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Plan Investments

Fiduciary Duties in an Age of Impact Investing

BY SUZANNE ROSS MCDOWELL

In recent years, managers of charitable organizations and pension plans have come under increasing pressure to adopt investment strategies that consider non-financial factors, such as environmental or corporate governance factors, or that further a moral, social, or political cause. Can pension plan and charity managers take into account non-financial factors when investing an organization's or plan's assets? Or do their fiduciary duties and other legal constraints require them to prioritize or focus solely on financial returns when evaluating investments?

The answer may be yes to both questions, depending on the circumstances, but the lines are far from bright. The appropriate action depends upon the type of organization, its purposes, the reasons for considering non-financial factors, and how the investment objectives relate to the organization's purposes.

This paper briefly describes what the term ''impact investing'' means, and then reviews how fiduciary duties applicable to managers of pension plan assets and charitable institution assets permit and restrict the use of nonfinancial factors in managing those assets. Key conclusions include:

- Trustees of qualified pension plans (and most public plans) may consider nonfinancial factors as part of their financial analysis but may not sacrifice financial returns in order to achieve a non-financial purpose.

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- Trustees and directors of charities have greater flexibility. They may adopt investment policies that require the managers to invest to maximize financial returns or may choose to adopt a policy that permits or requires the managers to select investments that seek attractive financial returns and further the organization's charitable purposes as well.

- However, the non-financial purposes that are furthered by a charity's investment must be related to the charitable purpose of the charity making the investment. Investments that further some general social good that is not related to a charity's mission are not permitted.

What Is Impact Investing?

Investment strategies that consider non-financial factors or causes can take many forms and are referred to by many different terms. Strategies may include: positive screens or negative screens (sometimes referred to as divestment); consideration of non-financial factors as part of investment analysis; or investments made for the purpose of furthering non-financial goals.

Impact investing is an umbrella term that is often used to describe all investments made with the intention to generate social and environmental impact alongside a financial return. It may include program related investments (''PRIs''); mission related investments (''MRIs''); socially responsible investments (''SRIs''); sustainable investments, investments that consider environmental, social and governance (''ESG'') factors; and economically targeted investments (''ETIs'').

It is easy to get lost in the dizzying array of impact investing acronyms. With the exception of PRIs, which are defined by tax law in the context of private foundations and discussed further below, none of these terms have legal definitions. IRC § 4944(c).

For purposes of this discussion, we divide investments into three groups based on the investment purpose:

- *Maximum Financial Returns Investing*: seeks maximum financial return consistent with risk without regard to non-financial considerations;
- *Mission Related Investing*: seeks attractive financial returns but non-financial impact as well—MRIs, SRIs, ESG, ETIs; and
- *Program Related Investing*: seeks primarily to achieve non-financial goals.

Pension Plan Investments

The Employee Retirement Income Security Act (ERISA) provides standards for investment of qualified plan assets and requires that such assets be placed in trust and managed by a trustee. 29 U.S.C. 1103. Trust law is the foundation of the ERISA fiduciary standards. 29 U.S.C. 1104 et seq. In general, under section 404 of ERISA, a fiduciary must (1) act solely in the interest of plan participants and their beneficiaries and with the exclusive purpose of providing benefits to them (the ''duty of loyalty''); and, (2) carry out their duties prudently; and follow the plan documents (unless inconsistent with ERISA) (the ''prudent person rule''). The duty of loyalty forbids a fiduciary not only from using plan assets for his or her personal interest but also from favoring the interests of a third party over the interests of a plan participant, even if the fiduciary's own interests are not implicated.

Public pension plans are not subject to ERISA. Most of them are trusts and are governed by trust law. Some state constitutions have relevant provisions as well. Under general principles of trust law, managers of public pension plans must invest the plan assets in a manner that is in the best interest of the beneficiaries. As a general rule, if managers of public pension plans comply with ERISA fiduciary standards, they will be in compliance with state law because the standards in ERISA are based on trust law.

