

WHO MAY SUE YOU AND WHY, HOW TO REDUCE YOUR EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) RISKS, AND THE ROLE OF FIDUCIARY LIABILITY INSURANCE

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PRACTICAL SUGGESTIONS FOR PLAN DESIGN AND ADMINISTRATION

There is no one “best” plan design. At the same time, although standardized plans offered in the marketplace might be useful starting points, it is important to have a plan structure that is (1) thoughtfully and intentionally designed; and (2) well-administered and consistently followed. Although no one plan provision or combination of provisions can eliminate the risk of litigation, employers may want to

- Avoid naming key corporate officers as fiduciaries.
- Carefully craft delegation authority.
- Define the roles of plan sponsor and fiduciaries.
- Consider creating or amending plans to include *reasonable time limits* within which claims must be filed or they will be denied as untimely.
- Plans should be created or amended to *give the claims fiduciary discretion* to construe the terms of the plan, make benefit eligibility determinations, and make factual findings.
- Plans should *warn participants that their failure to exhaust the internal claims procedures will result in a motion to dismiss* for failure to exhaust those procedures in the event a participant or beneficiary files a lawsuit.
- Plans should advise participants that *the plan has the right to correct and recoup any overpayments*.

Retirement Plan Design

- Include a Section 404(c) provision in defined contribution plans. Compliance with ERISA Section 404(c) may relieve the fiduciaries from liability for damages for “any loss or any breach” where a participant exercises control over assets allocated to his/her account in a defined contribution plan.
- Hire an outside fiduciary. Though not required by ERISA itself, consider engaging a third-party, independent fiduciary to be responsible for, and exercise authority over, any employer-stock investment fund.

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This is the second of a two-part article addressing the complex legal environment faced by fiduciaries of ERISA-regulated retirement and welfare benefit plans. The authors, Morgan Lewis & Bockius ERISA litigation partners Charles Jackson and Ward Kallstrom and Chubb Assistant Vice President Alison Martin, provide a summary of today's ERISA litigation environment (with particular emphasis on class action litigation), profile measures for reducing exposure, and generally describe why fiduciary liability insurance is critically important to help protect plan fiduciaries from personal liability when ERISA litigation is filed.

consider the available options that follow in consultation with their benefits counsel.

Overall Administrative Structure and Design

- Avoid naming the plan sponsor as a fiduciary. An Employee Benefits Committee structure may help differentiate the fiduciary functions from the non-fiduciary (i.e., business or settlor) functions and may also help to avoid attribution of knowledge from the sponsoring employer's executives to the fiduciaries.

Plans that include investment in employer stock should consider:

- *“Hard-wiring” the investment.* Consider designing the plan so that the investment in employer stock is locked into the plan document instead of being selected by the plan’s investment committee.
- *Consider converting the employer stock fund into an ESOP.* This may trigger a higher standard for plaintiffs to prove claims related to the prudence of employer stock and will generally require relatively small changes in most plans that already offer employer stock as an option.
- *Encouraging diversification outside of company stock.*

Medical Plan Design

- *Include a strong, clear reservation-of-rights clause.*
- *Explain the plan’s reimbursement rules.*

Plan Administration

With respect to plan administration, “procedural prudence” can be very important. Therefore, a procedure (in consultation with benefits counsel) to help meet fiduciary obligations, ensuring that these procedures are followed may help mitigate risk.

General procedures may include the following:

- *Have regular, structured meetings.*
- *Read the plan documents.*

With respect to the duty to monitor:

- *Identify point person(s).* Clearly identify the individuals who act as “appointing fiduciaries” with the duty to appoint, monitor, and remove fiduciaries. Appointing fiduciaries should not themselves be plan fiduciaries (*i.e.*, they cannot monitor themselves).
- *Appoint with care.* Follow a clearly defined process for appointing fiduciaries, carefully evaluating possible fiduciary candidates and documenting the selection process.
- *Keep fiduciaries informed.* Consider providing training to fiduciaries, especially as ERISA case law evolves and changes.

- *Keep at arm’s length for decisions.* Avoid involvement in fiduciaries’ decision-making.
- *Review performance.* Meet at least annually with appointed fiduciaries to review investment performance, fees and costs, and other significant events.
- *Review agreements with outside fiduciaries.*

With respect to selecting and managing investment options:

- *Consider establishing an investment policy.* If one is already established, review it at least annually.
- *Review investment performance (consider hiring an outside investment consultant).*
- *Remember diversification.*
- *Be educated about fees.*
- *Educate participant investors about the risks of company stock, consider limitations on amount that can be invested.*
- *Enhance disclosure to participants about fees.* Consider providing an annual “all-in” fee summary to participants to avoid claims that participants were not aware of fees and expenses. Consider providing a link to available Department of Labor disclosure regulations.
- *Periodically review regulatory requirements for the safe harbor of ERISA Section 404(c) to ensure that issues or concerns are addressed.*

With respect to privately held ESOPs:

