Social Investing

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Legal Restrictions on Social Investing

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Introduction

It is a pleasure for me to be here today to speak with you on a truly timely topic—the social investment of pension plan assets. It is no secret that the assets of pension plans today represent an enormous pool of investment capital. Recent statistics issued by the Department of Labor indicate that pension plan assets presently amount to well over $550 billion[1] and, indeed, could exceed $3 trillion by as early as 1995.[2] The sheer size of this pool of potential investment capital obviously attracts attention, particularly in view of the current state of the economy.

This brings me to the specific issue that I will be addressing today—the present legal restrictions on the use of pension plan assets to further social goals other than protecting and insuring the retirement income of pension plan participants. In addressing that topic, I will direct my comments primarily to the Em-

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[1] See Lanoff and Antsen, *Paper on Impact of ERISA on Investments by Employee Benefit Plans in Residential Housing*, [hereinafter, "Lanoff Paper"], reprinted in Pens. Repr. (BNA) No. 355 at R-4 (August 17, 1981).

[2] Ibid.

ployee Retirement Income Security Act of 1974,[3] or ERISA, as it is commonly known.

ERISA, of course, is a comprehensive federal regulatory statute designed to displace state regulation of the employee benefit plan field.[4] Although ERISA does not cover public pension plans,[5] it represents the preeminent reference point today for questions concerning the administration, management, and operation of private employee benefit plans. Even if public plans ultimately escape federal regulation, it can be anticipated that standards developed under ERISA will serve as guides in determining the permissible scope of investment of public pension plan assets.[6]

As a threshold matter, it is important to recognize that pension plan assets are already committed to a socially desirable end articulated by Congress—the adequate financing of retirement benefits. Indeed, both ERISA's legislative history and declaration of policy makes clear that the statute's overriding objective is the protection of the retirement income of pension plan participants and beneficiaries.[7] ERISA itself nowhere suggests that fiduciaries may accept lower economic returns on investments in order to accomplish purposes other than providing such retirement benefits. In fact, several proposals that would have sanctioned certain types of socially motivated investments by pension funds were discussed during Congressional consideration of ERISA and did not find their way into the statute.[8] Since

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[3] 29 U.S.C. §§ 1001, *et seq.* (1976 and Supp. V 1981).

[4] *E.g., Alessi v. Raybestos-Manhattan, Inc.*, 451 U.S. 504 (1981); ERISA Section 514, 29 U.S.C. § 1144; H.R. Rep. No. 1280, 93d Cong., 2d Sess. 383 (1974) (hereinafter, "Conference Report"). *See generally*, Hutchinson & Ifshin, *Federal Preemption of State Law Under the Employee Retirement Income Security Act of 1974*, 46th Chi. L. Rev. 23 (1978).

[5] ERISA Sections 3(32), 4(b)(1), 29 U.S.C. §§ 1002(32), 1003(b)(1).

[6] There have been a number of legislative proposals which would impose standards similar to those found in ERISA, particularly in the fiduciary area, upon public employee benefit plans. *See, e.g.*, H.R. 4928, 97th Cong., 1st Sess. (1981). *Cf.* District of Columbia Retirement Reform Act of 1979, Pub. L. No. 96-122, 93 Stat. 866 (1979), codified at District of Columbia Code § 1-701, *et seq.* [hereinafter "D.C. Retirement Act"] (congressional statute regulating District of Columbia retirement system; ERISA fiduciary standards generally imposed upon fiduciaries of retirement system). It can be anticipated that similar legislation will be proposed in the current session of Congress.

[7] ERISA Section 2(a), 29 U.S.C. § 1001(a). *See, e.g.*, S. Rep. No. 383, 93d Cong., 1st Sess. 1, 3-5 (1973); H. R. Rep. No. 533, 93d Cong., 1st Sess. 1-8 (1973); H. R. Rep. No. 779, 93d Cong., 2d Sess. 1, 3-4 (1974).

[8] *See Welfare and Pension Plan Legislation: Hearings on H.R. 2 and H.R. 462 Before the General Subcomm. on Labor of the House Comm. on Education and Labor*, 93d Cong., 1st Sess. (pt. 1) 260, 271-72, 292-93 (Statement of Ralph Nader and Karen Ferguson)

ERISA is designed to insure the financial soundness and stability of employee benefit plans, it, of necessity, limits the use of pension plan assets for other purposes. Accordingly, any attempt to use pension plan assets to further social goals which are unrelated or only related tangentially to insuring the retirement income of pension plan participants and beneficiaries must be measured against ERISA's regulatory framework.

The primary provisions regulating the investment of pension plan assets by ERISA fiduciaries are Section 404(a) of the statute,[9] which established uniform fiduciary standards that govern the conduct of all ERISA fiduciaries, and Section 406 of ERISA,[10] the so-called prohibited transaction provision. I will discuss briefly the general obligations imposed upon ERISA fiduciaries by these provisions, as well as their implications in the social investment context. I will then discuss a recent federal decision which illustrates the application of these provisions. I will conclude by attempting to suggest some guidelines for the ERISA fiduciary in considering social investments in the current legal climate.

