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David L. Heald
Attorney, The First National Bank of Chicago

Joseph P. Mulhern III
Attorney, The First National Bank of Chicago

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Directed Trustee Liability Under ERISA

DAVID L. HEALD*
JOSEPH P. MULHERN III**

INTRODUCTION

Over the last ten to fifteen years, directed trusts have increased in popularity among sponsors of employee benefit plans. This practice of conferring investment authority on one other than the trustee was prompted by a number of factors. Employee benefit plans were growing rapidly in number and in size, generating significantly larger pools of assets to be managed. Investment management

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** Attorney, The First National Bank of Chicago. B.A. Notre Dame (1971); J.D. Northwestern University (1974). The views expressed in this article are solely those of the authors and not necessarily those of the First National Bank of Chicago.

1. A directed trust is one in which powers normally exercised by the trustee—typically, authority to make investment decisions—are delegated to one or more third parties. These delegates then instruct or "direct" the trustee to implement their decisions. For a more comprehensive analysis of the form and function of directed trusts, see text accompanying notes 14-17 infra.

2. The trend in the late 1960's toward use of multiple investment managers, or "fund-splitting," was one indication of the increased interest in directed trusts. This trend has been documented and discussed by numerous commentators. See, e.g., SECURITIES AND EXCHANGE COMMISSION, INSTITUTIONAL INVESTOR STUDY REPORT 1285 (1971) [hereinafter cited as SEC INVESTOR REPORT]; Belliveau, Is Discretionary Management of Pension Funds in Jeopardy?, PENSIONS, Spring, 1972, at 47; Dreher & Rogers, Five Years of Splitting: What Have We Learned?, PENSIONS, Winter, 1973, at 29 [hereinafter cited as Dreher & Rogers]; Friedes, Too Many Cooks Don't Spoil the Broth, PENSION & WELFARE NEWS, Oct., 1971, at 30 [hereinafter cited as Friedes]; Rogers, How Pension Funds Will Be Managed Tomorrow, PENSION & WELFARE NEWS, Dec., 1971, at 54 [hereinafter cited as Rogers]; Whitworth, A Compass Needed for Direction Trusts, 111 TRUSTS & EST. 698, 740 (1972) [hereinafter cited as Whitworth].

3. For purposes of this article, the term "employee benefit plan" is used to encompass both pension and profit sharing plans. Both are designed to provide retirement benefits for employees and both may be funded by means of directed trusts. The primary difference between them is in the type of contributions the employer makes. In a pension, or defined benefit plan, the ultimate benefits are established and actuaries determine the amounts and the frequency of employer contributions necessary to provide those benefits. In a profit sharing, or defined contribution plan, the employer contributes a percentage of profits from time to time, and the plan provides a formula for calculating employees' interests in the fund. SEC INVESTOR REPORT, supra note 2, at 1285.

4. For example, the number of qualified retirement plans increased from 10,000 in 1946 to more than 150,000 by the end of 1967. Comment, Separable Liabilities of Trustees in Directory Trusts, 60 CALIF. L. REV. 1151 n.1 (1972), citing 1970 1 PENS. PLAN GUIDE (CCH) ¶ 503 (1970). The market value of assets of private non-insured qualified and non-qualified pension and profit sharing funds increased from $45 billion in 1961 to more than $105 billion in 1971. Id., citing SEC Statistical Series Release No. 2564, [1972] 3 PENS. PLAN GUIDE (CCH) ¶ 25,172. See generally Comment, Separable Liabilities of Trustees in Directory Trusts, 60 CALIF. L. REV. 1151 n.1 (1972).
firms, awakening to this growth, were increasing their marketing efforts to capture a portion of the burgeoning business. Plan sponsors were becoming disenchanted with the historical investment performance by trustees and were placing increased emphasis on performance of their funds' assets.

The directed trust appeared to be a logical and generally acceptable means of allocating the management of plan assets. Investment decisions were vested in one or more investment managers who, in the opinion of the plan sponsor, were more performance-oriented than a corporate trustee. Plan sponsors commonly felt that this type of trust insulated them from litigation for poor performance of the trust assets. Trustees generally, although not without considerable hesitation, agreed to participate in directed trusts despite the fact that the investment decisions they were required to implement were

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Trusts, 60 Cal. L. Rev. 1151 (1972) [hereinafter cited as Separable Liabilities]. The amount of assets in private insured and non-insured pension funds more than doubled between 1960 and 1969, and the book value of public pension funds almost doubled during the same period. Weirick, Passive Money Management is Dead, Pension & Welfare News, Dec., 1970, at 37 [hereinafter cited as Weirick]. The SEC, in investigating pension investments from 1964 to 1969, noted that all portfolio groups experienced growth in terms of both common stock holdings and total assets. SEC Investor Report, supra note 2, at 1288. Some felt that these increased assets were too unwieldy for the traditional single manager to handle. See, e.g., Dreher & Rogers, supra note 2, at 31.

5. The number of independent investment counsel firms increased dramatically in the late 1960’s, most with the specific objective of offering management assistance to large funds. See generally Rogers, supra note 2, at 54. Typical of their marketing efforts were a spate of articles written by managers and designed to reinforce the need for their services. See, e.g., Weirick, supra note 4, at 37.

6. The plan sponsor customarily is the company or companies whose employees receive benefits under the plan.

7. For example, corporate trustees have been criticized for placing too much emphasis on preservation of principal and too little on appreciation. See generally Cronin, Effectiveness of Exculpatory Clauses in Directory Trusts, 98 Trusts & Est. 1147 (1969) [hereinafter cited as Cronin]. The view that trustees tend to invest conservatively is widespread. See, e.g., Weirick, supra note 4, at 42; Whitworth, supra note 2, at 699; Note, Directory Trusts and the Exculpatory Clause, 65 Colum. L. Rev. 138, 138-39 (1965) [hereinafter cited as Directory Trusts]. Cf. SEC Investor Report, supra note 2, at 1007, 1288. That report disclosed that, despite a general trend toward diversity of management, bank management still predominated in corporate pension benefit plans in the late 1960’s.

8. In response to an SEC study, 110 out of 135 plans questioned responded “yes” to the question: “Does the employer attempt to measure the ‘performance’ of any of the plan’s managers?” The Commission concluded that plans therefore were becoming increasingly alert to the investment return on their accounts. SEC Investor Report, supra note 2, at 1008. For recognition and discussion of this “performance cult,” see Bagnall, Alternatives in Investment Management, Pension & Welfare News, December, 1970, at 31; Cronin, supra note 7, at 1147; Friedes, supra note 2, at 30; Kumber, Money Management Capabilities of Regional Bank Trust Departments, 111 Trusts & Est. 28 (1972).

9. Typically, the investment managers are independent investment management firms, although insurance companies and investment departments of large banks also participate to a lesser degree.
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made by investment managers. Directed trustees took comfort in exculpatory provisions\(^\text{10}\) which afforded them needed protection from liability for acting in accordance with the managers’ directions, or for failure to act in the absence of directions.

