"WATCHING THE WATCHERS" FIGUCIARY LIABILITY AND PRIVATE PENSION PLANS

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I. INTRODUCTION:

Fiduciary liability in regard to pension plans is a relatively new risk for insurers, based on old legal principles founded in common law. In a post-ENRON world, coupled with the emergence of class action lawsuits, a recent financial crisis and startling reports of pension meltdown, the number of fiduciary liability claims has increased, and will continue to climb.

This paper is written in two parts, both exclusive to the context of private pension and retirement income plans in Canada and the United States.[1] First, we offer a basic introduction to fiduciary liability and the pension legislation which governs it in both Canada and the U.S., rounding off the discussion with a review of claim concepts via a review of pertinent caselaw. The second part of the paper addresses the emerging risk management tool of fiduciary liability insurance. We review the basics of coverage, including the grant of coverage itself, as well as the defined terms and the basic exclusions common to every policy of fiduciary liability insurance. These key elements are reviewed to explain what and why fiduciary liability policies are specific to the risk. Finally, the convergence of fiduciary liability and other kinds of insurance, including directors and officers liability insurance is briefly examined.

Although this review of fiduciary liability and insurance concentrates on the Canadian experience, it is impossible to write about this topic without reference to a large and very active body of American jurisprudence in this area. Over the course of this paper, we cite caselaw from both the Canadian and American Courts at all levels to illustrate the common law basics and coverage issues. Many Canadian companies have a U.S. subsidiary or are subsidiaries themselves of American companies; cross-border claims scenarios are not uncommon. As both governments wrestle with the economic issues and pension reform, the judicial lessons from the American Courts take on increased relevance in Canada.

II. BASIC PRINCIPLES

A. WHAT IS FIDUCIARY LIABILITY?

Fiduciary liability begins with the concept of the fiduciary, a term derived from Roman law. In a nutshell, the concept of the fiduciary is based on a relationship between individuals in which one individual, the fiduciary, is empowered by statute or contract

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[1] Private pension plans in Canada are also known as registered pension plans, employer-sponsored pension plans, workplace pension plans or occupational pension plans. Any reference to pension plans in this paper is to private pension plans unless stated otherwise.

to exercise a degree of control over the other, namely the beneficiary. In the context of private pension plans, persons acting as fiduciaries may include financial planners, directors and officers of a company, pension plan administrators and managers, and trustees. The most critical point to remember is that a fiduciary is defined by the nature of their relationship with others and not by a job description.[2] The characteristics of a classic fiduciary relationship are best described by Wilson J. in the Supreme Court of Canada decision of *Frame v. Smith*:[3]

> 1) *The fiduciary has scope for the exercise of some discretion or power.*
> 2) *The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests.*
> 3) *The beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.*

Certain relationships in law are presumed to be fiduciary relationships, such as trustee-beneficiary, solicitor-client and principal-agent.[4] These classic fiduciary relationships impose duties on the fiduciary towards the beneficiary which are among the highest standards of duty imposed by law.

As discussed at length further in this paper and in the context of Canadian private pension plans, plan administrators act as trustees. In that role, they are guided by contractual obligations in the pension plan, or the trust instrument, by statute and by the common-law (or civil law) of contracts and trust. As for general requirements, the trustee must act in good faith towards all beneficiaries, must be impartial to all beneficiaries, and must never either profit from his own position or have a conflict-of-interest as a trustee. In the seminal ruling in the English House of Lords in *Boardman v. Phipps*[5], the no-profit, no-conflict rule for fiduciaries is described:

> [T]*he fundamental rule in equity* [is] *that a person in a fiduciary capacity must not make a profit out of his own trust which is part of the wider rule that a trustee may not place himself in a position where his duty and his interest may conflict.*

These duties are a code of conduct for trustees, reinforced by common law and enshrined in the applicable statutes at both the federal and provincial levels in Canada.[6]

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[2] *Blue Line Hockey Acquisition Co. v Orca Bay Hockey Ltd. Partnership* 2008 BCSC 27.
[3] [1987] 2 S.C.R. 99 at para. 40, 42 D.L.R. (4th) 81.
[4] *Perez v Galambos* 2008 BCCA 91.
[5] [1967] 2 A.C. 46, [1966] 3 All E.R. 721 as quoted in *Guaranty Trust C. of Canada v. Berry* 19 C.P.C. 157, [1980] 2 S.C.R. 931 (S.C.C.).
[6] Both provincial and federal pension plan legislation codify the conflict of interest rule: for example, the *Saskatchewan Pension Benefits Act*, 2004 c. 24 Section 11(2) states that plan administrators must "*act in good faith and in the best interests of members…and shall not prefer the interests of one person…over the interests of any*

B. WHAT IS FIDUCIARY LIABILITY INSURANCE?

In the context of private pension plans, fiduciary liability insurance is a relatively newer form of professional liability insurance now available to protect both companies and the individuals who function as fiduciaries in managing private pension funds for others. Fiduciary liability policies are "claims-made and reported" policies specifically designed to provide financial protection against legal liability arising out of the administration of benefit or pension plans. The policy provides coverage for losses sustained by the plan as a result of a wrongful act committed by a fiduciary – the policy does not guarantee the positive obligation on the part of the plan to pay benefits. Typical fiduciary liability policies cover plan administrators and managers, but do not provide coverage for third-party service providers, such as independently retained actuaries or accountants.

The need for fiduciary liability insurance flows from several direct causes. A rapid rise in both the number and severity of claims against fiduciaries in the last decade occurred because aging baby boomers and the trend towards early retirement put pressure on limited pension resources, and the result has been actuarial shortfalls. This trend may reverse itself as job losses and pension shortfalls result in a longer stay in the workforce. The rollercoaster performance of the stock market has led to under-funded plans on one hand, or on the other hand, to an actuarial surplus. In both cases, plan members will sue pension plan administrators and corporate sponsors of the plan. As well, class action lawsuits make it easier for beneficiaries as a group to pursue fiduciaries for allegations of mismanaged funds. The class action lawsuit has been called the perfect weapon for pensioners and beneficiaries in a dispute with corporations.

The most critical indicator of the need for fiduciary liability insurance are statutory penalties in both Canada and the U.S. Under the America federal statute, the Employment Retirement Income Securities Act (hereinafter "ERISA"[7]), fiduciaries may be *personally liable* for losses due to a fiduciary breach as defined. That the personal assets of the fiduciary are "on the line" is by itself enough to merit the need for fiduciary liability coverage. Under various provisions in ERISA, pension plan fiduciaries could face fines up to $100,000.00 and 10 years in prison.[8] Under federal law in Canada, similar fines apply for contravention of the statute governing national

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other person so entitled". The federal *Pension Benefits Standards Act* R.S.C. 1985 c. 32 (2nd Supp) codifies the conflict of interest rule in Section 8(6)-(9).

[7] All references to particular ERISA sections follow the United States Code (or "U.S.C.") section numbers in Title 29, Chapter 18 of the U.S.C.

[8] ERISA Section 1131 (1).

pension funds.[9] In the various provincial statutes described at length later on in this paper, penalty provisions include fines up to $200,000.00 for contravention of provincial law. With the advent of class action lawsuits, and "tagalong" claims (that is, ERISA claims which "follow on" the filing of a securities class action against Directors and Officers, alleging "stock-drops" or misrepresentation of corporate financial health) the need for coverage is self-evident.

Claims under fiduciary liability policies will arise from a variety of circumstances, including:

- failure of the fiduciary to make adequate disclosure and/or lack of reporting to plan members;
- mismanagement by the fiduciary of pension fund investments, which might include premature termination of the plan or failure to diversify plan assets;
- failure by the fiduciary to deal with surplus (where plan assets exceed liabilities) according to the terms of the plan;
- failure by the fiduciary to deal with shortfalls (or underfunding of the plan);
- personal conflict of interest of the fiduciary in regard to pension fund investments;
- failure of the fiduciary to act in the best interests of all classes of plan members, including employees and retirees;
- subsidiary or successor companies failing to protect pension plan members, interests which may include improper use of surplus funds; and
- allegations of inappropriate or excessive fees to administer or manage the plan (where fees are paid by plan participant accounts).

The second part of our paper addresses the fundamental ingredients of a fiduciary liability policy, including defined terms, the insuring clause and the most common exclusions in this type of policy.

C. OVERVIEW OF PRIVATE PENSION PLANS IN CANADA

Legislation in Canada and the U.S. dealing with private pension plans is discussed at length below. Private pension plans in Canada are generally of two kinds, defined benefit plan or defined contribution plan, each discussed below, although there are hybrid or combination plans which combine characteristics of both types.

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[9] *Pension Benefits Standards Act,* R.S.C. 1985, c. 32 (2nd Supp) Section 38. Provincial laws also have various penalty provisions.

1. Defined Benefit Plan or Defined Continuation Plan

A defined pension benefit plan defines the pension benefit to be provided to the employee when they retire. That benefit is defined by a specific formula based on years of work, years of plan membership, age of retirement and pay, among other variables. Oftentimes the formula will be based on the average salary of the employee in the last years of employment. This method is called the "*best or final average earnings*" method. The formula can also be based on "*career average earnings*", where the benefit is based on a percentage of each year's pensionable earnings over a career. A final formula is called the "*flat benefit*", where the member gets a specific dollar amount of benefit for each year of pensionable service. In all cases, the employee receives a defined amount of pension after retirement, and this is usually in the form of an annuity. The defined benefit plan places the long-term risk on the employer; in some cases the employee may not even be required to contribute to the plan.[10]

In Canada, defined benefit plans are usually funded in one of two ways; funds can be held in trust, or held by an insurance company. In an insured plan, the insurance company receives the payment and bears the risk of shortfall, undertaking to pay the benefits to members even if there is a difference between benefits promised and funds available to pay the benefits. When the plan is funded through a trust, the employer contracts with a trust company, which holds and invests the pension contributions, subject to a trust agreement.[11]

2. Defined Contribution Plan

A defined contribution plan is a type of plan in which employer and employee contributions are defined, as opposed to defining the amount of pension income that the member receives when they retire. A defined contribution plan is also known as a "money-purchase plan" in Canada. This kind of plan provides an individual account for each participant. Pension benefits are derived from defined contributions to the account made by the employee and employer, and those contributions are based on salary. The amount of contributions is specified and the account balance increases with investment income until retirement. The defined contribution plan is self-directed; the American "401(k)" is the best-known example of this kind of plan. The benefit the employee receives is determined when they retire and based on accumulated contributions, investment income and annuity rates. The sum collected in the individual account is most often used to purchase an annuity to provide a regular pension income

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[10] Cochrane, J. "*The Rise and Decline of Defined Benefit Pension Plans*" (The Advocate - November 2007) provides an overview of this kind of plan in Canada.
[11] *Buschau v. Rogers Communications Inc*. 2006 SCC 28 (at paragraph 14).

after retirement. As opposed to the defined benefit plan, the defined contribution plan places the risk squarely on the employee.[12]

While the defined benefit plan was popular in the 1970s and 1980s, defined contribution plans are now more common in both Canada and the United States. The defined benefit plan is being phased out by major employers, including heavy-hitters such as Nortel (in its heyday), because it places far greater burdens on trustees and administrators, as well as the corporate sponsor. This kind of plan costs more for any employer to maintain, especially as life expectancy has increased. Further, the defined benefit plan requires either (or both) an investment manager to manage the long-term liabilities of the investments and an actuary to calculate the financial needs of the plan, again over the long-term. Actuarial reports are mandated in provincial legislation across Canada for defined benefit plans. These requirements combine to place a much greater burden on administrators of defined benefit plans than on the self-managed, defined contribution plan. In the U.S., dozens of class-action lawsuits have been filed by beneficiaries against employers, relating to the conversion of the defined benefit plan to the defined contribution plan. The so-called "pension conversion" are most often framed as age discrimination cases, not as fiduciary liability claims.

Breach of fiduciary duty claims can arise in both defined benefit and defined contribution plans. When faced with disappointing investment returns, "self-directed" 401(k) plan sponsors or defined contribution plan sponsors in Canada can be the subject of fiduciary liability claims if there is a perceived failure to provide plan members with enough information to make good investment decisions. Part of the claim against corporate giant WorldCom was that fiduciaries allowed the 401(k) plan to continue to offer corporate stock as a plan investment, even as accounting irregularities were exposed.[13] Recent changes to ERISA have been deemed "safe harbor" provisions – discussed later in the paper - to protect fiduciaries involved with self-directed 401(k) plans who provide proper information to participants in plans that allow for default investments in the absence of election by the participant.[14] At present, there are no equivalent "safe harbor" provisions in Canadian legislation.

[12] Office of the Superintendent of Financial Institutions (or "OSFI") - "*Pension Guide for Members of Federally Regulated Private Pension Plans*" (February 2007).
[13] *Judy Wilson Rambo, et al v. WorldCom. Inc., et al* No. 3:02-CV-1088 (S.D. Miss) and S. Kalinowski and S. Nickerson, "*Taking Stock*" (Benefits Canada) 2006 <http://www.benefitscanada.com>
[14] ERISA Section 1104 (c).

D. NON-STATUTORY FIDUCIARY GUIDELINES

In addition to the legal framework for pension plans discussed in the next section, there are a myriad of tools available to assist administrators of private pension plans at both the federal and provincial level in Canada. The Canadian Association of Pension Supervisory Authorities (or "CAPSA") has published governance guidelines to help administrators of private pension plans in their role.[15] These "best practice" guidelines cover broad areas and are intended to apply to all private pension plans in Canada. The guidelines are very general and make it ultimately clear that it is the responsibility of the individual administrator to tailor the guidelines to the specific plan. The guidelines cover the following broad areas:

- investment decisions for capital accumulation plans;
- fiduciary responsibilities for the administrator;
- governance objectives for the management of the plan;
- performance measures;
- access to information requirements for members;
- risk management and internal control systems;
- compliance with statute and the plan documents; and
- accountability and transparency guidelines.[16]

The Office of the Superintendent of Financial Institutions ("OSFI") has also published guidelines for members, and best practices for administrators of federally regulated pension plans. These guidelines explain, in general terms, the minimum standards which apply to all federally regulated private pension plans and provide "prudent" governance practices. Each provincial regulatory authority publishes guidelines on their respective web-sites. In summary, the CAPSA and OSFI guidelines for plan administrators contain recommendations without legislative or regulatory authority. However, faced with a fiduciary liability claim, a private pension plan administrator will certainly be in a better position if the appropriate guidelines have been followed than if they have not.

