Considerations for Fiduciary Duty in the Corporate Pension Law — Specialization of Fund Functions and the Litigation Rights of Participants

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1. Introduction

The Corporate Pension Law, which the government has been working on since 1997, finally appears to be ready for passage in the current Diet session.[1] The law is expected to set appropriate rules to protect participants and beneficiaries of corporate pension plans — specifically the Employees' Pension Fund and Tax Qualified Pension Plan — to better guarantee that the plans provide income after retirement.

This paper considers what provisions for fiduciary duty should be included in the law. We first outline the functions of corporate pensions, and then examine issues surrounding fiduciary duty for the fund-type and contract-type plans proposed in the law.

In late 2000, five ministries and agencies (Finance, Health and Welfare, Labor, International Trade and Industry, and Financial Services) presented an outline of their jointly proposed law. Among the proposed measures to protect benefit rights are funding standards, reporting and disclosure requirements, and the following:

> *Fiduciary duty — From the perspective of protecting the benefit rights of participants and beneficiaries, with regard to employers and others engaged in management and investment activities for corporate pensions, responsibilities are to be stipulated including the duty of loyalty to participants and beneficiaries and duty of diversified investment, and rules of conduct are to be clarified including the prohibition of conflicts of interest.*

The concept of fiduciary duty, which is derived from trust law in the U.K. and U.S., allows for the exercise of discretion while preventing abuses.[2] In addition to trustees, any person appointed as fiduciary has a duty to act in good faith and in the best interests of another. Specifically, the duties include loyalty, care, and reporting.

Recently, in corporate pensions and other instances where assets are being managed in the interest of

others (at their risk), the importance of fiduciary duty has come to be keenly felt in Japan as well.

2. The Role of Fiduciary Duty in Corporate Pensions

We first describe the three function of corporate pensions, and examine the relationship of each to fiduciary duty.

(1) Delayed Payment of Wages (Benefits Design)

Corporate pensions (broadly speaking, retirement benefits including lump sum benefits) are a promise to pay present wages in the future (delayed payment of wages), and like wages and work hours, are a condition of employment. Thus the design of benefits is supposed to be determined in the employment contract (or employment rules or collective agreement) based on negotiation and agreement between workers and employers. Although participation in the corporate pension system is voluntary, to ensure fairness, minimum standards for vesting and other matters must be legally stipulated (discussion of tax issues is omitted here).[3]

Since the obligation of employers is to pay the promised amounts at the promised times, the issue of fiduciary duty basically does not arise.

(2) Funding

In promising to pay wages in the future, corporate pension plans face the risk of failure should the employer become insolvent or otherwise unable to pay. Because of the critical role of corporate pensions, it makes sense that employers are legally required to secure funding for the promised benefits either within the company or outside (while a payment guarantee system is an alternative, it runs into moral hazard and other problems).

In-house funding involves forming a trust or collateralizing real estate or securities owned by the employer, while outside funding involves paying contributions to institutions that manage pension assets and pay out benefits. The latter method is superior for both securing funding and paying out benefits smoothly.

Since the obligation of employers is to preserve assets or arrange external funding according to the methods and amounts that are legally prescribed, here again the issue of fiduciary duty does not arise.

To ensure that obligations are fulfilled, the small fines stipulated in enforcement provisions are not enough. What is needed is an arrangement in which supervisory agencies or participants (and benefi-

ciaries) of corporation pensions can force employers to secure the necessary funding. However, if doing so would lead to the employer's business failure, a grace period may be necessary, despite the conflict of interest between workers and pensioners.

(3) Management and Investment of Pension Money

Specifically, the management and investment of pension money mainly involves deciding on the investment policy (investment objective, asset composition, etc.), and entrusting the assets to a trust bank, life insurance company, or investment advisory. In-house asset management (possible on a limited basis with Employees' Pension Funds) is also included.

The objective of pension money is to fund the payment of promised benefits, and the people who benefit from the pension money are the plan participants and beneficiaries. In an uncertain economic and investment environment, the management and investment of pension money requires expertise and discretionary power. To serve the best interest of participants with this discretionary power while preventing abuses, it is necessary to clarify the fiduciary duty of the person who has discreationary control to management and invest the pension money (the same applies to the corporate pension system, but discussion is omitted here).

