

# Fiduciary Duties & Business/Legal Diligence in Investment Transactions

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September 14, 2023



# Agenda

Board's Fiduciary Duty

Delegation of Fiduciary Duty

SBCERA's Business Due Diligence

SBCERA's Legal Due Diligence

# Trustees as Fiduciaries

Article XVI, Section 17 of the California Constitution grants retirement boards sole and exclusive fiduciary responsibility over the assets, management, and investment of public pension funds to provide benefits and services to participants.

# Trustees as Fiduciaries

Government Code Section 31595 governs the Board's Standard of Care under California law regarding its investment duties.

- The Board has exclusive control of the investment of the employees' retirement funds;
- Discharge its duties solely in the interest of, and for the exclusive purposes of providing benefits to, participating and their beneficiaries, minimizing employer contributions, and defraying reasonable expenses of administering the system;
- Care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity;
- Diversify the investments of the system so as to minimize risk of loss and to maximize the rate of return.

# Trustees as Fiduciaries

## Prudent Fiduciary with Experience (Rest. 3d Trusts, secs. 77, 227)

- Trustee has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust.
- The duty of prudence requires the exercise of reasonable care, skill, and caution, and the obligation to educate oneself as to the core activities of the retirement system and matters on which the trustee's board has authority and responsibility.
- If the trustee possesses special facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill, such as the skills required of appointed and ex officio members (although other trustees are not required to defer to the special expertise of co-fiduciaries).

# Fiduciary Duty of Care:

## The “Prudent Fiduciary with Experience”

Skill required of trustees, standard is objective, not subjective to the trustee.

- The “prudence standard is ‘not that of a prudent lay person, but rather that of a prudent fiduciary with experience dealing with a similar enterprise’.” *Whitfield v. Cohen*, 682 F. Supp. 188, 194 (S.D.N.Y. 1998) (quoting *Marshall v. Snyder*, 1 Empl.Ben. Cases (BNA) 1878, 1886 (E.D.N.Y. 1979)).
- Courts may probe the thoroughness of a fiduciary’s analysis and basis for its decisions, rather than simply deferring to a determination that a fiduciary may make. See *Howard v. Shay*, 100 F.3d 1484, 1488 (9th Cir. 1996), cert. denied, 520 U.S. 1237.

# Fiduciary Duty of Care:

## Duty to Monitor, Question and Address

- The duty to monitor and take corrective action when reasonably appropriate is fundamental to a trustee's exercise of the duty of care.
- Prudence is forward-looking and must adapt to changing circumstances:

“Trust investment law should reflect and accommodate current knowledge and concepts. It should also avoid the mistake of freezing its rules against future learning and developments.”

Rest. 3d Trusts, § 227, p. 14 (1992), comment d; *Tibble v. Edison, Int'l.*, 575 U.S. 523, [135 S. Ct. 1823, 191 L. Ed. 2d 795 \(May 18, 2015\)](#) (“Tibble I”)

# Fiduciary Duty of Care:

## Duty to Monitor, Question and Address

- "Under trust law, a trustee has a continuing duty to monitor trust investments and remove imprudent ones . . . separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset."
- "[A] trustee cannot assume that if investments are legal and proper for retention at the beginning of the trust, or when purchased, they will remain so indefinitely. Rather, the trustee must 'systematic[ally] conside[r] all the investments of the trust at regular intervals' to ensure that they are appropriate."

*Tibble v. Edison Int'l*, 843 F.3d 1187, 1197 (9<sup>th</sup> Cir. 2016) (quoting A. HESS, G. BOGERT & G. BOGERT, LAW OF TRUSTS AND TRUSTEES § 684, 145-46 (3d ed. 2009)) ("Tibble II")

# Fiduciary Duty of Loyalty: Exclusive Benefit and Primary Duty Rules

- Except as otherwise provided in the terms of the Trust, a Trustee has a duty to administer the Trust solely in the interest of the beneficiaries, or solely in furtherance of the Trust's purpose.
- Except in discrete circumstances, the Trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict, or potentially the appearance of a conflict, between the Trustee's fiduciary duties and personal interests.

Rest. 3d Trusts, sec. 78.

# Fiduciary Duty of Care: Consult with Experts

“To the extent necessary or appropriate to the making of informed investment judgments by the particular trustee, care also involves securing and considering the advice of others [such as legal and investment internal and external experts] on a reasonable basis.”

