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Ten Commonly Asked Questions Regarding Fiduciary Liability Insurance

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Fiduciary Liability Insurance is one of the most misunderstood insurance policies. Yet, for an ESOP company, it is one of the most important insurance protection to obtain.

For an ESOP company, fiduciary liability insurance is written to cover the ESOP like most any other qualified retirement plan but the types of claims brought against the policy can be quite different due to the nature of plan's investments. As a result, the number of insurance companies willing to underwrite an ESOP company is limited.

It is important to remember that there is no standard fiduciary liability policy as insurance companies offering these policies usually have their own written form. However, the various forms are common in many respects and so the intent of this article is to help explain the important provisions found in a typical policy.

To help better understand this insurance, provided below are explanations to 10 of the most frequently asked questions that are asked by prospective buyers.

1. What is the difference between the ERISA Bond, Employee Benefits Liability and Fiduciary Liability Insurance?

The *ERISA Bond*, required by Federal law, provides the ESOP and other qualified plans with insurance protection for theft of plan assets by a plan administrator, trustee or fiduciary.

Employee Benefits Liability is insurance protection usually found in a General Liability policy covering the Plan Sponsor for errors or omissions involving the administration of an employee benefit plan, including an ESOP.

Fiduciary Liability is written to provide financial protection to the individual fiduciary or the Plan Sponsor's (employer's) obligation to defend the fiduciaries in the event a claim or lawsuit is brought alleging breach of fiduciary duty as defined under ERISA involving an ESOP or other qualified retirement or health and welfare plan.

2. Who and What is typically covered under the Fiduciary Policy?

Most if not all fiduciary liability policies are written with the intention of covering (i) the Plan Sponsor, (ii) the Insured Plan (must be a qualified plan regardless if it is a retirement or health and welfare plan), and (iii) any past, present or future person serving in a trustee or fiduciary capacity. Most fiduciary policies follow the ERISA definition when defining the covered person (fiduciary) as being any person who has discretionary authority over a plan or who assists in its administration.

3. Can Outside Trustees be covered as well?

In certain circumstances, an outside trustee, that is a person not an employee or director or officer of the Plan Sponsor can be covered in the Plan Sponsor's fiduciary liability policy if added by endorsement. In many cases, however, we have found that fiduciary

liability underwriters are not willing to add a financial institution or similar firm serving as an outside trustee.

4. What special precautions are there for a purchaser of this insurance with the "claims made" form?

Most if not all policies are written using a "claims made" form. Therefore, for a claim to be considered for coverage under the policy, the claim must be filed with the insurer either during the policy or during the extended reporting period, with the occurrence or wrongful act taking place after the policy's retroactive date (if any). If a policy is non-renewed or cancelled, policyholders are well advised to request the insurer to provide an extended reporting period (the policy form typically allows the insured to purchase at least one year) from when the policy ceased providing coverage. Usually there is an additional premium for this extension.

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5. Are "Prior Acts" covered?

If the policy specifically states a "Retroactive Date," usually on the Declarations Page of the policy, then generally, claims stemming from acts committed or alleged to have been committed prior to that date but for which is reported afterwards, will not be covered. Otherwise, absence of a "Retroactive Date" being on the policy and no other policy wording or responses in the policy application which would preclude coverage, the policy should provide coverage for "prior acts."

6. What limit of liability is typically purchased?

Unfortunately, there is no formula when determining what policy limit to purchase. Before making any recommendation, one should consider the size of the ESOP plan assets and/or the amount of assets that are vested, or the value of allocated shares but only in terms of staying within a certain ratio, otherwise it can be costly to think the policy limit needs to be near or close to the sum of any of these criteria.

