Reclaiming Fiduciary Balance through the Duties of Loyalty and Obedience to Charitable Purposes

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"[The duty of obedience] requires the director of a not-for-profit corporation to be faithful to the purposes and goals of the organization, since unlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'être of the organization."  Manhattan Eye, Ear & Throat Hospital v. Spitzer 715 N.Y.S.2d at 593 (1999)

Introduction

The directors, officers and entities that exercise discretionary authority over investment policies or practices of charitable institutions are subject to fiduciary obligations under state law and federal tax regulations.² This includes duties of prudence, loyalty to the interests of beneficiaries and obedience to the organization's charitable purpose.³ However, during economic boom times of the late 20th century, those separate legal duties began to be dominated by the duty of prudence and viewed simply as a directive that fiduciaries attempt to maximize current returns by following practices used at other similar investment funds.

Since the turn of the century, a series of unexpected economic shocks forced fiduciaries and their legal advisors to re-examine fiduciary duty in the context of historical legal fundamentals. Importance of the fiduciary duties of loyalty to the interests of beneficiaries and of obedience to charitable purpose, which were largely overlooked while markets only went up, have come back into focus.

As we head into the second decade of the 21st century, a more balanced understanding of fiduciary duty is evolving. The challenge for fiduciaries in this context is to move from a backward-looking view of fiduciary duty toward a forward-looking alignment of

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² For example, IRC §4944 requires that private foundations operate exclusively for the exempt purposes for which they were created and that they consider both short- and long-term financial factors associated with carrying out those exempt purposes. Most states have adopted the Uniform Prudent Investor Act and Uniform Prudent Management of Institutional Funds Act. Both Acts impose fiduciary standards similar to those that apply to private trusts. See Restatement of Trusts (Second) §389 and Restatement of Trusts (Third) §379.

investment and related risk management practices with loyalty to both the long-term interests of beneficiaries and the non-profit’s charitable purpose.

**Fiduciary Duty is a Dynamic Concept**

Fiduciary law is not static, nor is it tied to a single investment theory. Rather, it is a flexible set of principles that have been subject to varying interpretations over time. When explaining rejection of prior interpretations of the fiduciary duty, which treated investment in equities as imprudent, a comment was inserted into the Restatement of Trusts (Third) §227, that aptly observed:

"Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments."

**Effect of Market Changes and Ongoing Development of Knowledge**

Interpretation of fiduciary duty is under pressure from changes in the financial markets, economy and asset management industry since the 20th century. Those changes have included:

- Growth in the amount of global capital managed by fiduciaries who follow the same investment strategies to the point where herding behavior magnifies market cycles;
- Pressure to converge around short-term investment strategies and market-relative benchmarks that further encourage herding behaviors;
- Increasing market complexity that increases the influence of expert service providers on governing fiduciaries;
- Exposure to systemic and extra-financial risks that are often not reflected on market valuations and financial statements;
- Unexpected market shocks that were not anticipated under prevailing investment theories.

Old assumptions about market fundamentals and risk exposures have also been challenged by events of the past decade, with profound implications for fiduciary norms. Long-held beliefs that provided the basis for 20th century views on fiduciary duty are no longer uniformly held. For example, investors are no longer relied upon to behave rationally, it is recognized that biases of market participants can undermine efficient allocation of capital and there is a growing understanding that portfolio risk cannot be automatically diversified away without contributing to creation of systemic risk.4

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**Most Returns Result from Market Exposure - Not Outperformance**

New research shows that 75 percent or more of a typical fund’s returns come from general exposure to the market (beta), not from alpha seeking (market benchmark outperformance) strategies.\(^5\) This makes systemic market factors central to fund performance and fiduciary responsibility.

