AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
The Essential Resource for Today's Busy Insolvency Professional

Feature

BY GORDON Z. NOVOD[1]

ERISA Pre-Emption Does Not Offer a "Get Out of Jail Free Card" for an ESOP's D&Os

Gordon Z. Novod
Grant & Eisenhofer, PA
New York

Gordon Novod is a partner and the leader of Grant & Eisenhofer, PA's Bankruptcy and Distressed Litigation Practice in New York.

Creditors of all sorts have come to rely on a baseline of rights and remedies to protect their interests from corporate malfeasance and misconduct. These protections include common law rights of actions for breaches of fiduciary duties, as well as statutory prohibitions on unlawful corporate dividends.

But what happens when a debtor is owned by an employee stock ownership plan (ESOP)? ESOPs are governed by the Employee Retirement Income Security Act (ERISA).[2] ERISA is a federal statute of sweeping pre-emptive effect, designed by Congress to provide, *inter alia*, the exclusive structure through which ESOP participants and beneficiaries may resolve ESOP-related claims. Such claims include those that ESOP participants and beneficiaries may bring against the directors and officers (D&Os) of an ESOP-owned corporation who owe fiduciary duties to them under ERISA. However, these D&Os typically also owe fiduciary duties under state corporation law. When an ESOP-owned corporation goes bankrupt, therefore, the bankruptcy and ERISA regimes may conflict in unexpected ways. Does ERISA pre-emption prevent the liquidating trustee for a debtor corporation's estate from pursuing certain claims against its D&Os because such D&Os are also ESOP fiduciaries?

The Seventh Circuit Court of Appeals recently confronted these novel issues of ERISA conflict pre-emption and the interplay with the rights of a debtor's creditors in *Halperin v. Richards*.[3] In that case, the Seventh Circuit found that ERISA conflict pre-emption did not pre-empt the liquidating trustee's state corporation law claims against the debtor's D&Os. The Seventh Circuit reversed the district court's dismissal of state law claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and unlawful dividends against the debtor's D&Os, and remanded those claims.[4]

Background

Three basic concepts are relevant to the *Halperin* decision: (1) the vesting of a debtor's legal causes of action in the debtor's estate upon bankruptcy; (2) fiduciary duties owed by D&Os under state corporation law; and (3) federal pre-emption. First, upon the filing of a bankruptcy petition, the debtor's estate acquires all of the debtor's legal rights and remedies, and the debtor has the right to sue and be sued,[5] for the benefit of its estate and the debtor's creditors.[6]

Second, these causes of action include those that may exist against a debtor corporation's D&Os. States have traditionally regulated fiduciary duties owed to the corporation and its stakeholders,[7] including the duties of care and loyalty. Delaware courts have made it clear that disinterested and inde-

1 The author is counsel of record for the plaintiffs/appellants co-trustees in *Halperin v. Richards*, 7 F.4th 534, Case No. 20-2793, 2021 WL 3184305 (7th Cir. July 28, 2021). The views expressed herein are those of the author and do not necessarily express the opinions of the co-trustees.
2 29 U.S.C. § 1001, *et seq.*
3 *Halperin v. Richards*, Case No. 20-2793, 2021 WL 3184305 (7th Cir. July 28, 2021).
4 *Id.*
5 *See* 11 U.S.C. §§ 541(a)(1), 323(b) and 1107.
6 *Jefferson v. Miss. Gulf Coast YMCA Inc.*, 73 B.R. 179 (S.D. Miss. 1986); *see also Koch Ref. v. Farmers Union Cent. Exch. Inc.*, 831 F.2d 1339, 1343 (7th Cir. 1987), *cert. denied*, 485 U.S. 906 (1988) (claims for breach of fiduciary duty that "can be enforced by either the corporation directly or the shareholders derivatively before bankruptcy become property of the estate which the trustee alone has the right to pursue after the filing of a bankruptcy petition").
7 *In re PMTS Liquidating Corp.*, 452 B.R. 498, 507 (Bankr. D. Del. 2011) ("Under the internal affairs doctrine, one state alone has authority to regulate matters peculiar to relationships among or between the corporation and its current officers, directors, and shareholders. The state under which the corporation is chartered has this authority.") (internal citation omitted).