General Obligation of ERISA Fiduciaries

Broadly speaking, Section 404(*a*) of ERISA imposes on ERISA fiduciaries the common law duties of trustees, most notably, the duty to act as a prudent man, and the duty of undivided loyalty to the plan's participants and beneficiaries.[11]

(proposal to permit investment of up to 10 percent of a plan's assets in "special allowance investments", i.e., investments to reduce certain housing, medical, and consumer expenses of retirees); *Private Welfare and Pension Plan Legislation: Hearings on H.R. 1045, H.R. 1046, and H.R. 16462 Before the General Subcomm. on Labor of the House Comm. on Education and Labor*, 91st Cong., 1st & 2d Sess. 102–12, 186–94 (1969–70) (Statement of Andrew J. Biemiller) (Statement of Walter Reuther) (labor proposals to sanction pension plan investment in "socially useful projects" or "high social priority projects"). *Cf.* D.C. Retirement Act § 141, District of Columbia Code § 1-721 (prohibiting investment of plan assets in various types of "local" investments, e.g., real property located in the District of Columbia, Maryland, or Virginia, securities issues by the District of Columbia, Maryland, or Virginia or political subdivisions thereof).

[9] 29 U.S.C. § 1104(a) (1976 and Supp. V 1981).

[10] 29 U.S.C. § 1106 (1976 and Supp. V 1981).

[11] ERISA Section 404(a)(1), 29 U.S.C. § 1104(a), provides as follows:

(a)(1) Subject to Sections 403(c) and (d), 4042, and 4044, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and

Prudence of Investment Decisions

Turning first to prudence, Section 404(a) states that a fiduciary shall exercise "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 like character and like aims." This duty of prudence, while applicable to all of a fiduciary's plan responsibilities,[12] is of primary importance in the investment area.

The Department of Labor has issued a regulation which offers some guidance on the investment of plan assets under ERISA's prudent man rule.[13] The preamble to that regulation clarifies certain matters concerning the proper interpretation of ERISA's prudence standard. First, the regulation's preamble makes clear that ERISA's prudence rule is to be interpreted with "the special nature and purpose of employee benefit plans" in mind and thus is more flexible than its common law counterpart.[14] Indeed, the Department of Labor specifically stated that "the common law of trusts . . . should . . . not be mechanically applied to employee benefit plans" and that investments precluded at common law may be appropriate under ERISA's standard.[15]

(A) for the exclusive purpose of:
  (i) providing benefits to participants and their 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 a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
(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; and
(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title or Title IV.

The courts have recognized that these standards, while differing in certain respects, have been derived from the duties imposed upon trustees at common law. E.g., Eaves v. Penn, 587 F.2d 453 (10th Cir. 1978); Bueneman v. Central States, Southeast and Southwest Areas Pension Fund, 572 F.2d 1208 (8th Cir. 1978).

[12] See ERISA Section 404(a); 29 U.S.C. § 1104(a); 29 C.F.R. § 2509.75-8, FR-11 (prudence standard applies in connection with a fiduciary's delegation of plan responsibilities, including the selection, appointment, and monitoring of an investment manager); Donovan v. Mazzola, 2 EBC 2115, 2136–37 (N.D. Cal. 1981) (prudence standard applies to selection of service providers); DOL Advisory Opins. Nos. 77-07, 77-08 (prudence standard applies in connection with collection of delinquent contributions).

[13] 29 C.F.R. § 2550.404a-1.

[14] Preamble, Final Regulation, Rules and Regulations for Fiduciary Responsibility—Investment of Plan Assets under the "prudence" Rule [hereinafter cited as "Prudence Reg. Preamble"], 44 Fed. Reg. 37221, 37222 (June 26, 1979).

[15] Prudence Reg. Preamble, 44 Fed. Reg. at 37222.

Secondly, the relative riskiness of an investment, standing alone, does not render the investment per se prudent or per se imprudent.[16] Third, the regulation rejects the common law approach of analyzing an investment's prudence on an individual basis. Rather, as the regulation makes clear, an investment's prudence is to be judged within the context of its role within the overall plan portfolio.[17]

Against this background, the regulation sets forth a suggested course of action for the prudent fiduciary to follow in making investment decisions. It directs him to analyze all facts and circumstances relevant to the investment including (1) the characteristics of the investment itself, (2) the risk of loss and opportunity for gain associated with the investment, (3) the plan's cash flow and liquidity needs, and (4) diversification of the plan's assets.[18] Recent legal decisions, as well as statements from the Department of Labor, also make clear that the availability of alternative investments that serve the plan's needs should be considered.[19] The regulation then directs the fiduciary to make a determination as to whether the investment is designed reasonably to serve the plan's overall needs and objectives.[20] In short, rather than a hindsight test focusing solely on investment results,[21] the regulation establishes a "procedural prudence" standard which examines the thoroughness of the fiduciary's analysis of a particular investment, both in terms of the investment's own characteristics and within the context of the plan's

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16 Prudence Reg. Preamble, 44 Fed. Reg. at 37222, 37225.

