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Chapter 15

Public Employee Pension Plan Trusts

The Uniform Management of Public Employee Retirement Systems Act (“UMPERSA”), as noted, was promulgated by the NCCUSL in 1997. As of the publication date of this book, no state has yet adopted UMPERSA. [Author’s update: Wyoming and Maryland adopted UMPERSA in 2005.] However, as noted, the South Carolina legislature incorporated the fiduciary portions of UMPERSA as part of its Code of Laws in 1998. These portions include Sections 4 (public employee retirement plan assets are held in trust), 6 (delegation), 7 (general fiduciary duties), 8 (investing and managing fiduciary duties), 10 (no hindsight allowed), 11 (fiduciary liability), 12 (open/public meetings) and 17 (financial/actuarial disclosures: specifically, subsections 13, 14, 15 and 16) of UMPERSA.

At the end of 1999, about \$2.75 trillion in state and municipal pension fund assets were spread among about 2,300 public employee pension plans in the U. S.⁸⁵¹

A. The Strong Relationship Between The Act And UMPERSA

The heavy influence of the [Author’s note: Uniform Prudent Investor] Act on UMPERSA is readily apparent. The following language indicates how text from the Act has been extensively incorporated into UMPERSA.

Modern Portfolio Theory. The Act/UMPERSA:⁸⁵² “[Since] the late 1960’s, the investment practices of fiduciaries experienced significant change ... These changes occurred under the influence of a large and broadly accepted body of empirical and theoretical knowledge about the behavior of capital markets, often described as ‘modern portfolio theory.’”

Principles of modern prudent investing. The Act:⁸⁵³ “[The Act] makes five fundamental alterations in the former criteria for prudent investing. All are to be found in the Restatement.” UMPERSA:⁸⁵⁴ “[UMPERSA] facilitates the incorporation of modern investment practices, in large part, by revising and clarifying the standards of prudent retirement fund investing. Five generally accepted principles of modern fiduciary investment practice are implemented. All are found in the Restatement ... and all derive from the Uniform Prudent Investor Act.”

Standard of prudence. The Act:⁸⁵⁵ “A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.” UMPERSA:⁸⁵⁶ “A trustee or other fiduciary shall discharge duties with respect to a retirement system with the care, skill, and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose.”

Sensitivity to the risk/return ratio. The Act/UMPERSA:⁸⁵⁷ “The tradeoff in all investing between risk and return is identified as the fiduciary’s central consideration.” The Act/UMPERSA:⁸⁵⁸ “ ... sounds the main theme of modern investment practice, sensitivity to the risk/return curve ... Returns correlate strongly with risk, but tolerance for risk [varies/may vary] greatly ... ”

Total portfolio. The Act/UMPERSA:⁸⁵⁹ “The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments.” The Act/UMPERSA:⁸⁶⁰ “[I]nvestment and management decisions [respecting individual assets] must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the [trust/program or appropriate grouping of programs].”

The Act:⁸⁶¹ “Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:” UMPERSA:⁸⁶² “In investing and managing assets of a retirement system pursuant to Section 7, a trustee with authority to invest and manage assets shall consider among other circumstances:”

- “general economic conditions”⁸⁶³
- “the possible effect of inflation or deflation”⁸⁶⁴
- “the role that each investment or course of action plays within the overall trust portfolio”⁸⁶⁵
- “the expected total return from income and the appreciation of capital”⁸⁶⁶
- “needs for liquidity, regularity of income, and preservation or appreciation of capital”⁸⁶⁷
- “a reasonable effort to verify facts relevant to the investment and management of [trust assets/assets of a retirement system]”⁸⁶⁸
- “may invest in any kind of property or type of investment consistent with [this Act]”⁸⁶⁹

No investment or strategy is imprudent per se. The Act/UMPERSA:⁸⁷⁰ “All categorical restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the [trust/program] and that meets the other requirements of prudent investing.”

Diversification. The Act/UMPERSA:⁸⁷¹ “The long familiar requirement that [fiduciaries/trustees] diversify their investments has been integrated into the definition of prudent investing.” The Act/UMPERSA:⁸⁷² “A trustee shall diversify the investments of [the trust/each retirement program or appropriate grouping of programs] unless the trustee reasonably determines that, because of special circumstances, [the purposes of the trust are better served without diversifying/it is clearly prudent not to do so].”

Duty of loyalty. The Act:⁸⁷³ “A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries.” UMPERSA:⁸⁷⁴ “A trustee or other fiduciary shall discharge duties with respect to a retirement system solely in the interest of the participants and beneficiaries.”