pendent fiduciaries of an insolvent corporation must "recognize that the [corporation's] creditors have become its residual claimants."[8]

Third, the Constitution's Supremacy Clause pre-empts state laws that interfere with or are contrary to federal law.[9] "Pre-emption can generally occur in three ways: where Congress has expressly preempted state law, where Congress has legislated so comprehensively that federal law occupies an entire field of regulation and leaves no room for state law, or where federal law conflicts with state law."[10]

As an unusually broad federal statute, the scope of ERISA pre-emption is a frequently litigated issue. An ERISA pre-emption analysis begins with an understanding legislative intent. "Congress enacted ERISA to 'protect ... the interests of participants in employee benefit plans and their beneficiaries'.... [A]ny state-law cause of action that duplicates ... the ERISA civil enforcement remedy ... is therefore pre-empted."[11] ERISA § 514(a) states that ERISA "shall supersede any and all State laws insofar as they may now or hereafter *relate to any employee benefit plan*."[12] In addition, "ERISA is principally concerned with protecting the financial security of plan participants and beneficiaries."[13]

In enacting ERISA § 514(a), Congress intended "to ensure that [ERISA] plans and [ERISA] plan sponsors would be subject to a uniform body of benefits law ... [and prevent] the potential for conflict in substantive law ... requiring the tailoring of [ERISA] plans and employer conduct to the peculiarities of the law of each jurisdiction."[14] The U.S. Supreme Court has said that a state law is likely "related to," and thus pre-empted, if the state law has a "connection with" or "reference to" employee benefit plans.[15] This occurs when the state law (1) "mandate[s] employee benefit structures or their administration," (2) binds employers or plan administrators to particular choices or precludes uniform administrative practice, and (3) provides an alternative enforcement mechanism to ERISA.[16]

As is pertinent here, ERISA permits corporate officers to simultaneously serve as ERISA fiduciaries.[17] ERISA also establishes an "exclusive benefit rule" that requires ERISA fiduciaries to act exclusively for the benefit of plan participants.[18]

The Appvion Bankruptcy Filing

Prior to entering bankruptcy in 2017, Appvion manufactured specialty, high-value-added paper products. In 2001, its equity was acquired by the Appvion Inc. Savings and Employee Stock Ownership Plan. As an ESOP-owned company, Appvion had substantial financial obligations to the ESOP participants (*i.e.*, Appvion's employees), including to pay them cash for the fair value of their stock, either when employees retired or elected to receive a distribution. Prebankruptcy, Appvion's business was in terminal decline, with the deterioration of one of its core businesses compounded by its ever-growing ESOP obligations.

The Appvion Litigation

In October 2017, Appvion filed for bankruptcy protection.[19] **Alan D. Halperin** and Eugene I. Davis were appointed co-liquidating trustees (hereinafter, "co-trustees") of the Appvion Liquidating Trust to prosecute and resolve claims that vested in the trust, including claims against certain of Appvion's D&Os.[20] In 2019, the co-trustees sued Appvion's D&Os.[21] On Oct. 23, 2019, the U.S. Bankruptcy Court for the District of Delaware transferred certain of the claims against Appvion's D&Os, as well as claims against the ESOP trustee and ESOP trustee's financial advisor, to the U.S. District Court for the Eastern District of Wisconsin.[22]

Separately in 2019, Appvion's ESOP filed its own action, on behalf of the ESOP's participants and beneficiaries, against many of the same D&O defendants in the co-trustees' action.[23] The ESOP action alleged, *inter alia*, prohibited transactions under ERISA and breaches of ERISA fiduciary duties.[24]

The co-trustees' action alleged that while Appvion was insolvent, its D&Os fraudulently inflated stock valuations to reflect positive equity value. It is alleged that (1) Appvion's D&Os were motivated to do so because their compensation was directly tied to the ESOP valuations; (2) Appvion paid its direct parent company approximately $60 million in unlawful dividends in violation of Delaware law; and (3) Appvion's ESOP ownership structure exacerbated the consequences of the alleged misconduct, resulting in massive losses for its creditors.