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[15] CAPSA – Guideline No. 4 - *Pension Plan Governance Guidelines* (October 2004) – available at <http://www.capsa-acor.org>.

[16] CAPSA - *Guidelines for Capital Accumulation Plans* - the "CAP" Guidelines (May 2004) –available at <http://www.capsa-acor.org>.

III. THE STATUTORY FRAMEWORK:

A. CANADA – INTRODUCTION

In Canada, private pension plans are regulated by either federal or provincial law, depending on the type of employer. Private pension plans of certain federally regulated occupations are controlled by federal law. Complementing this regime, each province (with the exception of Prince Edward Island) has its own statutory scheme regulating the administration and governance of private pension plans for those employers not subject to federal control.[17] More than 90% of Canada's pension plans fall under provincial regulation. In Quebec, both the common-law and that Province's Civil Code govern the administration of the plan and how plan documents are interpreted in certain circumstances, for example, how and when employers deal with surplus assets under the plan, contribution holidays and amending the plan.

1. Federal Legislation

The *Pension Benefits Standards Act* R.S.C. 1985, c.22 (along with the accompanying Regulations[18]) governs the private pensions plans of employees in the various provinces who work in federally regulated occupations, such as in the banking sector, certain types of transportation and telecommunications that cross provincial boundaries, and maritime shipping. This group also includes Crown Corporations, and any other undertaking declared by Parliament to be for the general advantage of Canada (for example, the mining of uranium is a federal undertaking) The federal Act applies as well to private pensions in the Yukon, Northwest Territories and Nunavut. All other private pension plans, which are by far the majority of pension plans in Canada, fall under provincial jurisdiction. OSFI supervises all private pension plans under federal jurisdiction, as well as all banks and financial institutions in Canada. As of March 2007, there were 1,332 private pension plans federally regulated and overseen by OSFI, involving 582,000 employees.[19] In general then, the federal statute governs the terms and conditions of a formal pension plan, the minimum funding requirements of the plan and the investment of plan assets. Most recently, the federal government announced it was considering pension reform to make pensions more sustainable in the long run, including giving federally regulated companies extra time to repay pension shortfalls.

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[17] Prince Edward Island has not yet proclaimed its pension legislation.

[18] *Pension Benefits Standards Regulations*, 1985.

[19] 2007 *Annual Report* – OSFI at page 57. As of May 2008, those numbers had increased to 1,354 pension plans covering 586,675 active members (as per information provided directly by OSFI to the authors).

The *Income Tax Act,* R.S.C. 1985, c.1 (and accompanying Regulations) also applies to private pension plans. This Act mandates the preferential tax shelter provided for private pension plans until the benefits are paid to the member. The scheme shelters only those plans registered under the applicable provincial statute *and* the *Income Tax Act.* As the Supreme Court of Canada has stated:

> *Pension benefits…serve broader social goals…[t]ogether with government programs and individual savings, pension plans provide an aging population with invaluable financial support. In recognition of the social value of such an investment, pension contributions receive special tax treatment.*[20]

Simply put, employer contributions to a registered pension plan are tax-deductible (to a fixed maximum), while contributions by an employee to a registered pension plan are not considered taxable income until withdrawals are made. Under this Act, plan administrators must meet specific requirements for ongoing reporting, including an annual report with regard to the numbers of members and assets of the plan. However the *Income Tax Act* does not legislate a standard of care for the fiduciary/administrator of a private pension plan in Canada.

2. Administration and Standard of Care

Like its provincial counterparts, the federal *Pension Benefits Standards Act* dictates that private pension plans falling under federal jurisdiction are overseen by plan administrators. The standard of care of a federal plan administrator and how investments are to be managed is described as follows:

> *8(4) In the administration of the pension plan and pension fund, the administrator shall exercise the degree of care that a person of ordinary prudence would exercise in dealing with the property of another person.*
>
> *8(4.1) The administrator shall invest the assets of a pension fund in accordance with the regulations and in a manner that a reasonable and prudent person would apply in respect of a portfolio of investments of a pension fund.*

The administrator must invest the assets of a plan as would a reasonable and prudent person and if the administrator possesses a particular level of knowledge or skill, he or she is mandated by Section 8(5) of the federal statute to "*…employ that particular level of knowledge or skill in the administration of the pension plan or pension fund*". This wording implies a higher standard of care for those administrators who possess relevant qualifications or expertise.

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[20] *Buschau v. Rogers Communications Inc.* 2006 SCC 28 (at paragraph 13).

3. Funds in Trust

The plan administrator acts a trustee for the employer, the members of the plan, and for anyone entitled to pension benefits under the plan. The federal statute states that assets of the pension fund are held in trust for the members and the employer, and are administered by the administrator as a trustee for both:

> *8(3) The administrator shall administer the pension plan and pension fund as a trustee for the employer, the members of the pension plan, former members and any other persons entitled to pension benefits or refunds under the plan*

Pursuant to the federal statute, the employer must keep all monies in a private pension plan separate and apart from its own funds and hold those amounts in trust. These assets are held either by an insurance company or in trust by a trust company. In 2006, this overlap of common law trust principles and the governance of pension plans led to the seminal Supreme Court of Canada decision in *Buschau v. Rogers Communication* (supra), which limited the application of trust laws in the pension context, and which is discussed below.

B. PROVINCIAL LEGISLATION

Each province in Canada, with the exception of Prince Edward Island, has its own pension statute regulating provincial pension plans, i.e. those private plans not falling under federal jurisdiction. The private pension sector in Canada is thus governed by differing provincial guidelines, while national umbrella organizations such as CAPSA are involved in ongoing efforts to simplify and harmonize a myriad of pension plan regulations and federal and provincial laws across the country. The nine provincial statutes set the minimum standards for private pension plans in each jurisdiction; the laws share many features and mandate requirements for every step of pension administration, from the cradle of registration to the grave of winding-up. Common characteristics of the nine statutes are summarized below.[21]

1. Administration

Each common law province appoints a Superintendent to monitor registered plans within the jurisdiction.[22] In general, the Superintendent can terminate a plan at a specific date, appoint a plan administrator, or act as one during the winding up of a

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[21] Each Act is also accompanied by Regulations which must be read in conjunction with each Act; this section highlights provisions in the Acts only.

[22] Private pension plans in Quebec are monitored by the "*Regie des Rentes du Quebec*".

plan, and must be informed if surplus assets are transferred to the employer. The Superintendent in each jurisdiction operates within a provincial regulatory authority, for instance, the Ontario Financial Services Commission. Each of the provincial regulators has numerous policies, bulletins and resources available to plan administrators.

With the exception of Quebec, every statute also provides that an "administrator" administer, or in other words manage the affairs of any plan registered under the statute in accordance with the legislated scheme. Under Quebec civil law, a "pension committee" fulfills this function.[23] Some statutes allow for the employer to act as the administrator of the plan in certain circumstances.[24] However, the employer has separate duties even when it wears the "two hats" acting as both fiduciary/administrator and employer/sponsor of the plan. The Ontario Court of Appeal recently affirmed this principle:

> *In a traditional single employer pension plan, the employer is both plan sponsor and plan administrator. These distinct roles give rise to separate duties.*
>
> *In its role as plan sponsor, the employer decides whether to establish a plan and on its funding design. As plan sponsor, the employer owes no fiduciary duties to plan members. In deciding whether to establish or terminate a plan, in defining the categories of employees who are eligible for membership, and in determining what benefits will be offered, the sponsor may act in its own interests and may prefer the company's interests over those of the employees.*[25]

Importantly, both the Superintendent in each Province and the plan administrator serve the common purpose of maintaining the continued solvency of pension plans for the protection and benefit of all members.[26]

The administrator, in simplest terms, stands in the position of fiduciary to the members of the plan. Some Acts define the role categorically, for instance, legislation in Alberta, Saskatchewan and B.C. states explicitly that the administrator is a fiduciary (although

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[23] The *Supplemental Pension Plans Act* R.S.Q., chapter R-15.1, s. 147.
[24] For instance, provincial legislation in Newfoundland, Saskatchewan, Manitoba, Alberta, and B.C.
[25] *OMERS Sponsors Corp. v. OMERS Administration Corp.*, [2008] O.J. No. 425 (Ont. S.C.J.) – the same principles are espoused in *Patrick v. Telus Communications Inc.*, 2006 BCSC 854, 2006 B.C.J. No. 1243 (B.C.S.C.).
[26] The Supreme Court of Canada has recently pronounced on the powers of the Superintendent in cross-jurisdictional cases: *Boucher v. Stelco Inc.* 2005 SCC 64.

the term "fiduciary" is not defined by statute[27]). In terms of the legislated minimum standard of care, at least seven Acts state that the administrator must exercise the care, diligence and skill that a person of ordinary prudence would exercise when dealing with the property of another. This "prudent person" standard is similar to the standard of care required of trustees in estate trust legislation in the provinces.[28] For example, section 8(5) of the B.C. *Pension Benefits Standards Act* defines the responsibilities of the administrator / fiduciary of private pension plans as follows:

> *(5) In the administration of a pension plan, the administrator must*
>
> *(a) act honestly, in good faith and in the best interests of the members and former members and any other persons to whom a fiduciary duty is owed, and*
>
> *(b) exercise the care, diligence and skill that a person of ordinary prudence would exercise when dealing with the property of another person.*

At least six provincial Acts supplement the "ordinary prudence" standard of care with a complimentary section stipulating that special knowledge and skill shall be applied. For example, section 22(2) of the Ontario *Pension Benefits Act* states:

> *Special knowledge and skill*
> *(2) The administrator of a pension plan shall use in the administration of the pension plan and in the administration and investment of the pension fund all relevant knowledge and skill that the administrator possesses or, by reason of the administrator's profession, business or calling, ought to possess.*[29]

This standard is mirrored at the federal level in the *Pension Benefits Standards Act*.

2. Registration and General Requirements

A pension plan must be registered under the applicable statute for the statute to apply. Each Act stipulates that the Superintendent must receive and approve of the application for a plan, and the filed pension plan documents must contain standard provisions before the plan can be registered, including those relating to contributions or method of calculation of contributions, methods of determining benefits payable, other benefits

[27] Section 13 (5) of the *Alberta Employment Pension Plans* Act, R.S.A. 2000, c. E-8; Section 44 (2) of the B.C. *Pension Benefit Standards Act,* R.S.B.C. c. 352; Section 11(2) of the *Saskatchewan Pension Benefits Act*, 1992, C. P-6.001.

[28] The Trustee Acts of various provinces now mandate a "prudent" standard of care for trustees for investments made pursuant to an estate trust – the trustee must exercise the care and skill of a prudent investor in administering a trust.

[29] Ontario *Pension Benefits Act* R.S.O. 1190, c P.8.

and rights of members under the plan (such as how and when benefits accrue), retirement age or vesting requirements and how the plan itself is to be administered, among other general requirements.

3. Funds in Trust

All nine provincial Acts state that pension funds held by the employer are either "deemed to be held in trust" or are held "in trust" with respect to members. These funds are comprised of employer contributions, or monies withheld from an employee under the plan arrangements for employee contributions. Some Acts mandate that employer contributions must be kept separate and apart from the employer's own assets; other acts are silent on this requirement.

4. Membership and Vesting

Each of the provincial Acts sets out eligibility requirements for membership in a registered pension plan, founded squarely upon the length of employment (usually 2 years) and the employee achieving a minimum percentage of yearly pensionable earnings (usually 35%). Most acts allow for a separate plan for part-time employees. Minimum vesting requirements – when a members' right to benefits under the plan crystallize – are also set out in the provincial legislation. Vesting occurs when a member reaches a pensionable age, when a plan is terminated, or when membership in a plan terminates, among other circumstances.

5. Funding and Investments

Each Act specifies the minimum funding requirements for a pension plan with the goal of maintaining solvency (in other words, the ability to provide for payment of all member benefits at any given time). The majority of provincial Acts make express provision that defined benefit pension plans must meet solvency requirements and be appropriately funded at all times.[30] This solvency requirement has recently made national headlines as the world-wide economic crisis and plunging stock markets mean pension solvency is at historic lows.

[30] Section 48 of Alberta's *Employment Pension Plans Act,* R.S.A. 2000, c. E-8, Section 41 of B.C.'s *Pension Benefits Standards Act*, Section 40 of the Saskatchewan *Pension Benefits Act*, 1992, c.P-6.001, Section 26(1) of Manitoba's *Pension Benefits Act* C.C.S.M. c.P32, and Section 136-141 of the Quebec *Supplemental Pension Plans Act*, R.S.Q. c. R-15.1.

6. Surplus Assets of a Plan

The transfer of surplus assets in any registered provincial plan to the employer is subject to strict guidelines in each Act; a condition precedent to a transfer in most Acts is the notification and approval of the respective provincial Superintendent. Quebec's legislative treatment of surplus assets is the most strict. Any use of surplus assets of a plan to fund a change to the plan must be equitable for *all* members, whether active or non-active, and their beneficiaries. Some Acts require that pension plan members must approve the transfer (for instance, B.C. requires at least two-thirds of membership consent).[31]

7. Winding Up and Termination

The treatment of plan assets and liabilities upon termination or winding-up of the plan or upon employer withdrawal from a plan is critical to members. The Superintendent (or the "Regie" in Quebec) must be involved, and strict notice provisions apply to administrators in every province. The respective provincial Acts make provisions for private pension plans to be partially terminated. Once the plan is terminated, winding-up and distribution of assets must commence immediately but again only in an approved manner.

8. Conclusion re: Provincial Acts

Many Canadian companies have workers in different provinces. Each provincial government has agreed on the importance of reciprocity in overseeing various plans which in turn avoids administrative quagmire; if the majority of employees work in one province, that regulatory authority and statute prevail and the Superintendents' decisions are final.[32] That jurisdiction is then responsible for the administration and regulation of that particular plan. Overall, the civil-law jurisdiction of Quebec has the strongest legislation in Canada in terms of pension governance, use of surplus assets and solvency tests, as per recent amendments to its *Supplemental Pension Plans Act,* although many of the most stringent provisions will not come into effect until 2010.[33]
Most recently, the Province has announced it will take over the management of insolvent pension plans and guarantee income to pensioners for at least five years afterwards.

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[31] Section 61 of the B.C. *Pension Benefits Standards Act,* R.S.B.C. 1996, c. 352.
[32] *Boucher v. Stelco Inc*., [2005] 3 S.C.R. 279, 2005 SCC 64.
[33] Bill 30, *An Act to Amend the Supplemental Pension Plans Act*, adopted by the Quebec National Assembly in December 2006.

