

Morgan Lewis

Social Investing on Behalf of Employee Benefit Plans

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Agenda

- Introduction
- Basic Fiduciary Rules
- Social Investing and Economically Targeted Investments
- Socially Directed Proxy Voting and Shareholder Activism
- Relevant Case Law
- Ways to Mitigate Risk
- Questions and Answers

INTRODUCTION

Introduction

- Social investing is the process of avoiding or making particular investments for reasons separate from the investment returns or economic value of the investments
 - Actions that affect social concerns rather than value or rate of return
 - Examples:
 - Divestment (e.g., 1980's South Africa, tobacco companies, Sudan, Iran, etc.)
 - Screening securities (e.g., socially responsible funds)
 - Economically targeted investments (e.g., climate change investments)
- Recent Legislation
 - Sudan Accountability and Divestment Act signed into law December 31, 2007
 - At least 18 states have enacted Sudan and/or terrorism divestment laws (source: National Conference of State Legislatures)

BASIC FIDUCIARY RULES

Basic Fiduciary Rules

- Employee Retirement Income Security Act (ERISA)
 - Fiduciaries of ERISA plans are required to act prudently, solely in the interest of the plan's participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable plan expenses under Section 404(a) of ERISA
- State law
 - Public plans are tax exempt entities under Section 501(a) of the Code and are subject to Section 401(a) of the Code which provides that a plan, similar to ERISA, must be maintained and the fiduciaries must act for the exclusive benefit of its employees and beneficiaries
 - Public plans are not subject to ERISA, but generally attempt to comply with ERISA fiduciary duties because their laws are similar to ERISA

Basic Fiduciary Rules

ERISA Fiduciary Duties

- Loyalty
 - Exclusive purpose/solely in the interest/“eye single”
 - Incidental benefit rule
- Prudence
 - Prudent expert
 - Procedural prudence
 - Modern portfolio theory
- Diversification
 - Purpose of plan
 - Minimize large losses
- Adherence to Plan Documents

Basic Fiduciary Rules

ERISA Prohibited Transactions and Exemptions

- Party in Interest Transactions (Section 406(a)): Not an overstatement to say that all transactions involving “parties in interest” to ERISA plans are prohibited, unless there is an exemption for them
 - Sales and exchanges/leasing of property
 - Lending and extensions of credit
 - Furnishing of goods, services or facilities
 - Use of “plan assets”
- Fiduciary Self-Dealing (Section 406(b)): Fiduciary of an ERISA plan must NOT cause the plan to engage in a transaction with the fiduciary, its affiliates or any entity in which the fiduciary has an interest that “might” affect its best judgment as a fiduciary (these transactions are outright prohibited)
 - Self-dealing
 - Conflict of interest
 - Kickbacks

Basic Fiduciary Rules

Public Plans' Prohibited Transactions and Exemptions

- Public plans must avoid various prohibited transactions under Section 503(b) of the Code to continue to qualify as tax-exempt organizations
- Under Section 503(b) of the Code, public plan trusts cannot engage in the following transactions with “creator”, substantial contributor, or an entity controlled by “creator” (owns at least 50%):
 - Lend without the receipt of “adequate security” and a reasonable rate of interest
 - Payment of unreasonable compensation for services to the trust
 - Provide preferential services
 - Purchases of securities or other property for more than adequate consideration
 - Sales of securities or other property for less than adequate consideration
 - Engage in any other transaction that results in a substantial diversion of its income or corpus (catch-all provision)

Basic Fiduciary Rules

- ERISA imposes personal liability on fiduciaries for breaches of fiduciary duties
 - Obligation to make the plan whole
- Violation of ERISA or Code exclusive benefit rule could disqualify ERISA or public plans
 - Results in immediate taxation to all members on their accrued benefits
- Generally, may not indemnify fiduciaries out of plan assets
- Many state laws disallow indemnification of fiduciaries for willful breaches of their duties