The Department of Labor (''DOL'') has expressly considered whether a qualified plan trustee may consider non-financial facts in making investment decisions and has consistently taken the position that a manager may consider non-financial factors, but not at the expense of the plan's financial returns. In 1994, DOL first stated that fiduciaries of a retirement plan could consider ''collateral'' issues to the extent that they are relevant to an analysis of the expected financial return but non-economic factors cannot sacrifice financial yield. IB 94-1. This guidance emphasized that the financial returns and risk to beneficiaries must be paramount. In 2008, DOL revisited the issue and affirmed its 1994 legal analysis, but stated that consideration of non-economic factors should be ''rare and well documented.'' IB 2008-1.

This note of caution created concern among retirement plan fiduciaries. In response, DOL issued its most recent guidance on the topic in 2015 to ''correct a popular misperception at the time that investments in ETIs [economically targeted investments] are incompatible with ERISA's fiduciary obligations.'' IB 2015-1. The DOL guidance states: ''Consistent with fiduciaries' obligations to choose economically superior investments, the Department [of Labor] does not believe ERISA prohibits a fiduciary from addressing ETIs or incorporating ESG factors in investment policy statements or integrating ESG-related tools, metrics and analyses to evaluate an investment's risk or return or choose among otherwise equivalent investments.'' IB 2015-1.

Thus, managers of qualified pension plans must limit the plan's investments to those that fall within the category of ''maximum financial returns investing'' but may consider collateral factors to the extent that they affect financial returns. For example, there are studies that show that businesses with female CEOs outperform businesses in general. It appears that plan trustees, if they determined such studies are reliable, could consider whether a company has a female CEO as one factor in making an investment decision, because that factor contributes to the evaluation of the expected financial return from investments.

On the other hand, absent such studies or in the event that the trustees determined that the studies were flawed, plan trustees could not invest in companies led by female CEOs because they wanted to support female CEOs. Such a decision would violate the duty of loyalty in that it would favor the interests of female CEOs over the interests of the plan participants.

Another recent question for pension plans has been whether plan trustees should divest pension plans of investments in the fossil fuel industry. This was recently an issue in Montgomery County, Maryland, where I live. A bill introduced in the County Council would have required the trustees of the county's pension plan to divest the plan of investments in fossil fuel companies. In a written memorandum, the County Attorney noted that the language of the county statute is essentially the same as the language of ERISA and evaluated the bill under the standards of ERISA. The County Attorney concluded that the bill was not consistent with DOL guidance issued in 2015 because it required plan managers to divest based solely on ESG factors. *See* Memorandum from Marc P. Hansen, County Attorney, to Linda Herman, Executive Director, Montgomery County Employee Retirement Plans, dated November 15, 2016.

Pension plan managers should also keep in mind that consideration of non-financial factors may be complex in practice. Plan fiduciaries that consider non-financial factors must develop a reliable process for quantifying the projected effect of non-financial factors on an investment's performance. Processes for identifying, researching, and quantifying the effect of non-financial factors are not well established, although investment professionals are giving increased attention to this area and more data is being generated. Plan fiduciaries must also take care to manage the expense associated with incorporating non-financial factors into investment analysis. Consideration of non-financial factors may require an expansion of research and resources that drive up costs and thus reduce the financial return on an investment.

Charitable Organization Investments

The legal duties of fiduciaries of charitable organizations are found in state trust and nonprofit corporation law. While statutes vary from one state to another, as a general matter, all states impose upon charitable fiduciaries a duty of care and duty of loyalty, and some impose a duty of obedience. In general terms, the duty of care requires a trustee or director to first, take reasonable steps to be informed, and second, to discharge their duties in good faith with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. The duty of loyalty requires trustees and directors to act in good faith and in a manner the trustee or director reasonably believes to be in the best interests of the organization, rather than in his or her own interests or the interests of another entity or person. In those states that recognize a duty of obedience, a trustee is required to act in a manner consistent with the organization's stated purposes, as set forth in the corporation's organizational documents, and in compliance with law. Arguably, the duty of obedience is an element of the duties of care and loyalty.

The duty of care and the duty of loyalty have been incorporated into two uniform acts dealing specifically with fiduciary duties in the context of investing: the Uniform Prudent Investment Act (''UPIA''), which applies to charitable trusts, and the Uniform Prudent Management of Institutional Funds Act (''UPMIFA''), which applies to charitable corporations. UPIA has been adopted, at least in part, by 48 states and UPMIFA has been adopted by 49 states. Although different acts are applicable to charitable trusts and nonprofit corporations, the substance of the laws is essentially the same. These acts reflect the evolution of the prudent investor rule over time.

