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Conflicts of Interest (Part 3): Plan Advisors and

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the *Cornell* Decision

BY FRED REISH, JOAN NERI, AND JOSHUA WALDBESER

This article is the third in a series conflict of interest issues under the prohibited transaction rules of ERISA and the Internal Revenue Code and focuses on the implications of the Cornell *decision for future lawsuits under the prohibited transaction rules.*

This is our third article in a series that examines conflicts of interests that are prohibited transactions under the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the Code). In this article, we focus on the prohibited transaction that arises when service providers, including broker-dealers, registered investment advisers, and their representatives (collectively, advisors), as well as recordkeepers and third-party administrators (TPAs), provide services to private sector qualified retirement plans and Individual Retirement Accounts (IRAs). If the services are provided to an ERISA plan and because service providers are themselves "parties in interest" to the plans that employ them (more on this later), this arrangement is a "prohibited transaction" under ERISA enforced by the Department of Labor (DOL). Plan participants can also bring suits alleging prohibited transactions, particularly if they can allege harm to the plan, including to the participant's own plan account. The Code contains a similar prohibited transaction rule enforced by the Internal Revenue Service (IRS) that applies to service providers (referred to under the Code as "disqualified persons") not only to tax-qualified ERISA plans but also to other private sector qualified retirement plans, such as Solo 401(k)s and Keogh Plans (collectively, Plans) and IRAs.

The good news is that there is a statutory prohibited transaction exemption under both ERISA and the Code with which service providers can comply in order to be exempt from the prohibited transaction. It should be noted that prohibited transactions between plans and "parties in interest" or "disqualified persons" are a different type of prohibited transaction from fiduciary self-dealing prohibited transactions, where a fiduciary uses its fiduciary authority or responsibility to cause itself or another party in which it has an interest to receive additional compensation in connection with a plan.

In this article, we discuss the implications for service providers of a recent US Supreme Court decision that addressed whether plaintiffs need to allege (and ultimately prove) the lack of an exemption or the failure to comply with the terms of an exemption (for example, the Service Provider Exemption of ERISA Section 408(b)(2) as described under DOL Regulation Section 2550.408b-2(c)) when alleging a prohibited transaction. In a unanimous decision, the Supreme Court in *Cunningham v. Cornell University* [604 U.S. ____(2025), Slip Op. No. 23-1007] (*Cornell*) clarified that, in an ERISA lawsuit, the plaintiff need only allege the three elements of the prohibited transaction (that is, the 3-Part Test described below), reasoning that the burden of pleading and proving compliance with the Service Provider Exemption lies with the service provider, who must invoke the exemption as an affirmative defense. There is a concern among plan service providers that this decision will make it easier for plaintiffs to assert prohibited transaction claims and that it will lead to an increase in lawsuits against plan sponsors and their fiduciaries (such as plan committee members). However, there are steps that plan sponsors and other fiduciaries, and service providers, can take to address this risk.

Background—The Service Provider Exemption

Under ERISA, a prohibited transaction arises with respect to a plan service arrangement if the following three elements occur (the 3-Part Test):

1. a fiduciary causes a plan to engage in a transaction,
2. that the fiduciary knows or should know constitutes a direct or indirect furnishing of services,
3. between the plan and a party in interest. [ERISA § 406(a)(1)(C)].

A service provider is a "party in interest." (That includes advisors, recordkeepers, and TPAs.) [ERISA § 3(14)(B)]. The Code contains a similar prohibited

transaction rule applicable to Plans and IRAs, except that the Code uses the term "disqualified person" rather than "party in interest." [Code § 4975(c)(1)(C)].

To avoid this prohibited transaction under the Code and ERISA, the Plan or IRA needs to satisfy the following conditions of the Service Provider Exemption:

- The services must be necessary for operations of the Plan or IRA;
- The arrangement must be reasonable; and
- The Plan or IRA must pay its service providers no more than reasonable compensation. [ERISA § 408(b)(2); Code § 4975(d)(2)]

In addition, under ERISA, if a service provider reasonably expects $1,000 or more in compensation, then the service provider must provide a disclosure (the 408(b)(2) Disclosure) reasonably in advance of entering into the arrangement to the responsible plan fiduciary of the ERISA plan (that is, the fiduciary with authority to cause the plan to enter into the service arrangement). The disclosure must contain a description of the services to be provided and the direct and indirect compensation to be received, as well as a statement as to whether the service provider is an ERISA fiduciary and/or a registered investment adviser. [DOL Reg. 2550.408b-2(c)]. A covered plan for purposes of this disclosure includes ERISA-covered defined benefit and defined contribution plans, including ERISA-covered 403(b) plans, but does not include simplified employee pension plans (SEPs), simple retirement accounts (a SIMPLEs), or IRAs.