17 Prudence Reg. Preamble, 44 Fed. Reg. at 37222.

18 See 29 C.F.R. § 2550.404a-1(b)(1), (b)(2).

19 See Donovan v. Bierwirth, 538 F. Supp. 463, 473 (E.D.N.Y. 1981), *aff'd as modified*, 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 51 U.S.L.W. 3440 (U.S. Dec. 7, 1982); Donovan v. Mazzola, 2 EBC 2115, 2126 (N.D. Cal. 1981); Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F.Supp. 378, 384 (D. Hawaii 1980); Baker v. Smith, 2 EBC 1380, 1382 (E.D. Pa. 1981); Class Exemption for Transactions Involving Certain Residential Mortgage Financing Arrangements [hereinafter "Mortgage Financing Class Exemption"], 47 Fed. Reg. 21331, 21332 (May 18, 1982); DOL Letter to Robert A. Georgine, Nat'l Coordinating Comm. for Multiemployer Funds [hereinafter "Georgine Letter"] reprinted in Pens. Rep. (BNA) No. 327 at R-68 (Feb. 2, 1981).

20 29 C.F.R. § 2550.404a-1(b)(2).

21 The courts have agreed with this view of ERISA's prudence standard. As one court has stated: "The standard to be applied is that of conduct, tested at the time of the investment decision, rather than performance, judged from the vantage of hindsight." American Communications Ass'n v. Retirement Plan for Employees of RCA Corp., 488 F. Supp. 479, 483 (S.D.N.Y. 1980), *aff'd* 646 F.2d 559 (2d Cir. 1980). Accord, Donovan v. Mazzola, 2 EBC at 2134; Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan, 507 F. Supp. at 384.

entire portfolio. If a fiduciary complies with the terms of the regulation in making an investment decision, he will be deemed to have satisfied his responsibilities under ERISA's prudence standard since, as the regulation's preamble makes clear, the regulation is designed to serve as a "safe harbor" provision.[22]

Diversification of Portfolio

Closely related to a fiduciary's duty to invest the plan's assets prudently is his obligation to diversify the investments of the plan so as to minimize the risk of large losses.[23] Like the prudence standard, ERISA's diversification requirement rejects a mechanistic approach in favor of a flexible analysis which focuses upon the investment needs of the particular plan involved. Rather than establishing any fixed limits on investment concentration, the statute and its legislative history make clear that satisfaction of the diversification requirement turns on an analysis of the facts and circumstances of each particular case.[24] Factors pertinent to this inquiry include (1) the purpose of the plan, (2) the amount of the plan's assets, (3) financial and industrial conditions, (4) the type of investment and date of maturity, (5) the distribution of the plan's investments with respect to geographical location and industry,[25] and (6) the availability of alternative investments to satisfy the plan's diversification needs.[26] Despite this facts-and-circumstances approach, the diversification requirement does impose a significant limitation on the breadth of any specific investment program. As ERISA's conference report unequivocally states, "The fiduciary should not invest a whole or an unduly large proportion of the trust property in one type of security or in various types of securities

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[22] Prudence Reg. Preamble, 44 Fed. Reg. at 37222.

[23] ERISA Section 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C). At common law, the duty to diversify generally was viewed as a part of the prudence standard. *See* Restatement (Second) of Trusts § 228 (1958); 3 A.W. Scott, The Law of Trusts § 228 (3d ed. 1967); G. Bogert, The Law of Trusts & Trustees § 612 (rev. 2d ed. 1980). It is stated as an independent duty in ERISA, presumably to emphasize that "[t]he basic policy of [ERISA] is to require diversification". Conference Report at 304.

[24] Conference Report at 304; *Donovan v. Mazzola*, 2 EBC at 2135–36; *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. at 383.

[25] Conference Report at 304.

[26] *Donovan v. Mazzola*, 2 EBC at 2135-36; *Marshall v. Glass/Metal Ass'n & Glaziers & Glassworkers Pension Plan*, 507 F. Supp. at 383-84; DOL Inf. Ltr., Washington Service Bureau No. 80–26.

dependent upon the success of one enterprise or upon conditions in one locality, since the effect is to increase the risk of large losses."[27]

What implications do the prudence and diversification requirements have on social investing? At first glance, their flexible facts-and-circumstances approach, including adoption of the whole portfolio view, would seem to offer an opportunity to undertake such investments, at least on a limited scale. At the same time, however, the facts and circumstances that a fiduciary is directed to consider are clearly economic factors that focus squarely on the investment's ability to meet the needs and objectives of the plan. And, of course, plans have one overriding objective—to provide retirement income to their participants and beneficiaries. Accordingly, the Department of Labor, at least, has taken the position that the noneconomic consequences of an investment are not pertinent in determining whether the investment satisfies ERISA's prudence and diversification requirements.[28] Indeed, Secretary of Labor Donovan recently made this point in no uncertain terms stating that "we will not allow increased risk or decreased returns by so-called social investments—even those which have the noblest of purposes."[29] Consequently, while the prudence and diversification requirements do not appear to preclude a fiduciary from taking social consequences into account, it is unlikely that such factors could be used by him to justify an investment under those standards. Rather, at best, it would appear that he could consider those factors *after* the investment has been deemed proper on the basis of objective economic considerations.[30] In short, social considerations may provide a basis for selecting among alternative investments that otherwise satisfy ERISA's prudence and diversification standards—they do *not* provide a basis for overriding or satisfying those standards.

