



A Chubb Special Report

Who May Sue You and Why:
How to Reduce Your ERISA Risks, and the Role of
Fiduciary Liability Insurance

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Foreword

The fiduciary liability landscape has certainly evolved over the past few years with litigation arising against fiduciaries for allegedly offering inappropriate investment options, misrepresenting the risks of employer securities, permitting excessive fees and expenses to be charged to plans, and failing to administer plans in accordance with the plan terms. Plan sponsors and fiduciaries are more at risk today than ever before to such litigation. As such, Chubb asked the ERISA-experienced law firm of Morgan Lewis & Bockius, LLP, along with Alison L. Martin of Chubb's Specialty Claims Department, to write this special report to help our customers and brokers understand the potential liability that fiduciaries face in today's litigious environment.

In this report, Charles C. Jackson and D. Ward Kallstrom from Morgan Lewis & Bockius discuss the responsibilities of ERISA fiduciaries, the types of litigation that may be brought against them, and practical suggestions on plan design and administration. Alison L. Martin shares her insights on how the role of fiduciary liability insurance and other forms of protection may help to mitigate against financial loss to plan sponsors and their fiduciaries when faced with a lawsuit.

Chubb is pleased to share this information and hopes it will help you raise the awareness of your company's fiduciaries about the potential risks they face and serve as a practical resource in its overall loss prevention efforts.

Introduction

Providing a well-structured employee benefits program (e.g., medical, life, disability, and retirement plans) can go a long way toward attracting and retaining an appropriately skilled workforce—but doing so is not without its challenges. Employers need to weigh carefully the human resource advantages of providing benefits against the obligations they undertake in doing so. Establishing a balance between corporate benefits and obligations is especially difficult because the legal rules governing employee benefit plans—established under the Employee Retirement Income Security Act of 1974 (ERISA) [as amended, 29 U.S.C. §1001 *et seq*]—are complex (or, as the U.S. Supreme Court put it, “comprehensive and reticulated”; *Nachman v. PBGC*, 446 U.S. 359, 361). At the same time, benefit plan fiduciaries and plan sponsors today confront an increasingly active and ERISA-sophisticated plaintiffs’ class action bar. In addition, due to tightened legal rules for bringing securities cases, there has been a recent influx of skilled counsel from the securities field to the benefits arena, increasing both the chances that ERISA lawsuits will be filed and their potential financial impact when they are. On the other hand, because ERISA litigation is very different from securities litigation, a skilled ERISA defense counsel who understands ERISA’s complexities and nuances nonetheless can help provide a strong tactical advantage against such litigation.

ERISA class action lawsuits are not confined to the largest employers. Employers and plans of all sizes are vulnerable. Particularly in times of economic transition—when layoffs, workforce adjustments, and corporate mergers and acquisitions are more likely to occur—more plan participants are willing to step forward as ERISA plaintiffs. ERISA contains a discretionary statutory fees provision that, as applied, almost always provides attorneys’ fees to the plaintiffs when they prevail, but not to the defendants. This provision provides additional incentives to plaintiffs’ lawyers to bring such suits.

Although there are no “silver bullets” protecting employers, plans, and fiduciaries from litigation, employee benefits professionals *can* improve the chances that their company’s employee benefits program will avoid litigation and defeat legal challenge. The potential path to reducing legal exposure begins with a sound understanding of the ERISA-defined roles of plan-related personnel. ERISA does not impose liability at large. Rather, from the board of directors to the benefits manager, an individual’s role with respect to an employee benefit plan is critical to understanding potential exposure, including possible individual liability. We address those roles and responsibilities in Section I of this report. Section II provides an overview of the most prevalent (and serious) types of ERISA claims currently being filed. Section III, in turn, discusses a variety of plan-drafting and plan-administration measures that plan sponsors and fiduciaries should consider to mitigate litigation exposure. Section IV considers why fiduciary liability insurance should be deemed an integral part of any employee benefits program, providing protection to plan sponsors and fiduciaries against both personal liability and the sometimes significant costs associated with the defense of employee benefit lawsuits.

I. Understanding the ERISA Responsibilities of Plan Sponsors, Fiduciaries, and Parties in Interest

ERISA plans carry with them a host of complicated and interrelated responsibilities, which typically fall on different but interrelated players. On the one hand, setting up or changing benefit plans is the quintessential plan “settlor” activity. On the other hand, faithfully administering the plan is core “fiduciary” activity. But often a single individual may have both a settlor and a fiduciary role, or the roles, or parts of them, may be allocated to more than one person. This intermingling of roles and responsibilities is most apparent in class action litigation where, as a general rule, anyone remotely connected to an ERISA plan will be named in the lawsuit. Lawsuit targets typically include the plan sponsor; the plan administrator; any named fiduciaries, particularly members of any investment committees; appointing fiduciaries, particularly the CEO and members of the board of directors; the record keeper and/or trustee of the plan; investment managers; and other service providers (e.g., accountants, consultants, investment advisors, and attorneys).

While there is no avoiding such “all in” litigation, understanding the roles of key players with respect to an ERISA plan is an important first step to defeating these lawsuits. First, a “plan sponsor” is usually the company or employer that sets up a plan for the benefit of its employees. The responsibilities of the plan sponsor are called “settlor” functions, and they may include:

- *Plan creation*—The decision to establish a plan as well as all decisions concerning the design of the plan are settlor functions. For example, whether to have a defined benefit or defined contribution plan, the benefit formula for a defined benefit plan or the contribution rate for a defined contribution plan, and whether to have a subsidized early retirement feature in a defined benefit plan, are all plan sponsor or settlor decisions.
- *Making plan amendments*—The decision to amend a plan falls on the plan sponsor. For example, a change in participation or eligibility requirements or in benefit levels is a “settlor” function. However, it is very important that the plan specify the procedure for making amendments and that the plan sponsor follows that procedure. Amendments that do not follow the plan are void and cannot be implemented by the fiduciaries.
- *Plan funding*—The decision on the level of plan contributions and, in the case of defined benefit plans, the actuarial method used in determining the required contributions, are settlor functions.
- *Plan termination*—The decision to terminate, freeze, or merge a plan is a settlor function.

Settlor functions are not subject to ERISA’s fiduciary rules and generally cannot be attacked unless they violate the substantive statutory requirements of ERISA itself (or other federal laws such as Title VII and the Age Discrimination in Employment Act, as well as state laws that ERISA does not preempt). On the other hand, one does not need to be named as a fiduciary in plan documents to be deemed one. Under ERISA, “fiduciary” is defined functionally; conduct can make someone a fiduciary.

Fiduciaries are subject to the “prudent man” rule of ERISA Section 404. The prudent man rule states that fiduciaries must, when administering a plan, act prudently and with undivided loyalty to the participants and their beneficiaries, subject always to the terms of the plan so long as they are consistent with ERISA.¹ ERISA

¹ There is also a duty to diversify plan assets, which applies to retirement plans (other than ESOPs) and other funded plans.

fiduciaries are said (particularly by the plaintiffs' bar) to be charged with the "highest duty known to the law." Under ERISA, fiduciaries are personally liable for their breaches.

