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MEMORANDUM

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FROM: Thomas A. Decker
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DATE: June 3, 2021

RE: **Terminating Management In Discharging Fiduciary Duties**

The purpose of this memorandum is to analyze the statutory and common law fiduciary duties owed by members of the Board of Trustees (the "Board") of the Pennsylvania Public School Employees' Retirement System ("PSERS") to PSERS' beneficiaries. Specifically, we have analyzed the Board's duty to act, and its exposure if it does not act, when it has lost confidence in PSERS' management to implement the policies adopted by the Board in discharging its fiduciary obligations and to provide advice and recommendations to the Board consistent with its operation of PSERS in the interests and to the benefit of the PSERS beneficiaries.

As discussed further below, we have come to the following conclusions as they relate to the Board's fiduciary obligations:

- Pennsylvania law unequivocally imposes on Board members statutory and common law fiduciary duties to PSERS' beneficiaries which includes an obligation to oversee management;

- Board members' fiduciary duties require that they at all times act in furtherance of the beneficiaries' interests;
- In discharging these duties, Board members must demonstrate their reasonable belief in the reliability and competence of management on whose opinions and recommendations they are entitled to rely in discharging the Board's fiduciary duties; and
- Once Board members lose confidence in PSERS' management such that their reliance on management would or could no longer be reasonable, whether demonstrated by a lengthy period of underperformance or other circumstances, Board members have an obligation to take action, including replacing those of PSERS' management whose reliability or competence has become suspect. If Board members do not take action, they may be subject to claims that they have breached their fiduciary duties.

The analysis contained in this memorandum does not address the impact of applicable employment agreements, if any. Any such employment agreements should be considered by the Board when determining what action to undertake.

I. Executive Summary

It is well-settled that Board members have statutory and common law fiduciary duties to advance the interests of PSERS' beneficiaries. The Board's obligations include investing, disbursing, managing, and controlling the PSERS fund. The Board's primary obligation, therefore, is to preserve and grow the fund and avoid burden and risk to the beneficiaries.

In discharging his or her fiduciary duty, a Board member is to act for the exclusive benefit of PSERS' beneficiaries and is required to exercise his or her duties "in good faith" and "in a manner [he or she] reasonably believes to be in the best interests of the [beneficiaries] and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances." See 15 Pa.C.S. §§ 1712(a), 5712(a). While the Board may delegate to management some responsibility to oversee and manage the activities of PSERS' fund in furtherance of the Board's fiduciary duties, and is permitted to rely on management and management's experts in discharging his or her fiduciary duties, management and management's experts are not entitled to unfettered discretion, and the Board cannot relinquish to management its fiduciary obligation to PSERS' beneficiaries. Consequently, Board members have an undeniable obligation to oversee management, and if they become aware that their reliance on management and management's experts is unwarranted, they may be subject to claims that they have breached their fiduciary obligations if they continue to unreasonably rely on that management.

II. Board Members Have A Fiduciary Obligation To Terminate Management If Beneficiaries' Interests Are Not Protected

A. Board Members Owe A Statutory Fiduciary Duty To PSERS' Beneficiaries

The Board and its members are obligated to advance the interests of PSERS' beneficiaries. By Pennsylvania statute, Board members are "trustees of the [PSERS] fund" and, accordingly, have a "fiduciary relationship to the members of the system regarding the

investments and disbursements of any of the moneys of the fund” 24 Pa.C.S. §§ 8521(a), (e). Indeed, Board members have a statutory obligation “to invest and manage the fund for the exclusive benefit of the members of the system” and have the “exclusive control and management” of PSERS’ fund. *Id.* Board members’ status as fiduciaries is confirmed by § 1.3 of PSERS’ Statement of Organization, Bylaws, and Other Procedures which states, in part, “[t]he members of the Board stand in a fiduciary relationship to the members of [PSERS] regarding the investments and disbursements of moneys of the Fund.”¹ See also *Pennsylvania School Boards Ass’n, Inc. v. Com., Public School Employees’ Retirement Bd.*, 580 Pa. 610, 627, 863 A.2d 432 (2004) (noting “Retirement Code specifically provides that the Board, which is a legislative creation, stands in a fiduciary relationship to PSERS members”).

Based on the above, Board members owe a duty solely to PSERS’ beneficiaries which includes protecting the investments and disbursements of the PSERS’ fund. This inherently requires that the Board oversee management’s conduct consistent with PSERS’ Ethics Policy. Indeed, while the Board can charge management with the responsibility and authority to act on behalf of the Board, and can rely on the advice and recommendations of management that appear reasonable and proper in the eyes of the Board, it cannot delegate or relinquish to management the Board’s fiduciary obligations owed to PSERS’ members. See Ethics Policy of the Commonwealth of Pennsylvania Public School Employees’ Retirement Board at § 3(r)(1) (Section entitled “Board Oversight of PSERS’ Management and Staff” and providing, in part, “[i]f the Board determines that the Office of the Executive Director’s ability to faithfully serve PSERS’ interests has been compromised, the Board may initiate corrective actions that temporarily circumvent the compromised individual(s) in the Office of the Executive Director”).²

B. The Board Is Required To Act If Management Is Not Furthering The Beneficiaries’ Interests

As noted above, the Board is statutorily obligated to invest, disburse, and manage the PSERS’ fund for the exclusive benefit of PSERS’ beneficiaries. As trustees of the PSERS’ fund, and in accordance with their fiduciary duties to PSERS’ beneficiaries, Board members are required at all times to act in furtherance of the beneficiaries’ interests. See *In re Paxson Trust I*, 893 A.2d 99, 119 (Pa. Super. 2006) (“Case law makes it clear . . . that trustees must act in favor of the beneficiaries of the trust.”); *Estate of McCredy*, 323 Pa. Super. 268, 290, 470 A.2d 585, 597 (1983) (“In general, ‘[t]he trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary.’”). In Pennsylvania, a “fiduciary is required to use such common skill, prudence and caution as a prudent man, under similar circumstances, would exercise in connection with the management of his own estate.” *Dardovitch v. Haltzman*, 190 F.3d 125, 150 (3d Cir. 1999).

