NOTES

SOCIALLY RESPONSIBLE INVESTMENT OF PUBLIC PENSION FUNDS: THE SOUTH AFRICA ISSUE AND STATE LAW

I

INTRODUCTION

In 1980 public and private pension funds totaled more than $550 billion, owned more than 25% of all publicly traded stock, and controlled more than 40% of all debt capital in the United States.[1] Pension fund assets are expected to surpass $1.3 trillion by 1985.[2]

Although pension funds exist for the benefit of workers, control of the assets rests with trustees who, in turn, usually turn over the funds to a bank, an insurance company, or an independent investment manager. Control of the investment of such vast sums necessarily confers power to influence the economic and social direction of the nation.[3] While investment policies have been traditionally dictated by purely economic considerations,[4] growing concern for the social consequences of investment decisions now poses new questions of both law and policy.[5] To the partisans of "socially responsible" investing, investments are more than a vehicle for financial return; investment practice includes support or repudiation of the conduct of the entity invested in.

Interest in directing investment funds for social goals has focused on issues concerning nuclear power, export of infant formula to third world countries, military and media policies.[6] Unions have demonstrated interest in the labor policies of the corporations in which they invest; likewise, state and local governments favor investing pension funds to benefit the commu-

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1. *See generally* Cowan, *Pension Funds' Promise Also Contains Real Peril,* N.Y. Times, Nov. 16, 1980, at 4E; Lubin, *Union Step Up Use of Pension Cash to Push "Socially Desirable" Projects,* Wall Street Journal, July 23, 1980, at 25.

2. Hutchinson & Cole, *Legal Standards Governing the Investment of Private Pension Capital* [hereinafter referred to as Hutchinson & Cole] in EMPLOYEE BENEFIT RESEARCH INSTITUTE POLICY FORUM: SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES? 29 (1979) (citing SEC, 37 STATISTICAL BULL. 5, at 8 (May 1978)) [hereinafter referred to as EBRI]; STAFF REPORT OF THE SUBCOMM. ON ANTITRUST, MONOPOLY AND BUSINESS RIGHTS OF THE SENATE COMM. OF THE JUDICIARY 96TH CONG., 1ST SESS., BENEFICIARY PARTICIPATION IN PRIVATE PENSION PLANS 1 (Comm. Print. 1979).

This increase will mean that nearly half the external capital raised by U.S. corporations will come from pension funds. Hutchinson & Cole, *id.*

3. *See* P. HARBRECHT, S.J., PENSION FUNDS AND ECONOMIC POWER 284-85 (1959).

4. *See infra* text accompanying note 32.

5. *See* P. DRUCKER, THE UNSEEN REVOLUTION 35 (1976).

6. 7 NEWS FOR INVESTORS 21 (1980) (a monthly report on investors, corporations, public interest advocates and government agencies that make and affect decisions on private sector responsibility, published by the Investor Responsibility Research Center, Inc.) [hereinafter cited as IRRC] (on file at NYU Review of Law and Social Change [hereinafter referred to as

nity of the participants.[7] However, no issue in the ethical investment controversy is more far-reaching than the issue of investment in companies which do business in South Africa.[8] Investments which support South Africa's "apartheid" policy[9] exemplify what partisans of socially responsible investing want to avoid.[10]

The South Africa issue is a paradigm of the extent to which notions of social responsibility may be permitted to enter into pension fund investment decisions.[11] The focus is not clouded by the financial benefits which might flow to pension beneficiaries from creating a stronger union or community, as is the goal of some other kinds of nontraditional pension fund investment. The benefits are ethical. The debate has been snarled by competing interpretations of the traditional requirements of investing: "prudence" and the "sole benefit of the beneficiaries."[12] Presently, three states, Connecticut, Massachusetts, and Nebraska, have overridden these traditional investment guidelines[13] with legislative action on the South Africa issue.[14] In a

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NYU/RLSC]). Other areas of concern include toxic chemicals and occupational health, trade with Communist countries, labor relations, equal employment, and overseas payments.

7. *See, e.g.*, J. RIFKIN & R. BARBER, THE NORTH WILL RISE AGAIN 216-26 (1978).

8. *See* 7 IRRC 22 (1980). For the third consecutive year the South Africa issue will be the topic of more shareholder resolutions than any other issue. For a tally of specific resolutions, see *id.* at 28.

9. The apartheid policy separates South Africa's heterogeneous population of 26 million people into separate states, 10 African and one white. Africans, who comprise more than 70% of the population, are allotted 13% of the land and have no political rights in areas designated as white. The government restricts where Africans can live, move, and work and how they are educated. D. MYERS III, U.S. BUSINESS IN SOUTH AFRICA 1-3 (1980).

10. "South Africa is morally repugnant . . . because . . . a white-dominated industrial system systematically exploits and retards the social, political and economic development of the country's black majority." S. BALDWIN, J. TOWER, L. LITVAK & J. KARPEN, PENSION FUNDS & ETHICAL INVESTMENT 12 (1980) [hereinafter cited as CEP Cal. Study].

11. Some advocates of ethical investing argue that the repressive policies of South Africa make revolution, and consequent loss to investors, likely. *See, e.g.*, *infra* text accompanying notes 61-63. If the South Africa exclusion were truly motivated by concern about financial repercussions the policy would not be characterized as socially responsible investing. *See* Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979). Engel excludes from a definition of corporate social responsibility "a corporate action taken because of management's belief that it will maximize profits in the long run even if it may damage them this week or this year." *Id.* at 9.

12. *See infra* text accompanying notes 29-37.

13. Although attempts in Michigan to attach the South African criterion to state pension fund investments have thus far failed, *see, e.g.*, H. B. No. 4838 (1979) (copy on file with NYU/RLSC), Michigan has adopted the restriction for the disposition of surplus funds in the state treasury:

> To be a depository of surplus funds belonging to the state, a financial institution shall not encourage or condone legally required discrimination against an individual on the basis of race or color, by knowingly making or maintaining a loan to the Republic of South Africa, a national corporation of the Republic of South Africa, or to a subsidiary or affiliate of a United States firm operating in the Republic of South Africa.

MICH. COMP. LAWS ANN. § 21.145(5) (Supp. 1981).

14. CONN. GEN. STAT. ANN. § 3-13(f) (West Supp. 1981); Budget item 0612-1500, ch. 329, 1980 Mass. Acts, *reprinted in* 1980 Mass. Adv. Legis. Serv. 461-62 (Law Co-op.); Nebraska Legislative Res. 43, 86th Leg., 2d Sess. (Mar. 31, 1980).

fourth state, Wisconsin, the state Attorney General's interpretation of an older statute[15] has produced a similar effect.

These innovations by partisans of socially responsible investing are creating tensions in an area of law where significant questions of policy and procedure remain unresolved.[16] Although many studies have analyzed investment policies for private sector pension funds,[17] which are stringently regulated under federal law,[18] no study has examined these new state actions restricting public pension funds. This study will describe briefly the nature and structure of public pension plans. It will then trace the evolution of the concern for socially responsible investing which has resulted in states restricting South African investments in their plans. The study will next examine the various approaches taken in implementing this policy.

The core of this study is an analysis of the legal issues raised by legislating socially responsible investment of state pension funds. Before these issues are reached, factual questions about the effectiveness and the financial consequences of restricting South African investments are considered. The study concludes by suggesting practical guidelines for the future: elements essential for successful state statutes and techniques for accommodating the competing interests.

II

BACKGROUND

A. Structure

Public pension plans are enormously varied. In 1978, 6,630 independent state and local pension plans existed; Pennsylvania alone had more than 1400. Each plan had its own eligibility, vesting, financing, and benefit

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15. WIS. STAT. § 36.29(1) (1981); Op. Att'y Gen. 6 (1978).

16. California and Minnesota have made substantial moves in gathering information and conducting hearings preliminary to attaching the South Africa criterion to state fund investments. MYERS, *supra* note 9, at 284-85. Efforts in Illinois and Michigan have reached the state bill stage and several municipalities throughout the nation have begun, and in some cases completed, the divestment process. *See* THE AMERICAN COMMITTEE ON AFRICA, A CALL FOR LEGISLATIVE ACTION TO BREAK THE TIES WITH APARTHEID (1980) (copy on file with NYU/RLSC).

17. The plethora of material includes government releases and speeches by the administrator as well as books and articles by commentators with varied views. *See, e.g.*, Hutchinson & Cole, *supra* note 2, which treats most of the sources in the field. James Hutchinson is former administrator of Pension and Welfare Benefit Programs, U.S. Dept. of Labor, the agency responsible for administering ERISA.