Put in simple terms, a person is a fiduciary to the extent he or she (1) exercises discretionary authority or control over plan management; (2) exercises any authority or control over plan assets; (3) has any discretionary authority over plan administration; or (4) gives investment advice for a fee. A person becomes a fiduciary by being formally designated as a fiduciary, functioning as a *de facto* fiduciary, or appointing other fiduciaries. By default, the plan sponsor (usually the employer) is deemed to be the plan administrator (and hence a fiduciary) if one is not named in the plan document.

At this point, it is important to pause and reiterate that the test for fiduciary status is *functional*, meaning that plans may have *unintended and unknowing fiduciaries*. Someone may be a fiduciary because of the role he/she in fact plays for a plan, even though he/she:

- May not know he/she is a fiduciary and did not intend to become one; and
- Within his/her contract with the employer or the plan administrator, stipulates that he/she is *not* a fiduciary.

Being a fiduciary, however, is rarely a singular job. Plan sponsors often appoint managers or other company representatives to a fiduciary role, and those individuals must reconcile their "business" roles with their "fiduciary" roles. There is nothing wrong with that arrangement. In fact, ERISA specifically allows fiduciaries to wear "two hats"—one fiduciary and one non-fiduciary. In that case, the individual is a fiduciary only when performing fiduciary functions.

ERISA also separately identifies "parties in interest." Parties in interest include not only ERISA fiduciaries but also any person providing services to a benefit plan, the employer whose employees are covered by the plan, unions whose members are covered by the plan, and various other defined parties or entities that have some relation to the plan. Although fiduciaries are subject to the prudent man rule of ERISA Section 404, parties in interest are subject to the prohibited transaction provisions of ERISA Section 406. Section 406 automatically bars certain transactions with respect to benefit plans unless the party in interest can invoke one of the numerous exemptions to proscribed conduct provided by ERISA Section 408.

II. Legal Actions Brought Against Employee Benefit Plans and Personnel

The types of legal actions asserted against benefits plans and associated personnel vary significantly in their frequency and potential exposure. ERISA defines two broad categories of benefit plans:

- *Welfare benefit plans*, which include medical plans, disability benefit plans, vacation benefit plans, and the like; and
- *Pension benefit plans*, which include any plan designed to provide retirement income to employees or one that results in a deferral of income by employees to periods extending beyond termination of covered employment.

The most common legal claims asserted, by far, involve “denial of benefit” claims under medical and disability benefit plans. Typically, after having made an unsuccessful (or only partially successful) claim for coverage of a certain medical procedure under the terms of a medical plan, or for disability income benefits under a disability plan, the plan participant sues in court claiming that he/she was improperly denied coverage or reimbursement.

Other types of individual benefit claims, although somewhat less common, involve retirement plans. Upon retirement, a participant may claim that the employer miscalculated his/her retirement benefits, or that the employer improperly denied a surviving spouse the survivor benefits to which he/she was entitled. In a defined contribution plan, participants may claim that the plan administrator failed to follow specific investment instructions (e.g., move assets from Fund A to Fund B) or took some other action that adversely affected their retirement accounts.

These types of claims are the grist of employee benefits lawsuits—raising issues that in most circumstances personally affect the participant/claimant. These participant-focused disputes often are resolved short of litigation. Once a claim is filed, it is filtered through the benefits claims procedure that ERISA requires every plan to have. The claim may be allowed, adjusted in part, or denied. Normally, it is only after the claims procedure is fully exhausted and unsuccessful that litigation ensues. As discussed later, all benefits plan personnel should understand their roles, both to ensure that participant claims are handled properly, and to increase the chances that decisions made under the plan will be upheld should the dispute make its way to court. Fiduciary liability insurance can play a role in mitigating the cost of defending such claims.

Although less prevalent in terms of the number of lawsuits filed, the frequency of class action claims fueled by the plaintiffs’ bar has increased in recent years. These claims purport to be brought on behalf of part or all of the entire class of plan participants, and the aggregated financial exposure can be significant. For example, a claim may be asserted that investments affecting all retirement plan participants as a group contained excessive expense charges, or were selected in order to confer some benefit on the employer or another party in interest, or that a medical plan barred the plan sponsor from modifying retiree medical benefits. In addition to substantial damages, the plaintiffs may demand significant injunctive relief—to change the plan terms or long-established practices.

Class action ERISA cases may be categorized broadly as claims to recover benefits or suits for breach of fiduciary duty. To summarize, some of the most significant litigation concerning retirement plans includes:

- “Stock drop” (*Enron*-style) cases under defined contribution (ESOP and 401(k)) plans, alleging plan fiduciaries acted imprudently in offering an employer stock fund or misrepresented the risks associated with investments in a plan sponsor’s stock;
- “Fees and expense” cases alleging that the plan fiduciaries breached their obligations to the plan and its participants by charging or permitting excessive fees and expenses for plan services provided by third parties, such as investment management, recordkeeping, and asset custody;
- 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;
- “Anti-cutback” cases alleging that benefits (such as severance or pension adders) were promised and vested under the plan document and improperly cut back in anticipation of a change in control or during a time of corporate penury;
- Claims that plan administrators have otherwise acted in contravention of plan or statutory provisions, such as violating plan rules limiting which expenses the plan can pay or the kinds of distributions the plan may make, or violating the statutory benefit accrual or vesting rules; and
- “Cash balance” cases alleging that the cash balance pension plan itself violates ERISA prohibitions against age discrimination, or results in unfair annuity calculations or inappropriate benefit freezes upon conversion.
- Class action welfare plan cases which can also take various forms, including:
 - Retiree medical cases alleging that the plan sponsor or the plan fiduciaries improperly changed or terminated post-retirement medical benefits; and
 - Medical premium cases alleging that premiums are excessive or that fiduciaries breached their duties by failing to apply sufficient scrutiny to the cost structure attendant to benefits.
- Miscellaneous class action claims involving benefit plans, including:
 - ESOP claims alleging stock was improperly valued, plan fiduciaries engaged in prohibited transactions or other conflicts of interest, and/or corporate changes disadvantaged ESOP participants;
 - Misrepresentation or omission claims, such as that the employer failed to inform employees it was about to adopt severance or early retirement benefit improvements that were under “serious consideration” at the time of their separation or retirement;
 - “Alternative” worker claims alleging that some workers (such as independent contractors and leased employees) were inappropriately excluded from plan participation;
 - Long-term disability plan claims alleging that the plans were not administered in accordance with their terms (e.g., terms offsetting Workers’ Compensation and other benefits received under other benefit programs); and
 - “Discrimination” or retaliation claims, under ERISA Section 510, alleging that groups of individuals were selected for adverse employment actions (such as layoffs or termination of employee status while on disability) in order to prevent them from becoming eligible for or receiving medical and/or other benefits.

On the pages that follow, we discuss selected developments in retirement plan, welfare benefit plan, and miscellaneous benefits litigation to better illustrate potential liability exposures of employee benefit plans and plan fiduciaries. We caution, however, that many areas of litigation exposure are beyond the scope of this paper, including claims by the Department of Labor arising out of its benefit plan oversight function or investigations of claims made regarding plan administration and investment activity.

