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THE FEDERAL PRUDENT MAN RULE
UNDER ERISA*

JAMES D. HUTCHINSON†

I. INTRODUCTION

THE EMPLOYEE RETIREMENT INCOME SECURITY ACT of 1974 (ERISA)¹ represents the first comprehensive attempt to regulate private pension and welfare benefit plans. The congressional policy embodied in ERISA² reflects an intent to protect the benefit rights and retirement security of approximately forty million persons³ through 1) increased reporting to the government and disclosure to participating workers,⁴ 2) setting minimum standards for participation, vesting, benefit accrual, and funding,⁵ and 3) the creation of an insurance program for terminating pension plans.⁶ ERISA also establishes uniform federal fiduciary standards to govern the conduct of persons who manage or control the operations or assets of employee benefit plans and sets forth procedures for enforcing those standards.⁷

It is this final aspect of ERISA, the federal standards governing the conduct of fiduciaries, particularly the "prudent man rule,"⁸ that

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This article is an amplification and extension of remarks of the author before the Section of Real Property, Probate and Trust Law of the American Bar Association during the ABA's Annual Meeting in Atlanta, Georgia on August 10, 1976. Although the initial remarks were made at a time when the author was Administrator of Pension and Welfare Benefit Programs, United States Department of Labor, the views expressed herein are those of the author. The author wishes to thank Gary A. Growe of the George Washington University School of Law, Robert B. Coplan of the Georgetown University School of Law, and Nancy V. Sisemoore of the George Washington University School of Law for their assistance in the preparation of this article.

1. Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1381 (Supp. V 1975) [hereinafter cited as ERISA].

2. ERISA, § 2, 29 U.S.C. § 1001 (Supp. V 1975).

3. N. TURE, *THE FUTURE OF PRIVATE PENSION PLANS* 15-16 (1976).

4. ERISA, §§ 101-111, 29 U.S.C. §§ 1021-1031 (Supp. V 1975).

5. *Id.* §§ 201-306, 29 U.S.C. §§ 1051-1086.

6. *Id.* §§ 4001-4068, 29 U.S.C. §§ 1301-1368. Subtitle A of title IV of ERISA established the Pension Benefit Guaranty Corporation, a public corporation "within" the Department of Labor, which is responsible for administering the plan termination provisions. *Id.* § 4002, 29 U.S.C. § 1302.

7. *Id.* §§ 401-514, 29 U.S.C. §§ 1101-1144.

8. *Id.* § 404(a)(1), 29 U.S.C. § 1104(a)(1). Section 404(a)(1) provides in relevant part:

[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and—

(A) for the exclusive purpose of:

(i) providing benefits to participants and 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

is the focus of this article. In the brief period since ERISA's enactment on Labor Day 1974, no other portion of the Act has been the subject of more discussion, confusion, and alarm. Initial reaction to ERISA's fiduciary rules ranged from fears that they would destroy the sound operation and management of private benefit plans to statements that the basic rules for fiduciary conduct had not changed from preexisting common law standards.⁹

Approximately one-half of the private work force in this country participates in some form of private retirement program, and assets of almost \$200 billion are controlled by private retirement plans.¹⁰ The sound management of these plans is, therefore, an issue of vital public importance. The question now is whether ERISA will be interpreted in a way which serves two basic public policy goals: 1) ensuring the continued growth and economic stability of private pension and welfare plans, and 2) protecting the massive asset base which provides fringe benefit and retirement security to millions of workers and their families.

In an attempt to develop a structure for analyzing these issues, the following discussion will outline the rationale underlying the new regulatory structure contained in ERISA. Then, the ERISA provisions affecting the prudent man standard, including comparisons with common law standards, will be reviewed. Finally, ERISA's prudent man standard will be used as a framework in which to discuss the development and implementation of investment procedures for managing employee benefit plan assets.

II. REASONS WHICH PROMPTED ENACTMENT OF ERISA

A. *The Need for Regulatory Controls*

Before attempting to analyze ERISA's standards of conduct and their application to the diverse universe of employee pension and welfare benefit plans, a review of the evolution of the new regulatory

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.

9. Prior to ERISA's enactment, Solicitor of Labor Lawrence Silberman stated that ERISA's "statutory scheme . . . is along the lines and direction which the courts have gone in the development of trust law." *Hearings on H.R. 16462 Before the General Subcomm. of the House Comm. on Educ. and Labor, 91st Cong., 1st & 2d Sess. 521 (1969-1970)* [hereinafter cited as *Hearings on H.R. 16462*].

10. N. TURE, *supra* note 3, at 1-2.

scheme may be helpful in predicting its application to particular fact situations. During the course of the past decade, several congressional committees conducted hearings and studies in an attempt to determine the extent of employee benefit plan abuses.¹¹ Although it was generally recognized that many employee benefit plans had been soundly managed and operated with honesty and integrity, it also was apparent from the congressional findings that a major revision of the regulatory system was needed in order to control existing abuses.¹² Hearings documented examples of lost benefits, poor plan administration, misuse and abuse of plan assets, criminal acts, and violations of basic fiduciary obligations.¹³ Instances of abuse or negligent conduct by individuals entrusted with the care of benefit plan assets included the investment of plan money in high risk ventures with inadequate security, the outright diversion of plan assets to satisfy the operating needs of the sponsor corporation, and the dumping of worthless or declining stock into a plan by the controlling shareholders of the sponsoring company.¹⁴

B. *The Inadequacy of Prior Remedies*

Prior to the enactment of ERISA, there were few effective remedies available to correct abusive situations in a way that would protect the interests of plan participants and beneficiaries and restore lost or diverted assets to the plan. The available options were government action under the Internal Revenue Code (Code),¹⁵ labor protective statutes such as the Welfare and Pension Plan Disclosure Act of 1958,¹⁶ the Labor-Management Relations Act of 1947,¹⁷ and the Labor-Management Reporting and Disclosure Act of 1959,¹⁸ or pur-

11. See, e.g., *Hearings on Private Welfare and Pension Plan Study Before the Subcomm. on Labor of the Senate Comm. on Labor and Public Welfare*, 92d Cong., 2d Sess. (1972).

12. See S. REP. NO. 93-127, 93d Cong., 1st Sess. 13 (1973) [hereinafter cited as S. REP. NO. 93-127], reprinted in 1 SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, 94th Cong., 2d Sess., LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT, 1974, at 587, 599 (1976) (prepared by the staffs of the Subcommittee on Labor and the U.S. Department of Labor) [hereinafter cited as LEGISLATIVE HISTORY].

13. See *Hearings on Private Welfare and Pension Plan Study Before the Subcomm. on Labor of the Senate Comm. on Labor and Public Welfare*, 92d Cong., 2d Sess. (1972).

14. See generally *id.* The files of the Department of Labor which served as the basis for developing the Department's position during the legislative process recite examples of abusive situations which occurred under the administration of prior laws. Records on file at Division of Enforcement, Pension and Welfare Benefit Programs, U.S. Dep't of Labor.

15. I.R.C. §§ 401-404, 501-503.

16. 29 U.S.C. §§ 301-309 (1970) (repealed 1974).

17. *Id.* §§ 141-188 (1970 & Supp. V 1975).

18. *Id.* §§ 401-531 (1970).

suit of sanctions under the criminal laws.¹⁹ Private litigants often were left to remedies under the diverse state laws governing the operations of trusts. None of these options was particularly effective.

In administering the Code, the Internal Revenue Service (IRS) was the agency responsible for determining whether sponsoring employers and participating employees were entitled to certain tax benefits for the establishment and maintenance of qualified employee benefit plans.²⁰ However, the Code was designed primarily to regulate the receipt of tax benefits and to prevent tax abuse. The key to enforcement under the Code was the power of the IRS to accept or contest the qualified status of a plan. But the disqualification remedy under the Code was used infrequently, because it resulted in the imposition of Draconian penalties on innocent participants and beneficiaries.²¹ Section 503(b) of the Code permitted self-dealing between employers and plans as long as the transaction was based upon adequate consideration.²² Congress questioned both the effectiveness of existing Code provisions and the manner in which the IRS implemented those provisions so as to ensure that private pension plans operated in compliance with the law.²³

Section 302(c)(5) of the Labor-Management Relations Act (LMRA),²⁴ which was enacted to prevent unilateral union operation of employee benefit trusts, is the statutory base from which all jointly trustee employee benefit funds have developed.²⁵ The case law under section 302 indicated that the majority of courts interpreted the LMRA as applicable to the structure of covered plans and not as vesting jurisdiction in the federal courts to mandate fiduciary responsi-

19. *E.g.*, 18 U.S.C. §§ 664, 1027, 1954 (1970); *see* notes 39-42 and accompanying text *infra*.

20. *See* I.R.C. § 404(a) (allowing employers to deduct plan contributions as ordinary and necessary business expenses); *id.* §§ 402(a)(1), 403(a)(1) (taxing employees only when they receive benefits); *id.* § 501(a) (exempting fund from paying tax on income earned by it).

21. *See id.* §§ 401(a), 503(a); S. REP. NO. 93-383, 93d Cong., 1st Sess. 3-4, 18 (1973); *Hearings on Private Pension Plan Reform Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance*, 93d Cong., 1st Sess., pt. 1, at 290-91 (1973).

22. *See* I.R.C. § 503(b). Section 503(b) prohibits only the creator of the trust, substantial contributors, and corporations or family members associated with such individuals from transacting with the plan; plan trustees and administrators are apparently not included.

23. *See* SENATE COMM. ON LABOR AND PUBLIC WELFARE, INTERIM REPORT OF ACTIVITIES OF THE PRIVATE WELFARE AND PENSION PLAN STUDY, S. REP. NO. 92-634, 92d Cong., 2d Sess. 97 (1972) [hereinafter cited as S. REP. NO. 92-634]; note 21 *supra*.

24. 29 U.S.C. § 186(c)(5) (Supp. V 1975). Section 302 generally prohibits employers from making payments to employee representatives. 29 U.S.C. § 186(a) (1970).

25. *See* S. REP. NO. 93-127, *supra* note 12, at 4, *reprinted in* 1 LEGISLATIVE HISTORY, *supra* note 12, at 590.

bility in the administration of trust funds.²⁶ Moreover, although any person who willfully violates any of the provisions of section 302 is guilty of a misdemeanor and is subject to a fine, imprisonment, or both,²⁷ the Justice Department historically did not consider section 302 a primary tool for insuring the proper use of employee benefit plan assets.²⁸

The Labor-Management Reporting and Disclosure Act (LMRDA)²⁹ indirectly affects certain private employee benefit plans through provisions requiring the reporting of information and the bonding of persons handling plan assets.³⁰ However, as a basis for comprehensive regulation of employee benefit plans, the LMRDA had several major weaknesses. It was limited to union officials and, therefore, could not control the conduct of employer-appointed trustees.³¹ In addition, courts interpreting the LMRDA deferred to state law and held that union constitutions, bylaws, and resolutions could control the definition of a fiduciary's responsibilities.³²

Prior to ERISA, the law dealing most directly with private employee benefit plans was the Welfare and Pension Plan Disclosure Act (WPPDA), which provided the basis for some of ERISA's provisions, such as the bonding provisions and rules on employment of convicted persons.³³ Essentially, the WPPDA required that plan administrators compile, file, and send a description of the plan to

26. See, e.g., *Haley v. Palatnik*, 509 F.2d 1038, 1040-41 (2d Cir. 1975); *Snider v. All State Adm'r, Inc.*, 481 F.2d 387, 390 (5th Cir. 1973), *cert. denied*, 415 U.S. 957 (1974); *Bowers v. Ulpiano Casal, Inc.*, 393 F.2d 421, 424-26 (1st Cir. 1968). Most cases have held that the language of section 302(e) limits district court jurisdiction to restraining future violations of the section and does not permit granting relief by way of accounting, receivership, or removal of trustees. See, e.g., *id.* at 426.

27. Section 302(d) of the Labor-Management Relations Act imposes a fine of not more than \$10,000 or imprisonment for not more than one year, or both. 29 U.S.C. § 186(d) (1970).

28. See S. REP. No. 92-634, *supra* note 23, at 95-96.

29. 29 U.S.C. §§ 401-531 (1970).

30. The LMRDA requires every labor organization to file a copy of its constitution and bylaws, as well as an annual report, with the Department of Labor. 29 U.S.C. § 431 (1970). Also, the LMRDA empowers the Secretary of Labor to enter such places and inspect such records and accounts and question such persons as he may deem necessary to investigate violations. *Id.* § 521(a) (1970).

31. 29 U.S.C. § 501 (1970); see *Tucker v. Shaw*, 308 F. Supp. 1, 3-8 (E.D.N.Y. 1970) (court found section 501 of the LMRDA inapplicable to trustees appointed by the employer). For a discussion of fiduciary problems under the LMRDA, see Wollett, *Fiduciary Problems Under Landrum-Griffin*, 13 N.Y.U. CONF. ON LABOR 267 (1960).

32. *McNamara v. Johnston*, 522 F.2d 1157, 1163 (7th Cir. 1975), *cert. denied*, 425 U.S. 911 (1976). See also *Hood v. Journeymen Barbers*, 454 F.2d 1347, 1355 (7th Cir. 1972); Clark, *The Fiduciary Duties of Union Officials Under Section 501 of the LMRDA*, 52 MINN. L. REV. 437, 447-48 (1967).

33. 29 U.S.C. §§ 301-309 (1970) (repealed 1974).

participants and beneficiaries upon written request.³⁴ It was expected that such information would enable participants to police their own plans.³⁵ The emphasis on participant policing under the WPPDA was underscored by the limited investigative and enforcement powers given to the Secretary of Labor.³⁶ Furthermore, the courts took a limited view of the WPPDA, remitting an aggrieved participant to the narrow remedy of subjecting administrators to limited liability for failure to comply with the reporting and disclosure requirements of the Act.³⁷ Fiduciary obligations were not enforced.³⁸

Although federal criminal statutes offer a vehicle for prosecuting violations for theft, embezzlement,³⁹ false statements,⁴⁰ and bribery⁴¹

34. *Id.* § 304. The WPPDA required the administrators of welfare and pension benefit plans to publish a description of the plan and an annual report showing such information as the amount and type of the plan's income, benefits, receipts and disbursements, the plan's assets and liabilities, and the number of employees covered. *Id.* §§ 304, 306 (1970) (repealed 1974).