18. Employee Retirement Income Security Act of 1974, Pub. L. 93-406, 88 Stat. 833 (codified in scattered sections of titles 5, 26, 31 and 42 U.S.C. (1976)). The Employee Retirement Income Security Act of 1974 (ERISA) codified common law investment principles and added more frequent review of fiduciary action, a broader range of fiduciary personal liability, and access to the federal courts for enforcement. ERISA specifically preempts state law.

provisions.[19] Private pension plans are a useful basis of comparison.[20] Unlike private plans, public funds often require employee contribution and are more likely to have cost-of-living adjustments.[21] Only about 3½% of state and local plans are fully funded,[22] in contrast with private plans which are required to be eventually fully funded by the federal Employee Retirement Income Security Act of 1974 (ERISA).[23] By 1975, state and local plans had amassed an unfunded accrued liability of $270.3 billion.[24]

The statutes establishing state and local pension funds typically create a board of trustees who often are responsible for both pension administration and investment management.[25] Either the state treasurer alone or an investment committee is charged with making the ultimate investment decisions. Even if actual management is delegated to a professional investment manager, accountability for investment decisions remains with the public officials entrusted with the money. Absent statutory provisions to the contrary, these public officers are held to even stricter liability than fiduciaries handling private funds.[26] Guidelines for state investments are often set out in detail by the legislature.[27] State legislatures and state common law provide the trust concepts which measure the propriety of public pension fund administration.[28]

B. Traditional Legal Guidelines

The obligations of public pension fund trustees are measured by two well established rules of trust law: the prudence rule and the duty of loyalty to beneficiaries.[29] The common law "prudent man" rule, formulated in 1831 in *Harvard College v. Amory*[30] requires that a trustee

> exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their

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19. A. MUNNELL, PENSIONS FOR PUBLIC EMPLOYEES 6-7 (1979).
20. *See supra* notes 17 & 18 and accompanying text.
21. A. MUNNELL, *supra* note 19, at 20. Thirty five percent of contributions to state and local pension funds are made by employees. *Id.* at 32. More than 30% of state and local plans require contribution from at least some employees. *Id.* at 34.
22. "Funding," the recognition of expenses, is an accounting issue. "Funded" plans practice accrual accounting, setting aside funds as expenses are incurred; "pay as you go" plans are on a cash basis, paying expenses as they come due.
23. *See supra* note 17.
24. MUNNELL, *supra* note 19, at 47.
25. Leibig & Kalman, *How Much Federal Regulation Do Public Funds Need?*, PENSION WORLD, Aug. 1978, at 23.
26. 63 AM. JUR. 2D *Public Officers & Employees* § 328 (1972).
27. Casey, *Legal Limits on Investing: With Reference to State Regulations*, in INVESTMENT MANAGER'S HANDBOOK 650, 674 (S. Levine ed. 1980).
28. *Id.*
29. RESTATEMENT (SECOND) OF TRUSTS §§ 227, 170 (1959).
30. 26 Mass. (9 Pick.) 446, 461 (1831).

> funds, considering the probable income, as well as the probable safety of the capital to be invested.[31]

Most courts have judged the prudence of an investment exclusively in terms of the twin objectives of preserving the estate and attaining an adequate return.[32] Jurisdictions have also incorporated the prudence rule into their statutory framework.[33]

The other test of a pension fund trustee's actions involves the duty of loyalty owed to beneficiaries.[34] The trustee is to administer the trust "solely in the interest of the beneficiary."[35] This common law duty of loyalty is reinforced by provisions of the Internal Revenue Code.[36] To qualify for tax exempt status, a pension plan must be maintained "for the exclusive benefit" of employees or their beneficiaries.[37]

C. Evolution of Social Responsibility as an Investment Guideline

As early as 1959, Paul Harbrecht stressed responsible behavior for the common good in analyzing the significance of pension funds for a society.[38] The first attempts to use investment power to force corporations to behave in socially responsible ways focused on the proxy medium.[39] In the late 1960's, civil rights advocates attempted to enlist the voting power of institutional investors to change corporate policy.[40] The issues addressed varied from minority hiring practices to policies concerning the Vietnam War and the South African apartheid government.[41] One of the most publicized campaigns over corporate social responsiblity was waged against

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31. *Id.* at 561; Shattuck, *Development of the Prudent Man Rule for Fiduciary Investment in the United States in the Twentieth Century,* 12 OHIO ST. L.J. 491, 493 (1951).

32. Ravikoff & Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule,* 68 CALIF. L. REV. 518, 520 (1980). *See* RESTATEMENT (SECOND) OF TRUSTS § 227 (1959).

33. 3 A. SCOTT, THE LAW OF TRUSTS § 227.13 (3d ed. 1967 & Supp. 1979).

34. *Id.* § 170.

35. RESTATEMENT, *supra* note 29, § 170.

36. 26 U.S.C. § 401(a) (1976).

37. *Id. See also* Hutchinson & Cole, *supra* note 2, at 39-40.

38. P. HARBRECHT, *supra* note 3, at 289.

39. Under this technique activists buy shares of the stock so that they will have the right to submit shareholder resolutions and fight management over these issues at the annual stockholders' meeting. In soliciting other shareholders' support for the resolutions, rather than automatically signing proxies giving their votes to management, activists generate both publicity for their issue and public opinion pressure unwelcomed by management. Shareholder resolutions remain an important weapon for the ethical investor movement. *See* Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues,* 93 HARV. L. REV. 670 (1980); D. VOGEL, LOBBYING THE GIANT CORPORATION (1980).

40. Markiel & Quandt, *Moral Issues in Investment Policy,* HARV. BUS. REV., Mar.-Apr. 1971, at 37, 38.

41. *Id.*

General Motors through "Campaign GM"[42] which resulted in the appointment of Leon Sullivan, a black activist minister, as a director of General Motors. From Sullivan's efforts came the "Sullivan Principles," a code of fair employment practices which is now the central focus of the heated South Africa investment debate over public pension plans.[43]

The use of the proxy technique allows greater shareholder input in corporate decisions to do business in South Africa.[44] The idea of socially responsible investing, long a concern of only special interest groups, achieved widespread attention in 1978 with the publication of Jeremy Rifkin and Randy Barber's *The North Will Rise Again.*[45] Its statistics evoked interest from diverse segments of America.[46] The book posited a solution to the chronic economic crisis of the United States and the perceived injustice in the distribution of limited capital. It advised millions of workers bruised by inflation and unemployment in the decaying Northeast and Midwest to reclaim their rights through democratic control of pension funds. Such control necessarily requires that workers also consider questions about responsibility for investment decisions.[47]

Meanwhile, university campuses had become sites of sustained battles over investment portfolios and social responsibility.[48] Divestment of state university portfolios based on companies' involvement in South Africa triggered legal rulings on the issue. The Attorneys General of Wisconsin, Oregon, and Indiana gave official opinions in 1978 on the prudence of the South Africa question as an investment criterion.[49] These opinions[50]

42. The Campaign GM group proposed: (1) establishing a General Motors Shareholders Committee for Corporate Responsibility to make a report and recommendations about that corporation's role in society; (2) enlarging the corporate board of directors by adding three representatives of the public. *Id.* at 39.

43. *See infra* note 212 and accompanying text.

44. J. SIMON, C. POWERS & J. GUNNEMANN, THE ETHICAL INVESTOR 151 (1972).

45. The subject of this Peoples Business Commission publication is succinctly expressed in its subtitle: "Pensions, Politics and Power in the 1980s."

46. PENSIONS AND INVESTMENTS, Apr. 10, 1978, at 1, 31.

47. *See, e.g., Controversy Develops over $13 Billion New York Fund,* LABOR & INVESTMENTS (the publication on labor, pension and benefit funds, and investments of the Industrial Union Dept., AFL-CIO), Jan. 1981, at 8 (copy on file with NYU/RLSC).

48. *See* MYERS, *supra* note 9, at 285-86. As succeeding classes of students kept up the pressure, administrators eventually appointed committees and issued statements. *See, e.g.,* the summary of developments at Harvard and Boston Univ. in CEP Cal. Study, *supra* note 10, at 89-91, 83-85.

49. Letter from Wisconsin Attorney General La Follette to Edwin Young, President of the Wisconsin University System (Jan. 31, 1978), 67 Wis. Op. Att'y Gen. 20 (1978); letter from Oregon Attorney General Redden to Dr. R.E. Lieuallen, Chancellor of the State Dept. of Higher Ed. (#7616) (May 2, 1978), Ind. Op. Att'y Gen. 8 (July 17, 1978) (copies on file with NYU/RLSC).

