THE TIME HAS COME FOR A SUSTAINABLE THEORY OF FIDUCIARY DUTY IN INVESTMENT

By: Jay Youngdahl∗

I. INTRODUCTION

Trustees of pension and employee benefit funds today oversee trillions of dollars held on behalf of American workers.[1] In their efforts on behalf of their beneficiaries, these women and men are subject to an exceedingly strict set of legal fiduciary duties.[2] On the nature of this standard, the famous American jurist Benjamin Cardozo opined:

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[3]

While a number of different trust arrangements exist today, covered

∗ Jay Youngdahl is a partner in Youngdahl & Citti, P.C. He is a *Fellow*, College of Labor and Employment Lawyers, and a Visiting *Fellow* at the Initiative for Responsible Investment in the Hauser Center for Nonprofit Organizations at Harvard University. He represents a number of labor-affiliated benefit funds and is an Independent Trustee on the Middletown Works Hourly and Salaried Union Health Care Fund, which provides health insurance to nearly five thousand retired steelworkers and their families. He wishes to acknowledge the editorial assistance of Katie Grace and the research assistance of Cassie Haynes.

1. *See* Peter Brady, Sarah Holden, & Erin Short, *The U.S. Retirement Market, 2009*, RES. FUNDAMENTALS, May 2010, at 3 fig.1, *available at* www.ici.org/pdf/fm-v19n3.pdf. Globally, the monies accumulated for workers' benefits are extraordinarily large. Before the stock market decline in the last quarter of 2008, just one class of trust entity, defined benefit pension funds in the United States affiliated with unions or unionized public employers held assets in excess of $3 trillion. *Id*.

2. *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

3. *Id*. (citing Wendt v. Fischer, 154 N.E. 303, 304 (N.Y. 1926)).

by a variety of legal schemes, certain fiduciary duties form the bedrock in the world of trusts.[4] The legal responsibilities of a fiduciary include the foundational duties of loyalty and impartiality.[5] A fiduciary may not act in any way adverse or contrary to the interests of the beneficiary, from acting for her own benefit regarding certain subject matter to engaging in a fiduciary relationship that would result in a conflict of interest.[6] A trustee must avoid situations in which inherent strife could exist between the personal interests of the trustee and the interests of the beneficiaries.[7] Critical to the fiduciary relationship is the requirement of disclosure – a trustee must provide truthful and complete information to beneficiaries placing trust in her.[8] In their activities, all fiduciaries must exercise the entirety of their skill, care, and diligence when acting on behalf of a beneficiary.[9] A trustee must act with discretion when choosing whether to delegate authority and to whom and should spend money belonging to the trust only as necessary and in reasonable amounts that are properly within the scope of the fiduciary's investment responsibility.[10]

While the rigorous mandate to conform to these legal fiduciary duties has been a long-standing standard of trust law,[11] the definitional content of the investment function of this duty has been in constant evolution.[12] A close relationship exists between the strictures of the investment duty and changing societal conditions.[13] Thus, adherence to

4. Persons operating in a number of different spheres must adhere to fiduciary duties, yet the scope and meaning of such duties varies widely, often resulting in definitional ambiguity. As an example, corporate directors are subject to fiduciary duties, but those duties are less demanding than those in the trust context. Paddock v. Siemoneit, 218 S.W.2d 428, 431-32 (Tex. 1949). The fiduciary duties of corporate directors, for example, allow for significantly more flexibility than those that apply to benefit fund trustees, as "[a]cts which might well be considered breaches of trust as to other fiduciaries have not always been so regarded in cases of corporate officers or directors." *Id*. at 432. The result of these definitional difficulties is that any discussion of fiduciary duty must begin with an understanding of the description and demands of the particular legal form in which the duty arises.

5. *See generally* RESTATEMENT (THIRD) OF TRUSTS §§ 78, 79 (2007) (defining the duties of loyalty and impartiality, respectively). For commentary and case citations to these duties, see 1 AUSTIN WAKEMAN SCOTT ET AL., SCOTT AND ASCHER ON TRUSTS (5th ed. 2011).

6. RESTATEMENT (THIRD) OF TRUSTS § 78(2).

7. *Id*. § 78 cmt. b (stating that a fiduciary must refrain from conduct that "might be influenced by considerations other than the best interests of the beneficiaries").

8. *Id*. § 78(3).

9. *See* § 77(2) cmt. b.

10. *See* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. j (1992).

11. *See id*. § 227 cmt. b.

12. *See* Edward C. Halbach, Jr., *Trust Investment Law in the Third Restatement*, 77 IOWA L. REV. 1151, 1154-55 (1992).

13. *See id*. at 1154.

fiduciary duty is ironclad,[14] but the substance of the investment duty has always been malleable.[15] The authors of the Restatement (Third) of Trusts acknowledged this two decades ago when they wrote that "[t]rust investment law should reflect and accommodate current knowledge and concepts. It should also avoid repeating the mistake of freezing its rules against future learning and developments."[16]

Given the ethical and financial gyrations of the recent past, as well as the crisis in retirement security of America's workforce, it is time to reexamine the composition of the fiduciary duty regarding the investment function. As will be detailed below, serious ferment is present in the "science" of investing today; flaws are acknowledged by all, and many argue this theory of investing has been incompatible with productive investment in the conditions that exist today.[17] Yet, in spite of the recognition of these shortcomings, many lawyers continue to blissfully counsel their trustee clients that a strict adherence to a "Wall Street model" of investing, known as Modern Portfolio Theory, is the only way to comply with fiduciary duty in investment.[18] The advice is given in spite of the absence of significant supporting legal authority.[19] The apocryphal line that is often repeated in the field is that such lawyers tell trustees that the trustees will be sued and "lose their house" if they deviate from the Wall Street model.[20]

While it is beyond the scope of this article to thoroughly define a new investment theory to replace the current flawed Wall Street standard or to completely formulate a revised theory and application of the legal

14. *See* § 227 cmt. b.

15. *See* Halbach, *supra* note 12, at 1154.

16. RESTATEMENT (THIRD) OF TRUSTS ch. 17, intro. note (2007).

17. *See* Ben McClure, *Modern Portfolio Theory: Why It's Still Hip*, INVESTOPEDIA (Jan. 7, 2010), http://www.investopedia.com/articles/06/MPT.asp.

18. *See, e.g.*, William G. Droms, *Fiduciary Responsibilities of Investment Managers and Trustees*, FIN. ANALYSTS J., July-Aug. 1992, at 58, 62 (stating that in measuring prudence "[a]n expert portfolio manager would be expected to manage a portfolio within the context of modern portfolio theory").

19. *See id.* at 63 (noting that the law's interpretation of prudence has yet to incorporate modern investment theory and practice).

20. In general, a trustee is liable for losses if there is a breach of duty. Hogg v. Walker, 622 A.2d 648, 653 (Del. 1993). Specifically:

> If the trustee commits a breach of trust, he is chargeable with (a) any loss or depreciation in value of the trust estate resulting from the breach of trust; or (b) any profit made by him through the breach of trust; or (c) any profit which would have accrued to the trust estate if there had been no breach of trust.

RESTATEMENT (SECOND) OF TRUSTS § 205 (1959). The Department of Labor ("DOL") has the ability to levy a monetary fine against a trustee in an ERISA regulated fund for a breach, and certain common law legal remedies may be available as well for aggrieved beneficiaries.

conception of fiduciary duty in investing, the time has come to begin this project. Given the effects of their decisions on the overall economy that boomerang toward their beneficiaries, American trustees who otherwise comply with all aspects of their fiduciary duties must be free, without fear of personal liability, to heed concepts of financial and social sustainability, long-term investment return measurement, and ecological limits to growth. As the reporter for the American Law Institute ("ALI") wrote at the time of the publication of the Restatement (Third) of Trusts, "expert trustees [must be liberated] to pursue challenging, rewarding, non-traditional strategies when appropriate to a particular trust."[21] Duties to beneficiaries demand no less.