The enactment of the Employee Retirement Income Security Act of 1974 (ERISA)\(^\text{11}\) has raised substantial problems for the directed trustee. The Act prohibits exculpatory clauses\(^\text{12}\) and has raised considerable confusion over the scope of liability of the directed trustee for activities of the investment adviser. This article will explain the form and function of the directed trust. It will explore the scope of the directed trustee’s liability for investment decisions before ERISA, and it will analyze the problems raised by ERISA. Finally, it will propose means by which the directed trustee can comply with the letter and spirit of ERISA and, at the same time, protect itself from unwarranted liability for the acts of investment advisers.

**Form and Function of the Directed Trust**

Employee benefit plans usually are sponsored by companies seeking retirement benefits for their employees and typically are funded by means of trusts. The sponsor creates a trust and appoints an individual or corporate trustee.\(^\text{13}\) Under the terms of the trust instrument, the trustee normally takes legal title to the fund assets and may assume a variety of administrative duties including bookkeeping and accounting, preparation of data necessary for reports or

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10. For an analysis of the form and effectiveness of exculpatory, or “hold harmless,” provisions, see text accompanying notes 29-33 infra.


12. ERISA § 410(a), 29 U.S.C. § 1110(a) (Supp. V 1975) provides: "Except as provided in sections 405(b)(1) and 405(d), any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy." For discussion of the limits of that prohibition and the problems arising from its enactment, see text accompanying notes 39-40 infra.

13. “Corporate trustee” is a term of art describing any trustee which is not a natural person. Corporate trustees commonly are banks or trust companies. This article focuses on the directed corporate trustee and the legal authority and policy issues that determine its liability for decisions of investment managers. For example, it has been argued that the conduct of professional trustees, who most often are corporate trustees, should be measured by a higher standard of prudence than the “casual” trustee. See Cronin, supra note 7; Note, Standard of Care for Corporate and Professional Trustees, 42 Va. L. Rev. 665 (1956); Note, Standards of Care for Corporate Trustees, 16 U. Chi. L. Rev. 579 (1949). Numerous cases have found the professional trustee’s particular expertise significant. See, e.g., In re Estate of Beach, 15 Cal. 3d 623, 542 P.2d 994 (1975); Killey Trust, 457 Pa. 474, 326 A.2d 372 (1974). Nevertheless, both the statutory and decisional law discussed would apply similarly to corporate and individual trustees.
other disclosures required by federal or local law, custody of trust property, maintenance of records, and collection, payment, and distribution of fund assets. In the traditional non-directed retirement trust, the trustee also has discretionary authority over the investment of the fund's assets.

In a directed trust, however, appropriate provisions are included in the trust instrument that expressly authorize the delegation of investment responsibility to a party other than the trustee, customarily one or more professional investment managers. The trust agreement ordinarily requires the trustee to follow the manager's instructions. The trustee generally has no control over the decision to delegate this discretionary responsibility, and rarely does it have or want any voice in the choice of the manager. It merely is advised of the appointment of the manager. Thereafter, the manager makes all the investment decisions and directs the trustee to implement them.

**DIRECTED TRUSTEE LIABILITY BEFORE ERISA**

The primary purpose of the directed trust is to take investment authority out of the control of the trustee and place it in the control of an investment manager. The directed trustee, however, remains a fiduciary even in its primarily administrative or custodial capac-

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14. For a detailed description of the fiduciary functions of the traditional and directed trustee, see *Separable Liabilities*, supra note 4, at 1155, 1157-61.

15. A typical provision reads:

The Company, by any two officers, may direct the Trustee to segregate all or a portion of the Trust Fund in a separate investment account or accounts and may appoint an investment manager, as defined in the Employee Retirement Income Security Act of 1974 as heretofore or hereafter amended, to direct the investment and reinvestment of each such investment account or accounts. In such event, the Company, by any two officers, shall notify the Trustee of the appointment of such investment manager. Thereafter, the Trustee shall make every sale or investment as directed in writing by the investment manager. It shall be the duty of the Trustee to act strictly in accordance with each direction. The Trustee shall be under no duty to question any such direction of the investment manager, to review any securities or other property held in any such investment account or accounts acquired by it pursuant to such directions or to make any recommendations to the investment manager with respect to such securities or other property. The Trustee may rely upon any order, certificate, notice, direction or other documentary confirmation purporting to have been issued by the investment manager. The Trustee shall not be charged with knowledge of the termination of the appointment of any investment manager until it receives written notice thereof from the Company.

16. For purposes of convenience, this article will assume that the hypothetical plans discussed have only one investment manager. In reality, the number and types of managers vary depending on the size and the particular needs of the plan.

17. See generally 2 A. Scott, *The Law of Trusts* §§ 169-185 (3d ed. 1967) [hereinafter cited as Scott], and *Restatement (Second) of Trusts* §§ 169-185 (1959) [hereinafter cited as Restatement Second] for various fiduciary duties which are independent of the trustee's
Understandably, the pre-ERISA directed trustee was concerned about its potential liability for the subsequent acts or omissions of the manager.

The trustee's rights and responsibilities in general are determined by traditional trust law. Investment authority is a discretionary, as opposed to a ministerial, power, and traditional trust law prohibits a trustee from delegating this discretionary power. In a directed trust, however, it is the settlor, i.e., the company, and not the trustee who entrusts the investment control to the third party. It is well established that the settlor has the right to allocate discretionary authority in the trust agreement to achieve its particular goals. In the typical directed trust, therefore, the directed trustee has little concern that it will be held responsible for the company's decision to divest the trustee of one of its traditional duties.

Despite the directed trustee's express lack of authority over investment decisions, pre-ERISA trust law suggested that the trustee could be held liable for improper decisions of the investment manager. Although there are no relatively recent reported decisions construing a trustee's liability in the typical directed retirement trust, it long has been held that a trustee has certain responsibilities to police the exercise of any power of control which is held in a fiduciary capacity. The general consensus was that a party empow-
ered to make investment decisions and direct the trustee to implement them served in a fiduciary capacity.23 Even when the trustee was compelled by the trust agreement to follow the directions of the holder of this power of control, the trustee's compliance was not justified when it knew or reasonably should have known that the holder of the power was acting in violation of its fiduciary duty.24 The most authoritative pre-ERISA trust commentaries analogized the duty of a directed trustee to that of a co-trustee with respect to the acts of the other co-trustees.25 It was suggested that a trustee who was directed to follow a third party's investment decisions had a duty to investigate the appropriateness of any directed investments.26 The trustee further was obligated to inform the third party of any abuses of discretion it detected and to refrain from implementing any directions it felt were improper.27 If the third party refused to withdraw the objectionable directions, the trustee was under a fiduciary duty to apply to the court for instructions or for permission not to implement the third party's requests.28

that situation the trustee should not be held liable for complying with the holder's directions, so long as the directions do not violate the terms of the trust.