Because the Board “shall possess the power and privileges of a corporation,” see 24 Pa.C.S. § 8501(e), Pennsylvania’s statutory framework for corporate governance is instructive. Pursuant to 15 Pa.C.S. § 1712(a), “[a] director of a business corporation shall stand in a fiduciary relation to the corporation and shall perform his duties as a director, including his duties as a member of any committee of the board upon which he may serve, in good faith, in a

¹ A copy of the Statement of Organization, Bylaws, and Other Procedures can be found here: <https://www.psers.pa.gov/About/Board/Documents/Governance%20Manual/Statement%20of%20Organization,%20Bylaws,%20and%20Other%20Procedures.pdf>.

² A copy of the Ethics Policy can be found here: <https://www.psers.pa.gov/About/Board/Documents/Governance%20Manual/Ethics%20Policy.pdf>.

manner he reasonably believes to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.” Board members of nonprofit corporations are held to a similar standard. See 15 Pa.C.S. § 5712(a).

Importantly, when carrying out their fiduciary duties, Board members are “entitled to rely in **good faith** on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by any of the following: (1) One or more officers or employees of the corporation whom the director **reasonably believes** to be reliable and competent in the matters presented. (2) Counsel, public accountants or other persons as to matters which the director reasonably believes to be within the professional or expert competence of such person. (3) A committee of the board upon which he does not serve, duly designated in accordance with law, as to matters within its designated authority, which committee the director reasonably believes to merit confidence.” See 15 Pa.C.S. § 1712(a)(1)-(3) (emphasis added). See also 15 Pa.C.S. § 5712(a)(1)-(3) (providing same for director of nonprofit corporation).

With that said, however, Board members should not—and, in fact, cannot—blindly or unreasonably accept management’s and management’s experts’ information, opinions, reports, or statements. Doing so would vitiate the statutory and common law duties owed by Board members to PSERS’ beneficiaries because Board members have an ongoing duty and obligation to oversee management, and also must have confidence that they can reasonably and in good faith rely on what management advises the Board, including about the nature and weight of investments. If the Board reasonably believes that management is not furthering PSERS’ beneficiaries’ interests, their statutory obligations and common law duties, and PSERS’ Ethics Policy’s express language, require that the Board take some form of action which would include termination of management.

Additionally, by failing to take action against management in light of knowledge that management is not furthering PSERS’ beneficiaries’ interests, Board members may subject themselves to liability. Pennsylvania follows the business judgment rule, which “insulates an officer or director of a corporation from liability for a business decision made in **good faith** if he is not interested in the subject of the business judgment, is **informed** with respect to the subject of the business judgment to the extent he **reasonably** believes to be appropriate under the circumstances, and **rationaly** believes that the business judgment is in the best interests of the corporation.” *Linde v. Linde*, 220 A.3d 1119, 1143 (Pa. Super. 2019) (original emphasis omitted; emphasis added). Board members do not act in good faith when they have “knowledge concerning the matter in question that would cause [their] reliance to be unwarranted.” See 15 Pa.C.S. §§ 1712(b), 5712(b).

We understand that the Board recently received certification of PSERS’ fund’s 9-year investment returns which underperformed the statutory shared-risk threshold. The underperformance, of course, adversely affects PSERS’ beneficiaries, and the Board has statutory and fiduciary obligations to take action to mitigate any future detriment to the beneficiaries’ interests. Assuming that the underperformance is a result of management’s directions and recommendations to the Board, management should be terminated in that the Board can no longer reasonably and justifiably rely on management.³

³ It is our understanding that it is the opinion of some Board members that management has mishandled its relationship with the Board and has restricted the Board’s oversight over management. While the underperformance

Footnote continued on next page

Further, we understand that the Board has already retained a third-party investment advisory firm arising out of concerns about the calculation of the investment returns number and impact on risk sharing for PSERS' beneficiaries (irrespective of the cause for the apparent miscalculation of the returns number). This action may be interpreted to underscore the loss of faith by some members of the Board in management and the need for prompt attention to the ongoing relationship with management.

III. Conclusion

Board members owe an unmistakable fiduciary duty to PSERS' beneficiaries. In discharging that fiduciary duty, Board members must act solely to further the beneficiaries' interests which includes preserving PSERS' fund, ensuring adequate growth of PSERS' fund, and preventing burden on the beneficiaries. Although Board members are permitted to rely on management and management's experts with respect to recommendations on investment strategy, once Board members are aware that management is underperforming, Board members are permitted—and, in fact, are required—to take action including terminating management.

We are aware that there may be a suggestion that the decision to terminate management is related to an internal Board-directed investigation or a federal grand jury investigation. Those two issues have no impact on the above opinions. The PSERS' fund is substantially underperforming, and continued underperformance only causes further detriment to PSERS' beneficiaries. The Board should not—and cannot—knowingly permit continued mismanagement of PSERS' fund's investment strategy, and must have the ability to restore its faith in a competent management upon whom it can reasonably rely when discharging its fiduciary obligations.

and resulting loss of confidence in management, alone, are sufficient grounds for requiring the Board to take action, this additional conduct, if true, only furthers the conclusion that the Board must take immediate action with respect to management or face scrutiny that the Board unreasonably and unjustifiably relied on management.