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Economically Targeted Investments—
Can Public Pension Plans Do Good and Do Well?

PATRICK S. CROSS*

Indeed, there are no definitive or final answers to the ultimate questions facing any society. One is reminded of Gertrude Stein's final moments on earth. As she lay dying, she whispered: "What is the answer?" Receiving no reply, she responded: "In that case, what is the question?"

Pension plans are too large and are growing too fast for economists [and policymakers] to be stopped by the literal description of the pension plan or for them not to try to strip away the legal form and to reveal the economics of defined benefit pension plans.

INTRODUCTION

At the end of 1990, state and local government pension funds held assets totaling more than $949 billion, and public and private pension assets together—totaling $4.44 trillion—comprised the largest source of capital in the United States. Public pension funds, because they own huge amounts of capital, are able to wield significant economic power in U.S. capital markets.

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3. Joel Chernoff, U.S. Pension Assets Reach $4.44 Trillion, PENSIONS & INVESTMENTS, Jan. 25, 1993, at 1. The $949 billion figure, which is the most up-to-date figure available from the Federal Reserve System, does not include $296 billion worth of assets held in U.S. government plans. Id. at 1, 75. Private pension funds own assets totaling $2.26 trillion. Id. at 1. According to one report, in 1991 public and private funds together owned more than 28% of all equity in the U.S. economy. Employee Benefits Research Institute, Diversity of Pension Investments, EBRI ISSUE BRIEF No. 116, July 1991, at 4 [hereinafter EBRI ISSUE BRIEF]. Pension funds are growing at a rate not only faster than the U.S. economy, but faster than any other source of capital. The U.S. Department of Labor predicts that by the year 2000 pension funds will own about 40% of the equity capital of U.S. corporations. Jayne E. Zanglein, Pensions, Proxies and Power: Recent Developments in the Use of Proxy Voting to Influence Corporate Governance, 7 LAB. LAW. 771, 771 (1991) (citing U.S. DEPT. OF LABOR, PENSION AND WELFARE BENEFITS ADMINISTRATION, PROXY PROJECT REPORT 1 (1989)). Pension assets increased almost six times faster than the total assets of the economy during the 1950-1987 period. Arnold J. Hoffman, Pension Funds and the Economy, 1950-87, in TRENDS IN PENSIONS 96 (John A. Turner & Daniel J. Beller eds., 1989), “At year-end 1987, private plan assets constituted 73 percent and state and local assets constituted 27 percent of total pension funds.” Id. at 97.
4. Commenting on private pensions, one pension consultant stated that the "pension system is tremendously important to the national economy. It is not just a means of disbursing retirement income.
Consequently, public funds are increasingly being looked to by their sponsoring governments as a source for much-needed investment capital and, thus, as a means to stimulate economic development. In response, many states have adopted policies that provide incentives for, or require, public pension plans to invest in in-state ventures. For example, such a policy might require the trustees of a public plan to invest at least fifteen percent of a fund's assets in the securities of in-state corporations. Alternatively, such a policy might merely encourage public fund trustees to demonstrate a preference for investments that benefit the state's economy. Although there is no consensus on how to categorize these types of investment preferences and requirements, they are generally referred to as "economically targeted investments" (ETIs). 5

With ongoing budgetary retrenchment by the federal government and the resulting burden on state and local governments, it seems clear that pension fund trustees will increasingly be asked to make investment decisions with an eye toward stimulating economic growth. 6 Many plan participants and commentators are concerned that the increasing pressure on fund trustees to allocate a portion of fund assets for economic development might result in imprudent investments that will adversely affect fund security and, thereby, pension benefits. 7 Their concerns highlight both the legal and practical considerations shaping the debate over investment policies for public pension funds and the investments they make.

Although the issue of social investing and the ensuing debate over its legitimacy are not new, until recently surprisingly little legal commentary has

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5. ETIs are generally considered to be a form of social investing. See infra part I.

6. "Budgetary retrenchment" here means the shifting of the financial burden for the funding of infrastructure and social programs from the federal to the state and local level. It is reasonably clear that this policy will mean that state funds that were previously used to pay for infrastructure will be diverted for more pressing short-term needs, such as social services.

7. See, e.g., Pension Fund Socialism, PENSIONS & INVESTMENTS, Mar. 5, 1990, at 12 (editorial). One pension consultant notes that "[p]ressure is being placed by politicians on trustees to at least encourage, if not compel, them to make investments they ordinarily would not make as fiduciaries." Joel Chernoff, Funds Fear Clinton Pressure: Pension Assets Sought for Economically Targeted Investing, PENSIONS & INVESTMENTS, Nov. 23, 1992, at 1 (quoting pension consultant David Vienna).
been written exclusively about social investing by public plans. Instead, much of the commentary to date has focused on the legality of social investing by private funds under both federal law and the common law of trusts. In part, the lack of legal commentary regarding public fund investments is due to the varying standards among the states for the regulation of public funds. Unlike private pension plans, which are governed by the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), there is neither a national nor uniform regulatory scheme governing how state and local governments may invest public employee fund assets. Instead, individual states have adopted quite different approaches to regulating the investments made by their public pension funds. While many states have actively participated in the policy debate concerning the proper role for public pension funds in the U.S. economy, others have stood on the sidelines, opting for the status quo.

This Note focuses on social investments, particularly ETIs, made by public funds. Further, the analysis of this Note focuses primarily on public funds using a defined benefit approach to calculating benefits. Instead of simply restating the legal impediments that face governments that might consider pursuing targeted investment strategies, this Note points out some of the weaknesses in the theories put forward by commentators about social investing. In doing so, this Note explores the relevant public policy considerations essential to determining what the governing law should be for state and local funds. In addition, because they raise matters that help to define more clearly the issues in the debate about social investing, this Note examines the recent experiences of public funds using ETIs and judicial interpretations of the principles governing public fund investments.

Part I of this Note highlights the major issues involved in any discussion of "social investing," and the more narrowly defined category of "targeted investing." At the same time, this Note demonstrates that commentators have been unable to agree upon the basic terms and principles of social investing discourse. To establish a basis by which the available regulatory approaches

10. Although federally sponsored pension plans clearly qualify as public plans, this Note, unless indicated otherwise, uses the terms "public funds" and "public plans" to refer only to state and local plans.
11. See infra notes 117-33 and accompanying text for a discussion of some of the significant differences between defined benefit and defined contribution plans.
might be compared, Part II presents the various federal and state standards used to define the fiduciary responsibilities of pension fund trustees and to regulate fund investments. Part III presents a discussion of the legal and policy issues involved in determining the ownership of pension fund assets. An analysis of some of the public policy issues involved in determining both the desirability of targeted investing and what the proper standard should be for evaluating the legality of these investments is considered in Part IV. The purpose of this analysis is to lay a foundation that will enable state legislators and public policymakers to grapple with some of the basic issues involved in determining what legal standards should apply to public pension fund investments. In conclusion, this Note suggests that policymakers must more clearly define the issues surrounding the debate over targeted investing. They must not only recognize the competing interests of both sponsoring governments and plan members, but must develop policies that both provide for plan security and recognize the important role that pension funds play in our economy.

Let there be no mistake, as the conclusion to this Note makes clear, the author of this Note recognizes the economic and political liabilities that may be associated with social investing. But this Note does not advocate that state and local governments should rush to make economically targeted investments. Rather, these governments should develop sound approaches with objective standards for evaluating the benefits of targeted investment strategies.

I. DEFINING 'SOCIAL INVESTING

In recent years, various labor, political, and social groups have used increasing pressure to encourage pension fund trustees to invest plan assets in a way that promotes or protests specific economic, social, and political goals. These efforts often have taken the form of group activism against perceived social evils. For example, many groups oppose any investment of pension funds in companies that maintain business operations in South Africa, or companies that produce socially questionable goods, such as

12. This opposition is based on South Africa's systematic practice of racial discrimination, apartheid. As of September, 1990, 19 states, 55 cities, 8 counties, the U.S. Virgin Islands, and at least 77 universities had adopted South Africa-free investment policies. Margaret Price, Performance Clouds Issue of Divestment, PENSIONS & INVESTMENTS, Oct. 29, 1990, at 22; see also John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 MICH. L. REV. 72, 83-84 (1980). Langbein and Posner criticize the "arbitrariness of these conventions even as a litmus of activist thinking." Id. at 84. They argue that there are no "clear-cut criteria of portfolio exclusion and inclusion." Id. In addition, they are skeptical that a portfolio subject to socially responsible investment limitations
liquor, tobacco, or military and nuclear weapons. Other groups have encouraged pension fund trustees to choose investments that these advocates consider as beneficial to society. For example, some local and state governments have used linked deposit programs to encourage growth in the number of minority- and woman-owned businesses in a community. ETIs fall within this second category because the economic development they are intended to foster creates benefits for society. Despite the differences in form, both of these approaches have been referred to as social investing.

Much has been written over the past twenty-five years about the legality and consequences of social investing. Unfortunately, many commentators have failed to appropriately limit the application and scope of their analyses to the issues that are specific to different types of social investing. Moreover, because different commentators have used the same or similar terms to imply quite different meanings, no consensus has developed regarding how to define the basic terms of social investing discourse—including the term “social investing” itself. This indiscriminate use of terminology in much of the commentary often has yielded inadequate and unsatisfying explanations of the relevant issues in the debate concerning social investing. Although commentators must be painfully aware of the divergent use of these terms, many continue to posit theories about social investing without making relevant distinctions. In fact, several of the commentators who seem to disagree with one another’s theories might actually agree, or at least be able to more clearly define the areas of their disagreement, if they could settle upon common meanings for the terms of their analyses.

Several different terms have been used to refer to what has most commonly been called “social investing.” They include “alternative,” “economically
targeted," targeted, "developmental," targeted, "concessionary," targeted, and "strategic" in-
vesting. Judge Richard Posner and Professor John Langbein define social
investing as the "pursuit of an investment strategy that tempers the conven-
tional objective of maximizing the investor's financial interests by seeking to
promote nonfinancial social goals as well." Specifically, they define social
investing as "excluding the securities of certain otherwise attractive companies
from an investor's portfolio because the companies are judged to be socially
irresponsible, and including the securities of certain otherwise unattractive
companies because they are judged to be behaving in a socially laudable
way." Their more specific definition adequately defines the use of social
criteria in the selection of equity stock investments, but it falls short as a
general definition of social investing because it is limited to equities portfolio
design.

16. INSTITUTE FOR FIDUCIARY EDUCATION, ECONOMICALLY TARGETED INVESTMENTS: A
REFERENCE FOR PUBLIC PENSION FUNDS (1989) [hereinafter IFE SURVEY]. Langbem calls this form of
investing "localism." John H. Langbem, Social Investing of Pension Funds and University Endowments:
Unprincipled, Futile, and Illegal, in DISINVESTMENT: IS IT LEGAL? IS IT MORAL? IS IT PRODUCTIVE?,
AN ANALYSIS OF POLITICIZING INVESTMENT DECISIONS 1, 1 (1985) [hereinafter DISINVESTMENT].
18. Id. at 8, 17 (discussing developmental investing that is unable to offer competitive rates of
return). Unless indicated otherwise, references in this Note to "investment return" or "rate of return"
mean "risk-adjusted rate of return."
19. RICHARD PARKER & TAMSN TAYLOR, STRATEGIC INVESTMENT: AN ALTERNATIVE FOR PUBLIC
FUNDS (Strategic Inv. Advisors, Conference on Alternative State and Local Policies, Studies in Pension
Fund Inv. No. 6, 1979).
20. Langbein & Posner, supra note 12, at 73. Langbein, in a later article with Daniel Fischel, states
that "[s]ocial investing is commonly understood as an investment strategy that seeks to achieve some
socially desirable goal (however defined) at the expense of a suboptimal economic return to the fund."
Daniel Fischel & John H. Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule,
55 U. CHI. L. REV. 1105, 1143 (1988). This is basically the same definition used by Langbein and
Posner in their earlier work. Langbein and Fischel, however, indirectly characterize the type of definition
in the earlier work as unfortunate because it does not distinguish between two distinct forms: "(1) using
plan assets for social purposes at the expense of all those persons who otherwise would benefit under
the plan; and (2) using plan assets to benefit only a sub-group of those entitled to benefit under the
plan." Id.
practitioner of social investing would agree that there is a trade-off between social and more narrowly
financial interests. Some would say that social investing is enlightened profit maximization." Id.
Hutchinson and Cole make a distinction between inclusionary and exclusionary investing. See
Hutchinson & Cole, supra note 8, at 1384-85. Langbein and Posner also consider and seem to reject
as unpersuasive another economic "argument for social investing: that it confers a nonfinancial sort of
utility on the investor by catering to his moral or political preferences." Langbein & Posner, supra note
12, at 73.
22. This approach is supported by Modern Portfolio Theory (MPT). MPT posits that one can
minimize risk through the careful selection of a large number of stocks of varying degrees of risk,
whereby the risks may be offset against one another. In the context of portfolio design, MPT implies
that constraining the selection of stocks leads to higher administrative costs that will impair
diversification risk minimization. Langbein & Posner, supra note 12, at 93-94; see also infra note 39.
A more general and therefore satisfying definition is given by Professor Norman Stein, who distinguishes between two types of social investing: "moral social investing" and "pecuniary social investing." Moral social investing occurs when a trustee limits investments to firms or projects providing a perceived broadly focused social good, and pecuniary social investing occurs "when a trustee considers a lower return in exchange for other pecuniary benefits for at least some of the plan participants."

