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Double Indemnity: Does Your Plan's Fiduciary Indemnification Clause Protect Your Plan Administrator?

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Many plan documents promise that the employer will indemnify the plan administrator to the full extent permitted by law. In this article we ask if—for the in-house administrator—these provisions are redundant or, worse, unenforceable or, worst, just plain conflicting with more effective indemnification clauses in the company's bylaws? The law is surprisingly undeveloped. But we expect post-Enron litigation to push the law on all these questions. We end with a list of recommendations so the plan administrator and company can try to ensure that any indemnification provisions protect the administrator to the full extent all parties intended.

In our last article (Summer 2002) we discussed the potential reach of fiduciary status under ERISA. We here take up a related issue: the effectiveness of a common indemnification clause in an ERISA plan document—specifically, the typical plan's promise that the *employer* will indemnify the fiduciary. In a post-Enron era of volatile stock prices and rising litigiousness, this promise is especially important to the beleaguered fiduciary. The focus of our concern is the in-house fiduciary—in particular, the plan administrator, who might be

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a company officer, or a committee of company officers, directors, and perhaps managers who are neither officers nor directors.

The plan provision we are concerned about typically looks something like this:

> The Company agrees to indemnify and reimburse, to the fullest extent permitted by law, [various fiduciaries] for any and all expenses, liabilities or losses arising out of any act or omission relating to the rendition of services for or the management and administration of the Plan.

This is a clear expression of intent the company will cover its plan administrators for the risks of assuming ERISA fiduciary responsibility. But administrators and company management might now wish to give these clauses a hard look, and ask if they unambiguously embody the parties' intent and protect the plan administrator.

Here are just a few of the issues raised by plan promises of this kind: If the indemnification promise is in the plan, is it enforceable against the employer? Or is it just an expression of wishful thinking? If enforceable, does it conflict with the indemnification provisions of the company's bylaws? Does it promise that the company will advance the administrator's litigation costs? Or will the plan administrator first have to mortgage his or her house and dip into the kids' college fund to front an adequate legal defense? Is it going to be interpreted under the laws of a state agreeable to management and administrator alike? To the extent the indemnification has gaps, does the employer carry insurance to cover its in-house ERISA fiduciaries?

Below, we explore how these issues are largely unresolved. We conclude by recommending steps administrators and management might wish to take to solidify the indemnification promise.

WHY THE PLAN ADMINISTRATOR MIGHT BE WORRIED

Like other fiduciaries, the plan administrator may be personally liable to the plan for harm caused by fiduciary breach. Take the case of the administrator of an ESOP, profit sharing plan, or 401(k) plan with significant holdings in employer stock. After the company's share price tumbles, breach may be alleged on the basis of the administrator's failure to monitor plan investments, failure of his or her duty of prudence by failing to diversify, misrepresentation to plan participants with respect to the stock's likely value, and prohibited transactions arising from, for example, sale of the company's shares to the plan at an inflated price.

The plan administrator may also be subject to claims of violation of state and federal securities laws. In some cases, the plan administrator acting with maximum diligence and in the best faith may find his duties under ERISA and securities law in potential conflict. For example, consider the plan administrator who is in possession of material nonpublic information about the company's prospects, such as pending denial of a patent or drug approval. The law is still undeveloped as to the relationship between his duty under ERISA to disclose to inquiring plan participants, and his duty under federal securities law not to.

Given these hazards, and potentially conflicting duties, even the most careful plan administrator might wish to ensure that he or she is maximally protected against both liability and the costs of litigation.

CORPORATE INDEMNIFICATION

Virtually all states require a corporation to indemnify its officers and directors for the costs of a successful defense against claims brought against them for acts undertaken in the course of their work for the corporation. These "mandatory indemnification" statutes vary from state to state. For example, some states mandate reimbursement for a defense that is successful "on the merits," while others require only success "on the merits or otherwise." The "or otherwise" means that indemnification is required for exoneration on merely technical grounds, such a running of the statute of limitations. States also vary, for example, as to whether indemnification is required for costs defending acts undertaken for a different corporation (for example, a subsidiary), for fees spent to enforce indemnification provisions ("fees on fees"), and for partial indemnification in the event of partial success.