35. S. REP. No. 93-127, *supra* note 12, at 4, *reprinted in* LEGISLATIVE HISTORY, *supra* note 12, at 590.

36. 29 U.S.C. § 308 (1970) (repealed 1974). Section 308(d) gave the Secretary limited investigatory power to ensure the accuracy of the published information if he had reasonable cause to believe that investigation might disclose violations of the Act. *Id.* He had no authority to perform an annual audit or other reviews of plan activities in order to check routinely on the accuracy of published information. *See id.*; S. REP. No. 92-634, *supra* note 23, at 92.

37. *See, e.g.,* Moyer v. Kirkpatrick, 265 F. Supp. 348, 350 (E.D. Pa. 1967), *aff'd*, 387 F.2d 955 (3d Cir. 1968).

38. For a discussion of the weaknesses of the disclosure provisions of WPPDA, *see Hearings on H.R. 16462, supra* note 9, at 463 (statement of former Secretary of Labor George P. Shultz).

39. 18 U.S.C. § 664 (1970) provides:

Any person who embezzles, steals, or unlawfully and willfully abstracts or converts to his own use or to the use of another, any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith, shall be fined not more than \$10,000, or imprisoned not more than five years, or both.

Id.

40. *Id.* § 1027 (Supp. V 1975). This section provides:

Whoever, in any document required by Title I of the Employee Retirement Income Security Act of 1974 (as amended from time to time) to be published, or kept as part of the records of any employee welfare benefit plan or employee pension benefit plan, or certified to the administrator of any such plan, makes any false statement or representation of fact, knowing it to be false, or knowingly conceals, covers up or fails to disclose any fact that the disclosure of which is required by such Act or is necessary to verify, explain, clarify or check for accuracy and completeness any report required by such Act to be published or any information required by such Act to be certified, shall be fined not more than \$10,000, or imprisoned not more than five years, or both.

Id. This section previously applied to the requirements of the WPPDA. *See id.* § 1027 (1970) (amended 1974).

41. *Id.* § 1954 (Supp. V 1975). This section provides:

Whoever being — (1) an administrator, officer, trustee, custodian, counsel, agent, or employee of any employee welfare benefit plan or employee pension benefit plan; or (2) an officer, counsel, agent, or employee of an employer or an employer any of whose employees are covered by such plan; or (3) an officer, counsel, agent, or employee of an employee organization any of whose members

affecting private employee benefit plans, congressional studies document the limited viability of this enforcement scheme. For example, statistics for 1971 show that only nine persons were indicted and six convicted for violations of theft or embezzlement, while only sixteen were convicted for violations under the bribery statute.⁴² There were neither indictments nor convictions for false statements or concealments. These figures should not be surprising, because enforcement of the provisions of title 18 of the Criminal Code raises the traditional constitutional and procedural safeguards inherent in any criminal proceeding, such as proof of guilt beyond a reasonable doubt and protections against self-incrimination. Although there were times when the criminal process and the stigma of convictions were important, these criminal sanctions were not remedial, since they did not restore lost assets or afford the opportunity to change the underlying practices and policies of the benefit plans involved.

Prior to ERISA, federal regulatory provisions in large measure left plan participants and beneficiaries to the traditional remedies of state statutory and common law.⁴³ The inadequacy of this alternative was a major force in the passage of ERISA. Under state law, the terms of the trust instrument usually took precedence over any general standards of prudence;⁴⁴ exculpatory clauses were generally valid;⁴⁵ results were seldom uniform among the states;⁴⁶ plan participants and beneficiaries were without ready access to detailed information about their plans or ready access to the courts; and potential plaintiffs often were faced with the prospect of high costs when litigating against large

are covered by such plan; or (4) a person who, or an officer, counsel, agent, or employee of an organization which, provides benefit plan services to such plan receives or agrees to receive or solicits any fee, kickback, commission, gift, loan, money, or thing of value because of or with intent to be influenced with respect to, any of the actions, decisions, or other duties relating to any question or matter concerning such plan or any person who directly or indirectly gives or offers, or promises to give or offer, any fee, kickback, commission, gift, loan, money, or thing of value prohibited by this section, shall be fined not more than \$10,000 or imprisoned not more than three years, or both

Id. This section previously applied to the WPPDA. *See* 18 U.S.C. § 1954 (1970).

42. S. REP. NO. 92-634, *supra* note 23, at 95. For examples of successful prosecutions, *see* *United States v. Silverman*, 430 F.2d 106 (2d Cir. 1970), *cert. denied*, 402 U.S. 953 (1971); *United States v. Moore*, 427 F.2d 38 (5th Cir.), *cert. denied*, 400 U.S. 965 (1970).

43. 2 LEGISLATIVE HISTORY, *supra* note 12, at 3295-96.

44. RESTATEMENT (SECOND) OF TRUSTS § 164 (1959).

45. *Id.* § 222; *see* S. REP. NO. 93-127, *supra* note 12, at 29, *reprinted in* LEGISLATIVE HISTORY, *supra* note 12, at 615.

46. S. REP. NO. 93-127, *supra* note 12, at 29, *reprinted in* LEGISLATIVE HISTORY, *supra* note 12, at 615. To the extent that modern plans are increasingly interstate operations, the absence of uniformity is cause for concern. *Id.*

plans or sponsors.⁴⁷ It was against this backdrop of ineffective regulation of private employee benefit plans that Congress turned to the fiduciary responsibility provisions which were ultimately included in ERISA.

III. ERISA'S FRAMEWORK FOR REGULATING FIDUCIARIES

A. *Persons Classified as Fiduciaries*

The definition of a fiduciary in section 3(21)(A) of ERISA reaches all fiduciaries, thus extending beyond prior law, which focused on the duties of trustees. This section includes anyone exercising discretionary authority or control with respect to the management of a plan or its assets.⁴⁸ Therefore, persons considered to be fiduciaries may include officers and directors of the plan, members of a plan's investment committee, and persons who select these individuals.⁴⁹ The ERISA definition of a fiduciary focuses on the authority and responsibility of individuals, rather than their titles. Interpretations of these provisions by the Department of Labor adopt the position that only persons who perform one or more of the functions described in section 3(21)(A) with respect to employee benefit plans are fiduciaries.⁵⁰

47. See ERISA, § 502(g), 29 U.S.C. § 1132(g) (Supp. V 1975) (providing for the award of attorneys' fees); note 163 and accompanying text *infra*.

48. ERISA, § 3(21)(A), 29 U.S.C. § 1002(21)(A) (Supp. V 1975) states: [A] person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 1105(c)(1)(B) of this title.

Id.

Section 405(c)(1)(B) of ERISA allows the delegation to other persons of certain fiduciary responsibilities by the named fiduciary. In addition, an investment manager may be appointed. 29 U.S.C. § 1105(c)(1)(B) (Supp. V 1975); see text accompanying notes 61-65 *infra*.

49. H.R. REP. NO. 93-1280, 93d Cong., 2d Sess. 323, reprinted in [1974] U.S. CODE CONG. & AD. NEWS 5038 [hereinafter cited as CONFERENCE REPORT].

50. See U.S. Dep't of Labor Interpretive Bulletin 75-8, 40 Fed. Reg. 47,491-92 (1975). As an example of the type of definitional problems that may arise, the Department of Labor, in Opinion Letter 76-45 (April 26, 1976), responded to a public inquiry concerning the potential fiduciary status of an individual serving as a member of a committee bearing the responsibility of appointing an investment manager for the plan. The issue was whether the individual could continue to serve as a member of the board of directors of a trust company which was appointed to serve as the investment manager. *Id.* Section 408(c)(3) provides that one is not prohibited by section 406 from serving as a fiduciary in addition to being an officer or other representative of a party in interest. ERISA, § 408(c)(3), 29 U.S.C. § 1108(c)(3) (Supp. V 1975); see CONFERENCE REPORT, *supra* note 49, at 323.

For example, any person who performs purely ministerial functions within a framework of procedures developed by others is not a fiduciary.⁵¹

ERISA provides that every employee benefit plan shall be maintained pursuant to a written instrument which shall provide for one or more "named fiduciaries" who must have the authority to control and manage the plan.⁵² Plan trustees are to be named in the trust instrument or appointed by a named fiduciary.⁵³ These trustees have exclusive authority and discretion over the management of the fund assets, although the plan may provide that a trustee will be subject to the direction of a named fiduciary who is not a trustee⁵⁴ or may permit authority to be delegated to an investment manager.⁵⁵

Once an individual becomes a fiduciary, he is responsible for operating the plan solely in the interests of participants and beneficiaries,⁵⁶ adhering to the prudence standards to be discussed below,⁵⁷ accepting certain responsibility and liability for the actions of co-fiduciaries,⁵⁸ and preventing the plan from engaging in statutorily defined "prohibited transactions."⁵⁹ The fiduciary is subject to personal liability for a breach of any of these obligations.⁶⁰

B. *Limiting Liability by Allocation or Delegation of Responsibility*

Section 402(c)(3) of ERISA permits the appointment of an "investment manager" by a named fiduciary with respect to control or management of the assets of the plan.⁶¹ Section 3(38) defines an

51. *See generally* 40 Fed. Reg. 47, 491 (1975).

52. ERISA, § 402(a)(1), 29 U.S.C. § 1102(a)(1) (Supp. V 1975).

53. *Id.* § 403(a), 29 U.S.C. § 1103(a).

54. *Id.* § 403(a)(1), 29 U.S.C. § 1103(a)(1). Section 403(a)(1) provides that a trustee may be subject to "proper" directions from the named fiduciary "which are made in accordance with the terms of the plan and which are not contrary to [the Act]." *Id.* However, if the trustee does properly follow instructions from a named fiduciary, he generally is not to be liable for losses which arise out of the following of such instructions. CONFERENCE REPORT, *supra* note 49, at 302. Similarly, a trustee who is directed by an investment committee pursuant to the terms of the plan, should follow such direction unless it is clear that the action to be taken would be prohibited by the fiduciary responsibility rules of the Act or contrary to the terms of the plan or trust. *Id.* at 298.

55. ERISA, § 403(a)(2), 29 U.S.C. § 103(a)(2) (Supp. V 1975).

56. *Id.* § 404(a)(1), 29 U.S.C. § 1104(a)(1).

57. *See* text accompanying notes 73-163 *infra*.

58. ERISA, § 405, 29 U.S.C. § 1105 (Supp. V 1975).

59. *Id.* §§ 406, 407, 29 U.S.C. §§ 1106, 1107.

60. *Id.* § 409, 29 U.S.C. § 1109; *see* text accompanying notes 131-36 *infra*.

61. ERISA, § 402(c), 29 U.S.C. § 1102(c) (Supp. V 1975). This section provides: "Any employee benefit plan may provide . . . (3) that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint

“investment manager” as anyone who 1) has the power to manage, acquire, or dispose of plan assets; 2) has acknowledged fiduciary status in writing; and 3) is a bank (as defined in the Investment Advisors Act of 1940),⁶² or an insurance company qualified under the laws of more than one state to manage, acquire and dispose of plan assets, or a person registered as an investment advisor under the Investment Advisors Act of 1940.⁶³ If a qualified investment manager is properly appointed under section 402(c)(3), the appointing fiduciary is no longer responsible for individual investment decisions made by the investment manager,⁶⁴ except in those limited cases where the fiduciary knowingly participates in or conceals a breach. Further, under section 402(c)(2), if the plan so provides, a named fiduciary may employ other persons to render advice to the named fiduciary to assist him in carrying out his investment responsibilities under the Act.⁶⁵ Investment advice is defined in applicable regulations as 1) rendering advice to the plan as to the value of securities or other property, or 2) recommending the advisability of investing in, purchasing, or selling securities or other property in a context where the person rendering such advice or recommendation has either discretionary control with respect to purchasing or selling securities or other property for the plan, or where such person provides services which serve as a primary basis for investment decisions with respect to plan assets and renders individualized investment advice to the plan based on the particular needs of the plan regarding such matters as investment policies and strategies or diversification of plan investments.⁶⁶

If the trust instrument provides for a procedure under which a named fiduciary may designate persons who are not named fiduciaries

an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.” *Id.*

62. Act of August 22, 1940, ch. 686, tit. I, 54 Stat. 805 (codified in scattered sections 15 U.S.C.) (amended 1970 & 1975).

63. ERISA, § 3(38), 29 U.S.C. § 1002(38) (Supp. V 1975).

64. *Id.* § 405(d)(1), 29 U.S.C. § 1105(d)(1). Section 405(d)(1) provides: If an investment manager or managers have been appointed under section 1102(c)(3), then . . . no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.

Id. Sections 405(a)(1) and 405(d)(1) indicate continued cofiduciary liability in the case of a knowing participation or concealment. 29 U.S.C. § 1105(a)(1), (d)(1) (Supp. V 1975).

65. ERISA, § 402(c)(2), 29 U.S.C. § 1102(c)(2) (Supp. V 1975); *see* 40 Fed. Reg. 47,491, 47,492 (1975).

66. 26 C.F.R. § 54.4975-9(c)(1) (1976); 29 C.F.R. § 2510.3-21(c)(1) (1976).

to carry out fiduciary responsibilities, the named fiduciary will not be liable for acts and omissions of such cofiduciaries, except as provided in section 405 of the Act.⁶⁷

Specific duties and responsibilities with respect to the operation of the plan may be allocated among fiduciaries in accordance with the provisions of the trust instrument.⁶⁸ If such an allocation procedure is properly used under section 405(c), the named fiduciary will not be liable for acts or omissions of other fiduciaries in carrying out fiduciary responsibilities which have been allocated to them, except as provided in section 405(c)(2).⁶⁹

Department of Labor Interpretive Bulletins outline the steps a fiduciary may take when he believes that another fiduciary is or may be taking action clearly contrary to the prudence requirements of section 404.⁷⁰ If a fiduciary learns that another fiduciary has committed a breach, he has an obligation to "take reasonable steps under the circumstances to remedy the breach."⁷¹ These steps would include either notifying the plan sponsor of the breach, proceeding to an appropriate federal court for instructions, or bringing the matter to the attention of the Secretary of Labor for possible enforcement action. The legislative view of the appropriate remedy is evidenced by the following statement:

The proper remedy is to be determined by the facts and circumstances of the particular case, and it may be affected by the relationship of the fiduciary to the plan and to the co-fiduciary, the duties and responsibilities of the fiduciary in question, and the nature of the breach.⁷²

Therefore, under ERISA, fiduciaries are permitted to allocate certain responsibilities among themselves or to retain a qualified investment manager to whom they may delegate responsibility and liability for investment decisions. In all cases, however, fiduciaries who allocate or delegate responsibility must do so in accordance with plan documents, may continue to retain certain liabilities as co-fiduciaries and still retain overriding responsibility to exercise prudence in undertaking and continuing allocations or delegations.