Although commentators have often considered the two collectively, Stein notes that the issues raised by these two forms of social investing are distinct. Indeed, he adds that "one could argue that pecuniary social investing is not social investing at all." Another example of the inability of commentators to reach agreement on the basic premises of social investing is whether social investing may be undertaken without sacrificing investment return. For example, in formulating their definition, Langbein and Posner presume, as do most opponents of social investing, that all social investments sacrifice rate of return or incur higher uncompensated risk for some other benefit. Opponents of social investing for a more extensive analysis of MPT's techniques, see Harvey E. Bines, Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine, 76 COLUM. L. REV. 721, 734-50 (1976); Langbein & Posner, supra note 12, at 92 (stating that divestment economically impairs a trust fund only if it produces a stock portfolio of greater volatility or lower rate of return). However, portfolio theorists disagree over the proposition that MPT precludes social investing, see, e.g., Joel C. Dobns, Arguments in Favor of Fiduciary Divestment of "South African" Securities, 65 NEB. L. REV. 209, 237 (1986), and courts have not generally accepted MPT's risk-calculation techniques. See Comment, The South African Divestment Debate: Factoring "Political Risk" into the Prudent Investor Rule, 55 U. CHI. L. REV. 201, 211 (1986) (arguing that courts tend to consider the risk of individual investments instead of the risk of the entire portfolio). Contra Baltimore v. Board of Trustees, 562 A.2d 720, 735 (Md. Ct. App. 1989) (considering portfolio risk as a whole, but court did not indicate whether its decision was based on MPT's risk-minimization techniques).

24. Id.
25. Id.
26. Id. Stein's statement, presumably, is based on the notion that if there is a pecuniary benefit that must be figured as a part of the total return of the investment, then there is no sacrifice of return. Therefore, the investment is not a social investment.
27. Although it is not evident from his definition, Stein does recognize that social investments do not necessarily violate trust prudence and diversification standards. Id.
28. Whenever an investment is made, the investor usually expects to be compensated for the level of risk incurred. Langbein and Posner argue that for an ETI to earn a market rate of return, the investor must accept a level of risk above that of the market as a whole. They argue that even though an ETI earns a market rate of return, on a risk-adjusted basis, the return is still below the market rate. Granted, if the investment turns out to be a sound one, the actual return may be higher than the market rate. However, this view is ex post—a luxury that financial investors are not legally afforded. The higher expected returns for riskier investments is a central empirical finding in finance literature. See, e.g., JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE 108-43 (2d ed. 1985).
investing typically insist that, by definition, social investments involve some sacrifice of the rate of return that might otherwise be earned. They argue that if an investment sacrifices return for some collateral benefit, it is social investing. Likewise, if there is no sacrifice of return, then it is not social investing at all; it is simply a prudent investment and cannot be objectionable, no matter what one calls it. It seems, therefore, that it is not the social impact that these opponents find objectionable. Rather, opponents object to the lower rate of return that they perceive as essential in order to classify an investment as a "social investment."

Proponents of social investing, on the other hand, might fairly be said to fall into one of two categories. The first includes those who argue that social investments can be made without sacrificing return. For example, Richard Parker and Tamsin Taylor note:

[T]he issue of "social responsibility" has more and more come to be seen as one in which a trade-off is involved: most simply, one between "yield" and "morality." That is, both sides in the debate have frequently posed the choice between acting responsibly and acting profitably. No such trade-off need be made. Social responsibility and profitability may now be more compatible than ever before.

Parker and Taylor argue that public pension funds can find investments of comparable yield and risk to their present portfolios and still provide capital to meet vital social and economic needs.

Similarly, Lawrence Litvak, in his book Pension Funds & Economic Renewal, argues that there are three paths down which development investing can go, only one of which "will be fully compatible with the dual objectives of providing retirement income and enhancing economic development." He describes the preferred method as "development investing that fills unjustified capital gaps." Litvak stresses that "[a] successful strategy for development

29. Posner argues that social investing has three costs: (1) the cost of identifying companies that will be excluded or included as investment opportunities based on social-investing grounds—a slight cost, if only because the grounds are so nebulous that they do not invite costly research; (2) the cost of underdiversification of uncompensated risk; and (3) higher trading costs. Richard A. Posner, Law and the Theory of Finance: Some Intersections, 54 GEO. WASH. L. REV. 159, 172 (1986).

30. PARKER & TAYLOR, supra note 19, at 2 (emphasis in original). Obviously, many commentators will suggest that this "free lunch" approach is wishful thinking. The issue, of course, is whether there is in fact a trade-off; the very term "trade-off" suggests a balancing act between profitability and morality.

31. See generally id., see also Hopkins, supra note 12.

32. LITVAK, supra note 17, at 7.

33. Id. (emphasis in original) (footnote omitted). Litvak uses the term "unjustified" to mean "unjustified on the basis of the underfinanced projects' actual financial reward to risk as compared to other ventures with which they are competing for capital." Id. at 7 n.1. The two forms to avoid are: (1)
investing will enhance the community while still and primarily ensuring the unimpeded provision of retirement benefits." He suggests that "the key to success is concentrating on sectors and enterprises that have been underfinanced due to gaps and inefficiencies in our financial system." Thus, Litvak's approach is truly strategic investing in the sense that investments must be closely scrutinized to determine if analysts of the existing capital markets have merely overlooked, as opposed to rejected, a particular investment opportunity. If the investment opportunity appears to be sound and can provide economic benefits to the community, an economic inefficiency in the capital markets has been exposed.

A major premise of Litvak's theory is that by taking advantage of the inefficiencies in capital markets, pension plans can find opportunities for economic development that will not lead to a reduced rate of return. Thus, using Litvak's approach, ETIs used to fill capital gaps will always meet fiduciary requirements. Litvak does not recommend the use of targeted investments for their own sake, but only when a capital need has been

“development investing in name only,” also known as displacement investing and (2) “development investing that requires financial concessions.” Id. at 8 (emphasis omitted). The first targets investments that would probably have been well-financed by other institutions, and thus simply displaces other investors. The second, Litvak argues, “will fail to produce the best retirement benefits at the least cost.” Id.

34. Id. at 7 (emphasis in original).
35. Id. at 4. In 1982, the MILRITE Council, a business-government-labor cooperative formed to develop the Pennsylvania economy, commissioned a study to examine the issue of capital gaps in Pennsylvania's economy. The study found capital gaps for venture capital for new companies, working capital for small and medium-sized enterprises, and private placements. NEW YORK STATE INDUSTRIAL COOPERATION COUNCIL, OUR MONEY'S WORTH: THE REPORT OF THE GOVERNOR'S TASK FORCE ON PENSION FUND INVESTMENT 29 (1989) [hereinafter OUR MONEY'S WORTH].
36. Litvak notes:

Development-oriented debt investments will typically be more risky than traditional pension fund debt investments, and the same will be true for equity investments. Development investments will also generally require higher management expenses or fees, and will be less liquid. Offsetting these characteristics is the fact that development investments will compensate the pension investor at a higher rate of return for each of these undesirable features. [But due to the long-term investment horizon and ability to diversify away nonsystematic risk, f]rom a financial perspective, pension funds are in a better position to make these investments than almost any other financial institution.

LITVAK, supra note 17, at 123-24.

Some argue that fiduciaries have an obligation to optimize, not necessarily maximize, investment returns. These advocates suggest that if U.S. corporations are ever to compete effectively in world markets, they must change their "perspective from immediate profit-driven 'maximizing' actions (such as delaying research and development expenditures which might temporarily depress stock prices) to longer-term 'optimizing' strategic planning approaches." The Impact of Institutional Investors on Corporate Governance, Takeovers, and the Capital Markets: Hearing Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 101st Cong., 1st Sess. 3, 32 (1990) (report by Dr. Carolyn K. Brancato, Institution Investor Project: Columbia Center for Law and Economics Studies).
exposed and the investor/fiduciary has determined that the need can be met without making concessions in the expected rate of return. And presumably, as noted above, even critics of social investing would not object to this form of investing. If one agrees with Litvak’s economic analysis, his theory is provocative because it holds that, ex ante, social investments (depending on how you define them) are not per se imprudent. That is, opportunities exist for the use of targeted investments to stimulate economic development that are compatible with earning a competitive rate of return.

Litvak’s theory, however, does not address the major issues of what has conventionally been called “social investing”—where the rate of return is sacrificed for some other benefit. For this reason, Litvak’s fundamental premise—that there is a social investing approach that will not sacrifice rate of return—is one that Langbein and Posner would not accept. Presumably, they would argue that targeted investing using Litvak’s theory of filling capital gaps is destined to fail on the theory that capital markets operate efficiently, or at least as efficiently as any social investor can be expected to act. Thus, much of the disagreement between some opponents of social

37. Opponents of social investing might argue that it is not interesting merely to suggest that funds should make investments that are sound even though they are so-called “social investments.” The interesting and critical question is: To what degree should funds be able to sacrifice return or to make risk-return tradeoffs?

38. Langbein charges that there are only two possible outcomes for social investing—“the futile and the wealth-impairing.” Langbein, supra note 16, at 16.

39. See Langbein & Posner, supra note 12, at 77-83. The efficient market theory posits that with traded securities, if markets are “efficient,” the outlay of resources on securities research wastes plan funds. More importantly, efficiency “implies that an investment strategy attempting to outguess the market must be suspect.” Jeffrey N. Gordon & Lewis A. Kornhauser, Efficient Markets, Costly Information, and Securities Research, 60 N.Y.U. L. REV. 761, 764 (1985). Professors Gordon and Kornhauser cast doubt on the wisdom of relying on the efficient market hypothesis as applied to various areas of corporate law. They charge that legal decision makers and scholars have misunderstood the assumptions and limitations of the hypothesis. Their analysis questions the prevailing views of appropriate investment strategy by institutional investors. See generally id. They note that “[a]ny claim that capital markets work well reduces to a claim about the accuracy of prices on well-developed capital markets such as the New York Stock Exchange or the market for government bonds.” Id. at 768. Although in these contexts the theory is quite defensible, with many ETIs there is no well-developed market to which an investment may be subject. Nonetheless, the theory of diversification upon which these views are based is instructive. Funds pursuing ETIs should seek to ensure proper diversification of investments by not investing an inordinate amount of assets in any one geographical area or industry. For a list of sources supporting the view that markets operate inefficiently, see id. at 765 n.8. For material supporting the view that markets operate efficiently, see Richard A. Posner, Economic Analysis of Law § 15.1 (3d ed. 1986); Robert C. Pozen, Financial Institutions: Cases, Materials and Problems on Investment Management 139-75 (1978); James J. Junewicz, Portfolio Theory and Pension Plan Disclosure, 53 N.Y.U. L. REV. 1153 (1978); John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law, 1976 AM. B. FOUND. RES. J. 1; John H. Langbein & Richard A. Posner, Market Funds and Trust-Investment Law: II, 1977 AM. B. FOUND. RES. J. 1; Langbein & Posner, supra note 12, at 77-96; Robert C. Pozen, Money Managers and Securities
investing, like Langbein and Posner, and this first category of proponents is not actually about whether a trustee may permissibly sacrifice the rate of return for pension fund investments, but whether markets are in fact always efficient. If the capital markets are efficient, opportunities for profitable social investing should be nonexistent.

The second category of proponents of social investing includes those who believe that social investing is justifiable in some circumstances even though the rate of return for an investment is sacrificed. Supporters in this category may believe: (1) that collateral benefits from social investing compensate for any loss in the direct rate of return; (2) that there is a moral imperative to use the funds in an ethical manner; (3) that the funds are owned by the sponsoring government, not plan participants and beneficiaries; or (4) that public policy issues warrant that factors other than profit alone be considered in the investment decision-making process. These are the theories of social investing that pose the tougher questions for policymakers and that are the focus of this Note.

II. ECONOMICALLY TARGETED INVESTMENTS

Many states began implementing ETI programs in the 1970s, and now more than twenty-five states have in-state strategic investment policies. ETIs may be defined as investments "promoting a geographic area as a good place for doing business, assisting private development projects that serve public economic development objectives, developing public facilities, financing research," 51 N.Y.U. L. REV. 923 (1976).

40. Hutchinson and Cole propose yet another approach for classifying social investment policies within one of three groups: (1) "totally neutral," (2) "socially sensitive," and (3) "socially dictated." Hutchinson & Cole, supra note 8, at 1344. "Totally neutral" policies focus exclusively on the financial aspects of particular investments. Id. "Socially sensitive" policies involve the use of financial factors to select investments from among financially comparable alternatives. Id. at 1345. Hutchinson and Cole state that "so long as the fiduciary has not decided to sacrifice comparability of safety, return, diversification, or marketability in order to employ noninvestment considerations, he has discharged his responsibility" Id. Hutchinson and Cole define "socially dictated" policies as those that "either (1) permit the sacrifice of safety, return, diversification, or marketability; or (2) are undertaken to serve some objective that cannot be related to the interests of plan participants and beneficiaries" Id. at 1346.

