PLAN SPONSOR
Digest

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U.S. Supreme Court ruling may increase cases against plan sponsors

In April, the U.S. Supreme Court released a unanimous ruling in Cunningham v. Cornell University that may encourage more lawsuits against plan sponsors and fiduciaries. The court heard this case to resolve inconsistent rulings in various circuits of the U.S. Courts of Appeals. Many cases have been filed alleging that service providers were being paid excessive fees by plan sponsors. Different courts established different standards regarding what specific facts must be alleged for a case to survive a defendant's motion to dismiss the case, thus, the U.S. Supreme Court agreed to hear Cunningham v. Cornell University to create a nationwide pleading standard.

Background

If you think that a "nationwide pleading standard" sounds a bit wonky, you are right. Before we discuss how this ruling may affect plan sponsors, let's review some fundamental rules under the Employee Retirement Income Security Act (ERISA) of 1974. Under ERISA, entities that provide services to plans are considered "parties in interest." Due to the close relationship between these parties and the plan itself, they are generally prohibited from accepting money or other benefits from the plan. But this doesn't make much sense considering that service providers such as recordkeepers or investment providers—which are essential to running a compliant plan—will never provide these services free of charge.

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ERISA also contains numerous exemptions from the general prohibition. Specifically, there is no prohibited transaction between a party in interest and a plan sponsor if the plan pays the provider for services that are needed to operate the plan and if the compensation is reasonable.

The wonky part

Some lower courts ruled that when plaintiffs (who initiate the case) draft a complaint against a defendant (plan sponsor or other fiduciary), all that ERISA requires is a basic allegation that the defendant engaged in an impermissible act of paying a party in interest from plan assets and that participants were harmed. Other courts took a different approach and ruled that a bare-bones pleading was not enough to avoid a case dismissal, and instead, plaintiffs would also have to address the exemptions that allowed plan sponsors to use plan assets to pay reasonable expenses to service providers.

This higher pleading standard would require the plaintiff to include in the initial complaint credible allegations that, for example, the service provided was unnecessary or that the cost was unreasonable. Merely stating that “the cost was unreasonable” is not enough. In the initial complaint, the plaintiff would likely have to include facts that support the general claim of excessive fees paid by the plan. This might include details on plan expenditures for certain services and how they compare to industry averages. Instead of the plan sponsor being required to offer the “affirmative defense” of having an exemption under ERISA, the plaintiff would have to address this defense by specifically alleging the ways in which the service was unnecessary, or the fees were excessive. If the complaint did not adequately address the possible defenses, a court could dismiss the case early in the proceedings.

The U.S. Supreme Court ruling

The U.S. Supreme Court ruled unanimously that plaintiffs do not have to address all the possible exemptions in their pleadings (or allegations) of the case. That task is for the defendant plan sponsors to do when replying to the plaintiff’s allegations. Although the court was sympathetic to the argument that this low bar may create “an avalanche of meritless litigation,” it nonetheless ruled that “The Court must read it [the statute] the way Congress wrote it.”

The court continued: “The Court today holds that plaintiffs seeking to state a [prohibited transaction] claim must plausibly allege that a plan fiduciary engaged in a transaction proscribed therein, no more, no less.”

They do not have to plead (and prove) that any of the multiple exemptions in ERISA will get in the way of the plaintiffs prevailing in the lawsuit.

The result

Since plaintiffs are now more likely to survive a defendant’s motion to dismiss a case early in the proceedings, more cases are expected to move toward trial. This involves potentially expensive rounds of discovery, which may lead defendants to settle cases simply to reduce financial exposure. This, in turn, may embolden plaintiffs to pursue claims against plan sponsors and fiduciaries that have less legal merit.

The U.S. Supreme Court highlighted five tools that lower courts can use to discourage frivolous lawsuits. Whether these tools will prove sufficient to curtail “nuisance lawsuits” remains to be seen. Meanwhile, the plaintiffs’ bar is likely to continue exploring novel approaches to holding plan sponsors accountable—and earning substantial attorneys’ fees in the process.

It's not too soon to prepare for Roth catch-up contributions

The SECURE 2.0 Act requires certain higher-paid plan participants to treat any catch-up contributions as Roth contributions. Participants who reach age 50 at any time during the year can make additional elective deferrals (currently indexed to $7,500). If they make more than $145,000 (indexed) in wages from the plan sponsor in the previous year, they are subject to this rule. This provision was crafted as a simple way to raise revenue by preventing certain participants from deducting their catch-up contributions from taxable income. However, this straightforward provision has created some practical problems for plan sponsors and service providers.

This provision was originally slated to become effective in 2024, but the IRS delayed the start date until 2026, mostly to address the issues that had been raised by industry practitioners. Proposed regulations on this Roth catch-up requirement were published earlier this year and clarified several IRS positions. For example, these regulations point out that if "any" catch-up eligible participant who is subject to this new rule is allowed to make Roth catch-up contributions, then "all" participants who are catch-up eligible must be allowed to make Roth catch-up contributions. In other words, plan sponsors cannot permit only those who are subject to this rule to make Roth deferrals; all participants—even lower-paid ones—must be allowed to make Roth deferrals, including catch-up contributions.

Most 401(k) plan sponsors offer a Roth contribution option already but those who do not may want to reconsider this in light of the upcoming Roth catch-up rule. In addition, plan sponsors will want to work with their service providers to prepare for the transition to mandatory Roth catch-up contributions for their affected participants. Keep in mind that different providers, such as recordkeepers and payroll firms, may have various views on the best way for plan sponsors to capture catch-up contribution elections. Additionally, most providers will have to make changes to their systems and processes to stay in compliance with this rule so patience may be the order of the day.

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Looking ahead

With all that is happening these days—with the economy, legislation and litigation, and shifting plan requirements—plan sponsors may find it difficult to focus on simply running a compliant retirement plan that benefits participants and beneficiaries. Even now, as Congress is negotiating a 2025–2026 budget bill, there are provisions in it that may affect retirement savers. Several stand-alone retirement plan bills have also been reintroduced, including a bill that would create a federally-facilitated retirement program for workers not covered by a workplace plan. The current version of the budget bill contains a provision that would cut the U.S. Department of Labor's (DOL) budget by 26%. This is bound to have some effect on the DOL's capacity to enforce current rules and to draft much-needed guidance on SECURE 2.0 Act provisions. If and when the dust settles a bit, there will likely be much more news to discuss.

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