II. A BRIEF HISTORICAL OVERVIEW OF AMERICAN LAW OF TRUSTS

This article covers fiduciary duty as it applies to trustees who sit on the boards of employee benefit funds. Trusts in general, and benefit fund trusts in particular, come in many shapes and sizes. Funds that provide retirement security to older workers receive much attention today, given their accumulated assets and political issues involving retirement payments to public workers.[22] However, employee benefit funds cover not only retirement obligations, but also other workplace-related functions such as health care and training activities.[23]

It is important to note that the foundation of the duties of trustees in these modern funds began long ago.[24] Thus, to understand the evolutionary nature of the concept of the fiduciary duties of trustees and the needs of these trustees today, a short historical digression into the rich past of trusts is useful. Simply put, a trust is an entity in which money or property is held and managed on behalf of another.[25] The

21. Halbach, *supra* note 12, at 1155. The American Law Institute ("ALI") is composed of leading lawyers, law professors, and judges with experience in the subject area. *ALI Overview*, AM. L. INST., http://www.ali.org/index.cfm?fuseaction=about.overview (last visited Jan. 6, 2012).

22. *See generally* Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 852-55 (1987) (discussing the income security of older retired workers, focusing on the Social Security program itself, employer-provided pensions, and individual savings, and stressing a unified view of retirement security policy which considers interrelationships, confluences, and potential conflicts between retirement security and tax policy concerns).

23. *See* GEORGE GLEASON BOGERT ET AL., BOGERT'S TRUSTS AND TRUSTEES § 255 (6th ed. 2000) (providing an overview and analysis of the various types of employee benefit plans, including their funding and various components).

24. *See* Avisheh Avini, *The Origins of the Modern English Trust Revisited*, 70 TUL. L. REV. 1139, 1140-42 (1996).

25. *Definition of Trust*, THE AM. HERITAGE DICTIONARY OF THE ENGLISH LANGUAGE,

word "fiduciary" originates from the Latin words "fides" and "fiducia," meaning faith and trust.[26] The first trusts reminiscent of their present form are said to have been established around the time of the Middle Ages.[27] In an attempt to protect and preserve his wealth while fighting a war, a knight would transfer the legal ownership of his estate to a close friend or another third party.[28] Those involved understood that the ownership of the property would revert back to the knight upon his return.[29] Transferring the legal title allowed the third party to effectively manage the property and enforce the rights of the estate against all others in the knight's absence.[30]

Critical to the trust is the separation between legal ownership and equitable ownership.[31] This particular divide has its origins in the English courts.[32] Legal ownership was recognized and enforced through the common law courts, while the courts of equity recognized and enforced the equitable ownership.[33] Today, the same court generally enforces both interests; however, the two concepts remain distinct.[34] The difference between the two concepts is relatively simple:

> The legal owner of the trust, the "trustee," retains the right to possession, the privilege of use and the authority to transfer those rights and privileges. In the eyes of the rest of the world, the trustee looks like the owner of the property. That is to everyone except the person or persons for whom the money is held – the "beneficiary," the beneficial owner.[35]

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http://ahdictionary.com/word/search.html?q=trust&submit.x=38&submit.y=36 (last visited Jan. 6, 2012).

26. *Definition of Fiduciary*, LAW.COM, http://dictionary.law.com/Default.aspx?selected=744&bold= (last visited Jan. 6, 2012).

27. BETTY LINN KRIKORIAN, FIDUCIARY STANDARDS IN PENSION AND TRUST FUND MANAGEMENT 5 (1989). The history has been traced back even further to Roman and Salic law, and precursors of modern trusts can be found in Islamic law. *See* Avini, *supra* note 24, at 1141.

28. ALASTAIR HUDSON, EQUITY AND TRUSTS 41-42 (6th ed. 2010).

29. *Id*. at 42.

30. *Id*.

31. *See id*.

32. KRIKORIAN, *supra* note 27, at 5.

33. *See id*.

34. *Id*.

35. Jay Youngdahl, Address at the Harvard Law School Program for Advanced Trustee Studies: Fiduciary Duty: Challenges to the Traditional View 5 (July 28, 2010), *available at* http://hausercenter.org/iri/wp-content/uploads/2011/01/Youngdal_Fiduciary-Duty.pdf. Under the Uniform Trust Code ("UTC"), applicable in certain states, the term "beneficiary" is defined as "a person that: (A) has a present or future beneficial interest in a trust, vested or contingent; or (B) in a capacity other than that of trustee, holds a power of appointment over trust property." UNIF. TRUST

Beneficiaries retain the equitable title of trust assets and are the recipients of the benefits of the trust property.[36]

In 1822, Farmers' Fire Insurance and Loan Company became the first institution chartered in the United States in the business of trusts.[37] Within the next ten years, "[c]orporate trusts developed . . . to help raise money for new business ventures."[38] In the subsequent decades, more institutions became involved in the trust business, and many had independent departments entirely dedicated to trust services.[39] Interestingly, the next major expansion of the use of trusts came in relation to the regulation of affairs of Native Americans.[40] In 1906, Congress passed the Burke Act, which was "intended to accelerate the assimilation of the Indians by truncating the length of the trust period and benefits derived therefrom for Indians determined to be competent."[41] While the Act primarily affected American Indians and their real property rights, statutory changes in this area also enabled banks to serve as trustees.[42] In response, over one thousand banks offered trust services by 1921.[43] In the 1940s, in the aftermath of the Great Depression, employment benefit trusts became exceedingly popular.[44] Over time, concerns about their implementation and use arose, prompting Congress to pass the Employee Retirement and Income Security Act of 1974 ("ERISA")[45] that codified the general responsibilities of trustees managing certain funds.[46] Trust activity continued to grow, and by the early 1980s, more than eighty percent of

CODE § 103(3) (amended 2004), 7C U.L.A. 413 (2000).

36. BLACK'S LAW DICTIONARY 1622 (9th ed. 2009).

37. H. PARKER WILLIS & GEORGE W. EDWARDS, BANKING AND BUSINESS 335 (1922), *available at* http://chestofbooks.com/finance/banking/Banking-And-Business/index.html. The first important American case defining the duties of trustees was decided around this time. Harvard Coll. v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

38. *Trusts and Trustees*, REFERENCE FOR BUS.: ENCYCLOPEDIA OF BUS., 2D ED., http://www.referenceforbusiness.com/encyclopedia/Thir-Val/Trusts-and-Trustees.html#b (last visited Jan. 6, 2012).

39. *Id*.

40. *See* Burke Act, ch. 2348, § 6, 34 Stat. 182, 182-83 (1906) (codified as amended at 25 U.S.C. § 349 (2006)).

41. Cnty. of Thurston v. Andrus, 586 F.2d 1212, 1219 (8th Cir. 1978).

42. *See* 25 U.S.C. § 161 (2006).

43. Eugene N. White, *Banking Innovation in the 1920s: The Growth of National Banks' Financial Services*, *in* 13 BUSINESS AND ECONOMIC HISTORY 92, 96 (Jeremy Atack ed., 1984), *available at* http://www.h-net.org/~business/bhcweb/publications/BEHprint/v013/p0092-p0104.pdf.

