

Title

Does the trustee who socially invests entrusted funds breach his/her/its fiduciary duty of undivided loyalty, absent express authority to do so in the trust's terms?

Summary

On February 8, 2015, The University of California Student Association [which purports to represent all 240,000 students enrolled in the UC system's 10 campuses] passed [9-1-5] the following resolution, which, in part, calls upon the University to disinvest in U.S. bonds and other U.S. debt obligations:

"THEREFORE BE IT FURTHER RESOLVED, That the Board of Directors of the University of California Student Association determines if it is found that UC funds are being invested in any of the aforementioned governments [Brazil, Egypt, Indonesia, Israel, Russia, Turkey, Sri Lanka, Mexico, and the United States], the University of California Student Association calls upon the University of California to divest all stocks and securities of such governments, at such time and in such manner as fund trustee[sic] may determine, and maintain divestment from said governments, in accordance with the fund trustees' fiduciary duty, until they meet the University of California endorsed Principles of Responsible Investment."

In the resolution there is reference to some fiduciary duty of the fund trustees. The precise duty that the students have in mind, as well as to whom (or to what) that duty runs, is not explained. Social investing by fiduciaries, particularly trustees, is covered generally in §6.1.3.4 of *Loring and Rounds: A Trustee's Handbook*. See pages 491-498 of the 2015 Edition, which are reprinted below.

Text

§6.1.3.4 Indirect Benefit Accruing to the Trustee [Excerpted from the 2015 Edition of *Loring and Rounds: A Trustee's Handbook*]

Social investing. The practice of *social investing* (*socially responsible investing* or SRI to its proponents) illustrates how seductive this economic power can be.⁴³⁵ Corraling a workable definition of social investing is not all that easy. One social investor, for example, purports to define it this way: "Social investing is about investing in solutions in education, economic development, health, climate change and poverty alleviation."⁴³⁶ That is only not a definition but also descriptive of an investment strategy that one unmotivated by social investment considerations might pursue.

Social investing has been defined by Professor Langbein and Judge Posner as the "pursuit of an

⁴³⁵ See generally 4 Scott & Ascher §19.1.13 (Moral Considerations in Investing).

⁴³⁶ Geoff Burnand, *Social value of money*, 16(30) STEP J. 21 (Mar. 2008) (Mr. Burnand is Chief Executive at Investing for Good).

investment strategy that tempers the conventional objective of maximizing the investor's financial interests by seeking to promote nonfinancial social goals as well."⁴³⁷ In the latter part of the twentieth century, considerable social investing energy was focused on pressuring the trustees of charitable and pension funds to disinvest in companies that were doing business in apartheid South Africa. A similar campaign is currently under way targeting companies that do business in the Sudan and Iran.⁴³⁸

"A trustee ordinarily violates the duty of loyalty by using trust property to benefit anyone other than the beneficiaries, or to accomplish any objective other than a trust purpose."⁴³⁹ A trustee who *without express authority in the governing instrument*⁴⁴⁰ voluntarily undertakes to practice social investing uses the trust estate, *i.e.*, other people's property,⁴⁴¹ to promote the trustee's own political and social goals—a clear case of indirect self-dealing.⁴⁴² The trustee who yields to third-party pressure to practice social investing is acting on divided loyalties;⁴⁴³ the trustee who seeks the acclaim of particular constituencies, or at least the cessation of their criticisms,⁴⁴⁴ may be subordinating the interests of the trust to the interests of the trustee,⁴⁴⁵ particularly when under-diversification or sub-par investment performance, or both, is

⁴³⁷Langbein & Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 73 (1980). *See, e.g.*, Andrew Ross Sorkin, *Court Ties Up Hershey Deal, For Time Being*, N.Y. Times, Sept. 5, 2002, at C1, col. 5 (reporting the Pennsylvania attorney general's opposition to the efforts of the trustees of The Hershey Trust to diversify a portfolio that is heavily concentrated in the stock of Hershey Foods Corporation and his intention to "propose legislation that would change laws that govern charitable trusts so that trustees could consider the interests of a community before selling a controlling stake in a for-profit company"). *See generally* §8.35 of this handbook (the Hershey Trust).

