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7th Circ. Ruling Offers Arbitration Clarity For ERISA Claims

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On Sept. 10, the U.S. Court of Appeals for the Seventh Circuit ruled in Smith v. Board of Directors of Triad Manufacturing Inc. that an employee stock ownership plan's arbitration provision was unenforceable because it limited the relief available in arbitration to the individual claimant.

Citing the rarely used effective vindication doctrine, the Seventh Circuit decided that such individualized relief was incompatible with the statutory remedies[1] available under the Employee Retirement Income Security Act Section 502(a)(2) for breaches of fiduciary duty under ERISA Section 409(a).[2]

Although the ruling found the particular arbitration provision was unenforceable, it was the circuit court's first decision that broadly approved arbitration of ERISA claims.

The decision provides helpful considerations for plan sponsors when incorporating arbitration clauses into ERISA plans. The decision also indicates, however, an increasing concern by courts that the limitations in many arbitration provisions are incompatible with the planwide relief available under ERISA fiduciary breach claims.

Background

Former Triad Manufacturing employee James Smith brought an action alleging ERISA claims, including claims for breach of fiduciary duty, in the U.S. District Court for the Northern District of Illinois in April 2020 against the board of Triad, the company's three co-presidents and the trustee of the Triad Employee Stock Ownership Plan.

In his complaint, Smith alleges that Triad created the ESOP in December 2015. Prior to the creation of the ESOP, Triad was privately owned entirely by the three co-presidents, and there was no public market for the company stock.

Further, Triad employees were eligible to invest their retirement savings in a non-ESOP defined contribution plan,

which included a variety of mutual funds invested in stocks, bonds and money market funds.

Smith alleged that on Dec. 17, 2015, the individual defendants sold the entirety of Triad to the ESOP at an inflated value of $58.05 per share — $106.2 million in total.

The company subsequently filed financial statements with the U.S. Department of Labor indicating that by the end of the same month, Triad's share value had fallen to $1.85, or around $3.3 million in total.

Under vesting provisions in the ESOP, no employee could receive a distribution from the ESOP until December 2016. Employees who were eligible for a distribution in December 2016 received only $1.15 per share of Triad stock allocated to their accounts.

According to Smith, this steep decline in share value was precipitated by the individual defendants' withholding of information from the ESOP trustee.

Specifically, Smith alleged that the individual defendants knew that the financial projections underlying the share valuation were not realistic, that the valuation did not reflect that the ESOP would still lack control of the company despite owning 100% of the stock, and that the individual defendants retained the ability to dilute the ESOP's ownership interest by authorizing new Triad shares.

District Court Decision

Before the district court, several of the defendants moved to compel Smith to arbitrate his claims based on an arbitration provision that was incorporated as an amendment to the ESOP after Smith left his employment with Triad, but before he was permitted to withdraw his retirement funds from the ESOP.

In pertinent part, the arbitration provision required that covered claims "must be brought solely in the Claimant's individual capacity and not in a representative capacity or on a class, collective, or group basis." It also required that each arbitration

> be limited solely to one Claimant's Covered Claims, and that Claimant may not seek or receive any remedy which has the purpose or effect of providing additional benefits or monetary or other relief to any Eligible Employee, Participant or Beneficiary other than the Claimant.

The district court denied the motion to compel arbitration on two grounds.[3]

First, the court found that Smith never agreed to the arbitration provision. In reaching this conclusion, the court rejected the defendants' argument that continued participation in the ESOP was sufficient in view of the realities of ERISA plans.

Instead, the court cited traditional principles of contract formation, including that the essential elements of a valid contract under Missouri law require "offer, acceptance, and bargained-for consideration." Here, the district court found that Smith's consent was lacking.

Second, the district court found that the arbitration agreement was unenforceable on public policy grounds because it acted as a prospective waiver of a party's rights to pursue statutory remedies.

Specifically, the district court found that the arbitration provision

> eliminates [Smith's] right to pursue plan-wide statutory remedies that are expressly granted under ERISA § 502(a)(2), which authorizes plan participants to bring civil actions for appropriate relief under ERISA § 409 [for breach of fiduciary duty].

Seventh Circuit Decision

On appeal, the Seventh Circuit explicitly did not address whether Smith's continued participation in the plan constituted an agreement to the arbitration provision or whether a plan's sponsor can unilaterally amend such a plan to include an arbitration provision.

Instead, the circuit court affirmed the district court's denial of the motion to compel arbitration based on the effective vindication exception.

The effective vindication exception originated with the 1985 U.S. Supreme Court decision in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.[4]

There, the court ruled that the international nature of the transaction at issue warranted enforcement of the arbitration agreement, including resolution of American arbitration claims in Japan. The court, however, noted in a footnote that hypothetically, should

> the choice-of-forum and choice-of-law clauses [operate] in tandem as a prospective waiver of a party's right to pursue statutory remedies for antitrust violations, [the court] would have little hesitation in condemning the agreement as against public policy.

