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NEWSLETTER

Seventh Circuit Holds No Coverage for Unpaid Pension Benefits Resulting from Company's Business Distress; Enforces Consent to Settle Provision

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The United States Court of Appeals for the Seventh Circuit, applying Illinois law, has held that an insurer properly denied coverage for a claim under the Employee Retirement Income Security Act (ERISA) for unpaid employee benefits, reasoning that the shortfall resulted from the insured company's "business distress" rather than any negligence or breach of financial duty. *Federal Ins. Co. v. Arthur Andersen LLP*, 2008 WL 942640 (7th Cir. Apr. 9, 2008). The court also held that the insurer was not obligated to provide indemnity for the settlement because the insured company entered into the settlement without first obtaining the insurer's written consent.

The insurer issued a fiduciary liability policy to Arthur Andersen. In March 2002, after the accounting firm collapsed following its indictment for alleged conduct relating to Enron, a number of its former partners sued the firm, alleging violations of ERISA and seeking an immediate distribution of retirement funds. The firm tendered the complaint to the insurer in May 2002 and told the insurer that the firm had already retained counsel to defend it. Those suits were subsequently dismissed. In September 2002, the firm then tendered a new complaint, which had been filed in July 2002. The firm told the insurer that it had already retained defense counsel. In November 2002, the firm sought the insurer's policy limits for a settlement, but the insurer declined to contribute to a settlement because the policy excluded coverage for pension benefits due under a contract. In January 2003, the firm entered into a settlement. The next month, the insurer filed a lawsuit seeking a declaration that it was not required to defend or indemnify the firm.

The Seventh Circuit held that the insurer properly disclaimed coverage. It first determined that the policy did not afford coverage because the policy "defines as a covered loss any injury caused by negligence or a breach of fiduciary duty. The retirees were not injured in that way; their problem stemmed from Arthur Andersen's business and legal difficulties."

The court also held that coverage was precluded under the policy's exclusion for pension benefits due. The

court reasoned that the settlement reflected "the present value of the pension promises . . . rather than damages for anyone's misconduct. No insurer agrees to cover pension benefits; moral hazard would wipe out the market." If insurance polices covered such benefits, the court reasoned, then policyholders could readily abandon their obligations under pension plans, which would ultimately cause insurers to stop issuing fiduciary policies.

Finally, the court held that the firm was not entitled to coverage because it failed to obtain the insurer's consent for the settlement: "By cutting Federal Insurance out of the process, Arthur Andersen gave up any claim to indemnity—unless state law makes the policy's coverage clauses and exclusions irrelevant."

The accounting firm argued that, under Illinois law, the insurer was estopped from relying on the consent to settle provision of the policy because it did not file its lawsuit until February 2003, even though the underlying litigation was filed in July 2002. *See Employers Insurance of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999). The court questioned whether this delay was, in fact, excessive, but concluded that it did not need to reach the issue. The court explained that the estoppel doctrine does not apply if the insured does not want the insurer's assistance or is uncooperative. Here, the court explained, the firm had "made it clear that it would control both the defense and the law firm conducting that defense. By not tendering its defense to [the insurer], Arthur Andersen gave up any basis for demanding immediate action by the insurer." In addition, since the underlying complaint was based on contract, the court held that the insurer never had a duty to defend the complaint in the first place since it "was transparently outside the scope of coverage."