Governmental Fiduciary Liability Insurance:

PROTECTING TRUSTEES

BY DANIEL ARONOWITZ

N LAST DECADE, the cities of San Diego and Detroit both experienced high-profile insolvencies. Citizens demanded answers and the unfunded liabilities of the respective pension plans represented glaring financial losses. The San Diego City Attorney sued the trustees of the San Diego Employee Retirement System (SDCERS) for violating California conflict of interest laws. Likewise, a class action was filed against the trustees of the Detroit pension plans for allegedly causing the funding gap with imprudent investments.

The trustees of SDCERS asked the city to defend and indemnify them from liability, but the city declined discretionary indemnification. These trustees, who included city employees required to serve on the pension board, were faced with defending a $2 billion lawsuit with their own money and had to sue the city to seek indemnification. By contrast, the trustees of the Detroit pension plans received a quality defense from one of the best law firms in Michigan. The Detroit trustees did not have to spend a single dollar of their own money.

Why did the Detroit trustees receive a city-provided defense, whereas the San Diego trustees had to sue the city for several years of uncertainty to obtain a defense? The difference was the fiduciary liability insurance purchased by the Detroit plans. Indeed, the San Diego and Detroit ordeals demonstrate the limits of governmental indemnification, and why public risk managers should consider protecting their trustee fiduciaries with fiduciary insurance coverage.

FIDUCIARY LIABILITY EXPOSURE

Governmental trustees often believe that they have no fiduciary exposure because the federal Employee Retirement Income Security Acts (ERISA) does not apply to governmental benefit plans. It is true that section 4(b)(1) of ERISA excludes governmental plans from coverage under Title I of ERISA.[1] But even though ERISA does not apply, nearly every state derives its fiduciary standard of care from ERISA or the common law from which ERISA itself was derived.

Virtually every state has adopted the bedrock fiduciary standard from ERISA and the Internal Revenue Code that fiduciaries may be held personally liable for losses to a plan resulting from a fiduciary breach, and may be required to restore to the plan any profits that result from their use of plan assets. Applicable state and common fiduciary law require all contributions to state retirement systems to be held for the exclusive benefit of plan beneficiaries, and cannot be used for, or diverted to, purposes other than the exclusive benefit of plan benefit beneficiaries. Fiduciaries of employee benefit plans have this duty of undivided loyalty to the plan, its participants and their beneficiaries. Under the exclusive benefit rule, trustees of governmental plans must act in a manner that benefits only the participants and beneficiaries of the plan, defrays the reasonable expenses of administering the plan, and avoids unnecessary costs. And further like ERISA, nearly every state has some version of the "prudent person" standard, requiring a fiduciary to act with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Like the duty of loyalty, the prudence laws that apply to governmental plans are nearly identical to the high ERISA fiduciary standard applied to private plans.

THE LIMITS OF GOVERNMENTAL INDEMNIFICATION

Facing this personal fiduciary liability, trustees of employee benefit plans expect to be immune from liability or indemnified by the governmental entity for which they are serving or volunteering their time. But the San Diego crisis teaches that governmental trustees cannot rely on governmental immunity or indemnification when they are sued. Indemnification is never foolproof. In fact, the San Diego lawsuits stemming from the city's bankruptcy reminds us that indemnification has many discretionary limits that place volunteer trustees in potential jeopardy when something goes wrong.

Sovereign immunity is the legal principal that the sovereign or government is immune from lawsuits or other legal actions except when it consents to them. Most states provide sovereign immunity for actions by governmental agents, including trustees who sit on public benefit plans. But there are limits to sovereign immunity protection. Many states, for example, protect fiduciaries only for acts made in good faith; sovereign immunity will not apply for acts considered willful, wanton, reckless, malicious, grossly negligent or in bad faith. Yet other states have broad immunity statutes that have been limited by the courts.

Similarly, many states have indemnification provisions that are designed to protect governmental employees when they are accused of wrongdoing. But like the sovereign immunity statutes discussed above, these indemnification provisions typically have significant limitations and are subject to several levels of discretion. Similar to the law of sovereign immunity, the most common limitation restricts indemnification to official actions taken in "good faith." This standard retains personal liability for "bad faith, willful, wanton or fraudulent misconduct or intentionally tortious conduct."

