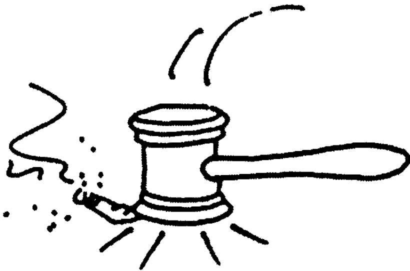
3 Legal Standards of Tobacco Divestment



This chapter discusses the legal authority of a retirement board to direct its retirement plan to sell tobacco company investments and avoid such investments in the future. So long as the board fulfills its duties to the beneficiaries, it can vote to implement tobacco divestment. The first section of this chapter outlines the duties that the board must fulfill: the duties of loyalty, prudence, and diversification of pension plan assets. A retirement board that fulfills these legal duties will minimize the risk of subsequent litigation challenging the board's tobacco divestment action. Any subsequent litigation could raise the issue of a board member's personal liability, discussed in the second section. If the same legal guidelines are followed, a board member will be insulated from personal liability.

Some have argued that fiduciary duty does not allow for nonfinancial considerations. The third section explores this issue, citing the California Constitution and statutory law, both of which allow investing in the public interest if fiduciary duty is not compromised. The fourth section covers the U.S. Department of Labor's position that a retirement board may weigh nonfinancial considerations in deciding how to invest pension assets, as long as the investment decision satisfies the duties owed to beneficiaries. Finally, the chapter discusses the law governing the tax-exempt status of pension plans and how tobacco divestment can be done without jeopardizing this status.

The basic conclusion of this legal analysis is that if pension fund assets currently invested in tobacco companies are reinvested in assets with similar risk and projected return, the decision will be upheld in court. A retirement board may justify tobacco divestment in one of two ways: (1) The board decides that tobacco stocks are a bad investment, and that selling the current holdings and avoiding these investments in the future is warranted on purely financial grounds. (2) The board concludes that other investments offer equivalent risk and return and, all other things being equal, decides to sell tobacco stocks based on nonfinancial reasons.

I. LEGAL DUTIES OF PENSION BOARD MEMBERS

This section discusses the three main legal (or fiduciary) duties that a retirement board owes to its beneficiaries: loyalty, prudence, and diversification. The discussion of these three duties cites California Constitutional law, statutory and case law, federal law, and laws of other states. While different sources of law organize the legal issues differently and use different terms for similar concepts, the fundamental analyses are consistent across the legal landscape.[1]

A. DUTY OF LOYALTY (THE "EXCLUSIVE PURPOSE" RULE)

The duty of loyalty is grounded in the common law. This duty requires a trustee not to engage in transactions that will personally benefit the trustee or third parties, at the expense of the beneficiary. From the common law, the duty has been codified into statutory provisions that apply to government pension plans. With subsequent codification, it has evolved into different terms of art, such as the "exclusive purpose" rule, "solely in the interest of beneficiaries," etc.[2] Pension plans are governed by trust law principles. Therefore, case law treats board members as trustees or fiduciaries.

1. California Constitutional and Statutory Law

A retirement board's duty of loyalty arises from the California Constitution and the Probate and Government Codes. The California Constitution dictates that

> [t]he members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. A retirement board's duty to its participants and their beneficiaries shall take precedence over any other duty.[3]

Different statutory provisions apply to the pension plans of different governmental entities,[4] but the basic rules discussed below apply to all California pension plans.

[1] For example, some cases treat the duty to diversify as part of the duty of prudence. Some cases will analyze a similar fact pattern under different duties, while some cases will analyze the facts under several duties. Lack of uniformity in organizing the legal concepts does not mean that there is uncertainty in how a retirement board implements tobacco divestment. So long as basic procedures are followed and the board carefully considers its options, the risk of subsequent litigation should be curtailed.

[2] Some courts use "exclusive purpose" to mean something more than the duty of loyalty. Some commentators use "exclusive benefit rule" instead of "exclusive purpose." Better practice would be to reserve the term "exclusive benefit" for how the Internal Revenue Code treats pension plans. *See infra* part V.

[3] CAL. CONST. art. XVI, § 17(b). "Participants" commonly refers to the employees covered by the retirement plan, and "beneficiaries" refers to the persons designated by the employee to receive benefits, commonly the employee's spouse. In this discussion, the term, " beneficiaries" will refer to both of these groups.

[4] *See* CAL. GOV'T CODE §§ 7515, 53216-53224, 31595 (West 1995, 1997, 1998). *See generally* CAL. PROB. CODE § 16002 (West 1991).

The assets of public pension and retirement systems are held in trust funds,[5] and are therefore covered by the laws governing trusts. Members of a retirement board are considered trustees of a trust;[6] therefore, the California Probate Code's legal duties apply. In particular, Section 16004 states that "[t]he trustee has a duty not to use or deal with trust property for the trustee's own profit *or for any other purpose unconnected with the trust,* nor to take part in any transaction in which the trustee has an interest adverse to the beneficiary."[7] Thus, the duty of loyalty has two parts: to take no action that benefits the trustee (or someone related to the trustee), and to take no action that harms trust beneficiaries. Most cases fall into the first category, namely using trust property for a trustee's own profit.[8] Tobacco divestment does not involve this first category since it will not benefit a trustee. A retirement board contemplating tobacco divestment must consider the prohibition on taking action "for any other purpose unconnected with the trust."[9] Thus, trustees cannot be motivated by a desire to benefit a nonbeneficiary at the expense of beneficiaries.

2. Duty of Loyalty and Benefiting Third-Party Nonbeneficiaries

The California Constitution and statutory law prohibit benefiting third parties at the expense of trust beneficiaries. An illustration of the rule against benefiting nonbeneficiaries is the case of *Conway v. Emeny.*[10] In *Conway,* the terms of the will of the decedent instructed that her home be maintained as a museum and that $400,000 be placed in a trust fund for the maintenance of that museum. The terms of the will further instructed that if the trustees determined that the public was not sufficiently interested in the museum, the museum property and maintenance trust fund should be transferred to the school to which the decedent had donated $7 million during her lifetime. The museum opened and was well attended for four years. During that time the school did not do well, suffering financial setbacks that threatened to close it. Despite the museum's popularity, the trustees voted to close the museum so that the proceeds could be used to save the school. No trustee who voted to close the museum did so based on the belief that a lack of public interest in the museum justified closure, and the trial court found that no trustee acted out of personal selfish motive.[11] Despite the lack of selfish motive, the *Conway* court held that by the

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[5] *See* CAL. GOV'T CODE § 53216.6 (West 1997).

[6] *See* CAL. GOV'T CODE § 53219 (West 1997).

[7] CAL. PROB. CODE § 16004(a) (West 1991) (emphasis added). *See also* CAL. PROB. CODE § 16002(a) (West 1991) ("The trustee has a duty to administer the trust solely in the interest of the beneficiaries.").

[8] *See In re* Estate of McClellan, 8 Cal. 2d 49, 53-54 (1936); Leigh v. Engle, 727 F.2d 113, 124 (7th Cir. 1984) (trustees violated duty of loyalty where they invested trust assets in the same companies that the trustees were personally investing in for the purpose of winning control of the corporation and thereby reaping a premium on their stock); Donovan v. Bierwirth, 680 F.2d 263 (2d Cir. 1982).

[9] CAL. PROB. CODE § 16004(a) (West 1991).

[10] 139 Conn. 612, 96 A.2d 221 (1953).