SOCIAL INVESTING AND ECONOMICALLY TARGETED INVESTMENTS (ETIs)

Social Investing and ETIs

- Exclusive benefit / duty of loyalty rules under both ERISA and the Code requires that first and foremost an investment must be made solely for the benefit of the participants and their beneficiaries – social benefits can only be a secondary consideration
- All other things being equal, can select an investment that benefits the plan or that serves a social goal
- As previously discussed, public plans must comply with Code requirements to maintain tax-exempt status

Social Investing and ETIs

ERISA Interpretive Bulletin 2008-1 relating to Investing in ETIs

- Fiduciary consideration of ETIs should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's fiduciary standards and the investment should be similar to other investments available to the fund
- 2008-1 modified and superseded ERISA Interpretive Bulletin 94-1 (which reasoned that fiduciary standards for ETIs are no different than fiduciary standards applicable to plan investments generally) by providing requirements that fiduciaries must follow in order to comply with ERISA when engaging in ETIs:
 - Preparation of a written record contemporaneously with the fiduciary's evaluation of various investment alternatives that takes into account the economic interests of the plan regardless of the non-economic benefits of the particular investment; and
 - As part of the written analysis, a consideration of the quantitative and qualitative factors (e.g., diversification of investments, liquidity of the fund, investment risk tolerance, etc.) in the analysis of the economic impact on the fund

Social Investing and ETIs

ERISA Advisory Opinion 98-04A (Screening investments)

- DOL guidance for ERISA plans investing in socially responsible funds which, as described in the opinion, are funds that invest in enterprises that fund managers believe make a significant contribution to society through their products and services and the way these enterprises do business
- Existence of social collateral benefits acceptable only if the fiduciary determines that the investment offering the collateral benefits is expected to provide an investment return commensurate to alternative investments having similar risks
- In discharging investment duties, fiduciaries must, among other things, consider the role of the particular investment or investment course of action in the plan's investment portfolio, taking into account such factors as diversification, liquidity, and risk/return characteristics

Social Investing and ETIs

Sudan Accountability and Divestment Act of 2007

- Authorizes State and local governments to divest assets in companies that conduct business operations in Sudan
- Determination of Sudan-related companies must be based on credible, public information
- Any measure adopted by a State or local government under this law shall provide written notice and a 90-day comment period for affected persons
- Ongoing compliance:
 - Public plans → Code requirements discussed previously
 - ERISA plans → “It is the sense of Congress that a fiduciary of an [ERISA] employee benefit plan” may divest or avoid investing without breaching its ERISA duties if conducted in accordance with ERISA Interpretive Bulletin 94-1

Social Investing and ETIs

Examples

- Plan sponsor who adopts a policy for investing in “green” companies must also consider non-“green” investments and may only remove an investment from the investment policy after the fiduciary has determined that the “green” investment would provide equal or better returns at the same or lower investment risks to the plan
- ERISA pension fund is considering divestment in companies doing business with Sudan-related entities permitted if independent experts determine that all other factors of divestment are expected to be same regardless of whether the plan engaged in the divestment or not

Social Investing and ETIs

Examples Cont.

- Collective investment fund with plan investments that invests in commercial real estate constructed or renovated with union labor may do so only after a review by the plan fiduciaries demonstrates that the union related investment options are equal or superior to non-union related investments
- Investment by a multiemployer plan in a loan for a construction project that is intended to create local jobs not permitted where investment chosen on the basis of local job creation and where there are other construction project loans in the area that the plan has already invested in (lack of diversification)

