PUBLIC WEALTH MAXIMIZATION: A NEW FRAMEWORK FOR FIDUCIARY DUTIES IN PUBLIC FUNDS

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This Article challenges the standard doctrine that public pension funds should be managed solely for the benefit of plan participants and their beneficiaries. Instead, economic logic suggests that public pension fund trustees owe their duties to the public collectively. This analysis is driven by the fact that, in practice, individual pension fund claimants function more like senior creditors than the residual claimants that are the typical recipients of fiduciary duties, and that the public—and current and future taxpayers specifically—are the true residual risk bearers for public pension funds.

This reframing of fiduciary duties in public funds has dramatic consequences for the investment policies of the funds. Most importantly, a shift in the locus of fiduciary duties to public wealth maximization will require fund managers to more fully consider the externalities accompanying their investments, which should serve to help them fully and accurately price their investments. Private investors might ignore certain negative effects, such as uncompensated harms from pollution or depleted natural resources, because the government absorbs the costs of such externalities. Indeed, a strict fiduciary duty to act in the interests of the fund would obligate a private investor to ignore such externalities, so long as they do not negatively affect the returns of the fund's investments. The government—and by extension, the public who funds the government—that absorbs the cost of these externalities, however, should view investments differently. They should view it with an eye to minimizing negative externalities, particularly those that are significantly more expensive to remediate than to prevent. Similarly, a strict reading of fiduciary duty would suggest that funds should ignore positive externalities from investments that benefit society but not the plan participants. A focus on public wealth maximization would suggest that positive externalities should also be taken into account in investment decisions, which might, as a consequence, result in more investment in sustainable enterprises and long-term projects.

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I. INTRODUCTION

Imagine a group of public pension fund trustees—some political appointees, some investment experts, and some union representatives or employees—gathered in a conference room for a quarterly meeting on investment policy. At issue is whether the pension fund, a multi-billion-dollar fund managing assets to fund the pensions of generations of state workers, should divest from companies that engage in coal mining and coal-based energy production. The trustees are fiduciaries, managing on behalf of others. But what does their fiduciary obligation require? Should they focus solely on maximizing the wealth of plan participants and their beneficiaries? Should more general societal interests, such as addressing climate change, play a role in how they make their decisions? What about the workers who may be affected by large-scale divestment from mining activities?

Public trustees have long been held to a strict duty of loyalty that, by design, limits their ability to direct the fund in ways that would not serve the interests of the pension plan participants and their beneficiaries. Trustees, in turn, narrowly focus fund managers on short-term wealth maximization[1]—or, as I will call it in this Article, "participant wealth maximization"—which limits the ability of a fund to invest in certain sustainable or socially responsible investment ("SRI") initiatives, and may also decrease the ability of a fund to invest in longer-term projects to the extent that the risks and returns of such projects are difficult to evaluate. For our pension fund trustees, a strict reading of their duty would require them to disregard worker and societal interests and focus solely on maximizing the value of the fund.

A limiting focus on participant value maximization has considerable virtues: it provides a simple, clear objective for fund managers and reduces managerial agency costs by dissuading managers from pursuing investments that are not in the interests of the fund beneficiaries. Furthermore, as Jensen argues, "200 years' worth of work in economics and finance indicate that social welfare is maximized when all firms in an economy attempt to maximize their own total firm value."[2] This argument applies equally well to public funds, so that not only are fund beneficiaries better off by focusing on maximizing total value, but society as a whole is better off as well.

The requirement of participant wealth maximization, however, suffers from several weaknesses. The standard economic analysis, on which participant wealth maximization depends, assumes well-functioning, liquid markets that accurately price assets and investment risk. After the financial crisis, however, many scholars are less confident in the financial markets' ability to effectively price assets.[3] Asset pricing may also be more difficult because of challenges in calculating risk. Risk is, arguably, often mispriced because markets fail to account for negative externalities[4] created when economic actors do not bear the full cost of their choices.[5] For example, a firm may pollute the water or air or deplete resources "without having to purchase the right to do so from the par-

1. WORLD BANK, EVALUATING THE FINANCIAL PERFORMANCE OF PENSION FUNDS 5 (Hinz et al. eds., 2010).

2. Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 13 (2001).

3. K.J. Martijn Cremers, Saura Masconale & Simone M. Sepe, *Commitment and Entrenchment in Corporate Governance*, NW. U. L. REV. 727, 748 (2016) (noting that a standard assumption of neoclassical economics is that current stock prices impound the discounted value of a firm's stream of future cash flows; after the financial crisis, however, "that argument is diluted of much of its strength").

4. Jensen notes that "[t]here can be no externalities as long as alienable property rights in all physical assets are defined and assigned to some private individual or firm. Thus, the solution to these problems lies not in telling firms to maximize something other than profits, but in defining and then assigning to some private entity the alienable decision rights necessary to eliminate the externalities." Jensen, *supra* note 2, at 254, 239. That these problems do require a solution suggests that the market has not been working. This is not to say that the market itself is necessarily flawed; market failures may result from government interference in an otherwise well-functioning market. The financial crisis, for example, shows government fingerprints, not least through the creation and support of Fannie Mae and Freddie Mac. *See, e.g.*, Dale Arthur Oesterle, *The Collapse of Fannie Mae and Freddie Mac: Victims or Villains?*, 5 ENTREPRENEURIAL BUS. L.J. 733, 746 (2010).

5. Jensen, *supra* note 2, at 254 n.6.

ties giving up the clean air or water."[6] Also, a market may not accurately price a risk—such as tail risk—because such a risk seems too remote.[7] Related to this, the market may fail to adequately price certain risks and externalities because of a shaky assumption—or more properly, a moral hazard—that the government will cover all or part of the cost of a crisis event. Pricing these risks is extremely difficult, especially in longer time frames. Similarly, protecting a portfolio against such risks, such as through the purchase of put options, is difficult because the options are very costly.[8]

Rather than contributing directly to arguments against private wealth maximization, however, this Article addresses the direction of fiduciary duty and specifically the standard doctrine that public fund trustees' duties are rightly owed to plan participants and their beneficiaries. Justice Frankfurter's famous question[9]—who should receive the benefit of fiduciary duties and what obligations are owed—is particularly relevant in the face of billions of dollars in unfunded liabilities for public and private pension funds.[10] Participant wealth maximization is justified in part by the notion that plan participants and their beneficiaries are the true residual claimants of the fund, as would be the case for most trust beneficiaries. Under this logic, plan participants are owed fiduciary duties because they are the primary beneficiaries when the fund is managed well and the primary victims when it is managed poorly.[11]

This is not the case for public funds, however, as other parties—namely, the government and taxpayers—bear almost all of the risk should a public fund fail. In practice, individual participant claimants function more like senior creditors with fixed claims that have little real risk that they will not be received. And, in the case of a surplus in the fund, the government and taxpayers funding the plan are the primary beneficiaries, whereas the pension plan participants and beneficiaries only have a claim to a fixed sum. As a consequence, fiduciary duties should flow to the true risk-takers: the public—the current and future citizens and residents—who will ultimately benefit or suffer from the investment choices of the public fund trustees.

6. *Id.*

7. A "tail risk" is so called because the event falls on the far "tail" end of a bell-shaped distribution curve of possibilities. *See Tail Risk*, PIMCO, https://www.pimco.com/resources/education/understanding-tail-risk (last visited Mar. 25, 2018).

8. Alan Gerstein, *The Challenges in Hedging Tail Risk*, N.Y. TIMES: DEALBOOK (Apr. 20, 2012, 3:18 PM), http://dealbook.nytimes.com/2012/04/20/the-challenges-in-hedging-tail-risk/?_r=0.

9. "But to say that a man is a fiduciary only begins the analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?" SEC v. Chenery Corp., 318 U.S. 80, 85–86 (1943).

10. The Pew Charitable Trusts estimates that state pension funds were underfunded by $968 billion in 2013; with municipal liabilities added in, that number exceeds $1 trillion. THE PEW CHARITABLE TRUSTS, THE STATE PENSIONS FUNDING GAP: CHALLENGES PERSIST 1–2 (2015), http://www.pewtrusts.org/~/media/assets/2015/07/pewstates_statepensiondebtbrief_final.pdf?la=en. Meanwhile, Mercer estimates the corporate shortfall among S&P 1500 companies to be approximately $346 billion. *S&P 1500 Pension Funded Status Continues to Improve Despite Falling Equity Markets*, MERCER (July 6, 2015), http://www.mercer.com/newsroom/june-2015-pension-funding.html.

11. *See infra* note 79 and accompanying text.

This reframing of fiduciary duties, from participant wealth maximization to public wealth maximization, has dramatic consequences for the management of trillions of dollars in public fund assets.[12] To return again to our public fund trustees huddled around a conference table, how might this shift affect a decision to divest from certain mining activities? Rather than merely focusing on the returns that such investments might bring in the short term, the trustees now wrestle with the larger question of the effect of these investments on the public generally (and the state's taxpayers, more specifically), of which the returns of the pension fund are an important, but no longer unique, consideration. Additional concerns may include, among other things, the communities in which the mining companies may operate (particularly if they are located in the state which sponsors the pension fund), the environmental effects of mining that the state may need to later remediate, and the potential for long-term investments in other forms of energy.

A shift to the proper recipient of fiduciary duties—current and future generations of citizens—requires fund managers to more fully consider the externalities accompanying their investments, which should serve to help them fully and accurately price their investments. Private investors might ignore certain effects, such as uncompensated harms from pollution, depleted natural resources, or widespread health problems, because the government absorbs the costs of such externalities. A strict fiduciary duty to act in the interests of the fund would obligate a private investor to ignore such externalities, so long as they do not negatively affect the returns of the fund's investments. The government that absorbs the cost of these externalities, however, should view investments differently, with a view to minimizing negative externalities, particularly those that are significantly more expensive to remediate than to prevent. As a result of this analysis, it follows that public funds should benefit from less constrained fiduciary standards that would encourage more investment in sustainable enterprises and long-term projects.

