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M E M O R A N D U M

TO: ERFC Trustees

FROM: Julia Penny Clark
Jenifer Cromwell

DATE: July 10, 2019

RE: Trustees' Fiduciary Duties and Insurance Coverage

The following is a summary of the Trustees' fiduciary responsibilities with regard to the ERFC Plan, and a brief description of the liability insurance coverage for the Trustees.

FIDUCIARY DUTIES

A. Act Solely in the Interest of Members and Beneficiaries, in Accordance with Plan Documents, and for the Exclusive Purpose of Providing Benefits to Members and Beneficiaries and Paying Reasonable Expenses of Administering the System.

1. Duty of Loyalty

A fundamental rule of trusts is that "A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries." See Va. Code § 64.2-785. This obligation to act solely on behalf of members and beneficiaries is generally called the duty of loyalty.

As you know, the Fairfax County ordinance that established ERFC (the “Enabling Ordinance”) vests “the general administration and proper operation of the system” in the Board of Trustees “subject to the supervision and control of the Fairfax County School Board.” The duty of loyalty requires that the Trustees administer and operate the system in the interest of members and beneficiaries. The duty of loyalty prohibits a trustee from acting out of self-interest or in the interests of third parties. The U.S. Supreme Court has held that this duty prohibits a trustee from acting in the interests of the party who appointed the trustee. *See NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981).

For example, it would be a breach of the duty of loyalty if: (1) an employer-appointed Trustee voted against policy changes in the ERFC regulations because a higher-level administrator demanded such a vote to reduce the impact of the Plan on the FCPS budget; or (2) an employee Trustee voted for increased COLA payments because of pressure from an employee organization; or (3) any Trustee voted to invest ERFC funds in county securities because of political pressure to do so.

As noted above, the School Board retains authority to supervise and control the system. As a result, there may be situations in which the School Board establishes certain administrative procedures that it expects ERFC to follow. Such direction may be appropriate given the authority retained to the School Board through the Enabling Ordinance, but the Trustees should evaluate such direction or supervision by the School Board to ensure that it is consistent with the Trustees’ duty of loyalty.

As you know, the Enabling Ordinance also authorizes the School Board to amend the Plan. When the School Board exercises that authority or instructs the Trustees to prepare an amendment for the School Board’s consideration, the School Board is not acting as a fiduciary and the Trustees do not violate their fiduciary duties by complying with that instruction.

A breach of the duty of loyalty can arise from even laudable purposes. For example, Trustees cannot make investments because of their “social utility” rather than because of potential investment value for ERFC. It therefore would not be appropriate to invest in socially responsible organizations or in low-interest mortgages only because of the assumed public good of such investments. However, Trustees may take into consideration an investment’s social utility, for example, by evaluating an investment using ESG investing principles, and may invest in socially responsible investments provided that such investments are consistent with the Trustees’ fiduciary duty. This means that such an investments must be competitive with other available investments for ERFC based on their financial characteristics.

Trustees also have a duty to use Plan assets only for the purposes of providing benefits to members and beneficiaries and paying for reasonable administrative expenses. It would not be loyal to the members and beneficiaries to spend Plan assets for other purposes, such as political contributions.

2. Duty to Comply with Governing Laws and Plan Documents

Fiduciaries also have a duty to comply with the law and the Plan documents.

In the case of law, this duty requires the Trustees to employ counsel to advise them of applicable laws and changes in those laws, and that in making decisions, the Trustees follow the provisions of those laws.

In the case of Plan documents, this duty generally requires that the Trustees administer the Plan as it is written. If the Plan document requires interpretation, the Trustees should interpret it consistently and in accordance with their best judgment of the interests of members and beneficiaries – not necessarily the interest of any individual member or beneficiary. The Trustees must always keep in mind the interest of all members and beneficiaries in the financial health and soundness of the Plan.