Duty of impartiality. The Act:⁸⁷⁵ “If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.” UMPERSA:⁸⁷⁶ “A trustee or other fiduciary shall discharge duties with respect to a retirement system impartially, taking into account any differing interests of participants and beneficiaries.”

Appropriate and reasonable costs. The Act:⁸⁷⁷ “In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee.” UMPERSA:⁸⁷⁸ “A trustee or other fiduciary shall discharge duties with respect to a retirement system incurring only costs that are appropriate and reasonable.”

No hindsight permitted. The Act/UMPERSA:⁸⁷⁹ “Compliance [with the prudent investor rule is/by the trustee or other fiduciary with Sections 6 through 8 must be] determined in light of the facts and circumstances existing at the time of [a trustee’s/the trustee or fiduciary’s] decision or action and not by hindsight.”

Delegation. The Act:⁸⁸⁰ “The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.” UMPERSA:⁸⁸¹ “The power of a trustee to delegate investment and management functions is affirmed, clarified, and subjected to safeguards.” The Act:⁸⁸² “A trustee may delegate investment and management functions that a prudent trustee of comparable skills could properly delegate under the circumstances. The trustee shall exercise reasonable care, skill, and caution in:” UMPERSA:⁸⁸³ “A trustee or administrator may delegate functions that a prudent trustee or administrator acting in a like capacity and familiar with those matters could properly delegate under the circumstances. The administrator shall exercise reasonable care, skill, and caution in:”

- “selecting an agent”⁸⁸⁴
- “establishing the scope and terms of the delegation, consistent with the purposes and terms of the [trust/retirement program]”⁸⁸⁵
- “periodically reviewing the agent’s [actions in order to monitor the agent’s] performance and compliance with the terms of the delegation”⁸⁸⁶
- “In performing a delegated function, an agent owes a duty to the [trust to exercise reasonable care to comply with the terms of the delegation/retirement system and to its participants and beneficiaries to comply with the terms of the delegation and, if a fiduciary, to comply with the duties imposed by Section 7]”⁸⁸⁷
- “A trustee [or administrator] who complies [with the requirements of subsection (a)/subsections (a) and (b)] is not liable to the [beneficiaries or to the trust/retirement system or to its participants or beneficiaries] for the decisions or actions of the agent to whom the function was delegated”⁸⁸⁸
- “By accepting the delegation of a trust function from the trustee [of a trust that is subject to the law of this State/or administrator], an agent submits to the jurisdiction of the courts of this State”⁸⁸⁹

B. Litigation Under UMPERSA

Section 11(a) of UMPERSA describes the nature of fiduciary liability and remedies available under UMPERSA.⁸⁹⁰ “A trustee or other fiduciary who breaches a duty imposed by [UMPERSA] is personally liable to a retirement system for any losses resulting from the breach and any profits made by the trustee or other fiduciary through use of assets of the system by the trustee or other fiduciary. The trustee or other fiduciary is subject to other equitable remedies as the court considers appropriate, including removal.” However, Commentary to Section 11 of UMPERSA makes clear that “[Section 11(a)] provides equitable remedies only. The language providing for personal liability for losses should not be misunderstood as providing legal relief.”⁸⁹¹

Nonetheless, other Commentary to Section 11 of UMPERSA notes that “[UMPERSA] does not preempt other causes of action against service providers [such as investment advisors, attorneys, accountants and actuaries]. Service providers would still be subject to actions outside [UMPERSA]

based on the terms of their contracts with retirement systems and on other independent sources of fiduciary or other obligations under state or federal law (such as [proceedings] alleging causes of action under agency, tort, or professional responsibility law).” Even though participants and beneficiaries of pension plan trusts subject to UMPERSA can’t recover monetary damages under UMPERSA, then, they may have causes of action that can be brought independent of UMPERSA.⁸⁹²

C. Case Studies

State legislatures often place investment restrictions on public employee pension plans. For example, a plan may be prohibited from investing in small company stocks - or even any stocks at all. However, such restrictions may not have much effect in situations where public pension plans are mismanaged as a result of fiduciary incompetence or fraud. Indeed, two examples from the 1990s involving public employee pension plans suggest that preventive action such as employing sufficient numbers of analysts properly trained in advanced monitoring procedures and well-versed in UMPERSA requirements may be useful in helping public employee pension plans avoid the damaging effects of fiduciary imprudence.

By 1994, the Kansas Public Employee Retirement System (“KPERS”) had suffered about \$250 million in losses. Some of those losses were the result of the federal savings and loan debacle of the 1980s. Others were caused by the self-dealing of individuals who were eventually convicted and sent to jail. The \$5 billion KPERS fund was never at risk of being unable to fulfill its financial obligations. But that was little solace to the taxpayers of Kansas. Instead of being wasted, the money lost in the mid-1980s could have been invested to grow more money for the KPERS fund. This may have reduced the tax revenues that would have otherwise been set aside for the fund and/or increased the benefits for the fund’s beneficiaries.