41. The practice of using public funds for policy objectives is not a new one. State and local governments have consistently restricted government deposits to local institutions, linked government deposits to holdings of depositor's securities through pledge requirements, and selectively used public credit, or the regulation of private dealings, to forward specific policy goals. See, e.g., Ronald W. Forbes, State and Local Government Cash Management Practices, in STATE AND LOCAL GOVERNMENT FINANCE AND FINANCIAL MANAGEMENT: A COMPRENDIUM OF CURRENT RESEARCH 53, 58-60 (John E. Peterson et al. eds., 1978); James Rowen, Public Control of Public Money, PROGRESSIVE, Feb. 1977, at 47.
public involvement in economic development projects, and retaining or enlarging an area's economic base. The presumption of policymakers and sponsoring governments that support the use of ETIs is that in-state targeted investments provide indirect economic returns to both the state (or community) and its residents. The indirect economic benefits flow from the economic growth attributable to the investment, such as increased job security and a stronger local or state economy. In addition, depending on the type, the terms, and the success of the investment, there will usually be direct economic returns from the investment in the form of investment income.

Although many of the same issues involved in determining whether it is appropriate for public pension funds to engage in social investing also apply to targeted investing, from a policy standpoint a distinction should be made between social investing and ETIs. First, the economic benefits derived from ETIs are more easily quantifiable than are those associated with many other categories of social investing. For example, although it might be difficult to determine the actual economic impact of an in-state direct placement, it would be much more difficult to determine the ethical impact (benefit) society derives through the advancement of some social policy. For example, it would be difficult to determine the perceived or actual benefit derived from an affirmative action program through which trustees award management contracts for the investment of fund assets to minority- or woman-owned investment management firms. Second, the function of ETIs is associated much more closely with the primary purpose for which pension funds are established—to provide economic benefits to plan beneficiaries. Arguably, there are collateral economic benefits that accrue to plan members (and other citizens) through ETIs, including increased job security, a stronger economy, increased tax revenue for local and state governments, and enhancement of the sponsor's ability to contribute to the fund in the future. These benefits are more clearly and closely related to economic interests than are those promoted by some advocates of social investing, such as the claimed benefit of a "more ethical society." Third, ETIs are generally not as value-laden as many forms of social investing, such as the divestment by a plan of equity stocks for moral reasons. Finally, whereas some might object to the use of ETIs by

42. Petersen & Spain, supra note 15, at 2-3. Petersen and Spain use the term "alternative investing" to describe this type of investment.
43. See, e.g., infra notes 62-63 and accompanying text.
44. It is not sufficient, however, to argue that growth-related economic benefits derive from in-state investments. One must also argue that, in the absence of the local investment, the economic growth would not have occurred. See supra notes 32-37 and accompanying text.
45. Although some might disagree about the efficacy of ETIs in advancing economic development, most would agree that economic development is a worthy goal. At the same time, there is likely to be
private funds because the primary role of business is not to promote the public good, promoting the public good is arguably the most important role played by government. Thus, the use of ETI strategies is much more justifiable in the public fund context. Depending on how one views the ownership claims to pension fund assets, an argument may be made that due to the government's ownership interest in public pension funds, the funds should be used in a manner that not only meets the government's pension promise, but one that is consistent with the sponsoring government's role; that is, to use the money in a way that benefits society the most.

A. Recent Experience with ETI Programs

There is a wide range of approaches public pension funds have used to invest in and for the benefit of their local economies. Pension-sponsored investment vehicles include residential housing mortgages, small business loans, commercial real estate mortgages, venture capital, certificates of deposit, and private placements. A 1989 study underwritten by the Ford

wide and varied opinion on the value of seeking to limit or promote certain activities through investment decisions, such as attempts to pressure companies to cease the production of munitions. Some are bound to argue that all munitions are a social evil, while others will stress the importance of munitions in strategic defense. Moreover, many question whether divestment is actually effective in applying pressure or bringing about change. See, e.g., William G. Milliken, Divestment Is Not the Answer, in DISINVESTMENT, supra note 16, at 95.

46. See infra part III.

47. For example, one report notes that since January, 1990, the New York City Retirement Systems have committed more than half of the funds' investments—$430 million—to targeted investments, including small business and housing programs. Christine Philip, Funds' New York City Investment Program on Target, PENSIONS & INVESTMENTS, July 20, 1992, at 8. Targeted investments by the system in the five-year period ending December 31, 1991, realized a 13% annualized return. During the same period, the Shearson Lehman Aggregate Bond Index earned an annualized return rate of 9.9%. Id.

48. For a discussion of an innovative approach used by two Milwaukee pension funds to help build affordable housing, see Hillary Durgn, 2 Milwaukee Funds Support Housing Effort, PENSIONS & INVESTMENTS, Aug. 31, 1992, at 26.

49. For a general discussion of real estate, private placement, and international investments, see EBRI ISSUE BRIEF, supra note 3, at 14.

A private placement is an arrangement between an investor and a firm, where the investor agrees to directly buy the equity or debt issued by the firm, thus bypassing the public market. The investor hopes to benefit by taking advantage of the potential market underpricing of the securities. See, e.g., Alabama Helps Finance Construction of Paper Facility, PENSIONS & INVESTMENTS, Oct. 1, 1990, at 9; City Has Brotherly Love, Good Return, PENSIONS & INVESTMENTS, Mar. 4, 1991, at 12; Ohio Teachers Top New Heights with N.J. Tower, PENSIONS & INVESTMENTS, Feb. 19, 1990, at 8; Margaret Price, R.I. Fund Jumps in to Give State a Hand, PENSIONS & INVESTMENTS, Apr. 2, 1990, at 42; States Seek Pension Capital, PENSIONS & INVESTMENTS, Jan. 8, 1990, at 2; Curtis Vosti, Alabama Chief Innovating Despite Barriers and Critics, PENSIONS & INVESTMENTS, Oct. 30, 1990, at 15. In April, 1990, the SEC issued rule 144A, which exempts institutions already holding at least $100 million in securities from registration requirements for the sale of stocks and bonds. Because individual investors are categorically shut out of this market, the rule allows pension funds to be more active in private placements. Id.
Foundation surveyed the 126 largest public pension systems in the nation regarding strategic investments the funds make to impact their local economies. The ninety-nine retirement systems responding to the survey held assets of more than $509 billion for more than 8.4 million members.

The survey found that statewide systems and systems with large asset amounts were more likely to make ETIs than their counterparts. Forty-one percent of the systems reported making ETIs, while another 3% stated they were considering implementing ETIs. The most commonly reported ETI programs were residential housing loans (made by 44% of systems reporting ETIs) and venture capital (made by 34% of systems reporting ETIs). Twenty-six percent of the systems reported making real estate investments and small business loans. The remaining investment vehicles included private placements and certificate of deposit programs in local banks.

Systems cited job creation and business development as the primary reasons for the targeted investments, most of which were programs for small business loans or venture capital. However, in terms of dollars allocated, residential mortgage loans, targeted for 67% of ETI program funds, garnered the lion's share. Respondents reported that venture capital investments comprised only 7 7% of ETI dollars.

50. IFE SURVEY, supra note 16.
51. Id. at 1.
52. Id. at 1. The study does note, however, that because of differences in defining ETIs, ETI activity may be under-reported in the survey. Id. at 2; cf. LITVAK, supra note 17, at 7. Litvak reports that a 1981 survey conducted by the Government Finance Research Center found 37% of public funds were making an effort to make investments beneficial to their respective local economy. Id.
53. Id. at 1. Sixty-three percent of the systems with assets greater than $5 billion reported ETIs, as compared to 41% for all systems. Id. "Statewide systems are nearly twice as likely to report ETIs (51.7 percent) as county or municipal systems (26.8 percent)." Id. at 2. These statewide systems presumably have more geographic options at which to target investments with greater diversification and, therefore, less risk.
54. IFE SURVEY, supra note 16, at 3-4.
55. Id. (reporting job creation and business development as primary reasons for 48 of the 78 reported ETIs).
56. Id. (reporting 30 programs were small business loans or venture capital programs).
57. The study notes that "because of past and present legal restrictions, many government funds have a bias toward mortgages and other fixed-income investments." Id. at 4.
58. Id. "In 1987, pension funds invested more than 40% of a record $4.2 billion in new venture capital. The majority of this money came from public pension funds. In all but the very largest states, public pension funds are the biggest single source of institutional capital." Belden H. Daniels & Catherine A. Crockett, Do You Know Where Your Capital Markets Are?, 1988 J. ST. GOV'T 129, 132 (arguing that because the nature of the economy has changed, states need new regulatory approaches); see also Joel Chernoff & Trudy Ring, States Seek Pension Capital, PENSIONS & INVESTMENTS, Jan. 8, 1990, at 2.

The results of a Goldman Sachs survey indicate that between 1987 and 1991, investments by public pension funds in alternative investment classes ($33 billion) significantly outpaced those by corporate funds ($10 billion). Thomas J. Healy and Fiachra T. O'Driscoll, Are Alternative Investments Right for
B. ETIs: Who Benefits and What's the Harm?

There are at least three groups of stakeholders in the debate over the effects of social investing, each having distinct and, at times, competing interests. Thus, defining how social investing impacts each of these groups is a critical first step in assessing the overall benefit or detriment of formulating and pursuing targeted investment strategies.

The first group of stakeholders includes taxpayers and sponsoring governments. Pension promises result from legislation—they are promises made to public employees by the state. In simplest terms, the trustees manage pension funds as a portfolio for taxpayers who are, in effect, investors. Although some would argue that governments do not always act in the best interests of taxpayers, for present purposes it is helpful to consider government as an amalgamation of the interests of citizen taxpayers.

The second group of stakeholders includes both plan participants and beneficiaries. Participants are the employee plan members themselves, while beneficiaries are those who would take an employee's benefits in the event of that employee's death. In many cases, the beneficiary is the spouse or a family member of the participant. Sometimes participants are also referred to as beneficiaries.

The third group of stakeholders includes plan fiduciaries, who are typically trustees. Their primary interest in regard to social investing is in having clear standards by which they can conform their conduct and thus fulfill their fiduciary roles. These fiduciaries look to their respective legislature and the courts to fashion laws that will guide the fiduciaries in the selection of fund investments. Because the competing interests of sponsoring governments and plan members present difficult questions, they are discussed more fully below.

1. Sponsoring Governments and Taxpayers

A successful targeted investment should help stimulate long-term economic development. Common byproducts of economic development efforts include: (1) the creation of new employment opportunities; (2) increases in tax revenue, created both by business activity and income taxes; and (3) increases in in-state expenditures. Although many economic development efforts are

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Your Pension Fund?, PENSION WORLD, July 1992, at 23, 25. This disparity is even more significant given the fact that fewer than 60% of the funds surveyed held alternative assets due to charters limiting fund investments to highly rated bonds and blue-chip stocks. Id.

59. This argument, however, could be used to reject any government policy. In a representative democracy, elected public officials do (or, at least, are supposed to) represent those who elect them.
targeted at new business start-ups, ETIs can also be used to provide economic incentives to help retain local businesses that are considering relocating outside the community or state. Although there may be no increase in local business activity, the local or state economy may benefit by preventing future decreases in tax and business revenue—levels that will be maintained if a company is persuaded to stay. In addition, costs, such as those associated with unemployment benefits for displaced workers, will be avoided. Of course, the potential benefits must be evaluated in each situation. In cases where a company is engaged in a declining industry or where the long-term prospects for a company's survival are questionable, the best plan may be not to offer economic incentives to the company.

An Ohio linked-deposit program illustrates one approach of how states can provide economic incentives to encourage companies to expand and become more competitive. The program funnels state money through Ohio banks to in-state businesses at reduced rates. The loans enable these businesses to refinance old debts or to reorganize and expand operations to become more competitive. To be eligible, small Ohio businesses must substantiate that their use of the funds will have a material impact on in-state employment. The Ohio Legislative Budget Office estimated that "for every dollar given up in investment revenue because of the lower yielding certificates of deposit, three to four dollars are returned to the Ohio Treasury in the form of personal income taxes, business taxes, sales taxes, and lower costs associated with unemployment." Thus, in purely financial terms, the Ohio program seems to make great sense. Of course, it would be difficult, perhaps impossible, to determine if the program actually spawned any new investment or whether the

60. ETIs may also be used to attract out-of-state businesses by encouraging them to relocate to the state sponsoring the ETI. For example, in Rhode Island, the state pension fund provided $23 million in financing to attract a unit of American Express to move from Boston to Providence. The pension fund furnished long-term financing for an office building to house the unit by purchasing a $23 million participating mortgage security issued by the Rhode Island Industrial Facilities Corporation, a state agency that issues bonds for economic development. Proceeds from the bond sale were used to pay off the developer's temporary financing. The pension fund was attracted to the investment for several reasons: (1) the participating mortgage carried an 8% fixed coupon; (2) the fund was to receive 25% of the net cash flows of the building's monthly operations and 25% of the building's net appreciation at the 10-year maturity of the bond; and (3) the deal brought 400 new, high-paying jobs to Rhode Island. Price, supra note 49, at 42-43.


63. Id.
state funds merely displaced other capital sources. The validity of the success of programs such as this is an empirical matter that is not considered here.

In addition to purely financial objectives, some forms of social investing have as their objective the advancement of some social policy. For example, in recent years a Pennsylvania program has used state pension funds to provide student loans to more than 77,000 students. The pension funds have earned a rate of return of one-half of a percentage point above the U.S. Treasury Bill rate and there is no investment risk for the funds; another state agency buys back loans on which students default. Thus, the overall return of the investment is even higher than the purely financial return. That is, the investment not only earns a competitive rate of return, but the use of the funds to help make higher education more financially accessible to state residents must also be regarded as a social good.

Regarding individual’s investment choices and consumption preferences, Langbein and Posner state:

[T]he decision of an individual to include social goals among his investment objectives is not interesting from a policy standpoint [because] presumably he has balanced the possible financial costs of such a policy against the utility—a form of personal consumption—that he derives from expressing support for the social aims implied by the fund’s investment policy.