Exceptions may sometimes be warranted. For example, if a member or beneficiary would have a legitimate legal claim against the Plan, the Trustees may grant an appeal or compromise that claim if the resolution is in the over-all interest of the Plan and its members and beneficiaries. This is the basis for our occasional advice that the Trustees may grant the appeal of a member who has relied to his or her detriment on erroneous information from administrators (*i.e.*, the member has been harmed by relying on advice from the retirement office), even though the Plan document otherwise would not justify the member's request.

Conflict of Interests

As discussed above, the duty of loyalty prohibits a trustee from acting out of self-interest or in the interest of third parties. The Virginia State and Local Government Conflict of Interests Act, Va. Code § 2.2-3100 *et seq.*, also prohibits certain specific transactions. The Act prohibits you from, among other things:

- a. soliciting or accepting money or other things of value for performing services as a trustee, except compensation paid by your employer or reimbursement for actual itemized expenses;
- b. accepting any money or other thing of value in exchange for giving someone employment, appointment, or promotion with ERFC;
- c. accepting any money or other thing of value in exchange for awarding a contract with ERFC;
- d. using confidential information that you obtained as a trustee for your own or anyone else's economic benefit;
- e. accepting any money, loan, gift, favor, service, or business or professional opportunity that reasonably tends to influence you in the performance of your official duties
- f. using your position to retaliate or threaten to retaliate against someone for expressing views on public matters or for exercising a right that is protected by law;

- g. participating in any transaction that applies solely to property or business in which you have a personal interest.

Note: You may participate in a transaction that affects a business, profession, occupation, or group of which you are a member, **if** you file a declaration describing: (a) the transaction involved; (b) the nature of your personal interest affected by the transaction; (c) that you are a member of that business, profession, occupation, or group; and (d) that you are able to participate in the transaction fairly, objectively, and in the public interest.

The ERFC Trustees have adopted Standards of Conduct to address questions that can arise when service providers (or candidates for such positions) offer you gifts or entertainment. FCPS Policy 4430.5 also addresses gratuities for school system employees generally. “Gifts” are defined in the FCPS policy to include all of the following:

Any gratuity, favor, discount, entertainment, hospitality, loan, forbearance, or other item having monetary value, including services as well as gifts of transportation, local travel, lodgings and meals, whether provided in kind, by purchase of a ticket that is actually used, payment in advance, or reimbursement after the expense has been incurred.

The FCPS policy contains an exception for “gifts or entertainment of negligible value that are distributed generally and are not otherwise prohibited by this section.” This exception would likely permit promotional items such as coffee cups or umbrellas with a service provider’s logo.

Section 2.2-3101 of the Act clarifies that “gift” does **not** include (i) scholarships or financial aid; (ii) a gift related to your private profession or occupation or that of a member of your immediate family, or to your volunteer service or that of a member of your immediate family; (iii) food or beverages consumed while attending an event at which you are performing official duties related to your ERFC service; (iv) food or beverages received at, or registration or attendance fees waived, for any event at which you are a featured speaker, presenter, or lecturer; (v) attendance at a reception or similar function serving only food and beverages that can be conveniently consumed while standing or walking; (vi) unsolicited awards of appreciation or recognition in the form of a plaque, trophy, wall memento, or similar item that you receive in recognition of your public, civic, charitable, or professional service; (vii) travel related to an official ERFC meeting or any meal provided at an official ERFC meeting; or (viii) gifts received from relatives or personal friends. “Personal friend” does not include any person that you know or have reason to know is a lobbyist or is a party to or seeks to enter into a contract with ERFC. (In other words, you may not count an ERFC service provider or someone who wants to be a service provider as your personal friend.) FCPS Policy 4430.5 was last reviewed in March 2015, and still has not been revised to reflect the amendments in 2016 and 2017 to the Act that clarified the meaning of “gift.” For the time being, it

would be prudent to continue to comply with the rule that is more restrictive in any particular context.