Under UPMIFA, management and investment decisions about an individual asset must be made in the context of the institutional fund's portfolio of investments as a whole, and as a part of an overall investment strategy, having risk and return objectives reasonably suited to the fund and to the institution. Fiduciaries must consider the following factors, *if relevant*: general economic conditions; the possible effect of inflation or deflation; the expected tax consequences, if any, of investment decisions or strategies; the role that each investment or course of action plays within the overall investment portfolio of the fund; the expected total return from income and the appreciation of investments; other resources of the institution; the needs of the institution and the fund to make distributions and to preserve capital; and an asset's special relationship or special value, if any, to the charitable purposes of the institution. UPIA, applicable to charitable trusts, similarly requires fiduciaries to consider numerous factors in evaluating investments.

Of particular relevance for this discussion is that fiduciaries may take into account ''an asset's special relationship or value to the institution's charitable purposes.'' The comments to UPMIFA state that ''a prudent decision maker can take into consideration the relationship between an investment and the purposes of the institution . . .in making an investment that may have a program-related purpose but not be primarily program-related.'' UPMIFA, Comment (e)(1). This commentary, as discussed below, provides support for mission related investments.

The fiduciary standards discussed above allow charitable organizations significant flexibility in determining the type of investment strategy that best serves the organization's mission. This is illustrated by applying the fiduciary standards to the three classes of investments described at the outset of this article.

Maximum Financial Returns Investing. **Some charities have adopted investment strategies that focus solely on maximizing financial return. Such strategies are entirely consistent with a fiduciary's duties. While these organizations do not necessarily eschew their responsibility for moral, social and political issues, they have concluded that they best serve their institutions needs by investing for maximum financial returns and seeking to advance moral, social and political issues through other means.**

For example, some top-tier universities, such as Stanford, the University of Pennsylvania, and the University of Denver have rejected student demands for the universities to divest investments in fossil fuel companies while recognizing that climate change is a serious issue and taking other initiatives intended to have an effect on climate change.

Similar to the rules that apply to pension plans, colleges and universities and other charitable institutions that do not seek to advance moral, social and political issues through investment policy may, nevertheless, consider such factors to the extent the fiduciaries conclude that they will not reduce the financial return compared to other investments or if they deem them relevant to evaluating the likely financial return from an investment.

For example, if an organization is seeking to invest in the energy sector, it may make an investment in a company that provides energy through wind turbines as an alternative source of energy if it concludes that that company will have a financial return as good as or better than a company that provides energy through fossil fuels. That is, the analysis of non-financial factors may be taken into account only insofar as they are relevant to the analysis of a proposed investment's financial performance or to the extent the fiduciaries conclude that they will not reduce the financial return compared to other investments.

Like pension plan managers, managers of charitable organization investments must also be cognizant of expenses associated with evaluation of non-financial factors. UPMIFA specifically requires that managers be attentive to costs and incur only those costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.

Unlike pension plans, however, charitable organizations are not required to adopt investment policies that maximize financial returns. As discussed below, under certain circumstances, a charitable organization may choose to forego financial return in order to further its charitable purposes.

Mission Related Investments. **As noted above, UPMIFA expressly permits fiduciaries to take into account "an asset's special relationship or value to the institution's charitable purposes." The comments to UPMIFA expand upon this statement, clarifying that charitable organizations may make investments that have a program-related purpose but are not primarily program-related." UPMIFA, Comment (e)(1). These are the investments that we have classified in group two under the name mission related investments—investments that further non-financial as well as financial objectives.**

The Internal Revenue Service has issued guidance that makes clear that private foundations can make mission-related investments. Federal tax law prohibits private foundations from making investments that jeopardize a private foundation's charitable purpose. IRC § 4944(a)(1). An investment jeopardizes the carrying out of a foundation's exempt purpose if ''foundation managers, in making such investment, have failed to exercise ordinary business care and prudence . . . in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.'' Reg. § 53.4944-1(a)(2)(i). Notice 2015-62 clarifies that foundation officers and directors may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Notice 2015-62, 2015-39 IRB 411 (09/15/2015). The Notice further states that fiduciaries that have exercised ordinary business care and prudence in making an investment that furthers a foundation's charitable purpose at an expected rate of return that is less than what the foundation might have obtained from an investment that is unrelated to its charitable purposes will not be subject to excise taxes under section 4944 for making a jeopardizing investment.

