

# FIDUCIARY RESPONSIBILITIES OF GOVERNING BOARD MEMBERS

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# Introduction

- At CIO Level 1 conference, a speech which gives the history of the fiduciary relationships or fiduciary duties concepts
- No history this time, but will consider application of fiduciary concepts to government officials and employees who invest government funds

Fiduciary is a vague term, and it has been pressed into service for a number of ends...

D.M. Waters, The Construction Trust, in Black's Law Dictionary

“A general definition of the word which is sufficiently comprehensive to embrace all cases cannot well be given.”

## Existence of fiduciary relationship

A fiduciary relation is not limited to cases of trustee and beneficiary, guardian and ward, attorney and client, nor other recognized legal relations, **but it exists in all cases in which confidence has been reposed and betrayed**, and the origin of the confidence is immaterial, and may be moral, social, or domestic, or merely personal.

## Existence of fiduciary relationship

- “Fiduciary” applies to any person occupying a position of peculiar confidence toward another.
- Refers to integrity and fidelity
- **Contemplates fair dealing and good faith, rather than legal obligation, as the basis of the transaction**

Existence of fiduciary relationship  
(on the other hand...)

Not every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship.

Meyer v. Cathey, 167 SW 3d 327, Tex. 2005

- Fiduciary duties of governing board members well developed in the corporate context
  - Duty of care
  - Duty of loyalty
- Some debate whether duty of good faith is part of the duty of care

# Duty of Care for Corporate Directors

- Duty of care
  - Director acts with the care a person in like position would reasonably believe appropriate in similar circumstances

# Duty of Care for Corporate Directors

- Both a subjective and an objective test
  - Objective because “person in like position” suggests a director should have a minimum degree of prudence or competence
  - Subjective because the director’s own background or experience may result in him or her being held to a higher standard

# Duty of Care for Corporate Directors

- Duty of care responds to 2 conflicting policy concerns
  - Need for standard because of importance of corporations to the economy
  - Concern that too-close regulation of corporate managers would inhibit risk-taking, which is an essential part of business

# Duty of Care for Corporate Directors

- Resolution of this dilemma is that the courts focus on the decision-making process, rather than the decision itself

# Duty of Care for Corporate Directors

- How to comply with the duty of care
  - Knowledge: basic familiarity with business, finance and accounting; familiarity with corporation's business operations and competitive environment

# Duty of Care for Corporate Directors

- How to comply with the duty of care
  - Commitment: put in the time and effort necessary to perform the monitoring, advisory and strategic roles
    - Attend all meetings
    - Prepare for the meetings
    - Be attentive and active participant in board meetings

# Duty of Care for Corporate Directors

- How to comply with the duty of care
  - Adequate information: Director must make sure she has the necessary information to make informed decisions
  - Examine the information provided critically

# Duty of Care for Corporate Directors

- How to comply with the duty of care
  - Duty to inquire: director must request more information if the materials previously provided raise issues or highlight problems
  - Directors cannot passively await signs of problems or “red flags”

# Duty of Care for Corporate Directors

- How to comply with the duty of care
  - Business Judgment Rule
    - Directors are deemed to have met the duty of care, even if they made the wrong decision, as long as the decision was arrived at in an appropriate way

# Duty of Care for Corporate Directors

- Business Judgment Rule
  - Rule does not apply if:
    - Director does not have adequate knowledge, commitment of information
    - Director or board failed to consider a particular matter
    - Issue is conflict of interest

# Duty of Care for Corporate Directors

- Business Judgment Rule
  - 3 prerequisites
    - Director must make decision in good faith
    - Decision-making process must be informed
    - Director or board must rationally believe decision is in best interest of the corporation

# Duty of Care for Corporate Directors

- Other subsets of the duty of care include:
  - Duty of good faith (debate by commentators whether this a separate fiduciary duty)
  - Duty to obey the law
  - Duty of disclosure to shareholders

# Duty of Loyalty

- Duty of loyalty requires a director to act in the best interests of the corporation, rather than his or her own interests
- A director should not use the corporate position for personal profit or gain or for other personal or non-corporate advantage

# Duty of Loyalty

- Basic idea is that director owes duty of fair dealing
- This may be more accurate statement. State of the law seems to be that director can pursue his self-interest, as long as he puts the interests of the corporation first

# Duty of Loyalty

- 2 basic ideas:
  - Directors engaged in transactions with the corporation (e.g. loans from the corporation) – conflicts of interest
  - Directors taking benefits or advantages that belong to the corporation (e.g. using insider information to take away a business deal from the corporation)

# Duty of Loyalty

- Example of conflict of interest
  - Kozlowski and his former CFO, Mark H. Swartz, created a criminal enterprise that they used over seven years to steal \$170 million from Tyco in unauthorized loans and bonuses, and to defraud investors of an additional \$430 million.