A. Claims Against Retirement Plans

1. WHAT KIND OF RETIREMENT PLAN ARE YOU—DEFINED BENEFIT OR DEFINED CONTRIBUTION? AND WHY IT MATTERS.

Defined benefit plans and defined contribution plans are two main types of retirement plans. Defined benefit plans are based on the traditional “pension” plan model, where the employer guarantees to the employee a stream of payments, often based on his/her years of service (e.g., you will receive monthly, upon retirement, the sum of \$100 for each year of service, or 2% of your final average pay times your years of service) and payable as an annuity. In theory,² participants in defined benefit plans bear little to no risk of investment loss and are shielded, by and large, from the ups and downs of the financial markets. However, traditional defined benefits are generally not “portable”; that is, they cannot be rolled into the plan of a new employer and often are not payable as lump sums upon termination.

Defined contribution plans—such as profit-sharing plans, money purchase plans, and 401(k) plans, which have now passed traditional pension plans in popularity—are completely different from defined benefit plans. In most defined contribution plans, participants designate how much money they would like to contribute to their retirement plan per pay period (subject to plan and statutory limits). The employer deposits that amount—be it expressed as a percentage of salary or a fixed-dollar amount—into an individual’s plan account. The employer may also contribute to the plan, subject to match limitations. Typically, the participant is able to direct the investment of the contributions among various investment options offered by the plan, and the participant bears the risk of investment performance over time. Those investment options may include employer stock. Unlike a participant in a traditional defined benefit plan, a defined contribution plan participant has no guarantee of any benefits at all when he/she leaves the employer, receiving only the assets that have accumulated in his/her account. But unlike in the defined benefit model, those individual account assets are portable in that they can be “rolled” into another employer’s plan.

Recently, the Supreme Court provided additional guidance on the remedies available to defined contribution plan participants in *LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. 248 (2008). *LaRue* is generally viewed as expanding the remedies available to plan participants; the Court found that a fiduciary who failed to follow the investment instructions of a participant could be required to provide equitable relief to the plan account in which the investments were to have been made. In so ruling, the Court distinguished defined contribution plans, and their individual investment accounts, from defined benefit plans as to which plaintiffs cannot recover individual or account-specific damages for fiduciary breaches. See, for example, *Mass. Mut. Life Ins. Co. v. Russell*, 473 U.S. 134 (1985).

Because different rules govern the two kinds of retirement plans, they carry different risks. We explore some of those risks below.

2. ERISA RETIREMENT PLAN STOCK DROP CASES: FROM ENRON AND MASSIVE FRAUD, TO LARGE SETTLEMENTS TO AVOID LITIGATION, TO TRIALS ON THE MERITS AND THE PRO-FIDUCIARY RULINGS IN US AIRWAYS AND TELLABS

Increasingly, ERISA class action stock drop lawsuits are being filed against fiduciaries of defined contribution plans that allow participants to invest in employer stock. In fact, more than 200 of these cases have been filed

² If the employer/plan sponsor fails, the Pension Benefit Guaranty Corporation has responsibility for supporting the benefits obligations of the failed employer, subject to statutory limits.

in the past decade. These suits allege, as a general matter, that the plan fiduciaries should not have allowed participants to invest in employer stock after a business or market event caused a company's stock price to drop. Typically, plaintiffs also assert that the fiduciaries misrepresented to the participants the risks associated with investing in employer stock by suggesting, for example, that the company itself would achieve X earnings or Y sales when, in reality, that was not what management actually expected. Often these cases are companion lawsuits to securities cases challenging the same events.

Stock drop claims have, for several years, made up a large percentage of class action filings under ERISA—and for good reason. First, the market itself has been volatile and unpredictable. Second, a number of high-profile ERISA class action attorneys actively solicit these kinds of claims from retirement plan participants. Using websites, press releases, and newspaper articles, these attorneys target particular companies that have, for example, restated corporate earnings, suffered a major stock price decline, changed or otherwise acknowledged the failure of a particular business plan or model, suffered decreased profits or revenue due to a downturn in an industry sector, or filed for bankruptcy.

If the plaintiffs survive motions to dismiss and/or for summary judgment or achieve class certification, defendants and their insurance carriers often feel pressure to settle. A number of factors contribute to this pressure. Although they are almost invariably inflated and subject to challenge on numerous grounds, the damages plaintiffs seek in these cases tend to be high. Fiduciary defendants in ERISA cases by statute face personal liability in the event a court rules that they have breached their duties; this drives an understandable desire to put the matter behind regardless of the merits of the claim. The prospect of discovery, especially the cost of electronic discovery, also adds financial pressure to settle. And, of course, litigating even a meritorious defense case carries with it inevitable costs and distractions. Thus, plaintiffs' attorneys have been able to secure large settlements disproportionate to the merits of a case.

What happens, however, when the price demanded by the plaintiffs is too high or management has principled objections to paying any demand? The alternative is trial. In the only two post-*Enron* full-blown stock drop cases that have gone to trial, defendants have prevailed on all issues. In *DiFelice v. US Airways, Inc.*, 436 F. Supp. 2d 756 (E.D. Va. 2006), *aff'd*, 497 F.3d 410 (4th Cir. 2007), the court held that 401(k) plan fiduciaries were not imprudent in continuing to permit participants to invest in US Airways stock after the events of September 11, 2001, even though US Airways filed for bankruptcy in August 2002. In *US Airways*, the court rejected plaintiffs' hindsight claim that a bankruptcy by US Airways was inevitable (when the stock became almost worthless), because the fiduciaries regularly considered the company's prospects and kept participants (who at all times had the option of trading out of the stock) fully informed of all developments.

In *Brieger v. Tellabs, Inc.* 629 F. Supp. 2d 848 (N.D. Ill. 2009), the court turned back analogous claims that, in the midst of the telecommunications industry downturn of 2001-2003, 401(k) plan fiduciaries should have forced plan participants to sell their company stock, contrary to their personal decisions to invest in Tellabs stock. The court faulted plaintiffs for their failures of proof, found that investment in Tellabs stock was substantively prudent because the company remained financially viable even though its stock price declined, and because market analysts predicted that the stock would recover. The court also found that the participants made informed choices to invest in Tellabs stock because the fiduciaries fully advised participants that the company was facing serious problems, although they expected it to recover. Taken together, the *US Airways* and *Tellabs* cases provide a roadmap for defending employer stock drop cases.

3. ERISA RETIREMENT PLAN FEES CASES: HOW MUCH DISCLOSURE IS ENOUGH, AND WHAT DOES “EXCESSIVE FEES” MEAN, ANYWAY?

As stock drop case law continues to evolve, a new type of ERISA class action case is making headway—plaintiffs are claiming that fiduciaries breached their obligations to plan participants by allowing the plan to pay excessive expenses to service providers and others. In the typical ERISA fees litigation case, the plaintiff alleges that the fees of plan service providers, such as investment-option providers and recordkeepers, have not been sufficiently disclosed, are unreasonable, or both. These claims typically are brought concerning all investments offered in the retirement plan, asserting that the plan fiduciaries have fallen short in various aspects of their duties, such as failing to investigate or understand the investments offered to participants and the costs, or otherwise not being vigilant in protecting the participants’ interests.

