



Public Sector Trustees: Rethink Your Fiduciary Protection in Today's Litigious Climate

While performing their duties as plan fiduciaries, trustees of public sector health and retirement plans have traditionally relied on sovereign immunity and indemnification for protection. Although these protections are theoretically strong, they have limitations. This publication examines those limitations and argues that, especially in today's environment, public sector plan assets, and the personal assets of plan trustees and employees, may not be adequately protected unless fiduciary liability insurance is purchased.

In the wake of the 2008 financial crisis, trustees of public sector plans have had to make difficult decisions on such challenging issues as funding, payouts, service fees, investment strategy and participant disclosure. There are already examples of lawsuits or government investigations addressing these issues and seeking remedies, such as monetary damages, fines or penalties. This activity underscores the importance of consulting with legal counsel on the adequacy of trustees' existing fiduciary protection and how that might be strengthened by fiduciary liability insurance.

Sovereign Immunity and its Limitations

Sovereign immunity is a traditional legal doctrine dating back to the era when kings and emperors had absolute power. It means a government entity cannot be sued unless it (the government entity) authorizes the lawsuit. Today, the dimensions and limitations of sovereign immunity are spelled out in the statutes and court decisions of the states.

Sovereign immunity is a very technical legal concept that has been addressed in amendments to the U.S. Constitution, federal laws, and numerous case law, including U.S. Supreme Court decisions. State laws increase the complexity. Sovereign immunity sounds good, but it comes with many conditional clauses that raise questions about whether, when, where, and how sovereign immunity will apply. If it does apply, the legal costs associated with its affirmation may be very high because any plaintiff will challenge it as a defense.

Several ongoing lawsuits against the trustees of a large Midwestern retirement system demonstrate the limitations of sovereign immunity. One is a certified class-action lawsuit. A second is a derivative action, which means the plaintiff is the benefit plan. Both lawsuits argue sovereign immunity should not apply because gross negligence is alleged. This also jeopardizes indemnification. While the final outcome is unknown, these cases highlight that sovereign immunity can

The Fiduciary Shield is a publication prepared by The Segal Company's National Fiduciary Liability Insurance Practice. This is the first issue for sponsors of public sector plans. We hope you find the information in *The Fiduciary Shield* informative and useful. Comments and suggestions are welcome. Contact information appears near the bottom of the next page.

be challenged. For these defendant trustees, insurance may be the only real protection available to them.

Moreover, for plans subject to the Uniform Management of Public Employees Retirement Systems Act, Section 11, which establishes a fiduciary's personal liability, is intended to waive any sovereign immunity defense.¹ So, for example, the trustees of a retirement system may not be protected from liability if a court or jury decides that the fund incurred losses due to the trustees' gross negligence. Typically, indemnification would also be denied on this basis. For the defendant trustees in such an action, insurance may be a valuable alternative or safety net.

Clearly, it may be naive for a trustee to assume that sovereign immunity will always be available.² Legal counsel should be consulted to help trustees fully understand the scope and limitations of sovereign immunity for a specific employee benefit plan, trustees and staff.

Indemnification and its Limitations

Indemnification means a government entity will use public assets to pay for the defense, settlements or judgment against any defendant public employee. Many states will pay the costs of defense and any damages awarded against public officials who are sued over the way they discharge their responsibilities, but exclude indemnification for acts outside the scope of employment, such as willful, wanton or fraudulent misconduct, gross negligence, criminal activity, and any act that would create a specific conflict of interest between the public entity and the employee.³

Equally important, many states appear to limit any indemnification to members of the retirement system's board of trustees and do not extend liability protection to other officers, agents

¹ See the comments on page 43 in the draft of the Uniform Management of Public Employee Retirement Systems Act by the National Conference of Commissioners on Uniform State Laws: <http://www.law.upenn.edu/bll/archives/ulc/mopepf/retirsys.pdf> Section 10, which is referenced, is now Section 11 of the Act.

² For more information, see the answers to the question "Is your retirement system's liability limited by sovereign immunity statutes?" on page 4 of the Results of NASRA Survey on Liability Coverage Held by Public Retirement Systems: <http://www.nasra.org/resources/insurancesurvey.pdf>

³ For example, see California Gov. Code §995.2.(a), Delaware code Title 29, Chapter 8308(j)(1)-(2), Illinois code 5 ILCS 350/2(b) or Maryland Code Annotated, §21-207.

or employees. Because public sector plans are not subject to the Employee Retirement Income Security Act (ERISA), this is determined under each state's own laws and court rulings. The adjacent text box lists some key questions that trustees of public sector plans should ask.