The critical point is that, if an investment sacrifices financial return in order to further a non-financial purpose, the non-financial objective and the non-financial factors that are considered must be related to the charitable purposes of the organization making the investment. For example, the University of Notre Dame endowment adheres to investing principles outlined by the US Conference of Catholic Bishops, which include a no-buy list of companies whose products, policies or charitable corporate giving support abortion, embryonic stem-cell research, contraceptives, or pornography. This is permissible because Notre Dame is a Catholic university and adheres to Catholic social teaching. On the other hand, an organization whose purpose is to protect endangered animals may not sacrifice return to adhere to Catholic principles because furthering Catholic social teaching is not related to its charitable purpose of protecting endangered animals.

An organization may also choose not to invest in assets that are inconsistent with, or detrimental to achievement of its mission. Thus, an organization engaged in cancer research may choose not to invest in tobacco companies. In practical application, however, determining whether an investment is mission-related can be challenging. While few would disagree that an organization engaged in cancer research may choose not to invest in tobacco companies because the link between smoking and lung cancer is considered well-established, it is less clear that an alcoholism treatment center should not invest in wine, beer and liquor companies because drinking alcohol is not the cause of alcoholism. Indeed, some studies suggest that moderate use of alcohol can be good for your health.

Program Related Investments. **Charitable organizations are also permitted to make investments for the primary purpose of serving their charitable purpose. Some uses of funds by charities are considered program expenditures rather than investments. UPMIFA defines a program related asset as an asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment. UPMIFA § 2(7). As such, these types of expenditures are not viewed as program expenditures, not investments, and are not subject to the prudent investor standard of UPMIFA.**

The IRS takes a similar approach to PRIs. For private foundations, a PRI is defined as an investment the primary purpose of which is to accomplish one or more of the foundation's exempt purposes, and no significant purpose of which is the production of income or appreciation in property. IRC § 4944(c). A PRI is a statutory exception to the definition of a ''jeopardizing investment.'' This type of investment often takes the form of a loan, equity investment, or a guarantee.

Although there is no analogous statutory provision, the IRS has provided guidance allowing public charities to invest in for-profit entities so long as the use of the funds is limited to charitable purposes. For example, the IRS ruled that investments by a public charity in businesses located in economically depressed areas were charitable activities, finding that the loans and equity investments at issue were ''not undertaken for purposes of profit or gain but for the purpose of advancing the charitable goals of the organization and [were] not investments for profit in any conventional business sense.'' Rev. Rul. 74-587.

Conclusion

In certain circumstances, a fiduciary may consider non-financial factors in selecting investments for charitable organizations and pension plans. Trustees of qualified pension plans may consider such factors only as part of their financial analysis and may not sacrifice financial returns in order to achieve a non-financial purpose. Although the laws applicable to public pension plans differ from one state or political subdivision to another, those laws are often similar to the rules applicable to qualified pension plans.

Trustees and directors of charitable organizations may also consider non-financial factors as part of their financial analysis. However, the manner in which they consider such factors will be determined by the investment policy developed by the charitable organization. If the charity's investment policy requires that investment managers maximize financial returns, the managers may consider non-financial factors only for purposes of evaluating the projected financial performance of an investment. On the other hand, a charity's investment policy may permit trustees and directors of charitable organizations to sacrifice financial returns in order to further the organization's charitable purposes. Thus, a charitable organization cannot select investments to achieve a broad social benefit unrelated to the charity's mission.

Finally, charitable organizations may make investments primarily for the purpose of accomplishing charitable purposes and without a significant purpose to produce income or have the investment appreciate in value. Such investments are considered program expenditures and are not subject to the standards imposed by laws governing investments.