These fees claims have arisen in three basic forms. The most common form is suits filed by class counsel directly against employers, their officers and directors, and sometimes service providers, contending that 401(k) plan fiduciaries were “asleep at the switch” in allowing plan service providers to be paid excessive amounts for their services and in failing to inform participants of the intricacies of compensation arrangements. For example, plaintiffs allege that “revenue-sharing arrangements,” in which mutual fund managers share part of their compensation with recordkeepers (who perform services for plans and mutual funds), are excessive and unlawful. These cases have challenged a broad array of practices common in the defined contribution industry, effectively attacking the way most corporate plans operate. Early decisions in cases of this kind have been favorable for employers, plan fiduciaries, and service providers. In *Hecker v. Deere* 556 F.3d 575 (7th Cir. 2009), the Court of Appeals for the Seventh Circuit held that ERISA does not require disclosure of revenue-sharing arrangements, and that fiduciaries of plans authorizing participant investment direction can be exempted from liability by the safe harbor of ERISA’s Section 404(c), which states (in effect) that fiduciaries are not liable for participants’ bad investment decisions.

A second type of claim (actually a subset of the first) is the “proprietary fund” case. Proprietary fund lawsuits allege that plan fiduciaries improperly bought, on behalf of the plan investment, products of affiliated entities of plan service providers. See, for example, *Dupree v. Prudential Ins. Co. of Am*, No. 99-8337, 2007 WL 2263892 (S.D. Fla. Aug. 7, 2007).

A third category of claims is “gatekeeper” cases, which have been brought as national class actions by fiduciaries of small to midsize plans against bundled service providers such as insurance carriers, alleging that improper revenue-sharing agreements provided unlawful “kickback” payments to the carriers, based on the percentage of plan assets invested in a particular fund. Bundled providers typically require their clients to receive all of the plan services from the bundled provider, and plaintiffs challenge this arrangement as inherently unfair. See, for example, *Haddock v. Nationwide Fin. Servs.*, 419 F. Supp. 2d 156 (D. Conn. 2006). The outcome of these cases turns on the reasonableness of the fees charged for all services provided and the disclosures made.

4. DEFINED BENEFIT LITIGATION: PROHIBITIONS ON INDIVIDUAL RECOVERY, ANTI-CUTBACK CLAIMS, AND CONVERTING TO CASH BALANCE WITH CARE

Defined benefit plans also face challenges to fiduciary conduct, but claims in that context have very different implications. Why? Misconduct by fiduciaries in a defined contribution plan has a direct impact on the very value of a participant’s benefits. For example, if a fiduciary fails to monitor a stock fund in which a participant invests assets, the participant may lose those assets. That is not the case in a defined benefit plan, where mismanagement of investments has no immediate impact on a participant’s entitlement to a defined benefit unless the misconduct threatens the existence of the plan itself. Certainly a claim of breach of fiduciary duty with respect to a defined benefit plan will also allege (as in defined contribution cases) mismanagement and fiduciary miscues. But such lawsuits, if successful, do not directly benefit the plaintiff participant because, regardless of the mismanagement, the participant remains entitled to receive his/her defined benefit under

the plan. As already discussed, the Supreme Court has consistently held that plaintiffs cannot recover individual damages for fiduciary breaches in a defined benefit plan. See, for example, *Mass. Mut. Life Ins. Co.*, 473 U.S. at 140-148. This prohibition has had a chilling effect on the kind of class litigation seen in the defined benefit context.

Except for routine claims by multiemployer funds to enforce benefit plan contribution requirements, the most common defined benefit plan lawsuits involve claims that vested benefits were impermissibly “cut back” in violation of prior plan commitments (“anti-cutback” claims), and statute-based challenges to cash balance plans. In the typical anti-cutback case, the plan sponsor makes changes to benefit plan features and arguably alters pre-existing commitments to pay benefits at previously established levels. Often, these claims are asserted on a class basis and arise in a corporate acquisition context when plans are combined or restated. The claim is essentially a contract claim based on the terms of the plan document.

Cash balance claims, in contrast, are statutory ones; they challenge the design of the cash balance plan based on arcane statutes and regulations governing benefit accruals. The litigation involving cash balance plans generally stems from their hybrid character. They are defined benefit plans that are structured to operate somewhat like defined contribution plans; that is, the defined benefit is stated as a lump sum benefit that is also payable as an annuity. At the same time, participants have a hypothetical cash balance account that tells participants at any point in time what their lump sum benefit would be if they elected to withdraw it. Although defined benefit plans are on the decline, the overall proportion of cash balance plans is rising as employers convert more traditional pension plans into cash balance plans.

Although a cash balance plan may make costs more predictable, conversion to a cash balance plan carries with it the risk of litigation. For example, participants have challenged cash balance design, arguing that it violated prohibitions against age discrimination. Money contributed on behalf of a younger employee, they have alleged, would be worth more than the same amount of money contributed on behalf of an older employee. Thus far, the Courts of Appeals have rejected these claims, finding that any allegedly discriminatory impact is more related to the “time value of money” than to any actual animus on the basis of age. See, for example, *Drutis v. Rand McNally & Co.*, 499 F.3d 608 (6th Cir. 2007) (cash balance plan not per se illegal); *Register v. PNC Fin. Servs. Group, Inc.*, 477 F.3d 56 (3d Cir. 2007) (same); *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636 (7th Cir. 2006) (same).

In another type of cash balance claim—the so-called “whipsaw” claim—participants allege that when the plan interest rate applied to their cash balance accounts was higher than the discount rate used to determine the participant’s lump sum payout, the amount of the lump sum was less than it should have been. Employers also face “wear-away” claims brought by participants whose opening balance upon a plan’s conversion to a cash balance formula was less than the accrued benefit under the plan’s old formula.

The Pension Protection Act of 2006 (PPA) brought much-needed cash balance guidance to the courts, fiduciaries, and attorneys. The PPA provided a safe harbor for cash balance plans from the ERISA anti-discrimination provision, as well as largely eliminating whipsaw and wear-away claims. But the PPA does not apply retroactively—it is only applicable to periods beginning on or after June 29, 2005, and to distributions made after its enactment, so employers are not yet out of the woods on claims arising before that time.

5. SPECIAL ISSUES INVOLVING EMPLOYEE STOCK OWNERSHIP PLANS

Employee stock option plans (ESOPs), particularly those in privately held companies, have also been the subject of litigation. In fact, ESOPs present unique risks that companies need to anticipate and address in plan design and administration. ESOPs are a mechanism to promote employee ownership of companies. They are defined contribution plans that are exempted specifically from ERISA’s diversification requirement because their assets are required to be primarily invested in employer stock.

