

COUNCIL OF INSTITUTIONAL INVESTORS

DIVESTMENT OF PLAN ASSETS
BASED ON NON-ECONOMIC FACTORS

GROOM LAW GROUP

MEMORANDUM

March 21, 2006

TO:

FROM: Ian D. Lanoff
Ellen M. Goodwin

RE: Divestment of Plan Assets based on Non-Economic Factors

This memorandum reviews the fiduciary standards that apply to a decision to divest a plan's portfolio of certain investments based in part on a consideration of non-economic or social factors. As this is written for use by governmental plans with different governing statutes and ordinances, out of necessity we have relied heavily on the federal Employee Retirement Income Security Act of 1974 ("ERISA"), the Restatement of Trusts and the model Prudent Investor Act. This may be appropriate as so many states and localities have used these authorities and also because they reflect examples of "best practices."

What follows is a recommended course of action for fiduciaries to follow in determining whether to divest a plan of certain holdings based on non-economic or collateral considerations. An appendix more thoroughly describes the legal background that supports the recommended course of action.

As described more fully below, prudence rules do not require fiduciaries to invest in or hold any particular investment or security, or to follow a particular investment strategy. Therefore, prudence rules allow fiduciaries not to invest in many, if not all, investments. However, loyalty rules do not allow fiduciaries to make investment decisions solely based on non-economic or collateral considerations. Any decision to divest or to not invest in the first place, must be grounded exclusively in financial-investment considerations.

I. Suggested Steps for Divestment Decisions

A. Prudence and Loyalty Analysis

Those who exercise discretion over a private employee benefit plan's investment portfolio will generally qualify as "fiduciaries" under state and local law. Fiduciaries are ordinarily required to carry out their official duties with respect to the plan in accordance with

strict standards of conduct, including the duties to act prudently and solely in the interest of the plan's participants and beneficiaries.

The prudence rule requires acting as a "prudent expert" would act under similar circumstances. The U.S. Department of Labor ("DOL") has promulgated a regulation under ERISA which clarifies the application of the prudence standard to investment decisions which makes clear that no investment is per se prudent or imprudent. Rather the prudence of an investment is to be judged based on an analysis of all the pertinent facts and circumstances surrounding the investment. Further, the prudence regulation makes clear that fiduciaries are to make investment decisions (including decisions to invest or sell off a plan's investments) solely on the basis of a consideration of the financial aspects of the proposed investment. Generally, particular investments or strategies are chosen based upon a financial analysis of the economic features of the investment performed by a professional with expertise in investment matters.

In performing this analysis, the investment professional is obligated to take into consideration certain factors, such as the investment's position in the plan's overall portfolio (or the portfolio over which the investment professional exercises discretion), the risk of loss associated with the investment, the opportunity for income, and the investment's impact on the diversification of the plan's portfolio and the plan's liquidity and cash flow needs.¹

Prudence rules require fiduciary decisions to be prudent from a procedural standpoint as well as from a substantive standpoint. Procedural prudence in the investment context requires fiduciaries to, among other things, conduct a complete study of all aspects of the investment, retain experts where necessary, obtain up-to-date reports regarding the investment, and document the analysis performed by the fiduciary and the reasons a particular decision was reached.

Fiduciaries are subject to the duty of loyalty to plan participants and beneficiaries in addition to the fiduciary duty of prudence. In general, the duty of loyalty would prohibit a fiduciary from making investment decisions solely to accomplish collateral objectives such as preserving participants' jobs or accomplishing social objectives such as demonstrating an antipathy to certain investments that arguably cause societal harm, for example, investments in companies that destroy rain forests or produce tobacco. This is because a fiduciary would violate his duty of loyalty to plan participants if he based his investment decisions on collateral considerations (such as societal harm or good associated with the investment) if the investment provided the plan with less return for the same amount of risk as other available investments or if the investment involved greater risk than other investments with similar return characteristics.

B. First Question: "Is it Prudent to Hold the Investment?"

The first step in determining of whether to divest a plan of any holdings requires a consideration of the economic features of the investment. In this regard, the plan fiduciary

¹ Arguably, a prudence analysis would also take into consideration any major litigation (or impending litigation) which may have an adverse effect on the security's value.

should begin with the question, "Is it prudent to hold the investment?" To answer this question, prudence rules require the fiduciary to analyze the investment solely on its economic merits. For example, the fiduciaries must review the risk and return features of the investment in addition to the investment's diversification and liquidity characteristics. In terms of procedure, the fiduciaries should conduct a thorough review of all aspects of the investment, seek up to date and accurate reports and information on which to base his review, hire outside experts where necessary, and thoroughly document his analysis.

