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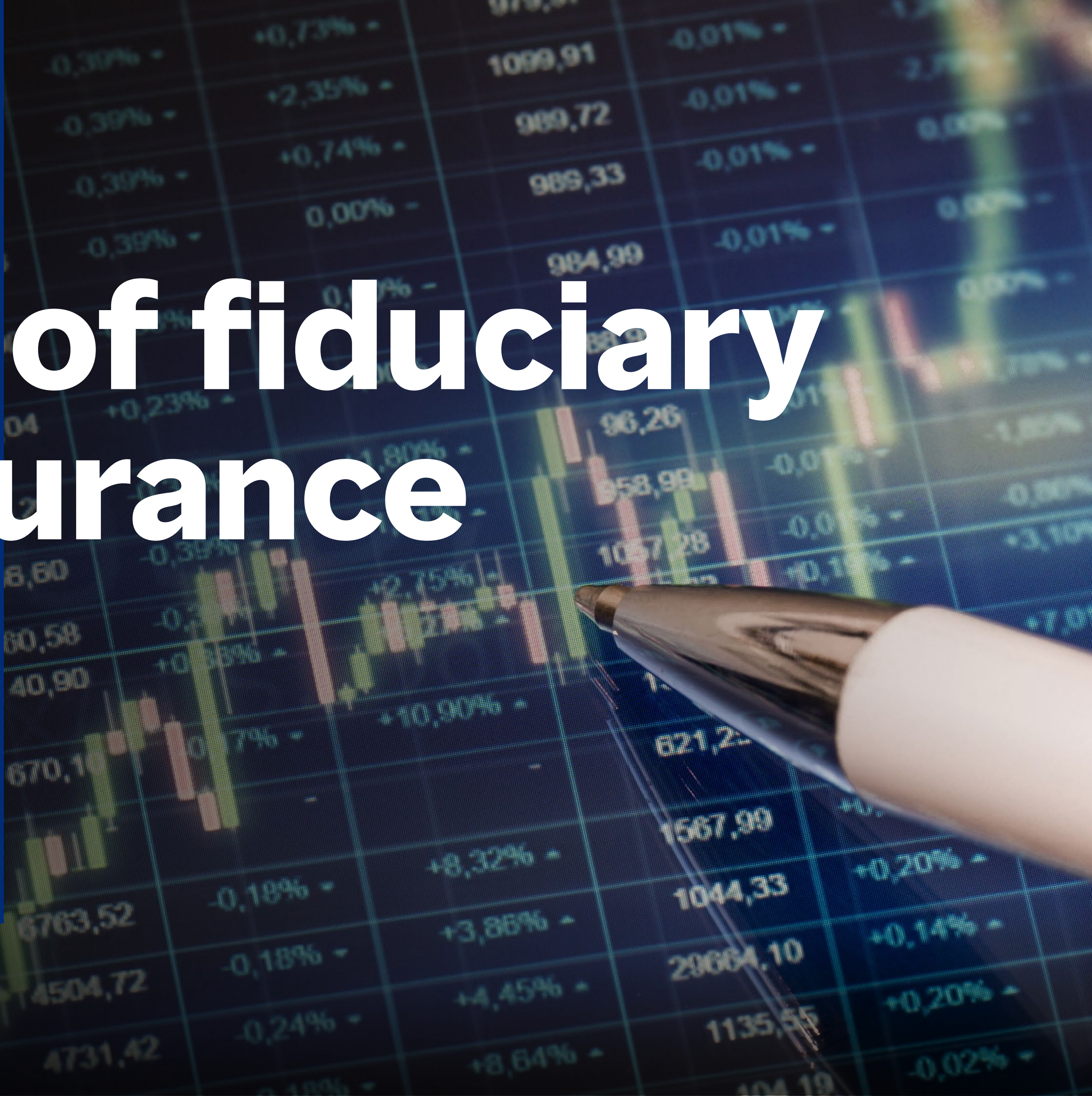
The basics of fiduciary liability insurance

FINPRO Spotlight Series 101



Fiduciary liability insurance protects fiduciaries of benefit plans, other employees, the plans themselves, and businesses (plan sponsors) against financial loss caused by claims for alleged mismanagement of plans and/or their assets. Organizations that sponsor benefit plans for their employees — including publicly traded companies, private companies, and nonprofits — have several responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA) and other federal, state, and local laws. These responsibilities include duties of loyalty to plan participants, to act prudently in making plan decisions, to diversify plan investments, and to follow plan documents.

