OFFICE OF THE ATTORNEY GENERAL
STATE OF ILLINOIS

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ATTORNEY GENERAL

FILE NO. 96-030

PENSIONS:
Fiduciary Duties of Trustees

Mr. Mark Boozell
Director
Department of Insurance
320 West Washington Street
Springfield, Illinois 62767-0001

Dear Mr. Boozell:

I have your letter wherein you pose the following questions:

1) May a pension fund trustee who is also an officer, member or owner/affiliate of an investment firm or institution participate in board decisions when: a) the investment firm or institution provides investment advice, custodial services or management services to the fund; b) the investment firm or institution advises or encourages the fund to engage in a particular practice or transaction under deliberation; and/or c) the practice or transaction being considered will result in compensation, directly or indirectly, to the trustee?

2) Does a pension fund trustee have a fiduciary duty to know and consider the costs to the fund of proposed investment services by a bank, insurance company or investment manager prior to using such services?

3) Is the Department's Pension Division authorized to consider and publish its findings and conclusions regarding compliance with section 1-110 of the Illinois Pension Code (40 ILCS 5/1-110 (West 1994)), in view of

> the enforcement mechanism provided by section 1-115 of the Code (40 ILCS 5/1-115 (West 1994))?

For the reasons hereinafter stated, it is my opinion that: 1) although subsection 1-110(c) of the Pension Code allows parties in interest to serve as pension fund trustees, it does not authorize such trustees to engage in self-dealing; 2) trustees must comply with the prudent man standard when considering the cost of services provided to a fund; and 3) the Department may consider and report upon possible fiduciary breaches, notwithstanding that it has no authority to bring an action for relief in the event a breach of fiduciary duty is found.

With respect to your first question, section 1-110 of the Illinois Pension Code provides, in part:

> "Prohibited Transactions.
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> * * *
>
> (b) A fiduciary with respect to a retirement system or pension fund established under this Code shall not:
>
> (1) Deal with the assets of the retirement system or pension fund in his own interest or for his own account;
>
> (2) In his individual or any other capacity act in any transaction involving the retirement system or pension fund on behalf of a party whose interests are adverse to the interests of the retirement system or pension fund or the interests of its participants or beneficiaries; or
>
> (3) Receive any consideration for his own personal account from any party

> dealing with the retirement system or pension fund in connection with a transaction involving the assets of the retirement system or pension fund.
>
> (c) Nothing in this Section shall be construed to prohibit any trustee from:
>
> (1) Receiving any benefit to which he may be entitled as a participant or beneficiary in the retirement system or pension fund.
>
> (2) Receiving any reimbursement of expenses properly and actually incurred in the performance of his duties with the retirement system or pension fund.
>
> (3) Serving as a trustee in addition to being an officer, employee, agent or other representative of a party in interest."

The term "party in interest" includes a person who provides services to the fund as well as employees, officers or directors of organizations providing such services. (40 ILCS 5/1-101.1(b) (West 1994).)

As you suggest, a cursory reading of subsection 1-110(c)(3) may appear to permit self-dealing that is prohibited by subsection 1-110(b). A comprehensive analysis of this issue, however, leads to a contrary conclusion.

There are no Illinois cases construing subsection 1-110(c)(3) of the Pension Code. Section 1-110 was added to the Code by Public Act 81-948, effective September 22, 1979. A review of the legislative history of that Act indicates that the fiduciary standards incorporated into the Illinois Pension Code

were taken from Federal law. (Remarks of Rep. Beatty, June 30, 1979, House Debate on Senate Bill No. 881, at 228-29; Remarks of Sen. Berning, June 30, 1979, Senate Debate on Senate Bill No. 881, at 104.) In fact, the provisions of section 1-110 are virtually identical to those found in sections 406 and 408(c) of the Employee Retirement Income Security Act of 1974 (hereinafter referred to as "ERISA") (29 U.S.C. §§ 1106, 1108(c)). The Federal courts have on a number of occasions construed those sections of ERISA. I will, therefore, refer to the Federal authorities because they are indicative of the intent of the State statute, as well.

Although the Federal authorities are helpful in construing the Illinois statute, it is necessary to keep in mind that the Illinois Pension Code is applicable only to public pension funds, while ERISA is applicable only to private employee welfare and benefit funds. Therefore, not all of the relationships that are the concern of the Federal standards, and the exceptions thereto, are involved in Pension Code funds.