[11] *See id.* at 618, 96 A.2d at 224-25.

terms of the trust, the trustees were under a duty of loyalty not to close the museum but to follow the terms of the will which commanded that the museum remain open as long as there was sufficient public interest.[12] In tobacco divestment, as long as trustees make sure that beneficiaries are not harmed (like the museum would have been harmed in *Conway*), the decision to divest is not a breach of the duty of loyalty. The case of *Withers v. Teachers' Retirement System*[13] illustrates this point.

In *Withers*, retirement board members voted to use trust assets to bail out financially strapped New York City. The issue in *Withers* was whether this action would harm the retirement system's beneficiaries. In 1975, the retirement board voted to buy $860 million of highly speculative and unmarketable New York City bonds as part of a plan that would prevent the city from going bankrupt. Retired teachers filed suit claiming that the decision violated the board's legal duties, including the duty of loyalty. They claimed the decision to buy the city bonds benefited the city, a nonbeneficiary, and that the investment was seeking to protect employees' jobs at the expense of the retirees.[14] Unlike *Conway*, the court upheld the investment in New York City bonds based on the duty of loyalty. The *Withers* court found "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."[15] The court was persuaded that the investment decision was based solely on the retirement board's motivation to maintain the city's contributions to the retirement plan, which would have been jeopardized if the city went bankrupt.[16]

The decision to buy New York City bonds helped prevent a dire financial situation from getting worse. Therefore, the investment benefited people other than the teachers who were part of the retirement system. *Withers* demonstrates that a retirement board will not breach its duty of loyalty simply because a nonbeneficiary receives a benefit from board action.[17] Unlike *Conway* where the outside benefit would have come at the expense of the museum, in *Withers* the benefit was upheld since the court found that the decision did not harm the interests of the beneficiaries—the teachers who were covered under the retirement system.

The *Withers* court distinguished *Blankenship v. Boyle*,[18] a case where retirement system assets were used to benefit someone other than plan beneficiaries. Like

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[12] *Id.* at 621, 96 A.2d at 225.
[13] 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).
[14] *See id.* at 1255.
[15] *Id.* at 1256.
[16] *See id.*
[17] *See* Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).
[18] 329 F. Supp. 1089 (D.D.C. 1971), *aff'd mem.*, 511 F.2d 447 (D.C. Cir. 1975).

in *Conway*, the *Blankenship* court found that the investment decision was made at the expense of the plan beneficiaries, and that the trustees had breached their duty of loyalty.[19] *Blankenship* involved the retirement fund of the United Mine Workers. Some retirement assets were invested in non-interest-bearing accounts in a bank owned by the union. The retirement fund also invested in certain public utility companies in coordination with the union-owned bank.[20] The union had exercised the retirement fund's proxies, along with its own, to force the utility companies to purchase union-mined coal. Despite the *Blankenship* court's finding that the retirement fund beneficiaries "benefited to some extent from the Union's activities[,]"[21] the court held that the retirement fund trustees breached their duty of loyalty because the investments were benefiting the union at the expense of the retirement fund.[22]

The issue of a retirement board's duty of loyalty also arose in the context of the South Africa divestment effort. In *Board of Trustees v. Mayor of Baltimore*,[23] the city passed two ordinances that mandated that the city retirement systems sell their investment holdings in companies doing business with South Africa or Namibia. The trustees of the retirement systems filed suit seeking a declaratory finding that the ordinances were invalid. In addition to causes of action involving the duty of prudence (discussed below), the trustees asserted that the ordinances would force the trustees to breach their duty of loyalty. In *Baltimore*, the Maryland Court of Appeals, the highest court in the State of Maryland, applied the municipal code's definition of loyalty: "The Board of trustees shall discharge its duties . . . solely in the interest of the members and beneficiaries and . . . [f]or the exclusive purpose of . . . providing benefits to members and beneficiaries . . . ."[24] The court's analysis first stated that the duty of loyalty encompassed more than just a prohibition against self-dealing and conflict of interest, neither of which was present in the case.[25] Citing *Conway*, the court affirmed the rule that the duty of loyalty bars a trustee from acting in the interest of third parties at the expense of beneficiaries.[26] The *Baltimore* court held that the trustee does not violate the duty of loyalty by considering social consequences of investment decisions, so long as the costs of considering such consequences are *de minimis*.[27] The court found that the costs of

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[19] *See id.* at 1106.
[20] *See id.* at 1105-06.
[21] *Id.* at 1112.
[22] *See id.* at 1106.
[23] 317 Md. 72, 562 A.2d 720 (1989).
[24] *Id.* at 109, 562 A.2d at 738. The duty of loyalty language is strikingly similar to the language applicable to California retirement boards.
[25] *See id.*
[26] *Id.*
[27] *Id.* at 109-10, 562 A.2d at 738.

implementing the ordinances were *de minimis* and that, therefore, the ordinances were not a breach of the duty of loyalty. The court reasoned that by investing in businesses with a proper sense of social obligation, the trustees may in the long run best serve the beneficiaries' interests and most effectively secure the provision of future benefits.[28]

The *Baltimore* court's reasoning of future benefit is an example of how the analysis of the duty of loyalty becomes interwoven with the analysis of the duty of prudence. To the extent that an investment creates future financial benefit, that benefit becomes part of the evaluation of an investment from a purely financial perspective, completely separate from the social benefit the investment may provide to nonbeneficiaries. In other words, a trustee may identify two competing investment options that promise similar risk-adjusted returns. The trustee can legally choose the investment option that also promises a benefit to a third-party nonbeneficiary. As part of this same analysis, the trustee may decide that the same factors that promise a benefit to a third-party may also make the investment more desirable from a purely financial perspective. In the context of tobacco divestment, a retirement board in California must take care to pursue divestment only if the social benefit of divestment does not come at the expense of beneficiaries. If selling tobacco investments will be financially beneficial to the retirement plan, the decision is justifiable on purely financial grounds.

B. Duty of Prudence

The duty of prudence involves the care with which board members make decisions. This duty also is grounded in the common law. Synonymous terms include "duty of due care," "prudent person rule," and "prudent investor rule." Case law supports the proposition that a board can divest from tobacco investments as long as it follows the same sound investment decision-making process as it would without tobacco divestment. Indeed, a board may decide that it need look no further than the uncertain future of the tobacco industry in deciding to divest.

1. California Constitutional and Statutory Law

A retirement board's duty of prudence arises from the same section in the California Constitution as the duty of loyalty:

> The members of the retirement board of a public pension or retirement system shall discharge their duties with respect to the system with the care, skill, prudence, and diligence under the circumstances then prevailing that a

[28] *Id.* at 110, 562 A.2d at 738.

> prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims.[29]

This standard demands that retirement board members make investment decisions with the same prudence as an average retirement board member.[30] It used to be the case that retirement boards didn't have as much autonomy in making investment decisions because restrictive lists of allowable financial instruments limited the board's discretion.[31] A retirement board that is not limited by a restrictive list will be judged by the more general standard of prudence, cited above.

