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OLD DUTIES – LAYING THE GROUNDWORK
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Introduction

Institutional investors today own large percentages of shares of their own or other corporations and are faced with the issue of how they should act as shareholders. The difficulty, of course, is that the companies and individuals involved in these decisions do not hold the shares to benefit themselves, but rather to benefit others, and the institutions for which they work and act are typically regulated entities each with their own set of legal constraints. The individual to whom these remarks are addressed may be a corporate officer serving as trustee of a company pension fund holding company stock, a state official acting as trustee of state pension plans, a trustee or director of a charitable foundation who is also a CEO of a company whose stock the foundation owns, or a director of a mutual fund who is also an officer of the investment advisor or of a corporation whose shares the fund owns or, last but not least, counsel to any of the above. In each of these situations, the individual will be wearing at least two hats and subject to at least two distinct sets of legal responsibilities. The individuals entrusted by the institutional investor with making decisions as shareholders need to know the legal framework in which they are operating. The following is an overview of that framework and its requirements.

The roles institutional investors and individuals play define the body of law and regulation that should guide their actions.

The Fiduciary Relationship

Whether a person is a corporate officer or director, or a trustee in the situations described above, he or she will be a fiduciary, because the law defines these roles as fiduciary in nature and sets rules for the conduct of fiduciaries in fiduciary relationships. Pinpointing the essence of the fiduciary concept has proven troublesome, but two of the best efforts at defining a fiduciary relationship are the following.

“A fiduciary relationship exists whenever any person acquires a power of any type on condition that he also receive with it a duty to utilize that power in the best interests of another, and the recipient uses the power.”
[J.C. Shepherd, *The Law of Fiduciaries*, 35-36 (1981)]

“A relation in which the principal’s interests are affected by, and are therefore dependent on, the manner in which the fiduciary uses the discretion which has been delegated to him. The fiduciary obligation is the

law’s blunt tool for the control of this discretion” [Weinrib, *The Fiduciary Obligation*, 25 U. Toronto L.J. 1,4 (1975)]

While the law defines fiduciary duty differently in different circumstances, the basic elements are the obligation to act in the best interest of the beneficiary of the fiduciary relationship (the duty of loyalty), and the obligation to act prudently in exercising power or discretion over the property or the interests that are the subject of the fiduciary relationship (the duty of prudence). These principles are most stringently applied to trustees and have been well developed in the various aspects of trust law.

ERISA Fiduciaries

A company pension plan or union plan fiduciary is subject to the fiduciary regime of the Employee Retirement Income Security Act (ERISA). [Employee Retirement Income Security Act of 1974, codified as amended at 29 U.S.C. §§ 1001-1461]. Under ERISA, “a person is a fiduciary with respect to a plan to the extent that (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control reflecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation...or has an authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.” [ERISA §3(21)(A); 29 U.S.C. §1002(21)(A)]. This body of law includes regulations and other interpretive statements of the Department of Labor, as well as case law. ... If the ERISA trustee or other fiduciary has another role, such as a corporate officer or bank officer, that person must comply with the relevant corporate law and/or banking law as well.

Fiduciaries of Charitable Funds and Foundations

A charitable foundation director or trustee will be governed by state law relating to charitable organizations and related case law. Many states have enacted a version of the Uniform Management of Institutional Funds Act defining the fiduciary standards for charitable fund fiduciaries whether they are trustees or directors. In other states, trust or corporate law will apply. ...

