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MEMORANDUM

To: Laura Berry, Interfaith Center on Corporate Responsibility

From: Covington & Burling LLP

Re: Ability of Plan Fiduciaries to Follow the Investment Approach Advocated by the Fossil Fuel Movement

You have asked for an analysis of whether members of the Interfaith Center on Corporate Responsibility ("ICCR") may divest their funds of investments in companies that are subject to the "fossil free" campaign within the confines of their fiduciary duties. The fossil free campaign is an effort that urges colleges and universities to divest their endowments from fossil fuel companies. The fossil free movement is led by 350.org, a group headed by environmentalist William McKibben, as well as groups such as the Sierra Club. As this movement has proliferated, members of the ICCR, which are predominantly pension funds for religious institutions across the country, have asked whether they can participate in the fossil free movement.

In our discussions, you have indicated that many ICCR members are pension plans that are subject to the Employee Retirement Income Security Act ("ERISA"), while other members are charities, educational institutions, non-profit entities or "church plans" that are exempt from ERISA and governed instead by state law. This memorandum provides an analysis of whether any of the plan fiduciaries described above may follow the recommendations of the fossil fuel divestment movement within the confines of its fiduciary duties.

I. Overview

As a general matter, a fiduciary of a pension plan or other investment vehicle owes fiduciary duties to the beneficiaries of that plan or investment vehicle. The duties imposed on decision makers of investment vehicles are formed by a combination of state and federal statutory law, common law, and *inter alia,* regulations of the Department of Labor ("DOL"), under ERISA, and the U.S. Tax Code.[1] Consequently, the nature of these duties, and their application to a particular organization, depends largely on whether the organization is a state,

[1] For example, Section 401(a) of the tax code provides that a plan fiduciary must act for the exclusive benefit of its employees and beneficiaries and 26 C.F.R. §1.403(b)-9(a)(2)(i)(C) provides that assets held in a Code section 403(b)(9) church plan retirement income account cannot be used for, or diverted to, purposes other than the exclusive benefit of plan participants or their beneficiaries. See Thomas A. Troyer et al., Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds, 74 Geo. L.J. 127, 157 (1985). Pension plans established by unions and one or more employers in multi-employer plans are subject to the Taft-Hartley Act, which requires that the trust be "for the sole and exclusive benefit of the employees of such employer, and their families and dependents." Labor Management Relations (Taft-Hartley) Act of 1947 § 302(c)(5), 29 U.S.C. § 185(a) (2013).

public pension plan, a charity, an educational institution, a church plan, or a plan subject to ERISA.

The management of an employee benefit plan is generally subject to fiduciary duties established under ERISA. However, an employee benefit plan established by a church or an organization affiliated with a church (a "church plan"), as well as a Federal, state, or local government plan is exempt from certain provisions of ERISA, including ERISA's fiduciary obligations, unless the plan elects to be covered by ERISA. Plans maintained by churches, charities, educational institutions and non-profit organizations are governed by a separate regime regarding socially responsible investing. These organizations are generally subject to the common law of trusts as well as statutory laws that are based on the Uniform Prudent Investor Act ("UPIA") and the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). The UPIA applies to charities organized as trusts, and the UPMIFA applies primarily to charities organized as non-profit corporations. State-managed pension funds are subject to state laws, most of which are modeled on the UPIA and apply traditional fiduciary duties of loyalty and care.

For the purposes of this memorandum, we will focus on the duties imposed on the fiduciary of a plan organized under ERISA, as well as the duties imposed on the fiduciaries of church, Federal, state, or local government plans.

II. Duties of a Plan Fiduciary Under ERISA

ERISA's provisions governing the management and administration of employee benefit plans focus on the conduct of plan fiduciaries. A person is a "fiduciary" under ERISA if the person exercises any authority or control over the management of the plan's assets. An ERISA fiduciary must act solely in the interest of a plan's participants and beneficiaries and for the exclusive purpose of providing benefits to them.[2] This duty flows directly from the language of Section 404(a)(1) of ERISA, which provides that a fiduciary shall discharge his duties with respect to a plan solely in the interest of its participants and beneficiaries, as well as

- for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan;
- with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;
- 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
- in accordance with the documents and instruments governing the plan.

[2] See generally, Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61, 734 (October 17, 2008) [hereinafter Bulletin 08-1].