44. JAMES A. WOOTEN, THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974: A POLITICAL HISTORY 45 (2004).

45. Pub. L. No. 93-406, 88 Stat. 829 (codified as amended at 29 U.S.C. §§ 1001-1461 (2006)).

46. *Id*.

workers with private retirement plans had defined-benefit plans.[47]

ERISA attempted to synchronize the concept of fiduciary duty along with other parts of the administration of employee benefits law for private sector benefit trusts.[48] However, similar types of public entities operating in the various states were subject to different conceptions of fiduciary duty in investment.[49] In response, in 2000 the National Conference of Commissioners on Uniform State Laws ("NCCUSL") made the first attempt to codify these common law practices regarding American trusts and estates into a uniform statutory code, the Uniform Trust Code ("UTC").[50] As of 2011, over twenty states have adopted some substantive form of the UTC.[51] The UTC was enacted subsequent to the Uniform Prudent Investor Act ("UPIA"), another model statute that NCCUSL drafted.[52] As of 2008, all but five states have adopted some form of the UPIA.[53]

III. TWENTIETH CENTURY EVOLUTION OF THE CONCEPT OF FIDUCIARY DUTY IN INVESTMENT AND THE ASCENDENCY OF MODERN PORTFOLIO THEORY

While the application of any definition of fiduciary duty in investment must be rigorous and unbending as Judge Cardozo observed, the concept itself has gone through a number of iterations. However, when considering its meaning for the trustee investing function, as with

47. *See* WOOTEN, *supra* note 44, at 277-78.

48. *See id*. at 257-58.

49. *See id*. at 258-59.

50. *See* UNIF. TRUST CODE § 102, 7C U.L.A. 411 (2000) (defining the scope of the Code).

51. *Legislative Fact Sheet – Trust Code*, UNIFORM L. COMMISSION, http://www.nccusl.org/legislativefactsheet.aspx?title=trust%20code (last visited Jan. 6, 2012).

52. *See* UNIF. PRUDENT INVESTOR ACT, 7B U.L.A. 16 (1994). Under the UPIA, if a legal question arises concerning the exercise of a trustee's fiduciary duty, it is the trial court's responsibility to decide whether a trustee has acted with prudence regarding investments. 76 AM. JUR. 2D *Trusts* § 477 (2005). In evaluating the suitability of any investment decision, a fiduciary should take into consideration several factors, including: the monetary value of the trust, the circumstances of the beneficiaries, the price trend and current cost of living, inflation and deflation, the marketability of the investment, and potential tax consequences. *Id*.

53. Ken Ziesenheim, *Guidelines for Advisors on the Uniform Prudent Investor Act*, THORNBURG INVESTMENT MGMT., http://www.thornburginvestments.com/research/articles/upia_aicpa_jan2008.asp (last visited Jan. 6, 2012). For an interesting view of the UPIA, see MATT TAIBBI, GRIFTOPIA 139-41 (2010). In addition, many state legislatures have promulgated legislation that regulates practices and activities of pension funds in their states. However, it must be observed that for purposes of the arguments herein, in spite of these diverse legal frameworks, differences in conceptions of fiduciary duty in investment between ERISA and non-ERISA covered funds are seldom crucial.

the interpretation of the U.S. Constitution over the last two and one-half centuries, new facts and situations lead to new analysis of seemingly simple legal phrases.[54]

Prior to the adoption of the "Prudent Investor Rule" with its relation to Modern Portfolio Theory, fiduciary duties looked very different.[55] In 1959, the Restatement (Second) of Trusts, a book of legal precedents produced by ALI, contained the "Prudent Man Rule" as a definitional guide to investment decisions.[56] This rule required trustees to invest trust assets as a "prudent man" would invest his own estate.[57] This standard was a significant alteration of rules that had lasted for decades, which often stated that investments of trusts could only be made in "safe" financial instruments, such as U.S. government bonds.[58] Under the Prudent Man Rule, a trustee must take into consideration the needs of the beneficiaries, the needs of the principle, and the amount and reliability of the income.[59]

The investment duty as defined under this Prudent Man Rule would be hardly recognized today. For example, the Restatement (Second) of Trusts described the following as improper investments:

> (1) purchase of securities for purposes of speculation, for example, purchase of shares of stock on margin or purchase of bonds selling at a great discount because of uncertainty whether they will be paid on discount because of uncertainty whether they will be paid on maturity; (2) purchase of securities in new and untried enterprises; (3) employment of trust property in the carrying on of trade or business; (4) purchase of land or other things for resale.[60]

54. *Compare* RESTATEMENT (THIRD) OF TRUSTS § 227 (1992) (defining the general standard of prudent investment), *with* Droms, *supra* note 18, at 63 (suggesting that legal definitions have yet to catch up with the developments in modern investment).

55. *See generally* Halbach, *supra* note 12, at 1151 (noting that among ALI's advisory group, "there was a solid consensus that supported fundamental revision of the so-called 'prudent man rule' as formulated in the original and second versions of the Restatement of the Law of Trusts and in traditional prudent-man doctrine" in most states).

56. *See id*. at 1152.

57. *Id*. (citing RESTATEMENT (SECOND) OF TRUSTS § 227 (1959)).

58. *See* W. Brantley Phillips, Jr., Note, *Chasing Down the Devil: Standards of Prudent Investment Under the Restatement (Third) of Trusts*, 54 WASH. & LEE. L. REV. 335, 340-41 (1997).

59. RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. e. The recognized overarching principal behind this rule is that a trustee must "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but 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." Harvard Coll. v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).

60. RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f.

A look at the investment portfolio or any large state public employee benefit fund today will reveal scores of investments that would be violative of the Prudent Man Rule.[61] Portfolios make all manner of bets on speculative securities, junk bonds, stock in start-up companies, property investments, and even the purchase of entire shaky enterprises.[62]

In 1992, ALI issued the Restatement (Third) of Trusts recognizing the contradiction between "modern" practices of investment management of trust assets and the dictates of the Restatement (Second) of Trust.[63] The previous Prudent Man Rule of the Restatement (Second) of Trusts of 1959 unduly limited the investments of trustees, subjecting them to liability if they invested in impermissible investment vehicles.[64] The judges, academics, and lawyers of ALI found that the definition of the duty in their previous volume conflicted with "modern asset-management practices."[65] The Restatement (Third) of Trusts enshrined adherence to Modern Portfolio Theory, it came to be believed, as the revised test of loyalty to proper fiduciary duty in investment.[66] Benefit

61. *See* Leslie Joyner Bobo, Comment, *Nontraditional Investments of Fiduciaries: Re-Examining the Prudent Investor Rule*, 33 EMORY L.J. 1067, 1080 (1984) (discussing the modern, nontraditional approach to investment, which promotes "the pursuit of [an] investment strategy that deviates from the conventional objectives of maximizing return and preservation of the corpus").

62. *See* Alec Sauchik, Note, *Beyond Economically Targeted Investments: Redefining the Legal Framework of Pension Fund Investments in Low-To-Moderate Income Residential Real Estate*, 28 FORDHAM URB. L.J. 1923, 1931 (2001) (discussing the use of risky investment techniques, such as speculative securities, junk bonds, and property investments, after ERISA was passed). In addition, all types of derivatives of investment vehicles are purchased with trust funds, including such inscrutable products as structured investment vehicles and synthetic collateralized debt obligations ("CDOs"). *See* Christopher J. Miller, Note, *"Don't Blame Me, Blame the Financial Crisis": A Survey of Dismissal Rulings in 10B-5 Suits for Subprime Securities Losses*, 80 FORDHAM L. REV. 273, 292-93 (2011) (discussing lawsuits that arose from the widespread use of derivatives of investment vehicles with trust funds, especially with CDOs). Many such investments failed during the crisis of 2008 and are the subject of litigation today. *See, e.g.*, Abu Dhabi Commercial Bank v. Morgan Stanley & Co., 651 F. Supp. 2d 155, 165 (S.D.N.Y. 2009) (addressing defendants' motion to dismiss plaintiff's claims of fraud for defendants' use of structured investment vehicles).

63. *See* Halbach, *supra* note 12, at 1153 (describing "[t]he need for modernization and clarification of the prudent man rule . . . evidenced by modern trends in both state and federal legislation, theoretical and empirical research, and a large and growing body of professional literature").

64. *See id*.

65. *See id*. at 1153-54.