If after satisfactory completion of procedural and substantive prudence requirements, an investment professional concludes that it is not prudent for the plan to hold the investment, the fiduciary must divest the plan of the investment. For example, as a part of an investment professional's analysis, if he concludes that the risk of holding a security in the plan's portfolio is too high because of anticipated major litigation which could potentially lead to large judgments against the company or industry, the professional may prudently conclude that the sale of the security is best for the plan's portfolio. Divestment of the security could then be completed in a manner which is prudent from a trading and investment standpoint, *e.g.*, total liquidation of all securities held with no new purchases or the sale of such securities over a certain period of time within a general price range.

One major public plan has identified specific criteria that, when satisfied, may lead to further analysis of the appropriateness of retaining certain Plan investments. In this regard, when the plan's investment staff determines that any three of the following criteria are satisfied with respect to plan investments in a certain industry, staff may ask the Plan's investment fiduciary to perform a prudence review of the Plan's holdings in that industry.

The factors identified include:

1. The industry, not an individual company, shares common exposure to product liability judgments (including but not limited to, potential judgments involving substantial punitive damage awards), settlements, and ongoing litigation that have the potential to exceed the industry's net worth.
2. There is a significant threat of industry-wide bankruptcy filings.
3. Regulatory and or legislative actions have the potential to substantially impair industry wide earnings.
4. Policy actions in the institutional investor community, in the aggregate, have the potential to have a deleterious effect on industry wide share prices.

Fiduciaries could consider adopting similar factors as part of the plan's overall investment policy statement.

C. Second Question: "Is it Imprudent to Sell the Investment?"

After conducting an analysis of the economic features of the investment, if the answer to the first question is "Yes, it is prudent to hold on to the investment(s) or to invest further", or if the answer is not clear, fiduciaries should ask, "Is it imprudent to sell the investment?" It would not be imprudent to sell the investment if the fiduciary's investment analysis identified other potential available investments that are equally advantageous from an economic perspective and offered similar risk and return characteristics.²

In this regard, there are limited circumstances under which a fiduciary may implement a policy of social investing. Under such circumstances, a fiduciary may select an investment course of action that reflects non-economic factors, provided that the application of such non-economic factors follows a financial and economic-based analysis that uncovers a number of potential investment opportunities that are equally advantageous from an economic perspective.³ In this way a fiduciary may implement an investment plan with social underpinnings because it satisfies fiduciary requirements of loyalty to plan participants, prudence and diversification.⁴ The DOL has approved economically targeted or social investments where they have satisfied ERISA fiduciary requirements in both individual exemptions and advisory opinions.⁵

In 1994 the DOL issued an Interpretive Bulletin specifically addressing economically targeted investments. According to the DOL, consideration of non-economic factors in investment decisions is not necessarily inconsistent with the concept of substantive prudence. In the context of economically targeted investments, the requirement that an investment be "substantively prudent" means that the investment must meet the so-called "everything being equal" test. In effect, this test provides that non-economic factors (such as societal harm or benefit) may not be considered in any investment decision unless it has been determined that

² The fiduciary should consider any transaction costs associated with the sale of the investment in his analysis of the overall prudence of divesting the plan's investment.

³ See, e.g., DOL Adv. Op. 98-04 (May 28, 1998).

⁴ One court has held that a city ordinance which authorizes trustees to divest companies with South African ties would not require trustees to violate duties of prudence and loyalty. In this case, the court devised its own duty of loyalty which is arguably inconsistent with traditional views of that duty. Employees Retirement System v. Mayor and City Council of Baltimore, 11 EBC 1521 (Md. Ct. of App. 1989), cert. denied, Lubman v. Mayor of City Council of Baltimore, 493 Md. 1093 (Md. 1990).

⁵ See, e.g., DOL Information Letter to Stuart Cohen (May 14, 1993); Northwestern Ohio Building and Construction Trades, PTE 85-58, 50 Fed. Reg. 11272 (Mar. 20, 1985).

proposed investment alternatives available to the plan have equivalent economic features, including risk and return characteristics.⁶

The collateral benefits of an investment decision may be considered and may even be decisive in evaluating an investment if the fiduciary determines that the investment providing the collateral benefits is expected to provide an investment return to the plan commensurate to alternative investments having similar risks.⁷ Any societal or non-economic considerations involved in such an investment decision are deemed "incidental."

After consideration of all of an investment's economic factors, it is especially important for purposes of procedural prudence to document the analysis behind a fiduciary's decision to implement a policy of economically targeted or social investing. The absence of such documentation regarding such investments will, in most instances, violate the procedural prudence requirement and will leave the investments open to challenge by the plan participants for violation of substantive prudence requirements and the duty of loyalty.

