

PUBLIC PENSION TRUSTEES' PURSUIT OF SOCIAL GOALS

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I. INTRODUCTION

Rising unemployment and declining inflation have reduced state and local tax revenues¹ at the same time that federal resources available for state and local services and development are being curtailed.² This economic climate has prompted many proposals for investing the burgeoning assets³ of state and local government retire-

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1. *See, e.g.*, Christian Sci. Monitor, Nov. 8, 1982, at 3, col. 1 (Midwest ed.); N.Y. Times, Nov. 8, 1982, at A1, col. 6; Am. Banker, July 28, 1982, at 42, col. 1; Daily Bond Buyer, Jan. 26, 1982, at 1, col. 4.

2. *See, e.g.*, N.Y. Times, Jan. 3, 1983, at A15, col. 1; Lindsey, *Economy Worries Officials of Cities*, N.Y. Times, Dec. 2, 1982, at A21, col. 1; Wash. Post, Nov. 16, 1982, at A1, col. 1; Teasdale, *Cuts Threaten BOCES Classes*, N.Y. Times, June 6, 1982, at 10, col. 5; Daily Bond Buyer, Sept. 18, 1981, at 1, col. 4.

3. In 1975 state and local government pension fund investments exceeded \$108 billion and were increasing by 13% annually. *See* STAFF OF HOUSE COMM. ON EDUCATION AND LABOR, 95TH CONG., 2D SESS., PENSION TASK FORCE REPORT ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS 48, app. III (1978) [hereinafter cited as CONGRESSIONAL TASK FORCE REPORT]. In 1979 the combined assets and reserves of private and public pension funds amounted to approximately \$650 billion, or almost

ment systems to create housing, jobs, additional sources of funds for mortgages and development loans and to otherwise benefit the local community, state or region.⁴

The current impetus to employ pension fund assets in ways that promote the economic vitality of the communities in which participants in public pension funds live and work is only one aspect of a larger movement to pursue multiple goals with pension fund assets rather than to focus solely upon the ultimate payment of retirement benefits.⁵ Such divergent goals may include avoiding any investment in entities that engage in activities deemed to be either immoral or against the long-term interests of the pension fund participants, the union that represents them or their employer. This desire has led to efforts to achieve "clean portfolios" by excluding certain investments from portfolios on the basis of nonfinancial criteria such as refusing to finance activities of the government of South Africa or opposition

17% of all financial assets in the United States. PRESIDENT'S COMM'N ON PENSION POLICY, FINAL REPORT, COMING OF AGE: TOWARD A NATIONAL RETIREMENT INCOME POLICY 18 (1981).

4. *E.g.*, H. CAREY, BUILDING FROM STRENGTH: A PROGRAM FOR ECONOMIC GROWTH AND OPPORTUNITY (1982); E. COLTMAN & S. METZENBAUM, INVESTING IN OURSELVES: PUBLIC EMPLOYEE PENSION FUND INVESTMENT STRATEGIES FOR ECONOMIC IMPACT AND SOCIAL RESPONSIBILITY (1979) (Report to the Task Force on Public Pension Investments of the Massachusetts Social and Economic Opportunity Council); GOVERNOR'S OFFICE OF DEVELOPMENT PLANNING, STATE OF NEW YORK, INVESTING IN NEW YORK STATE: THE ROLE OF PUBLIC PENSION FUNDS (1981); GOVERNOR'S PUBLIC INVESTMENT TASK FORCE, STATE OF CALIFORNIA, FINAL REPORT (1981); R. MESSINGER & MUN. RESEARCH INST., REVITALIZING NEW YORK CITY'S ECONOMY: THE ROLE OF PUBLIC PENSION FUNDS (Studies in Pension Fund Investments No. 8) (1980).