2. Prudence Standard Is Judged at Time the Investment Decision Is Made

A principal rule of the duty of prudence is that an investment decision is judged based on the surrounding circumstances at the time the decision was made.[32] This means that a trustee cannot be attacked for what proved to be a bad investment decision if at the time of the investment, the decision was made based on adequate investigation and sound decision making. The prudence of an investment decision will be judged based on the portfolio as a whole.[33] However, an imprudent decision will not be ignored simply because the total value of the portfolio shows overall increase.[34]

In California, the case of *Beach v. Carter*[35] illustrates the rule that prudence is judged based on the time of the investment decision. Seth Beach died in 1968 leaving an estate valued at $2.4 million. His will directed that a trust be created for the benefit of his four children. The estate included about $400,000 worth of stock of an oil and gas company. The executor, the Bank of California, sold a small fraction of the stock to pay for claims, taxes, and expenses of administering the estate. By the time the remaining stock was distributed to the testamentary trustee over a year later, the stock price had declined from $16 a share to $6 a share. Three beneficiaries contested the executor's failure to sell the stock earlier. The court held that despite the loss in

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[29] CAL. CONST. art. XVI, § 17(c). Similar language applicable to retirement boards appears at CAL. GOV'T CODE §§ 7515, 31595(b), 53216.6 (West 1995, 1997, 1997); and CAL. PROB. CODE §§ 16040(a), 16047(a) (West 1991, Supp. 2000).

[30] *See In re* Estate of Hamon, 60 Cal. App. 154, 157 (1922) ("A trustee must use at least the degree of care which an ordinarily prudent person would in connection with the transaction involved.").

[31] Some retirement boards still have such restrictive lists. *See, e.g.*, CAL. GOV'T CODE § 31966 (West 1988) (covering county peace officers).

[32] *See* CAL PROB. CODE § 16051(West Supp. 2000) ("Compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."); *see also* Day v. First Trust & Sav. Bank, 47 Cal. App. 2d 470, 477 (1941).

[33] *See* CAL PROB. CODE § 16047(b) (West Supp. 2000). *See also* 29 C.F.R. § 2550.404(b) (2000).

[34] *See In re* Bank of New York, 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S. 164 (1974); *see also In re* Morgan Guar. Trust Co., 89 Misc. 2d 1088, 1090; 396 N.Y.S.2d 781, 784 (Sur. Ct. 1977). Factors such as diversification and tax planning may properly be considered to mitigate what would otherwise seem an imprudent investment decision.

[35] 15 Cal. 3d 623 (1975).

value, the executor had not breached its duty of prudence.[36] The court's reasoning rested on the fact that the executor-bank made periodic reviews of the stock by its various experts and determined that continued investment was in the best interest of the estate.[37] *Beach* stands for the proposition that an investment decision that is proved a poor one in hindsight will not be found to be a breach of the duty of prudence so long as the decision was justified at the time it was made.[38]

In the context of tobacco divestment, the duty of prudence requires that a retirement board base its decision on a thorough investigation of the financial information, just as the bank's investment experts did in *Beach*. So long as this is done the decision should not be found imprudent.

3. Duty of Prudence and Seeking Expert Opinion

So long as a trustee conducts sufficient inquiry before making a decision, and relies on timely information obtained in making the decision, the investment decision will be upheld against an accusation of imprudence. However, the prudence standard requires that a trustee be able to evaluate whether there is enough information to make a prudent investment decision, and if not, that trustee has the duty to secure such expert advice. An illustration of this rule is the case of *Katsaros v. Cody*.[39]

In *Katsaros*, the court found that the trustees, ill equipped to evaluate the soundness of a proposed loan, had breached their duty of prudence by failing to seek outside assistance and instead relying exclusively on representations of the borrower.[40] *Katsaros* involved a loan of pension fund assets to a bank. The loan was made despite the fact that neither the trustees' accountant nor any other fund staff member had sufficient training to express an opinion on the soundness of the loan.[41] At trial, testimony was taken that ample information was available to the trustees at the time the decision was made that indicated that the bank was heading toward its eventual financial failure.[42] A reasonably careful inquiry would have revealed that the bank and the other assets used to secure the loan were overvalued by bank

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[36] *See id.* at 630.

[37] *See id.* at 640.

[38] *See also* Stark v. U.S. Trust Co., 445 F. Supp. 670 (S.D.N.Y. 1978) (In applying the prudence standard to an inter vivos trust which held stock portfolio that lost 90 percent of its value, the court found that the trustee did not breach its duty of prudence where the stocks were periodically reviewed by a portfolio manager, the investment policy committee, and the stock selection committee, and unforeseeable factors detrimentally affected the economy.).

[39] 744 F.2d 270 (2d Cir. 1984).

[40] The court's analysis was governed by the standard of prudence as defined by the Employee Retirement Income Security Act (ERISA): "ERISA requires a pension fund fiduciary to [. . .] discharge his duties 'with the care, skill, prudence, and diligence . . . 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 . . . .'" *Id.* at 279. This standard is almost identically worded to the one in the California Constitution. For a comparison to California Constitution, see *supra* text accompanying note 3.

[41] *See Katsaros*, 744 F.2d at 275.

[42] *See id.* at 276.

officers. In finding that the fund trustees breached their duty of prudence by failing to seek an outside expert opinion, the court stated that the testimony "revealed that the loan was a loser from its inception."[43]

In delegating investment and management functions, a trustee in California has the power to hire experts or other agents,[44] but must exercise judgment in selecting an expert and reviewing that person's work.[45] A trustee need not seek expert advice for every decision but should be able to recognize when such advice is warranted.[46]

In some cases, hiring an expert is not enough, especially if the decision of whom to hire was a poor one, or if the board does not critically evaluate the expert's advice. In *Donovan v. Mazzola,*[47] the Ninth Circuit found that the pension fund trustees breached their duty of prudence when they retained a consultant to perform a feasibility study on a recreational resort property, but the consultant was not qualified to perform such a study.[48] The evidence showed that the trustees never inquired into the consultant's qualifications, never discussed the consultant's oral proposals with any experts, and never solicited bids from other consultants. *Mazzola* stands for the proposition that not only does an uninformed retirement board need to consult an expert as is required by *Katsaros,* but that the board must exercise prudence in the selection of an expert.[49]

Marshall v. Glass/Metal Ass'n[50] represents a case where the pension fund trustees' effort to seek outside legal advice fell short of the duty of prudence.[51] In that case, the trustees voted to approve a real estate loan to a developer. Prior to approving the loan, the trustees had little or no personal experience in lending or finance, and the

[43] *Id.* at 279-80. *See also Whitfield v. Tomasso,* 682 F. Supp. 1287, 1301 (E.D.N.Y. 1988) (Court found breach of duty of prudence where 1) none of the trustees was familiar with purchasing a certificate of deposit of a property and casualty insurance company, 2) the trustees did not review the financial statements or insurance company ratings, and 3) they did not consult an expert in the field of investing in insurance companies.).

[44] See CAL. PROB. CODE § 16247 (West 1991 & Supp. 2000); *see also* RESTATEMENT (THIRD) OF TRUSTS § 227, cmt. j (1992).

[45] CAL. PROB. CODE § 16052(a) (West Supp. 2000) ("A trustee may delegate investment and management functions as prudent under the circumstances. The trustee shall exercise prudence in the following: (1) Selecting an agent. (2) Establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust. (3) Periodically reviewing the agent's overall performance and compliance with the terms of the delegation."); *see also* 29 C.F.R. § 2550.404(b)(3) (2000).

[46] *See* Donovan v. Bierwirth, 680 F.2d 263, 272–73 (2d Cir. 1982) ("We do not mean by this either that trustees confronted with a difficult decision need always engage independent counsel or that engaging such counsel and following their advice will operate as a complete whitewash which, without more, satisfies ERISA's prudence requirement. But this was, and should have been perceived to be, an unusual situation peculiarly requiring legal advice from someone above the battle.").