# Duty of Loyalty

- Kozlowski's defense will depend heavily on the argument that auditors and the board approved what was going on.

# Duty of Loyalty

- Safe harbor rules for conflicts of interest
- Note Local Government Code 81.002 – county judge and commissioners take oath that they will not have a direct or indirect interest in a contract with or claim against the county except a contract or claim expressly authorized by law; or a warrant issued to the judge or commissioners as a fee of office

# Duty of Loyalty

- But see Local Government Code Chapter 171 – judge and commissioners can have contracts with county if they declare their interest in an affidavit and refrain from discussing or voting on the contracts
- Texas Attorney General states Chapter 171 impliedly repeals Local Government Code Chapter 81.002, to the extent of any inconsistencies

- Why the emphasis on fiduciary relationships?

Failure of duty of care: **personal liability**  
for negligence or gross negligence

# Fiduciary standards extended to Texas local government officials?

- National trend towards applying fiduciary standards to board members of governmental entities
  - “The Ohio Revised Code explains the manner in which public boards may be operated, including the qualifications and fiduciary duties of board members”.

# Fiduciary standards extended to Texas local government officials?

- The general counsel of the Empire State Development Corporation (New York) stated: “The duties and legal responsibilities of board of director members of public authorities (“directors”) are generally equivalent to those of directors in the private and not-for-profit sectors

# Fiduciary standards extended to Texas local government officials?

- Pennsylvania municipal codes provide that those in control of municipal funds may be forced to reimburse municipality for mismanagement, misappropriation, or otherwise wrongful or unlawful use or expenditures of public monies

# Fiduciary standards extended to Texas local government officials?

- Searched over 800 Texas cases and Attorney General Opinion database
- Found no case or opinion explicitly extending fiduciary concepts of duty of care and loyalty to local government officials

Fiduciary standards extended to Texas local government officials?

- BUT, in the investment arena, the concepts have been extended in the main statute that governs investing government funds
- Public Funds Investment Act, Texas Government Code Chapter 2256

# Fiduciary standards extended to Texas local government officials?

- The PFIA applies to local governments:
  - Municipality
  - County
  - School district
  - An Article III, Section 52(b)(1) or (2) district

# Fiduciary standards extended to Texas local government officials?

- The PFIA applies to local governments:
  - Article XVI, Section 59 district
  - Fresh water supply district
  - Hospital district

# Fiduciary standards extended to Texas local government officials?

- The PFIA applies to local governments:
  - Any political subdivision, authority, public corporation, body politic, or instrumentality of State of Texas
  - Any non-profit corporation acting on behalf of any of those entities

# PFIA Requirements

- Local government authorized to purchase, sell and invest its funds and funds under its control
- In compliance with investment policies approved by local government
- According to the standard of care set out in the statute

# PFIA Requirements con't

- Standard of care:
  - Investment officer must exercise judgment and care, under prevailing circumstances, that prudent person would exercise in management of person's own affairs

Gov't Code 2256.005(f)

# PFIA Requirements con't

- Standard of care:
  - Investment officer must exercise judgment and care, under prevailing circumstances, that prudent, intelligent, person of discretion would exercise in management of person's own affairs
  - Not for speculation, but considering probable safety of capital and probable income

Gov't Code 2256.006

# PFIA Requirements con't

- Standard of care:
  - Prudence is determined by looking at all funds, rather than the prudence of a single investment
  - Prudence also determined by whether investment decision consistent with written investment policy

Gov't Code 2256.006

# PFIA Requirements con't

- Standard of care:
    - Governing body of the investing entity retains ultimate authority as fiduciaries of the assets of the entity
- Gov't Code 2256.005(f)