When this consumption value is added to the “pure investment value,” the social investment may equal or exceed alternative investment and consumption opportunities.

Similarly, when a government invests a portion of the pension fund assets it manages in a manner that provides some benefit to society or advances some public policy, the value of the benefit should be included along with any purely financial return to the fund to determine the total rate of return of the investment. Although not purely economic, the benefit created is a public good and amounts to a type of community consumption. Moreover, because the very purpose of government is to promote the common good, it makes sense that these collateral benefits should be considered in the overall return calculus.

Langbein and Posner hint at why they believe there is a difference between an individual making these judgments and fiduciaries making similar value

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65. Id.
67. Id. at 94.
judgments. They suggest that "[a] legal issue arises only when the investor or investment beneficiary has not consented to a decision by the investment manager to subordinate the investor's financial welfare to other objectives." In other words, they presume that the fund assets are wholly owned by plan members and that, absent consent, any investment that is not made solely in the interest of plan members amounts to a breach of the fiduciary's duty of loyalty. Notice, however, that this assumes the answer to the policy question it asks—whether plan members do, in fact, wholly own the plan assets, as opposed to merely possessing a claim to a future benefit. The competing claims of asset ownership are discussed in Part III.

2. Plan Members

Plan members have a significant interest in ensuring that they will receive their benefits at retirement. Indeed, members often invest great emotional, psychological, and practical faith in the pension promise. It is unclear, however, whether ETI strategies jeopardize that promise. Arguably, under a defined benefit plan, members benefit from ETIs to the same extent that other members of society benefit, if not more. That is, if the state or local economy is more robust due to the effective use of ETIs, plan members, as residents of the state or community, receive many of the same benefits that accrue generally to all other residents of the affected state or community. For example, if the effective use of ETIs somehow translates into a lesser financial burden on the sponsoring government, presumably this will mean a lesser tax burden on residents or an increase in, or the development of new, government services. In addition, plan members receive the more direct and added benefits associated with their continued employment. Stressing this point, one report advocating the use of ETIs states:

The multi-faceted interests of [plan] beneficiaries are largely compatible with the interests of other pension fund stakeholders. The reality of multiple mutual interests suggests that the investment goal, the best interests of the beneficiaries, is achieved not only by the traditional process in which the trustee considers the risk and return of each investment but also by consideration of the economic vitality of both the corporations in which the fund invests and the economy generally.  

68. Id. at 75.
69. See infra notes 117-33 and accompanying text for a discussion of some of the significant differences between defined benefit and defined contribution plans.
70. OUR MONEY'S WORTH, supra note 35, at 16.
While plan members benefit at least as much as do the residents of the geographical area affected by a particular targeted investment, assuming solvency of the fund and continued employment, they also bear the burden of investment loss to the same extent as society generally. As discussed in Part III, with a defined benefit plan the risk of investment loss incides on the plan sponsor. Further, when the plan sponsor is a government, any shortfall in revenue will presumably mean a higher tax burden on taxpayers or a shift of monies from the provision of other government services to the payment of pension obligations. Thus, either way, resident taxpayers, including plan members, bear the cost of increased taxes or decreased government services to compensate for investment losses. It is important to note, however, that even when there is a purely financial investment loss, there may be some nonfinancial benefit to the community that offsets a portion or all of the financial loss of an investment. In fact, although there may be some purely financial loss to the fund, the overall benefit to society may still be positive.

III. REGULATION OF PRIVATE AND PUBLIC FUNDS

While economic development leaders might view pension funds as a source of much-needed capital, many fund administrators and plan members take a different position. These opponents of social investing cite the fact that pension fund assets above all should be for the benefit of fund members. They argue that fund trustees have a fiduciary responsibility to both plan members and taxpayers to provide fully funded pensions at a low cost, and that social investing would violate these fiduciary duties. It is clear, however, that this opinion is neither universally accepted nor, perhaps, even mainstream. For example, Professor Scott, the eminent treatise author of trust law, states:

71. Unless, of course, the plan is overfunded.
72. This assertion is true to the extent that tax burdens are shared equally, an issue that is beyond the scope of this Note.
73. A project researcher for a recent survey of the nation's largest public pension funds noted that:
   it seemed that many retirement system officials resented the demands by public officials or constituent interests that the retirement systems make ETIs at all. Part of this resentment seemed to be rooted in the fear that programs of this type would lead down a slippery slope where performance was difficult to measure, and it becomes difficult to resist special pleading by politically influential interests.
IFE SURVEY, supra note 16, at iii.
74. See, e.g., Pension Fund Socialism, supra note 7.
75. Id.
Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles.

Institutional fiduciaries have come to realize that they have a concern in the social behavior of the corporations in whose securities they invest. Of course they may well believe that a corporation that has a proper sense of social obligation is more likely to be successful in the long run than those that are bent on obtaining the maximum amount of profits. But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.\(^7\)

In the corporate context, a reflection of judicial opinion supporting Professor Scott's view states:

Modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate. Within this broad concept there is no difficulty in sustaining, as incidental to their proper objects and in aid of the public welfare, the power of corporations to contribute corporate funds within reasonable limits in support of academic institutions.\(^7\)

These statements illustrate the tensions created by the competing claims of opponents and proponents of social investing. The roots of these tensions are best exposed by examining the differing standards to which plan fiduciaries are subject. One factor used to determine the applicable standard for a given


fund is whether the plan is public or private. Although the focus of this Note is on public plans, due to the greater development and uniformity of statutes governing private funds, it is helpful to consider the major provisions of federal law governing private fund investments. Accordingly, the discussion below analyzes the current statutory framework for the regulation of private funds. This analysis helps to demonstrate why the approach used to regulate private funds should not be adopted by states to regulate public plans.

A. Federal Regulation of Private Funds: The Employee Retirement Income Security Act

The main body of federal pension law, the Employee Retirement Income Security Act of 1974 (ERISA), defines uniform regulations that private pension funds must follow. ERISA was adopted to define standards of conduct for private pension fund administrators and trustees and to protect the financial interests of fund beneficiaries. Congressional committee reports also document Congress's belief that the common law's emphasis on the intent of the settlor of a trust to determine the responsibilities of the trust's fiduciaries was inappropriate in the pension fund context. Whatever its intended purpose, the practical impact of ERISA was to make clear that pensions are not merely gratuities (if that concept had not already been discredited), but are corporate liabilities enforceable at law. Whereas the legal claims of pension beneficiaries were formerly limited to pension assets,


79. Under ERISA, the terms "trustee," "fiduciary," "plan administrator," and "investment manager" have particular meanings. For the purposes of this Note, however, the general term "fiduciary" is used to refer to those with a fiduciary duty to plan members.

For a discussion of the economic implications of ERISA, see JEREMY I. BULOW ET AL., ECONOMIC IMPLICATIONS OF ERISA (Nat'l Bureau of Economic Research Working Paper No. 927, 1982). Another reason for the adoption of ERISA was to provide a uniform fiduciary standard for private funds in the context of interstate commerce. Hutchinson & Cole, supra note 8, at 1351. Obviously, there is no such need for state and local plans.

80. Hutchinson & Cole, supra note 8, at 1351 (citations omitted).
ERISA extended the enforceability of these claims in certain cases to include a portion of corporate assets.\(^8\)

Although public funds are not subject to ERISA’s provisions,\(^8\) it is instructive to consider the provisions of ERISA as they relate to social investing and public funds because many portions of ERISA are primarily the codification of common-law principles, some of which apply to public funds. Moreover, since the enactment of ERISA, judicial decisions, and rulings by the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL), have created an extensive and elaborate set of requirements for the administration of pension funds.

For the purposes of this Note, two major provisions of ERISA are relevant—the duties of prudence and loyalty.\(^8\) First, according to ERISA, fiduciaries must act “with the care, skill, prudence and diligence, under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”\(^8\) This standard is commonly referred to as the “prudent person” or “prudent expert” rule.\(^8\) It has been interpreted to

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81. For a discussion of why ERISA was adopted, see Jack L. Treynor et al., The Financial Reality of Pension Funding Under ERISA 5-13 (1976). Treynor, Regan, and Priest note:

The ostensible purpose of [ERISA] was to make certain that the beneficiaries got paid. This was accomplished by creating the Pension Benefit Guaranty Corporation (PBGC) and charging it with the responsibility to meet pension claims as they fell due. The act had at least two other purposes: (1) to prevent pension plans from becoming wards of the public—thereby socializing the private pension system, and (2) to see that the employer who receives consideration in the form of labor for its pension promises does not evade the financial responsibility for fulfilling these promises.

Id. at 85.

Bulow, Menell, and Scholes note that for private funds, ERISA and the establishment of the PBGC changed the economics of the defined benefit pension plan. If there were opportunities prior to ERISA to move assets from pension to corporate accounts or to overfund the pension plan to obtain tax benefits, ERISA reduced these opportunities. Bulow et al., supra note 79, at 24.


83. ERISA also codifies the common-law requirement that a trust fund’s investment portfolio be adequately diversified. Restatement (Second) of Trusts § 228 (1959); ERISA § 404(a)(1)(C), 12 U.S.C. § 1104 (a)(1)(C) (1988). Langbein and Posner argue that the decision to concentrate fund assets in one state or region would adversely affect diversification. Langbein and Posner, supra note 12, at 90. They note that “the costs in reduced diversification might be offset by gains in enhanced employment security for nonretired employees; but [they] think [it] unlikely.” Id. Their concerns about geographical risk might be mitigated through the use of consortiums. See, e.g., Five Public Plans Invest in Specific-Site Fund, Pensions & Investments, Feb. 19, 1990, at 4. Diversification across asset classes is also important. Diversification within a single class of assets (stocks, for example) cannot eliminate systematic risk—the risk of owning the entire class of securities. The only way to minimize the risk of an entire class collapsing is through the allocation of assets into unrelated investment vehicles.


include two principles that depart from the traditional prudent person rule of trust law.86

[F]irst, the relative riskiness of a specific investment or investment course of action does not render such investment either per se prudent or per se imprudent; second, the prudence of an investment decision should not be judged without regard to the role the proposed investment course of action plays within the overall portfolio, rather than standing alone.87

Second, ERISA codifies the common law duty of loyalty for trustees,88 typically known as the "exclusive benefit" rule.89 ERISA section 404(a)(1) states that a "fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries.90 Although the DOL has stated that the exclusive benefit rule prohibits "a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives,"91 the DOL has never taken the position that incidental benefits are prohibited under all circumstances.92

86. The prudent person rule dates from the 1830 case of Harvard College v. Amory, 26 Mass. (9 Pick.) 446, 461 (1830).
87. BUCK CONSULTANTS, REPORT TO THE PERMANENT COMMISSION ON PUBLIC EMPLOYEE PENSION AND RETIREMENT SYSTEMS STATE OF NEW YORK ON IN-STATE INVESTMENTS BY THE PUBLIC EMPLOYEE RETIREMENT SYSTEMS OF THE CITY AND STATE OF NEW YORK 24-25 (1988) (citing discussion of the regulation, 29 C.F.R. § 2550.404a-1 (1992)); see also LITVAK, supra note 17, at 43.
One court held that courts should not focus on the success or failure of the investment to determine whether the investment is, in fact, prudent. Instead, courts should examine the methods used by the fiduciaries to select the investment. Donovan v. Walton, 609 F Supp. 1221, 1222-28 (S.D. Fla. 1985), aff'd, 794 F.2d 586 (11th Cir. 1986).
88. RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959). Langbein notes that "[t]he decision to mold the pension fund into the trust form antedated ERISA. The tax code has long preferred the trust form for pension plans; and the Taft Hartley Act of 1947 mandated the trust for collectively bargained funds, in the hope of distacing pension and welfare benefit money from the dominion of union officers." John H. Langbein, The Conundrum of Fiduciary Investing Under ERISA, in PROXY VOTING, supra note 23, at 128, 130.
B. Regulation of State and Local Funds

Whereas private pension fund investment activities are limited by the provisions of ERISA, the fiduciary duties of public fund trustees are established by state law, either by statute or judicial decisions.\(^9\) In addition, some state constitutions contain provisions regulating the types of investments state-sponsored funds can make.\(^9\) While several states have adopted ERISA's prudent person rule as a guideline for fund investments, others have maintained a legal list of approved investment options and/or investment limitations.\(^9\) In the absence of state law requiring or proscribing specific investments, the duties of loyalty and care under the common law of trusts are applicable.\(^9\) This standard of loyalty is the same as that owed to the beneficiaries of a private trust at common law\(^9\) and similar to the duty of loyalty owed under ERISA.\(^9\)

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\(^9\) The ERISA prudence standard does not apply to state and local government-sponsored plans. Instead, these investments are governed by state law. Congress intentionally excluded governmental pension plans from ERISA’s provisions because additional information was considered necessary to determine the need for federal regulation of these plans. COMMITTEE ON EDUCATION AND LABOR, 95TH CONG., 2D SESS., PENSION TASK FORCE REPORT ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS (Comm. Print 1978). For a historical overview of federal efforts to regulate public pension plans, see CONGRESSIONAL RESEARCH SERVICE, COMMITTEE ON EDUCATION AND LABOR, 101ST CONG., 2D SESS., PUBLIC PENSION PLANS: THE ISSUES RAISED OVER CONTROL OF PLAN ASSETS (Comm. Print 1990).