67. ERISA, § 405(a), (c)(2), 29 U.S.C. § 1105(a), (c)(2) (Supp. V 1975). See also 40 Fed. Reg. 47,491 (1975).

68. ERISA, § 405(c)(1)(A), 29 U.S.C. § 1105(c)(1)(A) (Supp. V 1975).

69. *Id.* § 405(c)(2), 29 U.S.C. § 1105(c)(2).

70. U.S. Dep't of Labor Interpretive Bulletin 75-5, 40 Fed. Reg. 31,599-600 (1975). Mere resignation, without taking steps to prevent the imprudent action, will not allow the minority trustees to avoid liability once they have knowledge that the imprudent action is under consideration. *Id.*

71. ERISA, § 405(a)(3), 29 U.S.C. § 1105(a)(3) (Supp. V 1975).

72. CONFERENCE REPORT, *supra* note 49, at 299-300.

IV. THE PRUDENT MAN RULE

A. *Background*

In spite of the importance of ERISA's prudent man rule, there is relatively little legislative history to amplify its development. The most expansive commentary available on the considerations presented to the Congress on this issue can be found in the testimony of Secretary of Labor Shultz before the House Education and Labor Committee on April 16, 1970, when he testified regarding H.R. 16462.⁷³ With some modifications, H.R. 16462 had language comparable to the wording of the prudent man standard contained in section 404 of ERISA.⁷⁴ Secretary Shultz stressed one change in wording⁷⁵ which was eventually included in the ERISA prudent man standard, thereby distinguishing it from the common law rule. The common law rule was stated in terms of exercising such care and skill as a man of ordinary prudence would exercise in dealing *with his own property*. It was feared that this language would not provide sufficient flexibility for administrators of pension and welfare benefit plans whose financial dealings often are significantly more complicated than those of personal trusts.⁷⁶

Secretary Shultz stressed that the prudent man formula have built-in flexibility so that it would apply equally well to financial institutions and small trusts.⁷⁷ Flexibility was needed to accommodate the varying size, complexity, and purposes of different kinds of employee benefit plans. In addition, trustees should be evaluated in terms of the actions of other trustees facing similar circumstances.⁷⁸ Such an evaluation would include consideration of such factors as prevailing economic conditions and the characteristics of the particular plan.

The purpose of the Shultz testimony, and that of the vast majority of witnesses who appeared during the course of hearings on H.R. 16462, was to ensure that it would not be necessary to apply a single rigid rule or standard to all employee benefit plans.⁷⁹ The goal was the development of a standard whereby the determination of prudence

73. *Hearings on H.R. 16462, supra* note 9, at 463.

74. Compare H.R. 16462, 92d Cong., 2d Sess., § 14(b)(1)(B) (1970), with ERISA, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975). However, ERISA has added a diversification requirement. *Id.* § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

75. *Hearings on H.R. 16462, supra* note 9, at 476-77.

76. *Id.*

77. *Id.*

78. *Id.*

79. See *id.* at 159, 163-64 (statement of Richard A. Van Dueren); *id.* at 292-93 (statement of H.C. Lumb); *id.* at 772-73 (statement of Preston C. Bassett).

would turn on the facts of each case. This type of case-by-case analysis is borne out in the ERISA Conference Report, where it is noted that the courts should interpret the prudent man rule bearing in mind the "special nature and purpose of employee benefit plans."⁸⁰ It was within this setting that the present prudent man standard embodied in section 404 was adopted.

B. *The Scope of Section 404 Fiduciary Responsibilities*

Section 404 provides that a fiduciary "shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . . for the exclusive purpose of providing benefits . . . and defraying reasonable expenses of administering the plan."⁸¹ In discharging these obligations, the fiduciary is to 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 a like character and with like aims."⁸²

As has been pointed out, the ERISA prudent man rule governs *all* aspects of fiduciary responsibility, whereas pre-ERISA standards traditionally were applied to judge the more limited activity of trustee investment behavior. Therefore, the scope of the rule under ERISA is far more expansive, encompassing all fiduciaries, not just trustees, and applying to plan operation and administration as well as to the management and investment of plan assets.⁸³

80. CONFERENCE REPORT, *supra* note 49, at 302.

81. ERISA, § 404(a)(1), 29 U.S.C. § 1104(a)(1) (Supp. V 1975).

82. *Id.* Inherent in this responsibility is the obligation to "[diversify] 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." *Id.* The fiduciary must also act "in accordance with the documents and instruments governing the plan in so far as such documents and instruments are consistent with the provision of this title." *Id.*

83. For example, section 405, which defines liability for the breach of fiduciary obligations by cofiduciaries contains two cross references to section 404(a)(1), both of which indicate that the prudent man rule under ERISA incorporates all of the fiduciary duties under the Act. *See id.* §§ 404(a)(1), 405, 29 U.S.C. §§ 1104(a)(1), 1105. First, section 405(a)(2) declares that a fiduciary shall be liable for a breach of fiduciary responsibility by a cofiduciary if the fiduciary's failure to meet his obligations under section 404(a)(1) in the administration of his specific responsibilities enables the cofiduciary to engage in a breach. *Id.* § 405(a)(2), 29 U.S.C. § 1105(a)(2). Second, section 405(c), which permits certain allocation or delegation of duties among or by fiduciaries, provides that a named fiduciary who has so allocated or delegated duties to a person who becomes a cofiduciary may be liable for an act or omission of the cofiduciary. However, he is liable only to the extent that the named fiduciary violated section 404(a)(1) with respect to the establishment or implementation of the procedures in the plan permitting allocation or delegation. *Id.* § 405(c)(2), 29 U.S.C. § 1105(c)(2).

The legislative history of ERISA expresses a congressional intent to codify and make applicable to fiduciaries many of the principles in the pre-ERISA law of trusts.⁸⁴ However, in addition to applying these traditional standards to the investment decisions of trustees, the section 404 standards and those contained in the accompanying sections of part 4 of title I of ERISA⁸⁵ now govern the total conduct of plan fiduciaries in their management and operation of employee benefit plans. Therefore, the fiduciary must not only act prudently in the acquisition and disposition of plan assets, but must be guided by the same considerations in such matters as establishing sound operating policies, retaining advisors, and purchasing goods and services.

C. *The "Solely in the Interests of" and "Exclusive Purpose" Standards: Section 404(a)(1)(A)*

The duty of fiduciaries to act solely in the interests of the participants and beneficiaries of an employee benefit plan is a direct descendant of the common law duty of loyalty in the administration of trust funds.⁸⁶ Conflicts of interest, as well as the appearance of conflicts of interest, were strictly forbidden. An example of the application of this rule can be found in *City Bank Farmers Trust v. Taylor*,⁸⁷ a 1949 case that refused to permit the trust company administering a trust to hold the bank's stock after the bank and the trust company had merged. Under the common law duty of loyalty, fiduciaries are forbidden from entering into competition with the trust res⁸⁸ and are forbidden from taking bonuses, commissions, or other compensation from parties dealing with the trust.⁸⁹ Remedies for violations of this duty of loyalty include the removal of a trustee from office as well as enjoining the disloyal acts.⁹⁰

84. S. REP. NO. 93-127, *supra* note 12, at 29, *reprinted in* LEGISLATIVE HISTORY, *supra* note 12, at 615.

85. ERISA, §§ 401-514, 29 U.S.C. §§ 1101-1144 (Supp. V 1975).

86. RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); 2 A. SCOTT, THE LAW OF TRUSTS § 170, at 1297-98 (3d ed. 1967). Disloyal acts by the trustee would include purchasing trust property for himself individually or selling to the trust his personal property or property in which he has a personal interest. *See* RESTATEMENT (SECOND) OF TRUSTS § 170, Comments b, c (1959).

87. 76 R.I. 129, 69 A.2d 234 (1949).

88. RESTATEMENT (SECOND) OF TRUSTS § 170, Comment p (1959); *see* *Sauvage v. Gallaway*, 329 Ill. App. 38, 66 N.E.2d 740 (App. Ct. 1946).

89. RESTATEMENT (SECOND) OF TRUSTS § 170, Comment o (1959); *see* *Slay v. Burnett Trust*, 143 Tex. 621, 187 S.W.2d 377 (1945).

90. *See* RESTATEMENT (SECOND) OF TRUSTS § 199 (1959). Losses caused by a trustee's breach of trust may be recovered from him. *See id.* § 205.

Prior to the adoption of ERISA, "solely in the interest" language also was used in the LMRA⁹¹ and the LMRDA.⁹² Under the LMRA,⁹³ some courts have relied upon this statutory language to support the position that trustees of jointly administered trust funds are not free to promote the interest of the party they represent, but are legally bound to a standard of nonpartisan fiduciary responsibility.⁹⁴ On the other hand, it has been argued that administration of a LMRA trust fund is merely an extension of the collective bargaining process.⁹⁵ This argument was bolstered by citations⁹⁶ to statutory language under section 302 of the LMRA which requires that employers and employees be equally represented in the administration of the trust funds.⁹⁷ Apparently, the statutory use of a representative was seen to connote "partisan spokesman." Proponents of this "bargaining representative" theory also cited the statutory provisions under section 302,⁹⁸ which provide for the appointment of neutral trustees and impartial umpires as evidence that Congress envisioned that union and management trustees should not be expected to act as impartial fiduciaries themselves.⁹⁹

91. Labor-Management Relations Act, § 302, 29 U.S.C. § 186 (1970 & Supp. V 1975), provides in part:

(a) It shall be unlawful for any employer or association of employers or any person who acts as a labor relations expert, adviser, or consultant to an employer or who acts in the interest of an employer to pay, lend, or deliver, or agree to pay, lend, or deliver, any money or other thing of value (c) The provisions of this section shall not be applicable . . . (5) with respect to money or other thing of value paid to a trust fund established by such representative, for the sole and exclusive benefit of the employees of such employer, and their families and dependents (. . . jointly with the employees of other employers making similar payments . . .).

Id.

92. Labor-Management Relations Disclosure Act, § 501(a), 29 U.S.C. § 501(a) (1970), provides:

The officers, agents, shop stewards, and other representatives of a labor organization occupy positions of trust in relation to such organization and its members as a group. It is, therefore, the duty of each such person, taking into account the special problems and functions of a labor organization, to hold its money and property solely for the benefit of the organization and its members and to manage, invest, and expend the same in accordance with its constitution and bylaws and any resolutions of the governing bodies adopted thereunder

Id.

93. 29 U.S.C. §§ 141-188 (1970 & Supp. V 1975).

94. *E.g.*, *United Marine Div. v. Essex Transp. Co.*, 216 F.2d 410 (3d Cir. 1954).

95. Goetz, *Developing Federal Labor Law of Welfare and Pension Plans*, 55 CORNELL L. REV. 911, 921-25 (1970).

96. *Id.* at 923 n.54.

97. 29 U.S.C. § 186(c) (5) (Supp. V 1975).

98. Goetz, *supra* note 95, at 921-25.

99. 29 U.S.C. § 186(c) (5) (Supp. V 1975):

The essential issue is whether trustees should be viewed as fiduciaries or merely as bargaining agents of their appointing bodies.¹⁰⁰ In addressing this question, agencies and courts have held that trustees are agents of the parties to the agreement only when the facts of the case indicate that the trustees were not free to exercise their discretion as to a particular issue.¹⁰¹ When the agreement establishes a trust fund to be administered by the trustees for the exclusive benefit of the affected employees and the fund is independently administered, the trustees have been held not to be agents of the parties.¹⁰² The propositions that trustees have full fiduciary responsibilities as a result of the "solely in the interest" language in the LMRA and that the trust agreement is not an extension of the collective bargaining contract have significant support in the decisions.¹⁰³

Courts have distinguished between the administration of pension trust agreements and collective bargaining agreements in several ways.

100. A key to deciding the issue of "agent" or "trustee" status often will be the difference between those acts which are undertaken to establish a plan and develop its provisions and the actions which are taken to administer a plan once it has been established. See *In re Trustees of the Ironworkers Local 17 Pension Fund*, PENS. REP. (BNA) R-13 (Jan. 3, 1977) (Dworkin, Arb.).

101. In *Local 80, Sheet Metal Workers*, 161 NLRB 229 (1966), the union was found guilty of an unfair labor practice for refusing to bargain by insisting that the employer accept an industry promotion fund as a condition precedent to reaching an agreement. *Id.* at 237. The trustees of the trust fund were found to be agents of the union in that, while acting pursuant to the collective bargaining agreement, the trustees refused to accept payments into the trust fund tendered by the employer until the employer agreed to contribute to the separate industry promotion fund. *Id.* at 234. See also *Local 138, Int'l Union of Operating Eng'rs v. NLRB*, 321 F.2d 130, 137 (2d Cir. 1963) (trustees were officials of, and served at the pleasure of, their appointing bodies).

102. *NLRB v. United Bhd. of Carpenters Local 1913*, 531 F.2d 424 (9th Cir. 1976). This decision drew a distinction generally made by courts in this area:

It is generally agreed that both agents and trustees are fiduciaries, but there are significant differences between the two. An agent acts for and on behalf of his principal and subject to his control. A trustee acts for the benefit of the beneficiaries of the trust; he is an agent only if he agrees to hold title for the benefit and *subject to the control* of another Unless the Union can be said to have control of the operations of the Trust, the Trust should not be treated as the Union's agent.