[47] 716 F.2d 1226 (9th Cir. 1983).

[48] *See id.* at 1233–34.

[49] *See also* Whitfield v. Cohen, 682 F. Supp. 188, 195 (S.D.N.Y. 1988) (Trustee breached duty of prudence where he transferred pension plan assets to an outside investment firm but did not personally review the firm's employees' educational credentials, did not discover that the firm was not registered with the SEC, and did not inquire who the firm's other investors were, how the money would be invested, or what fees the firm would charge.).

[50] 507 F. Supp. 378 (D. Haw. 1980).

[51] *See id.* at 381, 384.

pension plan had never invested assets in a real estate loan. Although the trustees did receive legal advice concerning the loan, their decision to approve the loan relied in large part on information and opinions provided by the borrower.[52]

A retirement board that seeks expert opinion must also make sure that the information is not stale. In *Donovan v. Cunningham*,[53] the court was faced with whether the fiduciaries responsible for managing an employee stock option plan (ESOP) had paid too much per share for the stock of the company. The fiduciaries of the ESOP of a closely held corporation consulted an independent appraiser who recommended a price per share based on the company's projected revenue and income. The fiduciaries voted to purchase the shares from one of the directors at the price recommended by the appraiser. The stock transfers to the ESOP were consummated over a year later, at a point when the fiduciaries should have known that the actual revenue and income of the corporation were markedly below the projections relied upon by the independent appraiser. The *Cunningham* court held that the fiduciaries' reliance on an independent appraisal of the stock price was a breach of fiduciary duty since the fiduciaries had reason to suspect that the independent appraisal no longer represented the fair market value of the stock, and the fiduciaries failed to conduct further investigation to determine whether the previous appraisal was still accurate.[54]

Thus, *Mazzola*, *Glass/Metal Ass'n*, and *Cunningham* require trustees to seek out expert advice (where they have reason to do so based on their experience level) and make a prudent decision of whom to consult. These cases also require that the trustees critically review the information they receive (for both accuracy and timeliness)[55] and make their decision accordingly.[56] When the Florida Board of Administration (the body that manages the Florida's retirement system) was debating whether to implement tobacco divestment, it sought a legal opinion from the state's attorney general.[57] In that opinion, the attorney general stated that "[w]hile a trustee may

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[52] *See id.* at 381. *See also* Barrington Police Pension Fund v. Dep't of Ins., 211 Ill. App. 3d 698, 707, 570 N.E.2d 622, 627, 156 Ill. Dec. 146, 151 (1991) ("[A]lthough due care will often demand the taking of advice from attorneys, appraisers, investment bankers, and from others, the fact that such advice was obtained does not itself show that the trustee has used the requisite caution. He may have been guilty of a lack of ordinary judgment in weighing all the evidence he obtained about the projected investment.") (citation omitted); Withers v. Teacher's Retirement Sys., 447 F. Supp. 1248, 1254 (S.D.N.Y. 1978) ("In the area of investment decisions, the obligation to exercise prudence is essentially an obligation to . . . make independent inquiry into the merits of particular investments rather than to rely wholly upon the advice of others.").

[53] 716 F.2d 1455 (5th Cir. 1983).

[54] *See id.* at 1473.

[55] *See also Fink v. Nat'l Sav. & Trust Co.*, 772 F.2d 951, 957 (D.C. Cir. 1985) ("A fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard."); Brock v. Robbins, 830 F.2d 640, 648 (7th Cir. 1987) (trustees' decisions that are later found to be imprudently made may be subject to injunctive relief).

[56] *See* Troyer et al., *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 GEO. L.J. 127, 145 (1985).

[57] The state of Florida incorporates by reference ERISA's duty of prudence. FLA. STAT. ANN. § 215.47(9) (West 2000). ERISA's duty of prudence is similarly worded as the duty in the California Constitution.

consider the advice of qualified experts, the trustee ultimately must exercise independent judgment in making these decisions."[58] This means that a retirement board may weigh conflicting expert advice and vote to sell tobacco stock without breaching the duty of prudence.

When a California retirement board is deciding on tobacco divestment and relying on expert opinion (whether that expert opinion endorses divestment or is in opposition to it), the board must inform itself of the factors involved (whether that be poor stock performance, litigation risk, or effect of future regulation, etc.) to fulfill the duty of prudence that it owes to its beneficiaries. This financial analysis may warrant divestment on purely financial grounds,[59] or may reveal that divestment is neutral with respect to plan assets.[60] Either way the decision to divest is legally defensible. The specific consultation and analysis that was done should be documented in the board's records.[61] The decision of whether to divest ultimately falls with the trustees,[62] and after reviewing the information they are provided, they can decide to either follow the advice given or not.[63] Once a retirement board decides to sell tobacco stock, it should document the reasons supporting the board's decision,[64] and it should engage in periodic review to confirm that the information on which it relied is still correct.[65]

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[58] 97 Op. Att'y Gen. 29 (Fla. 1997), 1997 WL 348030, at *2.

[59] *See* Ann-Catherine Blank, Comment, *The South African Divestment Debate: Factoring "Political Risk" into the Prudent Investor Rule*, 55 U. CIN. L. REV. 201 (1986).

[60] *See* James D. Hutchinson & Charles G. Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 PENN. L. REV. 1340, 1367 (1980); *see also* Memorandum from Ian D. Lanoff to the California State Teachers Retirement System's Investment Committee regarding Points Concerning Investment and Divestment of Plan Assets in Conformity with Fiduciary Principles 4 (Mar. 24, 2000) ("If the analysis whether it is prudent to invest in or hold a security yields an uncertain or positive result, a fiduciary may still lawfully sell the security if it is not imprudent to do so. Under such circumstances, a fiduciary may lawfully choose to divest, provided that a financial and economic analysis performed by investment professionals uncovers a number of potential investment opportunities that are ostensibly equally advantageous from an economic perspective. In this way, a fiduciary may lawfully implement the divestment plan because it satisfies fiduciary requirements of loyalty to plan participants . . . and prudence.") (citations omitted) (on file with the Technical Assistance Legal Ctr., (510) 444-8252) (Messrs. Hutchinson and Lanoff are both former Administrators of the U.S. Labor Department's Office of Pension and Welfare Benefit Programs); Troyer, *supra* note 56, at 146.

[61] *See* Troyer, *supra* note 56, at 145.

[62] *See id.* at 148.

[63] *See* Lanoff, *supra* note 60, at 5.

[64] *See* Hutchinson, *supra* note 60, at 1383; Troyer, *supra* note 56, at 145; Lanoff, *supra* note 60, at 5; *see also More "Help" on the Way*, PUBLIC RETIREMENT JOURNAL, Mar., 2000, at 8 ("[A]ny [tobacco] divestment decision should be preceded by at least two other steps – the due diligence necessary to make an intelligent, defensible decision and the demonstration of a procedure through which this divestment decision and any subsequent such decision would pass.").

[65] *See* Katsaros v. Cody, 744 F.2d 270, 276 (2d Cir. 1984) (finding fault with trustees who received only sporadic, incomplete information from the borrower, and failed to examine the information that was provided); Whitfield v. Cohen, 682 F. Supp. 188, 197 (S.D.N.Y. 1988) ("Cohen's failure to apprise himself of the nature of the investments made by Penvest on behalf of the Plan and his acquiescence in Penvest's failure to account to the Plan establish a breach of his fiduciary obligation to monitor the performance of the Plan's investments."); *see also* Troyer, supra note 56, at 146; Lanoff, *supra* note 60, at 5. *See generally* INVESTOR RESPONSIBILITY RESEARCH CTR., TOBACCO DIVESTMENT AND FIDUCIARY RESPONSIBILITY: A LEGAL AND FINANCIAL ANALYSIS C:41-43 (Douglas G. Cogan ed., 2000), available from Investor Responsibility Research Ctr., (202) 833-0700, <http://www.irrc.org>.

