Supreme Court Issues Two Important Rulings

Insights
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In a pair of decisions issued today, the U.S. Supreme Court weighed in on two topics that impact employers across the country. The Court made it easier for workers to bring claims against their employers for losses to their 401(k) plans, while also clearing the way for employers to enforce arbitration agreements with their employees.

Supreme Court Allows 401(k) Participants To Sue Over Losses

In a unanimous decision expressly recognizing the prevalence of individual retirement account plans in today's workplace, the Supreme Court has allowed to go forward a suit by a 401(k) plan participant seeking losses to his retirement account based on an alleged breach of fiduciary duty. *LaRue v. DeWolff.*

Prior to today's decision, participants in defined contribution plans, such as the common 401(k), had been largely unsuccessful in seeking remedies for breaches that affected only their own account's value. Today's decision recognizes a remedy for individual account losses, and will likely spur litigation in the defined contribution plan arena. It sends a clarion call to plan fiduciaries of the need for ensuring absolute compliance with ERISA's dictates.

Employee's Retirement Plan Value Plummeted, Lawsuit Failed

James LaRue was a participant in his employer's 401(k) plan. He filed suit claiming that the plan's fiduciaries had failed to carry out trading instructions he submitted resulting in a loss of $150,000 to his retirement account. He made his claim under a section of the Employee Retirement Income Security Act (ERISA) that provides a cause of action to plan participants against plan fiduciaries for breaches of fiduciary duties resulting in losses to an employee benefit plan.

The U.S. Court of Appeals for the 4th Circuit rejected his claim as a matter of law, relying on the Supreme Court's decision in *Massachusetts Mutual Life Ins. Co. v. Russell.* In *Russell*, the Supreme Court had considered whether ERISA provided a cause of action by a participant for consequential damages as a result of the participant's benefit claim being wrongfully denied for a period of time.

It concluded that ERISA did not allow such a claim for individual relief. Rather, ERISA allowed only a claim for relief for losses that the plan, not an individual participant, had suffered. The 4th Circuit reasoned that because the losses suffered by Mr. LaRue were only to his own account, he was

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seeking individual, not plan-based, relief. It concluded it was constrained by *Russell* and denied relief.

Supreme Court: Lawsuits Can Proceed

Acknowledging that the 4th Circuit was faithful to the language of the *Russell* decision, the Supreme Court concluded the principles underlying *Russell* dictated a different result. The decision revolved around recognition that the type of pension plans prevalent when ERISA was enacted in 1974, defined benefit plans, have been largely replaced with defined contribution plans.

Under a defined benefit plan, a participant receives a set pension benefit based on age and years of service out of the plan's assets. In a defined contribution plan, the participant receives the value of his particular account in the plan. That value is dependent on numerous factors including the amount of the participant's contributions, the employer's contributions, and investment performance. The 401(k) is a common form of a defined contribution plan.

The Court reasoned that *Russell's* focus on only allowing damages benefiting the plan as a whole, as opposed to a single participant, was a product of the pension plan landscape being dominated by defined benefit plans at the time it was decided. In that context, breaches of fiduciary duty, such as mismanaging plan assets, normally diminished the corpus of plan assets used to pay all beneficiaries' claims. This background was not necessarily appropriate for consideration of breach of fiduciary duty claims relative to individual account plans such as Mr. LaRue's 401(k).

The Court then considered whether the type of loss alleged by Mr. LaRue was of the type Congress intended to protect plan participants against when it enacted the sections of ERISA delineating fiduciary duties. It defined the purpose of these duties as ensuring that plan participants received promised benefits. Because LaRue's allegation related to conduct impacting the amount of his benefit, as opposed to creating consequential damages sought in *Russell*, the Court concluded it was well within the type of conduct Congress intended to prohibit. Consequently, ERISA provides a cause of action "for fiduciary breaches that impair the value of plan assets in a participant's individual account."

What This Means For Employers

Many employers have 401(k) and other forms of defined contribution plans as benefits for their employees. A recent study found that 50 million workers have such plans with over $2.7 trillion invested. The standard model for managing such a benefit is for an employer to hire a third party to prepare all the documents and to manage all the assets. Usually, the employer, as the plan sponsor, selects the funds available for investment by plan participants, after consultation with investment advisors.