In December 1994, Orange County, California filed for municipal bankruptcy. The county’s treasurer employed an investment strategy for the municipal fund that resulted in total losses of \$1.6 billion. The fund⁸⁹³ was by law prohibited from investing in stocks because they were deemed too “risky,” so investments were made in financial instruments such as derivatives. Although such instruments can be a prudent way to hedge (or decrease) risk, they were used by Orange County investment managers to leverage (or increase) risk to increase return. The use of the financial instruments in this way turned out to be riskier than the stocks the county was prohibited from investing in. In any case, legal restrictions against certain investments didn’t stop the Orange County fund from making such investments.⁸⁹⁴ It may be more likely, then, that large losses in public employee plans can be avoided through consistent monitoring and scrutiny than by placing restrictions on investments.

Chapter Notes

⁸⁵¹ According to Greenwich Associates and the U.S. Census.

⁸⁵² Prefatory Notes to the Act and UMPERSA.

⁸⁵³ Prefatory Note to the Act.

⁸⁵⁴ Prefatory Note to UMPERSA.

⁸⁵⁵ Section 2(a) of the Act.

⁸⁵⁶ Section 7(3) of UMPERSA.

⁸⁵⁷ Prefatory Notes to the Act and UMPERSA and Sections 2(b) of the Act and 10(2) of UMPERSA.

⁸⁵⁸ Commentary to Section 2 of the Act and Section 10 of UMPERSA.

⁸⁵⁹ Prefatory Notes to the Act and UMPERSA.

⁸⁶⁰ Sections 2(b) of the Act and 10(2) of UMPERSA.

⁸⁶¹ Section 2(c) of the Act.

⁸⁶² Section 8(a)(1) of UMPERSA. Section 8 of UMPERSA applies only to a “trustee” who “has *ultimate* authority to manage a retirement system or to invest or manage its assets.” Section 2(22) of UMPERSA; emphasis added. Section 7 of UMPERSA applies to trustees *and other fiduciaries*. Section 2(11) of UMPERSA defines a “fiduciary” as a person who “(A) exercises any discretionary authority to manage a retirement system; (B) exercises any authority to invest or manage assets of a system; (C) provides investment advice for a fee or other direct or indirect compensation with respect to assets of a system or has any authority or responsibility to do so; or (D) is a trustee or a member of a board of trustees.” “[Section 8] specifies the fiduciary duties of trustees who have the ultimate responsibility for the investment and management of retirement system assets. Since a trustee covered by [Section 8] is also a fiduciary [See Section 2(11) of UMPERSA], [the duties specified in Section 8] supplement the general duties of Section 7.” Commentary to Section 8 of UMPERSA. “Delegates who invest and manage system assets are covered by Sections 6 and 7, but not [Section 8].” Commentary to Section 8 of UMPERSA.

⁸⁶³ Sections 2(c)(1) of the Act and 8(a)(1)(A) of UMPERSA.

⁸⁶⁴ Sections 2(c)(2) of the Act and 8(a)(1)(B) of UMPERSA.

⁸⁶⁵ Sections 2(c)(4) of the Act and 8(a)(1)(C) of UMPERSA.

⁸⁶⁶ Sections 2(c)(5) of the Act and 8(a)(1)(D) of UMPERSA.

⁸⁶⁷ Sections 2(c)(7) of the Act and 8(a)(1)(E) of UMPERSA.

⁸⁶⁸ Sections 2(d) of the Act and 8(a)(3) of UMPERSA.

⁸⁶⁹ Sections 2(e) of the Act and 8(a)(4) of UMPERSA.

⁸⁷⁰ Prefatory Notes to the Act and UMPERSA and Sections 2(e) of the Act and 8(a)(4) of UMPERSA. South Carolina, as noted, enacted the fiduciary portions of UMPERSA into state law. Title 9, Chapter 16, Article 1, Section 9-16-330(B)(3) of the South Carolina Code of Laws provides, in part: “(B) The annual investment plan must be consistent with actions taken by the board pursuant to subsection (A) and must include, but is not limited to, the following components ... (3) investment strategies, which may include indexed or enhanced indexed strategies as the preferred or exclusive strategies for equity investing ... ” Although no investment or investment strategy is imprudent *per se* under the Act, the South Carolina legislature appears to favor passive investing.

⁸⁷¹ Prefatory Notes to the Act and UMPERSA.

⁸⁷² Sections 3 of the Act and 8(a)(2) of UMPERSA.