A non-exhaustive summary of the legal vulnerabilities of privately held ESOPs to litigation includes:

- *Purchasing employer securities*, because the price is not defined on the open market, as it would be for shares of a publicly held company, exposing the transaction to claims that the securities were valued improperly.
- *Selling the company*, because of prohibitions on self-interested transactions, and because valuation of employer securities may prove difficult, exposing the transaction to claims that the sale was a prohibited transaction, or that securities were valued improperly.
- *Paying high levels of executive compensation*, because this gives rise to concerns that the interests of ESOP participants are being improperly diluted.
- *Engaging in related-party transactions*, such as where the ESOP is buying shares from or selling them back to an insider, and the fiduciaries must ensure that the ESOP is paying no more or receiving no less than fair market value as of the date of that transaction.

Identifying an independent trustee for closely held plans is key to avoiding such claims. A seller of securities who is also a trustee is especially at risk, because of the obvious conflict of interest. Appointing a CFO or other insider as trustee is also relatively risky, because participants may claim that such a trustee is under the influence of the selling shareholder. Appointing an independent but inexperienced trustee may avoid conflict-of-interest issues, but it may result in claims that the trustee lacks adequate understanding of his/her fiduciary responsibilities. The safest avenue is to use an independent, professional trustee who has no division of loyalty and fully understands the fiduciary context. Courts generally accord a deferential standard of review to actions of such independent fiduciaries. See, for example, *Armstrong v. Amsted Indus.*, 446 F.3d 738 (7th Cir. 2006).

B. Claims Against Welfare Plans

1. OBSERVATIONS ON WELFARE BENEFITS CLAIMS

The types of welfare benefits claims that might be made in litigation are extremely varied. Claims may be made for medical benefits, life insurance benefits, disability benefits, or severance benefits. Most of these cases are highly individualized, turning on the particular circumstances of the claimant and often on difficult-to-apply plan provisions. If the claimant is successful, exposures are generally limited to the benefits provided under the plan, but the claimant can seek a statutory attorney's fee.

ERISA requires that every plan provide a benefits claim procedure to facilitate administrative (non-judicial) consideration of claims by fiduciaries who are to consider the claim in light of what the plan requires. In a number of cases, the Supreme Court has made it clear that the plan administrator functions as a fiduciary when considering a benefits claim, and in making the decision owes a duty of loyalty to the plan participant and a parallel duty to enforce the plan as the settlor meant it to be enforced. See, for example, *Metro., Life Ins. Co. v. Glenn*, 128 S. Ct. 2343, 2348 (2008); *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989). If the plan is written to give the plan administrator discretion in construing the terms of the plan and the plan administrator complies with his/her duties in construing and administering the plan, the courts further hold that the administrator's decision may be entitled to some measure of deference in the event the claimant is not satisfied and brings a claim to court. See also *MetLife Ins. Co. v. Glenn*, 128 S. Ct. 2343 (2009) (measure of deference can vary depending on reviewer's financial interest in outcome and possible conflicts). These rules also apply to retirement plan claims in most instances.

2. SPECIAL ISSUES RELATED TO ERISA RETIREE LITIGATION: MUST MEDICAL OR LIFE INSURANCE BENEFITS BE PROVIDED FOR LIFE?

The recent economic downturn has given new life to claims challenging a plan sponsor's ability to change or eliminate post-retirement medical benefits. Invoking a theory of recovery litigated extensively in the 1980s, the plaintiff alleges that the plan or collective bargaining agreement guarantees a certain level of medical benefits for the retirees' lifetimes, resulting in the "vesting" of the benefits. See, for example, *UAW v. Yard-Man, Inc.*, 716 F.2d 1476 (6th Cir. 1983). Alternatively, retirees often argue that, even if the plan documents or contracts do not themselves "vest" their benefits, plan fiduciaries in some fashion promised them that they would have "vested" coverage. These plan document/contract claims are generally resolved by applying well-known rules of contract construction. For misrepresentation claims, on the other hand, resolution often depends on individual issues of proof, such as what each retiree was told and by whom, and whether the retiree relied to his/her detriment on what he/she was told.

Courts attempt to understand the clarity or ambiguity of the alleged promise, as well as to balance alleged promises with express reservations-of-rights clauses that make clear that benefits can be changed at the company's discretion. See, for example, *Jones v. Am. Gen. Life & Accident Ins. Co.*, 370 F.3d 1065 (11th Cir. 2004). The cases debate the level of evidence that plaintiffs must present to show—contrary to ERISA's presumption that retiree medical benefits are not vested—that they in fact have become contractually guaranteed. As a general matter, a conclusion of vesting is more likely with collectively bargained plans than with salaried employee plans, where that inference is seldom made and the courts strictly apply a unilateral contract analysis.

Case law also makes clear that companies must approach changes to post-retirement medical benefits carefully. Companies risk facing injunction proceedings where the court literally steps in and stops the company from making contemplated changes in the plan, or forces the plan sponsor to reinstate terminated benefits. See, for example, *Jensen v. Sipco, Inc.*, 38 F.3d 945 (8th Cir. 1994) (affirming injunction forcing plan sponsor to reinstate benefits). But see *Musto v. Am. Gen. Corp.*, 861 F.2d 897 (6th Cir. 1988), *cert. denied*, 490 U.S. 1020 (1989) (reversing district court's grant of preliminary injunction preventing implementation of cost increases for retiree medical coverage); *Brubaker v. Deere & Co.*, Civ. No. 3:08-cv-00113, 2008 WL 575 1964 (S.D. Ia. 2008) (in preliminary injunction proceeding, court refuses to reinstate retiree medical benefits where the employer was able to show that (1) the plan documents consistently contained a reservation of rights allowing the plan sponsor to change the plan and (2) plaintiffs failed to show that their evidence of alleged promises was likely to prevail). See also *Brubaker*, 2009 WL 3378980 (Oct. 16, 2009) (post-trial decision on merits in favor of *Deere*).

The bottom line with contemplated changes to retiree benefits is that the employer should pore over all past plan documents and employee/participant communications, including those of predecessor employers, to understand the strength of the reservation-of-rights language, what arguably can be said to constitute a promise of continuing benefits, and what changes have been made in the past to support the right to make continuing changes in the future. Depending on what the documents show, there might be multiple answers for different groups of participants—each with its own attendant legal risks and costs.

III. 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 consider the suggestions that follow in consultation with their benefits counsel.

A. Overall Administrative Structure and Design

- *Avoid naming the plan sponsor as a fiduciary.* Plan sponsors should not name the sponsoring employer as the fiduciary of an ERISA plan. Instead, consider whether a committee structure is more appropriate, creating an Employee Benefits Committee to be named as the fiduciary. The 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.
- *Avoid naming key corporate officers as fiduciaries.* CEOs and CFOs often possess inside information that plaintiffs may claim prevented them from fulfilling their duty of loyalty. The general counsel often possesses privileged information about the sponsor that plaintiffs may claim must be divulged if the general counsel wears “two hats” and the privileged information is arguably relevant to plan administrative matters.
- *Carefully craft delegation authority.* Consider allowing the named fiduciaries to designate a person who is not a named fiduciary to carry out fiduciary responsibilities without being liable for the latter’s acts or omissions. However, in order to do so, the Department of Labor requires that the plan provide a procedure for such delegation. If procedures are included in the plan, a named fiduciary will not be liable for the acts or omissions of delegated fiduciaries, provided the named fiduciary acts prudently in the delegation of responsibility *and* periodically reviews the performance of the delegated fiduciaries. However, once a delegation is made, the delegating fiduciary should periodically monitor the delegated fiduciary.
- *Define the roles of plan sponsor and fiduciaries.* In order to differentiate fiduciary functions from non-fiduciary functions, the fiduciary structure should clearly define the different roles; that is, clearly identify the individuals who act as “appointing fiduciaries” with the duty to appoint, monitor, and remove.
- Plans should be created or amended 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*.