ERISA imposes personal liability on fiduciaries to make good for losses sustained by plans, so fiduciary liability insurance protects fiduciaries' personal assets. Directors of a company may appoint other individuals as fiduciaries, but could also be deemed fiduciaries themselves under ERISA. Fiduciary liability insurance not only covers the personal assets of individuals, but also protects the balance sheets of plan sponsors and the plans themselves.

Fiduciary liability policies typically respond to the following types of wrongful acts, depending on how they are written:

- Any violation of any of the responsibilities, obligations, or duties imposed upon fiduciaries by ERISA or any similar common or statutory law to which a plan is subject. This includes but is not necessarily limited to:
  - The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA).
  - The Health Insurance Portability and Accountability Act of 1996 (HIPAA).
  - The Health Information Technology for Economic Clinical Health Act of 2009 (HITECH).
  - The Patient Protection and Affordable Care Act of 2010 (ACA).
  - The Pension Protection Act of 2006 (PPA).
- Any act, error, or omission by a plan administrator in the performance of administrative duties — considered "employee benefits liability" — which is often also covered by general liability policies.
- Settlor functions, including creating, amending, or terminating plans.
- Any matter claimed against an insured person solely by reason of his or her status as a fiduciary — status claims — but only with respect to a plan.

Types of plans

Fiduciary liability insurers look at the types of plans, their total assets, and financial health, among other things, in determining their risk.

Pension benefit plans are designed to provide retirement income to employees. The two main types of plans are:

1. **Defined benefit (DB) plans**, in which employers guarantee a stream of benefit payments upon retirement, often based on an employee's years of service.
2. **Defined contribution (DC) plans**, in which participants designate how much money they would like to contribute to their retirement plans. Examples include profit-sharing plans, money purchase plans, and 401(k) plans. 403(b) plans are similar to 401(k) plans but are sponsored by nonprofit entities.
   - **Employee stock ownership plans (ESOPs)** are DC plans designed to invest and hold the stock of sponsoring employers, which are typically private companies. ESOPs are exempt for ERISA's requirement to diversify investments, and can borrow money from, or on the credit of, the employer to buy stock.

Health and welfare benefit plans include medical plans, disability benefit plans, vacation benefit plans, life insurance plans, and the like. These plans usually have no assets.

Industry-wide **multi-employer plans** are sometimes used to fund benefits for unionized employees in some industries that are determined through collective bargaining agreements. Monies are contributed by various employers.

Multiple employer plans are sponsored by smaller (unrelated) employers across industry lines that sometimes band together to create economies of scale in providing benefits.

Who's covered?

Insureds on a fiduciary liability policy generally fall within three categories: organizations, known as plan sponsors; the plans themselves; and individuals. Individuals can include any of the following, but never any third-party service providers:

- Directors and officers.
- Employees.
- Plan trustees.
- Members of committees established by plans.

What's covered?

Claims under fiduciary liability policies can be brought by the Department of Labor (DOL); Pension Benefit Guaranty Corporation (PBGC), which ensures solvency of DB plans; the Internal Revenue Service (IRS); plan participants and beneficiaries; and other plan fiduciaries. Depending on the policy language and any unique facts and circumstances, claim scenarios typically covered under a fiduciary liability policy include:

- **Investment imprudence** cases alleging that plan fiduciaries breached their duties to invest plan assets prudently, breached their duty of loyalty, had conflicts of interest, and/or engaged in prohibited transactions.
- **Stock drop** cases — similar to those filed after the bankruptcy of Enron in 2001 — under DC plans alleging that plan fiduciaries acted imprudently in offering an employer stock fund or misrepresented the risks associated with investments in a plan sponsor's stock.
- **Excessive fee** cases alleging that plan fiduciaries breached their obligations to plans and their participants by charging or permitting excessive fees and expenses for plan services provided by third parties, such as investment management, record keeping, and asset custody.
- **Proprietary funds** claims against financial institutions for offering proprietary funds or services to, or in, plans to generate revenue for (or otherwise benefit) sponsors and/or affiliated service providers at the expense of plan participants.
- **Reduction of benefits** cases alleging that benefits (such as severance or pension adders) were promised and vested under plan documents and improperly cut back in anticipation of changes in control or during times of corporate need. This includes cash-balance conversion cases.
- **Denial of benefits** claims relating to welfare plans can take various forms, including retiree medical cases alleging that plan sponsors or fiduciaries improperly changed or terminated post-retirement medical benefits.

