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Pension Plan Fiduciaries: When Is There A Duty to Investigate?

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As the number of regulators knocking on the doors of pension fund trustees continues to grow, many governing boards are starting to wonder when there is a duty to investigate after an initial investment decision is made.

Investigations: "Before" vs. "After"

The touchstone of fiduciary duty under almost every legal framework governing pension plans -- ERISA, common law, state statutes governing public pension plans -- is the "prudent man" standard, which requires a fiduciary to act with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[1]

It is axiomatic that to meet this standard the fiduciary's decisions must be adequately informed. This will often require that the fiduciary diligently inquire into the underlying facts***.*** As a result, some form of investigation will typically be conducted ***before*** any important action is taken. For example, before authorizing a new form of investment, the fiduciary would normally conduct a careful evaluation of the investment to understand the historical returns and the risks and potential returns associated with this type of investment.[2] Where there is no reliable market price of an investment, an independent investigation into valuation may be required.[3] Before delegating to an investment manager, the fiduciary likewise would want to understand the manager's track record, any potential conflicts of interests, and ensure that the compensation to be paid is reasonable in light of the value of the services rendered.[4] Investigations of this type, taken before a decision is made, can also be referred to as "due diligence."

This article addresses a different and less common type of investigation – an investigation conducted ***after*** the initial decision is made. To use the examples listed above, if the investment once made were not producing the returns that were originally expected, or if a change in economic environment were to suggest that the risks associated with the investment were greater than originally thought, a prudent fiduciary might be obligated to investigate and re-evaluate whether to retain, modify or liquidate the investment. Similarly, if an investment manager were not producing the results expected, or if professionals at the investment manager have changed or if the entity itself has undergone a change in ownership, a prudent fiduciary might be obligated to investigate and re-evaluate whether to continue to retain the manager.[5] Finally, if information were to suggest a conflict of interest not previously understood, a prudent fiduciary should investigate and determine if such conflict is real.

A particularly sticky situation can arise if a new fiduciary, upon joining the board or other governing body, acquires information indicating that imprudent decisions have been made in the past by his or her co-fiduciaries. The new fiduciary may, in this situation, have an obligation to investigate and take action to rectify prior breaches.

Red Flags

The term “red flags” is often used by courts to refer to information that, while insufficient by itself to permit a conclusion that something is amiss, is nevertheless sufficiently suspicious or at odds with what would be expected that it requires a prudent fiduciary to investigate further. In litigation, of course, the importance of any purported red flags will be judged with the unique clarity of hindsight. As discussed below, a fiduciary who fails to investigate in the face of what are later determined to have been red flags can be held liable for breach of fiduciary duty.

There is no general rule for what constitutes a red flag. Each situation needs to be evaluated in its own full context. Obviously, anything that gives rise to a suspicion of misstatement, concealment, misappropriation, negligence, incompetence, violation of rules or policies or other form of irregularity should be investigated. In addition, as a general rule, prudent inquiry should be made into anything that is unexpected or contradictory, or that is accompanied by an explanation that doesn’t make sense, or that appears to lack appropriate documentation.

Here are some examples of situations that have been deemed to require further investigation:

- Where, based on advice of an investment advisor, an initial investment was made into a startup company as a short-term loan, with an expectation that the borrower would obtain long-term financing elsewhere, a plan fiduciary was liable for failing to investigate why the initial short-term loan was not repaid, and why the advisor subsequently recommended an increasingly large series of subsequent loans.[6]
- Fiduciaries of Enron’s retirement plan, which permitted investment in Enron stock, could be liable for failing to investigate after news articles in *The Wall Street Journal* and *Fortune* magazine suggested that Enron was a "hedge fund in disguise" and criticized Enron's “increasing secrecy, growing debt, bullish expectations, opaque accounting and dubious rationalizations."[7]
- Where an investment manager failed to provide detailed accounts of how funds were invested, and appeared to resist requests for more detailed information, plan fiduciaries were in breach for failure to investigate.[8]
- Where a plan is invested in mutual funds which become the subject of a state or federal investigation, the fiduciary should obtain information sufficient to evaluate the nature of the alleged abuses, their potential impact on plan investments, the steps taken by the fund to prevent future such abuses and any remedial action taken or contemplated to make investors whole.[9]

Acts Occurring Before the Tenure of a Fiduciary

ERISA, and most other legal regimes governing duties of plan fiduciaries, impose an affirmative duty on each fiduciary to prevent or rectify known breaches of duty by other fiduciaries.[10] The case of *Barker v. American Mobil Power Corp.* illustrates this principle.[11] There, assets of a retirement plan had been transferred to and commingled with the operating assets of the employer years before the defendant became a fiduciary. The fiduciary knew, or at least suspected, that such commingling had occurred and also that separate accounts were not being maintained for beneficiaries. In holding the fiduciary liable for losses suffered by the beneficiaries, the court stated:

> [The fiduciary] suspected that there were problems with the maintenance of the Plan. Any prudent individual who had a retirement account and who possessed the same suspicions that his own account was not being properly maintained would make inquiries to ascertain with certainty that the account was being properly funded… Not to investigate suspicions that one has with respect to the funding and maintenance of the plan constitutes a breach of that duty.