B. 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. This language should explain that the participants are responsible for managing the decision to invest or not invest in particular funds. That is, assuming the plan allows for investment diversification among various investment funds as provided in Section 404(c) regulations, the plan document and summary plan description should be clear that the participants have the full authority and responsibility to manage their investments from among the options available under the plan, and that the fiduciaries are not liable for resulting losses. The fiduciaries will also need to ensure that they provide all of the information to participants required by Section 404(c).
- *Hire an outside fiduciary.* Consider engaging a third-party, independent fiduciary to be responsible for, and exercise authority over, any employer-stock investment fund. If an independent fiduciary is appointed, the plan sponsor may consider granting the fiduciary the authority to remove the employer-stock investment fund as an option if prudence requires. At the very least, should the sponsor opt against a third-party fiduciary, consideration should be given to removing corporate officers (insiders) and directors from membership on the fiduciary committee responsible for overseeing the employer-stock investment fund. Be aware, however, that the company will continue to have ongoing fiduciary obligations even after the delegation (e.g., to monitor whether the delegation itself is prudent, to correct/prevent fiduciary breaches).

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. The plan document (and summary plan description) should clearly state that offering the stock investment is required under the terms of the plan. No language should be included that suggests that offering such an investment account is optional or discretionary. At the same time, some plan sponsors include language that participants have the option of directing their investments elsewhere.
- *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.* Remove restrictions on the sale or diversification of company stock. Offer employer stock through either a match or an employee-directed investment, but not both. Place a cap on the amount of company stock that participants can hold in their accounts.

C. Medical Plan Design

- *Include a strong, clear reservation-of-rights clause.* Ensure that all plan documents include an express reservation of rights to terminate or amend the plan at any time and for any reason. Be sure to include a description of the clause in the summary plan description.
- *Explain the plan’s reimbursement rules.* Clearly explain how the plan reimburses or pays for benefits, especially out-of-network services and services for which the participant fails to get precertification for treatment, and make the plan’s payment schedules accessible to participants and providers. In-network providers are typically paid according to a contractual fee schedule, so the participant has limited financial exposure. Most plans encourage participants to get precertification of treatment, which means (among other things) that they will know before the procedure exactly what it will cost. Because out-of-network providers have not agreed to be bound by the plan’s provider-reimbursement agreements,

however, plans typically pay a much smaller portion of bills for out-of-network services than for in-network services. These limitations are a frequent source of litigation because participants are commonly surprised by the size of their liability for out-of-network service bills. Similarly, it is important to alert participants to the penalties, and unexpected liabilities, they will face if they fail to comply with the plan's precertification requirement.

D. Plan Administration

With respect to plan administration, "procedural prudence" can be very important. Therefore, set up a procedure (in consultation with benefits counsel) to help meet fiduciary obligations, and ensure that these procedures are followed.

General procedures may include the following:

- *Have regular, structured meetings.* The plan administrative committee should meet regularly, in person, with agendas and binders of relevant materials, and should keep minutes.
- *Read the plan documents.* Every administrator and fiduciary of a plan should be familiar with the documents that govern the plan, such as the plan document itself, its trust instruments, its summary plan description, any underlying collective bargaining agreements and insurance policies, and the like. The first question the Department of Labor or a plaintiff's attorney is likely to ask is whether the defendant has read the plan.

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). Ensure that your ERISA fiduciary liability insurance policy covers those who are responsible for appointing fiduciaries.
- *Appoint with care.* Follow a clearly defined process for appointing fiduciaries, carefully evaluating possible fiduciary candidates and documenting the selection process. When reviewing applicants, ensure that candidates' qualifications are consistent with duties assigned to that individual.
- *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. These meetings should be documented. Replace non-performing fiduciaries!
- *Review agreements with outside fiduciaries.* Ensure that the acceptance of fiduciary status is documented, and that the parties' agreements include a clear statement of duties. Also review indemnities and limitation-of-liability clauses for compliance with ERISA Section 410, and require that corporate fiduciaries and other service providers are adequately capitalized and insured.

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).* Periodically review investment performance of all options against relevant benchmarks. Have and follow "watch list" standards for underperforming funds, and consider retaining an independent advisor to provide

assistance in monitoring fund performance and in identifying new managers, asset allocation strategies, and new asset classes. Identify and interview potential replacement managers for underperformers. Document all decisions.

- *Remember diversification.* Consider periodically whether the investment menu has the right number of options—too few may limit ability to diversify appropriately, but too many may lead to “paralysis by analysis.” In a defined benefit plan, be open to changing asset-allocation strategies and testing new asset classes.
- *Be educated about fees.* Know what you are paying and to whom. Demand full disclosure from all vendors, and include disclosure of fees in contracts. Compare with benchmarking data. Consider requesting proposals from vendors periodically. (The Department of Labor has a strong bias against “perma-vendors,” although change just for the sake of change is not generally prudent.) Make sure to periodically review and document fund choices that affect fees and why they make sense, (e.g., active vs. index funds, optimal share classes, mutual funds vs. managed accounts).
- *Educate participant investors about the risks of company stock.* The employer should make clear that a concentrated holding in one stock (such as employer securities) is a very aggressive investment. This language should be included on all participant communications, and any language suggesting any prospective degree of return on company stock or encouraging company stock investments should be avoided.
- *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.* Consider whether the trustee has retained independent financial and legal counsel. Consider whether the trustee has conducted a thorough investigation of the transaction. Review how the trustee negotiated on behalf of the ESOP. Consider the trustee’s review and understanding of any valuation report.
- *Understand the importance of a proper valuation.* Ensure that the appraiser is independent and qualified, a full valuation report is prepared and delivered to the trustee each year, the valuation opinions are dated appropriately, and the valuation reports follow the format specified in the Department of Labor’s proposed adequate-consideration regulation.
- *Sell company stock with care.* For related-party transactions, bring in an independent trustee to address any conflicts of interest, and ensure that the trustee receives independent financial and legal advice. For sales to unrelated parties, consider obtaining a fairness opinion for the ESOP. Ensure that all sales are supported by independent valuations.
- *Watch executive compensation.* Consider monitoring executive compensation to minimize the risk of participant claims alleging improper dilution, and ensure that appropriate safeguards are in place—for example, a compensation committee comprising outside directors and/or independent compensation consultants.

IV. The Role of Fiduciary Liability Insurance for Protecting Plan Sponsors, Fiduciaries, and Parties in Interest

A. Types and Terms of Fiduciary Liability Insurance

This report has demonstrated the complexity of ERISA and the types of litigation that can ensue. This section is designed to explain, in simple terms, the purpose and function of fiduciary liability insurance in protecting fiduciaries against ERISA claims.

