THE USE AND ABUSE OF LABOR'S CAPITAL

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The recent financial crisis has jeopardized the retirement savings of twenty-seven million Americans who depend on public pension funds, leading to cuts in benefits, increased employee contributions, job losses, and the rollback of legal rights like collective bargaining. This Article examines ways in which public pension funds invest against the economic interests of their own participants and beneficiaries, and the legal implications of these investments. In particular, the Article focuses on the use of public pensions to fund privatization of public employee jobs. Under the ascendant—and flawed—interpretation of the fiduciary duty of loyalty, public pension trustees owe their allegiance to the fund itself, rather than to the fund's participants and beneficiaries, notwithstanding the fact that the duty of loyalty commands trustees to invest "solely in the interest of the participants and beneficiaries" according to ERISA and similar state pension codes. I argue that this "fund-first" view distorts the duty of loyalty and turns the role of trustee on its head, leading to investments that undermine, rather than enhance, the economic interests of public employees. I turn to ERISA, trust law, agency law, and corporate law to argue that public pension trustees should consider the impact of the funds' investments on the jobs and job security of the funds' participants and beneficiaries, where relevant. I also adduce evidence that these controversial investments are widespread. I propose that public pension funds be governed by a "member-first" view of fiduciary duty focused on the economic interests of public employees in their retirement funds, which go beyond maximizing return to the funds. I argue that this view is more faithful to the original purpose of the duty of loyalty than is the fund-first view. I suggest ways to implement the member-first view, discuss potential extensions beyond the jobs impact of investments, and assess the proposed reform's practical effects.

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INTRODUCTION

For twenty-two years, Rick Thorne worked as a custodian in the public schools of Chelmsford, Massachusetts.[1] He earned $20 an hour "cleaning floors, cutting grass, and setting up for assemblies,"[2] and made biweekly payments to his retirement fund, the Middlesex County Retirement System (Middlesex). Middlesex's assets were (and still are) invested through the Massachusetts Pension Reserves Investment Trust (MassPRIT).[3] In December 2007, Thorne's retirement assets, along with those of his fellow Chelmsford school employees, and other public employees across the state, were directed by MassPRIT to fund the acquisition of Aramark Corp. (Aramark) by a private equity pool.[4] Aramark is a "global food-service and facility-management company" that focuses on, among other businesses, servicing public school districts.[5] In March 2011, Aramark won the custodial contract for the Chelmsford school district after underbidding Thorne's union.[6] Aramark offered Thorne and his fellow custodians their jobs back for $8.75 an hour—a fifty-six percent salary cut—equal to what Thorne earned when he started at Chelmsford in 1989.[7] Thorne declined the offer and was fired.[8] He now collects a substantially reduced pension from Middlesex, diminished by his abbreviated career.[9]

Job losses and pension reductions can be harmful to anyone. They can be particularly damaging to public employees because millions of them, including most Massachusetts public employees, forty percent of public school teachers across the country, and two-thirds of all public-safety employees, are ineligible for Social Security because

1 Martin Z. Braun & William Selway, *Pension Fund Gains Mean Worker Pain as Aramark Cuts Pay*, BLOOMBERG (Nov. 20, 2012, 12:01 AM), http://www.bloomberg.com/news/2012-11-20/pension-fund-gains-mean-worker-pain-as-aramark-cuts-pay.html.

2 *Id.*

3 *Id.*

4 *See id.* (noting that MassPRIT is an owner of Aramark).

5 *Id.*; *School Districts*, ARAMARK, http://www.aramark.com/Industries/SchoolDistricts/ (last visited Nov. 17, 2014) (noting that Aramark provides more than 500 school districts with food, custodial, and maintenance services).

6 Braun & Selway, *supra* note 1.

7 *Id.*

8 *Id.*

9 Telephone Interview with Martin Z. Braun, Public Finance Reporter, Bloomberg News (Aug. 7, 2013) (based on notes from Martin Braun's interview with Rick Thorne); *see also, e.g.*, MASS. STATE RET. BD., BENEFIT GUIDE FOR THE MASSACHUSETTS STATE EMPLOYEES' RETIREMENT SYSTEM 4 (2013), *available at* http://www.mass.gov/treasury/docs/retirement/retguide.pdf [hereinafter MASS. BENEFIT GUIDE] (calculating public pension benefits based on salary and years of service).

of their public pensions.[10] Those pensions are often all they have to sustain them in retirement.[11]

The Employee Retirement Income Security Act of 1974 (ERISA) requires fund trustees to prioritize the interests of fund participants and beneficiaries in making investments.[12] As addressed more fully below, ERISA does not apply to public pension funds, but it is authoritatively cited to interpret the fiduciary duties embedded in state pension codes. ERISA and state pension fiduciary duties share the same trust law ancestry; on occasion, state codes simply copy ERISA's

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[10] Most public employees in the Commonwealth of Massachusetts do not participate in Social Security. *See Social Security Coverage*, NAT'L ASS'N ST. RET. ADMINISTRATORS, http://www.nasra.org/socialsecurity (last visited Nov. 17, 2014) (discussing public pension fund recipients' participation in Social Security in Massachusetts). Nationwide, approximately one-fourth of public sector employees do not participate in Social Security, including over one-third of public school teachers and two-thirds of firefighters, police officers, and first responders. *See* 42 U.S.C. § 410 (a)(7) (2012) (excluding state employees from Social Security by default); Sec'y of Health, Educ., & Welfare v. Snell, 416 F.2d 840, 841 (5th Cir. 1969) (stating that state employees were excluded in order to avoid constitutional issues with Social Security); *Social Security Coverage*, *supra* (discussing public pension fund recipients' participation in Social Security nationwide).

[11] *See* Jack M. Beerman, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 4–9 (2013) (discussing pensions and recent trends in employee benefit law).

[12] Plan "participants" refers to current workers who are "either employees in, or reasonably expected to be in, currently covered employment . . . or former employees who have . . . a reasonable expectation of returning to covered employment or who have a colorable claim to vested benefits"; plan "beneficiaries" refers to "person[s] designated by a participant, or by the terms of an employee benefit plan, who [are] or may become entitled to a benefit thereunder." Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101, 107, 117 (1989) (citations omitted). I refer to plan participants and beneficiaries collectively as plan "members". The Uniform Management of Public Employee Retirement Systems Act of 1997 (UMPERSA) is designed for public pension funds but has only been adopted in two states, Wyoming and Maryland. *Legislative Enactment Status*, UNIFORM LAW COMMISSION, http://www.uniformlaws.org/LegislativeMap.aspx?title=Management%20of%20Public%20Employee%20Retirement%20Systems%20Act (last visited Nov. 14, 2014). The UMPERSA language substantially tracks the ERISA language discussed in this Article. *See* UNIF. MGMT. OF PUB. EMP. RET. SYS. ACT § 7 (1997) (establishing the duty of loyalty and exclusive purpose rule). The Uniform Prudent Investor Act (UPIA) has a duty of loyalty, and requires a trustee to operate the trust "solely in the interest of the beneficiaries." UNIF. PRUDENT INVESTOR ACT § 5 (1994). The Uniform Prudent Management of Institutional Funds Act (UPMIFA) does not have a duty of loyalty, although it reminds trustees that the duty of loyalty applies through other law, and explicitly permits a trustee to consider "an asset's special relationship or special value, if any, to the charitable purposes of the institution." *See* UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 3(b) (2006) (the duty of loyalty is imposed by other laws and must be complied with); *see also id.* § 3(e)(1)(H) (trustee may consider "an asset's special relationship"). The UPMIFA does not explicitly have an exclusive purpose rule, but the notes to the UPMIFA provide an example: A university could buy land next to the campus for future development, and, even though it may not conform to "prudent investor standards," it could be appropriate because the university needs to build a new dorm. *Id.* § 2 cmt. at 10. Although that example is geared toward the prudent investor rule, it could also be applicable to the exclusive purpose rule.

duties.[13] This stands in sharp contrast to the usual pattern, in which there may be sharp divergences between ERISA and state pension codes over issues like funding requirements, disclosure and reporting requirements, pension vesting and eligibility, and other key features of pension governance. I discuss interpretations of ERISA fiduciary duties not to endorse the application of those interpretations to public pension funds, but to provide the relevant legal background for assessing the fiduciary duties of public pension trustees. Under the ascendant view of ERISA and state fiduciary duties, consideration of the impact of a fund's investments on the jobs of fund participants is worse than irrelevant; it is considered to be a breach of the duty of loyalty and the exclusive purpose rule.[14] This is because the dominant interpretation of the fiduciary duties of public pension trustees requires them to prioritize the investment impact on the fund alone, and not its impact on the funds' participants and beneficiaries, like Thorne.[15] Even in the extreme case, in which an investment by a

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[13] *See* 29 U.S.C. § 1003(b)(1) (2012) (exempting governmental plans from ERISA); *see, e.g.*, FLA. STAT. § 215.47(10) (2011) ("The [Florida State Board of Administration] shall discharge its duties with respect to a plan solely in the interest of its participants and beneficiaries. The board . . . shall comply with the fiduciary standards set forth in the Employee Retirement Income Security Act . . . ."); *see also* CAL. CONST. art. XVI, § 17(a)–(d) (mirroring ERISA's exclusive purpose and prudent person rules and the duty of diversification in California); LA. REV. STAT. ANN. § 11:834(B) (2009) (requiring Louisiana public retirement system trustees to follow the exclusive purpose rule); *id.* § 11:263(A)–(B) (requiring Louisiana public retirement system trustees to follow the prudent person rule); N.Y. EDUC. LAW § 502(3) (McKinney 2014) (requiring the New York state teachers' retirement system to follow the exclusive purpose rule as stated in ERISA); 71 PA. CONS. STAT. § 5931(a), (e) (2014) (requiring Pennsylvania public pension trustees to comply with the exclusive purpose and prudent person rules); TEX. GOV'T CODE ANN. § 825.101 (West 2014) (mirroring ERISA's exclusive purpose rule in Texas); Bd. of Trs. of the Vill. of Barrington Police Fund v. Dep't of Ins., 570 N.E.2d 622, 626 (1991) (noting that Illinois Pension Code is analogous to ERISA); N.Y. COMP. CODES R. & REGS. tit. 11, § 136-2.3(a) (2011) (mirroring ERISA's prudent person rule in New York); EMP. BENEFITS RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS 20 (2005), *available at* http://www.ebri.org/pdf/publications/books/fundamentals/Fnd05.Prt05.Chp41.pdf ("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." (citations omitted)). For more on this, see *infra* Appendix.

[14] *See* 29 U.S.C. § 1104 (a)(1) (2006) (establishing the exclusive purpose rule); Interpretive Bulletin Relating to Exercise of Shareholder Rights, 73 Fed. Reg. 61,731 (Oct. 17, 2008) (finding that, when creating an investment policy, fiduciaries must consider only the economic interest of plan participants and beneficiaries).

[15] Comprehensive assessment of the particular rules and regulations of each state's pension code is beyond the scope of this Article. In the case of MassPRIT, the fund is managed by the Massachusetts Pension Retirement Investment Management Board (MassPRIM) whose mission statement—crafted by the Board itself, and not the state legislature—includes the goal of maximizing return on investment (ROI) for the fund. *See* MASS. PENSION FUND INV. MGMT. BD., INVESTMENT POLICY 1 (2012), *available at* http://

public pension fund in a company that competes with public employees is the proximate cause of the employees' loss of employment, the employees' lost compensation or benefits is irrelevant to the fiduciary analysis. Likewise, this "fund-first" view inhibits funds from negotiating with investee management to safeguard the jobs of the funds' participants, on the assumption that minimizing the employment impact of an investment would reduce returns to the fund.

This fund-first view of fiduciary duty was well-expressed by Phil Griffith, the chief investment officer of the Teachers' Retirement System of Louisiana (Louisiana Teachers), which also owns a substantial stake in an Aramark owner.[16] In 2010, "Aramark was hired to run food service for the Recovery School District, which took over Orleans Parish schools after the city was devastated by Hurricane Katrina."[17] As it did in Chelmsford, the company cut pay for Louisiana Teachers participants like Carol Sanders, a cook who had worked for Orleans Parish since 1982.[18] Before the Aramark contract, Sanders "had medical benefits, paid days off and was making $15 an hour."[19] Aramark "cut Sanders's time on the job in half, to 20 hours a week, leaving her working split shifts—2 hours in the morning and 2 more into the early afternoon, five days a week. Her pay dropped to $9 an hour."[20] Sanders "went without medical insurance and began drawing $200 a week in food stamps."[21] Eventually, she was fired.[22] According to Griffith, in considering an investment like the one made by the Louisiana Teachers in Aramark:

> We take a kind of hands-off approach, which is from a fiduciary responsibility . . . . We manage [the fund] for return and for our own constituents. We don't get into, 'Does that mean it lays off public

www.mapension.com/files/5313/2752/7256/Investment_Policy_-_01252012.pdf (stating the MassPRIT investment policy and mission statement); *see also* MASS. GEN. LAWS ch. 32, §§ 22–23 (2011) (establishing MassPRIT and MassPRIM). Thus, the fiduciary question assessed in this paper might manifest in slightly different ways depending on the state and the fund. Here, it might manifest in Middlesex's decision to opt into a fund like MassPRIT that maximizes ROI for the fund, or MassPRIM's decision to adopt a policy favoring maximum ROI while also purportedly being bound to the duty of loyalty. It might also manifest in the tension between a state regulation requiring ROI and also adoption of traditional fiduciary duties. It could also manifest as a policy question as to whether funds should adopt such a policy, or act as if current law requires it.

[16] *See* Braun & Selway, *supra* note 1 (quoting Griffith as saying Louisiana TRS chooses investments based on "the security of the trust, not whether or not it creates jobs or takes away jobs").

[17] *Id*.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id*.

[22] *Id*.

> workers?' The only thing we look at is the security of the trust, not whether or not it creates jobs or takes away jobs, whether it be public employees in Louisiana or public employees throughout the country . . . . Our responsibility is to the trust . . . .[23]

Under this view, if the Aramark investment had been screened out by Louisiana Teachers because of its potentially detrimental impact on the jobs of fund participants, or if Louisiana Teachers divested from Aramark in favor of a slightly less profitable investment that had no negative impact on participant jobs, then Louisiana Teachers trustees would have breached their fiduciary duties because the first investment is better for the fund, even if the net economic benefit to fund participants and beneficiaries would have been greater under the second investment. Under this same view, trustees might similarly breach their fiduciary duties by negotiating to protect their participants' jobs at some cost to return on investment, even if it would improve the investment's net economic benefit to fund participants and beneficiaries.

This dilemma is hardly limited to the investments made in Aramark by Middlesex/MassPRIT and Louisiana Teachers. For virtually every public sector function at the state, county, and municipal levels, there is a private sector industry seeking to perform it.[24] There are private prisons, private ambulance corps, private hospitals, private sanitation services, private police and fire services, private schools and privately run public school service companies, private security forces, private infrastructure services, and more.[25] Because the fund-first view of fiduciary duty effectively bars meaningful consideration of factors like participant employment when making investments, and because public pension fund holdings are usually publicly unavailable,[26] there is little direct data available to place the scope of the

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[23] *Id.*

[24] *See* Maria O'Brien Hylton, *Combating Moral Hazard: The Case for Rationalizing Public Employee Benefits*, 45 IND. L. REV. 413, 477–78 (2012) ("[E]verything that is done in the public sector can (and sometimes is) performed by the private sector.").

[25] *Id.*

[26] Although the SEC requires funds with greater than $100 million in assets to disclose their holdings quarterly on Form 13F, such forms are rarely filed by public pension funds themselves, and instead are filed by their outside investment managers. *See* 17 C.F.R. § 240.13f-1(a)(1) (2011) (requiring institutional investors with at least $100 million in assets to file Form 13F); *see also SEC Staff Answers Frequently Asked Questions About Form 13F*, SEC TODAY, Apr. 21, 1999, *available at* 2013 WL 37575 (indicating that investment managers with "investment discretion over $100 million or more of 'section 13(f)' securities" usually file Form 13F). These managers rarely if ever delineate which of their holdings belong to which clients. Consequently, it is nearly impossible for the public to ascertain the content of public pension fund portfolios.

problem in context. But certain straightforward empirical observations may still be made.

On the one hand, it must be conceded that the portfolios of these funds are so enormous, with over $3 trillion in assets under management,[27] that any particular investment issue appears small relative to the whole. Only a fraction of total public pension fund assets are invested in projects that undermine participant jobs. On the other hand, it is likely that many, if not most, public pension funds themselves are invested in businesses that directly undermine the employment security of their own participants—or are likely to do so in the future. These investments may well lower the cost of capital for those businesses, exacerbating the problem both for the participants and beneficiaries themselves and for the funds that lose participant and employer contributions. This observation follows from the fact that public pension funds are diversified investors with substantial assets and that virtually none of the nearly four thousand public pension funds in the United States deploy screening mechanisms to track this issue.[28] Public pension funds make up thirty-seven percent of the assets of private equity player Blackstone, suggesting that Blackstone's competitors may also manage substantial public employee retirement funds, and suggesting that such dollars may play an important role in financing privatizing investments.[29] In total, "public pensions have sunk about $435 billion into private-equity firms, almost a third of total investments in the industry . . . ."[30] It also follows from a handful of instances in which the issue has emerged publicly, several of which I discuss in this Article. In addition to their economic impact, which I assess in detail, these investments create considerable distrust and resentment between the funds' participants and beneficiaries (for simplicity, "members") and their trustees, in some instances leading to public campaigns or litigation threats against the latter.[31]

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[27] *See 2011 Annual Survey of Public Pensions: State and Local Data*, U.S. CENSUS BUREAU, https://www.census.gov/govs/retire/historical_data_2011.html (last visited Nov. 17, 2014) (showing total investments by state pension funds).

[28] *See* U.S. CENSUS BUREAU, 2012 STUDY OF PUBLIC PENSIONS: STATE & LOCAL DATA (2012) (showing 227 state and 3771 local defined benefit public pension plans).

[29] *See infra* Part III.A.1.b (discussing Blackstone's complex interactions with public pension funds). For an account of one public pension fund's relationship with Blackstone, see CHRIS TOBE, KENTUCKY FRIED PENSIONS: A CULTURE OF COVER-UPS AND CORRUPTION 110 (2013).

[30] Braun & Selway, *supra* note 1.

[31] *See* Matt Taibbi, *Who Can Stop the Koch Brothers from Buying the Tribune Papers? Unions Can, and Should*, ROLLING STONE (May 10, 2013), http://www.rollingstone.com/politics/news/who-can-stop-the-koch-brothers-from-buying-the-tribune-papers-unions-can-and-should-20130510 (quoting Liz Greenwood, LACERA trustee, on union campaign

It is not difficult to discern why businesses that compete against public employees would attract investments. Private sector actors can perform these functions profitably and for lower cost than their public sector equivalents—at least in the short term—when they can pay workers twenty-five to seventy-five percent less than what they were earning as public employees, and when they may provide lower quality services with fewer workers.[32] Others have pointed out that private sector competition creates more nimble enterprises that respond quickly to changing conditions, including deteriorating economic conditions like the recent downturn, giving them advantages over public sector employers like the ability to reduce costs and avoid the moral hazard of promising benefits that others will pay.[33]

Regardless, when public employees lose their jobs, or have their hours and compensation reduced, taxpayers cushion some of the blow when necessity drives the employees to seek public assistance, as did Sanders.[34] These investments are also politically attractive to elected officials who are themselves public pension trustees, or who appoint them, and who believe in reducing the size of the public sector or undercutting public employees or their unions. Such politicians have directed public employee retirement assets to fund companies that will compete against public employees for their jobs; I discuss an example of this below in Part I.C, where I examine the outright purchase of the ailing Edison Schools Company—a company that competes with teachers—by the Florida Retirement System, half of

against pension investments in private ambulance companies that compete with members); *see also* Brian K. Miller, *CalPERS Changing PPP Language*, GLOBEST.COM (Aug. 15, 2008), http://www.globest.com/news/9_159/sanfrancisco/CalPERS-Changing-PPP-Language-173101.html (describing threatened lawsuit by members in similar circumstances).

32 *See Privatization Myths Debunked*, PUB. INT. (2013), http://www.inthepublicinterest.org/node/457 (stating that private companies often perform lower quality service than public contractors and that many private employees earn less than the federal poverty level); *see also* Hylton, *supra* note 24, at 433–34 (discussing generous benefits provided to public sector employees); David Yarden, *Prisons, Profits, and the Private Sector Solution*, 21 AM. J. CRIM. L. 325, 327 (1994) (book review) (discussing lower operating costs and wage costs for tasks performed by private sector actors); Jeffrey H. Keefe, *Are Wisconsin Public Employees Overcompensated?* 2–3 (EPI Briefing Paper No. 290, Feb. 10, 2011), *available at* http://epi.3cdn.net/9e237c56096a8e4904_rkm6b9hn1.pdf (arguing that because the private sector cannot mirror public sector jobs, fundamental personal characteristics and labor market skills are the appropriate criteria to measure an employee's worth rather than a public/private job comparison); Randy Ludlow, *Vendor Fined $142,100 for Prison-Meal Problems*, COLUMBUS DISPATCH (Apr. 19, 2014, 4:53 AM), *available at* http://www.dispatch.com/content/stories/local/2014/04/18/prison_meals.html (noting that Aramark was fined by the State of Ohio for "failing to hire enough workers to prepare and serve meals").

33 *See* Hylton, *supra* note 24, at 479 (comparing the responsiveness to changing economic conditions of the private sector to that of the public sector).

34 *Supra* note 19–23 and accompanying text.

whose assets are comprised of teacher retirement funds. Such investments fulfill these elected officials' ideological commitments to reducing the size of the public sector and undermining public employees and/or their unions. The rise of this new class of politician/trustees who are actively interested in undermining public pension funds and their beneficiaries poses a new challenge for the legal architecture that is designed to protect those beneficiaries. It requires rethinking the recent evolution of the relevant legal protections and whether they cohere with their original purpose, which was to prioritize the economic interests of fund participants and beneficiaries in fund investments.

This problem is the focus of this Article. Whether outsourcing public sector jobs to the private sector is socially desirable, whether it would raise or lower net social welfare, is not the subject here. The primary question addressed here is whether the legal concept of fiduciary duty requires public employees to invest in, and effectively subsidize, their own demise. One can take the view that outsourcing jobs to the private sector is socially beneficial while also concluding that investment of public employee retirement savings in these businesses without considering the impact on participant employment is inconsistent with fiduciary duty (in particular the duty of loyalty), that it depresses the cost of capital for these private sector businesses, and that it directly harms the economic interests of the plan participants and beneficiaries, undermining the purpose of a trustee fiduciary in the first place.

This Article critiques the fund-first view of fiduciary duty and advocates instead for a "member-first" view in the investment context. I argue that, in connection with fund investments, public pension trustees' fiduciary duties run to the participants and beneficiaries themselves, and not to the fund alone.[35] I argue that this distinction

[35] In this Article, I advocate a member-first view based on fund members' economic interests in plan investments. In the English cases, *Cowan v. Scargill*, [1985] Ch. 270, 287, and *Harries v. Church Comm'rs for Eng.*, [1992] 1 W.L.R. 1241, 1246–47 (Ch.), the English Chancery Court held that a trustee must consider the beneficiaries' financial interests and the purpose of the trust. In *Cowan*, the court found that the defendant trustees breached their fiduciary duties in making an investment to advance the interests of the union, rather than the fund participants and beneficiaries themselves. Cowan, [1985] Ch. at 294. There is a tradition that goes beyond looking to member economic interests in fund investments to encompass member dignitary interests. *See infra* notes 297–98 and accompanying text (discussing boycott strategies based on the idea that investment in objectionable sectors causes a dignitary harm to pension fund members); *see also* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 280–81 (1999) (arguing for an approach to corporate decision making taking into account parties affected besides the shareholders in order to increase productivity); Yoon-Ho Alex Lee, *The Efficiency Criterion for Securities Regulation: Investor Welfare or Total Surplus?*, 56 ARIZ.

makes a real difference, and that a member-first view comes closer to the original purpose and meaning of the duty of loyalty. The practical significance of adopting a member-first instead of a fund-first view of fiduciary duty is not that investments like those described above would be barred outright, but that the impact of the investment on fund participant jobs would become part of the primary investment analysis. Once that occurs, investments that appear to be the most attractive based on their benefits to the fund alone may turn out not to be in the economic interests of fund members. This could affect both the actual investment practices of public pension funds and the informational environment in which they operate. I offer three primary arguments in favor of this member-first view: a textualist argument, an agency costs argument, and a practical argument suggesting how a member-first view could be deployed and why it could be expected to have an impact on investment behavior and on saving jobs.

The Article proceeds as follows: In Part I, I offer a textual analysis of the duty of loyalty and the exclusive purpose rule under both trust law and ERISA. I argue that, contrary to the interpretation offered by the U.S. Department of Labor (DOL) and some courts, the plain text of the exclusive purpose rule does not command a fund-first view of fiduciary duty, and that it can (and should) accommodate a member-first view. I also demonstrate that there is a line of cases holding that the fiduciary duties of trustees run directly to the fund's participants and beneficiaries, and not just to the fund alone, that at least one line of cases addressing below-market rate loans made by plans to plan members implicitly supports this member-first view in the investment context (as opposed to the benefits context), and that one state case approves trustee consideration of the jobs impact of trustee decision-making.[36] These cases, at a minimum, complicate our understanding of the duty of loyalty and the exclusive purpose rule, opening the door to a member-first view and undermining the claim by DOL and others that the "plain text" means "fund-first." I further argue that the member-first view in connection with plan investments is a better fit for the duty of loyalty than the fund-first view because the traditional focus of the duty of loyalty has been to force trustees to prioritize the interests of plan participants and beneficiaries over the interests of either the trustees themselves or of third parties, not to

L. REV. (forthcoming 2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2406032 (discussing the benefits of SEC regulations taking into account a society wide cost-benefit analysis, rather than only investor welfare).

[36] *See* Brock v. Walton, 794 F.2d 586, 588 (11th Cir. 1986) (holding that trustees did not violate their fiduciary duties by making below-market-rate loans to plan participants).

delineate a hierarchy between different economic interests of members. I also critique the narrow way in which DOL's interpretation permits "extraneous" considerations like employment only when selecting between investments of "equal value," a limitation which in practice eliminates consideration of this most vital economic interest of fund members.[37] I demonstrate that the member-first view is still a substantial constraint on trustee discretion, not only because it forces trustees to prioritize the economic interests of plan members, but because trustees remain bound by the duties of impartiality, prudence, and diversification. I conclude my textualist analysis by arguing that participant jobs ought to be taken into account even under a fund-first view.

