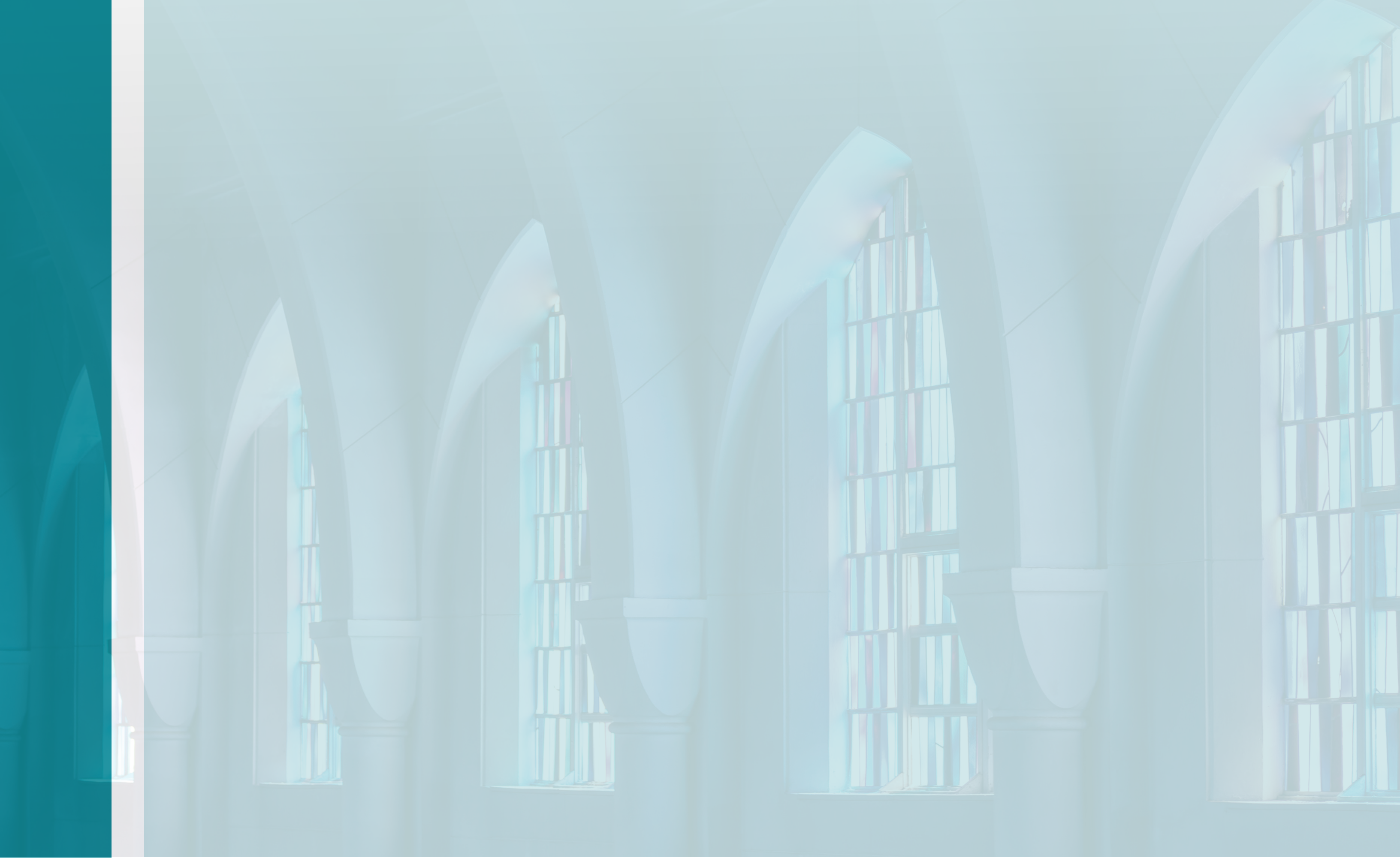
Faith-Based Investing:
CONSIDERATIONS FOR CHURCH PLAN FIDUCIARIES



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INTRODUCTION

Retirement plan fiduciaries have frequently been the target of class action litigation in which participants allege that the plans' fiduciaries violated their fiduciary duties owed to plan participants by offering poorly performing or unreasonably expensive investment options and by entering into agreements that allowed plan recordkeepers and investment providers to receive excessive fees. With two notable exceptions, discussed below, these lawsuits to date have involved retirement plans that are subject to the Employee Retirement Income Security Act of 1974 (ERISA).