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[27] Conference Report at 304.

[28] See *Donovan v. Walton*, Civil Action No. 81-6281-CIV-JAG (S.D. Fla., filed May 20, 1981) (action brought by Department of Labor challenging loans made by trustees to plan participants at below-market interest rates on both prudence and loyalty grounds); Mortgage Financing Class Exemption, 47 Fed. Reg. at 21332; Georgine Letter, *supra*; see *also* Lanoff Paper, Pens. Rep. (BNA) No. 355 at R-6.

[29] Statement of Sec. of Labor Raymond J. Donovan before Senate Labor Subcommittee on Labor, Jan. 26, 1982 [hereinafter "Donovan Statement"], reprinted in 9 Pens. Rep. (BNA) 307 (Feb. 22, 1982).

[30] See materials cited in note 28, *supra*.

Undivided Loyalty to Plan Participants and Beneficiaries

The fact that a particular social investment satisfies ERISA's prudence and diversification standards, however, does not end the inquiry. As noted earlier, ERISA also imposes a duty of undivided loyalty upon plan fiduciaries. This is expressed in Section 404's statement that a fiduciary must act "solely in the interest" of plan participants and beneficiaries and for "the exclusive purpose of providing benefits" to them.[31] The solely-in-the-interest standard requires not only that a fiduciary's loyalty to his plan be primary, but also that it be the *only* loyalty which affects his judgment when acting on the plan's behalf. As one court recently explained:

> Although . . . trustees . . . 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 [the party who appointed them] or, indeed, themselves, *their decisions must be made with an eye single to the interests of the participants and beneficiaries.*[32]

This duty of undivided loyalty clearly proscribes any self-dealing on the part of a plan fiduciary.[33] Moreover, it would appear to proscribe any activity that is not designed primarily with the interests of participants and beneficiaries in mind.[34]

This duty of undivided loyalty has important implications in the social-investing area since it focuses directly on the purpose of the plan investment involved. At the very least, it prohibits any investment activity whose primary purpose is to benefit a party that is responsible for the management or administration of the pension fund, even if that investment is otherwise prudent and satisfies the diversification requirements of the statute.[35] Of

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[31] ERISA Sections 404(a)(1), (a)(1)(A), 29 U.S.C. §§ 1104(a)(1), (a)(1)(A).

[32] *Donovan v. Bierwirth*, 680 F.2d 263, 271, (2d Cir. 1982), *aff'ing as modified* 538 F. Supp. 463 (E.D.N.Y. 1981).

[33] See, e.g., *Marshall v. Carroll*, 2 EBC 2491 (N.D. Cal. 1980); *Eaves v. Penn*, 426 F. Supp. 830 (W.D. Okla. 1976), *aff'd in part and remanded*, 587 F.2d 453 (10th Cir. 1978).

[34] See, *Donovan v. Bierwirth*, 680 F.2d at 271.

[35] See, e.g., *Marshall v. Carroll, supra* (defendant fiduciaries violated ERISA in causing or permitting plan assets to be deposited in banks in order to aid fiduciaries in obtaining loans from such banks); *Blankenship v. Boyle*, 329 F. Supp. 1089 (D.D.C. 1971), *aff'd mem.*, 511 F.2d 447 (D.C. Cir. 1975) (union fund trustees violated their pre-ERISA duty of loyalty through investments designed to promote purchases of coal from unionized companies).

course, the difficult question in this area lies in drawing the line between investments that are primarily designed to benefit such parties, for example, an employer sponsor or a union, as opposed to the plan's participants and beneficiaries. The *Withers* case [36] typifies this problem. In *Withers*, the court upheld the investment by the trustees of New York City's Teachers' Retirement System of approximately $2.5 billion in pension fund assets in highly speculative, unmarketable bonds issued by New York City at a time when the city was on the brink of insolvency. However, in upholding the investment against fiduciary challenge, the court emphasized that "neither the protection of the jobs of the city's teachers nor the general public welfare were factors which motivated the trustees in their investment decision."[37] Rather, the court found that the trustees' primary goal was to maintain the city's solvency because the city was the principal contributor to the fund and thus the ultimate guarantor of the employees' pensions.[38] Using this same rationale, some spokesmen for organized labor have argued that investment in unionized projects would not only provide earnings to fund retirement benefits, but also would help assure that the pension plans were still in operation when the participant was ready to retire.[39]

In sum, a fiduciary's duty of loyalty serves as an additional limitation on his ability to engage in social investing.[40] It clearly precludes him from engaging in any self-dealing with the plan's assets, even if the self-serving investment is otherwise proper from a prudence-and-diversification standpoint. Moreover, even in the absence of self-dealing, it may serve as a practical limita-

[36] *Withers v. Teachers' Retirement System*, 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).