But other than enrolling employees as they meet eligibility requirements, most employers have very little day to day interaction with the plan. What employers may not understand is that despite their minimal involvement, they are fiduciaries of the plan, either because they are named as such in plan documents or by virtue of actions they have taken with respect to the plans. They can be liable for the

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documents or by virtue of actions they have taken with respect to the plans. They can be liable for the type of losses alleged by Mr. LaRue even if they were not directly responsible for the act giving rise to liability.

Now that the impediment to individual claims has been removed, employers need to heighten their understanding of their fiduciary obligations. It is imperative that you review all agreements with third party providers, to determine your role and responsibility as well as your right to indemnification in the event of a vendor's negligence, such as failure to honor a participant's investment change. Examine systems that are in place to make certain that participants are receiving accurate information as well as all required disclosures. Finally, review your company's insurance contracts to ensure coverage for breaches of fiduciary duty and fidelity bonds are in place.

State Law Cannot Displace Parties' Agreement to Arbitrate

Also today, the U.S. Supreme Court issued a decision with major implications for the enforcement of arbitration agreements around the nation, one that will impact employment disputes as well as other types of business disputes. The Court held by a vote of 8 to 1 that the Federal Arbitration Act (FAA) supersedes a California law requiring submission of disputes involving talent agents to the state Labor Commissioner, despite the parties' prior agreement to arbitrate all disputes. *Preston v. Ferrer*

The Court held, "When parties agree to arbitrate all questions arising under a contract, state laws lodging primary jurisdiction in another forum, whether judicial or administrative, are superseded by the FAA." This decision reaffirms the FAA's national policy favoring arbitration and protects pre-dispute arbitration contracts from states' efforts to limit or undermine them. This decision is good news for employers who have agreed to arbitrate disputes with their employees. The Court has repeatedly struck down states' efforts to limit the reach of arbitration agreements in recent years, and *Preston v. Ferrer* continues that trend.

Background: Some States Hostile to Arbitration Agreements

The FAA provides a substantive body of law that strongly favors enforcement of private agreements to arbitrate, and seeks to eliminate traditional judicial hostility to arbitration and other roadblocks to the speedy and efficient resolution of disputes. To this end, the FAA preempts federal and state laws that seek to impose conditions on arbitration contracts not applicable to contracts generally.

California has been viewed as particularly hostile to arbitration in recent years. A number of California decisions have limited the enforceability of pre-dispute arbitration provisions and imposed special restrictions on arbitration agreements not applicable to other types of contracts.

But California is by no means alone in resisting the FAA. In *Buckeye Check Cashing, Inc. v. Cardegna,* a 2006 case, the Supreme Court struck down a Florida law that required challenges to the validity of an entire contract containing an arbitration clause to be heard first by a state court and not the arbitrator. The Supreme Court held that challenges to an entire contract, as opposed to only the arbitration provision, must ordinarily be heard by the arbitrator, not a court.

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arbitration provision, must ordinarily be heard by the arbitrator, not a court.

The question before the Court in today's *Preston v. Ferrer* decision was whether the FAA similarly overrides state laws that refer certain types of disputes to an administrative agency for hearing, rather than to a court as in *Buckeye*. Specifically, could the California Talent Agencies Act displace the parties' agreement to arbitrate all disputes between themselves, and force the parties to submit to the jurisdiction of the state Labor Commissioner? With the exception of Justice Clarence Thomas, the Court said no.

Judge Alex Doesn't Just Hear Disputes, He Creates Them

The genesis of this case was a dispute between Alex Ferrer, star of daytime television's *Judge Alex* show, and his former manager, Arnold Preston. In *Judge Alex,* ironically, Ferrer sits as an arbitrator hearing small-claims type legal disputes. Before *Judge Alex* hit the airwaves, Ferrer was a Florida state judge and former prosecutor. Preston was a California lawyer who provided management services for TV and movie actors.

In 2002, Ferrer and Preston entered into an agreement stating that Preston would provide "personal management services" in exchange for 12% of Ferrer's earnings from *Judge Alex.* The parties also agreed to arbitrate any dispute about the terms of the contract or its "validity or legality."

Not long before the first episode of *Judge Alex* aired in 2005, Preston initiated arbitration proceedings against Ferrer seeking to recover the management fees to which he claimed he was entitled under the contract. Ferrer countered by filing a petition to stay the arbitration proceedings and filing a claim with the California Labor Commissioner, arguing that the entire contract was void under the Talent Agencies Act (TAA), which regulates talent agents. Under the TAA, the Labor Commissioner is empowered to resolve disputes between artists and talent agencies.