ERISA contains its own definition of the term "fiduciary" and describes in some detail the duties that apply to ERISA fiduciaries and the prohibited transaction rules to which they are subject.[1] But what about retirement plans that are not subject to ERISA, such as one that meets the church plan definition set out in ERISA section 3(33)? Who is a fiduciary of a church plan, and are these individuals subject to any fiduciary rules? If so, what are they? Then there is the question that is the focus of this paper: How do applicable fiduciary rules apply if a church or church-affiliated employer exercises its constitutionally protected right to invest the assets of its church plan in a manner that is consistent with the church's or the employer's religious faith and belief?

Faith-Based Investment Screening

Many retirement plans that qualify as church plans impose some type of investment restriction or screening on their plan assets. Some churches and conventions or associations of churches may restrict investments in certain types of activities which are inconsistent with their particular faith and belief, such as restrictions on investing in companies known for producing alcohol, tobacco, abortifacients, military defense products, pornography or providing gaming facilities.[2] These restrictions and screens, in whatever form they take, are referred to in this paper as "faith-based investing."

Following a brief discussion of issues raised by ERISA fiduciary litigation, this paper examines the fiduciary rules that apply to a retirement plan that is a church plan exempt from ERISA. We then discuss two cases that squarely addressed fiduciary duty issues in the context of faith-based investing — and how certain First Amendment protections applied in those cases. We then conclude by providing several "takeaways" and "best practices" that plan sponsors and fiduciaries of church plans should consider to help protect themselves against a lawsuit filed by a plaintiffs' law firm, alleging that faith-based investing generated a fiduciary duty breach.

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ERISA Fiduciary Litigation

Though not the focus of this paper, we believe it is important for church plan fiduciaries to be aware of the ERISA fiduciary litigation regarding investment selection and fee monitoring, as it is possible that allegations related to faith-based investing could be combined with the claims most often seen in those cases. The first wave of such lawsuits was filed in 2006 and involved some of the country's largest plans and employers. While these lawsuits generally targeted for-profit employers, the plaintiffs' firms turned their focus in 2016 to many of the country's most prestigious universities — most of which are not-for-profit entities — and their 403(b) retirement plans. Class action litigation against all types of employers and plans has continued to increase at a startling pace. While most lawsuits involve very large plans, there is a trend toward smaller plans also being targeted.

What allegations are generally involved in ERISA fiduciary litigation?

While these lawsuits involve many different claims, the allegations generally involve the following questions:

- Was the fiduciary prudent in the selection and monitoring of investment funds offered in the plan?
- Was the fiduciary prudent in the selection and monitoring of service providers (generally, recordkeepers) and the fees paid to them from plan assets?
- Did the fiduciary act out of self-interest in selecting an investment option, a plan advisor or a recordkeeper (e.g., was there a relationship independent of the plan that influenced the fiduciary's decision)?

While there have been relatively few of these cases that have been tried on the merits, plaintiffs have had considerable success in extracting significant settlements (along with significant attorney fee awards) in many of these cases. This is particularly true when the plaintiffs have been able to survive a motion to dismiss because there are questions of fact that must be more fully developed through costly discovery.

Though this paper is focused on fiduciary considerations related to faith-based investing, this is only one of many issues to be considered by plan fiduciaries. Following are **a few best practices that plan fiduciaries should keep in mind,** as shown by the ERISA litigation discussed above:

- Clearly identify the individuals or groups who have fiduciary responsibilities.
- Meet regularly and document the actions taken and information considered by plan fiduciaries.
- Understand the manner in which service providers are compensated and periodically confirm that such compensation is reasonable for the services provided.
- Regularly review the performance and expenses of the plan's investment options and document the rationale for investment option selection and removal.
- Be aware of relationships both with the plan and the plan sponsor that could give rise to conflicts of interest and self-dealing issues.