[37] Ibid. at 1256.

[38] Ibid.

[39] See Statement of William Sidell, Vice President of the AFL-CIO Building Trades Department, Testimony Before President's Commission on Pension Policy (Dec. 11, 1979).

[40] The impact of the duty of loyalty on social investing is further complicated by ERISA's requirement that action be taken for the exclusive purpose of providing "benefits" to participants and beneficiaries. ERISA Section 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A). Read literally, this requirement would seem to prohibit social investments whose primary purpose is something other than the provision of actual retirement benefits to plan participants and beneficiaries. At the very least, it calls into question the legality of any investment decision that is not designed to further the interests of plan participants as such, but to further broader social concerns.

tion on his ability to consider social factors in selecting among alternative investments that are arguably comparable from an objective economic standpoint. Of course, arguments can be, and have been advanced that ERISA does not prohibit a fiduciary from selecting among economically comparable investments on the basis of their relative social merit.[41] The difficulty with this analysis lies in demonstrating first, that particular investment alternatives are truly comparable from an investment point of view and second, that the perceived noneconomic benefits are merely incidental to the decision on economic grounds. In light of this difficulty, the ERISA fiduciary would appear to risk potential violations of his duty of loyalty whenever he selected a course of investment activity on the basis of noneconomic factors that were not related primarily to the provision of benefits to plan participants and beneficiaries.

Prohibited Transactions

In addition to the general fiduciary standards, ERISA's prohibited transaction rules, set forth in Section 406 of the statute,[42] often pose an additional hurdle to social-investment programs. ERISA, of course, contains prohibited transaction rules of two types. The first, described in Section 406(a)(1), are transactions which either directly or indirectly involve a plan and a party in interest to the plan.[43] The second, described in Section 406(b), are transactions in which the fiduciary is guilty of some form of

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[41] See, Lanoff Paper, Pens. Rep. (BNA) No. 355 at R-6.

[42] ERISA Section 406, 29 U.S.C. § 1106.

[43] ERISA Section 406(a)(1) provides as follows:

(a) Except as provided in section 408:

 (1) A fiduciary with respect to a plan shall not cause the plan to engage in a transaction, if he knows or should know that such transaction constitutes a direct or indirect

  (A) sale or exchange, or leasing, of any property between the plan and a party in interest;
  (B) lending of money or other extension of credit between the plan and a party in interest;
  (C) furnishing of goods, services, or facilities between the plan and a party in interest;
  (D) transfer to, or use by or for the benefit of, a party in interest, of any assets of the plan; or
  (E) acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a).

self-dealing.[44] These prohibited-transaction provisions establish absolute structural bars to the transaction in question.[45] Thus, in the absence of an exemption, the enumerated transactions are prohibited no matter how fair or reasonable the transaction otherwise might be from a plan's perspective.[46]

These provisions pose particular problems in connection with social investment programs that would benefit a party in interest to the plan, such as an employer or the union. Obviously, they would interdict any direct transfer of plan assets to a financially strapped employer sponsor, even if the investment program was designed to create jobs in an industry and thereby provide at least indirect benefits to plan participants and beneficiaries.[47] Moreover, such a job-creation program could run afoul of these provisions even where no direct transfer of assets to a party in interest, such as an employer or union, took place. Section 406(a)(1)(D) prohibits any "transfer to, or use by or *for the benefit of*, a party in interest, of any assets of the plan." (Emphasis added) Accordingly, an "indirect" prohibited transaction could occur if a plan engaged in a transaction with an unrelated third party under circumstances designed to benefit a party in interest—for example, where a plan makes a construction loan to a third party on the understanding that the third party will contract with the employer sponsor to perform the work.[48]

In addition, the fiduciary self-dealing provisions of Section 406(b) often come into play when plan assets are used in a manner which promotes the interests of the employer sponsoring the plan or promotes the interests of the union. For example, an employer who sought to invest plan assets in a manner designed to promote his business most likely would run afoul of

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[44] ERISA Section 406(b) provides as follows:

(2) No fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a).

[45] *Curtaior v. Marshall*, 590 F.2d 523 (3d Cir. 1979); *Donovan v. Mazzola*, 2 EBC at 2136; *M&R Investment Co. v. Fitzsimmons*, 484 F. Supp. 1041 (D. Nev. 1980) *aff'd* 685 F. 2d 283 (9th Cir. 1982); *Freund v. Marshal! & Ilsley Bank*, 485 F. Supp. 629, 637 (W.D. Wis. 1979).

[46] Ibid.

[47] See ERISA Sections 406(a)(1)(A), (B), (D); 29 U.S.C. §§ 406(a)(1)(A), (B), (D).