23. Restatement Second, supra note 17, at § 185, comment c, provides that "a power given to some third person, who is expert in the making of investments, to control the trustee in disposing of or acquiring trust investments, would ordinarily be a power for the benefit of the beneficiaries of the trust generally." For a similar view, see also Blanchard, Pension Investment Performance vs. Fiduciary Responsibility, 110 Trusts & Est. 666 (1971). Although there is a dearth of case law construing the status of investment advisers in directed retirement trusts, numerous cases have concluded that various analogous non-interested third parties who held powers of control exercised their powers in a fiduciary capacity. See, e.g., Allen v. Nunnally, 180 F.2d 318, 320 (5th Cir. 1950) (power of son of settlor to revoke, alter, or amend the trust was held in a fiduciary capacity); Lewis v. Hanson, 36 Del. Ch. 235, 249, 128 A.2d 819, 828 (1957), aff'd sub. nom. Hanson v. Denckla, 257 U.S. 235 (1958) (trust adviser with power to limit the trustee's powers to sell trust property, to invest the proceeds of any sale of trust property, and to participate in any plan of merger or reorganization of any company in which trust proceeds had been invested was a fiduciary); United States Nat'l Bank of Portland v. First Nat'l Bank of Portland, 172 Ore. 683, 695-96, 142 P.2d 785, 790 (1943), clarified in 143 P.2d 909 (1943) (consultant bank which was given the power to retain custody of the securities forming the corpus of the estate, to collect dividends and do incidental accounting and reporting, and to veto all changes in investments or new investments acted for the protection of the beneficiaries and was a fiduciary); Gathright's Trustee v. Gaut, 276 Ky. 562, 565, 124 S.W.2d 782, 783-84 (1939) (advisers whose consent was required before the executor could buy or sell property for the trust had duties and status similar to those of trustees and should be considered as co-trustees with limited authority).

24. Scott, supra note 17, at § 185; Restatement Second, supra note 17, at § 185.

25. Scott, supra note 17, at § 185; Restatement Second, supra note 17, at § 185, comment e. For general discussion of the duties and liabilities of co-trustees, see Scott at §§ 184, 224 and Restatement Second at §§ 184, 224.

26. Scott, supra note 17, at § 185.

27. Id.

28. Id. See also Restatement Second, supra note 17, at § 185, comment e. The cases construing directed trustees' liability for failing to apply to the courts for bills of particulars, instructions, injunctive relief, etc., are almost all mechanical applications of the rule an-
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These strictures were both unreasonable in theory and unduly burdensome in practice. The directed trust was specifically designed to remove the trustee's traditional investment discretion and substitute the judgment of an investment adviser. Requiring the trustee to police the manager's exercise of that judgment contravened that underlying purpose by interposing the trustee's judgment as a check on the adviser's judgment. The trust instrument usually required the trustee to comply with the adviser's decisions. The courts' and commentators' co-trustee liability theory effectively neutralized that express provision, thereby frustrating the company's intent.

The directed trust also was viewed by the company as a way of allocating particular duties among the parties. The adviser specialized in investment management and the directed trustee concentrated on the various administrative functions. Any efficiencies promoted by this division of labor were undermined substantially by the co-trustee liability theory, for it effectively forced the trustee to monitor extensively, if not duplicate, the work of the investment adviser. It also required the trustee to invoke court assistance to resolve disputes over the propriety of investment decisions. These procedures were expensive for the trust and unduly cumbersome for the trustee who supposedly was not to be involved in the investment decision-making process.

In order to avoid this anomalous result, parties to pre-ERISA employee benefit trusts often agreed to incorporate exculpatory provisions into their trust agreements. The typical exculpatory section was designed to hold the directed trustee harmless for the acts of the investment adviser so long as the trustee did not act in bad faith or engage in gross negligence or willful misconduct. It was reasonable to deduce that the directed trustee, therefore, would not be held liable for implementing the adviser's decisions unless the trustee actively collaborated in the challenged decisions.

Many courts approved the practice of incorporating exculpatory

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29. A sample exculpatory provision is as follows:

The Trustee shall not be liable or responsible for any loss resulting to the Trust Fund by reason of any sale or investment made or other action taken pursuant to and in accordance with the direction of the person or persons having the power to direct the same or for the failure to take any action in the absence of any direction.
provisions into trust instruments. Agreements exonerating trustees from liability, however, often were carefully scrutinized and strictly construed. On various occasions courts held them ineffective to excuse bad faith, gross negligence, or willful misconduct by the trustee. Nevertheless, directed trustees felt that they did conform to those guidelines and so took comfort in the protection afforded by the provisions. Further, many realized that the courts had evaluated exculpatory agreements in the context of personal trusts which generally involved unsophisticated parties. Trustees privately anticipated that courts would fully endorse such provisions in retirement trusts which generally involved more sophisticated parties.

The protection afforded the directed trustee by exculpatory agreements made it possible to design an employee benefit trust which

30. See, e.g., United States ex rel. Willoughby v. Howard, 302 U.S. 445, 450 (1938) (upholding exculpatory clauses by implication by noting that every trustee has a duty to exercise reasonable care in the custody of the fiduciary estate unless excused by agreement, statute, or order of a court); Thompson v. Hays, 11 F.2d 244, 248 (8th Cir. 1926) (upholding right of parties to a trust to agree to exculpate the trustee for all but willful defaults); Browning v. Fidelity Trust Co., 250 F. 321, 324 (3d Cir. 1918) (stating as a general proposition that parties creating a trust can agree to limit the trustee's liability); Morrissey v. Curran, 351 F. Supp. 775, 782-83 (S.D.N.Y. 1972) (holding that exculpatory provisions could protect a trustee from liability resulting from negligence); Newhouse v. Canal Nat'l Bank of Portland, 124 F. Supp. 239, 249 (S.D. Maine 1954) (noting that although courts will strictly construe exoneration clauses, they generally will uphold them in the absence of bad faith or profit realized by the trustee); New England Trust Co. v. Paine, 317 Mass. 542, 549-50, 59 N.E.2d 263, 269-70 (1945) (holding an exculpatory provision valid to excuse a negligent or intentional breach of trust so long as there was no intent also to cause loss). See also Directory Trusts, supra note 7, at 140-41 for a more detailed list of cases upholding exculpatory clauses.


32. See, e.g., Thompson v. Hays, 11 F.2d 244, 248 (8th Cir. 1926) (clause ineffective to excuse willful default); Browning v. Fidelity Trust Co., 250 F. 321, 324 (3d Cir. 1918); Morrissey v. Curran, 351 F. Supp. 775, 782-83 (S.D.N.Y. 1972); Newhouse v. Canal Nat'l Bank of Portland, 24 F. Supp. 239, 249 (S.D. Maine 1954). Exculpatory provisions have on occasion been considered contrary to public policy. On occasion they also have been held ineffective because the breach of trust complained of did not fall within the scope of the exculpatory provision or because the provision was inserted in violation of a fiduciary or confidential relation between the settlor and the party covered by the provision. See generally Scott, supra note 17, at §§ 222, 222.1, 222.3, 222.4; Restatement Second, supra note 17, at § 222 and comments b, c, and d thereunder.

33. One often cited commentary lists 8 limitations on the effectiveness of exculpatory clauses. Nevertheless, the author concludes that they can offer important protection for the directed trustee, especially when they are broadly written and when they are used as an adjunct to the trustee's carefully extended powers. Cronin, supra note 7, at 1148. Another commentator details reasonable measures the directed trustee can take to ensure maximum protection from an exculpatory provision. Whitworth, supra note 2, at 701.
maintained the sponsor's right to allocate investment authority, while freeing the trustee from the burden of unwarranted, expensive, and duplicative monitoring activities. Within that structure, a corporate trustee found it feasible to accept a position as a directed trustee and discharge its administrative duties according to the terms of the trust instrument.

