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NOTES

MUST WE TEACH ABSTINENCE? PENSIONS' RELATIONSHIP INVESTMENTS AND THE LESSONS OF FIDUCIARY DUTY

Ethan G. Stone

INTRODUCTION

It has long been observed that when large numbers of small investors pool their money in a single firm, none can afford to take much of an interest in its management. The result is a strong temptation for managers to pursue their own interests along with, or even above, those of their investors. Of late, there have been proposals that some of the agency costs of corporate management might be alleviated if large financial intermediaries would engage in "relationship investing." Relationship

1. The first observation that corporate shareholders owned but did not control public corporations is often attributed to Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932). Shareholders have been on notice for far longer. See Joseph A. Grundfest, Subordination of American Capital, 27 J. Fin. Econ. 89, 100 (1990) (citing Adam Smith for proposition).

2. For a definition of financial intermediaries, see Mark J. Roe, A Political Theory of American Corporate Finance, 91 Colum. L. Rev. 10, 16 & n.19 (1991) [hereinafter Political Theory]. In the general discussions of relationship investing, this Note will alternately refer to these intermediaries as "institutional investors" and "money managers." The bulk of this Note will deal only with pension plans.

investing means that a money manager makes equity investments large and long-term enough to justify the expense of actively monitoring the management of companies in which it invests.

The agency problem, however, is ancient, and the proposed solution, in its general outlines, almost as venerable. Consequently, the proposal often has more the character of a fundamentalist revival than a progressive invention: Its proponents must explain not only why the strategy is clearly superior to present practice, but also why financial intermediaries did not adopt it long ago and without encouragement. One popular answer is that the regulations governing financial institutions prevent these institutions outright, or at least strongly deter them, either from holding large equity blocks or engaging in the kind of activism needed. This argument takes on slightly different forms for each


4. While financial intermediaries are not new institutions, their size and dominance of the equity market have grown substantially of late. In 1990, the percentage of all equities held by institutional investors reached 53.8%, a 15.3% increase from 1981. See Black, Agents, supra note 3, at 827. Pension funds themselves held 28.2% of the equity market. See id. Most of the proponents of relationship investing attribute the increasing activism of some institutions to this growth. Still, most are dissatisfied with the general level of activism.


There are other possible answers to the question. One is that it does not pay off. Myra R. Drucker, assistant treasurer of Xerox, whose pension plan has approximately $5.3 billion, and vice chairman of the Committee on Investment of Employee Assets, whose members manage more than $700 billion in corporate pension assets, recently commented that “[s]hareholder activism is one of many investment approaches and we don’t feel it gives us the biggest bang for our buck.” Leslie Wayne, U.S. Prodding Companies to Activism on Portfolios, N.Y. Times, July 29, 1994, at D1, D3 (incorrectly listing the pension assets of the committee’s members as $700 million). In this vein, see, e.g., Dylan Machan, Monkey Business, Forbes, Oct. 25, 1993, at 184, 190 (noting passive fund with lower management costs per dollar return than active fund). But see Lilli A. Gordon & John Pound, Active Investing in the U.S. Equity Market: Past Performance and Future Prospects: A Report Prepared for the California Public Employees’ Retirement System 36–38, 44–45 (1993) [hereinafter Gordon & Pound, CalPERS Report] (finding substantial evidence that certain active investment strategies, including properly executed relationship investing, produce above-market returns); Stephen L. Nesi, Long-Term Rewards of Shareholder Activism: A Study of the “Calpers” Effect, J. App. Corp. Fin., Winter 1994, at 75 (1994) (finding statistically significant returns from companies subject to CalPERS activism). Another answer is that certain strategies benefit investors but not their money managers.
kind of institutional investor. For the private pension funds, regulated by
the Employee Retirement Income Security Act of 1974 (ERISA), the
argument is that statutory fiduciary duties deter pension managers from
holding large blocks of stock or engaging in uncommon investment
strategies.

The claims of deterrence break down by the various fiduciary duties:
(1) the duty to act prudently in investing the beneficiary’s assets, (2) the
duty to diversify investments, and (3) the duty to act loyally, that is solely
in the interests of the beneficiaries. The duty of prudence might require
pension managers to mimic the actions of other pensions and even more
stringently regulated institutions, severely deterring any innovation in
investment strategy. The related duty of diversification might encourage
such excessive fragmentation of portfolios that even large investors could
not hold significant blocks of any one company. Finally, the duty of loy-
ality could pose problems because of the potential for conflicts of interest
inherent in closer relationships with, and more significant stakes in, the
investment.

This Note will argue that the concerns over the legal requirements of
prudence and diversification are largely groundless. To some extent,
they stem from misinterpretations of the statutory language, and to some
extent they are belied by the actual court interpretations of these duties.
ERISA’s fiduciary duties of prudence and diversification would not stand
in the way of any fiduciary who adequately convinced herself that relation-
ship investing in general and the particular investments contemplated
were economically justified. Problems of loyalty might block cer-
tain kinds of relationship investing. Their exact impact is uncertain, but
uncertainty might not be far from total deterrence in the field of fiduci-
ary investing.

Part I will set out the background to relationship investing and
ERISA’s fiduciary duties. Part II will discuss arguments claiming that
those fiduciary duties might impede relationship investing.

See, e.g., Gordon, Relational Investors, supra note 3, at 130–41 (money managers’
institutional conflicts and other problems argue against involvement beyond influencing
board composition); Rock, supra note 3.

The argument against regulation does not hinge on certainty that relationship
investing is desirable, but rather on a suspicion that regulations would prevent it if it were.
A discussion of whether relationship investing could make money at all is beyond the scope
of this Note. It will be assumed throughout that some form of relationship investing by
pension plans could be efficient in relation to other common investment alternatives.

§§ 1001-1461).

7. See Roe, Strong Managers, supra note 3, at 138–43; Black, supra note 5, at 553–56;
Coffee, supra note 3, at 1356–57 (diversification); Roe, Political Theory, supra note 2, at
23–34.
A. Relationship Investing

Relationship investing describes an investment strategy in which the investor acts as a long-term equity owner of a business, rather than a trader or arbitrageur of its securities. It falls somewhere along the gradient between pure arbitrage and sole proprietorship. Relationship investing, as the term will be used in this Note, requires some kind of long-term, mutual engagement between a large investor and corporate management in planning and evaluating the corporation's business decisions.

Different levels of oversight and intervention are possible. A weak approach might involve merely monitoring the investment's governance structure to assure that management does not impede the formal checks on its discretion and tenure. For example, the investor might oppose the adoption of certain poison pills or press for independent directors. A stronger approach might extend to monitoring and intervening in business decisions on a strategic planning level. This Note assumes the stronger model.

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9. For similar definitions, see Lowenstein, supra note 3, at 213–14; Gordon, Relational Investors, supra note 3, at 129.

10. See Black, supra note 5, at 580–84, 589–91 (listing those reforms most amenable to economics of scale); Gilson & Kraakman, Outside Director, supra note 3; Gordon, Relational Investors, supra note 3, at 130–41 (advocating relationship limited to monitoring board structure and intervening at times of crisis).

11. See Gordon, Relational Investors, supra note 3, at 134–35 (taxonomy of monitoring levels); Roe, Political Theory, supra note 2, at 55–56 (different taxonomy); see also Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy [sic] or Guidelines, 59 Fed. Reg. 38,860, 38,864 (1994) (to be codified at 29 C.F.R. § 2509.94-2) [hereinafter Governance Bulletin] (describing levels of "shareholder activism").

12. It is not assumed that the people presently managing institutional investors have the requisite expertise to monitor management at any given level of detail. However, it is assumed, for the purposes of this Note, that there are people who do and that they can be identified ex ante, though not necessarily at a cost justified by the gains they would bring. The assumption is not too far-fetched. For instance, California law requires both the California Public Employees Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) to retain a full-time employee who is "experienced and knowledgeable in corporate management issues to monitor each corporation and of whose shares are owned by the system and to advise the board on the voting of the shares owned by the system and on the responses of the system to merger proposals and tender offers." Cal. Gov't Code § 20,206.3 (West Supp. 1994) (CalPERS); Cal. Educ. Code § 22,354 (West 1994) (CalSTRS). Apparently neither has had difficulty in filling the position. CalPERS has also commissioned expert studies which it then shared with management in expressing its concerns. See Nesbitt, supra note 5, at 76.

Several limited partnerships now claim to be engaged in (or planning to engage in) relationship investing. These funds have raised significant amounts of capital and have been operating for years. See Brown Brothers Diversifies Investors in 1818 Fund II, Private
Proponents claim two main advantages to relationship investing. First, a large shareholder has better ability and incentives to watch that management diligently pursues shareholder value only. Second, the mutual trust and commitment of a long-term relationship could lower the costs of information to the investor and capital to the corporation. The investor invests with information better than the market and, if skilled enough to use it, can presumably obtain higher returns. Management, in turn, may obtain cheaper capital in times of need, because it need not pay a well-informed investor the full risk premium it would pay for outside, uninformed capital.

There are two possible ways to enter a relationship investment: voluntarily and involuntarily. Involuntary relationship investing is a strategy that might be adopted by large, institutional investors, with passive, indexed investment strategies that effectively immobilize their equity holdings. These investors cannot change their equity holdings without contradicting the basic purpose of the index, so some have attempted to monitor corporate management, hoping to minimize preventable

Placement Rep., Dec. 20, 1993, at 4, available in LEXIS, BANKS Library, ABBB File (first fund began in 1989); Mike Meyers, Investment Fund Plans on Turnaround, Star Tribune (Minneapolis), July 30, 1990, at 5D (Corporate Partners began in 1988); see also infra note 137. Presumably they believe and have convinced their investors, which include the private pension plans which ERISA governs, that they have some expertise in the enterprise. See Brown Brothers Diversifies, supra note 137 (8.7% of investments in new fund from private pensions). Similarly, LBO firms, which are also in the business of setting up long-term (or at least relatively illiquid) relationships with the companies they take over, apparently advertise their skills at monitoring the performance of these companies. See Black, Value, supra note 3, at 925 & n.133. But see Lowenstein, supra note 3, at 215 (taking skeptical view of monitoring offered by either LBO firms or relationship investing funds).

13. See, e.g., Black, Agents, supra note 3, at 832–33; Roe, Political Theory, supra note 2, at 14 (arguing that large investments give investors incentives to invest in monitoring so that falling profits swiftly bring intervention or quick, cheap shift in control through block sale).

14. "Returns" refer to long-term growth in the investment's worth boosted through careful evaluation and occasional guidance of management, not gains from short-term trading on inside information. Aside from open-ended mutual funds, institutional investors do not tend to need high liquidity at any time. The investor could eventually reap any gains through dividends and cautiously planned (or privately negotiated) sales of equity at times when inside information and short-swing profit rules did not prevent them.

15. See Lowenstein, supra note 3, at 211–17; William G. Ouchi, The M-Form Society: How American Teamwork Can Recapture the Competitive Edge 63, 87 (1984); Roe, Political Theory, supra note 2, at 14. The main criticism of both of these claims as applied to institutional investors is that the institutional money managers do not have the proper incentives to pursue the interests of their beneficiaries. See Coffee, supra note 3, at 1326–27; Gordon, Relational Investors, supra note 3, at 131–32; Rock, supra note 3, at 464–78. Both Black and Roe answer that juxtaposing agents with varying self-interests should allow at least some beneficial monitoring. See Black, Agents, supra note 3, at 876–82; Roe, Political Theory, supra note 2, at 55.

16. For a definition of indexing see Burton G. Malkiel, A Random Walk Down Wall Street 362 (5th ed. 1990); Machan, supra note 5, at 188, 190.
problems. Voluntary relationships are another matter. A voluntary relationship investor would make a conscious decision to search for and establish relationships with good, but undervalued companies. These investments would likely be pre-negotiated and carefully structured, and might include preferred stock and contractual governance rights (such as rights to information or board representation), creating incentives different from those of simple common stockholders.

The voluntary or involuntary nature of the strategy has two consequences for the discussion of fiduciary duties under ERISA. First, it impacts the test for prudence. Involuntary relationship investing is a strategy for monitoring investments that were originally chosen for other reasons. The fiduciary would have to defend the prudence of relationship investing as a monitoring strategy only. A voluntary relationship, however, itself reflects a strategy for picking investments. The fiduciary would have to defend the prudence of choosing the investments, not merely of monitoring them in a certain way. Second, the extent that an investment is structured or unstructured will affect the relationship between the money managers and corporate managers, and consequently, both the allocation of fiduciary duties and potential loyalty problems.


18. Carefully negotiated investments with extensive mutual bonding measures are presently the custom in relationship investing. See Robert T. Kleiman et al., Are There Payoffs For “Patient” Corporate Investors?, Mergers & Acquisitions, Mar./Apr. 1994, at 34. For examples of possible structures that both lock in a return higher than non-negotiated investments and place barriers to exit, see, e.g., Laura Jeresi & Keith H. Hammonds, Warren Buffet Makes Money by Making Nice, Bus. Wk., Aug. 7, 1989, at 58 (describing purchase of preferred stock at preferential rates of return coupled with right of first refusal to company in case of exit); Hilary Rosenberg, CalPERS Goes Direct, Institutional Investor, Sept. 1993, at 191 (describing limited partnership with natural gas company into which CalPERS donates cash and company donates its stock with negotiated minimum returns on stock and varying stakes in increments of profit); Allan Sloan, Polaroid Deal Doesn’t Click, Newsday (Nassau & Suffolk ed.), Feb. 1, 1989, at 43 (describing purchase of 15% stake combined with warrants exercisable and preferred shares convertible over seven years at 125% of tender-offer-inflated market price). Such deals often result from a takeover defense and may less reflect the investor’s confidence in management or the ultimate value of the company so much as they do an assessment that management can keep the company sufficiently afloat to pay out the preferred dividends. If this is the case, they are simply another instance of management self-entrenchment at shareholder expense. See Sloan, supra. Gordon and Pound were careful to account for this possibility in their study, measuring the success of even negotiated investments by return to common stockholders. See Gordon & Pound, CalPERS Report, supra note 5, at 3. Their results indicate that a “patient capital” investment in common stock produces high returns for stockholders, whereas a similar investment in preferred produces unusually low returns. See id. at 4. These findings are suggestive, but not definitive. See id.
B. **ERISA and Its Fiduciary Duties**

Private pension funds, which currently account for around one-fifth of U.S. stocks, make up the largest category of regulated intermediaries in the equity market.\(^{19}\) Within this category, defined benefit plans, to which this Note will confine itself, are a significant subclass.\(^{20}\) Accordingly, their actions are important both for a theory explaining shareholder behavior and for any program to change it. These funds are regulated by the Employee Retirement Income Security Act of 1974 (ERISA),\(^{21}\) which imposed a modified codification of the common-law

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19. See Roe, Strong Managers, supra note 3, at 125 (citing Board of Governors of the Federal Reserve System, Flow of Funds Accounts—First Quarter 1993, at 112). Some of the amount Roe lists for public pensions should be added to the total for these purposes. See infra note 21.

