DISINVESTMENT

Is it Legal?
Is it Moral?
Is it Productive?

AN ANALYSIS OF POLITICIZING INVESTMENT DECISIONS

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SOCIAL INVESTING OF PENSION FUNDS AND UNIVERSITY ENDOWMENTS: UNPRINCIPLED, FUTILE, AND ILLEGAL*

by

JOHN H. LANGBEIN**

Interest groups of various sorts have been campaigning in recent years to politicize the criteria that govern the investment of pension funds and university endowments. These funds should not, say the various campaigners, be invested in companies that do business in South Africa, or that have resisted labor union demands, or that manufacture munitions, or that pollute. Another strand of the social investing movement is localism; particularly as regards the pension funds of state and local government employees, there is pressure to invest for the purpose of stimulating the local economies.

This article is concerned to explain why the traditions of trust law, pension law, and the law of charity rightly forbid social investing. I shall direct primary attention to pension funds, whose enormous size and importance has made them the main target of the various social-investing pressure groups. In the final section of this paper (Part VII), however, I point to legal factors that make social investing objectionable for university and other charitable endowments.

I. UNDERSTANDING THE RISE OF PRIVATE PENSION FUNDS

At year-end 1983 the one thousand largest nonfederal pension plans in the United States had assets of $806 billion.¹ Total pension-fund assets exceed a trillion dollars.² These staggering sums reveal that a very large fraction of personal savings and of aggregate capital formation in the United States occurs through the medium of pension plans.

¹Pensions & Investments Age, Jan. 23, 1984, at 3.


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Huge demographic shifts underlie this phenomenon. People are living longer, thanks to many factors, of which the twentieth-century revolution in health care (above all, the discovery and refinement of antibiotics) is the most important. In consequence, the gap between the time we cease to work and the time we die is widening. For that interval in our lives, we need a source of income other than current employment—we need what has come to be called “retirement income.” In former times the retirement income gap tended for most people to be small or nonexistent, and transfers within the family tended to cover the gap. The elderly lived with their children and they did not live long. To the extent that private savings were insufficient, children were expected to help. But family structure has changed under the impact of urbanization, population mobility, and longevity. People have fewer children. Children leave their parents when they marry, and the elderly often find themselves living at great remove from their children. Furthermore, with increased longevity comes the problem of decrepitude in advanced old age. The increasing need for care of the elderly tends ever more to be met by specialized providers, both because of their expertise, and because the children of the elderly, especially when living in modern dual-wage-earner families, are ever less able to render such care at home.

As late as the early decades of the twentieth century neither government nor private industry seemed much concerned with the retirement income problem. Individuals were left to their own devices—private savings and intrafamilial arrangements. A few employers began to sponsor pension plans as early as the last quarter of the nineteenth century, but the great movement to organize saving for retirement through employer-sponsored plans did not get underway until World War II and thereafter.

The Great Depression struck at a time when many of the demographic changes that caused the retirement income problem were as yet recent. Many elderly people had not fully appreciated the implications of these changes; they had not (and perhaps could not have) made adequate provision through savings. The Social Security program was devised in the 1930s both to provide immediate relief to the destitute elderly of the day, and to guarantee retirement income to future retirees.

The defects of Social Security were long concealed, although they are now widely understood. Social Security is a transfer program rather than a savings plan. Present workers are taxed to pay retirement benefits to present retirees. Today’s present workers pay taxes in the expectation that future workers will be taxed to pay benefits when the present workers retire. But because of changes in birth rates and longevity, the workforce is declining in proportion to the number of retirees. Accordingly, the burden of financing the transfers has grown enormously. The prospect looms that tomor-

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row's smaller cohort of workers cannot be taxed enough to pay comparable retirement benefits to today's workers. The sense that Social Security cannot play as large a part in the retirement income of future retirees as it does for those today is one of the most important factors in the explosive growth of the private pension system.

The experience with Social Security has also left us an important lesson about the dangers of exposing the retirement income system to the winds of electoral politics. Successive Congresses sweetened current benefits and eligibility requirements with scant regard to the implications for future retirees. Only the most recent financial crises within the Social Security system have slowed that process. Further, Social Security has had devastating effects upon the economy. There is strong evidence for the view that, by promising substantial future income flows without requiring either individuals or the state to save enough to fund those obligations, Social Security has played the key role in the worrisome decline in American savings rates and capital formation.5

Only against this background can we fully appreciate the importance of the private pension system. The retirement income problem will become ever more acute: there are more retirees and they are living longer. Ever larger income flows must be generated to support them. Meanwhile, the financial contradictions of Social Security have put it under a cloud from which it will never fully emerge. The long process of lowering popular expectations about Social Security is well underway. The future of the retirement income system lies, therefore, in the private sector.6

II. HOW PENSION FUNDS WORK7

The variety of pension plan types and features is large and complex. The details can baffle almost anyone, sometimes even the professionals (accountants, actuaries, lawyers, plan administrators) who specialize in the field. Fortunately, in order to understand the main issues in the social investing debate, it will suffice to describe only some basic distinctions and characteristics.

Funding. The great difference between a modern private pension plan and a transfer system such as Social Security is that private plans are funded. Savings are set aside regularly during the employee's working career. This money is invested, and the investment yield (often called the "build-up") accumulates along with the savings. When the employee re-

tires, the fund is used to support him (and, under most plans, to support his spouse as well) until death.

Taxation. Federal tax policy has encouraged the private pension movement, especially since the 1940’s. The employer is allowed to deduct his contributions to a qualified pension plan immediately, even though the employee does not actually receive the money until he retires.\(^8\) Further, the build-up is exempt from taxation during the period of accumulation;\(^9\) only when the employee begins to receive retirement income from the plan is he taxed on what he receives. Taxation is thereby postponed. Since most people find themselves in lower tax brackets when they retire (retirement income usually being somewhat less than employment income), postponement has the further effect of reducing the amount of taxes for most people.

The Protective Policy. These tax concessions reflect a consensus that has been endorsed repeatedly in tax and other federal pension legislation. The policy is protective. Private pension plans are encouraged for fear that people would not, acting individually, save enough to meet their retirement income needs. The tax concessions are meant to induce employers and employees to allocate a larger share of compensation away from current wages and into retirement savings.

The protective policy is manifested elsewhere in pension law, apart from the tax code. Federal law imposes a “spendthrift” provision on most pension funds, preventing an employee or his creditors from alienating (and thereby consuming) pension savings before he retires.\(^10\) Likewise, federal law forbids the employee from waiving his right to have his pension fund invested prudently.\(^11\) The protective policy has been, although not the only policy, surely the centerpiece of pension taxation and pension regulation. It will be seen that the protective policy bears importantly on the question of whether an employee has the power to endorse social-investing proposals that may impair his retirement income security.

The Trust Form. Pension funds typically take the form of a trust. The trust relationship is one of the most highly developed categories of the Anglo-American legal tradition. Thus, although the private pension fund is a relatively young phenomenon, it rests upon a familiar juridical basis.

Trust-investment law, now enforced by special pension legislation, supplies the rules that regulate the investment of pension assets; we shall see that this body of law takes the harshest view of investment activities that are not undertaken for the exclusive purpose of maximizing the economic well-being of trust beneficiaries.

Contributory or Not. Many plans are funded entirely from employer contributions. Because there is no deduction from the employee’s pay-

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\(^9\)I.R.C. sec. 402.

\(^10\)I.R.C. sec. 401 (a)(13).

check, such plans are called “noncontributory”—the employee does not contribute. By contrast, “contributory” plans are those that require the employee to devote some fraction of gross pay—say, five percent—to the plan. Typically, the employer matches the employee’s contribution according to some formula, for example, one-to-one or two-to-one.