50. Attorneys general sometimes act in advisory capacities. "Where a question of law is before a court for determination, an opinion previously rendered by the attorney general on such question, while entitled to careful consideration and quite generally regarded as highly persuasive, is not binding on the court." 7 AM. JUR. 2D *Attorney General* § 11 (1980) (footnotes omitted).

present a limited consensus on the fate of the issue. The opinions of the Attorneys General of Indiana and Oregon, followed traditional common law principles in the absence of a pertinent state statute. The Indiana opinion stated that social responsibility could not be a criterion for university investments; the Oregon opinion viewed divestment as a probable violation of that state's "prudent man" rule.[51] A lawsuit protesting the Oregon opinion, filed in November 1978, was the first case to raise the question of the permissibility of using the South Africa issue as an investment guideline.[52]

The opinion of the Wisconsin Attorney General[53] came to the opposite conclusion in its analysis of divestment by the state university board of trustees. The opinion was based not on common law principles, or the state prudence rule, but on a 1973 statute which prohibited the investment of state university funds in companies which practice racial discrimination.[54] The Attorney General concluded that this statute required divestment.[55]

III

State Action: Diverse Approaches

A. Connecticut

Connecticut is thus far the only state to implement a specific South Africa criterion for securities selection[56] in standard state law form, passed by both houses and signed by the governor.[57] Connecticut is also alone in accepting adoption of the Sullivan principles[58] by a company as sufficient evidence of social responsibility to warrant investment. Section 1 of the act directs the state treasurer to review major investment policies to ensure that no monies are invested in corporations doing business in South Africa which have not adopted the Sullivan principles.[59]

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51. *See supra* opinions cited in note 49.
52. Pretrial Order, Associated Students v. Hunt, No. 78-329 (Or. Ct. App. 1978).
53. 67 Wis. Op. Att'y Gen. 20 (Jan. 31, 1978).
54. Wis. Stat. § 36.29(1) (1975).
55. 67 Wis. Op. Att'y Gen. (Jan. 31, 1978).
56. *See supra* note 13 for use of the South Africa criterion in state banking.
57. 1980 Conn. Pub. Acts 80-431 (effective May 27, 1980) (codified in scattered subsections of Conn. Gen. Stat. Ann. § 3-13f (Supp. 1981)).
58. For discussion of the Sullivan Principles *see infra* note 212 and accompanying text.
59. *See supra* note 57, Conn. Gen. Stat. Ann. § 3-13f. Section 2 of this Act directs that "among factors to be considered by the Treasurer with respect to all securities may be the social, economic and environmental implications of investments . . . [T]he treasurer shall consider the implications of any particular investment in relation to the foreign policy and national interest of the United States."

Section 3 provides that the state treasurer shall ensure that there are no investments in corporations doing business in Iran contrary to U.S. interests.

B. Nebraska

Nebraska's action takes the form of a legislative resolution,[60] rather than a statute. The state legislature called on the Nebraska Investment Council to review the list of corporations and banks which invest in South Africa[61] and to remove them from the list of entities approved for the investment of state funds. The resolution declares that investment in institutions supporting the apartheid system of South Africa is contrary to Nebraska's principles of human rights and social equality. The preamble includes a list of bases for action, ranging from state constitutional and statutory guarantees of equality to the assertion that the South African government is unstable. The resolution explicitly notes that the state investment officer has no guidance from the legislature other than the broad statutory requirement of "careful and prudent investment of state funds."[62]

C. Massachusetts

Although activists in Massachusetts were unable to secure passage of separate legislation addressing the South Africa question, they achieved a toehold in 1979 when they were able to influence the budget procedures for an additional $13 million reserve fund which the state needed to finance its share of the state employees' and teachers' retirement system.[63] A line item in the 1980 budget[64] restricted the reserve moneys: "No funds will be eligible to receive [moneys from the reserves] if they maintain any investments in any company doing business in or with the Republic of South Africa[65] after September first, nineteen hundred and seventy-nine." [footnotes added]

The restriction's impact is limited because it applies technically only to the reserve which is held separate from the much larger actual pension funds. However, the activists obtained a written statement from the state treasurer that for some time it has been the policy of the investment committee and state treasurer not to invest in firms doing business with the Republic of South Africa.[66]

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60. LR43, Neb. 86th Leg., 2d Sess. (Mar. 31, 1980) (copy on file with NYU/RLSC). Regarding the effect of resolutions of a state legislature, *see infra* note 187 and accompanying text.

61. The resolution specifies that this is the list compiled by the American Consulate General in Johannesburg.

62. The statute referred to in the resolution is a codification of the Nebraska "prudence" rule. NEB. REV. STAT. § 72-1247 (1943).

63. Like most state plans, the Massachusetts system is not fully funded. The difference is made up out of general revenues. *See* MUNNELL, *supra* note 19, at 44. In Massachusetts, the income from the pension funds provides less than half the annual retirement payments. MASS. SOCIAL AND ECONOMIC OPPORTUNITY COUNCIL, INVESTING IN OURSELVES 1 (1979).

64. 1979 Mass. Acts, ch. 393, item 0612-1500.

65. The list of companies doing business in South Africa was formerly published by the U.S. Dept. of Commerce; it is now updated by and available from World Trade Academy Press, 50 E. 42 St., New York City.

66. Letter to Mass. State Sen. Jack Backman from Philip D. Kett, Office of Mass. State Treasurer (Apr. 10, 1980) (copy on file with NYU/RLSC). This letter also explained that

D. Wisconsin

Wisconsin has no restriction on the investment of its pension funds, but an examination of a comparable restriction on investment of "gifts, grants, bequests and devises for the benefit or advantage of the [State University] system"[67] is instructive. Wisconsin's 1973 statute, unlike the actions in Connecticut, Nebraska, and Massachusetts, makes no specific mention of South Africa. Rather, it prohibits investment in "any company, corporation, subsidiary or affiliate which practices or condones through its actions discrimination on the basis of race, religion, color, creed or sex."[68]

The State Attorney General first gave an informal opinion on the reach of this statute in a letter to the Secretary of the State Board of Regents construing section 36.29 to prohibit investments in companies that do substantial business in South Africa and comply with its laws.[69] The Attorney General reasoned: "[S]uch companies are legally obligated to practice discrimination whether or not they condone it, because of the South African laws."[70] Subsequently, a formal Attorney General opinion reiterated that section 36.29 imposed duties on the board of regents which it was obligated to carry out, leaving questions of constitutionality to the courts. The opinion defended the constitutionality of the Attorney General's construction at length.[71]

IV

Analysis of the Legal Issues

A. Factual Bases

Answers to the legal questions raised in using social responsibility as a pension investment criterion must be predicated on assumptions about investments in general. This section will consider whether excluding some companies from investment portfolios is a rational means for achieving social goals and whether such exclusion is likely to impair investment results.

1. Effectiveness of Divestment

Critics sometimes denigrate divestment as mere gesture. They note that the operation of the stock market insures that the corporation already has

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approximately $20 million in securities of offending companies remain in the portfolio because they were purchased years ago and divestment in the foreseeable future would result in estimated losses of $12 million.

67. Wis. Stat. Ann. § 36.29(1) (West Supp. 1981).

68. *Id.*

69. Note, *Constitutionality of the No Discrimination Clause Regulating University of Wisconsin Investments,* 1978 Wis. L. Rev. 1059, 1060 n.9.

70. *Id.* at 1061.

71. Letter from Wisconsin Attorney General La Follette to University of Wisconsin President Young (Jan. 31, 1978), *supra* note 49, at 10-11.

the money. Selling effects only a transfer of ownership.[72] The critics urge that keeping the stock to force shareholder resolutions and to vote the proxies would be a preferable technique.[73]

In the practical world, however, even if individual sales are unlikely to affect the price of a security, the publicity attending ethical divestment may have deleterious effects. A fact of American business is that corporations need outside capital.[74] The largest single source of that capital is pension funds.[75] The sheer enormity of some state pension funds—for example, the $17 billion aggregate assets of the California Public Employees Retirement System[76]—allows them to "virtually [set] the bond market."[77] The cumulative effect of the funds of several states is immense.[78]

On a philosophical level, the exclusion technique is effective in making the investors' capital unavailable to enterprises which engage in conduct inconsistent with the investors' social values.[79] Social responsibility activists argue that investors have an ethical obligation to prevent corporations from condoning immoral practices.[80] Failure to divest necessarily means sharing the profits of the unethical behavior.

2. Impact on Investments

One form of exclusion is divesting the portfolio of existing holdings repugnant to the social responsibility criterion. There are usually transaction costs associated with selling the securities. One recent study found that the transactions involved in divesting stocks and bonds equal to 50% of the portfolio value would increase pension costs by 0.742%. If the divested securities made up 10% of the portfolio, the transactions would increase pension costs by only 0.144%.[81] Some transaction costs would occur, however, irrespective of the South Africa consideration, through normal trading for the portfolio.

The more substantial cost of divestment comes from having to sell securities at a loss. Managers of the Massachusetts general pension fund

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72. Marcus, *Pension Funds and the Urge to Cure All Ills,* N.Y. Times, Aug. 24, 1980, § 3 (Business), at 18, col. 5-6.

73. *See supra* notes 39-42 and accompanying text on the history of this use of proxies. *See supra* note 44 and accompanying text on drawbacks to this strategy.

74. *See* L. ENGEL & P. WYCKOFF, HOW TO BUY STOCKS, chs. 3-5 (6th ed. 1977).

75. *See supra* text accompanying note 1.

76. CEP Cal. Study, *supra* note 10, at 1.

77. MYERS, *supra* note 9, at 284 (*quoting* J. Harrington, former consultant to the state legislature's Select Committee on Investment Priorities and Objectives).

78. *See* Lubin, *supra* note 1.

79. Kennedy, *Shareholder Responsibility in Institutional Investment,* TR. & EST., Apr. 1975, at 216 (explaining the Yale "avoidance of social injury" concept).

