

Application of Fiduciary Duty to Sustainable Investment Practices

Special guest co-author, Susan Gary, is a Law School Professor at the University of Oregon and served as official Reporter for the Uniform Prudent Management of Institutional Funds Act on behalf of the Uniform Law Commission.

Trustees and directors who manage funds as fiduciaries have to consider their duties of loyalty and care when they create investment policies or make investment decisions. Two recent statements, one from the Internal Revenue Service (the "IRS") and one from the Federal Department of Labor (the "DOL"), provide guidance on the fiduciary rules, and confirm that fiduciaries can consider material environmental, social and governance ("ESG") factors as part of an investment strategy that combines ESG factors with traditional financial tools.

Trustees and directors who oversee investment of university endowments, pensions, charities and private trusts are all fiduciaries. They have a duty of loyalty to act in the best interests of their fund members, beneficiaries or charitable mission, and they have a duty of care to take care of the assets of the organization and manage the funds as a prudent investor would. These recent regulatory rulings provide important guidance on how to apply the duty of loyalty in today's investment market environment.

IRS Approves Aligning Investment Practices with Mission

One issue for fiduciaries of charities is whether they can adopt an investment strategy that reflects charitable mission goals—to provide competitive financial returns to the charity while deploying investment assets to promote charitable missions and either avoid or work to improve practices at investee companies which have a negative influence. Many fiduciary attorneys have advised nonprofit clients that an investment that furthers the charity's mission complies with the duty of loyalty, even if the investment results in a lower rate of return than would another investment. (See Susan N. Gary, *Is It Prudent to be Responsible: The Legal Rules for Charities that Engage in Socially Responsible Investing and Mission Investing*, 6 Nw. J.L. & Soc. Pol'y 106 (2011).) The IRS recently issued Notice 2015-62 (the

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"Notice"), confirming this view.

"Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation's charitable purposes."

The Notice applies to private foundations, a category of charities that typically has only one or a few donors. Under the Internal Revenue Code (the "IRC"), foundation managers must exercise "ordinary business care and prudence" in making investments. Treas. Reg. § 53.4944-1(a)(2)(i). Treasury Regulations set out factors to consider that are similar to the factors provided in state laws (*i.e.*, the Uniform Prudent Investor Act or Uniform Prudent Management of Institutional Funds Act). In other words, the IRC requires foundation managers to invest prudently, as do state laws.

The IRC provides special rules for program related investments ("PRIs"), defined as investments entered into primarily to accomplish one or more of the charitable purposes of the private foundation. IRC § 4944(c). PRIs may produce some financial gain, but any financial return is incidental to the primary purpose of carrying out the charity's mission.

However, until the Notice was issued, the treatment of mission-related investments, made for *both* charitable goals and financial return, had been uncertain. The Notice confirms that an investment that furthers a charity's purposes, but is also made to produce financial returns, does not run afoul of the IRC, even if the return on the investment is less than would be expected for an investment unrelated to the charity's purposes. The Notice explains that this result is consistent with state law, which is generally the same whether a charity is a private foundation or public charity, and is organized as a trust or nonprofit corporation.

The Notice supports the conclusion that a charity's trustees or directors can engage in mission-related investing without breaching their fiduciary duties.

DOL Affirms ESG Investing

ESG investing raises a slightly different question. For purposes of this comment, ESG investing, also called ESG integration, is an investment strategy that combines material ESG factors with traditional financial analysis and metrics. Questions have been raised about whether fiduciaries can engage in ESG investing without first determining whether the ESG factors relate directly to the mission of the charity or the purposes of the trust.

Two published statements that relate to an earlier form of investing, often called socially responsible investing ("SRI"), caused concern about investment strategies that consider any factors other than the traditional financial ones. A comment to the Uniform Prudent Investment Act, first published in 1994, stated that "[n]o form of so-called 'social investing' is consistent with the duty of loyalty" if it involves accepting below-market returns. At the time the statement was written, the assumption was that SRI necessarily resulted in below market returns.

Understanding of Fiduciary Duty has Evolved

Since 1994, several things have changed. One of the changes has been that the type of social investing referenced in the statement has evolved from use of negative screens that avoid certain investments on moral or ethical grounds to use of ESG or other sophisticated investment strategies that consider financially material issues that were outside traditional investment analysis in 1994. In addition, numerous recent studies have shown that returns on funds engaged in various forms of modern ESG investing can equal or exceed those of non-SRI (*i.e.*, socially responsible investment) funds. A prudent investor now has access to studies, data and investment approaches that were not available in 1994.

Financial analysts and investors increasingly use ESG data with the goal of managing investment risks and improving returns.

A second development was an interpretive bulletin issued by the DOL prior to the 2008 financial crisis, which provided confusing guidance for private section employee benefit plans governed by the Employee Retirement Income Security Act ("ERISA"). The investment standards applied to ERISA and endowment fiduciaries are patterned after trust law and intended to be generally consistent. The DOL had earlier issued Interpretive Bulletin 94-1 ("IB 94 1") to clarify that investments that were selected for collateral (*e.g.*, social or environmental) benefits as well as financial return were acceptable, so long as the financial

returns were comparable to the expected returns of other investments available to the pension plan. IB 94-1 emphasized that plan assets could not be used to promote public policy interests at the expense of the financial interests of the plan's beneficiaries, and the fiduciaries could not accept lower expected returns.

In 2008, the DOL issued Interpretive Bulletin 2008-01 ("IB 2008 1") which replaced IB 94-1. Although the DOL said that IB 2008 1 did not alter the basic legal principles of IB 94-1, the DOL stated that consideration of "collateral, non-economic factors" in investment decision-making should be rare and well documented. This statement resulted in confusion about how to treat ESG factors that have current or long-term financial or risk implications.

"Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."

The DOL has now issued Interpretive Bulletin 2015-01 ("IB 2015 01"), published as section 2509.2015-01. This new bulletin removes IB 2008-1, reinstates IB 94-1 and provides related guidance. IB 2015 01 addresses economically targeted investments (ETIs), which are selected for economic benefits as well as financial returns, and ESG investing. The DOL issued the new guidance because it had become concerned "that the 2008 guidance may be dissuading fiduciaries from (1) pursuing investment strategies that consider environmental, social, and governance factors, even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments, and (2) investing in ETIs even where economically equivalent."

This current guidance from the DOL makes it clear that, "fiduciaries should appropriately consider factors that potentially influence risk and return" and that "environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment." The DOL states, "In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary's primary analysis of the economic merits of competing investment choices."

In addition, the DOL clarifies that "plan fiduciaries may invest in ETIs based, in part, on their collateral benefits so long as the investment is economically



equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits."

IB 2015-01 has spurred ERISA attorneys to reframe advice to clients on integration of ESG factors into investment decisions. Since issuance of IB 2015-01, many law firms have begun to recognize that prior legal concerns about socially responsible and economically targeted investments do not apply where ESG factors are being considered for the purposes of enhancing returns or managing exposure to potential financial risks.

Implications for Endowment Fiduciaries

The IRS and DOL guidance provide comfort to endowment fiduciaries seeking to align their investment practices with the mission of their institution or to use ESG investing with the goal of improving financial return. There is now clear regulatory direction that material ESG factors can be properly included as components of a fiduciary's primary investment analysis.

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