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MEMO

To: Brian Yolles
From: Henry Smith
Re: Liability Protection Checklist for Private ESOP-Owned Insurance Brokers

You asked me to provide my thoughts on steps that can be taken by private Employee Stock Ownership Plan (“ESOP”)-owned insurance brokers to protect against ESOP-related liabilities. Those thoughts follow. Please let me know if you have any questions.

I. BACKGROUND:

Privately-owned insurance businesses that establish ESOPs often spend considerable time and resources during the ESOP establishment phase performing due diligence to ensure that the ESOP is suitable for the business and its owners (such as performing repurchase liability studies, undertaking cash flow analyses, considering fact-specific debt service issues, selecting appropriate lenders, service providers and fiduciaries, and the like). However, these ESOP sponsors often fail to consider – and protect against – issues that could arise during the life of the ESOP. Fortunately, with proper care, these risks can be managed.

II. LIABILITY EXPOSURES FOR OPERATING ESOPs:

A. Losses to Participants Caused by Fiduciary Malfeasance:

Although rare in practice, the law recognizes the possibility that a party that handles ESOP funds could misuse those funds. Therefore, every ESOP is required to maintain an ERISA Fidelity Bond – with terms and coverage limits specified by ERISA – to provide some protection to participants in such situations.

B. Claims Against ESOP Trustees, Plan Administrators and Employers (including Board Members and Executive Officers) for ERISA Fiduciary Breach:

If ESOP participants bring ERISA fiduciary breach claims against ESOP trustees, Plan Administrators and sponsoring employers, defendants must pay to defend themselves, regardless of the merit of the claims. Therefore, many employers purchase appropriate ERISA Fiduciary Liability Insurance policies in connection with their ESOPs so that a liability insurance carrier is standing by to help defend such lawsuits.

C. Losses Caused by Inadvertent Operational Errors:

More common than fiduciary malfeasance and fiduciary breach claims are losses related to inadvertent errors occurring during the day-to-day operations of an ESOP. These often occur because of the relative complexity of ESOPs (compared to more common defined contribution plans like 401(k) plans). Therefore, most ESOP sponsors protect against these losses by very carefully selecting, and continually monitoring, their ESOP service providers to ensure that they have the expertise and experience to operate the ESOP without error (and these sponsors ensure that their agreements with these providers specify that the provider will promptly correct any errors and make affected parties whole at the sole expense of the provider).

D. Losses of Retirement Security by ESOP Participants:

Of course, although perhaps not likely, it is always possible that – despite the best efforts of the employer and its employees and not as a result of any fiduciary breach or other malfeasance – the value of the employer stock held in the ESOP will decrease significantly or perhaps evaporate entirely, resulting in the participants’ retirement security being materially, significantly or completely impaired. A wide variety of factors could cause such a large decline, with many of these factors outside the control of the Board and management. Historically, there was no practical way to protect participants from this risk of loss, or to protect ESOP trustees, Plan Administrators and sponsoring employers from claims related to such a loss. Fortunately, employers may now consider an “ESOP Protection Trust” to substantially mitigate this risk.

(Note that insurance businesses may be more susceptible to this risk than other types of businesses because the central value of an insurance business “rides up and down the elevator” every day (i.e., their human capital). Also, insurance businesses’ success is often dependent on factors such as carrier behavior and their broker/agent compensation arrangements, community reputation, client base, competition from the internet, and the like. In fact, there have been widely reported cases of insurance business failures – some affecting businesses with ESOPs – resulting from factors such as these.)

III. SUMMARY:

Fiduciaries of ERISA-governed plans like ESOPs have personal, unlimited and joint and several liability for their fiduciary breaches (and sometimes for the breaches of other fiduciaries under ERISA’s “co-fiduciary” liability rules). Although ESOP fiduciaries sometimes are indemnified by the employer-sponsor of the ESOP, these indemnities often are limited in scope and of course only have value if the employer-sponsor is in the financial condition to honor them.

Employers and their owners begin to build protection against many ESOP-related risks through thoughtful planning and decision-making during the planning, design and establishment of their ESOPs. However, even in the case of the most thoughtfully established ESOP, various liability risks continue during the period of the ESOP’s operation. To maximize protection against liability, ESOP

sponsors should actively manage these risks by considering the following:

- Maintenance of the required-by-law ERISA Fidelity Bond;
- Purchase of ERISA Fiduciary Liability Insurance covering the appropriate parties and with appropriate coverage limits, deductibles, defense cost coverage, and the like;
- Careful selection and monitoring of ESOP service providers and inclusion in service provider agreements of provisions requiring the service providers to make affected parties whole and otherwise correct for their errors; and
- Participation in an ESOP Protection Trust