Fiduciaries First: Understanding the Scope of Fiduciary Liability Insurance Coverage and New York’s IBM Decision

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The Employee Retirement Income Security Act (ERISA) virtually created the market for fiduciary liability insurance because it both expanded potential liabilities for fiduciaries of benefit plans and—crucially—extended liability to the personal assets of individual fiduciaries. The demand for fiduciary liability insurance largely grew out of a desire to protect fiduciaries from such personal liability. This insurance—focused on protecting individual fiduciaries—by design did not cover a plan sponsor’s non-fiduciary acts, such as making business decisions regarding its employee benefit plans. New York’s high court recently issued a decision that recognized and confirmed this basic limitation in Federal Insurance Co. v. International Business Machines Corp., 965 N.E.2d 934 (N.Y. 2012).

Yet, commentators, carriers and insurance buyers alike continue to criticize the IBM decision as creating a new “gap” or marking a sea change in the scope of coverage. Such criticism does not hold up. The IBM decision is really nothing new. It reflects the traditional terms and function of fiduciary liability insurance—to protect fiduciaries. What’s more, the recent market trend toward expanding the scope of fiduciary liability coverage to plan sponsors may not ultimately serve the best interests of insurance buyers and the primary intended beneficiaries of the coverage—individual fiduciaries of employee benefit plans.

Settlor or Fiduciary: The Sponsor of an ERISA Plan May Wear Multiple Hats

A company that sponsors an employee benefits plan can “wear two hats: one as a fiduciary in administering or managing the plan for the benefit of participants and the other as employer in performing settlor functions such as establishing, funding, amending, and terminating the trust.”1 A plan sponsor acts as a fiduciary when it exercises discretionary authority over the management of a plan or its assets or the administration of the plan. But when a plan sponsor makes business decisions regarding a plan, such as whether to create, fund or terminate a plan, it acts as a settlor, not a fiduciary.

As a settlor, the plan sponsor may pursue the best interests of the company and its shareholders and is not subject to ERISA’s fiduciary duties. As a fiduciary, the sponsor’s
overriding concern must be the best interests of the plan participants. Since ERISA does not impose breach of fiduciary duty liability on a plan sponsor acting as a settlor, it may be asked: why do these differing “hats” matter? Because a plan sponsor can—in rare cases—be liable under ERISA for non-fiduciary acts. For example, settlor acts like amending an ERISA plan may violate ERISA’s “anti-cutback” or anti-discrimination rules.

**The IBM Decision: Fiduciary Liability Coverage for Liability as a Fiduciary**

IBM was sued in a class action alleging age discrimination under ERISA in connection with amendments to IBM’s pension plan—a settlor function. IBM settled the litigation and then sought coverage from its fiduciary liability insurance carriers for the settlement. IBM’s first excess insurer, Federal Insurance Company, filed a lawsuit seeking a declaratory judgment that the settlement was not covered because the class action did not allege that IBM acted in a fiduciary capacity. The Federal policy afforded specified coverage in connection with a “Wrongful Act,” defined, in relevant part, as “any breach of the responsibilities, obligations or duties by an Insured which are imposed upon a fiduciary of a Benefit Program by [ERISA].” Because the class action undisputedly did not concern conduct by IBM in its fiduciary capacity under ERISA, Federal maintained that the class action did not involve a “Wrongful Act.” The Court of Appeals of New York agreed, finding that “[a] straightforward reading of... the ‘Wrongful Act’ definition is that it covers violations of ERISA by an insured acting in its capacity as an ERISA fiduciary.” Since “IBM was not acting as an ERISA fiduciary in taking the actions that gave rise to the allegations” in the class action, but instead was acting as a plan settlor, the New York high court held that there was no coverage for the settlement.

**Reactions to IBM: Separating Fact from Fiction**

Despite its clear and straightforward holding, the IBM decision has generated unwarranted criticism from commentators, insurance carriers and insurance buyers:

- **The settlor capacity issue addressed by the IBM court is brand new, and now companies are suddenly left uninsured for something that always was covered.**

The IBM decision does not create a so-called coverage gap. It recognizes the fundamental purpose of fiduciary liability insurance – to protect fiduciaries from liability for breaches of fiduciary duty under ERISA. Other courts uniformly have agreed that settlor liabilities are not covered by fiduciary liability insurance policies, and IBM cited no cases to the contrary. In fact, as the IBM court noted, IBM’s argument that the policy covered any violation of ERISA whether or not it implicated IBM’s fiduciary capacity, was “strained and implausible” and would expand fiduciary liability coverage to “almost every lawsuit imaginable” against a company that happened also to be an ERISA plan sponsor.

- **Claims often involve a settlor act where no breach of fiduciary duty is pled, and most fiduciary policies pick up such an exposure.**
ERISA plaintiffs can, in rare cases, sue a plan sponsor solely for acts in its settlor capacity. Typically, though, ERISA litigation concerns the plan sponsor’s acts as both a settlor and a fiduciary: for example, the sponsor’s amendment of a plan (a settlor function) and its disclosures about the amendment (a fiduciary function). Such a “mixed action” would trigger – at least – defense costs coverage. And under the policies at issue in IBM, such a mixed action likely would have been covered subject to other common coverage defenses. Virtually none of the fiduciary liability policies on the market would cover the rare case clearly involving only settlor allegations, because it would not allege a Wrongful Act necessary to trigger coverage.

- The primary carrier settled the claim with IBM and paid its entire policy limit toward defense costs and the settlement whereas the excess carrier took a different position and sued the insured.

In fact, the primary carrier did not acknowledge coverage for the underlying action or pay the full limits of the primary policy. Rather, the primary carrier advanced IBM’s defense costs subject to a reservation of rights and at all times disputed the availability of indemnity coverage. The primary carrier ultimately settled its coverage dispute with IBM in exchange for a payment that left over 30% of its policy limits untouched.

**The Landscape of Fiduciary Liability Insurance: Changing for the Better?**

Even before the IBM decision, the fiduciary liability insurance marketplace has been moving toward providing limited coverage for settlor functions – limited to defense costs only or to particular types of settlor conduct. Whether such expansions of coverage will be beneficial for insurance buyers and viable in the long term for the carriers remains to be seen. It is not self-evident that such expansions will really benefit individual fiduciaries, whom the insurance was principally intended to protect.

Costly investigations or litigation focused on settlor issues may drain or completely exhaust the insurance limits available to protect individual fiduciaries from personal liability. Limits adequacy therefore should be a paramount consideration for the insurance buyer in reviewing these newer policy forms. In addition, the settlor coverage afforded under these newer forms may frequently provide very little additional protection. First, claims involving purely settlor issues are rare and, as noted above, mixed cases likely would be covered already. Second, the additional coverage likely extends only to defense costs because the damages recoverable in pure settlor cases are likely to be benefits that would have been due but for the assertedly improper conduct. Such damages would be excluded from coverage by the policy’s “benefits due” exclusion or carved out from the definition of covered Loss. Thus, while insurance buyers often presume “the more coverage the better,” buyers should closely review these newer forms and consider the practical effects of the so-called extensions of coverage and the primary purpose of obtaining fiduciary liability insurance in the first place when selecting the appropriate coverage.
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3 Id.
4 Id.