To summarize, prudence rules do not require fiduciaries to invest in, or hold, any particular investment or security or to follow any particular strategy. Therefore, prudence rules allow fiduciaries to avoid investing in many investments altogether. However, loyalty rules do not allow fiduciaries to make investment decisions solely based on non-economic or collateral considerations. Any decision to divest, or to not invest in the first place, must be grounded exclusively in financial-investment considerations.

⁶ See DOL Interpretive Bulletin on Economically Targeted Investments, 59 Fed. Reg. 32606 (June 23, 1994) ("DOL IB 94-1"). See also, comments to section 5 of the Model Uniform Prudent Investor Act, available on the National Conference of Commissioners of Uniform State Laws website, www.nccusl.org.

⁷ DOL IB 94-1.

Appendix

Legal Background

I. Fiduciary Standards

ERISA imposes strict standards of conduct on fiduciaries of employee benefit plans. Any person who exercises discretion over the investments made by a plan will qualify as an ERISA fiduciary. See ERISA § 3(21) (a fiduciary includes any person who exercises authority or control over the management or disposition of a plan's assets).

Specifically, section 404(a)(1) of ERISA provides that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

- (A) For the exclusive purpose of:
 - (i) providing benefits to participants and beneficiaries; and
 - (ii) defraying reasonable expenses of administering the plan;
- (B) With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;⁸
- (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so;⁹

The general fiduciary duties set forth in section 404(a) above impose three basic standards of conduct on a fiduciary and have been described as embodying the "central and fundamental obligation imposed on fiduciaries by ERISA" and containing, "a carefully tailored law of trusts."¹⁰ ERISA's legislative history indicates that Congress intended to incorporate these core principles in section 404 but with modifications appropriate for employee benefit plans.

⁸ The prudent Investor Rule of the Restatement of Trusts similarly provides that "The trustee is under a duty to the beneficiaries to invest and manage the funds of the trusts as a prudent investor would, in light of the purpose, terms, distributions requirements, and other circumstances of the trust." Restatement (Third) of Trusts § 227 (1992).

⁹ This requirement is also consistent with the "Prudent Investor Rule" found in the Restatement (Third) of Trusts § 227 (1992).

¹⁰ Eaves v. Penn., 587 F.2d 457 (10th Cir. 1978).

Those who interpret and apply ERISA's fiduciary standards were counseled to do so "bearing in mind the special nature and purpose of employee benefit plans."¹¹

II. The Prudent Man Rule

A. General Prudence

ERISA's prudence standard is of primary importance in the area of plan investments. In 1979 the DOL promulgated a regulation which clarifies the application of the prudence standard to the investment of plan assets.¹² The regulation's preamble makes it clear that for purposes of ERISA's prudence standards, no specific investment or investment course of action is per se prudent or imprudent based on its relative riskiness alone.¹³ Rather, the prudence of any investment decision is to be determined on the basis of an analysis of all the pertinent facts and circumstances, including the requirements and characteristics of the plan and the role the investment strategy is to play in the plan's portfolio.¹⁴ The preamble underscores this point by explicitly stating that "an investment reasonably designed – as part of the portfolio—to further the purposes of the plan, and that is made upon appropriate consideration of the surrounding facts and circumstances, should not be deemed to be imprudent merely because the investment, standing alone would have, for example, a relatively high degree of risk."¹⁵

Both the DOL and the courts have distinguished between two types of prudence: substantive and procedural prudence. Substantive prudence refers to the merits of the decision made by a fiduciary. Procedural prudence focuses on the process through which the fiduciary reaches his decision. As long as there is no conflict of interest that would impair the fiduciary's exercise of independent judgment, a fiduciary who considers the appropriate substantive factors (substantive prudence) and does so using proper procedures (procedural prudence) will satisfy ERISA's prudence standard.¹⁶ As with other fiduciary obligations, the fact that fiduciaries acted

¹¹ See H. Rep. No. 93-1280, 93rd Cong., 2d Sess. 323, 302 (1974) ("Conference Report").

¹² 29 C.F.R. § 2550.404a-1.

¹³ Preamble to ERISA Section 404 Prudence Regulation, 44 Fed. Reg. 37221, 37222 (June 26, 1979) ("Preamble").

¹⁴ Preamble at 37225.

¹⁵ Preamble at 37244.