20. ERISA permits several kinds of plans. In defined benefit plans, the sponsor specifies in advance the benefits that will accrue to retirees and then contributes to fund the future liabilities. See ERISA § 3(35), 29 U.S.C. § 1002(35) (1988). In defined contribution plans, the sponsor specifies a formula of contribution, and the employee’s benefits at retirement depend on the performance of the fund. See ERISA § 3(34), 29 U.S.C. § 1002(34). Many defined contribution plans are in the form of “individual account plans” under which each employee individually directs the investment of his funds. Such plans are largely exempt from ERISA’s fiduciary duties. See ERISA § 404(c), 29 U.S.C. § 1104(c). They are also not institutional investors. This Note will assume throughout that the plan in question is of the defined benefit variety. Although defined contribution, individual account plans are increasingly popular compared to defined benefit plans, see Defined-Benefit Plans on the Defensive, Institutional Investor, July 1988, at 101, the latter will continue to manage substantial assets for the near future and could be relationship investors. See What Will the Next Decade Bring?, Institutional Investor, Jan. 1990, at 121 (finding that 75% of private pension managers anticipate both defined-benefit and defined-contribution plans by end of decade). See generally The 1993 Pensions Directory, Institutional Investor, Jan. 1995, at 117 (detailing amounts of assets in each category for largest plans).


This Note will assume throughout that these plans also operate under the general rubric of ERISA. It stands to reason that their fiduciaries and the state courts will carefully consider federal materials in interpreting their parallel statutes, even though they are not directly governed by federal law. Federal law governs every private pension fund in the country, whereas any given state law often governs only one or two funds. The amount of federal court decisions and administrative materials expounding ERISA’s fiduciary duties is therefore much larger and more developed than any comparable body for a given state statute (if there is any at all). See, e.g., Board of Trustees v. Mayor of Baltimore, 562 A.2d
trustee's fiduciary duties on anyone with discretion and responsibility in the management of pension funds. The intent of Congress was to better protect employee retirement benefits by assuring that all private pensions would be subject to a uniform national standard, tailored to the needs and dangers of pension plans. ERISA also attempted to provide uniform and effective remedies for both beneficiaries and the Department of Labor (DoL) in the federal courts.

1. Plan Arrangement and Assignment of Fiduciary Duties. — ERISA specifies the structure of pension plans. Every ERISA plan must be set up according to a written instrument fixing at least one fiduciary, either by name or position. With a few exceptions, all plan assets must be held in trust. The trustee must have exclusive title to and control over the plan assets, unless the plan instrument grants discretion either to the named fiduciary (creating a passive trust and directed trustee) or to an investment manager. ERISA defines "fiduciary" functionally to include anyone who renders investment advice for compensation, or who exercises discretionary authority over plan assets or plan administration.

Joint fiduciaries and trustees may, by explicit authority in the plan instrument, share discretionary responsibility for plan assets or delegate it to investment managers. A given trustee's fiduciary duty extends only to assets under her control. Absent such an arrangement, joint trustees


29. See ERISA §§ 402(c), 403(a), 29 U.S.C. §§ 1102(c), 1103(a). For the definition of investment manager, see supra note 26.

30. See ERISA § 405(c)(2), 29 U.S.C. § 1105(c)(2).
have a duty to exercise reasonable care to prevent a co-trustee from committing a breach. In addition, all fiduciaries are liable for the breach of a co-fiduciary if they (a) knowingly participate in or undertake to conceal the breach, (b) enable the breach through their failure to fulfill their own fiduciary responsibilities, or (c) have knowledge of the breach and fail to make reasonable efforts to remedy it. Thus, if a trustee delegates responsibility to another fiduciary, the trustee’s duties of prudence and loyalty will apply both to selecting the delegee and periodically reviewing his performance.

2. Substantive Duties. — An ERISA fiduciary has three principal substantive fiduciary duties: prudence, diversification of investments, and loyalty to beneficiaries. Congress modeled these duties after those of trustees at common law, but modified them to meet the perceived needs of pension funds and apparently intended the courts to interpret them according to this special purpose.

a. Duty of Prudence. — The duty of prudence is the primary duty governing the fiduciary’s selection and monitoring of investments. ERISA

33. See Knickerbocker, supra note 27, at 662. Similarly, the “directed trustee” may carry out the named fiduciary’s directions only to the extent that they are proper under ERISA. See ERISA § 403(a)(1), 29 U.S.C. § 1103(a)(1).
36. See id. § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A); see also the list of prohibited transactions (self-dealing) in id. § 406, 29 U.S.C. § 1106. Section 404(a)(1)(D), 29 U.S.C. § 1104(a)(1)(D) also imposes a duty to act according to the plan instruments to the extent consistent with ERISA. This Note will not deal with restrictions voluntarily adopted in plan instruments.
37. See H.R. Conf. Rep. No. 1280, 93d Cong., 2d Sess. 302–03 (1974), reprinted in 1974 U.S.C.C.A.N. 5038, 5083 [hereinafter Conference Report]; see also J. Daniel Plants, Note, Employer Recapture of ERISA Contributions Made by Mistake: A Federal Common Law Remedy to Prevent Unjust Enrichment, 89 Mich. L. Rev. 2000, 2021–23 (1991) (citing ERISA’s legislative history and frequent use of common-law terms as evidence of congressional authorization to create federal common law). The distinctive purpose of ERISA seems to be “the supplying of retirement or deferred income and health and welfare benefits to employees covered under the plans.” This requires every fiduciary who invests plan assets “to adopt economically sound objectives and methods—policies, procedures, and particular investment decisions—designed to achieve that goal.” 125 Cong. Rec. 932 (1979) (remarks of Sen. Williams); see Bevis Longstreth, Modern Investment Management and the Prudent Man Rule 32–36 (1986). On a more concrete level, pension fiduciaries differ from private funds in that they do not have to weigh the interests of beneficiaries and remaindersmen, they receive a continuous influx of new funds, and their funds are tax exempt. See id. at 33. It is worth remembering, in this context, that Employers’ Accounting for Pensions, Statement of Financial Accounting Standards No. 87 (Fin. Accounting Standards Bd. 1982) requires that companies include information as to their pension liabilities and funding in a footnote to the annual financial statement and, under certain circumstances, in the balance sheet itself. This suggests that the employer executives who are typically the named fiduciaries of an ERISA defined-benefit plan now have a serious incentive to attain a high rate of return in actuality, not only to assume one in the footnotes of their annual reports.
§ 404(a)(1)(B) requires the fiduciary to “discharge his duties . . . (B) 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.” This standard is further developed in a regulatory section which suggests that the fiduciary give appropriate consideration to those facts and circumstances that, given the scope of [the] fiduciary’s investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role the investment or investment course of action plays in that por-


39. The traditional standard of the trust fiduciary, first enunciated in Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830), required that he (as she was then) imitate 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.” Some version of it now applies in most states. See 3 Austin W. Scott & William F. Fratcher, The Law of Trusts § 227, at 431 (4th ed. 1988); George G. Bogert & George T. Bogert, The Law of Trusts and Trustees § 613, at 57 & n.15 (rev. 2d ed. 1980 & Supp. 1993). Many states enacted the statutory version in the Model Prudent Investment Act, adopted by the Trust Division of the American Bankers Association in the 1940s. See John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 Am. B. Found. Res. J. 1, 5. Some of those statutes have now been revised from the original formulation, and some have replaced the Amory formulation of the duty of prudence with ERISA’s. See, e.g., Cal. Prob. Code § 16040 (West 1991).

40. The regulation was explicitly designed as a “safe harbor.” Thus, compliance with its provisions satisfies § 404(a)(1)(B), but “the Department does not view compliance with the provisions of the regulations as necessarily constituting the exclusive method for satisfying the requirements of the ‘prudence’ rule.” Investment of Plan Assets Under the “Prudence Rule”, 44 Fed. Reg. 37,221, 37,222 (1979) [hereinafter DoL Preamble] (discussion of regulation). Only one federal case has given this regulation anything more than a summary citation (LEXIS and Westlaw searches by its citation number reveal only five cases citing it at all). Even there, the court gave it very short shrift, noting that The DoL’s Rules and Regulations for Fiduciary Responsibility are “interpretative” and not “legislative” in character, and represent the Department’s opinion as to the meaning of the “prudence” rule and do not have the force of law. The value of this interpretative material thus hinges on whether its construction of ERISA is practical and consistent with the Act’s central purposes.

Donovan v. Walton, 609 F. Supp. 1221, 1243 (S.D. Fla. 1985) (citations omitted), aff’d, 794 F.2d 586 (11th Cir. 1986). Still, the typical fiduciary would probably prefer to dock in a safe harbor, even if equipped to ride out storms at sea. The beauty of trust law, from the perspective of a regulatory agency, is that paranoid fiduciaries can carefully plan their actions to minimize the risk of being sued. Cf. Longstreth, supra note 37, at 35 (Many cases settle out of court.). Jeffrey N. Gordon, The Puzzling Persistence of the Constrained Prudent Man Rule, 62 N.Y.U. L. Rev. 52, 66 (1987) (“[I]f the potential litigants are risk averse, the rules and categories of authoritative commentary will prove self-reinforcing.”). It might be argued that this effect would be mitigated by the fact that ERISA fiduciaries, unlike common-law trustees, often have an interest in the growth of their funds. See supra note 37. Still, where caution is possible and lawyers ubiquitous, only a very strong motivation could induce a fiduciary to dare the Department to follow through on its stated policies.
tion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and . . . act accordingly.\footnote{29 C.F.R. § 2550.404a-1(b)(1)(i)–(ii) (1993).} The full scope of appropriate consideration and relevant facts and circumstances is a factual question determined only by the context of each case.\footnote{See DoL Preamble, supra note 40, at 37,223.} However, the regulation specifically requires the fiduciary to determine that the investment or investment course of action\footnote{“Investment course of action” is defined as “any series or program of investments or actions related to a fiduciary's performance of his investment duties.” 29 C.F.R. § 2550.404a-1(c)(2) (1993).} “is reasonably designed, as part of the portfolio . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain.”\footnote{Id. § 2550.404a-1(b)(2)(i).} It also requires consideration of “(A) [t]he composition of the portfolio with regard to diversification; (B) [t]he liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and (C) [t]he projected return of the portfolio relative to the funding objectives of the plan.”\footnote{Id. § 2550.404a-1(b)(2)(ii)(A)–(C).} 

b. Duty of Diversification. — ERISA § 404(a)(1)(C) requires the fiduciary to “discharge his duties . . . by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.”\footnote{29 U.S.C. § 1104(a)(1)(C).} A regulation, supplementing the statute, suggests that the prudent fiduciary consider, among other factors, “[t]he composition of the portfolio with regard to diversification.”\footnote{See 29 C.F.R. § 2550.404a-1(b)(2)(ii)(A). For a discussion of the interpretive weight of this regulation, see supra note 40.}

The ERISA standard is nearly an exact copy of Restatement (Second) of Trusts § 228 and the Conference Report’s list of factors, and its advice to avoid investing the “whole or an unduly large proportion” of the plan assets in any one type of investment are lifted verbatim from comments b and c of the Restatement.\footnote{See Conference Report, supra note 37, at 304, reprinted in 1974 U.S.C.C.A.N. 5038, 5084–85.} ERISA departs significantly from the Restatement language only in requiring that any failure to diversify be “clearly” prudent. This requirement simply shifts the burden of proof, forcing the fiduciary to prove prudence if the plaintiff can show a lack of diversification.\footnote{See id.}

Together, these sections closely approximate the common-law trustee’s duty.

The common-law trustee “is under a duty to administer the trust solely in the interest of the beneficiaries.”52 The rule is prophylactic.53 The fiduciary “cannot contend ‘that, although he had conflicting interests, he served his masters equally well or that his primary loyalty was not weakened by the pull of his secondary one.’”54 Thus, the fiduciary who acts for some identifiable purpose other than providing benefits to the participants and reasonably administering the trust may breach her duty of loyalty.

ERISA’s exclusive benefit rule requires a fiduciary to discharge her duties “solely in the interest of the participants and beneficiaries and — (A) for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan.”55 This rule seems to be equivalent to the common-law duty. The Supreme Court in NLRB v. Amax Coal Co. held that a similar statutory formulation imposed “an unwavering duty of complete loyalty to the beneficiary of the trust, to the exclusion of the interests of all other parties.”56 ERISA, however, emphasizes the prophylactic aspect of the duty by setting out a separate series of prohibited transactions that constitute fiduciary breach regardless of the fiduciary’s motive or intent.

53. See Bogert & Bogert, supra note 39, § 543, at 246–47. Bogert compares the trust rule with corporate directors’ looser duty, which is satisfied by full disclosure and a showing of fairness and good faith. See id. at 262–63.
54. N.L.R.B. v. Amax Coal Co., 453 U.S. 322, 330 (1981) (quoting Woods v. City Nat’l Bank & Trust Co., 312 U.S. 262, 269 (1941)). The cases that have dealt with an ERISA fiduciary’s duty under cases of conflict of interest have sometimes applied a standard less strict than the common law prophylactic rule. In Donovan v. Bierwirth, 538 F. Supp. 463, 470 (E.D.N.Y. 1981), aff’d as modified, 680 F.2d 263 (2d Cir.), cert. denied, 459 U.S. 1069 (1982), for instance, the court did not require the plan’s fiduciaries, who were also officers of the sponsor, to resign rather than decide whether to tender the plan’s common stock in a takeover bid for the plan sponsor. See also the Seventh Circuit’s approving discussion of Donovan in Leigh v. Engle, 727 F.2d 113, 125–26 (7th Cir. 1984). This loosening, however, is in recognition of the fact that ERISA specifically contemplates having trustees who are officers of the sponsor. See Bierwirth, 538 F. Supp. at 469 (recognizing statutory allowance of officer-trustees as equivalent of authorization to engage in certain kinds of conflicted transactions in common-law trust instrument). If the interests are wholly foreign to the plan and its sponsor, the strict rule should still apply.
Section 406(b) prohibits transactions in which the fiduciary has certain conflicts of interest,\(^57\) absent a special exemption.\(^58\) The central difference between this section and the exclusive benefit rule is that the prohibited transactions specify particular behavior, requiring no additional showing that the action was other than for the exclusive benefit of beneficiaries.\(^59\) It should be noted that § 406(b)(1), which prohibits the fiduciary from dealing in his own interest, is not really more specific than the exclusive benefit rule.\(^60\) Subsections 406(b)(2)–(3), however, prohibiting the fiduciary from acting on behalf of both sides in a transaction and from receiving consideration from a party dealing with the plan, do not require an improper motivation.\(^61\)

Those who posit that regulatory barriers prevent American financial intermediaries from an otherwise headlong rush into relationship investing claim that private pension funds are largely held back by ERISA’s fiduciary duties.\(^62\) The rest of this Note will investigate the extent to which ERISA’s fiduciary duties could prevent pension fiduciaries from engaging in various forms of relationship investing.

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57. "A fiduciary with respect to a plan shall not — (1) deal with the assets of the plan in his own interest . . . [or] (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries . . . ." ERISA § 406(b)(1)–(2), 29 U.S.C. § 1106(b)(1)–(2).