- *Hire help.* Ensure that the ESOP has an independent valuation advisor (appraiser), who is required by law to be independent. Consider whether the trustees should engage legal counsel. (This is especially important if the trustee is not independent or not experienced.)
- *Monitor the trustee’s performance.*
- *Understand the importance of a proper valuation.*
- *Sell company stock with care.*
- *Watch executive compensation.*

THE ROLE OF FIDUCIARY LIABILITY INSURANCE FOR PROTECTING PLAN SPONSORS, FIDUCIARIES AND PARTIES IN INTEREST

Fiduciary liability insurance policy can be either issued to the plan itself or to an

employer that sponsors an employee benefit plan. It is designed to help protect insureds against claims alleging a breach of their fiduciary duties to the plan or alleging they committed an error in the administration of the plan.

It goes without saying that every insurance policy has its own particular terms, conditions, limitations, and definitions. Each claim is unique and policy terms vary, so care should be taken to review the specific policy against the specific claim. However, it is helpful to understand some of the more common policy provisions.

The Pivotal Role of Insurance in Protecting Insureds Against Fiduciary Liability

Personal Liability and Indemnification Issues. It should be apparent by now that plan sponsors and fiduciaries may be exposed to significant liabilities. This should be of particular concern to plan fiduciaries because ERISA Section 409 imposes *personal* liability on individuals who breach their fiduciary duties, thus putting the personal assets of the fiduciary at risk. Furthermore, ERISA Section 410 (the “Anti-Exculpatory Clause”) prohibits a plan from paying for or indemnifying a fiduciary for a breach of fiduciary duty.

That leaves the fiduciary’s employer (presumably the plan sponsor in a traditional single employer benefit plan scenario) as the only real barrier standing between the plaintiff and the fiduciary’s personal assets in a breach of fiduciary duty claim. However, even assuming an employer/plan sponsor is willing to indemnify a fiduciary for such a claim, there is a risk that the employer/plan sponsor may not have sufficient funds or liquidity to do so or that it may be prohibited from doing so by law. This concern is especially present during any economic downturn, where companies are often faced with insolvency and bankruptcy.

Special Considerations for Indemnification of ESOP Fiduciaries. Likewise, courts may preclude indemnification by ESOP plan sponsors. ESOPs are designed to invest in the stock of the participants’ employer (the plan sponsor). Some courts have determined that plan sponsors whose shares are owned by an ESOP plan are not permitted to indemnify the ESOP plan’s

fiduciaries because to do so would be detrimental to the ESOP plan. In essence, the ESOP plan and its participants would gain nothing by attempting to recover from an ESOP fiduciary for a breach of duty only to have that fiduciary turn to the plan sponsor for indemnification.

Ultimately, the value of the company stock held by the ESOP depends on the value of the plan sponsor, so any liabilities incurred by the plan sponsor (including indemnification liabilities) decrease the value of the plan sponsor and, consequently, the value of the ESOP shares. Thus, these courts reason that requiring the plan sponsor to pay for damages to a plan that are caused by an ESOP fiduciary simply moves money from the coffers of the plan sponsor and into the plan itself while depressing the value of the ESOP shares so that no real value inures to the benefit of ESOP participants. The ESOP, as the owner of the employer company that sponsored the plan, would in essence be paying damages to itself if the employer/sponsor company indemnified fiduciaries for the damages caused to the plan by their breach of duty. This is arguably a violation of the Anti-Exculpatory Clause of ERISA. The Department of Labor, and some courts have recently supported this prohibition on indemnification. *Johnson v. Couturier*, 572 F.3d 1067 (9th Cir. 2009); *Fernandez et al v. K-M Industries Holding Co*, 646 F.Supp. 2d 1150 (N.D. Cal. 2009).

State Restrictions on Indemnification. State corporate indemnification laws may also prevent or limit a plan sponsor's ability to indemnify plan fiduciaries. Some state statutes permit indemnification only where the fiduciary serves at the employer's request (*e.g.*, not *de facto* fiduciaries). Also, state corporate law may preclude indemnification unless the fiduciary was acting in good faith and in the best interests of the *employer* (not necessarily the best interest of the *plan*). This corporate law standard of conduct could be at odds with ERISA's requirements that all acts be undertaken in the exclusive interests of the plan participants. Thus, there is a potential disconnect between the standard of conduct for purposes of indemnification and ERISA's standard of conduct for fiduciaries. One obvious area where this disconnect could become acute is where

the fiduciary is required to pursue his/her employer (the plan sponsor) to contribute funds to the plan.

Other Constraints on Indemnification. Also, fiduciaries should keep in mind that even if an employer/plan sponsor is legally capable of indemnifying fiduciaries, it must be sufficiently capitalized and liquid to do so. Even if the sponsor has the financial wherewithal to indemnify fiduciaries, it may not be *required* under its corporate by-laws or state statutes to indemnify fiduciaries, absent some undertaking in the corporate documents.

What Is a Claim?