This Article proceeds as follows. In Part II, the Article describes the existing fiduciary standards for private funds under the Employee Retirement Income Security Act of 1974 ("ERISA") and how U.S. public funds are influenced by ERISA's standards—or apply other, equally stringent standards, developed from a common source—even though they are not directly subject to ERISA. In Part III, the Article challenges the application of a narrow, trust law-

12. This proposed shift in fiduciary obligations is most pronounced for pension funds. The scope and nature of sovereign wealth fund fiduciary duties have not received much attention; to the extent funds discuss them, they assume that managers owe a duty to the sponsor government. This follows naturally from the structure of sovereign wealth funds, which are government-owned enterprises without fixed beneficiary claimants. Pension funds, on the other hand, do have individual benefits claimants. However, because these claimants are not the true residual interest bearers in the fund, they should not receive the benefit of fiduciary duties; put more practically, protection of individual claims should not drive the governance of the fund, but should be one of many factors and risks that the true residual interest and risk-bearer, the government, takes into account in determining how to manage the fund. The fiduciary obligations of sovereign wealth fund managers, and pension fund trustees and managers, should thus be harmonized: both should be managed in the interests of the government and current and future citizens, not individual claimants.

derived conception of fiduciary duties, such as those promulgated through ERISA, to public funds. Trust law, with a clear residual claimant, differs considerably from the realities of public fund funding and liabilities. Furthermore, private pension funds differ considerably from public pension funds in terms of claimants and liabilities and yet, in the case of trusts, private funds, and public funds, the operative fiduciary duties remain the same. In Part IV, the Article considers the implications from these differences and explores how shifting fiduciary duties to the true risk bearers in pension funds would lead to important changes in how pension funds invest. In particular, public funds should have the ability to consider a much broader range of investments and increasingly focus on sustainable, long-term projects. This Part, however, also identifies the increased risk of a broader fiduciary standard for pension funds and suggests governance changes that should help to mitigate the increased risk of higher agency costs resulting from a broader fiduciary standard.

II. THE DEVELOPMENT OF FIDUCIARY DUTIES FOR PUBLIC FUND OFFICIALS

The fiduciary duties of pension fund officials are based in long-standing trust doctrines, tracing back to the 1830 case *Harvard College v. Armory*. *Harvard College* provides the core standard of care for trustees by requiring them "to observe how men of prudence, discretion and intelligence manage their own affairs."[13] This standard of prudence has evolved gradually over time, with the Restatement (Third) of Trusts requiring trustees to "administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust,"[14] with "reasonable care, skill, and caution."[15] If the trustee possesses special facilities or skills, the trustee also has a duty to use such skills.[16]

Along with the requirement to behave prudently and with due care, trustees are also bound by a strict duty of loyalty that requires them to "administer the trust solely in the interest of the beneficiaries,"[17] prohibits them from engaging in self-dealing transactions,[18] and obligates them to deal fairly with, and provide full disclosure of, "all material facts the trustee knows or should know" to the beneficiaries.[19] Trustees must also administer the trust impartially with respect to the various beneficiaries of the trust.[20]

These common-law standards are widely used by trusts in every imaginable context, from a grandparent's $10,000 trust for her grandchildren to a $10 billion pension fund for public employees. It is a testament to the power and flexibility of the core principles of prudence, loyalty, and impartiality that the law is able to function relatively effectively—with important caveats described

13. Harvard Coll. v. Amory, 26 Mass. 446, 461 (1830).
14. RESTATEMENT (THIRD) OF TRS. § 77(1) (AM. LAW INST. 2003).
15. *Id.* § 77(2).
16. *Id.* § 77(3).
17. *Id.* § 78(1).
18. *Id.* § 78(2).
19. *Id.* § 78(3).
20. *Id.* § 79(1).

below—to protect the interests of a variety of beneficiaries across such a wide range of trusts and funds. There are subtle, but important, differences, however, in how these principles are defined and applied in various contexts. Most importantly, there are differences in the law as applied to corporate pension funds as opposed to public pension funds.

A. ERISA's Shadow

Corporate pension funds are subject to ERISA and subsequent case law interpreting ERISA and related Department of Labor ("DOL") regulations.[21] ERISA's duties are, in essence, a restatement of the common law of trusts, although as a general matter, ERISA can be characterized as providing a more exacting standard of fiduciary duty for pension fund trustees than trust law generally provides. The standard of care required is to 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."[22] The standard of loyalty under ERISA requires a fiduciary to 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 those participants and their beneficiaries, as well as defraying reasonable expenses of administering the plan.[23]

This "exclusive benefit rule," as it is commonly known, has been interpreted to limit fiduciaries to engage in economically targeted investments and socially responsible investments, generally. In a 2008 Interpretive Release, for example, the DOL flatly stated that "ERISA's plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan."[24] The interpretive guidance, however, contemplates the possibility of an investment that satisfies both a risk-adjusted return goal as well as providing a particular economic or other type of benefit to other

21. Congress has repeatedly considered whether to regulate state and local public pension funds to the same extent that ERISA regulates private pensions. The Texas Pension Review Board reports:

> At the time of ERISA's passage, the Act included a provision requiring Congress to conduct a study on public employee retirement systems. The Pension Task Force Report on Public Employee Retirement Systems was published in 1978 by the House Committee on Education and Labor, four years after ERISA's adoption. The report was critical of state and local pension management. In response to the report, the Public Employee Retirement Income Security Act (PERISA) was introduced in Congress to impose ERISA-style reporting, disclosure and funding requirements on public sector retirement plans. However, the legislation was not enacted. Subsequent Congresses have seen similar proposals, including the Public Employee Pension Plan Reporting and Accountability Act (PEPPRA) in 1984, and the Public Employee Pension Transparency Act (PEPTA) introduced in 2010, 2011, and 2013, but none has been enacted to date.

TEXAS PENSION REVIEW BOARD, RETIREMENT BENEFITS IN THE PUBLIC AND PRIVATE SECTORS–A COMPARISON OF TRENDS, REGULATORY ENVIRONMENTS, AND RELATED ISSUES 13 (Research Paper No. 13-002, Aug. 2013), http://www.prb.state.tx.us/files/education/research/retirement_benefits_in_the_public_and_private_sectors.pdf.

22. 29 U.S.C. § 1104(a)(1)(B) (2012).

23. *Id.* § 1104(a)(1)(A)(i)–(ii).

24. Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734, 61,735 (proposed Oct. 17, 2008) (to be codified at 29 C.F.R. pt. 2509).

constituencies. Consider, for example, a situation in which a pension fund official is presented with two equally attractive investments with respect to their potential risk-adjusted returns. One of the investments provides additional societal benefits. Would not the fund officials be justified in selecting the investment which provides the additional benefits? The DOL clarified in the 2008 guidance that in the past it has, under limited circumstances, permitted fiduciaries to choose between otherwise equivalent investment alternatives on the basis of a factor *other than* sole economic benefit to the plan, such as societal benefits. This view is permitted by the statute, the DOL stated, because

> (1) ERISA requires fiduciaries to invest plan assets and to make choices between investment alternatives, (2) ERISA does not itself specifically provide a basis for making the investment choice in this circumstance, and (3) the economic interests of the plan are fully protected by the fact that the available investment alternatives are, from the plan's perspective, economically indistinguishable.[25]

The exclusive benefit rule requires, nonetheless, that the plan fiduciaries conclude that alternative investments truly are economically equal, "taking into account a quantitative and qualitative analysis of the economic impact on the plan."[26] It thus functions as a participant wealth maximization rule. For trustees and managers to act otherwise would compromise or subordinate plan participants' interests in the promotion of a "myriad [of] public policy preferences."[27]

The DOL replaced the 2008 guidance in 2015, after concluding that, "in the seven years since its publication, the 2008 guidance has unduly discouraged fiduciaries from considering [economically targeted investments] and SRI factors."[28] The DOL believed that fiduciaries were dissuaded from pursuing investments that consider SRI factors, "even where they are used solely to evaluate the economic benefits of investments and identify economically superior investments," and from pursuing economically targeted investments even in cases where such investments were economically equivalent.[29] The 2015 guidance was intended to clarify that plan fiduciaries could appropriately consider factors, such as SRI factors, that can influence risk and return. Viewed in this way, SRI factors are not merely tie-breakers among otherwise equivalent investments but, instead, can have "a direct relationship to the economic value of

25. *Id.*

26. *Id.* The 2008 guidance encourages plan fiduciaries to carefully document the basis for their conclusions in support of any economically targeted investment:

> In light of the rigorous requirements established by ERISA, the Department believes that fiduciaries who rely on factors outside the economic interests of the plan in making investment choices and subsequently find their decision challenged will rarely be able to demonstrate compliance with ERISA absent a written record demonstrating that a contemporaneous economic analysis showed that the investment alternatives were of equal value.

Id. at 61,735–36.

27. *Id.* at 61,735.

28. Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65,135, 65,136 (proposed Oct. 26, 2015) (to be codified at 29 C.F.R. pt. 2509).

29. *Id.*

the plan's investment."[30] As a consequence, plan fiduciaries should not treat otherwise appropriate investments as "inherently suspect or in need of special scrutiny" merely because they take into account SRI factors.[31] The guidance also clarified that economically targeted investments based on their collateral benefits are also appropriate "so long as the investment is economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits."[32] The 2015 guidance, thus, focuses on SRI issues, particularly as a potential risk-limiting set of factors—for example, the risks presented by climate change on a plan portfolio or the risks associated with certain governance arrangements. Note, however, that under the guidance, SRI investments continue to be viewed through a fiduciary lens focused on value to the plan participants and beneficiaries, and not to the public generally.

B. State Regulation of Public Pension Fund Fiduciary Duties

To summarize the preceding discussion, corporate pension fund fiduciaries are generally held to the following standards: fiduciaries must (a) manage funds solely in the interest of participants and beneficiaries; (b) for the exclusive purpose of providing benefits; (c) impartially, taking into consideration differing interests of various participant and beneficiary groups; and (d) with the care, skill, and prudence exercised by similar fiduciaries, including as to diversification of investments.[33] Public pension funds tend to follow basic private fund principles. As noted above, state and local public funds are primarily governed by state constitutions, statutes, regulations, and case law—not ERISA.[34]

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30. *Id.* at 65,136.

31. *Id.*

32. *Id.* In contrast to the 2008 guidance, the 2015 guidance seeks to reduce the transaction costs associated with investing according to environmental, social, and governance ("ESG") criteria and economically targeted investing:

> In addition, the Department does not construe consideration of ETIs or ESG criteria as presumptively requiring additional documentation or evaluation beyond that required by fiduciary standards applicable to plan investments generally. As a general matter, the Department believes that fiduciaries responsible for investing plan assets should maintain records sufficient to demonstrate compliance with ERISA's fiduciary provisions. As with any other investments, the appropriate level of documentation would depend on the facts and circumstances.