⁴³⁸*See* Jane Spencer, *Sudan-Divestment Laws Draw Attacks From Fund Managers, Business Groups*, Wall St. J., May 3, 2006, at p. C1.

⁴³⁹3 Scott & Ascher §17.2.3.

⁴⁴⁰*See generally* 3 Scott & Ascher §17.2.11 (Terms of the Trust).

⁴⁴¹"During his lengthy career as a self-appointed 'consumer advocate,'...[Ralph Nader]...has lectured others about the evils of monopolists, corporate polluters, and weapons makers." James M. Sheehan, *The Free Market*, May 2002, at 6. "Among his recent...[personal]...holdings: router monopolist Cisco Systems, fossil-fuel giant Occidental Petroleum, and missile manufacturer Raytheon." James M. Sheehan, *The Free Market*, May 2002, at 6.

⁴⁴²*See* Rounds, *Social Investing, IOLTA, and the Law of Trusts: The Settlor's Case Against the Political Use of Charitable and Client Funds*, 22 Loy. U. Chi. L.J. 163, 170–172 nn.27, 31 (1990).

⁴⁴³*See, e.g.*, Sarah Ellison, *Sale of Hershey Foods Runs Into Opposition*, Wall St. J., Aug. 26, 2002, at A3, col. 1 (reporting that the Pennsylvania attorney general who at one time called for diversification of The Hershey Trust investment portfolio has since reversed his position: "While the recent opposition by Mr. Fisher is viewed by many as political posturing, it could complicate the sale...[of the trust's 77 percent stake in Hershey Foods Corp.]...by scaring off bidders and giving some board members of the trust, already being criticized from local officials and employees, the cover they need to scrap the sale, say takeover experts.").

⁴⁴⁴*See, e.g.*, Sarah Ellison, *Hershey Foods' Controlling Trust Says It Has No Intentions to Sell*, Wall St. J., Sept. 27, 2002, B5, col. 1 (reporting that the trustees of The Hershey Trust, by "pulling Hershey Foods from the auction block at the eleventh hour despite receiving a \$12.5 billion offer from Wm. Wrigley Jr. Co.," were attempting to "appease" local residents and other constituencies who had been strenuously and publicly criticizing the portfolio diversification initiatives of the trustees and calling for the trustees to resign). *See generally* §8.35 of this handbook (the Hershey Trust).

⁴⁴⁵Langbein & Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 96–104 (1980). "We conclude that the duty of loyalty...forbid[s] social investing in its current form." Langbein & Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 76 (1980). *See also* Restatement (Second) of Trusts §170 cmt. q (providing that "[t]he trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person"); comment to §5 of Uniform Prudent Investor

the likely or actual consequence. In any case, regardless of the consequences, unauthorized social investing implicates the fraud on a power doctrine.⁴⁴⁶ In this case the power is a discretionary administrative power.⁴⁴⁷ The court, for example, will “interpose” if a trustee takes a bribe for making an investment.⁴⁴⁸ The considerations that flow to the trustee and/or third parties for social investing need not be so crass, however, for the doctrine to be implicated.⁴⁴⁹

Nor are benign motives a defense.⁴⁵⁰ “Even if the trustee does not act in bad faith, the court will interfere if the trustee acts with an improper motive.” Thus the trustees of a miners’ pension fund who have adopted a policy of not investing in any form of energy that competes with coal are on shaky legal ground:

In considering what investments to make, trustees must put aside their own personal views and interests. Trustees may have strongly held social or political views. They may be firmly opposed to any investment in South Africa or other