59. See Knickerbocker, supra note 27, at 651. Another difference is that prohibited transactions carry the possibility of civil fines and mandatory excise taxes for self-dealing. See ERISA § 2003(a), 26 U.S.C. § 4975 (f)(4); ERISA § 502(i), 29 U.S.C. § 1132(i).

60. See Leigh v. Engle, 727 F.2d 113, 126 (7th Cir. 1984) (requiring for § 406(b) accusations "the same searching investigation into . . . the fiduciary’s actions needed to apply the fiduciary loyalty provisions of section 404(a)(1)") (emphasis added).

61. See Donovan v. Bierwirth, 680 F.2d 263, 270–73 (2d Cir.), cert. denied, 459 U.S. 1069 (1982); Bogert & Bogert, supra note 39, § 543, at 225, 269 n.70 (citing only § 406 as duty of loyalty under ERISA). It should be noted that Bierwirth stated in dictum that this liability is not absolute, even for a prohibited transaction. The court suggested that a fiduciary might hire outside counsel rather than resign. See 680 F.2d at 272.

62. See supra note 7. Another problem often raised is that ERISA allows corporate management to control the investment of its workers’ pension funds. See ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3). This opens up the possibility that managers, sensitive to the threat an activist pension fund could pose to their own positions, will directly or indirectly instruct the investment managers of their companies’ pension plans to refrain from interfering with other companies’ management. See Coffee, supra note 3, at 1283 n.21, 1364–65; Roe, Political Theory, supra note 2, at 24–25; see also Rock, supra note 8, at 469 & n.80 (noting corporate managers’ propensity to pressure their investment managers into voting for proposals that further the corporation’s interests); Bruce Nussbaum & Judith H. Dobrzenski, The Battle for Corporate Control, Bus. Wk., May 18, 1987, at 102 (citing letters from CEOs facing proxy battles to counterparts requesting them to instruct their pension managers on vote).
It is worth mentioning that this Note will not examine, other than in passing, the extent to which fiduciaries may receive and act on legal advice that differs significantly from the "law" laid down in cases. There are many reasons why this might be the case. Fiduciaries often lack economic incentives to push the edge of the permissible and may have strong incentives to follow familiar and unexceptional paths. Inertia in a conservative area like trust law could slow down the pace of legal innovation. Fiduciaries might also try to avoid crossing the stated policies or perceived preferences of the Department of Labor in order to avoid litigation costs, even if they know that the government's policies ultimately would not hold up in court. It is undoubtedly prudent, in the non-technical sense, to avoid actions that might bring the full attention of governmental enforcement efforts. In other words, few fiduciaries are willing to act as martyrs to the cause of fiduciary freedom, so the Department of Labor’s policies may have a significant impact on fiduciary behavior independent of court pronouncements. The purpose of this Note is merely to discuss whether ERISA itself, in light of its language, history, and interpretation by the courts has the independent effect of preventing relationship investing.

II. How ERISA Might Impede Relationship Investing

A. Duty of Prudence

The critics who charge that ERISA’s fiduciary duties prevent relationship investing focus on the duty of prudence, claiming that it threatens to define most if not all relationship investing as imprudent. The arguments divide into two categories: (1) the duty of prudence directly forbids or discourages relationship investing, and (2) the duty of prudence prevents pension funds from adopting relationship investing strategies because it effectively forbids innovative investment techniques.

This section first sets out two preliminary observations which are necessary to frame the ensuing discussion: A standard is not necessarily an inefficient barrier if it prevents some marginal investment ideas, and ERISA fiduciaries do not necessarily bear full personal liability for their actions, despite a statutory scheme which purports to make them do so. The second subsection discusses Professor Bernard Black’s arguments

63. For instance, despite the fact that case law to date overwhelmingly indicates that lack of diversification cannot constitute per se impropriety, see infra notes 144-154 and accompanying text, the Department of Labor made that argument in recent litigation. See Reich v. King, Civ. A. No. WN92-2116, 1994 WL 461794, at *5 (D. Md. Aug. 17, 1994). Fiduciaries might well take note of the fact that the DoL began its investigation of the King plan, which had never suffered an actual loss, after a screen of annual plan filings revealed it to have more than 53% of assets in real estate. See Defendant’s Memorandum of Points and Authorities in Support of Motion for Summary Judgment at 7, King, Civ. A. No. WN92-2116, 1994 WL 461794. Even if a strategy of investing more than 53% of fund assets in real estate seemed to make sense to the fiduciary, it might not be worth the cost of beating off the government through four or five years of investigation and prosecution. See id. at 7–8.
that ERISA might directly prevent a fiduciary from spending plan money for legal fees or shareholder proposals and argues that his contentions are not supported by applicable law. The third subsection discusses claims that the duty of prudence prevents innovation. The charges stem partly from misinterpretation of the statute to require imitation rather than prudence, and partly from failure to recognize that prudence is largely a procedural standard, equally allowing and guiding both imitation and innovation. Subsection four discusses the requirements of prudent innovation as applied to relationship investing.

1. Two Preliminary Observations. — Before discussing specific charges, it should be noted that a strict duty of care is not in and of itself an improper barrier to deciding on and executing a relationship investing strategy. Presumably, the promoters of relationship investment believe that a reasonably cautious investor could conclude that it was a prudent way to spend money. Accordingly, a standard is not objectionable simply because it eliminates some strategies that might be cost-benefit justified in a world without information and agency costs. A standard is efficient and useful so long as the cost of gathering the information and expertise required by statutory prudence does not exceed the upper end of what any reasonable, if relatively conservative, investor would require.64 Such costs eliminate (as intended) endeavors that are only marginally or very unquestionably profitable in the first place. Promoters of institutional monitoring as a way of increasing the effective oversight of corporate management emphasize that, compared to unaffiliated directors, financial intermediaries could bring greater financial incentives to monitor and, consequently, an increased willingness to expend resources for monitoring.65 These promoters should take heart, rather than balk, at the thought that an institutional fiduciary might also have a stronger legal compulsion than present directors to carry out the job carefully.66

64. As noted infra note 100 and accompanying text, the courts have inclined toward more process than substance and have apparently never considered surcharging a fiduciary for excess investigation and monitoring costs. Consequently, it is possible that a fiduciary could have incentives to overspend in order to create enough of a “paper trail” to assure absolute safety from surcharge. A fiduciary who passed a certain level of excess caution, however, presumably would not engage in relationship investing at all, so that any fiduciary who did might tend to be less paranoid than the average. This might not be true if fiduciaries react to the present, strong, political pressure to engage in relationship investing. See infra note 99. Risk averse fiduciaries could make a few relationship investments in order to avoid political risk. Fearing a change in the political winds, however, these fiduciaries would be likely to go to great lengths in building defenses against future government repentance.

65. See supra note 15 and accompanying text.

66. A common criticism of the idea of relational investing is that the investors neither have the expertise needed to oversee the technical wizards of industry nor any great incentive to gather it. “People are a little taken aback when Nell Minow and Bob Monks [vocal proponents of relational investing] stand up and declare they know how to run a company better than its own management,” says one detractor.” Mary Lowengard, Relationship Angst, Institutional Investor, July 1993, at 229.
A second point necessary to understand the arguments and weigh their force is that all incorporate into their calculation of likely fiduciary choices the assumption that ERISA fiduciaries bear full personal liability for any breach. Professor Mark Roe argues that since, under this assumption, "[t]he risk to the fiduciary... is liability for the full amount of the loss" while his gains "are the enhanced fees and prestige from innovative action," the fiduciary sees the net of "portfolio loss (times risk of liability) versus gain in fees." He points out that this incentive structure creates a principal-agent problem, as it radically differs from that of the beneficiary who simply "balances the risk of loss against portfolio gain."

The basis of this assumption seems to be the combination of ERISA § 409(a), which imposes personal liability on fiduciaries for breach of their duties, with § 410, which forbids ERISA plans both to exculpate their fiduciaries contractually, a common practice in private trust instruments, and to purchase insurance covering liability or losses from fiduciary breach if the policy permits the insurance company recourse against the fiduciary.

The commentators seem to overlook ERISA § 410(b)(3) which allows "an employer or an employee organization [i.e. the Sponsor, to purchase] insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan." Such insurance is available. In general, the same people who run the employer company are its pension fiduciaries, so it is likely that most fiduciaries of plans large enough to engage in relationship investing are fully insured. The same seems likely to be true of professional money managers hired by ERISA plans.

All of this said, the possibility of suit might still justifiably worry an innocent or uncertain fiduciary enough to convince her to settle. Suits

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67. See Roe, Strong Managers, supra note 3, at 143; Black, supra note 5, at 555.
68. Id. at 143.
69. 29 U.S.C. § 1109(a) (1988). Another possible interpretation of Roe’s argument is that the fiduciary must take into account full liability for loss, whether through insurance premiums or the risk of direct liability. Competently negotiated insurance premiums are, however, by definition not as great a threat to the insured as the risk they insure.
70. Id. § 1110.
71. Id. § 1110(b)(3) (emphasis added).
would adversely affect the fiduciary’s reputation, an especially pressing concern for outside investment managers. Successful suits would also cause the insurance premiums to rise. While it is hard to gauge the effect of such collateral costs, however, they cannot bear near to the direct, personal liability that commentators have assumed.

2. **Charges that Prudence Directly Prevents Relationship Investing.** — One group of complaints against the duty of prudence claims that ERISA’s prudence standard directly discourages or forbids actions necessary for relationship investing. Professor Bernard Black is apparently unique in raising these claims. Black suggests that common-law per se rules of imprudence might forbid relationship investing because it resembles running a business. He also argues that the duty of prudence might discourage or forbid the fiduciary from spending trust money on monitoring costs and legal fees, effectively preventing relationship investing. Despite the threatening ring of a direct effect, these are by far the less serious claims. The standard for prudence under ERISA is so general that, short of some apparently-exorcised demons from the common law, it is nearly impossible to say that the duty directly forbids any category of investment.

Black notes that “the carrying on of a trade or business” is imprudent per se for a common-law trustee, according to the Restatement (Second) of Trusts. He warns that this rule, if still good law under the common law of trusts, might directly forbid relationship investing. The short reply is that an active equity stake would probably not constitute carrying on a business. Holding stock in an industrial company would not make the company an ERISA “plan asset,” even if a fiduciary actively monitored it.

Black’s concern also incorrectly assumes that ERISA includes the common law’s lists of per se imprudent investments. The duty of prudence, in its inception and simple wording, is a standard of reasonable care. Its substantive requirements are a question of fact, depending on “the use of methods and techniques which take into account principles,

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73. Black, supra note 5, at 555.
74. Black noted that the tentative draft of what has since become the Restatement (Third) of Trusts: The Prudent Investor Rule § 227 (1993) did not include this rule, but apparently he had doubts as to the legal effect of the change. It is worth noting that the Restatement (Third) departs sharply from the Restatement (Second) and much older case law and comment, not only in this isolated case, but by totally eliminating the list of investments deemed imprudent per se. The change appears to have been driven largely by a spate of academic criticism and a few state statutory changes, rather than a marked change in case law. Still, it should be noted that those who would serve as expert witnesses in any potential high-stakes trial for imprudence would in all probability be the same A.L.I. members who wrote the criticism and the new laws and blessed them both in the new Restatement.
75. See 29 C.F.R. 2510.3-101(a)(2) (1992); see also id. § 3-10(c) (defining “plan assets”).
76. See Donovan v. Cunningham, 716 F.2d 1455, 1464 (5th Cir. 1983) (“Section 404 imposes upon fiduciaries a duty of loyalty and a duty of care.”), cert. denied, 467 U.S. 1251 (1984).
theories, customs, and conventions generally observed by the investment management community." Historically, however, prudence has tended to become a question of law. Courts and legislatures gradually encrusted the standard with lists of per se imprudent types of investment. The lists of imprudent investments in the Restatement (Second) and Scott’s Treatise, from which Black draws the rule against running a business, are part of this history of encrustation.

Black is correct to think that these lists could have been incorporated under ERISA. He forgets, however, that ERISA § 404 eliminates the traditional standard’s talk of “speculation” and “permanent disposition.” Under the common law of trusts, courts construed this language to require a strict duty of caution, and generated from it lists of precluded investments. As noted, ERISA’s drafters intended their standard

78. After a promising start, see supra note 39, the nineteenth century proceeded to carve “legal lists” of permissible investment vehicles into statutory stone. See Bogert & Bogert, supra note 39, at § 613; Longstreth, supra note 37, at 12. Legal lists generally excluded common stocks and emphasized government bonds. Case law also restricted the scope of prudence. See, e.g., the celebrated King v. Talbot, 40 N.Y. 76, 86 (1869) which held that almost all common stocks were imprudent per se. Scott noted that courts tended “even in the absence of a statute to lay down definite subsidiary rules on what is and what is not a prudent investment.... [W]hat was decided in one case as a question of fact tends to be treated as a precedent establishing a rule of law.” 3 Scott & Fratcher, supra note 39, § 227, at 434–35. Scott’s statement is ironic in light of the key part his treatise played in modern trust law ossification. See Gordon, supra note 40, at 58 n.21.
79. See supra note 39.
81. While the ERISA standard does not include the catch-phrases of caution, it would be improper to conclude that there is no duty under ERISA to adopt a relatively conservative investment strategy. The congressional mandate to interpret the Act in light of its overall purpose — to safeguard the future benefits of beneficiaries — appears to demand some degree of conservativism. See supra note 37. There is a strong and unavoidable moral strain in any fiduciary duty. In general, it is hard to argue against the proposition that a trustee owes not only "such care only as a prudent man would take if he had only himself to consider... [but] rather... such care as an ordinary prudent man would take... to make an investment for... other people for whom he felt morally bound to provide." In re Whiteley, 33 Ch.D. 347, 355 (1886), aff’d sub nom. Learoyd v. Whiteley, 12 App. Cas. 727 (H.L. 1887); see also Tamar Frankel, Fiduciary Law, 71 Cal. L. Rev. 795, 825 (1983) (noting that strictness of fiduciary duties varies with beneficiaries’ opportunities to monitor, and trustees’ opportunities to abuse moral obligations). In the absence of per se rules, however, both courts and fiduciaries would have difficulty drawing useful distinctions between conservative, but effective strategies that adopt an appropriate amount of risk, and others that cross the line into imprudence. Cf. Note, Fiduciary Standards and the Prudent Man Rule Under the Employment [sic] Retirement Income Security Act of 1974, 88 Harv. L. Rev. 960, 975–79 (1975) (proposing awkward and inconclusive procedure to find target risk levels for plans, on theory that structure of ERISA “implicitly reflects certain basic judgments about risk-taking”). Such attempts would eventually lead to per se rules, but have been rejected by the federal courts. See infra note 84.
82. See Mayo A. Shattuck, The Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century, 12 Ohio St. L.J. 491, 492–95
to incorporate trust law only as modified to meet the special requirements of pensions.\textsuperscript{83} A new, federal statutory standard opened the way for a revival of the old standard’s original character. It presented the semblance of a clean slate to a federal judiciary, unused to administering the common law of trusts. It also came accompanied by congressional instructions to modify the common law, where necessary. Although the courts have decided few cases on this matter under ERISA, they have spoken unequivocally, strongly resisting per se rules that would turn particular applications of ERISA’s reasonableness standard into a question of law.\textsuperscript{84} While judges cite the Restatement (Second) of Trusts and its reporter’s classic treatise for support, no ERISA case appears to adopt

\textsuperscript{83} See supra note 37 and accompanying text. As noted, defined benefit plans, unlike most traditional trusts, have a definite goal, trustees personally interested in achieving it, a constant influx of new funds, and no remaindermen. These characteristics greatly reduce the need for preservation and increase the pressure to earn competitive returns. In a recent case brought by the Secretary of Labor, the DoL’s expert testified that a defined-contribution retirement plan, most of whose members were fairly young, was very intolerant of risks of default, but very tolerant of market volatility because of its long time horizon and should, therefore, seek to take advantage of its tolerance to obtain high returns in the long run by making investments which, in the short term, might be highly volatile. See Direct Examination of Richard P. Hinz, Chief Economist and Director, Office of Research and Economic Analysis, Pension and Welfare Benefits Administration, Reich v. King, Civ. A. No. WN92-2116 (D. Md. Sept. 26, 1994) (author’s notes on file with the Columbia Law Review) [hereinafter Hinz Direct Examination, King]. Such a calculation would have been impossible under the traditional view of trust investment. Under ERISA, it is effectively mandatory.