C. UNITED STATES

1. Overview of Federal ERISA Legislation

Unlike Canada, where there is no over-riding legislated code of minimum standards applying to private pension plans, the federal ERISA statute is the foundation of any fiduciary liability claim in the United States. Since its passage into law in 1974, this one statute has spawned entire industries in retirement and pension planning, both on the litigation side, and in terms of plan management and design. A complete review of the ERISA statute is beyond the purview of this paper, however since much of the fiduciary liability caselaw cited in this paper is American, it is important to review the legal basics of ERISA to understand the claims and lawsuits that result.

As its' name suggests, ERISA was designed to protect the interests of employees or beneficiaries. The statute is enforced by the U.S. Department of Labor. ERISA codifies the duties and requirements of fiduciaries (known under Canadian statute as, the "administrator"), and coverage under fiduciary liability policies in the United States flows from the duties and obligations laid out under this one law. In other words, ERISA sets the standard for pension plan regulation in the U.S. However, it does not apply to all pension plans. Plans administered by federal or state governments are not subject to ERISA. Under certain circumstances, the federal ERISA statute will pre-empt state law: for instance, federal Courts have exclusive jurisdiction to hear claims in regard to enforcing provisions of a plan.[34] Similar to provincial and federal pension plan legislation in Canada, ERISA does not mandate employers to establish plans, nor set a minimum level of benefits, but it does regulate the operation of a pension plan once it is established.[35]

In 2006 a new U.S. federal statute, the *Pension Protection Act of 2006* was signed into law, effective for plan years beginning on or after January 1, 2008.[36] This Act amends ERISA in many ways, including provisions in regard to fiduciary liability. The Act allows for "fiduciary advisors" to provide investment advice to a plan and its participants regarding plan assets, for a fee, provided the advice is given by fiduciary advisors meeting specified requirements.[37] As well, plan fiduciaries are relieved of liability for certain investment options, provided participants in the plan were given notice and had sufficient time to make alternative investment decisions; these "safe harbor" provisions in regard to defined contribution plans are discussed later in this paper.

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[34] *Funk Manufacturing Company and John Deere Health Benefit Plan v. Franklin et al,* 261 Kan. 91 (927 P2d 944) (Kansas Supreme Court).
[35] ERISA Section 1102 (a)-(c) includes a description of requisite and optional features of a plan.
[36] The *Pension Protection Act of 2006* (Public Law No. 109-280).
[37] The *Pension Protection Act of 2006*, Title VI, Section 601.

2. Definition and Duties of Fiduciary under ERISA

Under ERISA, the definition of fiduciary is very broad. It is defined based upon function of the actions of the fiduciary, not just its' job description. This is akin to the common-law definition in Canadian jurisprudence on fiduciaries. Under ERISA, a person is a fiduciary if he or she:

- holds and exercises any *discretionary* authority or *discretionary* control respecting the management, administration or disposition of a plan or its assets; or
- renders investment advice for a fee with respect to the plan.[38]

In every ERISA case involving an alleged breach of fiduciary duty, the first question asked by the Court is not how the beneficiary or members interests were affected, but whether the person in question was performing a fiduciary function when taking the action that caused the complaint.[39] The key element of the definition is the exercise of discretionary authority or control over the plan or its assets. The Court will review how the fiduciary made decisions and if discretion was exercised relating to the protection of the interests of participants in the plan. The mere disbursement of plan funds to beneficiaries is not an exercise in discretion, nor is the performing of mere administrative functions and benefit claims processing.[40]

The duties of a fiduciary under ERISA are very broad, and like the Canadian counterparts, are based on the prudent standard of care:

> *1104. Fiduciary duties*
> *(1) Subject to sections 1103(c) and (d), 1342 and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and –*
> *(A) for the exclusive purpose of:*
> *(i) providing benefits to participants and their beneficiaries; and*
> *(ii) defraying reasonable expenses of administering the plan;*
> *(B) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man 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;*
> *(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so…*

[38] ERISA Section 1002 (21)(A) (i)-(iii)
[39] *Pegram v. Herdrich* 530 U.S. 211, 120 S. Ct. 2143 (2000).
[40] *Tie Communications, Inc v. First Health Strategies, Inc,* 1998 WL 171126 (D. Kan.1998).

The fiduciary must discharge his or her duties solely in the interest of the participants of the plan, and exclusively for the purposes of providing benefits to participants (and their beneficiaries) and defraying reasonable expenses of administering the plan.[41] Similar to the Canadian pension legislation, the standard of care of fiduciaries under ERISA is that of a "prudent person" but the definition goes further and states the fiduciary is presumed to be acting with the care, skill, prudence and diligence under the circumstances then prevailing, in a like capacity, in an enterprise of like character and with like aims. Courts have determined that this is not the standard of a prudent lay-person, but instead it is an objective standard of a prudent fiduciary with similar experience dealing with a similar enterprise. One U.S. court noted that:

> *In sum, courts have construed the "prudent person standard" under ERISA as an "objective standard, requiring the fiduciary (1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions.*[42]

This is most critical in the management of fund investments (especially in light of the penalty provisions discussed below).

3. Violation and Penalties under ERISA

The need for fiduciary liability insurance coverage is obvious under ERISA; fiduciaries who do not follow the principles of conduct and who breach the standard of care set down in the statute may be *personally liable* to restore losses to the plan or to restore any profits made through improper use of plan assets.[43] The personal liability is codified in the statute. The law also makes reference to equitable or remedial relief for breach of fiduciary responsibilities, obligations and duties as the Court may deem appropriate, including removal of the fiduciary. The ERISA statute allows for a plan, a fiduciary or an employer or employee organization to purchase insurance coverage for fiduciaries to cover liability or loss for breach of fiduciary obligation.[44] However, this entitlement is limited. No fiduciary can have a "hold harmless" agreement, or contract out of potential liability. Any legal instrument that purports to do this is void as against public policy.[45] In comparison, Canadian legislation does not address fiduciary liability insurance and coverage.

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[41] ERISA Section 1104 (1) (A) – (D).
[42] *U.S. v. Mason Tenders Dist. Council of Greater New York* S.D.N.Y. 1995 (909 F. Supp 882).
[43] ERISA Section 1109(a).
[44] ERISA Section 1110(b).
[45] ERISA Section 1110(a).

The Civil Enforcement provisions in ERISA list the civil penalties for violations by fiduciaries of the prudent standard of care.[46] A civil action may be brought by a participant or beneficiary to recover benefits due to him under the terms of the plan, to enforce rights under the terms of the plan or to clarify future rights. The federal Secretary of Labor can assess a penalty against a fiduciary that has breached his fiduciary responsibilities up to 20 percent of the applicable recovery amount.[47] In comparison, under Canadian provincial and federal legislation, a contravention of the applicable legislation is deemed an "offence" and fines will result. As an example, under the *Pension Benefits Standards Act* in British Columbia, the maximum penalty to be imposed is $100,000.[48] Under the Ontario legislation, the maximum fine is $200,000.[49] Some fiduciary liability policies offer specific coverage for the civil penalties under ERISA for breaches of fiduciary duty. Many Canadian policies do not expressly cover civil penalties pursuant to Canadian law, however, depending on the wording of the policy, coverage may result if the relevant Canadian laws are similar to ERISA.

ERISA also provides for criminal penalties; a willful violation of the statute may lead to 10 years imprisonment and an individual fine up to $100,000 (USD) or a fine of up to $500,000 (USD) for a corporation.[50]

Uniquely, ERISA has a self-correcting mechanism. The "Voluntary Fiduciary Correction Program" is designed to allow employers and plan fiduciaries the chance to correct certain ERISA violations, including delinquent contributions and sale of plan assets in violation of the statute. Under the program, fiduciaries must restore to the plan the principal amount involved plus the greatest of either lost earnings or plan profits. The number of lawsuits alleging breaches of fiduciary liability under ERISA in the U.S. speaks loudly for the number of fiduciaries that take advantage of the program. There is no Canadian legislation equivalent to the Voluntary Fiduciary Correction Program.

4. "Safe Harbor" Provisions

The *Pension Protection Act of 2006* referenced earlier amended ERISA to provide limited "safe harbor" provisions for fiduciaries of self-directed private pension plans. The amendments to the fiduciary duty provisions apply to plans with automatic enrolment and participant investment direction provisions. The "safe harbor" is for plan

[46] ERISA Section 1132, in particular Section 1132(l).
[47] ERISA Section 1132 (l)(1).
[48] *Pension Benefits Standards Act* RSBC 1996, c. 352, Section 72.
[49] *Pension Benefits Act,* R.S.O 1990, c. P-8, Section 109 - 110.
[50] ERISA Section 1131.

fiduciaries who oversee plans involving participants who fail to exercise investment decisions when required by the plan. There are strict criteria and notice requirements for members in relation to qualified "default" investments. The individual account holder is deemed to have exercised control over plan assets in his account, in the absence of any election, if the assets were invested according to the regulations.

In a 2006 decision of the Seventh Circuit in the U.S. of *Jenkins v. Yager*[51], the Court clarified that plan fiduciaries who meet their fiduciary obligations can use the "liability shield" in ERISA which states that no fiduciary shall be liable for any loss which results when a plan participant or beneficiary exercises control in participant-directed plans.[52] Specifically, Section 1104 (c) states that "*…if a participant or beneficiary exercises control over assets in his account* [they} *shall not be deemed a fiduciary and …no person who is otherwise a fiduciary shall be liable under this part for any loss …which results from such participant's or beneficiary's exercise of control*". The Court determined that in those circumstances a fiduciary may not be in violation of the statute even if the self-directed plan inadvertently fails to meet the criteria for participant-directed accounts, as long as the fiduciary otherwise met his or her fiduciary obligations.[53]

Once again, Canadian law makes no such provision. To date there are no "safe harbor" provisions in Canadian pension legislation specifically applicable to defined contribution pension plans, and some have suggested that the CAP Guidelines (discussed earlier) should be legislatively endorsed to provide similar protection to plan sponsors and fiduciaries.[54]

IV. FIDUCIARY LIABILITY COMMON-LAW CONCEPTS

The four common-law concepts discussed below are meant to provide the framework for a typical Canadian fiduciary liability lawsuit, although American caselaw is also used to illustrate the expansion of fiduciary liability.

A. PARTIES TO A CLAIM FOR BREACH OF FIDUCIARY LIABILITY

The question of who has standing to bring a claim for breach of fiduciary duty is not a simple one. In Canada, the usual plaintiffs are members (or beneficiaries) of the pension plan, meaning those eligible under the specified plan for benefits, (which may include

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[51] *Jenkins v. Yager & Mid America Motorworks, Inc,* No. 04-4258 (7th Circuit, U.S. C.A., 2006).
[52] ERISA Section 1104 (c).
[53] *Jenkins v. Yager & Mid America Motorworks, Inc (supra)*.
[54] 4 W.B.P Robson "*Safe Harbours: Providing Protection for Canada's Money-Purchase Plan Sponsors*" (C.D.Howe Institute) No. 110 – January 2008.

survivors or spouses). Under federal law, the Superintendent may also bring a claim that a member, former member or any other person entitled to a benefit could bring.[55] Certain provinces allow for the provincial Superintendent to take action against the employer, or against the administrator if pension plans are being administered improperly.[56]

Under ERISA, a civil action can be brought by plan beneficiaries or participants, by the Secretary of the Department of Labor or by one fiduciary against another (under the breach of duty provisions).[57] However, recent U.S. case law may further expand this group to include plan participants who have already "cashed-out" of a self-directed plan. In the case of *Graden v. Coxenant Systems Inc.*[58], the U.S. Court of Appeals, Third Circuit, determined that a former employee had the statutory standing to sue plan fiduciaries not only for what was in his contributory pension account when he retired, but also what "*should have been*" in the account. The Plaintiff alleged that the mismanagement of the assets, namely the recommendation to direct money into a stock fund which ultimately dropped in value, caused a loss that harmed not only him but other plan participants. The appellate Court granted the Plaintiff standing to bring the suit – a very recent example of the expansion of beneficiary rights under the common law of fiduciary liability.

While breach of fiduciary liability claims are most often made against pension plan administrators and managers, there is an increasing likelihood that fiduciary liability claims will be made directly against the directors and officers of the company itself. Many directors and officers liability policies now contain an express exclusion for ERISA-type claims, which leaves a gap in coverage unless a stand-alone fiduciary liability policy is purchased by the insured. This coverage gap is discussed later in this paper.

B. REPRESENTATIVE ACTION

Because of the numbers of people affected by pension plan litigation, the class action is evolving as an effective litigation tool for plaintiffs in fiduciary liability claims. This "one for all" method of trying cases is cost-effective for litigants, allows greater "access to justice", and is a more efficient use of limited Court resources and time. However, the certification process, common to all provincial statutes governing representative

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[55] Section 33.2(1) of the *Pension Benefits Standards Act,* R.S.C. 1985 c.32.

[56] For instance, under the *Ontario Pension Benefits Act,* R.S.O. 1990 c. P-8, the Superintendent may make Orders and institute proceedings or hearings via the administrative auspices of the Financial Services Tribunal.

[57] ERISA Section 1132 (1)-(2) Civil Enforcement.

[58] *Graden v. Coxenart Systems Inc.* C.A.3 (N.J.), 2007.

actions, can be a high first hurdle for all potential plaintiffs. Canadian Courts appear willing to certify a fiduciary liability claim as long as the representative plaintiff demonstrates that class members have no conflict of interest, which can be difficult in pension cases where members shared differently in, for instance, surplus distribution or where success for some class members would not mean success for all. In a recent Ontario case, the Superior Court refused to certify a class proceeding in a breach of fiduciary duty claim where there were conflicting financial interests of active versus retired members, and between various sub-groups of pensioners.[59] The judge determined that because any resolution of the issues would have different effects on certain subgroups of plaintiffs, the resulting conflict of interest made the class action impossible to certify.

If standing is achieved, who does the Plaintiff represent when he or she brings a claim for breach of fiduciary liability? The main issue in every breach of fiduciary liability case is the financial soundness of the plan itself; restoring the plan is the object of the exercise. The U.S. Supreme Court has determined that beneficiaries bring claims under the statute for the benefit of the plan itself, and no extra-contractual or punitive damages flow to the successful beneficiary.[60] In a recent Ontario ruling, the Superior Court determined that the appropriate remedy for breach of fiduciary duty (or breach of trust) was return of the assets to the trust fund established in respect of a private pension plan.[61] In *Sutherland v. Hudson's Bay Company,* the Court commented that the class members could not directly receive damages or equitable compensation in the form of surplus assets prior to the termination of the plan.