66. *See id.* at 1164. While Modern Portfolio Theory was enshrined into the legal duty of a fiduciary in 1992 in the Restatement (Third) of Trusts, it had been the subject of vigorous debate and growing acceptance in the investment community for over fifteen years. In 1977, just after a particularly difficult investment period from 1973-1974, MPT was considered a "revolution," and it was argued that MPT proved that previous investment strategies were "inefficient, illogical, ill-conceived and frequently erroneous." PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE

trustees were counseled to use techniques that had been considered forbidden just a few years before.[67]

Thus today, "[t]he trustee is under a duty to the beneficiaries to invest and manage the funds of the trust as a prudent investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."[68] In the investment activities in which a trustee participates, she must employ "reasonable care, skill, and caution."[69] Today's common standard often evaluates prudence by assessing the actual volatility of return, or "risk," as it is commonly referred to in economic literature, with respect to the proper level of such risk for a specific investment portfolio.[70] In this vein, "a fiduciary is required to diversify the investments of the plan so as to minimize the risk of large losses."[71]

However, in spite of this seemingly crystal clear responsibility of the trustee, as well as three decades of adherence to what was considered the scientific law of investment, MPT, the meaning of the concept of fiduciary duty in the investment context is in ferment today. As Keith Johnson and Frank Jan de Graaf, two practitioners and theoreticians in this area, write, "[m]any assumptions underlying the way economists, policymakers, and regulators have traditionally viewed pension systems no longer apply."[72] Given the link between financial theory and fiduciary duty in investment, if the critics of MPT are correct, the foundation for the operative definition of fiduciary duty in investment must be reexamined as well.

IV. CRITICISM OF MODERN PORTFOLIO THEORY

The mighty revolution in investment theory, Modern Portfolio Theory, which was seemingly an "end of history" moment, has proven to be far from perfect in practice. Like the effect on the existing

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ORIGINS OF MODERN WALL STREET 256 (1992).

67. *Compare* RESTATEMENT (SECOND) OF TRUSTS § 227 cmt. f. (1959) (outlining specific improper trust investments), *with* RESTATEMENT (THIRD) OF TRUSTS § 227 cmt. f. (1992) (explaining that specific investments are never per se imprudent).

68. RESTATEMENT (THIRD) OF TRUSTS § 227.

69. UNIF. PRUDENT INVESTOR ACT § 2(a), 7B U.L.A. 20 (1994).

70. *See, e.g.*, DiFelice v. U.S. Airways, Inc., 436 F. Supp. 2d 756, 766 (E.D. Va. 2006) (describing low, moderate, and high risk portfolios).

71. SUSAN P. SEROTA & FREDERICK A. BRODIE, ERISA FIDUCIARY LAW (Susan P. Serota & Frederick A. Brodie eds., 2d ed. 2006). In addition, under this "whole portfolio" approach, "the standard of prudence applies to each investment as a part of the total portfolio." *Id*.

72. Keith L. Johnson & Frank Jan de Graaf, *Modernizing Pension Fund Legal Standards for the Twenty-First Century*, ROTMAN INT'L J. OF PENSION MGMT., Spring 2009, at 44, 44.

investment theory in the difficult 1973-74 investing environment that helped lead to the adoption of MPT, the recent financial difficulties have exposed major flaws in today's predominant theory of investing and risk aversion. In 2009, Professor Paul Woolley wrote that "[m]uch has come to pass in financial markets during the last ten years that has been at odds with the prevailing academic wisdom of how capital markets work."[73]

Paradoxically, like other areas in which a dominant paradigm pushes out all others, certain harmful unintended consequences have become clear.[74] Steve Lydenberg of Domini Social Investments wrote the following:

> [T]he dominant theory of investing today, Modern Portfolio Theory, is based on a definition of success that fails to acknowledge the extent to which investments at the portfolio level can affect the overall financial markets. In particualr, its techniques for controlling risk at the portfolio level—diversification, securitization, and hedging—can actually increase market-level risks to the of finance and the economy as a whole. In addition, the benefits that accrue from the practice of this theory are at best part of a zero-sum game and available to only a limited number of investors. In addtion the more investors that adopt its practices, particularly risk-control techniques, the less likely these practices are to succeed. Reform of this theory is not sufficient. Alternatives are needed.[75]

Lydenberg further argues that the chase for more and more return, the holy grail of MPT, has led to "increasing systemic risk through the increase of the supply of, and demand for, risky products."[76] Core concepts of risk failed in the onslaught of the financial crisis, an

73. Paul Woolley, *Why are Financial Markets so Inefficient and Exploitative – and a Suggested Remedy*, *in* THE FUTURE OF FINANCE 121, 121 (2010), *available at* http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter31.pdf.

74. Examples include problems associated with widespread use of common antibiotics that have resulted in viruses that are immune to these medicines or the burgeoning problems associated with certain herbicides and pesticides that result in unwelcome chemically resistant weeds and plants. *See* Kenneth Todar, *Bacterial Resistance to Antibiotics*, THE MICROBIAL WORLD (2009), http://textbookofbacteriology.net/themicrobialworld/bactresanti.html.

75. STEVE LYDENBERG, BEYOND RISK: NOTES TOWARD RESPONSIBLE ALTERNATIVES FOR INVESTMENT THEORY 2 (2009), *available at* http://www.unpri.org/files/Lydenberg_PRI2009.pdf.

76. LYDENBERG, *supra* note 75, at 15. Lydenberg is the Co-Founding Director of the Initiative for Responsible Investment in the Hauser Center for Nonprofit Organizations at Harvard University. *Steve Lydenberg Profile*, THE HAUSER CENTER FOR NONPROFIT ORGS. AT HARV. U., http://www.hks.harvard.edu/hauser/people/steve-lydenberg/ (last visited Jan. 6, 2012).

environment in which they were predicted to succeed.[77] While MPT advocates the advantages of a portfolio in which different asset classes behave differently, the underlying standard that they use encourages copycat behavior. This "lemming" standard "makes [t]rustees hesitant to try new approaches for fear of being different" and thus subject to personal jeopardy.[78] Even its advocates admit that certain types of risk that were powerfully operative in the crash of 2008 are not included in MPT.[79] One of the fathers of MPT, Harry Markowitz, has acknowledged its limitations in light of the financial crash, stating:

> Systematic risk, due to beta, does not diversify away; unsystematic risk does.
>
> . . . .
>
> This does not mean that individual securities are no longer subject to idiosyncratic risks. It means, rather, that the systematic risk swamps the unsystematic risk during [a crisis].
>
> . . . .
>
> . . . MPT never promised high returns with low risk. You pays your money and you-takes your choice.[80]

Further problems are evident. "Short-termism" skews the duties trustees have to beneficiaries.[81] The fundamental role of all benefit

77. *See* LYDENBERG, *supra* note 75, at 15-16.

78. Youngdahl, *supra* note 35, at 12.

79. *See id*. at 9.

80. Harry M. Markowitz, *Crisis Mode: Modern Portfolio Theory Under Pressure*, FIN. PROFS.' POST (June 8, 2010), http://post.nyssa.org/nyssa-news/2010/06/crisis-mode-modern-portfolio-theory-under-pressure.html. The current debate within the professions of economics and finance is ferocious. The author famous for his theory of "Black Swans," Nassim Taleb, argues that economics is akin to medieval medicine: "Medicine used to kill more patients than it saved – just as financial economics endangers the system by creating, not reducing, risk." Nassim Nicholas Taleb, *The Pseudo-Science Hurting Markets*, FIN. TIMES, Oct. 23, 2007, http://www.fooledbyrandomness.com/FT-Nobel.pdf.