This distinction between plans to which the employee contributes and those to which he does not would seem to be important, but in economic terms it is not. Because even the employer-paid component of a pension plan is a cost of employment, it is best understood as a part of the wage packet, hence a form of involuntary savings whose true cost is borne by the employee. Both the employer-paid and the employee-paid contributions derive from what is—in economic terms—the employee’s wages. Translating this point into traditional trust-law terms, we may say that the employee is in an important sense the “settlor” of his own pension trust.

Defined Contribution and Defined Benefit. Broadly speaking, there are two basic types of pension plans, defined contribution and defined benefit plans. A defined contribution plan is best analogized to a savings account. The plan calls for the establishment of a separate account for each employee. Contributions are credited to the account at a rate specified in the plan, and the account participates proportionately in the investment gains of the plan. When the employee retires, the size of his pension will depend entirely upon the size of his account. Ordinarily, the plan calls for the account to be annuitized and distributed over the remainder of his life (or, in the event of a joint annuity with his spouse, over the remainder of their two lives). The college and university teachers’ plan, TIAA-CREF, is the best-known defined contribution plan. IRA and Keogh accounts work on the same principle.

A defined benefit plan, by contrast, is one in which the employer (or other plan sponsor) promises to pay a retirement benefit according to a plan formula—for example, sixty percent of average salary over the last five years of the employee’s service. The employer makes regular contributions to the plan, in accord with actuarial projections of the sums needed to fund the promised pension levels.

Defined contribution and defined benefit plans allocate investment risk oppositely. Under a defined contribution plan, it is the individual employee who bears the burden of disappointing investment results or who enjoys the gains from exceptionally good results. Under a defined benefit plan, the employer bears the investment risk; since the employer has promised to provide benefits of a certain level, the employer remains liable to pay the benefits even if the fund turns up short.

Multiemployer Plans. Most pension plans are so-called “single-employer” plans—General Motors has a plan for its employees, IBM for its. In some industries, however, where employment patterns are episodic (the construction trades, entertainment, trucking, the needle trades, and a variety of others) individual companies do not sponsor pension plans. Rather,
groups of employers sponsor a common plan, mostly in response to collective bargaining with a labor union. Although the Taft-Hartley Act requires equal numbers of management and union trustees on the board of such a plan, in practice union interests tend to prevail, and these plans are often spoken of as union plans.

ERISA. Like most substantial fields of finance, pension plans have attracted government regulation. The federal tax concessions have been conditioned on various regulatory requirements since the 1940's. In 1974 Congress greatly extended the scope of federal regulation when it passed the Employee Retirement Income Security Act (ERISA). ERISA limits forfeiture of benefits under pension plans (through the so-called “vesting” rules); it imposes minimum eligibility and funding standards; it narrows the range of plan discretion in the design of benefit-accrual schemes; and it imposes fiduciary rules for the investment of plan assets. Title IV of ERISA introduced a federal insurance scheme, ostensibly patterned on FDIC insurance for bank deposits, that guarantees most benefits under defined benefit plans against shortfall or default. By making the federal government the pension paymaster of last resort, Title IV creates a further public interest in the financial soundness of the investment practices of private pension plans.

Compulsory Trusteeship. ERISA requires that pension plan assets be placed in trust, and ERISA refines and codifies traditional trust-investment law for the pension field. These provisions further the protective policy of pension law. Pension trustees are financial intermediaries who specialize in investing pension funds. Trusteeship removes investment decisions into the hands of professionals and prevents plan participants (most of whom are inexperienced in matters of high finance) from doing their own investing. Thus, while I am free to be foolish in investing my personal savings, my pension savings will necessarily be invested according to the professional standards of the investment industry.

Preemption. From the standpoint of the social-investing movement, one of ERISA's most important provisions is what lawyers call a preemption clause: ERISA expressly supersedes state law for most pension plans. By federalizing pension law—including pension-investment law—in this way, ERISA has greatly narrowed the scope for social-investing initiatives beneath the level of federal law. If, for example, the Missouri legislature were to enact a social-investing measure requiring the pension plans of Missouri firms to invest their funds in Missouri mortgages, the courts would quickly invalidate the statute for violation of ERISA's preemption rule.

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13ERISA secs. 201 et seq., 301 et seq., 401 et seq., 29 U.S.C. secs. 1051 et seq., 1081 et seq., 1101 et seq.
14ERISA secs. 4001 et seq., 29 U.S.C. secs. 1301 et seq.
15ERISA sec. 403, 29 U.S.C. 1103
16ERISA secs. 404 et seq., 29 U.S.C. secs. 1104 et seq.
17ERISA sec. 514(a), 29 U.S.C. sec. 1144(a).
State and Local Plans. States, municipalities, school districts, and various other public bodies operate pension plans for their employees. These governmental plans are exempt from the requirements of ERISA, which is a main reason why social-investing proposals have so often been directed at them. State and local plans differ from private plans and among themselves in matters of structure and governance. Often a state board, sometimes attached to the state treasurer, is responsible for those investment and administrative functions that would be performed by trustees for most private plans.

Like Social Security, most state and local plans are run by bodies that possess taxing powers. As with Social Security, the temptation has been felt to leave future taxpayers to pay the retirement benefits for today’s public workers, even though the entitlement to those benefits accrues presently and should be regarded as a cost of current employment. Thus, whereas Social Security is virtually entirely unfunded and is almost a pure transfer scheme, the state and local plans tend to be partially funded. There is some current saving and investment, but not enough to meet future obligations.

III. THE HIDDEN DYNAMIC IN SOCIAL INVESTING

The elderly are, as a group, neither affluent nor politically adventurous. Why, then, is the social investing movement aimed so resolutely at the pension funds that exist to support the elderly? Why do the proponents of social investing treat pension funds as being especially appropriate to bear the costs of an investment strategy that sacrifices financial for political interests?

Social investing could in principle be attempted by any investor, not just pension trustees. There are three small mutual funds which proclaim adherence to various social principles in selecting their investments. If an individual decides to invest in such a fund, presumably he has balanced the possible financial costs of such a policy against the personal satisfaction that he derives from supporting the social aims implied by the fund’s investment policy. Few individuals have found these funds attractive. Another indication that most investors disagree with most social investing campaigns is that shareholder initiatives in support of the main social investing causes are invariably defeated by margins of 95 percent or worse. Furthermore, there has been little pressure on trustees of individual trusts to adopt social

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19 See Marcia G. Murphy, Regulating Public Employee Retirement Systems for Portfolio Efficiency, 67 Minnesota Law Review 211 (1982).
20 These are Foursquare, Dreyfus Third Century, and Pax World. Foursquare avoids liquor, tobacco, and drug company stocks. According to its prospectus, Third Century limits itself to companies “contributing to the enhancement of the quality of life,” whatever that means. Pax World excludes any company more than five percent of whose sales are to the Defense Department. See Pacey, Investment Do-Goers: A Look at a Dogged Trio of Socially Conscious Mutual Funds, Barron’s, Jul. 21, 1980, at 9.
investing. The main purpose of the typical individual trust is to generate income for the immediate support of the current beneficiary, who would be strongly inclined to protest if the trustee adopted an inconsistent goal. Many trust instruments authorize the beneficiary or the settlor to change trustees, and such a provision tends to concentrate a trustee’s mind wonderfully on profit maximization.

Social investing proposals are directed at pension funds not in order to further the interest of the pensioners, but in disregard of their interests. It is the separation of ownership and control characteristic of pension-fund structure that social-investing proponents find so enticing. Vast sums of money are invested for—but not by—the concerned individuals. That separation, we have seen, exists in large measure to protect present and future retirees against the tendency that some might have to undersave for retirement, or to invest unwisely. But by concentrating the pension savings of tens of millions of people in the hands of a few thousand pension trustees, our private pension system has created a pressure point that would not otherwise have existed. Ironically, therefore, the separation of ownership and control that was meant to protect pension plan beneficiaries has also exposed them to a new danger—that pressure groups may politicize the process of investing their pension savings.