Church Plan Fiduciary Duties

As noted above, church plans are exempt from ERISA and its many requirements, including the ERISA fiduciary duty rules — which is commonly viewed as a good thing. However, ERISA also contains a special rule that preempts the application of state laws that "relate to" employee benefit plans covered by ERISA. Because church plans are not subject to ERISA, they do not get the benefit of ERISA preemption — thus church plan fiduciaries must examine state laws and what is referred to as "the common law of trusts" to ascertain potentially applicable fiduciary duties.

How is "fiduciary" defined under state law?

The "fiduciaries" of a church plan would be individuals who are considered to be such under common law principles. As a general proposition, a church plan fiduciary would thus, in all likelihood, include any person who owes plan participants a duty to act in their best interest. This would typically include the trustee or trustees of a retirement trust associated with the church retirement plan and any other individual who is responsible for selecting plan investments or engaging the plan recordkeepers and investment providers (such as the members of an "administrative committee" or similar group).[3]

What state laws could affect church plan fiduciary duties?

There are several types of state laws that could potentially define church plan fiduciary duties, but, as a threshold matter, it must be determined which state's statutes need to be reviewed, using choice of law principles. Fortunately, that issue can generally be resolved by stating in a retirement plan's governing documents (trust agreement and plan documents) that the laws of a particular state (typically the state in which the employer sponsoring the plan and creating the trust is located) apply for resolving issues involving the trust. This choice of law principle has the helpful result of making it clear that only the fiduciary laws of one state must be considered in determining a church plan fiduciary's duties. But what are those laws?

Uniform Prudent Investor Act

In 1994, the Uniform Law Commission released the Uniform Prudent Investor Act (UPIA), which establishes the duties imposed on trustees in managing a trust.[4] The UPIA has been adopted in all states and U.S. territories other than New York, Pennsylvania, Kentucky, Louisiana and Puerto Rico. The principal fiduciary duties imposed under the UPIA that need to be considered in addressing the issue with which this paper is concerned are the Duty of Prudence and the Duty of Loyalty.[5] Of importance, the UPIA permits the settlor or creator of a trust to carve out certain actions by a trustee that will not be subject to the Duties of Prudence or Loyalty by including a specific waiver of such duties with respect to such action in the trust agreement.[6]

Other State Laws to Consider

Other state laws that should be reviewed in connection with identifying a church plan fiduciary's state law duties include a state's trust code[7], if any, and a state's nonprofit corporation law (which may exempt the members of a nonprofit corporation's board of directors or trustees from liability for their actions or inaction unless such actions (or inaction) rise to the level of gross negligence or willful misconduct). Plaintiffs' attorneys may even allege that the actions taken by the plan fiduciaries violated a state's consumer protection laws.

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The Restatement of Trusts

The Restatement of Trusts (Restatement) is commonly viewed as representing the prevailing view of the so-called "common law of trusts" evidenced in court decisions dealing with issues involving trusts and trustees.[8] The Restatement distinguishes between certain "core" fiduciary duties and those that are considered only to be "ancillary" to the trust relationship. The Duties of Loyalty and Prudence are both stated to be core duties in the Restatement and are the duties that affect the analysis of the faith-based investing issues considered herein.[9]

Duty of Loyalty

The Duty of Loyalty as defined in both the UPIA and the Restatement requires a fiduciary (a trustee, in the case of the UPIA) to invest and manage the assets of a trust solely in the interest of the trust's beneficiaries.[10] Without modification, this rule would preclude a fiduciary from considering the interests of another party in administering the trust and managing its assets — for example, by taking into account the interests of a church or church-affiliated employer in making sure that retirement plan assets are invested in accordance with the church's or the employer's faith and belief. However, as noted above, both the UPIA and the Restatement permit a settlor to modify the Duty of Loyalty by explicitly doing so in the trust agreement[11] – for example, by providing that the trust assets must be invested in accordance with such faith and belief.[12]