80. This is the "moral minimum" position. *See, e.g.,* J. SIMON, C. POWERS & J. GUNNEMANN, *supra* note 44, at 17-21.

81. CEP Cal. Study, *supra* note 10, at 121; *see also id.* at 116-17.

have not sold stocks of offending companies for this reason (although they would no longer make new purchases of such stocks).[82] Several institutions rejected divestment based on studies of estimated cost to the portfolios. Others did not find cost to be an obstacle to divestment.[83] Differences in composition of the portfolios and in the flexibility of divestment requirements may explain the contrasting conclusions.

Although the costs of divestment can be computed for any particular moment, the more difficult question concerns the long term results of a policy excluding a sizeable number of investment options. Depending on the definition and interpretation of a particular exclusion policy,[84] up to 200 of the Standard & Poor's 500[85] corporations may be eliminated from consideration as investments.[86]

The orthodox approach to managing investments is to diversify the holdings of the portfolio to minimize the risks of large losses.[87] The dominant approach to investment management, modern portfolio theory, stresses general strategy, rather than the selection of individual securities.[88] By taking into account the instability of different classes of investments, investors can balance rate of return and security so that investments are hedges against each other.[89] Concepts of risk parameters derived from economic models aim at achieving an efficient portfolio. In the ideal portfolio, every stock's return would vary inversely with the others', resulting in portfolio return with no volatility.[90]

Opponents of divestment argue that drastically narrowing the available investment choices may preclude the effective use of modern portfolio theory. When divestment became an issue at the University of Wisconsin,[91] the fund's money manager resigned, insisting it was too difficult to effectively manage a portfolio without including large multinational companies.[92]

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82. *See supra* note 66.

83. CEP Cal. Study, *supra* note 10, at 76-77.

84. *E.g.*, Massachusetts refers to all companies doing business in South Africa, while Connecticut refers to non-signatories of the Sullivan Principles. *See supra* text accompanying notes 58 and 64-65.

85. This 500-stock index from the nation's largest securities research organization covers stocks which compose 86% of the total value of all the New York Stock Exchange stocks. The index serves as a barometer of the average movement of New York Stock Exchange prices. ENGEL & WYCKOFF, *supra* note 74, at 224-26.

86. *See* McKelvy, *States Offer Conflicting Opinions on Prudence of African Investments,* PENSIONS & INVESTMENTS at 1 (July 17, 1978) (citing John C. Windsor, president of Heritage Investment Advisors of Milwaukee).

87. 3 A. SCOTT, *supra* note 33, § 228; Casey, *supra* note 27, at 659.

88. *See* M. SCHWIMMER & E. MALCA, PENSION AND INSTITUTIONAL PORTFOLIO MANAGEMENT, chs. 5 & 6 (1976).

89. In the shorthand of economists, investors should not "put all their eggs in one basket." Silk, *Portfolio Theorist,* N.Y. Times, Oct. 14, 1981, at D22, col. 1.

90. N. SCHWIMMER & E. MALCA, *supra* note 88, at 86-87.

91. *See supra* text accompanying notes 48 and 49.

92. McKelvy, *supra* note 86, at 1. When Michigan State University divested, its money manager advised that the likelihood of achieving comparable returns was diminished by exclusion. 5 IRRC 229 (1978).

Divesting from the large multinationals means dealing with smaller companies on balance.[93] Smaller companies are considered greater potential risks,[94] thus increasing the probable volatility of the portfolio. Higher volatility is usually accepted by investors pursuing higher returns. Pension fund investors, however, normally look for safer investments, even at the cost of lower returns. Thus, the postexclusion list could present problems for efficient diversification. Trustees would probably still be able to construct a "core passive portfolio to track the market,"[95] but restricted alternatives would hamper active management.[96]

Proponents of exclusion document their arguments with studies showing that the only demonstrable long term impact is a minute increase in risk which will not be compensated for by increased return.[97] In addition, they contend that their critics give insufficient weight to the feasibility of substituting other good investments for the excluded firms.[98] Since institutional investors generally do not have a good record of producing extra returns through active management[99] and have exhibited little success in locating undervalued securities on a consistent basis,[100] narrowing their options may not produce a great loss. Finally, proponents point out that past performance of a stock tells nothing about how it will do in the future.[101] According to the efficient market theory, price stabilizes at the point where expected returns are normal for risk.[102] Therefore exclusion or inclusion of certain stocks "may not give you a better or worse portfolio at all—just a different one with return differences being balanced out by risk differences."[103]

So the "factual" question of whether the social responsibility criterion will impair investment returns yields an inconclusive and hotly debated answer. It is impossible to predict what will turn out to be a good investment. Some difference in probable risk, return, and diversification value will exist between almost any two investments,[104] even those which superficially appear to be equal.[105] Commitment to an exclusion policy may be feasible under some market conditions, but may result in a problem if the market changes.[106] This Note bases its discussion of the legal principles

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93. EBRI, *supra* note 2, at 234.
94. *Id.*
95. *Id.* at 351.
96. *See id.* at 235 and 351.
97. CEP Cal. Study, *supra* note 10, at 103.
98. *See id.* at 98.
99. *Id.* at 113.
100. "Undervalued" stocks are securities which are worth more than their market price would suggest. *See* ENGEL & WYCKOFF, *supra* note 74, at 12-13.
101. CEP Cal. Study, *supra* note 10, at 97.
102. *See id.*
103. *Id.*
104. EBRI, *supra* note 2, at 66.
105. Bowers, *Social Investing—Practicable or Not?*, PENSION WORLD, June 1980, at 20.
106. EBRI, *supra* note 2, at 233. A fund can do without corporate bonds for fixed income needs when the spreads between government and corporate rates are narrow. If the

involved on the assumption that the effect of exclusion on investment returns is as yet uncertain.

B. Legal Interpretations

The primary legal dilemma in applying the criteria for exclusion to public pension fund investments rests in reconciling such an approach with the "prudence" and "sole benefit" rules.[107] Opponents have also raised the objection that the policy violates the Supremacy Clause and the Commerce Clause of the Federal Constitution. Finally, there remain concerns about the liability of individuals involved in implementing the exclusion policy.[108]

1. Exclusionary Investing and the Prudence Rule

Trustees owe beneficiaries a duty to use reasonable care and skill to preserve the pension fund and make it productive.[109] This prudence is judged not by the results of the investment decisions (which would be an unfair use of hindsight) but by the circumstances at the time the decision was made.[110]

Thus some opponents of exclusion argue that, because paying and expanding retirement income have priority in investment policy, accepting lower returns is imprudent, at least until retirees are much better off relative to the rest of society.[111] Inflation is so significantly eroding the value of pension benefits that the elderly need ever increasing pensions to even approach a decent standard of living.[112] Furthermore, the already considerable unfunded liabilities of state and local pension plans[113] make it essential for prudent managers to invest the pension funds where they will receive the highest returns.[114]

A related argument insists that only a system which permits individual beneficiaries to elect to have their share of the funds subjected to the exclusion criteria would be permissible under the prudence rule.[115] These

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spreads open up again, however, staying with the government bonds will result in lower returns.

107. *See supra* text accompanying notes 29-37.

108. *Id.*

109. *See supra* notes 29-32 and accompanying text.

110. EBRI, *supra* note 2, at 217.

111. Schotland, *The Opponent's Arguments* in EBRI, *supra* note 2, at 137. Note also the emphasis on the retirement interests of participants under ERISA by its Senate floor manager, Senator H. Williams. 125 CONG. REC. S560 (daily ed. Jan. 24, 1979).

112. Schotland, *supra* note 112.

113. A. MUNNELL, *supra* note 19, at 48.

114. *See id.*

115. *See* Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980).

arguments apparently presume that an exclusion policy will impair investment results. But as this study shows, that issue is by no means settled.

Proponents of exclusion note that just as the terms of a trust document could authorize investments which would have been otherwise impermissible under common law,[116] a directive from the state legislature would solve the "prudent investment" problem. Underlying these opposing views are conflicting judgments about who has the right to control state pension fund policy. This study will address that question in a later section.[117]

In the "prudence" debate, exclusion proponents claim that more than money is involved in investment decisions. Some argue investments which provide other benefits to beneficiaries may be acceptable even at the expense of return depending on the type of trust and the trustee authorization.[118] By expanding the "prudence" concept, these proponents effectively blend this concept with the traditional notion of "benefit." This study will discuss the "sole benefit" issue in a later section,[119] but will discuss here the variety of support the proponents have amassed for their enlarged concept of "prudence."

