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NEWSLETTER

# Fiduciary Policy Does Not Cover Amounts Paid to Establish and Fund Employee Accounts

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The United States Court of Appeals for the First Circuit, applying Massachusetts law, has held that "loss" or "liability" under an ERISA fiduciary policy does not include amounts paid belatedly by a policyholder to establish and fund profit-sharing accounts for eligible employees under the company's profit sharing plan. *Pacific Ins. Co., Ltd. v. Eaton Vance Mgmt.*, 369 F.3d 584 (1st Cir. 2004).

The insurer issued an ERISA fiduciary policy to the company. The policy provided coverage for "[l]oss or liability incurred by the Insured, from any claim made against the Insured during the Endorsement Period, by reason of any actual or alleged failure to discharge his or its duties or to act prudently within the meaning of the Employee Retirement Income Security Act of 1974."

The company learned that it had mistakenly failed to create and fund the accounts of a number of employees eligible for the company's profit-sharing plan. It ultimately paid more than $850,000, including interest, to fund the accounts. Four months after learning of the mistake and six weeks after acknowledging its obligation to fund the additional employees' accounts, the company notified the insurer of the payments. Coverage litigation ensued.

The First Circuit held that the policy did not cover the contributions. It explained that the insurer could only be held liable under the policy if the company "incurred a (1) 'loss or liability' (2) 'by reason of' (3) 'any actual or alleged failure to discharge…its duties or to act prudently within the meaning of…ERISA…or by reason of any actual or alleged breach of fiduciary responsibility within the meaning of [ERISA].'" The court rejected the company's contention that the term "by reason of" is ambiguous and should be construed against the insurer. Instead, the court explained that "'by reason of' means 'because of,' and thus necessitates an analysis at least approximating a 'but for' causation test." Applying this standard to the facts of the case, the court explained that "the relevant liability for which [the company] seeks recovery from its insurer is *not* one for breach of fiduciary duty relative to the belatedly funded employee accounts; rather, [the company] seeks reimbursement for amounts it paid—principal and interest—in satisfaction of its Plan-created obligation to establish and fund those accounts to the level they would have attained had [the company] initially complied with the Plan."

The court also rejected the company's argument that the asserted breach of fiduciary duty was a concurrent cause of the obligation, reasoning that the underlying obligation to fund the Plan existed regardless of whether the policyholder fulfilled its fiduciary duties. The court concluded that "[i]t makes no sense to permit a dereliction of duty to transform an uninsured liability into an insured event."

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