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*A White Paper from Euclid Specialty Managers*
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# Euclid Specialty Managers White Paper on Governmental Benefit Plans
# Who Pays When a Trustee is Sued?

## Introduction

Cathy Lexin was performing her government job for the City of San Diego when she was sued after the City's retirement plan became insolvent. But when she asked the City to defend her, her request was denied. She faced defending a $2 billion lawsuit with her own money.

How could this happen? And more importantly, could this happen to other government workers? Cathy Lexin's ordeal is a wake-up call for all trustees of governmental benefit plans – particularly in the many jurisdictions across the country facing financial issues.

Lexin was the City's human resource director. By virtue of this position, she was required to serve as a volunteer trustee of the San Diego City Employees Retirement System (SDCERS).[i] SDCERS is a defined benefit plan with nearly 20,000 members. The pension fund is overseen by a thirteen-member Board of Administration, the SDCERS Board. The SDCERS Board is a fiduciary charged with administering the City's pension fund in a fashion that preserves it long-term solvency. In addition to Lexin, five other city workers were also required by City Charter to serve on the SDCERS Board of Administration, including the city's fire captain and treasurer.

In the midst of a public financial crisis in San Diego in May 2005, Lexin and the five other city employees on the SDCERS Board were charged with felony violations of state conflict of interest statutes. The lawsuit arose out of the city's fiscal crisis and inability to fund its employee retirement system adequately. The City Attorney alleged that Lexin and her fellow city employees on the SDCERS Board had voted to authorize an agreement allowing the City to limit funding of its retirement system in exchange for the City's agreeing to provide increased pension benefits to City employees, including themselves. The lawsuit alleged the SDCERS board members had exposed the City of San Diego to potential liabilities in the range between $1.4 billion and $2 billion. The Lexin defendants were also named in another lawsuit arising out of the fiscal crisis.

The City Council held a vote to decide whether the City should provide a defense for Lexin and the five other employees. The vote was 4-2 in favor of providing a defense, with some abstentions. But because five votes were required, the vote failed.

The City Council turned to the City Attorney – who had filed the initial lawsuit – to analyze whether the City owed the employees a defense. The City Attorney concluded that the City had discretion to deny a defense based on the Council's unconfirmed belief that the employees had acted improperly. Ultimately, the Lexin defendants were forced to file a lawsuit against the City of San Diego seeking indemnification of their defense costs.

**Lessons from the San Diego Pension Crisis:** The San Diego pension crisis provides lessons for all trustees of governmental benefit funds.

- *First,* when something goes wrong, politicians need someone to blame, and benefit plan trustees are easy targets. Cathy Lexin and the other city employees were required by statute to volunteer on the pension fund. But they were the first to be scapegoated when the City could not fund its obligations.
- *Second,* even though it might have been unfair, the San Diego lawsuits are a reminder that trustees face unlimited personal liability. In the San Diego crisis, the Lexin defendants were sued for up to $2 billion in liability.
- And *third,* the San Diego crisis teaches that governmental trustees cannot rely on governmental immunity or indemnification when they are sued. Indemnification is never foolproof. In fact, the San Diego example reminds us that indemnification has many discretionary limits that place volunteer trustees in potential jeopardy when something goes wrong.

This white paper addresses how governmental trustees can protect themselves.

## The Three Myths of Governmental Fiduciary Liability

Although it is rapidly changing due to increased education, trustees of governmental benefit plans have historically believed that they are immune from personal liability. This historical misconception is based on three misunderstandings. First, trustees often believe that they have no exposure because ERISA does not apply to governmental benefit plans. Second, trustees often believe that they are protected by sovereign immunity statutes. And finally, trustees expect to be indemnified by the governmental entity for which they are volunteering their time. But trustees are learning, and as the San Diego example demonstrates, the truth is much different. The following analyzes each of these three fallacies.

## I. ERISA does not apply, *BUT trustees are still subject to fiduciary liability from other sources*

ERISA sets a high bar of fiduciary responsibility. Indeed, ERISA codifies the principle that the fiduciary obligations of trustees and other fiduciaries are the highest known in the law. Under ERISA, a fiduciary must perform his or her duties: (1) solely in the interest of the plan's participants and beneficiaries (the duty of loyalty); (2) for the exclusive purpose of providing benefits to participants and beneficiaries of defraying the reasonable expenses of administering the plan (the exclusive purpose rule); (3) diversifying plan investments so as to minimize the risk of large losses unless it is clearly prudent to not do so; and (4) by acting in accordance with the documents and other instruments governing the plan, so long as those documents are consistent with ERISA.