The hidden dynamic in the social investing movement is this effort to take advantage of the separation between ownership and control of pension savings. The pension trustees who control pension investment work under the constraints of trust-investment law. The proponents of social investing understand that by reinterpreting trust-investment law to permit politicized investment they could capture pension savings for their causes.

But why should the proponents employ such a surreptitious strategy, pressuring pension trustees, when a more forthright path lies open? Why not pursue political causes in the political arena? It is vital to understand that, almost by definition, the causes that are grouped under the social-investing banner are those that have failed to win assent in the political and legislative process. Congress has the power to mandate all the well-known social-investing causes: forbid American firms to do business with South Africa; require American firms to cease making munitions, or to have unionized work forces; require pension assets to be invested locally; and so forth. Federal legislation could accomplish any of these goals. For example, present federal law applies to Cuba exactly the sort of prohibitions on commerce and lending that opponents of the South African regime have sought without success in recent years from both Democratic and Republican administrations. The reason, therefore, that the proponents of social investing are bullying pension trustees is that they have been unable to get their political programs accepted in the political process.
IV. PRINCIPLES OR POLITICS?

Are there principles of social investing that a trustee can follow with case? If not, then social investing is standardless, a mere label used to clothe pressure-group demands. If social investing is intrinsically standardless, adherence to it will expose pension trustees to a perpetual wave of political demands.

Consider, therefore, the question of investing in firms that do business in or with South Africa. It is important to understand that there is no controversy about the racial policies of South Africa. People on all sides of the matter have equal disdain for apartheid. But there is broad disdain in the United States for many other regimes. The hard question that proponents have not answered is this: Why is the campaign for divestiture directed almost entirely at South Africa, and not at such monstrously objectionable regimes as Libya or Soviet Russia? South Africa is a place in which 80 percent of the inhabitants are denied political and civil rights that Americans regard as basic. But there are many regimes in which 99 percent of the inhabitants are in this position.

In 1978 Yale University's Committee on South Africa Investments tried to duck this question in a report that said: "We acknowledge the possibility that the policies of other governments throughout the world are equally antagonistic to the basic principles of American society and this University; if so, then our recommendations concerning South African investments should be applied to them."21 It is not a possibility that there are other such societies; it is a certainty. (At the time that the Ad Hoc Committee wrote its report, the Amin regime was still in power in Uganda and the Pol Pot regime in Cambodia.) What the Committee seems to be saying, if one reads between the lines, is that it will not consider further applications of the social-investing concept until some group raises as great a stink as the opponents of the South African regime have raised. This approach makes social investing a branch of interest-group politics.

In truth, there can be no consensus about which social principles to pursue and about which investments are consistent or inconsistent with those principles. At a time when most of the social activism in investing was liberal or radical rather than conservative, there was some agreement among the activists as to the types of companies that should be avoided and the types that should be embraced. The ranks of the disapproved included companies doing business with South Africa, big defense contractors, non-union companies, and companies that polluted the environment. With the

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21Yale University, Ad Hoc Committee on South Africa Investments, Report to the Corporation 4 (Apr. 14, 1978).
rapid rise of social activism on the political right, we can expect social-
investing advocates to appear who will urge investment managers not to
invest in corporations that manufacture contraceptive devices, or publish
textbooks that teach the theory of evolution, or do business with Russia.\textsuperscript{22}

There is also increasing awareness that the criteria used to identify socially irresponsible companies are dubious even if the ultimate objective—say, pressuring South Africa—is accepted. An American corporation that has a
plant in South Africa where it creates jobs, provides training, and engages in
collective bargaining with a black union is not obviously contributing more
to the perpetuation of apartheid than an American corporation that, without
having an office in South Africa, manufactures goods that find their way to
South Africa. As the New York Times reported in September of 1984, “[a]
survey among black South African factory workers” established their “over-
whelming resistance to disinvestment by American firms.”\textsuperscript{23}

The Massachusetts legislature has lately supplied us with a splendid
illustration of the truth that social investing is nothing more than pressure
politics. In a recent statute the legislature singled out, in addition to South
Africa, one other country for the disapproval of the state pension fund:
Great Britain. Not Libya or Russia; not Iran, Cambodia or Syria, whose
regimes have recently massacred tens of thousands of their dissident citi-
zens; but Britain, mother of parliaments and closest great-power ally of the
United States. Why? Oh, nothing serious, just a little gratuitous intermed-
dling in the difficult Northern Irish situation, for the entertainment of the
Boston Irish. (The Massachusetts statute is reproduced below in
footnote.)\textsuperscript{24}

If we move beyond foreign affairs and examine other social-investing
causes, we find a similar lack of principle. In labor union circles it has
become fashionable to decry pension-fund investment in companies whose
work forces have rejected labor unions, but that complaint overlooks impor-
tant distinctions. For example, which unions? Some American labor unions
are clean and are devoted to their members, but others are dominated by
organized crime. Is it really “anti-social” to resist a latter-day Jimmy Hoffa?
And what of the right not to join a labor union? The elaborate election and
certification procedures for union representation under federal law presup-
pose that Congress meant to protect both the right to join and the right to

\textsuperscript{22}See John M. Leger, Business Links with Soviets under Attack, Wall Street Journal, Mar.
26, 1981, at 23, col. 3.

\textsuperscript{23}Alan Cowell, Blacks in a Poll Dispute Apartheid Foes’ Tactic, N.Y. Times, Sept. 23,
1984, at 10, Col. 5.

\textsuperscript{24}Annotated Laws of Massachusetts, Cumulative Supplement, Ch. 32, sec. 23 (1)(d)(iii):
[N]o public pension funds under this subsection shall remain invested in any bank or
financial institution which directly or through any subsidiary has outstanding loans to
any individual or corporation engaged in the manufacture, distribution or sale of
firearms, munitions, including rubber or plastic bullets, tear gas, armored vehicles or
military air craft for use or development in any activity in Northern Ireland, and no
assets shall remain invested in the stocks, securities or other obligations of any such
company so engaged.
abstain from union membership. Equating unionization with social rectitude thus flies in the face of federal law. Nor would compulsory unionization satisfy all proponents of this branch of social investing, since some have demanded disinvestment in firms, however fully unionized, that invest abroad ("export jobs").

Every social-investing cause can be subjected to a similar analysis. How much pollution is too much? Every time somebody goes to the toilet there is increased pollution. The question is not whether there shall be pollution, but how much, of what forms, in what places, subject to what controls, and so forth. The world is not divided into evil polluters and saintly nonpolluters. A vast body of regulatory law and private law exists to draw these difficult lines, and the blunt instrument of social investing has nothing to contribute to it.

Another form of social investing closely associated with labor union pressure is the effort to use pension funds to create jobs—for example, making mortgage loans from the carpenters’ pension fund in order to stimulate employment in the construction trades. If the loans were to be made at market rates of interest, there would be no increase in aggregate mortgage lending or in employment, on account of routine substitution effects (described in Part V below, treating the economic flaws of social investing). Thus, the major effort has been to get the pension fund to lend at below-market rates. This would indeed increase construction and thus stimulate some employment in the industry.

The objection to bargain-rate lending is that it is unprincipled in the sense that it violates the primary policies of pension law. By reducing the financial return to the pension fund, bargain-rate lending 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. But the objection runs deeper: the benefits and the costs affect different people and in different proportions. In particular, pensioners who are already retired and who depend upon the pension fund for current retirement income would derive no benefit from subsidizing employment for current workers. We shall see in Part VI that trust-investment law (and now ERISA) make it flatly illegal to sacrifice the interests of plan beneficiaries in this way.