In order to trigger coverage under a fiduciary liability insurance policy, a claim must be made against an insured for a wrongful act allegedly committed by the insured in his insured capacity. In other words, the claimant must accuse the insured of having breached his fiduciary duty with regard to the plan or erred in administering the plan and demand some form of relief.

Who Is an Insured?

A person or entity must be an insured as defined under the policy in order for coverage to apply. Insureds may include the plan sponsor(s), that is, the entity or group that creates and funds the plan (typically the employer(s) of the plans' participants). Insureds under fiduciary liability policies typically include the sponsoring organization's officers, directors and employees acting as fiduciaries or as members of any employee benefit committee, investment management committee, or administrative committee for the plan, as well as natural person employee trustees of the plan.

The plan as defined under the policy is itself also an insured. Plans often include employee welfare plans and pension plans and can be sponsored by for-profit organizations or not-for-profit organizations.

Just as important as understanding who is an insured, is knowing who is *not* an insured under the policy. Third-party service providers (such as investment advisors, investment managers, and third-party administrators) who are hired by the plan or plan sponsor, but who are not

employees of the insured, are typically not insureds under the fiduciary liability insurance policy, even if they are considered to be fiduciaries under ERISA.¹ Fiduciary liability insurance policies typically cover only plan fiduciaries who are employed by the entity that purchases the policy, and not other fiduciaries, particularly those employed by outside providers. This approach is important because it helps preserve policy limits for the plan sponsor's employee and director fiduciaries.

What Is a Wrongful Act?

Another important policy provision is the definition of the term "wrongful act". The definition varies from carrier to carrier and from policy to policy but, generally speaking, most fiduciary liability insurance policies cover, at a minimum, breaches of fiduciary duties by a fiduciary in their capacity as such and errors in the administration of the plan.

Loss and Benefits Due Provisions

Once a claim has been made against an insured for a wrongful act, the relief sought must constitute loss that is covered by (and not specifically excluded from) the fiduciary liability insurance policy. The definition of "loss" and the "benefits due" exclusion are really two sides of the same coin. Both are approaches that carriers use to address the nature of the requested relief in order to come to a coverage result. These policy provisions may be used to preclude coverage for indemnity payments that constitute benefits that are payable to participants or their beneficiaries under the terms of a plan (or that would have been payable under the terms of the plan had it complied with ERISA).

Defense Provisions

Most fiduciary liability insurance policies include a duty to defend provision, which means that the insurance carrier has the right and duty to defend the claim against an insured, including the right to select defense counsel. In such instances, insurance carriers work to select and retain defense counsel with the appropriate expertise and experience in light of the claims alleged. Policies that do not include a duty to defend provision often require

insureds to choose from a panel of pre-approved defense counsel for select claims including class action claims.

Partnering with the Insurance Carrier

Any discussion of fiduciary liability insurance would not be complete without including some “best practices” for insureds when a fiduciary claim is made against them.

Reporting a claim. The most fundamental best practice is to tender any claim to the carrier in a timely fashion. Many policies specify the reporting requirements for tendering a claim for coverage. Establishing point persons (*e.g.*, human resources, benefits department, and general counsel’s office) who are trained to recognize claims and timely report them (through the employer’s broker/agent) to the carrier will help to ensure that the policy responds as intended. Remember that many policies may define a “claim” as constituting not only civil and criminal complaints, but may also include verbal or written demands. Insureds imperil coverage if they tender a claim belatedly, because late notice, or late

reporting as it is often called, may serve as the basis for denial of coverage.

Cooperating with your carrier. Once the claim is submitted, insureds should make every effort to cooperate with the carrier to provide all information necessary to evaluate the claim. Also, insureds should not incur any liability (including defense costs), engage in any settlement discussions, or enter into any agreements that could impact the claim without first getting the carrier’s consent, because many policies have consent provisions that prohibit this type of activity. Just as an insured needs to cooperate and keep lines of communication open with the carrier, an insured is entitled to expect timely and forthright communication from the carrier, be it on coverage issues or questions about the claim in general. Prominent fiduciary liability insurance carriers employ experienced fiduciary claim examiners, many of whom are attorneys. These examiners can provide meaningful collaboration both with defense counsel and insureds as the claim progresses on such matters as defense arguments, case valuations and selection of mediators.

Purchasing fiduciary liability insurance. No one wants to be placed in the position of defending against an ERISA claim. By recognizing the potential fiduciary exposures and purchasing fiduciary liability insurance, insureds may mitigate against unnecessary inconvenience and personal loss should they be subjected to such a claim.

CONCLUSION

Plan sponsors and fiduciaries need to be proactive to insulate themselves in an ever-changing legal environment. Well-designed, well-executed, and well-administered benefit plans are an important foundation for helping to limit litigation exposure moving forward. Likewise, fiduciary liability insurance should be considered in any comprehensive corporate risk management program.

This article is abridged from a joint report prepared by Morgan, Lewis & Bockius and Chubb by the same title. That report can be found at <http://www.chubb.com/businesses/csi/chubb12107.pdf>.

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