5. Commentators have developed a number of terms to describe various nontraditional investment approaches. The most common rubric used is "social investing," which describes investments that pursue broad social goals. "Targeted" investments, a sub-category of so-called social investments, are those designed to benefit a target community or geographical region, generally where the pension fund participants live and work. Social investments that sacrifice some degree of safety or financial return, elements expected from prudent investments, may be designated "concessionary" or "subsidized" investments. In concessionary investments, part of the expected return or desired safety has been relinquished in concession to the social goal. In subsidized investments, other investments in the pension fund's portfolio that yield full prudent returns subsidize these social investments. On the other hand, some investments include economic development potential or social benefit as a "bonus" in addition to the safety and yield required under the prudent person standard. These may be called nonconcessionary, nonsubsidized, or social bonus investments. All of these terms are subsumed within "divergent investing," a term that describes any investment with goals diverging from the basic goal of providing retirement benefits to participants and beneficiaries of the pension fund.

to nonunion employers⁶ or competitors of the participants' employer. Such criteria obviously reduce the range of potential investments for the pension fund.⁷ On the other hand, goals that encompass additional positive benefits for the participants, their employer, or some wider community often result in a search for new investment opportunities rather than a narrowing of the range of possible investments.⁸

Investment of public pension fund assets for purposes other than the ultimate payment of retirement benefits departs from the traditional prudent person standard for the investment of trust funds.⁹ In addition, it often raises issues of fiduciary conflict of interests since many public pension fund trustees are also government officials or employees' representatives negotiating in the context of state and municipal budgets. These trustees therefore have other interests in uses of public pension funds that benefit the local or regional community.¹⁰ Consequently, a rigorous examination of the legal standards for investment of public pension fund assets is essential both to protect public pension fund participants and beneficiaries from potential loss of retirement security and to help trustees avoid liability for violating their fiduciary duties.

This article examines the legal basis for public pension fund trustees' consideration of goals that diverge from the direct financial benefits of investment safety and return. It does so in the context of a particular public pension system, the New York City Employees' Retirement System (NYCERS) and investments designed to promote economic development of a particular community or region. NYCERS is one of the largest public pension systems for municipal or state employees, indeed, one of the largest pension funds of any

6. For an analysis of the use of pension fund assets for capital boycotts as an unfair labor practice under the Taft-Hartley amendments to the National Labor Relations Act, see Kaiser, *Labor's New Weapon: Pension Fund Leverage*, 34 RUTGERS L. REV. 409, 434-49 (1982).

7. For discussion of the legal implications of "clean portfolios," see J. SIMON, C. POWERS & J. GUNNERMAN, *THE ETHICAL INVESTOR* 144 (1972); Reidhaar, *Memorandum: The Legal Implications of University Investments in Companies Doing Business in South Africa*, 7 J.C. & U.L. 164 (1980-81); Note, *University Investments with a South African Connection: Is Prudent Divestiture Possible?*, 11 N.Y.U. J. INT'L L. & POL'Y 543 (1979).

8. See, e.g., L. LITVACK, *PENSION FUNDS & ECONOMIC RENEWAL* (Studies in Development Policy vol. 12) (1981); R. MESSINGER & MUN. RESEARCH INST., *supra* note 4.

9. See *infra* text accompanying notes 23-35 & 243-95.

10. See *infra* text accompanying notes 146-71.

kind, in the United States.¹¹ Much of the federal law applicable to NYCERS also applies to other public pension funds. In addition, the state and local statutes applicable to NYCERS are based, to a great extent, on common law concepts that have been incorporated into state and local legislation governing public pension funds in other jurisdictions. Some applicable New York common law differs from that governing public pension funds in other states, but most of the common law concepts are comparable to those in sister states. Thus, this examination of one specific retirement system should illustrate the complex interrelationships among local, state and federal law with which trustees of and counsel to public pension funds must be concerned.

Numerous commentators and public officials have asserted in recent years that under existing law pension fund trustees may take into account all types of benefits to their funds, their participants and society as a whole. These commentators argue that trustees may weigh all these benefits when making investment decisions and not just the traditional factors of return and safety.¹² Current statutes and case law provide little support for these arguments.¹³ A distinction should be made here, however. Logically, pension fund trustees who have determined from a position of loyalty to the participants and beneficiaries that an investment satisfies the traditional criteria of prudence should then be able to consider other benefits to the pension trust or its participants, and then benefits to the governmental entity employing them or their community in deciding whether to make an invest-

11. NYCERS assets were valued at \$7,298,068,762 as of November 30, 1982. Division of Investment Accounting of the Office of the Comptroller of The City of New York. Cf. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 103 S. Ct. 488 (1982).

