Pension disputes: THE FULL MONTY

Are you fully covered when it comes to litigation and insolvency? Anne McCarthy and Sarah Turpin K&L Gates report

Pension disputes and regulation will remain high on the media agenda in uncertain financial markets. The impact of UK pensions regulation is only just beginning to make itself felt. In requiring the Bermuda-based holding company of Sea Containers to underwrite the pension scheme liabilities of its UK subsidiary, the long arm of the Pensions Regulator (TPR) has served notice that no company with an affiliation to a UK pension scheme is beyond reach.

Where do the pitfalls lie in terms of prospective litigation and a newly fledged regulatory environment? Should trustees be more proactive in seeking redress against failing professionals? Conversely, how can pension professionals best protect themselves in a more litigious environment? Moreover, does a standardised insurance policy afford the appropriate degree of control and protection?

Since the Pensions Act 2004, much time and effort has been given over to trustee training and attitudes to risk management have changed considerably. Conversely, the general approach towards insurance protection has not. As noted below, we lag behind our US counterparts in this respect.

A question of judgment

Insolvency and wind-up problems are a prime generator of claims, whether by the members against trustees, trustees against employers or claims against professionals for bad advice. Finance directors continue to strive for healthier balance sheets and pension benefits are a burden most sponsoring companies seek to rationalise in this economic climate. In short, there are plenty of opportunities for things to go awry.

Most insolvency events are clear enough, but what steps constitute a "notifiable" event requiring prior clearance from the Pensions Regulator (TPR)? A change of control of employer is clearly notifiable, but what of more subtle changes? For example, several changes of directors with financial responsibilities may conceivably be reportable, but it is a question of degree, requiring the exercise of judgment. A company with solvency issues provides fertile ground for disaffected members to challenge the judgment of trustees or the employer.

Sensitive area

The Pensions Act 2004 has increased the scope for claims because trustees have enhanced obligations, being responsible for all aspects of scheme management and the responsible delegation of investment advice. Scheme deficits have also prompted closer scrutiny of the actions of actuaries and investment advisers/managers.

Investment policies have assumed a higher profile since the case brought by Unilever against Mercury Asset Management. That case challenged the received wisdom that fund managers were not liable for underperformance against an agreed benchmark. In this part of the economic cycle, trustees should arguably be more proactive in assessing and pursuing advisers for possible failures. For example, should the trustees of a pension scheme with investments in hedge funds carrying sub-prime mortgage losses investigate whether the investment advice received has been competent? Investment advisers on the one hand will want to rely on their professional indemnity cover on such a claim and trustees on the other will want to be protected against claims for contributory negligence. Thus litigation for a trustee is a double-edged sword.

McCarthy: take cover

The pensions industry is a highly politicised and sensitive environment and those within it should ensure they have full protection. Insurance is necessary to protect against loss, but it should also ensure control of litigation and cost recovery.

Even if trustees are content to rely on the exoneration clause and indemnity within the trust deed, any claims made upon it deplete the fund. So insurance is still the preferable option. But how do you provide effective insurance coverage to match the duties and obligations of trustees in the modern pensions environment?

Turpin: bare essentials

Adequate cover?

Some trustees assume that any liabilities arising from their role as trustee of the company pension scheme will be included under the Directors & Officers (D&O) liability insurance taken out by the employer company. In practice, D&O policies typically exclude any claims made against the directors and officers arising from their role as pension scheme trustees. If this is the case, separate cover in the form of Pension Trustee Liability (PTL) Insurance will be required.

There are a number of misconceptions about PTL insurance and what it actually covers. Most PTL policies, in addition to insuring the trustees, also provide cover to the scheme and to the employer company to the extent that they have indemnified the trustees. PTL insurance therefore has the added benefit of covering not only the trustees but providing financial protection to the company and to the scheme.

Generally, a PTL policy is therefore preferable to reliance on indemnities, especially in an era of scheme deficits and increased litigation risk. PTL policies will typically cover all relevant parties involved with the pension scheme, including internal advisers or administrators and should potentially include all relevant losses and liabilities. The precise policy wording should be checked by trustees to ensure full coverage.

Wordings relating to fraud claims need particular care. Some PTL policies typically exclude claims arising from fraudulent or dishonest conduct, which might include claims where this is alleged but not yet proven. Conversely other policies only exclude fraud/dishonesty when established through admission or final adjudication, thus allowing the insured the benefit of payment of the costs of defending any claim. The other point to bear in mind is that the policy should contain appropriate "severability" language such that the fraud or dishonesty of one insured person does not affect the coverage of others. So for example if a trustee negligently fails to uncover the fraud of another, that trustee still has adequate cover.

The PTL policy should, in addition to providing cover for defence costs relating to civil, criminal and regulatory proceedings, cover legal costs relating to investigations and enquiries, for example by the Pensions Ombudsman or TPR.

Ideally, there should be a provision making it clear that the insured party can choose its own lawyer and for the retention of separate legal representation in a conflict of interest between any insured parties. Any attempt to restrict the choice of lawyer to those on the insurers' chosen panel should be avoided.

Complete discretion

Most pension scheme advisers or consultants will take out some form of Professional Indemnity Insurance (PI). This may or may not be specifically tailored to their particular profession. The PI market is more developed than the D&O/PTL markets and there will be differences in the terms, conditions and exclusions to reflect the different types of claim and liabilities faced by professionals.

For historic reasons, PI policies typically give the insurer the right to defend any third party claim rather than imposing the defence obligation on the insured (as with D&O/PTL policies). This apparently subtle distinction can have important consequences. It means that the insurer has the right to actually conduct the defence and to appoint their own choice of legal adviser. As noted above with PTL policies, some insurers will only appoint lawyers from their own chosen panel.

The settlement of any professional negligence claim is something which requires careful consideration given the potentially adverse consequences. Some PI policies give insurers complete discretion with regard to claims settlement and this can give rise to conflicts of interest between insured and insurer where one wants to settle but the other wants to fight on. These problems can be avoided by ensuring that the insured must be consulted in relation to any settlements.

Risk management

Our colleagues in the US routinely consider insurance policy issues which affect litigation and dispute resolution. Legal cost rules in the UK currently act as a discouragement to class-action claims, but the availability of legal costs insurance and organisations seeking to fund claims for a fee heralds a change in the accessibility of the court system to claimants and class actions generally. In this economic climate, adequate insurance coverage should be an essential part of risk management. **PW**

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In a nutshell

- pension disputes will continue to arise in an uncertain economic climate
- a standardised insurance policy may not give adequate cover in the event of litigation or insolvency
- separate protection under PTL and/or PI insurance may be necessary.