Id. at 426 (citations omitted) (emphasis in original).

103. Traditional fiduciary responsibilities were applied by the court in *Blankenship v. Boyle*, 329 F. Supp. 1089 (D.C. Cir. 1971). The court noted that the congressional scheme in enacting section 302(c)(5) of the Labor-Management Relations Act was to "reinforce 'the most fundamental duty owed by the trustee': the duty of undivided loyalty to the beneficiaries." *Id.* at 1095 (citations omitted). The provision allowing for the appointment of a neutral trustee was in anticipation of the honest differences in judgment that could arise. *Id.* The conclusion, that trustees are not representatives of the parties but are fiduciaries, finds further support in *Lamb v. Carey*, 498 F.2d 789, 793-94 (D.C. Cir.), *cert. denied*, 419 U.S. 869 (1974); *Miniard v. Lewis*, 387 F.2d 864 (D.C. Cir. 1967), *cert. denied*, 393 U.S. 873 (1968); *United Marine Div. Local 333 v. Essex Transp. Co.*, 216 F.2d 410, 412 (3d Cir. 1954); *Wynn v. Heller*, 391 F. Supp. 507 (S.D.N.Y. 1975); *American Bakeries Co. v. Barrick*, 162 F. Supp. 882 (N.D. Ohio 1958), *aff'd mem.*, 285 F.2d 426 (6th Cir. 1960).

First, jurisdictional sections of the LMRA, which authorize suits for breach of the collective bargaining agreement, have been held to be inapplicable to a suit seeking interpretation of the pension agreement.¹⁰⁴ Even though pension rights have their origin in the collective bargaining agreement, pension rights are uniquely personal and cannot be litigated under the LMRA.¹⁰⁵ Second, courts have not deferred to the process of arbitration in pension disputes, despite the national policy favoring arbitration of labor disputes.¹⁰⁶ In the pension area, courts often interpret the trust agreement and find no need for the appointment of a neutral umpire.¹⁰⁷ Thus, the enactment of ERISA, with its "solely in the interest" provision, should not force trustees of jointly administered plans to redefine their role in fund administration. Under the LMRA and ERISA, the trustees in most situations must view themselves as fiduciaries rather than as collective bargaining agents.

The Conference Report on ERISA sheds little light upon the "solely in the interest" provision,¹⁰⁸ although it is recognized that plan assets generally should not inure to the benefit of the employer.¹⁰⁹ However, even with this limitation, certain exceptions permit the return of employer contribution in specific situations.¹¹⁰

The requirement that fiduciaries act solely in the interests of participants and beneficiaries arises from an overall duty of loyalty, and should be read in conjunction with the "exclusive purpose rule" of section 404(a)(1)(A), which provides in part that "a fiduciary shall discharge his duties with respect to a plan . . . (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."¹¹¹

104. *E.g.*, *Cuff v. Gleason*, 515 F.2d 127 (2d Cir. 1975), *construing* LMRA, § 302(c)(5), 29 U.S.C. § 186(c)(5) (1970).

105. *See Cuff v. Gleason*, 515 F.2d 127 (2d Cir. 1975); *United Steelworkers v. Pullman-Standard Car Mfg. Co.*, 241 F.2d 547 (3d Cir. 1957). The conclusion to be drawn from these cases is that the trust agreement is not merely a labor agreement and that, therefore, the joint trustees are something more than an extension of the collective bargaining table.

106. *See United Steelworkers v. American Mfg. Co.*, 363 U.S. 564 (1960).

107. *See Poston v. Caraker*, 378 F.2d 439 (5th Cir. 1967); *Weinstein v. Brasso*, 69 L.R.R.M. (BNA) 2436 (S.D.N.Y. 1968).

108. CONFERENCE REPORT, *supra* note 49, at 303.

109. *Id.*

110. The Conference Report stated:

An employer's contributions can be returned within one year after they are made to the plan, if made as a mistake of fact . . . Also, if an employer contributes to a plan on the condition that the plan is tax-qualified or on the condition that a current tax deduction is allowed for the contribution, and it is later determined that the plan is not qualified (or the deduction is not allowed), the contribution can be returned if the plan provides for it.

Id.

111. ERISA, § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (Supp. V 1975) (emphasis added).

Since these requirements are in the conjunctive, any particular transaction must satisfy both requirements.¹¹²

Section 401(a) of the Internal Revenue Code traditionally has required that qualified retirement plans be administered for the "exclusive benefit" of the employees and their beneficiaries.¹¹³ As interpreted by the IRS, the term "exclusive" was read to mean "primary", *i.e.*, a transaction benefiting a third party was not a violation of the Code if it were for a proper plan purpose, prudent, and in the best interests of the participants.¹¹⁴ In discussing the background and meaning of section 404 of ERISA, the Conference Report reviewed criteria previously developed by the IRS to implement the exclusive benefit rule contained in section 401(a) of the Code.¹¹⁵ However, after listing these prior interpretations by the IRS, the conferees indicated that to the extent that a fiduciary meets the prudent man standard of section 404 of ERISA, he will be deemed to have met the exclusive benefit requirement retained in the Code. Thus, although prior "exclusive benefit" standards may be relevant historical guidance, section 404 standards now appear to be controlling. Such an interpretation is further reinforced by a review of additional legislative history indicating congressional dissatisfaction with prior Code sanctions and the IRS administration in this area.¹¹⁶ The Department of Labor recently filed an action against the fiduciaries of an employee benefit plan, even though the plan was deemed a qualified employee stock ownership plan

112. A fiduciary does not satisfy the exclusive purpose rule by a transaction which merely defrays reasonable expenses of administration unless those expenses were also incurred solely in the interest of the participants. See Cummings, *Purposes and Scope of the Fiduciary Provisions Under the Employee Retirement Income Security Act of 1974*, 31 Bus. Law. 15, 36-37 (1975).

113. I.R.C. § 401(a) provides:

(a) Requirements for Qualification. — A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section . . .

114. In explaining the exclusive benefit test (*i.e.*, for the sole benefit of the employees), the IRS stated that it does not mean that others are prohibited from receiving any benefit. Rev. Rul. 494, 1969-2 C.B. 88. The specific requirements which had to be met by an investment to satisfy the exclusive benefit test were as follows:

(1) the cost must not exceed fair market value at time of purchase; (2) a fair return commensurate with the prevailing rate must be provided; (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan, and (4) the safeguards and diversity that a prudent investor would adhere to must be present. However, the requirements set forth in item (2) with respect to a fair return is not applicable to obligatory investments in employer securities in the case of a stock bonus plan.

Id. See also Rev. Rul. 65, 1969-1 C.B. 114.

115. CONFERENCE REPORT, *supra* note 49, at 302.

116. Cummings, *supra* note 112, at 36. For a discussion of congressional dissatisfaction with IRS activities in the pension area, see S. REP. NO. 992-634, *supra* note 23, at 97; S. REP. NO. 93-127, *supra* note 12, at 4-5, reprinted in LEGISLATIVE HISTORY, *supra* note 12, at 590-91.

(ESOP) by the IRS. The Department's complaint alleged that many of the fiduciaries' actions in converting the prior profit-sharing plan into an ESOP were violations of the fiduciary provisions of section 404.¹¹⁷

D. *Care, Skill, Prudence, and Diligence:*
Section 404(a)(1)(B)

The specific articulation of ERISA's prudent man rule, as set forth in section 404(a)(1)(B),¹¹⁸ is discussed in depth later in this article.¹¹⁹ For the present, it should be emphasized that the entire scope of the general fiduciary obligations are subject to the prudent man rule. Therefore, standards of prudence govern actions ranging from the selection of an investment manager, to developing cost-sharing arrangements for administrative and support services, to the collection of delinquent contributions. Furthermore, even when administrative exemptions from the prohibited transaction rules are granted under section 408, the exempt transaction remains subject to the general standards of prudence.¹²⁰

E. *Diversification: Section 404(a)(1)(C)*

The requirement of diversification finds its roots in the common law. When imposed, this duty was merely an application of the general rule as to the care required of a trustee in making investments.¹²¹ While there was some disagreement among the states in approaching this issue, the courts frequently held that a trustee was under a duty to diversify investments.¹²² They proceeded on the theory of reducing the risk of large losses and followed the "proverbial injunction not to put all one's eggs in one basket."¹²³

117. *Usery v. Whately*, No. 77-6004A (E.D. Va., Jan. 5, 1977).

118. ERISA, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975). For the text of section 404(a)(1)(B), see note 8 *supra*.

119. See text accompanying notes 164-89 *infra*.

120. See Class Exemptions from Prohibitions Respecting Certain Transactions in Which Multiemployer and Multiple Employer Plans Are Involved, Prohibited Transaction Exemption 76-1, 41 Fed. Reg. 12,740 (1976); Exemption from Prohibitions Respecting Certain Classes of Transactions Involving Employee Benefit Plans and Certain Broker-Dealers Reporting Dealers and Banks, 40 Fed. Reg. 50,845 (1975).

121. See RESTATEMENT (SECOND) OF TRUSTS §§ 227, 228, Comment c (1959).

122. The Massachusetts view was that a trustee was ordinarily under a duty to diversify investments. See *First Nat'l Bank v. Truesdale Hosp.*, 288 Mass. 35, 192 N.E. 150 (1934). On the other hand, some courts have taken the position that there is no duty to diversify. See *In re Ardriance's Estate*, 145 Misc. 345, 260 N.Y.S. 173 (Sur. Ct. 1932); *In re Seager's Estate*, 340 Pa. 73, 16 A.2d 19 (1940).

123. *First Nat'l Bank v. Truesdale Hosp.*, 288 Mass. 35, 192 N.E. 150, 152 (1934) (although failure to diversify is normally a breach of duty, court found under the circumstances that trustee acted prudently).

ERISA has adopted much of the philosophy of the diversification rules as set forth by the American Law Institute *Restatement (Second) of Trusts (Restatement)* in section 228.¹²⁴ However, unlike the *Restatement* rule, under ERISA, plan documents cannot override the diversification requirement; but a potential exemption from the diversification requirement is available if it was *clearly* prudent not to diversify under the circumstances.¹²⁵ The Conference Report explicitly stated that it was not intended that a more stringent standard of prudence be established with the use of the term "clearly prudent."¹²⁶ The use of this language merely indicated that in an action to recover plan losses based on breach of the diversification requirement, the plaintiff will have the initial burden of demonstrating that there has been a failure to diversify. The defendant fiduciary will then carry the burden of demonstrating that the failure to diversify was prudent.¹²⁷ The logic of this position follows from the emphasis that ERISA places on diversification: "The basic policy [of the Act] is to require diversification."¹²⁸

Although not attempting to state the requirement as a fixed percentage, the conferees did indicate that "a fiduciary should not invest the whole or an unreasonably large proportion of the trust property in a single security" and should be wary of heavy concentration in geographical areas or industries.¹²⁹ The Conference Report drew heavily on the *Restatement* philosophy as to the factors to be considered in diversifying investments.¹³⁰ The *Restatement* recognizes that special

124. RESTATEMENT (SECOND) OF TRUSTS § 228 (1959) provides: "Except as otherwise provided by the terms of the trust, the trustee is under a duty to the beneficiary to distribute the risk of loss by a reasonable diversification of investments, unless under the circumstances it is prudent not to do so." *Id.* ERISA, § 404(a)(1)(C) provides: "A fiduciary shall discharge his duties with respect to a plan . . . (c) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly not prudent to do so." 29 U.S.C. § 1104(a)(1)(C) (Supp. V 1975).

125. ERISA elevates the diversification requirement to a statutory requirement. ERISA, § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (Supp. V 1975). The terms of the trust instrument are effective only insofar as they are consistent with the provisions of ERISA. *See id.* § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D); text accompanying notes 141-49 *infra*.

126. CONFERENCE REPORT, *supra* note 49, at 304.

127. *Id.*

128. *Id.*

129. *Id.*

130. RESTATEMENT (SECOND) OF TRUSTS § 228, Comment d (1959), states: "The trustee should not usually invest the whole or an unreasonably large proportion of the trust property in a single security." *Id.* Comment e to § 228 of the *Restatement* further provides:

Ordinarily the trustee should not invest the whole or an unduly large proportion of the trust property in one type of security or in various types of securities dependent upon the success of one enterprise or one class of enterprises or upon

circumstances might arise when a trustee would be excused from diversifying investments.¹³¹ As mentioned earlier, ERISA also recognizes the possibility of such situations and places the corresponding burden of justification on the trustee.¹³²

As a corollary to the diversification requirement, some courts have held a trustee liable for failure to dispose of assets which, at the time of the trust's creation, were improper investments.¹³³ There are numerous cases in which a trustee has been surcharged for failing to sell valueless or declining securities within a reasonable time after the creation of the trust.¹³⁴ The rule is well stated in *In re Taylor's Estate*¹³⁵ wherein the court found that a trustee is not immune from liability for the retention of unauthorized securities merely because the testator had purchased them.¹³⁶ Liability will result from failure to

conditions in one locality, since the effect is to increase the risk of large losses. Thus, although the trustee may be authorized to invest in industrial stocks, he should not invest a disproportionate amount of the trust fund in the shares of corporations engaged in a particular industry. If he is investing in mortgages on real estate he should not invest a disproportionate amount of the trust fund in mortgages in a particular district or upon a particular class of property so that a decline in property values in that district or of that class might cause a large loss.

Id. Comment e. The position taken by the *Restatement*, that it is improper for a trustee to invest too large a proportion of the trust funds in the securities of a particular locality, is supported by case law. *See, e.g., In re Ward's Estate*, 121 N.J. Eq. 555, 192 A. 68 (Prerog. Ct. 1936), *aff'd per curiam*, 121 N.J. Eq. 606, 191 A. 772 (1937).