An interesting case in the context of representative versus individual proceedings was recently decided in the U.S. In February 2008, the U.S. Supreme Court ruled in a majority decision that an individual participating in a defined contribution plan – a 401(k) – had the right to pursue an individual action against the fiduciary that failed to make certain changes to his investments as he directed.[62] The Court reasoned that since the majority of pension plans are now individual investment accounts (the kind not contemplated by the original drafters of ERISA), the claimant could bring his suit on an individual basis. The Court stated "*…whether a fiduciary breach diminishes plan assets payable to all participants...or only to persons tied to particular individual accounts, it creates the kind of harms that concerned [ERISA] draftsmen…*".[63] The Court drew a strong distinction between the defined benefit plans, which used to dominate the pension

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[59] *MacDougall v. Ontario Northland Transportation Commission* (2007) 31 C.P.C. (6th) 86; 56 C.C.P.B. 296 (Ont S.C.) - leave to appeal to the Ontario Court of Appeal and Supreme Court of Canada refused.
[60] *Massachusetts Mut. Life Ins. Co. v. Russell* U.S. Cal., 1985.
[61] *Sutherland v. Hudson's Bay Co* (2007) 60 C.C.E.L. (3d) 64, 61 C.C.P.B. 171 (Ont. S.C.J.).
[62] *LaRue v. DeWolff, Boberg & Associates Inc.* U.S. Supreme Court – No. 06-856.
[63] *LaRue v. deWolff* (supra) at page 7.

landscape and the modern reality of defined contribution plans. It held that the civil penalty provisions of ERISA that allow a plan participant to sue a fiduciary applied in the defined pension benefit context and authorized recovery for fiduciary breaches that affected the value of plan assets in an individual account.[64] In the end, the Court ruled that in any event, any recovery of plan assets is still paid back to the plan, not directly to the participant. That is, the statute did not provide a remedy for individual injuries, distinct from plan injuries, but will allow recovery for fiduciary breaches that impair the value of plan assets in an individual account.

Whether this case will open the floodgates to similar litigation in Canada over alleged fiduciary breaches in defined contribution plans remains to be seen. For insurers, the unwelcome prospect is not so much the potential damages, but the combination of damages, expense and time to defend multiple legal actions in regard to every plan. As the law develops, fiduciary duties in Canada may be imposed on plan administrators who delegate the management of defined contribution plans to external parties or who do not provide the right kind - or breadth - of advice in regard to investment options.

C. CONVERGENCE WITH TRUST LAW

In Canada, cases alleging breach of fiduciary liability are legally framed as breach of trust cases. In its 1994 decision in the *Schmidt v. Air Products of Canada Ltd*[65] case, the Supreme Court of Canada ruled unequivocally that a pension plan can be a true trust, and as a result, pension plans, are subject to trust law principles. At issue were two separate pension plans and the fate of a substantial surplus left over after all the benefits had been paid out under both plans. The Court first reviewed the competing claims to the pension surplus and the plans themselves to determine if the surplus funds were imbued with a trust. One of the two plans constituted a clear declaration of an intention to form a trust; the employer had instituted a contributory benefit plan (a money-purchase plan) incorporating a trust fund administered by a trustee. Under the second plan a trust was never created, entitling the employer to both a contribution holiday and a portion of the surplus.

More recently, the Supreme Court of Canada has narrowed the scope of trust law concepts applicable to pension cases. In the 2006 decision of *Buschau v. Rogers Communications Inc.* (supra), the Court reviewed a corporate takeover that included the retroactive merging of an existing defined benefit plan and contribution holidays taken by the company due to a large surplus. Pension plan members demanded that the surplus be distributed directly to members and began litigation that lasted over 10

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[64] ERISA Section 1132 (a) (2), namely "Civil Enforcement – Persons entitled to bring a civil action".
[65] *Schmidt v. Air Products of Canada Ltd.*, 994 CarswellAlta 138, [1994] 2 S.C.R. 611 (S.C.C.)

years. The members argued that the ancient trust law rule allowing members of a trust to terminate it (known as the *Saunders v. Vautier* rule) should apply. The B.C. Court of Appeal found that the plan could be rightfully terminated by members, even though neither the trust agreement nor the pension plan expressly provided for the termination by employees. The majority of the Supreme Court of Canada overturned the appellate decision and found, in summary, that:

> *[A] pension trust is not a stand-alone instrument. The Trust* [used to fund the pension plan in question] *is explicitly made part of the Plan. It cannot be terminated without taking into account the Plan for which it was created and the specific legislation governing the Plan. Any recourse available to members here is subject to the provisions of the federal statute.*

The Court found that federal pension law, especially as it applied to the termination of plans and distribution of assets, could *not* be superseded by a rule in the traditional common-law of trusts which would allow beneficiaries of a trust to depart from the original intentions of the trust. Neither the plan in question, nor the trust document itself provided for termination by employees. The Court held that in the heavily-regulated scheme of private pension plans, where termination of the plan was dealt with explicitly by federal legislation, the beneficiaries could not circumvent the legislation via an ancient common law trust principle.

D. COSTS IN PENSION CASES – WHO PAYS WHAT

The question of who pays costs in pension cases involving allegations of breach of fiduciary duty is critical; the evidence is often complex, trials can take many weeks and costs can soar as a result. In 2007, the Ontario Court of Appeal ruled that there is no special rule or presumption that entitled plan members to have pension litigation, including allegations of fiduciary liability, financed by the plan. In *Kerry (Canada) Inc. v. Ontario Superintendent of Financial Services*[66] the Court first reviewed the type of claim being made. The Court held that if the claim was being brought by either plan members or even the administrator for the benefit of all beneficiaries, then costs were properly payable out of the fund, as a legitimate expense of ensuring that the fund was properly administered. In a more recent decision on costs, the Ontario Superior Court allowed unsuccessful pensioners to have substantial costs paid out of the pension plan, due in part to public policy arguments and the novel aspects of the case not previously addressed by Canadian Courts. In *Sutherland v. Hudson's Bay Co.*[67] the Court ruled

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[66] *Kerry (Canada) Inc. v. Ontario (Superintendent of Financial Services)2007 ONCA 605* (leave to appeal to the Supreme Court of Canada granted, case number 33205, January 31, 2008).

[67] 2007 C.E.B. & P.G.R. 8254, 60 C.C.E.L. (3d) 64, 61 C.C.P.B. 171 (now under appeal to the Ontario Court of Appeal), and the costs decision in the same case of: *Sutherland v. Hudson's Bay Co.* 2008 WL 474950 (Ont S.C.J.)

against beneficiaries in a "classic" pension case brought by the members in regard to the employer's contribution holidays, but the decision is now under appeal.

In considering entitlement to costs, Courts will review both the actions of fiduciaries and plan provisions to determine whether or not fiduciaries are to be indemnified from the pension plan for costs in actions alleging a breach of fiduciary duty. Generally, fiduciaries are entitled to indemnity for all costs out of the plan, including solicitor-client costs, in proceedings in which the administration of the plan is raised, as long as the fiduciary has acted prudently and properly. If the fiduciary has acted in bad faith, or been negligent, no indemnification will follow.[68]

V. THE BASICS OF COVERAGE – AN INTRODUCTION TO FIDUCIARY LIABILITY COVER

The preceding review of the statutory framework and legal concepts applicable to fiduciary liability cases leads to a discussion of the primary risk management tool available to fiduciaries and administrators of private pension plans, namely fiduciary liability insurance. Fiduciary liability insurance is completely distinct from other kinds of insurance; for example, fidelity bonds are required by ERISA but they do not protect fiduciaries from liability claims and function only as insurance against "dishonesty" situations.

A. THE APPLICATION AND UNDERWRITING CONSIDERATIONS

There is no standard fiduciary liability insurance application form or policy in the marketplace to date; insurers in both Canada and the United States offer competitive products with differing coverage and exclusions. However, the policies and the applications for coverage have certain common features as summarized below. From an underwriting standpoint, the kinds of information below are most critical to the risk assessment process, and are required on every application for fiduciary liability cover.

- **General Information including**
  Type and Nature of Business
  Age of Business
  Ownership and management structure including subsidiaries
  Geographical location (including where incorporated)
  Financial Information (including annual and interim financial statements)

[68] *Deans v. Thacuk (* 2005) ABCA 368 (leave to appeal to the Supreme Court of Canada refused).

- **Plan Information**
  Age of Plan and Plan History
  Plan Type
  Total Assets
  Annual Contributions
  Participants (number)
  Identification of Administrators, Managers, and other professionals

- **Plan Administration**
  How Plan Assets are Managed
  Investment Managers
  "Outside" Management (including actuarial and legal)
  Performance indicators for management
  Surplus and transfer mechanisms

- **Regulatory Compliance**
  Compliance with Statutes (Federal, Provincial or ERISA equivalent)
  Compliance History
  Outstanding Payments

- **Plan Changes**
  Pending transfers, mergers or terminations of Plans
  Pending amendments to Plans (including reduction in benefits or cash conversions)

- **Plan Activities**
  Pending claims or plan amendments which may require coverage
  Statutory breaches (including ERISA or equivalent, actual or anticipated)
  Administrative or Regulatory Inquiries (actual or pending)

- **Loss History**
  Including date of loss, type of allegation, description of allegation, status, and defence and indemnity costs
  Recent fiduciary liability policies and claims circumstances

- **Continuity of Coverage or Current Coverage**
  Current policy in force and most recent application form

A renewal or replacement application for existing fiduciary liability coverage will be just as specific about the plans and persons involved as the main application itself. Likewise, the application form will use the same definitions (with the same meaning) as the policy itself.

The most critical information considered during the underwriting process for fiduciary liability insurance is the status of the pension plans themselves. An application form for fiduciary liability insurance contains a section to describe - in great detail - each pension plan, including its assets, status and type of plan. The insurer will require plan information including total assets, annual contributions, total participants and the most recent actuarial reports and annual or quarterly reports for the company. The application requests information in regard to overdue employer contributions or plan changes (including administrative changes and any terminations or mergers) in the previous years. Pricing and premiums for fiduciary liability insurance are based on data in the application, including plan assets, contributions, past claims, past losses and the company's funding practices.

B. THE GRANT OF COVERAGE

All fiduciary liability policies are "claims-made and reported" policies; the policy responds only to claims first made against the named insureds, and reported by them, during the policy period or, if applicable, during any optional extension period. The "claims-made and reported" policy, offering a fixed period of coverage, allows both the insurer and insured the opportunity to regularly evaluate and modify scope of coverage. Most fiduciary liability policies are renewable on a year to year basis, which allows for a continuity of coverage for the insured.

1. The Insuring Clause

The following samples of insuring clauses from fiduciary liability insurance policies currently available in the marketplace contain the essential terms and definitions that form the cornerstone of these policies. The clause will set out the kind and degree of fiduciary liability coverage provided by the insurer. Insuring clauses refer to the essential elements of the policy. Samples of insuring clauses and their critical terms, including "insured", "plans", "claim", "loss" and "wrongful act" are discussed separately below.

Sample 1**:**

The Underwriter shall pay on behalf of the Assureds, Loss resulting from any Claim first made against an Assured during the Policy Period, or, if exercised, during the Optional Extension period set forth in Clause XIII, for a Wrongful Act by an Assured, or, by any natural person for whose Wrongful Act committed, attempted, or allegedly committed or attempted such Assured is legally responsible, provided the Claim is reported to the Underwriter pursuant to Clause VII. Notification of this Policy, and subject to the other terms, conditions and limitations of this Policy.

Sample 2:

In respect of a loss resulting from a wrongful act which an insured individual(s) becomes legally obligated to pay on account of any claim first made against him or her during the policy period and reported to the Company during the policy period or discovery period, the Company shall pay: on behalf of the insured individual(s), as and to the extent permitted or required by the applicable law, the loss for which the insured individual(s) are not indemnified by the insured organization or the plan; and on behalf of the insured organization or the plan, the loss for which the insured organization or the plan has granted indemnification to such insured individual(s) as and to the extent permitted or required by the applicable law.

Sample 3*:*

Solely with respect to the Claims first made against an Insured during the Policy Period or the Discovery Period (if applicable) and reported to the Insurer pursuant to the terms of this policy, and subject to the other terms, conditions and limitation of this actual or alleged Wrongful Act by any such Insured (or by any employee for whom such Insured is legally responsible).policy, this policy shall pay the Loss of each and every Insured arising from a Claim against an Insured for any

Sample 4:

The Insurer shall pay on behalf of the Insureds all loss which the Insureds have become legally obligated to pay by reason of a Claim first made against them during the Policy Period or, if elected, the Extended Reporting Period, for any Wrongful Acts by the Insureds, or by any employee for whom such insured is legally responsible, provided the Claim is reported to the Insurer as set forth in Section IX below.

2. Who is an "Insured"?

Fiduciary liability insurance covers organizations and the people who work for them. Typically, the definition of "Insured" includes reference to natural persons, meaning individuals including pension committee members, administrators, trustees, employees and other natural persons (who may be specifically included by, and referred to in, an endorsement to the policy). The definition may refer to spouses of the insured and other named organizations, chief among them the employer (the sponsor of the plan). External trust companies who manage the plans via a trust agreement may also be named and covered. As well, subsidiaries and other organizations specified in the declarations will be included under the definition. Usually, subsidiaries are separately defined as companies of which the named insured company owns 50% or more of the voting stock. As discussed below, the issue of coverage for subsidiaries will often depend on a temporal issue, that is, the Court must determine whether an entity is a subsidiary under a fiduciary liability policy and at what time.[69] The one "given" in insurance law - that any ambiguity in language in a policy will be interpreted as against the insurer - means that the broader the definition, the better for those seeking the protection offered by fiduciary liability insurance.[70]

Three sample definitions of "Insured" from fiduciary liability policies currently available in the marketplace are as follows:

> Sample 1:
>
> Insured Person(s) means:
> *1. Any natural persons, who were, now are, or shall become duly elected or appointed pension committee members, trustees, directors de facto or otherwise, officers or employees of the Company or any Benefit Program or, with respect to a Subsidiary incorporated or a Benefit Program established outside Canada or the United States of America, their functional equivalents, or, any natural persons in an equivalent position in the event the Company is operating in a foreign jurisdiction; and 2. any other natural persons listed by specific endorsement.*
>
> Sample 2:
>
> *Insured(s) means:*
> *1. any natural person insured;*
> *2. any Plan(s);*
> *3. the Sponsor Organization;*
> *4. any other person or entity in his, her or its capacity as a Fiduciary, Administrator or trustee of a Plan who is included in the definition of "Insured" by specific written endorsement attached to this policy.*
>
> Sample 3:
>
> ***"**Assureds**"** means:*
> *1. the Company,*
> *2. the Benefit Programs, and*
> *3. the Insured Persons***.**

In the first two samples, "other insureds" are referenced by specific endorsement. The policy containing Sample #3 defines "company" most broadly as both the parent company and any subsidiaries of the parent company. "Benefit program" means any employee benefit plan or any government benefit plan and "Insured Persons" is defined as natural persons who "*were, now are, or shall become duly elected or appointed pension*

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[69] *Mary Kay Holding Corp. v. Federal Holding Co.* 2007 WL 4179313 (N.D. Tex).
[70] *Scott v. Wawanesa Mutual Insurance Co.* [1989] 1 S.C.R.

committee members, trustees, directors de facto or otherwise, officers or employees of the company or any benefit program…". This definition refers specifically to natural persons, the organization and the plan.