\textsuperscript{84} See Donovan v. Cunningham, 716 F.2d 1455, 1473 (5th Cir. 1983) (“[W]e do not think a court [in determining whether a private offering of the plan sponsor’s stock was bought for ‘reasonable compensation’] should require fiduciaries to follow a specific valuation approach as a matter of law under Section 3(18). The standard they must follow remains one of prudence.”), cert. denied, 467 U.S. 1251 (1984); Reich v. King, Civ. A. No. WN92-2116, 1994 WL 461794, at *5 (D. Md. Aug. 17, 1994) (“The Secretary argues that Defendant’s non-diversification is a per se violation of § 1104(a)(1)(C). Neither the case law nor the statutory language supports this proposition.”); Lanka v. O’Higgins, 810 F. Supp. 379, 388–89 (D.N.J. 1992) (finding no authority for plaintiff’s claim that contrarian investment strategy “per se imprudent” for “sacred” ERISA funds, court looks “to the circumstances of this case to determine whether this investment manager acted imprudently vis-a-vis these ERISA plans”); Lynch v. J.P. Stevens & Co., 758 F. Supp. 976, 1013 (D.N.J. 1991) (no imprudence claim where plaintiff “merely vaguely suggests the investment in futures and options was improper” without claiming poor investments or improper investigation); Jones v. O’Higgins, 11 Employee Benefits Cas. (BNA) 1660, 1667 (N.D.N.Y. Sept. 5, 1989) (rejecting plaintiff’s expert witness, a former DoI, attorney, who “really testified to a legal opinion rather than to an opinion based on any substantial experience in analyzing or investing stocks”); Foltz v. U.S. News & World Report, Inc., 627 F. Supp. 1143, 1170 (D.D.C. 1986) (holding that ERISA prudence standard gives fiduciary “sufficient discretion to render inadvisable reversal of his decision upon summary judgment”); see also Longstreth, supra note 37, at 35–36 (noting that none of the reported cases have used the “per se style of analysis characteristic of the Treatise, the Restatement, and most private trust cases”).
their infamous per se imprudent investment vehicles.85 Numerous cases affirm that each application of the prudence standard is a question of fact to be determined by the particular circumstances.86 Consequently, criticisms based on the assumption that courts will find per se imprudence under ERISA seem wholly unfounded.

Black also fears that spending any plan funds for the expenses of monitoring large investments would be very dangerous for a fiduciary. He draws a picture of embattled fiduciaries, cowing in affrighted passivity before the vague but threatening forms of surcharge, lurking in shadow on every side. According to Black, we do not know “whether a fund can spend money to defend a lawsuit by the company [invested in], sue the company if need be in furtherance of a proposal, or, worse yet, pay an adverse judgment out of plan assets.”87 He cites an article by David Walker, at the time Assistant Secretary of Labor, warning pensions that “proactive efforts” in corporate governance should be pursued with “caution” and only if “cost-beneficial,” and emphasizes the DoL’s silence on the “basic question of whether an ERISA fiduciary can ever spend plan money to promote a shareholder proposal” to explain why “no ERISA fiduciary, to my knowledge, has ever offered a proposal.”88 He contrasts their fearful passivity with “[p]ublic pension funds [which] aren’t governed by ERISA” and make many proposals.89

A first reply to these fears, if not a complete answer, is that it seems counterintuitive that a generalized duty to act prudently could cast serious doubt on the fiduciary’s ability to defend the trust from monetary losses; to exercise its valuable legal rights, including shareholder rights if the trust owned stock; or to fulfill its legal obligations. Failure to do these things would be a waste of trust assets and the more likely fiduciary breach.

On a more technical level, defending a suit or paying a judgment rendered against the plan could hardly fail to be a “reasonable expense,” covered by § 404(a)(1)(A)(ii),90 when compared with loss by default or prosecution for contempt. The decision to litigate or settle would seem to be a routine matter of finding the cheapest option.91 A fiduciary must cause the plan to comply with the law and pay its legal obligations. Signif-

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85. See Restatement (Second) of Trusts § 227 cmts. f, m (1957); 3 Scott & Fratcher, supra note 39, § 227.6, at 444–45, and its critics, e.g., Gordon, supra note 40, at 66–67; Edward C. Halbach, Jr., Trust Investment Law in the Third Restatement, 77 Iowa L. Rev. 1151, 1152–54 (1992); Langbein & Posner, supra note 39, at 24–28; see also DoL Preamble, supra note 40, at 37,225 (Department does not intend and will not consent to create “legal list” or declare any investment per se prudent or imprudent).
86. See supra note 84.
87. Black, supra note 5, at 555.
88. Id. at 554–55.
89. Id. at 555.
91. The questions of loyalty which might arise if the suit also implicated personal liability for the fiduciaries are ignored for the purposes of this section.
icantly, § 404(b)(1) explicitly allows the plan to insure itself against such contingencies, so long as the insurer has recourse against fiduciaries for breach. In fact, a plan may set up a reserve fund to reimburse fiduciaries for their legal fees in defending suits for breach upon favorable result. Plan reserves earmarked for this purpose are not available for distribution to beneficiaries until after the fiduciaries’ liability has been determined. 92 Finally, a fiduciary normally has not only the power but also the duty to sue on any legal claims of the trust and defend suits against it if the effort is likely to pay off. 93

Black’s argument for the danger of spending plan money to make shareholder proposals is also weak. First, his claim that no ERISA fiduciary has sponsored a shareholder proposal is inaccurate. Pension plans affiliated with the United Brotherhood of Carpenters (UBC) were among the most prominent shareholder activists of the late 1980s and sponsored many proposals. 94 Black also overlooks the fact that public funds which regularly offer proposals may be governed by exact copies of the ERISA fiduciary duties. 95 The California Public Employees’ Retirement System (CalPERS) is the prime example. 96 Apparently no fiduciary

95. He does note that he will treat private and public pension funds equally because both tend to be governed by offshoots of the common law and because he assumes that “though not formally subject to ERISA, [the public funds] will be reluctant to depart from ERISA’s codification of fiduciary duties.” See Black, supra note 5, at 553 n.110. This assumption seems to ignore the fact that many, if not all public funds have their own, specifically codified fiduciary duties. As noted, many of these are identical or close to ERISA’s language. See supra note 21. Black, however, not only fails to ground his assumption properly, but also ignores it. See supra note 89 and accompanying text.
96. See Cal. Const. art. XVI, § 17(d); see also supra note 21.
under the ERISA formulation has ever been surcharged for sponsoring a proxy proposal, although many have done so. The DoL's "silence" is meaningless. The DoL will not issue formal advisory opinions on the application of § 404(a) fiduciary duties to particular conduct. In any case, the Department has lately broken its silence, clarifying its opinion that it may be prudent to invest in corporate monitoring. The position

97. See sources cited supra note 94. The Florida State Board of Administration has also been fairly active, sponsoring one shareholder proposal in 1990, see Biersach, 1990 Voting, supra note 94, at 88, and three in 1991, see Mathiassen & O'Hara, 1991 List, supra note 94. As noted, supra note 21, the statute governing the Florida Board simply incorporates ERISA. Other funds subject to standards close or identical to ERISA's (that is to say, CalPERS, CalSTRS, various New York public pension funds, and the State of Wisconsin Investment Board) sponsored forty-five proposals in 1989, see Krasnow, 1989 Voting, supra note 94, at 111–16, and forty-eight proposals in 1990, see Biersach, 1990 Voting, supra note 94.

98. See ERISA Procedure 76-1 § 5.02(o), 41 Fed. Reg. 36,281, 36,282 (1976), 1 Pens. Plan Guide (CCH) ¶ 1919. On this count, Black is wrong, although not alone, in claiming that the DoL's letter to Avon Products "requires that the pension plan vote its shares, instead of abstaining." Black, supra note 5, at 554 (citing Letter from Deputy Assistant Secretary of Labor Alan Lebowitz to Helmuth Fandl, Avon Products, Inc., reprinted in 15 Pens. Rep. (BNA) 991 (Feb. 23, 1988)); see also Investor Responsibility Research Council, Writing Proxy Voting Guidelines: A Handbook for Institutional Investors 3 (1990) (same interpretation). The Avon letter merely noted that the right to vote is a plan asset and, consequently, voting is a fiduciary act. Its aim was to emphasize that, as with other fiduciary discretion over plan assets, ERISA required plans to designate precisely and in advance the fiduciaries with discretion to vote shares, and that the designated fiduciaries had to exercise independent judgment in voting. A recent DoL interpretive bulletin states explicitly, with respect to shares in foreign corporations, that fiduciaries must weigh the costs of voting against expected benefits. See Governance Bulletin, supra note 11, at 38,863, but cf. John Giudice, Custodians Meeting New Challenges: Foreign Markets Present Problems, Pensions & Investments, Sept. 19, 1994, at 19, 28 (referring to "recent publication of a Department of Labor regulation warning private pension funds they, [sic] too, were required to vote their proxies — even international proxies"). Although the implication is that the DoL does not expect the cost of voting domestic shares to exceed the benefit, that calculation is nowhere stated as a legal conclusion, nor could it be.

99. See Governance Bulletin, supra note 11, at 38,864. As noted, the Governance Bulletin, consistent with Department policy, does not declare any particular decision prudent. Rather, it "clarifies" the obvious: that shareholder activism is prudent if it "is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved." Id. It is significant only as a slightly more official effort in the Department's ongoing, informal cheerleading campaign to "encourage pension fund managers to take a more active role." Berg Urges Pension Fund Managers to Go Beyond Simply Voting Proxies, Pensions & Benefits Daily News (BNA), Feb. 28, 1994, at D2 available in Westlaw, at 21 BPR 456; see also Nell Minow, Do Your Duty, Retirement Managers, N.Y. Times, Jan. 30, 1994, at F11 (citing Olena Berg, Assistant Secretary of Labor, for making "clear her belief that private pension funds should evaluate shareholder activism just as they do any other investment strategy"). Berg herself described the move as "a helpful nudge." Wayne, supra note 5, at D1, D3 (quoting Berg). "Myra R. Drucker, assistant treasurer of the Xerox Corporation, which has $5.3 billion in its pension plan, said she 'doesn't see the likelihood of a massive shift in how corporations approach this issue.'" Id. Such a general government pronouncement can offer no comfort to fiduciaries beyond the knowledge that, under the current administration and so long as nothing goes drastically wrong with their particular investments, the DoL is unlikely to sue.
is hardly surprising. Acting to monitor and preserve the value of important and complex assets is almost synonymous with prudence and responsibility. The courts consistently encourage significant expenditures for both initial studies and ongoing, expert monitoring in cases of real estate investment, questioning only obvious breaches of loyalty. Accordingly, where the plan already holds significant stakes, the trustees should be able to pay for shareholder proposals suggesting changes that bear a reasonable relation to improved profitability. A cynic might even say that, since empirical studies purporting to demonstrate the profitability of shareholder activism have appeared only in the last few years, the significant fact for any fiduciary considering the danger of such activities is that the public funds have gotten away with so much, not that private funds have not tried.

3. Charges that ERISA Indirectly Prevents Relationship Investing: Incentives Against Innovation. — ERISA’s formulation of the prudence standard departs from the traditional phrasing in requiring “a prudent man acting in a like capacity . . . in the conduct of an enterprise of a like character and with like aims.” Several commentators claim that ERISA’s phrasing points the fiduciary’s attention specifically to similar organizations and might discourage innovative investment. A pension fund manager, prudent in the management of her personal liability as

them for shareholder activism. It can have no effect on beneficiary suits, and could not even stop the same administration from bringing suit should a disastrous investment raise pressure for public retribution against the “Wall Street . . . hounds of greed.” Petition for Appeal on Behalf of Morgan Stanley & Co., at 28, West Virginia v. Morgan Stanley & Co., (W. Va. Jan. 28, 1994) (No. 89-C-3700) (quoting state’s description of defendant in closing argument). Given the record of arguments for per se imprudence in the federal courts, see infra notes 112–118 and accompanying text, this should not have been a significant worry in any case.

100. The Walton court, for instance, admiringly recounts an almost comical list of precautionary measures taken by the fiduciaries, including retainers of two law firms besides the general counsel, engineers to take ground core samples, experts to appraise the land before purchase, a cost estimate of the site, an independent review of economic viability, an expert feasibility study, an independent review of the expert study, projections of cash flow, an independent investment manager to negotiate the lease, and frequent interventions by the fiduciaries (including design changes) into the progress of construction to prevent cost-overruns. See Donovan v. Walton, 609 F. Supp. 1221, 1240 (S.D. Fla. 1985). The only case that appears to surcharge a trustee for such spending criticizes not the idea of hiring a consultant to make a feasibility study, but rather the imprudence of paying a clearly inflated fee to a personal friend of one of the trustees who had no claim to experience (or even expertise) in the matter at hand. See Donovan v. Mazzola, 716 F.2d 1226, 1234 (9th Cir. 1983), cert. denied, 464 U.S. 1040 (1984).

102. See text accompanying supra note 39.
103. See supra note 39. The important difference is that the formulation in Harvard College v. Amory, 26 Mass. (9 Pick.) 446 (1830), holds up as its objective standard a uniform “prudent man” managing his own affairs (or, in some formulations, the affairs of another), whereas ERISA’s standard holds fiduciaries to a variable (though still objective) standard, depending on who they are “like.”
well as other people’s money, might restrict herself to strategies and even specific vehicles endorsed by the practice of many other large, institutional fund managers. Such a strategy might lead to “incorporation by reference” of other pension fund managers’ worst-case interpretations of ERISA’s requirements. Worse yet, it might encourage ERISA fiduciaries to imitate the investment practices dictated by the even more restrictive regulations of banks, insurers, and mutual funds (those institutions most “like” ERISA plans). Taken to an extreme, an ERISA fiduciary who was wise as well as prudent would not undertake any investment or investment strategy unless she had a file of cases in which “like” enterprises had done exactly the same thing. Pension fund fiduciaries would do their best to imitate each other as closely as possible and would have no incentive to innovate. It should be noted that the argument is not that the prudent man standard intrinsically favors any investment practice. Rather, it acts to “reinforce whatever the prevailing practice is,” and in the United States at the moment, this means no relationship investing.

