

MAINE STATE LEGISLATURE

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81-79A

JAMES E. TIERNEY
ATTORNEY GENERAL



STATE OF MAINE
DEPARTMENT OF THE ATTORNEY GENERAL
AUGUSTA, MAINE 04333

October 8, 1981

Robert Bourgault, Chairman
Board of Trustees
Maine State Retirement System
State House Station #46
Augusta, Maine 04333

Dear Chairman Bourgault:

The Board of Trustees of the Maine State Retirement System has requested an opinion from this Office on the question of the legality of the Board's investment of System funds in low-cost mortgages for System members.^{1/} The issue raised by this request is whether the prudent man rule permits the Board to consider the social utility of an investment in deciding whether the investment should be made.^{2/}

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- 1/ We do not address in this opinion any of the problems which may arise in establishing a structure and a procedure for making Maine State Retirement System funds available to members for low-cost mortgages, such as whether and how the System may be a direct lender. Nor do we address your second question: whether mortgages may be offered to members of the System at lower than market rates. While it appears from our review of the law in this area that there is no express prohibition of such a practice, it may be advisable to address this problem legislatively.
- 2/ We do not consider a second and related question: whether the Board would violate the common law duty of undivided loyalty to the trust by making the proposed investments. While the question is not altogether clear, we assume that this duty applies to the Trustees. Our research also indicates some doubt as to whether the duty of loyalty would be violated by the proposed transaction. See J. Langbein & R. Posner, Social Investing and the Law of Trusts, 79 Mich. L. Rev. 72, 97, n. 39 (1980), citing the Restatement and other authorities. Since legislation appears to be necessary to establish the program proposed by the Board, any problem as to the duty of loyalty can be addressed by the Legislature.

Conclusion

We think that the proposed investments should not be made without express legislative authorization. Under neither the traditional narrow interpretation of the prudent man rule nor a broader modern view may the social benefit of an investment be considered by trustees in determining its prudence. Under both versions, the financial soundness of the investment must first be evaluated; only after a particular investment is determined to be prudent may the social utility of the investment become a factor.

For a number of reasons, not the least of which is lack of financial expertise, we obviously cannot make a determination of the prudence of the proposed investment. The fact that its social utility cannot be considered in the prudence equation, however, suggests that there is a substantial risk that it will not comply with either interpretation of the rule.^{3/} In light of this risk, we think the better course would be to seek a statutory amendment authorizing the Board to undertake the proposed scheme.

Analysis

The prudent man rule in Maine is crystallized in statute at 18-A M.R.S.A. § 7-302, which reads, in pertinent part, as follows:

. . . [T]he trustee shall observe the standards in dealing with the trust assets that would be observed by a prudent person dealing with the property of another. . . .

This is a somewhat modernized version of the traditional rule which was stated in 18 M.R.S.A. § 4054 (now repealed) as follows:

In acquiring, investing, exchanging, retaining, selling and managing property for the benefit of another, a fiduciary shall exercise the judgment and care under the circumstances then prevailing, which men of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.

Other statements of the rule may be found in the cases and the substantial commentary, but they do not differ greatly from these formulations.

^{3/} This risk is not merely speculative, given the desire of the Trustees that the mortgages under this plan be made at lower than market rates.

The prudent man rule establishes an objective standard by which trustees' investments may be measured. It does not mandate or prohibit any given investment but provides a way of determining whether a specific investment is proper for a trustee. Thus, while it has been stated generally that an investment in first mortgages is prudent, see III Scott on Trusts, § 227.5 (3d ed. 1967) [hereinafter cited as Scott], neither mortgages nor any other investments can be considered per se prudent.^{4/}

For the purpose of this opinion, it is the requirement of caution in investing trust funds which concerns us.^{5/} This aspect of the rule of prudence may be generally stated as requiring that a given investment produce an adequate return and not risk loss to the corpus of the trust. See Scott, § 227.3 at 1811; 18 M.R.S.A. § 4054 (now repealed). This traditional interpretation of the prudent man rule would not be violated, assuming the mortgages are adequately secured, if the proposed investments generated a return equal to that of other investments currently available by the Board (taking into account, of course, the additional administrative and other costs to the System which will be generated either directly or indirectly by a mortgage subsidy program).^{6/} As noted above, mortgages are generally considered to be appropriate investments for trustees and, if their return was comparable to that of other investments now being made, the requirement of the rule would be satisfied.

^{4/} In some states, specific investments are statutorily designated as proper for trustees. Even in these cases, however, an independent analysis of the prudence of individual investments may be required depending on the statutory language. See, e.g., Withers v. Teachers' Retirement System, 447 F. Supp. 1248, 1254 (S.D. N.Y. 1978) (investment from statutory list must still be evaluated under rule).

^{5/} The other two elements of the rule - the requirements of care and skill in investing, see generally Scott, §§ 227, 227.1, 227.2 - will not be addressed herein. Since these elements must be applied on a case-by-case basis - in the case of mortgages, to each particular one or in the formulation of rules and regulations for the administration of a proposed program - we mention them only in passing and assume, for purposes of the analysis of this opinion, that they would be fulfilled.