81. Further, basing fiduciary duty on MPT, and short term results alone, belies the depth of the concept of fiduciary duty. Trustees have duties that are both legal and moral, including a duty of loyalty and a duty of care. They occupy this position to serve their beneficiaries. Of course, moral stances are complex enterprises, but in the area of pension funds, the core is that providing for a secure retirement for our participants affirms the transcendent worth of human beings. The dignity of the human person includes the ability to live one's retirement years in a safe and secure financial situation. Religious figures in all faiths have noted the moral position both of being in a fiduciary relationship with others and in the way that money is invested. Pope John Paul II wrote in

funds is to provide benefits for the worker participants over a long-term horizon.[82] These funds are invested in order to protect and build upon the assets necessary to pay off benefit liabilities that stretch out for years in the future, making nearly all funds long-term investments.[83] Yet, the actual practice of MPT investing leads to a fetishistic focus on quarterly results.[84] According to John Bogle, the former leader of the Vanguard Investment Company, there is a "dominance of a culture of short-term speculation over a culture of long-term investment."[85] Mainstream financial professions have recognized this.[86] The Centre for Financial Market Integrity, an arm of the CFA Institute that regulates many financial professionals, has recognized that "the obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance."[87] Even the Business Roundtable criticized "short-termism" in 2006, defining it as "excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation."[88]

In tracing the history of the relationship of pension funds, corporations, and investing, Thomas Croft argues that "a pension fund may actually harm its beneficiaries if it focuses on maximizing share

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the Papal Encyclical, *Centesimus Annus*, that investment "is always a moral and cultural choice." Encyclical Letter from Pope John Paul II, (May 1, 1991), *available at* http://www.vatican.va/holy_father/john_paul_ii/encyclicals/documents/hf_jp-ii_enc_01051991_centesimus-annus_en.html. John Wesley, founder of the Methodism, wrote, "Gain all you can, without hurting either yourself or your neighbor, in soul or body." John Wesley, *The Use of Money*, GLOBAL MINISTRIES, http://new.gbgm-umc.org/umhistory/wesley/sermons/50/ (last visited Jan. 6, 2012). Certainly this is an aspect of fiduciary duty that cannot be ignored.

82. *See generally* Dallas L. Salisbury, *Benefit Trends: Change is Now Constant*, WALL ST. J. (2008), http://online.wsj.com/ad/employeebenefits-benefit_trends.html (describing employee benefit trends and the ways in which employees pay into benefit funds).

83. *See id*.

84. *See* DEAN KREHMEYER ET AL., BREAKING THE SHORT-TERM CYCLE 3 (2006), *available at* http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2006.n1.4194 (describing the actions corporate managers take in order to reach "quarterly earnings number[s]," such as cuts in research, asset sales, and avoidance of strategic investments).

85. John C. Bogle, *The Clash of Cultures*, J. OF PORTFOLIO MGMT., Spring 2011, at 14, 23.

86. *See id*. at 22-24 (acknowledging that mutual funds, index funds, and the scientific and technological industries have recognized this trend).

87. DEAN KREHMEYER ET AL., *supra* note 84, at 1.

88. *Id*. at 3.

value on a firm-by-firm basis."[89] Yet, this type of analysis is at the bedrock of the application of MPT. For example, Croft argues:

> [T]he fund's equity portfolio may decline in aggregate value when the companies it holds work to increase their profits by imposing external costs on and withholding external benefits from each other. Such short-term strategies hurt a "universal shareowner" such as a large public pension fund that holds equity in thousands of firms, owns bonds and real estate, and whose beneficiaries have interests not only as indirect stockholders but also as "stakeholders" – employees, consumers, and citizens.[90]

MPT has given trustees, financial advisors, and their lawyers a false sense of security. Peter L. Bernstein, the foremost chronicler of the investment theory of MPT has written, "Perhaps the most remarkable feature of these ideas is the indomitable power of their influence on investment decisions, even though the theories failed to survive a batter of empirical testing."[91] As John Bogle has argued, slavish adherence to the theory is inappropriate as the touchstone in any analysis of the proper exercise by a trustee of fiduciary duty in investment:

> The modern quantitative and econometric techniques developed in the last generation have given investors and portfolio managers a new sense of confidence in the ability to forecast financial trends and behaviors. By compiling and analyzing historical data, and by building models that take into account current variables, econometricians often try to predict the movement of interest rates, stock prices, inflation, unemployment, and so on. During times of

89. THOMAS CROFT, UP FROM WALL STREET: THE RESPONSIBLE INVESTMENT ALTERNATIVE 28 (2009).

90. *Id*. The question of the proper application of fiduciary duties in the trustee investment function is not only important for the direct provision of benefits for the fund beneficiaries, but also for capital for the global economy, considering the provision of benefits has grown so large. Professors James Hawley and Andrew Williams have argued that these funds "own the economy" in the sense of the importance of the capital that they provide for economic activity in the national and world economy. JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 100 (2000). For additional information on this view, see ROBERT A.G. MONKS & NELL MINOW, WATCHING THE WATCHERS: CORPORATE GOVERNANCE FOR THE 21ST CENTURY (1996) (exploring the significance of the trust investment function on the world economy). Further, today such funds are major and active players in the ownership and control of the modern corporation. Their action or inaction has the possibility to affect the global economy and thus the investment and political milieu in which their funds exist. Therefore, the operation of the trust investment function, especially for larger funds, has direct as well as indirect effects as to the assets held on behalf of beneficiaries.

91. PETER L. BERNSTEIN, CAPITAL IDEAS EVOLVING, at xviii (2007).

> financial euphoria and investor panic, however, these techniques become virtually worthless. The reason is fairly simple: The vast majority of models rest on assumptions about normal and rational financial behavior. But during market manias, logical and analytical minds do not prevail. Such markets are driven more by hubris, elation, fear, pessimism, and the like—emotions that the current models do not, and perhaps cannot, compute . . . .[92]

Finally, the argument can be made that adherence to MPT does more harm than good and, in fact, betrays beneficiaries. In light of the enormity of the bank bailout of 2008 and the continuing large compensation paid to bank executives, academics have begun to argue that investing in such banks is a violation of the fiduciary duty of a pension fund trustee.[93] Nassim Taleb, author of *The Black Swan* and a professor at New York University, recently wrote, with a co-author:

> Why does any investment manager buy the stocks of banks that pay out very large portions of their earnings to their employees?
>
> . . . .
>
> Why do portfolio and pension-fund managers hope to receive impunity from their investors? Isn't it obvious to investors that they are voluntarily transferring their clients' funds to the pockets of bankers? Aren't fund managers violating both fiduciary responsibilities and moral rules? Are they missing the only opportunity we have to discipline the banks and force them to compete for responsible risk-taking?[94]

Those who defend the status quo often criticize this kind of "negative screening."[95] However, given the sacrosanct duty of trustees to their beneficiaries, arguments like Taleb's deserve to be respected.

92. *See* Bogle, *supra* note 85, at 24 (quoting HENRY KAUFMAN, ON MONEY AND MARKETS 303-25 (2001)).

93. *See* Nassim Nicholas Taleb & Mark Spitznagel, *The Great Bank Robbery*, PROJECT SYNDICATE (Sept. 2, 2011), http://www.project-syndicate.org/commentary/taleb1/English.

94. *Id*. Additionally, "[t]he Dodd-Frank Wall Street Reform and Consumer Protection Act directed [the Government Accountability Office] to conduct a one-time audit of the emergency loan programs . . . authorized by the Board of Governors of the Federal Reserve System (Federal Reserve Board) during the recent financial crisis." *Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance*, U.S. GOV'T ACCOUNTABILITY OFF. (July 21, 2011), http://www.gao.gov/products/GAO-11-696. This report found that outstanding loans to banks and other financial institutions topped $1 trillion in late 2008. *Id*.

95. *See* Youngdahl, *supra* note 35, at 23.

Thus, blind adherence to MPT no longer appears to be sufficient in fulfilling a trustee's true investment duties to beneficiaries in the real world of the marketplace.[96] Current conceptions of fiduciary duty need to reflect this reality.[97] Given this landscape and the cacophony of the critics, how can business as usual in investing be considered prudent activity for those who exercise stringent fiduciary duty on behalf of fund beneficiaries?