The root fallacy behind these proposals, which is repeated incessantly in their rhetoric, is that unions have the right to use their pension plans to promote their interests. But, of course, the plans are not theirs. The plans exist for the exclusive purpose of providing retirement income for the elderly. For the same reason that pension funds cannot be used to defray union organizing expenses or union officers’ salaries, they cannot be used to

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subsidize employment for union workers at the expense of retirement income for present and future retirees.

The most persistent of the social investing causes is also the most transparently ignoble—the protectionist crusade for in-state investing of state and local pension funds ("Michigan pension money should not be exported to Indiana"). But that phenomenon is better examined from another standpoint, in Part V, treating the economic futility of social investing.

To summarize: There is not and can never be a consensus about what causes are socially worthy. Consequently, a pension trustee who sought to adhere to the criteria of social investing would have no means of identifying the causes to which he had committed the fund. Since there are no principles, every cause entangles the fund in a political struggle. Social investing would impose upon the fund the turmoil and administrative costs of perpetual politicization of the investment function. But a pension trustee has no business making political choices for his beneficiaries; his job is to further the retirement-income security of his beneficiaries, and to leave them to participate in the political process on their own.

V. THE ECONOMICS OF SOCIAL INVESTING

From the standpoint of economic analysis, two fundamental flaws impair virtually all social investing proposals. First, most are futile. Powerful and well-understood economic forces would counteract most social investing strategies, rendering them hollow gestures. Second, social investing has costs—economic disadvantages that harm the interest of pension-plan beneficiaries. We shall see (below in Part VI) that these economic flaws bear vitally upon the legal standards that govern pension-fund investment.

Substitution. Capital markets (the markets where companies and countries seek to obtain a share of the available savings) are intensely competitive. Capital flows to users who offer the highest returns, adjusted for risk. The capital markets are also increasingly international, as recent experience with Middle Eastern petrodollars, Continental eurodollars, and Latin American debtors has underlined.

The competitive nature of the capital markets complicates many social investing strategies to the point of impossibility. That point has long been made regarding the campaign for divestiture of the shares of companies doing business with South Africa. The object of the campaign is to starve the South African economy of capital. Although it is unlikely that economic stagnation would really help rather than hurt the oppressed peoples of South Africa, it is even less likely that social investing would have any material effect upon the South African economy. Pension money is by no means the only source of investment capital; nor are American firms and lenders the only actors. To the extent that social-investing pressures succeed in limiting capital flows to South Africa from some American firms, that simply creates opportunities for other American firms and for foreign firms. In
global financial terms, the South African economy is miniscule and its external capital requirements correspondingly small. International enterprises and lenders abound who are free from the pressures of the American lobby that concerns itself with this cause. Thus, the campaign to affect the South African economy has had and will have no demonstrable effect.

An incidental indication that the campaign against South Africa is ineffectual is that nobody has bothered to invoke the doctrine of constitutional preemption, in order to have the federal courts declare unconstitutional the various state statutes and city ordinances that direct the respective state and local pension funds to divest South Africa-tinged holdings. These enactments impinge upon the federal monopoly over foreign relations, reaffirmed by the Supreme Court in 1968 in Zschernig v. Miller. In that case the court forbade “an intrusion by [a] state into the field of foreign affairs which the Constitution entrusts to the President and the Congress.”

In a study published recently in the New England Economic Review, the distinguished pension economist Alicia Munnell (of the Federal Reserve Bank of Boston) has pointed to the substitution effects that make economic nonsense of the campaign for in-state mortgage lending. Some state pension plans have been purporting to promote in-state construction activity by buying packages of federally insured GNMA mortgages that originate entirely within the state (as opposed to conventional packages that contain mortgages originating in all parts of the country). Since the federal insurance eliminates the risk of default, the regional underdiversification of these packages is unimportant. Munnell concludes that the increasing purchase of these instruments by state and local pension plans has “not increased the supply of mortgage funds . . . .” Rather, a pair of utterly predictable substitution effects are occurring. First, as pension funds increase their buying of these mortgage-backed securities, they simply displace other institutional purchasers such as insurance companies, who shift their investing toward the government and corporate bonds that the pension funds were previously buying. Second, the attempt to stimulate in-state construction by purchasing in-state packages (so-called “targeting”) appears to be equally futile, and for the same reason.

Whereas in the absence of the recent targeting rage, a state such as Massachusetts would buy GNMAs backed by mortgages from a number of states, such as Alabama, California, Pennsylvania, etc., now Massachusetts insists on GNMAs backed by Massachusetts mortgages, Alabama on Alabama mortgages, California on California mortgages, Pennsylvania on Pennsylvania mortgages, etc. As long as the state’s demand for mortgages is roughly proportional to the size of its pension fund, the developing trend of targeting

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29Id. at 27-28.
GNMAs should have no impact on the supply of mortgage credit among states.

In summary, while social investing through the purchase of targeted GNMAs produces market returns and thereby has no adverse impact on public pensions, this approach is also unlikely to increase either the aggregate supply of mortgage funds or the supply of mortgage credit within a particular state. This assessment has been generally recognized by financial experts. In fact, those who are less than enthusiastic about social investing often push the purchase of targeted GNMAs as a means of satisfying the pressure on fund managers to pursue socially oriented objectives.30

The largest claim for this form of social investing is, therefore, that it may deceive people into thinking that it alters investments outcomes, whereas in fact it results in no net increase in construction or in employment. We must emphasize that the reason these “targeted” portfolios of in-state GNMA mortgages are harmful to the pension funds that buy them is that they contain market-rate rather than below-market loans; and that the government guarantee against default eliminates what would otherwise be a menacing degree of underdiversification. Munnell has pointed out that other vehicles used by state pension plans to invest in in-state mortgages have lacked the federal guarantee and in some cases have entailed below-market lending. Under a Connecticut scheme, for example, she found that “the rates at which the mortgages have been offered has varied substantially to slightly below market. As a result, the yield to the pension fund has been well below the GNMA yield that prevailed at the time the funds were committed.”31 In Part VI below I explain that both under the common law rules of trust-investment law and under ERISA, it would be flatly illegal for a pension trustee to sacrifice the financial well-being of plan beneficiaries in this way. (ERISA does not apply to state and local plans.)

**Diversification.** Over the last quarter-century a great revolution has occurred in scientific understanding of the behavior of capital markets. This revolution in the theory of finance usually goes under the label of modern portfolio theory (MPT) or the theory of efficient markets.32

Crudely summarized, MPT has established two central propositions. First, a massive body of empirical investigation has shown that it is extremely difficult (some say impossible) even for investment-industry professionals to achieve long-term results better than the broad market averages, such as (for equities) the Standard & Poor’s 500. It seems that capital markets discount new information so rapidly and well that there are few opportunities to outsmart other investors by identifying undervalued securities to buy or overvalued ones to sell.

30Id. at 28.
31Id. at 34.
Second, the capital-market investigators have shown that there are substantial gains to be had from diversifying investments quite extensively. The common law of trusts has long enforced a duty to diversify trust investments, and ERISA codifies that rule. MPT research has given new meaning to the concept of diversification, by showing that in order to eliminate the uncompensated risk of underdiversification, a portfolio must be much larger than previously thought. Optimal diversification requires equity portfolios with hundreds of stocks. Furthermore, these portfolios must be weighted for capitalization, so that large companies such as the oil, auto, computer, chemical, and telecommunications giants are difficult to eliminate from optimally diversified portfolios. The question arises whether social investing, if rigorously pursued, would impair diversification. As more and more social causes are added to the list, the number of companies that are ranked as offenders will become large enough that an optimally diversified portfolio cannot be constructed from the remainder. Social investing would then require the pension plan to bear the costs of the uncompensated risk of inadequate diversification.