Rest. 3d Trusts, § 227, p. 15, comment d.

# Fiduciary Duty of Care: Consult with Experts

Complexity of the topic and good governance support delegation to experts.

- **Prudence** is the key to delegation as to all aspects of the topic:
  - Whether to delegate
  - How to delegate
  - To whom a task is delegated
  - How to supervise

# Fiduciary Duty of Care: Prudent Delegation

- Proper delegation requires application of the duty of care:
  - Duty to select appropriate delegates
  - Duty to monitor delegates
  - Duty to ensure delegates have adequate information and resources
  - Duty to impose standards of care and loyalty upon delegates
- Reliance on expert's opinion is reasonable when:
  - Expert has appropriate qualifications;
  - Expert has accurate and full information; and
  - Reliance on expert's opinion is reasonable under the circumstances
- Prudent fiduciaries should question methods and assumptions that don't make sense

# Prudent Delegation: Identifying Investment Opportunities

Delegation includes relying on Investment Staff working with the Investment Consultant to identify opportunities for the Investment Committee and Board to consider based on:

- Substantial research: fund performance, investment terms, fundraising related information, top quartile results, firm stability, turnover, changes in strategy over time
- Assessment of suitability investment for portfolio
- Reference checks, in-person and/or virtual interviews, on-site meetings

Must include disclosure of potential sources of conflicts, such as existing relationships with managers and related party transactions by managers

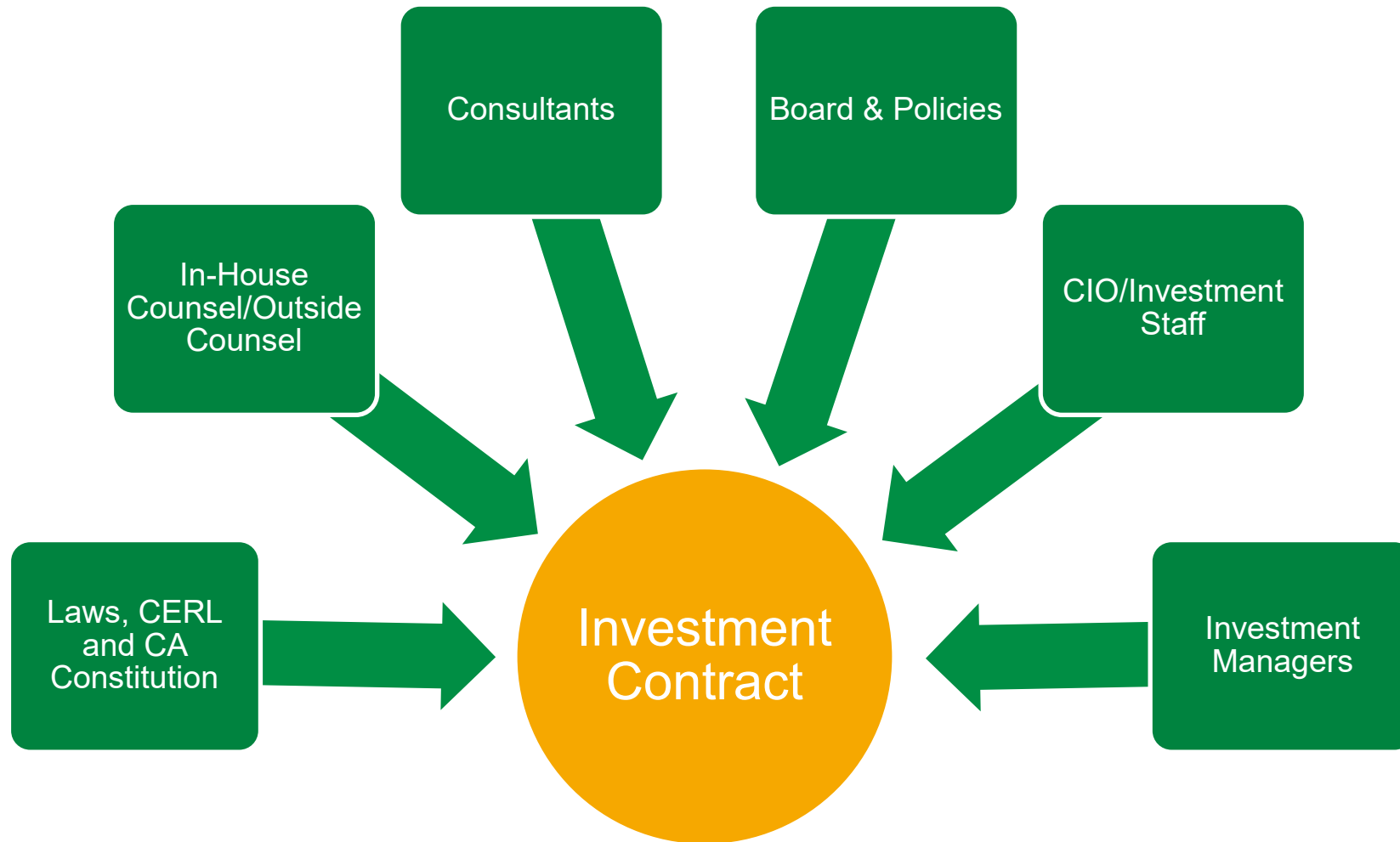
# Prudent Delegation: Monitoring of Investments

