ADVOCACY RESEARCH EDUCATION

National Conference on Public Employee Retirement Systems

The Voice for Public Pensions

Fiduciary Laws Pension Trustees Should Know

Presented by

Marcia S. Wagner
The Wagner Law Group
125 High Street, Oliver Tower-5th Floor
Boston, MA 02110
Tel: (617) 357-5200 / Website: www.wagnerlawgroup.com

© Wagner Law Group. All rights reserved. 2022

Fiduciary Review

- Some public pension plans are conducting fiduciary reviews.
- Generally voluntary, but mandated in some states:
  - New York, South Carolina, Ohio.
- One purpose of the review is to provide reassurance to stakeholders that plan trustees are satisfying their fiduciary duties.

State Law

- Each state imposes fiduciary responsibilities on its own state and local government employers.
- Duties may be in the form of:
  - State constitutional law,
  - State statutory law,
    - Each major governmental plan may have its own enabling statute,
  - Common law, or
  - While common law is a singular term, common law of trusts may have developed differently in each of 50 states.

State Law

- Subsets of common law include:
  - Restatement of Trusts (Third);
  - Uniform Trust Code;
  - Uniform Prudent Investors Act; and
  - Uniform Management of Public Employees Retirement Systems Act of 1997 (Uniform Management Act).
- Title I of ERISA also a source for state law.

Other Applicable State Law

- Unlike ERISA, state laws defining fiduciary duties generally do not preempt other state laws.
  - Claims may be brought for breach of contract; negligence, under agency law principles.
  - Claims under state's consumer protection laws.

Fiduciary

- State statute may specify who is a fiduciary of that state's retirement program.
- Many state statutes do not identify governmental plan fiduciaries by statute.
- At common law, a plan trustee would be a fiduciary.
  - Persons advising the trustee with respect to the investment of governmental plan assets, such as an investment manager or an investment advisor, would also likely be a fiduciary at common law.

Selection or Composition of Board of Trustees

- Governmental plan governance structure more varied than private pension plans' governance structure.
- Under ERISA, there must be one named fiduciary, and plan sponsor selects the trustee or custodian, determines the need for and size and scope of committees.
- For governmental plans, state law will determine the composition and method of selection of a board of trustees.

Selection or Composition of Board of Trustees

- Board of trustees of governmental plans may have different structures.
  - One set of trustees with ultimate authority over all aspects of the system.
- More than one set of trustees, with each set of trustees having ultimate authority over some aspect of the retirement system.
- Each person involved in public plan administration should ascertain precisely what his or her function is.

Core Fiduciary Duties

- Restatement of Trusts (3rd) identifies 3 core fiduciary duties.
  - Duty of prudence,
  - Duty of loyalty, and
  - Duty of impartiality.

Ancillary Fiduciary Duties

- Duty with respect to delegation.
- Duty with respect to co-trustees.
- Duty to furnish information to beneficiaries.
- Duty to keep records and provide reports.
- Duty to segregate and identify trust property.
- Section 90: duties relating to investing.
- Section 91: adherence to investment provisions found in trust itself or in statute.

Duty of Prudence

- Concept of prudence is relational or comparative.
  - Resembles the reasonable person of tort law.
- A prudent trustee behaves as others similarly situated would behave.
- Standard is objective, rather than subjective.

Duty of Prudence

- Almost every state will have in effect some version of the duty of prudence.
  - Some follow verbatim or adopt standards analogous to the ERISA standard the ERISA standard.
- "Acting 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 a like character and with like aims."
  - Sometimes referred to as the "prudent expert" standard.

Duty of Prudence

- This statutory approach does not obligate a state court to defer to DOL or federal courts in interpreting a state statute.
- Nonetheless, DOL and federal courts interpretation of ERISA is persuasive, if not binding, in large part because of dearth of state case law on the subject.
  - Practitioners frequently advise governmental plans to follow ERISA fiduciary standards, both in states that have copied ERISA and those that have not.
- ERISA thus operates as a type of shadow law, even though it has no application to and cannot be enforced against public pension funds.