State and local governments are exempt from the employee benefit protections in Title I of ERISA. Specifically, Section 4(b)(1) of ERISA excludes governmental plans from coverage under Title I of ERISA. Section 3(32) of ERISA defines governmental plans as any "plan established or maintained for its employees by the government or any state or political subdivision thereof, or by any agency or instrumentality or any of the foregoing." But governmental plans are still subject to fiduciary liability from sources other than Title I of ERISA that mirror ERISA or impose similar fiduciary requirements on governmental plans. Indeed, governmental plans are subject to fiduciary liability from state statutes and common law rules that rival the high standard of ERISA.

**Personal Liability:** Nearly all states adopt the bedrock fiduciary standard from ERISA that fiduciaries may be held personally liable for losses to a plan resulting from a fiduciary breach and may be required to restore to the plan any profits that result from their use of plan assets. This fundamental rule is derived from Section 409 of ERISA and applied universally across most jurisdictions.

**Exclusive Benefit Rule/Duty of Loyalty:** Second, governmental plans are still subject to the tax provisions in Title II of ERISA that specify the qualification requirements for tax exempt status. Section 401(a)(2) of the Internal Revenue Code provides that, in order to maintain its tax-deferred status, "all contributions made to the Retirement System, including all earnings, must be held for the ***exclusive benefit*** of plan beneficiaries, and cannot be used for, or diverted to, purposes other than the exclusive benefit of plan benefit beneficiaries." Fiduciaries of employee benefit plans have a duty of undivided loyalty to the plan, its participants and their beneficiaries. Under the exclusive benefit rule, trustees of governmental plans must act in a manner that benefits only the participants and beneficiaries of the plan, defrays the reasonable expenses of administering the plan and avoids unnecessary costs.

**"Prudent Person" Rule:** Third, governmental plans are subject to fiduciary requirements established under state and local law. Nearly every state derives its fiduciary standard of care from ERISA or the common law from which ERISA itself was derived. Under ERISA, a fiduciary must meet the "prudent person" standard: a fiduciary must act with the care, skill, prudence and diligence under the circumstances that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[ii] Thirty-four states apply the ERISA "prudent investor rule," which requires fiduciaries of a retirement system to evaluate an investment as part of the total portfolio rather than view it in isolation. Pennsylvania and seven other states impose a "prudent person" or "prudent man" rule, which requires fiduciaries to evaluate each investment in isolation rather than view it as part of the total portfolio. Like the duty of loyalty, the prudence laws that apply to governmental plans are nearly identical to the ERISA standard applied to private plans.

## II. Sovereign Immunity Provides Incomplete Protection

Sovereign immunity is the legal principal that the sovereign or government is immune from lawsuits or other legal actions except when it consents to them. Most states provide sovereign immunity for actions by governmental agents, including trustees who sit on public benefit plans. But there are limits to sovereign immunity protection. Many states, for example, protect fiduciaries for acts made in good faith; sovereign immunity will not apply for acts considered willful, wanton, reckless, malicious, grossly negligent or in bad faith. Connecticut's governmental immunity law, for example, provides that "[n]o state officer or employee shall be personally liable for damage or injury, ***not*** wanton, reckless or malicious, caused in the discharge of his or her duties or within the scope of his or her employment."[iii] Similarly, the state of Texas provides immunity to the board of trustees, executive director, and employees of the retirement system for any action or omission made or suffered by them *in the good faith* performance of any duty in connection with any program or system administered by the retirement system.[iv] Other states have broad immunity statutes that have been limited by the courts. For example, Alabama courts have held that sovereign immunity does not apply when the state agent acts, willfully, maliciously, fraudulently, in bad faith, beyond his or her authority, or under a mistaken interpretation of the law.[v] Likewise, the Rhode Island immunity statute provides immunity for good faith acts, but case law makes clear that "good faith" is a contestable question of fact that cannot be decided on a motion to dismiss.[vi] In sum, sovereign immunity has significant limitations and is not a complete protection for governmental trustees.

## III. The Scope of Indemnification by Governmental Entities is Limited and Often Discretionary

Many states have indemnification provisions that are designed to protect retirement board employees when they are accused of wrongdoing. But like the sovereign immunity statutes discussed above, these indemnification provisions typically have significant limitations and are subject to several levels of discretion.