The definition of fiduciary is another cornerstone of a fiduciary liability policy. Sample wordings of the definition from Canadian and American policies follow:

> Sample 1:
>
> *"Fiduciary" means any person or entity having fiduciary responsibilities with respect to the governance or management of a Benefits Program or the disposition of its assets, including, without limitation, a fiduciary as defined in ERISA, an administrator, a member of a pension committee or a member of a pension council* © Dolden Wallace Folick LLP 33 *as defined by the Pension Benefits Standards Act, R.S. 1985, c.32 and, in the province of Quebec, a member of a pension committee.*
>
> Sample 2:
>
> *"Fiduciary" means a fiduciary as defined in ERISA with respect to a Plan, or a person or entity who exercises discretionary control respecting the management of a Plan or the disposition of its assets.*
>
> Sample 3:
>
> *"Fiduciary" means any person who has or exercises discretionary authority or control over the management of any plan or its assets and who therefore is subject to fiduciary obligations under the applicable law.*

The fiduciary is generally defined as an individual with management or governance responsibilities for the plan, and who exercises discretion over its assets, pursuant to applicable law. The key to the definition, as reflected in the common law discussed earlier in this paper, is the element of discretion. Therefore, the definition is most policies is a "functional" one, relating to performance, not job title. The term "fiduciary" is most often referenced in the definition of "wrongful act", as discussed below. It is important to note that the definition of fiduciary contains no reference to time, that is, there is no restriction on when the fiduciary began or ended their relationship with the sponsor or employer.

3. What Plans are Covered?

The word "plan" is a defined term in every fiduciary liability policy but the definition differs from policy to policy. Two sample definitions follow:

Sample 1:

A pension plan as defined in ERISA which was, on or prior to the inception date of the policy, and on or prior to the Effective Time, sponsored solely by the Sponsor Organization, or sponsored jointly by the Sponsor Organization and a labour organization, solely for the benefit of the employees of the Sponsor Organization, provided that at any time prior to the inception date of this policy such plan has been reported in writing to the Insurer by the Named Sponsor pursuant the terms of the application for this policy, or any prior policy or its application issued by the Insurer and the Named Sponsor shall have paid any required premium relating to such plan.

This definition uses American wordings slightly modified for the Canadian market to provide coverage for any "ERISA type plan" and its fiduciaries. The Regulatory Compliance provision in some applications for fiduciary liability insurance requires the applicant to state whether the plans meet all regulatory requirements for each Canadian province, and, where applicable, under ERISA. In order to obtain coverage under this policy, the insured would first have to demonstrate that its pension plan, registered in a Canadian province, was "similar" to a pension plan defined in ERISA. Under ERISA legislation, a defined benefit pension plan is a legally recognized entity (as per the definitions and eligibility rules in the legislation). ERISA does afford a regulatory scheme not unlike the scheme provided for in many provincial statutes, so a favourable comparison would be likely. Second, the insured's application (and potentially the underwriting or placing file) would be reviewed to ensure the plan was fully reported in writing during the application process.[71] Some policies allow for coverage of created or acquired plans during the course of the coverage period, provided correct notification is made to the insured.

Some policy wordings are much broader in terms of which plans are covered, and offer "blanket" coverage. Other policies are very specific, and will only insure plans specifically listed and reviewed at an underwriting level. In the next sample definition from a current Canadian policy, the term "plan" is defined in part by very specific reference to legislation:

Sample 2:

"Employee Benefit Plan" means

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[71] As per the English Court of Appeal decision in *Goshawk Dedicated Ltd. And Others v. Tyser & Co Ltd. and Another* [2005] EWHC 461 (Comm) the placing file and claims documents can now be re-examined by underwriters, and must be produced by the broker in cases of reasonable necessity.

1. any plan so defined by the Pension Benefits Standard Act, 1985, R.S. 1985, c. 32 (2nd Supp), the Ontario Pension Benefits Act, R.S.O. 1990, c P-8, or similar provincial legislation, which is operated for the benefit of the employees of the Company;

2. any welfare benefit plan or disability plan as defined by the Canada Health Act, R.S.C. 1985, c. C-6, the Ontario Health Insurance Act, R.S.O. 1990, c.H-6, or, any other similar provincial legislation;

3. any plans as defined by the Ontario Insurance Act, R.S.O. 1990, c. 1.8, or, similar provincial legislation;

4. any medical and disability benefit plan as defined in the Canada Health Act, R.S.C., 1985, c. C-6, the Ontario Health Insurance Act, R.S.O. 1990, c. H-6, or any similar provincial legislation;

5. any retirement compensation agreement, flexible employee benefit plan or registered supplementary unemployment benefit or stock ownership plan not subject to Canadian legislation if sponsored by the Company for the benefit of the employees or the directors and officers of the Company;

6. in the United States of America, any plan, including a welfare benefit plan, as defined in ERISA, and

7. any other plan, fund or program specifically included as an additional Benefit Program listed in Item E. Benefit Programs, of the Declarations;

provided however, Employee Benefit Plan shall not include any multi-employer plan as defined in the Pension Benefits Act, R.S. 1985, c.32 (2nd Supp.), the Ontario Pension Benefits Act, R.S.O. 1990, c. P8 or ERISA or by the common, civil or statutory law of Canada, the United States of America or any province, territory, state or other jurisdiction anywhere in the world.

This definition is one of the most specific and demands compliance with the relevant listed legislation.

4. What is a "Claim"?

As noted above, fiduciary liability policies are "claims-made and reported" policies; the policy responds only to claims first made and reported against the named insureds during the policy period or, if applicable, during any optional extension period. This type of "reporting" policy is distinguished from an "occurrence-based" policy in which the policy that responds is the policy in effect when the fortuitous event occurred.

The definition of "claim" underpins each fiduciary liability policy and may encompass a claim for both monetary and non-monetary relief, as seen in the sample wording below.

> Sample 1:
>
> *"Claim" means:*
>
> *1. a written or oral demand for monetary or non-monetary damages, injunctive relief or other relief,*
>
> *2. a civil proceeding commenced by the issuance of a Notice of Action, Writ of Summons, Statement of Claim, Complaint or similar originating pleadings,*
>
> *3. a binding arbitration,*
>
> *4. a criminal proceeding commenced by the laying of an information or the return of an indictment,*
>
> *5. a formal administrative, adjudicative or regulatory proceeding commenced by the filing of a notice of charges, formal investigative order or similar document, or,*
>
> *6. a fact-finding investigation by the Superintendent of Financial Institutions, or the Minister of National Revenue, Canada Customs and Revenue Agency, the United States Department of Labor, the Pension Benefit Guaranty Corporation in the United States, or, any similar government agency anywhere in the world.*

Under this wording, an issue could arise as to the method and timing of reporting a potential claim. For example, if a lawsuit is commenced against an insured for retention of pension plan surplus, the filing date of the statement of claim may be the first notice to the insurer. However, plan members may have approached the provincial regulatory authority or Superintendent prior to initiating litigation. If so, this earlier reporting date could potentially put any claim outside of coverage. This type of situation could arise under the sample wording provided above where claim is defined as a *…a fact finding investigation by the Superintendent of Financial Institutions … or, any similar government agency…"*, as this definition includes differing forms of investigation by pension regulators. A second, more obvious coverage issue arises for insureds when a policy is cancelled – any claim made after the cancellation will not be covered, even if the facts and circumstances leading to the claim occurred during the coverage period.

As fiduciary liability policies are "claims made and reported", there may be no relief from forfeiture otherwise available by provincial statutes. If there is, for example, late reporting of a claim, legislation governing relief from forfeiture under a policy is unlikely to apply. Most fiduciary liability policies specify up-front - in plain and oftentimes "bolded" terms on the first page of every policy - that coverage only extends to claims made during the policy period. In 1998, the Ontario Court of Appeal overturned a lower Court ruling that preserved a realtor's rights under a "claims- made and reported" policy, despite a failure to comply with notice requirements. The Court of Appeal ruled that the notice provision in a "claims made and reported" policy was an integral part of the event triggering coverage. The insuring agreement in the errors and omissions policy stated:

> *…[t]he Company hereby agrees …to pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages resulting from any claim or claims first made against the Insured and reported in writing to the Company during the Policy Period…*

The Court determined that the wording of the policy in question was plain and capable of only one meaning. While the Court did not rule out the fact that relief from forfeiture might be granted under another "claims made" policy in the appropriate circumstances, the wording in this policy was not open to interpretation.

5. What is a "Loss"?

Fiduciary liability policies have strict definitions of "loss" to reflect the specific duties of fiduciaries in the administration of pension plans. The following wording is multi-faceted:

> Sample 1:
>
> *"Loss" means the total amount which Assureds are legally obligated to pay on account of any Claim made against them for Wrongful Acts for which coverage applies, including, but not limited to Defence Costs, Costs, Charges and Expenses, damages, (including compensatory, aggravated, punitive and exemplary damages…judgements, settlements, pre-judgement and post-judgement interest. Loss does not include (1) any amount not indemnified by the Company for which an Assured is absolved from payment by reason of any covenant, agreement or court order, or (2) matters uninsurable under the law pursuant to which this policy is construed.*

The definition of "defence costs" and "costs, charges and expenses" are an integral part of the definition of "loss". They are defined as follows under this sample wording:

> *"Defence costs" means necessary and reasonable costs, charges, fees (including but not limited to legal fees and Expert Fees and expenses incurred solely indefending or*

investigating a Claim, or, assisting the Underwriter in investigating a Claim pursuant to a request by the Underwriter.

"Costs, Charges and Expenses" means (a) Defence Costs, (b) Loss Avoidance Expenses, or (c) Expert Fees but shall not include:

1. salaries, wages, fees, overhead or benefit expenses of any kind associated with an Assured;
2. any amounts incurred in defence of any Claim for which any other insurer or underwriter has a duty to defend, or otherwise has to afford reimbursement;
3. any premiums for an appeal bond, attachment bond, or similar bond.

In this example, "Loss Avoidance Expense" is a constituent part of the definition of "Loss" and is defined as *"…reasonable and necessary lawyer's fees or costs arising solely by reason of the need to correct an actual or potential breach of fiduciary duty constituting a "Wrongful Act" provided such fees or costs are consented to in writing by the Underwriter".* That is, if a fiduciary retains an actuary to determine the amount of contribution to a covered plan to avoid a threatened action by beneficiaries for underfunding, this expense would be covered under the policy, if approved by the insurer.

Also under this wording, there is a single aggregate limit of liability for all claims. Most fiduciary liability policies offset any defence costs against the limits of liability, in other words, defence costs exhaust the available limit of coverage. This raises the spectre of the entire limit being used in the defence of the claim, with little or nothing left for indemnification for damages awarded by a Court. However, some insurers offer optional coverage for defense outside the limits of the policy, providing additional protection to fiduciaries and preserving policy limits for claims or indemnity payments.

The definition of "loss" in many fiduciary liability policies may not specifically exclude any amount for taxes or tax penalties. Recent American caselaw excludes taxes paid as "loss" under a fiduciary liability policy. In *Florists' Mutual Insurance Company v. Lucy Greenhouse Manufacturing*,[72] the insurer sought declaratory judgment for coverage under a fiduciary liability insurance for amounts paid to the IRS by a third-party payroll service that had misappropriated the funds intended for paying the taxes. The policy specifically stated that "loss" did not include taxes. The Ohio District Court ruled that the sums which comprised the insured's loss were taxes; therefore the insured did not sustain a "loss" under the strict terms of its policy and the insurer was not required to provide coverage.

[72] 521 F.Supp.2d 661 (U.S.D.C. Ohio, Western Division).

Would a fiduciary be covered for a claim for restitutionary relief? In other words, if a claim was made by an insured for a "loss" that resulted from its' own misappropriation of pension plan surplus – as opposed to a fortuitous event – would a fiduciary liability policy provide coverage? Canadian caselaw is scant, but in *Universite Concordia c. Cie d'assurance London Guarantee*,[73] decided under the Civil Code in Quebec, this type of claim was denied. The insured university was trustee of an employees' pension plan and it deliberately took a contribution holiday, modified the plan unilaterally and used pension plan proceeds to "organize" its business. When beneficiaries under the plan brought a class action to obtain reimbursement of the funds deliberately mishandled, the insured sought coverage under its fiduciary liability policy for defence costs and ultimately complete indemnity under the policy. The decision turned on the definitions of "loss" and "wrongful act" under the policy, defined respectively as follows:

> *The term "Loss" shall mean any amount which the Insured is legally obligated to pay for a claim or claims made against the Insured for Wrongful Acts, and shall include, but not be limited to, damages, judgments, settlements and costs…and amounts incurred in the defence of legal actions…"*
>
> [Wrongful act]*…any breach of the responsibilities, obligations or duties imposed upon trustees or fiduciaries of the Plan, or upon the Pension Committees of the Plan, by common or statutory law of Canada or any Canadian Province.*

The Quebec Superior Court determined that the amounts claimed by the insured were not "losses" as defined by the policy especially since the sums claimed by the university were not caused by a fortuitous event (the trigger upon which the policy was premised) but rather by a deliberate action by the insured. The underlying class action was intended to force the insured to respect its contractual obligations to the beneficiary-employees concerning the covered plans and the claim was for monies to which the insured was not legally entitled. The insured was denied coverage for monies the employees sought as reimbursement (but not damages) due back to the plan.

