Executive Risks

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October 2006 – Issue 4

Canadian Alert

Fiduciary Liability: So What Does the Policy Pay If It Doesn't Pay for Benefits?

The most common misconception about Fiduciary Liability insurance revolves around the issue of what is actually covered under the standard Fiduciary policy. The confusion stems from the fact that benefits are excluded from the definition of loss in virtually all Fiduciary Liability policies. The crux of the matter is found in what is commonly referred to as the "benefits wording."

Most Fiduciary policies broadly cover the liabilities of fiduciaries under the US legislation entitled the Employee Retirement Income Security Act (ERISA) and comparable laws and regulations around the globe. In Canada, the governing legislation is found in both provincial and federal pension benefit acts. The policies typically provide coverage for both the defense of any claim alleging a breach of fiduciary duty under ERISA (or the governing legislation outside the US) as well as the resulting loss. Defense is often, although not always, provided on a duty-to-defend basis and the carrier pays on behalf of the insured any covered loss. The confusion begins when we dig into the specifics of how loss is defined.

Defining Loss

Here is a typical definition of loss in a Fiduciary Liability policy:

> [T]he amount which any Insured(s) becomes legally obligated to pay on account of each Claim and for all Claims in each Policy Period…for Wrongful Acts for which coverage applies, including, but not limited to, damages, judgments, settlements, costs and defense costs…

In the US, it is also standard to expand this to include certain civil penalties. Until very recently, this meant mainly the Internal Revenue Service's five percent penalty assessable under ERISA §502(i) for prohibited transactions and the Department of Labor's 20 percent penalty arising under §502(l). Today, this may be further expanded to expressly include the IRS penalties under some of its voluntary compliance programs, such as the Closing Agreement Program (CAP), Voluntary Compliance Resolution (VCR) and Tax Shelter Annuity Voluntary Compliancy programs.

In Canada, coverage has not typically been expanded to include civil penalties.

For those with exposure in the UK, assorted penalties assessable under the UK Pension Protection Act may be covered. Punitive damages are also beginning to be included as part of covered loss. Since punitive damages are *not* currently available in an action under ERISA, unless and until the law changes, coverage for punitive damages would appear to be for non-ERISA plans including foreign plan exposures. In Canada, it is generally accepted that punitive damages are uninsurable.

Defense costs are central to Fiduciary coverage. Defense costs will typically include reasonable fees, costs and expenses associated with investigating, negotiating, defending and appealing a claim (including premiums for appeal bonds). Under ERISA, and under similar Canadian legislation, plaintiffs' legal fees are awardable and are (sometimes expressly) covered as well.

What About the Benefits Wording?

All of this may seem fairly straight forward – at least to those comfortable with insurance-speak. Now let's look at the carveout that is created by the benefits wording. Typically, we will find language like this: "Loss shall not include…Benefits or that portion of any settlement or award in an amount equal to such Benefits." An exception may be added for the unlikely situation where an individual is held personally liable for the payment of benefits as the result of a covered claim. But the bottom line is that benefits are not covered. All of this leads to the subject of this discussion: if the point of a pension plan is to provide benefits, and the point of Fiduciary

insurance is to protect against the loss brought on by failure on the part of individuals charged with the fiduciary responsibility to administer a pension, doesn't it stand to reason that benefits would be covered? The answer is no, due to the concept of loss as it is understood in such settings.

The underlying basis of the benefits wording or exclusion is that paying benefits is the reason why the plan was set up – what it contractually obligates its fiduciaries and administrators to do. Paying benefits, therefore, does *not* involve harm to the plan, the plan sponsor or its fiduciaries. No harm, no loss. For those familiar with Directors & Officers (D&O) Liability coverage, this is akin to the premise that when a company pays dividends it has not been harmed or suffered any loss, even where the dividend is paid to end a dispute with shareholders; D&O coverage does not respond (or address) dividend payments in determining or defining losses.

Crucial Distinction: Plan Assets Are Not Benefits

Just because benefits are not covered under Fiduciary policies does not mean, of course, that those parties suing fiduciaries will not seek lost benefit payments – in fact, that may be the only thing they seek. This is the case when a claim is brought by 10,000 retired employees angry about changes to their health benefits or by a single myopic employee suing for eyeglass coverage under a vision plan. It can be true whether the plan in question is a pension plan or a welfare benefit plan.

Conversely, some of the most expensive ERISA claims do not address benefits at all. Today's high-profile ERISA tagalong suits relating to employer securities in a company's 401(k) or other type of pension plan are one example of a line (and a costly line) of fiduciary cases that do not seek benefits. These suits seek to make the plan whole in the wake of poor investments (where the investments, not coincidentally, are in the company's own stock). The benefits wording is simply not relevant to claims that do not seek the payment of benefits.

The crucial distinction here is between plan assets and plan benefits. Claims alleging a breach of fiduciary duty in managing, investing or allocating the assets of the plan are *not* claims for benefits but for assets. Although benefits may be paid out of plan assets, the plan assets are not themselves benefits. For example, claims arising from derivative or junk bond losses taken by a plan are not benefit claims. Litigation over who is entitled to disbursements of plan overfunding would also fall into this category. Suits that assert that a plan has overpaid for assets and expenses and that seek the overpayment as damages are again claims for assets, not benefits. This last group includes claims relating to employee stock ownership plans or stock purchase plans. Claims against plan fiduciaries alleging illegal personal profits and seeking the return of the illicit gains or earnings are in the same category. The benefits wording carveout does not apply in any of these instances.

Other Fine Points of Confusion

In regard to plaintiffs' legal fees, which are covered under a Fiduciary Liability policy, it is important to note that under ERISA, and under similar Canadian legislation, fees may be *in addition to* the amount sought, as plaintiffs' legal fees are a separate form of remedy from the plan participants' recoveries. In a suit for a $100 million in past and future benefits, the plaintiffs' attorneys generally would not be looking to share a portion (generally a quarter to a third) of the $100 million, but would seek their fees as *an additional remedy* available under ERISA, thereby increasing the ultimate award or settlement costs.

It is certainly true that in a number of high-severity ERISA cases the Fiduciary Liability policy paid only (or mostly) defense expenses – but this was usually a function of the fact that inadequate limits were maintained. The policies' limits were fully exhausted by or before the defense of the claims was completed, with no coverage left to apply to the claims themselves. In examining the issue of prudent and adequate limits of Fiduciary Liability coverage, it would be a serious mistake to view the contract solely in terms of covering defense expenses.

Conclusion

In a Fiduciary Liability claim, here is a formula for calculating covered loss:

> Loss = legal defense expenses + plan losses suffered due to breach of fiduciary duty + expert witness fees + (possible) interest + other types of damages + cost of appeal(s) and any appeal bond(s) + plaintiffs' legal costs + certain civil fines/penalties or punitive damages where covered + benefits due where they are held to be a personal obligation of an individual insured.

Benefits are excluded by the benefits wording in most Fiduciary Liability policies, though this impacts only those suits (or portions of suits) that seek the recovery or payment of benefits due under a plan. While this may be a high frequency area of claims (and traditionally has been fairly low severity), it is only one possible avenue for claims against fiduciaries. Virtually all Fiduciary claims, however, whether or not benefits are at stake, involve costs that can be covered by Fiduciary Liability insurance.

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