Duty of Prudence

The Duty of Prudence generally requires a trustee or other fiduciary to invest and manage a trust's assets as a prudent investor would, in light of the purposes, terms, distribution requirements and other circumstances of the trust.[13] However, like the Duty of Loyalty, both the UPIA and the Restatement permit the Duty of Prudence to be expanded, restricted or even eliminated by the settlor's making provision for such a change in the trust agreement.[14] This would include a requirement in a retirement plan's trust agreement that plan assets be invested in accordance with denominational faith and belief and an exoneration of church plan fiduciaries for following this directive.

Duty to Follow the Plan and Trust Documents

One final duty that deserves mention is the duty of a church plan fiduciary to follow the terms and conditions of the plan and trust documents. Both the UPIA and the Restatement require a trustee to administer the trust agreement in accordance with its terms.[15] This requirement on its face means that a church plan fiduciary must follow a directive in a trust agreement that plan assets be invested in a particular way. However, this provision also can be a trap for the unwary if, for example, an ERISA fiduciary requirement is referenced in the trust document as being applicable under the trust agreement. The fact that a church plan is not subject to such a requirement would not avoid its application to a trustee or other fiduciary if the terms of the trust agreement impose it.

First Amendment and Religious Freedom Restoration Act Protections

Any limitation or restriction on a church's or church-affiliated organization's implementation of faith-based investment screening of its retirement plan assets must be viewed through the lens of the First Amendment and the Religious Freedom Restoration Act (RFRA).[16] The Free Exercise Clause of the First Amendment of the U.S. Constitution protects a person's right to exercise their religion of choice and prohibits government regulations that target their religious beliefs. The First Amendment protects not only religious beliefs but also religious practice. The Free Exercise Clause prevents the government from compelling religious belief, punishing religious expression or imposing rules and regulations that favor one religion over another.

First Amendment Protections

But does the First Amendment offer protection against laws that are neutral on their face with respect to religious expression and are of general application? In a 1963 Supreme Court case, Sherbert v. Verner,[17] the U.S. Supreme Court stated that, if a generally applicable law imposes a religious burden on a person, the government must show a compelling government interest for the law to stand. In 1990, in Employment Division v. Smith,[18] the Supreme Court backed off from its decision in Sherbert and stated that the government need not show a compelling interest in applying generally applicable laws to a specific person, indicating that religious exemptions from generally applicable laws should come via the legislative process. However, prior Supreme Court Free Exercise precedent requiring the showing of a compelling interest by the government continues to apply after Smith where the government action intentionally rather than incidentally burdens religious exercise.

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Religious Freedom Restoration Act

The Religious Freedom Restoration Act was enacted in 1993 in response to the Smith decision. In it, Congress, drawing on prior Supreme Court First Amendment precedent, imposed a heightened standard of review on government actions, including actions that are generally applicable, if they substantially burden a person's religious exercise. Once an individual has established that a substantial burden exists, the government must show that the law in question furthers a compelling governmental interest and that it is the least restrictive means of furthering that interest. RFRA gives individuals a private right of action to pursue claims that a particular governmental law or regulation violates their RFRA-protected rights. Because the Supreme Court ruled that RFRA cannot be constitutionally applied to the states, many states have enacted their own versions of RFRA that apply to their laws, both state-wide and local. RFRA also includes a "Rule of Construction," which states that all federal law enacted after its enactment is subject to RFRA unless Congress specifically states that it will not be applied to a particular law.

The Free Exercise Clause of the U.S. Constitution and RFRA provide church plan fiduciaries with a potent defense if they are ever challenged for making sure that the investments made by their retirement plans reflect their particular faith and belief. We believe there is a strong argument that, under Supreme Court precedent, a restriction on their ability to do that would substantially burden the free exercise of their religious faith. It is then difficult to imagine that the government could show that a law that prevents such a restriction on investments furthers a compelling governmental interest and is the least restrictive means of furthering that interest. This conclusion is borne out in two cases involving this very issue, a discussion to which we now turn.