In the context of fiduciary liability policies and the insurability of restitutionary damages, American caselaw relies on precedent from securities claims under Directors and Officers ("D + O") liability insurance. In *St. Paul Mercury Ins. Co. v. Foster*[74] a fiduciary insurance policy for a stock ownership plan would not cover insured fiduciaries to the extent they were ordered to make restitution of "ill-gotten" personal profits in underlying litigation. The Court relied on the decision of Court of Appeals

[73] 34 C.C.P.B. 112, [2002] R.R.A. 1212 (Q.S.C.) (reported in French only).
[74] 268 F.Supp. 2d 1035 (U.S. District Court Illinois)

Seventh Circuit in *Level 3 Communications, Inc. v. Federal Insurance Company.*[75], a securities fraud case. There, an insured was denied coverage under its D + O policy for restitutionary relief in an underlying case which alleged that the insured had "stolen" (in the judge's words) corporate property under false pretences. In *St. Paul* (supra), the Court commented that:

> *…as a matter of principle restitutionary relief, that is, relief intended to divest the insured of the net benefit of an unlawful act or "the restoration of an ill-gotten gain" is uninsurable because such protection would "insure a thief against the cost to him or disgorging the proceeds of the theft".*

6. What is a "Wrongful Act"?

The definition of "wrongful act" is typically very broadly worded in a fiduciary liability policy. The wide ranging definition will reference statutory law in both Canada and the U.S. and the wording will include errors and omissions, negligent acts, and breaches of the aforementioned statutory law. The critical point is that fiduciary coverage is only available if the "wrongful act" was committed whilst the individual was acting in the capacity of fiduciary (as defined). Again, the definition of a fiduciary is a functional one – if an insured acts as a fiduciary – for example, communicating with plan participants about financial viability – then that insured is acting in a fiduciary capacity.

> Sample 1:
>
> *Wrongful Act(s) means:*
> *1. any breach of the responsibilities, obligations, or duties imposed upon Assureds in their capacity as a Fiduciary of a Benefit Program under the Pension Benefits Standards Act, R.S. 1985, c.32 or ERISA or by the common, civil or statutory law of Canada, the United States of America, or any province, territory, state or other jurisdiction anywhere in the world;*
> *2. any other matter claimed against the Company or an Insured Person solely because of their service as a Fiduciary of any Benefit Program; or*
> *3. any negligent act, error or omission solely in the Administration of any Benefit Program.*

No definition of "wrongful act" can capture all actions by fiduciaries. The Courts will determine first who committed the acts, second, whether the acts fall within policy definitions and finally whether the pleadings allege a "wrongful act".

Although the recent U.S. case of *Mary Kay Holding Corp. v. Federal Holding Corp.* is limited by its fact, it shows how claims for alleged "wrongful acts" may not be covered,

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[75] 272 F. 3d 908 (U.S. Court of Appeals, 7th Circuit)

depending on who committed the acts. The case fell under U.S. federal legislation which provides temporary extensions of employment benefits, called the Consolidated Omnibus Budget Reconciliation Act (known as "COBRA"). COBRA gives employees and their qualified beneficiaries the opportunity to continue insurance coverage when a "qualifying event", such as dismissal, would normally result in the loss of coverage. The underlying lawsuit in *Mary Kay* raised allegations that the fiduciary failed to both provide continuation coverage to dismissed employees, and failed to alert them of their rights under COBRA. The Court's decision turned on the fact that the obligation to provide COBRA coverage was the responsibility of the plan's sponsor. Under ERISA, a sponsor of a benefit plan is very different from a fiduciary; actions taken in the capacity as a plan sponsor are not fiduciary in nature.[76] A plan sponsor, or an employer can alter or modify the terms of a plan, and when they do, they act not as fiduciaries, but are analogous to settlors of a trust.[77] The key difference is that while a settlor decides to set up the plan (within the ERISA parameters) a fiduciary administers the plan, as established and modified by the settlor. In *Mary Kay*, the Court found that the failure to provide, or even advise employees of certain COBRA rights with covered plans was not a "wrongful act", because the act itself was not committed by a fiduciary.

American caselaw decided under ERISA clearly distinguishes between fiduciary and non-fiduciary decisions. In *Gulf Resources & Chemical Corporation v. Grave*[78] the Court concluded that a termination of a plan may not attract coverage because decisions regarding the structure, adoption or termination of a plan are not fiduciary in nature. Those types of decisions did not directly involve the administration or management of a plan.

The earlier sample wording also illustrates that a "wrongful act" definition in a fiduciary liability policy can include any negligent act, error or omission in the "administration" of the plan. Under this policy, "administration" is defined as:

> *Administration means:*
> *1. Giving advice, counsel or interpretation to employees regarding a Benefit Program,*
> *2. undertaking the enrolment, termination or cancellation of a Benefit Program,*
> *3. maintaining or administering records or data in any form for the purposes of a Benefit Program.*[79]

[76] *Lockheed Corp. v. Spink*, 517 U.S. 882 (U.S.S.C. 1996)
[77] *Johnson v. Georgia-Pacific Corp.*, 19 F. 3d 1184, 1188 (C.A. 7 1994)
[78] 763 F. Supp. 1073 (U.S.D.C. 1991)
[79] This Canadian policy wording includes the termination of a plan, as opposed to the American caselaw under ERISA which categorizes any decision to terminate a plan as a non-fiduciary decision.

Some policy wordings – such as the one below - specify the types of activity which fall under the ambit of "administration" within the definition of "wrongful act":

> Sample 2*:*
>
> *"Wrongful Act" means (1) as respects a fiduciary of a plan, a plan or the insured organization; a violation of any of the responsibilities, obligations or duties imposed upon fiduciaries by the applicable legislation or any matter claimed against the insureds solely with respect to the applicable plan and solely by reason of their status as a fiduciary of a plan, a plan or the insured organization and (2) as respects an administrator of a plan, any act, error, or omission solely in the performance of one or more of the following administrative duties or activities but only with respect to the applicable plan: (a) counselling employees with respect to the plan; (b) providing interpretations with respect to the plan; (c) handling of records in connection with the plan; or (d) activities affecting enrolment, termination or cancellation of employees under the plan.*

American caselaw which turns on the concept of the "administration" of a plan shows that "administration" is almost always limited to routine, ministerial acts, that is, acts carried out under the supervision of another. This function or type of action is distinct from the discretionary activity which is usually the hallmark of fiduciary liability. Liability for a ministerial act in the U.S. was potentially expanded by *Adams v. Brink's Company*[80] in which an error in calculating plan benefits, normally a routine, administrative function, was fiduciary in nature because the mistake was made by the named fiduciary in the plan.

Courts have also distinguished between negligent and deliberate acts to determine coverage after examining the intention of the fiduciary committing the alleged "wrongful act". In *National Union Fire Ins. Co. of Pittsburgh Pa. v. Travelers Property Cas. Co.*[81] an intentional act did not attract coverage under an Employee Benefits Liability ("EBL") form providing fiduciary liability protection. The EBL Form required a "negligent" act, error, or omission. The underlying actions alleged that the employer engaged in a "deliberate" scheme (not a "negligent" one) to induce employees, so regardless of whether the actions of the administration of the plan were ministerial in nature, the policy did not provide coverage.

Finally, no matter how carefully worded, a fiduciary liability policy may not be called upon if the allegations in the pleadings are not properly worded. In *Mary Kay*, discussed earlier, the Court reviewed the "wrongful act" definition and determined that the "administration" of a plan did not include advising employees of any continuation

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80 372 F. Supp. 2d 854 (W.D. Va. 2005).
81 WL No. 05 Civ. 4648 (NBR) (S.D.N.Y. 2006) – not otherwise reported

coverage available under COBRA because the allegations in the underlying action did not correctly specify the plans in question.

C. EXCLUSIONS

Exclusions in a fiduciary liability policy limit the breadth of coverage available to insureds under the insuring agreement. Different insurers offer different wording and examples are offered below of the certain common exclusions. This discussion addresses the five exclusions commonly brought to the forefront in pension claims – the "conduct" exclusions (for fraud and personal profit or advantage), the "benefits due" exclusion, the "failure to comply" exclusion, exclusions for claims under other policies (for example, under D+ O liability policies), the "contract assumed" exclusion, and finally the "non-sponsor" exclusions when the insured is not the plan sponsor. Fiduciary liability policies in Canada may also exclude coverage for bodily injury, damage or loss of use of tangible property, for libel and slander, for pollution loss and for prior and pending litigation as damages would generally be covered by other kinds of insurance. Since these latter exclusions are rarely litigated, insurers may market a fiduciary liability policy without certain exclusions, to present more coverage to potential insureds and to negotiate better premiums.

1. Conduct Exclusions - Fraud

The fraud exclusion in a fiduciary liability policy may seem obvious, but the exclusion goes to the heart of coverage under the insuring agreement. Fraudulent acts by an insured are not covered by the policy. The key to the exclusion is how to determine if an act is fraudulent or not, because fraud is generally not a defined term in a fiduciary liability policy. Insurers offering fiduciary liability insurance generally use two wordings for the fraud exclusions; the "final adjudication" wording and the "in fact" wording, as discussed below. In either case, a mere allegation of wrongdoing will not trigger the exclusion. This language presents a legal hurdle to the insurer as the exclusion will not apply unless there is either a final adjudication or an external finding of fact.

A sample wording of the "final adjudication" type of exclusion from a current fiduciary liability policy available in the marketplace is as follows:

> Sample 1**:**
>
> *Based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving, any fraudulent act or omission or any willful violation of any statute, law or regulations by such Assureds as determined by a judgement or other final adjudication adverse to the Assured:*

The key element to this exclusion is that the finding of fraud against the insured is determined by a Court judgment or other final adjudication (this "final adjudication" language, requiring an external finding of fraud, is also present in the personal profit or financial advantage exclusion discussed further on in this paper). The "final adjudication" language relieves the insurer of the burden of categorizing an insureds' actions as fraudulent, and removes some ambiguity from the exclusion.

The preamble to this first sample exclusion, using the words "…*based upon, arising out of, directly or indirectly resulting from*…" is the broadest wording form of any exclusion. Not only is a direct act excluded from coverage, but related acts which might arise from the same circumstances are likewise excluded.

In relation to the "final adjudication" language, other fraud exclusion wordings are more specific and specify that the finding of fraud must be found to be material to the final judgment or adjudication, as shown in the sample below:

> Sample 2:
>
> *The Company shall not be liable under this policy to make any payment for loss respecting a claim resulting from or contributed to by the fraud of/by the insured individual determined by a final judgment or adjudication and which was material to the outcome of the judgment or adjudication.*

The "final adjudication" language still creates some ambiguities in the exclusion. First, when is a "final adjudication" actually final? In other words, what happens if the underlying finding of fraud against the insured is appealed? Second, using the sample wordings above, what happens if a settlement is reached in actions alleging fraud? The pleadings of the underlying action would not be the sole determinant, and coverage under the fiduciary liability policy may follow.

The next sample wording of the "in fact" fraud exclusion in a fiduciary liability policy implies that no coverage will apply if a deliberately fraudulent act is committed "in fact" by the insured:

> Sample 3:
>
> *The Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured…arising out of, based upon or attributable to the committing in fact of any criminal or deliberate fraudulent act…*

The words "*in fact*" do not require that any underlying action proceed to trial for a determination of the application of the exclusion. This wording of this exclusion is of obvious benefit to insurers, though as with any exclusion the onus remains ultimately with the insurer to prove that the exclusion applies if coverage is at issue.

2. Conduct Exclusions - Personal Profit or Advantage

A typical fiduciary liability policy will exclude coverage for the insured who gains any profit or financial advantage to which it is not legally entitled. This could occur if a sponsor organization took pension plan surplus and used it as corporate property. The example provided below is typical of the language found in most personal profit or advantage exclusions in fiduciary liability policies:

> Sample 1:
>
> *The Underwriter shall not be liable for Loss resulting from any Claim made against any Assured…based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving, any Assured gaining in fact any personal profit, remuneration or financial advantage to which such Assured was not legally entitled, provided, however, this exclusion shall not apply unless a judgement or other final adjudication against such Assured establishes that such Claim was brought about or contributed by having gained any personal profit, remuneration or advantage to which such Assured was not legally entitled.*

The operation of the personal profit exclusion is shown in the 2005 appellate case of *Federal Ins. Co. v. Kozlowski*[82]. The fiduciary liability policy issued to the insured contained a duty to defend provision, as well as a personal profit exclusion. The case was argued against the backdrop of underlying criminal and civil securities actions against the Defendants, in addition to an ERISA lawsuit. In the ERISA action, the allegations included that the Defendant and other fiduciaries negligently misrepresented plan assets. The criminal action alleged that the Defendant stole corporate assets. The insurer tried to avoid providing a defence by relying on the personal profit exclusion, which excluded claims "…*based upon, arising from or in consequence of such Insured Person having gained in fact any personal profit, remuneration or advantage to which such Insured person was not entitled*". The Court held that the allegations in each of the underlying actions demonstrated that the claims asserted did not *entirely* fall within the personal profit exclusion. Some of the claims included both covered and excluded behaviour. The Court held that the insurer had to provide a defence for both covered and non-covered claims if the latter are intertwined with

[82] 18 A.D. 3d 33, 792 N.Y.S.2d 397 (N.Y.A.D.), part of a series of cases against Tyco International and its' management.

covered claims. The insurer was ordered to pay all the insureds' defence costs – as the costs were incurred – subject to recoupment when liability was ultimately decided.

The *Kozlowski* case illustrates the use of the "severability of exclusions" clause, another common provision of most fiduciary liability policies. The Court found that a severability clause with respect to certain exclusions, including the personal profit exclusion, prevented the insurer from imputing to an insured any facts or knowledge of other insureds "…to determine if coverage was available" (as per the wording of the clause). In *Kozlowski,* the insurer attempted to rescind the policy by imputing knowledge of the Defendant, a Director and Officer of Tyco International Ltd., to the corporate Defendant – after the company made an allegedly fraudulent application for fiduciary liability cover. The insurer could not prove that Kozlowski participated – either directly or indirectly - in misrepresenting facts to induce the insurer to issue the policy, and could therefore not rescind the policy.