Section 2.2-3103.1 of the Act provides, in relevant part, that an officer or employee of a local governmental or advisory agency, or a member of the individual's immediate family, may not solicit, accept, or receive in a calendar year a single gift, or a combination of gifts, with a value in excess of \$100 for himself or herself, or a member of the individual's immediate family, from a person that he or she knows or has reason to know is a lobbyist or is a party to or seeks to enter into a contract with the local agency. Gifts worth less than \$20 do not have to be aggregated for purposes of the \$100 limit.

There are four exceptions to this general prohibition on accepting a gift with a value in excess of \$100.

- First, the Act provides that a gift of food and beverages, entertainment, or cost of admission valued in excess of \$100 may be accepted while the individual is attending a "widely attended event" if the gift is associated with the event. The definition of "widely attended event" means an event at which at least 25 persons have been invited to attend, or are expected to attend, and the event is open to people who (i) are members of a public, civic, charitable, or professional organization, (ii) are from a particular industry or profession, or (iii) represent persons interested in a particular issue.
- Second, the Act provides that a gift valued in excess of \$100 may be accepted from a foreign dignitary provided that the gift is accepted on behalf of the locality and is archived in accordance with established guidelines.
- Third, the Act provides that a gift valued in excess of \$100 may be accepted from a lobbyist or person who is a party to or seeks to enter into a contract with the local agency if the gift is provided on the basis of a personal friendship. Four factors will be considered when determining whether the person making the gift is a personal friend: (i) the circumstances under which the gift was offered; (ii) the history of the relationship between the person and the donor, including the nature and length of the friendship and any previous exchange of gifts between them; (iii) to the extent known to the person, whether the donor personally paid for the gift or sought a tax deduction or business reimbursement for the gift; and (iv) whether the donor has given the same or similar gifts to other persons who must comply with the Act.
- Fourth, the Act provides that gifts of travel, including travel-related transportation, lodging, hospitality, food or beverages, or other thing of value, with a value in excess of \$100 that is paid for or provided by a lobbyist or person who is a party to or seeks to enter into a contract with the local agency may be accepted when the officer or employee has submitted a request for approval of such travel to the Virginia Conflict of Interest and Ethics Advisory Council and has received the approval of the Council.

Section 2.2-3103.2 provides that a person shall not be in violation of any provision of the Act prohibiting the acceptance of a gift if (i) the gift is not used and the gift or its

monetary equivalent is returned to the donor or delivered to a charitable organization within a reasonable period of time after learning of the value of the gift and any donation of the gift is not claimed as a charitable contribution for federal income tax purposes, or (ii) the person receiving the gift pays the donor for the gift within a reasonable period of time upon learning of the value of the gift provided that such payment reduces the value of the gift to an amount not in excess of \$100.

As we have discussed with the Board previously, it is possible that Section 2.2-3103.1 of the Act does not apply directly to the Trustees because the ERFC Board of Trustees has not been placed on the list of boards in Fairfax County or FCPS whose members are required to file annual economic interest disclosure forms.¹ But that portion of the Act is unclear, and the Trustees may want to comply with these provisions in any context where they would prohibit accepting a gift that the Standards of Conduct or the FCPS policy statement might allow.

Trustees should comply with the specific rules in the ERFC Standards of Conduct and FCPS Policy 4430.5 and also consider the following questions when presented with any “perks” in their capacity as trustees:

- Is this gratuity by itself worth \$100 or more?
- Have I received or am I likely to receive from this individual or institution gifts or services that will exceed \$100 this year?
- How comfortable would I be if I accept this “perk” and it is reported on the front page of the Washington Post?

Finally, effective July 1, 2019, the Act requires all local elected officials to complete training on the provisions of the Act within two months of assuming office, and thereafter, at least once every two years while in office. Such training will be provided by the Virginia Conflict of Interest and Ethics Advisory Council, and the training may be provided online. Local elected officials in office on July 1, 2019, are required to complete such training no later than December 31, 2019. No penalty may be imposed on a local elected official for failing to complete a training session. Note that the Act does not define “local elected official.” It is possible that this provision does not apply to elected ERFC Trustees because the training requirement appears to be directed at officials who are “local filers,” *i.e.*, individuals required to file annual economic interest disclosure forms. As noted above, ERFC Trustees are not on the list of boards whose members are required to file annual economic interest disclosure forms, and as such, this new requirement of the Act may not apply to ERFC. We will review this further and advise on its application to elected ERFC Trustees in advance of the deadline for such training in 2019.

