Fiduciary and D&O Liability Insurance Issues for ESOP Companies/Fiduciaries

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Overview of Executive Liability Insurance

• Directors and Officers Liability

• Fiduciary Liability

• Employment Practices Liability

Directors and Officers Liability

– Insures the Corporation’s Board of Directors and Company Officers for Claims alleging “Wrongful Acts” in carrying out their Corporate responsibilities.

– Provides coverage to the individual D&O’s directly and the Corporation’s responsibility to Indemnify them.

– Most, if not, All D&O Policies Will Exclude ERISA Liability Exposures.
Examples of D&O Claims

1. Privately held ESOP company in the retail furniture business is sued by a customer alleging unfair trade practices and unfair debt collection on outstanding debts of the customer.

2. Privately held ESOP company is sued from a competitor alleging interference for attempting to solicit its customers in an inappropriate way.


Fiduciary Liability

- ERISA does not bar the purchase of liability insurance by a Plan, fiduciary, or employer. 29 USC § 1110(b).

- Insures the internal trustees or fiduciaries of a Qualified Plan for claims alleging breach of fiduciary duty (in accordance with ERISA). Definition of “Plan”:

- Sources of Claims could be the Plan Participant, on behalf of the Plan itself or State or Federal Government Agencies such as the DOL.

- DOL much more aggressive recently.

- Policy covers the Plan Sponsor, Plan Fiduciary and the Plan itself. Definition of “Insured”.

- Not an ERISA Bond

- Fiduciary Liability Coverage provides insurance for certain losses that an ESOP/ERISA fiduciary might sustain because of the fiduciary’s liability to third parties or the Government. May include coverage for certain statutory penalties imposed by ERISA, the IRS, or other statutes.
Fiduciary Claims

Fiduciary claims against the ESOP are governed by ERISA and may be brought by individual claimants/participants of the plan or their families, or, on a macro basis, by the Department of Labor (DOL). Definition of "Claim."

In addition to the policy covering the Plan(s), Plan Sponsor and internal Fiduciaries, coverage may also be extended to the outside trustee. Some policies include in definition of insured a plan fiduciary.

Definition of "Insured."

Most frequently alleged claims are:
- Denial or change of benefits
- Administrative error
- Incorrect benefit calculation
- Improper advice or counsel
- Misleading representation
- Wrongful Termination of the Plan
- Civil rights denial or discrimination
- Failure to adequately fund a Benefit Program
- Conflict of Interest
- Imprudent investments
- Employer Stock Investments
- Settlor vs. Fiduciary Liability
- Payment in excess of "Adequate Consideration," i.e., Fair Market Value

Definition of "Wrongful Act."

Example:

Company processes the internal paperwork to set up an employee in an ESOP, but processing through TPA is never completed. Company stock rises, but employee never became a participant due to the error. Employee sues to recover the lost value.
ERISA Violations

The DOL is charged with enforcing violations of ERISA

DOL is conducting audits, will perform formal investigations, and issue ERISA fines and penalties.

1. Audits - every ESOP will be audited, and perhaps more than once by the DOL.
2. The instance of formal investigations by DOL of ESOPs is trending upwards as are civil fines and penalties.

Fiduciary Coverage as it relates to DOL Claims

Definition of "Loss."

"Coverage of Fines and Penalties."

Typically, Fiduciary insurance does not include fines and penalties in its definition of Loss. However, with regard to the DOL and its powers to issue fines and penalties, a Fiduciary Liability Insurance policy will provide coverage for some fines and penalties imposed under ERISA.

Otherwise, coverage applies to damages, punitive or exemplary damages, settlements and cost of defense.

Fiduciary/DOL Claim Examples

After an audit, the DOL launched a formal investigation against the Plan. The DOL’s ultimate findings were that the Plan and its fiduciaries failed to appropriately invest Plan assets by keeping Plan assets in cash investments for long periods of time as opposed to more "prudent investments." The DOL also found that the fiduciaries breached their duties by failing to appropriately monitor the Plan investments and allowing the lending of money between the Plan and a party whose interests are adverse to the interests of the Plan and its participants, in the detriment of the Plan participants, and allowing a prohibited transaction between involving the transfer of assets from the Plan to the Company, even though it was repaid to the Plan within a couple weeks.

Additionally, the DOL found the fiduciaries failed to obtain an adequate fair market value of Plan assets resulting in an improper valuation of the stock price to the detriment of Plan participants.
Finally, the DOL found that the Plan failed to maintain an appropriately funded fidelity bond in violation of ERISA and failed to issue disclosures to its Plan participants conforming with ERISA requirements.

a) Impetus for the findings was the transfer of Plan assets from the Plan to the Company, even though the loan was repaid in full two weeks later. Commingling of funds like this is prohibited and improper.

b) If there is a finding such as the commingling of assets, the “kitchen sink” is going to be thrown into the findings, including judgments regarding investment choices.

c) In this instance, although the Department of Labor offered voluntary compliance, the offer was only with the imposition of fines and penalties.