In 1970 an Internal Revenue Ruling on an unemployment benefit trust upheld the tax-exempt status of the trust even though an amendment permitting low-risk, income-producing investments that served social purposes meant a rate of return lower than that otherwise available in the current market.[120] In a 1978 case, *Withers v. Teachers' Retirement System of the City of New York*,[121] a federal district court permitted the use of public pension funds to bail out New York City by an investment which fell distinctly short of the traditional prudence standard.[122]

The altered perspective on prudence is also visible in the pronouncements of two major authorities in the field, the author of the definitive treatise on trusts and the administrator of ERISA. In 1979 Austin W. Scott's *The Law of Trusts*[123] appeared with a new section in its annual supplement, "Moral considerations as to the making and retaining of investment."[124] In discussing whether trustees are rigidly bound to attempt to secure the maximum return consistent with safety, Scott states that trustees may properly consider the social performance of a corporation as a factor in investment decision: "They may decline to invest in, or to retain, the securities of corporations whose activities, or some of them, are contrary to

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116. 3 A. Scott, *supra* note 33, § 227.14.
117. *See infra* text accompanying notes 188-206.
118. *See* Ravikoff & Curzan, *supra* note 32 *passim*.
119. *See infra* text accompanying notes 132-147.
120. Rev. Rul. 70-536, 1970-2 C.B. 120.
121. 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979).
122. For a discussion of *Withers* and the sole benefit criterion, *see infra* text accompanying notes 132-147.
123. 3 A. Scott, *supra* note 33.
124. *Id.* § 227.17.

fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment and consumer responsibility."[125] The trustee need not be convinced that a socially responsible corporation will be more profitable. "[T]he 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."[126]

It is helpful to the South Africa exclusion partisans that Scott's strong social responsibility guidelines are general, applicable to international concerns as well as to local effects. On the other hand, the authority cited in support of the bold pronouncements is slight. For all of the above statements, Scott cites one Kentucky statute which authorizes fiduciaries to invest in low-cost housing, one book (*The Ethical Investor*),[127] and five articles on social responsibility in investing, four in *Trusts and Estates* and one in the *Harvard Business Review*.[128]

Because of the dearth of legal rulings on socially responsible pension investing, the pronouncements of the federal agency charged with regulating private sector pension plans under ERISA take on heightened significance. Originally, the Department of Labor took the position that retirement security of individual participants was such an overriding social objective that to introduce other social objectives might dilute the primary one. Therefore, it was inconsistent with the prudence standard to make investment decisions based on objectives other than traditional economic factors.[129] In a 1979 statement, the ERISA administrator, still insisting that social judgments could not be substituted for economic considerations, added that social factors could be considered in subsequent selection between two investments of otherwise equal desirability.[130]

On June 3, 1980 the administrator announced that he had refined his thoughts on allowing considerations of incidental features of ERISA investments that are equal in economic terms. Exclusion of a significant segment of the investment universe was still deemed generally not prudent; exclusion for social purposes without consideration of economic merit constituted insufficient care for, and disloyalty to, the individual participants. However, incidental exclusion might be acceptable. The key was to approach the social issue through the diversification requirement and to broaden the

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125. *Id.*
126. *Id.*
127. J. Simon, C. Powers & J. Gunnemann, *supra* note 44.
128. 3 A. Scott, *supra* note 33.
129. *Pension Fund Investment Policy: Hearings Before the Subcomm. on Antitrust, Monopoly, and Business Rights of the Senate Comm. on the Judiciary*, 96th Cong., 1st Sess. 3 (1979) (testimony of Ian Lanoff, Administrator of Pension and Welfare Benefit Programs, Department of Labor).
130. *Id.* at 4.

scope of investments considered by finding more choices economically equal and socially preferable.[131] Under this approach, the exclusion criterion operates to supply the bases for the investment decision. The emphasis is upon considering additional firms which meet the criteria rather than upon excluding otherwise desirable investments which do not.

While the evolution of positions within the Department of Labor may seem largely semantic, it does constitute the first positive approach to the validity of social criteria in the ERISA sphere. Achieving exclusion by emphasizing inclusion is not the approach of social responsibility partisans, but the effect may be comparable. At least exclusion is no longer regarded as per se imprudent.

2. *Reconciling the Trustees' Duty of Loyalty with the South Africa Criterion*

Exclusion of investment running counter to the loyalty to beneficiaries rule[132] has been criticized because the benefit of an exclusion policy runs to others. Any benefit to the beneficiaries accrues not in their capacity as beneficiaries, but more broadly, as members of the world community. Opponents of exclusion often cite *Blankenship v. Boyle*,[133] a 1971 case in which a union's use of pension funds to advance union interests was held a breach of fiduciary obligations. The opponents further contend that the need for a strict reading of the "solely in the interest of the beneficiaries" requirement is supported by the language of ERISA, which codified the common law standards. The explicit language included: "for the exclusive purpose of:
(i) providing benefits to participants and their beneficiaries; and
(ii) defraying reasonable expenses of administering the plan."[134]

Exclusion proponents assert that neither *Blankenship* nor ERISA precludes the South Africa criterion. The intent of the common law duty of loyalty was to prohibit situations where the trustees' interest led them to violate their duty to the beneficiaries.[135] The facts of *Blankenship* suggest

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131. I. Lanoff, *The Social Investment of Private Pension Plan Assets—May It Be Lawfully Done Under ERISA?* at 10-14 (before the International Foundation of Employee Benefit Plans, Wash. Legislative Update Meeting) (copy on file with NYU/RLSC), *reprinted in* 31 LAB. L. J. 387 (1980). Lanoff specifically approved the approach of the Chrysler-United Auto Workers agreement, *see* 6 IRRC 216 (1979), which established a joint investment committee to find investments with socially beneficial features and authorized the union to list five companies to be blacklisted from pension fund holdings because of their activities in South Africa. A key feature of the agreement, however, is that the pension plan trustees remain free to reject any union recommendations which do not "measure up economically." 7 IRRC 135 (1980).

132. 3 A. SCOTT, *supra* note 33, § 170; Hutchinson & Cole, *supra* note 2, at 39.

133. 329 F. Supp. 1089 (D.D.C. 1971).

134. ERISA § 404(a)(1)(A), 29 U.S.C. § 1104 (a)(1)(A) (1975).

135. 3 A. SCOTT, *supra* note 33, at 1298.

improper practices by trustees who furthered their own interests at the beneficiaries' expense.[136] Prohibiting the exclusion criterion solely because of any benefit to black South Africans would be an inapposite application of the loyalty rule.

Similarly, the legislative history indicates the "exclusive purpose" language of ERISA focused on prohibiting pension plan assets from becoming an advantage to the employer.[137] "All indications are that the 'solely in interest' and the 'exclusive purpose' requirements [of ERISA] together equal the trustee's common law duty of loyalty, and that each term has been used interchangeably to represent the same concept."[138]

Moreover, the Internal Revenue Service's "sole benefit" requirement[139] is not a stringent standard which looks to primary, not incidental, benefit.[140] The Internal Revenue Service has ruled that other parties, including employers, may benefit from pension fund investments if four conditions are met:

> (1) the cost must not exceed fair market value at time of purchase; (2) a fair return commensurate with the prevailing rate must be provided; (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to must be present.[141]

In *Withers*,[142] the Internal Revenue Service waived the exclusive benefit requirements to facilitate the trustees' purchase of $2.53 billion of highly speculative New York City bonds as part of a plan to avert the city's bankruptcy. The federal district court held that the investment was justifiable because the city was the major contributor of funds to the pension fund and the ultimate guarantor of pension benefit payments.[143] As a result, the "sole benefit" rule did not preclude an investment of decidedly long-range benefit to the fund beneficiaries.

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136. 329 F. Supp. 1089 (D.D.C. 1971) (Union welfare fund trustees left large amounts of uninvested cash in demand deposits in a bank controlled by the union. The court found the evidence compelled the conclusion of a continuing breach of trust by the trustees and a knowing acceptance of and participation in the breach by the bank.).

137. Section of Corporation, Banking & Business Law, ABA; *ERISA and the Investment Management & Brokerage Industries: Five Years Later*, 35 Bus. Law. 189, 233 (1979) (commenting on House & Senate Conf. Comm. Rep. on H.R. 2, Pension Reform, H.R. Rep. No. 93-1280, 93d Cong., 2d Sess., 303).

138. *Id.* at 232.

139. *See supra* notes 36-37 and accompanying text.

140. Hutchinson & Cole, *supra* note 2, at 40.

141. Rev. Rul. 69-494, 1969-2 C.B. 88.

142. 447 F. Supp. 1248 (S.D.N.Y. 1978). *See supra* notes 121 and 122 and accompanying text. Since the pension plan in *Withers* was public, it was not governed by ERISA. *See supra* note 17 and accompanying text.

143. 447 F. Supp. at 1248.