Thus it becomes necessary to clarify who is empowered to manage and invest pension money, and to define duties and responsibilities.

Basically, fiduciary duty with regard to managing and investing pension money should be defined under civil law as a duty to participants and beneficiaries. In addition, it is necessary for the supervisory agencies to ensure that this duty is performed.

Figure 1 Functions of Corporate Pensions (Outside Funding)

Function	Responsible party	Determination of duties & responsibilities
Delayed payment of wages (design of benefits)	Workers (labor) and employers (pension)	Contract between parties; minimum standard is legally specified
Outside funding	Employer	Determination and amount are legally specified
Management & investment of pension money	Whomever is given authority to manage & invest pension money	Responsible parties and duties are legally specified — fiduciary duty

For defined benefit corporate pensions, the amount of benefits is not linked to investment performance, and employers must bear the investment risks. However, the purpose of using outside funding is to protect future payment of wages in the long term against the employer's business failure and other risks. Thus except in cases where a complete payment guarantee system exists, the management and investment of pension money, which is isolated from the employer, should be conducted in the best interests of participants and beneficiaries.

(4) Types of Corporate Pensions

The government proposal calls for limiting the management of corporate pensions to three types — the present Employees' Pension Fund, and new fund-type and contract-type methods. The qualified pension plan is to be phased out and transferred to one of the other methods.

In the fund-type plan, which is equivalent to the Employees' Pension Fund without the public pension substitute portion, a fund is set up as a separate corporation from the employer to manage and invest pension money and pay out benefits. In the contract-type plan, which is based on the pension instrument agreed upon with labor, employers enter into a contract with trust banks or life insurance companies to have them manage the pension money and pay out benefits.

While similar to the present tax qualified pension plan, the contract-type plan invokes stricter rules regarding funding requirements and fiduciary duty.

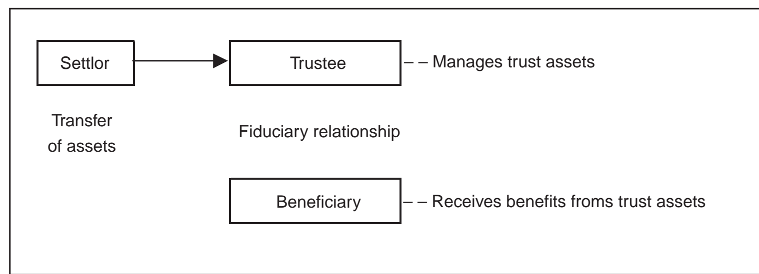
Below we refer to the Employees' Pension Fund and new fund-type plan as fund-type plans, and the tax qualified pension and new contract-type plan as contract-type plans.[4] The management and investment of pension money is performed by the fund in the fund-type plan, and by the employer in the contract-type plan.

3. Fiduciary Duty in the Corporate Pension Laws of the U.S. and U.K.

(1) Corporate Pensions and Trusts in the U.S. and U.K.

Trusts are firmly rooted in the U.S. and U.K., and due to tax requirements, corporate pensions have used trusts to manage plan assets (employers are also allowed be trustees). By using trusts, plan assets can be separated from employers and isolated from bankruptcy, and trustees can be assigned duties based on trust law.

Figure 2 Trust Arrangement



However, trust law — which is modeled on the gratuitous transfer of assets — did not always provide a sufficient barrier against misuse of pension assets and inappropriate investments because of lenient provisions. Thus fiduciary duty provisions in the corporate pension laws of the U.S. and U.K., while based on trust law, sought to put an end to rampant misconduct by imposing stricter duties and responsibilities on persons managing and controlling plan assets.

(2) ERISA in the U.S.

The Employee Retirement Income Security Act of 1974 is a comprehensive law aimed at protecting participants of corporate pensions. Before ERISA, employers and union executives frequently misused or embezzled pension assets. To protect participants from such abuses, ERISA defines fiduciaries broadly and imposes strict duties and responsibilities.