Example of recent DOL decision from a company that went through voluntary compliance:

- Case alleged unlawful deductions in the amount of $665,822.24
- Plus interest at 16% = $237,970.03
- Liquidated Damages at 6% = $39,949.42
- Civil penalty of $1,331,644.48
- Total = $2,275,386.17 (almost 4 times the actual damages of $665,822.24)

ERISA Tag Along Class Litigation – A Plan Sponsor being sued by a class of shareholders, (typically after a drop off in the company’s stock price), likely will allege liability under federal securities laws for committing fraud on the market or misrepresenting the company’s financial condition or outlook. Emerging from these lawsuits almost routinely now are class actions brought on behalf of participants of the company’s benefit and retirement plans, including ESOPs, that invest in the company’s stock, alleging breaches of fiduciary duty against the fiduciaries, directors and officers of the plan.
Employment Practices Liability

- Covers the Corporation, D&O's and Employees for claims from employees and third parties alleging
  » Discrimination of any kind
  » Wrongful Termination or Discharge
  » Sexual or Other Harassment in the Workplace
  » Failure to Promote or Employ
  » Failure to Provide Adequate Workplace or Employment Policies or Procedures
- Does NOT normally cover ESOP-type claims

Filing before the Equal Employment Opportunity Commission is an administrative prerequisite to proceeding to court in cases alleging violation of Title VII (prohibits discrimination on the basis of race, national origin, sex, religion). The EEOC also receives charges alleging disability discrimination and retaliation.

1. In 2011, the EEOC received the highest number of discrimination charges in its 45 year history approximately 100,000.
2. Retaliation, beginning in 2009, continues to be the most frequently cited form of discrimination. These claims make it easier for plaintiffs' attorneys to avoid defendants successfully disposing of the case through motion practice.
3. The EEOC filed 256 new lawsuits against employers in 2010 and recovered a record $404 million through enforcement and mediation efforts.
4. Disability discrimination charges increased 20% in 2010, likely due to amendments to the Americans with Disabilities Act.
5. Good News: Most EEOC charges dismissed.

Employment Practices Liability: Retaliation Example

An employee complains to his supervisor about insensitive treatment against him which he perceives is on the basis of his race. Subsequently, the employee is terminated. The employee's EEOC charge is very likely to allege that he was discriminated against on the basis of his race and that his treatment after reporting the perceived discrimination was in retaliation for having made the complaint.

• Employee must prove causation.
What These Policies Typically Contain

1. Declarations Page
2. Endorsements
3. Main Policy Form with Standard Terms and Conditions
   » Standard Policy Definitions
   » Policy Exclusions
   » What is Covered
4. Copy of the Completed and Signed Application

D&O, Fiduciary and Employment Practices Liability Insurance

“Claims Made” Issues:

1. Coverage Trigger: For a claim to be considered covered, it must be filed with the insurer while the policy is in effect or during the Discovery or Extended Reporting (ERP) Period pertaining to a Wrongful Act occurring on or after the policy’s Retroactive Date, if any.
2. Pending & Prior Litigation (P&P) Date: Will not cover any claim or litigation filed against insured prior to that date. Date will be shown on the Declaration Page of the policy and date should not change as policy is renewed each year.
3. Coverage Continuity: Addresses both Retroactive Date (if any) and Pending & Prior Litigation Date. If changing insurers, make sure the new insurer will adopt the same Retroactive Date, if any as well as the same P&P Date. Have new insurer accept a completed “renewal application” or agree to waive the warranty question on their main form application regarding previous claim activity.

D&O, Fiduciary and Employment Practices Liability Insurance

“Claims Made” Issues…(contd.)

4. Extended Reporting or Discovery (ERP) Period: If policy is ever cancelled or non-renewed for any reason, insured has the right to purchase from the insurer, an ERP. This allows an insured to file a claim after the policy has been cancelled or non-renewed for a specified time for a Wrongful Act which occurred prior to the date of cancellation or non-renewal. ERP can be one, two or three years. Additional premium is can be negotiable.

5. Change in Ownership: Should a change of ownership occur, the policy will automatically go into the ERP to cover claims involving the prior Plan Sponsor.
**What to Expect When You File a Claim**

**ACKNOWLEDGEMENT**

1. Within 48 hours of tender of the claim to the carrier, a claims representative from the carrier should have made contact with the Insured’s representative designated in the notice or in the Policy declarations.

2. Claims representative will likely want to discuss the substance and history of the dispute. Therefore, upon tendering the claim, the Insured should choose a contact for the Insurer knowledgeable about the dispute.

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**Defense Arrangements- Duty to Defend vs. Indemnity Policies**

1. **Duty to Defend Policy** - Insurer has the right and duty to select and appoint defense counsel on behalf of the insured.
   
   a. May do this through use of panel counsel-a list of law firms approved by the insurance carrier for selection by the insured.
   
   b. Alternatively, the carrier may simply appoint a specific law firm to handle the matter.
   
   c. Company can suggest counsel for approval, especially if high deductible-retention.