In Part II, I step away from textualist arguments to assess policy reasons why a member-first view is appropriate for public pension funds. I compare the agency costs of trusts, private pension funds, and public pension funds. I argue that application of trust law and ERISA in the public pension context ought to be sensitive to the differing sets of costs these bodies of law address. In particular, I argue that a member-first view of the duty of loyalty does not raise the same agency cost concerns in the public pension context that more broadly interpreted duties might in the trust or even in the private fund contexts.[38] That is because three aspects of public pension funds distinguish them from typical trusts and certain private ERISA funds: (1) unlike the corporate sponsors of single-employer private pension funds, the state and municipal sponsors of public pension funds are not subject to the market for corporate control and are not merged into or acquired by other entities; consequently, it is not necessary for the legal architecture to guard against the particularly acute agency costs that manifest in the mergers and acquisitions context[39] (such as

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[37] Some public pensions have adopted the "equal value" rule. *See, e.g.*, Letter of Advice to Ted Wheeler, State Treasurer, No. OP-2010-3 (Or. Attorney Gen. Aug. 5, 2010), *available at* 2010 WL 3200169, at *9 (explaining Oregon policy of looking to ERISA for equal value investments); 93 Md. Op. Atty. Gen. 168 (2008), *available at* 2008 WL 5501279, at *9 n.17 (comparing the similarity of Maryland's standards to ERISA's "truly equal" requirement).

[38] *See* Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. Chi. L. Rev. 1105, 1116 (1988) ("The stricter fiduciary rules of trust law mimic the contractual terms that the settlors and trustees would have agreed upon if the costs of negotiating and enforcing such contracts were zero."); Lee-ford Tritt, *The Limitations of an Economic Agency Cost Theory of Trust Law*, 32 Cardozo L. Rev. 2579, 2592–93 (agency costs are "the costs that stem from an assumed misalignment of the interests of principal and agent," such as the assumption that agents act in their own interest before the principal's).

[39] *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110, 112 (1965) (discussing the market for corporate control and the value associated with certain types of mergers). The market for corporate control has often been

the threat that corporate management will exploit the employee pension to fend off a hostile offer); (2) in contrast to private trusts, public pension funds operate in public where they can be monitored more easily (though they perhaps are not subject to as much disclosure as they should be ideally);[40] and (3) public pension fund participants and beneficiaries often elect representative peers to serve on fund boards of trustees, reducing the types of monitoring concerns ordinarily faced in a private trust.[41] For these reasons, some of the ordinary agency cost concerns one might find in a private trust or even a private pension plan may not exist in the public pension context or may exist in different form. Therefore, the shift from a fund-first to a member-first view of the duty of loyalty raises fewer agency cost concerns in the public pension context than it might elsewhere.[42]

Finally, in Part III, I discuss how a member-first view of fiduciary duty should be implemented and assess the practical implications of such a shift. I argue that the member-first view will alter the information environment, requiring disclosure and assessment of the jobs impact of fund investments. This new information environment may itself affect investor and investee behavior. I then consider how public pension funds ought to respond to this information, contemplating primarily the case in which a fund is invested, or plans to invest, in a project whose negative jobs impact outweighs its superior returns. I

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thought to lower agency costs, although that view has been challenged. Conversely, the absence of such a market for public pension fund control might raise the agency costs of public pension trustees. Plans sponsored by multiple employers are subject to additional protections, mainly in that employers who withdraw from supporting the plan are subject to withdrawal liability equal to their share of unfunded vested benefits. *See* 29 U.S.C. § 1381 (2012) (listing the conditions for withdrawal liability); Chi. Truck Drivers v. El Paso CGP Co., 525 F.3d 591, 594 (7th Cir. 2008) (commenting that liquidated damages could be imposed under withdrawal liability).

40 *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 822 (1993) (describing the public nature of public pension fund operations).

41 *See* David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 195–98 (2005) (discussing the reduced agency costs when pension beneficiaries elect plan members to serve on the board); Romano, *supra* note 40, at 821 (characterizing the correlation between improved pension fund performance and elected beneficiary board members as consistent with literature indicating the correlation between corporate performance and management owned equity). In terms of participant or beneficiary representation on fund boards, Taft-Hartley plans are more similar to public pension plans than are single employer plans in that they have boards of trustees composed of equal representation of labor and management. 29 U.S.C. § 186(c)(5)(B) (2012).

42 For an interesting parallel discussion weighing the costs and benefits of moving from a constrained to an unconstrained prudent man rule, foreshadowing the shift from the prudent person to the prudent investor rule, see Jeffrey N. Gordon, *The Puzzling Persistence of the Constrained Prudent Man Rule*, 62 N.Y.U. L. REV. 52, 88–94 (1987).

analyze pension choices in this situation using a familiar framework of investor choice: exit, voice, and proactive jobs creation, arguing that these tools can be brought to bear to protect jobs. In particular, I argue that under a member-first view, public pension funds could consider the potential risk to their employees of investing in companies that privatize public sector jobs—even if the investee is not actively bidding against the fund's own members—as long as the fund credibly believes that the investment poses a future threat to its members. Thus, a powerhouse fund like the California Public Employees' Retirement System (CalPERS) could exit or exercise voice with an investee that competes with workers' jobs in New York, not in solidarity with those workers, but because the same company would likely challenge CalPERS's own members' jobs in California. This would substantially increase the pool of capital that could exit or exercise voice over privatizing investments, and enhance the effectiveness of my proposed reform. I also examine the handful of funds that have attempted to implement policies that deal with the privatization issue.

I
The Legal Landscape of Fiduciary Duties for Public Pension Trustees: Functioning in ERISA's Shadow

An odd feature of the legal landscape for public pension fiduciary duties is that any analysis usually begins by reference to an inapplicable federal statute, ERISA. ERISA established a comprehensive legal regime governing employee benefit retirement and welfare plans.[43] ERISA covers several types of plans, including privately funded "employee welfare benefit plans" and "employee pension benefit plans."[44] The DOL is tasked with implementing the statute and periodically issues advisory opinions offering its statutory interpreta-

[43] *See* 29 U.S.C. § 1144(a) (2012) (ERISA preempts state laws governing employee benefit plans not excepted elsewhere); Jay Youngdahl, *The Time Has Come for a Sustainable Theory of Fiduciary Duty in Investment*, 29 Hofstra Lab. & Emp. L.J. 115, 120 (2011) (noting that Congress developed ERISA to create a unified body of law governing employee benefit plans).

[44] *See* 29 U.S.C. § 1002 (2012) (defining employee welfare benefit plans as programs funding benefits such as disability or medical care and employee pension benefit plans as those that provide retirement income to employees or allow for employees to contribute income to a retirement plan); *see also* 29 U.S.C. § 1003 (2012) (excluding federal, state, or local government employee benefit plans, church pension plans, plans prepared to comply with workmen's compensation, unemployment or disability insurance laws, plans maintained outside of the United States, or unfunded excess benefit plans); Roger C. Siske et al., *What's New in Compensation Matters: A Summary of Current Case and Other Developments*, SD56 ALI-ABA 1, 150 (1999) (discussing specific types of benefit plans subject to ERISA).

tions.[45] The Internal Revenue Service and the Pension Benefit Guaranty Corporation also play a role in shaping ERISA issues such as funding and benefit accrual and termination insurance, and sections of the tax code also copy ERISA.[46] DOL also investigates criminal and civil compliance with ERISA and compliance with the Labor Management Relations Act, also known as the Taft-Hartley Act, which governs unfair labor practices by employers or unions.[47] ERISA does not apply to public pension funds, and as noted in the Introduction, there are many sharp distinctions between ERISA and state pension codes.[48] But there are a number of reasons why ERISA plays a large role in the interpretation of state pension fiduciary duties, including the traditional duty of loyalty embodied in the exclusive purpose rule.[49] First, many states share, or have even copied, ERISA's fiduciary duties to govern their own pension funds.[50] This does not obli-

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45 *See* 29 U.S.C. ch. 18, subch. II (2012) (codifying the administration of ERISA).

46 *See* Raymond B. Yates, M.D., P.C. Profit Sharing Plan v. Hendon, 541 U.S. 1, 8–12 (2004) (discussing the interplay of ERISA, the PBGC, and the IRC as products of the same statutory purpose).

47 *See* 29 U.S.C. § 1134 (2012) (delineating the investigatory powers of DOL with respect to ERISA); *see also* 29 U.S.C. § 401 (2012) (describing the purpose of the Labor Management Relations Act); 29 U.S.C. § 521 (2012) (describing the investigatory powers of DOL with respect to the Labor Management Relations Act).

48 *See* 29 U.S.C. § 1003(b)(1) (exempting governmental plans from ERISA); Barnes v. Barnes, No. 99-CO-20, 2000 WL 817082, at *2 (Ohio Ct. App. June 22, 2000) (holding that Ohio public pension law does not allow the Qualified Domestic Relations Order exemption that ERISA permits). For example, under ERISA, one may be both a fiduciary and a settlor, which is expressly prohibited under trust law. 29 U.S.C. § 1108(c)(3) (2012).

49 *See* EMP. BENEFITS RESEARCH INST., FUNDAMENTALS OF EMPLOYEE BENEFIT PROGRAMS, PART FIVE: PUBLIC SECTOR 20 (2005), *available at* http://www.ebri.org/pdf/publications/books/fundamentals/Fnd05.Prt05.Chp41.pdf ("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.").

50 *See, e.g.*, Bd. of Trs. of Barrington Police Pension Fund v. Dep't of Ins., 570 N.E.2d 622, 626 (Ill. App. Ct. 1991) (noting that the Illinois Pension Code is analogous to ERISA); *see also* CAL. CONST. art. XVI, § 17(a)–(d) (mirroring ERISA's exclusive purpose and prudent man rules and the duty of diversification in California); FLA. STAT. § 215.47(10) (2011) ("The board shall discharge its duties with respect to a plan solely in the interest of its participants and beneficiaries. The 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)."); LA. REV. STAT. ANN. § 11:264.4 (2009) (requiring Louisiana public retirement system trustees to follow the exclusive purpose rule); *id.* § 11:263(A)–(B) (requiring Louisiana public retirement system trustees to follow the prudent man rule); N.Y. EDUC. LAW § 502(3) (McKinney 2011) (requiring the New York state teachers' retirement system to follow the exclusive purpose rule as stated in ERISA); 71 PA. CONS. STAT. § 5931(a), (e) (2014) (requiring Pennsylvania public pension trustees to comply with the exclusive purpose and prudent man rules); TEX. GOV'T CODE ANN. § 825.101 (West 2014) (mirroring ERISA's exclusive purpose rule in Texas); Honda *ex rel.* Kamakana v. Bd. of Trs. of Emps. Ret. Sys. of Haw., 120 P.3d 237 (Haw. 2005) (applying ERISA analysis for a public pension's board of trustees' fiduciary

gate the states to defer to DOL or federal courts in construing their own state fiduciary duties, much in the way that states may copy the Federal Rules of Civil Procedure or share rules similar to it, but deviate from federal court interpretations of those rules when applying them as state rules in state court.[51] Still, the shared language governing public pension funds in states whose fiduciary duties mirror ERISA's makes DOL or federal court interpretations persuasive, if not binding, and some state courts look to ERISA and federal cases construing fiduciary duties when there is a dearth of state case law on the subject.[52] Similarly, pension attorneys regularly cite ERISA for pension best practices, and advise their clients to follow such practices, both in states that have copied ERISA and in those that have not.[53] Thus, for public pension fund fiduciary duties, ERISA operates as a type of shadow law, governing the funds' conduct even though it is both inapplicable and unenforceable against them.[54]

Therefore, I will begin my analysis with ERISA, inapplicable but influential as it is. As discussed below, an ERISA interpretive bulletin issued by DOL unduly restricts, if not eliminates, the proper consideration of the economic interests of fund participants and beneficiaries in their jobs. Though I will argue that this analysis could apply to the types of plans that are governed by ERISA, there are substantial differences between such plans and public pension plans. DOL's interpretation of the duty of loyalty is a particularly bad fit for public pension plans.[55]

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duties); Wayne Cnty. Emps. Ret. Sys. v. Wayne Cnty., 836 N.W.2d 279, 301 (Mich. Ct. App. 2013) (using an ERISA analysis to examine public pension fiduciary duties, while noting ERISA is not binding); Bd. of Trs. of N.H. Judicial Ret. Plan v. Sec'y of State, 7 A.3d 1166 (N.H. 2010) (citing ERISA cases in analyzing public pension fiduciary duties due to their common source in common law of trusts); N.Y. Comp. Codes R. & Regs. tit. 11, § 136-2.3(a) (2014) (mirroring ERISA's prudent man rule in New York).

51 *See* 29 U.S.C. § 1003(b)(1) (exempting governmental plans from ERISA); *see also* Bacigalupo v. Kohlhepp, 240 S.W.3d 155, 156 (Ky. Ct. App. 2007) (noting that the Federal Rules of Civil Procedure are informative, but not binding on the state's rules of civil procedure).

52 *See, e.g.*, *Barrington*, 570 N.E.2d at 626 ("[G]iven the lack of Illinois case law construing the relevant portions of the Pension Code, we look for guidance to analogous provisions of . . . ERISA, and the federal case law construing ERISA.").

53 *See, e.g.*, *An Impulse to Help*, Pensions & Invs. (Dec. 24, 2012), http://www.pionline.com/article/20121224/PRINT/312249998/an-impulse-to-help (comparing New York Teachers' Retirement System to ERISA standards).

54 *See Barrington*, 570 N.E.2d at 626 (noting the inapplicability of ERISA).

55 There are two basic types of pension plans: defined benefit plans and defined contribution plans. The existence of defined benefit plans has declined sharply in the private sector, but remains the dominant form in the public sector. While the analysis below may have implications for defined contribution plans, which have become more prevalent in the public sector since the recent financial crisis, my default assumption will be that, in discussing public pension plans, I am referring primarily to defined benefit plans.

A. ERISA's Duty of Loyalty and the Exclusive Purpose Rule

ERISA codifies the traditional fiduciary duties of trust law, including the duties of loyalty and prudence.[56] Under the traditional duty of loyalty, trustees are required "to discharge their responsibilities with exclusive concern for the welfare of their beneficiaries."[57] This duty is embodied in Sections 403 and 404 of ERISA.[58] Section 403 states: "[A]ssets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries . . . ."[59] Section 404 of ERISA sets forth the "exclusive purpose" rule, which is the touchstone for analysis of fiduciary questions like the one presented here.[60] It states that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of the plan."[61]

Historically, the duty of loyalty required that a trustee "administer the trust solely in the interest of the beneficiary."[62] The First, Second, and Third Restatements of Trust make it clear that the primary purpose of the duty of loyalty is to prevent conflicts of interest between trustees and beneficiaries.[63] It was not created to prioritize the interests of participants and beneficiaries in maximizing returns to the fund over other participant and beneficiary interests in the fund.[64] According to the Restatements, trustees should not profit at the expense of beneficiaries,[65] sell trust properties to themselves, even if the sale is in good faith and the trustees pay fair consideration,[66] sell

56 *See* 29 U.S.C. § 1103(c)(1) (2012) (imposing duty of loyalty); *see also* 29 U.S.C. § 1104(a)(1)(B) (2012) (imposing duty of prudence).

57 *See* Edward A. Zelinsky, *Interpretive Bulletin 08-1 and Economically Targeted Investing: A Missed Opportunity*, 82 S. CAL. L. REV. POSTSCRIPT 11, 12 (2009) (citing RESTATEMENT (THIRD) OF TRUSTS § 78 (2007)) (discussing a trustee's duty of loyalty).

58 *See* 29 U.S.C. § 1103(c)(1) (2012) (codifying ERISA § 403); *see also id.* § 1104(a)(1) (codifying ERISA § 404).

59 *Id.* § 1103(c)(1) (codifying ERISA § 403(c)(1)).

60 *See id.* § 1104(a)(1)(A) (exclusive purpose rule).

61 *Id.*

62 RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); RESTATEMENT (FIRST) OF TRUSTS § 170 (1935).

63 RESTATEMENT (FIRST) OF TRUSTS § 170 cmt.; *accord* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt. (2007); RESTATEMENT (SECOND) OF TRUSTS § 170 cmt.

64 RESTATEMENT (FIRST) OF TRUSTS § 170 cmt.; *accord* RESTATEMENT (THIRD) OF TRUSTS § 78 cmt.; RESTATEMENT (SECOND) OF TRUSTS § 170 cmt.

65 RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. a; RESTATEMENT (FIRST) OF TRUSTS § 170 cmt. a.

66 RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. b; RESTATEMENT (FIRST) OF TRUSTS § 170 cmt. b.

trust property to a firm in which they have an interest,[67] etc. In short, the duty of loyalty has always been aimed at thwarting the frequent and enormous temptation for trustees to exercise their powers in their own interests, rather than in those of the trust's beneficiaries.[68] This preoccupation is so central to the fiduciary duty of loyalty that even transactions that can be shown to have caused no harm to beneficiaries are barred, because of the slippery slope they might create for fiduciaries.[69]

In part, the duty of loyalty was imported from trust law into ERISA in response to widespread corruption and racketeering inside labor unions like the Teamsters, which included the looting of union-controlled employee benefit funds.[70] The duty of loyalty was developed to require trustees to prioritize the interests of beneficiaries.[71] Crucially, the duty of loyalty also bars trustees from elevating the interests of third parties above beneficiaries.[72] As I will argue below, the ascendant view of fiduciary duty arguably violates this principle by elevating the interests of outside investment managers above fund participants and beneficiaries. Most investment managers are compensated based on the performance of their investment portfolios relative to industry benchmarks (in addition to the total assets under management).[73] Consequently, they are incentivized to value fund performance above all else. This may be the right compensation scheme for such managers, but it is not necessarily in the best eco-

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67 RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. c; RESTATEMENT (FIRST) OF TRUSTS § 170 cmt. c.

68 *See* TAMAR FRANKEL, FIDUCIARY LAW 108 (2011) ("[F]iduciaries [must] act for the sole benefit of the entrustors. . . . [P]reventive rules act to dampen the fiduciaries' temptations to misappropriate entrusted property or power, or to justify benefitting themselves, and establish a continuous reminder that entrusted property or power do not belong to the fiduciaries.").

69 *See id.* at 108–09 ("[F]iduciaries are prohibited from buying entrusted property for their own account . . . even if the purchase saves the entrustor a broker's commission. . . . Presumably, this transaction can be repeated to create a bad habit of considering one's own interests as well as the entrustors' interest in relationship to the entrusted property.").

70 *See* Fischel & Langbein, *supra* note 38, at 1110 (describing the events leading to the creation of ERISA).

71 *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE L.J. 929, 932 (2005) ("The underlying purpose of the duty of loyalty . . . is to advance the best interest of the beneficiaries.").

72 *See, e.g.*, Hastings v. PNC Bank, NA, 54 A.3d 714, 725–26 (Md. 2012) (citing Bd. of Trs. v. Mayor of Baltimore, 562 A.2d 720, 738 (Md. 1989) ("[Under the duty of loyalty, a] trustee also must refrain from using the advantages of the fiduciary relationship for the benefit of a non-beneficiary third party.")).

73 *See* Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 285–86 (2007) (noting that many fund managers are paid according to benchmarks as an incentive to earn higher returns).

nomic interests of fund members, at least when it comes to privatizing investments.

The DOL has issued two Interpretive Bulletins relating to the exclusive purpose rule that are relevant to this Article, the first under President Bill Clinton and the second under President George W. Bush. In June 1994, the DOL issued Interpretive Bulletin 94-1 (the 1994 Bulletin), offering its view of the exclusive benefit rule as applied to economically targeted investments (ETIs). ETIs are generally defined as "investments selected for the economic benefits they create apart from their investment return to the employee benefit plan."[74] According to the 1994 Bulletin, employee benefit plans may invest in ETIs if the expected rates of return and risk characteristics of the ETIs are "comparable" to those of other available alternative investments.[75] One observer stated that:

> [The 1994 Bulletin] did reinforce a departure from an approach suggested in earlier [DOL] letters to the effect that investment opportunities must be considered initially solely for their investment merit, and only then for their collateral benefits. The [1994] Bulletin implicitly allowed economic and collateral benefits to be considered side-by-side, although the economic considerations must take precedence.[76]

In October 2008, towards the end of President Bush's second term in office, DOL issued Interpretive Bulletin 08-1 (the 2008 Bulletin), which emphasized that fiduciary consideration of "non-economic" factors should be rare.[77] One could argue that the 2008 Bulletin was not a clarification of the 1994 Bulletin but in fact a narrowing of the fiduciary rule. However, the 2008 Bulletin itself holds

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[74] 29 C.F.R. § 2509.94-1 (2002); *see also* Michael B. Richman, *DOL Clarifies Position on Economically Targeted Investments*, 2 J. TAX'N EMP. BENEFITS 233, 233 (1995) ("ETIs are investments selected not only to generate an economic benefit for the investing plan, but also to create collateral benefits to the general economy, such as developing infrastructure or building low-income housing."); Patrick S. Cross, Note, *Economically Targeted Investments—Can Public Pension Plans Do Good and Do Well?*, 68 IND. L.J. 931, 934–35 (1993) (defining ETIs).

[75] Richman, *supra* note 74, at 233.

[76] *Id.* at 235; *see also* Jayne Elizabeth Zanglein, *High Performance Investing: Harnessing the Power of Pension Funds to Promote Economic Growth and Workplace Integrity*, 11 LAB. LAW. 59, 59 (1995) (arguing that, in the 1994 Bulletin, the DOL took a "strong position encouraging economically targeted investments (ETIs) and shareholder activism by pension funds").

[77] Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734 (Oct. 17, 2008) (to be codified at 29 C.F.R. pt. 2509) ("[The bulletin] clarifies, through explanation and examples, that fiduciary consideration of non-economic factors should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards.").

that its guidance "modifies and supersedes the guidance set forth in" the 1994 Bulletin.[78]

Quoting the exclusive purpose rule, the 2008 Bulletin states that "ERISA . . . establishes a clear rule that in the course of discharging their duties, fiduciaries may never subordinate the economic interests *of the plan* to unrelated objectives, and may not select investments on the basis of any factor outside the economic interest *of the plan* except in very limited circumstances . . . ."[79] The 2008 Bulletin further states that fiduciaries should examine, "the level of diversification, degree of liquidity and the potential risk/return in comparison with available alternative investments."[80]

There are three fundamental problems with these views of ERISA. Most generally, to the extent that the 2008 Bulletin correctly interprets the exclusive purpose rule, saying that fiduciaries must ignore participant and beneficiary economic interests—even interests directly related to plan investments—and focus instead on the plan alone, this rule is inconsistent with aspects of trust law, agency law, and even corporate law that would permit such considerations. More specifically, it illustrates a point I develop in Part II: Aspects of trust law that have been incorporated into ERISA are a bad fit for employee benefit plans, particularly public pension plans, because the agency costs of trusts differ markedly from those of public pension plans. Because these arguments take us beyond ERISA and trust law, I reserve them for discussion in a subsequent Part. Secondly, the plain text of the exclusive purpose rule does not necessarily exclude economic interests of plan participants and beneficiaries outside the economic interests of the plan; as I will demonstrate, it can be, ought to be, and has been read more broadly. Indeed, there are multiple cases suggesting that the duty of loyalty owed by fund trustees runs not to the fund but directly to the funds' participants and beneficiaries themselves, supporting the member-first view. Thirdly, even if one embraces the fund-first view, the 2008 Bulletin omits a factor in the investment analysis that is crucial to the financial health of the plan: participant and employer contributions. In addition to diversification, liquidity, and risk/return, fiduciaries should consider, when relevant, contributions made to the plan by the employer and by current and future participants, and the impact these contributions would have on the plan's bottom line.[81] Because recent reforms to public pension

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[78] 29 C.F.R. § 2509.08-1 (2013).

[79] *Id*. (emphasis added).

[80] *Id*.

[81] *See, e.g.*, Steven Yaccino & Michael Cooper, *Cries of Betrayal as Detroit Plans to Cut Pensions*, N.Y. Times, July 22, 2013, at A1 ("When [Detroit] shrank its work force [over

funds nationwide have almost universally resulted in increased contributions from fund participants, the employee-contribution aspect of the analysis will only become more important over time.[82] Consideration of participant and employer contributions, and future liabilities, necessarily requires fund fiduciaries to consider the impact of the fund's investments on participant employment, at least in this context. Unfortunately, fund fiduciaries fail to consider these factors.[83]

B. The Exclusive Purpose Rule Should Not Unduly Limit Consideration of the Broader Economic Interests of Plan Participants and Beneficiaries in Plan Investments

According to the 2008 Bulletin, "ERISA's plain text thus establishes a clear rule . . . ."[84] First, it is important to emphasize what "plain text" the 2008 Bulletin cites: Section 403's noninurement rule, and, more relevantly, Section 404's exclusive purpose rule. I disagree that the plain text of the exclusive purpose rule establishes such a narrow reading, and quote it again here for ease of comparison: "[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of the plan."[85] It is true that the existence of the fiduciary's duties arises "with respect to a plan."[86] A trustee is not a roving agent-at-large for plan participants and beneficiaries, responsible for their economic welfare in its entirety, making sure that they purchase a home for a fair price or

the prior six decades], it left fewer current workers to contribute to pension funds that still had to pay benefits that were earned by large numbers of older retirees who had served Detroit when it was a bigger city.").

82 *See In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013) (amended plan for the adjustment of city debts in Chapter 9 allowed to reduce pension obligations); *see also, e.g.*, Hazel Bradford, *Pace of Pension Reform Ebbs After 49 States Change Laws*, PENSIONS & INVESTMENTS, Apr. 14, 2014, at 4, 4 ("The financial crisis and its aftermath sparked some kind of pension reform in every state except Idaho."); Victoria M. Cosentino, *The Illinois State Pension Crisis: Secure Retirement for Public Servants at Risk*, 19 DCBA BRIEF 18 (2006) (noting that Illinois required increased state contributions to the state pension fund); ALICIA H. MUNNELL ET AL., CTR. FOR RET. RESEARCH, COLA CUTS IN STATE/LOCAL PENSIONS 4 (2014) (finding that of the nine states where court decisions on the reduction in cost-of-living adjustments (COLAs) for public pensions have been handed down, eight of the states' reductions have been upheld).

83 *See* Braun & Selway, *supra* note 1 (discussing public pension fund investments in private-equity-owned companies, like Aramark, whose activities lead to a loss of public jobs).