[48] See Prohibited Transaction Class Exemption No. 76-1, 41 Fed. Reg. 12740 (March 26, 1976); 29 C.F.R. § 2509.75-2; see *also* McDougall v. Donovan, 3 EBC 2385 (N.D. Ill. 1982).

Section 406(b)(1)'s prohibition against dealing with plan assets in a fiduciary's own account.[49] Similarly, any plan fiduciary who has loyalties to another entity, for example, a union official serving as a plan trustee, could violate Section 406(b)(2)'s prohibition against acting on behalf of a party with interests adverse to those of the plan if he takes part in an investment decision designed to foster the union's interests, such as job-creation programs.[50]

The impact of these structural prohibitions is mitigated by the availability of statutory and administrative exemptions.[51] Unfortunately, ERISA's statutory exemptions have little applicability to the types of transactions that usually arise in the social investment context. Accordingly, a fiduciary who wishes to pursue a course of social investing proscribed by ERISA's prohibited-transaction rules would have to seek an administrative exemption from the Department of Labor. That process can be both expensive and time consuming. More importantly, even if the fiduciary is granted an exemption from the prohibitions of Section 406, that exemption would not relieve him from complying with the other fiduciary obligations imposed upon him by ERISA in connection with the transaction.[52] Thus, the fiduciary would remain bound by the prudence, diversification, and loyalty requirements of Section 404, even if the exemption removed the structural impediment to the transaction found in Section 406.

Grumman Corporation Case

A recent federal decision serves to illustrate many of the general legal principles [discussed above].

Factual Background

That case, *Donovan* v. *Bierwirth*,[53] arose in connection with LTV Corporation's tender offer in late 1981 for Grumman Corpo-

[49] *Cf. Marshall* v. *Carroll*, *supra* (investment of plan assets designed to further fiduciary's own interests).

[50] See, *Curtaiar* v. *Marshall*, *supra*; 29 U.S.C. § 2550.408b-2(c)(1), (c)(2), (f).

[51] ERISA Section 408, 29 U.S.C. § 1108 (1976 and Supp. V 1981).

[52] See ERISA Section 408, 29 U.S.C. § 1108; Conference Report at 310-11.

[53] Donovan v. *Bierwirth*, 680 F.2d 263 (2d Cir. 1982), *aff'ing*, 538 F. Supp. 463 (E.D.N.Y. 1981).

ration. There, after Grumman's management had decided to fight the tender offer, Grumman corporate officers met in their capacity as fiduciaries of the company's pension plan to determine whether to tender the plan's significant holdings of Grumman stock. In a relatively short meeting, these corporate officers decided not to do so despite the opportunity for significant gain on the investment. In addition, they decided to purchase a large additional block of Grumman stock at the inflated price then prevailing. In making these investment decisions, the fiduciaries did not seek the benefit of advice from independent investment advisors or independent legal counsel. Nor, as the court found, did they conduct any true investigation into the facts allegedly supporting their actions.

Shortly after these decisions were made, the fiduciaries' investment conduct was challenged by the Department of Labor as a violation of both their loyalty and prudence obligations. The corporate fiduciaries defended on the ground that, in their view, Grumman stock was a good, long-term investment. In addition, they argued that an LTV takeover would have an adverse impact on the pension plan. The district court rejected these arguments, found that the defendant trustees had violated their duty of loyalty and had acted imprudently in connection with their activities, and entered a preliminary injunction restraining the defendants from taking any further action with respect to the plan's holdings of employer stock.[54] On appeal, the United States Court of Appeals for the Second Circuit affirmed the district court's decision in all pertinent respects.[55]

Analysis of the Judicial Decision

Turning first to the issue of loyalty, the Second Circuit rejected the DOL's argument, renewed on appeal, that the defendants, in effect, has committed a *per se* breach of their duty

[54] *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981). In addition, the district court ordered the appointment of a receiver to serve as investment manager for all employer stock held by the Grumman plan. *Donovan v. Bierwirth*, 2 EBC 2431 (E.D.N.Y. 1982). This aspect of the court's order was reversed on appeal as unnecessary inasmuch as the defendants had been enjoined from taking any action with respect to the plan's employer stock except upon order of the district court.

[55] As noted in note 54 *supra*, the Court of Appeals reversed the district court's decision insofar as it required the appointment of an investment manager for the plan's employer stock.

of loyalty by taking any action with respect to employer stock once the tender offer had been announced. The DOL contended that the trustees, by taking such action at a time when they possessed an obvious conflict of interest because of their contemporaneous role as corporate officers, had violated ERISA Section 406(b)(2) which structurally prohibits a fiduciary from representing a party whose interests are adverse to those of the plan. The Second Circuit saw no reason to expand the structural prohibition of Section 406(b)(2) to encompass the situation where no transaction between the plan and an adverse party, in fact, had occurred, "particularly in light of the . . . sweeping requirements of prudence and loyalty contained in Section 404" of ERISA.[56] Rather, in the court's view, the case turned on whether the defendants had satisfied their duties of prudence and loyalty despite their conflict of interest.[57]

