EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION

FIFTH CIRCUIT OPINION SHINES LIGHT ON POTENTIAL HOLES IN PLAN SPONSORS' FIDUCIARY LIABILITY COVERAGE

A recent Fifth Circuit Court of Appeals decision has highlighted the need for plan sponsors to review their fiduciary liability insurance policies to determine whether they will have coverage available if they are required by a service agreement to indemnify a third-party plan trustee or other vendor. In *Martin Resource Management Corp. v Federal Insurance Co.*, Martin Resource Management Corp. ("Martin"), the plan sponsor, sought coverage from its insurance company, Federal Insurance, for indemnification and defense claims stemming from a suit by plan participants against its appointed third-party trustee for alleged wrongful acts connected to the trustee's management of Martin's Employee Stock Ownership Plan ("ESOP"). The trustee was the only defendant named in the suit, and the case eventually settled.

As required by the ESOP's trust agreement, Martin paid the cost of defending the lawsuit. Martin then made a demand on Federal Insurance to cover the cost of indemnification and defense. The insurance company initially agreed to cover defense costs, but subsequently denied the claim and ceased to provide coverage, explaining that claims from a third-party were not covered under the fiduciary liability coverage section of the policy. Martin filed suit in the Eastern District of Texas for breach of contract, declaratory judgement, violations of the Texas Insurance Code, and related claims. Federal Insurance filed a successful motion to dismiss, and the Fifth Circuit affirmed the dismissal.

In its opinion, the court agreed with Federal Insurance that a plain reading of the policy did not include coverage for "Wrongful Acts" committed by parties other than Martin. The policy reads, in part, "[Federal] shall pay, on behalf of the Insureds, Loss on account of any Fiduciary Claim first made against the Insureds . . . for a Wrongful Act committed, attempted or allegedly committed or attempted . . . by such Insureds." The court explained that "A careful, plain reading of the Insurance Clause shows coverage is only available if a Fiduciary Claim is made against an Insured for a Wrongful Act by an Insured. The Demands, as they appear from [the trustee], are facially insufficient to trigger the Insuring Clause, which requires the assertion of a "Fiduciary Claim . . . made against [Martin] . . . for a Wrongful Act committed . . . by [Martin.]".

Martin pointed to a provision of the policy stating that, "The Company [i.e., Federal Insurance] shall not be liable for Loss on account of any Claim against an Insured . . . based upon, arising from or in consequence of the liability of others assumed by any Insured under any written or oral contract or agreement; provided that this Exclusion . . . shall not apply to the extent that . . . the liability was assumed in accordance with or under the agreement or declaration of trust pursuant to which the Plan was established." Martin argued that this clause indicated that the policy was intended to cover indemnity obligations under the trust agreement. However, the court determined that this exception to the exclusion for contractually assumed liabilities only applied if the claim was a covered Wrongful Act by an Insured in the first place. In other words, if an Insured committed a Wrongful Act in connection with a contractually assumed liability, coverage would be available if the contractual assumption occurred via the trust agreement, but not otherwise. In contrast, if there was no Wrongful Act committed by an Insured, issues of contractual assumption and the trust agreement exception would not need to be considered, since no coverage was available.

Next Steps

The Fifth Circuit's decision is one decision by one court. The Fifth Circuit opted not to publish the decision formally, limiting its precedential value. Furthermore, the decision in *Martin* was based on the specific wording of the policy at work in that case, and on Texas law regarding the proper construction of insurance contracts. For all of these reasons, the *Martin* case cannot be taken as an indication that insurance coverage is unavailable for indemnity obligations as a general matter. However, the outcome of this case nonetheless points to the importance of understanding the scope of fiduciary liability insurance coverage. In light of the principles articulated in *Martin*, plan sponsors should:

- Review their fiduciary liability insurance policies to determine the scope of their coverage.
- Review any agreements requiring them to indemnify third-party trustees, plan administrators, and other vendors, and consider the standard of care required to invoke indemnification and how that standard relates to insurance coverage.
    - Aside from issues of coverage, plan fiduciaries should be sure their vendors are required to provide services of an appropriate level of quality. Many vendors require plan sponsors to indemnify them against liabilities and expenses (including attorney fees) absent a finding of negligence or gross negligence. The gross negligence standard, in particular, can give a vendor a high degree of protection even if its conduct was problematic. Plan fiduciaries have an obligation to be sure that plan vendors are offering services in a competent fashion. Thus, the Department of Labor expects plan fiduciaries to assess the prudence of contractual clauses providing for indemnity and limiting vendors' potential liability. Failure to provide proper oversight can expose the fiduciaries to direct liability even if the vendor's conduct eventually disqualifies the vendor from indemnity.
- When entering into agreements for services under their plans, consider the scope of indemnification required compared to the coverage provided under their insurance policies.
- When entering into service agreements, and in the course of routine reviews of vendor relationships, inquire whether plan service vendors have adequate fiduciary liability and errors and omissions (E&O) coverage to protect themselves in the event of a claim against them by a participant, and ascertain whether that coverage must be exhausted before an indemnity obligation is triggered.

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