The campaign for in-state or localized investing raises especially serious risks of underdiversification. The last thing that workers in declining areas need is to have their retirement savings jeopardized for the supposed benefit of the regional economy. Or suppose that a school board in the vicinity of Mount St. Helens had insisted on investing locally.

*The Social-Bargain Fallacy.* The claim is sometimes made that social investing is really economically advantageous to pension-plan beneficiaries. For example, companies that do business in South Africa could suffer damage or expropriation from civil war or revolution; companies that resist unionization may incur strikes and boycotts; polluters will get entangled in environmental liabilities; and so forth. Avoiding investment in these firms is, therefore, really a strategy for enhancing the financial well-being of plan beneficiaries by avoiding companies headed for trouble.

This argument is simply another theory of how to beat the market, and like all such theories, it runs afoul of the empirical studies underlying MPT, which strongly imply that consistent market-beating strategies are not to be found. The notion must be that the risks associated with the disfavored companies have not been fully discounted by the securities markets, even though those risks are widely known. But securities markets exist precisely in order to discount such information—that is, to take account of the information in securities prices. Accordingly, all that we know about the behavior of the securities markets suggests that political risk, like any other information that affects future profitability, is fully reflected in current

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33Restatement of Trusts (Second) [hereafter cited as Restatement] sec. 228 (1957); ERISA sec. 404(a)(1)(C), U.S.C. sec. 1104 (a)(1)(C).
prices. The indifferent performance of the three small mutual funds that have been following social-investing strategies underscores this point.\textsuperscript{35}

To conclude: From the standpoint of economic analysis, there are two types of social-investing outcomes—the futile and the wealth-impairing. The futile are those, such as the in-state GNMA packages, that make no real contribution to the ostensible social goal. The wealth-impairing outcomes lower the return on the fund's savings, or expose it to increased administrative costs, or impose upon it the uncompensated risk of inadequate diversification. We shall now examine the reasons why wealth-impairing social-investing schemes are illegal.

VI. WHY SOCIAL INVESTING IS ILLEGAL

A trustee who sacrifices the beneficiary's financial well-being for any social cause violates both his duty of loyalty to the beneficiary and his duty of prudence in investment.

The Duty of Loyalty. The essence of the trustee's fiduciary relationship is his responsibility to deal with the trust property "for the benefit of"\textsuperscript{36} the trust beneficiary. The authoritative Restatement (Second) of Trusts says: "The trustee is under a duty to the beneficiary to administer the trust solely in the interest of the beneficiary."\textsuperscript{37} Although most of the case law applying this duty of loyalty to the beneficiary's interest has arisen in situations of self-dealing or other conflicts of interest in which the courts have acted to prevent the trustee from enriching himself at the expense of the trust beneficiary,\textsuperscript{38} the same result has been reached with regard to fiduciary investments for the benefit of a third party (that is, a party other than the trust beneficiary or the trustee). The Restatement says, in its Official Comment treating the duty of loyalty: "The trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person."\textsuperscript{39} Because the entire object is to protect the trust beneficiary, nothing of principle turns on the identity of the party who profits at the beneficiary's expense.

In the leading case of Blankenship v. Boyle,\textsuperscript{40} decided in 1971, the duty

\textsuperscript{35}Supra note 20.
\textsuperscript{36}Restatement, supra note 33, at sec. 2.
\textsuperscript{37}Id. at sec. 170(1)(emphasis added).
\textsuperscript{39}Restatement, supra note 33, at sec. 170, Comment q (emphasis added). See id. at sec. 187, Comment g (emphasis added): The court will control the trustee in the exercise of the power where the acts form an improper even though not a dishonest motive. That is, where he acts from a motive other than to further the purposes of the trust. Thus, if the trustee in exercising or failing to exercise a power does so because of spite or prejudice or to further some interest of his own or of a person other than the beneficiary, the court will interpose.
\textsuperscript{40}329 F. Supp. 1089 (D.D.C. 1971).
of loyalty was applied to social investing of pension funds. A multi-employer fund for coal miners that was dominated by the United Mineworkers Union bought large blocks of shares in certain electric utilities in order to induce their managements to buy union-mined coal. On the complaint of some of the pension-fund beneficiaries, the court enjoined “the trustees from operating the Fund in a manner designed in whole or in part to afford collateral advantages to the Union or the [employers].”

ERISA codified the duty of loyalty for pension trusts in its “sole interest” and “exclusive purpose” rules. Section 404(a)(1) provides that the “fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries ...” In an essay published in 1980, a pair of Washington lawyers, Ronald Ravikoff and Myron Curzan, attempt to escape this provision of ERISA. I shall devote some space in this article to refuting their essay, both because the essay is misleading, and because it typifies the flimsiness of the legal arguments that are advanced in social-investing circles.

Ravikoff and Curzan correctly observe that ERISA restates the common law duty of loyalty. Accordingly, they reason, since “[t]he purpose of the duty of loyalty is to require a fiduciary to avoid” self-dealing, social investing is unobjectionable “[a]s long as the fiduciary avoids self-interested transactions.” But the view that the trustee’s duty of loyalty governs only in situations of self-dealing is simply incorrect. To be sure, most people who steal do it for their own gain; that is why most of the case law concerns self-dealing. But the trustee’s duty of loyalty exists solely for the protection of the trust beneficiary, and the duty is equally violated whether the trustee breaches for the trustee’s enrichment or that of a stranger.

Regarding ERISA’s requirement that the fiduciary invest “for the exclusive purpose of ... providing benefits to participants and their beneficiaries,” Ravikoff and Curzan assert that “[t]he concept of ‘benefits’ ... need not be limited to payments that a participant or beneficiary would receive upon retirement, i.e., economic return to an investment. It is arguably broad enough to include numerous types of positive returns, e.g., job security and improved working conditions.” This interpretation of the term “benefits” was rejected by the former administrator of the Labor Department’s ERISA office, James D. Hutchinson, and a co-author, Charles

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41329 F. Supp. at 1113.
45Id. at 531.
46Id.
47See text at note 39 and note 39.
49Ravikoff & Curzan, supra note 44, at 532.
C. Cole, in an article cited by Ravikoff and Curzan but ignored on the
precise question.\textsuperscript{50} Hutchinson and Cole point out that ERISA uses the term
"benefits" throughout the statute in the more narrow and natural sense "to
refer to those cash benefits that a participant or his family would receive in
accordance with the specifications of the [retirement] plan."\textsuperscript{51} Hutchinson
and Cole conclude "that ERISA trusts are to be established and maintained
for the limited purpose of providing retirement benefits and not for other,
socially desirable purposes which provide collateral or speculative 'benefits'
to plan participants or appeal to the philosophical leanings of the plan
sponsor or other parties associated with the plan."\textsuperscript{52}

\textit{The New York Teachers' Case}. The \textit{Blankenship} case insists uncompro-
misingly that pension trustees must invest for the purpose of maximizing the
financial well-being of the pension beneficiaries. Proponents of social
investing seeking to escape the force of that precedent have been tempted to
juxtapose a misunderstanding of the 1978 case, \textit{Withers v. Teachers' Retirement
System}.\textsuperscript{53} In the \textit{Withers} case, retirees who were beneficiaries of the New
York City schoolteachers' pension fund, Teachers' Retirement System
(TRS), challenged the decision of the TRS trustees to purchase $860 million
of New York City bonds as part of the plan that prevented the city from
going bankrupt in late 1975. Like most public employee pension funds,
TRS had not been fully funded. The main asset of TRS was the city's
contractual liability to pay benefits out of future tax revenues calculated on
past service. City payments to TRS in the 1974 fiscal year constituted sixty-
two percent of TRS's total income (as opposed to nine percent derived from
employee contributions and twenty-nine percent from investment income).
The TRS trustees testified that although the legal situation was far from
certain, their best guess was that in the event of city bankruptcy essential
city services and past city bond debt would have priority over payments to

\textsuperscript{50}James D. Hutchinson & Charles G. Cole, Legal Standards Governing Investment of
Pension Assets for Social and Political Goals, 128 University of Pennsylvania Law Review
1340 (1980). Ravikoff and Curzan cite the Hutchinson and Cole article as it appeared in
Employee Benefit Research Institute, Should Pension Assets Be Managed for Social/Political
44, at 531 n. 49. I cite the revised version of the Hutchinson and Cole article that appeared
subsequently in the University of Pennsylvania Law Review, supra.