In August 2020, the Wisconsin District Court dismissed the co-trustees' claims, holding that ERISA conflict pre-emption applied.[25] The co-trustees appealed, arguing that ERISA did not pre-empt claims for breaches of state fiduciary duty laws and unlawful dividends where the corporation was insolvent and the claims are being pursued for the benefit of the debtor's creditors.

The Seventh Circuit's Opinion

In July 2021, the Seventh Circuit reversed the Wisconsin District Court's dismissal of the claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and unlawful dividends against Appvion's D&Os.[26] The Seventh Circuit held that "ERISA does not pre-empt the plaintiffs' claims against [D&Os] ... who serve dual roles as both corporate and ERISA fiduciaries."[27]

---

8 *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 546-47, 547 n.13 (Del. Ch. 2015) (citing *Trenwick Am. Litig. Tr. v. Ernst & Young LLP*, 906 A.2d 168, 174-75 (Del. Ch. 2006), *aff'd sub. nom.*, *Trenwick Am. Litig. Tr. v. Billett*, 931 A.2d 438 (Del. 2007)); *see also Prod. Res. Grp. LLC v. NCT Grp. Inc.*, 863 A.2d 772, 790-91 (Del. Ch. 2004) (where Delaware corporation is insolvent, fiduciary duties are owed for benefit of all residual claimants, which include creditors).

9 *See* U.S. Const. Art. VI, § 2.

10 *Wachovia Bank NA v. Burke*, 414 F.3d 305, 313 (2d Cir. 2005), *cert. denied*, 550 U.S. 913 (2007) (internal citations omitted).

11 *Aetna Health Inc. v. Davila*, 542 U.S. 200, 208-09 (2004) (citation omitted).

12 29 U.S.C. § 1144(a) (emphasis added).

13 *Nat'l Sec. Sys. Inc. v. Iola*, 700 F.3d 65, 81 (3d Cir. 2012), *cert. denied*, 569 U.S. 919 (2013).

14 *N.Y. State Conf. of Blue Cross & Blue Shield Plans v. Travelers Ins. Co.*, 514 U.S. 645, 656-57 (1995) (internal punctuation omitted).

15 *Id.* at 654.

16 *Tr. of AFTRA Health Fund v. Biondi*, 303 F.3d 765, 775 (7th Cir. 2002) (citing *Travelers*, 514 U.S. at 658-60) (internal citations omitted).

17 29 U.S.C. § 1108(c)(3).

18 29 U.S.C. § 1104(a)(1)(A)(i).

19 *See In re OLDAPCO Inc.*, Case No. 17-12082 (Bankr. D. Del.).

20 *See id.*, D.I. 970, Art. VIII.G.1, IX.C. The exclusive beneficiaries of the Appvion Liquidating Trust are certain of Appvion's creditors.

21 *See Halperin, et al. v. Richards, et al.*, Adv. No. 18-50955 (MFW) (Bankr. D. Del.).

22 *Id.* at Adv. D.I. 112, 113.

23 *See Appvion Inc. Ret. Sav. & Emp. Stock Ownership Plan v. Douglas P. Buth, et al.*, Case No. 1:18-cv-01861-WCG (E.D. Wis.).

24 *Id.*

25 *See Halperin v. Richards, et al.*, Case No. 1:19-CV-1561, 2020 WL 5095308 (E.D. Wis. Aug. 28, 2020).

26 *See Halperin*, 2021 WL 3184305. The Seventh Circuit affirmed the Wisconsin District Court's dismissal of claims against Argent (the ESOP trustee) and Stout (the ESOP trustee's financial advisor).

27 *Id.* at *1.