Duty of Prudence

- Not a single prudent expert against which fiduciaries of state and local retirement systems will be measured.
  - Not measured against CALPERS.
  - Benchmark-prudent fiduciaries for similar systems under similar circumstances.
  - Retirement systems differ in a wide number of parameters:

Duty of Prudence

- Size,
- Complexity, and
- Purpose of system.

Duty of Loyalty

- As with duty of prudence, state laws either follow ERISA verbatim or adopt substantially similar language.
- Fiduciary must act "solely in the interest of the participants and beneficiaries."
  - Analysis is applied at the fund level rather than the individual participant level.
  - Maximize the return to the fund rather than what would be in the best interest of a plan participant.

Duty of Loyalty

- Not limited to self-dealing or conflict of interest where fiduciary would benefit personally.
- Relevant plan fiduciary cannot take action for benefit of a third person.

- Unlike duty of prudence, which is objective, duty of loyalty is frequently determined subjectively.
  - "Why did the fiduciary take or not take some action?"

Purpose

- Purpose of governmental retirement plan is to provide benefits to participants and beneficiaries.
  - Purpose is relevant because duty of loyalty precludes a fiduciary from being influenced by motives other than the accomplishment of the purposes of the trust.
  - Under ERISA, the duty of loyalty is backstopped by prohibited transaction provisions, but few jurisdictions require these.

Prohibited Transaction Provisions

- Under the Internal Revenue Code and ERISA, there are two kinds of prohibited transactions:
  - Party in interest; and
  - Fiduciary self-dealing.
- Under federal law, complicated statutory and class exemptions.
  - Reluctance to duplicate that complexity at state and local level.

Prohibited Transaction Provisions

- Most states have broad code of ethics and conflict of interest rules that apply in a broad range of government employees and officials that prohibits much of same conduct as prohibited transaction rules.

Duty of Impartiality

- Derived from duty of loyalty.
- While loyalty to all participants and beneficiaries is required, different groups of persons can have different interests at different times:
  - Active employees and former employees;
  - Full-time and part-time employees;
  - Younger and older employees; and
  - Long-term and short-term employees.

Duty of Impartiality

- Duty of impartiality does not require absolute equality between different categories of plan participants.
  - A fiduciary can favor one group of participants and beneficiaries over others, but such decisions must be made carefully and after weighing the different interests.

Duty to Interpret Applicable Law in Good Faith

- Not a common law or restatement principle but appears in Uniform Management Act.
- Premise-Not all failures to comply with the law are fiduciary violations, only those that do not reflect a good faith attempt to comply.
- Premise: Prudent fiduciary may not be able to predict that an action a Board member is lawful, even if a court later decides to the contrary.
- Applicable in far fewer states than the duties of prudence, loyalty, and impartiality.

Duty With Respect to Delegation

- Traditional rule: prohibited delegation by trustees of all discretionary investment and management functions.
- Modern trend reverses the rule.
  - Restatement (Third) of Trusts Prudent Investor Rule;
  - Section 9 of Uniform Prudent Investor Act; and
  - State law may permit delegation of authority to manage or control retirement system assets to persons other than trustees or investment managers.

Duty of Delegation

- The fiduciary delegating his/her authority must exercise prudence in both the selection and monitoring of the person to whom responsibility has been delegation.
- State law may address the extent to which the person or persons making the delegation is responsible for the actions of the person appointed.
  - The terms of any delegation agreement should also be stated prudently for the benefit of Plan participants.

Duty With Respect to Co-Trustees

- At common law and under ERISA Section 405, co-fiduciary liability is an important concept.
- Less Frequently Expressly Provided for under State Law.
- Rationale: properly applied the general fiduciary standards under state law already impose the duties specified in greater detail in ERISA Section 405.

Duty of Disclosure to Plan Participants

- State retirement systems will not track ERISA on this issue.
- Applicable plan fiduciary must determine, at a minimum, the disclosure requirements to plan participants and beneficiaries under state law including, where relevant, case law.
- Overriding fiduciary principles- participants and beneficiaries must know their benefits and must be provided with sufficient information with respect to any plan decision to allow them to make an informed decision.