Id.

33. James Hawley, Keith Johnson & Ed Waitzer, *Reclaiming Fiduciary Duty Balance*, 4 ROTMAN INT'L J. PENSION MGMT. 4, 4, 7 (2011).

34. Some parts of ERISA govern various aspects of state and local public pension plans, including Title III, "Jurisdiction, Administration, Enforcement; Joint Pension Task Force, Etc.," and parts of Title II, "Amendments to the Internal Revenue Code Relating to Retirement Plans." The Employee Benefit Research Institute also notes

> But while many ERISA provisions do not always apply to retirement plans of state and local governments, those requirements may indirectly influence plan design and administration in areas ranging from investment and fiduciary standards to pension rights of surviving spouses. Moreover, although public-sector plans are excluded from several sections of ERISA, these plans are required to comply with pre-ERISA requirements of the [Internal Revenue Code]. These pre-ERISA requirements thus continued to shape the plan qualification rules for both private- and public-sector plans in the years following the establishment of ERISA.

In many cases, states apply ERISA's prudent-man standard to state-managed funds. In such cases, the state often looks to ERISA to fill in gaps in the law. This process, howver, is complicated, by the fact that many states have put in place specific legislation governing the duties of public fund officials (sometimes in the state constitution itself), and the legislation does not specifically follow ERISA. These differences can be illustrated by briefly considering the state law for the five largest public pension systems in the U.S.[35]

1. California

California's constitution essentially adopts ERISA's exclusive benefit rule, stating that "the retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system," and that "the assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system."[36] California reinforces the exclusive benefit rule by requiring that trustees of the funds manage the funds "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system,"[37] and that this duty to the participants and their beneficiaries

EMP. BENEFIT RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 428–29 (6th ed. 2009). Congress has repeatedly considered whether state and local public pension funds should be subject to some federal regulation. The Texas Pension Review Board reports:

> At the time of ERISA's passage, the Act included a provision requiring Congress to conduct a study on public employee retirement systems. *The Pension Task Force Report on Public Employee Retirement Systems* was published in 1978 by the House Committee on Education and Labor, four years after ERISA's adoption. The report was critical of state and local pension management. In response to the report, the Public Employee Retirement Income Security Act (PERISA) was introduced in Congress to impose ERISA-style reporting, disclosure and funding requirements on public sector retirement plans. However, the legislation was not enacted. Subsequent Congresses have seen similar proposals, including the Public Employee Pension Plan Reporting and Accountability Act (PEPPRA) in 1984, and the Public Employee Pension Transparency Act (PEPTA) introduced in 2010, 2011, and 2013, but none has been enacted to date.

TEXAS PENSION REVIEW BOARD, *supra* note 21, at 13.

35. State-owned permanent funds differ from state and local public pension funds in that, even more than public pension funds, they are free from federal regulatory pressures. Because they are not benefits plans and have no plan beneficiaries, ERISA does not apply to such funds, nor does the Internal Revenue Code ("IRC") and related regulations. Although the IRC does affect state pension regulations, some (including the IRS) have suggested that such regulation does not have a significant impact. The IRS has issued a revenue ruling taking the position that public pension plans must comply with section 401(a) to receive beneficial tax treatment under the IRC. A House committee task force, however, found that this ruling "has had virtually no practical significance for state and local plans. Enforcement of the qualification standards against public plans has for the most part been non-existent." STAFF OF H. COMM. ON EDUC. & LABOR, 95TH CONG., 2D SESS., TASK FORCE REPORT ON PUBLIC RETIREMENT SYSTEMS 33 (Comm. Print 1978). In essentially every case, however, the public officials managing these funds are considered to be fiduciaries.

36. CAL. CONST. art. XVI, § 17(a).

37. *Id.* § 17(b).

"shall take precedence over any other duty."[38] The standard of care is exactly the same as ERISA's:

> The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[39]

Unlike ERISA, however, the California Constitution also adds that the legislature may, by statute, prohibit certain investments by a retirement board "where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board pursuant to this section."[40]

2. New York

New York State and Local Employees' Retirement System, the New York State and Local Police and Fire Retirement System, and New York's Common Retirement Fund, some of the largest pension funds in the U.S., are managed solely by the Comptroller of the State of New York, rather than by a board.[41] The fiduciary responsibilities of the Comptroller are not expressly set out in the state constitution or by statute, but the Comptroller is subject to a code of conduct that states that the Comptroller is a fiduciary, "and as such shall act solely in the interests of the members, retirees and beneficiaries of the Retirement System."[42] In addition to the adoption of the exclusive benefit rule, the Code of Conduct also imposes a standard duty of care to act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person 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."[43] Similar to many states, the New York Code has a lengthy set of statutes outlining various restrictions on investments. Such statutes are a vestige of the "legal lists" of authorized investments that most, if not all, states put in place to guard against speculative or corrupt investments.[44] The statutes now serve as a limitation of the broad investment authority granted under the flexible prudent investor standard.[45]

38. *Id.*

39. *Id.* § 17(c). The only difference between ERISA's standard and the California Constitution provision is California's use of the gender-neutral term "prudent person" instead of "prudent man." *Id.*

40. *Id.* § 17(g).

41. OFF. OF N.Y. STATE COMPTROLLER, CODE OF CONDUCT FOR NYSLRS AND NYSCRF 1 (Sept. 25, 2009), http://www.osc.state.ny.us/pension/codeofconduct.pdf.

42. *Id.* at 2.

43. *Id.*

44. *Id.*

45. *Id.*

3. Ohio

The trustees of the Ohio pension system are also subject to an ERISA-like exclusive benefit rule, and are subject to the same prudential standard of care.[46] Ohio, however, adds additional legislative intent to social investing in its statute:

> In exercising its fiduciary responsibility with respect to the investment of the funds, it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens where the investments offer quality, return, and safety comparable to other investments currently available to the board. In fulfilling this intent, equal consideration shall also be given to investments otherwise qualifying under this section that involve minority owned and controlled firms and firms owned and controlled by women, either alone or in joint venture with other firms.[47]

Ohio's legislation thus employs a kind of "tie-breaker" in favor of minority-owned and women-owned investments, but does not require Ohio's pensions to invest in enterprises that would divert pension returns towards other social goals. Note, however, that the statute only requires that the investments be comparable in quality, return, and safety, and "comparability" as a standard suggests flexibility and considerable discretion.

4. Texas

Texas uses an exclusive benefit rule like ERISA's.[48] The standard of care is not ERISA's, however, but is adapted from the prudent-man standard set out in *Harvard College v. Amory*.[49] The Texas statute states:

> In making investments, a board shall exercise the judgment and care under the circumstances then prevailing that persons of ordinary prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income therefrom as well as the probable safety of their capital. The legislature by law may further restrict the investment discretion of a board.[50]

46. OHIO REV. CODE ANN. § 145.11(a) (West 2017).

47. *Id.* § 145.11(b).

48. TEX. LOC. GOV'T CODE, § 802.203(a) (2012); *see also* TEX. CONST. art. XVI, § 67.

49. 26 Mass. (9 Pick.) 446, 446 (1830). The relevant passage in *Harvard College* reads:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and 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 funds, considering the probable income, as well as the probable safety of the capital to be invested.

Id. at 461.

50. TEX. CONST. art. XVI, § 67(a)(3).

5. Florida

The Florida State Board of Administration perhaps goes the furthest in adopting ERISA standards. The Florida Statute states that "[t]he board shall discharge its duties with respect to a plan solely in the interest of its participants and beneficiaries" and that "[t]he board in performing the above investment duties shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act of 1974 at 29 U.S.C. § 1104(a)(1)(A) through (C)."[51]

III. DIFFICULTIES IN APPLYING TRUST LAW AND ERISA STANDARDS TO PUBLIC PENSION FUNDS

Although state pension fund fiduciary duties largely reflect the common-law vision—and, by extension, ERISA's vision—of strict fiduciary duties, including the exclusive benefit rule, there are crucial differences between pension funds and common trusts, on the one hand, and between public and private trusts on the other. Outlining these differences is key to demonstrating why the standard of participant wealth maximization is not appropriate for public pension funds.

A. Difficulties in Applying Trust Law to Pension Funds

Nearly thirty years ago, John Langbein and Daniel Fischel pointed out numerous difficulties in applying trust fiduciary duties, such as those imposed by the Uniform Prudent Investor Act, to pension plans.[52] Looking at employer-sponsored and ERISA-regulated plans, they identified significant differences between the paradigmatic private trust and pension and employee benefit plans. First, they note that in the case of a private trust, the settlor who creates the trust is readily ascertainable, as is the beneficiary. In the case of employee benefit plans, however, "it is for many purposes impossible to distinguish the settlor from the beneficiary."[53] Because employee benefit plans form part of a total compensation scheme, they argue that, "it is best for many purposes to conceive of employer and employee as both settlor and beneficiary."[54]

Employees can be considered settlors to the extent that they bargain for the plans and accept lower income in consequence of the plans. Also, because tax law creates an incentive to receive compensation in the form of pension benefits, "the employer can deliver and the employee can receive more value per dollar of compensation through pension benefits than through cash wag-

51. FLA. STAT. § 215.47(10) (West 2017). The statute states, however, that "[i]n case of conflict with other provisions of law authorizing investments, the investment and fiduciary standards set forth in this subsection shall prevail." *Id.*

52. Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1106–07 (1988).

53. *Id.* at 1117.