¹⁶ Katsaros v. Cody, 744 F.2d 270, 279 (2d Cir.), cert. denied, 469 U.S. 1072 (1984).

in good faith or with good intentions is no defense if challenged conduct falls short of meeting the required standard of conduct.¹⁷

B. Substantive Prudence

With respect to plan investments, substantive prudence refers to the merits of the investment decision made by the fiduciary. A fiduciary charged with an investment decision must act as a prudent expert would under similar circumstances, taking into account all relevance substantive factors, as they appeared at the time of the investment decision, not in hindsight.¹⁸

The prudence standard under ERISA "is not that of a prudent lay person, but rather of a prudent fiduciary with experience dealing with similar enterprises."¹⁹ "The prudence standard charges fiduciaries with a high degree of knowledge. This standard measures the decisions of plan fiduciaries against the decision that would be made by experienced investment advisors."²⁰

To satisfy the statutory obligation of prudence in connection with plan investments, a fiduciary must give "appropriate consideration" to those facts and circumstances that, given the scope of the fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment plays in that portion of the plan's portfolio.²¹

"Appropriate consideration" with respect to an investment course of action includes the following considerations made by the responsible fiduciary:²²

- (i) The investment must be evaluated as part of the plan's overall portfolio;²³

¹⁷ Donovan v. Cunningham, 716 F.2d 1455 (5th Cir. 1983) ("A pure heart and an empty head are not an acceptable substitute for proper analysis.")

¹⁸ Donovan v. Walton, 609 F. Supp. 1221 (S.D. Fl. 1985).

¹⁹ Whitfield v. Cohen, 682 F. Supp. 188, 194 (S.D.N.Y. 1988) quoting Marshall v. Snyder, 1 EBC 1878, 1886 (E.D.N.Y. 1979).

²⁰ Joint Committee on Taxation, Overview of the Enforcement and Administration of ERISA, at 12 (JCX 16-90) (June 6, 1990).

²¹ 29 C.F.R. § 2550.404a-1(b)(1).

²² 29 C.F.R. § 2550.404a-1(b)(2).

²³ Both traditional trust law and ERISA require that the analysis of an investment's prudence be determined within the context of the plan's entire investment portfolio. See also Restatement (Third) of Trusts (Prudent Investor Rule) § 227 (1992).

- (ii) The design of the portfolio, including the investment, must be reasonable for the purposes of the plan;
- (iii) The risk of loss and opportunity for gain (or other return) must be favorable, relative to alternative investments;
- (iv) The investment must take into consideration the diversification of the portfolio;
- (v) The investment must take into consideration the liquidity and current return of the entire portfolio relative to anticipated cash flow requirements of the plan; and
- (vi) The investment must take into consideration the projected return of the portfolio relative to the funding objectives of the plan.

C. Procedural Prudence

The concept of procedural prudence requires that the plan's investments be reviewed impartially on a case-by-case basis. The regulation under section 404(a) establishes a procedural prudence standard which focuses on the fiduciary's analysis in reaching an investment decision and not on investment results. This procedural approach has received judicial endorsement in numerous cases.²⁴ In these cases, the courts judged the fiduciary's prudence on the basis of his independent inquiry into the merits of a particular investment decision,²⁵ with particular emphasis on the conduct of the fiduciaries, the extent of the fiduciary's diligent investigation and the performance of acts consistent with the purpose of the plan or the failure to satisfy requirements that seem to be reasonable under the circumstances.²⁶

ERISA's prudence regulation sets forth a suggested course of action for the prudent fiduciary to follow in making investment decisions. As the regulation makes clear, a fiduciary will be deemed to have satisfied ERISA's prudence standard if he complies with this course of decisionmaking.²⁷ However, the regulations' preamble further specifies that the regulation is in the nature of a "safe harbor."²⁸ Thus, while compliance with the regulation's terms will be

²⁴ See, e.g., Donovan v. Bierwirth, 680 F.2d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1987); Dimond v. Retirement Plan, 4 EBC 1457 (W.D. Pa., Mar. 7, 1983).

²⁵ See Bierwirth, *supra*.

²⁶ See, e.g., Donovan v. Mazzola, 2 EBC 2115 (N.D. Cal. 1981), aff'd, 716 F.2d 1226 (9th Cir. 1983), cert. denied, Mazzola v. Donovan, 464 U.S. 1040 (Jan. 9, 1984).

²⁷ Preamble at 37255.

²⁸ Preamble at 37255.

deemed to satisfy the requirements of section 404(a)(1)(B), such compliance is not the exclusive method of satisfying the prudence standard.

