

Outline of Possible Interpretative Release by States’
Attorneys General Under
The Uniform Prudent Management of Institutional Funds Act

Introduction.

All fifty states have enacted some version of the Uniform Prudent Management of Institutional Funds Act (“UPMIFA”), which governs the management and investment of funds held by not-for-profit corporations and certain other institutions. When managing and investing the funds they are responsible for, fiduciaries subject to UPMIFA must satisfy a standard of prudence, the basic requirements for which are set forth in the Act. The variations in different state versions of the Act probably do not vary at all in respect of prudence and its discussion here. The Attorneys General of our states are charged with interpreting and enforcing the Act as enacted within their respective jurisdictions.

The approach that institutional investors should take towards investing in the fossil fuel industry and in industries affected by climate change is a question of pressing concern. Recent years have revealed a growing understanding and acceptance of the fact that anthropogenic greenhouse gas (“GHG”) emissions are causing climate change, and of the urgent global need to phase out fossil fuels. The investment risks associated with climate change, and the bright future prospects for clean energy, are increasingly recognized by financial intermediaries, regulatory bodies, and others.¹

There is a need for interpretative guidance for fiduciaries subject to the Act as to how the duty of prudence should be exercised with respect to the rapidly growing climate change risks to the coal, oil, gas and other fossil fuel industries as well as to industries significantly dependent on such sources of energy. An interpretative release by a state’s Attorney General would, of course reflect only the views of that office. As with other statutes, the interpretation of the Act is ultimately a matter for the courts.

¹ See, e.g., GOLDMAN SACHS, THE FUTURE OF CLEAN ENERGY, *The Low Carbon Economy; Key Takeaways from the Paris Agreement*; and *Financing the Future: Capital Innovation and the Clean Energy Industry* (2015), available at <http://www.goldmansachs.com/our-thinking/new-energy-landscape/future-of-clean-energy/index.html>; Dec. 29, 2015 Statement by chiefs of five major North American tire makers, available at <http://www.tirereview.com/five-tiremakers-urge-firm-action-on-climate-change-threat/>.

A. The Prudence Standard.

Section 3 of UPMIFA sets the standard of conduct for fiduciaries managing and investing funds subject to the Act. In subsection (b), the duty of prudence is stated as follows:

“[E]ach person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.”

The language in Section 3 of UPMIFA derives from the Revised Model Not-for-profit Corporation Act and from the prudent investor rule of the Uniform Prudent Investor Act. The Drafting Committee intended, by adopting language from both the RMNCA and the UPIA, to clarify that common standards of prudent investing apply to all charitable institutions, whether in corporate or trust form. Of high importance to understanding the Act is the fact that the phrase “care, skill and caution,” found in the UPIA (2(a)) as well as the Restatement (Third) of Trusts (337), the Uniform Trust Act (804) and the Restatement (Second) of Trusts (174) is said by the Drafting Committee to be “implicit in the term ‘care’ as used in the RMNCA”, and therefore, equally implicit in that term as used in UPMIFA.

It is the need for fiduciaries subject to UPMIFA to exercise caution that distinguishes the meaning of prudence for such fiduciaries from directors subject to the business judgment standard of corporate law. In the Prefatory Note to UPMIFA, the Drafting Committee notes that “the preservation of the endowment fund” has been added as a prudence factor, making clear the requirement for caution in evaluating risky investments that could pose the threat of impairment.

B. Climate Change Risks to Investment in Fossil Fuel Companies.

1. Risk Disclosures by Public Companies.

The investment risks associated with climate change have previously been recognized by the Securities and Exchange Commission (SEC) in connection with its disclosure requirements. The SEC’s Interpretative Release (Nos. 33-9106; 34-61469), titled *Commission Guidance Regarding Disclosure Related to Climate Change*, with an effective date of February 8, 2010, set forth the SEC’s views on how its existing disclosure requirements apply to climate change matters. Since that date, the special concerns for issuers affecting and affected by climate change have grown dramatically, as evidenced by the recent Paris Agreement and the underlying findings upon which that Agreement was based.²

2. Summary of Principal Terms of Paris Agreement.

² Note that the Release requires companies to “consider, and disclose when material, the impact on their business of treaties or international accords relating to climate change.” (Part IV, B) The Paris Agreement is clearly an “accord” within the meaning of the Release.