4. Retirement Boards May Consider Nonfinancial Factors

A trustee's consideration of nonfinancial factors will not automatically breach the duty of prudence. In *Aloha Lumber Corp. v. University of Alaska*,[66] the University of Alaska sold timber rights in a remote area owned by the university. The university sought to maximize revenue as well as to ensure that all legal and regulatory standards would be met. The university made clear that it would not be obligated to accept the highest offer if another bidder satisfied the university's best interests. Plaintiff Aloha Lumber submitted the highest financial proposal, although it was not eventually chosen. The university retained a professional forester to independently review the two highest-valued proposals. She concluded that Aloha's proposal failed to provide information about its operating plans, its company's financial information, and its history of completing similar projects. She recommended accepting the proposal of the second-highest-valued proposal.[67] In considering plaintiff's claim that the university breached its fiduciary duty to obtain maximum economic gain, the Alaska Supreme Court noted that Aloha Lumber did not dispute that the timber sale was for less than fair market value. This fact was important since even the plaintiff was not arguing that the price offered by the chosen bidder was a basis for establishing a breach. The alleged breach was based solely on the trustee's failure to accept the maximum bid. The court rejected plaintiff's argument, and held that the university was justified in, "considering criteria other than the financial offer to protect the university's best interests . . . ."[68]

The holding in *Aloha Lumber* is consistent with a number of cases that hold that retirement boards do not breach their duty of prudence by pursuing investments that do not maximize return on investment. For example, in *Board of Trustees v. Mayor of Baltimore*,[69] discussed above, Maryland's highest court rejected the plaintiffs' contention that South Africa divestment would cause a breach of the duty of prudence.[70] In upholding the ordinances calling for divestment, the court cited with approval Professor Austin Scott's treatise on trusts that states that trustees may properly consider the social performance of the corporation in deciding whether to invest,[71] so long as the costs of pursuing a socially motivated investment scheme are *de minimis*.[72] Applying this standard to the facts, the court found that the initial

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[66] 994 P.2d 991 (Alaska 1999).

[67] *See id.* at 995.

[68] *Id.* at 1000.

[69] 317 Md. 72, 562 A.2d 720 (1989).

[70] *Id.* at 105, 562 A.2d at 736. The court's evaluation rested on both the common law duty ("A trustee is required to manifest in all his management of the trust the care, skill, prudence, and diligence of an ordinarily prudent man engaged in similar business affairs and with objectives similar to those of the trust in question." *Id.* at 103, 562 A.2d at 735), as well as the prudence standard of ERISA, which was expressly adopted by Baltimore municipal ordinance, and which is similarly worded to the standard in California (see *supra* text accompanying note 3).

[71] *See id.* at 106, 562 A.2d at 736, citing III A. SCOTT, THE LAW OF TRUSTS § 227.17 (4th ed. 1988).

[72] *See id.* at 108, 562 A.2d at 737.

cost of one-sixteenth of 1 percent of the funds' total value, plus the annual cost of 0.1 percent of the funds' total value, was within the *de minimis* standard announced by the court.[73]

The *Baltimore* decision was cited with approval by the Florida attorney general's opinion dealing with tobacco divestment.[74] The attorney general was asked to render an opinion on the state board's then-pending decision on whether to sell the tobacco stock held by the Florida Retirement System Trust Fund. Attorney General Robert Butterworth concluded that a board, after considering the volatility of the stock price, the litigation pending against the tobacco companies, and the then likelihood of U.S. Food & Drug Administration regulation of cigarettes, could decide to divest and fulfill its fiduciary duty.[75] Florida's retirement board also commissioned an outside legal opinion which concluded that a fiduciary may divest where prudence requirements are met.[76] The state board voted to sell its tobacco stock holdings.

Other cases have upheld pension plan investments based on nonfinancial considerations. In *Brock v. Walton*,[77] the court held that a pension fund can lend money to employees covered by that fund for the purchase of residential property and charge an interest rate 2 percentage points lower than the prevailing rates in the community. The court made this holding based on an interpretation of two relevant sections of ERISA, one being the duty of prudence.[78] Factors that weighed in favor of upholding the mortgage lending rates included (1) the fact that the trustees consulted professionals including lawyers, accountants, actuaries, and mortgage bankers; (2) the trustees determined that they would not find any willing borrowers at the prevailing rates charged by commercial banks; (3) each borrower's employment background; (4) the borrower would pledge accrued pension benefits; (5) the interest rates provided a higher rate of return than any of the assets in the remaining 90 percent of the fund's portfolio; and (6) the interest rates were in excess of the fund's actuarial and funding requirements.[79]

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[73] *See id.*

[74] 97 Op. Att'y Gen. 29 (Fla. 1997), 1997 WL 348030, at *3.

[75] *Id.*, 1997 WL 348030 at *5-6; *see also*, Lanoff, *supra* note 60, at 3.

[76] "[I]f as a part of an investment professional's analysis, he concludes that the risk of holding a security in the plan's portfolio is too high because of anticipated major litigation which could potentially lead to large judgments against the company, the professional may prudently conclude that the sale of the security is best for the portfolio." Memorandum from Ian D. Lanoff regarding Investment and Divestment of Retirement Plan Assets under Applicable Fiduciary Laws to Florida's State Board of Administration 10 (Aug. 29, 1996) (on file with the Technical Assistance Legal Ctr., (510) 444-8252).

[77] 794 F.2d 586 (11th Cir. 1986).

[78] *See id.* at 588.

[79] *Cf. Donovan v. Mazzola*, 716 F.2d 1226, 1232-33 (9th Cir. 1983) (Court found breach of duty of prudence where union's pension fund made a below market loan to the same union's convalescent fund. Unlike in *Brock*, the circumstances surrounding the loan demonstrated that it did not satisfy the duty of prudence. Before granting the loan, the lending pension fund 1) failed to ascertain the value of the property deeded as security for the loan, 2) failed to discover the unreasonable risk of the loan, 3) the trustees acted on both sides of the transaction, and 4) the loan was at the expense of the lending pension fund.).

The fact that the below-market mortgage loans were offered only to pension beneficiaries suggests that nonfinancial considerations played a part in offering the loans. This nonfinancial consideration is not discussed in the *Brock* court's analysis of the board's duty of prudence, suggesting that if the board fulfills the duty with regard to its financial obligations, it is free to make loans that offer benefits other than providing for the retirement of the plan beneficiaries. Just as below-market mortgages benefit home buyers, advocates for tobacco divestment believe that selling tobacco stock will contribute to the effort to reduce smoking rates in California. So long as the retirement board engages in the necessary financial analysis to ensure that the beneficiaries will not be harmed, *Brock* provides persuasive legal backing for tobacco divestment.