Portico Litigation

The only reported fiduciary litigation to date involving a church retirement plan relates to two lawsuits involving plans maintained by the Board of Pensions of the Evangelical Lutheran Church in America (referred to herein by its current name — Portico Benefit Services, or Portico).

Basich Case

In **Basich v. Board of Pensions, Evangelical Lutheran Church in America (ELCA),**[19] several Lutheran pastors, a lay employee and a Lutheran congregation filed a lawsuit against Portico and the ELCA alleging breach of contract and breach of fiduciary duty with respect to denominational defined contribution plans. The plaintiffs' claims related to Portico's policy — which reflected the ELCA's opposition to apartheid in South Africa — to divest from (and refrain from making new investments in) companies with South African holdings whenever the conditions of risk and return were equal between stock and bonds held by Portico.[20]

The Minnesota Court of Appeals dismissed the plaintiffs' claims pursuant to the First Amendment of the U.S. Constitution and the Freedom of Conscience Clause of the Minnesota Constitution. Following is a summary of the court's analysis:[21]

- The primary consideration was whether the court's review of the plaintiffs' claims would create "excessive entanglement" between church and state. This analysis required examination of the nature of the intrusion into religious administration, the character and purpose of the involved institutions and the resulting relationship between the religious authority and government.

- The court concluded that any review of Portico's investment policies with respect to South Africa would entangle the court in reviewing ELCA doctrine and policy, based on the following: (i) the highest legislative authority of the Lutheran church directed Portico to implement the divestment policy at issue; (ii) Portico was created to both provide for pastors' retirement needs **and** assist the ELCA in accomplishing doctrinal goals; and (iii) the ELCA enacted the investment policy at issue to further its social and doctrinal goals of opposing apartheid. The court also concluded there were no neutral principles of law that would enable the court to distinguish between investments that Lutheran doctrine would find morally acceptable and those that are morally unacceptable.

- The court also analyzed Minnesota's Freedom of Conscience Clause — which in the court's view affords greater protection for religious liberties than the Establishment Clause.[22] In summary, the court concluded that its review of the case would burden the exercise of a sincerely held religious belief and that the proper forum for adjudicating the grievance was the ELCA's Churchwide Assembly.

Bacon Case

In a separate lawsuit filed years later, **Bacon v. Board of Pensions of the Evangelical Lutheran Church in America,**[23] the plaintiff pastors asserted that Portico selected investments (including certain social purpose funds) that performed poorly relative to other available institutional investments and charged unreasonable fees for administering the plans in violation of its fiduciary responsibilities. This case was filed by the plaintiffs' firm that filed the initial wave of ERISA fee litigation in 2006, and the claims more closely resembled those ERISA litigation claims than the Basich case. The causes of action included breach of fiduciary duty, breach of trust and fraud and concealment related to the administration and management of the Portico plans.

The District Court dismissed the claims, relying heavily on the Basich analysis that its review would create excessive entanglement between church and state. This decision was reversed on appeal, however, as the Minnesota Court of Appeals concluded that many of the allegations were not tied to religious doctrine, and the court generally would not need to adjudicate the validity of doctrinal questions.

The court was clear that an analysis relating to the "social purpose funds" in the Portico plans, which invest in ways that are compatible with the social policies of the ELCA, would result in excessive entanglement and thus violate the First Amendment (which the plaintiffs conceded). However, the remaining claims regarding investment selection and reasonableness of fees were not, in the court's view, tied to religious doctrine or ecclesiastical concern, and were instead based on secular, neutral principles of law. As a result, the court concluded it was possible to adjudicate the claims without reaching the governing religious documents, disturbing a ruling of a governing ecclesiastical body or determining the validity of a doctrinal question.

The Court of Appeals remanded the case to the District Court, and the case settled in 2020. The settlement included an $11 million payment for allocation to participants and a $3.66 million attorney fee award, along with the required implementation of certain procedures related to evaluation of administrative expenses.