Since Mitsubishi Motors, the court has repeatedly acknowledged the existence of the effective vindication exception, but has declined to apply the exception to invalidate an arbitration agreement.

Mostly recently, in American Express Co. v. Italian Colors Restaurant, the Supreme Court in 2013 considered the respondents' argument that they were unable to effectively vindicate their rights under the Sherman Act because the class action waiver in the arbitration agreement at issue made the cost of expert analysis necessary to prove the antitrust claims greatly exceeded the maximum recovery for an individual plaintiff.[5]

The court rejected that argument, ruling that

> the fact that it is not worth the expense involved in proving a statutory remedy does not constitute the elimination of the right to pursue that remedy.[6]

In reviewing the arbitration provision under this exception, the Seventh Circuit noted that the provision precludes a participant from seeking or receiving relief that

> has the purpose or effect of providing additional benefits or monetary or other relief to any Eligible Employee, Participant or Beneficiary other than the Claimant.

The court ruled that this limitation impermissibly denied Smith his statutory right to seek "equitable or remedial relief as the court may deem appropriate, including removal of [a] fiduciary" for breaches of fiduciary duty.

The court emphasized that its decision should not be interpreted as a challenge to the individualized nature of arbitration proceedings:

> To reiterate, the problem with the plan's arbitration provision is its prohibition on certain plan-wide remedies, not plan-wide representation.[7]

Implications for ERISA Plans

In reaching its conclusion, the Seventh Circuit explicitly endorsed arbitration of ERISA claims for the first time, including claims under employee retirement plans.

For sponsors and trustees who have been hesitant to incorporate arbitration provisions into their plans, the decision shows important considerations for drafters.

Certainly for ESOP and other defined contribution plans, plan sponsors should evaluate any limitation on the remedies that are available under applicable arbitration provisions. Where such limitations could be interpreted to preclude planwide relief, such as replacement of a fiduciary, sponsors should consider amending such language.

Sponsors should also evaluate whether they are more comfortable having planwide relief evaluated before an arbitration panel or a court. For sponsors who choose to maintain their arbitration programs, revisions to their arbitration policies may be needed to ensure the panel has the necessary expertise for planwide relief.

Sponsors should also consider whether specifically providing for appeal of ERISA arbitration decisions may be prudent given the availability of planwide relief.

Although the court's decision endorsed arbitration of ERISA claims, sponsors are likely to continue to see challenges to ERISA arbitration provisions under the effective vindication doctrine.

The Triad Manufacturing language prohibiting relief beyond the individual claimant is largely the same to such limitations regularly incorporated into arbitration agreements.

Although the Seventh Circuit framed its ruling in Smith as specific to the language in the Triad agreement, the decision is strikingly similar to another recent decision from the U.S Court of Appeals for the Second Circuit. In Cooper v. Ruane Cunniff & Goldfarb Inc., the Second Circuit in March stated that the representative nature of fiduciary breach claims is difficult to reconcile with the individualized nature of arbitration agreements.[8]

As with the Smith decision, the Second Circuit cited the effective vindication exception discussion in Italian Colors. Ultimately, the Second Circuit ruled that the arbitration agreement did not cover the claims and avoided the effective vindication question, but it seems likely that additional challenges to ERISA arbitration agreements under the exception will be forthcoming.[9]

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[1] 29 U.S.C. § 1132(a)(2).

[2] 29 U.S.C. § 1109(a).

[3] Smith v. Greatbanc Tr. Co., No. 20 C 2350, 2020 WL 4926560, at *1 (N.D. Ill. Aug. 21, 2020), aff'd sub nom. Smith v. Bd. of Directors of Triad Mfg., Inc., No. 20-2708, 2021 WL 4129456 (7th Cir. Sept. 10, 2021).

[4] Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc., 473 U.S. 614 (1985).

[5] American Express Co. v. Italian Colors Restaurant, 570 U.S. 228, 231, 133 S. Ct. 2304, 2308 (2013).

[6] Id. at 236. See also Green Tree Fin. Corp.-Alabama v. Randolph, 531 U.S. 79, 90 (2000) (declining to apply the exception where the petitioner argued that potentially large arbitration costs could preclude her from vindicating her statutory rights under the Truth in Lending Act); Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20, 28 (1991) (declining to apply the exception where the petitioner argued that arbitration was inconsistent with important social policies underlying the Age Discrimination in Employment Act).

[7] Smith, 2021 WL 4129456, at *7.

[8] Cooper v. Ruane Cunniff & Goldfarb Inc., 990 F.3d 173, 184 (2d Cir. 2021).

[9] See also Hawkins v. Cintas Corps., No. 1:19-CV-1062, 2021 WL 274341, at *6 (S.D. Ohio Jan. 27, 2021) (finding that an arbitration provision in individual employment agreements did not require arbitration of fiduciary breach claims as

such claims are brought on behalf of the defined contribution retirement plan, which was not a party to the employment agreements).
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