12. Some commentators advocate applying the prudent person rule less stringently to permit indirect financial benefits to the employee benefit trust to compensate for somewhat lesser safety and/or return. See, e.g., Leibig, "You Can't Do That With My Money"—A Search for Mandatory Social Responsibility in Pension Investments, 6 J. PENSION PLAN. & COMPLIANCE 358, 366 (1981); Ravikoff & Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CALIF. L. REV. 518, 526 n.28 (1980). Others also suggest that even general social benefits to the community may counterbalance safety and return. See, e.g., 3 A. SCOTT, LAW OF TRUSTS § 227.17 (3d ed. 1967) (Supp. 1981); E. COLTMAN & S. METZENBAUM, *supra* note 4, at 43.

13. See *infra* text accompanying notes 245-95. See also Murphy, *Regulating Public Employee Retirement Systems for Portfolio Efficiency*, 67 MINN. L. REV. 211, 215-27 (1982) (discusses economic case against "social welfare improvement" as goal for public pension fund investments).

ment. There is no judicial authority to the contrary.¹⁴ In other words, in considering two prudent investments of equal financial merit, trustees should be able to choose the investment offering the more desirable indirect benefits to the pension fund or the greater benefit to its participants' community.¹⁵

Thus, the substantial legal issue raised by divergent investments is whether benefits to the trust and its participants—as participants of the fund, governmental employees or residents of the area—can justify pension fund investments that do not or may not satisfy traditional fiduciary standards of return on and safety of principal. We conclude that, absent carefully crafted federal and state legislation, such benefits do not supply the necessary justification under the current state of the law.

In the second section of this article, the traditional investment standards of fiduciaries are reviewed briefly.¹⁶ Then, the statutory frame-

14. Some commentators have concluded from the traditional articulation of the prudent person rule that fiduciaries may not take into account any other factors once return and safety are assured. See SHOULD PENSION ASSETS BE MANAGED FOR SOCIAL/POLITICAL PURPOSES: AN EBRI POLICY FORUM 8 (Salisbury ed. 1979); Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 96, 104 (1980).

15. See Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340, 1346-47 (1980); Schotland, *Should Pension Funds Be Used to Achieve 'Social Goals'*, TR. & EST. Sept. 1980, at 10; Oct. 1980, at 27. Cf. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 103 S. Ct. 488 (1982).

Raymond Donovan, the Secretary of Labor, Jeffrey N. Clayton, the current Administrator of the Office of Pension and Welfare Benefit Programs of the Department of Labor, Ian D. Lanoff, Clayton's predecessor, and James Hutchinson, the first administrator of that office all believe that if a decision on a particular investment is a prudent one and in the sole interest of participants and beneficiaries, the fact that it is also socially desirable causes no problem under the Employee Retirement Income Security Act of 1974, as amended, 29 U.S.C. §§ 1001-1461 (1976 & Supp. IV) [hereinafter cited as ERISA; citations are to the Act's section numbers as enacted rather than to the United States Code]. Hutchinson & Cole, *supra*, at 1349, 1353-57; Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 LAB. L.J. 387, 390 (1980); R. Donovan, Statement of the Secretary of Labor before the Subcommittee on Labor, Senate Committee on Labor and Human Resources 1 (Jan. 29, 1982). See *Prudential Life Ins. Co., Dep't of Labor Op.* Letter (Jan. 16, 1981).

Cf. Murphy, *supra* note 13, at 218 (no possible objection on economic grounds to selection of financially comparable investments which produce gains for nonplan participants).

16. See *infra* text accompanying notes 21-37.

work applicable to NYCERS' investments is outlined.¹⁷ The fourth section examines the statutes and relevant common law in detail in order to derive an integrated approach to the issues.¹⁸ Next, several representative investments, designed to achieve goals in addition to securing retirement benefits which have been proposed for NYCERS, are scrutinized in light of the preceding legal analysis.¹⁹ Finally, possible legislative solutions are examined for the issues raised in the course of this article.²⁰

II. TRADITIONAL INVESTMENT CRITERIA

Traditionally, trustees have two basic investment duties—a duty to invest prudently by maximizing return on and safety of the trust assets and a duty of undivided loyalty to the beneficiaries of their trust.²¹ Courts hold these duties to be inherent in legislatures' repeated use of such terms as "trust," "trustee," "fiduciary" and "beneficiary" in the statutes governing public pension funds.²² Moreover, local, state and federal statutes applicable to the investment decisions of public pension fund trustees in one way or another incorporate these two common law duties.