The Paris Agreement, signed by 195 countries on December 12, 2015, provides a long-term temperature goal of “holding the increase in global average temperature to well below 2 degrees C above pre-industrial levels and to pursue efforts to limit the temperature increase to 1.5 degrees C.” Article 2. Of all the parties to the Agreement, 188 accepted the requirement to prepare “Intended Nationally Determined Contributions,” or pledges of “ambitious efforts” to cut emissions, which are to become progressively more ambitious over time. Article 4. While developed countries “should continue taking the lead by undertaking economy-wide emission reduction targets,” Article 4 ¶ 4, the Agreement tasks both developed and developing countries with reducing their dependence on fossil fuels, and investing in renewable energy and the development of clean energy technology.

The Agreement also provides that “in order to achieve the long-term temperature goal ... Parties aim to reach global peaking of greenhouse gas emissions as soon as possible and to achieve rapid reductions thereafter in accordance with best available science so as to achieve a balance between anthropogenic emissions by sources and removals by sinks of greenhouse gases (GHGs) in the second half of this century.” Article 4 ¶ 1.

The principal terms of the Paris Agreement, and the facts underlying them, evidence new and major risks to the future prospects and valuations of fossil fuel companies, as national, subnational, and international authorities take action against climate change. These risks include:

- a) pricing carbon so as to account for the uncompensated damage emitting GHG does to the planet;
- b) eliminating the billions of dollars provided annually as subsidies to the exploration, development and sale of fossil fuels;
- c) providing increased subsidies for the development and use of renewables; and
- d) restricting GHG emissions to an increasing degree until, within the second half of this century, a global balance of net zero GHG emissions is achieved.

3. Need for Guidance in regard to Investments by Fiduciaries.

In its 2010 Release, the SEC addressed the impact of climate change on disclosures required of public companies. In light of the Paris Agreement, it would not be surprising for the SEC to update and augment this release. But in any event, for fiduciaries responsible for other people’s money who are subject to the Act, there is no authoritative interpretation of prudence and how it should be exercised in regard to climate change risks. It is to fill this void that the AG has prepared this Interpretative Release.

D. The Prudence Standard Applied to Fossil Fuel Investments.

1. General Comments.

To achieve the Paris Agreement’s long-term temperature goal, fossil fuel usage must be phased out, and the phase out must be far swifter than previously imagined. A recent paper in

Nature Climate Change suggests that carbon dioxide from electricity would have to be brought close to zero by 2050, and by then around 25% of energy required for transportation would also need to come from electricity.

It would not be the purpose of an interpretative release to substitute an Attorney General's judgment for that of every fiduciary subject to the Act in answering the question whether securities of fossil fuel companies may continue to be held. Rather, the purpose of such a release would be three-fold:

- a) To prescribe, as a minimum, the elements of adequate inquiry that must be observed and recorded to demonstrate that the duty of care in Section 3 of UPMIFA has been exercised with respect to any decision to hold or invest in a fossil fuel security;
- b) To discuss some of the special risks that are arising from the circumstances – unique in the history of mankind – created by climate change and the world's response to the threat it poses for the planet; and
- c) To note the overriding command of the Act, in regard to managing and investing an institutional fund, to “consider the purposes of the institution and the purposes of the institutional fund.”

2. Minimum Elements of Inquiry.

The 2010 SEC Release lists the following four topics as representing some of the ways climate change may trigger disclosure requirements. Similarly, these topics should be considered and assessed by fiduciaries subject to the Act in determining whether an investment meets the prudence requirement:

- 1) Impact of legislation and regulation
- 2) International Accords
- 3) Indirect consequences of regulation or business trends
- 4) Physical impacts of climate change

Carbon Tracker Initiative's *Engagement Principles for Investors* sets forth seven risk engagement principles for fossil fuel companies to consider. Fiduciaries should in turn inquire as to whether these principles are satisfied. Namely, they should ascertain:

- 1) Whether there is any divergence between the company's commodity market planning assumptions and demand levels implied by climate and energy policy targets
- 2) How the board oversees climate risk management
- 3) How management would incorporate climate policy targets into investment decisions
- 4) Whether forward-looking projections evaluate potential project portfolios; whether quantitative disclosure aligns with data used by the company for investment decision-making and risk management

- 5) The company's vulnerability to price risk, as explained through stress-tests or sensitivity analysis
- 6) The assumptions underpinning financial reporting and impairment analysis
- 7) If a company's management is unable to provide answers to any of the above, a credible explanation should be given.

