THE LEGAL REPORT

Thomas C. Michaud

VanOverbeke, Michaud & Timmony, P.C.

COVERING YOUR ASSETS

Protecting Against Fiduciary Liability

Michigan public employee retirement system boards are vested with the authority and responsibility for the administration of pension benefits and the investment of plan assets. As fiduciaries, trustees must act in the best interest of the plan, defray reasonable plan expenses, act with skill, prudence and diligence of a prudent person under the same circumstances, diversify the plan's investments so as to minimize the risk of large losses, and administer the plan in accordance with the governing plan documents.

Fiduciaries who breach their responsibilities shall be "personally liable" for any losses to the plans which they administer and shall be subject to other equitable or remedial relief, including criminal penalties. Given the numerous responsibilities and the potential liabilities (plan and personal), trustees often ask, "How do we cover our assets?"

Although fiduciaries may permissibly allocate duties among themselves and delegate duties to investment professionals, fiduciaries cannot rely upon exculpatory provisions in the plan documents to protect themselves from liability. However, a plan may purchase insurance which covers liabilities or losses occurring by reason of the act or omission of a fiduciary.

Fiduciary liability policies issued by insurance companies, such as AIG, Chubb, Hartford, Travelers, and Zurich, have been procured by public plans. Yet, not all public pension funds have obtained fiduciary liability insurance. Some public plans have determined that the cost of coverage, the availability of statutory rights to defenses (immunity) and indemnity, or the terms and limitations contained in the policies make it more prudent to "self insure" or go without coverage.

A decision to purchase fiduciary liability insurance, like any other decision of a board, must be made on the basis of whether the expense is appropriate for the plan. In considering whether fiduciary insurance is appropriate, trustees should consider such issues as the cost of the insurance, the value and nature of the coverage provided, what assets of the plan are subject to execution, the potential for suits against the plan, and the effects of any judgement which may be rendered against the plan. A decision to be or not to be insured should be supported by a record demonstrating trustees made an informed decision based upon thorough consideration.

If a board decides to purchase fiduciary insurance, the board should consider several factors, including the amount of coverage required, the cost of coverage, the nature of the coverage available, and the financial stability of the underwriter. Specifically, a board should have an understanding of the answers to the following questions and that the policy clearly reflects that understanding.

Who is the insured? Policies should identify coverage for the plan; employer/plan sponsor; plan trustees; and any director, officer or employee of the plan. Due to individual transitions, the insured should be identified by position, rather than by individual names.

What is insured? Covered acts vary from policy to policy, but generally include any negligent act, error, or omission of the insured in the administration of employee benefits, and the alleged violation of any responsibilities, obligations or duties imposed upon fiduciaries by law.

What is excluded? Policies commonly exclude coverage for intentional wrongful acts, punitive damages, contractual obligations, bodily injury, property damage, libel/slander, taxes, fines, penalties, and sanctions. While some policies will not pay damages for certain claims, the policy may provide for the coverage of defense costs.

How much is insured? Determining the appropriate amount of coverage is one of the most difficult issues. The amount of coverage should be based upon the level of risk presented by each of its investments/benefit issues, the potential cost to defend a suit and the size of the fund. Most policies contain a per-claim limit and a policy aggregate limit. If defense costs are included in the policy limits, coverage may be exhausted through the process of defending a claim. Further, coverage is frequently subject to a deductible which may apply to various claims within a period or to defense costs.

How is a claim made or paid? Policies are typically written on a "claims made" basis where coverage is triggered so long as the claim is made during the policy period, regardless of when the wrongful act is alleged to have occurred. As such, written notice should be immediately provided to the carrier when a claim is made against the plan. As most policies exclude claims for which there was prior knowledge, it is imperative to disclose at the time of application those circumstances which may give rise to potential claims.

The insurance company will generally defend any suit to which the insurance policy applies wherein a claim against the plan is alleged. Defense costs, charges and expenses incurred by the insurance company, or by the plan when it is defending and investigating, would be paid under the policy. Under a duty-to-defend policy, the insurance company usually possesses the right to select defense counsel. If a pay-on-behalf policy, the plan may select counsel and control defense. Typically, legal defense costs which are incurred are applied against the indicated deductible amount.

It is important to note that policies often contain "subrogation" provisions whereby the insurance company can seek to recover amounts paid under the policy from parties (e.g., trustees) causing or responsible for the loss that gave rise to the claim. While not directly applicable, ERISA prohibits a fiduciary from using plan assets to pay for fiduciary liability insurance that does not permit recourse by the insurer against the breaching fiduciary. In light of public policy and fiduciary responsibilities to the plan, the assets of a public employee retirement system should not be used to obtain insurance coverage for trustees in their individual capacity. However, a non-recourse rider (or a waiver or recourse) to the plan's fiduciary liability insurance policy may be purchased (usually at a nominal premium) using non-plan assets (i.e., by the individual trustees, the employer, an employee organization) to protect the trustees individually from personal liability.

The decision to obtain fiduciary liability insurance should not be viewed as a means of eliminating liability, but as a risk management function. A Board should continue to control the risk of exposure to liability by complying with plan documents; establishing and following policies and procedures; retaining qualified professionals; maintaining proper records; obtaining education, and following an ongoing process of review and evaluation. While the procurement of fiduciary liability insurance serves to insulate the plan from liability exposure, a fiduciary must continue to use extraordinary precaution to assure that decisions and transactions are in the best interest of the plan and its participants. Ultimately, a Board's proper exercise of prudence and due diligence serves as the best insurance policy.

IMPORTANT NOTE: This summary is intended to be informational only and is intended to provide a general overview. Reference should be made to the law and regulations in addressing specific questions. Trustees are encouraged to familiarize themselves with the provisions of the Act and how they may affect governmental plan administration. In certain cases, plans may need to be amended in order to take advantage of the pension reform provisions. This information should not be considered the rendering of legal advice or other professional services and Trustees should consult with their plan professionals regarding the implications of this law.