54. *Id.*

es."[55] They also note that pension and benefits plans are beneficial to both companies and beneficiaries because they reduce employee turnover and allow for economies of scale in insurance purchasing. Because both the employee and the employer benefit from pension and benefit plans, the plan should not—contrary to ERISA's exclusive benefit rule—be considered to be managed for the sole benefit of the employee beneficiary: "The plans are established for the mutual advantage of employer and employee, not for the exclusive benefit of one. The exclusive benefit rule on its face is inconsistent with the economic realities of the plans."[56]

In a simple private trust, the settlor seeks to maximize the benefits flowing to the beneficiary. Because the beneficiary and settlor cannot easily monitor the actions of the trustee, the trustee's fiduciary duties require the trustee to act in the exclusive interest of the beneficiaries and limit the discretion of the trustee to engage in conduct that could impair the interests of the beneficiaries and frustrate the intentions of the settlor. Likewise, with employee pension plans, the settlor also seeks to maximize the benefits accruing to the beneficiary. In the pension plan context, however, the employer and employee occupy dual roles as both settlors and beneficiaries of the pension plan. Furthermore, "because the employer and the employees continually monitor the performance of the trustee of an employee benefit plan, there may be less need for strict fiduciary duties that limit the discretion of the trustee to engage in conduct that may be mutually beneficial to both groups."[57]

Potential conflicts between beneficiaries also complicate the application of the exclusive benefit rule to pension funds. Although conflicting interests between employer and employee seem most obvious (manager-trustee interests in a corporate takeover, for instance, that might result in job loss for employees), employees may have conflicting interests depending on how close they are to retirement, not to mention different views on controversial issues that fall under the broad category of environmental, social, and governance concerns. Fischel and Langbein argue that "any particular use of pension plan assets may have different consequences for different classes of employees,"[58] and the exclusive benefit rule provides no guidance on balancing competing interests.

In the context of corporate pension funds subject to ERISA, Fischel and Langbein note that "the fiduciary may owe duties not only to the 'participants and their beneficiaries,' as ERISA's exclusive benefit rule mandates, but also to the employing firm and its shareholders, to the revenue authorities, and to the federal pension insurer, the PBGC [Pension Benefit Guaranty Corporation]."[59] Stepping back from this analysis, one notes that the binding characteristic for all of these parties is that all of them are, potentially, residual risk-bearers for the pension fund's performance. ERISA inappropriately requires trustees to ex-

55. *Id.* at 1118.
56. *Id.*
57. *Id.* at 1119.
58. *Id.* at 1121.
59. *Id.* at 1157.

ercise their fiduciary responsibilities for the exclusive benefit of employee-beneficiaries, as though they are the only beneficiaries of the fund and the only risk-bearers should the fund not perform well. The exclusive benefit rule, thus, fails to take into account the realities of risk-sharing in a corporate pension plan.

B. Differences Between Public and Private Pensions

Many of the concerns with how fiduciary duties are applied in the ERISA fund context are just as applicable to the public fund context. Just as with private funds, it is difficult to distinguish the settlor from the beneficiary in public funds: the public employer seeks to provide an optimal amount of benefits to the employee and is itself benefited by the provision of pension benefits. And, as in private funds, conflicts of interest may arise between different generational cohorts and among beneficiaries with respect to environmental, social, or governance issues. Finally, public pensions have an equally broad set of actors who are at risk should the fund perform poorly.

State pension funds, however, differ from private pension funds in several important ways. As noted above, private funds are regulated through ERISA while state funds are regulated primarily through state laws. Although many states follow ERISA-like standards with respect to fiduciary duties and investment selection, this Section describes how they differ from private funds in two important ways. First, the enforcement of fiduciary duties by private fund participants and beneficiaries is considerably more robust than participants in public plans. Second, private plan participants bear considerably more of the residual risk associated with plan failure compared to public plan participants.

1. Differences in Enforcement of Fiduciary Duties

ERISA is subject to a comparatively rigorous enforcement regime, with causes of action for breach of fiduciary duty available to participants, beneficiaries, fiduciaries, or the DOL. Enforcement within the DOL is managed by the Employment Benefit Security Administration ("EBSA"), including fiduciary duties. Overall, the EBSA closed over 2,000 civil investigations in 2016, of which over two-thirds were closed with results, and 144 civil cases filed.[60] Benefits advisors also refer matters to the EBSA for enforcement, with 662 investigations opened because of referrals from advisors.[61] Private ERISA litigation is also robust, as the cases are often certified as class actions and thus more attractive to plaintiffs' firms. In 2014, for example, numerous ERISA class ac-

60. U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, FACT SHEET 1, https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/ebsa-monetary-results.pdf (last visited Mar. 25, 2018).

61. *Id.* at 3.

tions produced multi-million-dollar awards,[62] including actions alleging that fiduciaries breached their duties by awarding themselves excessive fees and receiving improper benefits,[63] failing to prudently and loyally manage assets,[64] and, most popularly, continuing to invest in the company's own common stock when such an investment was not prudent.[65]

By contrast, suits against state public fund officials are rare, and even more rarely successful. Unlike private pension funds operating under ERISA, state pension laws do not provide for private causes of action, particularly for generalizable claims.[66] Even where a cause of action is available, a plan participant may have difficulty showing that a particular investment caused an injury to the participant. For example, in 2010, a Texas teacher sued the trustees of the Teachers Retirement System on behalf of all current and retired teachers, alleging imprudent investment in derivatives.[67] The court found that the plaintiff lacked standing because she failed to allege a concrete, particularized injury caused by the trustees' conduct; although the fund may have decreased in value because of the trustees' investment decisions, that decline had not yet resulted in decreased benefits to the plaintiff.[68]

Suits against state plan officials are also rare because, as public officials, they are protected by sovereign immunity.[69] In *Ernst v. Rising*,[70] for example, a

62. Significant cases on ERISA litigation are reviewed each year by the law firm Seyfarth Shaw; the firm analyzed 1,123 decisions in 2013 alone. *See* SEYFARTH SHAW LLP, ANNUAL WORKPLACE CLASS ACTION LITIGATION REPORT i (2014), https://www.workplaceclassaction.com/wp-content/uploads/sites/214/2014/01/CAR-2014.pdf.

63. Nolte v. Cigna Corp., No. 2:07-cv-2046-HAB-DGB, 2013 U.S. Dist. LEXIS 184622, at *16 (C.D. Ill. Oct. 15, 2013).

64. *In Re* Coventry Health Care, Inc. ERISA Litig., 290 F.R.D. 471, 472 (D. Md. Mar. 21, 2013).

65. *In Re* Advanta Corp. ERISA Litig., No. 2:09-CV-4974-CMR, 2014 WL 7692446, at *1 (E.D. Pa. Jan. 9, 2014); Griffin v. Flagstar Bancorp, Inc., No. 2:10-CV-10610, 2013 U.S. Dist. LEXIS 173702, at *3–4 (E.D. Mich. Dec. 12, 2013); *In Re* Regions Morgan Keegan ERISA Litig., No. 09-MD-2009, 2013 WL 5614285, at *1 (W.D. Tenn. Feb. 28, 2013); Alford v. United Cmty. Banks, Inc., No. 2:11-CV-309-WCO, 2013 U.S. Dist. LEXIS 187387, at *1 (N.D. Ga. Jan. 31, 2013).

66. Provided that they are well-calibrated, private rights of action provide an important check on fiduciary misbehavior. If state legislators believed that private causes of action would be valuable, they could provide for them in at least three different ways. First, states have the ability to waive sovereign immunity for public officials, thus opening the actions of the fiduciaries to scrutiny in state and, potentially, federal courts. Second, state legislatures could include in their pension fund legislation provisions providing for a cause of action for breach of fiduciary duties. Finally, a state may create a politically independent pension fund entity that would not clearly be characterized as an "arm of the state" under sovereign immunity jurisprudence. Aside from the potential benefits that the threat of liability may have on trustee behavior, a politically independent governance structure would be less susceptible to political interference, politically motivated investments, and pay-to-play schemes.

67. Ramon v. Teacher Ret. Sys. of Tex., No. 01-09-00684-CV, 2010 WL 1241293, at *1 (Tex. Ct. App. 1st Apr. 1, 2010).

68. *Id.*

69. "Generally, public officials are not subject to personal liability unless they act willfully, wantonly and in reckless disregard of human life, safety and property. Such circumstances are never protected by waiver of immunity statutes because they are not considered conduct in the interest of the public good." THE LAW EVERY TRUSTEE MUST KNOW, KLAUSNER, KAUFMAN, JENSEN & LEVINSON 29 (2017), Presentation at Nat'l Conference on Pub. Emp. Ret. Sys.: 2017 Trustee Educational Seminar (May 21, 2017), http://www.ncpers.org/files/Conference%20Docs/TEDS/2017/PPTs/Klausner.PDF.

70. 427 F.3d 351, 354 (6th Cir. 2005).

group of Michigan state court judges sued the officials of the government retirement system (including the state treasurer and the members of the Michigan Judges Retirement Board), alleging that Detroit-area judges received more favorable retirement benefits than other judges in the state. The central issue before the Sixth Circuit panel was whether the retirement system was an "arm of the state," and thus entitled to sovereign immunity under the Eleventh Amendment.[71] The court noted that the members of the retirement systems board included elected public officials and members appointed by the governor with the advice and consent of the state senate.[72] The board is compensated by the Michigan legislature and takes an oath of office, which is filed with the Michigan Secretary of State.[73] The board's activities are subject to the Michigan Administrative Procedures Act, and the state Department of Management and Budget is responsible "for the budgeting, procurement, and related management functions of the retirement system."[74] The retirement system funds are invested according to the state Public Employee Retirement System Investment Act, and the funds are subject to annual state reporting and auditing requirements.[75] Perhaps most importantly, the court noted that the retirement system is funded, in part, by annual legislative appropriations and other public funds.[76] The retirement system thus functioned as an arm of the state and was entitled to sovereign immunity.[77]

2. *Differences in Risk of Failure*

Under both private and public systems, fiduciary duties are structured so that funds are managed for the general benefit of plan participants and their beneficiaries. Fiduciary duties, in general, can be understood as providing beneficiaries with a minimum standard of protection against mismanagement by fiduciaries who manage funds on their behalf. Fiduciary duties are generally owed to the "residual claimant" who, as the ultimate risk-bearer, has the best incentives to maximize the value of the trust. This is why in the private trust context fiduciary duties are owed to the trust beneficiaries, and in the corporate

