
Common Mistakes of Fiduciaries Responsible for Investments

By Lynn Hopewell

Trustees of pension plans, directors of charitable boards, executors of wills, trustees of testamentary trusts and other fiduciaries all have strict responsibilities to act with expertise and prudence. Yet, most do not have the requisite knowledge of prudent investment procedures. Here is a short list of the most common mistakes these fiduciaries make.

Appointees to the board of directors of a charitable organization or as a trustee of a church or school are usually people of accomplishment and ability. Yet, when those organizations have substantial funds to manage, lay board members often find themselves unequipped for the task.

Proper fund management means establishing an expert, detailed, written strategy for the entire investment process—from setting investment objectives to selecting investment managers and monitoring results.

Why shouldn't this task be difficult? After all, most persons selected to boards are chosen for reasons other than their investment expertise. Indeed, having *some* investment expertise often leads directors and trustees astray. They apply rules, procedures and concepts they have learned as personal savers to their job as fiduciaries for institutional funds where such ideas are often inappropriate.

Who Are Fiduciaries?

Fiduciaries are people who are responsible for the management of money that does not belong to them. Examples of people who find themselves in fiduciary positions are:

- Pension Plan Trustees
- School Board Trustees
- Church Deacons and Vestry Members
- Board Members of Charitable Organizations
- Executors of Wills
- Trustees of Testamentary Trusts
- Trustees of Charitable Trusts

All these positions require special duties of the people who serve in them. Because they are in positions of trust, fiduciaries have historically been tasked under various laws to conduct the affairs

of their organizations or entities with great circumspection.

Fiduciaries Are Liable For Imprudence

Volunteer board members are often surprised to find that, under most applicable laws, they have significant liability for imprudent behavior. They can be held *personally* liable for imprudent actions. They do not benefit from a corporate shield of liability.

Worse, fiduciaries can be joint and severally liable. This means that of a group of trustees or directors of an organization, any one of them can be made to bear all financial liability if an aggrieved party successfully obtains damage awards from courts or regulatory agencies.

In addition to restoring plan losses resulting from a breach of fiduciary duties, for pension funds, ERISA now allows an additional penalty of 20% of the amount recovered by court order or settlement agreement.¹

It's Not Whether You Win Or Lose, It's How You Play The Game

For fiduciaries, good intentions do not count. In the management of their assets fiduciaries must actually carry out specific steps which are deemed "prudent."

An important distinction should be understood by every fiduciary. Fiduciaries are not held accountable for poor investment performance per se. If the stock market goes down, and an investment fund experiences losses, that does not necessarily mean that fiduciaries have been imprudent.

However, if it is found that investments in the stock market were concentrated in only three stocks that were personal favorites of the fiduciary, then that's another story.

What fiduciaries are responsible for is behaving responsibly and with expertise:

*"A search of court cases has not revealed a single case in which the courts upheld a complaint based solely on poor portfolio results when it was determined that the fiduciary prudently fulfilled his or her duties."*²

Since it is procedure and not results for which fiduciaries are responsible, it is vital that the implementation of prudent procedures be documented. Fiduciaries must be able to prove that they followed prudent procedures. After the fact, verbal reconstructions are of little defensive use.

Six Key Steps

The prudent process that fiduciaries should follow is found by mining state statutes, the *Restatement of the Law Third, Trusts (Prudent Investor Rule)* and ERISA. The following is a compilation of key procedures.

1. An investment policy specifying all aspects of the procedures for managing investments must be established and must be in writing.³
2. Assets must be diversified. Diversification may be obtained along several dimensions, both securities selection and asset classes.⁴
3. Investment decisions must be made with the skill and care of a prudent expert.⁵

4. Investment performance must be monitored.⁶
5. Investment expenses must be controlled.⁷
6. Prohibited transactions (conflicts of interest) must be avoided.⁸

¹ERISA Section 502(1). See also, "Report to the Secretary of the Task Force on Enforcement" (9-90), relating to the ERISA Enforcement Strategy Implementation Plan, Pension and Welfare Benefits Administration, U.S. Department of Labor, Washington, D.C.

²Donald B. Trone, William R. Allbright. *Procedural Prudence: The Fiduciary's Handbook For Management of Retirement Plan Assets*, Veale & Associates, Include, Cincinnati, Ohio, p. 6, citing Sandoval v. Simmons, 622 F. Supp 1174 (DC. Ill. 1985).

³ERISA Sections 402(a)(1), 402(b)(1)-(2), 404(A)(1)(D).

⁴ERISA Sec. 404(a)(1)(C).

⁵ERISA Sec. 404(a)(1)(B).

⁶ERISA Sec. 405(a).

⁷ERISA Sec. 404(a).

⁸ERISA Sec. 406(a)-(b).