Events of the last decade have increased awareness that institutional investors are not immune from the state of the economy - investment success and economic health have a symbiotic relationship. Given the increased growth and influence of institutional investors, their practices now influence the market. Conversely, market integrity and systemic risks influence investment success. Even before the 2008 economic crisis, a joint study by leading investment and business organizations found:

> “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.”\(^6\)

**Understanding of Risk is also Evolving**

An additional outcome of recent developments has been a greater appreciation that the risks borne by fund beneficiaries are not limited to the four corners of financial statements. For example, the primary professional association for financial analysts provides the following current advice:

> “The CFA Institute stresses as a fundamental governing principle that financial professionals worldwide have a duty to act in the best interests of their clients and ultimate beneficiaries. There is an increasing recognition of the need to include the analysis of ESG (environmental, social and governance) factors in order to more completely fulfill this duty.”\(^7\)

The top ten risks cited by managers at large US pension funds in 2010 included plan governance, advisor risk, ability to measure risk, decision process quality and fiduciary-related litigation exposure.\(^8\) Risk management for investors is clearly no longer limited to what is captured by market benchmarks. Fiduciaries are well advised to integrate this broader view into their investment management practices.

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\(^6\)“Breaking the Short-Term Cycle,” CFA Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics, July 2006.


\(^8\) “MetLife U.S. Pension Risk Behavior Index,” Metropolitan Life Insurance Company (February 2010).
Duty of Loyalty

The duty of loyalty is generally referenced as a prohibition on self-interested transactions. Indeed, that is an important application of the duty. However, it also requires that fiduciary procedures reflect a proper alignment of interests between the procedures and practices used by fund managers and the interests of fund beneficiaries. Loyalty also imposes a general prohibition on engaging in activities that create an avoidable conflict between a fiduciary’s legal obligations and personal interests, including the interests of third parties.

The duty of loyalty precludes use of fund assets to further causes or issues that are unrelated to the organization’s purpose and the interests of its beneficiaries. This is often misinterpreted as an obligation to support the status quo, even though current practices might not be in the interests of beneficiaries or be consistent with the organization’s charitable purposes.

Loyalty is a high standard, based on trust law’s recognition that (a) it is difficult, if not impossible, for a person to act impartially in a matter in which he has an interest; (b) fiduciary relationships lend themselves to exploitation; and (c) disloyal conduct is hard to detect. Accordingly, the duty of loyalty in investment matters is stricter at non-profit than at for-profit companies. The duty also includes obedience to charitable purposes and an obligation to act impartially when dealing with divergent interests of beneficiaries (although sometimes obedience and impartiality are expressed as duties separate and apart from loyalty).

Impartiality and Obedience to Charitable Purposes

The Uniform Prudent Investor Act (governing trusts) and the Uniform Prudent Management of Institutional Funds Act (governing other entities) both require that fiduciaries at non-profits consider charitable purposes of the entity in managing investments to serve both current and future beneficiary interests. While sometimes expressed as a separate duty, the fiduciary duty of obedience to charitable purpose is often described by courts and commentators as part of the duty of loyalty.9

The duty of obedience recognizes that charitable purpose is what justifies tax exempt treatment of charities. It also contemplates that the investment and program functions of non-profits not work at cross purposes.

"Some commentators even argue that the duty of obedience 'is more basic, constituting the foundation on which the duties of care and loyalty ultimately rest.' Some courts echo the view, pointing out that non-profit directors must be 'principally concerned about the effective performance of the nonprofit's mission.'\textsuperscript{10}

The duty of impartiality assumes competence in respect of long-term value creation and risk mitigation. To be clear, the issue is not that a short-term outlook is wrong but, rather, that a deliberate balance must be struck between current and future needs. This has profound implications for evaluation of risk exposures and investment approaches at organizations whose purpose extends beyond the near term. Indeed, impartiality should be a major focus of fiduciaries at charities which are intended to exist in perpetuity.

The CFA Institute's Code of Conduct for Members of a Pension Scheme Governing Body advises that an effective trustee will "consider the different types of beneficiaries relevant to each pension scheme" and "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough to support real benefit increases for active participants who will become future beneficiaries while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners."

Together, loyalty, impartiality and obedience to charitable purposes provide a powerful counterbalance to herding pressures fostered by excessive focus on the duty of prudence and its use of similar investors a reference point for fiduciaries. They bring a balance to fiduciary investment practices that preclude self- or other-dealing and reflect both a more holistic understanding of risk and a commitment to fairness between current and future beneficiaries.