- The written instrument of the pension plan is to provide for named fiduciaries who have authority to manage the pension plan.
- Pension assets are to be placed in a trust (excludes life insurance policies)
- Authority to invest pension assets belongs to the named fiduciary, trustee, or investment manager entrusted by the pension plan.
- Including the above persons, any person who exercises or has discretionary power in investing and managing the pension plan, or offers investment advice to the plan, is defined as a fiduciary.
- The fiduciary owes the duty of loyalty, care, and diversification of investment, and is prohibited from certain transactions not in the best interests of participants and beneficiaries.
- If a fiduciary commits a breach of duty, other fiduciaries, participants or beneficiaries, or the Department of Labor can bring civil action to recover losses caused by the breach.
- Usually, lawyers, accountants, actuarials, consultants and other advisors are not fiduciaries.[5]

In ERISA, the framework for fiduciary duty is stipulated in abstract terms, including the functional definition of a fiduciary. While this allows more flexibility in the law's application, it has also spawned numerous litigations contesting the law's interpretation.

(3) Pensions Act 1995 of the U.K.

In the past, corporate pensions were regulated by a patchwork of laws. But prompted by the massive abuse of pension assets in the Maxwell case of 1991, the Pensions Act was enacted in 1995.

- One-third of trustees are to be appointed by participants.
- The duty of care in investment cannot be waived.
- While the authority to make investments resides with the trustees, investment can be entrusted to an investment company that has been approved under the Financial Services Act (for in-house investment, an approved asset manager must act as guardian).
- Investments must be diversified and appropriate.
- Trustees are to establish an investment policy after consulting with financial experts and the employer.
- Trustees are to appoint pension actuarials and auditors, who are to report any misconduct of the trustees to relevant authorities.

Many of the rules and regulations regarding corporate pensions are more concrete and practical than in the U.S. For example, trustees appointed by participants are granted paid vacation time for training and education.

4. Fiduciary Duty in Fund-Type Plans

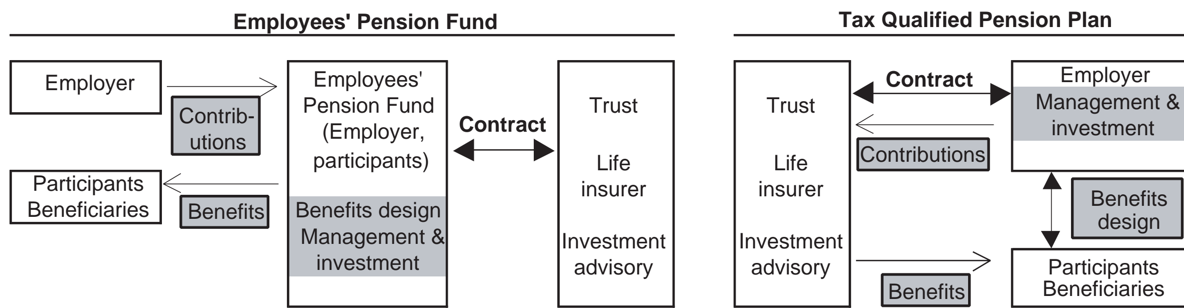
(1) Status of Fiduciary Duty Rules for the Employees' Pension Fund

The Employees' Pension Fund is a public corporation comprised of employers and participants. It contains a council of representatives that acts as the decision making organ, and a director who acts in an executive capacity.

The director, who is equivalent to the director of a company, has the duty of care because of his fiduciary relationship with the fund. As for the management and investment of pension money, the Employees' Pension Insurance Law has provisions on the duty of loyalty and prohibition of actions involving conflict of interest. In addition, the director is responsible for the duties stipulated for the fund — safe and efficient investment, establishment of an investment policy, and presentation of investment guidelines to the asset manager.

In case of breach of duty, under civil law the director can be held liable by the fund for breach of contract, and by others for tort related liability.[6] In addition, the Employees' Pension Insurance Law contains provisions for the director's joint responsibility regarding the management and investment of pension money.

Figure 3 Comparison of Employees' Pension Fund and Tax Qualified Pension Plan



(2) Fiduciary Duty of the Fund and Director

Along with the deregulation of investment in recent years, there has been a trend toward clarifying and specifying the director's fiduciary duty, such as in the establishment of "Guidelines for Fiduciary Duty" (Ministry of Health and Welfare, 1997), which specifies the role of the director.

While much of this is due to the efforts of the ministry and Association of Employees' Pension Funds, we must not overlook another factor — the arrangement of the Employees' Pension Fund itself. The fund and its director, as a separate entity from employers and acting independently in the best interests of participants, have come to undertake fiduciary duties similar to trusts and trustees in the U.S. and U.K. The concept of fiduciary duty has been incorporated into this arrangement through its interpretation of the director's duties of care and loyalty, while also referring to ERISA.