A sample wording of the severability clause currently used in the marketplace is as follows:

> *Severability of Exclusions No fact pertaining to or knowledge possessed by an Assured shall be imputed to any other Assured for purposes of applying the Exclusions set forth…*

This kind of clause puts the onus squarely on the insurer to have evidence against each and every named insured against whom the insurer may seek to rely on an exclusion to deny coverage.

The personal profit exclusion will often contain the "in fact" language found in the fraud exclusion. How this wording applies is best illustrated by caselaw. In *St. Paul Mercury Insurance Company v. Foster,*[83] the insurer sought to rely on the exclusion to exclude coverage for fiduciaries in underlying litigation involving stock ownership plans. It was enough, the insurer argued, that there were allegations in the underlying action that the insureds gained personal profit to which they were not entitled; that alone would bar coverage under the policy. A final adjudication of wrongdoing was not required, only an allegation. The Court disagreed, and implied a "final adjudication" standard to the exclusion:

> *The very language of the exclusion is premised upon an "insured gaining in fact any personal profit ... St Paul's interpretation renders the "in fact" language superfluous…as the [fiduciaries] in this case could receive personal profits and be legally entitled to retain them so long as adequate consideration was given in return, and that issue remains to be determined at trial in the underlying litigation, it is clear that any determination as to*

[83] 268 F. Supp2d 1035 (U.S.D.C. 2003).

whether an insured in this case gained personal profit in fact must await resolution of the underlying litigation.

The Court wanted further evidence before relying on the personal profit exclusion to deny coverage. In other cases, Courts focus on whether there was sufficient evidence in the underlying complaint to show that profits received were illegal or undeserved within the meaning of the exclusion in the fiduciary liability policy. [84]

3. Benefits Due Exclusion

One of the most problematic exclusions in fiduciary liability insurance policies is for claims involving actual or alleged benefits under a covered plan. This is commonly known as the "benefits due" exclusion. In the broadest terms, benefits due to members under a plan are *not* covered under the fiduciary liability policy, so claims under the policy which involve the failure to contribute to the plan will not be indemnified. [85]This situation could arise if, for example, the employer failed to forward contributions to plan trustees for its employees and the error in remitting contributions went undetected. The exclusion is often misunderstood because at first reading it appears to derail any coverage under the plan. A review of the samples below shows why this is not the case.

Two current wordings of this exclusion now in the marketplace are as follows:

> Sample 1:
>
> *The Insurer will not be liable for loss resulting from any claim made against the Insured based upon, arising out of, directly or indirectly resulting from, or in consequence with or in any way* ***involving actual or alleged benefits which are due or to become due under a Benefit Program or benefits which would be due under a Benefit Program if its terms complied with all applicable law****….unless recovery for benefits is based upon a covered wrongful act.* (emphasis added)
>
> Sample 2:
>
> *The Insurer shall not be liable for that part of Loss…which constitutes benefits, due or to become due under the terms of a Benefit Program unless, and to the extent that, (1) the Insured is a natural person and the benefits are payable by such Insured as a personal obligation and (ii) recovery for the benefits is based upon a covered Wrongful Act.*

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[84] *Alstrin v. St. Paul Mercury Ins. Co.*, 179 F. Supp. 2d 376 (D.Del.2002).
[85] "*Fiduciary Liability: So What Does the Policy Pay If It Doesn't Pay for Benefits*" October 2006 – Issue 4, Executive Risks, Willis – Canadian Alert available at <http://www.willis.co.uk>

The reasoning behind the "benefits due" exclusion is that private pension plans are established to provide benefits for members; under the plan the fiduciary is contractually obligated to pay benefits. That is the obligation of the plan. For example, if the fiduciaries of a plan depleted its' assets, through carelessness, and an employee who should have received $800.00 a month now receives $400.00, a fiduciary liability policy does not permit the employee to claim the balance. Fiduciary liability policies will only pay for "loss" flowing from a "wrongful act"; otherwise the insurer becomes a back-stop for bad management practices. As summarized by the United States Court of Appeals, Seventh Circuit:

> *It would be passing strange for an insurance company to insure a pension plan (and its sponsor) against an underpayment of benefits, not only because of the enormous and unpredictable liability to which a claim for benefits on behalf of participants in or beneficiaries of a pension plan of a major employer could give rise, but also because of the acute moral hazard problem that such coverage would create ("moral hazard" is the term used to denote the incentive that insurance can give an insured to increase the risky behavior covered by the insurance). Such insurance would give the plan and its sponsor an incentive to adopt aggressive (just short of willful) interpretations of ERISA designed to minimize the benefits due, safe in the belief that if, as would be likely, the interpretations were rejected by the courts, the insurance company would pick up the tab.*[86]

Recent caselaw best illustrates the effect of the exclusion. In *BOC Group Inc. v. Federal Insurance Co.*[87], decided in 2007, a class action settlement of $69 million (USD) compelled the insured sponsor of an employee benefit plan to seek indemnity under the fiduciary liability policy issued by Federal to BOC. The plan had been converted from a traditional defined benefit plan to a cash balance plan by plan administrators. The Plaintiffs in the underlying action alleged that the plan failed to properly calculate their benefits, in particular, lump sum pension distributions upon termination. The issue in the coverage action was whether the litigation claim and the large settlement constituted benefits paid under the plan.

The insuring clause in the policy read:

> *The Company shall pay on behalf of each of the Insureds all Loss for which the Insureds becomes legally obligated to pay on account of any Claim first made against the insured during the Policy Period…for a Wrongful Act committed, attempted or allegedly committed or attempted, before or during the Policy Period by an Insured or by any person for whose Wrongful Acts the Insured is legally responsible.*

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[86] *The May Department Stores Company v. Federal Insurance* 305 F. 3d 597 (U.S.C.A. 7th 2002).
[87] *The BOC GROUP INC. v. Federal Insurance Company* Not reported in A.2d. 2007 WL 2162437 (N.J. Super.A.D. – 2007). This is an unpublished opinion.

"Wrongful act" was defined as:

> *(i) any breach of the responsibilities, obligations or duties imposed upon fiduciaries of the Sponsored Plan by the employee Retirement Income Security Act of 1974, as amended, or by the common or statutory law of the United States…(iii) any negligent act, error or omission in the Administration of any Sponsored Plan.*

The "benefits due exclusion" read:

> *The Company shall not be liable for that part of Loss, other than Defense Costs…which constitutes benefits due or to become due under the terms of a Benefit Program unless, and to the extent that, (i) the Insured is a natural person and the benefits are payable by such Insured as a personal obligation, and (ii) recovery for the benefits is based upon a covered Wrongful Act.*

The Court stated that plans governed by ERISA contained both implied and express terms, and that the plan administrators here used an enhanced rate of return in calculating benefits that, although not in the actual plan, was considered part of the benefits due to participants under the plan. The claimants in the underlying action did not bring their claim under the civil enforcement provisions of ERISA, to recover benefits, but for alleged ERISA violations that the employer had breached certain Treasury Regulations for "protected benefits" under that Regulation.[88] The Court stated:

> *…regardless of whether the plan itself expressly entitled the claimants to the benefits they sought, the treasury regulation provided that, under the circumstances asserted by the claimants, such benefits will be treated as provided under the terms of the plan…[t]he claimants, moreover, sought those unpaid benefits as damages, which they termed "restitution". Thus by whatever name, once the relief the claimants sought constituted "benefits under the plan", the policy exclusion applied.*

The Appellate Court repeated its earlier warning that the "moral hazard" that could be created if plan administrators could count on insurance to relieve them of the consequences of poor administrative decisions. This public policy argument supporting the "benefits due" exclusion was neatly summed up as follows: "*[w]ho wouldn't buy insurance if he could decide whether to perform or decline to perform some act which would give him coverage for that action?"*[89] Underlying this exclusion is the premise that plan assets

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[88] ERISA Section 1132 Civil Enforcement provisions states that a person is empowered to bring a civil action to recover benefits due under the terms of a plan.

[89] *Waste Corp of Am., Inc. v. Genesis Ins. Co.,* 382 F. Supp. 2d 1349, 1354-55 (S.D.Fla 2005) as quoted in *BOC GROUP* (supra) at page 9.

are different from plan benefits; benefits are paid from plan assets. A claim that a fiduciary has breached her duty to manage, invest or allocate plan assets (for instance, a plan surplus) is not a claim for benefits, but rather for restoration of plan assets.

The "benefits due" exclusion could apply when companies are merged, or when pension plans may be split into two plans to accommodate a transfer of corporate assets or divisions within a company. In *Viacom International, Inc. v. Federal Insurance Company*[90] the Plaintiff was the successor company, by merger, to Paramount Communications. Prior to selling of one of its divisions, Paramount had provided pension coverage to employees in that division. Before the plan spinoff which accompanied the sale, the pension plan committee did not consider whether the terms of the old plan required full funding of vested benefits being transferred to the new plan. When the new plan was terminated, it was found to be severely underfunded. Viacom sought coverage under its fiduciary liability policy and alleged the committee's failure to consider the funding issue was a "wrongful act".

The Court barred the claim for several reasons, including the "benefits due" exclusion. The insured argued that the exclusion did not apply because it related "*…to a refusal to pay a specified benefit to a particular claimant under the plan [and] is not remotely applicable to the issue of full funding of the spinoff*". The plan members had expressly sought relief under Section 502 of ERISA, the "benefits due" provisions. The final judgment in the underlying action was for the amount of each beneficiary's benefits. The Court in the coverage action determined that the "benefits due" exclusion was precisely on point to the underlying action and excluded the claim.

4. Failure to Comply Exclusion

A typical fiduciary liability policy will exclude coverage for any "*…actual or alleged intentional failure of any insured to comply with any statute*" with respect to a pension plan. Simply, if the fiduciary intentionally breaches, or fails to comply with the law, no coverage will follow. Several sample wordings of the "failure to comply" exclusion are provided below:

Sample 1:

The Underwriter shall not be liable for Loss resulting from any claim made against an Assured…based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving any actual or alleged intentional failure of any Assured to comply with any law with respect to any

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[90] Not Reported in F. Supp., 1997 WL 154042 (S.D.N.Y. – 1997).

Government Benefit Plan; provided this exclusion shall not apply to any actual or alleged obligation of any Assured, pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 of the United States of America, as amended.

Sample 2:

The Company shall not be liable for Loss on account of any Claim made against any Insured based upon, arising from, or in consequence of any deliberately fraudulent act or omission or any willful violation of any statute or regulation by such Insured, if a judgement or other final adjudication adverse to the Insured establishes such a deliberately fraudulent act or omission or willful violation.

How does this exclusion apply in the fiduciary liability context? In British Columbia, pursuant to Section of the 60 of the *Pension Benefits Standards Act,* actuarial surplus (as an asset of the plan) must not be transferred out of the plan without the approval of the provincial pension regulatory body. Other Canadian jurisdictions have similar provisions. If a fiduciary transferred surplus from a plan without member approval, no coverage would result. In 1984, when Conrad Black transferred $56 million from pension plan surplus of the Domgroup Ltd. without consulting pension plan members, (he considered the surplus as the employer's property) the Supreme Court of Canada eventually ruled the surplus was to stay in the plan to increase members benefits. This resulted in strict new laws about pension withdrawals. In the context of fiduciary liability insurance, if plan administrators intentionally transferred surplus without this approval in place, the "failure to comply" exclusion could result in a denial of coverage.

The focus of this exclusion is "intentional", "deliberate" or "willful" acts. An insured cannot intentionally breach a law or statute, otherwise the plan administrator would have an incentive to disregard the law, relying on insurance coverage for any deliberate flouting of a statute (raising the "moral hazard" argument). The exclusion is supported by similar provisions in provincial Insurance Acts across Canada. For example, under Section 28 of the British Columbia *Insurance Act* R.S.B.C. 1996, c.226,

Effect on contracts of violation of law

28. Unless the contract otherwise provides, a violation of a criminal or other law in force in British Columbia or elsewhere does not render unenforceable a claim for indemnity under a contract of insurance ***unless the violation is committed by the insured, or by another person with the consent of the insured, with intent to bring about loss or damage, except in the case*** *of a contract of life insurance this section applies only to disability insurance undertaken as part of the contract.* (emphasis added)

In Ontario, the *Insurance Act* R.S.O. 1990 c. I 8 states:

> *Violation of law, effect of, on claim for indemnity*
>
> *118. Unless the contract otherwise provides, a contravention of any criminal or other law in force in Ontario or elsewhere does not, by that fact alone, render unenforceable a claim for indemnity under a contract of insurance* ***except where the contravention is committed by the insured, or by another person with the consent of the insured, with intent to bring about loss or damage,*** *but in the case of a contract of life insurance this section applies only to insurance undertaken as part of the contract whereby the insurer undertakes to pay insurance money or to provide other benefits in the event that the person whose life is insured becomes disabled as a result of bodily injury or disease.* (emphasis added)

While it may seem obvious that fiduciary liability policies will not provide coverage for intentionally breaking the law, many policies will contain exclusions in regard to payment of civil or criminal fines or penalties, or for punitive or exemplary damages. The sample wording below typifies this type of exclusion:

> *The Underwriter shall not be liable for that part of Loss, other than to the extent the Claim gives rise to any Costs, Charges and Expenses:*
>
> *Based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving actual or alleged civil or criminal fines or penalties, punitive or exemplary damages, or the multiple portion of any multiplied damage award; provided this exclusion shall not apply to the five percent (5%) or less, or the twenty percent (20%) or less, civil penalties, imposed upon an Insured Person as a Fiduciary under Section 502(i) or (l), respectively, of ERISA.*

Under this fiduciary liability policy, defence costs are covered under a “carve-back” provision; the policy separately defines “costs, charges and expenses” and “defence costs” (the former definition includes the latter) and coverage is provided for the necessary and reasonable costs incurred in defending and investigating a claim against the insured.

