transactions. As relevant to the plaintiffs' allegations, Section 408(b)(2)(A) allows for "[c]ontracting or making reasonable arrangements with a party in interest for office space, or legal, accounting, or other services necessary for the establishment or operation of the plan, if *no more than reasonable compensation* is paid therefor." (emphasis added).

On appeal, the plaintiffs argued they had plausibly alleged that the plan fiduciaries committed a prohibited transaction in violation of Section 406(a)(1)(C) by causing the plan to pay fees to the plan's recordkeepers, which were "parties in interest." The Second Circuit disagreed.

2. The Second Circuit Recognizes an Existing Circuit Split

The Second Circuit began its analysis by describing a split among other circuit courts with respect to what facts a plaintiff must allege to plead a plausible prohibited transaction claim under Section 406(a)(1)(C). On one side, the Third, Seventh, and Tenth Circuits require plaintiffs to allege something more than the bare elements of Section 406(a)(1)(C), because that section in isolation from Section 408 exemptions would produce the "absurd result" of blocking fiduciaries from paying third parties to perform "essential services" like "recordkeeping and administrative services" for a plan. In particular, the Third Circuit in *Sweda v. University of Pennsylvania* required a plaintiff to allege "intent to benefit a party in interest." In *Albert v. Oshkosh Corp.*, the Seventh Circuit interpreted existing Circuit precedent as requiring that an alleged prohibited transaction must "look[] like self-dealing." And the Tenth Circuit in *Ramos v. Banner Health* clarified that a service provider is a "party in interest" only where the provider has a "prior relationship" with a plan's fiduciary.

On the other side, the Eighth Circuit held in *Braden v. Wal-Mart Stores, Inc.* that a plaintiff only needs to plead the elements of Section 406(a)(1)(C) (*i.e.*, a plaintiff does not need to plead that compensation was unreasonable), based on the Eighth Circuit's view that Section 408 provides affirmative defenses that are defendants' burden to prove. In other words, plaintiffs need not plead that the compensation was unreasonable. In *Bugielski v. AT&T Services, Inc.* the Ninth Circuit joined the Eighth Circuit in holding that Section 408 exemptions are affirmative defenses, albeit in a decision at the summary judgment stage that did not address the pleading standard for an alleged prohibited transaction under Section 406(a)(1)(C).

3. The Second Circuit Weighs in to Clarify the Pleading Standard for Prohibited Transaction Claims

The district court in *Cunningham* sided with the Third, Tenth, and Seventh Circuits, and held that the plaintiffs must allege that payment of the plan's recordkeeping fees involved "self-dealing or disloyal conduct." The Second Circuit did not adopt the specific pleading requirement from the district court's decision, but it expressly disagreed with the approach adopted by the Eighth Circuit. The Second Circuit instead held that "to plead a violation of Section 406(a)(1)(C)], a complaint must plausibly allege that a fiduciary has caused the plan to engage in a transaction that constitutes the 'furnishing of . . . services . . . between the plan and a party in interest' *where that transaction was unnecessary or involved unreasonable compensation*."

To arrive at its holding, the Second Circuit explained that Section 408 exemptions are different from affirmative defenses, which are usually "narrow." Section 408 exemptions, in contrast, are broad and can be "presumed in most cases." Although the Court acknowledged ways in which Section 408 exemptions are not like affirmative defenses, the Court applied those observations only to the pleading standard, and did not overturn prior Second Circuit precedent recognizing that defendants have the burden of persuasion with respect to the exemptions on the merits.

The Second Circuit reasoned further that "when one cannot articulate what the statute seeks to prohibit without reference to the exception, then the exception should be understood as part of the definition of the prohibited conduct—and thus its inapplicability must be pled." And the Court concluded that Section 406(a) "is such a statute." The Court explained that Congress could not have meant to block plans from merely paying compensation to third parties for plan services, since that would be "absurd"—instead, Congress was only concerned with prohibiting compensation that was "unreasonable."

After holding that the plaintiffs needed to make plausible allegations that the plan paid unreasonable compensation to its recordkeepers, the Second Circuit concluded that the plaintiffs' allegations were insufficient. The Court found it was not enough that the plaintiffs alleged the plans paid more than $1,050,000, which was the specific dollar amount that plaintiffs claimed would be a "reasonable recordkeeping fee." In rejecting these allegations, the Court observed it "is not unreasonable to pay more for superior services," and "Plaintiffs have failed to allege any facts going to the relative quality of the recordkeeping services provided, let alone facts that would suggest the fees were 'so disproportionately large' that they 'could not have been the product of arm's-length bargaining.'"

4. The Second Circuit Affirmed the District Court's Grant of Summary Judgment to Defendants as to Plaintiffs' Fiduciary Breach Claims

In addition to challenging the dismissal of their prohibited transaction claim, the plaintiffs appealed the district court's decision to grant summary judgment to the defendants with respect to three claims in which the plaintiffs alleged the defendants breached fiduciary duties of prudence in violation of ERISA section 404. The plaintiffs' claims at issue involved recordkeeping fees, retention of underperforming investment options, and an alleged failure to transition to lower-cost institutional shares. The Second Circuit rejected the plaintiffs' arguments and affirmed the district court's summary judgment decision.

GROOM INSIGHT: The Second Circuit's analysis should provide much grist for plan fiduciary defendants to use in challenging the sufficiency of alleged prohibited transactions under ERISA section 406(a)(1)(C). It is significant that the Second Circuit recognized plaintiffs must allege plausibly that compensation paid to plan service providers was "unreasonable," and it is not enough just to allege (as the plaintiffs did in *Cunningham*) that compensation paid by the plan was X and it should have been Y.

While *Cunningham* dealt specifically with the interplay between Sections 406(a)(1)(C) and 408(b)(2)(A) in a traditional defined contribution plan context, its effect may not be so limited. The *Cunningham* rationale should apply to other party-in-interest claims in other contexts. For instance, plaintiffs frequently argue in cases challenging ESOP stock purchase transactions that merely alleging that a transaction occurred is sufficient at the pleading stage to state a claim for a prohibited transaction under Section 406(a). Under this view, the price the ESOP paid to acquire employer stock is immaterial at the pleading stage, because Section 408(e)'s exemption of transactions in which employer stock is acquired for no more than "adequate consideration" is an affirmative defense. But under the Second Circuit's reasoning in *Cunningham*, plaintiffs should have the burden to negate Section 408(e)'s exemption by pleading that an ESOP stock purchase transaction was not for "adequate consideration."

With the Second Circuit joining the Third, Tenth, and Seventh Circuits in reading Section 406(a) in conjunction with Section 408(b) on the one hand, and with the Eighth and Ninth Circuits reading Section 406(a) strictly as excluding Section 408(b)'s exemptions on the other, the issue may be ripe for Supreme Court consideration to resolve the circuit court split.