84 29 C.F.R. § 2509.08-1 (2013).

85 29 U.S.C. § 1104(a) (2006).

86 *Id.*

balance their checkbooks.[87] Because the fiduciary's duties arise "with respect to a plan" there must be a connection between these duties and decisions related to the plan itself. But this is not the same as suggesting, as the 2008 Bulletin does, that the fiduciary, "may not select investments on the basis of any factor outside the economic interest of the plan . . . ."[88] What about selecting investments for the plan solely in the economic interests of its participants and beneficiaries? What about selecting investments that maximize the economic interests of the participants and beneficiaries, even if they further the economic interests of the plan less than other investments? Before entertaining these questions, I address the strongest textual argument for the 2008 Bulletin's "fund-first" view of the exclusive purpose rule.

The strongest argument favoring the view contained in the 2008 Bulletin emerges from the requirement that a fiduciary discharge her duties, "for the exclusive purpose of . . . providing benefits . . . ."[89] The legal definition of "benefits" is debatable.[90] Some observers have concluded that "benefits" refers to "those cash benefits that a participant or his family would receive in accordance with the specifications of the [retirement] plan."[91] Others advocate a broader view of what constitutes benefits, with references throughout the legislative history of ERISA to "benefits" of any type, which includes, for example, health benefits, and which is arguably broad enough to include almost anything that works to the advantage of fund participants and beneficiaries.[92] Such a broad reading is plausible and would be more conducive to my argument, but it is not necessary. I will begin my

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[87] This point is beyond doubt, as the final clause empowers trustees to defray reasonable expenses of the plan, and not reasonable expenses of participants and beneficiaries personally insofar as those expenses are unconnected to the plan itself. 29 U.S.C. § 1104(a) (2006).

[88] 29 C.F.R. § 2509.08-1 (2013).

[89] *Id.*

[90] *See* Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 504 (1981) (allowing worker's compensation benefits to count toward the benefit received by the pensioner even though it was not directly provided by the pension fund and noting that ERISA leaves open the question of what constitutes the content of the benefit).

[91] James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340, 1370 (1980).

[92] *See, e.g.*, *id.* (arguing that ERISA's legislative history could be read to define "benefits" as benefits related to retirement, but not other socially desirable benefits); Ronald B. Ravikoff & Myron P. Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CALIF. L. REV. 518, 531–32 (1980) (arguing that ERISA's legislative history indicates that "benefits" could mean job security and improved working conditions); S. REP. NO. 93-127, at 30 (1973), *reprinted in* 1 SUBCOMM. ON LABOR OF THE SENATE COMM. ON LABOR AND PUBLIC WELFARE, LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 587, 616 ("[A fiduciary must] act consistently with the principles of administering the trust for the exclusive purposes . . . enumerated . . . ."). *But see* John H. Langbein & Richard A. Posner, *Social Investing and*

analysis by utilizing the narrowest definition of "benefits"—that it means "retirement benefits"—for purposes of assessing the exclusive purpose rule.

A proponent of the 2008 Bulletin's approach to fiduciary duty might argue that because the fiduciary must invest for the purpose of providing "those cash benefits that a participant or her family would receive," the fiduciary should consider only the economic interest of the plan, since it is the plan that pays those benefits.[93] To consider economic interests like employment would presumably go beyond the "exclusive purpose . . . of providing benefits" and would therefore exceed the trustee's authority under the rule.[94]

There are two straightforward responses to this argument. First, the benefits provided to plan participants and beneficiaries are inextricably linked to the participants' employment by the state, county, or municipal entity that is the plan sponsor. For virtually all public pension plans, the size of the retirement benefit is a direct function of the plan member's salary and length of service.[95] Loss of employment means reduced retirement benefits.[96] Similarly, reductions in the number of hours worked, or demotions from full-time to part-time

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the Law of Trusts, 79 MICH. L. REV. 72, 103 (1980) (critiquing the Ravikoff & Curzan reading of "benefits" as misleading).

93 Hutchinson, *supra* note 91, at 1370.

94 29 C.F.R. § 2509.08-1. Langbein and Posner treat consideration of the jobs impact of fund investments as a form of socially responsible investing, albeit with a "wrinkle": Such investing, "*may* provide a pecuniary offset to the financial cost of departing from conventional investment strategy." Langbein & Posner, *supra* note 92, at 76. They define "social investing" to mean "excluding the securities of certain otherwise attractive companies from an investor's portfolio because the companies are adjudged to be socially irresponsible . . . ." *Id.* at 73. As I make clear throughout this paper, I base my argument not on the idea that companies that privatize public employee jobs should be excluded because they are socially irresponsible, but that investments in such companies by public pension funds may not be in the economic interests of fund participants and beneficiaries, and that it is this economic interest the trustees should consider in making investments.

95 Telephone Interview with William B. Fornia, FSA, President, Pension Trustee Advisers, Inc. (Aug. 30, 2013) (interview notes on file with the *New York University Law Review*) [hereinafter Fornia Interview]. Fornia is a well-known retirement consultant and actuary with more than thirty years of industry experience. For Fornia's professional biography, see *About Pension Trustee Advisors: William B. (Flick) Fornia*, PENSION TR. ADVISORS, http://www.pensiontrusteeadvisors.com/about.html (last visited Nov. 17, 2014). *See also* Longley v. State Emps. Ret. Comm'n, 931 A.2d 890, 905 (Conn. 2007) (showing that, under state law, the base salary used to calculate a public employee's pension is based off the employee's three highest years of state service); 60A AM. JUR. 2d *Pension and Retirement Funds* § 1142 (2014) (discussing generally the ways in which longevity of employment and salary based on merit shape public pensions).

96 *See* Bandt v. Bd. of Ret. of the San Diego Cnty. Emps. Ret. Ass'n, 136 Cal. App. 4th 140, 159 (Ct. App. 2006) ("[T]he pension of a member who loses his job will be dramatically affected by that job loss."); *see also* MASS. BENEFIT GUIDE, *supra* note 9 (calculating public pension benefits based on salary and years of service); Alan L. Gustman & Thomas L. Steinmeier, *Pension Portability and Labor Mobility: Evidence from the*

status (as in the case of Carol Sanders, discussed in the Introduction), results in lower retirement benefits payments.[97] Such losses are even more tangible to participants than investment losses incurred by the fund, because most public pension funds are defined benefit plans, entitling beneficiaries to fixed retirement payments.[98] In theory, investment losses are not passed along to beneficiaries.[99] (In practice, investment losses harm participants and beneficiaries. For example, losses from the recent financial crisis have resulted in reduced benefits, higher contribution rates, and higher medical costs for public employees.[100]) Because of the close connection between employment and retirement benefits, trustees who consider the impact of plan investments on the employment of the funds' participants and beneficiaries may be discharging their "duties with respect to a plan solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits . . . ."[101] This is only the analysis under the narrowest definition of "benefits."[102] If one were to expand the definition of benefits to include nonretirement benefits like health benefits, which are also directly linked to employment by the sponsor, the argument becomes even more straightforward.

Survey of Income and Program Participation, 50 J. PUB. ECON. 299, 300 (1993) (stating that defined benefit pensions calculate benefits from formulae using job tenure and/or wages).

97 MASS. BENEFIT GUIDE, *supra* note 9.

98 *See* Edward A. Zelinsky, *The Aftermath of the Cash Balance Controversy: Applying the Contribution-Based Test for Age Discrimination to Traditional Defined Benefit Pensions*, 29 VA. TAX REV. 1, 5 (2009) ("A defined benefit plan, as its name implies, defines benefits, i.e., promises participants outputs in the form of retirement income."); *see also* Karen Eilers Lahey & T. Leigh Anenson, *Public Pension Liability: Why Reform Is Necessary to Save the Retirement of State Employees*, 21 NOTRE DAME J.L. ETHICS & PUB. POL'Y 307, 311 (2007) (noting that most private pension plans are defined contribution plans); Travis Bayer, Note, *Defined (Yet Uncertain) Benefit Pension Plans in America*, 87 CHI.-KENT L. REV. 201, 205 (2012) (noting that most public employees have defined benefit plans).

99 *See* Zelinsky, *supra* note 98, at 5 ("The employer sponsoring a defined benefit pension guarantees these promised payments.").

100 Bradford, *supra* note 82, at 4 ("The financial crisis and its aftermath sparked some kind of pension reform in every state except Idaho . . . . [Cost cutting measures included] some combination of increasing employee contributions, raising age and tenure requirements, trimming salary calculation formulas used to set pension levels and shrinking or stopping cost-of-living increases.").

101 29 U.S.C. § 1104(a) (2006). Similarly, a California appeals court approved pension trustees' consideration of the impact of their decisions on participant jobs. "Even assuming . . . the Board's sole duty is to protect members' interests as beneficiaries, the pension of a member who loses his job will be dramatically affected by that job loss. Thus, a member's interest as an employee is clearly related to his interest as a pension beneficiary." *Bandt*, 136 Cal. App. 4th at 159.

102 Even under this narrowest of definitions, trustees should still be able to consider the economic harm of the job loss itself, and not just the economic harm of the lost or reduced benefits resulting from the job loss, even if they assess the former loss secondarily, as I discuss below regarding the meaning of the word "exclusive."

A second response to the argument that narrow construction of the term "benefits" requires trustees to prioritize return on investment for the fund stems from the meaning of the word "exclusive" in the phrase, "exclusive purpose of providing benefits." In several instances, including in the 2008 Bulletin itself, DOL has interpreted the term "exclusive" to mean "primary" rather than "sole."[103] For example, in discussing the "investments of equal value rule," the 2008 Bulletin allows selection of investments "on the basis of a factor other than the economic interest of the plan," as long as the fiduciaries are deciding between "two or more investment alternatives . . . of equal economic value to a plan."[104] I critique the "investments of equal value rule" below in Part I.C because it subordinates the economic interests of plan members to the economic interests of the plan, going as far as allowing fiduciaries to select investments that *harm* members so long as they are of equal value to the plan. Even the view contained in the 2008 Bulletin tolerates an understanding of "exclusive" to mean "primary" rather than "sole." It concedes that interests beyond the economic interests of the plan may be considered. The question then becomes not whether fiduciaries may consider the employment impact of investments, but at what stage in the investment analysis they may consider it, and how much weight it ought to be given.

Read this way, the exclusive purpose rule appears to be more accommodating of broader economic considerations like participant employment than the 2008 Bulletin allows. This reading is buttressed by the original purpose of the duty of loyalty: to prioritize the interests of fund members over the interests of trustees, stemming from the natural concern that fiduciaries will be tempted to exercise their enormous power over the fund in their own interests, rather than in those of the members. Thus, the "plain text" of the exclusive purpose rule does not clearly support a fund-first view. While there is support for a fund-first view in the case law, as I discuss below, there is competing precedent supporting a member-first reading of the duty of loyalty as well.[105]

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103 *See* 29 C.F.R. § 2509.08-1 (2013) (permitting fiduciaries to choose between investments of equal economic value to the plan).

104 *Id.*

105 In this Article, I advocate a member-first view based on member economic interests in plan investments. There is a literature arguing that fiduciaries should be able to consider interests that go beyond economic and financial interests. *E.g.*, THE ASSET MGMT. WORKING GRP. OF THE UNITED NATIONS ENV'T PROGRAMME FIN. INITIATIVE, FIDUCIARY RESPONSIBILITY: LEGAL AND PRACTICAL ASPECTS OF INTEGRATING ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT (2009), *available at* http://www.unepfi.org/fileadmin/documents/fiduciaryII.pdf. I discuss this point below in

Consider the United States Supreme Court's decision in *Varity Corp. v. Howe*.[106] In *Varity*, the Court allowed individual claimants to proceed with their claim for equitable relief under ERISA.[107] The plaintiffs sought to be transferred from their new pension plan back to their original pension plan, arguing that the defendants had deceived them into switching plans.[108] The Court rejected defendants' argument that such relief was unavailable under ERISA because of Section 409, which authorizes damages for fiduciary breaches to be paid to the plan only.[109] That the Court allowed the plaintiffs to proceed as individuals for breach of fiduciary duty makes it clear that such duties run to the individuals, and not to the plan alone.[110] In fairness, courts, including the United States Supreme Court in *Varity*, have treated fiduciary duties in the investment context somewhat differently than in other contexts, though whether this treatment is correct, and whether it is in fact driven by a debate over the remedies for fiduciary breaches and not the substance of the fiduciary duties themselves, is a separate question.[111]

Part III.A.1, in which I consider the prospects of a divestment or boycott strategy for privatizing investments.

106 *See* Varity Corp. v. Howe, 516 U.S. 489, 510 (1996) (holding that ERISA section 502(a)(3) contained an individual right of action for beneficiaries seeking "appropriate equitable relief").

107 *Id.* at 515.

108 *See id*. at 492 (determining that reinstatement into the plan was an equitable action, and thus allowed as "equitable relief").

109 *See id.* at 510 (holding that section 409 limited the rights of action to the whole plan only for actions seeking nonequitable damages).

110 *Id.* at 515.

111 *See* LaRue v. DeWolff, Boberg & Assocs., Inc., 552 U.S. 248, 255–56 (2008) (distinguishing from *Russell* by holding that an individual plaintiff may proceed under ERISA section 409 for damages to his defined contribution plan, saying that "[w]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only to persons tied to particular individual accounts, it creates the kind of harms that concerned the draftsmen of § 409"); *Varity*, 516 U.S. at 515 (analyzing the rights of action available to an injured individual for fiduciary breaches); Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 147–48 (1985) (holding that extracontractual damages were unavailable under section 409(a)).

As noted, the 2008 Bulletin espouses a fund-first view of fiduciary duty. Separate from the question of what constitutes a breach of fiduciary duty under ERISA and state pension codes is the question of what remedies are available for such breaches. Here, comparisons between ERISA and state pension codes become more problematic. For example, ERISA section 502(a)(2) allows for civil actions to be brought for relief under section 409, entitled "Liability for Breaches of Fiduciary Duty." Section 409 provides remedies for the fund alone, although individuals may bring a claim under sections 502(a)(2) and 409, and may obtain relief, at least in the defined contribution context. *See In re* Mut. Funds Inv. Litig., 529 F.3d 207, 219 (4th Cir. 2008) (holding that plaintiffs who have already cashed out of their plan and are seeking damages as benefits owed directly to themselves individually based on what the value of their plan would have been at the time of cash out without a

At least one state court has held that pension trustees may take participant jobs into account when making fiduciary decisions. In *Bandt v. Board of Retirement, San Diego County Employees Retirement System*, plaintiff fund participants sued the board of trustees of a public pension fund for agreeing to an interim fund valuation that would reduce the county employer's contribution to the fund.[112] The county had agreed to increase retirement benefits for fund participants and beneficiaries by $1.1 billion, and sought to have its fund contribution for half of that amount ($550 million) accounted for in a postcontribution interim valuation.[113] The board agreed to the interim valuation, even though it would reduce the county's contribution to the fund from what it would have been in the absence of the interim valuation (though the revised contribution would still be higher than what it would have been had the county never agreed to the increased benefits in the first place).[114] The California Court of Appeals for the Fourth District rejected the plaintiffs' contention, among others, that the board had improperly considered the county's assertion that failure to conduct the interim valuation would have forced it to lay off 1500 fund participants.[115] Even though the interim valuation would hurt the fund by reducing the employer's contribution to it, the court rejected the claim that the trustees had breached their fiduciary duties.[116] Its reasoning suggests that the trustees' conduct was justified

breach of fiduciary duty still have standing to make a claim under section 502(a)(2) on behalf of the plan).

The Supreme Court has been sharply criticized by scholars who have argued that its interpretations of ERISA have created gaps between the statute's substantive fiduciary duties and the remedies available for breach of those duties. *See, e.g.*, John H. Langbein, *What ERISA Means by "Equitable": The Supreme Court's Trail of Error in* Russell, Mertens, *and* Great-West, 103 COLUM. L. REV. 1317 (2004) (critiquing Supreme Court opinions holding that "equitable relief" in section 502(a)(3)(B) excludes damages); Colleen E. Medill, *Resolving the Judicial Paradox of "Equitable" Relief Under ERISA Section 502(a)(3)*, 39 J. MARSHALL L. REV. 827, 835–52 (2006) (offering numerous examples of how erroneous judicial interpretation of ERISA has led to cases in which there are no remedies under the statute for clear violations of the statute). I do not mean to suggest that these scholars view interpretations of section 502(a)(2) as having created a similar gap; I only underscore the difference between substantive ERISA fiduciary duties and remedies. Regardless of how one reads ERISA's remedies, they differ substantially from those found in state pension codes, in contrast to substantive fiduciary duties, which are quite similar. For example, just five states and the District of Columbia have an equivalent of section 409. COLO. REV. STAT § 24-51-207 (2014); D.C. CODE § 1-742 (2001); 40 ILL. COMP. STAT. ANN. 5 / 1-114 (2013); LA. REV. STAT. ANN. § 11:264.5 (Supp. 2009); MD. CODE ANN., STATE PERS. & PENS. § 21-206 (LexisNexis 2009); WYO. STAT. ANN. § 9-3-443 (2013).

112 136 Cal. App. 4th 140, 159 (Ct. App. 2006).

113 *Id.*

114 *Id.*

115 *Id.*

116 *Id.*

under both a member-first view and the modified fund-first view I advocate below in Part I.E. It supports a member-first view because the court concluded that the interim valuation "was in its members' interests": "[T]he pension of a member who loses his job will be dramatically affected by that job loss. Thus, a member's interest as an employee is clearly related to his interest as a pension beneficiary."[117] And it supports the modified fund-first view too: "[T]he Board was informed by the Association's actuary that job losses could also negatively impact the financial condition of the retirement fund itself."[118] The holding in *Bandt* squarely supports the position taken in this Article, and it does so while interpreting California's duty of loyalty and exclusive purpose rule, which is practically indistinguishable from ERISA Section 404.[119]

Turning specifically to the breach of substantive fiduciary duties in the investment context, I have found some evidence that the exclusive purpose rule has been read by courts—in one case rejecting positions taken by DOL in legal briefs—to embrace (in effect if not in word) the member-first view.[120] I do not wish to overstate this argument, but a couple of cases have arguably crossed that line, or at least have come tantalizingly close to doing so. The cases grapple with the fiduciary implications of fund loans made to fund participants and beneficiaries at below-market rates. Section 1108 of Title 29 of the United States Code exempts loans to plan participants or beneficiaries from ERISA's restrictions against transactions between plans and parties in interest, so long as the loans are "available to all such participants and beneficiaries on a reasonably equivalent basis, (B) are not made available to highly compensated employees . . . in an amount greater than the amount made available to other employees . . . , (D)

117 *Id.*

118 *Id.*

119 *See* CAL. CONST. art. 16, § 17(b) ("The members of the retirement board of a public pension . . . shall discharge their duties with respect to the system solely in the interest of . . . participants and their beneficiaries, [and the] board's duty to its participants and their beneficiaries shall take precedence over any other duty."). The *Bandt* court's ruling did not rely upon the clause "minimizing employer contributions thereto" because the final provision of section 17 prioritizes acting in the interests of participants and beneficiaries over the interests of the employer. 136 Cal. App. 4th at 150.

120 *See* Brock v. Walton, 794 F.2d 586, 587 (11th Cir. 1986) (permitting trustee to make below-market-rate loans to plan participants); *see also* Bd. of Trs. of the Vill. of Barrington Police Pension Fund v. Dep't of Ins., 570 N.E.2d 622, 630 (Ill. App. Ct. 1991) (holding that below-market-rate loans were not current compensation and thus did not violate the statute prohibiting compensation in addition to salary); *Bandt*, 136 Cal. App. 4th at 159 (rejecting appellants' argument that pension trustees must consider the interests of the fund only and approving the trustees' consideration of the jobs impact of completing an interim fund valuation that would reduce the employer's contribution to the fund).

bear a reasonable rate of interest, and (E) are adequately secured."[121] At least two courts have ruled that trustees did not breach their fiduciary duties in loaning plan funds to participants and beneficiaries at below-market rates. In *Brock v. Walton*, the trustees of the Operating Engineers Local 675 Pension Fund created a program to make first mortgage loans on residential property available to fund participants carrying an interest at a rate 2 1/8 percentage points below the prevailing rates in the community.[122] DOL sued, alleging, inter alia, that the trustees violated Section 404's exclusive purpose rule by failing to charge the market rate.[123] The logic of DOL's argument is identical to the view expressed in the 2008 Bulletin. To loan money to the funds' participants and beneficiaries at below-market rates is to favor the interests of the funds' participants and beneficiaries (at least the ones who take out loans) over the funds themselves. In essence, accepting a lower rate of return in this context confers economic benefits on at least some fund participants and beneficiaries. This should be consistent with the duty of loyalty and the exclusive purpose rule as long as the net economic benefit of the transaction to participants and beneficiaries is at least equal to an alternative investment with higher returns and the benefit is subject to the fiduciary considerations of impartiality, prudence, and diversification, which I discuss below in Part I.D.1–2.

In its brief to the Eleventh Circuit on appeal, DOL argued that, "[t]he trustees established and operated the discount mortgage loan to provide collateral, non-retirement benefits in the form of subsidized housing for Plan participants. The program, therefore, was not 'for the exclusive purpose . . . of providing [retirement] benefits,' as required by Section 404(a)(1)(A)."[124] The Eleventh Circuit rejected this argument and denied that the loan program violated the exclusive purpose

121 29 U.S.C. § 1108(b)(1) (2012). DOL has taken the position that nothing in this section "suggest[s] that Congress intended such loans to be exempt from the general fiduciary obligations set forth in section 404 of the statute." Reply Brief for the Appellant, Secretary of Labor at 23, Brock v. Walton, 794 F.2d 586 (11th Cir. 1986) (No. 85-5641) (on file with the *New York University Law Review*).

122 *Brock*, 794 F.2d at 587. I focus here on the circuit court's opinion. *See also* Paul J. Wessel, Comment, *Job Creation for Union Members Through Pension Fund Investment*, 35 BUFF. L. REV. 323, 351–52 (1986) (interpreting the lower court opinion in *Brock* to mean that job-creating investments within the union are not per se violations of the ERISA duty of loyalty).

123 *Brock*, 794 F.2d at 587–88.

124 Brief for the Appellant Secretary of Labor at 10, Brock v. Walton, 794 F.2d 586 (11th Cir. 1986) (No. 85-5641) (alteration in original). Note that here the DOL inserted the term "retirement" in brackets in its brief, reflecting its long-standing effort to restrict the term "benefits" to retirement benefits alone, even though the word retirement does not appear in Section 404. *Id.*

rule.[125] *Brock* highlights the thorough process employed by the fund trustees to evaluate the investment, including extensive consultation with lawyers, accountants, actuaries, and mortgage bankers, examination of loan rates charged by major commercial financial institutions in the area, the rates of nontraditional mortgage loans in the area, such as owner-financed loans, and each borrower's employment background.[126] The trustees further required that loan participants pledge their accrued pension benefits as collateral for the loan, and that borrowers whose equity was less than twenty percent obtained mortgage insurance.[127]

In finding no breach, the court stated that "[t]he trustees examined loan rates charged by major commercial financial institutions in the area and determined that if they applied those rates they would have virtually no loan activity."[128] What this means is not apparent.[129] Admittedly, this somewhat cryptic statement in *Brock* makes it difficult to definitively conclude that the action favors the interests of plan participants and beneficiaries, rather than the narrower interests of the plan. Proponents of a "fund-first" reading of this case would argue that this means that the trustees made a "fund-first" decision by concluding that the prevailing rates in the community were too high, and that no one would take out a loan from the fund if they charged such rates. Under this reading, the board concluded that loaning out money at approximately eight percent would be more profitable to the fund than loaning it out at or above ten

[125] *See Brock*, 794 F.2d at 587 (holding that the provision of such program did not cause the trustees to violate their fiduciary duties under ERISA). The Illinois Court of Appeals reached a similar conclusion under similar facts in *Board of Trustees of the Village of Barrington Police Pension Fund v. Department of Insurance*, 570 N.E.2d 622, 627 (Ill. App. Ct. 1991) (concluding that a similar participant mortgage program does not violate the exclusive purpose rule, absent a finding of imprudence). In another noteworthy case, *Foltz v. U.S. News & World Report, Inc.*, 865 F.2d 364, 373–74 (D.C. Cir. 1989), the D.C. Circuit flatly stated that, "Section 404 creates no exclusive duty of maximizing pecuniary benefits . . . ERISA's evident approval of E[mployee] S[tock] O[wnership] P[lan]s precludes any claim that it forbids employee ownership as a legitimate plan objective." This statement undermines DOL's fund-first view, at least to the extent that this view reflects the understanding that trustees are required under the exclusive purpose rule to maximize returns to the fund. However, *Foltz* is distinguishable from the circumstances of most public pension funds because one stated objective of the plan at issue in *Foltz* was to perpetuate employee ownership of the defendant company, U.S. News & World Report.

[126] *Brock,* 794 F.2d at 588.

[127] *Id.*

[128] *Id.*

[129] In an effort to discern the court's exact meaning, I requested the relevant trial court and appellate briefs from the United States Court of Appeals for the Eleventh Circuit and the United States District Court for the Southern District of Florida. The Clerk of the Court sent me the appellate briefs, but was unable to locate the district court materials for this case.

percent because there would be more loan activity. If this were correct, one wonders why the market rate was not eight percent. This fund-first reading confers an extraordinary amount of power on boards to substitute their own pricing assessments for those of the market.[130] It is analogous to a board of trustees denying it breached its fiduciary duties by paying $36 for Microsoft stock trading at $30 because, in the board's estimation, the stock was really worth $36.

The opinion is more intelligible only when one concedes that the primary investment analysis must have contemplated that a primary benefit of the loan program was that it would allow fund participants and beneficiaries to borrow at below-market rates.[131] Under this read, the court's statement—"that if they applied [market] rates they would have virtually no loan activity"—means that plan participants and beneficiaries would not benefit from, and would therefore not bother participating in, the loan program if it were offered at market rates.[132] Since they could obtain the same rates elsewhere, there would be no loan activity for the fund. Such a reading is more plausible because it does not require one to read the opinion as conferring upon boards the enormous power to set their own prices when market rates are available. Read this way, the opinion offers support for the member-first view. Furthermore, it supports the view that "benefits" could include things like the benefit of taking out a below-market-rate loan from the fund, which goes well beyond the narrow definition of benefits referenced above. Admittedly, an explicit analysis of the favorable impact of the loan program on fund participants and beneficiaries as measured against the sacrifice in the return on the investment would help to clarify the board's conclusion that the net tradeoff was in the economic interests of fund participants and beneficiaries overall. However, even without overt analysis of this point, a contrary, fund-first reading strains credulity. The fund-first view of the opinion would require readers to believe that fund trustees spent months consulting with experts to devise a loan program offering below-market rates to plan members. Additionally, trustees must have viewed this benefit as merely incidental to the investment's purportedly attractive rate of

[130] Greater deference to board assessments of price might be appropriate when market rates are nonexistent or unavailable.