In another case involving below-market-rate home mortgage loans, *Barrington Police Pension Fund v. Department of Insurance,*[80] an Illinois appellate court held that the fact that the loan program earned a return less than the market rate was "insufficient reason to hold as a matter of law that the program was an imprudent investment in violation of the Pension Board's fiduciary duty."[81]

Courts have found breaches of the duty of prudence only in cases of flagrant lapses of judgment. For example, in *Lynch v. Redfield Foundation,*[82] trustees allowed trust income to accumulate in a non-interest-bearing account for five years, a breach of their duty of prudence.[83]

The *Aloha Lumber, Baltimore, Brock,* and *Barrington* cases stand for the proposition that a trustee need not maximize return to fulfill the duty of prudence so long as investments are made with the skill, care, and diligence that the duty of prudence demands.[84]

C. DUTY TO DIVERSIFY

Like the duty of loyalty and the duty of prudence, the duty to diversify appears in the California Constitution and applies to government pension plans in California:

> The members of the retirement board of a public pension or retirement system shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.[85]

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[80] 211 Ill. App. 3d 698, 570 N.E.2d 622, 156 Ill. Dec. 146 (1991).
[81] *Id.* at 707, 570 N.E.2d at 627, 156 Ill. Dec. at 151.
[82] 9 Cal. App. 3d 293 (1970).
[83] *See id.* at 302. *See also* Blankenship v. Boyle, 329 F. Supp. 1089 (D.D.C. 1971).
[84] *See also* Foltz v. U.S. News & World Report, 865 F.2d 364, 373 (D.C. Cir. 1989) (finding ERISA's duty of prudence "creates no exclusive duty of maximizing pecuniary benefits."); Anderson v. Mortell, 722 F. Supp. 462, 470 (N.D. Ill. 1989) ("The duty required of a fiduciary, however, is merely that he conduct a prudent, independent investigation of a particular investment, not that he achieve the highest possible price.").
[85] CAL. CONST. art. XVI, § 17(d). Similar language applicable to retirement boards appears at CAL. GOV'T CODE § 31595(c) (West 1988), and CAL. PROB. CODE § 16048 (West Supp. 2000).

Some cases treat the duty to diversify as part of the duty of prudence.[86] In *Baltimore*,[87] discussed above, the court begins its prudence analysis with a discussion of the effect the South Africa divestment ordinances would have on the pension funds' diversification. In holding that the ordinances did not alter the trustees' duty of prudence, the court considered that (1) despite the fact that the ordinances would involve a large proportion of the current holdings,[88] the trustees would be able "to construct an almost perfectly diversified portfolio . . . .";[89] (2) the transition would occur gradually over a two-year period;[90] and (3) the ordinances empowered the trustees to suspend divestiture if it became imprudent.[91] The *Baltimore* opinion (and the surrounding South Africa divestment effort) has generated much commentary, some criticizing the case as wrongly decided.[92] Indeed, the commentary has vastly eclipsed the case law in the area of divestment.[93] Objections raised to the *Baltimore* case and to South Africa divestment do not apply to tobacco divestment.

For example, the *Baltimore* opinion cites Langbein and Posner,[94] who are contrary voices, but apparently did not find them persuasive. In their article, Langbein and Posner argue that social investing is a breach of fiduciary duty since it adds the administrative costs of screening out investments and the costs of adding or subtracting investments from a stock portfolio based on social factors.[95] But they go on to state that the costs to an actively traded portfolio need not be greater with social investing since stock transactions are taking place anyway.[96] In addition, Langbein and Posner state that a portfolio could exclude many U.S. firms and still be adequately diversified.[97] In the tobacco divestment arena, most pension plans hold a small percentage of tobacco stocks and therefore would not trigger the level of underdiversification to which Langbein and Posner would object.

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[86] *See, e.g.*, Beach v. Carter, 15 Cal. 3d 623, 634, n.9 (1975).

[87] 317 Md. 72, 562 A.2d 720 (1989).

[88] Plaintiffs asserted that one-half of the market capitalization of the Standard & Poor's 500 would be affected. *Id.* at 103, 562 A.2d 735.

[89] *Id.* at 104, 562 A.2d 735.

[90] *Id.* at 105, 562 A.2d 736.

[91] *See id.*

[92] *See* Deborah J. Martin, *The Public Piggy Bank Goes to Market: Public Pension Fund Investment in Common Stock and Fund Trustee's Social Agenda*, 29 SAN DIEGO L. REV. 39, 45 (1992).

[93] Only two other cases touched on the issue of South Africa divestment in the context of public assets, and disposed of them on non-substantive grounds: Associated Students of Univ. of Or. v. Or. Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986) (trial court ruled that South Africa divestment violated the prudent investor rule, but the reviewing court held that the students lacked standing to bring the action since they failed to show direct injury); and Regents of Univ. of Mich. v. Michigan, 166 Mich. App. 314, 419 N.W.2d 773 (1988) (court found that a state statute directing the University of Michigan to divest from South Africa unconstitutionally usurped the university's autonomy).

[94] John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980).

[95] *See id.* at 93.

[96] *See id.* at 93-94.

[97] "[B]ecause most of the gains from diversification can be achieved with a portfolio significantly smaller than the market portfolio or some approximation thereto such as the S&P 500, it is possible that a portfolio could be constructed in which a significant fraction of the largest U.S. firms were ineligible for inclusion yet which was not grossly underdiversified." *Id.* at 87; *see also* Hutchinson, *supra* note 60, at 1386.

The case law suggests that underdiversification would have to be egregious to breach the duty to diversify. In *Mandel v. Cemetery Board,*[98] the court held that lending 80 percent of the cemetery endowment fund to a limited partnership was a breach of the prudent investor rule. In *In re Estate of Collins,*[99] the trustees breached the prudent investor rule when they invested two-thirds of the trust principal in a junior mortgage in a single piece of unimproved real property. In *Marshall v. Glass/Metal Ass'n,*[100] the pension plan trustees breached their duty of prudence when they invested 23 percent of total assets in a single borrower. And in *Marshall v. Teamsters Local 282 Pension Trust Fund,*[101] the trustees violated the duty of diversification when they sought to invest 36 percent of total pension assets in one investment.

Retirement boards in California can implement tobacco divestment without breaching the duties of loyalty, prudence, and diversification if the interests of the beneficiary are not harmed, the boards engage in careful study to make sure that the decision to divest is a financially sound one, and diversification is maintained. Indeed, the trustees may decide that the duty of prudence demands that they sell tobacco stock (completely separate from the public health appropriateness of such investments) given the financial uncertainty surrounding the tobacco industry.

II. PERSONAL LIABILITY OF BOARD MEMBERS

Some retirement board members may be concerned about whether divesting from tobacco stock will open them up to personal liability. Before even reaching this issue, a plaintiff-beneficiary would have to show that the retirement board breached one of the duties described above. Thus, fulfilling the duties prevents any further inquiry as to liability. If there is a breach, the beneficiary has the ability to file suit against board members.[102] A board member's decision regarding tobacco divestment is covered by broad rules that insulate government officials acting in their official capacities. The California Government Code provides:

> Except as otherwise provided by statute, a public employee is not liable for an injury resulting from his act or omission where the act or omission was the result of the exercise of the discretion vested in him, whether or not such discretion be abused.[103]

[98] 185 Cal. App. 2d 583 (1960).
[99] 72 Cal. App. 3d 663 (1977).
[100] 507 F. Supp. 378 (D. Haw. 1980).
[101] 458 F. Supp. 986 (E.D.N.Y. 1978).
[102] *See* 71 Op. Att'y Gen. 129 (Cal. 1988), 1988 WL 385198, at *3.
[103] CAL. GOV'T CODE § 820.2 (West 1995).