Planning and Conducting the Investigation

Careful planning of the investigation is crucial. The investigation should be broad enough to provide assurance that all relevant information is obtained and evaluated while avoiding unnecessary delay, expense and disruption. The appropriate scope of the investigation will depend on a number of factors, including the nature of the red flags, how difficult or easy it is to obtain reliable information, and whether there is a risk of litigation or governmental inquiry. In some cases, a simple request by the fiduciary for additional detail, or for an explanation of a seemingly anomalous bit of information, followed by receipt of a plausible response from a reliable source, will be all that is needed. In other cases, particularly those raising concerns about the honesty or integrity of persons to whom responsibility has been delegated, or involving complex legal or accounting issues, it will be advisable to engage independent counsel to conduct the investigation.

In selecting counsel, plan fiduciaries should look for a number of attributes. First, counsel should be sufficiently independent to give assurance that there will be no bias or conflict of interest in the assignment. Typically this means that counsel selected to do an investigation will have limited or no prior relationship with those persons whose conduct could be called into question. Second, counsel should have experience in conducting investigations. This will ensure that counsel has both the requisite legal knowledge, as well as an appreciation for how to appropriately organize, size and sequence an investigation to conduct an efficient and effective effort. Third, counsel should be knowledgeable about fiduciary law as well as accounting, finance and any other non-legal issues relevant to the inquiry. Perhaps most important of all, counsel must understand that the ultimate purpose of the investigation is to protect the interests of plan beneficiaries and that excessive delay, expense, disruption or unnecessary injury to morale is not likely to serve such interests.

In most cases it will be desirable to plan the investigation so that the plan fiduciaries have the option of claiming confidentiality of the results of the investigation under the attorney-client privilege and/or the attorney work product immunity. This is particularly important where adversarial proceedings are a possibility.

Documenting the Results

The results of every investigation, even a simple and informal one, should be documented. Depending upon the apparent seriousness and/or complexity of the issue, documentation can take many forms – for example, making and receiving requests for information in writing, recording discussions in minutes, or writing a memo to the file. Where independent legal counsel is engaged, it will assume the responsibility for assembling a solid and well-documented evidentiary record.

Conclusion

Plan fiduciaries should be alert for “red flags” which, with the benefit of hindsight, may later be deemed to have put them on notice of errors or irregularities affecting the plan. Where red flags are observed, sufficient investigation should be conducted to satisfy the duty of inquiry inherent in the reasonable man standard of prudence. When in doubt, consult with independent legal counsel about the nature and scope of fiduciary obligations under the specific facts at hand.

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[1] See, e.g., ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B); Cal. Const., art. XVI, § 17(c).

[2] See, e.g., *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir. 1984).
[3] See, e.g., *Eyler v. Commissioner*, 88 F. 3d 445 (7th Cir. 1996).
[4] See, e.g., *Allison v. Bank One - Denver*, 289 F.3d 1223, 1241 (10th Cir. 2002); ERISA §§ 404(a)(1)(A)(ii), 406(a)(1)(C), and 408(b)(2), 29 U.S.C. §§ 1104(a)(1)(A)(ii), 1106(a)(1)(C), and 1108(b)(2).
[5] Under ERISA, a named fiduciary under a plan who has appointed an investment manager has a duty to monitor the investment performance of the investment manager and to withdraw the investment if and when it became clear that the investment was no longer proper for the plan. See, e.g., *Morrissey v. Curran*, 567 F.2d 546 (2d Cir. 1977).
[6] *De Costa v. Rodrigues*, No. 03-CV-598, 2008 BL 57048 (D. Haw. 2008).
[7] *In re Enron Corporation Securities, Derivative & "ERISA" Litigation*, 284 F. Supp.2d 511 (E.D. Tex. 2003).
[8] *Whitfield v. Cohen*, 682 F. Supp. 188 (S.D.N.Y. 1988).
[9] Statement, Employee Benefits Security Administration, *Duties of Fiduciaries in Light of Recent Mutual Fund Investigations*, (Feb. 17, 2004) (http://www.dol.gov.ebsa/newsroom/sp021704.html).
[10] ERISA § 405(a), 29 U.S.C. § 1105(a).
[11] 64 F.3d 1397 (9th Cir. 1995).