2. **Indemnity Policy** - The Insured has the right to appoint defense counsel of its choosing, provided consent is obtained from the insurer.
   
   a. Insured should obtain the consent in writing even if it is by email.
   
   b. Insured may benefit from working with Insurer to retain counsel of its choosing, as Insurer may be able to obtain a better hourly rate, which is advantageous to the Insured as they may be required to pay defense costs under a retention/deductible.
Defense Arrangements-Duty to Defend vs. Indemnity Policies

3. **Hybrid Policy** – The Insurer has the right and duty to select and appoint defense counsel on behalf of the Insured, but the Insured has the ability to opt out and choose its own counsel if it does so within a specified time period (example: 60 or 90 days):

   a. This type of defense arrangement is trending and becoming more and more common.

   b. Allows Insureds who really desire control of retention of defense counsel to have it, but similarly allows Insureds who are comfortable surrendering the process to the carrier, to do so. Some Insureds are not familiar with litigation and the process, and prefer to have the insurance company guide the litigation. In this instance, some carriers are hesitant to recommend counsel to an Insured under an indemnity policy for fear of overstepping the policy.

4. **Counsel Issue Prior to Coverage Commitment** –

   What if the Insurer informs you that it has not yet determined coverage or is still investigating the availability of coverage?

   a. **Duty to Defend Policy** – Consider requesting the Insurer appoint counsel while its investigation into coverage is pending.

   b. **Indemnity Policy** – Consider requesting the Insurer consent to Insured’s choice of counsel while its investigation is pending. Many policies will not cover fees incurred prior to consent, and this avoids that issue once the Insurer does make its coverage determination.

   c. At a minimum, secure counsel. Give example, i.e., inspection.

5. **Reservation of Rights/Declination/Investigation** – Usually, within 30 to 60 days, the Insurer will issue one of the following:

   a. Declination/Denial – issue a declination or denial of coverage under the Policy. The letter of declination should specifically itemize and explain the reason the Insurer maintains no coverage is available under the Policy. (i.e. Insuring Agreement in policy is not triggered, a policy exclusion applies, application or prior knowledge issues).

   b. Reservation of Rights Letter – Generally, accepts the tender and recognizes a coverage obligation under the Policy, but reserves insurer’s rights as it learns more about the matter and as the matter develops to continue to evaluate coverage, including the right to deny coverage at a later date. This letter may also outline some coverage limitations, define retention obligations, etc.
6. Investigative Stance
   a. Insurer may indicate they do not have sufficient information to make a coverage determination.
   b. In this instance, the Insurer will likely reserve rights and should:
      1. Identify what further information it requires, and,
      2. Provide a timeline for how long it will take to make a coverage determination.
   c. Accept as “Notice of Circumstance.”

7. Life of Claim/Resolution
   a. Insurer will work with the Insured and their counsel throughout the life of the claim. Most policies expressly indicate settlements entered into without the Insurer’s knowledge are not covered.
   b. Settlement- Insured should work closely with the Insurer in negotiating any settlement.

8. Consent Clauses (“Hammer Clause”) - Two Types:
   a. If insurer recommends a settlement and Insured refuses, the insurer may limit their exposure to the amount of their recommendation. Anything additional would be excluded.
   b. If insurer recommends a settlement and Insured refuses, the insurer may limit their exposure to a certain percentage applied to the amount which exceeds the earlier recommended amount. Typically, 50% or perhaps higher.
Common DOL Investigation – Insurance Issues
(a) Notice
• The DOL sends an innocuous letter stating that the XYZ Employee Stock Ownership Plan “has been selected for review by this office.”

(b) What to do Next?
• Panic?
• Your time to shine.
• Immediately report to fiduciary insurance carrier
  - Most policies require prompt notice within 60 days or so.
Common Insurance Issues with DOL Investigation

(c) Coverage problem: Many policies include the commencement of a government investigation within the definition of “claim” (although some carriers take the position that there is no duty to defend upon receiving an initial notice of government investigation because a “claim" requires allegation of a “wrongful action” and mere notice from DOL is not enough).

- Investigation can last for years.

(d) Tolling: If requested to toll, involve your insurance carrier. No prejudice to carrier provision.

Common Further ESOP Insurance Coverage Issues

(e) Definition of “Loss.” Definitions differ. Does it include or exclude punitive damages, penalties, fines or multiplied damages, and at 100% or less? Can there be such coverage subject to state public policy?

(f) Who is the Insured? Include Trustees?
(g) Defense control and costs – ability to select counsel, and who pays and when? Eroding policy limits?

(h) Coverage for Injunctive Relief? Section 502(a)(3) of ERISA authorizes an injunction as a remedy for certain claims. Many fiduciary policies do not provide coverage for injunctive – non-monetary relief. Does yours?

(i) Allocation Clauses – Policies differ on whether the insurer has a duty to defend the entire lawsuit if some counts – claims are not covered by the policy. Does yours?

Selecting an Insurance Company

Insurance Companies

• Not all alike. Each have own character.

• Sometimes you get what you pay for.

• Only a few offer fiduciary coverage for ESOP companies and fiduciaries.
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