**Directed Trustee Liability After ERISA**

ERISA at once clarifies and confuses the scope of liability of the various parties involved in directed trusts. The Act tacitly approves the concept of the directed retirement trust; it establishes procedures whereby a "named fiduciary"—generally the plan sponsor or administrator—may appoint an investment manager to control the investment of trust assets. This statutory sanction makes it clear that the company's delegation of investment authority is permissible. Sections 405(c)(1) and (2) imply that the appointing fiduciary will not be liable for the subsequent investment performance of the fund, provided the named fiduciary exercises reasonable judgment and care in the selection of the investment manager and continues to review the wisdom of the appointment on a periodic basis.

34. ERISA § 402(a)(2), 29 U.S.C. § 1102(a)(2) (Supp. V 1975) provides:
   For purposes of this title, the term "named fiduciary" means a fiduciary who is named in the plan instrument, or who, pursuant to a procedure specified in the plan, is identified as a fiduciary (A) by a person who is an employer or employee organization with respect to the plan or (B) by such an employer and such an employee organization acting jointly.

35. ERISA § 402(c)(3), 29 U.S.C. § 1102(c)(3) (Supp. V 1975) provides:
   (c) Any employee benefit plan may provide—
   (3) that a person who is a named fiduciary with respect to control or management of the assets of the plan may appoint an investment manager or managers to manage (including the power to acquire and dispose of) any assets of a plan.

36. ERISA §§ 405(c)(1), (2), 29 U.S.C. §§ 1105(c)(1), (2) (Supp. V 1975) provide:
   (c)(1) The instrument under which a plan is maintained may expressly provide for procedures (A) for allocating fiduciary responsibilities (other than trustee responsibilities) among named fiduciaries, and (B) for named fiduciaries to designate persons other than named fiduciaries to carry out fiduciary responsibilities (other than trustee responsibilities) under the plan.
   (2) If a plan expressly provides for a procedure described in paragraph (1), and pursuant to such procedure any fiduciary responsibility of a named fiduciary is allocated to any person, or a person is designated to carry out any such responsibility, then such named fiduciary shall not be liable for an act or omission of such person in carrying out such responsibility except to the extent that—
   (A) the named fiduciary violated section 404(a)(1) (which section establishes the primary benefit, prudence, and diversification requirements for fiduciaries)—
   (i) with respect to such allocation or designation,
   (ii) with respect to the establishment or implementation of the procedure under paragraph (1), or
   (iii) in continuing the allocation or designation; or
ERISA specifically confirms the common law consensus that investment managers, like trustees, serve in a fiduciary capacity with respect to the trust assets. Moreover, it formally enunciates the principle that where two or more parties are fiduciaries with respect to the same assets, each may be held liable for breaches of responsibility by any of the others. This codification of a co-fiduciary theory, coupled with ERISA's express recognition of the form and function of the directed trust, places the directed trustee in an unreasonably awkward position. ERISA approves the settlor's intent to divide the trust duties among different parties, but totally eviscerates that intent by holding the directed trustee responsible for acts specifically delegated to another.

Directed trustees were dealt a further blow by the enactment of ERISA section 410(a) which explicitly voids exculpatory provisions

(B) the named fiduciary would otherwise be liable in accordance with subsection (a).

37. ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A) (Supp. V 1975) establishes the threshold requirements for ERISA fiduciaries:

(21)(A) Except as otherwise provided in subparagraph (B), a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan. Such term includes any person designated under section 405(c)(1)(B).

(Subparagraph B details circumstances not customarily applicable to the manager of a directed trust) ERISA § 3(38), 29 U.S.C. § 1002(38) (Supp. V 1975) specifies:

(38) The term “investment manager” means any fiduciary (other than a trustee or named fiduciary, as defined in section 402(a)(2))—

(A) who has the power to manage, acquire, or dispose of any asset of a plan;

(B) who is (i) registered as an investment adviser under the Investment Advisors Act of 1940; (ii) is a bank, as defined in that Act; or (iii) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and

(C) has acknowledged in writing that he is a fiduciary with respect to the plan.

38. ERISA § 405(a), 29 U.S.C. § 1105(a) (Supp. V 1975) provides:

(a) In addition to any liability which he may have under any other provision of this part, a fiduciary with respect to a plan shall be liable for a breach of fiduciary responsibility of another fiduciary with respect to the same plan in the following circumstances:

(1) if he participates knowingly in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach;

(2) if, by his failure to comply with section 404(a)(1) in the administration of his specific responsibilities which give rise to his status as a fiduciary, he has enabled such other fiduciary to commit a breach; or

(3) if he has knowledge of a breach by such other fiduciary, unless he makes reasonable efforts under the circumstances to remedy the breach.
as against public policy. There is little doubt that Congress intended to strictly prohibit such provisions, for sections similar to 410(a) were submitted with various drafts of the House and Senate bills which eventually were synthesized into ERISA.

The directed trustee may feel that section 405(d)(1) grants partial relief from the harshness of section 410(a). Section 405(d)(1) provides:

(d)(1) If an investment manager or managers have been appointed under section 402(c)(3), then, notwithstanding subsections (a)(2) and (3) and subsection (b), no trustee shall be liable for the acts or omissions of such investment manager or managers, or be under an obligation to invest or otherwise manage any asset of the plan which is subject to the management of such investment manager.

39. ERISA § 410(a), 29 U.S.C. § 1110(a) (Supp. V 1975) provides:

(a) Except as provided in sections 405(b)(1) and 405(d), any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this part shall be void as against public policy.

40. See, e.g., S. 1557, 93d Cong., 1st Sess. § 14(g) (1973), reprinted in 1 LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 314-15 (1976) [hereinafter cited as LEGISLATIVE HISTORY], which stated:

(g) No fiduciary may be relieved from any responsibility, obligation, or duty under this Act by agreement or otherwise. Nothing herein shall preclude any agreement allocating specific duties or responsibilities among fiduciaries, or bar any agreement of insurance coverage or indemnification affecting fiduciaries, but no such agreement shall restrict the obligations of any fiduciary to a plan or to any participant or beneficiary.

In introducing S. 1557, which was designed to amend the Welfare and Pension Plans Disclosure Act, Senator Javits remarked that exculpatory provisions had no place in employee benefit plans, despite any usefulness they might serve in testamentary trusts. He further explained that the large numbers of people and enormous amounts of money involved in such plans, coupled with the public interest in their financial soundness, required that no such provisions be permitted. 119 CONG. REC. 12076 (1973) (remarks of Sen. Javits), reprinted in 1 LEGISLATIVE HISTORY, at 277. See also H.R. 9824, 93d Cong., 1st Sess. § 111(g) (1973), reprinted in 1 LEGISLATIVE HISTORY, at 733, which stated:

(g) Except as provided in subsection (e)(1)(B) of this section, any provision in an agreement or instrument which purports to relieve a fiduciary from responsibility or liability for any responsibility, obligation, or duty under this title shall be void as against public policy.