131. Compare CONFERENCE REPORT, *supra* note 49, at 304, with RESTATEMENT (SECOND) OF TRUSTS § 228 (1959). The *Restatement* provides:

Since the rule stated in this Section is an application of the general rule stated in § 227, there may be special circumstances in which the trustee is excused from diversifying investments. Thus, where the trust estate is very small it may be proper for the trustee to invest the whole or substantially the whole of it in one security or type of security. If, for example, the trust estate amounts to one or two thousand dollars, it may be proper to invest the whole amount in a single mortgage. So also, in times of crisis and general financial instability, it may be proper to invest a large portion or even the whole of the trust estate in a single type of security such as government securities. In any event the trustee is not liable if under all the circumstances his conduct is that of a prudent man and he complies with the provisions of the terms of the trust and of any statute which may be applicable.

RESTATEMENT (SECOND) OF TRUSTS § 228, Comment c (1959).

132. CONFERENCE REPORT, *supra* note 49, at 304.

133. RESTATEMENT (SECOND) OF TRUSTS § 230 (1959); 3 A. SCOTT, *supra* note 86, at § 230.3. The duty is also applied where the trustee is limited by statute or decision to certain types of investments, and the securities received have ceased to be proper. *See id.*

134. *E.g., Paul v. Girard Trust Co.*, 124 F.2d 809 (7th Cir. 1941) (retention of shares for 16 years); *McInnes v. Whitman*, 313 Mass. 19, 46 N.E.2d 527, 531-32 (1943) (retention of shares of stock); *In re Garvin*, 256 N.Y. 518, 177 N.E. 24, 242 N.Y.S. 830 (1931) (executor retained stock until it became valueless). However, no liability would result if the trustee acted prudently in retaining the securities. *See In re Kent's Estate*, 6 Cal. 2d 154, 57 P.2d 901 (1936) (failure to sell shares for three years during the Depression).

135. 277 Pa. 518, 121 A. 310 (1923).

136. *Id.* at 529, 121 A. at 313.

dispose of imprudent holdings within a reasonable time.¹³⁷ A more recent example of this principle can be found in *Steiner v. Hawaiian Trust Co.*,¹³⁸ an action by a successor trustee against the former trustee for breach of trust.¹³⁹ Although recognizing that the rule of diversification should be applied less strictly to the retention of investments by the trustee, the court held that prudence dictates steps to achieve the diversification of an overly concentrated initial portfolio.¹⁴⁰

F. *Adherence to Plan Documents Which Are Consistent with Title I of ERISA: Section 404(a)(1)(D)*

ERISA provides that a fiduciary shall discharge his duties with respect to a plan "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title."¹⁴¹ The significance of this provision lies in its departure from the common law rule of trusts under which the trustee was charged with carrying out the intent of the settlor as specified in the trust instrument.¹⁴² The provisions of the trust instrument were binding upon the trustee unless compliance was impossible, illegal, or unless there had been a change of circumstances.¹⁴³ Under ERISA, a fiduciary may disregard the plan document if compliance with the document would be inconsistent with any of the provisions of ERISA, including the prudent man standard.¹⁴⁴ For example,

137. *Id.*

138. 47 Hawaii 548, 393 P.2d 96 (1964).

139. *Id.* at 549, 393 P.2d at 99.

140. *Id.* at 563-64, 393 P.2d at 105-06.

141. ERISA, § 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D) (Supp. V 1975).

142. RESTATEMENT (SECOND) OF TRUSTS § 227(c) (1959). Comment q provides that "[a]s a general rule a trustee can properly make such investments as are authorized by the terms of the trust and cannot properly make investments which are forbidden by the terms of the trust." *Id.* § 227, Comment q.

29 U.S.C. § 1102(a), (b) (Supp. V 1975) states in pertinent part:

For purposes of this title, the term "named fiduciary" means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly. . . .

Every employee benefit plan shall—

- (1) provide a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and the requirements of this title.
- (2) describe any procedure under the plan for the allocation of responsibilities for the operation and administration of the plan (including any procedure described in section 1105(c)(1),
- (3) provide a procedure for amending such plan, and for identifying the persons who have authority to amend the plan, and
- (4) specify the basis on which payments are made to and from the plan.

Id.

143. RESTATEMENT (SECOND) OF TRUSTS §§ 165-167 (1959).

144. A fiduciary must compare the trust instructions to the prudent man rule of ERISA in order to assure the propriety of his actions.

a plan provision permitting fiduciary self-dealing or authorizing the acquisition or retention of employer securities in excess of section 407 limits¹⁴⁵ would not be effective.

There are certain provisions which are required by the Act to be included in plan documents and other provisions which are only permitted by the Act. Sections 402(a), 402(b) and 403(a) set forth the provisions which must be included in the plan document.¹⁴⁶ For example, the plan must be evidenced by a written document(s)¹⁴⁷ and must provide for named fiduciaries who have the authority to control and manage the operation of the plan.¹⁴⁸ The plan also must establish a funding policy, an amendment process, and must specify the basis of payments into and out of the plan.¹⁴⁹ An example of a "permissible" provision would be the authority under section 402(c)(3) to appoint an investment manager.¹⁵⁰

G. *Liability for the Breach and Available Civil Remedies*

Under title I of ERISA, a fiduciary who breaches the fiduciary requirements of the Act may be held personally liable for any losses to the plan resulting from his breach and may be required to restore to the plan any profits earned through the use of plan assets; he is subject to such other appropriate relief as may be ordered by a federal court.¹⁵¹ The language in section 409 is quite broad, and the nature of the relief that may be obtained either by the Department of Labor or by private litigants is limited only by the particular facts of a case and the plaintiff's ability to obtain creative relief from the court.¹⁵²

In addition, section 410 of ERISA provides that exculpatory provisions which relieve a fiduciary from liability for breach of the fiduciary responsibility rules are void as inconsistent with public policy.¹⁵³ This section marks a significant departure from the common

145. 29 U.S.C. § 1107 (Supp. V 1975).

146. *Id.* §§ 1102(a), (b), 1103(a).

147. ERISA, § 402(a)(1), 29 U.S.C. § 1102(a)(1) (Supp. V 1975).

148. *Id.*

149. *Id.* § 402(a)(2), (b), 29 U.S.C. § 1102(a), (b).

150. *Id.* § 402(c)(3), 29 U.S.C. § 1102(c)(3).

151. *Id.* § 409, 29 U.S.C. § 1109 provides:

Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.

Id.

152. *See, e.g.*, *Eaves v. Penn*, No. 76-0450D (W.D. Okla. Dec. 29, 1976).

153. ERISA, § 410(a), 29 U.S.C. § 1110(a) (Supp. V 1975).

law in many states.¹⁵⁴ Congress apparently did contemplate the use of insurance to absorb some liability:

However, a plan may purchase insurance for itself and for its fiduciaries to cover liability or loss resulting from their acts or omissions if the insurance permits recourse by the insurer against fiduciaries in case of breach. Also, . . . a fiduciary may purchase insurance to cover his own liability and an employer or union may purchase liability insurance for plan fiduciaries.¹⁵⁵

One of the key changes brought about by ERISA is the assignment of major enforcement responsibilities to the Department of Labor under the Act. In addition to the traditional criminal penalties set forth in section 501 for willful violations of the reporting and disclosure rules,¹⁵⁶ the Department has been given broad civil investigatory and enforcement powers under sections 502 and 504 of the Act.¹⁵⁷ These powers include significant investigatory powers under sections 504(a) and 504(b), and liberal subpoena power under section 504(c) of the Act, which incorporates by reference the authority contained in the Federal Trade Commission Act.¹⁵⁸ Under section 502(a), the Secre-

154. 3 A. SCOTT, *supra* note 86, at § 222.

155. CONFERENCE REPORT, *supra* note 49, at 320-21; *see* ERISA, § 410(b), 29 U.S.C. § 1110(b) (Supp. V 1975).

156. ERISA, § 501, 29 U.S.C. § 1131 (Supp. V 1975). Penalties include a fine of up to \$5,000 or up to one year imprisonment, or both, for an individual, and fines up to \$10,000 for others. *Id.*

157. *Id.* § 502(a)(2), (4), (5), (6), 29 U.S.C. § 1132(a)(2), (4), (5), (6).

158. *Id.* § 504, 29 U.S.C. § 1134. Section 504, provides:

(a) The Secretary shall have the power, in order to determine whether any person has violated or is about to violate any provision of this title or any regulation or order thereunder — (1) to make an investigation, and in connection therewith to require the submission of reports, books, and records, and the filing of data in support of any information required to be filed with the Secretary under this title, and (2) to enter such places, inspect such books and records and question such persons as he may deem necessary to enable him to determine the facts relative to such investigation, if he has reasonable cause to believe there may exist a violation of this title or any rule of regulation issued thereunder or if the entry is pursuant to an agreement with the plan. The Secretary may make available to any person actually affected by any matter which is the subject of an investigation under this section, and to any department or agency of the United States, information concerning any matter which may be the subject of such investigation; except that any information obtained by the Secretary pursuant to section 6103(g) of the Internal Revenue Code of 1954 shall be made available only in accordance with regulations prescribed by the Secretary of the Treasury. (b) The Secretary may not under the authority of this section require any plan to submit to the Secretary any books or records of the plan more than once in any 12 month period, unless the Secretary has reasonable cause to believe there may exist a violation of this title or any regulation or order thereunder. (c) For the purpose of any investigation provided for in this title, the provisions of sections 9 and 10 (relating to the attendance of witnesses and the production of books, records, and documents) of the Federal Trade Commission Act (15 U.S.C. 49,

tary of Labor has the authority to initiate federal district court litigation seeking injunctive or other relief,¹⁵⁹ and under section 502(h), the Secretary may intervene in litigation brought by private parties.¹⁶⁰

Section 502 also specifically confers the right upon plan participants and beneficiaries to bring civil actions for relief from violations of the fiduciary rules or other sections of the Act.¹⁶¹ One of the important parts of ERISA's enforcement strategy is the section 502(g) provision allowing the award of attorneys' fees in litigation brought by individual participants, beneficiaries, or fiduciaries,¹⁶² a provision which may well encourage private suits.¹⁶³

V. ERISA VERSUS THE COMMON LAW RULE

The basic rule under state and common law was that a trustee was under a duty in administering a trust to exercise such skill as a man of ordinary prudence would exercise in dealing with his own property, with a view toward the preservation of the estate and the

50) are hereby made applicable . . . to the jurisdiction, powers and duties of the Secretary or any officers designated by him.

Id.

159. *Id.* § 502(a)(5), 29 U.S.C. 1132(a)(5). For recent examples of litigation instituted by the Secretary, see *Usery v. Wilson*, No. 3-76-373 (E.D. Tenn., filed Nov. 23, 1976); *Usery v. Penn*, No. 76-0450D (W.D. Okla., filed June 3, 1976).

160. ERISA, § 502(h), 29 U.S.C. § 1132(h) (Supp. V 1975). For recent examples of intervention by the Secretary, see *M&R Inv. Co. v. Fitzsimmons*, No. LV 76-114 (D. Nev., filed Oct. 19, 1976); *Harris v. Stryco Mfg. Co.*, No. C-75-1831 (N.D. Cal., filed Oct. 14, 1976).

161. ERISA, § 502(a)(1)-(4), 29 U.S.C. § 1132(a)(1)-(4) (Supp. V 1975).

162. *Id.* § 502(g), 29 U.S.C. § 1132(g).

163. Provision for attorneys' fees was also made in the Civil Rights Act of 1964. See 42 U.S.C. § 2000a-3(a) (1970). Guidelines for the proper awarding of attorneys' fees under title VII stem from the Supreme Court decision of *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400 (1968). In that case, the Supreme Court observed: "If [the plaintiff] obtains an injunction, he does so . . . as a 'private attorney general,' vindicating a policy that Congress considered of the highest priority . . . Congress . . . enacted the provision for counsel fees . . . to encourage individuals injured by racial discrimination to seek judicial relief . . ." *Id.* at 402 (footnotes omitted).

Thus, courts have liberally applied the attorneys' fees provision of title VII. See *Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974); *Clark v. American Marine Corp.*, 437 F.2d 959 (5th Cir. 1971), *aff'g per curiam* 320 F. Supp. 709 (E.D. La. 1970). Factors to be considered include: 1) time and labor required; 2) difficulty of the legal issues; 3) skill requisite to perform the legal service properly; 4) preclusion of other employment by the attorney due to acceptance of the case; 5) customary fee; 6) whether the fee is fixed or contingent; 7) time limitations imposed by the client or the circumstances; 8) the amount involved and results obtained; 9) the experience, reputation, and ability of the attorneys; and 10) the nature and length of the professional relationship with the clients. 488 F.2d at 717-19. Even in the absence of statutory authorization, the Supreme Court, relying upon the substantial benefit test, has allowed the awarding of attorneys' fees to plaintiffs suing under title I of the LMRDA. *Hall v. Cole*, 412 U.S. 1, 5-6 (1973).

amount and regularity of the income to be derived.¹⁶⁴ Generally, there developed two prudent man rules in the state courts.¹⁶⁵ The "majority rule" required a trustee to exercise the skill and prudence of a reasonable, prudent man in retaining and investing trust assets,¹⁶⁶ while other states adopted what came to be known as "legal lists," which allowed only a percentage, if any, of the assets to be invested according to the prudent man standard.¹⁶⁷ The fact that a trustee was acting gratuitously or for compensation did not alter the standard of prudence required of the trustee, although high compensation could be evidence of representations of superior ability.¹⁶⁸

The common law prudent man rule encompassed three major duties for a trustee: 1) the duty of care; 2) the duty of skill; and 3) the duty of caution. Generally, a trustee needed only to exercise that amount of care and skill that an ordinary man would exercise.¹⁶⁹ As a matter of public policy, if a particular trustee possessed greater skill than that of an ordinary man, he was frequently held to a duty to exercise that level of skill.¹⁷⁰ The issue did not concern the amateur or professional status of the trustee. The issue centered on the level of his actual ability and his claims of competence prior to the acceptance of the trusteeship.¹⁷¹ Investment decisions were governed by the trust instrument or by statute and were generally judged by the conditions prevailing at the time the investment was made.¹⁷²

Prior to the development of modern investment strategies, the prudent common law trustee was advised to consider the amount of the trust estate, the situations and needs of the beneficiaries, and the cost

164. RESTATEMENT (SECOND) OF TRUSTS §§ 174, 227 (1959). Section 174 provides: The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property; and if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill.