¹ The Virginia State and Local Government Conflict of Interests Act requires certain officials to file an annual disclosure form. As noted above, although the ERFC Board of Trustees has not been placed on the list of boards in Fairfax County or FCPS whose members are required to file these annual forms, the values are a reasonable guideline for amounts that may be thought to create an appearance of influencing a board member in his or her official duties. Note that there is a separate prohibition against accepting gratuities (even if their individual value is negligible) so frequently as to give rise to an appearance of improper influence.

B. Act with the Skill, Care and Caution that a Prudent Person Familiar with Such Matters Would Use

A fundamental part of a trustee’s duty is to collect, receive, and hold money that belongs to the trust, and to invest the trust’s assets within the investment authority granted by the documents that govern the trust.² The Enabling Ordinance authorizes and directs the Trustees to invest ERFC assets “in investments which would be made by prudent men of discretion and intelligence who seek reasonable income and preservation of capital. The investment shall be in accordance with the laws of this Commonwealth as such laws apply to fiduciaries investing such funds.” Fairfax County Code § 3-4-6(a)(5).

Virginia laws on this subject are modeled after the “prudent investor rule.” The rule that applies to local government retirement systems is the following:

If the governing body of any county, city, or town establishes a retirement system . . . any funds that may be allocated, segregated, or otherwise designated for the retirement system, which are on hand at any time and are not necessary for immediate payment of pensions or benefits, shall be invested with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with the same aims. Such investments shall be diversified so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.

Va. Code § 51.1-803. The Uniform Prudent Investor Act (“UPIA”) sets forth a similar standard of care for trustees in general:

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.

Va. Code § 64.2-782.

Both versions of this rule in the Virginia Code hold a trustee to the standard of someone who is familiar with investing, whether or not the particular trustee has had as much experience with investing as the average trustee. “A trustee’s lack of familiarity with investments is no excuse: . .

² The duty to collect money that belongs to the trust would include money that may be payable to the trust in settlement of class actions under securities law. The Trustees have entered into an agreement with a well-respected class-action law firm to monitor such settlements and to review the custodian bank’s performance in applying for payment from any settlement in which ERFC has a right to participate. That law firm also monitors investment losses in the ERFC portfolio that are the result of corporate misconduct; it will advise the Trustees if it identifies a meritorious claim for which ERFC ought to consider seeking status as lead plaintiff. We anticipate that there will be few, if any, cases in which ERFC’s loss would justify the administrative expense of serving as lead plaintiff.

. trustees are to be judged according to the standards of others ‘acting in a like capacity and familiar with such matters[.]’” *Katsaros v. Cody*, 744 F.2d 270, 279 (2d Cir.), cert. denied, 469 U.S. 1072 (1984). It has also been stated that a “pure heart and an empty head” are no defense.

This standard imposes a responsibility on trustees to obtain investment advice from experts (such as Segal Marco, ERFC’s investment consultant) and to educate themselves about investment issues (for example, by attending educational sessions sponsored by the Wharton School). This is especially important in today’s investment environment, when deciding whether to invest in (or avoid) complex investment products such as private equity, hedge funds of funds and global asset allocation products.

Examples of the Responsibility to Act Prudently

1. Ensure Prudent Investment

- a. Trustees must maintain diversity of investments. See Va. Code § 51.1-803 (quoted above).

There is no set rule for what constitutes sufficient diversification. Investment in a broad range of equity and fixed-income investments and a variety of styles (for example, value and growth) should meet this requirement since these asset classes cover a broad range of materially different risk and return characteristics. This is an area in which Trustees should look to the investment consultant and knowledgeable staff members for guidance.