Both the San Diego and Detroit lawsuits alleged bad faith and intentional acts potentially outside the scope of the indemnification statute. Consequently, indemnification can be lost at the initial pleading stage, long before innocence or guilt can be adjudicated. Most states further require the act in question to have been taken "in the scope of employment" or "to further the purposes for which the board was established." And many states limit indemnification to members of the board of trustees and do not extend liability protection to other officers, agents or employees.

In other states, the indemnification is at the discretion of the governing board of the plan, or delegated to the attorney general or other outside decision maker to decide. Moreover, most states have not resolved the question as to who makes the decision to indemnify, through what process, and subject to what review. Who determines whether the act was taken in good faith can vary from the board of trustees, the attorney general, or the courts. Needless to say, each of these decision-makers creates risk of potential uncertainty to a trustee or governmental employee needing indemnification. Finally, most state indemnification statutes do not address the full scope of indemnification. This silence creates uncertainty as to whether

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defense costs, judgments, penalties and other expenses are covered. Uncertainty also exists as to when defense and other expenses will be paid or reimbursed.

INCREASE IN CLAIMS AGAINST GOVERNMENTAL PLANS

Public fund trustees are increasingly a target of breach of fiduciary duty claims as municipalities and states face funding issues across the country. Indeed, many plans have changed retirement and health benefits for government employees. These changes heighten the prospect that participants will sue plans and their trustees for breach of fiduciary duty. Public fund trustees are also a target of breach of fiduciary duty claims involving imprudent investments or failure to properly manage investments; insufficient funding; reduction of benefits or increase in contributions; denial or improper calculation of benefits; selection or monitoring of service providers; self-dealing or conflict of interests; dishonesty and pay-to-play schemes; failure to collect contributions; administrative

THE KEY FEATURES OF GOVERNMENTAL FIDUCIARY LIABILITY INSURANCE

A fiduciary liability insurance policy is a contract designed to protect trustees against claims alleging breach of their fiduciary duties to the plan, or alleging they committed an error in the administration of the plan. The policy provides two important basic benefits, defense and indemnity: (1) the policy generally pays for the cost of defending trustees accused of violating their duties to the benefit fund; and (2) the policy also indemnifies trustees for their alleged violations of duty and negligent administrative acts or omissions in the event of a settlement or judgment of liability. Many modern fiduciary policies now expand to cover voluntary compliance programs to correct plan mistakes with the Internal Revenue Service and other regulatory agencies to maintain non-profit status, as well as HIPAA and other regulatory penalties.

The key coverage issue is whether the governmental fiduciary policy restricts coverage for claims in which sovereign immunity or indemnification could apply. Labeled different ways, several leading policies restrict coverage for "government-defended claims." These limitation provisions provide that the policy will not provide a defense or indemnity if the governmental plan sponsor is required or permitted to provide indemnification. The San Diego example demonstrates the problem with these provisions. In the lawsuit brought by the San Diego City Attorney, the city council asked the City Attorney—the very plaintiff who brought the lawsuit—whether indemnification was proper. The City Attorney opined on the public record that indemnification was discretionary, and the city council ultimately had insufficient votes to rule in favor of a defense. The coverage under an insurance policy with a government-defended restriction could limit coverage when indemnification is discretionary. Risk managers should seek transparency on this critical coverage issue, which is often not clearly disclosed by insurance companies.

The San Diego and Detroit experiences demonstrate the fiduciary liability exposure of governmental trustees. Governmental trustees are typically held to an ERISA-like standard of care, but cannot fully rely on sovereign immunity or governmental indemnification because of many gaps in the protection. Consequently, the best and only reliable way to protect against personal liability is through the purchase of fiduciary liability insurance. ■

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FOOTNOTE

1 Section 3(32) of ERISA defines governmental plans as any "plan established or maintained for its employees by the government or any state or political subdivision thereof, or by any agency or instrumentality or any of the foregoing."