Proponents of exclusion also raise another justification for the South Africa criterion. It is the product of an enlargement of the "benefit" concept, paralleling the enlargement of the "prudence" concept discussed above.[144] This study has already noted an increasing acceptance of benefit to others in connection with the "prudence" analysis.[145] But another approach to the concept is that "benefit" may be other than financial. In the case of the South Africa exclusion, the benefit is not condoning unjust practices.[146] This social responsibility argument can be brought full circle and supported by traditional financial concerns: exclusion avoids ill-fated investments which would generate large losses if the repression in South Africa culminates in revolt.[147]

3. *Legislating the South Africa Exclusion Without Violating the Federal Constitution*

The issues of "prudence" and "sole benefit" usually dominate the exclusion debate. But on one occasion constitutional concerns were a major focus where the relevant state statute had settled those issues.[148] Although the Wisconsin statute at issue did not specifically mention South Africa,[149] it occasioned a debate over whether states may legislate exclusion under the supremacy clause.[150] This argument surfaced in the case *Associated Students v. Hunt.*[151]

a. The Supremacy Clause Objection

Opponents of exclusion argue that restriction of investments by any state on the basis of the South Africa criterion is an intrusion into the field of foreign affairs, which is reserved by the Constitution to the federal government.[152] The formal opinion of the Attorney General of Wisconsin contains a lengthy rebuttal of this objection.[153] The opinion relies first on the holding of *National League of Cities v. Usery* concerning the states' retention of authority to regulate their own important governmental activity.[154] It also cites *Clark v. Allen*[155] for the rule that state statutes which

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144. *See supra* text accompanying notes 109-131.
145. *Id.*
146. *See supra* notes 79 and 80 and accompanying text.
147. There is a reference to this concept in the Neb. Leg. Res. 43, 2d Sess. (1980), which begins: "WHEREAS, the South African government is unstable, resting not with the consent of the governed, but rather relying on violence and the support of outside investment in strategic sectors of the economy . . . ."
148. *See supra* text accompanying note 71.
149. *See supra* note 67.
150. U.S. CONST. art. VI, cl. 2.
151. No. 78-7502 (Or. Ct. App. 1978) (Pretrial Order).
152. *See* Note, *supra* note 69, at 1066-69.
153. 67 Wis. Op. Att'y Gen. (Jan. 31, 1978).
154. 426 U.S. 833 (1976).
155. 331 U.S. 503 (1947).

"have only some incidental or indirect effect in foreign countries do not intrude on federal authority."[156] It finds also that the "*Zschernig* doctrine,"[157] which distinguishes between the facial validity of the statute and its constitutionality "as applied" in foreign relations, combined with the emphasis in *Usery* "on states' ability to function effectively in a federal system", does not render the exclusion unconstitutional.[158]

b. The Commerce Clause[159] Objection

Critics argue that exclusion is unconstitutional because it is a direct burden on interstate commerce, lacks a legitimate local benefit, and is not a proper exercise of state police power.[160] The Wisconsin opinion concluded, however, that the application of the statute to South Africa was justified by "[t]he legitimacy of the state's interest in determining how state finances are to be managed and in setting public policy on an issue which concerns the general welfare, fundamental rights, and individual dignity of its citizens . . . ."[161] In comparison with the local interest involved, the opinion found the potential burden on interstate commerce slight and the effect speculative. Thus the statute is within the permissible area delineated by *Great Atlantic & Pacific Tea Co. v. Cottrell*[162] and *Pike v. Bruce Church.*[163]

The same constitutional attacks and defenses could be made regarding any of the state actions considered in this study. The very presence of a specific state statute, while mitigating prudence and sole benefit problems, may well facilitate a constitutional attack.

4. The Liability of Trustees Implementing Exclusion

Trustees are personally liable for losses resulting from the breach of any fiduciary responsibility.[164] If the trustees violate their duty of loyalty,

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156. 67 Wis. Op. Att'y Gen. 5 (quoting Clark v. Alen, 331 U.S. at 517).

157. 389 U.S. 429, 433 (1968). The Oregon statute at issue in *Zschernig* provided for escheat unless non-resident aliens who inherited property could show that a reciprocal right of U.S. citizens to inherit existed in the alien's nation and that the person taking the property, rather than the foreign government, would in fact have the use or benefit of the property. Such determination would require a case by case inquiry "into the type of governments that obtain in particular foreign nations." *Id.* at 434.

158. 67 Wis. Op. Att'y Gen. at 7.

159. U.S. CONST. art. I, § 8, cl. 3.

160. *See* Note, *supra* note 69, at 1065.

161. 67 Wis. Op. Att'y Gen. at 3.

162. 424 U.S. 366 (1976). The Court held that the Commerce Clause protected free trade among the states from interference by any state which attempted to restrict trade to a reciprocal basis. The Court specifically noted, however, that an exercise of local power is not invalid merely because it has some effects on interstate commerce. The states retain broad power in matters of local concern. *Id.* at 371.

163. 397 U.S. 137 (1970). Here the Court held that prohibition against shipping uncrated produce out of state was invalid if it served no purpose, but simply forced growers to have crating done in the home state. The Court noted that state statutes evenhandedly and properly applied to legitimate local public policy, and having incidental effect on interstate commerce, could be upheld under the Commerce Clause. The nature of the local interest involved determines the extent of the burden tolerated. *Id.* at 142.

164. RESTATEMENT, *supra* note 29, §§ 197-226A.

liability for all losses is included regardless of the fairness or prudence of the investment.[165] Trustees may also be liable for additional equitable or remedial relief.[166] A court may enjoin violative activity and order that such activity not be undertaken in the future.[167]

Beneficiaries who disagree with South Africa policy specifically or with the concept of using pension fund assets for social purposes can sue.[168] Even a fiduciary opposed to the exclusion policy might challenge it.[169] The prospect of litigation is most likely with respect to a "defined contribution plan." Under such a plan, the funding obligation of the employer is limited to the amount specified in the plan documents; employees bear the direct risks of investments.[170] An individual account is provided for each participant and benefits are based solely on the amount contributed to the participant's account and on any income, expenses, gains and losses, and any account forfeitures of other participants which may be allocated to the participant's account.[171] Because such beneficiaries would feel the sting of losses directly, they are more likely to take an interest in the investment policy of the plan.[172]

A "defined benefit plan," by contrast, holds the sponsoring employers responsible for making contributions adequate to provide specified levels of benefits to participants. Thus, the sponsor bears the primary risk of capital loss or inadequate income to cover the plan's current obligations.[173] But even with this type of plan unsuccessful investments based on the exclusion criterion could preclude an increase of benefits which might prompt a lawsuit.[174]

Good faith compliance with a law would insulate trustees from liability.[175] Since the state is responsible for paying the pension, in some respects, the directives of the state legislature parallel those of the settlor of a trust; thus directives may alter what would otherwise be the common law requirements. Under ERISA, however, plan documents are not permitted to alter the policy embodied in the federal statute.[176]

165. *Id.* § 206; 3 A. SCOTT, *supra* note 33. Fiduciaries found in violation of the law and assessed damages would suffer the severe penalty of having to make a lump sum payment back into the fund; they could not amortize the loss over a period of years, as the pension plan could. EBRI, *supra* note 2, at 286.

166. RESTATEMENT, *supra* note 29, §§ 197-226A.

167. Senior trustees may be as concerned with being sued, found in violation of the law and having injunctive relief assessed against them as they are about money damages. EBRI, *supra* note 2, at 286.

168. Hutchinson & Cole, *supra* note 2, at 83.

169. *Id.*

170. *Id.* at 51.

171. Public plans often require employee contribution as well. A. MUNNELL, *supra* note 19, at 20.

172. Hutchinson & Cole, *supra* note 2, at 82-83.

173. *Id.* at 50.

174. *Id.* at 83.

175. 63 AM. JUR. 2D *Public Officers and Employees* § 322 (1972).

176. *See supra* note 18, § 404(a)(1)(D). Some states, too, refuse on grounds of public policy to permit the terms of the trust to legalize more dangerous acts of disloyalty. Hutchin-

In ascertaining liability, it is necessary to determine whether the particular state statute compels the trustees' action or merely permits it. The Connecticut statute and Nebraska resolution strictly proscribe investment in offending companies.[177] The trustees' implementation would thus be ministerial. The distinction is highlighted by another part of the Connecticut statute, which allows the treasurer to consider other "social, economic and environmental implications."[178] Trustees authorized to consider such factors can act beyond ministerial implementation with discretion. The concomitant responsibility for discretionary acts results in increased liability since the trustees are no longer simply complying with the law.[179] The Massachusetts budget item[180] makes the exclusion plans with South African investments from the distribution of the reserve fund ministerial. But the trustees of the individual pension funds who need the reserve moneys are left with more remote authorization. The budget item restriction creates incentive for those funds to divest; their need for the reserve moneys may in effect give them no choice. Although some discretion remains with the trustees, the explicit restriction policy provides reasonable authority to support the choice to divest.

Another determinant of liability is the scope of the authorization from the legislature. State policy may intend to prohibit only new investment in South Africa, or it may also include divestment of existing holdings. The Connecticut statute requires divestment[181] while the Nebraska resolution requires only removal of the offending corporations and banks from the approved list of investments.[182] No directions are given to divest investments which were authorized when made and liability, then, remains possible. The Massachusetts item[183] impliedly requires divestment by denying moneys to funds which maintain investments in offending companies.

Trustees claiming good faith compliance with the law may be challenged on the validity of the legislative directive under which they act. The

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son & Cole, *supra* note 2, at 39, citing G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 543(U) at 377-78 (rev. 2d ed. 1978).