Act (available on the Internet at <<http://www.uniformlaws.org/Act.aspx?title=Trust%20Code>> as Article 9 of the Uniform Trust Code) (suggesting that “[n]o form of so-called ‘social investing’ is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries.”). *Cf.* *Cryan v. Crocker Nat’l Bank*, No. 721368 (Cal. Sup. Ct., Mar. 10, 1981) (surcharging bank trustee for selling trust property to a charity on whose board a trust committee member was serving). It should be noted, however, that the Report of the Massachusetts Prudent Investor Act Committee, which forms a part of the legislative history of Mass. Gen. L. ch. 203C (the Massachusetts Prudent Investor Act), by implication, endorses the practice of social investing: “Social investing using screens of socially responsible criteria to select a universe of investments from which to select a portfolio that the trustee *believes*” “[emphasis added] will accomplish the objectives of the trust [is] allowed.” Whether Massachusetts courts will apply the Report’s subjective “belief” standard to trustees who practice social investing remains to be seen. *See also* 29 C.F.R. §2509.94-1 (1995). Section 2509.94-1, the U.S. Labor Department’s Interpretive Bulletin relating to ERISA, states that §§403 and 404 of ERISA do not prevent trustees of private employee benefit trusts who comply with ERISA prudence requirements from investing in Economically Targeted Investments (ETIs). Section 2509.94-1 defines ETI’s as investments “selected for the economic benefits they create apart from their investment return to the employee benefit plan.” 29 C.F.R. §2509.94-1 (1995). “Secretary of Labor Robert Reich interpreted IB-1 to mean that ‘a pension trustee, given two investment choices of equal risk and return, may pick an investment based on social goals.’” John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* 845 (2000) (citing 63 Tax Notes 1745 (1994)). For a brief discussion of the concept of “costless social investing” in the ERISA context, *see* John H. Langbein & Bruce A. Wolk, *Pension and Employee Benefit Law* at 844–845. On May 9, 1995, U.S. Representative Jim Saxton (R-N.J.) introduced a bill that would effectively rescind the Interpretive Bulletin. *See* H.R. 1594, 104th Cong., 1st Sess. (1995). For an analogous controversy in the corporate area, *see* *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 681 (D.C. Cir. 1970), wherein the court noted “that there is a clear and compelling distinction between management’s legitimate need for freedom to apply its expertise in matters of day-to-day business judgment, and management’s patently illegitimate claim of power to treat modern corporations with their vast resources as personal satrapies implementing personal political or moral predilections.” *But see* 404 U.S. 403 (vacating the lower court decision as moot because after certiorari was granted to the U.S. Supreme Court, the corporation acquiesced to the stockholder’s request and included anti-napalm proposal in its 1971 proxy statement).

⁴⁴⁶*See generally* §8.15.26 of this handbook (the fraud on a power doctrine).

⁴⁴⁷*See generally* §3.5.3 of this handbook (discussing discretionary administrative powers).

⁴⁴⁸3 Scott & Ascher §18.2.3.

⁴⁴⁹*See generally* §8.15.26 of this handbook (the fraud on a power doctrine).

⁴⁵⁰*See generally* §8.15.26 of this handbook (the fraud on a power doctrine).

countries, or they may object to any form of investment in companies concerned with alcohol, tobacco, armaments or many other things. In the conduct of their own affairs, of course, they are free to abstain from making any such investments. Yet, under a trust, if investments of this type would be more beneficial to the beneficiaries than other investments, the trustees must not refrain from making the investments by reason of the views they hold.⁴⁵¹