The Portico cases illustrate the importance of First Amendment (and potentially state law) protections with respect to a church plan's implementation of faith-based investing, while also serving as a reminder that such protections may only apply to the extent a court concludes that a legal challenge requires an evaluation of church doctrine or governance.

Takeaways and Best Practices for Faith-Based Investing

Though not subject to ERISA's fiduciary duty rules, those responsible for church plan administration and selection of investment funds are potentially subject to fiduciary responsibilities under state trust law. To the extent a church plan fiduciary seeks to utilize plan investments that reflect the faith and belief of the plan sponsor, it is important for the fiduciary to consider how that decision can be consistent with any applicable fiduciary duties. Though it is not possible to prevent all claims or allegations, the following steps[24] can help the plan and its fiduciaries demonstrate that a faith-based investing approach is an extension of the plan sponsor's exercise of religion — and thus should be better protected from a claim that such approach is a breach of any applicable fiduciary duties:

To the extent a church plan fiduciary seeks to utilize plan investments that reflect the faith and belief of the plan sponsor, it is important for the fiduciary to consider how that decision can be consistent with any applicable fiduciary duties.

- To the extent the faith-based investing approach is based on denominational direction or religious values, document that direction as a motivating factor in the fiduciary's investment decisions.

- Establish an investment policy statement that reflects the role of faith and belief in investment decisions.

- Provide clear direction in the investment policy statement (and, when possible, the plan and trust documents) regarding the requirement (if mandatory) or the option (if permissive) to incorporate faith and belief in investment decisions.

- Clearly define the individual or group that is responsible for investment fund selection and include faith-based objectives in a governing charter.

- During the periodic review process for plan investments, monitor whether investment options continue to adhere to desired faith-based limitations and objectives and reflect such monitoring in meeting minutes.

- Communicate the faith-based purpose of the plan to participants. Emphasize that the employer's maintenance of the plan is a part of its religious mission and will be operated in a manner consistent with that concept.

The church plan fiduciary has valuable tools that can help the fiduciary and the plan address challenges relating to faith-based investing. We hope the principles discussed in this paper are useful in assessing the risk of such challenges and the steps that can be taken to best position the plan for a successful response.

[1] Section 3(21)(A) of ERISA defines a fiduciary as a person who exercises any discretionary authority or control over a retirement plan's management or over the management or disposition of the plan's assets. The term "fiduciary" is also defined to include someone who renders investment advice to the plan for a fee or who has any discretionary authority or responsibility for the administration of the plan.

[2] Though not directly applicable to church plans, church plan fiduciaries should be aware of the evolving guidance issued by the United States Department of Labor (DOL) regarding the consideration of environmental, social and governance (ESG) factors (e.g., climate change, board composition and diversity practices) when establishing a retirement plan investment menu. We believe the faith-based investing approach described in this paper can be distinguished from the ESG analysis (though some church plans may consider ESG factors in their investment selection process). An ERISA plan fiduciary must determine whether and to what extent ESG factors — among other factors — can or must be considered within a prudent consideration of investment options. In contrast, the fiduciary of a church plan that utilizes faith-based investing knows that its investment analysis is guided by the underlying faith and belief of the plan sponsor because such influence is prescribed by plan's governing documents and in some cases the specific direction of the church or denomination.

[3] In ERISA litigation, plaintiffs have also asserted that the plan sponsor and the board of directors or other governing body of the plan sponsor are fiduciaries with respect to the alleged duty to monitor the performance of plan fiduciaries and administrative or investment services providers.

[4] The UPIA is only applicable to trustees by its terms, but a state adopting it is free to make it applicable to other fiduciaries as well.

[5] The UPIA also imposes a duty of ensuring that trust asset investments are adequately diversified and that trustees administer their trust relationships in a manner that is impartial — that is, in a manner that does not favor current income beneficiaries over trust principal or remainder beneficiaries.

[6] UPIA § 1(b).

[7] The Uniform Law Commission has also adopted and released a Uniform Trust Code, a version of which has been adopted in 36 states.

[8] The Third Edition of the Restatement of Trusts provides the current statement of this prevailing view and is referred to herein as the "Restatement."