177. Connecticut: "The state treasurer shall review the major investment policies of the state for the purpose of ensuring that no monies are invested in corporations doing business in South Africa which have not adopted the Sullivan Principles. All monies invested in such corporations shall be disinvested . . . ."

Nebraska: "[T]he Legislature calls on the Nebraska Investment Council to review the list of corporations and banks which invest in South Africa . . . and to remove them from the approved list for investment of Nebraska trust funds." *See supra* note 14.

178. *Id.*

179. *See supra* note 175 and accompanying text.

180. Massachusetts: ". . . [N]o funds will be eligible to receive moneys from such reserve if such funds are invested in any company doing business in or with the Republic of South Africa . . . ." Budget item 0612-1500, ch. 329, 1980 Mass. Acts.

181. *See supra* note 177.

182. *Id.*

183. *See supra* note 180.

Connecticut statute, a product of routine statutory procedure,[184] commands a presumption of validity. The Massachusetts item[185] has narrow but conventional legal authority. The Nebraska legislative resolution[186] expresses the sentiment of the legislature but is not a law. Since Nebraska has a unicameral legislature, the resolution may be considered equivalent to a concurrent resolution. Such resolutions express the formal sense of the body on a matter, but do not become public laws and do not require executive assent.[187] With this less authoritative directive there is correspondingly less insulation for the trustee whose action is challenged.

Thus, trustees of state pension funds are in a sensitive position in any scheme of socially responsible investing. Effective legislation must shield the trustees from personal liability for implementing social policy. The nature and scope of the authorization conferred on the trustees will determine whether the South Africa restriction functions effectively or remains mere rhetoric.

C. *Policy Questions*

1. *Who should control investment policy?*

Given the factual bases that can be developed and the legal principles that can be analogized, the question of who has the right to make the necessary investment policy decisions must still be addressed. This question can be best answered by weighing the competing interests involved.

One logical approach to control is to look to fund ownership or, in traditional legal terms, to who has an interest in them. However,

> [t]he application of well-established doctrines of trust law to the field to employee benefit trust funds is a most difficult task. To an ever increasing extent these funds are leaving the realm of usually understood trust principles and are posing an entirely new concept for dealing with property that has no parallel elsewhere in the law.[188]

In traditional terms, trustees have the legal interest in pension funds and beneficiaries have the beneficial interest, which may be vested or contingent depending upon their status under the plan regulations.[189] Participants also have an interest in the plan from its character as a deferred wage.[190]

184. *See supra* note 57 and accompanying text.
185. *See supra* note 64 and accompanying text.
186. *See supra* note 60 and accompanying text.
187. H. LINDE & G. BUNN, LEGISLATIVE & ADMINISTRATIVE PROCESSES 131 (1976).
188. Final report of the SENATE SUBCOMM. ON WELFARE & PENSION FUNDS, S. Rep. No. 1734, 84th Cong., 2d Sess. 67 (1956).
189. *See, e.g.*, EBRI, *supra* note 2, at 277-79.
190. *See, e.g.*, Inland Steel, 77 N.L.R.B. 1, 179 F.2d 247 (7th Cir. 1948), *cert. denied*, 336 U.S. 960 (1949).

Taxpayers could argue, however, that in the present, pension funds are largely government money, set aside today to help pay expenses tomorrow.[191] Therefore, the issue of ownership yields little help in settling control.

A functional approach to control asks who would suffer from a decrease in investment performance, arguing that that party ought to control investment. With public pension plans, taxpayers have a claim to the right to make investment decisions because they have the deferred residual obligation to pay out the pension.[192] In defined benefit plans[193] taxpayers appear to be the principal risk-bearers because they must meet the pension commitment if the funds are not available or if the state defaults.[194]

On the other hand, the factors which lead authorities to conclude that a defined contribution plan[195] will be the setting for the first lawsuits triggered by social responsibility investing[196] also argue for beneficiary control of investment policy. Defined contribution plan benefits are not predetermined, but will rise or fall with the performance of the fund's investments. Moreover, in contrast to private sector plans, public pension funds often require contribution from participants.[197] Therefore, the employees' own funds are also being invested.

There are even arguments that beneficiaries may be risk-bearers in a defined benefit public plan. Beneficiaries may find that future generations of taxpayers will refuse to honor the benefits defined[198] as progressively larger tax burdens caused by substantial underfunding may collide with future needs.[199] Bankruptcy could leave a state unable to fulfill its promises.[200] Although some state employees are covered by plans which are bound constitutionally or legislatively from reducing benefits for current employees and beneficiaries, the strength of these legal provisions is ambiguous. Court rulings in several states have already indicated that the provisions may be inadequate to compel employers to meet current benefit payments or statutory funding requirements.[201] Many states have little or no such protection[202] and few places have yet enforced beneficiaries' rights.[203]

191. Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 1010 (1977).
192. EBRI, *supra* note 2, at 277.
193. *See supra* text accompanying note 173.
194. *See* EBRI *supra,* note 2, at 284.
195. *See supra* text accompanying note 170.
196. Bowers, *supra* note 105, at 22 (*quoting* J. Hutchinson).
197. A. MUNNELL, *supra* note 19, at 20.
198. L. KOHLMEIER, CONFLICTS OF INTEREST 14 (1976).
199. *Id.* at 15.
200. *Id.* at 16.
201. A. MUNNELL, *supra* note 19, at 51.
202. EBRI, *supra* note 2, at 271, 284.
203. *Id.* at 271.

There have already been some decreases in or terminations of local pension fund benefits.[204] Even when legal remedies exist, they are cumbersome and expensive.[205]

This strong argument for beneficiary rights in pension fund investment policy depends largely on the presence of some future inequity. After all, it is the payment of the pension, not the pension fund itself, which the worker is entitled to.[206] In section V, this study suggests methods of balancing the rights of beneficiaries and taxpayers to resolve this issue of control.

2. If exclusion based on a company's doing business in South Africa were desirable and permissible, what should the specific standard be?

The permissibility of including social responsibility criteria in investment policy is based on the presumption that the ethical principles involved are generally accepted ones.[207] Among the partisans of socially responsible investing, however, there is controversy over whether the ethical course is to stay in South Africa and use the corporate presence for good or to cut all ties with South Africa.[208] The Massachusetts and Nebraska actions analyzed here mandate severance.[209] The Connecticut statute[210] permits investments in companies with ties to South Africa providing that the companies have adopted the Sullivan Principles.[211]

The Sullivan Principles are a code of fair employment practices which signatory companies agree to follow in their South African operations.[212]

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204. A. MUNNELL, *supra* note 19, at 50.
205. Leibig & Kalman, *supra* note 25, at 24-25.
206. *See, e.g.*, EBRI, *supra* note 2, at 274.
207. *See supra* text accompanying note 123.
208. MYERS, *supra* note 9, at 285-86.
209. *See supra* notes 60-66 and accompanying text.
210. *See supra* notes 57-59 and accompanying text.
211. *See supra* text accompanying note 58.
212. MYERS, *supra* note 9, at 327-29. *See generally* W. Daniels & J. Cartwright, *The Sullivan Principles: In the Eye of a Storm*, in BACKGROUND INFORMATION ON PROXY CONTROVERSY, at 17-33 (1980). The Sullivan Principles, as currently promulgated, may be summarized as follows:

> (1) desegregation of all workplace facilities, including toilets and cafeterias; (2) equal employment opportunity, including abolition of designated job reservations for whites and apprenticeship restrictions for non-whites; (3) comparable pay and benefits for all employees on the same job; (4) training programs to school non-whites for clerical, technical, administrative, supervisor and management positions in meaningful numbers; (5) promotion of non-whites to supervisory and executive posts; (6) a commitment to improve living conditions for non-white employees with particular emphasis in such crucial areas as housing, education, health care and transportation; and (7) support for the union organizing activities of non-white workers.

Id. at 22. *See also* Kahn, *Annals of International Trade*, NEW YORKER, May 14, 1979, at 117.

By April 1980, 136 companies had signed. IRRC, Analysis T: The Sullivan Principles and American Companies in South Africa T-5 (Apr. 2, 1980) (on file at NYU/RLSC). Each

Those who favor using the Principles believe that they serve to hold South African subsidiaries accountable to parent companies for labor practices and to give concerned investors an objective report where none previously existed.[213] This viewpoint holds the downfall of apartheid without violence as a long range goal, with the Sullivan Principles as an impetus to make needed improvements in labor and education policies in the interim.[214]

Other proponents of exclusion condemn the Sullivan Principles as an expedient response to hostile inquiries which forestalls criticism while injustice is perpetuated.[215] This view argues that the Principles rely too heavily on data voluntarily supplied by the companies under scrutiny, thus representing nominal compliance, but rare actual implementation. More significantly, acceptance of the Sullivan Principles permits foreign investment to remain a vital prop to the racist South African government.[216] In this view, the firms' presence in South Africa, rather than employment practices alone, is the fundamental problem.[217]

The choice between the pragmatic Sullivan approach and the absolute severance position may require continued attention from the state fund policy makers. Reverend Sullivan himself warned in September 1980 that "if the interim measures he proposed did not bring an end to apartheid, he would support 'total divestment' and an embargo on all imports from and exports to South Africa."[218]

V

RECOMMENDATIONS

While constitutionality is certainly a threshold question, state legislation seems to have sufficient bases for withstanding challenges under either the supremacy clause or the interstate commerce clause. The statute should emphasize the state's strong interest in a policy of social responsibility as an integral part of the state's authority to regulate its own important governmental activities.