To supplement mandatory indemnification, virtually all publicly held corporations have additional indemnification in their bylaws (or by contract). These are typically upheld by the courts as binding on the corporation under state contract law. The corporation can thus promise its officers and directors, for example, that it will indemnify them for actions short of success, for acts undertaken on behalf of other corporations, and in advance of a final judgment.

A typical indemnification clause in corporate bylaws promises indemnification "to the full extent permitted by law." Not surprisingly, state laws vary on the permitted limits of this contractual indemnification. For example, some states void indemnification clauses for acts not undertaken in the best interest of the corporation,

others only for acts approaching outright theft. In some states, such indemnification clauses imply an enforceable promise to advance lawyers' fees and other expenses; in others, advances are mandatory only if expressly promised in the bylaws (or contract). In some states, indemnification promises are read to include payment of expenses to enforce the promise (fees on fees); in other states, not.

To fill the gaps in its indemnification provisions, corporations typically buy Directors and Officers (D&O) insurance. Insurance is typically permitted to indemnify the officer, even where he or she could not be indemnified by the corporation. Moreover, insurance is additional protection in the event of the company's insolvency.

WHAT THE PLAN ADMINISTRATOR AND COMPANY SHOULD BE ASKING

The first and most basic question the company and plan administrator should be asking is this: When the plan promises that the employer will indemnify the fiduciary, is this promise binding on the employer?

The normal enforcement mechanisms of ERISA Section 502 are not unambiguously available to the administrator who tries to enforce the plan's indemnification promise against the employer. The administrator could sue under Section 502(a)(3)(A) to enforce the plan's indemnification provision. But the Supreme Court's recent decision in *Great-West Life & Annuity Insurance Company v. Knudson,* 122 S.Ct. 708 (2002), raises the possibility that this action would be considered "legal" in nature, rather than equitable as required under Section 502(a)(3)(A) (injunction to compel the payment of money past due under contract, or specific performance of past due monetary obligation, may not be brought under Section 502(a)(3)(A) because not typically available in equity). The administrator might sue under Section ERISA 502(a)(3)(B) for "restitution" or "other equitable relief." But as the employer is unlikely to have specific funds set aside, again under *Knudson*, the administrator's suit may not be viewed as an equitable action for a constructive trust or equitable lien, but rather a legal action not enforceable under Section 502(a)(3)(B).

The plan administrator may be able to sue under state contract law—but it is unclear whether this is preempted by ERISA. At least one case has suggested that indemnification promises may be enforced by a plan fiduciary against the employer under the "common law of ERISA"—*Wells Fargo Bank v. Bourns, Inc.*, 860 F.Supp. 709

(N.D. Cal. 1994) (when trustee sued to enforce extra-plan contractual indemnification agreement against plan sponsor, promise not enforceable under state contract law, because preempted by ERISA, but enforceable under ERISA common law).

There is just about no law on this point. Such clauses have been upheld, for example, by the Seventh Circuit in *Packer Engineer, Inc. v. Kratville*, 965 F.2d 174 (7th Cir. 1992). In this case, however, the court did not discuss—and the employer seems not to have argued—whether the promise was unenforceable under state contract law, or under ERISA procedural grounds, such as the limitations of ERISA Section 502.

Moreover, if the plan's promise of indemnification by the employer is an enforceable promise, it is not a vested right. It can be amended out of the plan at any time, unilaterally by the employer. It is not like bylaws, for example, which might be alterable only by vote of the shareholders or under other state law constraints. This is not typically a concern between the plan administrator and his or her current management. But it might be if plan sponsorship is assumed, for example, by another corporation in a hostile takeover, or by the creditors' committee after the employer's bankruptcy. On this point, there would seem to be no case law at all.

But let's assume that the plan promise is enforceable by the administrator, and is not amended out of the plan. The administrator's queries should not be over. If the promise is enforceable, is it going to be read as a supplement to the indemnification provisions in the bylaws? Or in lieu of them? If the latter, there are more questions and maybe more problems.

First, there may be substantive conflicts. For example, the bylaws may promise advancement of expenses, while the plan may not. Which prevails?