SOCIALLY DIRECTED PROXY VOTING AND SHAREHOLDER ACTIVISM

Socially Directed Proxy Voting and Shareholder Activism

ERISA Advisory Opinion 2007-07A

- Impermissible to use plan assets to further public policy and political activities through proxy resolutions that have no connection to enhancing the value of a plan's investment in a company
- Clarifies ERISA Interpretative Bulletin 94-2, which provides that a fiduciary must use procedural prudence when considering a proxy proposal or engaging in activities to influence the management of a corporation, by laying out specific requirements:
 - Fiduciary must review the cost of the action; and
 - Thereafter, only if the fiduciary concludes that the activity is reasonably likely to enhance the value of the investment and it will not place unrelated objectives ahead of the interests of plan participants and beneficiaries, it can proceed
- ERISA Interpretive Bulletin 2008-2: Fiduciaries must be prepared to articulate a clear basis for concluding the proxy vote, investment policy, or other activity intended to influence management is more likely than not to enhance the economic value of the plan's investment

Socially Directed Proxy Voting and Shareholder Activism

ERISA Advisory Opinion 2008-05A

- Use of plan assets to promote or oppose union organizing and union goals in collective bargaining negotiations that subordinates interests of participants and beneficiaries is impermissible
- Fiduciary may only consider factors relating to the interests of participants and beneficiaries
- Specifically, fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in connection with union goals

RELEVANT CASE LAW

Relevant Case Law

State Cases

<u>Compliant</u>	<u>Fiduciary Violation</u>
<i>Withers</i> (S.D.N.Y. 1978): Investment in State bonds by NYC Teachers' Fund found proper where Fund otherwise would have gone bankrupt and trustees had reports demonstrating the Fund would likely go bankrupt without these investments	<i>University of Oregon</i> (Court of Appeals of Oregon 1986): State Board of Education resolution instructing endowment funds to divest funds of investments in companies doing business in South Africa, Zimbabwe, and Namibia found improper because Board did not engage in proper diligence (<i>But see City of Baltimore</i>)
<i>City of Baltimore</i> (Court of Appeals of Maryland 1989): Divestment in companies doing business with South Africa or Namibia permitted where costs of investing in this manner were found <i>de minimis</i>	

Relevant Case Law

ERISA Compliant Case

- *Donovan v. Walton* (S.D. Fla. 1985)
 - Union pension fund trustees decided to construct an administration building on the fund's property and lease the space to the union
 - Court found that the trustees' decisions were reasonably calculated – for example, they retained an appraiser of the property
 - Court held that the trustees' business decisions must be made with the interests of plan participants, but incidental social benefits will not necessarily result in a violation of fiduciary duty

Relevant Case Law

ERISA Fiduciary Breach Cases

<u>Exclusive Benefit Violation</u>	<u>Prudence Violation</u>
<p><i>Harris Trust</i> (2d Cir. 2002): John Hancock purposely allocated poorly-performing assets to its group pension contracts and away from its general account for which it bore the investment risk to benefit new customers at the expense of old clients.</p>	<p><i>Tittle</i> (S.D. Tex. 2003) (Enron class action): Participants in Enron's retirement plans filed a series of lawsuits challenging the prudence of investing the plans' assets in Enron stock. Court found that the officers and directors violated fiduciary duties by failing to disclose material non-public information regarding Enron's financial condition to plan participants and by continuing to invest in Enron stock.</p>
<p><i>Donovan v. Bierwirth</i> (2d Cir. 1982): DOL sued plan trustees of a target corporation over the trustees' decision not to tender the shares of the target held by the plan. Trustees breached duty to participants by failing to seek independent expert advice.</p>	<p><i>Mason Tenders District Council of Greater NY</i> (S.D.N.Y. 1995): Court determined that the ERISA duty of prudence was violated when a trustee purchased real estate without obtaining an appraisal or advice from a real estate expert.</p>

WAYS TO MITIGATE RISK

Ways to Mitigate Risk

- Express delegation of fiduciary responsibility to investment managers
- Use of "Expert" service provider as evidence of upholding fiduciary standard of care
- Obtain indemnity or insurance commitment
- Proper diligence and monitoring of service providers
- **PROPER DOCUMENTATION OF ACTIONS**

QUESTIONS AND ANSWERS

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