^{6/} This conclusion assumes that the current investments of the Board comply with the rule.

A problem would arise if the investment scheme required to create a low-cost mortgage program for M.S.R.S. members could not produce an adequate return or create an inordinate risk of loss to the corpus. Under the traditional approach to the prudent man rule, where each investment is considered on its own merits, it is difficult to avoid the conclusion that an investment such as the one proposed, which did not provide a return within the general range earned by other trust investments and/or where the risk factor was beyond reasonable bounds, would be imprudent. Courts would not consider any other criteria in assessing the investment. See, e.g., Mattocks v. Moulton, 84 Me. 545 (1892).

A more relaxed view of the prudent man rule has recently been suggested by a number of commentators. J. Hutchinson & C. Cole, Legal Standards Governing Investment of Pension Assets for Social & Political Goals, 128 U. Pa. L. Rev. 1940 (1980) [hereinafter cited as Hutchinson & Cole]; R. Ravikoff & M. Curzan, Social Responsibility in Investment and the Prudent Man Rule, 69 Calif. L. Rev. 518 (1980) [hereinafter cited as Ravikoff & Curzan]; but see contra J. Langbein & R. Posner, Social Investing and the Law of Trusts, 79 Mich. L. Rev. 72 (1980) [hereinafter cited as Langbein & Posner]. The most persuasive of these sources has suggested an approach based largely on the fiduciary standards promulgated by the Department of Labor governing the Employees Retirement Income Security Act (ERISA). See Hutchinson & Cole at 1353-57. Under this analysis, risk and return are not the only investment goals which may be considered by a trustee. Instead, the investment is analyzed from the standpoint of its effect on and its purpose in the whole investment portfolio, and an investment may sacrifice return or corpus safety if it furthers the trust's investment plan in other ways, such as increasing liquidity or diversification. Hutchinson & Cole at 1356; see 29 C.F.R. § 2550.404a-1.

For purposes of your inquiry, this proposed interpretation of the prudent man rule differs very little from the traditional view of the rule. Under both constructions, the primary consideration of the trustee is the financial soundness of the investment. See Hutchinson & Cole at 1356. While the newer view permits consideration of more and different financial factors, it does not differ from the traditional formulation in excluding the social utility of an investment as a proper concern of the trustees. Id. at 1357. Only when a number of investments present equal financial attractiveness may the trustees favor the socially useful investment. Thus, this so-called new analysis helps very little in determining the propriety of social investments. It

merely enlarges the pool of investments which will be acceptable from the perspective of financial soundness.^{7/} In light of this analysis of the newer reading of the prudent man rule, it seems clear that, even if this interpretation is adopted by the Maine courts, an unlikely proposition in our view,^{8/} its application would make little difference in analyzing the prudence of the proposed investment scheme, and, in any event, it would not justify the Board's consideration of non-financial factors in evaluating the prudence of the investment.

While there may be factors militating in favor of a finding that the proposal would constitute a prudent investment - for example, that it would provide benefits directly to present and future beneficiaries of the trust - the analysis in this opinion raises serious uncertainties as to the propriety of the Trustees' investing in low-cost mortgage for System members under the present statute. In this light, it would seem to be far the wiser course

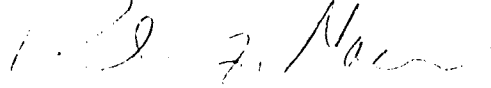
^{7/} The Hutchinson & Cole approach represents the middle of a spectrum of analyses of the commentators who have recently addressed the question of the propriety of social investing. At the extremes are Ravikoff & Curzan, who suggest, unpersuasively, that certain social investments will be approved by the courts based on the "other benefits" which they provide; and Langbein & Posner, who take the view, as a result of a very complex economic analysis, that social investing will always result in inadequate diversification and will therefore violate the trustee's duty.

^{8/} It is unlikely that the approach suggested by the newer commentators can or will be applied to the investment by the Maine State Retirement System in low-cost mortgages for its members. A number of factors militate against the acceptance of the more modern rule in this case. First, the primary guideline in the new approaches is the ERISA regulations, which are inapplicable to public pension plans such as the Maine State Retirement System. Further, no court to our knowledge has adopted such a relaxed view of the prudent man rule and, as indicated earlier, disagreement has been expressed by other commentators as to the correctness of the new approach. In addition, the "whole portfolio" view described above is contrary to the traditional practice of analyzing the prudence of each individual investment. See Scott, § 227.

to seek prior legislative approval of the proposed investment plan by amendment of the relevant statute. Addressing the problem in this way would eliminate the significant uncertainties discussed herein and would also provide clear⁹/ authority and consensus for the establishment of the plan.

If you have any further questions, please feel free to contact this office.

Very truly yours,



PAUL F. MACRI
Assistant Attorney General

PFM:mfe

9/ It should be noted that at least one state which has set up a mortgage plan similar to that proposed by the Board has addressed by legislation problems similar to those analyzed herein. Conn. Pub. Act. No. 81-343.