Ferrer's claim with the Labor Commissioner was that his contract with Preston was void because Preston was acting as an unlicensed talent agent in violation of the TAA, not as a personal manager (an occupation unregulated by the TAA). If the contract was void under the TAA, then Preston would not be entitled to any fees for his services. The substance of the parties' dispute over fees thus turned on whether Preston was acting as an unlicensed talent agent. The procedural dispute involved who gets to decide whether Preston was an unlicensed talent agent or an unregulated personal manager.

California Court of Appeal Backs State Law

By a 2-1 decision, the Court of Appeal held that the Labor Commissioner had authority to resolve the dispute about whether Preston was a talent agent under the TAA. As a result, the Labor Commissioner would effectively determine the validity of the contract between Ferrer and Preston as well. The Court of Appeal reasoned that since the TAA vested "exclusive original jurisdiction" in the Labor Commissioner, the parties were required to use the Labor Commissioner's administrative procedures before they could arbitrate.

The Court of Appeal further held that the FAA did not preempt the TAA because the Supreme Court in *Buckeye Check Cashing, Inc. v. Cardegna* had not addressed the situation where a party is

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in *Buckeye Check Cashing, Inc. v. Cardegna* had not addressed the situation where a party is required to exhaust administrative remedies through an agency procedure.

Supreme Court Rejects California's Efforts to Carve Out Exception to FAA

Preston appealed the decision to the California Supreme Court, which denied review, and then appealed to the U.S. Supreme Court. The Supreme Court wasted no time in reversing the decision of the California Court of Appeal. Oral argument in this case was heard on January 14, 2008, and this decision issued barely one month later.

The Supreme Court found *Preston v. Ferrer* to be essentially controlled by its prior decision in *Buckeye.* Whenever parties agree to arbitrate all disputes arising under a contract, state laws that purport to give state courts or administrative forums primary jurisdiction to hear the dispute are superseded by the FAA, and the dispute must be heard in the first instance by the arbitrator.

The Court rejected Ferrer's argument that state law did not prohibit submission of the dispute to the arbitrator, but merely required the parties to exhaust their administrative remedies by presenting the dispute to the Labor Commissioner first. The Court noted that requiring submission of disputes to the Labor Commissioner granted the Labor Commissioner exclusive jurisdiction to hear controversies that the parties had agreed to arbitrate, imposed prerequisites to the enforcement of an arbitration agreement beyond those applicable to enforcement of contracts generally, and hindered the speedy resolution of the parties' controversy by delaying the arbitration proceedings.

The Court's holding that the FAA supersedes any state law vesting jurisdiction in state judicial or administrative forums does not mean that the FAA entirely displaces state law. The Court reiterated that by agreeing to arbitrate their dispute, neither party had given up any substantive rights under the Talent Agencies Act or other state law. Rather, they only agreed to resolve the dispute through arbitration proceedings.

What This Means for Employers

This decision is a positive development for employers, particularly those with operations in California and other states that have attempted to limit the enforceability of pre-dispute arbitration clauses. *Preston v. Ferrer* reiterates that state law cannot impose special procedural hurdles for arbitration agreements, such as a requirement that disputes first be heard by an administrative agency. While the dispute between the parties is narrow â€“ does Ferrer owe Preston 12% of his earnings from *Judge Alex*? â€“ this case addresses the broader issue of whether agreements to arbitrate can be enforced despite state laws that seek to undermine or limit such agreements.

As always, it is important to review your arbitration agreements periodically to be sure they comply with current law. Employers may wish to consider revising and updating their agreements to specify an agreement to arbitrate under the Federal Arbitration Act. It may also be wise to specify that the parties will have the benefit of procedural safeguards under state law (such as those provided by *Armendariz v. Foundation Health Psychcare Services* in California), to facilitate enforcement of the arbitration agreement by state trial courts.

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For more information on these decisions, contact a Fisher Phillips attorney at any of our offices across the country. Our Benefits Practice Group attorneys are available to advise on the implications of the 401(k) decision.

This Labor Alert is provided as an overview and explanation of this case. It is not intended to substitute for legal advice regarding the facts of any specific situation. In all such cases, employers should consult with competent legal counsel.

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