This is a critical excerpt from the decision of the English judge (Megarry VC) in *Cowan v. Scargill* (1985).⁴⁵² Since 1985, proponents of social investing have been endeavoring to make the difficult case that the “Megarry Judgment” in no way closed the door on social investing by fiduciaries. “Commentators supporting social investing tend to concede the overriding force of the duty of loyalty” arguing instead “that particular schemes of social investing may not result in below-market returns.”⁴⁵³ They advocate a “facts and circumstances” or “no harm no foul” test. In other words, to the extent actual investment performance is unaffected by the trustee’s social investing activities, the fiduciary duty of undivided loyalty that is owed *to the trust beneficiaries* or *to the trust’s specific charitable purposes* is not implicated. In fact, the manager of one mutual fund has consistently outperformed the market by adhering to the Shariah code of the Islamic faith in the selection of the fund’s underlying assets. In any case, the fund trustees’ fiduciary’s duty of loyalty would not be implicated as the fund’s goals and purposes are fully disclosed to prospective investors:

The limits to investing are many: most financial firms that earn interest, such as banks and brokerages, as well as tobacco and alcohol companies and any venture engaged in adult entertainment. Companies that have a lot of debt are frowned upon—yet so are those that have piled up too much interest-bearing cash.⁴⁵⁴

It should be noted here that social investing is sometimes confused with mere efforts at enhancing shareholder value. A trustee, for example, who attempts to influence by proxy voting the internal governance of a company would not be engaging in social investing, provided the investment is prudent and the goal of the voting is a narrow one, namely the enhancement of shareholder value in furtherance of the specified purposes of the trust.⁴⁵⁵ In fact, the trustee may have an affirmative duty to exert his influence in this way.

It appears that under the Restatement (Third) of Trusts (and the Uniform Prudent Investor Act), social investing has no place in the default law of trusts.⁴⁵⁶ If social investing has a place, as Professor Scott

⁴⁵¹Cowan v. Scargill, [1985] 1 Ch. 270, [1984] 2 All E. R. 750 (England).

⁴⁵²[1985] Ch 270.

⁴⁵³Uniform Trust Code §5 cmt.

⁴⁵⁴Karen Richardson, *Extra Work: Investing by Rules of Islamic Faith*, Wall. St. J., Jul. 19, 2006, at pg. C3. *See generally* 4 Scott & Ascher §19.1.13 (Moral Considerations in Investing) (confirming that the policy of both the Restatement (Third) of Trusts and the Uniform Prudent Investor Act is that “[o]nly to the extent permitted by the terms of the trust or the consent of the beneficiaries may the trustees of private trusts properly take social considerations into account in making investment decisions”).

⁴⁵⁵*See* Uniform Prudent Investor Act §5 cmt (suggesting that “[n]o form of so-called ‘social investing’ is consistent with the duty of loyalty if the investment activity entails sacrificing the interest of trust beneficiaries—for example, by accepting below-market returns—in favor of the persons supposedly benefited by pursuing the particular social cause”). *But see* 3 Scott on Trusts §227.17 (suggesting that a trustee is “entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to the community” even if it were not so that “a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits”).

⁴⁵⁶Restatement (Third) of Trusts §78 cmt. f. *See also* Restatement (Third) of Trusts: Prudent Investor Rule §227 cmt. c.

suggested it had,⁴⁵⁷ then it is incumbent upon the courts and the legislatures to create objective standards, *i.e.*, to define this exception to the trustee's duty of undivided loyalty in a way that establishes reasonable limits on a trustee's right to promote with the trust estate his own personal, political, and social goals, or the personal, political, and social goals of third parties,⁴⁵⁸ something Professor Scott did not do particularly well. The only guidance he offered us was that the trustees who have a "concern in the social behavior of the corporations in whose securities they invest" could decline to invest in companies "whose activities or some of them are contrary to fundamental and generally accepted ethical principles."⁴⁵⁹ Identifying someone's "favorite cause" is one thing.⁴⁶⁰ Identifying "fundamental and generally accepted ethical principles," however, is quite another.⁴⁶¹ The problem is that what is "ethics" to one man is often mere "politics" to another.⁴⁶²