(3) Recommendations for Fiduciary Duty in the Fund-Type Plan

Basically, fiduciary duty for fund-type plans should conform to that of the Employees' Pension Fund. However, the fund's functions and organizational form need to be revised.

1. Reevaluation of functions and organizational form of the fund-type plan

For the Employees' Pension Fund, membership qualification and benefits are prescribed in the pension instrument, which is approved by a council composed of an equal number of representatives from labor and management. The council is responsible for the design of benefits. (However, the employer establishes the original instrument based on agreement with labor. In addition, while not stipulated by law, a new agreement is necessary if the benefits design is revised downward.)

However, the idea that the council democratically decides on the benefits design of the corporate pension plan, which is a key condition of employment, is an illusion. The benefits design should be determined outside of the fund in the employment contract.[7] Also, we need to consider whether a separate

agreement from the wage agreement is actually necessary.

Thus it is appropriate to separate benefits design from the fund, and have it specialize in managing and investing pension money and paying out benefits.

At the same time, changing the organizational form to a foundation would simplify the fund's management by eliminating the council of representatives (which has been criticized by some as being useless). As a forum in which participants can participate or monitor activities, a board of directors could be established, with directors chosen by participants (as well as beneficiaries).

2. Where responsibility resides

In a fund-type plan, fiduciary duty resides in the director.

3. Duties and responsibilities

The duties and responsibilities of a director of a fund-type plan are similar to those of the Employees' Pension Fund. However, the scope of the duty of loyalty need not be restricted to the management and investment of pension money, while clarifying the duty of care would be helpful.[8]

In the MHW guidelines mentioned earlier, the director's duty of loyalty is described as "solely considering the interests of participants and beneficiaries," while the government proposal also appears to assume a duty to participants and beneficiaries. However, if a fund assumes a corporate organization, it would be sufficient to hold the director liable to the fund only, and to understand responsibilities and duties to be as described above.

The question arises as to whether the director of an Employees' Pension Fund commits a breach of duty of loyalty to participants and beneficiaries by dissolving the fund or reducing benefits. The U.S. Department of Labor has determined that settlor functions — establishing, terminating, and designing the pension plan — pertain not to the management of the pension plan but to its formation, and thus not subject to fiduciary duty under ERISA.[9] The benefits design function is not suited to fiduciary duty. Thus the fund needs to specialize by omitting this function.

4. Liability for breach of duty

If a director commits a breach of duty, he is liable to the fund which has entrusted him. Oversight agencies are expected to exercise their functions of conducting inspections, issuing administrative orders, and exacting penalties.

In addition, participants and beneficiaries must become empowered to pursue legal action against the director as in class action suits by shareholders. In addition to enhanced reporting and disclosure requirements, we should count on the monitoring role of participants and beneficiaries. Also, employers should be allowed to pursue action against directors should a breach of duty result in the need for additional employer contributions. However, it should be noted that the director has wide discretionary power and cannot be held liable for poor performance in hindsight.

5. Fiduciary Duty in Contract-Type Plans

(1) Fiduciary Duty in Tax Qualified Pensions

Tax qualified pension plans enjoy a special tax status under corporate tax laws, and no stipulations are provided regarding fiduciary duty. Thus it is difficult to argue that a fiduciary duty to participants and beneficiaries arises when the employer enters a contract with an asset manager.

(2) Fiduciary Duty in Contract-Type Plans

1. Need to clarify fiduciary duty

Due to the lack of oversight agencies and pension fund/director type arrangements, the concept of fiduciary duty has been weak in tax qualified pensions. However, since employers have the same discretionary powers as the directors of Employees' Pension Funds, there is a great need to impose discipline and clarify the concept that pension money is to be managed and invested in the best interests of participants and beneficiaries.

With regard to fiduciary duty in contract-type plans, rather than arising from the use of such arrangements as trusts in the U.S. and U.K. and fund-type plans in Japan, duties will apparently be created under the corporate pension law (although it could also be interpreted as a confirmation of existing duties).

2. Where responsibility resides

In a contract-type plan, the employer enters into a contract with (selects and controls) an asset manager, and as a contracting party, is responsible for managing and investing pension money.