A good starting point is an explanation of what a fiduciary liability insurance policy does. Put simply, a fiduciary liability insurance policy can be issued either to the plan itself or to an employer that sponsors an employee benefit plan. It is designed to protect insureds against claims alleging the 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.

1. WHAT IS A CLAIM?

Definition of 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 other words, the claimant must accuse the insured of having done something wrong with regard to the plan and demand some form of relief.

Generally, a claim may be a written demand for monetary damages or injunctive relief; a civil complaint; a formal administrative or regulatory proceeding commenced by the filing of a notice of charges or formal investigative order; or a written notice by the Department of Labor or the Pension Benefit Guaranty Corporation of an investigation against an insured for a wrongful act.

A common misconception is that fiduciary liability insurance can be used to restore losses to an employee benefit plan when a plan sponsor or employer discovers that it made an error. That is not the case. Fiduciary liability insurance is “third-party” coverage, meaning that someone must make a claim against an insured for a wrongful act. In turn, the fiduciary liability insurance policy will provide a defense against the claim (assuming that the policy includes a duty to defend provision, as discussed further on) and then pay for any covered award entered against the insured up to the policy’s limit of liability. Fiduciary liability insurance is not “first-party” coverage or a bond, meaning that the insured cannot draw on the policy to restore losses to the plan.

Optional Coverage for Voluntary Correction Programs in Absence of a Claim

Many carriers offer optional coverage for costs associated with an insured’s voluntary effort to bring its plan into compliance with certain requirements of ERISA and/or the Internal Revenue Code (IRC) without requiring that a claim be made against an insured. Such correction programs typically carry a filing fee and/or fine or penalty.

An insured can pursue several different compliance actions depending on the circumstances. When an insured has discovered that its retirement plan is out of compliance with IRC requirements, it can correct such inadvertent non-compliance (without risking plan disqualification) through the Employee Plans Compliance Resolution System (EPCRS), which is administered by the Internal Revenue Service. [See Rev. Proc. 2003-44, 2003-1 C.B. 1051]. The EPCRS is made up of several components, including the Self-Correction Program, the Voluntary Correction Program, and the Audit Closing Agreement Program. Similarly, the Employee Benefits Security Administration of the Department of Labor administers the Voluntary Fiduciary Correction Program and the Delinquent Filer Voluntary Compliance Program. [See 67 Fed Reg 15052, 15058 (March 28, 2002)]. These programs are designed to encourage employers to voluntarily comply with ERISA, including ERISA's annual reporting requirements, by self-correcting certain violations of law.

This type of coverage is typically subject to a sublimit, meaning that there is a lower limit of liability applicable to this type of coverage as compared to the overall limit of liability for the policy. The sublimit is usually part of, and not in addition to, the limit of liability. Also, any grant of coverage will usually not cover the actual costs of bringing a plan into compliance (e.g., the policy will not pay for the funding obligations of the plan sponsor).

2. 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 itself, as defined under the policy, is also an insured. "Plan" often includes employee welfare plans and pension plans and can be sponsored by for-profit organizations or not-for-profit organizations. Note that defined contribution plans that are sponsored by not-for-profit organizations or by education organizations may be known as "403(b) plans," referring to the applicable provision of the IRC addressing these organizations' plans. Under many fiduciary liability insurance policies, the term "plan" is not confined to traditional ERISA plans and, as such, may include plans that are not subject to ERISA (e.g., "top hat" plans, excess benefit plans, church plans, government plans, and plans that are created and maintained outside the United States).

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.³ 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 preserves policy limits for the plan sponsor's employee and director fiduciaries.

3. 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 and errors in the administration of the plan.

³ Claims filed against third-party providers are typically covered by that third-party provider's own errors and omissions insurance (not fiduciary liability insurance) policy because their liability arises from professional services rendered for another party's plan.

Depending on the nature of the breach and how many beneficiaries are impacted, a claim of breach of fiduciary duty can result in a significant exposure to the plan and other insureds. Many such claims have resulted in significant loss payments under fiduciary liability insurance policies (e.g., employer stock drop claims). In addition, numerous other breach of fiduciary duty claims may also present significant liability potential, such as allegations involving misinterpretation of a plan document, wrongful administration of a plan in a way that is not in compliance with the plan documents, providing imprudent investment options to participants in a pension plan, failing to accurately communicate relevant information to plan participants, or making misrepresentations about plan investments.

Fiduciary liability insurance coverage may also be triggered by an insured's error in the administration of the plan. In this context, administration commonly includes handling paperwork for the plan, providing interpretations with respect to any plan, or giving advice to participants regarding the plan. Such claims are common. For example, say a company's human resources department manager tells an employee that the employee is eligible to add his/her newborn child to the health insurance plan as long as he/she does so within 60 days after birth. However, the plan terms allow only 30 days to do so. The child becomes ill a few months later and the health insurance carrier denies the claim for medical benefits because the child was not added to the insurance plan until 40 days after the date of birth. The employee sues the plan, alleging that he/she was given improper instructions on how to enroll the newborn child in the plan. That claim could constitute a claim for a wrongful act in that it involves an error in the administration of the plan.

4. 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).

Note that even when the relief sought is not a loss or constitutes benefits due, the insureds may still have coverage for defense costs. For example, if a retiree sues a pension plan for erroneously calculating an underpayment of a lump sum distribution, fiduciary liability insurance would pay to defend against the retiree's claim, whereas the plan would have to pay any settlement or judgment awarding the retiree the underpaid portion of his/her distribution (*i.e.*, the benefits due under the plan).

5. 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. 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.

The duty to defend provision is sometimes met with resistance from insureds. However, there are benefits to be gained by the exercise of this duty. The right and duty to defend provision includes the insurance carrier's right to select defense counsel. Fiduciary liability insurance carriers, who regularly provide the defense of fiduciary liability claims, are familiar with experienced ERISA defense counsel. Accordingly, fiduciary liability insurance carriers play a pivotal role in providing insureds with appropriate defense counsel to mount the best defense possible.

Moreover, due to the volume of the claims they handle, fiduciary liability insurance carriers commonly negotiate lower rates with the defense firms. Thus, insureds receive the benefit of a defense by accomplished ERISA defense counsel at reduced rates, preserving available policy limits for any covered loss that may arise

either in settlement or judgment. These experienced ERISA defense counsel have familiarity with relevant law, which is constantly evolving. Fiduciary liability carriers also typically have litigation management guidelines in place that help to ensure that the costs of defense are reasonable and necessary. These defense provisions are important because fiduciary liability policies typically pay for defense costs within the limits of liability, meaning that every dollar spent by the carrier on defense costs erodes the available limit of liability by that same amount. These types of policies are commonly referred to as “eroding limits” policies.

Another benefit of the duty-to-defend provision is the management of discovery costs, which can be significant. In today’s electronic age, a large portion of defense costs may comprise electronic discovery efforts, such as harvesting information from obsolete databases, gathering years’ worth of email traffic, and cataloguing all discovery information. Fiduciary liability carriers continue to create solutions to deal with this electronic discovery in an efficient, cost-effective manner, such as negotiating vendor agreements with third-party providers to provide these services at reduced rates.