The duty of prudence was first articulated in 1830 by the Supreme Judicial Court of Massachusetts in *Harvard College v. Amory*:

All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is

17. See *infra* text accompanying notes 38-125.

18. See *infra* text accompanying notes 126-361.

19. See *infra* text accompanying notes 362-76.

20. See *infra* text accompanying notes 377-409.

21. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830).

22. See *infra* text accompanying notes 41-42.

Professor Scott and Ravikoff and Curzan rely on analogies with investment powers of corporate directors and trustees or directors of charitable trusts to support their contention that trade-offs between safety or return and nonfinancial benefits are permissible for investments by public pension fund trustees; 3 A. SCOTT, *supra* note 12, § 227.17 (Supp. 1980); Ravikoff & Curzan, *supra* note 12, at 536. These analogies are inapposite because the standard of care applicable to directors of business and charitable corporations derives from the business judgment rule, not from the fiduciary standard applicable to trusts established for particular beneficiaries. Ward, *The Charitable Fiduciary Liability Question*, 17 REAL PROP. PROB. & TR. J. 700, 709-13 *passim* (1982). In addition, the rationale that has generally protected corporate directors from liability for acts of apparent corporate altruism is that the directors were actually pursuing the longer-range financial interest of the corporation. Accord, Langbein & Posner, *supra* note 14, at 100.

to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.²³

This represented a relaxation of both the early English rule obligating a trustee to return to a grantor or beneficiary of a trust property identical to that entrusted to him and the later rule obligating trustees to make virtually risk-free investments.²⁴

In 1869 the New York Court of Appeals enunciated its now classic formulation of the "prudent person" rule. In *King v. Talbot*,²⁵ it stated that "the trustee is bound to employ such diligence and such prudence in the care and management [of the trust], as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs."²⁶ At the same time, the court departed from the Massachusetts prudence standard by holding that the security of the trust corpus and acquisition of a reasonable income must be the trustee's paramount objectives, even if at the expense of capital appreciation.²⁷ The authorities agree that New York courts apply a somewhat stricter standard, one of a cautious prudent investor who is more interested in preserving capital than in taking the risks necessary for significant capital appreciation.²⁸ The trend, however, is to adopt the Massachusetts rule.²⁹

In New York and other jurisdictions following traditional common law principles, a fiduciary must exercise the same prudence with respect to each investment decision.³⁰ The fact that the trust's portfolio has increased substantially in total value during the period of time under scrutiny will not insulate the fiduciary from responsibility for imprudence in selecting or retaining particular investments for which

23. *Harvard College v. Amory*, 26 Mass. (9 Pick.) 446 (1830).

24. 3 A. SCOTT, *supra* note 12, §§ 227.4, 227.5; E. COLTMAN & S. METZENBAUM, *supra* note 4, at 41-43.

25. 40 N.Y. 76 (1869).

26. *Id.* at 85.

27. *Id.* See 3 A. SCOTT, *supra* note 12, §§ 227.3, 227.6.

28. 3 A. SCOTT, *supra* note 12, § 227.3 at 1812. See *Mills v. Bluestein*, 275 N.Y. 317, 325, 9 N.E.2d 944, 948 (1937) (dissenting opinion).

29. *Id.*

30. *In re Bank of New York*, 35 N.Y.2d 512, 517, 323 N.E.2d 700, 703, 364 N.Y.S.2d 164, 168 (1974). See 3 A. SCOTT, *supra* note 12, § 213.

he may be surcharged.³¹

Prudence is a matter of conduct, not of investment performance.³² There is no inherent connection between a loss sustained on an investment and imprudence in the investment decision. If a fiduciary has prudently chosen or retained an investment, he may not be held liable for any loss sustained as a result of that investment decision.³³ Conversely, it is possible for an imprudent investment to yield a profit or gain for the trust. In such cases, the fiduciary has equally breached his fiduciary obligations. There is simply no damage to the trust beneficiaries.³⁴ Since prudence is a matter of the fiduciary's conduct, his prudence should always be "tested at the time of the investment decision, not from the vantage point of hindsight."³⁵

The trustee's duty of loyalty is the duty to act in the interest of the trust, as if the trustee had no interests of his own to protect. The trustee must resolve all conflicts which may exist between his personal or other interests and those of the trust and its beneficiaries in favor of the latter³⁶ and must treat all beneficiaries evenhandedly.³⁷

III. STATUTORY FRAMEWORK

While the basic concepts involved in investments by pension fund trustees derive from the common law of private trusts, these concepts have been further developed and supplemented by legislative action. Local, state and federal laws all contain requirements and restrictions, often overlapping, which must be considered by public pension fund trustees.