Public Fund Trustees

Trustees or administrators of public pension or other funds must follow state law and regulation, which may provide generally for duties of fiduciaries or may be specific to the type of fund or both may apply. Several ...opinions of state attorneys general illustrate the manner in which state statutes are interpreted in light of other sources of fiduciary law. A 1996 California opinion draws on the Restatement (Third) of Trusts as well as the Uniform Prudent Investor Act as adopted in California in regard to a county treasurer delegating investment management. [1996 Cal AG LEXIS 13; 79 Atty Gen. Cal. 88] Ohio and Florida opinions use cases and other sources related to ERISA to interpret state statutes based on ERISA, but recognize differences in the state versions of the law and the effect of other state statutory and case law in construing the statute in particular circumstances. [1995 Ohio AG LEXIS 14; 1995 Op. Atty Gen. Ohio 71; 1997 Fla. AG LEXIS 9]

Bank Fiduciaries

Bank trustees must look to the relevant banking law, as well as state law defining obligations of trustees. For national banks Regulation 9, issued by the Comptroller of the Currency, sets some fiduciary standards and defines what constitutes acting in a fiduciary capacity. [12 C.F.R. Part 9] In addition, a bank serving as a fiduciary must comply with ERISA or other law governing a particular fund. [See e.g. Reich v. Valley National Bank of Arizona, 837 F. Supp. 1259 (S.D.N.Y. 1993)].

What does the duty of loyalty require?

The fiduciary has to determine the parties to whom she owes the duty of loyalty (the beneficiaries), and then put the interests of the beneficiaries above the fiduciary's own interests and those of third parties. According to the Restatement of Trusts §170 (1), "the trustee is under a duty to administer the trust solely in the interest of the beneficiaries." However, in the situations described in the introduction to this overview, the fiduciaries have at least two sets of duties to meet and may owe loyalty to different groups of beneficiaries, (e.g., as an ERISA fiduciary with a duty to ERISA plan participants and beneficiaries and as a corporate officer with a duty to shareholders of a corporation). These duties may conflict with one another and in many circumstances, the fiduciary may have personal concerns to deal with as well, e.g. their job or a golden parachute in a takeover scenario or other business concerns, such as preserving an important client relationship.

Under ERISA, the fiduciary must act "solely in the interest of the plan participants and beneficiaries" and "for the exclusive purposes of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying the reasonable expenses of administering the plan". [ERISA §404(a)(1)(A), 29 U.S.C. 1104(a)(1)(A)] A leading case, *Donovan v. Bierwirth*, examined the duty of loyalty under ERISA in a situation where the fiduciaries had acute conflicts of interest. [538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd as modified*, F.2d 263 (2d Cir.), *cert. Denied*, 459 U.S. 1069 (1982). *Donovan v. Bierwirth*, 754 F.2d 1049 (2d Cir. 1985)] Several top corporate officers were also trustees of the corporation's pension plan which held company stock. In the context of a hostile effort to take over the corporation, the trustees determined not to tender the pension plan's stock and, further, to purchase additional company stock for the pension plan. In considering whether the trustees had breached their duty of loyalty to the pension plan participants, the court found that "when a fiduciary has dual loyalties, his independent investigation into the basis for an investment decision which presents a potential conflict of interests must be both intensive and scrupulous and must be discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan." [Bierwirth, 538 F. Supp. 463 at 470]

While ERISA seeks to limit the effect of conflicts of interest of fiduciaries through a strong section prohibiting self-dealing and transactions with interested parties [§406, 29 U.S.C. §1106], it also builds in conflicts of interest by permitting defined benefit plans to hold up to 10 percent of plan assets in company stock and permitting employee stock ownership plans (ESOPs) that invest primarily in company stock [ERISA §407, 29 U.S.C. 1107] and allowing company officers to act as trustees of the ESOP. Transactions and contests for corporate control in companies with ESOPs have generated much litigation because of the acute conflicts of interest they engender [See e.g., *Reich v. Hall Holding Company, Inc.*, 990 F. Supp. 955 (E.D. OH 1998); 1998 U.S. Dist. Lexis 562; 1998 U.S. Dist. Lexis 2957; *Herman v. Nationsbank Trust Company*, 126 F.3d 1354 (11th Cir. 1997)].