\(^9\) For example, although it is the only state with such a constitutional provision, the Indiana State Constitution prohibits any entity of the state, including the Indiana Public Employees' Retirement Fund and the Indiana Teachers' Retirement Fund, from becoming a “stockholder in a corporation or association.” IND. CONST. art. XI, § 12; see also 37 Ind. Att'y Gen. Op. 185 (1962).

\(^9\) The IFE Survey indicates that the following investment policies apply as legal authority for the stated percentage of public funds it surveyed: (1) financially prudent person, 56.6%; (2) legal list, 27.3%, (3) financially prudent expert, 17.2%, (4) diversification requirement, 15.2%; (5) basket clause, 15.2%; (6) specific statute requiring ETIs, 2%; (7) socially prudent person, 1%, and (8) other, 22.2%. IFE SURVEY, supra note 16, at 16 (noting that because respondents were asked to check all that apply, some systems have more than one legal authority).

A 1989 survey by the National Council of State Legislatures found that 52% of the plans the Council surveyed had state laws limiting equity investments to maximums varying from 0% to 75% of a fund’s total assets. RONALD K. SNELL & SUSAN WOLFE, PUBLIC PENSION FUNDS’ INVESTMENT PRACTICES: RESULTS OF A SURVEY CONDUCTED BY THE NATIONAL CONFERENCE OF STATE LEGISLATURES AND THE NATIONAL ASSOCIATION OF LEGISLATIVE FISCAL OFFICERS (1989).


Although public funds are exempt from most ERISA provisions,99 to maintain their tax-favored status, funds are required to comply with the pre-ERISA requirements of the Internal Revenue Code (IRC). The IRC sets forth provisions that both public and private pension funds must meet to qualify for tax-exempt status.100 A key provision of the IRC is that investments must be made for the exclusive benefit of plan participants.101 Thus, although ERISA's "exclusive benefit" requirement does not apply to public funds directly, if a public plan intends to maintain its tax-exempt status, the IRC provisions effectively impose the same standard of loyalty as does ERISA.

The exclusive benefit rule has not always been applied with full force. As one researcher notes, because the "exclusive benefit" approach, if technically enforced, would be such a literal interpretation of the law, "the courts and administrative agencies have not indicated [a] willingness to" technically enforce the rule.102 Proving this contention, the IRS has interpreted the IRC provision to mean that investment decisions must be made for the primary, not necessarily exclusive, benefit of plan participants.103 Thus, investments that benefit plan participants and also benefit other parties are not necessarily precluded.104 According to one IRS ruling, other parties may benefit from plan investments so long as: (1) the investment cost does not exceed fair market value at the time of purchase; (2) the investment receives a "fair" return commensurate with the prevailing market rate; (3) the fund maintains

99. ERISA's provisions do not address issues concerning the special role pension funds play as key figures in today's financial markets. Congress has considered, but not enacted, legislation that would impose fiduciary provisions similar to ERISA on public pension plans. See sources cited supra note 93.

100. These provisions include the "nondiversion" and "exclusive benefit" rules, which originated in the 1938 Revenue Act. A report by the Congressional Research Service (CRS) notes that "enforcement of those rules for public plans is problematic because the only sanction for violation is the revocation of the plan's tax exemption. Because state and local governments are exempt from federal taxes, the only tax penalty for a public plan that violates the nondiversion or exclusive benefit rules would be to tax the employees covered by the plan on their pension benefits as they accrue." CONGRESSIONAL RESEARCH SERVICE, supra note 93, at 37; see also id. at nn.34-35. Even though sponsoring governments are not subject to taxation themselves and derive no benefit from the tax-exempt status, certain benefits do accrue to plan members.


103. Rev. Rul. 69-494, 1969-2 C.B. 88; ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1) (1988). Section 401(a) of the Internal Revenue Code also requires that a pension plan be maintained "for the exclusive benefit of the employees and their beneficiaries" to qualify for tax exemption under § 404 of the Code. I.R.C. § 401(a). In general, however, the position of the IRS on the fiduciary duties of pension plan trustees has been more lenient than that of the Department of Labor under ERISA. Hutchinson & Cole, supra note 8, at 1348.

sufficient liquidity to permit distributions in accordance with the terms of the plan; and (4) the trustees follow the safe practices and maintain the level of diversity a prudent investor would.\textsuperscript{105}

In view of the IRS ruling, the Congressional Research Service (CRS) concluded that:

Social investing or investments targeted to enhance the economic development of a State or locality are not prohibited by the exclusive benefit rule as interpreted and enforced by the IRS. It would be possible to engage in quite a bit of targeted investing while still observing the guidelines of [the IRS ruling]. As long as the investments provide a fair rate of return, the trust fund retains sufficient liquidity to pay benefits, and the investment portfolio exhibits the diversity that a prudent investor would expect, the IRS would appear to be satisfied. All other factors being equal, there does not appear to be any restriction on the trustees' considering local economic benefit in the investment. Even a prudent investor may have a small percentage of speculative investments in a portfolio.\textsuperscript{106}

As the CRS observes, the IRS, by using the terms "fair rate of return" and "sufficient liquidity" in its ruling, opened the door for some flexibility in the selection of investments that provide collateral benefits. It is difficult to know, however, at what point a rate of return becomes unfair and at what level liquidity is deemed insufficient. Even though there is some ambiguity, it is significant that the IRS ruling does suggest that fund trustees, when making investment decisions, possess some latitude to consider benefits that will accrue to the local economy.

More recently, however, the IRS issued a General Counsel Memorandum (GCM) that takes a harsh stand against social investing.\textsuperscript{107} Although the GCM may not be relied upon or cited by taxpayers as precedent, the decision makes the position of the IRS on social investing less certain. The issue addressed in the GCM was "[w]hether, for purposes of plan qualification, a provision in a trust agreement that permits the trustee in the case of a tender offer to consider non-financial employment-related factors violates the exclusive benefit rule of I.R.C. § 401(a)(2)."\textsuperscript{108} The case addressed by the

\footnotesize{\textsuperscript{105} Rev. Rul. 69-494, 1969-2 C.B. 88; see also Examination Guidelines Handbook, 4 Internal Rev. Man. (CCH) § 711.1 (Feb. 13, 1981); Rev. Rul. 73-380, 1973-2 C.B. 124 (finding that safeguards and diversity a prudent investor would adhere to were present in investment plan); Rev. Rul. 73-532, 1973-2 C.B. 128; Shelby U.S. Distribs. v. Commissioner, 71 T.C. 874, 885 (1979) ("[I]t is recognized that the investments of a trust may result in some benefit to another person without the trust losing its exemption, so long as there is no misuse of the trust funds."); 82 Idaho Att'y Gen. Op. 7 (1982) (finding similar conclusion with respect to Idaho state pension funds).}

\footnotesize{\textsuperscript{106} CONGRESSIONAL RESEARCH SERVICE, supra note 93, at 42-43 (emphasis added).}


\footnotesize{\textsuperscript{108} Id.}
IRS in the GCM involved two employee stock ownership plans for which a company submitted applications to the IRS and the DOL for determination letters. Both the IRS and the DOL objected to language in the plans that required "the trustee to consider non-financial factors before acting upon tender offers." The provision stated that:

The Trustee, in addition to taking into consideration any relevant financial factors bearing on any such decision, shall take into consideration any relevant non-financial factors, including, but not limited to, the continuing job security of Participants, conditions of employment, and the prospect of the Participants and prospective Participants for future benefits under the Plan.

The IRS concluded that because the provision allowed the trustee "to consider non-financial employment-related factors," the provision violated the exclusive benefit rule. The IRS seemed to be particularly concerned that investment decisions by the trustees might "reflect management concerns relating to hostile takeover situations." In a parting shot, the Service stated:

We also note that by permitting the trustee to consider non-financial factors, the trustee is engaging in a form of "social investing." Decisions based on factors such as continuing job security of company employees and future employment opportunities serve social purposes. Social investing requires the trustee to go beyond the fiduciary duties of satisfying the liabilities of the plan and to consider purposes not authorized by the Code.

Although this GCM may be a harbinger regarding the stance the IRS will take on social investing, the issue is far from settled. For example, one report notes that a more recent draft recommendation by the DOL calls for the agency to adopt a more flexible approach "that would encourage money managers to consider investments that provide economic benefits to a region or industry, without sacrificing returns for retirees." The recommendation may have been prompted in part by comments President Clinton made during his election campaign indicating that he would use retirement fund assets to supplement federal government spending to help boost the economy and to

109. Id.
110. Id.
111. Id. at 7857.
112. Id. at 7859 (citing Treas. Reg. § 1.401-2(a)(3)); see also id. at 7860 (citing Rev. Rul. 69-494).
113. Id. at 7861.
114. Id. (citations omitted).
rebuild the nation's infrastructure.\footnote{We will have to wait to see if President Clinton proposes the increased use of ETIs and what role pension plans will play in any such proposal. We must also await congressional and judicial reactions to any initiatives that might result.}

\section{C. Defined Benefit vs. Defined Contribution Plans}

When discussing the legality and the advisability of pursuing targeted investment strategies, one must distinguish between defined contribution and defined benefit plans.\footnote{Because a significant number of state and local government plans are defined benefit plans, the distinction is particularly important in the public plan context.}\footnote{The most significant difference between defined benefit and defined contribution plans is the allocation of risk. With a defined contribution plan, the employer makes specified contributions to an account established for each participating employee. The retirement benefit is the sum of employer contributions, any employee contributions, and accumulated investment gains or losses. With many defined contribution plans, each member directs the fund's trustees to invest the member's account assets among the plan's investment options, and consequently determines the level of risk for his or her own personal account.}

With a defined benefit plan, a specific formula is used to calculate a guaranteed benefit level for each plan member upon retirement. The formula is usually established by statute and typically incorporates factors such as the employee's age at retirement, average annual earnings, and length of service.

\begin{itemize}
\item \footnote{See id. at F1; see also Joel Chernoff, Proposals Target Pension Money; Infrastructure Financing Detailed, PENSIONS \& INVESTMENTS, Nov. 9, 1992, at 1. As the Governor of Arkansas in 1985, Bill Clinton signed a bill encouraging public employee pension funds in Arkansas to invest between 5\% and 10\% of fund assets in Arkansas. Vise, supra note 115, at F4.}
\item \footnote{EBRI Issue Brief, supra note 3, at 8. The distinction is also significant as it relates to questions as to who owns the assets in a defined benefit pension plan, discussed infra part III. See Richard A. Ippolito, Pensions, Economics and Public Policy 81 (1986) (noting that defined benefit plans held about 70\% of private pension assets as of 1984). One study notes that "[o]ne of the more obvious results of ERISA [and subsequent legislation] was the growth of defined contribution plans relative to defined benefit plans." Wayne Wendling et al., The Regulatory Impact on Pensions 37 (1986). Contra Roger L. Vaughn, Defined Benefit Plans and the Reality Behind the Misconceptions, PENSION WORLD, Jan. 1992, at 21, 22.}
\item \footnote{A survey conducted by the Government Finance Officers Association found that less than 10\% of the 271 government entities the Association surveyed had some type of defined contribution plan. Curtis Vosti, Governments Look at Defined Contribution, PENSIONS \& INVESTMENTS, May 11, 1992, at 3. Defined contributions are, however, becoming more popular with government funds. Id. Interestingly, for the first time in several years, employer contributions to defined benefit plans increased in 1992. Christine Philip, Top 1,000 Funds Increase by 9\%, PENSIONS \& INVESTMENTS, Jan. 25, 1993, at 1, 76.}
\end{itemize}
employment. The employer, usually through a trustee or trustees, determines the allocation of the fund’s assets, invests the fund’s assets, and bears the risk of investment gains and losses.

With targeted investments, and social investing generally, the differences between defined benefit and defined contribution plans present important and pivotal policy questions vis-à-vis the fiduciary responsibilities of fund trustees. Specifically, the risk of investment loss associated with an ETI is allocated differently with a defined benefit plan than it is for a defined contribution plan. With a defined contribution plan, an investment deemed to be a breach of fiduciary duty—for example, an investment that violates the standard of prudence because it results in an unreasonably low rate of return—has a direct impact on the benefits of plan members. The actual damage to the interests of plan members would be the difference between the investment return under the specific investment policy and the amount that the same funds would have generated had they been invested “prudently.”

With a defined benefit plan, however, the risk of investment loss is borne initially by the plan sponsor, and, assuming solvency, the benefits of plan members under the same scenario as above would remain unaffected. For this reason, arguably there is no injury to plan members under a defined benefit scheme when there is investment loss. If there is no injury and if the plan sponsor is still able to meet its pension obligations as they become due, it seems that any claim for damages should be deemed moot because there are, in fact, no damages to be recovered. Moreover, if damages are to be calculated and awarded using the same approach as is used for a defined benefit plan, employers receive a promise for a specified benefit at retirement. Employers often hire actuaries to determine how much money the employer should contribute each year to the pension fund to adequately fund promised benefits. Norman P. Stein, Qualified Plans and Tax Expenditures: A Reply to Professor Zelinsky, 9 AM. J. TAX POL’Y 225, 229 (1991).


Some argue that the performance of pension plan investments may affect the benefit received during retirement—directly in the case of defined contribution plans and indirectly in the case of defined benefit plans. Although a defined benefit plan sponsor has no obligation to increase retirement benefits, higher investment returns arguably influence the likelihood of postretirement benefit increases, or decrease the amount of future employer contributions.