71. *Id.* at 355.
72. *Id.*
73. *Id.* at 361.
74. MICH. COMP. LAWS § 38.2205 (2017).
75. *Ernst*, 427 F.3d at 360.
76. *Id.* (citing MICH. COMP. LAWS §§ 38.2302, 38.2304).
77. *Id.* at 354. In perhaps the best-known case in which a breach of duty action was pursued against the officials of a local political unit, the City of Baltimore, the fiduciary duties of the managers were construed relatively broadly and flexibly, but the court did not abandon the essential financial orientation of public pension funds. *See* Bd. of Trs. v. City of Baltimore, 562 A.2d 720, 735 (Md. 1989). In that case, the City of Baltimore put in place a divestment ordinance that required the city's three public employee pension funds, which at the time held a combined total of $1.2 billion, to divest from "banks or financial institutions that make loans to South Africa or Namibia or companies 'doing business in or with' those countries." *Id.* at 724. The City of Baltimore incorporated ERISA's exclusive benefit rule that trustees must discharge their duties "solely in the interest of the members and beneficiaries and for the exclusive purpose of providing benefits to members and beneficiaries." *Id.* at 738. The court held, however, that "if, as in this case, social investment yields economically competitive returns at a comparable level of risk, the investment should not be deemed imprudent." *Id.* at 737.

context, why fiduciary duties are owed to shareholders. As Easterbrook and Fischel have noted, in the context of corporate law:

> As the residual claimants, the shareholders are the group with the appropriate incentives . . . to make discretionary decisions. The firm should invest in new products, plants, etc., until the gains and costs are identical at the margin. Yet all of the actors, except the shareholders, lack the appropriate incentives. Those with fixed claims on the income stream may receive only a tiny benefit (in increased security) from the undertaking of a new project. The shareholders receive most of the marginal gains and incur most of the marginal costs. They therefore have the right incentives to exercise discretion.[78]

In answer to Justice Frankfurter's famous question, "to whom is he a fiduciary," we have a simple and clear analytical tool: the residual claimant(s). In the context of pension funds, however, the identification of the residual claimant is complex. In the case of a defined benefit pension fund, an employee entrusts a portion of his or her compensation to the pension fund in the expectation that upon retirement, the pensioner will be able to draw the full measure of benefits promised by the pension fund.[79] The fiduciary duties, articulated under the Prudent-Man Standard, the Prudent-Person Standard, and ERISA's Prudent-Person standard, all create a general expectation that fund officials will seek to maximize the value of the assets under management, with some rare and limited exceptions. The duties would seem to be owed to the plan participants and their beneficiaries because they are the persons who are at risk should the plan not be managed appropriately. This assumption, however, is not wholly accurate for either private or public pension funds. Furthermore, between the two types of fund claimants, public pension fund participants and their beneficiaries are even less at risk than private fund participants and their beneficiaries.

a. Risk of Failure in Private Pension Plans

As described above, federal law provides strict guidelines on the investment activities of private pension fund officials. Notwithstanding these protections, ERISA also provides for a scheme of pension fund insurance as an additional level of security for fund participants. A federal government-created corporation, the Pension Benefit Guaranty Corporation ("PBGC"), operates as an insurer for ERISA-covered pension funds.[80] Just as with other types of insurance, pension funds pay premia to the PBGC in return for coverage should

78. Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403 (1983).

79. Private pension funds have increasingly shifted to defined contribution schemes, in which the employer and the employee both regularly contribute a certain amount of funds to the employee's retirement account, and the employee draws down from this fund during retirement. Unlike with a defined benefit fund, which promises a certain level of pension benefits through the remainder of a pensioner's lifetime, a defined contribution scheme will only pay out what has been contributed to the fund, adjusted by the performance of the assets in the account.

80. Press Release, Pension Benefit Guar. Corp., PBGC Guarantee Limit for Single-Employer Plans Increases for 2017 (Oct. 28, 2016), https://www.pbgc.gov/news/press/releases/pr16-16.

the company default in its ability to pay out pension benefits as obligated, such as a result of a bankruptcy. The PBGC, thus, takes on most, but not all, of the residual risk of private pension fund failure.

There are two factors which limit the extent to which the PBGC acts as the residual risk-bearer for private pension funds. First, ERISA limits the maximum amount of individual benefits guaranteed by the PBGC. In 2017, the PBGC was limited to providing a maximum of $64,432 a year for workers aged sixty-five.[81] This maximum, which is not adjusted annually for inflation, decreases for workers retiring before the age of sixty-five.[82] Thus, under the rules, an employee who retires before the age of sixty-five, or is due a pension that provides more than the maximum amount, will see a reduction in their benefits should the employee be forced to rely on the PBGC in the event of a corporate bankruptcy.[83]

The second factor limiting the PBGC's risk-reduction function is the poor financial condition of the PBGC itself. The Government Accountability Office ("GAO") categorizes the PBGC as a high-risk program,[84] and even though the PBGC's portfolio holds over $89 billion in assets, its "financial future is uncertain" because it also has a net accumulated financial deficit of $61.8 billion.[85] At the end of its 2013 fiscal year, the PBGC also estimated that its exposure to losses for underfunded plans was $184 billion.[86]

The GAO has recommended a number of reforms which could help reinforce the PBGC, including redesigning the PBGC's single employer program rate structure, making governance changes, increasing funding requirements for plan sponsors as economic conditions improve, and developing a strategy to fund PBGC claims over the long term. All of this could be done as the defined benefit pension system continues to decline and fewer firms are paying into the overall insurance scheme.[87] Pending such changes, however, the PBGC places significant risk of failure on pension plan participants and beneficiaries, particularly if their benefits exceed the maximum allowable benefit or they retire early. In addition, even short of a bankruptcy, private plan participants may have their benefits reduced as part of a negotiated plan restructuring.

b. Risk of Failure in Public Pension Plans

Contrast this risk with the risk faced by pension plan participants and beneficiaries in the private sector. Public employees typically enjoy more pro-

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81. *Id.*

82. *Guaranteed Benefits*, PENSION BENEFIT GUAR. CORP., https://www.pbgc.gov/wr/benefits/guaranteed-benefits (last visited Mar. 25, 2018) (see https://www.pbgc.gov/about/factsheets/page/multi-facts where it states, "[t]he guaranteed benefit is not adjusted for inflation or cost-of-living increases.").

83. *Id.*

84. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-290, HIGH-RISK SERIES: AN UPDATE 335 (2015), http://www.gao.gov/assets/670/668415.pdf.

85. *Id.*

86. *Id.*

87. *Id.* at 340.

tections against default than private plan participants. First, public plan participants often enjoy significant legal protections against changes in their pension plans. Amy Monahan explains:

> In many states . . . courts have held that the same statutes that established state retirement systems also created a contract between the state and its employees that cannot be impaired. In particular, courts in California and the twelve other states that have adopted California's precedent have held not only that state retirement statutes create contracts, but that they do so as of the first day of employment. The practical result of this rule is that pension benefits for current employees cannot be detrimentally changed, even if the changes are purely prospective. Thus, the only readily available option for changing employee pension benefits in these states is to limit such changes to new hires.[88]

In some states, pension plan protections were placed in the state constitution itself. For example, Section Five of the Constitution of Illinois states that "[m]embership in any pension or retirement system of the State, any unit of local government or school district, or any agency or instrumentality thereof, shall be an enforceable contractual relationship, the benefits of which shall not be diminished or impaired."[89]

It is not clear if this protection is as strong as legislators and pensioners had assumed, however. While the protections of a state statute or constitution may protect a pensioner against changes to a pension plan prior to bankruptcy, they may not apply once a municipality files for bankruptcy under Chapter 9 of the Federal Bankruptcy Code. In a landmark 2013 ruling in connection with Detroit's bankruptcy, a U.S. bankruptcy court held:

> The state constitutional provisions prohibiting the impairment of contracts and pensions impose no constraint on the bankruptcy process. The Bankruptcy Clause of the United States Constitution, and the bankruptcy code enacted pursuant thereto, explicitly empower the bankruptcy court to impair contracts and to impair contractual rights relating to accrued vested pension benefits. Impairing contracts is what the bankruptcy process does. . . . The Bankruptcy Clause gives Congress express power to legislate uniform laws of bankruptcy that result in impairment of contract; and Congress is not subject to the restriction that the Contracts Clause places on states.[90]

If other courts follow this ruling, state protections would seem to be of primary benefit against state- and municipal-level changes to benefits but would not provide protection against changes to pension benefits because of a federal bankruptcy. Compared to private firms, however, public entities are less susceptible to the risk of bankruptcy. From 2010 through 2016, there have been

88. Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1032 (2012).

89. ILL. CONST. art. XIII, § 5.

90. *In re* City of Detroit, Mich., 504 B.R. 97, 150 (Bankr., E.D. Mich. 2013).

only nine municipal bankruptcies in the U.S.[91] By contrast, there were ninety-nine bankruptcies among public companies in 2016 alone.[92]

Public pensions are under tremendous pressure and will be for the foreseeable future, which will undoubtedly increase the number of municipal bankruptcies. But several factors should continue to limit the number of bankruptcies. First, most states do not allow for municipal bankruptcies.[93] Municipalities also have additional incentives and ability to avoid bankruptcy. Unlike corporations, a municipality cannot simply sell off all its assets and cease to exist; citizens continue to live in the city, services continue to be provided, and taxes continue to be collected. A municipality, thus, has continuing financial needs, and as a continual, locked-in player in the municipal credit markets, should be highly resistant to declaring bankruptcy. As Standard & Poors ("S&P") stated in a recent analysis of municipal bankruptcies, "there are few actions that should carry greater stigma in the municipal credit markets than a bankruptcy filing."[94] Additionally, S&P notes that "insolvency is rare in the municipal sector because governmental entities enjoy several unique characteristics not found in other quarters of the capital markets. Most notably, governments are perpetual entities and, with the force of law behind them, can literally bank on collecting tax revenues into the future."[95] As a result, municipal insolvency is not only rare, but "it can actually be difficult to demonstrate."[96]

Finally, even in jurisdictions without explicit protections for pension plan participants, participants and their beneficiaries have tended to receive their pension benefits. Even in the worst cases of financial collapse, such as Detroit's bankruptcy, pension plan participants receive all, or almost all, of their expected benefits. Under the "grand bargain" struck by the city and its pensioners, civilian pensioners took a 4.5% cut to their monthly checks and the elimination of annual cost-of-living adjustments; police and fire pensioners had no cuts to their monthly checks, and their annual cost-of-living adjustments were reduced from 2.25% to 1%.[97]

91. *Bankrupt Cities: Municipalities List and Map*, GOVERNING, http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html (last visited Mar. 25, 2018).