Delegation includes relying on Investment Staff working with the Investment Consultant to monitor investments the Board authorized and report on performance.

- Regular and detailed performance reviews
- Identification of any material changes in performance, changes in key personnel, civil or criminal investigations, or economic or geopolitical changes that may warrant Investment Committee action
- Cost-conscious and risk-adjusted-return focused management “not only in making investments but also in monitoring and reviewing investments” [Rest. 3d Trusts, § 90(c)(3); *see also id.* § 88.]

The Board hires an Investment Consultant to work closely with the Investment Staff.

# Investment Contracts: Business and Legal Considerations and Negotiations





# Delegation to Experts

## Board's Assignment of Investment Responsibilities

- Chief Executive Officer
- Chief Investment Officer
- Investment Staff
- Investment Consultants
- Operational Diligence Consultant
- Chief Counsel
- Outside Investment Counsel



# Process of Business Due Diligence

- Interview manager (phone, in person, onsite and virtual)
- Review marketing materials
- Conduct independent research (review specialized databases for performance, investment terms, fundraising, quartile results, firm stability, turnover, management team, and changes strategy over time)
- Reference and background checks
- Third party operational diligence
- Investment consultant

# Business Due Diligence

- Uncover, minimize and allocate potential risk
- Assess and quantify risk of exposure
- Evaluate efforts to mitigate risk
- Check compliance with law and requirements
- Understand investment strategy
- Establish level of comfort with manager
- Monitor (frequently and regularly) performance, compliance and trigger events



## Legal Due Diligence – Counsel’s Focus

- Review business diligence and recommendations
- Conduct independent review of legal terms
- Information gathered (good and bad) during diligence will guide legal negotiations
- Confirm business and legal terms are market
- Confirm manager’s representations are adequately documented
- Confirm sufficient legal protections in event of non-performance
- Establish compliance with applicable laws, policies and procedures
- Understand risks and limitations on liabilities on damages

# Legal Considerations Under California Law

Based on statutes, policy or established practice

## Reporting Requirements

- Ralph M. Brown Act (Cal. Govt. Code § 54950)
- California Government Code Section 7514.7
- California Public Records Act (Cal. Govt. Code § 7920)

## Placement Agent Disclosures

- California Government Code Section 7513.85
- California Ethical Guidelines
  - SBCERA Conflict of Interest Code
  - Government Code 1090

# Legal Considerations Under California Law

- Sovereign Immunity
- Governing Law
- Indemnification and Exculpation
- Transactions With Executive Staff and Trustees
- Venue and Jurisdiction
- No Waiver of Jury Trials
- Gifts Policy
- Tax Exemption Status
- Personal Identifiable Information

# Common Legal Diligence Issues

Examples of common issues that arise in the course of legal due diligence include:

- Negotiation of indemnification/exculpation provisions
- GP change of control or transfer of ownership
- Conflicts and related parties/affiliated transactions
- Fund expenses vs GP expenses
- Oversight over co-investments, allocation of opportunities, continuation funds
- Statutory concerns for public pension systems

# Fiduciary Duties Post-Closing

Fiduciary duty to monitor after closing and during term of investment

- LPAC membership and duties
- Request for investor consents
- Proposed transfer of ownership or change in control
- Secondary sales
- Liquidation (e.g., term extensions, continuation funds)

Reminder: prudent fiduciary decision-making is process-oriented. What may be prudent for one investment may not be so for another, and vice-versa. Documentation and process are key.

# Questions?