Under a defined benefit plan, there are technical, practical, equitable, and political considerations that come into play. As a technical matter, some states neither deem the pension promise to be a contractual right (as defined by state statute) nor stand behind the promise with the full faith and credit of the state treasury. The state may claim, in effect, sovereign immunity from any claim a pension beneficiary might bring against the state were the state to default on its pension promise. See, e.g., sources cited infra note 143. On the other hand, in practical, equitable, and political terms, it is hard to conceive that state officials could withstand the political storms that would occur were they to disavow the pension promises the state has made to its employees.
contribution plan, then the payment of damages under a defined benefit plan may, as far as plan members are concerned, merely amount to an accounting adjustment. Although a plan sponsor might be required to pay into a fund an amount equal to the "economic loss" caused by what is deemed to be an imprudent investment, the transfer will have no effect on plan member benefits. In both the short and the long term, the employer can simply reduce the rate of its future contributions to the plan and effectively recover the amount the employer was earlier required to pay into the fund. Therefore, because there are no actual damages to the interests of plan members, a defined benefit plan effectively diverges from traditional trust analysis.

D Pension Funds and Long-Term Investment Horizons

The very nature of pension funds—a generally long investment horizon combined with the predictability of future liabilities many years in advance—makes it possible for funds "to employ long-term investment strategies and to utilize investments with long maturities that match their long-term liabilities." This means that as long as pension funds are compensated for the

122. Recently, a number of states with varying degrees of success have attempted to do exactly that. By changing funding levels or the actuarial assumptions upon which state contributions to the funds are dependent, these states have sought to reduce the levels of their future contributions. See, e.g., Steve Hemmerick, $2 Billion to Stay with California, PENSIONS & INVESTMENTS, Apr. 27, 1992, at 8; Steve Hemmerick & Anne Schwummer, States' Pension Grabs Fought, PENSIONS & INVESTMENTS, Aug. 17, 1992, at 2; Christine Philip, 2 More States Look at Pension Systems, PENSIONS & INVESTMENTS, Feb. 3, 1992, at 4; Sabine Schramm, Connecticut Seeks Pension Changes, PENSIONS & INVESTMENTS, Apr. 27, 1992, at 29. In New York, a state supreme court ruled that a 1990 state law requiring use of the projected unit credit (PUC) actuarial method for determining state contributions to a state retirement fund violated the New York State Constitution because the law removed from the state comptroller the power to determine what actuarial method the state would use. McDermott v. Regan, 587 N.Y.S.2d 533 (N.Y. Sup. Ct. 1992). However, in California a state appeals court allowed the governor and state legislature to reallocate close to $2 billion from a state pension fund to balance the state's budget because the action did not impair the vested rights of the pension contract. Claypool v. Wilson, 4 Cal. App. 4th 646 (Ct. App.), review denied, 1992 Cal. LEXIS 3163 (June 18, 1992), cert. denied, 113 S. Ct. 812 (1992) (refusing to intervene without comment). In November, 1992, California voters approved Proposition 162—The California Pension Protection Act of 1992—a state constitutional amendment intended to prevent future governors and legislatures from tapping into public pension funds in the state. Paul Jacobs, U.S. High Court Lets Stand Cut in State Pension Funds, L.A. TIMES, Dec. 15, 1992, at A34. The measure, which passed only by a 51% to 49% margin, gives public pension boards of trustees the exclusive power in providing actuarial services to the funds, a function given to the governor under existing law. Sabine Schramm & Terry Williams, State Voters Approve Pension Initiatives, PENSIONS & INVESTMENTS, Nov. 9, 1992, at 4.

123. OUR MONEY'S WORTH, supra note 35, at 20. In fact, the findings of a two-year research project sponsored by the Harvard Business School and the Council on Competitiveness indicate that investment is the most critical factor to national economic competitiveness, and that the U.S. system for allocating capital is failing. Michael E. Porter, Capital Disadvantage: America's Failing Capital Investment System, HARV. BUS. REV. Sept.-Oct. 1992, at 65, 65. This failure is due in part to investors' sensitivity to
incremental increases in investment risk that they take, over the long term these plans should be able to accept higher levels of risk.\(^{124}\)

If pension funds would match their long-term investment horizons with long-term investments, they could serve an additional critical function in our economy—the provision of long-term, patient capital. Carliss Baldwin notes that corporations can invest in “losing projects” and still manage to meet standards of profitability and a fair rate of return.\(^{125}\) Baldwin states that “[t]he resolution of this paradox lies in the difference between a subsidy and a speculation. A subsidized investment never generates a satisfactory return. In contrast, a successful speculation provides low returns for a period of time, but at maturity is transformed into a highly profitable economic swan.”\(^{126}\) Baldwin concludes that “[t]he ability to sustain a speculation, holding near-term capital costs down in order to gain higher returns in the future, is a valuable competitive weapon.”\(^{127}\) Baldwin’s thesis, if true, fully supports the arguments of ETI advocates. There does not seem, however, to be enough political will to implement the types of policies that would encourage pension funds to maintain such a long-term orientation. That is not to say that no one has tried.

In 1989, U.S. Senators Robert Dole and Nancy Kassebaum proposed legislation to tax profits resulting from short-term pension plan investments.\(^{128}\) The proposal, rejected by the House of Representatives, would have encouraged pension plans to make long-term investments. As one commentator notes, “the legislation would have explicitly amended the prudence standard to include an economically targeted investment characteristic.”\(^{129}\)

Based upon the allocation of risk, as long as plans are reasonably funded, defined benefit plan members should be indifferent about the investments that plan sponsors make. In fact, an EBRI/Gallup public opinion survey conducted

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\(^{124}\) Because pension funds and other institutional investors own significant stock portfolios in U.S. corporations, they have been able to use their enormous voting power to influence corporate policies. See generally Zanglem, supra note 3, at 771-76. By using this economic power, pension funds can help to reform some of the abuses in corporate governance. See, e.g., Linda J. Barris, The Overcompensation Problem: A Collective Approach to Controlling Executive Pay, 68 IND. L.J. 59, 89-90 (1992).


\(^{126}\) Id. at 186.

\(^{127}\) Id.


\(^{129}\) Frederic G. Burke, 'Prudent Man' Allows Trustees to Consider Social Investments, PENSION WORLD, Apr. 1992, at 18, 19.
in April, 1990, demonstrates that most defined benefit plan members probably are indifferent about the rate of return of fund investments. Respondents were asked whether they preferred high risk/high return investments or low risk/low return investments. The survey found that as long as investment choices would not impact plan benefits, a substantial portion of plan beneficiaries expressed indifference about the investment choices fund sponsors make. Professor Langbein, himself a critic of social investing, similarly notes that “[t]he simple truth is that investment policy is seldom of concern to the participants in a single-employer defined benefit plan.” Instead, as Langbein notes elsewhere, participants in a single-employer defined benefit plan shift the responsibility for investment policy to the employer, who is the risk bearer.

As noted earlier, the central theme of this Note is that state legislatures must fashion policies that protect the real and practical interests of plan members (that is, their claims to benefit payments at retirement), while still effectively using pension funds as the powerful economic tools that they are. Policymakers must grapple with the bases for the divergent and passionate views of the interested parties. This is so because despite the empirical evidence regarding the indifference of plan members, the use of pension funds to forward interests in addition to the creation of pension income continues to cause tension between the claims to pension assets made by plan participants and sponsoring governments. These competing claims and some of the issues involved in assessing the validity of each are considered below.

III. ASSET OWNERSHIP IN A DEFINED BENEFIT PLAN: WHOSE MONEY IS IT ANYWAY?

Disputes regarding the ownership of pension fund assets are central in the debate over the legality of social investing. Generally, two competing classes have made arguments to support their ownership claims to assets in defined benefit public pension funds: plan members and sponsoring governments. How one views these claims is critical. The dispute over asset ownership is significant because presumably the class deemed to be the owner of the fund assets, if either is indeed the “owner,” should be able to determine the manner

130. EBRI ISSUE BRIEF, supra note 3, at 7-8.
131. Id. at 8. If the employer absorbs any investment gains or losses from investments and the amount of retirement benefits are not affected (as in a defined benefit plan), 47% of those surveyed responded that the investment choice would not matter to them; 18% preferred high risk/high return investments, and only 28% preferred low risk/low return investments. Id.
132. Langbein, supra note 88, at 132 (emphasis in original).
133. Langbein, supra note 16, at 23.
in which the assets will be invested. It is not clear, however, which claim should predominate—both classes have legitimate interests and convincing claims.

A. Claim One: Pension Assets Belong to Plan Members

ETI opponents have argued that the assets in a defined benefit plan belong to the plan’s participants and beneficiaries, just as though the plan were a defined contribution plan. One commentator states:

Pensions are earned; they are not gratuitous from a munificent government, or a paternal employer. Pensions are the result of earlier labors, compensations for producing goods and services that have been deferred or saved. Maintaining this distinction between welfare and self-support is vital to sustain our society’s ethic of the rights of the individual and the obligations of the individual.

Similarly, Langbein argues that “the employer-paid component of a pension plan is a cost of employment, hence a form of involuntary savings whose true cost is borne by the employee. Both the employer-paid and the employee-paid contributions derive from what is—in economic terms—the employee’s wages.”

But these observations are not self-evident. With a defined benefit plan, where the employer makes a promise to pay a certain level of benefits, the true cost of providing these benefits is borne by the employer, not the employee. It is no more accurate to suggest that the employee bears this cost than it is to say that the employee bears the cost of his or her own salary—both are borne by the employer. Langbein, despite his earlier characterization, recognizes this when he states, “since the employer has promised to provide benefits of a certain level, the employer remains liable to pay the benefits even if the fund turns up short.”

Langbein’s statements seem to be based upon a belief that sponsoring governments should maintain a hands-off policy regarding pension fund assets. Langbein is concerned that sponsor involvement will adversely affect fund security. He notes that “the temptation has been felt to leave future taxpayers to pay the retirement benefits for today’s public workers, even

134. BULOW & SCHOLES, supra note 2, at 3. Langbein and Posner, without explanation, assume that plan beneficiaries are the “true owner[s] of the investment” Langbein & Posner, supra note 12, at 77.
137. Id.
though the entitlement to those accrues presently and should be regarded as a cost of current employment.” 138 One must recognize, however, that the distribution of risk with a defined benefit plan provides the plan sponsor with an independent ground for resisting investment practices that are not in its own long-term interests and to adopt those policies that serve its long-term needs generally. Certainly, one of the sponsoring government’s long-term interests is to meet its liabilities for pension plan promises. 139 Moreover, even if the entitlement to benefits does accrue presently, this does not mean ipso facto that plan members have an immediate claim to the assets that might be used to pay the future benefit. In fact, in many states there is no requirement that sponsoring governments maintain pre-funded or fully funded pension plans in the first place. 140

B. Claim Two. Pension Assets Belong to the Sponsoring Government

A second group believes that the sponsor of a defined benefit plan retains ownership of fund assets and that the pension promise is only a liability of the sponsor. For example, in the corporate context, many financial economists consider large corporate plans to be a “corporate asset, and that the obligation to pay employees during retirement is a corporate liability.” 141 It is “a

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138. Id. at 7; see also Zvi Bodie & Leslie E. Papke, Pension Fund Finance, in PENSIONS AND THE ECONOMY 149 (Zvi Bodie & Alicia H. Munnell eds., 1992) (describing the goals and financial policies of pension plans). See generally supra note 122.

139. Some opponents express skepticism that pension fund investors will be able to deal with the political pressures and the conflicts of interest that are bound to arise over the use of targeted investments. Although it is a major concern that sponsoring governments will make unwise investments, with a defined benefit plan, governments already have proper incentives to maximize the rate of return earned on pension investments. First, any shortfall in return must be made up by the sponsoring government; and more importantly, any improvement in return reduces the contributions the sponsoring government must otherwise make. Still, the concern that funds will make unwise decisions is legitimate. One way to decrease the potential for political pressure that might lead to improper investments is to establish an investment intermediary to screen and recommend investment opportunities.

140. In the United States, private plan sponsors must “fund their defined benefit plans either by insuring them through an insurance company or by making contributions to a special pension trust. There are no such requirements, however, for pension plans sponsored by state and local governments.” Bodie & Papke, supra note 138, at 152.

141. BULOW & SCHOLEs, supra note 2, at 3. Note, however, that corporations cannot record plan assets on their balance sheets as assets of the corporation. The Financial Accounting Standards Board (FASB) requires each corporation to measure pension liabilities on its balance sheet as “the present value of pension benefits owed to employees under the plan’s benefit formula absent any salary projections and at a nominal rate of interest.” Bodie & Papke, supra note 138, at 157 (citing FASB Statement 87).
promise[] to pay benefits to employees, similar in economic effect to promises to its other creditors.\footnote{142}

Similarly, in the public context, this approach means that plan members would have only a claim to benefits against the sponsoring government that may be exercised at retirement. These theorists contend that any claim that plan members own pension fund assets ignores the fact that with a defined benefit plan the sponsoring government bears the entire investment risk. Moreover, they believe that because sponsoring governments bear the investment risk, these governments should have broader discretion in making investment decisions. Going one step further, one commentator suggests that "[a]lthough the Supreme Court has not yet had an occasion to consider the question, congressional action leaving state pension funds to state regulation is consistent with a judgment that such funds are the state's own funds and are not merely funds subject to general state regulation."\footnote{143} Although this assertion is bound to be quite controversial, recent judicial decisions indicate that sponsoring governments do have at least some interest in the funds.\footnote{144}

\footnote{142. BULOW & SCHOLES, supra note 2, at 3; see also Fisher Black, The Tax Consequences of Long-Run Pension Policy, FIN. ANALYSTS J., July-Aug. 1980, at 21 (arguing that the pension fund and pension promise are separate; the fund is an asset of the firm and the promise is a liability of the firm); Irwin Tepper, Taxation and Corporate Pension Policy, 36 J. OF FIN. 1 (1981) (arguing that pension fund assets and liabilities are no different than corporate account assets and liabilities used in constructing an augmented balance sheet).
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A report by a New York pension task force argues that the public has a significant economic interest in the operation of public pension funds because: (1) the state is obligated, principally through tax revenue, for pension payments; (2) state and local government contributions, paid with tax revenue, are significant budget items; and (3) the favored state tax status enjoyed by the funds translates into lost tax revenue that taxpayers must make up. OUR MONEY'S WORTH, supra note 35, at 7.