Id.

165. G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 612, at 410 (2d ed. 1960 & Supp. 1976) [hereinafter cited as BOGERT].

166. *Id.* at 407-10. The prudent man rule was first applied to investments in *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830). The court described the duties of the trustee as follows:

All that can be required of a trustee to invest, is that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs . . . in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.

Id. at 461; see 3 A. SCOTT, *supra* note 86, at § 227.

167. BOGERT, *supra* note 165, § 612, at 410, § 614.

168. *Id.* § 541 at 453; 2 A. SCOTT, *supra* note 86, § 174, at 1410.

169. RESTATEMENT (SECOND) OF TRUSTS § 227, Comments b, c, e (1959).

170. *Id.* § 714, Comment a (1959); see BOGERT, *supra* note 165, § 541, at 453-55.

171. BOGERT, *supra* note 165, § 541, at 453-54.

172. *Id.* § 612, at 418; 3 A. SCOTT, *supra* note 86, § 227, at 1807.

of living.¹⁷³ Factors to be considered in selecting specific portfolio holdings included: 1) marketability of the security; 2) maturity date; 3) duration of the trust; 4) probable condition of the market at the termination of the trust; 5) probable condition of the market at the time of reinvestment; 6) value of the trust and nature of the other investments; and 7) the tax consequences of each security.¹⁷⁴ As a general rule, investments in speculative securities were outlawed, while government securities and high-grade corporate bonds were usually considered prudent.¹⁷⁵ But the states divided as to whether investment in common stock was proper.¹⁷⁶ Today, the general prudent man standard for trust investments has been adopted by statute or judicial decree in a significant majority of states, although a few states still require that no more than a certain percentage of the trust funds be invested according to the prudent man standard.¹⁷⁷

Although these pre-ERISA standards of prudence are relevant as a starting point for discussing the ERISA prudent man rule, the common law of trusts cannot serve as a definitive guide to standards under ERISA because of the basic differences in size, scope, and purpose between personal trusts, whether inter vivos or testamentary, and employee benefit plans. A key distinction lies in the absence of the traditional tension between the interests of income beneficiaries and remaindermen.¹⁷⁸ Pension trustees have more opportunity to make investment decisions than do personal trustees. In a pension plan, the regular influx of new capital generally alleviates some of the liquidity pressures which personal trusts face. The tax structure of pension plans also relieves plan trustees from such restrictive planning considerations as to whether income will be taxed at capital gains or ordinary income rates.¹⁷⁹

173. RESTATEMENT (SECOND) OF TRUSTS § 227, Comment e (1959).

174. *Id.* § 227, Comment o; 3 A. SCOTT, *supra* note 86, § 227.12.

175. RESTATEMENT (SECOND) OF TRUSTS § 227, Comment f (1959).

176. 3 A. SCOTT, *supra* note 86, § 227.11; *see* RESTATEMENT (SECOND) OF TRUSTS § 227, Comment m (1959).

177. BOGERT, *supra* note 165, § 612, at 62 n.18 (Supp. 1976). Only a few states still had legal lists in effect as of 1972. *Id.*; *see* note 167 and accompanying text *supra*.

178. *See* Note, *Fiduciary Standards and the Prudent Man Rule Under the Employee Retirement Income Security Act of 1974*, 88 HARV. L. REV. 960, 967 (1975).

179. *Id.* at 968. If a pension plan qualifies under the Code, the employer can deduct contributions to the plan as ordinary and necessary business expenses at the time the contribution is made. I.R.C. § 404(a)(1). Employer contributions are not includable in the taxable income of participating employees until actually received. *Id.* § 402(a)(1). In some cases, benefit distribution will be taxed to the employees at capital gain rates, *i.e.*, lump-sum distributions. *Id.* § 402(a)(2), (a)(5). Finally, investment earnings on funds accumulated under trust-funded plans are exempt from taxation, unless they constitute unrelated business income. *Id.* § 501(a), (b).

Of the more than 470,000 employee benefit pension plans that recently filed reports with the Department of Labor under ERISA,¹⁸⁰ 76% use trusts to hold their assets.¹⁸¹ Of the reporting plans, 77% were defined contribution plans, while the remaining 23% were defined benefit plans.¹⁸² Over 90% of all pension plans filing had fewer than 100 participants within each plan, and the type of plans filing included welfare plans, defined benefit pension plans, stock bonus plans, profit-sharing plans, thrift and savings plans, and many plans with combined features.¹⁸³

A consideration of the diverse spectrum of plans in existence today makes it clear that ERISA's prudent man rule contemplates a comparative standard of performance. A fiduciary's conduct must be compared to that of other fiduciaries "acting in a like capacity, and familiar with such matters . . . in the conduct of an enterprise of like character and with like aims."¹⁸⁴ Thus, fiduciaries of large plans with large pools of assets should be judged differently from fiduciaries of small plans which accumulate limited asset holdings because of their paramount need for liquidity. Trustee performance must be judged with due regard for such varying plan characteristics as the nature and size of the plan, funding status, liquidity needs, and contribution rates.¹⁸⁵

Some commentators have asserted that ERISA has created a prudent expert standard.¹⁸⁶ Emphasis is placed on the key words "familiar with such matters," in order to show the incorporation of a standard of expertise.¹⁸⁷ It can be conceded that in appropriate cases, the proper measure of a prudent man will indeed be that of a professional money manager. However, a full review of the legislative history will not support the general imposition of a prudent expert rule. The emphasis remains on flexibility.¹⁸⁸ A plan trustee managing a small plan with limited assets should not be held to the same standard of expertise as a trust company.¹⁸⁹

180. U.S. Dep't of Labor Press Release No. 76-1403, Background Paper (Nov. 12, 1976).

181. *Id.*, Background Paper, at 2.

182. *Id.*, Background Paper, at 1.

183. *Id.*

184. ERISA, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975).

185. *Hearings on H.R. 16462, supra* note 9, at 477; see Klevan, *Fiduciary Responsibility Under ERISA's Prudent Man Rule: What Are the Guideposts?*, 44 J. TAX. 152-53 (1976).

186. See Cummings, *supra* note 112, at 35.

187. *Id.*

188. See text accompanying notes 73-80 *supra*.

189. See *Hearings on H.R. 16462, supra* note 9, at 477, 521; Klevan, *supra* note 185, at 153.

VI. MANAGING EMPLOYEE BENEFIT PLAN ASSETS UNDER ERISA

A. *Determining Plan Characteristics and Needs*

Shortly after ERISA's enactment, a significant amount of commentary developed as attempts were made to determine what impact, if any, the Act would have on the manner in which employee benefit plan assets were managed. As is frequently the case when any measure of certainty is sought in a new area of regulation, traditional concepts often were overlooked as the search proceeded to discover clear guidelines which would produce the "safest" or "most conservative" investment strategies so that fiduciaries would be insulated from challenge under ERISA.¹⁹⁰

This approach ignores the fact that ERISA's prudent man rule was meant to measure a fiduciary's performance against that of a prudent man operating in a factual setting involving similar circumstances and a plan "of a like character and with like aims."¹⁹¹ Without a threshold analysis of a plan's characteristics and needs, there is little basis for determining whether a fiduciary has acted prudently in attempting to serve the interests of the participants and beneficiaries of the plan. Prudence is not an abstract concept. It must be measured in the context of the facts and circumstances prevailing at the time of the relevant action.

Therefore, a thorough review of the characteristics and needs of an employee benefit plan is a prerequisite to the development of sound investment objectives and the selection of an appropriate investment strategy to achieve those objectives. In the following discussion, the terms "investment objectives" and "investment strategies" will be used to identify two different aspects of the investment process. As used herein, investment objectives are the broad precepts that identify a plan's needs, as for example, a particular desired rate of return achieved from a particular level of asset risk, with stated levels of liquidity, within a stated time frame. Investment strategies are the methods utilized by a trustee or investment manager to achieve the investment objectives, as for example, a particular asset mix between equities and fixed income securities, a planned schedule of the maturity dates of

190. See SENATE COMM. ON FINANCE, 94th Cong., 2d Sess., BANK TRUST STOCK HOLDINGS: RESPONSES TO FINANCIAL MARKETS SUBCOMMITTEE QUESTIONNAIRE *passim* (Comm. Print 1976) (Question 11 and responses thereto). See also Merrión, *At Long Last, Word from Washington on What is 'Prudent,' Pensions and Investments*, Sept. 13, 1976, at 1, col. 1, and 45, col. 5; Gordon, *Textile Workers Pension Fund Master Craftsman*, 12 PENSION WORLD 68, 80 (1976).

191. ERISA, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975).

bonds, certificates of deposit, or short term government securities to meet identifiable cash flow needs. Well-articulated objectives developed from a thorough review of plan characteristics and needs can provide the basis for effective communication between plan sponsors¹⁹² and other fiduciaries as well as serve as the basis for reviewing a plan's investment performance.

1. *The Nature of the Plan*

As noted earlier, employee benefit plans subject to ERISA range from the corporate or multiemployer defined benefit plan to small profit-sharing and stock bonus plans or myriad welfare benefit plans with benefits ranging from hospitalization payments to training or educational funds.¹⁹³ These different types of plans often will have distinctly different objectives.

For example, an apprenticeship, training, educational, or vacation fund which expends most of its assets during the course of a year would not be likely to accumulate large reserves which might benefit from long term professional management. On the other hand, a mature corporate pension fund with significant asset accumulations which can be expected to be the source of defined benefit payments to retirees over the course of many years should review investment alternatives which would be consistent with the liquidity and safety needs of the plan and still produce a reasonable rate of return consistent with plan needs. For such a review, professional management is probably essential.

Similarly, a defined benefit pension plan¹⁹⁴ with a young work force, no unfunded liabilities, and a contribution level which is not a significant portion of corporate profits, could evaluate its tolerance to investment risks differently from a profit-sharing or other defined contribution plan with a significant number of vested participants who will be retiring in the near future and looking to their individual account balances as the source of retirement security. In the defined benefit plan, the amount of the pension benefit is fixed and is not directly related to the investment performance of the fund.¹⁹⁵ The employer is required to make sufficient contributions to meet ERISA's

192. A "plan sponsor" is the employer, employee organization, or the group of representatives who establish or maintain the plan. *Id.* § 3(16)(B), 29 U.S.C. § 1002(16)(B).

193. *See generally* U.S. Dep't of Labor Press Release No. 76-1403, Background Paper (Nov. 12, 1976).

194. ERISA, § 3(35), 29 U.S.C. § 1002(35) (Supp. V 1975) states: "The term 'defined benefit plan' means a pension plan other than an individual account plan" *Id.*

195. For further discussion, *see* Note, *supra* note 178, at 961-63. *See also* CHARTERED FINANCIAL ANALYSTS RESEARCH FOUNDATION, PENSION FUND INVESTMENT MANAGEMENT 27-52 (1969) [hereinafter cited as PENSION FUND MANAGEMENT].

minimum funding standards to enable the plan to meet its liabilities as they come due.¹⁹⁶ In the defined contribution plan, the amount of the employer's contribution is fixed while the pension benefit varies according to the plan's investment performance up to and including the point at which participants receive their distributions.¹⁹⁷ Therefore, the ultimate receipt of pension benefits depends upon the amount of the plan's assets allocable to the retiring employee.¹⁹⁸ These key differences between the plans originate from their fundamental design and result in differing dependence of both benefits and contributions upon the investment performance of the fund.¹⁹⁹ Such differences should be considered in the establishment of plan objectives.

2. *The Size of the Fund*

The amount of assets available for investment will play a significant role in determining plan objectives and strategies. For example, the asset base may determine whether a plan should consider a pooled investment fund or insurance account which can offer the type of broad diversification and flexibility that would not be achieved if the limited assets of a small fund were invested independently. On the other hand, a large fund may be able to design individual strategies more readily adaptable to that plan's objectives than a pooled investment vehicle. Moreover, the size of the asset pool may affect either the fund's ability to absorb short term losses or the ease with which primary holdings can be moved from one investment vehicle to another.

3. *Operating Expenses and Unfunded Liabilities*

Annual operating costs include current expenses such as investment and brokerage fees, actuarial, accounting, and legal fees, and administrative costs which are inherent in recordkeeping, reporting, and calculating and paying benefit claims. When these costs are combined with the contributions necessary to meet current annual funding requirements and the amortization of unfunded liabilities which may be spread over a period of thirty or forty years depending upon the type of pension plan involved,²⁰⁰ they directly affect the costs of maintaining a plan and the desired level of investment return. Although increased contributions are one available means of meeting escalating operating and funding costs, the plan's actuary can be called upon to

196. 29 U.S.C. §§ 1081-1085 (Supp. V 1975); see Note, *supra* note 178, at 962.

197. See Note, *supra* note 178, at 961.

198. See PENSION FUND MANAGEMENT, *supra* note 195, at 27-29.

199. See Note, *supra* note 178, at 962.

200. See ERISA, § 302(b)(2), 29 U.S.C. § 1082(b)(2) (Supp. V 1975).

calculate the rate of return on investments which, when combined with stated contribution levels, will meet the future funding and benefit needs of the plan. These calculations, which directly affect the type of investment strategy a fund may follow to produce the necessary return, will vary when comparing a fund with minimal unfunded liabilities against one with large unfunded liabilities.

4. *Liquidity Considerations*

The determination of a plan's current and future liquidity needs is one of the primary factors affecting its investment objectives and the type of investment strategy needed. Phrased in another way, the question is: "How much money must be available for benefit payments and operating costs, and when will it be needed?"

There are many diverse factors which must be weighed in determining a plan's liquidity needs. These factors include the work force characteristics normally considered by an actuary in calculating funding needs, such as the age profile of the work force, expected employee turnover, the ratio of active to retired lives in defined contribution plans, and projections for work force expansion or contraction. Additional factors which affect the amount of available reserves necessary to make benefit payments will include the amount and stability of contributions and the percentage of the sponsor's total corporate income required to meet contribution requirements. For example, the rapidly increasing financial needs of a plan may be met more easily by increased employer contributions if the plan's sponsor has a healthy balance sheet and is in a capital intensive rather than a labor intensive industry; in those circumstances, pension contributions would not be a significant drain on net assets.