The disclosure is intended to provide the plan fiduciary with sufficient information to evaluate the reasonableness and prudence of the service arrangement. While there is no required format for the disclosure, a common industry practice is to include these disclosures in the service agreement and provide it in advance to the responsible plan fiduciary (usually, the plan sponsor or plan committee).

The *Cornell* Court's Holding

The issue presented in the *Cornell* decision was whether a plaintiff can state a claim for relief by simply alleging that the fiduciary engaged in a prohibited transaction with a service provider under the 3-Part Test or whether the plaintiff must also disprove the applicability of the Service Provider Exemption. The lower court, the Second Circuit, reasoned that the Service Provider Exemption (that is, ERISA Section 408(b)(2)) is incorporated into the statute that describes prohibited transactions (that is, ERISA Section 406) and, therefore, the plaintiff must affirmatively allege that the Service Provider Exemption was not available or that its conditions were not satisfied. The Second Circuit noted that several courts, including the Third, Tenth, and Seventh Circuits, also had declined to interpret the prohibited transaction rule narrowly in a manner that would prohibit a plan fiduciary from paying service providers for essential plan services. The Second Circuit's decision was in contrast to Eighth Circuit and Ninth Circuit decisions, which held that a plaintiff need only allege the elements of the 3-Part Test. [Braden v. Wal-Mart Stores, Inc., 588 F. 3d 585, 600-602 (8th Cir. 2009); Bugielski v. AT&T Servs., Inc., No 21556196, 2023 WL 4986499 (9th Cir. August 4. 2023)]

Given this split among the Circuit Courts, the Supreme Court granted *certiorari*. In reaching its decision, the Supreme Court examined the statutory construction, observing that the prohibited transaction rules and the relevant exemptions, including the Service Provider Exemption, are separately set forth in two different sections of ERISA The prohibited transaction rules are in ERISA Section 406; whereas the exemption rules are in ERISA Section 408. The Supreme Court reasoned that this separation indicates that the exemption rules, including the Service Provider Exemption, should be characterized as affirmative defenses. Moreover, the Supreme Court observed that ERISA Section 408 contains a wide range of exemptions in addition to the Service Provider Exemption and *"it would make little sense to put the onus on plaintiffs to plead and disprove"* all of the potentially relevant exemptions. [Emphasis added.] Therefore, the Supreme Court held that the plaintiff need only allege the elements of the 3-Part Test without addressing the potential exemptions.

Recognizing that its decision could encourage future plaintiffs to bring "barebones" lawsuits under the prohibited transaction rules, the Supreme Court pointed out that district courts have tools at their disposal to screen out meritless claims. These district court safeguards include:

1. Authority to order plaintiffs to submit a reply setting forth specific nonconclusory allegations showing the exemption does not apply,
2. Dismissal when plaintiffs allege a prohibited transaction occurred but fail to identify an injury,
3. Discretionary authority to expedite or limit discovery to mitigate unnecessary costs,

4. Imposition of sanctions where an exemption obviously applies and the plaintiff lacks a good faith basis to believe otherwise, and
5. Discretion to award reasonable attorney fees and costs of the lawsuit to either party.

What This Means for Plan Sponsors

It is likely that this decision will lead to more lawsuits based on allegations of service provider prohibited transactions and accordingly, plan sponsors and their fiduciary officers and managers should take steps to ensure that the conditions of the Service Provider Exemption are satisfied and that there is documented evidence of compliance. This includes the following:

- Periodically calculate and evaluate compensation of service providers (by comparison to relevant industry data) to ensure that they are reasonable as compared to providers of comparable services;
- With respect to the 408(b)(2) Disclosure;
  - — Make sure that the covered service providers have provided compliant disclosures to the plan fiduciary reasonably in advance of entering into an agreement with the providers;
  - — Ensure that, when appropriate, the disclosure includes an acknowledgement of ERISA fiduciary status with respect to the services to the plan; and
  - — Ensure that the description of services and compensation—both direct and indirect—is accurate and complete.

Because of the Supreme Court's holding in *Cornell*, it will still be possible for plaintiffs to bring lawsuits, and likely avoid having their cases dismissed prior to discovery, even if the responsible plan fiduciary would be able to demonstrate compliance with the Service Provider Exemption. However, ensuring that the steps above are completed will help prevent fiduciaries from being held liable in the end, and may enable district courts to take the types of actions summarized above if the plaintiff's case is found to be meritless or frivolous.

Conclusion

The *Cornell* decision will likely lead to an increase in prohibited transaction lawsuits against plan sponsors and their plan committees. To protect themselves, plan sponsors and fiduciaries should ensure that:

1. They have received compliant disclosures from their service providers;
2. They have calculated and compared the fees to industry data about the compensation commonly paid for similar services by similarly situated plans; and
3. They retain that documentation as evidence to prove compliance with the conditions of the Service Provider Exemption. ■