[131] The *Brock* court also stated that "[t]here is little question that a rate could be so far below the market rate that it could not be justified as being in the best interest of the plan or within the realm of prudence . . . ." 794 F.2d at 588. The statement is, again, ambiguous on the fund-first versus participant-and-beneficiary first view. "Best interest of the plan" is clearly a fund-first statement, but to add "or within the realm of prudence" suggests something other than "best interest of the plan." Otherwise, the second clause is superfluous.

[132] *Brock*, 794 F.2d at 588.

return, 2 1/8 percentage points below the market rate. A fund-first proponent would be better off arguing that the court simply got it wrong.

In discussing *Brock*, I do not argue that the weight of authority is on the side of a member-first rather than a fund-first view. In *Donovan v. Mazzola*, the court found that a loan made at below-market rates violated the exclusive purpose rule, although the court dwelled on the numerous deficiencies with the loan and the process by which it was made, and the lack of adequate collateral obtained, in sharp contrast to the loan made in *Brock*.[133] In addition, at least one district court has rejected the approach taken in *Brock*, albeit in more extreme circumstances.[134] Still, while other courts have emphasized the fund-first view, they are distinguishable from the situations contemplated here. In *Withers*, a non-ERISA case based on New York state law, a federal district court rejected the claim that the trustees of the Teachers' Retirement System of New York City violated their fiduciary duties by investing in low-rated, unmarketable New York City bonds.[135] The court noted that the trustees had not made the investment to protect participant jobs, but to protect the fund, which was threatened by the imminent bankruptcy of New York City in the late 1970s.[136] "The extension of aid to the City was simply a means the only means [sic] in their assessment to the legitimate end of preventing the exhaustion of the assets of the T[eachers'] R[etirement] S[ystem] in the interest of all of the beneficiaries."[137] Interestingly, the court noted the sizable payments, made to the fund by the city, as justification for the investment, which would help preserve the city and thereby the city's payments to the fund.[138] The court noted in passing that participant contributions to the fund constituted between seven and nine percent of total fund income and twenty-nine

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133 Donovan v. Mazzola, 716 F.2d 1226, 1233–34 (9th Cir. 1983). Interestingly, the *Mazzola* court had the opportunity to reject the notion that jobs are an appropriate consideration for pension trustees under ERISA, but shied away from doing so. "Finally, appellants assert that the new investment manager is inappropriate because he or she will favor stock market investments as opposed to those generating employment for union members. Nothing in the record, however, suggests that a court-appointed investment manager will make investments in a manner inconsistent with ERISA." *Id.* at 1239. Note that references throughout this opinion to the trustees' duties to the "Pension Fund" are references to a specific fund—in contrast to the "Convalescent Fund"—and not to the pension fund versus its own participants. *Id.* at 1226.

134 *See* McLaughlin v. Rowley, 698 F. Supp. 1333, 1338 (N.D. Tex. 1988) (holding that below market rate loans violated duty of prudence for numerous reasons).

135 Withers v. Teachers' Ret. Sys. of N.Y.C., 447 F. Supp. 1248, 1259 (S.D.N.Y. 1978).

136 *Id.* at 1257.

137 *Id.*

138 *Id*. at 1255.

and thirty-one percent of fund investment income—smaller than the city's contributions, but still substantial.[139] It is odd that the court concluded that the investment's impact on participant employment was an extraneous consideration, but that the investment's impact on the health of the city's finances was not. Although not stated by the court, perhaps the distinction is possible because of the relative size of the city's contributions, or because reduction in participant employment reduces not only contributions, but also the fund's liabilities. On this point the court is also silent.

Even if one takes the position that the fund generally benefits from layoffs, it is not clear that this is true when the sponsor faces bankruptcy, as did New York when *Withers* was decided, and as cities like Detroit, Michigan, Stockton, California, and others face today.[140] In another frequently cited opinion, *Blankenship v. Boyle*, a federal district court found that pension fund investments that benefitted a union and not the fund itself violated fiduciary obligations.[141] An investment that benefitted a union and not fund participants and beneficiaries would also violate the member-first view propounded here. While it is possible for there to be significant overlap between a union's interests and the interests of fund members, the interests are not the same, and it is the interests of the fund participants and beneficiaries that must remain paramount in the trustees' calculations. Again, I discuss *Brock* (and *Bandt*) above not to assert that the weight of existing authority favors the member-first view, but to support the idea that member-first is a plausible reading of ERISA, and the duty of loyalty more generally. And the weight of *Withers* and *Blankenship* favoring a fund-first view should not be overstated either. *Blankenship* and *Withers* are district court cases, and *Blankenship* is not clearly on point. It is more accurate to describe existing case law as not having squarely settled the issue.

Finally, while a comprehensive account of the origins of the fund-first view is beyond the scope of this paper, I offer here some observations on its scholarly and professional treatment. Some scholars and practitioners have shaped a fund-first view of the duty of loyalty in the

139 *Id*. at 1251 n.2.

140 *See* Nancy Kaffer, Stephen Henderson & Matt Helms, *Detroit Files for Bankruptcy Protection*, USA TODAY, July 18, 2013, http://www.usatoday.com/story/news/nation/2013/07/18/detroit-prepares-bankruptcy-filing-friday/2552819/ (reporting that Detroit filed for bankruptcy protection in July 2013); Malia Wollan, *Years of Unraveling, Then Bankruptcy for a City*, N.Y. TIMES, July 19, 2012, at A1 (describing Stockton, California's demise and eventual filing of bankruptcy protection).

141 Blankenship v. Boyle, 329 F. Supp. 1089, 1106 (D.D.C. 1971).

context of the socially responsible investing debate.[142] There is substantial academic debate about whether, and to what extent, socially responsible investors sacrifice returns, with some advocates arguing that such investing is more profitable in the long run, and others arguing that social investing underperforms the market.[143] Some influential scholarship on the duty of loyalty has focused on concerns that fund fiduciaries will use fund assets to pursue their own social and political goals at the expense of fund participants and beneficiaries.[144] Viewed in this context, fund-first may appear to be more protective of the economic interests of fund members. The member-first view differs from a socially responsible investment view towards privatizing investment. I do not justify the member-first exercise of exit or voice over privatizing investments based on broad social concerns, but on the economic interests of fund members. Prior scholarship treats the jobs impact of investments as a form of socially responsible investment, and it could be viewed that way if one considers that providing stable employment and sustainable retirement funds for a middle and working class population is a social good.[145] I do not argue that sacrificing returns is justified by the advancement of broad social goals, though perhaps it is. I argue that sacrificing returns might be justified if it were offset by economic gains to fund members from preserved or newly created jobs and from contributions to the fund by both employers and employees. Furthermore, consideration of employer and employee contributions requires that considering the jobs impact of investments may improve the financial soundness of the fund itself.

142 Briefly, socially responsible investing means investing in companies that pursue laudable social goals (e.g., green energy) or divesting from companies that pursue social harms (e.g., tobacco companies). *See* Langbein & Posner, *supra* note 92, at 73 (defining socially responsible investing).

143 *See, e.g.*, Hylton, *supra* note 24 (exemplifying one side of this debate); Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 22 J. FIN. & QUALITATIVE ANALYSIS 353 (1987) (same).

144 *See* Langbein & Posner, *supra* note 92, at 74 (concluding that socially responsible investing may not comply with the duty of loyalty because it permits another party to gain at the beneficiaries' expense); *see also* Ian D. Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 LAB. L.J. 387, 390–92 (1980) (discussing duty of loyalty implications involved in social investing); Zanglein, *supra* note 76, at 71–73 (discussing pension investments in affordable housing, school construction, and job-creating investments).

145 *See* Langbein & Posner, *supra* note 92, at 76 (describing the jobs issue as a "wrinkle" on the social investment theme). For reasons I describe in the text, I view the jobs impact of investments as distinct from social investment because it maintains focus exclusively on the direct economic interests of fund participants and beneficiaries.

One objection to the member-first view's consideration of jobs by fund trustees is that it violates the protective nature of pensions.[146] This argument has also been raised by critics who view consideration of jobs as a form of socially responsible investing.[147] Broadly speaking, the "protective policy" refers to two closely-related concepts: (1) the goal of protecting the retirement of pensioners and (2) ERISA and state pension code protections from taxation, underfunding, collapse, alienation, or assignment of pensions.[148] The "paternalistic" protective policy is designed "to assure [that] American workers . . . look forward with anticipation to a retirement with financial security and dignity, and without fear that this period of life will be lacking in the necessities to sustain them as human beings within our society."[149] Examples of the protective policy include the tax-favored treatment of pensions, and the anti-alienation provisions of ERISA that prevent creditors from seizing pensions and bar nonretired workers from alienating their pensions to buy a sports car.[150] Section 1056(d)(1) of ERISA is an example of an anti-alienation provision, stating that each plan "shall provide that benefits provided under the plan may not be assigned or alienated."[151] Courts have discussed the protective policy almost exclusively in the context of its anti-alienation or anti-assign-

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146 *See, e.g.*, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal: Hearing Before the H.J. Econ. Comm.*, 104th Cong. 10 (1995) (statement of John H. Langbein, Kent Professor of Law and Legal History, Yale Law School), *available at* http://www.law.yale.edu/documents/pdf/Faculty/Langbein51895.pdf ("By reducing the financial return to the pension fund, bargain-rate lending [to create jobs] necessarily sacrifices future retirement income. For present workers it involves just that trade-off of retirement-for-preretirement income that pension plans were created to guard against."). As discussed above, both *Barrington* and *Brock* permitted bargain-rate lending under ERISA and Illinois's state pension code, respectively. *See* Board of Trs. of the Vill. of Barrington Police Fund v. Dep't of Ins., 570 N.E.2d 622 (Ill. App. Ct. 1991) (holding that the offer of below market loans from a pension did not violate a local city statute limiting public employee compensation to that provided by city ordinance); Brock v. Walton, 794 F.2d 586 (11th Cir. 1986) (holding that ERISA requirement that mortgage loans provided from pension be "reasonable" is distinct from requiring that they match the prevailing rate).

147 Langbein, *supra* note 146, at 10.

148 Boggs v. Boggs, 520 U.S. 833, 845, 851 (1997) (referencing both the broad purpose of ERISA in protecting retirement beneficiaries as well as the specific application of ERISA's anti-alienation provision as "a pension law protective policy of special intensity" among other protections).

149 Sharon Reece, *The Gilded Gates of Pension Protection: Amending the Anti-Alienation Provision of ERISA Section 206(d)*, 80 OR. L. REV. 379, 383–84 (2001) (quoting S. REP. NO. 93-727, at 13 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4838, 4849) (describing "paternalistic" aspects of ERISA).

150 Langbein, *supra* note 146, at 20.

151 29 U.S.C. 1056(d)(1) (2012).

ment implications, like the one just quoted.[152] Importantly, the policy is not absolute, and exceptions exist, like knowing and voluntary waiver of benefits executed to reach a settlement.[153]

Some critics have argued that investments that sacrifice retirement income for current income run afoul of the protective policy.[154] The argument is essentially the same as the argument justifying fund-first, as is my response to it. The idea is that the exchange of below-market rates of return for jobs preservation—or, as in *Brock*, mortgage loans—necessarily sacrifices retirement income for current income, violating the protective policy.[155] While the protective policy is merely a policy and not a particular statutory provision, it is a goal that manifests in a variety of statutes and rules, and to which there are exceptions. Because its purpose is to protect the retirement security of fund participants and beneficiaries, it would make little sense to implement the policy in a way that thwarts its own goal. It is unsurprising that pension policies should favor retirement income over current income, but this should not lead to the conclusion that pension policy should always favor the reduction of the pensioner's overall economic welfare simply to improve retirement income. For example, in *Rhoades v. Casey*, the Fifth Circuit allowed an individual to alienate his rights to a retirement fund in order to settle a lawsuit, even though it reduced his retirement income in favor of another benefit, the set-

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152 *See* Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan, 555 U.S. 285, 292–93 (2009) (citing *Boggs*, 520 U.S. 833, in discussion of whether waiver of ex-spouses' rights to a pension is a type of proscribed alienation or assignment); *Boggs*, 520 U.S. at 845, 851 (invoking the "special intensity" of the protective policy implied by anti-alienation clauses); Estate of Kensinger v. URL Pharma, Inc., 674 F.3d 131, 138 (3d Cir. 2012) (holding that the special protective policy of *Boggs* does not give anti-alienation protection to already distributed pension funds); Rhoades v. Casey, 196 F.3d 592, 598–99 (5th Cir. 1999) (citing *Boggs*, 520 U.S. at 851) (holding that the "protective policy" of anti-alienation clauses can allow some knowing settlements to waive retirement benefits); *In re* Block, 121 B.R. 810, 813 (Bankr. C.D. Ill. 1990) (holding that the "policy of protecting pension benefits" removes pensions from the reach of bankruptcy creditors).

153 *See, e.g.*, *Rhoades*, 196 F.3d at 598–99 ("In general, the anti-alienation provision will be read broadly as a '*protective policy* of special intensity' which reflects the policy that retirement funds should remain inviolate until retirement." (emphasis added) (quoting *Boggs*, 520 U.S. at 851)). However, the anti-alienation provision of ERISA is not absolute. *See id.* at 598 ("Courts, including this one, have noted that there is an exception to ERISA's anti-alienation provision for a knowing and voluntary waiver of retirement benefits that is executed to reach a settlement." (citing Finz v. Schlesinger, 957 F.2d 78, 82 (2d Cir. 1992); Lumpkin v. Envirodyne Indus., Inc., 933 F.2d 449, 455 (7th Cir. 1991)).

154 *See* Langbein, *supra* note 146, at 10 ("By reducing the financial return to the pension fund, bargain-rate lending [to create jobs] necessarily sacrifices future retirement income. For present workers it involves just that trade-off of retirement-for-preretirement income that pension plans were created to guard against.").

155 *Id.*

tlement itself.[156] Thus, even if a jobs-preserving investment or divestment reduces retirement income, it is not clear that the protective policy should thwart such an investment decision, at least not unless the investment clearly reduces economic welfare, which a member-first view would disallow.[157]

In cases like *Brock* and *Bandt*, the "protective policy" was not viewed as a barrier to allowing below-market-rate investments. Courts have simply not discussed the protective policy in this context. The fact that courts have departed from the policy by allowing a party to alienate his ERISA-protected retirement income for purposes of settling litigation suggests that the protective policy is not fatal to the member-first view. At a minimum, even a strong advocate for applying the protective policy in this context should not oppose consideration of the jobs impact of investments under a fund-first view, as discussed in Part I.E. More importantly, as I develop further in Part I.D–E, privatizing investment of public pension funds can undermine both current and retirement income for fund participants and beneficiaries. It is not necessarily a zero-sum game.

I address another critique of member-first—that it impartially benefits current workers at the expense of retirees—in Part I.D–E.[158]

C. The Inadequacy of the "Investments of Equal Value Rule"

The 2008 Bulletin permits fund trustees to consider factors outside the economic interest of the plan in "very limited circumstances."[159] Those limited circumstances are delineated by what I call the "investments of equal value rule." As DOL explains:

> Situations may arise, however, in which two or more investment alternatives are of equal economic value to a plan. . . . [U]nder these limited circumstances, fiduciaries can choose between the investment alternatives on the basis of a factor other than the economic

156 Rhoades v. Casey, 196 F.3d 592, 598–99 (5th Cir. 1999).

157 *See* Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961, 1011 (2001) (arguing that the basis for the evaluation of legal rules should rest entirely on welfare economics with no weight given to notions of fairness).

158 *See, e.g.*, Langbein, *supra* note 146 ("[P]ensioners who are already retired and who depend upon the pension fund for current retirement income would derive no benefit from subsidizing employment for cur-rent [sic] workers . . . . [T]rust-investment law (and now ERISA) make it flatly illegal to sacrifice the interests of plan beneficiaries in this way."). In Part I.D–E, I argue that current retirees may, in fact, benefit from subsidizing employment for current workers, and that, in any case, member-first does not necessarily violate the duty of impartiality. Langbein's arguments here are directed to private pension funds and to investments that create jobs, not to public plans, and not to investments that destroy or undermine jobs, though the logic of these arguments may be extended to privatizing investments by public plans.

159 29 C.F.R. § 2509.08-1 (2008).

> interest of *the plan*. . . . [B]efore selecting an economically targeted investment, fiduciaries must have first concluded that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the economic impact *on the plan*. ERISA's fiduciary standards expressed in sections 403 and 404 do not permit fiduciaries to select investments based on factors outside the economic interests *of the plan* until they have concluded, based on economic factors, that alternative investments are equal. . . . [F]iduciaries 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.[160]

Thus, if Middlesex/MassPRIT and Louisiana Teachers had first identified another investment of equal economic value to the Aramark investment, only then could they have considered factors like the employment of Rick Thorne or Carol Sanders in their investment analysis. Under the 2008 Bulletin, the employment impact analysis—a substantial part of the analysis conducted in the interests of participants and beneficiaries—plays no role until the risk/reward calculation for the plan has been made. Consequently, this part of the analysis is rarely reached, or comes too late, for purposes of protecting the economic interests of fund participants and beneficiaries like Thorne and Sanders. This explains why many funds would not even bother to assess the economic impact of their investments on the employment of the funds' participants and beneficiaries, as noted by Phil Griffith of Louisiana Teachers in the Introduction.[161] The risk/reward characteristics would be more favorable in the school services sector for companies that pay lower wages because of the lower wages themselves.[162] As such, it is unlikely that a fiduciary would identify a competing investment of equal value that also had no impact on employment. The investments of equal value rule thus obscures analysis of the actual, economic stakes of participants and beneficiaries in favor of analysis of the economic interests of the plan alone.[163]

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160 *Id.* (emphasis added).

161 Braun & Selway, *supra* note 1 (quoting Griffith).

162 The comparison need not be limited to two investments in the same economic sector.

163 The DOL's position dates back to at least 1990, when Ian Lanoff, the Pension Administrator of the DOL stated that while ERISA "does not exclude the provision of incidental benefits to others, the protection of retirement income is, and should continue to be, the overriding social objective governing the investment of plan assets." Jayne Elizabeth Zanglein, *Protecting Retirees While Encouraging Economically Targeted Investments*, 5 KAN. J.L. & PUB. POL'Y 47, 48–49 (1996). Interestingly, the investments of equal value rule was instituted by Lanoff to dislodge the presumption established by DOL

The investments of equal value rule has even more problematic implications when applied in the context of employment.[164] It turns the notion of a fiduciary on its head by allowing a public pension trustee to select an investment *because* it harms the economic interests of plan participants and beneficiaries, so long as the investment is of equal value (to the fund) to another investment that does not harm participants and beneficiaries. In the absence of litigation, it is nearly impossible for an outside observer to assess what motivated particular investments by public pension fiduciaries, but there is ample reason to believe that some public pension investments might be selected to undermine participant employment. Consider an investment made by the Florida Retirement System—which invests the retirement savings of Florida public employees, about half of whom are public school teachers—in the Edison Schools Company, today called EdisonLearning, Inc. (Edison).

Edison was founded in 1992.[165] At that time, it was a private company that contracted to run public schools, claiming it could run the schools more cheaply and for a profit by, among other things, paying teachers less.[166] The company attracted favorable recognition from those sympathetic to the school choice movement and for-profit edu-

during the presidential administration of Gerald Ford that an investment with a positive union jobs impact was presumptively a form of socially responsible investing and a breach of fiduciary duty. Telephone Interview with Ian D. Lanoff, Principal, The Groom Law Group (Mar. 11, 2014). Lanoff represents five of the top ten and eight of the top twenty largest public and private pension funds in the United States, and served as head of the ERISA Program of the U.S. Department of Labor under the presidential administrations of Jimmy Carter and Ronald Reagan. *Ian D. Lanoff*, GROOM L. GROUP, http://www.groom.com/attorneys-Ian-Lanoff.html (last visited Nov. 17, 2014). Thus, while the investments of equal value rule may be an improvement on what preceded it, it still falls short of maximizing the economic interests of fund participants and beneficiaries, as described above.

164 The investments of equal value rule may still be the right rule to follow in the context of socially responsible investing. Ultimately, the question turns on the economic value of the non-plan benefit to the plan participant or beneficiary. In the absence of a tangible, measurable economic benefit like preservation or creation of jobs, it may well be that the most prudent course is to follow the investments of equal value rule.

165 Marc Caputo, *Edison Schools Accepts Buyout*, MIAMI HERALD, Nov. 13, 2003, at 1, *available at* http://nepc.colorado.edu/publication/edison-schools-accepts-buyout.

166 *See* David Moberg, *How Edison Survived*, NATION, Mar. 15, 2004, at 22 ("Edison's strategy often pushes out experienced teachers; relies heavily on lower-cost, newer teachers whom Edison trains; and increases teacher turn-over—raising costs and undercutting teaching."); *see also* Marianne D. Hurst, *Fla. Teachers Riled by Edison Deal*, 23 EDUC. WK. 14, 14 (2003), *available at* http://www.edweek.org/ew/articles/2003/10/08/06edison.h23.html ("Although Edison maintains it is not anti-union and does not seek to eliminate jobs . . . its critics point to the company's experience in the 200,000-student Philadelphia school district, where Edison laid off classroom assistants, hallway monitors, and school secretaries when it took control of 20 schools last year.").

cation, including elected officials.[167] It also encountered frequent opposition from public school teachers and teachers unions, who challenged its claims about improving test scores and asserted that its business model relied on pushing out experienced teachers in favor of newer, lower-cost teachers while shifting other costs to the public sector.[168] The company spent four years listed on NASDAQ (1999–2003),[169] during which time it reported a profit in just one quarter and its stock price fell from a high of $36.75 to a low of 15 cents.[170]

In 2002, around the same time that Edison was flailing, Jeb Bush was seeking reelection as the governor of Florida on a platform that included privatization of public schools, promotion of school vouchers, and criticism of teachers unions.[171] His reelection was strongly opposed by the Florida Education Association, Florida's public school teachers union.[172] Upon reelection, Bush (and two of his cabinet members) resumed their positions as trustees on the Florida State Board of Administration, which directs investment for the Florida Retirement System.[173] In July 2003, shortly after Bush resumed office, Liberty Partners, investing the Florida Retirement System's pension assets, announced its anticipated purchase of Edison Schools for $182 million.[174] The deal was completed in November 2003.[175] Thus, like the investments of Middlesex/MassPRIT and Louisiana Teachers in Aramark, the Florida State Board of Administration utilized teacher retirement funds to invest in a business that undermined teacher employment.

In the absence of a factual record established in litigation, it is impossible to know exactly what motivated this investment. Bush

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167 *See* Moberg, *supra* note 166, at 22 (noting that Edison "attracted both enthusiastic investors and support from politicians").

168 *See id.* ("Critics say Edison also cuts support staff (at times increasing discipline problems), avoids handicapped students and pushes out problem students.").

169 *See* Helen Huntley, *Legislators, Teachers Balk at Deal for Edison Schools*, ST. PETERSBURG TIMES (Sept. 26, 2003, 1:49 AM), http://www.sptimes.com/2003/09/26/Business/Legislators__teachers.shtml (discussing the financial downfall of Edison schools).

170 Moberg, *supra* note 166, at 22.

171 *See* Moberg, *supra* note 166, at 22–23 (calling Jeb Bush an "ardent promoter of privatization and school vouchers" and noting his reelection in 2002).

172 *Id.* at 22.

173 *John Ellis (Jeb) Bush (1953-)*, FLA. MEMORY, http://www.floridamemory.com/collections/governors/bush.php (Nov. 17, 2014). Under Florida law, the governor and two of his cabinet members comprise the State Board of Administration. FLA. STAT. § 121.0312 (2013).

174 *See* Moberg, *supra* note 166, at 23 (noting Liberty Partners' winning bid in 2002 and formal signing of the contract in July 2003).

175 *See id.* (discussing nominal investments made by Liberty Partners in November 2003 after criticism of the deal).

stated publicly that, "he knew nothing of the deal before it was announced," which might have been a damaging admission in a world in which fiduciary duty functioned normally.[176] The teachers unions alleged that the investment was driven by Bush's school choice politics and there were reports of numerous political and financial contacts between Edison Schools, the bankers involved in the deal, and the Bush administration.[177] Doug Wiles, the leader of the Florida House of Representatives at the time, stated that he had "deep concerns about investing our state employees' retirement funds in a company that seeks to eliminate public jobs."[178] Under DOL's investments of equal value rule, Bush and the State Board of Administration could have directed the Florida Retirement System to purchase Edison Schools *because* it undermined participant employment and economic interests, so long as the SBA could show that the risk/return, liquidity, and diversification properties for the Florida retirement fund itself alone were equal to other potential investments. Whether the Edison investment might have been chosen for this reason is difficult to say, but the example points to the possibility that it could have been chosen for this reason, illustrating the problem.

Consider how the investment analysis changes under the member-first view rather than the investments of equal value rule. In addition to assessing risk/return, liquidity, and diversification, trustees would have to assess the employment impact of the investment, its potential for layoffs (and future hires), and the effect those layoffs would have on plan participants and beneficiaries. More generally, trustees would need to have a sense of how the investment impacts current and future contributions to the fund by employees and the employer, assuming the investment might contribute to layoffs or reduced working hours for current fund participants.[179] It is possible that the Florida Retirement System's investment in Edison might still have qualified under this analysis, but it could only have done so if it would outperform other investments after accounting for its projected negative impact on teacher employment.[180] Note that the member-first view of fiduciary duty effectively reverses DOL's investments of equal value rule. Under the latter rule, trustees could select the

176 Caputo, *supra* note 165, at 2.

177 *Id.*

178 Kris Hundley, *State Pays $180 Million in Fees, Gets Little from Long-Term Investment*, TAMPA BAY TIMES (Oct. 17, 2010 8:21 PM), http://www.tampabay.com/news/business/state-pays-180-million-in-fees-gets-little-from-long-term-investment/1128708.

179 I analyze the question of whether investments can actually impact these employment decisions in Part III.A.1.b below, in which I discuss the exit option.

180 For a discussion of how this impact might be assessed, see *infra* Part III.A.1.b. And the duty of impartiality analysis still applies, as discussed below in Part I.D.