This statutory exclusion applies only to directed trusts created in accordance with section 402(c)(3) and only absolves the trustee from liability for two of the three circumstances which give rise to liability under section 405. It relieves the trustee from liability if the trustee fails to comply with section 404 and thereby enables the manager to commit a breach.\(^2\) It also absolves the directed trustee from liability if it fails to "make reasonable efforts under the circumstances" to remedy a breach by the manager.\(^3\)

Both of these exclusions are consistent with the form and function of the directed trust.\(^4\) Since the trustee is required by the trust instrument simply to implement the adviser's directions and not to make any inquiries as to the appropriateness or wisdom of the decisions, the directed trustee should have no cause to review the substance of the manager's directions or to monitor the assets themselves. The trustee should not be required to anticipate the ways in which its conduct might trigger a breach of duty by the manager. The trustee should not have to constantly evaluate investment activity or take affirmative steps to block any transaction which it feels is unwise. Requiring such involvement would defeat the company's purpose of divesting the trustee of investment decision-making power. In addition, the imposition of section 405(a)(2) or (a)(3) liability on the directed trustee would interfere severely with the efficient management of investments. Lengthy trustee investigations or even protracted court proceedings might be necessary if the directed trustee were bound to ensure that its actions did not enable the manager to commit a breach of duty or if the trustee were bound to comply with the amorphous "reasonable efforts" standard in section 405(a)(3).

The one situation in which section 405(d)(1) does not relieve the trustee of liability is enunciated in section 405(a)(1). That section provides that a directed trustee may be held liable for an investment manager's breach if the trustee knowingly participates in, or knowingly undertakes to conceal, an act or omission of such other fiduciary, knowing such act or omission is a breach.\(^5\) Although the directed trustee should not be relieved of liability for actively initiating or collaborating in the planning of conduct prohibited by ERISA, it should not be held liable merely for serving in a passive

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42. See ERISA § 405(a)(2), the text of which appears at note 38 supra.
43. See ERISA § 405(a)(3), the text of which appears at note 38 supra.
44. Section 405(d)(1) also relieves the trustee of liability for acts prohibited by subsection 405(b) which deals with express co-trustee relationships. This protection is of little relevance to the directed trustee, however, as few directed trusts operate with more than one trustee.
role.\textsuperscript{46} It is not clear from the statute itself what acts are prohibited or what standards will be used to assess a defendant's "knowledge." The directed trustee is a fiduciary; furthermore, it provides custody of fund assets, settlement of trades and periodic accounting with regard to the trust assets. If courts construe "knowledge" as anything less than intentional initiation of or active collaboration in investment misconduct, it is possible that directed trustees may be held liable for activities of advisers in which they, the trustees, took absolutely no active role. It therefore is necessary to explore the concept of "knowledge"—or scienter—as the courts may and should define it and to examine how these interpretations apply to the directed trustee's activities.

\textbf{The Concept of Scienter and Directed Trustee Liability}

To date, the federal courts have not had an opportunity to interpret the concept of "knowledge" under section 405(a)(1). The legislative history of ERISA offers little guidance.\textsuperscript{7} In order to determine the interpretation that future courts may adopt, it may be helpful to examine the concept of scienter ("knowingly") as it is defined in those areas of the law which treat the issues pertinent to retirement trusts as well as those which have undertaken the most comprehensive analysis of the subject. Breaches of fiduciary duty by trustees traditionally have been governed by common law fraud theories. Alternatively, courts interpreting federal securities laws recently have focused considerable attention on the proper interpretation of scienter. In 1977 the Seventh Circuit decided, in \textit{Daniel v. International Brotherhood of Teamsters},\textsuperscript{48} that a beneficiary's interest in a pension plan is a security. Subject to modification or rever-

\textsuperscript{46} For additional discussion of the directed trustee's custodial duties, see text accompanying notes 14-16 supra.

\textsuperscript{47} The only references to the scope of the directed trustee's liability appear in the Conference Report which accompanied ERISA. The Report indicated that if a retirement plan manager permits the appointment of an investment manager, the named fiduciary may do so, and the directed trustee "would not be liable for the acts or omissions of the investment manager." The Report also stated that the plan may also provide that the trustee is to be subject to the direction of a named fiduciary with respect to the investment decisions. "In this case, if the trustee properly follows the instructions of the named fiduciaries, the trustee \textit{generally} is not to be liable for losses which arise out of following these instructions." \textit{H. Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. 301-02 (1974), reprinted in [1974] U.S. Code Cong. & Ad. News 5082-83.} However, while this language seems to indicate that Congress intended that a directed trustee should be statutorily excused from liability for acting under the investment manager's directions, it does not invalidate the seemingly contrary provisions in section 405(a)(1). In addition, section 405(d)(2) specifically provides that subsection 405(d) is not intended to free the trustee from liability for its own acts. For analysis of this enigmatic provision, see text accompanying note 79 infra.

\textsuperscript{48} 561 F.2d 1223 (7th Cir. 1977).
sal by the Supreme Court on review, Daniel may foreshadow increasing application of federal securities principles to retirement trusts, a prospect none too appealing to plan sponsors or trustees.

The common law concept of scienter has its roots in Derry v. Peek, a leading English case in which the House of Lords held that a finding of conscious misrepresentation was necessary in order to maintain an action for deceit. Professor Prosser and other commentators believe that many courts only pay lip service to the case and find liability for deceit where misrepresentations are made without actual intent. The precise standard is unclear. Professor Loss, in discussing the relationship between the securities law and common law concepts of knowledge noted: "Scienter under the common law has been defined as everything from knowing falsehood with an implication of mens rea, through the various gradations of recklessness down to nonaction such as is virtually equivalent to liability without fault."

Although there is no consensus among courts as to the common law requirement of scienter, a majority of jurisdictions have held that recklessness or conscious ignorance of the truth or falsity of

49. [1899] 14 A.C. 337. Defendants, directors of a tramway corporation, issued a prospectus in conjunction with a public stock offering. The prospectus contained the unqualified assertion that "the company has the right to use steam or mechanical motor power instead of horses." The company did not actually have that right. The plaintiff who purchased stock in reliance on the statement brought an action for deceit. The court held that mere negligence was insufficient to maintain the action; rather, it was necessary to prove the false representation had been made 1) knowingly, 2) without belief of its truth, or 3) recklessly, i.e., careless of the truth or falsity of the representation. See W. Prosser, The Law of Torts, § 107 at 699 (4th ed. 1971) [hereinafter cited as Prosser].

50. See, e.g., Angus v. Clifford, 2 Ch. 449 (1891) in which the defendant, who intended to state his knowledge truthfully but whose careless use of language created a misstatement, was held not liable to the plaintiff who was misled thereby. See Bohlen, Misrepresentation as Deceit, Negligence or Warranty, 42 Harv. L. Rev. 733, 734 n.2 (1929).


52. 3 L. Loss, Securities Regulation 1432 (2d ed. 1961).

53. A minority of courts have expanded the concept beyond its traditional bounds (or perhaps have left the concept behind) and have considered holding defendants liable for negligent representations or strictly responsible for innocent misrepresentations. Prosser, supra note 49, at § 107, at 710-14; Bucklo, Scienter—Rule 10b-5, 67 Nw. U.L. Rev. 562, 572 (1972) [hereinafter cited as Bucklo—Scienter].