To establish that he has exercised prudent procedural judgment in making an investment decision, a fiduciary should take such steps as:

- (i) conducting an impartial study of the advantages and disadvantages of the transaction;
- (ii) exercising due diligence in researching all aspects of the transaction;
- (iii) utilizing acceptable standards in retaining qualified experts and consultants';²⁹
- (iv) Relying on complete and up to date information.³⁰
- (v) Documenting all decisions made, the information on which the decision is based, the reason's for the decision and any alternatives considered.

D. Diversification Requirements

Under section 404(a)(1)(C) a fiduciary is obligated to diversify the investments of the plan so as to minimize the risk of losses, unless under the circumstances it is clearly prudent not to do so.

The legislative history of ERISA indicates that satisfaction of the diversification requirements, like the prudence requirement from which it is derived, turns on an analysis of the

²⁹ The recent trend of thinking about fiduciary investing has been to encourage, if not require, fiduciaries to seek sophisticated expert advice. Under ERISA, if fiduciaries do not possess the skills necessary to conduct adequate investigation of particular investments or investment courses of action, they are required to seek outside assistance. There is no good faith defense if fiduciary is found to have violated a standard of substantive prudence. In light of the development of a variety of sophisticated and innovative investments, ERISA's encouragement of reliance on expert advice has promoted responsible fiduciary investment practices. See, e.g., Donovan v. Mazzola, supra.

³⁰ See., e.g., Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987) (Court held trustees violated the prudence standard when they approved the fee provisions of a contract, committing the plan to pay over \$10 million after less than ten minutes discussion and without any study.)

facts and circumstances of each particular case.³¹ A fiduciary should not invest an unreasonably large percentage of plan assets in a single security in one type of security or in various types of securities that are dependent upon the success of one enterprise or upon conditions in one locality.³²

III. The Fiduciary Duty of Loyalty

ERISA section 404(a) requires plan fiduciaries to discharge their duties to the plan "solely in the interest of the plan's participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries and defraying the reasonable expenses of administering the plan." In effect, these requirements impose on a fiduciary the duty of undivided loyalty applicable to trustees at common law in performing their trust responsibilities.³³ Not only must a fiduciary's loyalty to the plan be his primary loyalty, it is the only loyalty which may affect his judgment when acting on the plan's behalf.³⁴ A plan fiduciary may not take actions at the expense of the plan's participants or beneficiaries which tend to favor himself or a party in which he has an interest.

The "solely in the interest" standard is not violated by actions which incidentally benefit a fiduciary or a party in interest so long as the action was taken solely with the interest of the plan participants and beneficiaries in mind. As the Second Circuit noted in Donovan v. Bierwirth,

Although officers of a corporation who are trustees of its pension plan do not violate their duties as trustees by taking action which, after careful and impartial investigation, they reasonably conclude best to promote the interests of participants and beneficiaries simply because it incidentally benefits the corporation, or indeed themselves, their decisions must be made with an eye single to the interests of the participants and beneficiaries.³⁵

With respect to plan investments, the legislative history accompanying the fiduciary provisions of ERISA and the case law interpreting these provisions strongly suggest that fiduciaries violate their exclusive benefit obligations when they consider interests other than those of the participants and beneficiaries in their investment decision if:

- (A) the investment provides the plan with less return, in comparison to the risk involved, than comparable investments; or

³¹ Conference Report at 304.

³² Id.

³³ NLRB v. Amax Coal, 453 U.S. 322 (1981).

³⁴ Id.

³⁵ 680 F.2d at 271.

- (B) involves greater risk to the security of plan assets than other investments with similar returns.³⁶

In such case, the other interests taken into consideration will not be considered "incidental."³⁷

IV. Uniform Prudent Investor Act

The Uniform Prudent Investor Act is a model state statute governing investment fiduciaries that has been adopted in at least 44 states, including the U.S. Virgin Islands. The Act contains many provisions that are substantially similar to ERISA's fiduciary rules. For example, the Act requires consideration of the prudence of an investment in light of its relationship to the total portfolio, rather than in isolation. The model statute's prudent investor rule requires a fiduciary, in evaluating the prudence of the investment, to consider first and foremost its economic features including its risk and return characteristics, liquidity, the general economic circumstances, the impact of inflation or deflation, and the expected tax consequences of the investment. In addition, the Act requires the fiduciary to adhere to a strict standard of loyalty to the trust's beneficiaries.

³⁶ See generally, 29 C.F.R. § 2550.404a-1(b).

³⁷ See Donovan v. Bierwirth, *supra*; DOL Information Letter to Stuart Cohen (May 14, 1993).



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INVESTORS

Council of Institutional Investors
1730 Rhode Island Ave., NW, Suite 512
Washington, DC 20036