In addition, Section 403(c)(1) of ERISA provides that "assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries…"

The failure of a trustee to comply with these obligations can be significant. If a trustee breaches its fiduciary duties the trustee can be held personally liable to the plan for any losses resulting from the breach; the trustee may be removed from his or her position; and the trustee may be subject to criminal penalties, including a $100,000 fine, ten years of imprisonment, or both.[3]

A. DOL Guidance - Application of ERISA Duties to Socially Targeted Investments

Based on the general principles outlined above, the DOL Bulletin 08-1 says that a plan fiduciary may only choose an investment targeted for economic or social reasons if the alternative options "are truly equal, taking into account a quantitative and qualitative analysis of the economic impact on the plan." Further, it provides a plan fiduciary may "never subordinate the economic interests of the plan to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest of the plan except in very limited circumstances…" To illustrate this point, it uses the following example:

> A plan sponsor adopts an investment policy that favors plan investment[s] in companies meeting certain environmental criteria (so called 'green' companies). In carrying out the policy, the plan's fiduciaries may not simply consider investments only in green companies. They must consider all investments that meet the plan's prudent financial criteria. The fiduciaries may apply the investment policy to eliminate a company from consideration only if they appropriately determine that other available investments provide equal or better returns at the same or lower risks, and would play the same role in the plan's portfolio.

Along similar lines, and as explained in an advisory opinion issued to the Calvert Group, Ltd., a plan fiduciary's selection of a "socially-responsible fund," for a Section 404(c) plan (a plan in which the fiduciary selects the investment options provided to a plan participant, who then makes investments from among the selected choices), is subject to the same duties described above. Consequently, a fiduciary may select such a fund as a plan investment, in the case of an ERISA Section 404(c) plan, or a designated investment alternative "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."[4]

1. Application of the DOL Guidance to the Fossil Free Movement

The DOL guidance discussed above establishes essentially a two-step process that an ERISA plan fiduciary must follow before making a plan investment based on economic or social

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[3] See generally 29 U.S.C. § 1101 (2013); 29 U.S.C. § 1131 (2013).
[4] See 98-04A Op. Dep't of Labor ERISA Section 404(c) (May 28, 1998).

considerations:

- First, the fiduciary must consider all investments that meet the plan's prudent financial criteria.

- Second, the fiduciary must conclude that the prospective investment provides equal or better returns at the same or lower risks, and would play the same role in the plan's portfolio.

These obligations are difficult to reconcile with the basic mandate of the fossil free movement, which requires that a plan divest itself entirely of investments in the fossil fuel industry. The fossil fuel mandate does not consider whether such investments provide equal or better returns than other investments at the same or lower risks, or the diversification role that such investments play in a plan's portfolio. For example, eliminating fossil fuel investments from a plan entirely could have a number of important impacts on its portfolio, including:

- preventing a plan from investing in a broad array of index-based funds, many of which include companies in the fossil fuel industry;

- precluding a plan from hedging or balancing against risks of other industries through investments in the energy sector;

- preventing a plan from investing in high-performing stocks to the extent that they are companies in the fossil fuel industry, some of which may not have alternative investments that provide equal or better returns at the same or lower risks; and

- preventing a plan from investing in fossil fuel companies that have expanded beyond fossil fuels into other businesses in the energy sector.

The foregoing considerations do not appear to preclude a plan fiduciary from considering whether a particular investment should be added or eliminated from a plan portfolio based on whether the company is in the fossil fuel industry. However, it does appear to preclude a fiduciary from eliminating the entire industry without considering each investment on a case-by-case basis, and assessing the overall portfolio of the plan at issue.

III. Duties of a Plan Fiduciary for a Church, Charity, Educational Institution or a Non-Profit Corporation Plan

As noted above, churches, charities, educational institutions and non-profit organizations are governed by a separate regime regarding socially responsible investing. This regime is defined by state common law and by state laws that are largely modeled after the UPIA and the UPMIFA. The UPIA and the UPMIFA are model acts that focus on the management and administration of investments by trustees and generally have been applied to church plans, charities, educational institutions, and non-profit entities. The UPIA is primarily focused on trustees of private trusts, but has been applied to church plans that hold investments in trust for

their beneficiaries and to charities organized as trusts. The UPMIFA is primarily focused on charities that are organized as non-profit corporations. [5] Although we have not conducted a 50-state survey regarding the topic, it appears that many states have adopted laws governing churches, charities, educational institutions, and non-profit entities that are modeled after the UPIA. For example, most U.S. states have adopted laws that are modeled after the UPIA and the UPMIFA.[6] Since the ICCR has members that are organized in a variety of corporate structures and in a variety of states, and since the UPMIFA as well as many of the laws that apply to ICCR members are modeled after the UPIA, we have evaluated the fossil free movement in light of the general framework provided by the UPIA. Because our analysis focuses on the UPIA, members of the ICCR should review the common law and relevant statutory laws of the jurisdictions in which they are organized, as well as their general organizing documents, as they evaluate whether they may participate in the fossil free movement.