Edison investment or an alternative investment of equal diversification, liquidity, and return properties; therefore, it could select the Edison investment precisely because it undermines public employee jobs. But under the member-first view, when faced with two investments of equal value to the fund, trustees would have to select the investment that does not harm public employee jobs, because any negative employment impact would tip the balance away from the jobs-harming investment. The negative employment impact of such an investment, assuming there was one, could have forced the Florida Retirement System to select another investment.

This illustrates the flaws of DOL's fund-first view and the inadequacy of the investments of equal value rule. The fund-first view utilizes the duty of loyalty and the exclusive purpose rule—which were designed to elevate the interests of fund participants and beneficiaries over the interests of trustees or third parties—to undermine the economic interests of members under the guise of advancing those same interests in the fund alone.

D. Under a Member-First View, Trustee Discretion Is Still Constrained by the Duties of Impartiality, Prudence, and Diversification

I have focused on the duty of loyalty and the exclusive purpose rule because it is DOL's interpretation of them that most directly forecloses consideration of the employment impact that I advocate in this Article. However, public pension trustees are governed by a matrix of fiduciary duties that overlap with the duty of loyalty—including the duties of prudence, impartiality, and diversification—that have implications for my member-first proposal. In this Subpart, I argue that these duties constrain the agency cost concerns of my proposal and appropriately limit the ways in which the employment impact of fund investments may be taken into consideration.

1. The Duty of Impartiality

A member-first view of fiduciary duty might raise concerns about the duty of impartiality, particularly as it manifests in potential conflicts between younger workers and older workers or retirees.[181] It

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[181] *See* Frankel, *supra* note 68, at 177–78 (discussing fiduciaries who serve entrustors with conflicting interests); *see also* White v. Pub. Emps. Ret. Bd., 268 P.3d 600, 609 (Or. 2011) (citing the duty of impartiality in the Restatement (Third) of Trusts § 79(1)(a) (2005)); Withers v. Teachers' Ret. Sys. of N.Y.C., 447 F. Supp. 1248 (S.D.N.Y. 1978) (citing Redfield v. Critchley, 252 A.D. 568 (N.Y. App. Div. 1937)) ("New York law imposes an obligation on trustees to accord impartial treatment to beneficiaries."). The duty of impartiality is established in trust law. The Restatements of Trusts, discussed below, clearly

might also raise concerns about conflicts between workers within the same retirement fund who perform different jobs, such as firefighters and teachers. The duty of impartiality requires trustees "to take impartial account of the interests of all beneficiaries."[182] Under the *Restatement (Third) of Trusts*, a trustee "must act impartially and with due regard for the diverse beneficial interests created by the terms of the trust . . . ."[183] Trustees must not let personal favoritism affect their decision-making, and must balance the various interests of beneficiaries in carrying out their duties.[184] A trustee should balance these interests by looking to "the terms, purposes, and circumstances of the trust."[185] However, this does not require equal balancing of diverse beneficiary interests.[186] A final comment from the Third Restatement is worth noting: "The duty of impartiality is an extension of the duty of loyalty to beneficiaries but involves, in typical trust situations, unavoidably and thus permissibly conflicting duties to various beneficiaries with their competing economic interests."[187] The comment describes the duty of impartiality as an extension of the duty of loyalty to fund beneficiaries themselves, illustrating that at least some duties run past the trust or the fund itself as in the member-first view. Moreover, the inevitability of competing economic interests among fund participants and beneficiaries reinforces the notion that a trustee need not attempt the impossible—namely, to act equally in the interests of all participants and beneficiaries at all times.[188]

contain a duty of impartiality. The weight of authority suggests that ERISA also contains a duty of impartiality, though the issue is not completely settled. ERISA enumerates several specific fiduciary duties without mentioning the duty of impartiality, and many state pension codes likely remain silent on the topic as well. There might be good reason why the duty of impartiality does not belong in ERISA and state pension codes. Since employee benefit plans must cater to diverse constituencies—for example, firefighters, police officers, and teachers all participating in the same retirement fund—a robust duty of impartiality might paralyze fiduciary decision-making, as it would be difficult, if not impossible, to make decisions that are truly impartial across such a large and diverse constituency. Because the weight of authority suggests that the duty of impartiality applies to ERISA and state pension codes, I analyze it here.

182 Varity Corp. v. Howe, 516 U.S. 489, 514 (1996); *see also* Summers v. State St. Bank & Trust Co., 104 F.3d 105, 108 (7th Cir. 1997) ("Picking and choosing among beneficiaries [would be] in violation of the traditional duty imposed by trust law of impartiality among beneficiaries."); RESTATEMENT (SECOND) OF TRUSTS § 183 (1959) ("When there are two or more beneficiaries of a trust, the trustee is under a duty to deal impartially with them.").

183 RESTATEMENT (THIRD) OF TRUSTS § 79(1)(a) (2007).

184 *Id.* § 79 cmt. b–c.

185 *Id.* § 79 cmt. b (citation omitted).

186 *Id.* § 79 cmt. c.

187 *Id.*

188 "Trustees could not treat every beneficiary equally. . . . '[I]t would be overly simplistic, and therefore misleading, to equate impartiality with some concept of "equality" of treatment or concern—that is, to assume that the interests of all beneficiaries . . . are

One impartiality concern raised by a member-first view relates to potential conflicts between younger workers, older workers, and retired workers, although these conflicts are not always as sharp as they are depicted to be.[189] One potential conflict lies at the heart of this Article: the interests of fund participants in their jobs. As Fischel and Langbein observed twenty-five years ago, younger workers expect more of their future income from their jobs than from their retirement accounts, whereas the reverse is true for older workers, and, of course, retired beneficiaries depend entirely on their pensions.[190] Thus, a policy that incorporates consideration of the impact of fund investments on participant jobs runs the risk of favoring younger workers at the expense of older and retired workers, in violation of the duty of impartiality. This is a real risk, and it is one that should be weighed carefully under a member-first view. But it does not justify a blanket rule prohibiting consideration of the resulting impact on jobs when making fund investments.

In many instances the age conflict may be nonexistent, or at least not a zero-sum game between older/retired and younger workers because the former may have a direct economic interest in the latter maintaining their jobs and contributing to the retirement fund. As I discuss in Part I.E., retirees and older workers may also have an economic interest in younger workers maintaining their jobs, contributing to the retirement fund, and triggering employer contributions to the fund. The interests of current workers in their own jobs is clearly greater than retirees' interest in those jobs, but the retiree interest is not zero, and may even be substantially above zero. It is therefore possible that the fund-first view harms retirees—and not just current

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entitled to the same weight . . . .'" Awakuni v. Awana, 165 P.3d 1027, 1037 (Haw. 2007) (quoting RESTATEMENT (THIRD) TRUSTS § 79 cmt. b (2007)); Salmon v. Old Nat. Bank, No. 4:08–CV–00116–JHM, 2012 WL 4213643, at *7 (W.D. Ky. Sept. 19, 2012) ("Importantly, however, impartiality does not mean equality.").

189 *See* Fischel & Langbein, *supra* note 38, at 1120–21 (discussing the various divergent interests of younger and older workers); *see also* Larry W. Beeferman, *Paradigm Lost: Employment-Based Defined Benefit Plans and the Current Understanding of Fiduciary Duty*, *in* CAMBRIDGE HANDBOOK OF INSTITUTIONAL INVESTMENT AND FIDUCIARY DUTY 100 (James P. Hawley et al. eds., 2014) (arguing that the current understanding of fiduciary duty is a poor fit for defined benefit plans).

190 *See* Tussey v. ABB, Inc., 746 F.3d 327, 333 (8th Cir. 2014) (holding that the *Firestone* standard applies to a breach of fiduciary duty claim); Foltz v. U.S. News & World Report, Inc., 865 F.2d 364, 373 (D.C. Cir. 1989) (noting that retirees rely heavily on a fiduciary's duty to act solely with respect to plan participants' and beneficiaries' interests); Fischel & Langbein, *supra* note 38, at 1120 (comparing retirees' singular interest in retiree benefits with the predominance of the "income stream from employment" on current employees' finances). *But see* Futral v. Chastant, 564 F. App'x 117, 118 n.1 (5th Cir. 2014) (holding that the *Firestone* standard only applies to denial of benefits claims and not to suits for breaches of fiduciary duty).

workers—by ignoring the investment impact of fund investments on current workers, and that retirees, too, would be better off under a member-first view, even if they benefitted less than current workers. Only the member-first view allows for the calculation of the actual economic interests of fund participants and beneficiaries to be done accurately, since it is the only view that completely considers their economic interest in fund investments. Thus, it would be ironic to exploit the duty of impartiality to undermine a member-first view when the purported beneficiaries of the duty of impartiality—in this context, retirees—might be better off under it.

There is no reason to believe that a member-first view increases the risks of impartial decision-making by trustees across the board. Instead, it merely invites fund trustees to consider the complete set of economic interests of participants and beneficiaries in fund investments. To the extent it manifests sharply, it appears to lead to "unavoidably and thus permissibly conflicting duties to various beneficiaries with their competing economic interests."[191] The unavoidability of the age conflict suggests that trustees should manage it under a member-first view the same way they manage it now: in good faith, and with due regard to the various interests at hand, but without being paralyzed by it. Consider a fund's decision to make a long-term investment that it believes will earn a market-beating rate of return ten years from now. This is the kind of decision trustees face today under the fund-first view. Older retirees may never see the benefits of this investment. Decades may pass before younger workers reap its benefits, if at all. But the same types of conflicts will manifest with another investment choice, perhaps benefiting a different subset of plan members. Trustees could hardly be found liable for breaches of the duty of impartiality when age conflicts such as this one are inevitable, which explains why courts review such decisions under the highly deferential arbitrary and capricious standard.[192] In the rare case in which courts have found a violation of the duty of impartiality, they

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191 RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. c (2007).

192 *See, e.g.*, Mahoney v. Bd. of Trs., 973 F.2d 968, 971–72 (1st Cir. 1992) (citing 3A AUSTIN W. SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 232 (4th ed. 1987)) (acknowledging the discretion trustees have in fulfilling their duty of impartiality, and consequently applying an arbitrary and capricious standard of review to the trustees' decision to increase benefits for beneficiaries who are still working); Williams v. WCI Steel Co., 37 F. App'x 723, 730 (6th Cir. 2002) (affirming the lower court's grant of summary judgment to the defendant trustees because the trustees had "provided detailed reasons for the unequal allocation of benefits," satisfying arbitrary and capricious review). *But see* Moench v. Robertson, 62 F.3d 553, 567 (3d Cir. 1995) (refusing to apply the arbitrary and capricious standard of review to the ESOP fiduciaries' investments in the employer because there was no evidence on the record that the fiduciaries actually interpreted the terms of the ESOP plan or used their judgment).

have done so when the conflict was not inevitable and where one set of beneficiaries inexplicably bore the harm of an investment decision.[193]

Another potential conflict within public pension funds that implicates the duty of impartiality is between participants who work in different government sectors. For example, a general employees' retirement fund might include teachers, firefighters, police officers, clerical workers, sanitation workers, prosecutors and judges, etc. This can complicate the impartiality analysis under a member-first view because a firefighter's job would not be at risk in an investment in Edison Schools; similarly, a firefighter might be harmed by negotiations to reduce the negative jobs impact on teachers of an Edison Schools investment at some reduced rate of return to the fund. On the other hand, a firefighter could benefit from an investment that led to more hiring of teachers and therefore more contributors to the fund. Also, while firefighters might be harmed by sacrificing returns to reduce the negative impact on teacher jobs of a particular investment, they might benefit overall from a member-first view, to the extent that it would allow their own jobs to be considered when other investments are proposed.

This impartiality conflict is substantially reduced in public pension funds that are organized by employment sector.[194] Many funds organize as teachers' retirement systems or police or fire retirement systems in which intrafund conflicts by job sector may be trivial or nonexistent.[195] A teachers' retirement system would face fewer impar-

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[193] *See* Jackson v. Truck Drivers' Union Local 42 Health & Welfare Fund, 933 F. Supp. 1124, 1144–45 (D. Mass. 1996) (finding violation of the duty of impartiality when trustees of a health and welfare union fund granted participants coverage of prospective health and welfare benefits but denied coverage of existing claims, as the trustees could not place the "primary burden of a funding shortfall on a small number of sick beneficiaries"). *But see* Summers v. State St. Bank & Trust Co., 104 F.3d 105, 108 (7th Cir. 1997) (finding, in a unique factual situation involving a dummy sale of stock to an ESOP, that wages and fringe benefits were not plan assets and that consideration of them by outside fund fiduciary in pricing ESOP stock would have violated the duty of impartiality by favoring current workers over retirees).

[194] More uniform funds have less conflict and are more efficient. Paul M. Secunda, *Litigating for the Future of Public Pensions in the United States* (Marquette Law Sch. Legal Stud. Paper No. 14-19, 2014), *available at* http://papers.ssrn.com/sol3/papers.crm?abstract_id=2443147 (concluding that public pension plans are best served through uniform regulation); Todd Richmond, *Exemptions for Police, Fire Fighters in Walker Budget Bill Sparks Questions of Political Payback*, Oshkosh Northwestern (Feb. 14, 2011), http://www.thenorthwestern.com/viewart/20110214/OSH0101/110214045/Exemptions-police-fire-fighters-Walker-budget-bill-sparks-questions-political-payback (quoting Paul Secunda discussing the costs and difficulties of treating different public pensions differently within a state).

[195] Many funds organize as police or fire pensions. *See, e.g.*, *Police and Firemen's Retirement System (PFRS)*, Div. Pensions & Benefits (May 8, 2013),

tiality conflicts over an Edison Schools investment decision than would a general retirement system that includes teachers. A police and fire retirement system would be unlikely to face a jobs-related issue at all when deciding to invest in a company like Edison, not because of impartiality concerns, but because Edison does not compete with its participants for jobs. In such cases, the jobs impact on teachers would be irrelevant to the analysis. The member-first view is not about solidarity between public employees to avoid investing in businesses that may harm other public employees. It is about fiduciaries vindicating the actual economic interests of their funds' participants and beneficiaries.

Thus, the duty of impartiality requires trustees to assess the potentially disparate impact on fund participants and beneficiaries of a jobs-sensitive investment decision, but does not itself conflict with a member-first view of fiduciary duty.

2. *Duties of Prudence and Diversification*

ERISA sets forth a modified version of the prudent person standard of care, stating that fiduciaries should discharge their duties "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."[196] Plan fiduciaries also have a duty to diversify the plan's investments "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."[197] Departing from the old prudent person rule, DOL interpreted ERISA's prudent person rule to require that each investment be considered in the context of the whole investment portfolio, to accommodate the diversification requirement and the rise of Modern Portfolio Theory (MPT).[198] This interpretation is consistent with the rise of the prudent investor rule, which has replaced the prudent

http://www.state.nj.us/treasury/pensions/pfrs1.shtml (all New Jersey police and fire are required to join an exclusive state public pension system rather than a local pension system).

[196] 29 U.S.C. § 1104(a)(1)(B) (2012).

[197] *Id.* § 1104(a)(1)(C); *see also* Peabody v. Davis, 636 F.3d 368, 374 (7th Cir. 2011) (noting that under ERISA Eligible Individual Account Plans (EIAPs) are exempt from diversification requirements with respect to employer securities); Quan v. Computer Scis. Corp., 623 F.3d 870, 878 (9th Cir. 2010) (holding that 401(k)s are EIAP accounts and exempt from diversification requirements); *Moench*, 62 F.3d at 568 (holding that fiduciaries of ESOPs are exempt from duty to diversify).

[198] *See* Max M. Schanzenbach & Robert H. Sitkoff, The Prudent Investor Rule: A Theoretical and Empirical Reassessment 1, 2–8 (Mar. 2012) (unpublished manuscript) (citing 29 C.F.R. § 2550.404a-1(b)(1)(i) (2013)), *available at* http://www.utexas.edu/law/wp/wp-content/uploads/centers/clbe/schazenback-the-prudent-investor-rule.pdf (describing

person rule in most jurisdictions, and focuses on the overall performance of the portfolio rather than individual investments.[199] Still, ERISA's legislative history indicates how the statute retained certain elements of the prudent person rule:

> These salient principles place a twofold duty on every fiduciary: to act in his relationship to the plan's fund as a prudent man in a similar situation and under like conditions would act, and to act consistently with the principles of administering the trust for the exclusive purposes previously enumerated, and in accordance with the documents and instruments covering the fund unless they are inconsistent with the fiduciary principles of the section.[200]

Of most relevance to this Article is how MPT and the prudent investor standard require fiduciaries to analyze investments. As with the prudent investor rule, the investment inquiry focuses not on any particular asset's individual risk—as was the case under the prudent person rule—but rather on how the asset's risk contributes to the portfolio's risk.[201] A critic of the member-first view would argue that this view invites fund trustees to decrease returns or increase the risk of the overall investment portfolio either by screening out investments that harm participants' jobs, by permitting fund trustees to seek accommodations from investees to reduce the adverse jobs impact of the investment, or by permitting investments selected for a combination of their return on investment (ROI) and their potentially positive impact on participant jobs, rather than ROI alone.[202] The pro–member-first view argument is that such investments could advance the overall economic interests of fund participants and bene-

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the roots of the prudent investor rule under the Restatement of Trusts, the Uniform Prudent Investor Act, and federal law).

199 *Id*. at 9.

200 H.R. Rep. No. 93-533, at 13 (1974); *see also* 29 U.S.C. § 1104(a)(1)(D) (fiduciaries are to follow the specific guidelines of a trust so long as such guidelines are consistent with the prudent person standard of care).

201 Schanzenbach & Sitkoff, *supra* note 198, at 9 ("[MPT emphasizes] that an investment cannot be analyzed in isolation, but must be placed in the context of the portfolio. We do not care about an asset's individual risk, but rather how that asset's risk contributes to the portfolio's risk.").

202 The Restatement (Second) of Trusts § 227 (1959) states: "[T]he trustee is under a duty to the beneficiar[ies] . . . to make such investments, and only such investments, as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived . . . ." A fund-first proponent might argue that "preservation of the estate" means maximizing return on investment, but for reasons similar to those I state in Part I.B, the amount and regularity of the income to be derived are both directly affected by jobs, and therefore this traditional formulation of a trustee's duties does not decisively favor the fund-first approach. Regardless, section 227 of the *Restatement (Second)* has been superseded by Restatement (Third) of Trusts § 90 (2007), which jettisons this particular formulation of the duty.

ficiaries, not that they advance the interests of their portfolios alone. Under a member-first view, it is possible that *funds* would fare more poorly than they would under a fund-first view, although it is also possible that they would not; the question is whether the fund-member tradeoff is justified if the jobs gains to participants outweigh the investment costs, or if investment losses are offset by the employee and employer contributions made in connection with participant jobs. To the extent that there is a clash between fund and member interests, the legal questions become: To what extent does a member-first view clash with the duties of prudence and diversification? Can it be accommodated under the prudent investor rule, or for that matter, under the traditional prudent person rule?

The short answer is that there is little legal clash here. The original prudent person standard required that a trustee exercise the care, skill, and caution that "a man of ordinary prudence would exercise in dealing with his own property."[203] A trustee had to make "an investigation as to the safety of the investment and the probable income to be derived therefrom."[204] The standard of skill to be applied was "the skill of a man of ordinary intelligence," and the standard of caution was the "caution of a prudent man . . . with a view to the safety of the principal and to the securing of an income reasonable in amount and payable with regularity."[205] Logically, under the prudent person standard, a person of ordinary prudence would not invest her own property without at least considering its potential impact on her other income, if she had reason to believe it could have such an impact. The owner of a McDonald's franchise would not automatically invest her assets to open a Burger King across the street without considering the Burger King's impact on her McDonald's, even if the Burger King investment alone would offer a good return. She would consider the potentially negative impact of the investment on her McDonald's, the probability that the Burger King would open anyway, and whether there are alternative investments that would have less of an impact on her McDonald's, perhaps a Taco Bell. Under the prudent person rule, she would not be permitted to make investments as a trustee that she would not make for herself.

Over time, several problems emerged under the old prudent person standard. For example, it discouraged investments in stocks in favor of purportedly conservative investments like corporate and municipal bonds, thereby exposing portfolios to substantial inflation

203 RESTATEMENT (SECOND) OF TRUSTS § 174.
204 *Id.* § 227 cmt. b.
205 *Id.* § 227 cmt. c, e.

risk, particularly during the 1960s and 1970s.[206] Another problem was liability under hindsight bias. Because the prudent person standard applied to each investment on an individual basis, trustees could be held liable for the poor performance of any particular investment, notwithstanding the performance of the overall portfolio.[207] Thus, to accommodate MPT, diversified portfolio investing, and stock investments more generally, the prudent investor standard became the norm.[208] In the aftermath of the recent financial crisis, critics of the new prudent investor standard have argued that it substantially increased the risks for investors, who would have been better off under the old prudent person standard and perhaps even under the "legal lists" of the nineteenth century.[209] Nevertheless, the prudent investor standard remains the ascendant legal standard today. Its defenders have argued that it has provided superior returns.[210]

The shift to analysis of the overall investment portfolio under the prudent investor rule does not mean that investor employment is irrelevant. Rational diversification strategies are not "fund only"; they account for investor employment. For example, ordinary prudent investors would include technology stocks in a diversified investment portfolio, but technology workers would rationally reduce their investment exposure to the industry because they are exposed to it through their jobs.[211] If one were to myopically assess these tech workers' diversification strategies based on their portfolios alone, one might incorrectly conclude that their portfolios were poorly designed because they underweight the technology sector.[212] In addition,

[206] *See* Schanzenbach & Sitkoff, *supra* note 198, at 4–5 (citing this as one of the criticisms leveled against the prudent man rule during the late twentieth century).

[207] *See id*. at 4 (describing judicial applications of the prudent man rule that searched ex post for evidence that an investment was too risky when made).

[208] *See id*. at 5–7 (describing the gradual repeal of the prudent person rule and enactment of prudent investor statutes in several states, and the widespread adoption of the PIR after the publication of the relevant sections of the RESTATEMENT (THIRD) OF TRUSTS (1992) and the Uniform Prudent Investor Act (1994)).

[209] *See* Joshua Getzler, *Fiduciary Investment in the Shadow of Financial Crisis: Was Lord Eldon Right?*, 3 J. EQUITY 1, 16, 19, 23–24 (2009) (describing the effects of the shift from the prudent person rule to the prudent investor rule); *see also* Stewart E. Sterk, *Rethinking Trust Law Reform: How Prudent Is Modern Prudent Investor Doctrine?*, 95 CORNELL L. REV. 851, 867–79 (2010) (critiquing modern prudent investor doctrine).

[210] Schanzenbach & Sitkoff, *supra* note 198, at 24 (praising the "brilliance" of the prudent investor rule).

[211] *Id.*; *see also* ALICIA H. MUNNELL & ANNIKA SUNDÉN, COMING UP SHORT: THE CHALLENGE OF 401(K) PLANS 97 (2004) (describing the "considerable latitude" afforded to defined contribution plans to invest in company stock despite ERISA's imposition of an otherwise forceful duty to diversify).

[212] *See* Schanzenbach & Sitkoff, *supra* note 198, at 9 (explaining that the breadth of diversification decreases a portfolio's risk).

ERISA has long recognized departures from diversification requirements for Employee Stock Ownership Plans (ESOPs) and 401(k)s.[213] To own stock in the company that employs you is to concentrate your investments, not diversify them. But ESOPs and even 401(k) investments in the employer have been justified on several grounds, including "encourag[ing] saving for retirement and . . . support[ing] employee stock ownership."[214] Such plans have also been criticized because they lead to underdiversification.[215] They lead employees to be doubly exposed to their employers—through their jobs and their investment portfolios—and also to unduly concentrate their investments in one company.[216]

Regardless of one's perspective, the larger point is that rational investors do not ignore their employment income when making investment decisions, and nothing in the prudent investor rule or the prudent person rule contradicts that point. Moreover, it can hardly be argued that the member-first view results in an undiversified investment portfolio. As has been repeatedly observed, one can construct a diversified investment portfolio with thirty to forty stocks.[217] Nonetheless, the fund-first view requires pension fiduciaries to practically ignore their participants' and beneficiaries' jobs when making investment decisions on their behalf, a position which a rational investor would never take with her own money.

The justification for the fund-first view must therefore arise from two basic concerns about fiduciary capitalism: (1) Fiduciaries might invest in their own interests, rather than those of their beneficiaries—

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[213] *See* MUNNELL & SUNDÉN, *supra* note 211, at 97 (ERISA exempts many plans from diversification requirements and employer stock ownership limits).

[214] *Id*. A version of ESOPs has also been proposed as a solution to the challenge of outsourced labor. Robert Hockett, *Toward a Global Shareholder Society*, 30 U. PA. J. INT'L L. 101, 102 (2008).

[215] *See* Summers v. State St. Bank & Trust Co., 104 F.3d 105, 106 (7th Cir. 1997) ("This novel incarnation of syndicalism [the ESOP] has been criticized for underdiversification . . . .").

[216] Joseph Blasi, Michael Conte & Douglas Kruse, *Employee Stock Ownership and Corporate Performance Among Public Companies*, 50 INDUS. & LAB. REL. REV. 60, 61 (1996) ("Because it ties employee income and wealth to company performance, employee ownership has often been viewed as a means to improve productivity and performance by decreasing labor-management conflict and encouraging employee effort, cooperation, and information-sharing."); *see* MUNNELL & SUNDÉN, *supra* note 211, at 95 (criticizing ESOPs and 401(k) investments in the employer because such investments cause "participants [to] hold an asset closely correlated with their earnings" rather than diversifying). *But see id.* (noting managers' preference for matching employee contributions in stock rather than in cash because doing so supposedly aligns the interests of the employees with those of the company).

[217] Meir Statman, *How Many Stocks Make a Diversified Portfolio?*, 3 J. FIN. & QUALITATIVE ANALYSIS 353, 362 (1987) (concluding that a diversified portfolio requires thirty stocks for a borrowing investor and forty stocks for a lending investor).

therefore, their discretion must be constrained by narrow fiduciary obligations—and (2) fund participants and beneficiaries may have diverse economic interests, and the simplest way to navigate those diverse interests is to focus on the one they all share: the fund itself. I have already addressed the duty of loyalty concerns above.[218] I elaborate upon why the agency costs of public pension funds counsel in favor of a member-first view below in Part II.A. I addressed the second concern in the duty of impartiality section above in this Subpart, and do so further below in Part I.E. The bottom line of these arguments is that neither the prudent man nor the prudent investor standard leads to a fund-first view of fiduciary duty, nor is the fund-first view justified by standard agency cost analysis.