In Marshall v. Snyder (2d Cir. 1978), 572 F.2d 894, the Secretary of Labor successfully sought to remove the fiduciaries of employee benefit plans established by a labor union. The fiduciaries were all union officers and were the principals of a corporation formed to manage fund assets. Each was paid a significant salary from fund assets, although most of his time was devoted to union business. None was paid directly by the

union. In addition, they had caused the benefit plans to pay for the office quarters used jointly by the union and the plans. After holding that such self-dealing clearly violated section 406 of ERISA, the court disposed of the contention that exceptions found in section 408(c) (which is identical to section 1-110(c) of the Pension Code) permitted such conduct. The court stated therein:

> " * * *
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> That Section [408](c)(3), permitting for example, a union officer to serve as a fiduciary of an employee benefit plan, is irrelevant to the present case follows from the impropriety of the transactions involved. The sub-section is not a license to engage in prohibited transactions. It goes no farther than its terms; the fiduciary remains a 'party in interest' and subject to the substantive requirements of Section [406]; that sub-section and § [408](b)(2) simply make it possible to justify transactions which would otherwise be unequivocally prohibited transactions by demonstrating their fairness and reasonableness. They prevent the transactions from being invalidated simply because they are self-dealing transactions without further inquiry.
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> * * * "
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> (Emphasis added.) Marshall v. Snyder (2d Cir. 1978), 572 F.2d 894, 901.

The fiduciary standards in section 406(b) of ERISA, which are mirrored in subsection 1-110(b) of the Pension Code, were further explained in Lowen v. Tower Asset Management, Inc. (2d Cir. 1987), 829 F.2d 1209. In that case, trustees of a fund sued their corporate investment manager, related corporations and

their common individual owners to recoup investment losses. The investment manager had invested large sums of fund assets in unsound ventures with which it or its affiliates had contracts to find capital, and from which it or its affiliates received compensation for fund investments. The court held the corporate and individual defendants jointly and severally liable for the losses. Regarding the applicable standards, the court stated:

" * * *

> The 'in connection with' requirement of Section 406(b)(3) moderates the strict common law rule that a trustee may not profit (other than from trust administration fees) from transactions involving trust assets. [Citations.] The statutory loosening of this rule appears to have been necessary because pension plans may need to utilize investment advisors whose own interests and operations are so large as to preclude the complete isolation of fiduciary transactions demanded at common law but for whom the potential conflict of interest is so small as not to affect their judgment. To that end, Congress included the 'in connection with' language and also authorized the promulgation of regulations defining certain exemptions from Section 406. * * *
>
> We believe that a fiduciary charged with a violation of Section 406(b)(3) either must prove by a preponderance of the evidence that the transaction in question fell within an exemption, [citation], or must prove by clear or convincing evidence that compensation it received was for services other than a transaction involving the assets of a plan.
>
> The burden is on the fiduciary for two reasons. First, although the 'in connection with' requirement departs from the strict common law rules regarding trustees, we are nevertheless instructed by ERISA to look to

> those rules for interpretive guidance. [Citations.] * * * Second, because the fiduciary has a virtual monopoly of information concerning the transaction in question, it is in the best position to demonstrate the absence of self-dealing. Placing the burden of proof on the fiduciary is thus justified.
>
> We also believe that the relatively stringent 'clear and convincing' test should be imposed for two reasons in addition to those justifying a shift in the burden of proof. First, when the fiduciary enters into such transactions, it has the power to arrange them in a way that dispels all ambiguity. * * * Second, the exemptions contained in Section 408 or in regulations promulgated thereunder ought to be regarded as the usual method by which a fiduciary engages in transactions otherwise prohibited by Section 406. Accordingly, transactions that fall outside these exemptions deserve exacting scrutiny.
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> * * *
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> Lowen v. Tower Asset Management, Inc. (2d Cir. 1987), 829 F.2d 1209, 1214-16.

There was some evidence in Lowen v. Tower Asset Management, Inc. that the trustees had directed the investment manager in the making of the bad investments. However, the court rejected this as a defense because pursuant to ERISA, like the Pension Code (40 ILCS 5/1-101.1 (West 1994)), an investment manager is an independent fiduciary responsible for his own acts. Lowen v. Tower Asset Management, Inc. (2d Cir. 1987), 829 F.2d 1209, 1218-20.