On this latter issue, the trustees did not fare nearly as well. Although the court accepted their contention that the mere fact that Grumman derived benefits from the transaction did not, in and of itself, violate ERISA, the court made clear that this was true *only* if their actions had been taken "after careful and impartial investigation" and "with an eye single to the interests of the participants and beneficiaries" of the plan.[58] As a result, the defendants were duty bound to avoid placing themselves in a position where their corporate loyalties prevented them from functioning with the complete loyalty to participants demanded by ERISA.[59] If nothing else, that duty required them "to take every feasible precaution to see that they had carefully considered the other side" before taking action.[60] In short, although the court rejected the Department of Labor's *per se* argument, it made clear that the defendants' divided loyalties were highly pertinent to the question whether their conduct had violated ERISA's fiduciary standards and, indeed, imposed a heightened obligation upon them to act fairly on behalf of the plan's participants.

Judged against these standards, the court concluded that the

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[56] *Donovan v. Bierwirth*, 680 F.2d at 270.
[57] Ibid.
[58] Ibid., at 271.
[59] Ibid.
[60] Ibid., at 276.

defendants' actions had fallen woefully short. First, despite their clear conflict of interest, the defendants had taken no real steps to determine their duties to the plan participants and beneficiaries under the circumstances. In the court's view, such action was necessary because of the difficult situation in which the defendants found themselves; they already had decided in their corporate capacities many of these same questions that they later faced as plan fiduciaries. Accordingly, the court concluded that the defendants' duties of prudence and loyalty dictated that they seek out impartial advice, e.g., independent legal counsel, that would assist them in avoiding a potential conflict of interest when discharging their duties to the plan.[61]

Second, and perhaps more importantly, the defendants failed to conduct any true investigation into the facts underlying their decisions with respect to employer stock. Turning first to the perceived threat to the pension fund posed by an LTV takeover, the court pointed out that a more thorough investigation of LTV's treatment of its own employee benefit plans indicated that the trustees' fears may have been unfounded. Moreover, the court noted that even if the trustees' fears had been grounded in fact, they should have made some effort to ascertain what, if any, steps LTV legally could have taken to inflict financial harm upon the Grumman plan and its participants. In this regard, the court pointed out that the trustees easily could have retained an ERISA expert to advise them on the subject. Finally, the trustees were faulted for simply discounting LTV's statements that it would inflict no harm on the pension fund without making any attempt to discuss that issue with LTV management or to obtain from them some binding commitment on the matter.[62]

The trustees' analysis of the economic merit of the transaction was tainted by the same lack of investigation. As the court noted, any investment decision "should have involved a calculation of the risks and benefits involved".[63] No such analysis was conducted. Rather, once the trustees decided not to tender the employer stock already held by the fund, they swiftly decided to invest $44 million in the purchase of additional Grumman stock at the inflated prices that prevailed due to the tender offer. If the

[61] Ibid., at 272–73.
[62] Ibid., at 273–74.
[63] Ibid., at 274.

trustees had conducted any risk-benefit analysis, they should have realized that the additional purchases were placing the plan in a no win situation. As the court pointed out:

> If the LTV offer succeeded, the Plan would be left as a minority stockholder in an LTV-controlled Grumman. . . . If it failed, as the Plan's purchase of an additional 8 percent of the outstanding Grumman stock made more likely, the stock was almost certain to sink to its pre-offer level.[64]

Accordingly, the court found it "exceedingly difficult to accept [the defendants'] testimony that the purchase of additional shares was justified from an investment standpoint—or even to conclude that the trustees really believed this."[65] The court therefore had little difficulty in affirming the district court's judgment that the defendants had violated their prudence and loyalty obligations in connection with the transactions.

Relevance to Social Investing

The *Bierworth* court's analysis of the prudence and loyalty issues there involved has clear relevance in the social-investing context. First, the fact that the court, in effect, imposed higher standards of prudence and loyalty upon plan fiduciaries confronted with a potential conflict of interest is particularly significant. In light of the current state of the economy, the social-investing debate increasingly has focused on the use of plan assets to bolster financially strapped employer sponsors or to create jobs in depressed industries. While programs of this nature may promote the long-range financial interests of the plan, at least indirectly, the fact remains that in considering such programs, plan fiduciaries who have loyalties to the programs' direct beneficiaries, i.e., the employer sponsor or union, are confronted with much the same conflict of interest faced by the corporate trustees in *Bierworth*. Accordingly, if they decide to go forward with the investment, they can expect their decision to be carefully scrutinized, from both a prudence and loyalty perspective, to insure that they acted "with an eye single to the interests of the [plan's] participants and beneficiaries."[66]

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[64] Ibid., at 275.

[65] Ibid.

[66] Ibid., at 271; see also *Donovan v. Walton*, supra note 28.