V. FERMENT IN THE LANDSCAPE OF THE FIDUCIARY DUTY IN INVESTMENT

In reaction to this landscape, political and regulatory ferment has erupted. The locus of the most major conflicts involving allowable investment activities can be found in the area subject to ERISA.[98] Pursuant to this statute, the DOL has issued a number of pieces of guidance that are essentially political in nature, cautioning against certain activities in trustee investments.[99]

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96. Due to changes in the investment landscape, the fiduciary duty that normally attaches to investment professionals who serve fund trustees has eroded, making trustee investment activity even more crucial. *See* Bogle, *supra* note 85, at 22. Bogle wrote, "The idea that fund officials 'act as fiduciaries, with an eye single on the best interests of fund shareholders' has now been totally discredited." *Id.* (quoting MATTHEW FINK, THE RISE OF MUTUAL FUNDS: AN INSIDER'S VIEW 258 (2011)). Speaking of the investment area he knows best, Bogle wrote:

> Ever since its provisions were enacted into law more than 70 years ago, the federal Investment Company Act of 1940 has demanded that funds be "organized, operated, and managed" in the interest of shareholders rather than fund managers and distributors. But those provisions have been ignored, lost in the dustbin of history. Paradoxically, it was only a short time after the 1940 Act became law that the industry's culture, balanced in favor of stewardship before that standard was enacted, began to shift soon thereafter toward a balance in favor of salesmanship. In the decades that followed, the interests of fund shareholders became subservient to the interests of fund managers, and the fund industry largely became just another consumer products marketing business.

Id. An example of this tension can be seen in the recent backtracking by the DOL, in the face of industry resistance, over their clarification of the reach of fiduciary status to cover certain investment professionals. *See* Youngdahl, *supra* note 35, at 21.

97. *See* Halbach, *supra* note 12, at 1154. Halbach and his fellow drafters seemed to recognize the likelihood of further refinements in the duty:

> The prudent investor project was undertaken with a clear recognition that trust investment law should reflect and accommodate current knowledge and concepts in the financial community. While seeking to incorporate the lessons of modern experience and research, a scrupulous effort was made to avoid either endorsing or excluding particular theories of economics or investment. In addition, an important objective in drafting the prudent investor rule was to preserve the flexibility necessary for the incorporation of future learning and developments.

Id.

98. *See* Youngdahl, *supra* note 35, at 5.

99. *See, e.g.*, 29 C.F.R. § 2550.404a-1 (1979) (outlining factors to be considered when

Prior to the passage of ERISA in 1974, policymakers had become increasingly concerned with the lack of federal regulation of employee pension plans.[100] ERISA is a powerful statute as it preempts or supersedes "any and all State laws insofar as they . . . *relate to* any employee benefit plan [covered by ERISA]."[101] ERISA does not mandate the establishment of pension plans nor does it require a minimum level of benefits; instead, it controls the administration of a pension or employee benefit plan once it has been established.[102] For example, ERISA provides, *inter alia*, that each employee benefit plan shall, in its basic plan document, identify the name of fiduciaries.[103] Further, ERISA defines the requirements a fiduciary must meet in order to satisfy a fiduciary duty in investment.[104] For example, ERISA contains the "prudence" requirement that a fiduciary must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[105]

Much of the basis of this dispute concerns activities of private sector labor-affiliated benefit plans.[106] Authorized by the Taft-Hartley Amendments to the National Labor Relations Act, multi-employer pension and other benefit plans involving unionized employers take the

determining whether the fiduciary duty of an investor is satisfied). *See also* Johnson & de Graaf, *supra* note 72, at 50 n.12 (stating that investment practices that are not compliant with ERISA include "excessive investment herding behaviors, obsession with short-term performance and inattention to systemic risks").

100. *See* Thomas M. Griffin, *Investing Labor Union Pension Funds in Workers: How ERISA and the Common Law Trust May Benefit Labor by Economically Targeting Investment*, 32 SUFFOLK U. L. REV. 11, 31-34 (1998) (stating that expansion of pension plans in the 1950s resulted in widespread abuse, and in response, Congress promulgated various legislation, including ERISA, which was enacted to protect employee pension plans).

101. 29 U.S.C. § 1144(a) (2006) (emphasis added). *See also* Cal. Div. of Labor Standards Enforcement v. Dillingham Const., Inc., 519 U.S. 316, 324-25 (1997) (stating that a state law relates to an ERISA-covered plan if the law specifically refers to such a plan, "acts immediately and exclusively upon" the plan, or if the plan's existence "is essential to the law's operation"). The extent of this relationship remains an unsettled issue in the United States and is sure to be subject to judicial scrutiny in the near future.

102. *See* Griffin, *supra* note 100, at 34.

103. 29 U.S.C. § 1102(a).

104. *See* Griffin, *supra* note 100, at 34-40 (describing fiduciary duty of loyalty, duty to be prudent, and duty of impartiality as ERISA's fiduciary duties of investment).

105. 29 U.S.C. § 1104(a)(1)(B). This phrase from the statute highlights the definitional issue discussed above. The description comports with a "prudent investor" standard, yet uses the "prudent man" language. *See id*.

106. *See* Paul M. Secunda, *The Forgotten Employee Benefit Crisis: Multiemployer Benefit Plans on the Brink*, 21 CORNELL J.L. & PUB. POL'Y 77, 79 (2011).

form of a trust, with trustee power shared equally between labor and management.[107] For over a half-century, these benefit plans created under the Taft-Hartley Act have provided benefits to a specific portion of working America, particularly laborers, such as construction workers, who are covered by a collective bargaining agreement and employed by various employers within one industry.[108] The Taft-Hartley Act provides a loose structure with which plans operating under the Act must comport.[109] The wider spectrum of considerations, including fiduciary responsibility, was generally not discussed at a federal level until the enactment of ERISA.[110]

In this context, the practical meaning of fiduciary duty under ERISA has become a battleground in the struggle of labor and capital. The U.S. Supreme Court has said, "ERISA's legislative history confirms that the Act's [UPIA] fiduciary responsibility provisions . . . 'codif[y] and mak[e] applicable to [ERISA] fiduciaries certain principles developed in the evolution of the law of trusts.'"[111] Yet, depending on the administration in power, corporate influence has attempted to impede what it considers pension fund "activism" under the guise of a "strict" definition of fiduciary duty.[112] Due to the high stakes concerning the use of vast pools of capital that exist in employee benefit funds and the political realities of current American politics, the DOL has issued guidance to trustees as to the approach they may take in regard to investment activities that use anything other than Wall Street considerations.[113] In order to make a political point, the guidance has often ignored the reality of the investment universe today, as well as the history of the evolution of this trustee duty.

107. *See id*. at 83.

108. *See id*. at 79-80. Without the security of Taft-Hartley plans, it would be nearly impossible for mobile union employees to find portability within their employee benefits. The authority for Taft-Hartley plans is hidden in the text of the Taft-Hartley Act, as these plans were actually created as an exception to the general proposition that employers cannot give money, or anything else of value, to employee representatives. *See* 29 U.S.C. § 186(a).

109. *See* 29 U.S.C. § 186.

110. *See* Youngdahl, *supra* note 35, at 5.

111. Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 110 (1989) (quoting H.R. Rep. No. 93-533, at 11 (1973)).

112. *See, e.g*., Letter from Robert J. Doyle, Dir. of Regulations and Interpretations, U.S. Dep't of Labor, to Thomas J. Donohue, President and CEO, U.S. Chamber of Commerce (Dec. 21, 2007) *available at* http://www.dol.gov/ebsa/pdf/ao2007-07a.pdf (detailing the U.S. Chamber of Commerce's activity in this area). A similar situation exists for trustees that desire to use economically targeted investments ("ETIs"). *See* Griffin, *supra* note 100, at 22-27.

113. This issue first became prominent in the DOL in 1994 during the Clinton Administration. Youngdahl, *supra* note 35, at 21 n. 29. Most recently, the DOL issued a government proclamation under the Bush Administration. *See* 29 C.F.R. § 2509.08-1 (2008).