However, the management and investment of pension money, which must be conducted in the best interest of participants and beneficiaries, differs from other functions and responsibilities that characteristically belong to the employer, such as designing benefits and securing outside funding. Many

problems can arise when the employer manages and invests pension money by delegating authority within the company because the investment objectives are unclear and conflicts of interest are unavoidable (between the employer and participants and beneficiaries). While one alternative is to hold company executives responsible in addition to the employer, this does not seem to be a practical solution since executives owe their loyalty to the company, and not to the pension plan.[10]

Thus for corporate pension plans above a certain size — whether they be managed in-house or entrusted to a financial institution — it would be appropriate to require the adoption of a fund-type plan for the purpose of securing an independent management and investment entity. In that case, the fund can shed the benefits design function and specialize in the management and investment of pension money. Moreover, as with tax qualified plans, benefit payments should be entrusted to trust banks and life insurers. While the employer must be prevented from misusing the fund, the separation of functions between employer and fund should also be convenient to the employer in terms of compliance and reducing litigation risk.

When a contract-type plan is used for small corporate pensions, it would be appropriate to require the establishment of an advisory committee that includes the employer and representatives of participants and beneficiaries.

3. Responsibilities and liabilities

With regard to the management and investment of pension money, the employer should be legally prescribed the same duties and responsibilities as directors of fund-type plans (including those which the director bears that are duties of the fund).

The employer should be held liable to participants and beneficiaries.

4. Liability for breach of duty

Similar to the fund-type plan, it is necessary to introduce a way for participants and beneficiaries to seek recourse in case of a breach of duty (including the actions of executives).

6. Conclusion

The system of corporate pensions is a voluntary one, and its growth would be hampered by excess regulations. On the other hand, minimum rules are necessary to protect participants and beneficiaries. Since the management and investment of pension money is an endeavor performed in the interest of others, an appropriate framework needs to be created that fulfills this purpose.

While the U.S. and U.K. have used trusts and functional definitions for fiduciary, Japan has used the framework of the Employees' Pension Fund to clarify and specify the fiduciary duty of corporate pensions. To protect participants and beneficiaries, we recommend that the Employees' Pension Fund — created as a vehicle to partially substitute for the national pension — specialize its functions by shedding the benefits design function in particular, and continue to serve as a vehicle of fiduciary duty for corporate pensions.

Notes

1. The Corporate Pension Law will cover defined benefit plans. A bill for defined contribution pensions was resubmitted in the extraordinary session last November, and is n deliberation.

2. Norio Higuchi, *The Fiduciary Age,* Yuhikaku, 1999, p. 101.

3. Regarding the omission of vesting standards in the government proposal, see "What is Missing in the Corporate Pension Draft Bill," *Nissay Pension Strategy,* January 2001 (http://www.nli-research.co.jp/).

4. In fund-type plans, benefits rights are derived from the status as fund member, while in contract-type plans they are derived from the contract. However, we must remember that in either case, benefit rights actually originate in the employment contract.

5. Regarding the responsibilities of persons who are not fiduciaries, see Osamu Tonami, "Scope of Defendants in Civil Litigation Regarding Liability in Corporate Pension Investments," *Jurist,* no. 1193, February 1, 2001.

6. A director who moves to dissolve a fund is deemed to be acting in a public capacity, and cannot be held personally liable (The Japan Spinning Industry Pension Fund Case, Osaka District Court decision, June 17, 1998.

7. If several employers jointly establish a corporate pension, it may be convenient but is not necessary for the fund to undertake the benefits design function.

8. Laws pertaining to investment trusts and investment companies stipulate the duty of loyalty as well as care for the investment companies that manage investment trusts.

9. *BNA Pension & Benefits Reporter*, March 17, 1986. If corporate executives also happen to be fiduciaries of the corporate pension, they can be held liable by participants not for actions taken as executives, but as fiduciaries of the corporate pension.

10. ERISA is instructive in that it establishes the concept of a named fiduciary, and defines the fiduciary by focusing on actual functions performed. However, we should note that the framework's successful operation is based on several factors: pension assets other than those of life insurers are entrusted, trust and fiduciary are firmly established as legal principles, and numerous litigations including those brought by the Department of Labor have helped clarify liability issues.