\footnote{143. Thomas A. Troyer et al., Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds, 74 GEO. L.J. 127, 159 n.126 (1985); see also Trustees of the Minn. Pub. Employees Retirement Ass'n v. Minn. State Bd. of Inv., No. 452938 (Dist. Ct. Jan. 22, 1982) (dismissing action claiming property, beneficiary, and contractual rights in pension fund based in part on finding that public pensions are gratuities—plaintiffs had no standing to bring the action); Memorandum in Support of Defendants' Motion to Dismiss at 11-13, Trustees of the Minn. Pub. Employees Retirement Ass'n v. Minnesota State Bd. of Inv., No. 452938 (Dist. Ct. Jan. 22, 1982). MINN. STAT. § 353.38 (1980) (repealed 1984) stated that "[n]othing done under the terms of this chapter shall create or give any contract rights to any person " See also Marcia G. Murphy, Symposium: Governance of Public Enterprises: Regulating Public Employee Retirement Systems for Portfolio Efficiency, 67 MINN. L. REV. 211 (1982).
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\footnote{144. See infra part IV In addition to the theorists who claim complete ownership by one of the two classes of stakeholders, there are those whose theories fall somewhere in between the two approaches. Bulow and Scholes, for example, reject any contention that either group may claim sole ownership of fund assets. Instead, they posit a group model of compensation that implies that the surplus in the pension fund—plan assets less the present value of accrued benefits—is owned in part by the sponsor and in part by the employees. BULOW & SCHOLES, supra note 2, at 21. Bulow and Scholes reject the theory that employees trade current compensation for future compensation when receiving a pension promise as too simplistic. Instead, they argue that employees "negotiate with the employer for a total compensation package, and allocate compensation among members of the group according to marginal

Taking a less polar and arguably more equitable approach, one commentator argues that neither party may claim complete ownership of the fund assets. Zvi Bodie notes that in the corporate context, "if pension assets exceed the [accumulated benefit obligation], the corporate sponsor cannot include the surplus on its balance sheet." Bodie argues that there is a "widely held view among pension professionals that as guarantor of the accrued pension benefits, the sponsoring corporation is liable for pension asset shortfalls but does not have a clear right to the entire surplus in case of pension overfunding." In addition, Bodie notes that "[r]ecent court rulings in cases of terminations of overfunded plans have left unclear how much of the surplus belongs to the plan sponsor, but it is clearly less than 100%." Thus, whether one is talking about corporate or public pension plans, only one thing is clear—there is no consensus regarding asset ownership.

IV DUAL ROLES? RETIREMENT BENEFITS AND ECONOMIC DEVELOPMENT

An analysis of the competing ownership claims indicates that both plan sponsors and plan participants have legitimate claims to at least an interest in the assets of a defined benefit fund. If one recognizes that both groups have legitimate claims, the pervasive question is: What should the public policy be regarding the ownership of fund assets? The answer to this question, depending on one’s view, is driven by one of two competing public policies. The first view stresses the need to limit the temptation to politicize fund investments, thereby helping to ensure the security of retirement benefits. The second perspective stresses the need to invest fund assets in a manner that is most beneficial to society, thereby providing economic benefits to both

product, returns from previous equity investments, and purchases and sales of claims on the equity of the firm [between younger and older employees.]" Id. at 20. Although their model is quite interesting, because it is ill-suited for application to public pension funds, a discussion of the model is beyond the scope of this Note. Bulow and Scholes conclude that with defined benefit plans using the augmented balance sheet model of pension finance, stockholders own pension plan assets. Using the group model, both employees and stockholders share ownership of pension assets. Id. at 25.

146. Id.
147. Id.
148. See generally Langbein, supra note 16 (explaining why the traditions of trust law, pension law, and the law of charity forbid social investing); supra note 139 (pointing out the need to insulate pension fund investment decisions from political pressures and conflicts of interest).
TARGETED INVESTING

plan members and society generally. Thus, the critical task for policymakers is to determine which policy concern should predominate.

Although the present legal framework for the regulation of fund investments is important as a reference point, it should not limit the legal debate among policymakers in their attempts to develop coherent policies. As one commentator emphasizes, "[p]ension plans are too large and are growing too fast for economists [and policymakers] to be stopped by the literal description of the pension plan or for them not to try to strip away the legal form and to reveal the economics of defined benefit pension plans." If an evaluation of the economics reveals the need for change, interested parties should look to the political process. State legislatures, within certain limitations—namely those imposed by the Internal Revenue Code—have the power to change some of the ground rules of pension fiduciary law for public plans. Although it is doubtful that policy analysis will sway the most zealous advocates on either side of the debate, the observations below are intended to show that the bases upon which some opponents of social investing rest many of their contentions are not as impermeable as these opponents suggest. The analysis below suggests that policymakers should not pursue a course that advocates the wholesale opting out of the use of ETIs. Instead, policymakers should develop approaches and policies that recognize the diverse interests of the concerned parties, including society as a whole.

A. The Common Law of Trusts & ERISA as Models for Policy Development

As policymakers consider alternatives to best meet societal needs, they are likely to use existing legal frameworks as guides for policy development. In the area of pensions, ERISA and the common law of trusts comprise the bulk of the existing legal framework for pension regulation. Because the provisions and principles of this framework have been interpreted and refined, and because pension fund administrators and regulators have extensive experience

149. See infra notes 160-62 and accompanying text.
150. BULOW & SCHOLES, supra note 2, at 1-2.
151. But see Scaglione v. Levitt, 337 N.E.2d 592, 595 (N.Y. 1975) (holding that although the legislature may expand or restrict classes of investments, it is powerless in the face of constitutional nonimpairment clause to mandate that fiduciaries mindlessly invest in whatever securities the legislature directs). Litvak argues that "[t]he immediate problem for many retirement systems is that the specific requirements for investments have not responded to an abundance of changes in financial market conditions and institutional investment practices, as well as to the changing needs of the retirement systems themselves." LITVAK, supra note 17, at 128.
152. This situation exists mainly because there are divergent views about governments' abilities to effectively implement public policy, particularly as related to ETIs
with these bodies of law, this framework is an excellent model against which policy proposals may be compared. At the same time, an examination of the major provisions of these bodies of law makes clear that they are poor models for the public fund context.

The manner in which pension fund law has developed, particularly as it relates to social investing, creates a source of practical difficulty for the administration of pension funds. For example, most of the default rules of pension fund law are those taken from the common law of trusts. Although the law of private trusts has been purposefully applied to pension funds, as Langbein observes, "there are huge differences between a private gratuitous trust and a pension plan. The conventional private trust is a donative transfer. The distinctive logic of a donative transfer is that the benefits are not reciprocal." It is significant that with a private trust the settlor has no continuing interest in the trust that he creates and funds.

The modern defined benefit plan is more like a contract than a gratuity. Employers provide pension plans to help them in marketplace competition to attract and retain employees, and to defer a portion of the cost of employing labor until an employee retires. At the same time, employees bargain for the benefit of retirement security—a trade-off of pre-retirement for post-retirement income as a means to stabilize their lifetime income streams.

The failure of the common law framework to recognize and account for the mutually beneficial nature of the defined benefit approach makes it an ill-suited form for modern pension plans. Moreover, because Congress adopted much of the common law of trusts as the basis for the law formulated in ERISA, ERISA may prove to be an equally poor framework for public plans. In essence, the deficiencies of the common law as applied to pension funds have simply found their form again in modern code. Unfortunately, the effects of these deficiencies may be more broadly felt because many state legislatures have used ERISA as a model to formulate state policies.

Fischel and Langbein argue that the statutory purpose of pension plans to provide retirement security,

...coupled with the language of the exclusive benefit rule that focuses solely on employees' interests, appears to preclude recognition of the employer as a beneficiary. As a result, courts have been forced to indulge in pretense, such as the notion that benefits to employers are merely "incidental," in order to reconcile ERISA with [economic realities].

153. Langbein, supra note 88, at 129 (footnote omitted). Langbein similarly argues that the problem with ERISA fiduciary law is its failure to account for the differences between private gratuitous trusts and pension plans. Id.

154. Fischel & Langbein, supra note 20, at 1158.
Further, Fischel and Langbein stress that "[d]espite the exclusive benefit rule, there is nothing exclusive about employees' interests in pension and welfare benefit plans."\(^{155}\)

Langbein observes that as "[ERISA] declares, and the asset reversion jurisprudence of the 1980s strongly underscores, the employer who bears the investment risk not only shoulders the risk of [investment loss, but] is entitled to reap the [investment gains], whether by way of reversion, or by reducing the future rate of contribution to the plan."\(^{156}\) Similarly, Fischel and Langbein recognize that the duty of loyalty prescribed by "[t]he exclusive benefit rule works well enough against thieves and thugs,"\(^{157}\) but in its more common application, the rule creates more problems than it solves because it is not tailored to the structural and economic realities of modern funds. Thus, as Fischel and Langbein observe, "[i]n many situations, the exclusive benefit rule, by oversimplifying the nature of these arrangements, has misdescribed the reality of the interests, misled the courts, induced inappropriate analysis, and produced improper results."\(^{158}\)

As an alternative, Litvak suggests the standard should be one that states that a trustee owes a "fundamental duty to the interests of the participants and beneficiaries."\(^{159}\) He believes this approach more clearly expresses the concept that the protection of retirement benefits should be the primary but not the only interest.

It seems clear that the adoption at the state level of the provisions of the common law of trusts or the equivalent provisions of ERISA would not

\(^{155}\) Id. at 1157. Fischel and Langbein also note that many times there is a conflict between younger and older employees, and between retirees and active employees. Elsewhere, Langbein argues that ERISA, especially the exclusive benefit rule, is incoherent in regard to investment matters because it overprotects plan participants, who are ordinarily at little or no risk, and ignores the security needs of shareholders. Langbein, supra note 88, at 136.

\(^{156}\) Langbein, supra note 88, at 130 (footnotes omitted). Langbein concludes that ERISA's "fiduciary rules should have been more concerned to protect the employer's stockholders and the [Pension Benefit Guaranty Corporation] than the plan participants." Id. at 133 (footnote omitted). In the public context, taxpayers, in effect, are the shareholders.

\(^{157}\) Fischel & Langbein, supra note 20, at 1110; see supra notes 88-92 and accompanying text.

\(^{158}\) Fischel & Langbein, supra note 20, at 1110; see, e.g., Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982) (finding Grumman Corporation officials to have breached duty of loyalty to beneficiaries where they used plan assets to fend off a hostile takeover). Langbein characterizes the participants' claims in the case as "Alice-in-Wonderland litigation" because the plan members' interests were not affected by the decrease in value of the plan assets. The shareholders of the corporation took the loss. Langbein, supra note 88, at 131. But see Donovan v. Walton, 609 F. Supp. 1221 (S.D. Fla. 1985), aff'd per curiam sub. nom. Brock v. Walton, 794 F.2d 586 (11th Cir. 1986). In Donovan v. Walton, 609 F. Supp. at 1245, the court emphasized that the exclusive benefit rule "simply does not prohibit a party other than a plan's participants and beneficiaries from benefitting in some measure from a prudent transaction with the plan."

\(^{159}\) Litvak, supra note 17, at 130.
promote a recognition of the proper roles of employers and employees. First, the common law of trusts and ERISA may be ill-suited for the regulation of pensions generally. Moreover, there are substantial differences between public and private plans that warrant legislative recognition and accommodation.

B. Using Resources Efficiently
Some Lessons from Property Law

Broadly stated, one of the objectives of property law is to help ensure that societal resources are put to their best use. In regard to public fund assets, there are bound to be major differences of opinion among policymakers on what the "best use" is at any given time. Although providing retirement benefits is an important function that should be valued by society, providing these benefits and maximizing the total return to society of fund investments are not necessarily mutually exclusive functions.

One commentator argues that "[e]ven if [social investing] impairs the economic well being of beneficiaries, modern property law supports such an impairment when the property system fails to allocate property in the most socially beneficial manner." Similarly, others suggest "that historical changes in trust law itself, from the separation of legal and equitable ownership to the rule against perpetuities, represent erosions of the property rights of some to further socially beneficial goals." In support of this view, another author observes:

Indeed, courts have long recognized that property embodies social relationships as well as economic ones, and therefore may prefer societal objectives over an individual's property rights. For instance, in landlord-tenant law, courts have often preferred the tenant's need for affordable and adequate housing over the landlord's interest in maximizing profit. In many other areas, courts have upheld price controls, land use regulation, and other social action that infringes on individual property rights. Courts confronted with the complex effects of property disputes have not


161. Recent Case, supra note 160, at 822 n.36 (citing Joel C. Dobris, Arguments in Favor of Fiduciary Divestment of "South African" Securities, 65 NEB. L. REV. 209, 225-27 (1986)).
given absolute effect to either party's claim but have balanced the interests of all those affected by the dispute.\textsuperscript{162}

Other examples of situations in which property law recognizes social and economic relationships include the concepts of eminent domain, adverse possession, and progressive and regressive income tax schemes. Thus, it seems clear that even if one disapproves of these approaches to the allocation of property rights, one must recognize that there are legal and policy precedents whereby the rights and individual interests of one party or class are subjected to those of others.