# PFIA Requirements con't

- Investment officer with personal business relationship with business organization offering to engage in investment transaction with entity, or related to someone who wants to sell an investment to the entity must file statement with entity and Texas Ethics Commission

Gov't Code 2256.005(i)

# PFIA Requirements con't

- Treasurer, chief financial officer if treasurer is not chief financial officer, and investment officer required to receive investment training
- This requirement does not apply to conservation and reclamation districts that meet other statutory requirements

Gov't Code 2256.008(a), (b)

# Is the PFIA a True Fiduciary standard?

- Why does the statute state that fiduciary responsibilities remain with the governing body, but members of governing body are not required to get training?
- Does the fiduciary duty extend to the employee?
- What penalties for violation of the statute?

# Is the PFIA a True Fiduciary standard?

- Many commentators see fiduciary relationships as the foundation of government
- Stephen B. Young: To govern others is to have power or authority in a relationship with them.

# Is the PFIA a True Fiduciary standard?

- If government is an agent and a servant of the public, then officials work under the burden of normal fiduciary duties: a duty of loyalty and a duty of due care. The duty of loyalty is faithfulness to the public trust
- The duty of care requires that we use our best thinking and our skills to advance the larger good of the community

# Public Finance Fiduciary Duties in Context: Orange County

- Orange County, California declared bankruptcy in December, 1994 – the largest municipal bankruptcy in history
- County treasurer oversaw \$7.5 billion investment pool for 187 government participants, including 34 cities and 38 school districts.

# Public Finance Fiduciary Duties in Context: Orange County

- Treasurer used high-risk investment strategy using reverse repurchase arrangements and derivatives that led to \$1.1 billion loss
- 200 local governments agreed to forego their right to sue the county and county finance officials in return for better repayment terms (monetary and priority of claims)

# Public Finance Fiduciary Duties in Context: Orange County

- Voters rejected increase in sales tax to help solve the crisis
- Interest income from the pool was the single largest source of discretionary revenue for the county – Proposition 13
- Within 1 year of bankruptcy filing 10+ lawsuits over suitability, disclosure, and violations of state law filed against broker, Merrill Lynch

# Public Finance Fiduciary Duties in Context: Orange County

- County treasurer, for 24 years, pleaded guilty to 6 felony charges
- County reduced budget from \$3.7 billion to \$3.4 billion; reduced discretionary spending more than 40%; layoffs
- SEC brought enforcement actions against county officials

# Public Finance Fiduciary Duties in Context: Orange County

- Holding government employees to a fiduciary standard is consistent with the theoretical foundations of representative government, the widespread tradition of referring to public office as a ‘public trust,’ and the common law
- Fiduciary obligation also promotes and even demands professional competence

# Public Finance Fiduciary Duties in Context: Orange County

- There is rarely a legitimate excuse for professional government finance officials' inadequately fulfilling their official duties.
- Maintaining professional competence is widely recognized as an obligation of holding public office

Carol W. Lewis, Money, Morality and Municipal Bankruptcy in Orange County; Budget and Finance, Summer 1996

# Public Finance Fiduciary Duties in Context: Orange County

- California State Auditor found that treasurer
  - Violated the basic principles of prudent investing
  - Made unsafe, highly risky, and extremely volatile investments

# Public Finance Fiduciary Duties in Context: Orange County

- California State Auditor found that treasurer
  - Leveraged the portfolio more than 2.7 times and invested more than 40% in inverse floaters and other structured securities
  - Violated trust responsibilities by altering accounting records and misallocating earnings and losses

# Application to your day-to-day activities

- Criminal liability – Penal Code 32.45
  - Offense to intentionally, knowingly or recklessly misapply property held as a fiduciary or property of a financial institution in a manner that involves substantial risk of loss to the owner of the property or to a person for whose benefit the property is held

# Application to your day-to-day activities

- Criminal liability – Penal Code 32.45
  - Penalties range from Class C misdemeanor to first degree felony for sums over \$200,000

# Application to your day-to-day activities

- Assume you are a fiduciary, even if you are not an elected official
- Behave like a fiduciary
  - remember personal civil liability
  - criminal liability