92. George Putnam, *2016 Corporate Bankruptcy Recap: Bankruptcies Up 25%; 41% Were Oil & Gas/Energy Sector-Related*, SEEKING ALPHA (Jan. 10, 2017, 11:15 AM), http://seekingalpha.com/article/4035631-2016-corporate-bankruptcy-recap-bankruptcies-25-percent-41-percent-oil-and-gas-energy-sector.

93. Only fifteen states allow municipalities to seek some form of bankruptcy protection. *See* James Spiotto, *Financial Emergencies: Default and Bankruptcy*, *in* THE OXFORD HANDBOOK OF STATE & LOC. GOV'T FIN. 763 (Robert D. Ebel & John E. Petersen eds., 2012).

94. Gabriel J. Petek et al., *Municipal Bankruptcy: Standard & Poor's Approach and Viewpoint*, STANDARD & POORS 2 (Oct. 4, 2012), http://www.nasra.org/Files/Topical%20Reports/Legal/MuniBankruptcy_PI1.pdf.

95. *Id.* at 5.

96. *Id.*

97. These cuts were overwhelmingly approved by the pensioners themselves. *See* Nathan Bomey & Matt Helms, *Detroit Pensioners Back Grand Bargain; Creditors Object*, USA TODAY (July 22, 2014, 1:02 AM), https://www.usatoday.com/story/news/nation/2014/07/22/detroit-pensioners-back-grand-bargain/12980243/.

This returns us to the issue of who bears the residual risk of loss when a pension fund fails. Certainly, pension plan participants and their beneficiaries bear a portion of the risk, although as noted above, failures, particularly in the public context, have been rare. And even when they have occurred, pension plan participants have typically received significant protections. In the case of private pension funds, the participants receive the benefit of the (seemingly tenuous) insurance protection provided by the PBGC. By contrast, the "ultimate guarantors of government pensions are the taxpayers."[98] In the case of public pension funds, the participants and their beneficiaries seem to effectively hold the position of senior creditors[99] compared to other contractual claimants because they have tended to receive relatively generous protections in the rare cases of municipalities going bankrupt.

Contrast the risk of these defined benefit plan participants with defined contribution plan participants, in either the public or private context. In a defined contribution scheme, an employee might select investments very poorly and have very little, if any, return over their working life. Thus, they may have very little in the account from which to draw over retirement. In the case of spectacular corporate failures, such as Enron, many employees had their retirement wealth largely, or entirely, tied up in corporate stock and therefore were completely exposed to the risk of loss in the company's stock.[100] A defined contribution plan participant is the residual risk-bearer of the performance of the participant's portfolio.

In the case of defined benefit funds, the primary residual risk-bearer is typically not the participant and the participant's beneficiaries, and this is particularly true of public pension funds. Most (if not all) of the risk for public funds is borne by the taxpayers of the state or municipality itself. To the extent that the federal government provides assistance to ailing states and municipalities, some of the risk is then borne by the federal government and federal taxpayers. Furthermore, even if the pension fund beneficiaries find their benefits reduced as a result of a bankruptcy filing or other benefit restructuring, some of the cost of providing for the participants and beneficiaries may fall on the local, state, or federal government.[101] The federal government also bears some risk

98. KATELIN P. ISAACS, CONG. RESEARCH SERV., 98-810, FEDERAL EMPLOYEES' RETIREMENT SYSTEM: BENEFITS AND FINANCING 11 (2015), https://fas.org/sgp/crs/misc/98-810.pdf.

99. I am indebted to Joshua Rauh for this characterization.

100. *See* Richard A. Oppel, Jr., *Employees' Retirement Plan Is a Victim as Enron Tumbles*, N.Y. TIMES (Nov. 22, 2001), http://www.nytimes.com/2001/11/22/business/employees-retirement-plan-is-a-victim-as-enron-tumbles.html.

101. John Coffee has made a similar observation with respect to corporate restructuring and bankruptcy:

> [One may] view the state's role as that of an insurer for the losses that limited liability spares shareholders. Because costs do not disappear just because shareholders escape them, it follows that the state often bears these costs as, in effect, an ultimate residual risk bearer. At a minimum, the state's welfare rolls increase when corporations fail, and often the state winds up partially compensating tort creditors. . . . Axiomatically, if plants are closed and workers and managers are laid off in the aftermath of either a takeover or a defensive tactic that increases corporate leverage, much of the resulting costs will fall on the state, which typically will be required to pay increased welfare benefits and make other transfer payments. In the case of local communities, there may also be extensive firm-specific investments that the community

for private funds in that it arguably provides an implicit guarantee against the failure of the PBGC; the health of the PBGC—a nominally private enterprise—is a regular topic of study by the GAO[102] and the Congressional Research Service,[103] suggesting that it receives special attention to the political risks of its failure. The likelihood that the PBGC would receive assistance from the federal government is found in the fact that the government provided explicit assistance to Fannie Mae and Freddie Mac[104]—which, like the PBGC, did not benefit from an explicit guarantee of federal support during normal market conditions—when those entities were in danger of failure.[105]

The fact that pension fund risks are borne by the public in general, rather than just the narrow class of pension fund participants and beneficiaries, has crucial implications for the fiduciary duties of fund officials. Importantly, if we see pension plan officials as *public* fiduciaries, it helps to enlarge the scope of investments pension funds can undertake. As this Article describes in the next Part, viewing the government—and by extension, the taxpayer and future taxpayers—as an important, and perhaps primary, risk-bearer for pension funds leads to a view of investments in intergenerational terms, with an enhanced focus on the sustainability of such investments.

IV. THE PROMISE AND PERIL OF A PUBLIC WEALTH MAXIMIZATION MODEL FOR PUBLIC PENSION FUNDS

The logic of focusing fiduciary duties on public wealth maximization rests on the status of the taxpayers, current and future, as the true residual claimants and guarantors of public pension funds. A public wealth orientation allows pension fund trustees to consider all of the impacts of various investments—including positive and negative externalities that would be borne by the taxpayers—in determining how to invest. This will likely result in an increased

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has funded to create the infrastructure of social services that surround a major plant or corporate headquarters.

John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 72 (1986).

102. Apart from covering the PBGC in its "High Risk" series, the GAO has issued numerous reports—including six since the beginning of 2010 alone—on the PBGC. *See Pension Benefit Guaranty Corporation Insurance Programs*, U.S. GOV'T ACCOUNTABILITY OFF.: KEY REPORTS, http://www.gao.gov/highrisk/pension_benefit/why_did_study#t=3 (last visited Mar. 25, 2018).

103. The Congressional Research Service lists three reports on the PBGC in 2014 alone. *See Pension Benefit Guaranty Corporation Congressional Research Service (CRS) Reports*, U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS GREEN BOOK: 2014 GREEN BOOK (Aug. 19, 2014), http://greenbook.waysandmeans.house.gov/2014-green-book/chapter-12-pension-benefit-guaranty-corporation/pension-benefit-guaranty-corporati-0.

104. Adam J. Levitin & Tara Twomey, *Mortgage Servicing*, 28 YALE J. ON REG. 1, 17 (2011) ("(2) RMBS issued and guaranteed by government-sponsored enterprises ('GSEs') Federal National Mortgage Association ('Fannie Mae') and Federal Home Loan Mortgage Corporation ('Freddie Mac') . . . .").

105. In the event that the federal government did not support the PBGC if it were at risk of failure, then the residual risk bearers would, of course, be the pension participants and beneficiaries. The PBGC is a limited liability entity, so its shareholders are only the residual risk-bearers for the performance of the PBGC; should it fail, they do not bear the risk of liability for the pension benefits payments.

focus on what has been labeled as a socially responsible investment, and it will also likely affect the time horizon of investments.

A. Investing to Account for Positive and Negative Externalities

As noted above, a focus on public wealth maximization should lead to an increased focus on the externalities caused by business activity. Under the standard description of externalities, business activities will not only result in private effects (private expenditures and private wealth generation) but will also result in societal benefits and costs. Consider, for example, the externalities associated with a coal mine. Among the positive externalities are the jobs that would be created to provide goods and services to the mining company and its employees. Among the negative externalities are the untaxed or uncompensated environmental effects created by coal extraction and coal burning.

How could pension funds take these externalities into account? Because many negative externalities—such as soil and water remediation, or increased health costs—are easily identifiable expenditures, it is likely that a government would have at least some sense of how to account for such externalities. Positive externalities may be roughly quantifiable in terms of economic growth and increased tax receipts. Even though some externalities will be quantifiable, however, it is not clear that investment will always be able to remediate the externalities or prevent their effects. Attempting to limit negative externalities through investment screening or boycotts may be particularly challenging. Munnell and Sundén argue that while social investors are putting their money to work in ways they believe will build a better, more sustainable economy, the academic literature "suggests the opposite; boycotting a stock is unlikely to have any impact on its price, because the demand for a company's stock is almost perfectly elastic."[106] This is certainly accurate in a market where social investing is minimal and the preferences of the social investors are swamped by the stock-price-maximizing investors. Where the market has significant numbers of socially responsible investors though, the effect of these preferences, as expressed through the sale of less sustainable businesses, could be significant. As socially responsible investing becomes increasingly prevalent, will we begin to see the effects of SRI on stock prices? Further studies on the numerous divestitures from fossil fuel producers will likely provide some answers to this question.

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106. Alicia H. Munnell & Annika Sundén, *Social Investing: Pension Plans Should Just Say "No"*, *in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY RESPONSIBLE INVESTING 13, 21 (Jon Entine ed., 2005). The authors explain the point by comparing a product boycott to a stock boycott:

> The demand curve for Chilean grapes [an item that consumers boycotted in the early 1970s to protest the coup by General Pinochet] has a relatively steep slope, so a consumer boycott of the product, which shifts the curve to the left, results in fewer grapes sold and at a lower price, assuming an upward-sloping supply curve . . . . The action hurts Chilean grape growers and the Chilean economy. In contrast, the demand curve for stocks is essentially horizontal. (The supply curve is vertical since in the short run the supply of outstanding stock is fixed.) That is—in economists' terms—the demand curve is almost perfectly elastic. Elasticity measures the percentage change in the quantity demanded for each percentage change in price.

Id. at 21–22.