ERISA's "solely in the interest of plan participants and beneficiaries" standard builds in another potential conflict of interest, as the interests of retirees may differ from those of employee plan participants, especially in situations such as tender offers or other decisions on the short-term versus long-term benefits to plan assets. This standard and the "exclusive purpose" purpose clause have also taken on particular significance in debates over shareholder activism and social investing.

In a major early case involving public pension funds, the court specifically considered issues relating to the differing interests of retired and working teachers. [*Withers v. Teachers' Retirement System of the City of New York*, 447 F. Supp. 1248 (S.D.N.Y.1978), *aff'd mem.* 595 F.2d 1210 (2d Cir. 1979)] The *Withers* case involved public pension plan trustees who had other conflicting interests as well. For example, one plan trustee charged with deciding whether to buy Municipal Assistance bonds with pension assets was also a City official working on the City recovery plan. The court found that the presence of conflicting interests did not mean that the fiduciaries necessarily breached their duty of loyalty to the plan participants and retirees, but it did require "an especial obligation to act fairly on behalf of those concerned with the results of the action taken." [*Withers* at 1256]

To summarize, the fiduciary has to determine the beneficiaries to which she owes a duty of loyalty under the legal regimes relating to the various roles the fiduciary has undertaken and the standard of loyalty to which she will be held. She must clearly identify conflicts of interest and act scrupulously in investigating and considering independently what course of action will benefit each group of beneficiaries. She must not favor one group of beneficiaries over another (duty of impartiality) and she must put the beneficiaries' interests before her own or those of third parties. If the conflicts of interests resulting from her various roles and the particular set of circumstances are such that the fiduciary cannot comply with the legal mandates, she should consider relinquishing one of her roles, at least in regard to the decisions affected by the conflict, or delegating decision-making to an independent fiduciary. [See e.g. *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 635 F. Supp. 246 (S.D.N.Y. 1986)]

What does the duty of prudence require?

The classic statement of this duty is the Prudent Man Rule, enshrined in various formulations in case and statutory law, and derived from *Harvard College v. Amory*, 26 Mass. (6 Pick.) 466, 461 (1830).

"All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

ERISA contains a widely used formulation of the rule requiring a fiduciary to discharge her duties with respect to the plan "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims". [§404 (a)(1)(B), 29 U.S.C. 1104(a)(1)(B)] Another subsection adds a duty to diversify the investments to minimize risk. The Department of Labor has issued a regulation clarifying the duty of prudence and integrating modern portfolio management concepts such as evaluation of risk of loss and opportunity for gain based on the whole portfolio rather than on individual investments. See the supplementary materials for the text of relevant ERISA sections and 29 C.F.R. 2550.404a-1. While an ESOP trustee is excused from the diversification requirement, it is not excused from other fiduciary standards. [ERISA §404(a)(2), 29 U.S.C. 1104(a)(2)]

A clause that does not appear in other typical formulations of prudence or loyalty is ERISA 404(a)(1)(D) which requires fiduciaries to act “in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV”. Thus, a fiduciary acting in accordance with plan documents must constantly consider whether the effect of so acting in a particular set of circumstances would cause the fiduciary to act imprudently or contrary to the interest of the plan participants or beneficiaries. In such a circumstance the fiduciary must regard the standards of ERISA itself as taking precedence over the plan documents. [See, e.g., 29 C.F.R. 2550.94-2]

With the publication of the Restatement (Third) of Trusts, the Prudent Man Rule has become the Prudent Investor Rule, and the Uniform Prudent Investor Rule is being widely adopted into state law. ... The Restatement “posits a prudent investor standard in which the portfolio is evaluated as a whole, with regard to the characteristics of the fund, the beneficiaries’ needs and their identity. The terms of the trust still dominate and may include or exclude specific forms of investment. Diversification and proper choice of the level of risk, selected and evaluated by reasonably accepted methods, are the touchstones of prudence under this standard.” [Krikorian, p. 1-12] Section 227 of the Restatement specifically notes a trustee’s duty to “incur only costs that are reasonable in amount and appropriate to the investment responsibilities of the trusteeship.” The Uniform Prudent Investor Act contains a similar provision.