- b. Consider all investment circumstances. The UPIA lists the following as the circumstances the fiduciary shall consider in investing and managing the trust assets:

- a. general economic conditions;
- b. the possible effect of inflation or deflation;
- c. the role that each investment plays within the overall trust portfolio;
- d. the expected total return from income and the appreciation of capital; and
- e. needs for liquidity, regularity of income, and preservation or appreciation of capital.

Va. Code § 64.2-782 (omitting the statutory factors that are relevant only to private trusts).

- c. Monitor investments. A U.S. Supreme Court case, *Tibble v. Edison International*, describes a fiduciary’s on-going duty under trust law (and ERISA) to monitor investments and to remove imprudent investments. A fiduciary is required to conduct regular reviews of investments in a manner that is reasonable and appropriate to the investment. This is an

area in which Trustees should look to the investment consultant and knowledgeable staff members for guidance.

2. Trustees must obtain enough information to make an informed decision. All Trustees should have access to the same information and all viewpoints should be heard and considered. Minority or dissenting views should not be discouraged.

Trustees should not be “led” by one or more individuals. For example, new Trustees should not remain silent because they think “someone else must be addressing that” or “they must have resolved that problem before I got here.” Instead, a new Trustee should be asking questions about any topic about which he or she needs more information, is uncomfortable, or lacks knowledge.
3. Employ agents with appropriate expertise and monitor their actions (*e.g.*, banks, consultants, staff, lawyers, and investment managers).
4. Oversee co-fiduciaries. Because each Trustee has a fiduciary relationship to the members and beneficiaries, each Trustee shares responsibility for all actions of the Board in which that Trustee participates or potentially even for actions of the Board that the Trustee voted against but should have tried to prevent. Trustees should be sure to attend Board meetings regularly and stay informed regarding all Board activity.

CONSEQUENCES OF FAILING TO ABIDE BY FIDUCIARY STANDARDS

Failure to abide by the fiduciary standards discussed in this memorandum could result in civil liability for the Trustees. Although ERFC and the Trustees may be immune from civil liability for negligent acts or omissions under Virginia law, the extent of such immunity in regard to an entity such as ERFC has not been addressed by Virginia courts. In addition, the Trustees may not be immune from liability for claims asserted under civil rights or other federal statutes. In any case, under either federal or state law, Trustees may lose their immunity if they engage in certain types of conduct, such as willful misconduct, gross negligence, deriving personal advantage, or acting outside the scope of their authority.

FIDUCIARY RESPONSIBILITY INSURANCE POLICY

ERFC has two fiduciary insurance policies – one with Hudson Insurance Company for \$15,000,000, and one with Travelers for \$6,000,000, for combined coverage of \$21,000,000. The policies run from July 1, 2018 through July 1, 2019. We updated you on those policies in 2018. Binders were issued by the same carriers in the same amounts for coverage July 1, 2019 through July 1, 2020. When the policies are issued, we will review them and provide you a summary of the fiduciary insurance coverage.

Although fiduciary insurance is important for the protection it gives individual Trustees and employees of the Plan, it also protects the Plan itself. If a claim of fiduciary breach relating to Plan investments were to end with a judgment that the Plan had suffered an investment loss

because of a breach of fiduciary duty, the fiduciary insurance would pay the amount of that loss to the Plan (up to the available policy limit).

It is important for each Trustee to notify the Executive Director or counsel promptly upon learning of any claim or any circumstances that may be likely to lead to a claim. Fiduciary insurance coverage, including coverage for defense costs, is conditioned on ERFC providing notice to the carrier(s) “as soon as practicable” after the Plan learns about a claim. In addition, in each new application for insurance, FCPS is required to disclose any known circumstances that might lead to liability covered by the fiduciary insurance. A knowing failure to disclose such circumstances could give the insurer a reason to cancel the insurance or deny coverage later when a claim is made.