A. The UPIA - Overview

The UPIA and its progeny focus primarily on the conduct of trustees as fiduciaries. For the purposes of the UPIA, a trustee is someone who holds property in trust.[7] A trustee is evaluated by an objective "prudent investor" standard under which a trustee must "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust."[8]

In addition, a trustee under the UPIA is subject to a duty of loyalty. That duty is generally viewed to be created by Section 5 of the UPIA, which provides that "a trustee shall invest and manage the trust assets solely in the interest of the beneficiaries." [9] As will be discussed later, it is this duty that is most difficult to reconcile with the approach to investing that is advocated by the fossil free movement. In this respect, the commentary to the UPIA indicates that the duty of loyalty "is not limited to settings entailing self-dealing or conflict of interest in which the trustee would benefit personally from the trust," but instead provides that "it is

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[5]A church plan that holds investments in trust on behalf of its participants would generally be subject to fiduciary duties under the UPIA *See*, *e.g*., Johnson v. Evangelical Lutheran Church in America, Civ. No. 11-23 (D. Minn. 2011) (holding the manager of a church plan subject to fiduciary duties under Minnesota's Prudent Investor Act).

[6] According to the Uniform Law Commission, all states other than Louisiana, South Dakota, Illinois, Kentucky, Georgia, Maryland and Delaware have adopted the UPIA. *See* Legislative Fact Sheet, publicly available at http://uniformlaws.org/LegislativeFactSheet.aspx?title=Prudent Investor Act. New York has incorporated the UPIA into the Section 11-2.3 of the New York Estates, Powers & Trusts Law ("EPTL"). All U.S. states, with the exception of Pennsylvania have adopted the UPMIFA.

[7] Although the UPIA does not define "trustee," Section 3 of the Restatement (Second) of Trusts, defines a "trustee" as someone who holds property in trust. In large part the UPIA is based the Restatement (Second) of Trusts.

[8] *See* Section 1 of the UPIA.

[9] Unlike the UPIA, the UPMIFA does not include a duty of loyalty provision. Instead, the UPMIFA looks to the duties imposed by the Revised Model Nonprofit Corporation Act, which requires that a director act "in a manner the director reasonably believes to be in the best interest of the corporation." See Rev. Model Nonprofit Corp. Act § 8.30 (1988).

improper for the trustee to sell trust property to a third person for the purpose of benefitting the third person rather than the trust."[10]

Beyond the broad duties described above, the UPIA is fairly specific with respect to how a trustee may satisfy the general standards described above. First, the UPIA provides that a trustee is expected to exercise reasonable care, skill and caution in making decisions on behalf of the trust beneficiaries.[11] Specifically, a trustee under the UPIA must (i) make decisions based on the overall trust portfolio; (ii) consider eight specific factors outlined by the UPIA; and (iii) seek to diversify the investments in the trust.[12] Each of these requirements is discussed in greater detail below.

- *Make Decisions Based on the Overall Trust Portfolio*. Under the UPIA, a trustee's investment and management decisions are evaluated in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. This portfolio-based standard gives trustees some flexibility in evaluating individual investments. For example, as noted in the commentary to this section, an investment that might be imprudent standing alone can become prudent if undertaken in relation to other trust assets. This consideration also suggests that the purpose of the trust should be taken into consideration. For example, the commentary notes that a trust that is organized to support an "elderly widow of modest means" will have a lower risk tolerance than a trust that is organized to support a "young scion of great wealth."

- *Consider Eight Specific Factors Outlined By The UPIA*. The UPIA also provides that a trustee must consider the following factors in making investment decisions:

  (1) general economic conditions;

  (2) the possible effect of inflation or deflation;

  (3) the expected tax consequences of investment decisions or strategies;

  (4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;

  (5) the expected total return from income and the appreciation of capital;

  (6) other resources of the beneficiaries;

  (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and

  (8) an asset's special relationship or special value, if any, to the purposes of

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[10] *See* Commentary to Section 5 of the UPIA, quoting from the Restatement of Trusts 2d § 170, comment *q*, at 371 (1959).
[11] *See* Section 2(a) of the UPIA.
[12] *See* Sections 2(b)-(c), as well as Section 3 of the UPIA.

the trust or to one or more of the beneficiaries.

Notably, the UPIA does not indicate that these factors are the only factors that may be considered by a trustee in making an investment decision. Instead, these factors are described in the commentary as "factors that commonly bear on risk/return preferences in fiduciary investing."

- *Diversification*. In addition to the foregoing considerations, the UPIA provides that a trustee must seek to diversify the investments held in trust. The only exception to this general rule is the circumstance in which the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying.

B. <u>Application of the UPIA to the Fossil Free Movement</u>

As noted above, the duty of loyalty imposed by the UPIA and similar provisions of law is difficult to reconcile with the fossil free movement. In fact, much like the ERISA guidance described above, the UPIA explicitly indicates that a trustee may not sacrifice the interests of trust beneficiaries in order to accomplish a broader societal goal. Specifically, the commentary to the UPIA provides in pertinent part:

> No form of so-called "social investing" is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.