The Seventh Circuit reasoned that because the co-trustees' claims were against Appvion's D&Os "serving dual roles as to both corporate and ERISA fiduciaries," ERISA did not pre-empt those claims.[28] The Seventh Circuit explained that ERISA "explicitly allows corporate insiders" (*i.e.*, D&Os) to simultaneously "serve as ERISA fiduciaries"[29] and that service as a "dual-hat fiduciar[y]" gives rise to a "fundamental contradiction."[30] Nonetheless, the Seventh Circuit found that "Congress clearly desired" to give employers incentives to form ERISA plans, and permitting D&Os of corporations to simultaneously serve as ERISA fiduciaries would further that purpose.[31]

The Seventh Circuit recognized that there was little circuit-level precedent assessing whether and to what extent ERISA pre-empts state corporation-law claims against dual-hat D&Os.[32] It expressed skepticism that state laws may be used to saddle ERISA fiduciaries with other distracting and potentially conflicting duties to the corporate employer.[33] However, the Seventh Circuit found that "when it comes to corporate [D&Os], ERISA tolerates some measure of dual loyalty."[34] In that respect, the Seventh Circuit held that since Congress permitted D&Os to serve as ERISA fiduciaries despite their dual loyalties, "[p]re-empting the plaintiffs' corporation law claims against the [D&Os] would also thwart ERISA's purpose to protect plan assets from misuse."[35]

The Seventh Circuit recognized that the co-trustees were not seeking to "circumvent ERISA's exclusive remedial scheme" by pursuing state law claims.[36] The co-trustees lacked standing to bring claims under ERISA, since they were not ERISA plan participants, beneficiaries or fiduciaries.[37] In essence, the co-trustees, as "non-ERISA plaintiffs, were not parties to an ERISA bargain" and "did not give up [their] state law causes of action [in order] to receive federal causes of action under ERISA."[38]

In addition, the Seventh Circuit noted the perverse implications of applying ERISA conflict pre-emption to prevent a debtor's creditors from suing, which would leave creditors without any recourse for allegedly fraudulent conduct, essentially "loot[ing] the company as it was sinking toward bankruptcy."[39] Citing ERISA's legislative history, the Seventh Circuit noted that Congress enacted ERISA in response to "widespread looting of plan funds" and observed that "[i]t would be odd if ERISA operated to shield similar fraudulent activity in this case."[40] After all, "ERISA was not intended as a device to permit corporate [D&Os] to defraud with impunity corporate shareholders and creditors."[41]

The Seventh Circuit also accepted the co-trustees' policy arguments, acknowledging that pre-emption of the co-trustees' claims "could also frustrate congressional intent by discouraging ESOP formation" and that "[i]t could be rational for creditors to demand high interest rates or more security for loans to ESOP-owned companies to account for the risk that [D&Os] might abuse the corporation without any recourse for creditors under corporate law."[42] The Seventh Circuit made clear that its holding "is limited to the plaintiffs' particular claims in this case, which would impose corporate liability that runs parallel to, not in conflict with, ERISA's fiduciary duties."[43]

Potential Implications

The *Halperin* decision holds substantial precedential value because it permits a liquidating trustee, as the representative of a debtor's estate, and the creditors who hold beneficial interests in the liquidating trust to hold corporate fiduciaries accountable for malfeasance and misconduct. The Seventh Circuit sanctioned the pursuit of these claims in spite of the recognized breadth of ERISA's conflict pre-emption's "related to" language. Even in cases where a debtor is organized as an ESOP, the Seventh Circuit preserved corporate accountability to creditors. These actions are preserved even when the debtor's D&Os wear "dual hats," simultaneously serving as fiduciaries of an ESOP. The Seventh Circuit rejected the D&Os' argument that their service as ESOP fiduciaries renders them immune from liability to the corporation and its creditors under state law.

This ruling permits creditors, who lack standing under ERISA, to seek damages for malfeasance to an insolvent corporate enterprise. At its core, the Seventh Circuit helped preserve the implicit bargain between debtors and creditors, thus preserving the fundamental state common law protections from corporate malfeasance and misconduct. abi

Reprinted with permission from the ABI Journal, Vol. XL, No. 11, November 2021.

28 *Id.*
29 *Id.* (citing 29 U.S.C. § 1108(c)(3)).
30 *Id.*
31 *Id.*
32 *Id.* at *7.
33 *Id.*
34 *Id.*
35 *Id.* at *9.
36 *Id.* at *6.
37 *Id.* (citing 29 U.S.C. § 1132(a)(3)).
38 *Id.* (internal quotations and citations omitted).
39 *Id.* at *9.
40 *Id.*
41 *Id.* (internal quotation and citation omitted).
42 *Id.* at *10.
43 *Id.*