**"Good Faith" Limitation:** Similar to the law of sovereign immunity, the most common limitation restricts indemnification to official actions taken in "good faith." This standard retains personal liability for "bad faith, willful, wanton or fraudulent misconduct or intentionally tortious conduct." For example, a member of the Arizona State Retirement System (ASRS) board is "immune from civil liability . . . for any act or omission . . . if the member was acting in good faith and within the scope of the member's official capacity, unless the damage or injury was caused by willful or wanton or grossly negligent conduct of the member.[vii] Similarly, Illinois law permits the state retirement system to indemnify fiduciaries, but not for "willful misconduct and gross negligence."[viii] The problem for fiduciaries is that the standard is contingent on a judgment or appraisal of whether the underlying conduct was in "good faith." This judgment call is often subjective, vague, and without specificity as to how it will be determined. Delaware, for example, limits indemnification to good faith conduct reasonably believed in the "best interest" of the state.[ix] Moreover, many claims and allegations of wrongdoing increasingly allege bad faith. Consequently, indemnification can be lost at the initial pleading stage, long before innocence or guilt can be adjudicated.

**Limited to Scope of Employment:** Most states require the act in question to have been taken "in the scope of employment" or "to further the purposes for which the board was established." For example, Alabama requires good faith conduct in the scope of authority under statute; Arizona and New Hampshire require good faith conduct within the scope of official duty; Georgia limits indemnification to conduct in an official capacity; Idaho, Illinois, Iowa, Missouri and Oklahoma limit conduct within the scope of employment; and New Mexico's indemnification applies only if decisions were made pursuant to, and in accordance with the state retirement act. Under these varying and often subjective and vague standards, actions that breach a fiduciary duty are arguably outside the scope or purpose of employment.

**Who is Eligible?** Many states limit indemnification to members of the board of trustees and do not extend liability protection to other officers, agents or employees. This is the case in states like Arizona, Delaware, Georgia, Kentucky, Maine, New Mexico and Washington. Illinois law, by contrast, is more expansive in providing indemnification for "trustees, staff and consultants."[x] Similarly, Kansas law provides indemnification protection for "trustees, officers, employees and

agents" (unless "such person acted with willful, wanton or fraudulent misconduct or intentionally tortious conduct)."[xi]

**Who Decides?** In Minnesota, indemnification is at the discretion of the governing board of the plan,[xii] and in New Hampshire, the attorney general is the decision maker.[xiii] But most states have not resolved the question as to who makes the decision to indemnify, through what process, and subject to what review. Who determines whether the act was taken in good faith can vary from the board of trustees, the attorney general, or the courts. Needless to say, each of these decision makers creates risk to a trustee needing indemnification.

**What Costs or Damages can be Indemnified?** Most state indemnification statutes do not address the full scope of indemnification. This silence creates uncertainty as to whether defense costs, judgments, penalties and other expenses are covered. Uncertainty also exists as to when defense and other expenses will be paid or reimbursed.

## Trustees of Governmental Benefit Plans Need Fiduciary Liability Insurance

Nearly half of the states expressly authorize the board of trustees or its equivalent to purchase fiduciary liability insurance for plan trustees, officers, agents and employees, including Alaska, Arizona, California, Georgia, Idaho, Illinois, Kansas, Louisiana, Missouri, North Carolina, Ohio, South Carolina, Texas, Utah, Virginia, and West Virginia. The purchase of insurance is required in Arizona, Colorado, and Maryland. But even in states in which fiduciary liability insurance is not specifically mentioned in state statutes, nothing prohibits a fund from purchasing insurance to protect its trustees. Indeed, given the significant risks trustees face, no trustee should agree to serve on a board of trustees unless they are protected with fiduciary liability insurance. Prudence demands no less.

## Conclusion

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

## About Euclid

Founded in 1952, Euclid Insurance Services, Inc. is a family-owned, managing general agent and underwriting manager and claims administrator. The firm offers a wide range of professional liability, property, casualty, life, accident and health insurance products through agents and brokers nationwide. Euclid Specialty Managers is a division of the company that specializes in fiduciary liability and other insurance programs for the labor affinity market.

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[i] San Diego City Charter, art. IX, §141; San Diego Mun. Code § 24.0101.
[ii] ERISA § 404(a)(1).
[iii] Conn. Gen. Stat. Ann. Section 4-164.
[iv] Tex. Rev. Civ. Stat. Section 811.007.
[v] *Johnson v. Sorensen*, 914 So.2d 830 (Ala. 2005).
[vi] Section 36-8-3 of the Rhode Island General Laws. *But see Abbatematteo v. State*, 694 A.2d 738 (R.I. 1997) (whether or not the allegations are characterized as intentional or negligent, the issue of good faith presents a question of fact that cannot be disposed of in a motion to dismiss).
[vii] Ariz. Rev. Stat. § 38-717B.
[viii] 40 ILCS § 5/1-107.
[ix] Del. Code §8308(j).
[x] 40 ILCS § 5/1-107.
[xi] Kan. Stat. Ann. § 74-4904.
[xii] Minn. Rev. Stat. Ann. §356A.11.
[xiii] N.H. Rev. State § 99-D:2.