⁸⁷³ Section 5 of the Act.

⁸⁷⁴ Section 7(1) of UMPERSA.

⁸⁷⁵ Section 6 of the Act.

⁸⁷⁶ Section 7(4) of UMPERSA.

⁸⁷⁷ Section 7 of the Act.

⁸⁷⁸ Section 7(5) of UMPERSA.

⁸⁷⁹ Sections 8 of the Act and 10(1) of UMPERSA.

⁸⁸⁰ Prefatory Note to the Act.

⁸⁸¹ Prefatory Note to UMPERSA.

⁸⁸² Section 9 of the Act.

⁸⁸³ Section 6 of UMPERSA.

⁸⁸⁴ Sections 9(a)(1) of the Act and 6(b)(1) of UMPERSA.

⁸⁸⁵ Sections 9(a)(2) of the Act and 6(b)(2) of UMPERSA.

⁸⁸⁶ Sections 9(a)(3) of the Act and 6(b)(3) of UMPERSA.

⁸⁸⁷ Sections 9(b) of the Act and 6(c) of UMPERSA.

⁸⁸⁸ Sections 9(c) of the Act and 6(d) of UMPERSA.

⁸⁸⁹ Sections 9(d) of the Act and 6(e) of UMPERSA.

⁸⁹⁰ Section 11 of UMPERSA is derived from Sections 409 and 410 of ERISA.

⁸⁹¹ A “legal” remedy (i.e., legal relief) involves monetary damages for breach of trust. See Section 198 of the Second Restatement. The object of monetary damages is twofold: (1) to compensate for losses sustained as a result of the breach and (2) to induce trustees to comply with their obligations by making them disgorge any profit or by imposing a penalty. See Preliminary Restatement Section 205. An “equitable” remedy involves (1) the removal of the trustee, (2) an injunction, (3) the appointment of a receiver to take possession of the trust property and continue administration or (4) compelling the trustee to perform its duties. See “Breach Of Trust” by Andrew Zabronsky in *California Trust And Probate Litigation* (Berkeley, CA: California Continuing Education Of The Bar (CEB), 1999) (“*Zabronsky*”).

⁸⁹² Contrast a fiduciary’s liability for breach of duty under ERISA: “Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary.” Section 409 of ERISA.

⁸⁹³ Both the Orange County Retirement System and the Orange County employees’ 457(b) deferred compensation plan were investors in the municipal fund.

⁸⁹⁴ The treasurer, Robert Citron, used “reverse repurchase agreements” to buy Treasury securities, and pledged them as collateral for investment bank loans. He then used the loan proceeds to buy more bonds with longer maturities. The strategy worked as long as interest rates continued declining. As interest rates fell, the bonds became more valuable so fewer bonds were needed as collateral for subsequent loans. Low interest rates also translated into favorable terms for additional loans. In addition, Citron invested approximately \$7 billion of the county’s \$20 billion municipal fund in “inverse floater” derivatives which are extremely sensitive to interest rate fluctuations. As long as interest rates declined and remained low, Citron’s strategy enabled the Orange County fund to generate returns far in excess of other municipal funds. Citron’s leveraged strategy increased the fund’s sensitivity to interest rate changes, causing a severe liquidity problem when the Federal Reserve Board started raising short term interest rates in February 1994. The Orange County fund was impacted by the Fed’s action in two ways: the cost of the money it had borrowed rose while the value of the bonds needed to back its borrowings fell, which triggered a collateral call. With rising interest rates, the fund’s short term borrowing costs rose until they exceeded the county’s returns on its longer-term securities, resulting in a net outflow of capital. The highly leveraged nature of Citron’s strategy ultimately forced him to sell the fund’s securities and realize what had been only paper losses. Although Citron traded primarily in default-free government debt, and holding such debt until maturity would have insured 100% repayment of the principal, the county’s liquidity crunch was so severe that it was forced to sell off positions prematurely to cover current obligations. Before interest rates began rising, Orange County had \$2.2 billion in liquid assets to meet the short term needs of its various municipal investors. By December, only \$350 million in cash and liquid assets was left. As the fund’s yield dwindled and its assets went to cover collateral calls, the county simply couldn’t meet the immediate cash needs of its investors. Citron had leveraged the fund, without any offsetting hedge, to an extent that rendered it insolvent when interest rates rose. See “Speculating On The Efficacy of ‘Speculation:’ An Analysis Of The Prudent Person’s Slipperiest Term Of Art In Light Of Modern Portfolio Theory” by Michael T. Johnson, *Stanford Law Review*,

Vol. 48, January 1996, pages 419-47 (*Johnson*). This example shows that leveraging is a risk consciously assumed by an investor.