Retirement board members are considered public employees and are therefore immune from personal liability when they act within the scope of their duties.[104] If retirement board members are named in a suit, the public employer is required to defend them in any civil action brought against them in their roles as public employees.[105] A beneficiary who brought suit would have to show not only a breach of a duty but also that the pension fund lost money as a result.[106] If board members have fulfilled the duty of prudence, the public employer is also required to indemnify its employees against liability for any acts occurring within the scope of their employment.[107] The duty to defend and indemnify requires the employer to provide legal counsel, to pay for the costs incurred in litigation, and to pay any settlement or judgment for compensatory damages.[108]

III. California Constitutional and Statutory Law Allow Social Investing

Some have argued that the duties described above (especially the language "solely in the interest of, and for the exclusive purpose of providing benefits") prohibit any nonfinancial considerations from influencing investment decisions. But the argument that nonfinancial considerations are off-limits is undercut by contrary Constitutional and statutory language.

Article XVI, Section 17(g) empowers the Legislature "to prohibit certain investments . . . where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty."[109] This section demonstrates that a board can pursue nonfinancial considerations "in the public interest" while still fulfilling the duties of loyalty and fiduciary care. The argument that nonfinancial considerations cannot be pursued would render meaningless this section. In the past, the Legislature has acted to prohibit certain investments on public policy grounds, similar to what is contemplated by Section 17(g). In 1986, the Legislature barred investments in South Africa, to be phased out over a several-year period.[110] The legislation was repealed in 1994.[111]

The Legislature has also passed laws directing that pension assets be invested in California residential real estate. Government Code Section 20194 mandates that the California Public Employees' Retirement System (CalPERS) invest at least 25 percent of money

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[104] *See, e.g.*, Masters v. San Bernardino County Employees Retirement Ass'n, 32 Cal. App. 4th 30 (1995); Hittle v. Santa Barbara County Employees Retirement Sys., 39 Cal. 3d 374 (1985).

[105] *See* CAL. GOV'T CODE § 995 (West 1995).

[106] *See* Martin, *supra* note 92, at 62; *but see* Patrick S. Cross, Note, *Economically Targeted Investments – Can Public Pension Plans Do Good and Do Well?*, 68 IND. L.J. 931, 959 (1993).

[107] *See* CAL. GOV'T CODE § 825 (West 1995 & Supp. 2000); Stanson v. Mott, 17 Cal.3d 206, 226-27 (1976).

[108] *See* CAL. GOV'T CODE §§ 996, 996.4 (West 1995).

[109] CAL. CONST. art. XVI, § 17(g).

[110] Law of 1986, ch. 1254, § 2, CAL. GOV'T CODE § 16648, *repealed by* Stats. 1994, ch. 30 (S.B. 1285), § 4.

[111] *Id.*

for new investments in residential realty located in California.[112] Section 20194 is similar to the above-cited Section 17(g) in that the California residential realty investments requirement is subordinated to the duties of loyalty and fiduciary care.[113] In these two sections, we find two different types of nonfinancial considerations: Section 17(g) contemplates explicitly avoiding certain investments, while Section 20194 mandates investing in a category of investments.

IV. U.S. LABOR DEPARTMENT'S POSITION ON SOCIAL INVESTING

The U.S. Department of Labor has the authority to enforce the fiduciary standards for pension funds covered by the Employee Retirement Income Security Act (ERISA).[114] Although ERISA does not cover government pension funds, the position of the Labor Department has some bearing on how courts in California would interpret California laws governing a board's fiduciary standards. In 1979, the Labor Department took the position that safeguarding retirement income was such an "overriding social objective that to introduce other social objectives might dilute the primary one."[115] Therefore the prudence standard dictated that investment decisions could not deviate from traditional economic factors.[116]

In 1980 Ian Lanoff, then Administrator of the Labor Department's Office of Pension and Welfare Benefit Programs, which is charged with enforcing ERISA, stated that ERISA's exclusive purpose rule (governing a fiduciary's duty of loyalty) "does not exclude the provision of incidental benefits to others, [although] the protection of retirement income is . . . the overriding social objective governing the investment of plan assets."[117] The duty of prudence, he continued, is not violated by a fiduciary making investment decisions based on other objectives.[118] "If the socially beneficial investment meets objective investment criteria which are appropriate to the goals of the portfolio, it may be considered in the same manner as other investments which meet these criteria."[119] Mr. Lanoff also

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[112] *See also* CAL. EDUC. CODE § 22362 (West 1994 & Supp. 2000) (mandating the same set aside be done by the California State Teachers' Retirement System (CalSTRS)).

[113] *See* CAL. GOV'T CODE § 20194(d) (West Supp. 2000).

[114] "[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 administering the plan; (B) 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; (C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so . . . ." 29 U.S.C.A. § 1104(a)(1) (West 2000).

[115] Patricia McCarroll, Note, *Socially Responsible Investment of Public Pension Funds: The South Africa Issue and State Law*, 10 REV. L. & SOC. CHANGE 407, 421 (1980-1981).

[116] *See id.*

[117] Ian Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully under ERISA?*, 31 LAB. L.J. 387, 389 (1980).

[118] *Id.*

[119] *Id.* at 390.

suggested that social factors may affect the financial evaluation of a potential investment,[120] thus weaving together the social and financial analyses.

With regard to the duty to diversify assets, Lanoff stated fiduciaries could direct their money managers to broaden the investment vehicles under consideration so that more options are presented from which to select social investments.[121] Under this method, the fiduciary will be given a number of options with similar risk and return. "If, after evaluating other factors, two investments appear to be equally desirable, then social judgments are permissible in determining which to select. . . . [T]here is no one 'best' investment to be made to the exclusion of all others."[122] In summary, Lanoff stated the position of the Labor Department that "economic considerations are the only ones which can be taken into account in determining which investments are consistent with ERISA standards. Nevertheless, ERISA provides sufficient flexibility to permit consideration of incidental features of investments which are equal in economic terms."[123]

In 1994, the U.S. Labor Department issued an Interpretive Bulletin on whether economically targeted investments (ETIs) conform to the fiduciary standards of ERISA.[124] ETIs are defined as "investments selected for the economic benefits they create apart from their investment return to the employee benefit plan."[125] The Bulletin states that ERISA does not prevent fiduciaries from investing plan assets in an ETI if it has an expected rate of return comparable to that of available alternative investments with similar risk characteristics, and if the ETI is otherwise an appropriate investment in terms of diversification and the investment policy of the plan.[126] The Labor Department's permissive position with regard to ETIs would most likely apply to tobacco divestment as long as the Interpretive Bulletin's criteria are met—that substitute investments have similar risk and rates of return.

V. Internal Revenue Code Section 401(a)—Exclusive Benefit Rule

Pension assets receive the following favorable federal income tax treatment: (1) employer contributions to the plan are not considered as income to the employees, and (2) interest

[120] "[W]hat the pension plan fiduciary needs to determine about an investment is not, first, whether it is socially good or bad but how the proposed investment will serve the plan's participants and beneficiaries. The stability of a company's labor relations, the political situation in a country in which the investment is located or with which a company does business, and the effect that the public view of a company's social commitment may have on the profitability of a company are all factors which may properly enter into the evaluation of an investment." *Id.*

[121] *See id.* at 390-91.

[122] *Id* at 390. This method is counter to the argument that detailed financial analysis will always reveal the better investment option.

[123] *Id.* at 392.

[124] U.S. Department of Labor Interpretive Bulletin 94-1, 59 Fed. Reg. 32,606, 1994 WL 275570.

[125] *Id.*, 1994 WL 275570, at *32607.