The relationship between contribution levels and benefit payments can impact upon the need for short term cash or liquid reserves, thereby dictating certain investment behavior. For example, if a multiemployer pension plan is operating so that current benefit payments, and those for the next five-year period, can be met by incoming contributions, there will be a stable reserve of assets which may be invested under a long term strategy. However, if significant asset withdrawals are necessary to cover benefit payments, the plan's assets cannot be tied up in investments which can be liquidated only by taking a significant investment loss. Other factors, such as the age profile of those workers covered by the plan, the projections for stable or increasing contribution levels based upon steady or increasing employment in the industry, or projections of the need for benefit increases to meet inflation or labor

market competition, all affect the plan's available amount of money and the time frame during which it will be available for investment purposes.

Additional factors affecting the need for reserves include projections of the economic strength of the sponsoring employer, industry growth patterns, and the relative strength of the parties in a collectively bargained plan which may be the subject of impending contract negotiations. An example that demonstrates the impact of economic or industry trends is the compound pressure that multiemployer welfare plans often face during periods of high unemployment in the covered work force. Not only do contributions diminish as employment decreases, but plans often experience increased benefit demands when workers are in layoff status, unable to make contributions, but nonetheless taking advantage of health and welfare benefits.

Each of these considerations will influence the direction and level of asset flow in employee benefit plans. Therefore, in setting investment objectives and implementing those objectives, the maturity date, mix, and liquidity characteristics of asset holdings will be dictated by liquidity needs which must be considered if the plan is to produce a realistic return on invested plan assets and still be able to make benefit payments.

B. *Retaining a Professional Investment Manager*

After a thorough review of plan characteristics and needs has been completed, one of the most important questions facing many employee benefit plans is whether it is necessary or desirable to obtain professional investment advice and whether to designate an investment manager under section 402(c)(3) of ERISA.²⁰¹ As noted earlier, if the plan has a limited pool of assets, and if those assets are expended without being held for an appreciable period of time, short term government obligations, a savings account, or even a checking account for part of the fund may well be appropriate. Under such circumstances, sophisticated and costly professional investment services are not necessary. However, if a significant asset pool is available, and a greater return on assets consistent with plan needs would be possible through sound asset management, professional expertise should be made available to the plan.

201. Section 402(c)(3) provides: "Any employee benefit plan [may] provide — (3) that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan." 29 U.S.C. § 1102(c)(3) (Supp. V 1975).

In recent years, the investment management industry has become a major force in the financial sector of the economy.²⁰² In 1970, \$700 billion, or about one-fourth of the total national wealth, consisted of debt and equity securities held by institutional investors.²⁰³ This huge growth in investment assets has been paralleled by the growth of investment firms and professional managers.²⁰⁴ As more and more of our nation's private capital reserves are being held by private employee benefit plans, it is logical to expect that professional investment managers will be managing a significant percentage of the approximately \$200 billion in assets held by these plans.²⁰⁵

The question now is to what extent this trend will be encouraged by ERISA's provision that retaining a qualified investment manager,²⁰⁶ consistent with the plan's authorizing provisions, will relieve the plan trustees of day-to-day responsibility for investment decisions,²⁰⁷ so long as the investment manager is prudently selected and retained. An added impetus behind a movement toward professional investment managers could be found in the elimination of exculpatory clauses and the opening of the federal courts to participants and beneficiaries who wish to challenge the actions of plan fiduciaries.²⁰⁸ However, the mere desire to shift responsibility and ultimate liability for investment decisions should not overshadow the basic issue of whether the plan's characteristics (and the available time and expertise of the plan fiduciaries) suggest the need for professional advice. In this area of plan operations, as well as all others involving the discharge of fiduciary obligations, a fiduciary must act "solely in the interest of the participants and beneficiaries and . . . with the care, skill, prudence, and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use"²⁰⁹ Therefore, if a review of the plan's characteristics and needs indicates that professional investment advice would be in the best interests of the plan, and can be afforded, a prudent course under ERISA suggests that such assistance should be sought.

Once the threshold decision has been made that a professional investment manager should be retained, the process of selecting an appropriate manager is a key aspect of the plan fiduciary's obligations.

202. See *Hearings on Investment Policies of Pension Funds Before the Subcomm. on Fiscal Policy of the Joint Economic Comm.*, 91st Cong., 2d Sess. 218 (1970) (Statement of David L. Babson) [hereinafter cited as *Hearings on Investment Policies*].

203. *Id.*

204. See *id.* at 224-25.

205. See N. TURE, *supra* note 3, at 19.

206. ERISA, § 405(c), 29 U.S.C. § 1105(c) (Supp. V 1975).

207. *Id.* § 405(d), 29 U.S.C. § 1105(d).

208. See notes 151-63 and accompanying text *supra*.

209. ERISA, § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975).

This selection process involves a review of such questions as: Can the prospective investment manager effectively manage this type of fund? Are the manager's organization and investment philosophies consistent with the needs of the plan? Certain investment managers have reputations as being stronger in the equity area than in the fixed income area,²¹⁰ or vice versa, and while a number of managers can perform well under varied investment plans, plan fiduciaries should satisfy themselves that the particular manager selected has performed well under similar investment plans, has a sound organization with adequate resources and capitalization, and has a well-conceived management structure for handling investment accounts. Considerations which can affect these judgments include past performance as some indication of the return a manager may be able to achieve on the plan's assets. However, prior percentages are meaningless without comparative data on the objectives and strategies used to achieve those results. Although selection based upon prior performance has gained some support of late, there has been some sound criticism of its predictive value.²¹¹ A better measurement of a manager's past performance would be that manager's track record for meeting the stated objectives of clients. Fund managers must be cognizant of the fact that their performance will be measured by their ability to achieve results consistent with the plan's stated objectives. An organization's ability to execute professionally, to adapt its behavior to the needs of the client plan, and to resist many of the shortrun competitive pressures which may be inconsistent with plan objectives are even more important than records of raw percentage yields in the past.²¹²

C. *Establishing Investment Objectives and Strategies*

1. *The Planning Process*

Once it has been decided that a professional investment manager should be retained, and such selection has occurred, the process of charting the plan's basic investment objectives should begin. The participants in this process should include the plan sponsor or trustees, the actuary, and the investment manager. The plan's legal counsel also can play an appropriate role in this process if used as a resource by the other participants. However, at this stage, counsel should be

210. See *Top 50 Performers in Equity and Fixed Categories*, Pensions and Investments, Sept. 13, 1976, at 11, col. 1.

211. See Walton, *Pension Funds Sharpening Approaches in Selecting Right Investment Manager*, 13 INT'L FOUNDATION DIG. 10 (1976). The author notes that a recent Canadian study indicates that the practice of selecting investment managers on the basis of past performance has many pitfalls. *Id.* Top quartile performers in 1974 came from the bottom quartile performers of 1969. *Id.*

212. Finally, cost should be considered in determining whether the plan is obtaining competitive rates, although "bargain" rates may well point out weaknesses in support operations which are necessary to produce sound performance.

careful not to distract the planners from the development of sound investment objectives, drawn from the characteristics and needs of the plan. Well-conceived investment objectives should be reviewed in light of ERISA's standards, so that potential problem areas can be identified. But legal issues should not be the starting point for developing original objectives.

The degree of interaction between plan sponsors and investment managers during the objective-setting process varies considerably between particular plans and particular managers. On balance, however, ERISA's requirements that a plan contain "a procedure for establishing and carrying out a funding policy and method consistent with the objectives of the plan and the requirements of [ERISA]," and that fiduciaries prudently manage plan assets consistent with plan objectives and needs²¹³ suggest that the plan fiduciaries can not abdicate this responsibility by retaining an investment manager. Investment managers may well face litigation challenging investment results which were achieved by adherence to deficient objectives set by plan sponsors. Therefore, both parties must be involved in the objective-setting process.

2. *Desired Rate of Return and Risk Tolerance*

Two of the key components in developing investment objectives and deciding upon an acceptable investment strategy to achieve them are the interrelated concepts of desired rate of return and risk tolerance. Traditional theory indicates that risk is often viewed as the premium investment or price that must be paid for the opportunity to obtain an increased rate of return.²¹⁴ Although a detailed discussion of the theoretical relationship between risk and return is beyond the scope of this article,²¹⁵ many of the commonly recognized aspects of risk include the possibility of deterioration in the underlying value of the asset, the degree of fluctuation in asset value (volatility), and the risk that the return on an investment will not achieve the predicted level of return as a result of such factors as common inflation.²¹⁶

213. ERISA, § 402(b)(1), 29 U.S.C. § 1102(b)(1) (Supp. V 1975).

214. See, e.g., Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604, 1607-08 (1971).

215. For further discussion of this relationship, see generally H. MARKOWITZ, *PORTFOLIO SELECTION* (1959); D. PETERSON, *FINANCIAL RATIOS AND INVESTMENT RESULTS* (1974); W. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* (1970). For less mathematical analyses, see *FINANCIAL ANALYSTS' HANDBOOK I: METHODS, THEORY, AND PORTFOLIO MANAGEMENT* (S. Levine ed. 1975); J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* (1973).

216. Hayes, *The Multi-Dimensional Aspects of Risk*, 2 J. OF PORTFOLIO MANAGEMENT 23 (1976); Kennedy, *The Risks of More Give than Take*, 2 J. OF PORTFOLIO MANAGEMENT 15 (1976).

As plan objectives are being developed, a necessary rate of return is determined which will meet the plan's projected funding needs (including funding for projected benefit increases) when combined with an acceptable or fixed level of contributions over the time frame being analyzed. For example, a plan may decide that it is willing to sacrifice a certain portion of a potential long term rate of return in order to obtain a more limited level of volatility in the value of the fund's assets and, consequently, a more predictable level of contributions for meeting funding needs. Such a plan may decide that its characteristics and needs indicate that preservation of assets, combined with limited volatility in asset value and predictable contribution levels are consistent with its funding and liquidity needs; a reduced rate of return on assets may be acceptable for such protection and stability. On the other hand, a plan that has made a reasoned decision to combat the effects of increasing inflation over a long term period by seeking a higher rate of return may turn to investment vehicles such as equity securities which historically have produced a higher return, but which also have a history of higher volatility.²¹⁷

Equity securities have become the most popular investment vehicle today. Even with recent stock market performance which has produced increased interest in fixed income securities, equities still comprise 63% of private plan holdings.²¹⁸ The pattern of greater returns on common stocks over fixed income investments has caused a shift to common stocks.²¹⁹ In the recent past, debt securities have slightly outperformed common stock, but over extended periods (and assuming no adjustment for risk), equity investments have performed considerably better than fixed income investments.²²⁰ Equities also are viewed as a better hedge against inflation.²²¹

In translating the foregoing general propositions into strategies for achieving return at the chosen level of risk, decisions are then made on a portfolio mix between equity, fixed income investments, and other investment vehicles such as real estate, mutual funds,²²²

217. *Hearings on Investment Policies*, *supra* note 202, at 222-23; see P. DIETZ, PENSION FUNDS: MEASURING INVESTMENT PERFORMANCE 31-43 (1966); PENSION FUND MANAGEMENT, *supra* note 195, at 75-80.

218. N. TURE, *supra* note 3, at 20.

219. *Hearings on Investment Policies*, *supra* note 202, at 223; PENSION FUND MANAGEMENT, *supra* note 195, at 53.

220. *Id.*

221. *Id.*

222. Straus, *Investing Through Mutual Funds*, 1 EMPLOYEE BENEFITS J. 14 (1975).

pooled investment accounts,²²³ index funds,²²⁴ options,²²⁵ and guaranteed return contracts. From historical data based upon a time frame of fifty years or less, studies of the performance of common stocks, bonds, and government securities can be done to indicate the *probabilities* of expected returns for portfolios either with different asset mixes or different components within asset mix.²²⁶

As noted earlier, the prudence standards contained in ERISA were enacted with an appreciation of the fact that many of the statutory principles drew upon common law concepts.²²⁷ Nevertheless, the courts are expected to interpret the prudent man rule "bearing in mind the special nature and purposes of employee benefit plans"²²⁸ and recognizing the wide diversity between plans in terms of size, purpose, and characteristics.²²⁹ Because of these diverse characteristics and purposes, no single set of investment objectives is universally applicable which ensures compliance with ERISA's standards of prudence.

Employee benefit plan assets are being managed in a marketplace that has accepted modern portfolio theory, which focuses upon the relationship among the individual investments comprising a portfolio. This theory rejects the notion that a trustee's or investment manager's performance should be measured solely by the riskiness of a single investment, without regard to that investment's relationship to other

223. CONFERENCE REPORT, *supra* note 49, at 305.

224. Babson, *Index Funds: Why Throw in the Towel?*, 2 J. OF PORTFOLIO MANAGEMENT 53 (1976). See also Langbeim & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUNDATION RESEARCH J. 1; Langbeim & Posner, *The Revolution in Trust Investment Law*, 62 A.B.A.J. 887 (1976). For a rebuttal to the Langbeim and Posner thesis, see Humbach & Dresch, *Prudence, Information, and Trust Investment Law*, 62 A.B.A.J. 1309 (1976).

225. Options are contracts which entitle the holder to purchase or to sell a given quantity of stock for a set price before a definite date in the future. H. FILER, UNDERSTANDING PUT & CALL OPTIONS 18-19 (1966). The attractiveness of options is a consequence of the limited amount of money which must be spent in comparison to the underlying security. The premium on an option is generally 10% of the value of the underlying stock. Note, *Prudence in Trust Investments*, 8 U. MICH. J.L. REF. 491, 517-18 (1975). The issue here is whether these techniques have a role to play in modern portfolio construction. Viewed in terms of a total portfolio theory, use of these vehicles for certain plans might be prudent. For example, these techniques may produce no current income, because the underlying security may be "owned" by another party if the plan has purchased a call; however, the writing of a call does produce an immediate source of return through "premium."