There might also be jurisdictional conflict. Indemnification provided by the company's bylaws is interpreted under the corporation law of the company's state of incorporation. As an aside, this is likely to be a state with laws protective of the corporation's officers and directors. But the "legal effect" boilerplate of the typical ERISA plan document states that "the terms of this plan will be construed in accordance with the laws of the State of. . ."—wherever the company may have its headquarters, its operating facilities, etcetera. To the extent the indemnification promise is embedded in the plan document, and is a right of state contract law, it arguably is to be construed only under the corporation law of whatever state is designated in the plan. In a company that has grown rapidly by acquisition, the

administrator could be administering plans construed under the laws of, say, California, North Dakota, Texas, New York, and Kansas. And if things go very wrong for the company, he or she could be sorting out the indemnification laws of each of these states.

The choice of law questions are mind-boggling—and potentially expensive to the plan administrator.

To pick up again on the hot-button question of advancement: In some states, indemnification "to the fullest extent permitted by law" is read to require advancement of the officer's legal fees, but in others it is not. In some states, indemnification contracts are read to include "fees on fees," in others, not. In some states, indemnification for state securities law violation are permitted, in others, not. In some states, indemnification is barred for actions not undertaken in the best interest of the corporation, in others, only for outright bad faith or even theft. In some states, indemnification automatically covers acts undertaken by a corporate officer on behalf of the corporation's subsidiary, in others, not. When the indemnification provisions of the employer's plan and its bylaws are arguably construed under different state statutes, sorting out these questions can be important, time-consuming, and expensive.

WHAT THE PLAN ADMINISTRATOR AND COMPANY SHOULD BE DOING

As we have seen, the plan's promise that the employer will indemnify the fiduciary carries an uncertain burden. Best case, it is redundant. Worse, it may be unenforceable, and worst case, it may conflict with more protective provisions in the company's bylaws. They are in any event a potential source of expensive, worrisome litigation in the event of the employer's insolvency or acquisition.

Once the plan administrator and the company have sorted out what the intended scope of the administrator's indemnification is, here are some steps they may wish to undertake.

1. Cross-Reference Plan Promise to Bylaws.

One simple way to reduce the number of questions about the scope of indemnification is simply to cross-reference the plan promise to whatever else the company is doing. If the employer wants to ensure employer indemnification of the fiduciary, for example, the plan might say: "the plan fiduciary will be indemnified to the extent promised by the Company's bylaws." This is helpful to the plan fidu-

ciary if he or she is one of the parties covered by the bylaws' indemnification and—as is likely—the company is incorporated in a state with relatively pro-management corporation law, including indemnification provisions. It also sidesteps any post-*Knudson* possibility that the plan's promise to bind the employer is not enforceable.

2. Supplement with Agreement between Company and Plan Administrator.

The plan administrator and company may wish to enter into an agreement covering indemnification of fiduciary liability and advancement of costs. This kind of agreement can cover substantive gaps in the bylaws, such as any ambiguities related to advances. As a bilateral contract it may arguably be less prone to rescission by the employer. And it may cover individuals not covered in the bylaws' indemnification, such as administrators who act in a fiduciary capacity but are neither officers nor directors.

Even contractual indemnification via the bylaws or a supplemental employment contract, however, does not answer all the questions raised in this thorny area. Here are a few additional issues for the administrator and company management to think about:

Is the Contractual Indemnification Promise to the Fiduciary Enforceable under State Law, or ERISA?

Extra-plan agreements between the plan sponsor and service providers are typically enforced under state contract law. But one court has held, in *Bourns*, that an indemnification agreement by the employer to an independent fiduciary, even though contained in a separate document outside of the plan, was governed by ERISA and thus not enforceable under state contract law. But, the court went on to say, the extra-plan indemnity agreement was enforceable under the "common law of ERISA."

In light of evolving restrictions in ERISA preemption theory, this rather oddly reasoned case may not be good law, if it ever was. (Compare *Abraham v. Norcal Waste Systems, Inc.*, 265 F.3d 811 (9th Cir. 2001) (ESOP participants' action against ESOP trustee under state law theories of fraud and breach of contract, for trustee's action regarding employer's shares and notes in ESOP, not preempted by ERISA).) But until further development of the law on this point, *Bourns* continues to lurk out there as a wild card in the interpretation of indemnification agreements for ERISA fiduciaries.

Is Employer Indemnification Forbidden for the Breaching Fiduciary?