This explicit approach to social investing has been adopted by a number of states, including Texas, North Carolina, Montana, Colorado, Idaho, and Tennessee. Several large states, however, such as New York and California, have not adopted this commentary when they enacted legislation based on the UPIA.

Even trustees of trusts organized in states that have not adopted the above commentary to the UPIA likely remain subject to the other restrictions based on the UPIA, which are also difficult to reconcile with the UPIA. Specifically, in evaluating an investment, a trustee

- must exercise reasonable care, skill, and caution in analyzing whether the investment is permissible,

- must consider the non-exhaustive factors listed above in Part III.A,

- must conclude that the investment will benefit the overall investment strategy and not increase the risk or decrease the return of the overall portfolio, and

- must conclude that the investment is consistent with the principle of diversification.

These obligations are difficult to reconcile with the basic mandate of the fossil free

movement, which requires that a plan divest itself entirely of investments in the fossil fuel industry. That mandate does not consider whether fossil fuel investments provide equal or better returns than other investments at the same or lower risks. It also does not allow for a case-by-case analysis of the diversification role that fossil fuel investments play in a plan's portfolio. For example, eliminating fossil fuel investments from a plan could have the same detrimental impacts on its portfolio, discussed in the ERISA analysis above, including:

- preventing a plan from investing in a broad array of index-based funds, many of which include companies in the fossil fuel industry;
- precluding a plan from hedging or balancing against risks of other industries through investments in the energy sector;
- preventing a plan from investing in high-performing stocks to the extent that they are companies in the fossil fuel industry, some of which may not have alternative investments that provide equal or better returns at the same or lower risks; and
- preventing a plan from investing in fossil fuel companies that have expanded beyond fossil fuels into other businesses in the energy industry.

The above fiduciary requirements do not preclude a trustee from considering whether a fossil fuel investment should be added or eliminated from a plan portfolio. However, the foregoing provisions, especially the duty of loyalty, likely preclude a fiduciary from eliminating the entire fossil fuel industry from its portfolio without looking at each investment that would be effected on a case-by-case basis.

The challenge faced by fiduciaries that support the goals of the fossil free movement, but that have concerns about the impact of divestment on their fulfillment of their fiduciary duties is well documented. For example, in the fall of 2013, Harvard University declined to adopt the divestment strategy advocated by the fossil free movement, noting:

> Despite some assertions to the contrary, logic and experience indicate that barring investments in a major, integral sector of the global economy would — especially for a large endowment reliant on sophisticated investment techniques, pooled funds, and broad diversification — come at a substantial economic cost." [13]

Similarly, the presidents of Cornell and Tufts announced similar conclusions. In declining to pursue the divestment strategy advocated by the fossil free movement, the President of Tufts noted the potential adverse economic effect that such a strategy would have on its portfolio:

> Much research has been done about whether divestment succeeds in changing corporate behavior or influences the moral or policy issue that is the goal of such action. Generally, there is scant evidence that divestment has affected the former, and mixed evidence on

[13] *See* Fossil Fuel Divestment Statement, dated October 3, 2013 (publicly available at http://www.harvard.edu/president/fossil-fuels).

> the latter, except in the case of apartheid in South Africa, where college and university divestment were cited as important by Nelson Mandela and F.W. de Klerk.
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> … the Tufts Divestment Working Group asked the university's Investment Office to conduct a rigorous analysis of what would happen to our endowment if we divested from fossil fuel companies. Even the most conservative model showed that the endowment would experience a significant loss of return—$75 million in market value over the next five years—in large part because of our investments in commingled funds.
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> …
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> To put the projected impact in perspective, $75 million would provide endowment income to fund scholarships for 100 undergraduates or annual stipends for 125 Ph.D. students, or fund the entire 2012 state appropriation for the Cummings School of Veterinary Medicine.
>
> In short, in today's environment, divestment would likely result in a significant reduction in operating funds and would have an immediate adverse impact on the educational experience at Tufts. It would not be prudent to expose the university to that kind of risk at this time. We will, however, continue to examine the feasibility of divestment in the future.[14]

We believe these same considerations will constrain many churches, charities, educational institutions and non-profit organizations from subscribing to the divestment strategy advocated by the fossil free movement.

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[14] *See* Statement on Divestment from Fossil Fuel Companies (February 12, 2014) (publicly available at http://president.tufts.edu/2014/02/statement-on-divestment-from-fossil-fuel-companies/, respectively); *see also* Response to Faculty Senate Resolution on Divestment (February 26, 2014) (publicly available at http://www.cornell.edu/statements/2014/20140226-divestment-response.cfm).