Secondly, the analysis used by the court in determining that the defendant trustees had violated their duties of prudence and loyalty is worthy of note. In reaching that conclusion, the court focused on the defendant trustees' failure to conduct a thorough and independent investigation into the facts underlying their investment decision at the time that decision was made. The defendants' unfounded assumptions and posthoc rationalizations were found an inadequate substitute for the "careful and impartial investigation" which ERISA demanded.[67] Consequently, the court's decision appears to constitute a clear endorsement of the "procedural prudence" standard adopted by the Department of Labor in its prudence regulation. Moreover, it appears to carry that analysis into the loyalty context as well. Thus, the decision underscores the necessity both of conducting a thorough investigation into the facts and circumstances surrounding a particular investment before going forward, whether or not such investment constitutes a "social" investment, and of documenting the basis for that decision in order to demonstrate that proper procedures, in fact, were followed in the event of subsequent challenge.

Lastly, and perhaps more important from a social investment standpoint was the court's treatment of the noninvestment justification, i.e., the threat to the plan posed by an LTV takeover, advanced by the trustees to support their investment conduct. The court's willingness to consider that justification, in and of itself, was significant since that consideration was not related to the economic merit of trustees' actions from a pure investment standpoint. Thus, *Bierworth* would appear to indicate that a trustee can take noninvestment factors into account when making an investment decision, at least where those noninvestment considerations are related directly to the interests of the plan's participants and beneficiaries. Nonetheless, the court's willingness to consider these noninvestment factors does not necessarily imply that, if well-founded, it would have upheld the trustees' investment activity on these bases alone and without regard to whether the investment also could withstand scrutiny from an objective, economc standpoint. Indeed, the fact that the court held that the trustees had to satisfy *both* their duties of loyalty and prudence in connection with the transaction and

[67] *Donovan v. Bierwirth*, 680 F.2d at 271.

found the investment violative of ERISA from an objective, economic point of view indicates that it would not have done so. Accordingly, *Bierworth* would appear to be consistent with the Department of Labor's position that the prudence of an investment must be established on an objective, economic basis before social considerations may be taken into account.

Guidelines for Social Investing

As should be evident from my comments thus far, the current legal environment is fraught with peril for the ERISA fiduciary who seeks to engage in a program of social investment. What then should he do when presented with this type of investment question? As a threshold matter, I believe he should reject out of hand what some commentators have termed *socially dictated investments*.[68] These are social investments which (1) ask the fiduciary to sacrifice traditional investment quality, i.e., safety, return, diversification, or marketability, to advance a social goal, or (2) are undertaken to serve some objective that cannot be related, at least indirectly, to the interests of the plan's participants and beneficiaries.[69] The fiduciary who ignores traditional investment criteria in pursuit of social ends faces a substantial risk that he will be found to have violated ERISA's prudence standard.[70] Similarly, if the investment is designed to benefit himself or third parties, and not the plan's participants and beneficiaries, he faces a substantial risk of violating his duty of undivided loyalty.

What commentators have termed *socially sensitive* investments pose a different issue.[71] These are investments that are selected from among financially comparable alternatives on the basis of nonfinancial considerations.[72] To the extent that such nonfinancial considerations are intended to advance the interests of plan participants and there is no evidence of self-dealing

[68] Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, [hereinafter "Hutchinson & Cole"], 128 U. Pa. L. Rev. 1340, 1346 (1980).

[69] Ibid.; *see also* Lanoff Paper, Pens. Rep. (BNA) No. 355 at R-6.

[70] Ibid.; *see also* Donovan Statement, 9 Pens. Rep. (BNA) at 307.

[71] Hutchinson & Cole, 128 U. Pa. L. Rev. at 1345; Lanoff Paper, Pens. Rep. (BNA) No. 355 at R-6.

[72] Ibid.

these socially sensitive investments would appear to pass legal muster.[73] However, to the extent such considerations are not related to the interests of plan participants, but to those of third parties, such investments very well could run afoul of the duty of loyalty or ERISA's prohibited transaction rules.[74]

The following three-step analysis should aid fiduciaries in determining whether to go forward when presented with a social-investment proposal:

1. Is the proposed investment appropriate under ERISA's prudence and diversification standards from an objective, economic viewpoint? This analysis should include a thorough analysis of available alternative investments.
2. What "social" goals will be advanced by the investment, i.e., is the investment consistent with the fiduciary's duty of undivided loyalty? The further those goals are from the interests of participants and beneficiaries, the greater the likelihood that the investment will be deemed violative of the fiduciary's duty of loyalty. Moreover, if any element of self-dealing is present, the investment should not go forward.
3. Is the investment proscribed by ERISA's prohibited transaction rules?[75]

In view of the uncertain state of current law in this area, the use of this analysis obviously will not immunize an ERISA fiduciary from challenge. Nonetheless, by proceeding in this fashion, the fiduciary should be able to avoid those social investments which are clearly impermissible under current law and, instead, focus his attention on those investments which may withstand ERISA scrutiny.

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[73] Ibid.; see also Mortgage Financing Class Exemption, 47 Fed. Reg. at 21332; Georgine Letter, Pens. Rep. (BNA) No. 355 at R-68.

[74] Hutchinson & Cole, 128 U. Pa. L. Rev. at 1345-46.

[75] Ibid., 128 U. Pa. L. Rev. at 1384-85.