6. OTHER FORMS OF INSURANCE PROTECTION

In addition to the more commonly known fiduciary liability insurance policies that cover traditional, single employer plans, there are other types of fiduciary liability policies designed to cover certain multiemployer plans, commonly referred to as “Taft-Hartley” plans. Established to address collective bargaining agreements in accordance with the Taft-Hartley Act, these plans provide benefits for people who are members of a specific union (e.g., a local chapter of the Teamsters) but are employed by different employers. A Taft-Hartley multiemployer plan is characterized by provisions that allow its participants to continue to earn benefits based on work with multiple employers, as long as each employer contributes to the plan. Policies insuring these plans (sometimes called labor management trust (LMT) policies) are constructed differently than the traditional fiduciary liability insurance policy because such LMT policies cannot be issued to a single employer as a plan sponsor. Instead, they are issued to the plan itself.⁴ Such LMT policies typically cover wrongful acts similar to those that are covered by fiduciary liability insurance.

Public entity plans (i.e., governmental plans) are similar to Taft-Hartley/multiemployer plans in that insureds are often public employees who work for a variety of different public agencies or governmental divisions (e.g., a plan may cover all teachers employed by public schools within the state, even though they are employed by several different school districts). Accordingly, these policies, like LMT policies, are usually issued to the plans themselves.

There are also optional employee benefit liability (EBL) endorsements that may be endorsed onto commercial general liability policies.⁵ These EBL endorsements should not be confused with the coverage afforded by the fiduciary liability insurance policies, as such EBL endorsements may not provide coverage for breach of fiduciary duty claims. Such EBL endorsements may only provide coverage for errors in the administration of a plan (which fiduciary liability insurance also covers) and, even then, may often be subject to more restrictive terms and conditions than those of a fiduciary liability insurance policy. One notable exception, however, is that defense costs under an EBL endorsement may not deplete policy limits because this endorsement is appended to a general liability policy, which is typically a policy in which defense costs do not erode limits. Fiduciary liability insurance limits, on the other hand, are generally eroded as defense costs are paid.

Fiduciaries should not rely on the fact that they have executive liability insurance, commonly referred to as directors and officers (D&O) liability insurance, in the event a fiduciary liability claim is made against them. As discussed previously, the same person may serve as both a plan fiduciary and as a director and/or an officer. A person’s capacity depends on the nature of the activity in which he/she is engaged. If he/she conducts business on behalf of the employer, then he/she may be acting as a director and/or officer. If he/she administers the plan or deals with plan assets, then he/she may be acting as a plan fiduciary. Even

⁴ ERISA Section 410 permits plans to purchase fiduciary liability insurance.

⁵ Commercial general liability insurance covers all liability exposures of a business that are not specifically excluded. Coverage typically includes advertising and personal injury liability, product liability, completed operations, premises and operations, and medical payments.

when a director is also a plan fiduciary, D&O liability policies typically cover only directors and officers for activities performed in their capacity as directors or officers, not as plan fiduciaries. Furthermore, D&O liability insurance policies typically exclude from coverage any claims based on or arising from an ERISA violation.

Finally, a fiduciary liability policy will not satisfy any bonding requirements under ERISA for theft of plan assets (although the fiduciary liability policy could pay for the defense of a fiduciary who was sued by a plan participant for breach of fiduciary duty for allegedly failing to prevent or detect the theft of funds).

B. The Pivotal Role of Insurance in Protecting Insureds Against Fiduciary Liability

1. 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, when insureds are often faced with insolvency and bankruptcy.

Even when an employer/plan sponsor is willing and financially able to indemnify plan fiduciaries, it may be prohibited from doing so by applicable law. For example, plaintiffs may make the argument to a court to hold that the employer/plan sponsor is prohibited from honoring its agreement to indemnify the plan fiduciaries, when such agreement to indemnify is conditioned on the plan fiduciaries following instructions provided them without exercising independent judgment. Plaintiffs will contend that courts should prohibit indemnification in such situations to dissuade fiduciaries from not questioning whether the instructions that they were given were in the best interests of the plan and plan participants because of their fear of losing their rights to indemnification. Courts have also suggested that public policy underlying ERISA’s Anti-Exculpatory provision may prohibit indemnity that absolves fiduciaries of responsibility for their breaches of duty.

A special note of concern surrounds multiemployer plans because there is no sponsor present to indemnify fiduciaries as there is with a traditional single employer plan. Instead, the plan is established under a collective bargaining agreement and then a board of trustees is assembled, comprising representatives from both labor and management. As such, the LMT policy is the only available source of protection for the trustee fiduciaries.

2. 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 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. The Department of Labor, and some courts, recently supported this prohibition on indemnification. See, for example, *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).

3. 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 when 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 a fiduciary's 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 when the fiduciary is required to pursue his/her employer (the plan sponsor) to contribute funds to the plan.

4. 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* to indemnify fiduciaries, absent some undertaking in the corporate documents.

Fiduciary liability insurance should not be subject to the same legal and financial restrictions that limit corporate employer indemnification of fiduciaries. Fiduciary liability insurance from a reputable, highly rated insurer provides fiduciaries with the added comfort that adequate funds will be available for their defense even when their employers are illiquid or financially troubled. In many instances, a fiduciary liability insurance carrier's decision to defend and/or indemnify a fiduciary may be independent of a plan sponsor's decision to defend and/or indemnify a fiduciary.

5. A SPECIAL NOTE ABOUT PUBLIC ENTITY EXPOSURE

Public-entity plans are typically created by statute and are subject to the law of the jurisdiction where the plan was created, meaning that the standard of conduct imposed on these plan fiduciaries is dictated by state law, as are the remedies for any breach. These plans are not subject to ERISA's fiduciary requirements. [ERISA Section 401(b)(1), 29 U.S.C. § 1101(b)(1)]. However, the fact that these plans are not subject to ERISA does not relieve the fiduciaries of liability exposure and may even broaden the scope of potential liability. This is because ERISA sets forth clear, tightly drafted statutory conduct requirements and limitations on liability, as well as the specific causes of action and remedies that plaintiffs may pursue. For example, plaintiffs cannot recover consequential or punitive damages under ERISA. ERISA also contains an exclusivity provision that dictates that ERISA preempts all other laws regarding fiduciary liability. This means that with respect to non-exempt, qualified ERISA plans, plaintiffs cannot make any state law claims or unrelated federal law claims against fiduciaries regarding an alleged breach of duty. Because public entity plans are exempt from ERISA, they do not get the benefit of the limitations that ERISA imposes on claims. As a result, fiduciaries of public entity plans could face liability for state law claims, such as common law breach of fiduciary duty, violation of traditional trust law, and negligence.

C. 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.

Report 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, even where there is no prejudice to the insurer.

Cooperate 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.

Purchase 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 limiting litigation exposure moving forward. Likewise, fiduciary liability insurance should be considered in any comprehensive corporate risk management program.

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