A. *The Plan*

Unlike the more typical employer-adopted pension plans,

31. *Id.*

32. *In re Morgan Guar. Trust Co.*, 89 Misc. 2d 1088, 1091, 396 N.Y.S.2d 781, 784 (Sur. Ct. 1977). *See also* 29 C.F.R. § 2550.404a-1(b)(1) (1982)

33. *In re Bank of New York*, 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974); 3 A. SCOTT, *supra* note 12, § 227.1.

34. *Cf.* ERISA §§ 409(a), 502(a). These sections appear to authorize injunctive relief against trustees who have breached their fiduciary obligations, regardless of whether specific losses have been incurred.

35. *In re Morgan Guar. Trust Co.*, 89 Misc. 2d at 1091, 396 N.Y.S.2d at 784.

36. *See infra* text accompanying notes 128-38.

37. *See infra* text accompanying notes 214-17.

NYCERS was established pursuant to statute.³⁸ The Administrative Code of the City of New York provides for the administration of NYCERS by a "board of trustees."³⁹ This is repeated in a later section of the Administrative Code, which provides that the members of the board "shall be the trustees of the several funds provided for by this title."⁴⁰

Use of the traditional legal term "trustees" to describe the relationship of the members of the board to the funds of NYCERS indicates the legislature's intention to establish a traditional trustee relationship between the members of the board and the participants and beneficiaries of NYCERS.⁴¹ Legal authorities construing the obligations of public employee pension systems have assumed that these obligations are governed by the principles of law developed with respect to trustees of private trusts.⁴²

The NYCERS trustees have "full power to invest" the system's assets⁴³ subject to restrictions imposed by the Administrative Code and other statutes.⁴⁴ The New York City Comptroller's statutory designation as custodian of NYCERS' assets, subject to the control of

38. NEW YORK CITY ADMIN. CODE ch. 3, tit. B (1976). Public pension funds that are not established under detailed statutory plans have trust instruments or plans similar to those under which private pension funds are established.

39. *Id.* § B3-2.1.

40. *Id.* § B3-22.0. Most public pension funds or systems are comprised of two or more discrete trust funds. For example, NYCERS includes four separate trusts. *Id.* § B3-14.0. The requirements for "qualification" contained in the Internal Revenue Code of 1954, as amended, § 401(a) [hereinafter cited as IRC] must be satisfied by each trust. See *infra* notes 81-89 and accompanying text. In this article, it is assumed that all trusts in a system either do or do not qualify under § 401(a), and the terms "trust," "fund" and "system" are used interchangeably to denote an entire system of trust funds for providing retirement benefits to a single group of employees.

41. See *Savings Bank of New London v. New York Trust Co.*, 27 N.Y.S.2d 963, 975 (Sup. Ct. 1941) (term "trustee" connotes trust, confidence, reliance and active diligence). Cf. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981) (Congress' use of such terms as "held in trust" and "for the sole and exclusive benefit of the employees . . . and their families and dependents" necessarily implies Congress' intent to incorporate the law of trusts).

42. See, e.g., *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1254 (S.D.N.Y. 1978), *aff'd mem.* 595 F.2d 1210 (2d Cir. 1979) (municipal pension fund trustees are subject to the "prudent man rule" and are therefore obligated to preserve trust corpus and procure reasonable income while avoiding undue risks); 1977 Op. N.Y. Att'y Gen. 37, 38 (1977).

43. NEW YORK CITY ADMIN. CODE § B3-22.0 (1976).

44. N.Y. RETIRE. & SOC. SEC. LAW §§ 177-79 (McKinney 1971 & Supp. 1981); NEW YORK CITY ADMIN. CODE §§ B3-22.0 (1976), E49-1.0, -3.0 (1975). See N.Y.

the NYCERS trustees,⁴⁵ confirms their investment power. When the Comptroller invests NYCERS' assets pursuant to the trustees' delegation of authority, he is subject to the same limitations as their agent.⁴⁶

The only other local law applicable to the investment power of the NYCERS trustees bars them from having any direct or indirect interest in the gains or profits of the system's investments, borrowing or using NYCERS' assets on behalf of themselves or any third party, receiving any pay or emolument for their services, or guaranteeing or insuring any loans to or from NYCERS.⁴⁷