Further, the fiduciary should make an explicit judgment that the decision to hold or invest meets the elements of skill, care and caution required by the Act, based upon a thorough and satisfactory inquiry into the matters specified above, as well as a consideration of the special risks of climate change discussed below.

3. Discussion of Special Risks of Climate Change.

The prudence standard of the Act can easily support a decision not to continue to hold or invest in fossil fuel companies. The risks and rewards now offered by such securities are asymmetric, in the sense that the foreseeable rewards are not likely to be equal to the foreseeable risks. The risk that, at some unknown and unknowable, yet highly likely, point in the future, markets will begin to adjust the equity price of fossil fuel company securities downward to reflect the swiftly changing future prospects of those companies, is as serious as it is immense. Moreover, the possibility of that adjustment being a swift one is also a serious risk. A decision to linger in an investment with such an overhanging risk, and expect to time one's exit before the danger is recognized in the market, is a strategy hard to fit within the concept of prudence.

Whether the duties of care, skill and caution today compel a decision not to hold or invest in fossil fuel companies can ultimately only be answered by a court, which always looks back in time, and therefore can be subject to the force of hindsight.

At some point down the road towards the red light of 2 degrees C, however, it is entirely plausible, even predictable, that continuing to hold equities in fossil fuel companies will be ruled negligence. Here a powerful 2d Circuit decision by the famous jurist, Learned Hand, decided in 1932, becomes relevant. In that case, *The T.J. Hooper*, tug boat owners were found liable for loss of cargoes in a nor'easter because they hadn't issued to operators what were then newly developed short-wave receivers. At the time, this new-fangled device was a rarity on tugs. Had the operators possessed them, they surely would have picked up weather reports warning of a storm and sought refuge on the inland waterway.

Here's the crucial finding of this great judge:

"Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission." [Emphasis supplied.]

Many, if not most, fiduciaries subject to the Act serve charitable purposes enabling them to act as long term investors in the management of institutional funds. As such, they need not worry unduly about short-term results. Anticipatory divestment of fossil fuel company holdings could reasonably be viewed as having unknown short-term consequences for the portfolio, which could involve loss as well as gain. However, in the long run, those short-term results could reasonably be considered unimportant. The risks for fossil fuel companies described above could reasonably support a fiduciary's judgment that fossil fuel companies will prove to be bad investments over the long term and, therefore, with foresight that anticipates this result, should be removed from long-term holdings before the strengthening likelihood of this result becomes commonplace in the market.

4. Duties Owed to Purposes of the Institution.

Section 3(a) of UPMIFA requires fiduciaries, in managing and investing an institutional fund subject to the Act, to "consider the charitable purposes of the institution" to which that fund is dedicated and "the purposes of the institutional fund." Section (e) (1) requires fiduciaries, in managing and investing an institutional fund, to consider, if relevant, "an asset's special relationship or special value, if any, to the charitable purposes of the institution." Paragraph (H).

The Drafting Committee, in its Comment on Section 3, states: "Further, the decision maker must consider the charitable purposes of the institution and the purposes of the institutional fund for which decisions are being made." This requirement is described by the Committee as "a fundamental duty." And, in further elaboration of this so-called "charitable purpose doctrine", the Committee said: "In making decisions about whether to acquire or retain an asset, the institution should consider the institution's mission, its current programs ...in addition to factors related more directly to the asset's potential as an investment."

The Act itself, and the interpretation thereof by the Drafting Committee responsible for its language, make it entirely clear that fiduciaries must consider the purposes for which the funds they manage and invest are held. This duty is in addition to, and overrides, the duty of prudence as applied solely to financial considerations.

It would not be the purpose of an interpretative release to apply this standard to any institution subject to the Act or even generally to various categories of institutions subject to the Act. Nor, indeed, could it do so.

The purpose here is merely to call attention to this fundamental duty of fiduciaries subject to the Act, a duty that could surely affect the choice of investments to hold or avoid, based in whole or in part, on the purposes of the institution. Thus, for example, if, in the judgment of its fiduciaries, it would be inconsistent with the purposes of an educational institution to hold, and thereby necessarily seek to profit from, investments in fossil fuel companies, such investments could not be held.