These three factors (the collapse of the certainty of MPT, the growing understanding of the effects of investment practices on the long-term real economy, and the political battles in this sector) have created an unstable environment in which trustees must exercise their fiduciary duties. Thus, benefit fund trustees in the United States, who must always consider potential personal liability for breaches of their fiduciary duties in their investing function, face an unsettled situation. An outdated interpretation of the concept of the fiduciary duty of trustees is often the cudgel for a recalcitrance to consider the issue of sustainability in investment.[114] Fund attorneys, taking the easy advisory road, have been slow to step into this breach. This timid approach contradicts the growing practice in many European countries in which a more modern conception of fiduciary duty, with strong support for more sophisticated investment considerations, is moving front and center for those who invest the monies held to provide pension and other benefits for the workers of the continent.[115] It is time for the United States and American fiduciary lawyers to follow this more enlightened approach.

114. *See* Youngdahl, *supra* note 35, at 9.

115. *See* Benjamin J. Richardson, *Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?*, 22 BANKING & FIN. L. REV. [B.F.L.R.] 145, 191 (2007) (Can.). There is a philosophical distinction between advocates and critics of MPT that deserves mention. One of the more interesting new approaches in finance, spearheaded by Lydenberg, is to consider the difference between "rational" and "reasonable" investment behavior. LYDENBERG, *supra* note 75, at 35 n.8. Rational behavior, including that which is defined in current concepts of fiduciary duty in investment, is self-interested and seeks the most efficient means of achieving one's personal ends. *Id*. at 8. It is concerned with the efficient attainment of private goals. *See id*. While prior laws have tended to use the term reasonable – reasonable man or reasonable person – the concept has morphed into a selfish kind of utility. If critics of MPT are correct that conduct of large pension funds has the tendency to harm the financial system at large, "rational" behavior in investment by trustees in fact harms beneficiaries. *See id*. at 9. Focusing solely on whether a particular investment has helped beat a short-term financial benchmark appears to have had a destabilizing effect on financial systems, demonstrated by the series of major booms, busts, and financial crises that began in the first years of the twenty-first century. The strategy of chasing a benchmark has shown itself incapable of dealing with the implications of investment policies for the sustainability of the environment specifically and the effects of investments on society generally. *Id*. at 33-34. Reasonable behavior, on the other hand, supposes that one takes into account the effect of one's actions on others. *See* JON ELSTER, REASON AND RATIONALITY 2 (Steven Rendall trans., 2008). It is concerned with the protection or enhancement of the common good, a concept that appears more and more important in our fragile world. *Id*. Considering the overall duty a trustee owes to a beneficiary, more "reasonable" behavior seems to be called for. *See* AMARTYA SEN, THE IDEA OF JUSTICE 48 (2009) (stating that society's "lack of reasoned engagement and action" hinders sustainability).

VI. CAN ENVIRONMENTAL, SOCIAL, AND GOVERNMENT ("ESG") STRATEGIES BE EMPLOYED UNDER CURRENT CONCEPTIONS OF FIDUCIARY DUTY?

This article argues that it is time for a reevaluation of the present definitions of fiduciary duty in investment, especially in the ERISA context. The burden on well-meaning trustees is heavy, even with a settled legal landscape. The current confusion is cruel and unhelpful to those who are willing to act as trustees and is harmful to their beneficiaries.[116] Yet, many claim with significant merit that sustainable investment is allowable today, in spite of occasional DOL guidance to the contrary.[117] While a complete replacement theory has yet to be developed, outlines are appearing.[118] Certain concepts within MPT remain valid while others are being redefined.[119] Still others that proved to be counterproductive or failed in practice are being discarded.[120] One fundamental observation in this new paradigm is that investments play a major role in the sustainability of the nation and the planet.[121] As employee benefit trusts are by definition primarily entities that exist to service long-term obligations to beneficiaries,[122] trustees must observe issues of responsibility and sustainability in society and finance. A worldwide movement for responsible investment is growing that seeks to align investment practices with long-term sustainability in investment

116. Paradoxically, in most trust fund meetings for Taft-Hartley funds, for example, the trustees have the most difficult legal duties and are the least compensated for their work, if they are compensated at all.

117. *See* Roger Urwin, Global Head of Investment Content, Watson Wyatt Worldwide, Address at the Principles for Responsible Investment Academic Conference: Sustainable Investing Principles: Models for Institutional Investors 11 (Oct. 1, 2009), *available at* http://www.unpri.org/files/Urwin_PRI2009.pdf.

118. *See, e.g.*, THE BRANDES INSTITUTE, THE PAST, THE FUTURE, AND MODERN PORTFOLIO THEORY 5-6 (2004), *available at* https://www.brandes.com/Institute/Documents/Past%20Future%20MPT%20081604.pdf.

119. *See, e.g.*, BRIAN M. ROM & KATHLEEN W. FERGUSON, POST-MODERN PORTFOLIO THEORY COMES OF AGE 349 (1993), *available at* http://www.actuaries.org/AFIR/Colloquia/Orlando/Ferguson_Rom.pdf (explaining Post-Modern Portfolio Theory, which modifies MPT in return and risk, and asset allocation concepts).

120. *See id*. at 354 (concluding MPT's mean-variance methodology is inefficient).

121. *See* Robert D. Hormats, Under Sec'y for Econ., Energy and Agric. Affairs, Address at the World Investment Forum: Importance of Investment in the Global Economy (Sept. 6, 2010), *available at* http://www.state.gov/e/rls/rmk/2010/146894.htm.

122. *See* EQUITY INCENTIVES LIMITED, EMPLOYEE BENEFIT TRUSTS 2 (2005), *available at* http://www.equityincentives.co.uk/documents/pdfs/EBT2005.pdf.

returns and real economic growth, spotlighting the importance of this climate for investment returns.[123]

Certainly that is the case in Europe, where nearly all countries have large benefit funds and some form of a legal fiduciary duty for trustees.[124] Even Germany, one of the most conservative investing nations, has seen the use of sustainability criteria in ESG investment to be required as part of the fiduciary duty in investment.[125] These ESG concerns of sustainable investment, which are generally associated with socially responsible investing, employ broader considerations than simply short-term investment performance.[126] Spurred by concerns about climate change, oil spills, and corporate malfeasance, ESG-informed investing is becoming an integral part of financial calculations in the corporate world.[127] In 2009, an official of Starbucks Coffee Company revealed that it has been lobbying the Obama Administration for more action on climate change.[128] The company believes climate change is having a negative impact on coffee production in the world, which will adversely affect Starbucks's profits and stock price in the future.[129] Even the U.S. Securities and Exchange Commission has issued guidance by counseling companies to pay attention to this

123. *See The Principles for Responsible Investment*, PRI, http://www.unpri.org/principles/index.php (last visited Jan. 9, 2012). The United Nations Environment Programme Finance Initiative and United Nations Global Compact have partnered to develop six principles for responsible investment:

> (1) We will incorporate ESG issues into investment analysis and decision-making processes; (2) We will be active owners and incorporate ESG issues into our ownership policies and practices; (3) We will seek appropriate disclosure on ESG issues by the entities in which we invest; (4) We will promote acceptance and implementation of the Principles within the investment industry; (5) We will work together to enhance our effectiveness in implementing the Principles; and (6) We will each report on our activities and progress towards implementing the Principles.

Id.

124. *See* AXEL HESSE, LONG-TERM AND SUSTAINABLE PENSION INVESTMENTS: A STUDY OF LEADING EUROPEAN PENSION FUNDS 34 (2008), *available at* http://webcounter.goweb.de/30889LINK-0&http://www.sd-m.de/files/Long-term_sustainable_Pension_Investments_Hesse_SD-M_Asset4.pdf.

125. *See id*. at 41.

126. *See* Andrew Ness, *The Integration of ESG in Emerging Markets*, PROF. WEALTH MGMT. (Feb. 7, 2010), http://www.pwmnet.com/news/fullstory.php/aid/2801/The_integration_of_ESG_in_emerging_markets_.html.