\textsuperscript{51}Hutchinson & Cole, supra note 50, at 1370 & 1371 n. 151. The only reason that ERISA is
less than explicit in defining "benefits" as a strictly economic term is that no other usage even
occurred to the draftsmen. In the Congressional findings that constitute the preamble to the
statute the term "benefits" is repeatedly used in the conventional and strictly economic sense.

"Congress finds . . . that despite the enormous growth in [pension and other] plans many
employees with long years of employment are losing anticipated retirement benefits owing to
the lack of vesting provisions in such plans; that owing to the inadequacy of current minimum
standards, the soundness and stability of plans with respect to adequate funds to pay promised
benefits may be endangered; that owing to the termination of plans before requisite funds have
been accumulated, employees and the beneficiaries have been deprived of anticipated benefits
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\textsuperscript{52}Hutchinson & Cole, supra note 50, at 1371.

\textsuperscript{53}Restatement, supra note 33, at sec. 164(a).
TRS and hence that payments to TRS would cease. In making the loan to the city, the TRS trustees acted in concert with four other municipal-employee pension funds, which agreed to purchase $2.5 billion in city obligations over a two-and-one half-year period.

The court upheld the trustees’ action, even though the bonds bore such a high risk of default that they would not have satisfied the normal standards of prudent investing (the purchase was also excessive in amount and would have been in breach of the duty to diversify). Ravikoff and Curzan interpret the court’s rationale as follows:

*Withers* may represent an interpretation of the prudent man rule that is quite different from that set forth in *Blankenship*. *Blankenship* espouses the traditional conception of the rule: a trustee may not select an investment that fosters nontraditional objectives at the expense of adequate rate of return and corpus safety. In contrast, *Withers* appears to permit a fiduciary to compromise these traditional objectives in favor of the other goals—at least to some extent. The court upheld the trustees’ investment only because the investment gave much-needed aid to the fund’s principal contributor and helped to preserve the jobs of funds participants. That is, the investment was prudent in this case because it provided “other benefits.”

In truth, what the *Withers* court did was to point to the host of special factors that made the TRS purchase justifiable under the traditional wealth-maximizing standards of trust-investment law. The court found that the trustee’s “major concern” was “protecting what was, according to the information available to them, the major and indispensable source of TRS’s funding—the City of New York,” and that the trustees “went to great lengths to satisfy themselves of the absence of any reasonable possibility that the City would be able to obtain the needed money from other sources.” The trustees used the bond purchase to precipitate federal government financing for New York City, thereby creating for TRS’s beneficiaries the prospect of reaching the federal treasury to satisfy the City’s liability to TRS. They “obtained a provision conditioning the pension fund’s investment in the City bonds on the enactment of federal legislation” providing for interim financing for the City. Indeed, since the trustees’ $860 million investment was about what the City would have had to pay TRS over the two-and-a-half year period in question, TRS “could be no worse off under the plan than it would be in bankruptcy without City funds.” The court in *Withers* endorsed the *Blankenship* case, and declared that “*neither the protection of the jobs of the City’s teachers nor the general public welfare were factors which motivated the trustees in their investment decision.* The extension of aid to the City was simply a means—the only means, in their assessment—to the legitimate end of preventing the exhaus-

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34Ravikoff & Curzan, supra note 44, at 523.
36447 F. Supp. at 1253.
37447 F. Supp. at 1253.
tion of the assets of the TRS in the interest of all the beneficiaries."\textsuperscript{58} The trustees found favor with the court for their effort to protect their greatest asset, which was the liability of the City to pay off its obligations to TRS over future decades.

\textit{The Duty of Prudent Investing}. Another obligation that trust law imposes on fiduciaries is the duty of care known as the prudent-man or prudent-investor rule. The case law is now effectively codified for pension law in ERISA.\textsuperscript{59} The \textit{Restatement of Trusts} words the rule thusly: "In making investments of trust funds the trustee is under a duty to the beneficiary . . . 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 . . . ."\textsuperscript{60}

For historical reasons that are widely understood, trust law has placed greater emphasis on risk-avoidance than the modern theory of finance does,\textsuperscript{61} but risk and return, however, weighted, are factors exclusively related to the investor’s financial well-being. The highly risk-averse investor of traditional trust law accepts a lower return for a lower risk. He does not accept a lower return for some other, nonfinancial purpose. The duty of prudent investing therefore reinforces the duty of loyalty in forbidding the trustee to invest for any object other than the highest return consistent with the preferred level of portfolio risk.\textsuperscript{62}

In 1980, the then chief ERISA administrator, Ian D. Lanoff of the Department of Labor, rejected the suggestion that social investing was not subject to ERISA’s rules of prudence and loyalty. He said that ERISA requires that the fiduciary’s "overall investment strategy . . . be designed to protect the retirement income of the plan’s participants," and that both the duty of loyalty and the prudent investor rule would be violated if a fiduciary were to make an "investment decision based on other objectives, such as to promote the job security of a class of current or future participants."\textsuperscript{63} Social factors may be brought in only if it is costless to do so. Similarly, the Labor Department approved a 1979 Chrysler/UAW agreement endorsing some social investing of pension-fund assets on the understanding that the investments in question would be "economically competitive with other investment opportunities which may not contain similar socially beneficial features."\textsuperscript{64} (As previously explained, the field for costless substitutions is largely limited to the economically futile forms of social investing.)

\textsuperscript{58}447 F. Supp. at 1256 (emphasis added).
\textsuperscript{60}Restatement, supra note 33, at sec. 227.
\textsuperscript{61}See Langbein & Posner, supra note 32, at 3-6.
\textsuperscript{62}A similar rationale underlies the trustee’s familiar duty to invest promptly, in order to make trust funds productive. See Restatement, supra note 33, at sec. 181, Comment c.
\textsuperscript{64}Id. at 392.
The attorney general of Oregon issued a formal opinion in 1978 applying the state’s statutory prudent-investor rule to the question whether investment managers for the state university endowment funds could "take political and moral considerations into account in making investment decisions." He ruled that "[i]t is inappropriate and irrelevant for the investment managers to consider any factors other than the probable safety of, and the probable income from, the investments required by the statute."65

The proponents of social investing have never reconciled the sacrifice of beneficiaries' financial advantage with the prudent-investor rule. Ravikoff and Curzan try to avoid the common-law rule by rewording it to suit their purpose. After quoting the Restatement version,66 they purport to summarize it in a form which changes it radically, and which they thereafter treat as a statement of the law. The objects of the prudent-investor rule, they say, are "preservation of the trust corpus and attainment of an adequate return."67 The term "adequate" is their own invention, and in thus implying a standard less than "optimal" or "maximum" it is wholly without authority. The authors later endorse a movement from "adequate" to "moderate or even no return,"68 still in the name of prudence. It is a revealing commentary on the weakness of the legal case for social investing that its proponents are driven to such transparent manipulation of the legal rules that oppose them.