55. See, e.g., Joseph Greenspon's Son's Pipe Corp. v. Hyman-Michaels Co., 133 S.W.2d 426, 428 (Mo., 1939), where the court stated:

It is, of course, not necessary in order to make out a case of fraudulent representation that the defendant should have actual knowledge that the facts stated by him were false, but instead it will suffice if it be shown that he made the particular representation with consciousness that he was without knowledge as to their truth or falsity, when, in fact, they were untrue.
a statement or action qualify as scienter. According to Professor Prosser, there is general agreement that scienter is present when the representation is made without belief as to its truth or with reckless disregard of whether it is true or not, and that “all courts have extended [scienter] to include representations made by one who is conscious that he has no sufficient basis of information to justify his belief.”

Finally, as Justice Goldberg pointed out in SEC v. Capital Gains Research Bureau, Inc., any evaluation of the contours of common law fraud requires an examination of “the nature of the relief sought, the relationship between the parties and the merchandise in issue.” Perhaps the relaxation of the stringent standards is due both to the expansion of the concept of fiduciary duties and to the changing patterns of commerce which involve not only transactions of land and other tangible goods, but also the sale of securities and other intangibles.

The concept of scienter under the securities laws has also been in a state of flux. Standards of negligence, recklessness, constructive fraud, among others, have all been adopted on occasion. One commentator concluded in 1972 that “proof of an intention to mislead has been eliminated as an element of proof under Rule 10b-5.” Although the majority of federal courts have required either actual knowledge of the falsity of the misstatement or a reckless disregard of the truth to establish scienter under 10b-5, at least three circuits have moved in the direction of recognizing a negligent intent under that rule.

See also Hollerman v. F.H. Peavey & Co., 269 Minn. 221, 130 N.W.2d 534 (1964); Sovereign Pocohontas Co. v. Bond, 120 F.2d 39 (D.C. Cir. 1941).

PROSSER, supra note 49, at § 107, at 700-01.

Id. The requisite state of mind must be inferred from circumstances, and the unreasonableness of a belief may be very strong evidence that the defendant does not in fact hold the belief.


Id. at 193.

PROSSER, supra note 49, at § 107, at 710-14.

See Bucklo—Scienter, supra note 53, at 567.

Id. at 573.


White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963). See also Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 n.12 (1976).
In the recent case of *Ernst & Ernst v. Hochfelder*, the Supreme Court granted certiorari specifically to “resolve the question of whether a private cause of action would lie under section 10b of the Securities and Exchange Act of 1934 and Rule 10b-5 in the absence of any allegation of scienter.” The Court answered this question in the negative. However, although the Court ruled out negligence as a basis for rule 10b-5 liability, its discussion did not clarify what state of mind is necessary to establish the requisite intent element. While the Court initially defined scienter as a “mental state embracing intent to deceive, manipulate or defraud,” it specifically left open the possibility that reckless behavior might be sufficient. In fact, one commentator who undertook an extensive analysis of scienter standards under *Hochfelder* and subsequent lower court cases concluded that “the great bulk of decisions and the more influential scholarly commentators that have considered the question have argued that recklessness should suffice for liability under Rule 10b-5.”

Further, the Court’s analysis, terminology, and supporting citations could sustain three inconsistent interpretations of the meaning of scienter: intent, knowledge, or recklessness. Predictably, lower

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65. 425 U.S. 185 (1976). The factual background of *Hochfelder* is as follows: Leston Nay, president of First Securities Company committed suicide and left a note stating that his actions had left the firm bankrupt, and that he had converted to his own use funds that the plaintiff investors believed had been placed in escrow. Nay had concealed the identity of the escrow accounts from auditors by utilizing a “mail rule” under which he alone opened all mail addressed to him. The plaintiff investors charged Ernst & Ernst, First Securities’ independent accountants, with aiding and abetting May’s fraud in violation of section 10(b) by their failure to investigate First Securities’ internal accounting control procedures. The district court granted defendants’ motion for summary judgment. The Seventh Circuit reversed, holding that the negligent inaction of the accountants could be the basis for an aiding and abetting action under rule 10b-5. See also Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder*, 29 STAN. L. REV. 213, 215-16 (1977) [hereinafter cited as Bucklo—Supreme Court].

66. 425 U.S. at 193.


68. 425 U.S. at 193-94 n.12.

69. Id. The Court noted:

In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some acts. We need not address here the question whether in some circumstances reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5.

70. Bucklo—Supreme Court, supra note 65, at 235. In Bucklo’s view, a recklessness standard would further the policy of investor protection which underlies the federal securities laws. See also ALI SEC. CODE (1974 Revised Text Draft Nos. 1-3) which defines scienter to include recklessness. See generally ALI-ABA COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, RESOURCE MATERIALS FOR SECURITIES LITIGATION 116-19 (2d ed. 1977).

71. See Bucklo—Supreme Court, supra note 65, at 218-19. The author synthesized the
courts have been unable to agree on Hochfelder's requirements. Some jurisdictions have found "wanton ignorance," or "reckless disregard for the truth" sufficient; others have required "willfulness" or "actual knowledge." The courts that set the above standards each cited Hochfelder as authority for their divergent tests.

Whether common law tort or federal securities principles are applied, it is possible that some of the directed trustee's purely administrative functions may subject it to liability under section 405(a)(1). Although considerable confusion remains in both areas as to the precise definition of scienter, it appears that something less than actual intent, e.g., recklessness, may be sufficient to inculpate a defendant. In addition, the duty owed to retirement plan participants is of the highest nature, and courts interpreting section 405(a)(1) therefore may be inclined to follow those cases which construe the concept of scienter most broadly. Most unfortunately, some thoughts of those involved in the drafting of ERISA highlight a further concern for finding the trustee liable for the manager's breaches of duty. It was apparently reasoned that the trustee should be held liable despite its pure ministerial role because it generally would have greater resources to satisfy any judgment than would the investment manager. The possibility that this "deep pocket"

implications of this indefinite reasoning as follows:

At first glance, therefore, Ernst & Ernst appears to define scienter as Humpty Dumpty would—"it means just what [the Justices] choose it to mean—nothing more, nothing less." Such ambiguity leaves litigants, commentators and lower courts in doubt as to the proper culpability standards under rule 10b-5 and free, much as Alice feared, to "make [the Justices'] words mean so many different things."

Id. at 215.

76 However, authorities have suggested that the limits of actionable fraud are now broader under common law than they are under the securities laws. See, e.g., ALI-ABA COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, RESOURCE MATERIALS FOR SECURITIES LITIGATION 118 (2d ed. 1977).
77 See, e.g., ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B) (Supp. V 1975) which defines the trustee's standard of care:

(a) every fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and . . .

(B) 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. . . .
78 These thoughts were expressed by various Congressional staff people during a visit in 1972 with representatives of the Corporate Fiduciaries of Illinois to discuss possible revisions
theory might influence courts certainly is not a comforting thought to directed trustees.