A well drawn statute, enacted in full compliance with the state's required procedures, seems to effectively shield pension fund trustees from

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is required to submit summary reports to Sullivan every six months. On-site inspections are periodically requested but not required by Sullivan's representatives. *Id.* at T-3.

213. A problem with designating the Sullivan Principles as the only acceptable standard, as the Connecticut statute does, is ignoring other, especially international, guidelines. The European Common Market countries and Canada have also developed codes. Daniels & Cartwright, *supra* note 197, at 22-23.

214. *Id.* at 24.

215. *Id.*

216. Low Income Planning Aid, Memorandum to Mass. Senate Ways & Means Comm. from Jack Kitteredge, Jan. 4, 1980 (copy on file with NYU/RLSC).

217. *Id.*

218. 7 IRRC 176 (1980).

personal liability for following the statutory mandate. Legislative recommendations, rather than commands, would enable the trustees to make informed investment decisions, taking into consideration all the facts relevant at any time. Prudence problems would then be greatly reduced. However, the trustees would no longer be shielded by the ministerial character of their actions and would be open to liability to the extent of their discretion.[219]

The traditional concept of the "benefit" to the beneficiaries is radically enlarged by legislating socially responsible investing. Without a resultant loss being sustained by beneficiaries, there would seem to be no basis for prohibiting the legislature from making this alteration.

Investment prudence is perhaps the most difficult issue to resolve. Experts are in conflict as to whether the exclusion policy can be pursued without financial loss. If the policy, over time, has no significant adverse effects on investment return, the other arguments will probably disappear. If loss does follow, the question of the legislature's violation of the beneficiaries' property rights will likely be litigated.

State legislatures need to act carefully in this controversial new area because of a significant possibility more troublesome than the prospect of litigation. Federal preemption of the pension field already has considerable support in the form of a Public Employees' Retirement Security Act, paralleling ERISA.[220] Abuses in funding and conflicts of interest within the state plans,[221] much like those which gave rise to ERISA for the private sector, make the state area ripe for federal regulation. Thus far, constitutional arguments of federalism and important differences between the states' and private plans' situations have left the states in control of their own pension funds.[222]

Approaches perceived as highhanded abuses of authority on the part of the state legislatures could be the final factor that tips the scales toward total federal control. Ironically, the results would probably not reverse the movement toward social responsibility in investing, as this study has shown by the evolution in ERISA's approach to exclusion. However, a labyrinthine layer of federal regulations dictating requirements and responsibilities would enormously complicate plan provisions, transactions, and fiduciary liabilities.[223]

The issue of who should control public pension investment policy is one yet to be resolved. Some small-scale studies have already shown the public

219. *See supra* notes 177-180 and accompanying text.

220. Salisbury, *Should Pension Assets Be Managed for Social/Political Purposes?* EBRI, *supra* note 2, at 9 n.13; Hutchinson & Cole, *supra* note 2, at 43-44 n.54.

221. *See, e.g.*, KOHLMEIER, *supra* note 198.

222. *See supra* text accompanying note 154 (federalism); §§ II, A & IV, C(1), *supra* (state plans versus private plans).

223. *See, e.g.*, 35 BUS. LAW., *supra* note 137, at 193-97.

to be surprisingly responsive to ethical investing.[224] The problem lies in translating this response into operative principles. The state legislature provides a structure unique to the public sector, representing state taxpayers (the employer) and probably most participants (the public employees). The legislature, however, does not necessarily represent the beneficiaries, who may have moved out of the state and have interests as beneficiaries different from those of the mass of state taxpayers. The legislature's access to tax resources adds to its ability to exercise more freedom than private plans. Because of the complexity of the legal relationships involved, state legislatures might conclude that their own representative capacity allows them to make the policy decision.[225]

One approach for state legislatures which wish to avoid challenges to their policy would be to provide an explanation of their exclusion policy along with routine pension information and payments.[226] Participants and beneficiaries could be provided with a form for objecting to the policy.[227] To comply with traditional interpretations of trust law, states would have to provide an alternative pension fund for individuals who objected to the South Africa criterion.[228]

Another technique for achieving equitable control of decision-making is readily available to states which use investment committees. The inclusion of appointed or elected beneficiaries, including retirees, would enable the committees to make recommendations paralleling the widely praised Chrysler contract[229] while acting in accord with the state statute. Alternatively,

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224. *See, e.g.,* Wis. public sector survey, cited in EBRI, *supra* note 2, at 265; LOU HARRIS, 1979 STUDY OF AMERICAN ATTITUDES TOWARD PENSIONS AND RETIREMENT 62-63, cited in EBRI, *supra* note 2, at 263; Longstreth, *Social Aspects of Business Behavior,* TR. & EST., May, 1973, at 322; Ford Foundation Report. *Id.* at 325. *Contra,* N.Y.S. Controller's bulletin and response, *see* EBRI, *supra* note 2, at 261.

225. *See* § IV, C(1), *supra.*

226. *Cf.* Int'l Assoc. of Machinist v. Street, 367 U.S. 740 (1961), in which compulsory union dues were used to support political candidates or causes not approved by some members. The Court held that "a blanket injunction against all expenditures of funds for the disputed purposes" was not "a proper exercise of equitable discretion." *Id.* at 772. "Any remedies . . . would properly be granted only to employees who have made known to the union officials that they do not desire their funds to be used for political causes to which they object." *Id.* at 774. Justice Douglas, concurring, noted, "Some forced associations are inevitable in an industrial society." *Id.* at 775. Consequently, "[l]egislatures have some leeway in dealing with the problems created by these modern phenomena." *Id.* at 776. Pension funds are an equally troublesome area of law. *See, e.g., supra* text accompanying note 188. The analogy provided by *Machinists* is all the stronger because the South Africa criterion would only prohibit spending funds in the disputed way, while the union in *Machinists* was actively spending the dues in the way objected to.

227. Data could be enclosed with the paychecks of participant workers and with the benefit checks sent to beneficiaries.

228. This is the approach propounded by Langbein & Posner, *supra* note 115, invoking the "ratification doctrine" of traditional trust law. *Id.* at 104-107.

229. *See supra* note 131. The extensive CEP Cal. Study, *supra* note 10, concludes that the best approach to social responsibility investing is through a committee, which can weigh each investment decision on its individual merits, functioning as active, concerned shareholders in the service of a coherent overall perspective of corporate responsibility. *Id.* at 162-63.

the statute could provide for an even stronger role for the beneficiaries, as in a recent proposal of the New York public employees union:[230] the public worker representatives would have a minority position with veto power. The legislation could also contain a "sunset provision" which would ensure that social responsibility legislation continues to represent the wishes of its constituents as policy and financial conditions develop. The time for reauthorization should be fixed so that the legislature may assess the financial and political effects of the exclusion policy.

VI

CONCLUSION

Several states have already restricted investment of their pension funds in companies which do business in South Africa. More states are in the process of doing so.[231] Recognizing the legal issues and the competing rights creates much confusion. Objections are substantial, but so are policy considerations in favor of using available legal bases to support socially responsible investing. State pension funds have a special character because of the government's special responsibility to respond to the needs of society. Connecticut State Treasurer Henry Parket, a pioneer in implementing the South Africa criterion for state funds investment explains, "[I]nvesting in an enterprise which is . . . stubbornly ignoring public policy constitutes implicit endorsement of those policies . . . .[G]overnment cannot in good faith support such activity without abrogating its duties to the citizens."[232]

Like so many private sector pension participants and beneficiaries, states now know the potential power of their fund assets. Reversing the momentum toward control of investment decisions would be as hard as putting toothpaste back in the tube.[233] The realistic question is no longer whether participants and beneficiaries should share in the control of their pension funds. Instead, the question is how to best integrate considerations of the social impact of investments with competing economic interests involved in state pension funds. This study concludes that a flexible application of legal principles can indeed enable state legislatures to implement the public decision to reject investment in apartheid.

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230. LABOR & INVESTMENT, Jan. 1981, at 8.

231. The American Committee on Africa's New York City office coordinates a nationwide campaign for state and municipal action to cut ties with South Africa. Copies of state and local laws, bills, and resolutions are available.

232. Treasurer's Policy on the Prudence of Trust Fund Investments (copy on file NYU/RLSC).

233. *See* Editorial, *Pension Experts Can't Afford To Play Ostrich,* PENSIONS & INVESTMENTS June 19, 1978, at 8. P & I published an Editorial Advisory Panel report on the use of pension funds for socially responsible investments. Three of the 125 panel members chastised P & I for raising the issue. The editorial noted that whatever the wishes of individual pension investors, the social responsibility issue was "likely to loom larger in the years ahead."