E. Even Under a Fund-First View, the Investment Impact of Layoffs and Future Hiring Should Be Evaluated by Trustees in Making Investment Decisions

Before assessing the law and economics arguments below in Part II, I conclude with an alternate argument: Even under a fund-first view, trustees should consider participants' jobs in making investment decisions. Public pension funds do not hire and fire workers for their plan sponsors, and nothing in this Article suggests that they should. Such decisions should be made by the state, county, and municipal entities that must retain the authority to make employment decisions based on their needs and budgets. Nevertheless, those employment decisions directly affect public pension funds by altering employee and employer contributions and the funds' long-term assets and liabilities.[219] In an ideal pension world, such decisions would have no impact on the fund's health because pensions would be fully funded by employers and employees as they work, and thus hiring decisions would make no difference to the health of the fund.[220] In such a world, new employees would neither improve nor harm a fund's financial health.[221]

The real world is more complicated. Terminating employees reduces the flow of employee and employer contributions to the

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218 *Supra* Part I.A–B.

219 *See, e.g.*, Bandt v. Bd. of Ret., San Diego Cnty. Emps. Ret. Sys., 136 Cal. App. 4th 140, 159 (Cal. Ct. App. 2006) (citing pension fund actuary's assertion that job losses could negatively impact the pension fund itself); *see also* NAT'L ASS'N OF STATE RET. ADM'RS & CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, EFFECTS OF PENSION PLAN CHANGES ON RETIREMENT SECURITY 4 (2014), *available at* http://www.nasra.org/files/JointPublications/Effects%20of%20Pension%20Plans%20on%20Retirement%20Income.pdf (discussing employer's need to provide supplemental pension savings when hiring new employees).

220 Fornia Interview, *supra* note 95.

221 *Id.*

funds, and reduces the funds' long-term liabilities.[222] Eliminating jobs in their entirety affects future hires and future cash flows, which can be problematic for several reasons. Even if plans may benefit from layoffs when the benefits are more generous than the contributions,[223] plans may have generational bulges and depressions. They may become imbalanced, with relatively few participants paying into a system compensating many retirees or conversely with many participants paying into a system with few retirees. Moreover, employers must often make a contribution to fund a percentage of any current unfunded liability when making a new hire.[224] Thus, hiring and firing of workers may be relevant to the fund's financial health for asset allocation and cash flow reasons.[225] And, as noted earlier, this factor is likely to become more important over time as the recent wave of pension reforms has increased participant contributions to funds nationwide while simultaneously lowering benefits—or at least not increasing them.[226]

There are other reasons why sponsor employment decisions matter to the fund. As pension funds contract, they lose efficiencies

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222 *See, e.g.*, Yaccino & Cooper, *supra* note 81 ("When [Detroit] shrank its work force [over the prior six decades], it left fewer current workers to contribute to pension funds that still had to pay benefits that were earned by large numbers of older retirees who had served Detroit when it was a bigger city.").

223 Some argued that because most fund assets are comprised of investment income, the retirement benefit always outweighs employer and employee contributions. *See, e.g.*, NAT'L ASS'N OF STATE ADM'RS, PUBLIC PENSION PLAN INVESTMENT RETURN ASSUMPTIONS 1–2 (2014), *available at* http://www.nasra.org/files/Issue%20Briefs/NASRAInvReturnAssumptBrief.pdf. ("[I]nvestment earnings account for a majority of revenue for a typical public pension fund . . . ."). But this argument has been strongly criticized by actuaries who argue that almost all of that investment income is simply the time-value of money. *See* Fornia Interview, *supra* note 95. And, as noted in the text above, recent reforms have increased the importance of employee contributions to the funds. *Supra* notes 81–82 and accompanying text.

224 Fornia Interview, *supra* note 95; *see also* Keith Brainard, *Public Pension Funding 101: Key Terms and Concepts*, BENEFITS MAG., Apr. 2013, at 28, 28–33, *available at* http://www.nasra.org/files/Articles/Benefits101-1304.pdf (describing the accounting and funding requirements to cover unfunded pension liability).

225 Fornia Interview, *supra* note 95.

226 *Supra* notes 81–82 and accompanying text; *see also* Jack M. Beerman, *The Public Pension Crisis*, 70 WASH. & LEE L. REV. 3, 89 (2013) (suggesting that restrictions imposed by contractual obligations of public pension funds should not prevent reforms intended to close loopholes that encourage abusive pension spiking); Richard E. Mendales, *Federalism and Fiduciaries: A New Framework for Protecting State Benefit Funds*, 62 DRAKE L. REV. 503, 541 (2014) (advocating for an emergency backup fund of state public pension funds where the backup fund would be funded in part by member contributions); Amy B. Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1034–35 (2012) (noting that, in many states, legal restrictions and legal uncertainties appear to take certain reform options off the table); Secunda, *supra* note 194, at 6, 26 (discussing increasing contributions without parallel increases in benefits, and using Wisconsin state pensions as an example).

and economies of scale.[227] Larger funds may obtain better investment returns.[228] Their investment expenses tend to be lower because managers may reduce fees to manage greater sums of capital, and they can spread their costs over a larger base of contributors.[229] Conversely, as pension funds shrink, their operational expenses become a larger fraction of pension assets.[230]

Each of these factors varies by fund, depending on its size, its funding level, and its generational bulges and depressions. What is clear is that while funds do not and should not involve themselves directly in employment decisions, they may make investments that any reasonable trustee knows or should know could have a substantial effect on such decisions. It may well be the case that the investment is prudent and loyal because its return on investment, diversification, and liquidity characteristics outweigh the negative impact on the fund of layoffs and permanent elimination of jobs, or even because refraining from the investment will do nothing to protect employee jobs because other investors will fill the void. But to the extent that its employment impact actually harms the fund, such an investment may also be imprudent and disloyal. This cannot be known if the employment impact is not assessed.

According to the 2008 Bulletin, plan trustees should consider "diversification, liquidity, and risk/return" when making plan investments.[231] In most situations, this guidance is entirely appropriate. But investment decisions made by fund trustees that affect participant employment may have a reasonably foreseeable impact on the flow of participant and employer contributions to the fund, and therefore on the fund's health. Thus, trustees considering the impact of an investment on participant contributions (and future liabilities) by assessing the jobs impact of an investment act consistently with the duty of loyalty because they make that investment "solely in the interest of the participants and beneficiaries and (A) for the exclusive purpose of (i) providing benefits to participants and their beneficiaries . . . ."[232]

[227] Fornia Interview, *supra* note 95; *see also* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609, 620–21 (2001) (discussing general acceptance that economies of scale exist in the fund context).

[228] Fornia Interview, *supra* note 95; *see also CalPERS Says it Spent $139 Million on Costs in 1996*, 9 Andrews Pension Fund Litig. Rep. 10 (1998) (indicating that CalPERS' costs were 30% less than similar multi-billion dollar funds).

[229] Fornia Interview, *supra* note 95.

[230] *Id.*

[231] 29 C.F.R. § 2509.08-1 (2013).

[232] 29 U.S.C. § 1104(a) (2012).

II
CRITIQUING THE TRUST LAW MODEL FOR PUBLIC PENSION FUNDS: A COMPARATIVE AGENCY COST ANALYSIS OF TRUSTS, PRIVATE PENSIONS, AND PUBLIC PENSIONS

In this Part, I step away from textualist arguments to consider the law and economics of trusts as compared to employee benefit plans generally and public pension funds in particular. In doing so, I engage the literature that assesses the agency costs that trust law was designed to address. Briefly, agency costs are the costs to the principal of hiring an agent.[233] Because the principal and the agent have different interests, and because the agent may have more information, the principal may have difficulty in monitoring the agent to make sure that the agent is acting in the principal's interests.[234] Legal scholars have applied agency cost analysis to a broad array of institutions and legal doctrines to deepen understanding of those institutions and the laws that are designed to govern them. Of particular relevance to this Article is agency cost analysis that has been applied to corporations and corporate law and to trusts and trust law. Here, I argue that the agency costs of public pension funds are different from those of the private donative trust, and even from the private pension funds ERISA was actually designed to regulate. Thus, application of trust law and ERISA in the public pension context ought to be done with sensitivity to the differing sets of costs these bodies of law should address. In particular, I argue that a member-first view of the duty of loyalty does not raise the same agency cost concerns in the public pension context that more broadly-interpreted duties might in the trust or even the private fund contexts.[235]

Four aspects of public pension funds distinguish them from trusts generally or private ERISA funds: (1) Unlike the corporate sponsors of private pension funds, the state and municipal sponsors of public pension funds are not subject to the market for corporate control and are not merged into or acquired by other entities; consequently, it is not necessary for the legal architecture to guard against the agency

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233 LUCIAN BEBCHUCK & JESSE FRIED, PAY WITHOUT PERFORMANCE 15–16 (2004) (discussing the concept of agency costs and its impact on levels of executive compensation).

234 *Id.*

235 *See* Fischel & Langbein, *supra* note 38, at 1116 ("The stricter fiduciary rules of trust law mimic the contractual terms that the settlors and trustees would have agreed upon if the costs of negotiating and enforcing such contracts were zero.").

costs that manifest in the mergers and acquisitions context;[236] (2) in contrast to private trusts, public pension funds operate in public where they can be more easily monitored (though perhaps they are not subject to as much disclosure and monitoring as they should be);[237] (3) for many funds, pension fund participants and beneficiaries may elect representative peers to serve on fund boards of trustees, reducing the types of monitoring concerns one might ordinarily face in a private trust;[238] and (4), public pension fund members also contribute to the fund, unlike private trust members—they are donors in addition to being beneficiaries. The fourth distinction matters less for the agency cost analysis than it does for the point that these conflicted investments inflict a dignitary harm on members.[239] For the first three reasons, some of the ordinary agency cost concerns one might find in a private trust or even a private pension plan may not exist in the public pension context, or exist in different form. Therefore, the shift from a fund-first to a member-first view of the duty of loyalty raises fewer agency cost concerns in the public pension context than it might elsewhere.

A. The Problem of Applying Trust Law to Employee Benefit Plans Generally and Public Pension Funds in Particular: Insights from Agency Law and Corporate Law

ERISA's own legislative history acknowledges that the statute's application of trust law to employee benefit plans is problematic because trusts differ from employee benefit plans:

> [R]eliance on conventional trust law often is insufficient to adequately protect the interests of plan participants and beneficiaries. This is because trust law had developed in the context of testamentary and inter vivos trusts (usually designed to pass designated property to an individual or small group of persons) with an attendant

236 Manne, *supra* note 39, at 117–18. The market for corporate control has often been thought to lower agency costs, although that view has been challenged. The absence of such a market for public pension fund control might raise the agency costs of public pension trustees.

237 *See* Romano, *supra* note 40, at 822 (describing the public nature of public pension fund operations).

238 *See* Hess, *supra* note 41, at 195–98 (2005) (describing how the political independence and direct financial interest in the plan of member trustees enables them to focus on beneficiary interests); Romano, *supra* note 40, at 821 (characterizing the correlation between improved pension fund performance and elected beneficiary board members as consistent with literature indicating correlation between corporate performance and management owned equity).

239 *See infra* Part III.A.1.a (explaining that the basis for the divestment approach is the idea that the funds contributed by members should not be used in ways that are offensive to them or harmful to their interests).

> emphasis on carrying out the instructions of the settlor. . . . [T]he typical employee benefit plan, covering hundreds or even thousands of participants, is quite different from the testamentary trust both in purpose and in nature.[240]

Scholars have described and reinterpreted the trust form in terms of agency costs.[241] Discussing trust law in terms of agency costs poses some problems because trustees are not necessarily agents.[242] Still, agency cost analysis has provided one framework within which to understand trust law and compare it to other bodies of law. Such analysis has been used to explain why trust law has stricter fiduciary duties than, for example, corporate law, a discussion which offers insights here.[243] Trusts and corporations differ in several respects. For instance, there is no secondary market for the residual claims of beneficiaries of a trust because "spendthrift" clauses bar beneficiaries from alienating their trust interests.[244] In contrast, shareholders of a publicly-held corporation may exit by liquidating their holdings in secondary markets.[245] Trust beneficiaries have little or no say over trustees.[246] This restriction is designed to effectuate the will of the settlor.[247] In contrast, shareholders, at least theoretically, may vote out corporate directors.[248] In this respect, pension funds are more similar

240 H.R. REP. NO. 93-533, at 12 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4649–51; *see also* Varity Corp. v. Howe, 516 U.S. 489, 497 (1996) ("ERISA's standards and procedural protections partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection. . . . Consequently, we believe that the law of trusts often will inform, but will not necessarily determine the outcome of, an effort to interpret ERISA's fiduciary duties.").

241 *See, e.g.*, Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 638–48 (2004) (discussing agency costs in the trust context); Reid K. Weisbord, *Social Security Representative Payee Misuse*, 117 PENN ST. L. REV. 1257, 1280–82 (2013) (same).

242 *See* FRANKEL, *supra* note 68, at 5–6 (discussing the differences between trust and agency and noting that trust law places greater restrictions on trustees than agency law does on agents).

243 *E.g.*, Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 J. CORP. L. 565, 570–71 (2003); Fischel & Langbein, *supra* note 38, at 1115–16.

244 Sitkoff, *supra* note 243, at 570 (citing RESTATEMENT (THIRD) OF TRUSTS § 58 (2003); RESTATEMENT (SECOND) OF TRUSTS §§ 152–53 (1959)).

245 *Id.*

246 *Id.* at 571.

247 *Id.* (explaining that the prohibition on beneficiaries' alienation of their interests and lack of ability to replace trustees operate to ensure that the will of the settlor is achieved).

248 *See id.* (pointing out that beneficiaries cannot easily replace trustees). *But see* Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1051–52 (2007) (noting that corporations do not squarely fit the traditional model of agency relationships at common law, because corporate boards, although acting as agents with fiduciary duties to the principals—the shareholders—are not controlled by them throughout the relationship). Note that unlike trust law, ERISA does have a provision for the replacement of trustees. *See* 29 U.S.C. § 1109 (2012) (codifying ERISA section 409 and stating that ERISA

to the corporate model than the trust law model, in that they allow for removal of trustees.[249] Trusts also operate largely in private,[250] in contrast to public corporations which are publicly scrutinized and have extensive disclosure obligations under the securities laws.[251] Here, too, pension funds bear a closer resemblance to corporations than to trusts because they have public disclosure requirements.[252] Because trusts operate in private and trust beneficiaries have no market check, no effective exit, and no ability to hire or fire the trustees, trustees wield greater power over beneficiaries than do corporate CEOs and boards over shareholders.[253] Consequently, strict fiduciary duties play a more important role in policing trustee behavior than in the corporate context.[254] For example, as Robert Sitkoff has pointed out, transactions in which a trustee has engaged in self-dealing are automatically voided, and there is "no further inquiry" into whether trust beneficiaries were harmed by the transaction.[255] In contrast, corporate officers who engage in self-dealing transactions have not per se violated their fiduciary duties.[256] The lack of meaningful checks on trustee power explains the stricter fiduciary duties that apply to trustees.[257]

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fiduciaries can be removed for breach of fiduciary duty); Mass. Mut. Life Ins. Co. v. Russell, 473 U.S. 134, 139 (1985) (noting that under ERISA section 409(a), 29 U.S.C. § 1109(a), a fiduciary may be removed for a violation of section 411 of ERISA); Best v. Cyrus, 310 F.3d 932, 935 (6th Cir. 2002) (holding that a plan's trustee has a duty to secure all funds due to the plan and that a breach of this duty allowed for his removal under ERISA).

249 *See, e.g.*, 29 U.S.C. § 1109 (2012) (codifying ERISA section 409).

250 Sitkoff, *supra* note 243, at 570.

251 *See id.* ("[I]f managers install a weak system of internal governance and in so doing expand their opportunities for mal-, mis-, or nonfeasance, then the price that investors will be willing to pay for the firm's securities will fall accordingly.").

252 *See, e.g.*, ERISA Form 5500 (2013), *available at* http://www.dol.gov/ebsa/pdf/2013-5500.pdf (requiring annual report of administration, participation, and categorization information for employee benefit plans, including pensions); Peralta v. Hispanic Bus. Inc., 419 F.3d 1064, 1073 (9th Cir. 2005) (holding that a fiduciary is required to go beyond even the extensive reporting requirements in ERISA in notifying and informing beneficiaries); Liberty Mut. Ins. Co. v. Donegan, 746 F.3d 497, 503 (2d Cir. 2014) (discussing the annual detailed reports mandated by ERISA and the DOL's broad authorization to study, analyze, and research employee benefit plans).

253 Sitkoff, *supra* note 243, at 570–71.

254 *Id.* at 571.

255 *Id.* at 573.

256 *Id.* ("Under the no-further-inquiry rule, even if the self-dealing transaction is objectively fair, the beneficiaries need only show the existence of the trustee's self-interest in order to prevail. Once the beneficiaries prove the fact of self-dealing, there is 'no further inquiry' and the transaction is voided.").

257 *See id*. at 572 ("Applied here, the fiduciary obligation is a crude substitute for the mechanisms of market efficiency that cause prices to reflect all available information and so underpin the rationality of shareholder passivity in the corporate context.").

Thus, altering the fiduciary duties that apply to trustees risks undermining an important check on trustee behavior. One should consider the possible costs and benefits of reinterpreting the duty of loyalty to encompass a member-first view. One advantage of the fund-first view is that it confines trustees to a narrow objective by which their performance is measured: fund performance.[258] This narrow constraint helps police trustee misbehavior because it limits discretion and therefore the potential for abuse and malfeasance.[259] Expanding the duty of loyalty to the interests of participants and beneficiaries, rather than the fund alone, arguably expands trustee discretion and the potential for trustee misbehavior.

Although this expanded discretion may not be inherently suspect if the current narrow rule can be shown to undermine the interests of fund participants and beneficiaries, it may still have disadvantages. Under the guise of expanded discretion via a broader duty of loyalty, trustees could justify departures from performance benchmarks by pointing to investments that may have earned subpar returns but were justified on the basis of reduced negative employment prospects for fund participants. The impact of investments on participant jobs, and in particular the avoided negative impact on jobs, might be difficult to measure or detect, particularly by someone who does not serve on the board of trustees and may not have access to all of the relevant information at the time of investment. Hence, there is some risk that trustees could abuse the expanded discretion of a member-first view.

Consider one context that is inapplicable to public pension funds but is frequently cited as justification for the fund-first view, in which a member-first rule might risk this type of abuse: mergers and acquisitions.[260] Company *A* offers to acquire Company *B*, aiming to reduce labor costs by downsizing Company *B* employees. Company *B*'s man-

[258] *See supra* notes 15–23 and accompanying text (introducing and describing the basic function of the fund-first view).

[259] Sitkoff, *supra* note 243, at 572.

[260] *See, e.g.*, I.R.S. Gen. Couns. Mem. 39,870 at 5–7 (Jan. 23, 1992) (opining that the consideration of "non-financial employment-related factors" by the trustee of an employee stock ownership plan may be used by management as an "antitakeover device" and constitutes a form of "social investing" unauthorized by the exclusive benefit rule of the Internal Revenue Code). Two commentators described the latter statement by the I.R.S. assistant general counsel as being "unsupported by meaningful analysis." Richard A. Gilbert & Greg R. Riddle, *Economically Targeted Investments, or "Doing Good Without Being 'Done In,'"* Q219 ALI-ABA 189, 204 (1993). It is ultimately DOL's position on the interpretation of the exclusive benefit rule that matters. *See* Richman, *supra* note 74, at 234–35 (noting that the IRS must give the DOL the opportunity to block any action disqualifying a plan for violating the exclusive benefit rule, and that IRS General Counsel Memoranda are not necessarily binding or precedential under Section 6110(j)(3) of the Internal Revenue Code).

agement opposes the merger; several managers sit on the board of the company pension fund. Company *B*'s manager/trustees could direct the pension fund to acquire shares of Company *B* and vote those shares against the merger, ostensibly (perhaps actually) in the interests of protecting the jobs of Company *B* employees, who are participants in the fund.[261] If consideration of fund participant jobs is irrelevant to the fiduciary analysis or would itself be considered a breach of fiduciary duty, then the risk that corporate managers could use the fund as an entrenchment mechanism is almost eliminated. Diversification and liquidity considerations alone might rule out such an investment.

Still, the concerns raised in the mergers and acquisitions context might not be enough to justify the fund-first view, even for private pension plans. It remains the case that purchasing stock in Company *B* to fend off a merger that would result in fund participant downsizing might be in the best economic interests of fund participants and beneficiaries, even accounting for the potentially unattractive risk/return, diversification, and liquidity prospects of such an investment. Presumably, proper analysis of the jobs impact of the investment alongside these more traditional components of the investment analysis could identify the best economic interests of fund participants and beneficiaries while remaining within the constraints of a broader duty of loyalty, and the duties of prudence, impartiality, and diversification. Of course, agency costs are potentially high here, and corporate managers interested in entrenching themselves might abuse their positions as fund trustees to secure an investment by the fund that is not in the best interests of fund participants and beneficiaries.[262]

But these types of conflicts regularly manifest in the corporate context.[263] Corporate law has developed ways of coping with them

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261 *See, e.g.*, Donovan v. Bierwirth, 538 F. Supp. 463, 471 (E.D.N.Y. 1981) (holding that corporate pension trustees violated the duty of prudence in directing the pension fund to purchase shares in the sponsoring company to help fend off a hostile tender offer). Importantly, the court did not find that this action constituted a breach of the duty of prudence per se, but rather, that the fiduciaries failed to conduct "sufficient inquiry into the facts upon which they based their decisions." *Id.*

262 *See* Varity Corp. v. Howe, 516 U.S. 489 (1996) (finding that a corporation that acted as both employer and fund manager violated ERISA fiduciary duties by transferring money-losing divisions from one subsidiary to another and tricked employees into forfeiting benefits by joining transferred divisions); *see also* I.R.S. Gen. Couns. Mem. 39,870, at 1 (Jan. 23, 1992) ("A provision in a trust agreement violates the exclusive benefit rule of section 401(a)(2) for purposes of plan qualification where the trustee is allowed to consider non-financial employment-related factors in the tendering, voting and handling of securities."); Fischel & Langbein, *supra* note 38, at 1138–42 (discussing conflicts in the context of a takeover bid).

263 *See* Fischel & Langbein, *supra* note 38, at 1140–41 (explaining the conflict between younger and older employees in mergers, namely that younger employees' future income

short of blanket rules that bar entire sets of transactions. For example, Delaware law provides enhanced protections for minority shareholders faced with a buyout offer from a controlling shareholder.[264] The agency-cost concerns of controlling shareholder acquisitions are well-known. Controlling shareholders have access to inside information; they may time the acquisition to favor their own interests and thereby squeeze out minority shareholders, opportunistically depriving them of future benefits of ownership.[265] Also, the board of directors—the typical shareholder agents—may be compromised by conflicts of interest and poorly positioned to vindicate the rights of the minority shareholders.[266] One solution to this dilemma would be to create legal rules that effectively bar an entire class of transactions—in this case, controlling shareholder acquisitions. But such a ban would also deprive shareholders of the potentially profitable opportunity of receiving a premium for the shares from a controlling shareholder, who may have perfectly legitimate reasons to make an offer.[267] Corporate law has opted to thread the needle by permitting such transactions while requiring greater protections for minority shareholders in controlling shareholder acquisitions.[268]

Similarly, there are protections short of the fund-first view that could safeguard the economic interests of plan members in transactions like the hypothetical one described above. For instance, one could require that only employee representatives be eligible to

derives more from employment than investments and the opposite is true for older employees).

264 David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907, 922–23 (2014).

265 *See* Kahn v. Lynch Commc'n Sys., Inc., 638 A.2d 1110, 1116–17 (Del. 1994) (citing Citron v. E.I. Du Pont de Nemours & Co., 584 A.2d 490, 502 (Del. Ch. 1990)) (setting out the policy rationale for applying the higher "entire fairness" standard to controlled mergers).

266 *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that business judgment deference does not apply in a controlled merger, and overruling precedent to that effect; in a controlled merger, the burden is on the acquirer to show entire fairness).

267 *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787 (2003) (discussing control premium).

268 There are other examples of how corporate law has accommodated apparently conflicted transactions. For example, in 1880, contracts between a corporation and its directors were "voidable at the instance of the corporation or its shareholders, without regard to the fairness or unfairness of the transaction." Gordon, *supra* note 42, at 92 (quoting Harold Marsh, Jr., *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 36 (1966)). But thirty years later, this rule was dead. As Gordon explains, "the courts realized that the relaxed rule permitted the parties to save on transaction costs. Buyer and seller could use their corporate connection to find one another and to gain quick access to reliable information . . . . In short, the relaxed rule appeared to be more efficient." *Id.*

approve such an investment, and that they must do so unanimously after a thorough fiduciary review that concludes that the investment is in the best economic interests of fund participants and beneficiaries, and that it is consistent with the duties of impartiality, diversification, and prudence. One could also require independence criteria for those who vote on the investment. The fundamental point is that there likely are creative options short of a de facto ban on such transactions that could maximize the economic interests of fund participants and beneficiaries.[269]

Whether these potential agency costs justify a blanket rule requiring trustees of target company pension plans to ignore jobs of target plan participants in making a defensive investment is a question for another article. The relevance of the discussion to this Article is simply to illustrate that a primary justification for the fund-first view is not applicable to public pension funds, which are not merged or acquired. Plan members do not need the law to protect them from nonexistent harms, particularly when the purported legal protection hurts them in other ways.

It is true that public pension funds may face different sets of agency costs from those of private trusts or private pension plans. Having politicians on one's board of trustees introduces a host of potential concerns, including the risk of politicians seeking to use the funds to advance their own interests or those of constituents who are not fund beneficiaries. Research shows that public pension funds that have a critical mass of beneficiary board members outperform funds that are dominated by politicians.[270] These member trustees are either invested in the fund or currently collect benefits from it as retirees. They have skin in the game, and as a consequence, they are in a better position than the typical trust beneficiary to monitor trustee conduct.[271] They can check the behavior of non member trustees, like

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[269] *See* Beeferman, *supra* note 189 (arguing that plan sponsors should be able to consider workers' interests in the enterprise associated with the pension fund).