B. *Investment Restrictions: The Legal List*

Both the Administrative Code of the City of New York⁴⁸ and the New York State Retirement and Social Security Law⁴⁹ restrict the NYCERS trustees' investment power by incorporating the list of permissible investments for savings banks in New York State.⁵⁰ Provisions in the Retirement and Social Security Law⁵¹ and the Administrative Code further limit the trustees.⁵² The Retirement and Social Security Law also specifically authorizes certain investments⁵³

BANKING LAW §§ 235, 235-a (McKinney 1971 & Supp. 1981). *See also infra* text accompanying notes 48-49.

45. NEW YORK CITY ADMIN. CODE § B3-24.0 (1976).

46. *See infra* text accompanying notes 328-29.

47. NEW YORK CITY ADMIN. CODE § B3-27.0 (1976).

48. *Id.* § B3-22.0.

49. N.Y. RETIRE. & SOC. SEC. LAW § 177(1) (McKinney 1971).

50. N.Y. BANKING LAW §§ 235, 235-a (McKinney 1971).

51. N.Y. RETIRE. & SOC. SEC. LAW § 177(1) (McKinney 1971) (limitations on investments in conventional mortgages, obligations of the International Bank for Reconstruction and Development, Canadian obligations, equipment trust certificates and obligations of railroads and public utilities); *id.* § 177(2) (further limitations on investments in equity securities authorized for investment by § 235 of the New York Banking Law); *id.* § 178 (limitations on investments in insured mortgages and conventional mortgages).

52. NEW YORK CITY ADMIN. CODE § E49-1.0 (1975) (subject to certain conditions, notes or bonds secured by purchase money mortgages accepted by the City at the time it sells real property acquired in tax enforcement foreclosure proceedings); *id.* § E49-3.0 (railroad, industrial, electric and gas, telephone and waterworks obligations).

53. N.Y. RETIRE. & SOC. SEC. LAW § 177(3) (McKinney 1971) (conventional mortgages guaranteed by state banks of a certain size); *id.* § 177(4) (obligations of New York State banks secured by federally insured or guaranteed mortgages); *id.* § 177(5) (participation in conventional mortgages in which only specified kinds of

that would or might be impermissible under the list of permissible savings bank investments.

Together, these statutes comprise the so-called "legal list" of investments in which the trustees have power or authority to invest.⁵⁴ Although the legal list is couched in positive terms,⁵⁵ in effect it restricts the trustees from investing in certain types of securities and other investments.⁵⁶ Ironically, the original purpose of the legal list was to liberalize the scope of investments that trustees could consider. Courts applying the prudent person standard of *King v. Talbot*⁵⁷ tended to extrapolate from the imprudence of a specific investment before another court the imprudence of all investments of that type. The legislature developed the legal list to make clear to trustees and courts that listed investment types were authorized for investment by

institutions participate); *id.* § 177(6) (real property acquired for specified purposes and in specified ways); *id.* § 177-a (first mortgages on real property located anywhere in United States); *id.* § 177-c (investment grade mortgage pass-through certificates secured by certain kinds of property); *id.* § 179 (obligations of Municipal Assistance Corporation for the City of New York).

54. In the past, "legal lists" have limited the investment authority of trustees in a large number of states. Many have been repealed, however, in recent years. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 194. Of the legal lists still in force for public pension funds, New York's probably is the most complex in the United States. HAMILTON, JOHNSTON & CO., REPORT TO NEW YORK STATE COMMISSION ON PUBLIC EMPLOYEE PENSION AND RETIREMENT SYSTEMS 16 (1981). *Cf.* CAL. GOV'T CODE § 20205 (Deering 1982) (investments of California state retirement fund are subject to the same conditions and restrictions imposed upon investments of savings banks, as well as special restrictions imposed solely upon state retirement fund).

55. Permissible investments on the legal list include, but are not limited to, obligations of the United States, N.Y. BANKING LAW § 235, subd. 1 (McKinney 1971); obligations of New York State, *id.* § 235, subd. 2; obligations of New York City, *id.* § 235, subd. 4; and obligations for which the full faith and credit of the United States, New York State or New York City is pledged, *id.* § 235, subd. 1-2, 4; N.Y. CONST. art. VIII, § 2; bonds issued by electrical, natural gas and telephone utility companies incorporated in the United States, N.Y. BANKING LAW § 235, subd. 13-15 (McKinney 1971); preferred stock of United States corporations as authorized by the New York State Banking Board, *id.* § 235, subd. 26(a); and any security specifically made eligible by the State Banking Board, *id.* § 235, subd. 19.