These arguments erroneously interpret the statutory language to confine the fiduciary to investments “like” its peers’. The language, however, does not require the fiduciary to imitate her peers’ choices, but rather their methods of choosing. The language situating the fiduciary’s model “prudent man” in a “like” situation is apparently meant to emphasize that, while the standard is objective, it cannot be applied without particularized consideration of specific facts and circumstances of a given decision. The size and sophistication of the fiduciary’s plan are factors that help to determine the conduct expected. However, far from imposing more restrictive models as the commentators claim, it seems that larger size and more resources add to the fiduciary’s options. In trials, both the DoL and ERISA fiduciaries bring expert

105. See Roe, Strong Managers, supra note 3, at 139–41; Black, supra note 5, at 553; Howard R. Williams, The Prudent Man Rule of the Pension Reform Act of 1974, 31 Bus. Law. 99 (1975); see also Longstreth, supra note 37, at 36 (examples of expert opinions advising fiduciaries to wait and watch others go first).

106. See Roe, Strong Managers, supra note 3, at 140–41 (describing concentric circles of less and less “like” institutions).

107. See Black, supra note 5, at 553.

108. See Roe, Strong Managers, supra note 3, at 140 (rule is impartial and could require relationship investing if it gained enough acceptance through efforts of non-ERISA investors). For a recent attempt to portray shareholder activism as a duty of prudence, see Minow, supra note 99.

109. See supra notes 77–86 and accompanying text.

110. This variable standard, depending on the character and size of the plan, stands in contrast to the traditional trust law standard which assumed a generic prudent man. See supra note 39. For this reason, it has often been called a “prudent expert” standard, demanding of the fiduciary proper expertise and a prudence informed by it. See, e.g., Restatement (Third) of Trusts: Prudent Investor Rule § 227, Reporter’s General Notes (1992).

111. In reference to earlier legislation, the Secretary of Labor described the aim of a similar prudent investor rule as allowing the flexibility to expect investment of different skill and sophistication from a “small plan with an uncomplicated portfolio or an
witnesses specializing in the particular field of investment discussed, not the habits of large investors. If ERISA fiduciaries operate in an imita-


112. For a case specifically rejecting the idea that other plans’ investment practices constitute a model of prudence, see Brock v. Teamsters Local Union No. 863, 115 F.R.D. 32, 34 (D.N.J. 1986) (rejecting defendants’ claim that it could not defend prudence of its conduct without discovering DoL records on investment practices of other ERISA funds). The court in Jones v. O’Higgins apparently took a similar attitude, rejecting the expertise of plaintiff’s witness, an ERISA attorney who had worked in the Department of Labor enforcing § 404, because he testified “to a legal opinion rather than to an opinion based on any substantial experience in analyzing or investing stocks.” 11 Employee Benefits Cas. (BNA) 1666, 1667 (N.D.N.Y. Sept. 5, 1989); see also Katsaros v. Cody, 744 F.2d 270 (2d Cir.) (holding with respect to challenged loan to insolvent bank that only banking expertise, not experience in pension fund management, was necessary), cert. denied, 469 U.S. 1072 (1984); Donovan v. Cunningham, 716 F.2d 1455, 1468–69 (5th Cir. 1983) (following expert witnesses on valuation of privately issued securities); Donovan v. Mazolla, 716 F.2d 1226, 1232 (9th Cir. 1983) (following “expert testimony regarding the prevailing standards . . . applied by competent real estate lenders”), cert. denied, 464 U.S. 1040 (1984); Jones, 11 Employee Benefits Cas. (BNA) at 1666 (finding that witness with “experience in the field of investment advice and management” establishes that defendant’s portfolio was “generally prudent by the standards of the investment industry”); Marshall v. Glass/Metal Ass’n and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378, 382 (D. Haw. 1980) (hearing testimony of experts on both sides to establish standards of “experienced lender”); cf. Donovan v. Walton, 699 F. Supp. 1221, 1242 (S.D. Fla. 1985) (noting that unlike Mazolla and Glass/Metal Ass’n, government was not “able to call expert witnesses who testified that the fiduciaries’ actions did not comport with prevailing practices in the [construction lending] industry”).

In the trial of Reich v. King, Civ. A. No. WN92-2116 (D. Md. Sept. 26–28, 1994), both sides were tempted to compare the plan’s investment pattern (up to 70% of assets in residential mortgages) to those of “like” institutions. In both cases, however, the adversary system functioned and the opponent forced an admission that mere similarity or dissimilarity to the portfolios of comparable entities could not determine whether a plan’s investment pattern was prudent or imprudent. The defendant objected that the government witness’s testimony concerning the aggregate investment patterns of other defined contribution plans was irrelevant. The government replied that the evidence spoke not only for what other plans appeared to do but why they did it. Apparently the argument was that, given the King plan’s extreme deviation from the norm and the norm’s agreement with the DoL expert’s opinion as to how a plan like King’s should prudently invest, evidence as to the norm and the reasoning behind it would, at least, place the full burden of explanation squarely on the defendants. See Hinz Direct Examination, King, supra note 83. Judge Nickerson commented that, were the trial before a jury, he would not have admitted the statistical charts into evidence. See id. The defense later extracted the government witness’s testimony that, in his opinion, it was not necessary for a plan to diversify across asset classes in order to avoid a risk of large losses, but that diversification was the usual way to do it. See Cross Examination of Richard P. Hinz, Chief Economist and Director, Office of Research and Economic Analysis, Pension and Welfare Benefits Administration, King, Civ. A. No. WN92-2116 (D. Md. Sept. 27, 1994) (author’s notes on
tive culture, they are not driven to it by the word “like” in ERISA’s formulations of the standard of prudence, nor are they restricted to imitating ERISA plans or large financial intermediaries. Rather, the imitation is endemic in general investment culture.\footnote{115}

ERISA’s prudent man rule is similar in this respect to the corporate fiduciary’s duty of care. Both impose a standard of conduct, an objective test of “whether an undertaking is carried on in a fashion which sufficiently tends to accomplish its aims.”\footnote{114} What the standard requires is that the fiduciary deliberate and decide upon the action in a manner which would allow a person “familiar with such matters” (whatever they might be) and acting in a similar position to satisfy himself that he had made a reasonably careful decision.\footnote{115}

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file with the Columbia Law Review). The government similarly objected when the defendant began to testify to his knowledge that a local bank invested a percentage of its assets in mortgages that was even higher than the plan’s. Judge Nickerson allowed the witness to continue only because the testimony went to the trustee’s “mindset.” Cross Examination of Walter W. King, \textit{King}, Civ. A. No. WN92-2116 (D. Md. Sept. 26, 1994) (author’s notes on file with the Columbia Law Review). The government was later careful to make the president of the bank, called by the defendants as an expert in mortgage lending, testify that commercial banks, unlike ERISA plans, had no duty to diversify their investments and were prohibited from investing in common stock. See Cross Examination of David E. Brock, President, Bank of Brunswick, \textit{King}, Civ. A. No. WN92-2116 (D. Md. Sept. 27, 1994) (author’s notes on file with the Columbia Law Review).


\footnote{114} Bines, supra note 77, \S 1.02[1]; see also Longstreth, supra note 37, at 35–36 (citing trend in ERISA cases to focus on fiduciary’s investigative process, using language similar to business judgment cases). In \textit{Smith v. Van Gorkum}, for instance, the court cited \textit{Cunningham}, 716 F.2d 1455, a classic ERISA case, for the proposition that “[t]he representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information.” 488 A.2d 858, 872 (Del. 1985). The crucial differences lie not in the general nature of the standard of action, but in its specific applications. The directors of for-profit corporations are expected to search for and take risks with the potential for a high payout. This expectation changes the “financial interests of others” that courts expect them to represent. A business corporation can properly, if candidly, represent its shareholders’ interests in wild speculation; a pension fund never serves that role. Corporate directors’ duties also differ from pension fiduciaries’ in the standards of judicial scrutiny and liability applied to their actions. The standard for liability under the business judgment rule is gross negligence. See id. In contrast, the ERISA fiduciary is liable under a strict duty of care that is even higher than that of simple negligence, since it requires the care of a “prudent” person of similar attributes and position, rather than the general “reasonable man” of tort.

\footnote{115} See \textit{Jones}, 11 Employee Benefits Cas. (BNA), at 1667 (objective test of whether fiduciary “(1) employed proper methods to investigate, evaluate, and structure the investment, (2) acted in a manner as would others who have a capacity and familiarity with such matters, and (3) exercised independent judgment when making investment decisions”). In \textit{Reich v. King}, the government repeated this test in its opening statement. See Government’s Opening Statement, \textit{King}, Civ. A. No. WN92-2116 (D. Md. Sept. 26, 1994) (author’s notes on file with the Columbia Law Review). The government’s expert witness also testified to the process that any “investment manager” would go through to evaluate the “investor’s” needs and plan a portfolio to meet them. See \textit{Hinz, Direct Examination}, \textit{King}, supra note 83. It should be noted that this is neither a necessary, nor a
Although both the process of investigation and the actual decision must be prudent, the first is much more important because it largely determines the legal credentials of the second. Once a fiduciary demonstrates that she diligently and carefully assembled all reasonably available information and outside expertise needed to make a competent, independent decision, it would seem nearly impossible to prove that her decision was unreasonable, absent bad faith. Although such blatant second-guessing is possible, no federal court has shown an inclination to engage in it under ERISA. Instead, the courts focus their inquiry "on a review of the fiduciary’s independent investigation of the merits of a particular investment, rather than on an evaluation of the merits alone." Courts generally examine the "objective merits" of an investment only if they find a breach of the duty of prudence and must determine whether it actually caused loss, because a prudent investigation would have led to a different result.

necessarily permanent, interpretation of the duty of prudence. As noted above, supra note 78 and accompanying text, the duty of prudence historically transformed itself into a substantive standard for disallowing specific types of investment per se. As will be argued, however, it is the reasonable and currently reigning interpretation. It also seems to be a trend (though far from the dominant trend) in state law. See Stark v. United States Trust Co., 445 F. Supp. 670, 678–80 (S.D.N.Y. 1978); In re Morgan Guar. Trust Co., 396 N.Y.S.2d 781, 784–85 (Sur. Ct. 1977); see also Gordon’s criticism of these rulings because, "detached from any substantive standard, [they] invite[] analysis of paper trails rather than investment rationales and may well encourage expensive formal procedures that do not contribute to beneficiary welfare," Gordon, supra note 40, at 73; see also supra note 64 and accompanying text. For an example of a state court which remains more traditionally oriented, see Petition for Appeal, West Virginia v. Morgan Stanley & Co., Inc., (W. Va., Jan. 28, 1994) (No. 89-C-3700), (describing trial court, holding as matter of law that "a real and identifiable element of risk," evidenced by "the fact of the losses," constituted breach of duty of prudence).

116. See, e.g., the fabled case In re Chamberlain’s Estate, 156 A. 42, 43 (N.J. Prerog. Ct. 1931), where the court stated, “It was common knowledge [in 1929] . . . that a [stock market] crash was almost sure to occur.”

117. Cunningham, 716 F.2d at 1467 (citing cases).

118. See Gochnauer v. A.G. Edwards & Sons, Inc., 810 F.2d 1042, 1050 (11th Cir. 1987) (upon proof of a breach in the process of selecting an investment “the question . . . becomes part of the question of causation”), In re Morgan Guar. Trust Co., 772 F.2d 951, 956–57 (D.C. Cir. 1985), the defendants raised the statute of limitations, claiming that it began to run when the trust sent out information to the beneficiaries containing the substantive facts that the plaintiffs used to support their charge of imprudence. The court held that the trustees’ failure to investigate the investment properly was not disclosed and this breach was separately actionable. See id. at 957–58. Judge Scalia (as he was then) argued in dissent that a breach of the duty to investigate had meaning only to the extent it caused a losing bet on a substantively poor investment. See id. at 962. While Scalia’s seems the better position, both the dissent and the majority agreed that the crucial element of breach was the failure to investigate prudently, rather than the failure to make a substantively correct investment choice. See also Cunningham, 716 F.2d at 1467 (“the test of prudence — the Prudent Man Rule — is one of conduct, and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment, and not whether his investments succeeded or failed.”) (quoting 19B Business Organizations, S. Young, Pension and Profit-Sharing Plans
Roe’s interpretation of a recent case, *Jones v. O’Higgins*,119 illustrates these points. In *Jones*, the defendant served as investment manager for the small ERISA plan of a private doctor’s office. Pursuant to his contrarian investment strategy, the defendant invested over 90% of the funds in three depressed stocks. When the stocks fell below buying price, the plaintiff, a doctor near retirement who was both trustee and main beneficiary, insisted on selling off the stocks and diversifying the portfolio. He simultaneously sued for breach of fiduciary duty. The case is important in that the court had to decide whether the strategy itself, rather than merely the method of execution, was prudent. The court found both the strategy and its execution prudent, although the strategy by definition required bucking popular wisdom.

Roe regards the result as anomalous. He accounts for it only by claiming that *Jones* established a “new doctrine” allowing a fiduciary to establish the prudence of an investment strategy by demonstrating that a “respectable minority” of plans have adopted it. This “doctrine,” he adds, could “reduce the impact of the prevailing-wisdom rule.” However, Roe’s solution leaves him with a “chicken-or-the-egg problem.” On the one hand, he doubts that prudent ERISA fiduciaries could adopt a minority strategy before it became respectable. On the other hand, he doubts that a minority could become respectable among ERISA fiduciaries if it were not prudent in the first place.120

If the duty of prudence is taken as a procedural standard of care, *Jones* is not a problematic case and certainly does not require legal gymnastics to explain. Roe sees difficulties in *Jones* because he interprets the duty of prudence as a duty to imitate. The same misinterpretation forces him to interpret *Jones* to declare a new doctrine, allowing deviation from imitation, although the court’s decision does not mention a new doctrine. Not surprisingly, the “doctrine” turns out to preclude its further

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119. 11 Employee Benefits Cas. (BNA), at 1660.
120. Roe, Strong Managers, supra note 3, at 139. Roe does acknowledge that “[s]ome evolution is now occurring,” and that investors such as CalPERS, Berkshire Hathaway, and private relationship investment partnerships could become a “respectable minority.” Id. at 139–40. He nonetheless fails to recognize that the duty of prudence requires only a level of care in selecting investments similar to that exercised by like institutions, not investments similar to those of like institutions. If the fiduciaries of CalPERS, Berkshire Hathaway and the relationship investment partnerships have prudently concluded that their investment strategies are profitable, any ERISA fiduciary should be able to do the same, starting from the same position.
application. Roe’s conceptions do not explain the decision in the first place, so they cannot produce a way to replicate it.