Section 410(a) of ERISA provides that "Any provision in any agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation or duty under this part shall be void as against public policy." Among other exceptions, ERISA Section 410(b)(3) states that nothing shall preclude an employer from "purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan."

Labor Department regulations reconcile these two provisions by reading them to "void any arrangement for indemnification of a fiduciary of an employee benefit plan by the plan," but to permit any arrangement that "merely permit another party to satisfy any liability incurred by the fiduciary in the same manner as insurance." According to 29 C.F.R. Section 2509.75-4, examples of permitted indemnification include indemnification of the fiduciary by the employer/plan sponsor.

We think the best way of reading Section 410 of ERISA is as allowing the employer to indemnify the fiduciary, even when the fiduciary is found liable for breach, to the extent not otherwise prohibited by state corporation law. This conclusion is not watertight, however. Scattered *dicta* in recent cases arguably open the door for the argument that employer indemnification may be void for a breaching fiduciary: *Packer Engineer, Inc. v. Kratville*, 965 F.2d 174 (7th Cir. 1992) (employer indemnification promised by plan, not void because fiduciary exonerated of breach); *Delta Star, Inc. v. Patton,* 76 F.Supp. 2d 617 (W.D. Penn. 1999) (indemnification of breaching ESOP trustee by employer void under ERISA Section 410—but arguably limited to facts of company owned by ESOP under logic of *Donovan v. Cunningham*, 541 F.Supp. 276, 289 (S.D. Tex. 1982), affirmed in part, reversed in part, vacated in part on other grounds, 716 F.2d 1455 (5th Cir. 1983)).

Again, the broader point is that the law is very little developed on this issue—and may be pushed as companies and plans are embroiled in more ERISA-related litigation.

3. Check for Gaps in Bylaws and Any Contractual Indemnification Provisions.

The plan administrator may wish to check that the bylaws and any supplemental employment agreements do not exclude coverage

of the administrator for his or her role as an ERISA fiduciary, for acts undertaken regarding other corporations (for example, in management of plans covering employees of subsidiaries or joint ventures), and so forth. Any holes should be covered by insurance.

4. Consider Amending the Plan To Provide for Backup Indemnification and Advancement by the Plan.

To supplement any promises offered by the company, the company and the plan administrator may wish to have indemnification and advancement promised by the plan itself.

The courts have interpreted ERISA Section 410 to permit indemnification by the plan of the plan fiduciary, provided no fiduciary breach is found. (*Leigh v. Engle*, 858 F.2d 361, 369 (7th Cir. 1988); cf. *Martin v. Walton*, 773 F.Supp. 1524, 1527 (S.D. Fla. 1991). See also ERISA Opinion Letter 78-29 (December 1, 1978).)

The issue of advancement by the plan is a little trickier. The Department of Labor has held that advancement by the plan is permitted only if the plan obtains a written legal opinion from independent legal counsel that, based on review of the relevant facts, the acts in question did not constitute breach of a fiduciary duty. (See Department of Labor Advisory Opinion, Ref. No. CA-3588(a) (September 9, 1977).) At least one court has applied a more liberal standard. Ruling in *Moore v. Williams*, 902 F.Supp. 957 (N.D. Iowa 1995), an Iowa district court held that a plan may advance the fiduciary's legal fees, pending outcome of the case, if the trust so provides, and the fees are returned if fiduciary breach is found. The *Moore* court expressly considered, and rejected the arguments that the payments violated ERISA Section 410, as well as the prohibited transaction provisions of ERISA Sections 406(a)(1)(B) (loans from the plan to a party-in-interest) and 406(a)(1)(D) (transfer of plan assets to a party-in-interest).

The enforceability of these provisions under Section 502(a) of ERISA has not been argued after *Knudson*. But the common law of trusts generally provides that, under equitable theories of exoneration and reimbursement, the trustee may recover from the trust any expenses properly incurred, including the successful defense of suits brought by trust beneficiaries. And he or she may enforce his or her indemnity right by equitable lien on trust assets. (See generally *Restatement of Trusts* 2d, Section 244, *Scott on Trusts* Section 244.1.) Thus, when the plan's indemnification promise runs to the plan, rather than to the employer, *Knudson* arguably is less problematic for the administrator's ability to enforce.