In Donovan v. Daugherty (S.D. Ala. 1982), 550 F. Supp. 390, the trustees and attorney for retirement and welfare plans operated jointly by a union and an employer group were found to

have violated ERISA fiduciary standards because they had approved for themselves and one another greater than reasonable compensation for their services. In addition to their monthly stipend for meetings, they had approved the plan's payment of contributions as their "employer" at a full-time rate so as to qualify themselves for benefits under the plan. Both the stipend and the contributions were contrary to the plan documentation and constituted self-dealing.

In yet another case, a former pension fund trustee, who was also a beneficiary of the fund, was held to have breached his fiduciary duties by convincing the trustees to adopt an expensive cost of living adjustment (COLA) which benefited only that one trustee, who also served as executive vice president of the organization which created the plan. (Schaefer v. Arkansas Medical Society (8th Cir. 1988), 853 F.2d 1487.) The COLA provision resulted in large unfunded liabilities for the plan, which was ultimately terminated.

Other cases illustrate the sort of problems concerning divided loyalties which exceptions to the strict fiduciary standards were intended to address. In Newell v. Prudential Ins. Co. of America (11th Cir. 1990), 904 F.2d 644, a plan administrator/trustee used its own employee to determine whether charges were medically necessary. In Ashenbaugh v. Crucible, Inc., 1975 Salaried Retirement Plan (3d Cir. 1988), 854 F.2d 1516, 1531-32, cert. denied, 490 U.S. 1105, 109 S. Ct. 3155 (1989), U.S. reh'g

denied, 492 U.S. 932, 110 S. Ct. 12 (1989), the trustees of an employer-established fund referred to the employer's counsel for advice concerning operation of the plan, rather than hiring independent counsel. In Hlinka v. Bethlehem Steel Corp. (3d Cir. 1988), 863 F.2d 279, 286-87, a beneficiary claimed he had not received a full and fair hearing on denial of a particular benefit from an employer-established fund, because the pension board was composed of company employees. In each case, the court held that such apparent divided interests were of the sort intended to be within the scope of the statutory exceptions permitting parties in interest to serve as fiduciaries of plans, and that no breach of fiduciary duty had occurred.

Using these authorities as a guide, it is my opinion that the exceptions in subsection 1-110(c) of the Illinois Pension Code should not be construed to permit fund trustees to engage in self-dealing, but only to permit persons to serve as trustees who might, under traditional fiduciary rules, be seen as having some divided loyalties. Thus, for example, members or beneficiaries of a police or fire department might be permitted to serve as trustees of police or fire pension funds. Employees, officers or members of investment or banking firms may serve as trustees even though the firm's business may be affected in some way by the fund's investments because of the extent of that firm's presence in the market. An individual trustee may not, however, engage in the sort of self-dealing which will result in

income or gain directly to the trustee or a firm with which he may be associated. A trustee can be reasonably compensated for his or her services as such (40 ILCS 5/1-110(a) (West 1994)), but he or she may not cause the trust fund to do acts which inure to his or her benefit at the expense of the fund and all of its beneficiaries. Where it appears that a trustee has divided loyalties, the burden is on the trustee to prove by a preponderance of evidence that the transaction falls within an exception, or by clear and convincing evidence that any compensation received was for services other than a transaction involving fund assets.

Your second question concerns whether a pension fund trustee has a fiduciary duty to know and consider the costs to the fund of proposed investment services by a bank, insurance company or investment manager prior to using such services. Again referring to Federal cases, it is my opinion that a trustee must not act in an arbitrary and capricious manner with respect to the cost of services to the trust fund.

Both ERISA and the Pension Code impose a prudent man standard of care on fiduciaries. (See Schaefer v. Arkansas Medical Society (8th Cir. 1988), 853 F.2d at 1491; 29 U.S.C. § 1002(21)(A); 40 ILCS 5/1-109(b) (West 1994).) Thus, a trustee is required to exercise 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 with like character and with like aims. In Schaefer v. Arkansas Medical Society, it was evident that the other trustees of the plan had breached their fiduciary duties by their failure to conduct an independent investigation of the legality and cost to the fund of a COLA provision primarily benefitting the one fiduciary who proposed it. Mr. Schaefer was barred from recovering, in equity, only because of his own breach of duties. Other cases provide further examples.

In Benvenuto v. Schneider (E.D. N.Y. 1988), 678 F. Supp. 51, a labor union welfare benefit plan retained a law firm to provide pre-paid legal services to plan beneficiaries. A review of the arrangement revealed that payments to the law firm from the plan exceeded by several times the reasonable value of the services actually provided, or which might realistically be expected to be provided. Both the trustees of the plan and the law firm which participated in the trustees' breach of duty were held accountable to the fund.