In 2002, for example, in response to calls for Harvard to divest itself of stock in companies that do business with or in Israel, Harvard University President Lawrence Summers "criticized...[such calls for]...divestment as an unwarranted attempt to 'single out' Israel as an odious abuser of human rights," condemning "the divestment movement and other extreme anti-Israel efforts as anti-Semitic in effect, if not in intent."⁴⁶³

On February 8, 2015, The University of California Student Association, which purports to represent all 240,000 students enrolled in the UC system's 10 campuses, passed (9-1-5) a disinvestment resolution which, in part, purports to proscribe fiduciary investing by UC in U.S. debt, such as U.S. treasuries. Here is the wording:

THEREFORE BE IT FURTHER RESOLVED, That the Board of Directors of the University of California Student Association determines if it is found that UC funds are being invested in any of the aforementioned governments [Brazil, Egypt, Indonesia, Israel, Russia, Turkey, Sri Lanka, Mexico, and the United States], the University of California Student Association calls upon the University of California to divest all stocks and securities of such governments, at such time and in such manner as fund trustee[sic] may determine, and maintain divestment from said

⁴⁵⁷3 Scott on Trusts §227.17.

⁴⁵⁸*See, e.g.,* Jenna Russel, *Some on Harvard, MIT faculties urge divestment in Israel*, Boston Globe, May 6, 2002, at B3, col. 1 (reporting that about seventy-five faculty members at the two institutions have signed an online petition asking the schools to divest from companies doing business in Israel until its forces withdraw from occupied territories). "[Paul Nemirovsky, a doctoral student at MIT]...wrote a response pointing out that other nations responsible for 'infinitely larger' civilian casualties haven't been similarly condemned..." Jenna Russel, *Some on Harvard, MIT faculties urge divestment in Israel*, Boston Globe, May 6, 2002, at B3, col. 1. With the abolition of South Africa's system of apartheid, social investors have been focusing much of their attention on companies that make tobacco products. As of June 2000, approximately 14.5 percent of all U.S. charitable foundations were employing some sort of social or political investment screen. "A growing number of funds have been set up to invest in a socially responsible manner." Chart, *Different Definitions of Responsibility*, N.Y. Times, Feb. 11, 2001, at NE 26, col. 3. "But there are many different ideas about what this means." Chart, *Different Definitions of Responsibility*, N.Y. Times, Feb. 11, 2001, at NE 26, col. 3.

⁴⁵⁹3 Scott on Trusts §227.17.

⁴⁶⁰4 Scott & Ascher §19.1.13.

⁴⁶¹4 Scott & Ascher §19.1.13.

⁴⁶²*See generally* Pension Fund Politics: The Dangers of Socially Responsible Investing, American Enterprise Institute (John Entine ed., 2005).

⁴⁶³Jon Berkon, *Levin Must Speak Out Against Divestment*, 34 Yale Herald, No. 12 (Nov. 21, 2002).

governments, in accordance with the fund trustees' fiduciary duty, until they meet the University of California endorsed Principles of Responsible Investment.

Note that in the resolution there is reference to some fiduciary duty of the fund trustees. There is, however, no accompanying commentary shedding light on the nature of the duty that is being contemplated by the students, nor on to whom (or to what) that duty runs. In any case, the resolution probably should have been expanded to include personal disclaimers by the students of any federal funds to which they, themselves, might otherwise be entitled, now and in the future. If it is socially irresponsible to purchase a U.S. debt instrument with other people's money, surely it is even more so to personally partake, whether directly or indirectly, in the proceeds from its sale.