Even if pensions are unable to fully limit the effects of negative externalities, they may be able to make a strong impact by funding investments with positive externalities. Such investments could include investments in infrastructure and new types of energy production that, on balance, produce positive externalities and relatively fewer negative externalities. Many of these types of investments require something few investors possess: very patient capital and readily invested in sustainable assets. Indeed, because of the relative lack of patient capital, some investments pay what is known as an "illiquidity premium"[107] that compensates investors for their inability to readily convert the asset into cash or its equivalent. Because pension funds must pay out benefits on a regular basis, standard pension practice has been to limit the amount of investment in less liquid assets (which, of course, are not chosen because of their positive externalities but because they offer better returns) and keep significant funds in more liquid assets. As a result, a pension fund would likely be limited in the investments it could make in less liquid assets, even if it did provide significant positive externalities.

Accounting for positive and negative externalities is not an easy task and would require enhanced coordination by various state or municipal agencies and departments. It may also require significant investment in data analytics. This Article does not purport to suggest how all externalities are to be accounted for—a set of calculations involving officials and experts in environmental impacts, medicine, economics, accounting, and the law, among other areas—but merely notes that recognition of externalities follows as a natural consequence of public wealth maximization, which in turn follows from recognition of the taxpaying public as the true residual risk-bearers in public pension funds.

B. Concerns with Public Wealth Maximization

A number of commentators have argued against plan officials taking SRI considerations into account—a reasonable proxy for public wealth maximization—for a variety of reasons.[108] Many of these reasons tend to assume SRI investments benefit third parties, with one to the detriment of fund participants and beneficiaries, although, as discussed above, that is not necessarily the case. Commentators have also noted particular concerns that arise because of the status of public pension funds as public entities acting in private markets.[109] Both sets of concerns highlight the governance challenges of moving to a public maximization model.

107. *See, e.g.*, BLACKSTONE GROUP, LLC, PATIENT CAPITAL, PRIVATE OPPORTUNITY: THE BENEFITS AND CHALLENGES OF ILLIQUID ALTERNATIVES 13 (2014), https://www.cfainstitute.org/learning/products/publications/contributed/altinvestment/Documents/patient%20capital%20private%20opportunity_blackstone.pdf.

108. John H. Langbein & Richard Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 92–93 (1980).

109. *Id.* at 75.

1. *SRI Is Wasteful Because It Has Little Effect*

The evidence from certain SRI efforts in past decades, such as boycotts, shows poor results. A well-known study examined the effects of divestment from South Africa in protest of the country's apartheid regime.[110] The study noted three primary pressures on U.S. firms with operations in South Africa: (1) Congressional acts, including the Comprehensive Anti-Apartheid Act of 1986;[111] (2) divestment from private investors, including universities and pension funds;[112] and (3) other U.S. companies (including clients of the remaining firms) that decided to withdraw from South Africa.[113] They found that, "despite heated public debate over divestment," there was no significant effect on the firms: "the announcement of legislative or shareholder pressure had no discernible effect on the valuation of banks and corporations with South African operations or on the South African financial markets."[114] This conclusion is consistent with Munnell and Sundén's view that demand curves for stocks are highly elastic, and boycotts—at least to the extent that most investors do not participate in the boycott—are unlikely to have a significant effect on the stock process of the boycotted firms.[115]

Munnell and Sundén also reviewed numerous studies on the impact of SRI on portfolio returns. Their review found that "the vast majority of the empirical evidence supports the theory that the impact on risk-adjusted returns of a carefully constructed, socially screened portfolio is zero."[116] Indeed, they point to research indicating that social investing may even have significant negative effects on returns.[117]

Posner and Langbein also argue that there is little reason to believe that investing based on social or political risk factors will produce better returns.[118] They reject the notion that the social investor will be able to more consistently pick winners than other investors: "This is just another theory of how to beat the market, and it has no firmer basis than any other such theory."[119]

More recent studies, however, find different results—at least to the extent that SRI might be thought to harm returns. In an expansive review of the extensive available academic literature, RBC Global Asset Management found that SRI does not result in lower investment returns. They sensibly note that:

> [T]he question of whether or not SRI reduces investment returns will never be laid completely to rest. One reason is that this is a difficult empirical question and there will always be legitimate disputes over the

110. *See generally* Siew Hong Teoh, Ivo Welch & C. Paul Wazzan, *The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South Africa Boycott*, 72 J. BUS. 35 (1999).

111. *Id.* at 36.

112. *Id.*

113. *Id.*

114. *Id*. at 79, 83.

115. Munnell & Sundén, *supra* note 106, at 21–22.

116. *Id*. at 34.

117. *Id*.

118. Langbein & Posner, *supra* note 108, at 78.

119. *Id.* at 92–93.

> quality of the data and the most appropriate methodology to use. Perhaps more importantly, this question will never be answered to everyone's satisfaction because many of the people engaged in this debate carry with them strong ideological baggage. Opponents of SRI are opposed to the notion of anything other than financial factors affecting the value of a security that, in their view, "hell will freeze over" before they accept that this is not the case. Likewise, some proponents of SRI are so steeped in their own moral superiority that they cannot fathom the possibility that the integration of ESG ("environmental, social, and governance") factors does not have a beneficial effect on investment returns. The challenge for the rest of us is to ignore the rhetorical noise emanating from these extreme views and focus on the facts.[120]

2. *Public Funds Generate Corruption and Rent-Seeking*

While both public and private funds are at risk from self-dealing transactions and shirking by fund officials, public funds face particular obstacles as creations of the state. As noted above, private trustees are more susceptible to suit for breach of their fiduciary duties. In the case of funds covered by ERISA, the trustee can face both private litigation as well as enforcement action by the DOL. Furthermore, as Rounds notes, fiduciary liability insurance for private trustees can be "prohibitively expensive," if it can be obtained at all.[121]

In addition, Rounds notes that the public sector is not involved in the administration of private funds, other than as a judicial arbiter of claims brought by the parties.[122] There are multiple legal safeguards in place to prevent trustees from investing in ways that might harm the beneficiaries, and "the beneficiaries serve as independent private watchdogs of the activities of the private trustee, and the state court ensures that these watchdogs have nice, sharp teeth."[123] By contrast, these protections "melt away" if the government is involved in the administration of a trust, an inevitable consequence when the state "becomes a party to a legal relationship, as well as its regulator and adjudicator."[124]

Aside from these structural concerns, public pension funds are exposed to special risks of political capture, rent-seeking, and other forms of political patronage. As Romano explains:

> Public fund managers must navigate carefully around the shoals of considerable political pressure to temper investment policies with local considerations, such as fostering in-state employment, which are not aimed at maximizing the value of their portfolios' assets. This tension is not an iso-

120. RBC GLOBAL ASSET MGMT., DOES SOCIALLY RESPONSIBLE INVESTMENT HURT INVESTMENT RETURNS? 8 (2012), http://funds.rbcgam.com/_assets-custom/pdf/RBC-GAM-does-SRI-hurt-investment-returns.pdf.

121. Charles E. Rounds, Jr., *Why Social Investing Threatens Public Pension Funds, Charitable Trusts, and the Social Security Trust Fund*, *in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY RESPONSIBLE INVESTING 56 (Jon Entine ed., 2005).

122. *Id.*

123. *Id.* at 57.

124. *Id.*

lated phenomenon. Much of the activity of states in what is referred to as economic development—providing tax concessions or direct payments to in-state businesses—is in response to similar concerns.[125]

Romano also notes that even though some private funds (such as mutual funds) may hesitate to oppose incumbent corporate managers for fear that the corporation may make reprisals on the fund company—for example, by eliminating access to fund as a 401(k) option—the same risk exists for public funds, as "corporate managers who threaten private fund managers or their employers with loss of business as the price of opposition can just as effectively threaten public funds with economic loss through, for example, local plant closings."[126]

Romano tests for a connection between pension board politicization and returns by examining five years of data, 1985 through 1989, from fifty different public pension funds.[127] In her sample, she noted that most trustees—over 80%—were not elected by fund beneficiaries, but were political appointees or elected officials.[128] Romano hypothesized that pension boards with higher proportions of political trustees would perform worse than those with lower proportions due to the costs of political patronage, rent-seeking, and wasteful projects designed to secure votes—in effect, transferring wealth from pension beneficiaries to voters.[129] She found a significant positive relationship between performance and board independence, so that "[t]he smaller the proportion of board members who are appointees, and *ex officio* members, the higher a fund's returns."[130] Her results are consistent with the hypothesis that public pension fund boards face political demands that can negatively impact their performance.

Romano addresses another potential justification, offered by Litvak, for special investment by public pension funds: there are capital market gaps in the financing of small local businesses and low-income housing, and pension funds can exploit these gaps to make a nonconcessionary return.[131] Romano counters that it is doubtful that such gaps exist,[132] and that if a particular business or

125. Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 796 (1993).

126. *Id.* at 796–97.

127. *Id.* at 823.

128. In thirty-two states, all board members were political. *Id.*

129. *Id.* at 820.

130. *Id.* at 825.

131. *Id.* at 812–13. A "concessionary" investment would be an "investment[] that sacrifice[s] some financial gain to achieve a social benefit." *See* Paul Brest & Kelly Born, *When Can Impact Investing Create Real Impact?*, STAN. SOC. INNOVATION REV. (Fall 2013), http://ssir.org/up_for_debate/article/impact_investing.

132. Romano, *supra* note 125, at 812–13. Brest and Born have identified numerous frictions in markets that can produce the kind of gaps Litvak suggests. Among these are imperfect information (particularly about investments in developing nations or in low-income areas in developed nations); skepticism about achieving both financial returns and social impact; inflexible institutional practices (such as the use of heuristics that simplify decision making but exclude potential investments); small deal size (which may be less economical for some investors given due diligence and other transactional costs); limited exit strategies (which are less important for long-term investors such as pension funds or sovereign wealth funds, but more important for time-limited investments like private equity); and governance problems (including uncertainties about property rights, contract enforcement, and bribery). Brest & Born, *supra* note 131.

housing project is unable to attract financing from the private sector, it is more probable that the market has simply and efficiently priced the risk and reward of the business or project and found that it is an unsuitable investment.[133] Even if there are such gaps, however, she argues that it would be preferable to fund these projects directly through general revenues rather than finance them through pension fund investments that serve as a "hidden tax" on pension fund assets.[134] Direct funding, she argues, would distribute the financial burden of the project more equally across state residents and make the cost of such projects more easily measurable.[135]

It is likely true that there are few social-impact investments that produce a nonconcessionary return. Likewise, it is difficult to find such investments because, if there were positive market returns, the market would have found them. As Brest and Born put it:

> But if an impact investor is not willing to make a financial sacrifice, what can he contribute that the market wouldn't do anyway? We believe that in publicly traded large cap markets, the answer is nothing: Even quite large individual investments will not affect the equilibrium of these essentially perfect markets. The frictions or imperfections inherent in some smaller, private markets, however, may offer the possibility of achieving both market returns and social impact.[136]

As a practical matter, however, certain investments, such as infrastructure investments, are often the result of a public/private partnership, and the government alone may not have funds available to pursue such opportunities. Furthermore, public pension funds (or their external managers) possess the requisite skill in evaluating the cost and potential financial benefits of such investments. Given the predominantly financial orientation of the fund's managers, the fund is likely to possess significantly more skill than government bureaucrats that may be more focused on the ephemeral "multiplier" benefits from impact investing.