[270] Hess, *supra* note 41, at 216–17 ("[Member-elected trustees] are motivated, accountable to plan beneficiaries, and independent of political influence. . . . Member-elected trustees' dedication to their duties also appears to be beneficial to plan financial performance." (footnote omitted)); David H. Webber, *Is "Pay-To-Play" Driving Public Pension Fund Activism in Securities Class Actions? An Empirical Study*, 90 B.U. L. REV. 2031, 2069–70 (2010) ("[B]oard members who are elected by plan participants and are themselves fund beneficiaries are likely to be less susceptible to political influence or pressure because their personal retirement funds are at stake and their positions do not depend on the good graces of state officials." (quoting Romano, *supra* note 40, at 820)). Private pensions also have employee representatives, and may face similar job conflicts, like pension investment in outsourcing.

[271] *See* Hess, *supra* note 41, at 198 (arguing that member trustees incentivized by direct financial interest may improve fund performance); Romano, *supra* note 40, at 821

politicians and their appointees, either by outvoting them or by calling attention to their potentially self-interested behavior, at least when it comes to making plan investments.[272] Under either a member-first or fund-first view, funds may be better off with beneficiary board members than without them, and most boards do have at least some beneficiary members. But the benefits of member-first outlined above are not automatically negated by the presence of politicians; on the contrary, the example of the Florida Retirement System's investment in Edison Schools illustrates at least one way that political agency costs could be reduced under a member-first view. If anything, such costs counsel in favor of reducing political influence over boards, not favoring a fund-first over a member-first approach.

In sum, the typical agency cost concerns for private trusts as well as private pension plans should not prevent a transition from a fund-first to a member-first view of fiduciary duty. An assessment of the types of costs associated with public pension funds in particular does not alter this conclusion.

III
Implementing a Member-First View of the Duty of Loyalty and Assessing Its Practical Effects

The purpose of shifting from a fund-first to a member-first view is to properly prioritize the economic interests of plan members in the making of investment decisions. As I have argued above, the fund-first view undermines the original purpose of the duty of loyalty and the exclusive purpose rule by demoting these interests to maximizing return on investment for the fund. Currently, funds following the 2008 Interpretive Bulletin consider prospective investment returns, diversification, liquidity, the prudence of the investment, its impartiality as between participants and beneficiaries, and whether it complies with the fund-first view of fiduciary duty.[273] Under a member-first view of fiduciary duty, fund trustees would assess all of these factors along with the prospective jobs impact of the respective investments.[274] My

(characterizing the correlation between improved pension fund performance and elected beneficiary board members as consistent with literature indicating correlation between corporate performance and management-owned equity); *see also* Webber, *supra* note 270, at 2069–70 (adopting Hess and Romano's corporate performance analogies to contend that beneficiary board members will better oversee and regulate board activity).

272 Hess, *supra* note 41, at 198.

273 29 C.F.R. § 2509.08-1 (2013); *see also supra* notes 84–89 and accompanying text (discussing the investment standards laid out in the 2008 Bulletin).

274 *See supra* Part I.C (discussing the inadequacy of the "investments of equal value" rule, namely that it requires trustees to find an investment of equal value before considering the jobs impact as a deciding factor).

argument favoring a member-first view does not concede that fund-first is currently the law, only that fund-first is the ascendant view of the law. This Part assesses the practical effects of a shift to a member-first view of fiduciary duty. I argue that this shift will alter the information environment, creating conditions that will require greater awareness and disclosure of investments by public pension funds in companies that compete with their members. Alteration of the information environment alone could change investment behavior.

Once this information environment is enriched, funds will likely find that they are either currently invested in companies that have an impact on their members' jobs, or that they may prospectively make investments that have such an impact. A fund should still proceed with an investment that may have an adverse jobs impact unless the adverse impact outweighs the comparative advantages of the investment.

Under a member-first view, funds would have three possible responses to these investments: (1) they could exit investments that violate the member-first standard; (2) they could hold such investments and engage investee management in an effort to reduce the investments' negative jobs impact; or (3) they could proactively select investments that enhance participant jobs and/or the number of employee-contributors to the fund.[275] Of course, all three options may be exercised in combination. In many instances, fund investments will have no impact on participant employment, and consequently, no analysis is necessary beyond what funds normally undertake under a fund-first view. But for investments that implicate participant employment, the member-first view could have a dispositive impact on asset allocation, as discussed in Part I.C. In this Part, I discuss what this assessment should look like, and how it should be applied.

A. How a Shift to a Member-First View of Fiduciary Duty Alters the Informational Environment in Which Investment Decisions Are Made

Under a member-first view, fiduciaries making investment decisions will be required to assess the potential impact on participant jobs. The most efficient way for public pension funds to comply with a

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[275] Radhakrishnan Gopalan, *Large Shareholder Trading and Takeovers: The Disciplinary Role of Voting with Your Feet* 1 (Univ. of Mich., Ross Sch. of Bus., Job Market Paper, 2005), *available at* http://apps.olin.wustl.edu/workingpapers/pdf/2006-07-011.pdf; *see also* ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 21, 30 (1970) (identifying customers' stoppage of purchasing a firm's products as a type of "exit" and customers' expression of dissatisfaction to management as "voice").

member-first duty of loyalty would probably be to institute conforming investment policies. The basic principle is straightforward: Fund investments should be designed to prioritize the advancement of the economic interests of fund participants and beneficiaries. Generally, fund trustees do not directly assess every investment.[276] Instead, they establish investment policies implemented by internal investment staffs, outside investment managers, or some combination of the two.[277] Under a member-first view, these policies would require funds to account for the participant jobs impact of fund investments. In the first instance, investments that could affect jobs must be flagged for assessment. Once identified, those making the investment decision will have to account for that jobs impact, either by assessing it themselves, requiring disclosure of the investees' assessments, or some combination of the two. The bottom line is that funds will need to analyze the potential jobs impact of the investment, which requires disclosure and appraisal of the relevant information.

Because funds are not currently required to take jobs into consideration, jobs-harming investments are often made without the knowledge of the fund trustees or the investment staffs, and may only be discovered when angry fund participants discover these investments on their own—if they are discovered at all.[278]

The mere disclosure of the potential jobs impact of an investment could itself alter investment behavior. Investment staffs or outside investment managers might be more inclined to seek out investments that enhance participant employment, or to avoid investments that harm it.[279] Businesses that compete with public employees for their jobs and that depend on funding from public pension plans might sua sponte explore ways to minimize their negative impact on participant jobs. With public pension plans operating under a member-first view, such businesses would have a direct economic incentive to make their

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[276] *See* Dianne Del Guercio & Jennifer Hawkins, *The Motivation and Impact of Pension Fund Activism*, 52 J. FIN. ECON. 293, 301 (1999) (describing the existence of investment staffs and managers responsible for implementing investment fund policies).

[277] *Id.*

[278] *See* Taibbi, *supra* note 31 (describing a union campaign against investment in private ambulance companies).

[279] Outside investment managers are particularly eager to please large institutional clients like public pension funds; these managers are compensated not only on the basis of fund performance, but also by total assets under management; asset shifts by public pension clients from one outside investment manager to another may substantially affect the managers' compensation. *See* Daisy Maxey, *How to Pay Your Financial Advisor*, WALL ST. J., Dec. 12, 2011, at R1 (stating that compensation based on a percentage of total assets under management has been the prevailing method of compensating financial advisors and noting that "[a]dvisers have a strong incentive to boost client returns, because their fees increase as the assets grow—and fall if the assets decline").

business plans more friendly to plan participants when seeking funding from public pensions.[280]

Still, it should be noted that, while the disclosure of relevant information might alter investment behavior, it likely cannot vindicate a member-first view on its own. The next question is how funds should respond to investments that harm (or help) participant jobs once they are aware of this impact. There are three potential responses: exit, voice, and proactive jobs creation.

1. Exit or Screening

Assume that a fund identifies an investment that harms participant jobs, and this harm more than offsets the superior expected returns of such an investment. One response might be to exit from the investment, or to decline the prospective investment in favor of another that is more likely to advance the economic interests of plan members. One consideration is whether exit could actually reduce the negative jobs impact on plan participants, or whether another indifferent investor might fill the investment void. This may depend on the investment context—whether it is a private equity investment, a private placement, or an exchange-based securities transaction in highly liquid secondary markets.[281] Often, limited partners in private equity investments have limited exit (and voice) rights.[282] But some public pension funds have become more sophisticated about private equity investments, demanding separate investment accounts rather than limited partnerships, thereby maintaining greater say over their investments than they would have as limited partners.[283] Even limited partners in private equity investments may retain leverage over investees, to the extent that the latter are interested in obtaining capital in the future from the limited partners. In contrast, exit from exchange-traded investments is comparatively easy, but this same ease of exit may undermine its effectiveness because of the high probability that another investor will step in and minimize the harm of exit to the

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280 This depends, in part, on how easy it would be to replace public pension funding with other sources of funding. For more on this, see *infra* Part III.A.1–2.

281 *See* Hirschman, *supra* note 275, at 26–27 (describing the possible failure of the exit option in market contexts that indicate a high level of liquidity).

282 Josh Lerner & Antoinette Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, 72 J. Fin. Econ. 3, 4–5 (2004) (describing the role of limited partners in private equity funds).

283 *E.g.*, Lisa Parker, *Investors Looking to Invest in Private Equity via Separate Accounts – October 2014*, Preqin (Oct. 9, 2014), https://www.preqin.com/blog/101/10025/pe-via-separate-accounts.

investee.[284] In some cases, exit could have no effect or even be counterproductive, leading a fund to sacrifice the superior returns of a jobs-harming investment while gaining no jobs protection for its participants.

Shareholders employ a range of exit strategies, from boycotts and divestment campaigns to the "Wall Street Walk."[285] Institution of a member-first view bears some resemblance to these strategies, but it also differs from them in substantial ways, potentially limiting their applicability to implementation of the view. The basic intuition behind exit strategies is that they succeed because they depress the target's price or value.[286] By reducing the pool of capital available to the target, or by creating downward pressure on asset prices, exit increases the target's cost of capital, makes it more vulnerable to takeovers, or harms managers who own stock of declining value.[287]

Whether exit works in practice is a matter of extensive debate.[288] The exit option may be limited for public pension funds, which are large, diversified funds that employ passive investment strategies

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[284] *See* ALICIA H. MUNNELL, SHOULD PUBLIC PLANS ENGAGE IN SOCIAL INVESTING? 5 (2007) (using the Vice Fund, which invests in alcohol, tobacco, and firearms companies, as one example of the presence of an alternate investor that could undermine the effectiveness of divestment efforts).

[285] *See, e.g.*, Anat R. Admati & Paul Pfleiderer, *The "Wall Street Walk" and Shareholder Activism: Exit as a Form of Voice*, 22 REV. FIN. STUD. 2645, 2645 (2009) (examining "whether a large shareholder can alleviate conflicts of interest between managers and shareholders through the credible threat of exit on the basis of private information"); Siew Hong Teoh, Ivo Welch & C. Paul Wazzan, *The Effect of Socially Activist Investment Policies on the Financial Markets: Evidence from the South African Boycott*, 72 J. BUS. 35 (1999) (arguing that divestment is ineffective because investors who are indifferent to the targeted issue fill the void created by activist investors who choose to divest); Jayne Elizabeth Zanglein, *From Wall Street Walk to Wall Street Talk: The Changing Face of Corporate Governance*, 11 DEPAUL BUS. L.J. 43, 45–47 (1998) (discussing the transition from divestment to strategic voting and direct communication as the method by which pension funds seek to influence corporate decision-making); Eric Hendey, *Does Divestment Work?*, HARVARD U. INST. POL., http://www.iop.harvard.edu/does-divestment-work (last visited Nov. 17, 2014) (discussing divestment as a means of influencing companies to adopt renewable energy strategies and using the South African divestment campaign as an example of the political effectiveness of divestment).

[286] *See* HIRSCHMAN, *supra* note 275, at 22–23 (discussing the assumptions underlying the presumed effectiveness of exit strategy, including the analogy to supply, demand, and price dynamics).

[287] *See id.* (discussing the assumptions underlying the presumed effectiveness of exit strategy, including the analogy to supply, demand, and price dynamics); Gopalan, *supra* note 275, at 32–40 (discussing increased susceptibility to takeover as an effect of divestment).

[288] *See* HIRSCHMAN, *supra* note 275, at 26 (describing circumstances under which exit would fail to harm investees); Gopalan, *supra* note 275, at 7–8 (discussing increased susceptibility to takeover as an effect of divestment).

across large segments of their portfolios.[289] Diversification requirements may limit the extent to which the funds can credibly threaten exit, although some funds have exercised the exit option in the past.[290] Certain funds may be more capable of exiting from private equity investments than from investments that are part of their indexing strategies. Additionally, exit may harm the investee, but it may harm the exiting investor too, who could be hurt by declining prices caused by its own departure.[291] A final potential weakness of exit is that it may not work if other investors are willing to step in to support the price.[292]

Whether exit succeeds may depend on several factors, including the investment context, the amount of capital exiting, and the exit strategy, that is, whether it is a boycott-type exit that leaves no room for voice and is broadly targeted, or a narrower, "Wall Street Walk" exit that allows for voice and is target specific. Below, I analyze boycotts and the Wall Street Walk, and explain why I think the latter may be the more appropriate choice.

a. Boycott or Divestment

There is some skepticism about the economic effectiveness of divestment among finance academics. For example, although the famous South Africa boycott over apartheid may have played a role in increasing the salience of the racist practices of that society, rallying the victims and bringing moral suasion to bear upon its practitioners, at least one study has suggested that it was ineffective in that it failed to cause economic harm to its targets.[293] Similar claims have been made about divestment from Sudan, tobacco companies, and firearms

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289 *See* Benjamin J. Richardson, *Can Socially Responsible Investment Provide a Means of Environmental Regulation?*, 35 MONASH U. L. REV. 262, 272 (2009) (observing that divestment campaigns narrow the investment pool and may impede diversification, therefore increasing risk).

290 *See* Michael Sicilia & Ricardo Duran, *CalSTRS Statement on its Decision to Divest of Certain Firearms Holdings*, CAL. ST. TCHRS.' RETIREMENT SYS. (Jan. 9, 2013), http://www.calstrs.com/statement/calstrs-statement-its-decision-divest-certain-firearms-holdings (discussing CalSTRS's decision to divest from firearms companies).

291 *See* Martin B. Meznar, Douglas Nigh & Chuck C.Y. Kwok, *Effect of Announcements of Withdrawal from South Africa on Stockholder Wealth*, 37 ACAD. MGMT. J. 1633, 1641 (1994) (finding that firms that announced their divestment from South Africa experienced a 5.5% decline in stock price in the days following the announcement).

292 *See* HIRSCHMAN, *supra* note 275, at 26 (noting that exit could fail if a target firm acquires new customers as it loses old, exiting ones).

293 *See, e.g.*, Teoh et al., *supra* note 285, at 79–83 ("We find no support for the common perception . . . that the anti-apartheid shareholder and legislative boycotts affected the financial sector adversely. . . . [It] had no discernible effect on the valuation of banks and corporations with South African operations or on the South African financial markets."). The authors also entertain the possibility that "the boycott primarily reallocated shares and

companies.[294] The Vice Fund is a notorious example of how boycott efforts can be undermined: The fund was created to invest in alcohol, tobacco, and firearms companies at least partly in response to divestment campaigns targeting those industries. The theory behind the Vice Fund is that it targeted companies that were both profitable and undervalued because of the boycotts against them.[295] The arguable ineffectiveness of divestment campaigns could be due to the costs of implementing the boycotts themselves.[296]

Boycott or divestment is one potential approach to the problem of public pension funds investing in companies that compete with their members for jobs. Funds could simply bar investments in such companies. One basis for such a boycott is rooted in the idea that public pension fund investments in companies that privatize public employee jobs inflict dignitary harm against fund members.[297] Members are forced to contribute to the funds. Therefore, the funds should not harm their interests or be used in ways they find offensive. Thus, even if these investments are economically beneficial to fund members, they could still be avoided because of the dignitary harm caused by the investment.[298] Similarly, the divestment approach could be justified as a form of socially responsible investing. For example, according to a report issued by Freshfields Bruckhaus Deringer (Freshfields Report), which offers a summary of fiduciary law as it applies to environmental, social, and governance investing globally,

operations from 'socially responsible' to more indifferent investors and countries," which would offer some support for voice and engagement strategies over exit. *Id.* at 83.

[294] *See* Luke A. Patey, *Against the Asian Tide: The Sudan Divestment Campaign*, 47 J. MOD. AFR. STUDS. 551 (2009) (arguing that efforts by groups in the United States to encourage divestment from Sudanese oil companies have failed in part due to the ambivalence of Asian governments and the investment funds that they run, which are willing to fill the investment gap).

[295] *See* MUNNELL, *supra* note 284, at 5 ("The 'Vice Fund,' which was established in September 2002, specializes in only four sectors—alcohol, tobacco, arms, and gambling, and thus stands ready to buy the stocks screened out of standard portfolios.").

[296] *See* HIRSCHMAN, *supra* note 275, at 86 (describing the boycott mechanism as costly to both sides); Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U. L. REV. 1, 7 (1992) (describing boycotts).

[297] *See, e.g.*, FRESHFIELDS BRUCKHAUS DERINGER, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT, UNITED NATIONS ENVIRONMENT PROGRAMME FINANCE INITIATIVE 96 (2005) ("[W]e think there is a strong argument that there will be a class of investments that could be reasonably offensive to the average beneficiary . . . . [T]he types of investment that might fall into that class include investments that are linked to clear breaches of widely recognized norms . . . .").

[298] *Id.* ("[The] statement that investment powers must be exercised in the beneficiaries' best interests is taken to mean that . . . trustees may take into account the broader interests of beneficiaries, beyond merely their financial interests.").

fiduciaries may exclude investments that could "reasonably be assumed offensive to the average beneficiary" on the basis of "clear breaches of widely recognized norms, such as international conventions on human rights, labour conditions, tackling corruption and environmental protections."[299] DOL's interpretation of ERISA appears to foreclose such an approach, allowing these considerations only after trustees first conclude that the investments are of equal value.[300] But other sources of U.S. law allow fiduciaries to take into account social considerations—and the purpose of the trust itself, which is to provide benefits to fund participants—when making investment decisions.[301] I do not favor the boycott approach to the jobs issue addressed in this article, but a version of it has been adopted by at least one fund in the United States, the Ohio Public Employees Retirement System (OPERS), which maintains an investment policy that comes close to boycotting privatizing investments.[302] The OPERS investment policy states:

> OPERS does not aim to promote privatization of public sector jobs through its Private Equity investment program. It is highly unlikely that OPERS Private Equity investments would be in partnerships that are dependent on privatization strategies. In evaluating private equity partnerships, the Staff shall use its best efforts to limit circumstances where privatization may have an adverse actuarial impact on OPERS. If such limitation is not possible, the Staff shall seek guidance from the Board prior to committing to such a partnership.[303]

This near-boycott approach has some support under international fiduciary standards, although it is more difficult to reconcile the OPERS policy with a view of fiduciary duty that focuses exclusively on economic interests.[304] Boycotts bar consideration of the potential economic benefits of such investments to fund members and to the

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299 *Id*. But note that the Freshfields Report, in discussing United States law, pointedly observes that "[t]here appears to be no bar to integrating [environmental, social, and governance] considerations into the day-to-day process of fund management . . . *provided the focus is always on the purposes or beneficiaries of the trust and not on securing unrelated objectives*." *Id.* at 114 (emphasis added).

300 *Id*. at 110.

301 *See* Michael Wines, *Stanford to Purge $18 Billion Endowment of Coal Stock*, N.Y. Times, May 7, 2014, at A15 (noting that Stanford University's internal investment guidelines permitted it to consider whether "corporate policies or practices create substantial social injury" when selecting endowment investments).

302 *See* Ohio Pub. Emp. Ret. Sys., Private Equity Policy (2014), *available at* https://www.opers.org/pdf/investments/policies/Private-Equity-Policy.pdf.

303 *Id.* at 7.

304 *See* Edward J. Waitzer & Douglas Sarro, *The Public Fiduciary: Emerging Themes in Canadian Fiduciary Law for Pension Trustees*, 91 La Revue Du Barreau Canadien 163, 191 (2012) (citing Freshfields Bruckhaus Deringer, *supra* note 297).

fund itself.[305] Such investments might be in the economic interests of public employees, even accounting for their potentially negative impact on participant jobs. Moreover, as discussed more fully below, boycotts do not allow for the exercise of voice, and so substantially reduce the possibility of constructive engagement with investees.[306] There is no reason for investees to consider modification of their business plans to reduce the negative impact on public sector jobs if the only investors in these businesses are indifferent to this impact. Perhaps businesses that compete with public employees for their jobs will never meaningfully reduce their negative jobs impact. But assuming that voice might work, the boycott approach could plausibly increase the risk that participants would lose their jobs to private sector competitors because exiting or boycotting retirement funds have no leverage over these competitors. It could be the case that the boycott approach is the best way to vindicate the economic interests of fund members if the following conditions are always true: the negative jobs impact of investments in these companies outweighs their expected return and other investment attributes, boycotts actually cause economic harm to their target that outweighs the harm to the boycotter, and voice is ineffective. It is unlikely that all three of these conditions always hold.

Still, in fairness, the boycott policy does speak to the emotional resonance of this issue for many fund members, the deeply felt sense that these investments constitute a breach of trust even if they do not directly violate a governing legal principle. But even the emotional resonance of the issue may not be enough to lead funds to implement boycott policies. In a prior study, I examined, among other things, the socially responsible investment criteria of the largest fifty-three public pension funds by asset size.[307] Only nineteen of fifty-three (36%) maintained any socially responsible investment criteria.[308] Among a separate set of funds, each of which participated as a lead plaintiff in a securities class action, and might therefore be expected to be more activist than the average fund, just twenty-five of seventy-eight (32%) maintained socially responsible investment criteria.[309] This raises

[305] *See* HIRSCHMAN, *supra* note 275, at 30 ("[Boycott] is undertaken for the specific and explicit purpose of achieving a change in policy on the part of the boycotted organization . . . .").

[306] *See id.* (contrasting exit and voice on the basis that the latter, but not the former, involves an ongoing relationship with the target firm); Hylton, *supra* note 296, at 11 (contrasting boycott with other forms of activism aimed at persuading a firm to alter its objectionable behavior).

[307] Webber, *supra* note 270, at 2068 tbl.9.

[308] *Id.*

[309] *Id.*

questions about the prospects for actual implementation of boycott policies over privatizing investments at United States public pension funds. It also points to a potential advantage of adopting a member-first view. A member-first view, depending on the source of the legal authority that adopts it, has the potential to apply to all funds because it has the potential to become compulsory. In contrast, the boycott approach is likely to remain voluntary, adopted by some funds and not others, and therefore applicable to a smaller pool of capital and less likely to be effective than adoption of a member-first view.

b. The "Wall Street Walk"

The "Wall Street Walk" is another form of exit. In theory, investors can discipline managers by selling their stake in a company if they are unhappy with it, usually because of dissatisfaction with company performance.[310] Some studies have demonstrated the effectiveness of exit as a tool for instituting corporate governance reform; exit may depress prices and increase liquidity, thereby making public companies more vulnerable to hostile takeovers.[311] Depressed prices may also punish managers whose compensation is tied to share price.[312] For repeat players, both investors and investees, exit may have downstream effects by souring relations between the parties, thereby inhibiting future deal making. More broadly speaking, there is a debate within the finance literature as to whether stock prices are sensitive to demand, though the most recent evidence suggests that they can be.[313] As with the divestment discussion above, these studies rely on a variety of assumptions not present here, including assumptions about investor access to private information or a unified interest in maximizing share price. The studies also tend to focus on exit from one target company. Here, a member-first realignment would require exit or voice decisions to be made across a comparatively large swath of

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310 HIRSCHMAN, *supra* note 275, at 4, 21–25 (describing the exit option as "uniquely powerful").

311 *See* Gopalan, *supra* note 275, at 32–40 (discussing increased susceptibility to takeover as an effect of divestment).

312 *See* Admati & Pfleiderer, *supra* note 285, at 2646–47 (arguing that when manager compensation is linked to stock price, the existence of shareholders with a large enough stake to impact stock price upon exit can help to reduce agency costs); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1326–27 (1991) (describing incentive compensation as a means of giving investment managers a stake in performance and reducing agency costs).

313 ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 22 (2000) (citing Jeffrey Wurgler & Ekaterina Zhuravskaya, *Does Arbitrage Flatten Demand Curves for Stocks?*, 75 J. BUS. 583, 600 (2002)) (analyzing chart that measures the cumulative abnormal returns, and the demand shock, of stocks added to the S&P 500).

companies. Still, a realignment towards a member-first view of fiduciary duty is about properly prioritizing the economic interests of fund participants and beneficiaries, not offering a public statement of disapproval for these companies by barring investments in them. Consequently, it requires funds to decide whether the expected returns from such companies offset the potential or actual job losses, or the likelihood that those jobs might be lost anyway, even without the fund's investment. In this respect, funds must calculate what they believe to be in the actual economic interests of their members, which bears a closer resemblance to the analysis that takes place in the Wall Street Walk context than the divestment context.

Analyzing the potential jobs impact of an investment presents a challenging estimation problem. How could a fund determine if exit would plausibly save member jobs? The numbers analysis likely requires some estimation of how exit would increase the investee's cost of capital, reduce manager (or investment manager)[314] compensation, and how this might deter harm to member jobs. There are several components of the analysis. If possible, trustees, or investment staffs, should look to prior actions of the investee, or to companies that perform similar services, and assess the extent to which public employee jobs were terminated as a result of the investee's business. They should also request investee assessments of the jobs impact and independently examine the investee's business plan to make an independent assessment of the potential impact, if possible. Trustees or investment staffs should compare the jobs impact of these businesses to other potential investees, along with the comparative risk and expected rates of return, diversification, and liquidity properties of the investments. Trustees and staffs could assess other sources of capital for the potential investees, in particular, what other funds that adopt a member-first view might be investing in or exiting. Trustees or staffs might assess the extent to which their own exit (and that of other funds) increases the costs of the potential project or otherwise alters it, and how exit might negatively affect the investee. To the extent that the practice of exiting under a member-first view becomes common, trustees could observe whether investees improve the terms of post-exit capital investment, or whether they scale back their jobs-harming projects. Experience may show that, at some point, the cost of capital could rise high enough to force the investee to change course, particularly if the investors are empowered under a member-first view to articulate terms under which they would be willing to

[314] For a discussion of the impact of the member-first view on investment managers, see *infra* notes 327–32 and accompanying text.

invest, i.e., to exercise voice. It may become apparent over time that exit is only effective when a certain level of capital exits, which may be connected to the exit of particularly large or influential funds. Outside investment managers may play a valuable role here, and to the extent funds utilize them, it would make sense to consult them. They may be more intimately familiar with how the investee and companies like the investee are likely to price their capital needs.