Swarthmore, too, has been pressured to socially invest its charitable assets. In 2013 Danielle Charette wrote in *The Wall Street Journal*: "The latest upheaval has centered on the school's radical environmentalist club, Montana Justice, which has led a multiyear campaign calling on the college to divest its \$1.5 billion endowment—one of the highest endowments-per-student in the nation—of fossil fuel companies."⁴⁶⁴

Are fiduciaries constrained only by their subjective social and political predilections in deciding whether to yield to third-party pressure to make political statements with endowments? Is SRI so subjective as to be, for all intent and purposes, "what you make of it"⁴⁶⁵ or "whatever the loudest person in the room says it is,"⁴⁶⁶ as some have suggested? If it is, should it be? If not, and assuming social investing by fiduciaries such as trustees is to be tolerated, if not encouraged, there need to be objective criteria to guide them in the selection of those companies and countries that are fair game for targeting and those that are not. Otherwise, we run the risk of trusteeships, particularly charitable and pension trusteeships, becoming political footballs.⁴⁶⁷ Take the overwhelming vote (431–462) of the General Assembly of the Presbyterian Church (USA) calling for a divestment campaign targeted at corporations doing business in Israel:

The church is not calling for divestment of its \$7 billion portfolio from China, despite China's denial of the most basic political and religious rights and its particularly harsh treatment of followers of Falun Gong. It is not condemning Russia, even though Russia's policies in Chechnya are by any human-rights standard atrocious. It is not even calling for economic sanctions against Syria or Iran, whose human-rights records for their own people are egregious and whose Jewish citizens are denied the basic civil rights and liberties afforded to all Israelis, including its Arab citizens, some of whom even serve in the Knesset.⁴⁶⁸

⁴⁶⁴Danielle Charette, *My Top-Notch Illiberal Arts Education*, *Wall St. J.*, May 16, 2013, at A13.

⁴⁶⁵Joel C. Dobris, *SRI-Shibboleth or Canard*, 42 *Real Prop. Prob. & Tr. J.* 755, 756 (No.4-2008) (the opinion of the article's author).

⁴⁶⁶Joel C. Dobris, *SRI-Shibboleth or Canard*, 42 *Real Prop. Prob. & Tr. J.* 755, 756, n.4. (No.4-2008) (the opinion of a friend of the article's author).

⁴⁶⁷At a conference on social investing, one panelist, a proponent of social investing, publicly suggested to the author that the investment decisions of trustees of charitable and pension funds as a matter of public policy ought to be subject to political influence.

⁴⁶⁸Jay Lefkowitz, *Singled Out*, *Wall St. J.*, July 30, 2004, at W13, col. 1. *See also* Jim Roberts, *Turn Left at the Presbyterian Church*, *Wall St. J.*, June 15, 2006, at A14 (suggesting that a large majority of the members of the Presbyterian Church are of the opinion that the church needs to abandon divestment as a hostile action against Israel in favor of "investment" in Israel and Palestinian groups that are working as "bridge-builders for peace").

In any case, knowledgeable commentators remind us that promoting a particular social or political goal by social investing is one thing, achieving it by social investing is quite another:

According to Doug Henwood, editor of *Left Business Observer* and a well-known socialist critic of the stock market, there is simply no way to invest responsibly....Social responsibility, he warns, is an exercise of futility in a capitalist system....Oddly, I find myself in agreement with these leftist thinkers. They are right: their ambitions are not achievable in the stock market. Capitalism is too complex to serve a narrow political ideology.⁴⁶⁹

Let there be no misunderstanding: Congress—and probably the state legislatures, as well—can always make it a crime for private fiduciaries to invest in certain companies. Criminal proscriptions will almost always trump the fiduciary principles that are the subject of this handbook, provided the proscriptions are the product of statutes that are both duly enacted and constitutional. IOLTA's quasi-criminal proscriptions are problematic on both counts.

⁴⁶⁹James M. Sheehan, *The Free Market*, May 2002, at 6. *See also* Elizabeth Benton, *Yale's New Political Activism: Middle and Center*, 34 *Yale Herald*, No. 7 (Oct. 18, 2002) (reporting that in response to calls for Yale to divest itself of countries doing business in Israel, its president made the following observation: "The University has investments in many public companies that do business in America—I'd bet that if you looked at the 1,000 biggest companies in America, 900 do business in Israel...[T]o divest of holdings in Israel, one would have to divest in a great portion of the American economy").