[126] *See id.*

and dividends are not considered as income to the employees. To receive this favorable tax treatment, the Internal Revenue Code requires that no part of the corpus or income of the pension fund be used "for the *exclusive benefit* of [the] employees or their beneficiaries."[127] This rule applies to any investments of a pension fund (including public pension funds).[128]

The "exclusive benefit" standard has been interpreted by a 1969 Internal Revenue Service (IRS) ruling which suggests that the standard allows for flexibility in taking into account nonfinancial considerations in a pension board's investment decisions.[129] If the board maintains the primary purpose of benefiting employees or their beneficiaries when making trust investments, Revenue Ruling 69-494 allows nonbeneficiaries to derive some benefit from a transaction of the trust. The ruling lists four trust investment requisites which must be met for compliance with the exclusive benefit rule: (1) the cost must not exceed fair market value at time of purchase; (2) a fair return commensurate with the prevailing rate must be provided; (3) sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan; and (4) the safeguards and diversity that a prudent investor would adhere to must be present. The ruling was based on an employees' trust seeking to invest in the stock of the employer corporation, and it applies to all trusts covered by the exclusive benefit rule of Section 401(a), including government pension trusts.

In 1970, the IRS issued a ruling on a proposed amendment to an unemployment benefit trust:[130] The ruling stated that "permitting low-risk income-producing investments that serve social purposes, do not accrue for the benefit of related parties, and are not contrary to employees' interests, will not affect the exempt status of the trust."[131] Not only did the ruling allow for social benefit, but it also allowed for a lower rate of return: "Low-risk investments that produce income and also serve a social purpose will not be considered a diversion of the corpus or income from the trust's purposes even though such investments yield a rate of return lower than that in the current market."[132]

The IRS did withhold tax-exempt status from an employees' trust in which the trustee was empowered to invest trust funds without regard to whether investments were new, speculative, hazardous, adventurous, or productive of income.[133] The ruling was based on the four investment requisites delineated above. It stated that the expansive investment

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[127] 26 U.S.C.A. § 401(a) (West 2000) (emphasis added).

[128] Rev. Proc. 72-6, 1972-1 C.B. 710, 1972 WL 29205.

[129] Rev. Rul. 69-494, 1969-2 C.B. 88, 1969 WL 19130.

[130] Although unemployment benefit trusts are governed by a different Internal Revenue Code section than pension trusts (26 U.S.C.A. §501(c)(17) (West 2000)), the tax exemption provided to unemployment benefit trusts is governed by similar language to that governing pension trusts. *Compare* 26 U.S.C. § 501(c)(17) (unemployment benefit trusts) *with* 26 U.S.C.A. § 401(a) (West 2000) (pension trusts).

[131] Rev. Rul. 70-536, 1970-2 C.B. 120, 1970 WL 20500.

[132] *Id.*

[133] Rev. Rul. 73-532, 1973-2 C.B. 128, 1973 WL 33124.

provision in this trust relieved the trustee from any duty to conform to any of the investment requisites and, therefore, the trust was not designed for the exclusive benefit of the employees.[134]

These rulings suggest that the IRS's interpretation of the exclusive benefit rule is more permissive of investments that benefit nonbeneficiaries (than the duties of loyalty, prudence and diversification discussed above). Courts have gone even further than the IRS in interpreting the exclusive benefit rule to allow trustees to consider nonfinancial factors. Two tax court cases illustrate this point.

In *Shelby U.S. Distributors, Inc. v. Commissioner,*[135] the tax court upheld the plan's tax exemption under the exclusive benefit rule. In Shelby, 96 percent of the pension plan's assets were invested in secured notes and preferred stock of the employer.[136] The funds lent to the employer were used to purchase new businesses and provide additional capital for business operations.[137] The *Shelby* court cited *Feroleto Steel Co. v. Commissioner,*[138] stating that "investments of a trust may result in some benefit to another person without the trust losing its exemption, so long as there is no misuse of the trust funds."[139] It distinguished *Feroleto* based on the facts. In *Feroleto,* the pension plan consisted of insurance policies on the life of each plan participant. The trustees borrowed the cash surrender value from the insurance company.[140] Trustees immediately loaned the proceeds to the company's majority shareholder who lent the money to the company at a higher interest rate (8.5 percent versus 4.8 percent).[141] In finding that the plan was not for the exclusive benefit of the employees, the *Feroleto* court announced that its holding did not preclude third parties from benefiting from the plan.[142] The *Shelby* court observed that *Feroleto* involved a pension plan lending money at a rate significantly lower than what was available. Whereas the facts in *Shelby* showed that while "the employers, their officers, and the trustees may all have derived some indirect benefit from the use of the trust funds, it appears that the trust was also allowed to earn a reasonable return on its investments and that there was no channeling of trust profits into the hands of individuals."[143]

In *Shedco, Inc. v. Commissioner,*[144] the court was faced with a pension plan that lent 90 percent of its assets on an unsecured basis to a company with whom the trustees had a

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[134] *See id.*
[135] 71 T.C. 874 (1979).
[136] *Id.* at 876.
[137] *Id.* at 885.
[138] 69 T.C. 97 (1977).
[139] *Id.*
[140] The amount represented two-thirds of the value of all of the policies funding the pension plan.
[141] *See id.* at 103-04.
[142] "By our holding here, we do not mean to imply that the exclusive benefit rule is contravened whenever a benefit inures to someone other than the employees or their beneficiaries as the result of an investment of the funds of an employee trust." *Id.* at 113.
[143] *Shelby,* 71 T.C. at 885.
[144] 76 T.C.M. (CCH) 267, T.C. Memo 1998-295, 1998 WL 470663.

longtime financial relationship. The court held that although the borrower received some benefit in that the cost of borrowing the money was slightly less than the cost of borrowing a similar amount from another source, that the loan did not hinder the annual payment of benefits and, therefore, the primary purpose of the loan was to benefit plan participants.[145] The *Shedco* court reached this result despite the fact that it found that a breach of the duty of prudence had occurred.[146]

Although the IRS has advocated a more stringent standard for the exclusive benefit rule of Section 401(a),[147] the courts have declined to adopt one. The exclusive benefit rule of Internal Revenue Code Section 401(a) does not impose an investment standard higher than that of general trust principles.[148] The rulings and court cases discussed above suggest that Section 401(a)'s exclusive benefit rule does not hamper a pension plan trustee from making investment decisions based on nonfinancial considerations, so long as the trustee carries out the duties of loyalty, prudence, and diversification.

VI. CONCLUSION

When a retirement board is adequately informed of the financial effect of tobacco divestment and makes a sound decision based on that information, the threat of litigation is severely curtailed. The board has ultimate responsibility in making financial decisions and also has broad discretion in carrying out the functions of the pension plan. Tobacco divestment falls within the board's discretion and can be achieved within the duties of loyalty, prudence, and diversification.

[145] *See id.* at last paragraph of opinion.

[146] *Id.*

[147] In 1992, the I.R.S. issued a non-precedential General Counsel Memorandum which took the position that a proposed employee stock option plan which would allow a trustee to consider non-financial factors before acting upon tender offers violated the exclusive benefit rule. Gen. Couns. Mem. 39,870, 1992 WL 798078. This memorandum is distinguishable from tobacco divestment in that the enumerated factors to be considered (job security, employment conditions, prospect for future benefits) regarding tender offers would certainly affect either the financial outcome of plan assets or the portfolio's diversification.

[148] Hutchinson, *supra* note 60, at 1348.