The first problem with Roe’s interpretation is his assertion that ERISA’s prudence standard forces fiduciaries to imitate the investments of fellow ERISA fiduciaries and similar financial institutions. In deciding whether the defendant’s investment was prudent, Jones rejected the testimony of an expert in ERISA enforcement in favor of the testimony of professional investors with no special connection to ERISA. Far from establishing a new doctrine, Jones merely shows that any investor can establish prudence. The investor need not be an ERISA fiduciary or, technically speaking, prudent herself. Thus, there is no “chicken-or-the-egg” problem. The standard of prudence is determined by experts within the area of investment under consideration, not the habits of ERISA fiduciaries and their ilk.

121. Roe claims that ERISA’s prudence standard “encourages pensions to imitate other institutions’ investments, creating another feedback loop.” Id. at 139.

122. The plaintiff’s expert was an experienced ERISA lawyer who had enforced the fiduciary provisions of the Act at the Department of Labor. He testified that he was familiar with the investment industry through frequent contact with investment advisers, but the court was unimpressed and stressed that he had no experience or training in investment. It seems that he also failed on more substantive grounds. He not only “was not familiar with the contrarian investment philosophy” (something that, if his claims to familiarity with industry practice were believed, might have boded ill for the defendants) but also “offered no criticism of it.” Jones, 11 Employee Benefits Cas. (BNA), at 1667.

123. See supra note 112 and accompanying text. Roe points out that too few of the investors aside from ERISA fiduciaries may have the business motivation, financial muscle, and legal authority to begin a trend to relationship investing. See Roe, Strong Managers, supra note 3, at 140. It should be noted, however, that institutions which are not themselves ERISA fiduciaries might still receive ERISA funds for relationship investing. If an ERISA plan invests in a “venture capital operating company,” the company’s underlying assets are not considered “plan assets,” and their managers are not ERISA fiduciaries. The regulations on ERISA define venture capital operating company to include any entity that, during a given year, has at least 50% of its assets in investments “as to which the investor has or obtains ... contractual rights directly between the investor and an operating [i.e., not an investment] company to substantially participate in, or substantially influence the conduct of, the management of the operating company,” 29 C.F.R. §§ 2510.3-101(d)(3)(i), (ii) (1993), and which “actually exercises [these rights] with respect to one or more of the operating companies in which it invests.” Id. § 2510.3-101(d)(1)(ii). If a venture capital operating company were formed to act as a relationship investor, the plans investing in it would fulfill their fiduciary duties if they selected and monitored it for financial expertise and managerial track records of its sponsors and for its promise and progress, not in managing their assets, but in providing the return expected over the time-frame negotiated (which tends to be long in such investments). The company’s management would be bound only by the fiduciary duty of a general partner or corporate director. It would be free (having made this plan explicit from the outset) to invest according to the business judgment rule and in the general interests of the pooled shareholders.

Such companies are not only possible, but apparently operating under present law. For several examples, see supra note 12. At the moment, the full scope of this possibility is still constrained by other federal regulation. The Investment Company Act of 1940, ch. 686, § 52, 54 Stat. 847 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-52) generally regulates any entity which pools capital for purposes of investing. Its strict regulations
Second, and more important, Roe assumes that to be prudent, an ERISA fiduciary must be imitating someone else’s investment. The decision in Jones makes it clear that the defendant’s detailed and compelling explanation of his contrarian strategy in theory and practice were at least as important as his expert witness’s testimony that contrarian investing was acceptable among investors. In other words, there is no special doctrine that a fiduciary may imitate a “respectable minority.” The duty of prudence allows fiduciaries themselves to innovate prudently. A carefully chosen and executed innovation falls within the scope of a procedural standard of prudence.

In sum, a fiduciary who can meet her needs with a strategy or method of investment that has gained widespread adoption and created a body of conventional practices about it might achieve respectability with very little particularized care and skill, just as a person with the right body shape can wear clothes off-the-rack and look respectable without hiring a tailor. The fact that someone can wear clothes off-the-rack does not mean that everyone can. Moreover, a person who aspires to be distinguished, not simply respectable, may prudently select and pay a good tailor. An ERISA plan with peculiar needs or high ambitions can respectably and prudently choose and pay for a specially designed strategy. For instance, convincing pensions to enter unusual private debt placements might “require some very big players, highly recognized for their credit expertise, to sponsor the first funds and do the initial marketing.”

could make it very hard for any registered investment company to engage in relationship investing. See Black, supra note 5, at 551-53; Gilson & Kraakman, MSIC, supra note 3, at 997-1004. The partnerships presently engaged in relationship investing are exempted from the Investment Company Act because they have less than 100 beneficial owners. See Investment Company Act of 1940 § 3(c) (1) (A), 15 U.S.C. § 80b-3(c) (1988). For example, Corporate Partners raised $1.6 billion in 1988 from forty limited partners, including pension funds. See William Taylor, Can Big Owners Make a Big Difference?, Harv. Bus. Rev., Sept.-Oct. 1990, at 70, 82. This limitation, however, also significantly limits their possible size and total capital, especially if they attempt to be vehicles in which plans can make a fairly modest investment. Still, present law seems to provide adequate opportunities for investors “unencumbered” with ERISA fiduciary duties to engage in negotiated relationship investments.

The size limitation may soon disappear, in any case. The SEC has introduced legislation to allow unregistered investment companies with unlimited numbers of subscribers who are “Qualified Purchasers,” a status for which a typical, large pension plan would qualify. See S. 479, 103d Cong., 1st Sess. §§ 3–4 (1993). The definition of “Qualified Purchaser” is similar to the definition of “Qualified Institutional Buyer” under Rule 144A of the Securities Act of 1933, 17 C.F.R. § 230.144A (1993).

Investment companies which seek to engage in non-negotiated relationship investing with ERISA money, by contrast, are not insulated from ERISA fiduciary duties. See The Patient Capital Revolution, Corp. Control Alert, May 1994, at 15, 17.

124. See Jones, 11 Employee Benefits Cas. (BNA), at 1666. The defendant was himself expert. In fact, he appears to have been approximately as expert as the “expert witness.”

125. ERISA fiduciaries, like other institutional investors, may not have incentives to try to distinguish themselves. See supra notes 62, 113.

4. The Requirements of Prudent Innovation Under ERISA. — The appropriate question, then, is not whether ERISA's prudent man rule would prevent fiduciaries from engaging in relationship investing, but to what extent it would prevent certain fiduciaries from engaging in certain kinds of relationship investing. For any given fiduciary and scheme, this is a roundabout way of asking whether he can reasonably justify his plan, the costs of carrying it off carefully, and the expected returns. The answers to these questions depend on the particular investment structure, investment, and circumstances of the plan.

It should first be noted that the burden of proving prudent relationship investing might vary depending on whether the strategy was "voluntary" or "involuntary."127 The burden would be heavier for a "voluntary" relationship investor, who would have to prove the prudence of both the strategy and each investment chosen under it. An "involuntary" relationship investor would merely have to prove that the strategy was a prudent measure for monitoring independently selected investments.

A "voluntary" relationship investor — a plan that wanted to adopt relationship investing as a general strategy, choosing for the portfolio companies particularly suitable for good relations and buying stakes through structured, negotiated transactions — would face a double burden. The plan would have to prove that its non-standard investment approach was both prudently chosen and executed. This would certainly involve a high degree of procedural care (long meetings and thick "board books").

An "involuntary" relationship investor, by contrast, might have a much lighter burden. It could credibly claim to have chosen to begin relationship investing as a way to monitor and enhance the performance of large blocks of funds already immobilized by indexing, rather than as a new and independent asset allocation strategy.128 Assuming that the fidu-
ciary assembled the portfolio on some other basis, only the decision to
monitor, not the choice of stocks, would have to be defended as an inno-
vation, and expenditures for monitoring are easy to justify as prudent.

For both voluntary and involuntary relationship investors, prudence
would require investigation. As noted above, hiring experts and paying
for studies to monitor important and complex assets are activities which
bear a veritable sheen of prudence and responsibility and are generally
couraged by the courts.129 Trustees already holding a large investment
could reasonably pay to investigate a superficially reasonable idea for
monitoring them effectively. The standard for deciding to pay for a pre-
liminary investigation would presumably be fairly loose. Afterwards, as
long as each stage of the investigations, studies, and performance “con-
$\text{firm}ed$ what the trustees suspected all along” (that the project would pay
off),130 the fiduciary could prudently spend funds for the next step.

In either case, after conceiving the idea of a relationship investing
strategy, the fiduciary would have to obtain the information reasonably
necessary to make an independent, informed decision about its commer-
cial viability. An initial investigation would reveal whether there was
enough credible evidence that the idea could work profitably and
whether anyone was credibly expert in its requirements. Finding both,
the fiduciary would next determine his various options and their prob-
able relative costs and benefits, including the cost of properly choosing,
negotiating, and monitoring the relationships, the expected effect on
portfolio returns (including timing and variability and compared to avail-
able alternatives), and any associated liabilities, such as a loss of liquidity
or diversification and the potential of fiduciary conflicts of interest.131

plans were to hold more concentrated portfolios, the larger ones might often hold the
5–10% of a company’s stock that would allow relationship investing. Professor Coffee has
suggested a rule against diversification in excess of the plan’s ability to monitor its
investments. See Coffee, supra note 3, at 1355–57. CalPERS is considering cutting down.
See White, supra, at A12. Still, trailing the market benchmark is much more visible and,
hence, more embarrassing and dangerous for the fiduciary, than foregoing an opportunity
to beat the market.

Even if institutions continue to invest in very broad indexes, however, the possibility of
“involuntary” relationship investing remains. Plans that largely indexed could invest a
relatively small amount in nondiversified relationship investment funds each of which
invested in a few of the stocks in the index. The plans would retain their fragmented
indexes while the relationship investment funds could pool enough capital to wield
influence with the selected companies. The small cost of proportional stakes in
relationship investment funds could bring higher returns on the index as a whole, without
forcing the plan to take uncompensated risk or to stray from the safety of broad
diversification. The question would be whether returns on a relationship investment fund,
combined with any boost on index returns, justified the management fees and other
expenses of investment. This is apparently CalPERS thinking in considering relationship
investment partnerships. See Gordon & Pound, CalPERS Report, supra note 5, at 1.

129. See supra note 100 and accompanying text.
131. See, e.g., id. (finding that evidence showed that trustees did “virtually everything
that a prudent person would have done to identify and minimize [associated] risks”). Note
The decision to enter a negotiated investment, structured so as to assure both a long-term commitment to the investment’s management and a preferential claim to returns to the plan, in recognition of its efforts, would often be the crucial moment in the investment for a fiduciary. A contractual structure, once in place, would heavily influence (if not dictate outright) the prudent choice in later decisions within the relationship. Thus, the fiduciary would have to decide whether any liquidity and diversification lost in the contract, as well as possible conflicts of interest, were justified by the negotiated benefits.

Prudence would also require expertise. First, an innovating fiduciary would need to have enough expertise (either her own or hired) to determine that a relatively novel strategy could nonetheless be prudently executed. Second, she would need expertise to carry out the strategy.

How could a fiduciary determine whether he or a hired expert had enough expertise to rely on in adopting a relatively untried investment strategy? Most cases do not address the problem because most cases concern recognized and established fields of investment such as real estate and public bond trading. Jones v. O’Higgins132 is the exception and provides a hint as to the answer. In Jones, the court apparently relied on the defendant and his expert witness to judge investment industry standards, finding the plaintiff’s “expert” to have no formal training in investment advising or experience in portfolio management.133 The defendant testified that he had developed his strategy through “many years of training and experience in the field of investment advisement,” which had led him to the conclusion that “a large corporation had a tremendous ability to regenerate itself into an efficient and profitable organization.” He then “thoroughly detailed” how he had chosen his stocks. The defendant’s expert witness, an experienced, contrarian investment manager, testified, based both on an examination of the stocks and the defendant’s reasoning, that the portfolio “was in keeping with both a contrarian investment strategy and was generally prudent by the standards of the investment industry.”

It is unclear from this record exactly how the defendant “offered convincing evidence that his contrarian investment strategy was within industry standards.”134 The court seems, however, to concentrate on O’Higgins’s general investment management expertise and experience (at best endorsed by an “expert” with similar credentials to his own) to establish his competence to evaluate investment strategies for their com-

that a similar, staged procedure might also apply to a pilot program to try relationship investing with a few of the largest stakes already held by the plan.


133. See supra note 122 and accompanying text.

134. In describing both O’Higgins’ testimony and that of his expert, the court only notes that they testified that the investments were in keeping with a contrarian strategy.
patibility with the standards of the industry and the needs of a plan. With this established, he appears to have proven the prudence of his specific actions with a cogent explanation both of the reasoning behind his strategy and the deliberative process by which he carried it out. Some successful experience in the strategy at issue may also have been significant. Importantly, however, there is no indication in the record that the defendant appealed to the practices of any other investment managers in proving that his strategy was prudently selected or even executed.\footnote{135}

There are problems with relying too heavily on Jones as a guide for preparing a worst-case defense for the large plans which could engage in relationship investing.\footnote{136} Still, it appears to follow the general trend of courts in interpreting the prudent man rule. Accordingly, the fiduciary is probably safe to consider whether some respected and experienced

\footnote{135. The defendant's own expert witness testified that he was more "conservative" and would not invest in less than six stocks. Cf. Lanka v. O'Higgins, 810 F. Supp. 379, 388-89 (N.D.N.Y. 1992) (both parties' experts agreed that certain unnamed persons, whom the defendant's witness identified as contrarians, were "noted 'experts' in the field of investment management"). It is unclear what weight this had, but the implication is that proving that there are acknowledged experts in investment management, whether ERISA fiduciaries or not, who follow a given strategy is enough to establish it as a possibility for prudent investors. Of course, establishing the possibility of prudent investment, with proper expertise, does not prove that the fiduciary in question had that expertise. Robert E. Denham, whom Warren Buffett installed as his replacement at the head of Salomon Bros., comments that "[t]he fact that Warren Buffett has done . . . relational investing and done it well only proves that it can be done by mortals; it does not prove it can or should be done by most money managers." Ted Bunker, 'Relationship Investing': The Successor to LBOS?, Investor's Bus. Daily, May 18, 1993, at 4.}

\footnote{136. Jones concerned a plan encompassing one small doctor's office. The plaintiff was the named fiduciary and sole trustee and appears to have been the main beneficiary. See Jones, 11 Employee Benefits Cas. (BNA), at 1661. In these close conditions, the court presumed the plaintiff's prior, full acquiescence with the defendant's strategy. See id. at 1662. Acquiescence is not legally determinative, since the duty to act prudently is also a duty to act independently. Still, it put the plaintiff in the awkward position of claiming that the defendant had been imprudent in allowing him to act imprudently. Cf. Etter v. J. Pease Constr. Co., 963 F.2d 1005, 1007 ("The Plan is unusual in that many, potentially all, of the benefited employees are also trustees, managing and investing mostly their own money."); Hecht v. Colorboard Packaging Corp., 856 F. Supp. 184, 188-90 (S.D.N.Y. 1994) (mentioning but then ignoring beneficiary's claim of fiduciary breach for nondiversification where three-person pension plan of three-person company invested almost completely in one parcel of land). In addition, the plaintiff apparently did not bring an expert witness who could seriously testify on the prudence of specific investments and investment strategies. See Jones, 11 Employee Benefits Cas. (BNA), at 1667. Additionally, by the trial date, two out of three of the investments had risen dramatically. See id. at 1663. Again, prudence is theoretically a test of the fiduciary's performance, not the stocks', but it is still easier for a winner to argue his prudence. "It is difficult . . . for a judge or anyone else to disregard the lesson taught by subsequent events . . . .", 3 Scott & Fratcher, supra note 39, § 227 at 433-34 (citing In re Chamberlain's Estate, 156 A. 42, 43 (N.J. Prerog. Ct. 1931), in which the lower court stated, "It was common knowledge [in 1929] . . . that a [stock market] crash was almost sure to occur."). A final caveat about this case is that a man who could convince people to invest their retirement money in such a scheme must have been an extraordinarily persuasive witness as well.}
investment advisor could say under oath that the contemplated strategy could be executed reasonably. Most fiduciaries of large ERISA funds would, like O'Higgins, fulfill this standard by convincing themselves.\textsuperscript{137}

Determining whether someone had enough expertise to execute a relationship investment would be easier. ERISA fiduciaries acting as corporate monitors (and especially as board members) on behalf of a plan would have "thereby made their business the business of directing industrial firms."\textsuperscript{138} Prudence would then require that the fiduciary act only with the skill and care on which one "familiar with such matters" would insist. Relationship investing is a very complex process, but neither the main idea nor its elements are new. Structured minority investments are far from unprecedented. There are many people who, with varying degrees of credibility, claim expertise in identifying, negotiating, and managing such investments at varying degrees of risk and return. The real novelties of relationship investing lie in applying the technique to large, established, public companies rather than small, struggling, private ones and in having large financial intermediaries execute it rather than wealthy individuals, corporate managers, and venture capitalists.