Two other factors need to be kept in mind. First, as in most fiduciary policies, the payment of defense costs can erode the policy limit that would otherwise be used to pay for a settlement. Policyholders need to determine whether defense costs are paid outside the policy limit or within. Second, since a growing number of fiduciary policies are being sold in a combined policy form with Director's and Officer's and Employment Practices Liability, the sharing of the policy limit will erode the limit if a claim triggers these other coverages. Generally, ESOP companies should purchase a limit that it can afford and they think will provide enough financial protection for the legal costs and any settlement of a claim involving their ESOP.

7. What is the advantage of combining this coverage with others such as Director's and Officer's Liability or Employment Practices Liability?

Cost is perhaps the biggest advantage of combining these three coverages into one policy. Many of the insurance companies offering these three coverages are doing so using a Director's and Officer's Liability Policy as the base policy and endorsing both the Fiduciary and Employment Practices Liability. These policies can be purchased with a separate limit of liability for each of the three coverages or combined. The latter approach is the most economic but provides the least amount of protection.

One other point to make is that if an ESOP company is to purchase both the Director's and Officer's Liability and the Fiduciary Liability, that both coverages should be placed with the same insurance carrier. Quite often when an ESOP company receives a Fiduciary Liability claim or suit, allegations made by the plaintiff or plaintiff group can trigger both coverages. To have them with two distinctly separate insurance carriers has the potential of creating a quagmire when it comes to obtaining defense from the two insurance companies.

8. Can you provide an example of some fiduciary liability claims against ESOP Companies?

Perhaps the biggest type of claim in terms of dollars spent for defense and settlement is when the price per share drops. Fortunately, these claims are not very frequent but when they do happen, large amounts of money is spent by the Plan Sponsor for defense. Plan participants are the likely plaintiffs in these types of

cases. Other examples of fiduciary claims against an ESOP include:

♦ The Department of Labor brought a claim against the plan fiduciaries questioning the validity of the share valuation.

♦ A beneficiary sought compensation from the plan administrator for a benefit amount lost by reason of an incorrect interpretation of the plan.

♦ Claims brought by plan participants alleging the plan sponsor failed to provide adequate information about the poor condition of the related industry prior to the acquisition of stock by the ESOP.

9. What factors or issues are reviewed by the insurance company underwriter when determining whether to offer a proposal for coverage or to determine the annual premium for the policy?

Fiduciary Liability is rated on several factors pertaining to the ESOP. Some of these factors though are somewhat subjective. A careful review of the Plan Sponsor's latest financials and the plan's annual return (Form 5500) will be undertaken. In certain cases, the underwriter may request a copy of the latest share valuation report. The use of an outside Trustee usually does not impact the policy premium in any way. The prospective insured may be required to complete an ESOP questionnaire or supplemental application which will provide additional information specific to their plan. For example:

♦ The underwriter will be interested in whether any other retirement plan was terminated when the ESOP was implemented?

♦ Current asset value of the ESOP plan?

♦ Total number of unallocated shares in the ESOP?

♦ What percentage of shares in the ESOP are allocated to the plan participants?

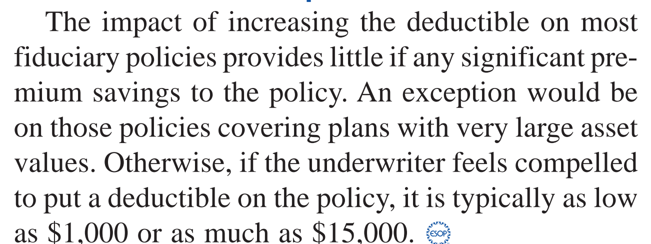
♦ Whether the ESOP is leveraged?

♦ The manner in which the plan participant can "cash out" their shares?

♦ Who is voting the participant shares on major issues faced by the Board of Directors of the Plan Sponsor?

10. What impact does the deductible have on the premium?

The impact of increasing the deductible on most fiduciary policies provides little if any significant premium savings to the policy. An exception would be on those policies covering plans with very large asset values. Otherwise, if the underwriter feels compelled to put a deductible on the policy, it is typically as low as $1,000 or as much as $15,000.



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