226. See Ibbotson & Sinquefeld, *Stocks, Bonds, Bills and Inflation: Year-by-Year Historical Returns (1926-1974)*, 49 J. BUS. U. CHI. 11 (1976); Ibbotson & Sinquefeld, *Stocks, Bonds, Bills and Inflation: Simulations of the Future (1976-2000)*, 49 J. BUS. U. CHI. 313 (1976). For simulations with regard to differing components within asset mix, see generally D. PETERSON, FINANCIAL RATIOS AND INVESTMENT RESULTS (1974).

227. See notes 73-75 and accompanying text *supra*.

228. CONFERENCE REPORT, *supra* note 49, at 302.

229. Klevan, *supra* note 185, at 152, 153 & nn.5a & 7.

asset holdings in the portfolio.²³⁰ This analysis recognizes that to the extent that particular assets or categories of assets react differently (an inverse relationship) to the same economic, market, or political conditions, the volatility of the portfolio as a whole has been reduced. Therefore, when a trustee or investment manager is called upon to account for the prudence of his investment actions, a consideration of the construction of the entire portfolio must be an integral part of the analysis rather than an isolated examination of individual investments.

This total portfolio approach to measuring prudent investment behavior is not consistent with some state law precedent involving trusts other than employee benefit trusts. As the New York Court of Appeals decision in *Bank of New York v. Spitzer*²³¹ would indicate, state courts faced with personal trust suits will often turn to common law precedents, which place emphasis on individual investments. In determining the impact of the New York case, however, it should be noted that *Spitzer* involved a personal trust, and that the court's language concerning the emphasis on individual investments was dicta.²³² Furthermore, the ultimate decision was favorable to the trustee because the court recognized that "hindsight" and the standard of "investment infallibility" were improper tests.²³³ As the earlier discussion indicates, common law trusts which do not have the continuing contribution, tax qualification, and other distinguishing characteristics of employee benefit trusts cannot provide an appropriate analytical structure for measuring prudence under ERISA. If that case were followed, it would result in a direct frustration of the legislative intent underlying ERISA, which stressed the unique nature and purposes of employee benefit plans.²³⁴

3. *Achieving Appropriate Diversification*

Considerations of diversification are integrally related to questions of risk and volatility. The guidelines for appropriate diversification under ERISA are not susceptible to fixed percentages which will apply to all plans. The factors to be considered, which are set forth in the Conference Report²³⁵ and closely parallel the standards con-

230. Cohen, *supra* note 214, at 1609-11; Note, *supra* note 178, at 970.

231. 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974).

232. *Id.* at 515, 323 N.E.2d at 703, 364 N.Y.S.2d at 168.

233. *Id.* at 516, 323 N.E.2d at 704, 364 N.Y.S.2d at 169; see Klevan, *supra* note 185, at 155 n.16.

234. See Klevan, *supra* note 185, at 155.

235. See note 49 *supra*.

tained in the *Restatement*,²³⁶ include the following: "(1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity."²³⁷ When these considerations are translated into operating guidelines, they indicate that an unreasonably large proportion of the plan assets should not be tied up in a single security, or in securities dependent upon the success of one company, industry, or the conditions in one locality. In addition, maturity dates should be staggered if the liquidity needs of the plan indicate different periods of cash demands.²³⁸

Consistent with the general importance placed upon flexibility throughout the fiduciary provisions of ERISA, the Conference Report explicitly states that in deciding on a diversification policy, "a prudent fiduciary must consider the facts and circumstances of each case."²³⁹ This means that the differing size, purpose, and current characteristics of individual plans will produce different criteria for appropriate diversification.²⁴⁰

4. *Investment Time Frames*

The time frame within which an investment strategy is implemented directly affects notions of liquidity, achievable rate of return, asset mix, diversification, and other components in the investment process. Returning to examples discussed earlier,²⁴¹ a welfare plan such as a training or vacation fund which expends most of its annual contributions during the course of a year has a short time horizon that will limit the types of investments which would be consistent with its cash flow requirements. On the other hand, a defined benefit pension plan covering a young work force, with contributions which can be expected to exceed benefit payments well into the future, has greater flexibility in selecting assets which can be held for long term growth and return potential. Likewise, real estate holdings, long term mortgages, or deposit contracts which include penalties for short

236. See RESTATEMENT (SECOND) OF TRUSTS § 228, Comment b (1959).

237. CONFERENCE REPORT, *supra* note 49, at 304.

238. The diversification aspects of pooled funds, mutual funds, and insurance contracts were considered during the legislative process. The diversification rule is to be applied to these pooled investment mechanisms by examining the diversification of the underlying investments in the pool. Therefore, a plan could be invested wholly in an insurance annuity contract on the assumption that an insurance company's assets are to be invested in a diversified manner. CONFERENCE REPORT, *supra* note 49, at 305.

239. *Id.* at 304.

240. *Id.*

241. See text accompanying notes 193-94 *supra*.

term withdrawals would be more consistent with this latter plan's needs than with the needs of the vacation or training trust. When short time horizons are involved, the liquidity of widely traded equities offers an opportunity to dispose of assets more readily. This feature would then be balanced against the prospect that sale of a security at an inopportune time could produce an undesirable loss. Thus, when a plan sponsor is developing its investment objectives with an investment manager, the time frame for investments *and* for evaluating the manager's performance is an integral component of the process and one which must be agreed upon between the parties.

5. *Statement of Objectives*

As discussed above, during the process of setting a plan's investment objectives, the participants will be discussing desired rates of return, risk, liquidity, diversification, and investment time frames. The entire effort, however, can be lost or greatly attenuated unless the final step in the process is the development of a written statement of investment objectives, agreed to by the plan sponsor and investment manager, to clarify the responsibilities of the parties and the applicable standards of performance. The plan sponsor and investment manager should conclude the process with a clear understanding of such issues as:

1. The rate of return sought through management of the assets;
2. A general statement of the risk tolerance for the plan;
3. The scope of the manager's discretion to acquire and hold particular kinds of assets, and to determine the amounts;
4. The time frames for measuring performance;
5. The procedures which will be used to monitor and evaluate performance.

D. *Measuring Investment Performance*

As important as objectives and manager selection are to sound asset management, the ongoing process of monitoring the performance of plan trustees or designated investment managers lies at the core of the fiduciary responsibility for managing plan assets.²⁴² Fulfilling this fiduciary obligation requires periodic reviews of investment performance to determine if original objectives have been achieved and whether any modifications in underlying plan objectives or investment

242. See BOGERT, *supra* note 165, at § 685. A trustee, upon taking office, either by receipt of the trust property from the settlor or executor owes the trust the duty of examining the trust property "for the purpose of ascertaining whether it corresponds in kind and amount with that which ought to be delivered." *Id.* The trustee also owes the duty of examining and checking the investments periodically. *Id.* § 685, at 355.

strategies are warranted. In order to achieve the limitation of liability contemplated by section 405(d) of ERISA,²⁴³ the named fiduciary must not only act prudently in choosing an investment advisor but also must act prudently and in the best interests of the plan in maintaining a proper review of the investment manager's performance.²⁴⁴ The evaluation process can draw upon varying standards in gauging the performance of the investment manager.²⁴⁵ Some commentators have accepted the performance of one pension plan relative to other plans as a relevant criterion.²⁴⁶ However, the differences between plans render most such comparisons superficial.²⁴⁷ The comparative method of evaluation is weakened by the dissimilar investment objectives among plans, differences in investment timing, investment philosophies, ability to absorb risk, varying dates of plan inception, size, funding posture, liquidity needs and financial condition of the sponsor. Meaningful interfund comparison can be made only if quantitative data is supplemented with information concerning fund objectives and philosophies, to ensure that similar plans are actually being compared.²⁴⁸ Comparison with other investment managers also creates pressure to perform in the "short run," which may not be advantageous to long term planning. If professional money managers are called upon to outperform other money managers, it can create a preoccupation with day-to-day results and inhibit the rational implementation of a plan's objectives.

Undue reliance on established stock indices as a measure of a manager's performance should also be suspect. Again, such comparisons neither gauge relative risks taken to achieve particular results nor consider certain factors in a plan's makeup which either demand a higher return or a more conservative yield than the Standard and Poors' 500.

The cornerstone for reviewing the investment performance of a manager or plan should be the original investment objectives established for the plan in question. Investment managers should be evaluated on their ability to meet these stated objectives and goals

243. ERISA, § 405, 29 U.S.C. § 1105 (Supp. V 1975).

244. See CONFERENCE REPORT, *supra* note 49, at 301.

245. See generally McCandlish, *Some Methods for Measuring of a Pension Fund*, FINANCIAL ANALYSTS J. 105 (1965). For example, compound of return measures whether the fund would have been better off being deposited in a savings bank or an insurance company. Average return relates total earnings to a base investment. Another technique measures performance in terms of the trend of a fund's market value.

246. See *id.* at 109.

247. See PENSION FUND MANAGEMENT, *supra* note 195, at 116.

248. *Id.*

rather than on a superficial review of recent market activity or the average performance of other investors. In addition, it is important to evaluate performance results so that interim, long term, and full composite results can be reviewed against the time frames in the original investment objectives. This step makes it possible to determine whether year-end performance levels are low because of one poor quarter or whether mediocre year-long results were improved by a flurry of good luck and high activity in the last quarter of the reporting year.

Similarly, an attempt should be made to determine whether the net result was achieved by broad participation of the asset holdings or whether a few isolated high return investments lifted the net performance level of the portfolio. These and other types of information can aid in evaluating the actual management of an account. Also, the investment manager should be challenged to explain, in understandable terms, the *reasons* behind particular results. Were they attributable to unusual economic or market conditions, an unrealistic original expectation for investment return, or the turnover that was necessary to restructure a portfolio for which the manager recently assumed responsibility? These and other factors should be assessed in deciding how successful the manager has been, whether consideration should be given to changing managers, or whether current investment policies should be revised.

The key to an effective monitoring of professional investment managers is a procedure which ensures that the plan sponsor or trustee controls the nature, timing, and content of the reviews. A "slick overview" or complicated report which confuses or buries real performance results is of little help to the fiduciaries seeking to discharge their obligations to the plan, its participants, and beneficiaries. It also does little to capitalize on the investment manager's expertise, which can be helpful in reexamining underlying plan objectives.

VII. CONCLUSION

Much of the emphasis under ERISA is on the *procedures*²⁴⁹ which should be followed in properly managing assets or selecting and monitoring investment managers. This emphasis is based upon the fact that sound management of employee benefit plan assets and proper fiduciary conduct under ERISA's prudent man rule are tied

249. Many of ERISA's key provisions place emphasis on *procedures within which* different courses of action may be pursued. For example, "procedure" for establishing a funding policy is required by section 402(b)(1), and the "procedure" for ~~permitted~~ allocation of responsibilities must be in the plan pursuant to section 402(b)(2). See ERISA, § 402(b)(1), (2), 29 U.S.C. § 1102(b)(1), (2) (~~Supp. VI-1975~~).

to a standard which focuses upon 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."²⁵⁰

Prior to the adoption of ERISA, investment policy was found in state statutes, case law, and trust instruments. The fact that an investment was on a "legal list" raised a strong presumption that the investment was sound.²⁵¹ However, the ERISA prudent man standard has effectively eliminated "legal lists" for employee benefit plan investments. Standard rules to fit all plans are not consistent with ERISA's purposes. ERISA contemplates a diversity of plans, with a standard of prudence that reflects the differences between plans.

The relevant factors under ERISA are not whether a plan performed better than most plans, but instead whether the needs of the plan and its participants and beneficiaries were carefully determined; whether realistic investment objectives and strategies were developed to meet those needs; whether care was used in selecting, monitoring, and retaining a professional investment manager; and whether plan objectives and strategies were reviewed periodically for appropriate modification to meet changing circumstances. Because all plans are not identical, courts will have to recognize their differences in measuring compliance with these principles and assessing possible liability.

Similarly, the courts will be called upon to recognize modern concepts of portfolio management as they apply to employee benefit trusts, which are distinctly different from common law trusts. This should lead to the acceptance of the principle that each investment should be acquired and retained not only for its intrinsic qualities but also for its place in a plan's overall portfolio strategy. This result does not mean that speculation has been promoted by ERISA's prudent man standard. But neither does it mean that conservative investment strategies are mandated unless the characteristics and needs of the particular plan so dictate.

Governed by the circumstances prevailing at the time of the investment decision, fiduciaries cannot be held to an infallible standard. Unforeseen movements in the market should not result in instant liability. Nevertheless, ERISA's prudent man rule should prompt a heightened awareness of the need for careful attention to the management of plan assets. Prudent methodologies, practiced by different investment managers or plan trustees, will result in sound, but diverse, practices.

250. *Id.* § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

251. *See* text accompanying notes 164-89 *supra*.

The underlying rules governing fiduciary responsibility have not changed drastically with ERISA. However, some plans and investment managers will be required to take a more thoughtful and analytical approach to the manner in which plans are administered and assets are managed. In addition, documentation of the steps taken to develop sound and appropriate investment practices will be required. The major change in this area under ERISA is that the actions of fiduciaries will be reviewed and challenged more frequently. Access to the federal courts to enforce fiduciary standards has been granted to participants and beneficiaries;²⁵² fiduciaries have been made personally liable;²⁵³ and prospective plaintiffs have been given a statutory basis to recover attorneys' fees for bringing such actions.²⁵⁴

To estimate properly the impact of these new statutory responsibilities and remedies, it is helpful to bifurcate the analysis in determining whether fiduciaries have been exposed to increased liability under ERISA. The two components of the analysis are the likelihood of litigation challenging fiduciary conduct and the probability of ultimate substantive liability. It would appear that the probability of substantive liability has not increased significantly due to ERISA. Indeed, tempering common law precepts of prudence with a recognition of the nature of employee benefit plans and modern investment practices should produce more flexible standards for judging fiduciary conduct in managing plan assets. In assessing the likelihood of litigation challenging fiduciary conduct, however, it can be expected that the new statutory remedies and improved access to the courts will increase the probability of litigation, at least at the outset.

252. ERISA, § 502(a)(1), 29 U.S.C. § 1132(a)(1) (Supp. V 1975).

253. *Id.* §§ 405, 409, 29 U.S.C. §§ 1105, 1109.

254. *Id.* § 502(g), 29 U.S.C. § 1132(g).