Neither of these novelties seems to produce special legal problems under ERISA's duty of prudence. Applying an established technique to new surroundings is like adopting a new investment strategy. It requires the person doing it to demonstrate a high degree of skill (either personally or through prudently selected and monitored advisers) in the underlying activities and a careful consideration of the new circumstances and aims. The fiduciary's lack of experience is in and of itself not a bar to investment. A fiduciary who carefully prepared herself for the decisions facing her would not be subject to liability. No case has ever ruled that ERISA fiduciaries who were not competent to evaluate an investment proposal should have ignored it, so long as there were other investments that they could understand without help. In fact, courts have even found that such fiduciaries breached an affirmative duty to bring in whatever exper-

\textsuperscript{137} The relationship investment program recently launched by CalPERS provides an example of this process. See David A. Vise, Calif. Pension Fund Plans An Investment in Power: The Management Role It Seeks Stirs Alarm, Wash. Post, Nov. 7, 1993, at A1, H1 (reporting $125 million commitment to Dillon, Read & Co.'s Allied Investment Partners funds and board approval of plan for billions of dollars of investment and two new securities analysts to identify and later monitor companies' performance). As mentioned, CalPERS is subject to a copy of ERISA's fiduciary provisions. See supra note 21. In preparation for this step, CalPERS asked Lilli Gordon, a consultant to CalPERS and other pension funds on proxy activism, to prepare a study on the track record of this kind of investment. See Gordon & Pound, CalPERS Report, supra note 5. Apparently satisfied with the results, it then commissioned an evaluation of four funds purporting to specialize in relationship investing (The Lens Fund; Lazard Freres' Corporate Partners; Brown Brothers Harriman & Co.'s 1818 Fund L.P.; and Dillon, Read & Co.'s Allied Investment Partners L.P.) before choosing Allied Investment Partners. See Joel Chernoff & Marlene Givant, Star, Three Studies Support Relationship Investing, Pensions & Investments, Jan. 11, 1993, at 3.

\textsuperscript{138} Roe, Strong Managers, supra note 3, at 142.
tise was necessary to allow them to reasonably evaluate the idea and, if desirable, to execute it.\textsuperscript{139}

This section has attempted to show that ERISA’s duty of prudence should not inefficiently prevent a fiduciary from engaging in relationship investing. The fiduciary would have to prove to herself (and, if necessary, to a court) that the investment was prudent. Assuming, however, that it is substantively a good idea, ERISA should not preclude such proof. The standard of prudence in investment is one of reasonable care, based on the standards of the investment industry. It requires the fiduciary to follow procedures acceptable to the industry in evaluating a proposed investment, not, as some have claimed, that the fiduciary slapdash imitate the investment pattern of its closest peers. Thus, to the extent that professional investors convince themselves that a relationship investing strategy is reasonable, an ERISA fiduciary could do so as well.

B. \textit{Duty of Diversification}

Several commentators have suggested that ERISA’s formulation of the duty of diversification\textsuperscript{140} could prevent or at least significantly deter a fiduciary from engaging in relationship investing by discouraging any strategy other than the maximum possible fragmentation of a portfolio. The argument is that the statutory language focuses the fiduciary’s attention on individual large losses, rather than the risk to the entire portfo-

\textsuperscript{139} See Katsaros v. Cody, 568 F. Supp. 360, 367 (E.D.N.Y. 1983) (holding that fiduciary, not personally competent to evaluate proposed loan to bank, had affirmative obligation to retain expert counsel), aff’d, 744 F.2d 270 (2d Cir.), cert. denied, 469 U.S. 1072 (1984). For other cases dealing with the duty to hire outside counsel where the fiduciary is inexpert, see, e.g., Struble v. New Jersey Brewery Employees’ Welfare Trust Fund, 732 F.2d 325, 335 (3d Cir. 1984) (stating that deciding whether fiduciaries breached duty of prudence required court to “consider . . . whether they consulted with others, for example their attorneys.”); Donovan v. Cunningham, 716 F.2d 1455, 1474 (5th Cir. 1983) (finding fiduciaries breached duty of prudence in relying on outdated stock appraisal, rather than updating the old estimate either through their own expertise or, if inadequate, by hiring experts); Whitfield v. Cohen, 682 F. Supp. 188, 194 (S.D.N.Y. 1988) ("[A] trustee has a duty to seek independent advice where he lacks the requisite education, experience and skill."); Marshall v. Glass/Metal Ass’n and Glaziers and Glassworkers Pension Plan, 507 F. Supp. 378, 381 (D. Haw. 1980) ("While [inexperienced] trustees did receive legal advice concerning the Grenco, Inc. loan, they themselves made the investment decision, relying in large part upon information and opinions provided by the borrower.").

\textsuperscript{140} See supra notes 46–49 and accompanying text.
lio.\textsuperscript{141} With the standards of diversification undefined\textsuperscript{142} and extreme fragmentation the industry norm, there seems to be nothing to lose in fragmentation. Even the slightest concentration seems to bear some risk of failing to minimize the risk of loss. Further, if a court finds that the portfolio was not diversified, the fiduciary is faced with the task not only of rebutting arguments of imprudence, but of affirmatively proving prudence.\textsuperscript{143}

These charges, while reasonable in the abstract, are not well-grounded in practice. The requirement to avoid large losses does not command the fiduciary to leave no large investment standing for an unexpected disaster to strike. Rather, it prohibits subjecting a disproportionate amount of the funds to too many of the same, predictable risk factors.\textsuperscript{144} Moreover, the requirement of diversification, far from a man-

\begin{itemize}
\item \textsuperscript{141} See Roe, Strong Managers, supra note 3, at 138–39; Black, supra note 5, at 553–54; Coffee, supra note 3, at 1356–57 (raising concern, but expressing some doubt as to validity and importance). The criticism is based in “portfolio theory” which posits that the value of a given investment can be judged only by considering its place in an investor’s portfolio, not independently. For full accounts, see Malkiel, supra note 16, at 215–68; Edwin J. Elton & Martin J. Gruber, The Lessons of Modern Portfolio Theory, in Longstreth, supra note 37, at 161–94. For accounts specifically applied to trusts see Halbach, supra note 85, at 1159–66; Langbein & Posner, supra note 39, at 6–13; see also Malkiel’s useful list of additional sources in order of increasing mathematical density, Malkiel, supra note 16, at 420–21.
\item \textsuperscript{142} See Conference Report, supra note 37, at 304, reprinted in 1974 U.S.C.C.A.N. at 5084–85.
\item \textsuperscript{143} The legislative history of the Act explicitly states that it is “not intended that a more stringent standard of prudence be established with the use of the term ‘clearly prudent.’” Id. at 304, reprinted in 1974 U.S.C.C.A.N. at 5084. But see Roe, Strong Managers, supra note 3, at 138 (“ERISA requires the fiduciary to diversify, unless it is clearly prudent not to do so.”). Bearing the burden of affirmative proof in the face of a “basic policy . . . to require diversification” is not an appealing prospect, even if the putative standard is unchanged. Conference Report, supra, at 304, reprinted in 1974 U.S.C.C.A.N. at 5084. Still, in both Lanka v. O’Higgins, 810 F. Supp. 379, 381, 388 (N.D.N.Y. 1992), and Jones v. O’Higgins, 11 Employee Benefits Cas. (BNA), 1660, 1666 (N.D.N.Y. Sept. 5, 1989), the courts looked for prudence in a relatively straightforward way after finding a failure to diversify. Marshall, however, declared that “[t]he burden is not merely to prove that the investment is prudent, but that there is no risk of large loss resulting from the non-diversification.” 507 F. Supp. at 384 (D. Haw. 1980). Neither the statute nor the Conference Report supports this view and no other court seems to have adopted it. The effects of one or another standard of proof on trial results might, in any case, be dwarfed by the potential costs of a standard for diversification that cannot be resolved on summary judgment.
\item \textsuperscript{144} See Conference Report, supra note 37, at 304, reprinted in 1974 U.S.C.C.A.N. at 5084–85 (listing as factors financial and industrial conditions, type of investment, geographic distribution, industrial distribution, dates of maturity); see also Marshall, 507 F. Supp. at 384 (“[A] commitment of 23% of the . . . total assets to a single loan subjects a disproportionate amount of the trust assets to the risk of a large loss.”). Without denigrating the importance of modern portfolio theory, it should be recalled that the theory’s main achievement lies in its clarification and analysis of the intuitive concept of risk. The new, rigorous analysis leads to non-intuitive and counter-intuitive strategies to achieve more efficiently the same goals that were previously pursued, if only vaguely and inefficiently.
\end{itemize}
date for maximum fragmentation, is as easy-going as it is undefined. Federal courts have allowed high levels of concentration without comment. It seems that the concentration must be near complete or the risk extraordinarily high to bring liability.

This result is consistent with the common law of trusts, whose record of enforcing diversification is weak at best. In addition, the courts' approach seems a sensible response to the very concern raised by the commentators: the undefined standard for sufficient diversification. The diversification requirement grows out of the duty of prudence because diversification is fundamental to prudent investing under most circumstances. Consequently, proof of extreme nondiversification may make a prima facie case for imprudence and shift the burden of proof to the fiduciary. A court, faced with a charge of nondiversification, considers whether the fiduciary so obviously failed to diversify that his action raises an underlying concern as to prudence. Like the commentators, the courts have realized that the only clear cases lie at the extremes: the maximum fragmentation accepted in the industry and nearly complete concentration. The commentators worry that a court might impose

145. See Leigh v. Engle, 727 F.2d 113, 116, 129 n.25 (7th Cir. 1984) (accepting in dictum defendant's claim that shifting 30% of assets to three common stocks could constitute diversification of 100% fixed-income portfolio); Sandoval v. Simmons, 622 F. Supp. 1174, 1199, 1208 (C.D. Ill. 1986) (finding no failure to diversify where plan held, at separate times, 18% of equity assets in single stock and slightly less than 32% in three stocks); Brock v. Citizens Bank of Clovis, No. Civ. 83-1054 BB, 1985 WL 71535, at 5 (D.N.M. Dec. 20, 1985) (enjoining plan, at DoL's suggestion, from investing more than one-third of plan assets in any one investment or investment type, where plan originally invested 82% of assets in first mortgages on local commercial property and insisted on a "free hand in selecting investments"), aff'd, 841 F.2d 344 (10th Cir. 1988), cert. denied, 488 U.S. 829 (1988). Concentrations of this magnitude would not be necessary (nor would they be prudent) for the largest funds to take significant positions and yield the necessary influence. Corporate Partners, for instance, operates on only $1.65 billion in capital. See Marlene Grant Star, Partnership Turns Profit from Sale, Pensions & Investments, July 12, 1993, at 32.

146. See, e.g., GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc., 895 F.2d 729, 731, 733 (11th Cir. 1990) (holding that plan investing "70 percent in long-term government bonds [without staggered maturities], 15 percent in zero coupon bonds (strips), 10 percent in stocks, and 5 percent in cash" failed to diversify in light of its cash-flow needs); Katsaros v. Cody, 744 F.2d 270, 274 (2d Cir.) (60% of assets invested in single, inexpertly negotiated loan), cert. denied, 469 U.S. 1072 (1984); Jones, 11 Employee Benefits Cas. (BNA), at 1666 (over 90% of assets in three stocks); Marshall, 507 F. Supp. at 384 (25% of assets in single, inexpertly negotiated, high-risk loan).

147. See Bogert & Bogert, supra note 39, § 612, at 18–20; 3 Scott & Fratcher, supra note 39, § 228.

148. "The duty to diversify is based mainly on standards of care and skill. It warns trustees against taking unwise risks, risks that are unnecessary and unrewarded, without justification." Halbach, supra note 85, at 1170.

149. Cf. Bogert & Bogert, supra note 39, § 543, at 248 (noting, in reference to duty of loyalty, that rules that "are necessarily general and offer limited help in resolving a concrete problem" cannot be interpreted as forcing trustee to act at her peril if she merely suspects problem) (citing Fulton Nat. Bank v. Tate, 363 F.2d 562, 569 (5th Cir. 1966)).
liability for deviation from maximum fragmentation. In practice, however, they appear to have imposed liability only for extreme concentration. This approach reasonably recognizes the common-law tradition and routine investment practice. It also acknowledges that no fiduciary can be expected to have foreseen the intermediate line that a trial court might draw. Only in rare cases of extreme concentration may a court impose liability with little risk of unfairness.

If the courts applied a more modern understanding of diversification, the result might very well be a tightening of the requirement, as it became easier to specify and measure the required methods and goals. Along with a clearer analysis of the problems involved in investment, portfolio theory\textsuperscript{150} attempts to quantify and empirically test its more exact understanding. The results include both putatively exact measures of volatility for given securities ("beta") and a series of estimates of the best possible diversification from the smallest possible portfolio. Legal authors often cite these theoretical outer limits as if they establish practical programs for investment.\textsuperscript{151} It might be argued, however, that the old danger of per se rules lurks in such quantification. These numbers seem to present clear bases for decision, while hiding the essential uncertainty of their generation and subtlety of their exact meaning.\textsuperscript{152} Portfolio theory could, then, be much more accommodating ground for the growth of bright lines and per se rules than the DoL’s regulation\textsuperscript{153} which recognizes the general validity of these theories as prudent guides to investing, but refuses to impose any single version as a rule of law. The latter seems to guard more carefully an essential reluctance to penalize anything short of clearly improper behavior, where the exact limits of propriety are neither morally ingrained, intuitively obvious, nor exactly definable.