**ERISA's No-Waiver Rule Applied to Social Investing.** A general rule of trust-investment law, known as the authorization doctrine, permits the settlor to impose on the trust whatever investment policy he sees fit.69 The settlor can waive otherwise applicable rules and authorize the trustee to engage in acts of self-dealing or imprudent investment. One of ERISA's innovations was the prohibition against "any provision . . . which purports to relieve a fiduciary from responsibility or liability."70 Therefore, as Hutchinson and Cole observe, "the [pension] plan documents cannot authorize a policy of social investment that would otherwise be impermissible under the fiduciary standards of the Act."71 This rule against exculpatory clauses eliminated the authorization doctrine from pension trusts.

Consequently, a pension trust cannot be drafted to permit a social invest-

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66Restatement, supra note 33, at sec. 227, quoted in Ravikoff & Curzan, supra note 44, at 520.
67Ravikoff & Curzan, supra note 44, at 520.
68Id. at 528.
69Restatement, supra note 33, at sec. 164(a).
71Hutchinson & Cole, supra note 50, at 1372, 1373-75.
ing strategy that would violate the duties of loyalty or prudent investment. This result is quite consistent with the economic analysis of pension savings (discussed in Part II, supra, under the subheading “Contributory or Not”). Because both employer-paid and employee-paid contributions are best understood as deferred wages, they derive from the employee’s compensation packet. Since the employee is in this important sense the “settlor” of his own pension-trust account, there is good reason to prevent plan sponsors (whether union or employer) from using the authorization doctrine to impose social investing upon him.

Since, however, the employee rather than the plan sponsor is the settlor-equivalent person, the opposite question arises: Might a pension plan be lawful if it contained a social-investing option that the individual participant could elect or decline? For example, the plan might offer two funds, one that ignored social-investing causes and another that adhered to some political strategy such as excluding the securities of nonunion firms. The employee could elect between the two funds.

It might be possible to bring a social-investing option of this sort within the so-called ratification doctrine of the common law of trusts. Unless a beneficiary is deceived or acts under an incapacity, trust law allows him to ratify investment practices that would otherwise be in breach of the trust instrument or of the common law.72 The idea is that if the beneficiary is entitled to receive and waste the trust fund, he is equally entitled to allow the fund to be wasted while still in the hands of the trustee. But it is just there that pension trusts part company from ordinary trusts, on account of the protective policy of pension law. The pension beneficiary is not allowed to reach pension assets on whatever terms please him. For example, we have seen that ERISA’s mandatory spendthrift rule prevents the pension beneficiary from consuming his pension account before retirement.73 Further, the Internal Revenue Code now conditions the pension tax concessions on the requirement that retirement benefits be made available in the form of an annuity,74 in order to protect the retiree from improvident consumption that could exhaust his pension benefits during his lifetime.

Accordingly, it seems unlikely that a genuinely costly social investing scheme could pass muster even as a beneficiary-elected option. For the same reason we do not allow a current worker to spend his pension account on a sports car, we should not allow him to spend it on contributions to political or social campaigns (which is what he is doing when he accepts a below-market return in his pension savings). On the other hand, this ration-
ale seems not to extend to social investing schemes of the merely futile sort, such as in-state GNMAAs. Even for these investments, however, the plan sponsor should be obliged to disclose to plan participants that the price of costliness is futility; and the sponsor should be obliged to arrange for confidentiality respecting the portfolio election of each participant, in order to protect participants from union or other pressures.

This discussion of a social investing option presupposes a defined contribution plan, with individual accounts whose investment risk is borne by each plan participant. In a pure defined benefit plan, where investment risk is shifted to the employer as plan sponsor, there is less reason in law to prevent the employer from assuming the increased costs of a social-investing strategy that entails below-market yields. The employer, however, has good reason to resist such efforts to induce him to increase his pension costs and liabilities. For just that reason, most of the social-investing pressures have not been directed at single-employer defined benefit plans, but rather at union-dominated multi-employer plans, state-and-local plans, and multi-employer defined contribution plans such as the college teachers' TIAA-CREF.

Even within the realm of the defined benefit plan, the plan sponsor does not bear the whole of the investment risk. Under the federal insurance scheme enacted as Title IV of ERISA, a federal agency called the Pension Benefit Guaranty Corporation (PBGC) bears the ultimate responsibility for paying most of the pension benefits promised under a defined benefit plan, in the event that the plan should default.75 PBGC thus has an interest in preventing plan sponsors from engaging in improvident investment practices that might require PBGC to have to honor the sponsor's defaulted promises. Furthermore, PBGC insurance does not protect plan participants wholly, because there are statutory ceilings on the amount of the benefits covered.76 Since, therefore, the plan participant would remain at risk for the portion of a defaulted plan not insured by PBGC, the protective policies that indicate that the participant should not have the power to acquiesce in a social-investing option under a defined contribution plan pertain as well in an attenuated fashion to a defined benefit plan.

Corporate Social Responsibility. Proponents of social investing sometimes think they can find solace in the authorities that allow a corporation to engage in charitable giving or other "socially responsible" endeavors at the expense of its shareholders. Indeed, this analogy misled the distinguished

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75ERISA secs. 4001 et. seq., 29 U.S.C. sec. 1301 et. seq.
trust writer, Austin Scott, who, shortly before his death endorsed social investing of trust funds.\textsuperscript{77}

The legal analysis that has been applied in the corporation cases, is, in fact, directly contrary to that which would be needed to sustain social investing of trust funds. The rationale that has protected corporate directors from liability when shareholders have brought suit complaining of seeming corporate altruism is that the directors were in fact pursuing the longer-range self-interest of the firm and hence that their conduct has been wealth-maximizing.\textsuperscript{78}

Constitutional Objections. There are serious doubts about the constitutionality of the two types of social-investing measures that crop up in state legislation directed at state and local pension funds. As regards the legislation directed against South Africa (or any other foreign power), I have previously mentioned the doctrine of constitutional preemption,\textsuperscript{79} designed to preserve the federal monopoly of authority in foreign relations, which was expansively reaffirmed by the Supreme Court in the 1968 case of Zschernig v. Miller.\textsuperscript{80}

There is also a long constitutional tradition inimical to protectionist state legislation. A main purpose of the commerce clause of the federal constitution was to create national markets. For example, the Supreme Court held in a famous case that New York could not by statute prevent price competition in New York from cheaper Vermont milk.\textsuperscript{81} State legislation attempting to create preferences for in-state securities should be no more justifiable under

\textsuperscript{77}Scott writes:
Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporation whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment and consumer responsibility . . . . Of course they may well believe that a corporation which has a proper sense of social obligation is more likely to be successful in the long run than those which are bent on obtaining the maximum amount of profits. [Scott is here reciting the social-bargain fallacy, refuted above in Part V of the present essay.] But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.

3 A. Scott, supra note 38, at sec. 227.17 (Supp. 1980). Scott makes no effort to reconcile his support for social investing with the trustee’s duties of loyalty and prudence that he canvassed so extensively in the body of the treatise. 2 id. at sec. 170-170.25 (loyalty); 3 id. secs. 227-227.16 (prudent investing). He ignores the ERISA rules, discussed above, that contradict his position. Scott cites some of the literature on corporate social responsibility but does not disclose that the legal analysis that has been applied in the corporation cases is the opposite of the rule he is supporting for the law of trusts.

\textsuperscript{78}See, e.g., Shiensky v. Wrigley, 95 Ill. App. 2d 173, 180-81, 237 N.E.2d 776, 780 (1968).

\textsuperscript{79}Supra text at note 27.