[9] The third core duty is that of impartiality, and like the duty of impartiality found in the UPIA, focuses on a trustee's decision-making in terms of not favoring income beneficiaries over principal or remainder beneficiaries, unless the settlor of the trust has stated otherwise in the trust document.

[10] UPIA § 5; Restatement § 78.

[11] UPIA § 1(b); Restatement § 76 (see comment (b)(2)) and § 78 (see comment (c)(2)).

[12] In addition to the Duty of Loyalty, the *Internal Revenue Code* imposes an "exclusive benefit rule" on Code § 401(a) qualified plans (including 401(k) plans), Code § 403(b)(7) and Code § 403(b)(9) plans. Very generally, the exclusive benefit rule requires that plan assets must be used for the exclusive benefit of plan employees or their beneficiaries.

[13] UPIA §§ 1 and 2; Restatement § 77 and § 90.

[14] UPIA § 1(b); Restatement § 76 (see comment (b)(2)) and § 77 (see comment d), § 90 and § 91.

[15] UPIA § 2(a); Restatement § 76(1).

[16] This section of our paper summarizes an excellent paper prepared by the Congressional Research Service titled "The Religious Freedom Restoration Act: A Primer", published on April 3, 2020. The CRS paper can be located at https://crsreports.congress.gov/product/pdf/IF/IF11490.

[17] 374 U.S. 398 (1963).

[18] 494 U.S. 872 (1990).

[19] 540 N.W.2d 82 (Minn. Ct. App. 1995).

[20] The "South Africa free" investment policy was not applied to all Portico investment funds. Rather, it only applied to investment funds which together made up the default investment options of the plans.

[21] In considering whether the First Amendment of the U.S. Constitution deprived the court of jurisdiction, the court applied a test described in a 1971 U.S. Supreme Court case, Lemon v. Kurtzman, 403 U.S. 602 (1971). The Lemon case established that, for an exercise of governmental authority to be valid under the Establishment Clause of the First Amendment, it must: (i) have a secular purpose; (ii) neither inhibit nor advance religion as its primary effect; and (iii) not create excessive entanglement between church and state. A separate U.S. Supreme Court case, Jones v. Wolf, 443 U.S. 595 (1979), established that a civil court can only hear disputes that can be determined on the basis of neutral principles of law.

[22] In determining whether government action violates the Minnesota Freedom of Conscience Clause, the Basich court examined whether: (i) the objector's belief is sincerely held; (ii) the action burdens the exercise of religious beliefs; (iii) the state's interest is compelling; and (iv) the state action uses the least restrictive means.

[23] No. 15-1999, 2016 WL 3961960 (July 25, 2016).

[24] These recommendations relate to the implementation of faith-based investing. These measures do not eliminate the need for a plan fiduciary to be prudent and diligent with respect to other components of plan administration — such as monitoring service providers and investment options. A few general best practices are included above, but a full discussion of these measures is beyond the scope of this paper.

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Danny Miller is a partner in the Conner & Winters LLP law firm where he heads a national practice that provides advice and counsel to churches and other religious nonprofit organizations with respect to their employee benefit and executive compensation needs. In the church employee benefits area, Mr. Miller serves as outside benefits counsel to a number of Protestant denominations and church conventions or associations, as well as advising Roman Catholic archdioceses and dioceses on their employee benefit issues.

Mr. Miller also from time to time advises the Church Alliance, a coalition of 37 denominational employee benefit programs, in connection with that organization's legislative and regulatory initiatives in Washington, D.C. Mr. Miller has co-authored several amicus briefs in the past few years in connection with a number of lawsuits challenging the church plan status of pension plans maintained by church-affiliated health care organizations, including an amicus brief filed on behalf of the Church Alliance in connection with the U.S. Supreme Court in connection with the *Advocate Health Care v. Stapleton* case decided by the Court in 2017.

Mr. Miller also regularly counsels his clients and their boards of directors on the duties imposed on church plan fiduciaries under applicable state fiduciary laws.

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