127. *See* REMY BRIAND, ROGER URWIN & CHIN PING CHIA, INTEGRATING ESG INTO THE INVESTMENT PROCESS: FROM ASPIRATION TO EFFECTIVE IMPLEMENTATION 2-3 (2011), *available at* http://www.geog.ox.ac.uk/news/events/110922/briandetal.pdf.

128. Media Brief, Oxfam Int'l, Business & Climate Change: Dissension in the Ranks (Dec. 2009), *available at* http://www.oxfam.org/sites/www.oxfam.org/files/business_oxfam_brief.pdf.

129. *See id*.

matter.[130] Leading accounting firms are observing that "institutional investors are starting to view financial and non-financial performance as two sides of the same coin."[131] Credit-rating agencies now inquire about sustainability practices and tools for measurement of sustainability abound.[132]

For those trustees prepared to implement ESG principles in order to secure long-term sustainable investment returns, Keith L. Johnson and Frank Jan de Graaf propose general recommendations that can serve as a guide for the modernization of pension fund legal standards in the United States.[133] Johnson and de Graaf recommend that the appropriate regulatory bodies should:

> (1) Recognize the risks of excessive investment herding behaviour for both the economy and fund participants/beneficiaries . . . (2) Emphasize the duty of impartiality and the need to balance short-term and long-term obligations . . . (3) Encourage fee structures that better align interests of service providers with those of fund participants/beneficiaries . . . (4) Confirm the importance of systemic and extra-financial risks (e.g., items not reflected on the financial

130. Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release Nos. 33-9106, 34-61469, 75 Fed. Reg. 6290 (Feb. 8, 2010), *available at* http://www.sec.gov/rules/interp/2010/33-9106.pdf.

131. *CFO's Sustainability Role Still Growing, E&Y Says*, ENVTL. LEADER (Aug. 24, 2011), http://www.environmentalleader.com/2011/08/24/cfos-sustainability-role-still-growing-ey-says/. The question of the meaning of "non-financial" criteria and their effects on financial performance is the subject of much discussion and research in the investing community.

132. *Id*.

133. *See* Johnson & de Graaf, *supra* note 72, at 48-49. In addition, the United Nations Environmental Programme ("UNEP") promulgated recommendations for pension fund trustees, which should be closely observed and considered. *See* U.N. ENV'T PROGRAMME FIN. INITIATIVE, FIDUCIARY RESPONSIBILITY: LEGAL AND PRACTICAL ASPECTS OF INTEGRATING ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 31 (2009), *available at* www.unepfi.org/fileadmin/documents/fiduciaryII.pdf (following up the 2005 "Freshfields Report" *infra*). They include the following: pension fund trustees must be fully transparent about investment strategies, including the extent to which the strategies incorporate ESG considerations; trustees should search out expert advice on proposed investment strategies, including advice on how to incorporate ESG issues into investment analysis and decision-making; the pension fund should express in its Statement of Investment Principles exactly how they take ESG issues into account when contemplating an investment; trustees should express precisely which ESG issues are to be considered; trustees should communicate the mid- to long-term return period over which the performance of the asset manager will be assessed; the asset manager should be required to report every six to twelve months on the fund and on ESG implementation; the pension fund should adopt and require the asset manager to adopt the Principles of Responsible Investment (PRI) and require the asset manager to be actively involved in the development of the PRI; and the pension fund should make sure that the asset manager agrees to periodic independent audits of their implementation of investments taking into account ESG considerations. *Id*.

> statements) that could affect the short- or long-term well-being of participants/beneficiaries . . . (5) Convene a market-specific best practices commission to develop and maintain general standards aimed at improving the governance practices of pension funds . . . (6) Organize educational programs to promote fiduciary professionalism.[134]

Assuming the economic effects of ESG activity are always kept front and center, a keen eye on the whole of fiduciary duties argues that ESG investing is allowed under U.S. law today.[135] In fact, the seminal "Freshfields Report," written by an international corporate law firm in the United Kingdom and surveying law in a number of countries including the United States, states that "there appears to be a consensus that, so long as ESG considerations are assessed within the context of a prudent investment plan, ESG considerations can (and, where they affect estimates of value, risk and return, should) form part of the investment decision-making process."[136] This view is in concert with many American legal authorities.[137] In *The Law of Trusts*, the authors wrote:

> Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment, and consumer responsibility.[138]

Thus, it is fair to argue that, at the very least, when examining legal authorities with a view as to how ESG considerations may fit in, ESG principles may be accorded weight so long as they "are motivated by

134. Johnson & de Graaf, *supra* note 72, at 48-49.

135. *See* FRESHFIELDS BRUCKHAUS DERINGER, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 114 (2005), *available at* http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf [hereinafter "FRESHFIELDS REPORT"].

136. *Id*.

137. *See id*.

138. 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 227.17, at 500 (4th ed. 1988). The Uniform Management of Public Employee Retirement Systems Act, adopted in two states, states that a trustee "may consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits." UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 8(a)(5), 7A Pt. III U.L.A. 64 (1997). The DOL view can often be seen as a similar mandate.

proper purposes and do not adversely affect the financial performance of the entire portfolio."[139] This is especially the case if the process of ESG implementation is performed in a prudent manner, keeping the interests of the beneficiaries always foremost in mind, without slavish adherence to problematic doctrines. While political considerations within the DOL might occasionally dictate a different approach, the evidence is mounting that ESG investing activity is consistent with a powerful and thoughtful exercise of this fiduciary duty.[140]

VI. CONCLUSION

Trust law counsels that the performance of investment duties must conform to societal conceptions of prudent investment and financial activities.[141] Given the failures in the previous model, Modern Portfolio Theory, this legal area must acknowledge that change is necessary in the definitions of fiduciary duty in investment and in the regulation of those trustees who exercise such a duty. Trustees must be free to implement strategies of sustainability when they are exercising their sacrosanct duty to provide promised benefits to those who labor in America. Twenty years ago, the drafters of the Restatement (Third) of Trusts realized the importance of allowing well-meaning trustees the flexibility to serve their beneficiaries, as Edward C. Halbach, Jr., wrote:

> The rules are designed to be general and flexible enough to adapt to the changes that may occur over time in the financial world. They are also designed to be flexible enough to allow prudent use of any investments and techniques that are suitable to the different abilities of different trustees and to the varied purposes and circumstances of the diverse array of trusts to which the prudent investor rule will inevitably apply. Accordingly, the prudent investor rule is intended to liberate expert trustees to pursue challenging, rewarding, non-traditional strategies when appropriate to a particular trust. It is also designed to provide unsophisticated trustees with reasonably clear guidance to practical

139. FRESHFIELDS REPORT, *supra* note 135, at 109.

140. *See id*. at 110.

141. *See e.g.*, Christin V. Adkins, *Oklahoma Uniform Prudent Investor Act and Its Influence on Oklahoma Trust Investment Law*, 22 OKLA. CITY U. L. REV. 1235, 1270 (1997) (concluding that "the basic premise of trust investment law remains unchanged – a trustee is expected to exercise reasonable care, skill, and caution when investing and managing trust property"); Melanie B. Leslie, *Trusting Trustees: Fiduciary Duties and the Limits of Default Rules*, 94 GEO. L.J. 67, 90-94 (2005) (discussing social and moral norms in trust law and finding that "fiduciary standards embody commonly accepted and understood social norms").

> courses of investment that are readily identifiable, expectedly rewarding and broadly adaptable.[142]

The way trust investments are managed is important for the long-term health of the beneficiaries and the long-term health of society. Legal definitions of the prudent fiduciary duty in investment should not constrain the ability of trustees to adequately provide for the well being of the beneficiaries of their trust. A cautious freedom for trustees who exercise this function is critical if the accumulated retirement and benefit funds of American workers will be able to be protected in this uncertain financial climate.

142. *See* Halbach, *supra* note 12, at 1154-55.