Plan indemnification, of course, is narrower than the permitted scope of corporate indemnification, or of a commercial insurance policy covering ERISA fiduciary claims. After a finding of breach, the fiduciary may not be indemnified by the plan, and must return any advances from the plan. Noncompliance on this score subjects him or her to the possibility of punitive excise taxes under Section 4975 of the Internal Revenue Code for any expenses improperly reimbursed. These may be assessed by the IRS even if the Labor Department never asserts the breach, according to *O'Malley v. Commissioner of IRS,* 972 F.2d 150 (7th Cir. 1992). Moreover, like all nonvested plan promises, it is of course subject to unilateral deletion by the employer. By contrast, the company's bylaws or an employee contract may guarantee indemnification of the breaching fiduciary, to the extent permitted by governing state corporation law (for example, absent a finding of bad faith, theft, or the like.)

Even though limited, provisions for indemnification and advancement by the plan may be at least a partial backstop for the plan administrator. They may be valuable in the event of employer insolvency, for example. And even for the breaching fiduciary, they may not be totally worthless. Plan indemnification is permitted—and advances may be kept—for defenses of any ERISA claims successfully defended against, even if the fiduciary was unsuccessful on some or all of the breach claims, according to *Leigh v. Engle,* 619 F. Supp. 154 (N.D. Ill. 1985). Moreover, indemnification is arguably permit-ted, and advances keepable, for the defense—successful or unsuccessful—of non-ERISA claims such as claims brought under securities laws.

For these reasons, the administrator and company may wish to amend the plan so that it is a backup indemnifier in the event of the company's inability to pay.

5. Check the Employer's Fiduciary Insurance.

The final fallback the plan administrator seeking indemnification is the commercial arrangements the company may have entered into for ERISA fiduciaries. As noted above, this insurance can cover acts that may not be indemnified by the corporation itself under state corporation law. It also provides an extra layer of protection in the event of corporate insolvency. Finally,—to the extent ERISA governs and limits the employer's indemnification of the plan fiduciary—commercial insurance policies are arguably exempt from these limitations by ERISA's "savings" clause that protects commercial insurance from ERISA preemption.

The plan administrator who is an officer or director should not assume this protection is included in the employer's D&O insurance. Such policies typically exclude coverage of ERISA liability. The administrator should check whether this exclusion applies (it probably does). In this case, the plan administrator is protected by insurance only if policy has an express rider for ERISA coverage, or the employer has purchased ERISA liability insurance. The non-officer, non-director administrator will, of course, also want to check his or her employer's insurance for ERISA fiduciaries. If the corporation has not bought this kind of insurance, the administrator's very last ditch defense may be his or her own purchase of fiduciary insurance. This is expensive at best, so should only be a last resort, after the other possible sources of protection discussed here have been explored.

CONCLUSION

The good news for the ERISA plan administrator is that ERISA carries its own protections against a finding of breach. The careful plan fiduciary who creates and keeps adequate records showing that he or she has met ERISA's procedural requirements necessary to show care, has an excellent chance of protecting him or herself against a finding of breach.

The bad news is that the law is unsettled and changing rapidly, and the variety of laws the administrator is exposed to include not only ERISA, but also securities laws and possibly other statutes as well. Moreover, even the innocent fiduciary may have trouble mounting an effective legal defense if forced to draw on his or her own resources before ultimately getting reimbursement from the company, plan, insurer, or opposing party.

For these reasons, the plan administrator and corporate management might be advised to review the indemnification promises in their plans. They may wish to ensure these provisions work as intended by following any or all of the steps outlined in this article:

1. Amend the plan so that it picks up by cross-reference any desired indemnification provision in the bylaws;
2. Supplement both plan and bylaws with an individual indemnification agreement between company and administrator;
3. Check for gaps in contractual indemnification (whether by bylaws or side agreement) that cannot be closed because of constraints in state law or for other reasons;

4. Amend the plan to provide fall-back indemnification and advancement in the event the company can not pay; and
5. Check the employer's commercial insurance coverage for fiduciary breach, and improve it if possible.

As a last redoubt, individual fiduciary insurance is available, but might be expensive and hard to get. Plan administrator and company management alike may feel that the in-house fiduciaries is more fully and fairly protected by first making best use of these other sources of indemnification.

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