Investment Duties

- Only incur expenses that are appropriate and reasonable.
- Wasting the monies of participants and beneficiaries is imprudent.
- Determining what expenses are appropriate and reasonable is fact-sensitive, including:
  - The purpose of the trust,
  - Type of assets held, and
  - Skills of trustee.

Diversification

- Requirement to diversify existed at common law, also reflected in modern portfolio theory.
  - No precise rules as to when a portfolio becomes undiversified.
- No defined set of asset categories.
- No requirement as part of the duty of diversification that all basic categories need to be included in a plan's portfolio.

Diversification

- Exception: Unless under the circumstances it is prudent not to do so.
  - Situations in which this exception to the diversification rule applies are more likely to appear in the private rather than the public sector.

Categoric Restrictions on Investments

- At one time, most states had some form of categoric restriction on investments, referred to as legal lists.
  - Not only directed towards alternative investments, bt also provided caps on equities.
  - Began to change in 1980s, but still necessary to determine if state law prohibits any type of investment, either for all government plans, or for government entities below a certain asset level.

Collateral Benefits

- Terminology has changed over time.
  - What is now referred to as ESG was in the 1990's referred to as ETI, economically targeted investments.
- Unlike today, there was no focus upon risk adjusted returns.
  - Laws in 1990's prohibiting investment or requiring divestiture in South Africa, North Ireland, or companies complying with the Arab league boycott of Israel.

Collateral Benefits—2017 Pew Report

- Stated that some state statutes direct that governmental pension plans invest within their states or in certain specific offerings.
- Seven states have statutes or regulations permitting consideration of collateral benefits, only when fiduciaries determine that the investment would be prudent without the additional benefits.
- State limits on ETIs range from 2 to 3 percent of assets in Florida and Montana to 10 percent in Arkansas.
- Some states provide no guidance on ETIs.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Sovereign immunity and indemnity were two traditional bases upon which state officials could be protected from liability for fiduciary breaches.
- Sovereign immunity: State is immune from lawsuits or other legal actions except when it consents.
  - Issues can arise in connection with alternative investments.
  - Sovereign immunity applies only to states and arms of the state.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Sovereign immunity does not apply to counties, cities, or towns.
- Employees of counties, cities, and towns are not covered by sovereign immunity.
  - Can only be covered by governmental immunity.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Sovereign immunity may apply only for acts made in good faith.
  - Sovereign immunity will not apply for acts considered willful, wanton, reckless, malicious, grossly negligent.
  - Litigation for breach of fiduciary duty may allege one of the above.
- Some states with broad immunity statutes have been construed in a limited fashion by courts.
  - May still be available in certain circumstances.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Ex Parte Bronner-171 So. 3d 614 (Ala.2014).
- Case also addressed separation of powers issues.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Indemnification by a public sector entity means a plan fiduciary will receive legal representation and protection from financial liability if sued in capacity of trustee.
- When trustees of San Diego Employees Retirement System requested indemnification, city exercised its discretion to decline.
  - Trustees of San Diego plan had to sue city to seek indemnification.

Sovereign Immunity, Governmental Immunity, and Indemnification

- Conditions for indemnification.
  - Acting within your capacity as a trustee.
    - "In the scope of employment" or to further the purposes for which the board was established."
    - State indemnification law may apply only to board of trustees and not to other officers and agents.
  - State indemnification statute may not address the scope of the indemnification.

Fiduciary Liability Policy

- Policy provides two basic benefits:
  - Defense
  - Indemnity
- Doesn’t provide absolute protection.
  - Review for exclusions such as availability of sovereign immunity and indemnity.

Best Practices

- Become familiar with the governing state laws.
- Clearly delineate the responsibilities of all parties administering the plan.
- Fiduciary training and ethics orientation.
- Documentation of decision-making process.
- Maintenance of due diligence file.
- Periodic meetings with advisors and consultants.
- Comprehensive policies and procedures.

Best Practices

- Comprehensive procedures for evaluating and monitoring investments in defined contribution plans.
- Consider application of ERISA if appropriate for a particular matter under your plan.
- Determine state law for record keeping purposes.
- As a practical matter, may need to maintain records of a defined benefit plan for a longer period of time.

QUESTIONS?

A0695540.PPTX