Most trustees will be subject to one of the foregoing standards, or a similar formulation. Given the degree to which the prudence of investments depends upon the particular circumstances surrounding the investment choices it is often very difficult to reach a conclusion on the substantive prudence of the decision. This is particularly so since the determination must be based on factors present at the time the decision was made. The fact that an investment proved unprofitable does not mean that the decision to invest was not prudent when it was made.

However, the law does set objective criteria for the conduct of fiduciaries in making investment decisions. The Ohio and Florida Attorney General Opinions cited earlier both recognize this fact and, in construing their state statutes, cite ERISA case law and the Department of Labor’s regulation setting parameters for prudent conduct. ... Comment d. to Sec. 227 of the Restatement (Third) offers this description of criteria, including the well established principle that a fiduciary that holds itself out as an expert will be held to an expert’s standard of care.

The trustee must give reasonably careful consideration to both the formulation and the implementation of an appropriate investment strategy, with investments to be selected and reviewed in a manner reasonably related to that strategy. Ordinarily this involves obtaining relevant information about such matters as the circumstances and requirements of the trust and its beneficiaries, the contents and resources of the trust estate, and the nature and characteristics of available investment alternatives. To the extent necessary or appropriate to the making of informed investment judgments by the particular trustee, care also involves securing and considering the advice of others on a reasonable basis...

On the other hand, it follows from the requirement of care as well as from sound policy that, if the trustee possess a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill.

Other fiduciaries may have less stringent standards, such as charitable fund directors or trustees in states that have adopted the Uniform Management of Institutional Funds Act. The Act calls for “ordinary business care and prudence under the facts and circumstances prevailing at the time...” [Act, §6]

Despite the differences in formulations of prudence standards, courts make quite similar types of analyses in cases alleging breach of the duty of prudence or due care. They review the terms and legal standards in the instrument that establishes the fiduciary relationship, the relevant statutes, and the case law. The court considers the purposes of the fiduciary relationship, its intended duration, and the identity and needs of the beneficiaries. The information-gathering and evaluation process of the fiduciary is scrutinized to determine whether alternative courses of action were weighed and the effects of all possibilities projected. The court will look to see if the fiduciary sought expert opinions, took time to evaluate those opinions, and then made its own carefully considered decision.

Legal standards specifically applying fiduciary law principles to institutional investor fiduciaries acting as shareholders.

The broadest and most detailed statement on what institutional investors may or may not do as fiduciaries and shareholders is the Department of Labor’s Interpretive Bulletin 94-2, codified at 29 C.F.R. 2509.94-2. This bulletin presents some of the opinions on proxy voting expressed by the Department in two letters issued in 1988 (the Avon Letter) and in 1990 (the ISSI Letter) and provides guidance on other related matters. The regulation applies directly to ERISA plan fiduciaries, but may well be persuasive to courts or attorneys general evaluating the conduct of other fiduciaries. This may be particularly true for public pension funds subject to statutes modeled on ERISA.

With regard to proxy voting, the Bulletin reiterates its statement in the Avon Letter that “(t)he fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock”. With this statement, the Department brought proxy voting under the legal regime that governs the conduct of ERISA fiduciaries. The Bulletin characterizes voting the shares as a trustee responsibility except to the extent that the power to manage, acquire and dispose of plan assets has been properly delegated to one or more investment managers or properly retained, or otherwise provided for, by the named fiduciary of the plan. When discretionary investment decision-making has been delegated to the manager, the authority to vote the shares would rest with the investment manager and the manager would have a fiduciary duty to make an independent decision on voting in accordance with the duties of loyalty and prudence as expressed in ERISA. Arrangements that would take the voting authority from the investment manager are possible, but must be established in the plan documents or investment management contract in accordance with ERISA delegation provisions.