The effectiveness of exit depends on how much capital exits. Exit by one small fund would be unlikely to have the desired result. Exit by a larger fund would increase the impact. Exit by a group of public pension funds, large and small, would make it even more likely that the investee harm would be substantial enough to alter the investee's course, perhaps by raising the investee's cost of capital enough to thwart its ability to underbid public employees for job contracts. Any one fund's exit decision[315] might be determined by its assessment of whether other funds will also exit.

Because trustees' fiduciary duties run only to their own fund's members, one might conclude that they could never exit an investment that harmed the jobs of participants in other funds. But that is incorrect. Trustees need not wait until the investee is actively bidding against their own fund's members for jobs before assessing the potential jobs impact of the investment. For example, the Middlesex County Retirement System could exit an investment because, hypothetically, that investment harmed jobs in neighboring Norfolk County.[316] Reasonable Middlesex trustees do not have to wait until Aramark actually submits a bid to privatize Middlesex member jobs before assessing the potential jobs impact on Middlesex's own members of the fund's investment in Aramark. Although Middlesex trustees owe no fiduciary duty to the members of the Norfolk County Retirement System, they can look to the experience of other counties and make reasonable assessments about the investee's potential to harm the jobs of its own members, so long as it plausibly believes that the investee will eventually challenge its own members' jobs. Similarly, the $176.8 billion New York State Employees Retirement System (NYSERS)[317] could exit an investment that harmed jobs for members of the $294.7

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[315] For simplicity, I discuss only the exit option here; I discuss the alternative "voice" approach below in Part III.A.2.

[316] For purposes of this hypothetical example, I set aside the more complicated analysis of the role of the MassPRIT in these investments.

[317] *Pension Fund Overview*, OFF. ST. COMPTROLLER (Mar. 31, 2014), http://www.osc.state.ny.us/pension/snapshot.htm.

billion California Public Employees Retirement System (CalPERS)[318] so long as it based that calculation not on the harm to CalPERS members, to whom NYSERS trustees owe no duty, but on the potential harm to NYSERS members.[319] So could any other public pension fund in the state of Massachusetts or in the country that credibly believed that Aramark or other privatizing companies could compete for jobs against its own members. These observations suggest two important points about implementing a member-first view: It becomes more effective as it becomes more widely adopted, and it could potentially redirect substantial sums of capital in ways that could vindicate the actual economic interests of fund members in fund participant jobs.

The potential effectiveness of this tactic does not assure its correct deployment, which undoubtedly is based on challenging estimation problems. But that is merely a difference in degree, not in kind, from the challenging estimation problems that funds and many businesses face daily. Assessing the expected returns of investments involves consideration of a complicated array of factors and involves estimations of future events. Corporations regularly make investment decisions which may be intimately connected to worker employment by assessing the costs of such decisions and their effect on competitors. Liability for such decisions is rarely, if ever, conditioned upon whether the trustees correctly predicted the future.[320] That type of standard would lead to liability under hindsight bias. Instead, the liability regime governing such decisions is more often focused on whether the decision-makers undertook a thorough process in reaching their decision.[321] Although some decisions to exit or hold the investment might be so obviously incorrect as to constitute breaches

318 *Current Investment Fund Values*, CALPERS (Aug. 7, 2014), http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/mvs.xml.

319 It should be noted that if public pension trustees of separate funds colluded with one another to avoid investing in companies that harm each other's workers, they could raise antitrust concerns. But unilateral actions that merely parallel the actions of other funds are substantially less likely to be actionable under antitrust laws, barring evidence of collusion. *See, e.g.*, Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 553 (2007) (holding that a claim of antitrust violation requires more than a showing of parallel action; actual evidence of collusion must be shown).

320 *See* Kathleen Paisley, *Public Pension Funds: The Need for Federal Regulation of Trustee Investment Decisions*, 4 YALE L. & POL'Y REV. 188, 221–22 & n.211 (1985) (indicating that the business judgment rule does not apply to pension fund trustees, but that courts apply an equally deferential standard that declines to second guess trustees' decisions except in cases of obvious abuse); *see also, e.g.*, Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976) (offering a traditional iteration of the business judgment rule—that mere error on the part of directors is not grounds for liability in negligence), *aff'd*, 387 N.Y.S.2d 993 (App. Div. 1976).

321 FRANKEL, *supra* note 68, at 171–72.

of fiduciary duty, in most cases, courts will likely look to the procedures undertaken by trustees or investment staffs in making the investment decision.[322] Courts would likely want to see that trustees engaged in the right inquiry, asked the right questions, consulted the right sources—as described above—and reached a reasonable conclusion, even if it turned out to be the wrong one.[323]

An investment decision based on benefits to the fund alone could constitute a failure to invest "solely in the interests of participants and beneficiaries, and for the exclusive purpose of providing benefits," if, in a relevant context, it failed to account for the investment's jobs impact.[324] Such an investment decision could have been made in the interests of third parties or outside investment managers, who are compensated on the basis of returns and not harmed by job losses.[325] Such an investment might also violate the duty of care for failing to adequately account for the interests of fund participants and beneficiaries.[326] It may be the case that some funds, on account of their

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322 *E.g.*, Tibble v. Edison Int'l, 729 F.3d 1110, 1121, 1128 (9th Cir. 2013) (focusing on the procedure by which plan fiduciaries arrived at the challenged decisions); *see also* Shaver v. Operating Eng'rs Local 428 Pension Trust Fund, 332 F.3d 1198, 1202–03 (9th Cir. 2003) (stating that allegations of failure to follow proper accounting procedures sufficed to plead breach of fiduciary duty even absent showing of loss).

323 *See, e.g.*, *Tibble*, 729 F.3d at 1128, 1130 (applying the abuse of discretion standard and explaining that courts take into account the fiduciaries' explanations of their decisions and other factors related to the reasonableness of the fiduciaries' decisions).

324 29 U.S.C. § 1104(a)(1) (2012).

325 *See, e.g.*, *In re* Fairchild Indus., Inc. & GMF Invs., Inc., ERISA Litig., 768 F. Supp. 1528, 1533–34 (N.D. Fla. 1990) (denying motion to dismiss for violations of the exclusive purpose rule and the duty of care when plaintiffs alleged that defendant used employees' vested funds to purchase stock in a company of which he was a creditor); DeMott, *supra* note 248, at 1056 (noting that punitive damages also may follow upon an agent's breach of the duty of loyalty); *see also* Langbein & Posner, *supra* note 92, at 102 ("[T]he trustee's duty of loyalty exists solely for the protection of the trust beneficiary, and it is equally violated whether the trustee breaches for the trustee's enrichment or that of a stranger.").

326 *Compare* 29 U.S.C. § 1104(a)(1)(B) (establishing duties of care, skill, prudence, and diligence for fiduciaries of federal pension funds), *with* CAL. CONST. art. XVI, § 17(a)–(d) (mirroring ERISA's exclusive purpose and prudent man rules, as well as a duty of diversification), FLA. STAT. § 215.47(10) (2011) (requiring public pension fund trustees to comply with the fiduciary duties in ERISA), LA. REV. STAT. ANN. § 11:263(A)–(B) (2009) (requiring Louisiana public retirement system trustees to follow the prudent man rule), *id.* § 11:834(B) (requiring Louisiana public retirement system trustees to follow the exclusive purpose rule), N.Y. EDUC. LAW § 502(3) (McKinney 2014) (requiring the New York state teachers' retirement system to follow the exclusive purpose rule as stated in ERISA), 71 PA. STAT. ANN. § 5931(a), (e) (West 2014) (requiring Pennsylvania public pension trustees to comply with the prudent man and exclusive purpose rules), TEX. GOV'T CODE ANN. § 825.101 (West 2014) (mirroring ERISA's exclusive purpose rule), *and* Bd. of Trs. of the Vill. of Barrington Police Fund v. Dep't of Ins., 570 N.E.2d 622, 626 (Ill. App. Ct. 1991) (noting that the Illinois Pension Code is analogous to ERISA and applying ERISA's prudent person standard). *See also* DeMott, *supra* note 247, at 1056–57 (noting that, in an action for breach of fiduciary duty, a showing of "but-for" causation typically required in

small size or other factors, conclude that exit will rarely work for them. They could then opt to follow a de facto fund-first approach under the member-first umbrella, at least when it comes to exit. They could still opt for voice strategies, conveying their preference to the investee to spare participant jobs when reasonable, even if the effectiveness of voice might be limited by the small absolute size of the investment. If nothing else, such voice strategies—which are constrained under the fund-first view—will still vindicate the dignity interests of fund participants who may be offended by these investments.

There is a final point to be made under this analysis. The presence of investment managers arguably enhances the leverage of public pension funds, particularly large funds, in making both exit and voice decisions. In the direct investment context, exit's effectiveness depends in part on the exiting investor's ability to indirectly impact the investee: If exit reduces share prices or increases the cost of capital, it may be effective.[327] In the investment manager context, exit's effect is immediate and direct. Investment managers are compensated under two metrics: fund performance and total assets under management.[328] Any reduction in assets under management harms the manager. True, it is always possible that the exit of one public pension fund client, or even a reduction of that fund's assets maintained with the manager, can be replaced by other clients. But this process is sticky, costly, and not as fluid as it might appear to be on a theoretical level. Fund managers invest large sums in client recruitment and retention. For instance, whole categories of funds, called feeder funds, exist for no apparent reason other than to funnel highly coveted investment clients into particular investment managers.[329]

Anecdotally, investment managers appear to be eager to avoid exit by their pension fund clients. In one high-profile example, Blackstone, a large investment manager, issued a strong statement of sup-

tort actions is not necessary and that it suffices to show that an agent's disloyal conduct was a substantial factor in an outcome adverse to the principal and also pointing out that it is no defense for an agent to assert that he fulfilled his duties of performance despite his disloyal conduct).

327 HIRSCHMAN, *supra* note 275, at 21–24 (discussing the assumptions underlying the presumed effectiveness of exit strategy, including the analogy to supply, demand, and price dynamics, and the effect of a drop in share price on management behavior).

328 *See* Illig, *supra* note 73 (noting that many fund managers are paid according to benchmarks and total assets under management).

329 *See* John D. Rea, Brian K. Reid & Kimberlee W. Millar, *Operating Expense Ratios, Assets, and Economies of Scale in Equity Mutual Funds*, 5 INVESTMENT COMPANY INST. PERSP. 1, 3 n.5 (1999) (collecting studies).

port for public pension funds.[330] It did so shortly after the New York City Employees' Retirement System, a large client of Blackstone's, cancelled a planned meeting with the firm over concerns with the firm's stance on public pension funds.[331] As the *Wall Street Journal* pointed out, "[a]bout $37 of every $100 of Blackstone's $111 billion investment pool comes from state and local pension plans."[332] Thus public pension fund leverage over investment managers may enhance the effectiveness of exit and voice in the member-first context and may have potent downstream effects for investees who hope to turn to such funds for capital.

2. *Voice or Engagement*

A second option for funds facing an investment that has attractive characteristics, but harms or threatens to harm fund participant jobs, is to exercise voice. Rather than exit, funds could maintain their investments and seek to reduce their negative employment impact. They could urge the investees to minimize the number of participant jobs negatively impacted by the investment, and to avoid future action that would further harm participant jobs. The intuition behind voice is closely connected to exit.[333] Investees eager to avoid investor exit and its costs may be willing to meet investor demands regarding their business practices, particularly where the cost of meeting those demands is less than the cost of exit or the cost of a hostile but engaged shareholder.[334] One influential fund, the California State Teachers Retirement System (CalSTRS), maintains voice policies that they apply in the limited context of public-private partnerships.[335] Arguably, such policies could be applied more broadly than just the public-private partnership context. The CalSTRS policies state that, in the context of

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330 Michael Corkery, *Blackstone Group Loves Public Workers*, WALL ST. J. (Jan. 20, 2011, 10:03 AM), http://blogs.wsj.com/deals/2011/01/20/blackstone-group-loves-public-workers/. The statement reads, in part: "We oppose scape-goating public employees by blaming them for the structural budget deficits that cities and states face." *Id.*

331 *Id*. (noting that, one year earlier, a high-profile Blackstone advisor had publicly described state workers' benefits as "too generous").

332 *Id*.

333 HIRSCHMAN, *supra* note 275, at 36–37.

334 *See id.* (describing exit as a "last resort" after voice has failed, and the balancing of prospects of each method that may affect shareholders' decision to pursue one method over the other to influence companies). Shareholders can exercise leverage even if exit is not a meaningful option. They can push for seats on the board of directors, vote against executive compensation packages, seek out hostile buyers, etc.

335 CALSTRS, TEACHERS' RETIREMENT BOARD POLICY MANUAL, at M-13 (2012), *available at* http://www.calstrs.com/sites/main/files/file-attachments/boardpolicymanual_5.pdf. The policy applies "in circumstances where the investment vehicle is working with a state, local or municipal agency to establish public-private partnerships ('PPPs') or to bid on public offers for the sale, lease or management of public assets." *Id*.

public-private partnerships, the investment staff must secure a written agreement from the managers of the domestic investment vehicle that states that "the investment vehicle shall make every good faith effort to recognize the important role and contribution of public employees to the development and operation of such assets."[336] In so doing, "the investment vehicle shall make good faith efforts to ensure that such transactions have a de minimis adverse impact on existing jobs."[337]

Although these policies are admirable, phrases like "good faith efforts" and "de minimis adverse impact" may be broad enough to permit the adverse impact to be ignored in practice. Consider how under a member-first view the adverse jobs impact becomes part of the primary investment calculus—in effect, it counts against the expected return of the investment. Therefore, it no longer suffices for the investment staff to ask the investee to make good faith efforts to minimize the negative jobs impact of the investment. By deducting the negative jobs impact from expected returns—in other words, by prioritizing the actual economic interests of fund participants and beneficiaries in the investment—the investment staff must believe that the investment will still outperform competing investments once the adverse jobs impact is taken into account. If it turns out that the investment underperforms competing investments under the new analysis, then voice looks quite different. It is no longer about asking the investee to make a good faith effort to minimize the negative jobs impact. It is about telling the investee that, if the adverse jobs impact is not reduced, then the fund may have to exit the investment or avoid making it in the first place in favor of other investments that look stronger under the member-first view. Recall that under a fund-first view, as interpreted by DOL, exit (or voice) would violate the duty of loyalty because it arguably harms the fund.

A skeptic would point out that there must be a tradeoff between investment returns and protecting jobs—the privatizing investment is profitable because it pays workers less to do the same job that was previously performed by a fund participant. However, reducing worker compensation may be just one component of the investment's profitability. It is plausible that the worker impact could be reduced while the return on investment remains competitive. For example, to return to where this Article began, Aramark's Education Services website touts its ability to achieve superior returns using the latest

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336 *Id.*

337 *Id.* Interestingly, CalPERS instituted the policy in 2008 in response to a threatened lawsuit by Professional Engineers in California Government (PECG), an organization of CalPERS participants. Miller, *supra* note 31. PECG dropped its lawsuit after CalPERS instituted the new investment policy. *Id.*

cleaning and "proprietary information technolog[ies]."[338] Aramark claims that superior employee training, productivity, and performance, as well as the use of more reliable equipment with better energy performance, drives the returns.[339] These are all efficiency gains that do not depend directly on firing public workers or paying them less, and could presumably leave a margin of profitability even if the company complied with fund demands to reduce the negative impact of its business on fund participants and beneficiaries. Of course, it may be that Aramark's extensive catalogue of efficiency claims is just hype, that the efficiencies account for a trivial percentage of Aramark's profits, if at all, and that its business model depends entirely on severely cutting worker wages and benefits (two aspects of the business model not mentioned on Aramark's website, but implemented in Chelmsford, MA and Louisiana). In that case, exit may be the more appropriate course, assuming another competitive investment is available.

3. *Proactive Job Creation*

Finally, under a member-first view, public pension funds should be able to deploy their assets to proactively preserve or create participant jobs, so long as doing so remains in the economic interests of fund members.[340] The economic interests of current participants and retirees may well be affected not only by the ability of current participants to maintain their own jobs, but by the ability of the employer to create future employee-contributors.[341] Future hires, or investments that maintain current employment of existing participants, lead to contributions to the fund by such participants and contributions made on their behalf by employers to the fund, even as they increase the fund's liabilities.[342] Of course, such future hires could act to the detriment of current fund participants, and if that is the case for a particular fund, such investments should be avoided. The discussion above in Part I.E suggests how such hires can be beneficial: They can expand

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338 *Core Services*, ARAMARK K-12 EDUC., http://www.aramarkschools.com/facilities/core-services.php (last visited Nov. 17, 2014).

339 *Id.*

340 *See* Wessel, *supra* note 122 (finding that in the context of ERISA private pension plans and job creation, the primary purpose of a fund's investment should be determined by weighing the cost to the fund of an investment with higher labor costs against the collateral benefits of such an investment to union members); *cf.* Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734 (Oct. 17, 2008) (to be codified at 29 C.F.R. pt. 2509) ("[F]iduciary consideration of non-economic factors should be rare and, when considered, should be documented in a manner that demonstrates compliance with ERISA's rigorous fiduciary standards.").

341 *Supra* notes 219–23.

342 *Supra* notes 219–23.

the base of the contributor-pyramid to help make payments to current retirees and they can improve economies of scale and other efficiencies from which all participants benefit.[343]

Despite all this, I am not currently aware of public pension funds that engage in such investment strategies, perhaps in part because of lingering uncertainty over the current fiduciary regime. Taft-Hartley funds have made such investments, for example, in the construction field for the purpose of increasing the hiring of construction workers who are current plan participants, or who will become plan participants.[344] As a theoretical matter, there is no reason public pension funds might not do the same. Such investments might present economic challenges. It may be that the comparatively high cost of public employee labor will make such investments too unattractive to compete with other investments, even accounting for their positive jobs impact. Still, the same argument could be made about the Taft-Hartley funds investing in projects that hire presumably more costly unionized workers who in turn contribute to the funds.

Whether such investments make economic sense will depend on the specifics of particular transactions. But under the ascendant fund-first view of fiduciary duty, the jobs benefits that such transactions could confer on fund participants and beneficiaries would be irrelevant to the investment analysis. Under a member-first view, the jobs benefits to current participants and beneficiaries, as well as the fund, will count in the primary investment analysis alongside its risk/return, diversification, and liquidity characteristics. Such benefits are in the actual economic interests of fund members, and they ought to be considered in the primary investment analysis.

Conclusion

The ascendant fund-first view of fiduciary duty requires public pension plan trustees to exclusively consider the economic interests of the plan in making investment decisions. This Article instead advocates a member-first view of fiduciary duty, which would require fiduciaries to consider the economic interests of plan participants and beneficiaries in making fund investments. As I show, the fund-first view can lead to investments that harm the interests of plan members, in particular, privatizing investments that replace public employee jobs with private sector ones. I resurrect overlooked case law to show

343 *Supra* notes 219–23.

344 *See* Wessel, *supra* note 122, at 355 ("Participant members of construction unions have strongly supported the efforts of their leadership to use their pension assets to finance job opportunities; more work means not only a steadier living wage, it also means a greater likelihood for workers of vesting and eventually receiving a pension.").

that, contrary to DOL's interpretation of the duty of loyalty and the exclusive purpose rule, trustees are not tethered to this fund-first view by the plain text of ERISA, which can accommodate a member-first view. The member-first view is more faithful to the original purpose of the duty of loyalty—to prioritize the interests of fund participants and beneficiaries in fund investments—than is the fund-first view. Nor is such a view disabled by concerns that it would raise agency costs of pension trustees. Agency cost concerns are abated by the fact that public pensions operate in public and have participant and beneficiary board members, in contrast to private trusts. Moreover, a central pre-occupation for advocates of the fund-first view—the agency costs of mergers and acquisitions—are simply nonexistent in the public pension context. I argue that a member-first view still functions in concert with the full suite of fiduciary duties that bind trustee discretion, including the duties of impartiality, prudence, and diversification. And I demonstrate that the member-first view may be feasibly implemented to advance the economic interests of fund participants and beneficiaries via the familiar investor tools of exit, voice, and proactive jobs creation.

While the fund-first view has advantages, particularly a narrow fiduciary obligation that enables relatively straightforward assessment of trustee performance, its weaknesses become acute in the context of privatizing investments. In the privatization context, the fund-first view often undermines the actual economic interests of public employees—the very same interests that are supposed to be prioritized under the duty of loyalty. Plan participants may lose their jobs or face reduced working hours (and consequently reduced benefits) as a result of investments made with their own retirement funds. Although one could take an absolute approach to such investments by barring them outright, this Article advocates a more nuanced approach. Such investments should not be banned, but they should be assessed under a member-first framework that accounts for their actual economic impact on fund participants and beneficiaries. The member-first view corrects a distortion introduced into fiduciary duty by the fund-first view and fulfills the ultimate purpose of the duty of loyalty and the exclusive purpose rule: to prioritize member interests in the investment of their retirement funds. Institution of this view could come from a variety of sources, including a new Interpretive Bulletin from the Department of Labor which would be influential, but not binding on state pensions; clarifying pronouncements by state attorneys general; and legal actions brought by pension fund participants and beneficiaries seeking to insure that their retirement funds are invested in their economic interests.

APPENDIX
COMPARISON OF ERISA AND STATE PENSION CODE EXCLUSIVE PURPOSE RULES[345]

State	Citation	Same	Close	Similarly Purposed Language
Alabama	ALA. CODE § 36-26-14(g) (2013)		X	
Alaska	ALASKA STAT. § 39.35.011 (2012)		X	
Arizona	ARIZ. REV. STAT. ANN. § 38-712(D) (2014)		X	
Arkansas	ARK. CODE ANN. § 24-2-207 (2013)	X		
California	CAL. CONST. art. XVI, § 17(a)	X		
Colorado	COLO. REV. STAT. § 31-31-901(3) (2014)[346]	X		
Connecticut	CONN. GEN. STAT. § 5-155a(c) (2013)			X
Delaware	DEL. CODE ANN. tit. 29, § 5541 (2014)		X	
Florida	FLA. STAT. § 122.355(2) (2013)		X	
Georgia	GA. CODE ANN. § 47-1-85(a) (2014)	X		
Hawaii	HAW. REV. STAT. § 88-22.5(a)(1) (2013)	X		
Idaho	IDAHO CODE ANN. § 59-1301(2)(a) (2014)	X		
Illinois	40 ILL. COMP. STAT. ANN. 5 / 1-109(a) (2014)	X		
Indiana	IND. CODE ANN. § 5-10-5.5-2.5(b)(2) (2013)	X		
Iowa	IOWA CODE § 410.3 (2014)			X
Kansas	KAN. STAT. ANN. § 74-4921(1), (2) (2014)	X		
Kentucky	KY. REV. STAT. ANN. § 61.650(1)(c)(2) (West 2014)	X		
Louisiana	LA. REV. STAT. ANN. § 11:834(B) (2014)	X		
Maine				
Maryland	MD. CODE ANN., STATE PERS. & PENS. § 21-203 (West 2014)	X		
Massachusetts	MASS. GEN. LAWS ANN. ch. 32 § 23(3) (2014)	X		

345 Note: This chart is not intended to represent a comprehensive account of the exclusive purpose rule as applied to state or local pension plans in the United States. There are other sources of fiduciary duties that apply to public pension plans that are not referenced here. The chart's primary purpose is to demonstrate that the exclusive purpose rule governing a broad swath of public pension plans is either identical or highly similar to ERISA's exclusive purpose rule. Naturally, some judgment is required in determining the similarity of the duties when the language differs even slightly. The final column, "Similarly Purposed Language," means that the rule appears to have the same basic purpose as the others but the language differs from it. For example, CONN. GEN. STAT. § 5-155a(c) (2014) requires that pension trustees abide by "strict fiduciary standards and responsibilities" without explicitly defining them.

346 Applies to Colorado fire and police pension fund only.

Michigan	MICH. COMP. LAWS ANN. § 38.1133(3) (2014)		X	
Minnesota	MINN. STAT. ANN. § 356.001(b) (2014)	X		
Mississippi				
Missouri	MO. REV. STAT. § 105.688(3) (2014)		X	
Montana	MONT. CONST. art. 8, § 15(1)		X	
Nebraska	NEB. REV. STAT. § 72-1239.01(b) (2014)	X		
Nevada	NEV. REV. STAT. § 287.430(2) (2014)	X		
New Hampshire	N.H. REV. STAT. ANN. § 100-A:15(I-a)(a)(2) (2012)	X		
New Jersey	N.J. STAT. ANN. § 43:15A-5(i)-(*l*) (West 2014)			X
New Mexico	N.M. CONST. art. 20, § 22(a)	X		
New York	N.Y. COMP. CODES R. & REGS. tit. 11, § 136-2.3(a) (2014); N.Y. EDUC. LAW § 502(3) (McKinney 2014)		X	
North Carolina	N.C. GEN. STAT. § 147-69.7(a)(2) (2013)	X		
North Dakota	N.D. CENT. CODE § 54-52.3-03 (2013)			X
Ohio	OHIO REV. CODE ANN. § 145.11(A) (West 2014)	X		
Oklahoma	OKLA. STAT. ANN. tit. 74, § 909.1(A)(1) (West 2014)	X		
Oregon	OR. REV. STAT. § 243.435(2) (2013)	X		
Pennsylvania	71 PA. CONS. STAT. ANN. § 5931(e) (West 2012)	X		
Rhode Island	R.I. GEN. LAWS § 35-10-6(b)(1) (2011)	X		
South Carolina	S.C. CODE ANN. § 9-16-40(2) (Supp. 2013)	X		
South Dakota	S.D. CODIFIED LAWS § 3-13-51.1 (2013)	X		
Tennessee	TENN. CODE ANN. § 8-36-920(f) (Supp. 2013)		X	
Texas	TEX. GOV'T CODE ANN. § 825.101 (West 2012)	X		
Utah	UTAH CODE ANN. § 49-11-301(3) (West 2013)	X		
Vermont	VT. STAT. ANN. tit. 3, § 472a(b) (2013)	X		
Virginia	VA. CODE ANN. § 51.1-124.30(C) (2013)		X	
Washington	WASH. REV. CODE ANN. § 41.50.780(4) (West 2014)	X		
West Virginia	W. VA. CODE § 5-10B-10(a) (2014)	X		
Wisconsin	WIS. STAT. § 40.01(2) (2013)		X	
Wyoming	WYO. STAT. ANN. § 9-3-439(a)(ii) (2013)	X		
TOTAL	*N*=48	32	12	4