Recently, some types of public funds (especially sovereign wealth funds) have engaged in public/private partnerships in various markets within their own borders. In particular, these partnerships have been effective in infrastructure investments, in part because these partnerships use the link of the public fund to a political body as an advantage. Large infrastructure investments can have difficulty attracting private investors for several reasons. Among other reasons, they often occur over a long time frame, which makes risk and revenue projections difficult. Such projects often depend on governmental concessions or government-mandated rates (such as electrical rates), which introduces the risk that, should the government change the rate, the project could become uneco-

133. Romano, *supra* note 125, at 812–13.
134. *Id.* at 812.
135. *Id.*
136. Brest & Born, *supra* note 131.

nomical.[137] Finally, infrastructure projects often have very high transaction costs, such as numerous costly and lengthy regulatory permit processes.

A public investor that co-invests with private investors can resolve some of these problems. Most importantly, as a long-term entity with a political link to the state, they provide an implicit political risk guaranty that may help protect the deal into the future. Their presence in the deal may also reduce regulator concerns, thereby speeding regulatory processes.

A government may put in place stringent structures to prevent a legislature from political patronage and other forms of political corruption that have reduced the effectiveness of public funds; this helps to ensure that politicians are acting loyally and in the best interests of their constituencies. This naturally manifests itself as acting in the best interests of *present* constituencies. As Thompson observes, "[d]emocracy is partial toward the present. Most citizens tend to discount the future, and to the extent that the democratic process responds to their demands, the laws it produces tend to neglect future generations. The democratic process itself amplifies this natural human tendency."[138] This bias, which Thompson calls "presentism," "manifests itself in laws that neglect of long-term environmental risks, the consequences of genetic engineering, problems of population growth, and development of the democratic process itself."[139]

Thompson suggests protecting against presentism through the application of a democracy "trusteeship" model of governance,[140] which has obvious and clear applications to a public fund governance structure already based on trusteeship. A democratic trusteeship model could take at least two different forms. In a less demanding form, citizens should seek to preserve a democratic process "that gives future citizens at least as much capacity for collective decision making as present citizens have."[141] Thompson analogizes this to Locke's principle for the preservation of real property, which grants rights to land "where there is enough, and as good left in common for others":[142] present democracies should leave to future generations "'enough and as good' democratic sovereignty as they themselves enjoy."[143]

137. This occurred recently in Norway. A group of investors built an oil and gas pipeline network, expecting tariffs at a set rate to produce returns on their investment. The Norwegian government reduced the tariff rates by 90%, and the investors sued the government for infringing on their property rights. The government's increase was upheld by an Oslo court. *See* Georgi Kantchev & Ese Erheriene, *Investors Lose Gas Pipeline Fight with Norway*, WALL ST. J. (Sept. 25, 2015, 8:43 AM), http://www.wsj.com/articles/norway-wins-court-case-against-allianz-cppib-and-other-investors-in-gassled-pipeline-dispute-1443170794.

138. Dennis F. Thompson, *Representing Future Generations: Political Presentism and Democratic Trusteeship*, 13 CRITICAL REV. INT'L & POL. PHIL. 17, 17 (2010).

139. *Id.* at 17–18.

140. *Id.* at 26.

141. *Id.*

142. JOHN LOCKE, TWO TREATISES OF GOVERNMENT 116 (Rod Hay ed., McMaster University 2014) (1823).

143. Thompson, *supra* note 138, at 26. A more demanding form of the trusteeship principle would require that any current political generation should seek to maximize the control that future generations will enjoy, "up to the point that control over their own decision making begins to decrease . . . ." *Id.* Thompson, notes, howev-

Applying this concept to public fund governance, Thompson's trusteeship model suggests that a public fund should be managed so as to support the autonomy and sovereignty of future generations.[144] An important aspect of protecting the autonomy and sovereignty of future generations is to reduce burdens on future generations because such burdens will inevitably limit the sphere of action available to them. These burdens can take the form of large debts that take up a significant portion of the governmental budget, and thereby reduce the spending of the government on other programs. It is this very real burden that pushes current governments to take greater risks in their quest for high return-generating investments. The pension plan choices of past generations have bound the hands of the current generation as states and municipalities face billions in unfunded liabilities and must make difficult choices in how they will fund benefits in the future. These choices must be made with great care, however, because excessive risk-taking by current generations may burden future generations even further if investments do not perform well. In addition, the quest for returns may so occupy current generations that they disregard the negative externalities created by their investment decisions. This creates difficulties for future generations in the same way as unfunded liabilities: a financial burden related to these negative externalities—such as the need to pay for rising public health expenses or environmental remediation costs—limits the ability of the government to fund other governmental priorities.

Public funds, with an unlimited lifespan, are ideally situated to consider and monitor long-term investment effects. Unlike many other institutional investors (and, as importantly, the managers who run these funds), public funds do not have a set investment time horizon that would limit investments to short-term investments or a short-term focus on perpetual investments, such as equity investments in corporations. As noted above, public funds cannot ignore the inevitability of uncertainties or "black swan" events, which may not be priced into private investment decisions.[145]

C. Can Governance Resolve These Risks?

As noted earlier, the greatest impediment to long-term investing by pension funds is the governance of the funds themselves. The same governance structures that create a risk of corruption—the mingling of politicians and policy functions with the management of the fund itself—ultimately damage the ability of funds to invest in long-term investments. The self-limiting logic of politicized pension funds follow a predictable path—a fund is set up by the government to provide for the pensions of public employees. A political official is appointed to monitor the funds, ostensibly to more tightly monitor the investment decision-making of the fund's managers and to ensure political ac-

er, that although this version "would more reliably overcome the dead hand of past generations, it may also place excessive and unrealistic demands on earlier generations." *Id.*

144. *Id.*

145. *See supra* note 132 and accompanying text.

countability. The fund, however, can also be used to pay rent-seekers and to reward political supporters. Either as an *ex post* reaction, or as an *ex ante* prevention, investment restrictions are put in place to limit the ability of the fund to invest in certain types of investments. The government may (and, as described above, usually does) enact statutes that impose a strict fiduciary duty on the fund to invest solely for the benefit of the pension plan participants and their beneficiaries.

The core problem with this structure is that fiduciary duties alone are much too slender a support to carry the governance load of a public fund, particularly in the context of public funds that carry political risks. And because public fund fiduciary duties do not have the enforceability of fiduciary duties in private funds, they are even weaker as a governance structure. Other structures must carry the load and help ensure that a fund is managed properly. The simplest governance change is to separate the policy functions of the fund—the political decision of what a fund should do, how it should be done, and for whom it should be done—from the actual management of the fund itself. This easy policy prescription has been used successfully with other types of public funds, including sovereign wealth funds.[146] A primary purpose of separating the policy-making function from the management function is to limit the possibilities for politicization of the fund. The fund is given clear, public rules on how it should be managed, and for whom. Politicians are not involved with the management of the fund and only serve as a public accountability mechanism. The separation of these roles also improves the enforceability of fiduciary duties, as the structure eliminates the self-interest in the current structure in which a politician, such as a state treasurer, may be simultaneously in a management role, a monitoring role, and an enforcement role.

Creating a politically insulated structure is not a simple task if it requires uprooting a politicized structure with entrenched interest groups. In some cases, these political structures may be difficult or impossible to change. Even if such changes cannot be made, however, pension funds may still have some ability to invest more expansively and thereby maximize public wealth.

V. CONCLUSION

To whom should fund duties be owed? Economic logic suggests that public pension fund trustees owe their duties to the public collectively. In practice, individual pension fund claimants function more like senior creditors than the residual claimants that are the typical recipients of fiduciary duties. The public in general, and current and future taxpayers specifically, are the true residual risk-bearers for public pension funds.

This reframing of fiduciary duties in public funds has dramatic consequences for the investment policies of the funds. Most importantly, a shift in the locus of fiduciary duties to public wealth maximization will require fund

146. Jeffery V. Bailey, *Investment Policy: The Missing Link*, *in* PENSION FUND INVESTMENT MANAGEMENT 27 (Frank J. Fabozzi ed., 1997).

managers to more fully consider the externalities accompanying their investments, which should serve to help them fully and accurately price their investments. Private investors might ignore certain negative effects, such as uncompensated harms from pollution or depleted natural resources, because the government absorbs the costs of such externalities. Indeed, a strict fiduciary duty to act in the interests of the fund would obligate a private investor to ignore such externalities, so long as they do not negatively affect the returns of the fund's investments. The government—and by extension, the public who funds the government—that absorbs the cost of these externalities, however, should view investments differently, with a view to minimizing negative externalities, particularly those that are significantly more expensive to remediate than to prevent. Similarly, a strict reading of fiduciary duty suggests that funds should ignore positive externalities from investments that benefit society but not the plan participants. A focus on public wealth maximization would suggest that positive externalities should also be taken into account in investment decisions, which might, as a consequence, result in more investment in sustainable enterprises and long-term projects.

Fiduciary duties, however, are not a substitute for other kinds of governance structures. This is particularly the case with public pension funds as there is very little that the nominal beneficiaries can do to enforce the fiduciary duties. To take advantage of a shift to public wealth maximization—indeed, before any statutes could be rewritten—state and local governments need to ensure that their governance structures are robust enough to manage the potential agency costs that arise with increased socially-responsible investing.