In Stewart v. National Shopmen Pension Fund (D.C. Cir. 1986), 795 F.2d 1079, the trustees of the pension fund cancelled retroactive service credits of employees of an employer which withdrew from the fund prior to paying in contributions necessary to fund the service credits. The court upheld the cancellation of the credits as reasonable to prevent the dumping of unfunded liabilities on the fund. The court observed that the trustees were required to act prudently, and were obliged to take no

action which would have been arbitrary and capricious in light of all of the circumstances involved. That the trustees had adopted a policy of cancelling unfunded credits for past service met this standard.

While no case specifically requires every trustee to know in detail the cost of each investment services agreement, the prudent man rule, and the cited cases, require that trustees have an understanding of the expenses to the fund of their actions. In my opinion, entering into an agreement for services, including investment services, without meaningful information regarding the cost and value of such services, would not meet the prudent man standard, and would be arbitrary and capricious.

Your final question concerns whether the Department's Pension Division is authorized to consider and publish its findings and conclusions regarding compliance with section 1-110 of the Pension Code, in view of the enforcement mechanism provided by section 1-115 of the Code (40 ILCS 5/1-115 (West 1994)).

Section 22-502 of the Pension Code (40 ILCS 5/22-502 (West 1994)) provides that the Pension Division shall make periodic examinations of funds within its jurisdiction, and further provides:

" * * *

> The examinations to be made by the Division hereunder shall include an audit of financial transactions, investment policies and procedures, an examination of books, records, documents, files and other pertinent

> memoranda relating to the financial, statistical and administrative operations, and a review of policies and procedures maintained for the administration and operation of the fund or system. The Division shall seek to ascertain if full effect is being given to the statutory provisions governing the operation of such funds or systems, and whether the administrative policies in force are in accord with the purposes of such legislation and effectively protect and preserve the rights and equities of participants thereunder. The Division shall also determine if proper financial and statistical records have been established and whether adequate documentary evidence is recorded and maintained in support of the several types of annuity and benefit payments being made.
>
> A copy of the report of examination as prepared by the Division shall be submitted to the secretary of the retirement board or board of trustees, as the case may be, of each such fund or system examined, and the Director of Insurance, upon request, shall grant a hearing to the officers or trustees thereof or their duly appointed representatives, upon any facts contained in such report of examination before filing the same, and before making public such report or any matters relating thereto; and he may withhold any such report from public inspection for a period of not more than 60 days subsequent to the date of said hearing."

The plain language of the section provides for examination and reporting. A review of policies and procedures for investments, administration and operation of a fund should, in my opinion, include whether such policies and procedures complied with fiduciary standards set forth in section 1-110 of the Code. The report on such an examination should properly include any such findings and conclusions. Indeed, the provisions in the

last paragraph of section 22-502 requiring that the report be submitted to the officers of a fund, granting such officers the right to a hearing upon facts contained therein and permitting the Director to withhold the report from the public for a period of time, appear to assume the inclusion of such matters. If the report were to be nothing more than a statistical recitation or audit, there would be little basis for the provision of a hearing thereon.

The inclusion of such matters as compliance with fiduciary duties in the Division's periodic examination and report, however, does not give the Division enforcement authority. In Board of Trustees v. Washburn (1987), 153 Ill. App. 3d 482, it was held that section 22-502 does not give the Director authority to review and reverse adjudicatory decisions of a pension board. Section 22-502 plainly does not authorize the Division to reverse specific decisions of pension boards, or to order defaulting trustees to account. Such matters are separate from the authority and duty imposed upon the Department to review and report.

Sections 1-114 and 1-115 of the Pension Code (40 ILCS 5/1-114, 5/1-115 (West 1994)) set forth the liability for breaches of fiduciary duties and the enforcement thereof. The Attorney General, a participant, beneficiary, or fiduciary of a fund may bring a civil action for relief. Such an express enumeration in a statute tends to exclude others not mentioned. (Burke v. 12

Rothschild's Liquor Mart, Inc. (1992), 148 Ill. 2d 429, 442.) Therefore, although enforcement actions must be brought by parties other than the Department, nothing would prevent such parties, particularly the Attorney General, from basing such an action on the information publicly reported by the Department.

Sincerely,

JAMES E. RYAN
ATTORNEY GENERAL