The directed trustee usually retains legal custody of the trust assets and settles any trade initiated by the manager. It records exchanges of cash and securities on the trust books. It reports periodically to the plan sponsor regarding activity in the trust account and submits lists of the assets held by the trust. It compiles trust accounting statements cataloguing all securities. These activities are purely administrative. They do not indicate—either directly or by inference—that the directed trustee acted in collusion with the manager, or that it actively participated in any financial conspiracy, mismanagement, or cover-up. On the contrary, the exercise of these duties reflects no involvement whatsoever by the directed trustee in the investment decision-making process. However, the directed trustee may be deemed to be aware of the investments in question if it has settled the trade and recorded it in some manner. If the “knowledge” required under section 405(a)(1) encompasses “reckless” conduct, it is possible that a court may find a trustee “reckless” if the trustee is aware of a decision the court finds improper, but does not take appropriate action to correct the impropriety. It is very possible that a court might find a trustee to have knowingly participated in or knowingly concealed a breach by the adviser, even though the directed trustee would argue that it is a mere custodian of the trust assets and has no cause to review either the substance of the manager's directions or the assets under the manager's control. Nevertheless, given the fluctuating standards for “knowledge” under analogous case law, ERISA's high standard for fiduciary responsibility, and the corporate trustee's historical financial stability, such results are conceivable, if not probable.

**POTENTIAL LIABILITY UNDER SECTION 405(d)(2)**

The final and most enigmatic source of potential directed trustee liability is ERISA section 405(d)(2) which states: "Nothing in this and ramifications of the draft language of ERISA. One suggestion proposed by the CFI was to adopt the following language in the proposed Bills so as to avoid the problems now being faced by a directed trustee:

No fiduciary may be relieved from any responsibility, obligation or duty under this Act by agreement or otherwise provided, however, nothing herein shall preclude any agreement allocating specific responsibilities, obligations or duties among fiduciaries in which event such a fiduciary to whom certain responsibilities, obligations or duties have not been allocated shall not be liable either individually or as a fiduciary for any loss resulting to the fund arising from the acts or omissions to act on the part of another fiduciary to whom such responsibilities, obligations or duties have been allocated.
subsection shall relieve any trustee of any liability under this part for any act of such trustee." 9 The legislative history is silent as to Congress' intended meaning for this provision. If read literally, the provision suggests that the directed trustee should be held liable for all acts prohibited under section 405(a), notwithstanding the exclusion in subsection 405(d)(1). This analysis would render section 405(d)(1) meaningless, a result hardly consistent with any legitimate method of statutory interpretation.

Another possible interpretation is that Congress intended that the trustee be held liable for all acts other than those excluded by section 405(d)(1). However, if this interpretation is correct, the subsection could have been so phrased. Moreover, there is no need for the provision. Since section 405(d)(1) creates only a limited exclusion, it is assumed, as a standard rule of interpretation, that the directed trustee could be held liable for any acts outside the scope of the exclusion.

Finally, it might be argued that subsection 405(d)(2) merely means that the directed trustee should not be relieved of liability for its own discretionary acts. Perhaps Congress wanted to make certain that the exclusion provision would not be extended beyond the context of the directed trust. Again, this intent could have been enunciated more clearly than the language of 405(d)(2) indicates. In addition, the liability remaining under section 405(a)(1) appears sufficient to cover any discretionary acts by the trustee. If nothing else is accomplished by the inclusion of this obscure provision, it highlights Congress' apparent concern to include the trustee well within the scope of liability expressed throughout Part I of ERISA.

MEANS OF PROTECTING THE DIRECTED TRUSTEE UNDER ERISA

ERISA threatens the directed trustee with several sources of potential liability for the acts of investment managers. The scope of its liability is still uncertain. The directed trustee may be in great peril if it relies merely on the statutory exclusions found in section 405(d)(1). To reduce the exposure to liability, the directed trustee should have protective provisions included in the trust agreement. Several approaches have been suggested.

As a first approach, the directed trustee may retain a veto power over the selection of the investment manager. This would allow the trustee to review the choice of the organization or individual for whose acts it later may be held responsible. The directed trustee can thus ensure that the investment authority is given to a manager

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with whom it is comfortable, one who, the trustee hopes, will be unlikely to direct the acquisition or retention of improper investments. This approach may help reduce the trustee's potential liability exposure, but it does not provide the breadth of protection the directed trustee deserves.

As a second approach, the directed trustee may maintain some sort of screening process or review over the directed investments. Two general types of monitoring schemes have been employed. One involves what has been termed "fail-safe" screening. Under this scheme, a set of guidelines to detect bad risk investments is established. The trust investments are reviewed periodically according to those guidelines. If any decision fails to pass the screen, the plan sponsor and the manager are notified immediately so that corrective action may be commenced. If nothing else, this program should reinforce the trustee's claim of good faith by showing that it took appropriate steps to remedy a breach. It also may detect bad investments before losses become severe. However, the trustee will be protected only to the extent that the guidelines adopted are deemed appropriate by the courts,\(^8\) and only to the extent that the screen does not allow any bad investments to slip through without notice. Judicial standards, of course, are subject to constant change, making it even more difficult for the directed trustee to rely on the screen as a mirror of the current law.

As a variation of the "fail-safe" plan, the directed trustee may retain a veto power over any directions given by the manager. For this power to be valuable, however, the trustee must substantively review each direction to determine whether or not to comply. In order to obtain maximum protection, the trustee also should monitor continuously the effects of past investment directions to see if the manager's investments have become inappropriate for the trust. Under this system the trustee must substitute its investment discretion for that of the manager, a result diametrically opposed to that intended by the company in creating the directed trust. Although this program is likely to arrest some inappropriate investment decisions, the duplication of effort and cost required to maintain it may

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well negate any benefits to be gained by allocating investment authority to an investment manager in the first place.

From the trustee's point of view, neither of these variations provide the protection due the directed trustee in its primarily custodial role. Screening or monitoring may aid in keeping unwise decisions from escalating into major catastrophes. However, by initiating and maintaining an evaluation program, the directed trustee may be guaranteeing its liability under section 405(a)(1) for any acts of the investment manager. If it has actively undertaken to oversee that decision-making process, a court likely will find the trustee to have satisfied the requirements of "knowledge" and/or "participation" under that subsection.

Each of the approaches explained so far requires surveillance by the trustee and does not eliminate the specter of liability. If the directed trustee instead decides to assume its proper role by taking only the administrative action necessary to implement the manager's investment decisions, it might consider an agency defense if it is sued for participating in the adviser's mismanagement. It could be argued that as a mere agent of the company—or of the manager, for that matter—it had no power or occasion to exercise any review or control over the investment decisions and hence, lacked the requisite "knowledge" under section 405(a)(1) of any wrongful activity. This defense accurately reflects the company's intent to make the trustee little more than a custodian of the assets. However, the possibility that a court might impute "knowledge" of a breach to a properly inactive directed trustee substantially lessens the utility of this defense.

Given the troublesome "knowledge" standard in ERISA section 405(a)(1), none of the approaches discussed above guarantees the security the directed trustee deserves when it accepts such a limited role. The method best suited to ensure that security is an indemnity agreement between the trustee and the plan sponsor. In a typical indemnity agreement, the plan sponsor would agree to accept full financial responsibility for any liability assessed against the trustee in its capacity as directed trustee. The agreement should cover all...
losses, including legal fees, which might be incurred when the trustee either follows the manager's directions or refrains from acting in the absence of directions.