**The Way Forward**

Interaction between loyalty, impartiality, obedience to purposes and the duty of prudence in serving beneficiaries' interests presents a series of challenges for fiduciaries. For fiduciaries who seek fulfillment of the full intent of their legal obligations, rather than to merely do what is required to avoid liability, there are four critical focus areas where realignment of fiduciary practices could better address the challenges.

- **Board governance practices:** Empirical evidence has identified key drivers of long-term investment fund success as including: (a) selection of skilled governing board members, with stakeholder representation; (b) adoption of sensible investment beliefs and understanding of organizational purpose; (c) adequate size to allow cost effective management; (d) insulation from conflicting interests or agendas; (e) clarity of accountability and

\textsuperscript{10} Id. at 468.
understanding of the different roles of board and staff; and (f) development of a continuous self-improvement culture.\textsuperscript{11}

- **Service provider conflicts of interest:** Attention to effective management of conflicts of interest and alignment of interests may require (a) imposition of fiduciary obligations throughout the supply chain with use of selection criteria and contract clauses; (b) better alignment of fee structures with charitable purpose and beneficiary interests; (c) ongoing reporting, oversight and enforcement of behavioral standards; and (d) regular reporting on conflict identification and management practices.

- **Precautionary risk management:** Fiduciary duties run to beneficiaries as human beings rather than to the trust fund as a pool of assets. Consequently, fiduciaries must take the interests of beneficiaries to whom fiduciary obligations are owed into account and seek to "do no harm" to them.\textsuperscript{12} This is part of the duty of loyalty and, for most non-profits, the duty of obedience.

- **Integrating sustainability into investment management practices:** Systemic and environmental, societal and governance risks with real economic consequences do not always appear on balance sheets. Long-term capital growth opportunities that would accrue to the benefit of a non-profit's beneficiaries may not be evident when investment practices are focused exclusively on immediate results. The challenge for fiduciaries with long-term obligations and risk exposures is to integrate these factors into their investment practices.

Ongoing industry consideration of improvements to investment and risk management policies, procedures and oversight will likely be needed to address these issues. The factors in Table 1 (below) are suggested to guide fiduciaries at non-profits in reclaiming a fiduciary duty balance that reflects 21st century realities and a more holistic understanding of investment risk.

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Table 1
Reclaiming Fiduciary Balance – Issues for Non-Profit Governing Fiduciaries

<table>
<thead>
<tr>
<th>Fiduciary Challenges</th>
<th>Policies and Procedures</th>
<th>Oversight Responsibilities</th>
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<tbody>
<tr>
<td>• Changing circumstances &amp; knowledge base</td>
<td>• Allocate resources &amp; time to understand challenges</td>
<td>• Acquire expertise to understand fiduciary challenges</td>
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<tr>
<td>• Systemic &amp; long-term risk exposures</td>
<td>• Adopt sensible investment beliefs and an holistic risk management approach</td>
<td>• Revise service provider RFPs to address fiduciary issues</td>
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<tr>
<td>• Equitable treatment of current and future obligations</td>
<td>• Include benchmarks tied to short- and long-term impact on obedience to charitable purposes</td>
<td>• Review and support investor research on long-term issues &amp; fiduciary challenges</td>
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<td>• Unbalanced short-termism pressure</td>
<td>• Understand global best governance practices</td>
<td>• Foster collaboration between similar investors on shared issues &amp; development of resources</td>
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<td>• Conflicts of interest throughout service provider chain</td>
<td>• Develop fit for purpose governance capabilities</td>
<td>• Measure success impartially in regard to both current and future beneficiary interests and obedience to charitable purposes</td>
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<tr>
<td>• Improve non-profit governance practices</td>
<td>• Expand investment reporting to specifically address obligations of loyalty, impartiality and obedience to charitable purposes</td>
<td>• Identify, measure &amp; manage investment-related risks to charitable purposes</td>
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<tr>
<td>• Implementation of do no harm principle</td>
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<td>• Align service provider contracts &amp; fees with beneficiary interests and obedience to charitable purposes</td>
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<tr>
<td>• Alignment of investment policies &amp; procedures with duty of obedience to charitable purposes</td>
<td></td>
<td>• Manage investment opportunities consistent with charitable purposes</td>
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