C. Social Investing and the Courts: Withers v Teachers' Retirement System and Board of Trustees v City of Baltimore

By adopting and upholding policies that promote economic growth, legislatures and courts might help achieve a more desirable and equitable allocation of property. Equity will be achieved, however, only if the competing interests of sponsoring governments and plan members are balanced. In the public fund context, courts seem to be drawn to this balancing approach. The following analyses of two cases illustrates this proposition.

1. Withers v. Teachers' Retirement System

Some commentators have argued that concessionary investing is per se imprudent.\textsuperscript{163} There are circumstances, however, under which courts have

\textsuperscript{162} Id. at 822 nn.37-40 (citing Joseph W. Singer, The Reliance Interest in Property, 40 STAN. L. REV. 611, 652-63 (1988)); see also Pennell v. City of San Jose, 485 U.S. 1, 13-15 (1988) (upholding rent control that accommodates the interests of landlords and tenants and guarantees landlords a "fair" return); Penn Cent. Transp. Co. v. New York City, 438 U.S. 104, 135-37 (1978) (upholding City's decision to designate certain properties as "landmarks" and thereby to restrict building rights); Nebbia v. New York, 291 U.S. 502, 523 (1934) (holding that prices may be regulated in the public interest); Miller v. Schoene, 276 U.S. 272, 279 (1928); Javins v. First Nat'l Realty Corp., 428 F.2d 1071, 1074-75 (D.C. Cir. 1970) (holding that landlord-tenant law must take account of the tenant's need for a "package of goods and services" as well as the landlord's interest in income); Dobbs, supra note 22, at 225-27.

Another example of government requiring financial institutions to behave in a socially responsible manner is found in the Community Reinvestment Act (CRA). 12 U.S.C. §§ 2901-2905 (1988 & Supp. I 1989). The CRA requires regulated financial institutions to demonstrate that their activities serve the credit needs and convenience of the entire community in which they conduct business, consistent with safe and sound operating procedures. 12 U.S.C. § 2903. The duty defined in the statute assumes that banks bear continuing, affirmative responsibilities to their communities. An effective program under the Act includes support of community development projects and programs. Legal Developments, 75 Fed. Reserve Bull. 297, 304 (1989).

\textsuperscript{163} See supra notes 28-30 and accompanying text.
been unwilling to validate this assertion. For example, *Withers v. Teachers' Retirement System*\(^\text{164}\) is often cited as a demonstration of judicial support, or at least tolerance, for socially motivated investments by public pension funds. In *Withers*, beneficiaries of the New York City Teachers' Retirement System challenged the System's decision to purchase $860 million of the City's bonds as part of a financial plan to prevent the potential bankruptcy of New York City. The court upheld the action of the System's trustees even though under similar circumstances such an investment might not meet the normal requirements of prudence. In effect, by allowing the System to purchase the City's bonds, the court sanctioned the System's consideration of some factor other than the risk-adjusted rate of return of its investment.

Of course, some object to the assertion that *Withers* demonstrates judicial support for social investing and instead argue that the purchase of the municipal bonds was probably the most prudent investment the System could have made at that time. The main contributor to the System, New York City, was in serious financial trouble and the City's failure to sell its bonds might have forced the City into bankruptcy\(^\text{165}\).

Langbein and Fischel argue that the court in *Withers* concluded that the trustees "were entitled to take extraordinary action to stave off the City's bankruptcy"\(^\text{166}\). It is questionable, though, whether the pension benefits were actually in any real long-term danger. In what might be characterized as an overly simplistic assessment, the court found that:

> [N]either the protection of the jobs of the City's teachers nor the general public welfare were factors which motivated the trustees in their investment decision. The extension of aid to the City was simply a means—the only means, in their assessment—to the legitimate end of preventing the exhaustion of the assets of the [Fund] in the interest of all of the beneficiaries.\(^\text{167}\)

Despite the court's rhetoric, it seems overbroad for the court to state that neither the continued employment of the City's teachers nor public welfare motivated the decision reached by the trustees. Ravicoff and Curzan similarly discount the court's statements and argue that "[t]he court upheld the trustees'..."

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165. Under similar circumstances in 1991, the Pennsylvania Public School Employees' Retirement System loaned $37.5 million to the financially troubled City of Philadelphia. The fund expected a 26% rate of return on the loan, based on its short duration and the two points the City paid up front. Special terms assured the fund that it would get its money. A third-party custodian bank was appointed to intercept all the tax payments that normally would go to the City treasurer and defer them to lenders. *City Has Brotherly Love, Good Return, PENSIONS & INVESTMENTS*, Mar. 4, 1991, at 12.
investment only because the investment gave much-needed aid to the fund's principal contributor and helped to preserve the jobs of fund participants. That is, the investment was prudent in this case because it provided 'other benefits.'”¹⁶⁸ They urge that “[t]he prudent man standard that emerges from Withers [is]: a trustee is permitted to sacrifice adequate return and corpus safety only where the investment provides ‘other benefits’ to the interested parties.”¹⁶⁹

Although these were desperate financial times for New York City, it seems undeniable, despite what the court said, that the risk-adjusted rate of return was sacrificed for some benefit. Even though the benefit sought by the trustees was to help secure the uninterrupted payment of pension benefits, the effect was similar to the benefit some proponents of targeted investing point to: Using ETIs to strengthen the local or state economy, and consequently the sponsoring government, is prudent because pension fund security is enhanced.

Although the court was loath to admit doing so, it utilized a balancing approach whereby it measured the interests of the community, New York City, against the security of the Retirement System. Implicitly, the court made a determination that recognized and balanced the competing interests of the sponsoring government and the plan members. Thus, under these circumstances, the court's decision that the trustees did not violate their fiduciary responsibility makes great practical sense.

2. Board of Trustees v Mayor of Baltimore

Just as in Withers, the court in Board of Trustees v. Mayor of Baltimore¹⁷⁰ found that the rate of return earned by pension fund investments may be sacrificed in some circumstances. A unanimous Maryland Court of Appeals upheld Baltimore ordinances requiring Baltimore's pension funds to divest their holdings of companies doing business in South Africa. Because beneficiaries of the pension funds were entitled not only to "specific future benefits," but were also entitled to "variable benefits" that depend on the rate

¹⁶⁸. Ravicoff & Curzan, supra note 76, at 523.
¹⁶⁹. Id., see Donovan v. Cunningham, 716 F.2d 1455, 1467 (5th Cir. 1983), cert. denied, 467 U.S. 1251 (1984) (holding that ERISA requirement that trustees receive a "reasonable" rate of return permits them to obtain a rate below the "prevailing market rate."). But see Langbein & Posner, supra note 12, at 101-02. Langbein and Posner criticize this contention and argue that "[t]he term 'adequate' is [Ravicoff's and Curzan's] own invention, and in thus implying a standard less than 'optimal' or 'maximum' it is wholly without authority." Id. at 103.
of return of the funds' investments, any sacrifice of the rate of return earned by the funds translated into diminished benefits for the beneficiaries.

The pension funds' trustees argued that the Baltimore ordinances mandating divestment impaired Baltimore's contractual obligation to the plan members by reducing the variable benefits those plan members would receive. The court rejected this argument and the trustees' additional argument that the city's actions amounted to the taking of property by the government without compensation in violation of due process. In doing so, the court concluded that the ordinances were valid because: (1) the economic impact of divestment would be insignificant, (2) divestment would affect only the variable benefits and, therefore, did not interfere with "distinct investment-backed expectations," and (3) there was no self-dealing. A significant part of the court's analysis is its summary dismissal of the trustees' assertion that the ordinances interfered with the plan members' claims to "specific future benefits." In addition, the court gave little credence to the claimants' argument that the injury to "variable benefits" created a cause of action, even though it was demonstrated that the ordinances would cause a reduction in the rate of return.

The court also rejected the trustees' contention that the city's action impermissibly altered their fiduciary duties by requiring them to consider issues "unrelated to investment performance." The court held that trustees may "properly consider the social performance of the corporation[s]" in which they invest. The court further held that the consideration of social factors did not violate the trustees' duty of prudence because the trustees were not required to maximize the return of the investments they made. The court stated that prudence requires only that chosen investments earn a "just" or

171. See id. at 723.
172. Id. at 734.
173. Id. at 738-39; see supra notes 160-62 and accompanying text.
174. The circuit court found that divestment would impose an initial cost of 0.32% of the pension systems' assets and an ongoing cost of 0.2%. Baltimore, 562 A.2d at 725-27.
175. Id. at 740 (citing Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 225 (1986)). The "distinct investment-backed expectations" depended directly on the fund's rate of return, and accrued only when the annual rate of return exceeded 7.5%. Id. at 734.
176. Id. at 739-40 (applying the three-prong takings test of Penn Cent. Trans. Co. v. New York City, 438 U.S. 104, 124 (1978)). Although the City did not appropriate the funds for its own use, it did use the funds for a purpose for which the City thought society generally would benefit. Therefore, arguably the City did use the funds to promote its own interests.
177. Id. at 736.
178. Id. (quoting 3 SCOTT & FRATCHER, supra note 76, § 227.17).
"reasonable" return and avoid "undue risk." Finally, and most significantly, the court stated that by considering the interests of nonbeneficiaries, the trustees did not violate their duty of loyalty.

Although the Baltimore ordinances most likely did not reflect the social interests of each plan beneficiary, the ordinances did reflect the policy preferences of the funds’ sponsoring government. In reaching its decision, the court noted that the trustees might reasonably believe that certain investments best serve the long-term interests of the funds’ beneficiaries. Thus, the court found, among other findings, that if a social investment produces a "reasonable" rate of return and avoids undue risk, neither the trustees’ prudence nor loyalty can be called into question. The court, in effect, fashioned a policy to balance the competing interests of the beneficiaries, fund trustees, and sponsoring government. In doing so, arguably the court gave its approval for trustees to pursue socially motivated investments. The court resolved the conflict between the competing claims for the use of pension assets by approving an approach that ensures plan members a reasonable rate of return, while enabling policymakers to develop public policy that respects and reflects community values.

CONCLUSION

The purpose of this Note is not to suggest that public pension funds or sponsoring governments charge blindly ahead to implement targeted investment programs. Rather, the analysis in this Note is intended to more clearly define the issues surrounding the debate of social investing, and targeted investing specifically. As this Note points out, in some circles there is a cloud of impermissibility that hovers over any investment proposal that might be characterized as a social investment. This is unfortunate—not all social investments are losing propositions. Moreover, for public policy reasons, in some rare circumstances both public pension funds and their

179. See id. 736-37 (citing 3 SCOTT & FRATCHER, supra note 76, § 227.17); see also Brock v. Walton, 794 F.2d 586, 588 (11th Cir. 1986) ("a reasonable rate may be different from the prevailing or market rate," mere showing of a below-market interest rate not enough to present factual question that trustees failed to charge a reasonable rate of interest or violated prudence); Barrington Police Pension Fund v. Illinois Dept. of Insurance, 570 N.E.2d 622, 627 (Ill. App. 1991) (holding that fact that "the [investment] program earned a less than market rate of interest, alone, is insufficient reason to hold as a matter of law that the program was an imprudent investment in violation of the Pension Board’s fiduciary duty").

180. Baltimore, 562 A.2d. at 738.

181. Id. (citing 2A SCOTT & FRATCHER, supra note 76, § 170; 3 SCOTT & FRATCHER, supra note 76, § 227.17).

182. Id. at 737-38.
sponsoring governments might benefit from an investment that sacrifices rate of return for a collateral economic benefit. Withers aptly demonstrates this proposition. Further, just as some suggest that the costs of providing pension benefits should be included among the costs of employment, all the economic and social benefits derived from a particular investment should be included among the calculated benefit "return."

Policymakers must more fully consider the complex issues associated with developing cogent policies to shape a proper role for public pension funds in modern society. They must recognize that it is inappropriate to apply the same standards to public plans as are applied to private funds. As the first administrator of ERISA observed, "[p]ublic plans, in fact, are different. Th[at] issue[] must be placed squarely on the table before, rather than after, we decide what kind of legislation to apply to those plans."

If markets are inefficient, or if there is no well-functioning market for a particular investment, then the use of ETIs might capture some benefit that otherwise might not be captured. Also, as states compete for industry, there are bound to be winners and losers. The economic winners among states may well be those that identify the inefficiencies in their economies and find investment instruments to meet their capital needs. Although there may be rent-seeking costs associated with efforts to lure and retain businesses, states cannot be expected to sit idly by and to let fate determine the success of their respective in-state economies.

State legislatures must adopt policies that promote long-term economic development and maintain optimal—not necessarily maximum—security for pension funds. The two objectives are not mutually exclusive. Policymakers must recognize that the role of fund fiduciary has taken on new importance in our economy. Pension funds must not only fulfill their important role in securing the payment of retirement benefits, but within the limits of proper prudence they must also recognize broader financial and social interests. Most importantly, governments at all levels must adopt policies that enable pension funds to fulfill their role as financial institutions upon which our economy is profoundly dependent.