ERISA, in its final form, does not treat the suitability of indemnity agreements between trustees and sponsors of directed retirement trusts. Several of the early congressional bills, however, expressly approved such arrangements. The absence of any comment in the final draft is perplexing. At the very least, it suggests that Congress did not intend unequivocally to prohibit indemnity agreements as it had exculpatory provisions. Both arrangements are similar in their effects on the directed trustee: both relieve the trustee from financial responsibility for the acts of the investment manager. To that extent it is unusual that Congress prohibited one and not the other. Nevertheless, Congress' implicit approval of indemnity agreements is justifiable on more than one ground. First, indemnity agreements, while absolving the trustee, do not disturb an injured party's ability to obtain relief: they merely determine who ultimately will satisfy any judgment assessed against the trustee. Therefore, indemnity agreements do not interfere with ERISA's manifest purpose of protecting plan beneficiaries.

Exculpatory

by the Company from and against any and all personal liability to which the Trustee may be subjected by carrying out any directions of an investment manager issued pursuant hereto or for failure to act in the absence of directions of the investment manager including all expenses reasonably incurred in its defense in the event the Company fails to provide such defense; provided, however, the Trustee shall not be so indemnified if it participates knowingly in, or knowingly undertakes to conceal, an act or omission of an investment manager, having actual knowledge that such act or omission is a breach of a fiduciary duty; provided further, however, that the Trustee shall not be deemed to have knowingly participated in or knowingly undertaken to conceal an act or omission of an investment manager with knowledge that such act or omission was a breach of fiduciary duty by merely complying with directions of an investment manager or for failure to act in the absence of directions of an investment manager or by reason of maintaining accounting records.

See, e.g., S. 4, 93d Cong., 1st Sess. § 15(g) (1973), reprinted in 1 LEGISLATIVE HISTORY, supra note 40, at 177-78, which provided in part:

Nothing herein shall preclude any agreement allocating specific duties or responsibilities among fiduciaries, or bar any agreement of insurance coverage or indemnification affecting fiduciaries, unless specifically disapproved by the Secretary.


See ERISA § 2(b), 29 U.S.C. § 1002(b) (Supp. V 1975), which reads:

(b) It is hereby declared to be the policy of this Act to protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of con-
provisions merely state that the trustee is not liable, so it is possible that their use may impede an injured party's ability to obtain relief. Indemnity agreements more closely comport with the form and function of directed trusts than exculpatory provisions. The sponsor usually has total discretion over the choice of the manager and specifically intends the trustee to have neither any initial input nor any voice in the day to day management of investments. It makes sense, then, that the sponsor, not the trustee, should bear the primary responsibility for overseeing the manager's activities. Exculpatory provisions relieve the trustee of responsibility but do not otherwise allocate the burden of monitoring the decisions of the manager. As ERISA is designed in part to protect the beneficiaries of retirement trusts, it is highly likely that Congress intended, by its silence, to give implicit, if tentative, approval to indemnity agreements.

ERISA section 410(b) lends further support to indemnity agreements by expressly upholding the trustee's and the plan's rights to obtain certain kinds of insurance to cover breaches of duty by plan fiduciaries. An indemnity agreement is a type of insurance, and section 410(b)(2) specifically allows fiduciaries to purchase insurance to cover liability for breaches of their own duties. Section 410(b)(1) does require that insurance purchased by a plan to cover fiduciaries' liability must permit recourse by the insurer against the

duct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal court.

84. ERISA § 410(b), 29 U.S.C. § 1110(b) (Supp. V 1975) provides:

(b) Nothing in this subpart shall preclude—

(1) a plan from purchasing insurance for its fiduciaries or for itself to cover liability or losses occurring by reason of the act or omission of a fiduciary, if such insurance permits recourse by the insurer against the fiduciary in the case of a breach of a fiduciary obligation by such fiduciary;

(2) a fiduciary from purchasing insurance to cover liability under this part from and for his own account; or

(3) an employer or an employee organization from purchasing insurance to cover potential liability of one or more persons who serve in a fiduciary capacity with regard to an employee benefit plan.

85. Cf. H.R. Con. Res. 609, 93d Cong., 2d Sess. (1974), reprinted in 3 LEGISLATIVE HISTORY, supra note 40, at 4771, where Senator Javits explained why the Act required that insurance obtained by the sponsor provide for recourse against the breaching fiduciary. The purpose of the qualification was to spare the plan—and its participants and beneficiaries—the expense of exorbitant premiums in the absence of recourse provisions. There is no justification, according to Senator Javits, for plan participants and beneficiaries to have to shoulder the burden of subsidizing breaches of fiduciary responsibility committed by their trustees. Those remarks suggest that at least Senator Javits did not favor the sponsor bearing the financial responsibility for the trustee's actions. However, if the goal of the provision is to keep premiums low, that end may be achieved with or without indemnity agreements; the presence of recourse provisions, not the absence of indemnity provisions, is what keeps premiums low.
fiduciary in case of a breach of a fiduciary obligation. However, that subsection does not prohibit the sponsor from agreeing independently to indemnify the directed trustee for any such liability. The Department of Labor reinforced the validity of indemnity agreements under ERISA by issuing an interpretive bulletin expressly permitting them.86

Thus, the directed trustee can most effectively protect itself from unwarranted liability by assuming the limited role of a custodian of the trust assets, confining its activities to the administrative tasks required under the trust agreement, and incorporating an indemnity provision in the trust agreement. The trustee should not accept any indemnity without some preliminary review of the company's financial position. The promise of indemnity will be of little value if the sponsor is not financially stable enough to satisfy the liabilities that may be assessed against the trustee in the future. In addition, it may be helpful for the trustee to obtain a written opinion from the sponsor's counsel stating that the indemnity agreement is valid against and binding on the sponsor under the terms of the sponsor's charter and by-laws and any relevant state statutes or case law.

CONCLUSION

The directed trust is a well established and potentially effective means for dividing retirement trust duties among various investment managers. However, if the efficiencies intended by the separation of functions are to be maintained, each party—and specifically the directed trustee—should be held responsible only for its own discretionary acts. If the directed trustee is held liable for the investment adviser's mismanagement, it would have to take steps to protect itself by policing the very functions it was not supposed to perform. Parties to pre-ERISA directed trusts avoided this unwarranted duplication of effort by the use of exculpatory provisions.

In enacting ERISA, Congress recognized the directed trust and specifically approved the use of the investment manager. Thereby, Congress tacitly endorsed the plan sponsor's intent to retain the directed trustee in a purely administrative or custodial capacity. Yet the drafters impeded efficient functioning of directed trusts by voiding exculpatory provisions. They confused the scope of directed trustee liability by prohibiting "knowing" breaches, while at the same time failing to define "knowledge." Finally, Congress enacted

86. ERISA Interpretive Bulletin 75-4, [1976] 3 PENS. AND PROFIT SHARING (P-H) ¶ 110,048.
section 405(d)(2), which emphasizes a general desire to hold the trustee liable for wrongdoing, but does not enunciate the appropriate scope of that liability.

The directed trustee can attempt to protect itself from unwarranted liability under ERISA by obtaining a comprehensive indemnity agreement from the plan sponsor. Nevertheless, the specter of statutory liability under ERISA remains. The courts eventually will interpret ERISA's liability provisions, but it is uncertain whether that evolution will generate the definitive standards that parties to directed trusts need to plan and implement retirement trusts efficiently. Congress would do well to end the confusion and concern by clarifying the meaning of “knowledge” and by explaining the scope of section 405(d)(2). Most importantly, if the directed trust is to remain a viable structure for employee benefit plans, Congress should clearly provide that each fiduciary is responsible only for acts within its own sphere of discretion.