The emphasis on the procedural aspects of delegating or retaining investment and voting power is undoubtedly due to the fact that the named fiduciary or trustee may be subject to strong conflicting interests by virtue of the other roles they play or concerns for their own jobs or financial well being. Fiduciaries to whom voting power is not allocated may not simply take back the power to vote shares when the vote is hotly contested. In the words of the Bulletin, the fiduciary responsible for voting must “consider those factors that may affect the value of the plan’s investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives.” In other words, the fiduciary must meet its duties of prudence and loyalty.

The named fiduciary who appoints the investment manager must monitor its conduct with respect to voting and the manager must keep records of its votes and procedures to permit such monitoring and these are fiduciary responsibilities for the named fiduciary.

With regard to shares of domestic corporations, the fiduciary must vote on matters that may affect the value of the plan's investment, but for foreign stocks, recognizing the potential additional cost, the Department requires the fiduciary to "consider whether the plan's vote, either by itself or together with the votes of other shareholders, is expected to have an effect on the value of the plan's investment that will outweigh the cost of voting." The Department sets the cost-benefit hurdle a little lower by permitting the fiduciary to consider the probable effect of other votes in addition to its own, since, by itself, one plan's vote is unlikely to significantly affect the investment value of the stock.

In the section on statements of investment policy, the Bulletin permits the use of such statements, recognizes that they may properly include statements of voting policy, and makes the determination of the terms of a policy by the named fiduciary an "exercise of fiduciary responsibility" subject to the terms of ERISA. Such policy statements would be part of the plan documents and the appointment of an investment manager may be conditioned on the manager's acceptance of the terms of the policy. However, under ERISA section 404(a)(1)(D), the manager would have the responsibility for determining whether compliance with the policy would, in given circumstances, be imprudent and, in such a case, determining not to comply with the policy. A trustee subject to an investment policy would have the same duty of independent evaluation and action.

A manager of a pooled investment vehicle with several ERISA plan participants may establish an investment policy statement and condition participation in the pool on acceptance of the policy, including a voting policy. If the pool manager has no policy, it may be subject to voting policies of participating plans. If these policies conflict, the manager should attempt to reconcile them or to vote the shares in proportion to each plan's interest in the pool in accordance with each voting policy. In all of these circumstances the manager must not comply with the policies if doing so would be imprudent.

In the final section of the Bulletin, the Department extends its reasoning on proxy voting and investment policy statements to other areas of shareholder activism with the following statement. "An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA where the responsible fiduciary concludes that there is a reasonable expectation that such monitoring or communication with management, by the plan alone or together with other shareholders, is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved." The Bulletin goes on to provide examples of circumstances when such activism might be warranted, aspects of corporate governance that might appropriately be the subject of activism, and forms that activism may take. By again permitting the fiduciary to consider the actions of other shareholders in conjunction with its own the Department sets the economic justification hurdle lower.

Of the three general areas covered by the Bulletin, only proxy voting appears to be mandatory, and then only if the appropriate cost-benefit analysis warrants it. The other sections provide comfort to ERISA fiduciaries that wish to engage in the covered activities, and suggest how the fiduciary and delegation sections of ERISA apply in those contexts.

It does not yet seem clear how influential this Department of Labor interpretation will be for funds outside of the scope of ERISA. However, fiduciaries not governed by ERISA must still consider how to build a case

for their activities in light of requirements for incurring only reasonable and appropriate costs in the Restatement (Third) and the Uniform Prudent Investor Act.

This overview has focused on the general law of fiduciaries, and on fiduciary law as embodied in ERISA and related state statutes. Most other presentations in this conference will concentrate on the corporate arena. The fiduciary principles discussed here are present in the responsibilities of corporate directors and officers, and the ERISA fiduciary regime establishes another set of standards corporate officers must often deal with in critical situations. Setting the proper course of action for a fiduciary at the intersection of multiple sets of responsibilities requires careful attention and awareness of the issues and potential pitfalls.