Two common sources of ERISA claims are church plans and ESOPs. ERISA exempts plans that are established and maintained by churches or organizations controlled by churches. Many religiously-affiliated hospitals, for example, claim church plan exemptions; some of their plans would be considered underfunded by ERISA standards. Plaintiffs in litigation against such plans and their fiduciaries often claim that they do not qualify for church plan exemptions and must comply with ERISA but fail to do so, particularly with regard to DB plan funding levels. Claimants against ESOPs, meanwhile, often allege that their sponsors (private companies) receive too much from plan participants due to flaws in valuations by third parties. Other common ESOP claims involve prohibited transactions, such as sales or loans between plans and fiduciaries.

When is coverage triggered?

Specific policy language will rule, but there are a few possible "triggers" for coverage:

- **A claim**, which is generally a written allegation of a wrongful act (breach of fiduciary duty or error/omission in plan administration) by an insured, including:
  - Written demands for monetary or injunctive relief.
  - Civil or criminal proceedings.
  - DOL investigations against insured for wrongful acts.

Five reasons why your organization should consider purchasing fiduciary liability insurance

1. ERISA imposes upon plan fiduciaries a heightened standard of care.
2. People dealing with a plan may unwittingly be fiduciaries.
3. ERISA imposes personal liability on fiduciaries; fiduciaries who don't have insurance may be placing their personal assets at risk.
4. Plans cannot indemnify or relieve fiduciaries of liability — and sponsors may not be willing and/or able to indemnify.
5. Fiduciaries cannot delegate responsibility to providers.

  - Target investigations by enforcement units (not DOL).
  - Inquiries, including subpoenas and interviews of insured persons.
  - Requests to toll statutes of limitations.
  - Pre-claim investigations.
  - Benefit denial appeals.
- **An audit** by the DOL or PBGC in the normal course of business, which is not associated with a claim.
- **Reporting under voluntary compliance programs**, which could include:
  - Department of Labor programs:
    - **Delinquent Filer Voluntary Compliance (DFVC)**, which provides administrators with a way to voluntarily
report delinquencies in compliance with annual reporting requirements.
    - **Voluntary Fiduciary Correction Program (VFCP)**, which is designed to encourage self-reporting and correction of certain ERISA violations.
  - The IRS Employee Plans Compliance Resolution System (EPCRS), which includes:
    - **Self-Correction Program (SCP)**, which allows a plan sponsor to correct operational failures, such as a failure to follow plan provisions.
    - **Voluntary Correction Program (VCP)**, which provides procedures for correction of all types of qualification failures.
    - **Audit Closing Agreement Program (Audit CAP)**, which allows for negotiated settlements with the IRS to rectify all failures not corrected in accordance with the Voluntary
Correction Program.

How do retentions apply to fiduciary liability?

For smaller companies — especially private ones — with fewer plan assets, there's often no retention. Companies that have more plan assets, or are publicly traded, might have retentions that are established relative to the size and nature of the risk. Even larger public companies with significant amounts of company stock in their plans might have separate, larger retentions that apply to securities claims.

What key policy terms should be considered?

Fiduciary liability policies tend to be claims-made policies, meaning that in order to trigger coverage, a claim must first be made during the policy period. In order to trigger coverage, there must be a claim alleging a wrongful act against an insured for a loss; each of these terms is defined in the policy. In order to understand the breadth of coverage under your fiduciary liability program, you should consider and discuss the following with your insurance advisor:

Program structure considerations:

- **Total program limit assessment:** Based on ownership (public, private, nonprofit) and size of benefit plan assets.
- **Carrier selection:** Experience and expertise from both an underwriting and claims perspective.

Coverage Considerations:

- Who is covered?
- What are they covered for?
- Do you have any unique benefit plans that don't fit well within the policy definitions?
- How broad is the definition of a claim?
- What conditions must be met for coverage to be triggered or apply?
- Does the policy cover audits by the DOL or PBGC?
- Does the policy cover various voluntary compliance and self-correction programs?
- How narrowly have the exclusions been tailored?
- How favorable is the severability language?
- Is coverage non-cancellable and non-rescindable, except for non-payment of premium?
- Does the policy provide adequate protection should the company become insolvent?
- Does the alleged "bad behavior" of one person nullify coverage for all?
- Do allegations of fraud limit coverage from the outset?
- Is there any coverage in a criminal context — for example, fines and penalties?
- Who picks defense counsel? Can an insured retain any defense counsel law firm of its choosing?
- What are the policyholder's notice and reporting obligations?
- Is a policyholder required to seek the insurer's consent before retaining counsel, negotiating a settlement, or incurring any costs?

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