Another facet of the “failure to comply” exclusion, illustrated in Sample 1 above, is an exception for the American COBRA law (already mentioned in the context of “wrongful act”). The sample exception dictates that the exclusion will not apply to “*…any actual or alleged obligation of any Assured pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985 of the United States of America”*. Once again, the *Mary Kay* case provides guidance. Violations of the COBRA law were alleged against the insured who then sought COBRA coverage from the insurer under an exception to the exclusion worded like the one above. The Court relied on both the definition of "wrongful act" as used in the insuring agreement, and the COBRA exception, which stated:

> *The Company shall not be liable for Loss on account of any Claim made against any Insured:…(f) based upon, arising from, or in consequence of the failure of the Insured to comply with any law governing workers' compensation, unemployment, social security or disability benefits or any similar law, except the Consolidated Omnibus Budget Reconciliation Act of 1985.*

The Court concluded that the factual allegations in the insured's claim did not trigger a duty to defend, because the allegations did not constitute "wrongful acts" as defined by the fiduciary liability portion of the policy. In basic terms, if the insured could not show that the claim against it was covered by the insuring agreement (i.e. a "wrongful act") then it certainly could not invoke the COBRA exception to the exclusion - especially in isolation from the insuring agreement to "create" coverage.

5. Exclusions for Claims under Other Policies

Stand-alone fiduciary liability coverage is the most comprehensive protection available for fiduciaries in regard to their role. There is limited overlap with other kinds of policies, most commonly through an endorsement to D + O liability insurance. However, most D + O policies typically exclude fiduciary liability, as shown in the sample wording from one such policy below:

> *The Insurer shall not be liable to make any payment for Loss in Connection with a Claim made against an Insured…alleging, arising out of, based upon or attributable to a breach of any of the responsibilities, obligations or duties* ***imposed upon fiduciaries*** *by the Canada Pension Benefits Standards Act, R.S.C. 1985 c. 32 or any federal or provincial workers compensation legislation or any similar statutory or regulatory law of Canada or the United States.*

The American case of *Zahler v. Twin City Fire Ins. Co.*[91] shows how a fiduciary liability exclusion in a D + O policy would work in a claims situation. Here, two different D + O insurance policies came into play. The insured sought coverage after class action securities litigation alleged that the directors misled investors about the financial health of the business. The first D + O policy defined "wrongful act" to include any actual or alleged breach of fiduciary duty under ERISA, and, critically, the definition included subsequent claims relating to the same facts, including acts constituting fiduciary breaches. A class action complaint alleging securities fraud was filed during the course of this first policy. After the first policy expired, a second D + O policy was secured

[91] Not reported in F. Supp. 2d, 2006 WL 846352 (S.D.N.Y. – 2006).

from another insurer. The second policy had an endorsement that no coverage was available for claims for fiduciary wrongful acts, or for any claim which was the subject of any notice under any other D + O or fiduciary liability policy (a "prior notice" exclusion). A class action alleging fiduciary breaches under ERISA was filed during the second policy. The ERISA litigation contained parallel facts and claims as those alleged in the first securities litigation.

Most important, both policies contained "inter-related wrongful act" provisions, in other words, "wrongful acts" as defined by the policy involving the same facts as another "wrongful act". All claims which resulted from inter-related wrongful acts therefore constituted a single claim. The Court had to decide whether the allegations in the second ERISA litigation were the same as alleged in the securities litigation first filed under the first D + O policy. The Court concluded that the second policy could not cover the ERISA litigation, otherwise its "prior notice" exclusion and "interrelated wrongful act" provision would be rendered meaningless. The intent of the first policy was to cover both claims made during that policy period, as well as any subsequent claims arising from the same facts, including breaches of fiduciary duty.

In some circumstances, different kinds of policies may offer coverage for fiduciary liability claims. In *Pacific Ins. Co. Ltd. v. Eaton Vance Management*[92] the insurer had issued an Errors and Omissions policy ("E + O") that ultimately covered the insured for a claim arising from a failure to fund a particular profit-sharing plan. The E + O policy provided coverage for:

> *Loss or liability incurred by the Insured…by reason of any actual or alleged failure to discharge his or its duties or to act prudently within the meaning of the Employee Retirement Income Security Act of 1974…by reasons of any actual or alleged breach of fiduciary responsibility within the meaning of said Act or any amendments thereto or successor law or any rule or regulation in the Insured's capacity as a fiduciary with respect to any pension or employee benefit plan or trust.*

Relying on its earlier ruling that the insured had breached its fiduciary duty under ERISA, the Court found that the E + O policy expressly covered not only "loss" but the "liability" stemming from the insured's failure to properly fund the plans. The Court ruled that the liability the insured incurred as a result of a breach of fiduciary duty was of the kind the insurer agreed to indemnify.

[92] 260 F. Supp. 2d 334 (U.S.D.C. Mass. – 2003).

Many fiduciary liability policies contain exclusions for claims for "loss" if those claims are insured under another type of policy. A policy now in use in the Canadian marketplace contains the following environmental loss exclusion:

> *The Underwriter shall not be liable for Loss resulting from any Claim made against any Assured:*
>
> *Based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving, actual or alleged seepage, release, dispersal, transportation, emission, pollution, irritants, mould, vapour, soot, acids, alkalis, infectious or medical waste, asbestos, noise, silica, Sudan 1 dye or contamination of any kind including but not limited to the treatment, removal or disposal, of waste of any kind including radioactive, toxic, explosive, or nuclear material waste or any other substance defined or identified on a list of hazardous substances issue by or pursuant to the Canadian Environmental Protection Act, the United States Environmental Protection Agency, the United States Atomic Energy Act of 1954 or any federal, provincial, state, county, municipal or local counterpart thereof- provided however, and subject to all other terms, conditions and exclusions of this policy, this exclusion shall not apply to any Loss payable to any Insured Person*
>
> *(a) which is on account of any Claim brought by any plan member of an Employee Benefit Plan of a Company in his or her capacity as such,*
>
> *(b) which represents Costs, Charges and Expenses for Claims brought, commenced and conducted in the territorial limits and jurisdiction of Canada…*

This policy has been "Canadianized" by including reference to any federal or provincial counterpart of American laws in regard to pollution and environmental control. The same policy contains an exclusion for any claim under an employment practices liability policy, namely:

> *The Underwriter shall not be liable for Loss resulting from any Claim made against any Assured:*
>
> *Based upon, arising out of directly or indirectly, resulting from or in consequence of, or in connection with, or in any way involving, directly or indirectly, discrimination in violation of any law other than ERISA.*

In the U.S., Employee Benefits Liability (or "EBL") coverage only protects against claims for administrative errors and omissions in relation to benefit plans. These kinds of errors might include mishandling of paperwork, such as a failure by the administrator to enroll an employee in the pension plan. EBL coverage would not cover, for instance, a claim that a fiduciary selected the wrong investment instrument, or in any case involving the exercise of fiduciary discretion which is the hallmark of liability under

ERISA. EBL endorsements to a Comprehensive General Liability policy may very well exclude coverage for a fiduciary's personal liability as a result of an ERISA claim. On the other hand, a fiduciary liability policy may offer EBL insurance either by endorsement or by basic form.

As discussed earlier, the definition of "wrongful act" in fiduciary liability policies results in coverage only if fiduciaries were acting in that very capacity at the time of this alleged wrongdoing. Coverage will not be available if the fiduciary is sued in the capacity of a Director and Officer of the company. A common scenario in this last decade has been an overlap between securities type claims, which most often name the D + Os, and pension-related fiduciary liability claims – the "tag-along" or "follow-on" cases. The case of *In re: Tower Automotive, Inc.*[93] is a good example. Here the insurer was ordered to provide coverage under a fiduciary liability policy for lawsuits against the D + Os who oversaw Tower's employee benefit plans in spite of a "Securities-Based Claims Exclusion" which read that no coverage was available for any securities based claim against an Insured if the claim sought relief for any purchaser or holder of securities issued by the insured. The exclusion read:

> *No coverage will be available under this coverage section for any Securities-Based Claim if such Securities-Based Claim, or any other written demand or civil or administrative proceeding against an Insured, seeks or has sought relief for any purchaser or holder of securities issued by [Tower] who is not a Plan participant or beneficiary based upon, arising from, or in consequence of any Wrongful Acts, facts or circumstances or situations described in 1(a) or 1(b) above or any related Wrongful Acts, facts, circumstances or situations.*

A "Securities-Based Claim" was any claim involving information relating to stock value or to the financial or operational performance of the company's stock. Six fiduciary actions were filed against the D + Os alleging violations of ERISA; at the same time five other actions were filed against some of the same officers alleging securities violations. Both types of actions alleged that the officers made misleading statements about the insured company's finances.

Two facts were irrefutable. First, the ERISA actions were found to be "Securities-Based Claims" as per the exclusion. Second, the five other securities actions were (as per the exclusion) civil proceedings seeking relief for puchasers of stock who were not plan participants. The insurer argued that the exclusion should be interpreted to deny coverage because the securities actions were another civil proceeding and there could be no coverage for the ERISA actions once the securities actions had been filed. The Court stated:

[93] 361 B.R. 660 (U.S.D.C. – New York, 2007).

> *Because securities claims are frequently asserted by public shareholders who are not Plan participants or beneficiaries, the practical effect of Federal's reading of the Exclusion is to bar any coverage whatsoever for securities claims asserted against Tower's ERISA Plan fiduciaries. Given that coverage for securities claims is necessarily a core element of the coverage grant in a fiduciary policy, this result would be counterintuitive, to say the least.*

The Court reasoned that to link the coverage of ERISA type actions to an entirely unpredictable development such as the filing of securities based claims against an ERISA defendant would defy logic.

Finally, there is often confusion between fiduciary liability insurance and the "fidelity or fiduciary bond" required by ERISA (mentioned in the introduction to this section). Fidelity bonds are mandated under the law and the bond protects the plan from loss due to theft or dishonesty by the fiduciaries, however it does not cover claims for breach of fiduciary duty.[94] The fidelity bond will not protect the fiduciary, the administrator or the company for discretionary decisions which are the hallmark of the fiduciary.

6. Exclusions for Contract Assumed

The "contract assumed" exclusion in a typical fiduciary liability policy relates to the fact that many pension plans are administered by an external trust company via a trust agreement with the company. Unless the contract was assumed in accordance with the trust agreement, coverage is removed for express contractual undertakings. The rationale for the exclusion is obvious – no insurer wants to be bound by an insured's contractual relationships unless those undertakings are directly related to the plan. Otherwise, a so-called "moral hazard" would result – as described in the *BOC Group* case – whereby insurance can provide an incentive to the insured to increase risky behaviour thereafter covered by insurance.

Several sample wordings of the "contract assumed" exclusion in current fiduciary liability policies are provided below:

> Sample 1
>
> *The Underwriter shall not be liable for Loss resulting from any Claim made against an Assured:*

[94] ERISA Section 1112.

Based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving liability of others assumed by any Assured under any written, oral, express, or implied contract or agreement; provided this exclusion shall not apply to the extent (i) the Assured would have been liable in the absence of such contract or agreement; or (ii) the liability was assumed in accordance with or under the trust agreement or equivalent document pursuant to which the Benefit Program was established.

Sample 2

The Insurer shall not be liable for Loss on account of any Claim alleging, based on, arising out of or attributable to liability of others assumed by the Insureds under any contract or agreement. However this exclusion shall not apply to (i) Defence Costs; and (ii) to the extent that liability would have attached to the Insured in the absence of such contract or agreement, or where the liability was assumed in accordance with or under the agreement or declaration of trust or equivalent document pursuant to which the Plan was established.

7. Exclusion for Non-Sponsor

Fiduciary liability policies address the uncertainties created by the sale or takeover of a company by creating a temporal exclusion based on when the company was a sponsor of a private pension plan. A sample wording of this exclusion from a current fiduciary liability policy is as follows:

Sample 1:

The Underwriter shall not be liable for Loss resulting from any Claim made against any Assured…based upon, arising out of, directly or indirectly resulting from, or in consequence of, or in connection with or in any way involving any Wrongful Act by a Benefit Program or any Assured of such Benefit Program to the extent the Wrongful Act occurred when the Company was not a sponsor of or participant in such Benefit Program.

The operation of the non-sponsor exclusion is shown in *Mary Kay Holdings Corp. v. Federal Holding Co (*discussed earlier in the "wrongful act" context). Here, Mary Kay - the parent company - held substantial stock in a subsidiary called MSC. MSC went bankrupt and after a corporate re-organization, Mary Kay ceased to have any direct or indirect interest in it. When Mary Kay arranged for fiduciary liability cover, it owned no MSC stock when the policy incepted or at any other time during the policy term. In an underlying action, brought after the bankruptcy, MSC shareholders alleged that Mary Kay fiduciaries were negligent in the administration of MSC pension plan sponsored by Mary Kay. A sponsored plan under the policy was defined as a plan sponsored by Mary

Kay or one of its subsidiaries. The Court made the following comment critical to the temporal issue:

> *In corporate families, subsidiaries may be acquired and divested. It is not the case that once a subsidiary, always a subsidiary. Thus, in determining whether an entity is a subsidiary under the Policy, the Court must consider at what time.*

The Court found that in order to be subsidiary under the Policy, the corporate entity must be a subsidiary as defined *when* the policy incepted. This was the most sensible conclusion in terms of underwriting and would allow for the accurate assessment of the insured risk; no policy would automatically cover new subsidiaries or perpetually cover former subsidiaries. The risk for underwriters would be too great and too unknown.

To prevent these sorts of coverage disputes, fiduciary liability policies often contain an adjustment clause for coverage after an insured acquires or creates another organization (or benefit program) during the lifetime of the policy, or if the parent company itself is merged, consolidated or bought out by another company. Any corporate activity during the policy period involving subsidiaries or acquisitions must be reported, in full, to the insurer. This allows a continual, and developing, assessment of the risk associated with the policy and the insured.

VI. SUMMARY AND CONCLUSIONS:

The perfect storm has arisen in North America for an increase in fiduciary liability claims. The current economic crisis, corporate and pension meltdown in the U.S. and Canada, the development of class action legislation in Canada and a workforce which may now defer retirement are all factors which combine to mean that companies with pension plans should not be without fiduciary liability insurance and the protection the policies can bring. In fact, any individual that exercises a discretionary role related to a pension plan must be protected. There is a very real risk of personal liability for breach of fiduciary duties under ERISA-type plans. As greater numbers retire, and pensioners look to their plans for financial security both earlier in life, and for a longer period of time, (or conversely, cannot afford to retire) litigation in Canada for breach of fiduciary duties and obligations is certain to increase, especially in the case of larger, more lucrative plans.

The end result for insurers and insurance counsel is the same; a growing number of claims in an evolving legal environment which shows an early tendency to favour the beneficiary over the fiduciary. The pension landscape in both Canada and the United States is heavily regulated, but the Courts will still expand the obligations of fiduciaries, even in defined contribution scenarios. As the challenges of tough economic times put increased strain on pension solvency, more fiduciary liability claims are inevitable.