\textsuperscript{80}389 U.S. 429 (1968).

the commerce clause than legislation preferring in-state enterprises. The privileges-and-immunities clause of the constitution has also been interpreted to forbid protectionist legislation aimed at out-of-staters.\textsuperscript{82}

VII. UNIVERSITY ENDOwMENTS

I have thus far considered the social-investing question only in context of the pension fund. The analysis changes when we move from pension trusts to charitable trusts (or to charitable corporations, which for present purposes are indistinguishable from charitable trusts).\textsuperscript{83} This is an area of considerable consequence for university trustees; they are currently being pressured to apply social criteria to the investment of their endowment funds, and some boards of trustees have succumbed.

The distinguishing juridical feature of the charitable trust is the absence of conventional beneficiaries. A private trust (including the pension trust) must identify by name or by class the persons who are to receive the trust property, but a charitable trust is void if it is found to serve individual rather than community benefit.\textsuperscript{84} The charitable trust occupies a legally privileged position: it is not subject to the rule against perpetuities; the attorney general or other public officer may enforce it; the cy pres doctrine protects it against ordinary rules of defeasance; and it enjoys a variety of tax and procedural advantages pursuant to statutes that follow the common law criteria for defining charitable trusts.\textsuperscript{85} The law conditions the grant of these privileges on the requirement of indefiniteness of beneficiaries. A charitable trust will fail if “the persons who are to benefit are not of a sufficiently large or indefinite class so that the community is interested in the enforcement of the trust.”\textsuperscript{86}

In place of the definite beneficiaries of private trust law, the law of charitable trusts substitutes the standard of community benefit defined by a circumscribed set of charitable purposes: the relief of poverty; the advancement of religion; the advancement of education and of health (including research); and the promotion of governmental, municipal, and other purposes beneficial to the community.\textsuperscript{87} At the border of each of these catego-

\textsuperscript{82}See, e.g., Hicklin v. Orbeck, 437 U.S. 518 (1978).
\textsuperscript{83}See generally 4 A. Scott, supra note 38, at sec. 348.1.
\textsuperscript{84}A recent Pennsylvania decision dealing with the claim of the Fraternal Order of Police to be a charitable organization concluded that the group “is essentially a labor organization existing solely for the benefit of its own membership,” and that those that “its benefits are not applied for the advantage of an indefinite number of persons as would be the case if the public were to benefit.” Commonwealth v. Frantz Advertising, Inc., 23 Pa. Commw. Ct. 526, 533-34, 353 A.2d. 492, 496-97 (1976). For a good general background on such cases, see 4. A. Scott, supra note 38, at sec. 375.2.
\textsuperscript{85}See Restatement, supra note 33, at secs. 365 (unlimited duration), 391 (public enforcement), 395 (cy pres).
\textsuperscript{86}Id. at sec. 375.
\textsuperscript{87}Id. at sec. 368.
ries there can be serious questions about whether particular schemes qualify, but the typical university charter declares purposes that fall unambiguously within the category of education and research (and often within that of health as well).

In analyzing social investing by private and pension trusts, we saw that the trustee’s obligation to invest for the maximum financial well-being of the trust beneficiaries derives from the trustee’s duties of loyalty and prudent investing; but since, by definition, the charitable trustee does not owe such duties to particular private beneficiaries, the question arises whether there are any legal impediments to social investing of university endowment funds. There are several:

Charter. University charters are often granted by special legislative act, both for state schools and private universities. A university may also be chartered under the general nonprofit corporation statute of the jurisdiction. In principle, an authorizing instrument under the common law of trusts would also suffice. Regardless of the form, a university’s charter is usually restrictive; it dedicates the institution to educational and related purposes.

A variety of the causes espoused in the name of social investing are not within the purposes of such charters—for example, expressing disapproval of selected foreign governments, or supporting certain labor union organizing campaigns. For university trustees to spend university funds on such causes directly would be ultra vires and put the trustees in breach of their fiduciary duty to the institution.\(^{88}\) Were the trustees to pursue the same end by engaging in social investing of the university’s endowment funds, they would simply be attempting to do indirectly what they may not do directly.

Under conventional charitable trust law, the state attorney general has standing to sue to prevent such misuses of university endowment funds. Because he is a political officer, and there will often be more votes to gain from supporting than from opposing the groups that advocate social investing, his intervention might not always be a serious prospect. But the attorney general probably does not have a monopoly of standing in such cases; other persons who have a significant economic interest in the fate of the endowment—for example, professors and students—probably may sue.\(^{89}\)

Noncharitable Purposes. If a particular charter is too restrictive to permit a particular scheme of social investing, the proponents of the scheme may reply that the institution ought to get its charter amended. When the charter originates in special state legislation, the legislature can authorize virtually any use of institutional funds (at least as regards the state law of charitable purposes, although not the federal tax consequences). When the charter is

\(^{88}\)See id. at sec. 379.

\(^{89}\)In Coffie v. William Marsh Rice Univ., 403 S.W. 2d 340 (Tex. 1966), two opposing groups of alumni were held to have standing to intervene in a lawsuit in which the trustees of Rice University were seeking the application of the cy pres doctrine in order to eliminate racially restrictive provisions from the trust instrument that had created the school.
nonstatutory and subject to the common law of charitable trusts, valid charter amendments will be impossible for many social investing schemes. The law of charitable trusts denies private autonomy over the definition of what purposes qualify as charitable. The standard of community benefit does not vary with the tastes of universities or their founders, trustees, and donors.

Some of the schemes favored by proponents of social investing are incompatible with these legal standards. In England, a trust for the purpose of changing existing law is not charitable. Although this rule generally has not been followed in American law, our law does attempt to distinguish between “social” purposes, which are permissible, and “political” purposes, which are not. Trusts to promote socialist political and educational activity have been held not charitable, a similar fate befell a bequest to create an educational and information center for the Republican women of Pennsylvania. A Scottish case held that a trust to support resistance to strikebreaking and lockouts was political and hence void, and a New Zealand case ruled similarly against a trust for the League of Nations. University trustees faced with pressures to adapt their portfolios to the requirements of union organizing campaigns, or some group’s foreign-policy views, must beware the force of such precedents. The price of yielding to social-investing demands may be litigation costs and potential liability for breach of fiduciary duty.

Costs. From a practical standpoint, university trustees are obliged to give full weight to the savings in administrative costs that result when the institution is spared the needless portfolio reviews and difficult investment decisions that are involved in social investing, especially in view of the absence of agreement on the social principles to be pursued.

Donors. Past donors—more likely their heirs or successors—may claim that since social investing constitutes a diversion from the educational purposes for which the funds were given, it breaches an implied or express condition and ought to trigger defeasance of the funds in favor of the donor. In Illinois, legislation in force since 1874 denies to universities the “power to divert any gift . . . from the specific purpose designed by the donor.” Donors would have a strong argument against applying the cy pres doctrine in order to prevent defeasance, since cy pres applies only when it “becomes impossible or impracticable or illegal to carry out the original charitable

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914 A. Scott, supra note 38, at sec. 374.6.
92See id.
purpose."97 Thus, trustees who yield to pressures to divert endowment funds from education to other causes are exposing their endowments to the restitutinary claims of donors and heirs.

VIII. CONCLUSION

In emphasizing the legal risks that pension trustees and university and other charitable trustees incur in pursuing social investing, I do not suggest that the law requires social grievances to go without remedy. The law of trusts has been constructed on the quite intelligent premise that the grand social issues of the day should be resolved in those institutions whose procedures and powers are appropriate to them. The political and legislative process of the modern democratic state is well adapted to dealing with pressures for social change. Pension trusts have been designed to provide retirement security, and charitable trusts have been designed to serve specialized purposes—in education, healing, the arts, research, and so forth. A board of trustees is not well suited to be a forum for the resolution of complex social issues largely unrelated to its work. There is every reason to think that trustees will best serve the cause of social change by remitting the advocates of social causes to the political arena, where their proposals can be fairly tested and defined, and if found meritorious, effectively implemented.

97Restatement, supra note 33, at sec. 399.