Luckily, perhaps, the courts have continued to apply an “economically unsophisticated”\textsuperscript{154} but lenient standard of diversification, leaving the general evaluation of investments to the prudent man standard.

C. Duty of Loyalty

The duty of loyalty requires that the trustee act solely in the interest of the beneficiaries.\textsuperscript{155} This section will discuss two general areas in

\begin{itemize}
\item[150.] See supra note 141.
\item[151.] See, e.g., Roe, Strong Managers, supra note 3, at 139 & n.40; Black, supra note 5, at 553.
\item[152.] See, e.g., Malkiel, supra note 16, at 238–54 (illustrating need for non-quantitative judgment in deciding the worth and meaning of beta generated from simple formula).
\item[153.] See supra note 41 and accompanying text.
\item[154.] Coffee, supra note 3, at 1356. Coffee's full description is “unique and economically unsophisticated,” but, for better or worse, it is hardly unique. As noted above, supra notes 48–49 and accompanying text, ERISA closely follows the Restatement (Second) of Trusts § 228 (1957). The Restatement (Third) seems to require at least some acceptance of portfolio theory. See Restatement (Third) of Trusts: Prudent Investor Rule § 227 cmt. g (1998).
\item[155.] See supra notes 50–61 and accompanying text.
\end{itemize}
which a strategy of relationship investing might cause loyalty problems: general social concerns and the personal interests of fiduciaries. Previous commentators have not raised these concerns, but they might well be the most problematic of the ERISA fiduciary duties for the relationship investor, since they directly concern the fiduciary’s relationships with the trust’s business associates.

156. The ERISA fiduciary who became a director of a relationship investment by way of monitoring and participating in the relationship might also face conflicts between his fiduciary duties to the plan beneficiaries and the company’s shareholders. A negotiated relationship investment would often involve debt, preferred stock, or special contractual rights or duties. The investor would, thus, have interests which diverged to some extent from those of a pure common stockholder. This is unlikely to pose a serious problem for most relationship investments. First, the fiduciary could vote for the beneficiaries’ interests, even if they conflicted with the interests of other common stockholders, and still maintain the protection of the business judgment rule against corporate director’s liability, see Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985), so it seems reasonable to assume that fiduciaries would favor the beneficiaries’ interests in doubtful cases. Second, the fiduciary could generally avoid truly conflicted decisions by abstaining from board votes or by appointing a temporary outside fiduciary. The question, then, becomes more one of prudence than loyalty. The fiduciary would have to determine, before investing, how frequent and serious the conflicts were likely to be. If they would arise only infrequently and in extraordinary conditions, as seems likely to be the case in most investments, the fiduciary could prudently plan to abstain from board votes or appoint temporary independent fiduciaries without seriously compromising the relationship’s value to the plan. Third, and perhaps most important, to the extent that the plan had no intention to leave the relationship, a formal minority vote on the board would not be as important as having continuing, informal access to confidential information and the ear of management. Finally, if the investment were carefully negotiated to create structural barriers against exit and other foreseeable temptations, it would not matter much if an unbiased, outside fiduciary was temporarily given control in a crisis, such as a tender offer. If the original investment had been well planned, its structure would largely determine the prudent choice. See supra text accompanying note 131. A cynic might doubt the true independence of a temporary fiduciary, but a more bitter cynic would argue that, with good advance planning and careful adherence to formalities, any subtle pressures remaining behind the scenes could at least be rendered non-actionable.

It should be borne in mind that other fiduciaries, too, have a duty of loyalty. To date, this does not seem to have prevented corporations and partnerships from sending their fiduciaries to sit on the boards of other corporations and partnerships in which they had acquired a significant stake. Corporate Partners, for instance, generally takes a board seat or two. See William Taylor, Can Big Owners Make a Big Difference?, Harv. Bus. Rev., Sept.–Oct. 1990, at 70 (noting that “the fund expects seats on the board of directors and a voice in company affairs”). Warren Buffett also often takes a board seat in his investments. See, e.g., Jeresi & Hammonds, supra note 18, at 58 (describing board seat negotiated as part of investment in Gillette). Corporate Partners is a limited partnership. Buffett acts through Berkshire Hathaway, a corporation (though it must be noted that Buffett owns near 50%). Presumably, this difference is to some extent attributable to differences between the duties of loyalty under corporate and trust law, especially the lower barriers in the way of beneficiary and government suits. Corporate directors can force shareholders first to demand relief, attempt to dismiss the suit, and finally, if they must go to trial, they are protected by the business judgment rule. See Unocal, 493 A.2d at 958; Deborah A. DeMott, Shareholder Derivative Actions: Law and Practice §§ 5:01–5:28 (1992 & Supp. 1994) (describing demand on directors requirements and procedures to dismiss suit through litigation committees).
1. **Social Investing.** — It might be possible to claim that the fiduciary had decided to adopt a relationship investing strategy, not because it could produce a superior return on investment for the individual investor, but rather because it could help society. The reasons alleged would presumably be the same ones that have impelled some academics to promote relationship investing: concern with general inefficiencies in the American corporate governance system and their effect on American wealth and international competitiveness; the desire to serve as "a herald of joy to the humble./ To bind up the wounded of heart... [so that they may] build the ancient ruins,/ Raise up the desolations of old,/ And renew the ruined cities,/ The desolations of many ages."\(^{157}\)

In practice, this kind of breach should not be a major concern because neither the duty of prudence nor the logic of relationship investing would allow it. The point of relationship investing is to increase shareholders' return by reducing agency costs. A fiduciary acting prudently to carry it out would seem unlikely to be liable, even if, along with mistakes in predicting returns, he had made some unwise evangelical statements. The fiduciary does not "necessarily [violate] the duty of loyalty by considering the social consequences of investment decisions. If... the costs of considering such consequences are de minimis, the trustee ordinarily will not have transgressed that duty."\(^{158}\) On the other

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157. Isaiah 61:1–4 (Jewish Publication Society trans., 1985). For a description of the problem, see id. at 56:11 ("Moreover, the dogs are greedy./ They never know satiety./ As for the shepherds, they know not/ What it is to give heed./ Everyone has turned his own way,/ Every last one seeks his own advantage."). See also Labor Secretary Robert Reich's description of private pension managers' "fiduciary role as custodians for the long-term performance of the economy." Peter Szekely, U.S. Urges Pension Funds to Be Active Shareholders, Reuter Eur. Bus. Rep., July 28, 1994, available in LEXIS, NEWS Library, REUEUB File.

hand, a fiduciary who purposefully or negligently selected an inefficient relationship investment (or at least one of doubtful efficiency) or who selected relationship investing as a strategy without prudently deciding that it made business sense would deserve to be surcharged. A prudent fiduciary could easily maintain documentation that would preclude any charge of disloyalty.

2. Personal Interests. — Fiduciaries are forbidden to pursue their personal interests in managing plan assets, whether these interests are direct and pecuniary or indirect and personal.\textsuperscript{159} Fiduciaries' personal interests present a more serious problem because it is in the nature of a relationship investment that the plan fiduciary will build a close relationship with the investment.\textsuperscript{160} The simplest, though probably not the most serious, problem would be accusations that the fiduciary had succumbed to "structural bias," acting from concern for the personal interests of friends among corporate management rather than from independent and prudent deliberation.\textsuperscript{161} Shareholders have attempted this argument in corporate derivative suits, and though courts have been reluctant to find structural bias, they have recognized at least the theoretical possibility of proving it.\textsuperscript{162} It should be noted that these courts were faced only with requests that they lower the business judgment standard, recognize a prima facie case, and allow the substantive suit to progress. On questions of ultimate liability, they might be even more reluctant to recognize claims that fell short of egregious domination. In addition, the classic argument for structural bias — that Governance Bulletin, see supra note 11, the ETI Bulletin merely clarifies that "[t]he fiduciary standards applicable to ETIs are no different than the standards applicable to plan investments generally." ETI Bulletin, supra, at 32,607. Like the Governance Bulletin, it is significant as an expression of moral support (or political pressure, depending on one’s perspective), not as a legal innovation. This Note will not descend any further into those murky depths. Given the unlikeliness that any fiduciary would overtly justify relationship investment (or even actually undertake it) on the basis of social benefit, these concerns seem of only marginal concern here.

159. See Leigh v. Engle, 727 F.2d 113, 127 (7th Cir. 1984) (citing approvingly Frank M. Cappuccio, Note, The Duties of Employee Benefit Plan Trustees Under ERISA in Hostile Tender Offers, 82 Colum. L. Rev. 1692, 1703 n.51 (1982), for proposition that "interest" includes "any interest, financial or nonfinancial").

160. ‘Ultimately, board membership is part of being a big stakeholder,’ says [Tullio Cedraschi, president of the Investment Division of the Canadian National Railway pension fund]. ‘The only potential drawback is that you can fall in love with a company. You do sell at some point, you know.’ “ Clark, supra note 126, at 67.

161. According to Ralph Whitworth, former president of United Shareholder Association, “Cooperation is important and that’s the best approach . . . [b]ut there’s got to be someone out there keeping vigil. And when you are having cocktails with corporations and consorting with them, that’s more difficult. Sometimes, you need distance.” Leslie Wayne, Have Shareholder Activists Lost Their Edge?, N.Y. Times, Jan. 30, 1994, at F7.

the interested director selected the board which served at her pleasure —
would not pertain in most relationship investments. It follows that a
structural bias argument for breach of the duty of loyalty would be
unlikely to succeed against an ERISA fiduciary.

A more likely argument would be that the particular agent who han-
dled the relationship acted in his own interest in job security, rather than
in the interests of the beneficiaries. Any intensive relationship invest-
ment would require some agent who specialized in maintaining the rela-
tionship with particular companies. The agent might be an employee of
the plan, an outside investment manager, or an investment company.
Any such agent would have a problematic interest in personal job secu-
ity. To keep his job, he would have to maintain friendly relations with
both the plan and the corporation. His job would also depend on the
corporation remaining a desirable relationship investment. These inter-
est could lead to two conflicts of interest with the plan beneficiaries.

First, the fiduciary might not be willing to deal harshly with manage-
ment, for fear of losing his ability to maintain a relationship. For
instance, the fiduciary might notice indications that the business was stag-
nant or failing. An independent analyst might conclude that the prob-
lem lay in top management. The relationship specialist, however, might
be reluctant to reach that conclusion or to mention it to the corporate
managers. A hostile reaction could destroy his ability to maintain a
friendly relationship with management and, thus, his job.

Second, the fiduciary would also be unwilling to take steps that
might eliminate the company as a viable or relationship investment.
Again, where the best course of action was liquidation or sale, the fiduci-
ary would face a conflict. If he recommended these options to the com-
pany’s managers and they took him seriously and sold or wound down
the corporation, his relationship would have no further value. Similarly,
mentioning the company’s dire condition to the investor plans would sig-
nificantly reduce the value of the fiduciary’s relationship with it, espe-
cially if its management had rejected suggestions that it liquidate or go on
the block. He would face the same dilemma if he became convinced that
the plan should divest for other reasons.

These conflicts are not insoluble. The agent who actually handled
the relationship might not have to worry about ERISA fiduciary duties. It
might be an investment company organized as a “venture capital operat-
ing company” so that its assets would not be “plan assets” and its prin-
cipals would not be ERISA fiduciaries.164 Alternatively, a plan employee
would generally have fiduciary liability insurance, supplied by the spon-
or.165 In either case, the individual agent would be willing to risk the
appearance of a conflict. The plan itself might breach its duty of pru-

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164. See supra note 123.
165. See supra note 72 and accompanying text.
dence in engaging an agent who was likely to face a conflict. Prudence, however, is a much more flexible standard than loyalty. A plan might prudently find a fiduciary with a good professional reputation and calculate that the interest in maintaining it would offset any conflicting personal interests.

The conflict would also be less serious for agents who specialized in “bottom feeding”: establishing a relationship with troubled companies in need of and amenable to medium-term, specified assistance. These agents would be expected to find significant problems in the companies in which they invested. Their investors would also expect them to take harsh action, if necessary. The agents themselves would never plan to invest in their target companies indefinitely, but only until they and their share value were sufficiently returned to health. Accordingly, they might be less dependent on maintaining friendly relationships with the managers of individual companies than on their general reputations for expertise and sound judgment.

Formally, then, the problems of loyalty, while potentially serious also seem avoidable.

CONCLUSION

It does not seem to be true that ERISA’s fiduciary duties conspire to formally prevent a determined pension fund from engaging in relationship investing. As noted, the duties of prudence and diversification have been construed liberally by the courts as standards of conduct. A fiduciary’s conduct must, generally speaking, conform to the customary standards of care and skill in the investment community. These conclusions might be tempered by some considerations of the special conservative purposes of the Act and by the requirements of the individual trust. Nonetheless, an eager fiduciary could find appropriate expertise to both evaluate and execute a strategy if it could actually be shown to promise favorable returns. In addition, the fiduciary could look to cases encouraging active and expensive monitoring of complex investments for some assurance that the investment would be viewed more in the conservative,

168. The fact that a court would be unlikely to find a relationship investor liable for breach of the duty of loyalty does not necessarily mean that the duty could not prevent relationship investing. Exposure to expensive suits, whether by the government or beneficiaries, that could not be resolved on summary judgment might be a heavy deterrent, even where ultimate victory is almost assured. It is difficult to know exactly how serious a problem this is or how much of an impact it might have on fiduciary choices, though, for the moment, it seems clear that the government is unlikely to bring suits against activist investors without serious additional provocation. See Governance Bulletin, supra note 11.
back-to-basics light in which the advocates of relationship investing generally portray it.

Nonetheless, it is hard from the few cases and statutory law alone to know what effect greater exposure to the costs of even frivolous suits might have on a fiduciary or its sponsor, in the face of bad publicity and high insurance costs. It is, perhaps, in this sense that ERISA fiduciary duties could block high-stakes strategies and actions whose failure could attract the attention of government enforcement and individual plaintiffs.

Loyalty is slightly more ambiguous. The agent who carried out a relationship investment might face conflicts of interest between a personal interest in maintaining the company and the agent’s relationship with it, and the beneficiaries’ interests in drastic change or liquidation. Still, agency might be structured either to avoid ERISA fiduciary duties altogether or to insulate fiduciaries against any personal threat of litigation. Many “bottom feeding” relationship investors would not face the conflict at all. Given the vagueness of most of the possible conflicts, the duty of loyalty in itself would probably not prevent relationship investing.

It is hard to know whether pension funds do not engage in relationship investing because it is not profitable. There are other possible regulatory barriers, such as the securities rules against insider trading and short-swing profits. ERISA itself may raise structural barriers by granting permission for corporate executives to serve as fiduciaries of their companies’ pension funds, and setting relatively low barriers to suit against ERISA fiduciaries. This Note, however, has attempted to show that at least one of the possible barriers does not exist.