Fiduciary Liability Insurance's Additional Protection

Fiduciary liability insurance should be considered because it provides defense, settlement and judgment coverage in accordance with the policy's terms and conditions, which is greater certainty of protection than either sovereign immunity or indemnification. A typical policy reads, "The Company shall pay ... all sums which the Insured shall become legally obligated to pay..."⁴

Note the phrase "shall pay" which is stronger than permissive language found in almost all public sector entity indemnity provisions. The insurance policy clarifies that the insurer's obligation includes defense costs, settlements, and judgments. Based upon typical policy language, if a covered claim is properly submitted, at least defense costs will be available for any breach of fiduciary duty lawsuits, even if the pleadings allege willful or wanton violations, gross negligence and, in certain instances, even criminal violations. Coverage for any settlements or judgments is less certain and its availability will depend on the specific facts and policy language.

Whether fiduciary liability insurance is permitted depends on applicable law. Each state's laws must be individually researched on a periodic basis.

Where fiduciary liability insurance is permitted, the scope of coverage purchased is critical because *not all fiduciary liability policies are the same*. The following three examples, all of which have a direct impact on the trustees and administrative staffs of public sector plans, demonstrate this:

- **Waiver-of-Recourse Provision** In any state with a provision equivalent to ERISA §410,⁵ such as California Code §7511, the trustees need to insist that the policy have a waiver-of-recourse provision. Failure to address this waiver issue may result in the purchase of insurance that will ultimately fail to protect the trustees' and employees' personal assets.
- **Individuals Covered** Policies may limit coverage to either the trustees or the trustees plus scheduled (*i.e.*, specified) administrative positions.

⁴ This language is from Chubb, form 14-02-3817 (Edition 01/01/1990).

⁵ Section 410 of ERISA (29 USC 1110) voids any "hold-harmless" clause as being against public policy, but allows plans to purchase insurance as a first source of recovery for the plan, which, as a practical matter, often eliminates the need to seek recourse against the liable individuals. It also allows the individuals to purchase their own insurance with non-plan assets to cover any residual personal liability. This is now known as the waiver-of-recourse provision. See <http://www4.law.cornell.edu/uscode/29/1110.html>

Key Questions about Applicable Laws

The following are some key questions that need to be asked and answered in an appropriate legal format:

- What are the state's statutory and other applicable laws that define a trustee's responsibilities and liabilities?
- Do state laws of the participants' residency apply?
- What federal laws apply?
- Is "employee" defined to include plan trustees and employees? For example, will it include a plan trustee or employee of an independent school district?
- Does the plan have appropriate legal opinions identifying the scope of any indemnification or immunity protections, including any limitations?
- If indemnity is provided, will the public agency absorb the cost or, ultimately, charge it back to the trust assets?

- **Defense-Only Coverage** Some policies only provide defense coverage. In this structure, the plan trustees or employees must fund any settlement or judgment either personally or using other non-insurance sources.

To be meaningful, fiduciary liability insurance must be properly designed. This requires the use of an expert insurance broker who knows the insurance product and the public sector industry group.

Conclusion

Today more than ever before, public sector trustees and staff are confronted by numerous, complex issues. In the current climate, the assumption that sovereign immunity or indemnification provides adequate protection must be examined. Fiduciary liability insurance, when properly designed with the help of an expert, offers real defense, settlement and judgment coverage. It is additional protection a public sector plan, its trustees and employees need to have.



Segal can assess current coverage, work with boards of trustees to determine adequate protections and negotiate insurance. For more information about these services and fiduciary liability insurance for jurisdictions, contact Brian L. Smith, head of Segal's National Fiduciary Liability Insurance Practice at 212.251.5333 or bsmith@segalco.com.

The Fiduciary Shield does not provide legal advice or a binding interpretation of coverage. While sections of California code were referenced, other sections may have equal or greater applicability. State and local governments should always rely on their legal counsel for authoritative advice on all issues involving the interpretation or application of laws and regulations.