56. Securities that are excluded de facto include:

- (a) Securities of companies incorporated outside of the United States or Puerto Rico; N.Y. BANKING LAW § 235, subd. 26(a)-(c) (McKinney 1971);
- (b) Securities not listed on a national securities exchange, *id.* § 235, subd. 26(c)(1); and
- (c) Securities of casualty and fire insurance companies that have senior securities outstanding or derive more than 55% of their premiums from fire and motor vehicle risk, *id.* § 253, subd. 26(d).

57. 40 N.Y. 76 (1869). *See supra* text accompanying notes 25-27.

fiduciaries and that a given investment could be challenged solely on the basis of its own particulars.⁵⁸ Accordingly, the presence of a particular type of security or other investment on the legal list makes it eligible for investment consideration, but it does not actually authorize the trustees or their properly designated agents to invest in a particular investment of that type. The trustees still may authorize only prudent investments and must satisfy their duties to exercise care and skill in selecting particular investments and to invest for the benefit of NYCERS' participants and beneficiaries.⁵⁹

Trustees must closely review legal list investments that are coupled with a guaranty or other additional security not contained on the legal list. The relationship between investments of this type and the safety required by the prudent person standard may be conceptualized as a continuum. At one end would be investments that are authorized by a provision of the legal list and that the trustees deem to be clearly prudent. Any additional security for such an investment is "icing on the cake." An example of this situation might be a loan to a real property owner to upgrade a prime commercial property secured by a mortgage on the property guaranteed by a state bank,⁶⁰ for which the trustees obtain standard performance bonds from the contractors and subcontractors on the project. The performance bonds are not required or authorized by the legal list, and probably are not required in order for a fiduciary to find that the loan is prudent. Yet the trustees might well desire the bonds as an additional precaution.

At the other end of the continuum would be investments that, although also on the legal list, are deemed by the trustees to be clearly imprudent. However, the additional security is prudent, either alone or in combination with the authorized investment, but not on the legal list. An example might be a construction loan to build an office building on swamp land. Independent engineering consultants assure the trustees that current technology cannot provide an adequate foundation for the buildings, but David Rockefeller executes his per-

58. See 3 A. SCOTT, *supra* note 12, § 227.3. Cf. *Governor's Memorandum on ch. 817 of the 1960 N. Y. Laws*, NEW YORK STATE LEGISLATIVE ANNUAL 548, 549 (1960).

59. *Delafield v. Barrett*, 270 N.Y. 43, 48, 200 N.E. 67, 69 (1936) (fiduciary who invests in securities specified in statutes is not thereby freed from liability if he fails to exercise reasonable judgment and discretion in making investments); *In re Weinz' Will*, 65 N.Y.S.2d 302 (Sur. Ct. 1946) (trustee surcharged for loss on legal but imprudent investment in a mortgage).

60. N.Y. RETIRE. & SOC. SEC. LAW § 177(3) (McKinney 1971).

sonal guaranty of the timely repayment of the loan. The trustees would not truly be investing in the developer's mortgage but in Rockefeller's credit, which is not on the legal list. In these circumstances it would seem that the "package" of the construction loan plus the guaranty should not be deemed to be a legal investment.⁶¹

C. State Regulatory Review

The New York Insurance Law authorizes the Superintendent of Insurance of New York State to promulgate standards for investment policies and the discharge of fiduciary responsibilities with respect to New York State and City public employee retirement systems.⁶² Such standards have been promulgated as Part 136 of Title 11 of New York Codes, Rules and Regulations (Insurance Regulations).⁶³

The Insurance Regulations affirm that the NYCERS trustees are

61. This conceptualization is supported by the final regulations issued by the Department of Labor on the definition of some plan assets under ERISA. In its Notice promulgating the final regulations, the Department described several kinds of securities issued, guaranteed or insured by governmental and quasi-governmental entities and backed by mortgage pools, including securities issued by the Government National Mortgage Association (GNMA). 47 Fed. Reg. 21,241 (1982). The Department concluded that in each case the securities represent beneficial ownership interests in the underlying mortgages. It determined for several reasons, however, to exclude the underlying mortgages from the definition of assets owned by pension trusts purchasing the securities. One key reason for its determination was the Department's perception of the investment intent, which generally accompanies a pension trust's purchase of governmental mortgage pool securities:

GNMA guaranteed pass-through mortgage certificates are guaranteed by the United States, and where such a guarantee by the United States exists with respect to a plan's investment in a mortgage pool, the Department believes that a plan that invests in the pool will look to the guarantee, rather than to the mortgage underlying the pool, for assurance that amounts due on its investment will be paid. Although FHLMC [Federal Home Loan Mortgage Corporation] and FNMA [Federal National Mortgage Association] mortgage pool certificates are not guaranteed directly or indirectly by the United States, each corporation guarantees principal and interest on such investments and, accordingly, an investing plan will rely on the creditworthiness of the issuing corporation in making its investment decision.

Id. at 21,243. The Department concluded and the regulations provided that pension fund investments in such securities should be treated as investments in securities backed by the full faith and credit of the United States and not as investments in any of the underlying mortgages. *Id.* at 21,243; 29 C.F.R. § 2550.401b-16(a)(1). This conclusion is equivalent to finding that the governmental guarantee, or "additional security," is the true investment, not the underlying mortgages.

62. N.Y. INS. LAW § 36-a(2) (McKinney Supp. 1981).

63. NYCRR tit. 11, § 136 (1978).

fiduciaries and reiterate the prudent person rule as the basic standard for the discharge of their fiduciary responsibilities.⁶⁴ In addition, the Insurance Regulations provide that the trustees must act "solely in the interests of the members and beneficiaries"⁶⁵ of the pension fund, a reformulation of the traditional duty of loyalty.⁶⁶ They also contain four prohibitions which further define the duty of loyalty owed to the pension fund by its trustees, agents, consultants and employees.⁶⁷

Finally, the Insurance Regulations provide that a breach of fiduci-

64. 11 NYCRR § 136.6(a). Section 136.6(a) provides that "[t]he administrative heads are fiduciaries They shall perform their responsibilities in a manner consistent with those of a reasonably prudent person exercising care, skill and caution." Under § 136.2(b), "administrative head" means: "if not otherwise defined by law, the board of trustees of a retirement system, in their individual and collective capacities." "Administrative head" is not otherwise defined in any other statute applicable to NYCERS. The definition, by referring to the "individual and collective capacities" of the trustees, appears also to incorporate the common law principle that a trustee is responsible for all trustees' participation or failure to participate in the administration of the trust. *See In re Palmer's Will*, 132 N.Y.S.2d 311, 315 (Sur. Ct. 1954) (trustees owe their beneficiaries the duty of independent judgment); *In re Pate's Estate*, 84 N.Y.S.2d 853, 862 (Sur. Ct. 1948) (administration of a trust rests with trustee and he may not delegate or abdicate that duty), *aff'd*, 276 A.D. 1008, 97 N.Y.S.2d 542 (1st Dep't 1950); 2 A. SCOTT, *supra* note 12, § 184 (a trustee is under a duty not to delegate to third persons any acts that he can reasonably be required to perform). *Cf.* N.Y. EST. POWERS & TRUST LAW § 10-10.7 (McKinney Supp. 1982) (a joint power, other than a power of appointment, conferred upon three or more fiduciaries, is exercisable by a majority of the fiduciaries unless contrary to the express provisions of the trust). Moreover, under certain circumstances, a trustee is responsible for applying to the court to prevent a breach of trust by his co-trustee. *See In re Garland*, 159 Misc. 333, 287 N.Y.S. 918 (Sur. Ct. 1936) (when will creating trust named corporation and widow as co-trustees and trust committee of corporate trustee had reached conclusion that bonds belonging to trust estate should be sold, corporate trustee had duty to insist upon sale of bonds notwithstanding opposition of widow); 3 A. SCOTT, *supra* note 12, § 194 (when the circumstances are such that failure to exercise a power is breach of trust and one of two trustees wishes to exercise the power but the other refuses to concur, trustee wishing to exercise the power is duty bound to apply to court for directions). *Cf.* CAL. CIVIL CODE § 2261 (Deering 1981) (Board of Administration of the California Public Employees' Retirement System must invest consistently with duties of loyalty and prudence).

65. 11 NYCRR § 136.6(a).

66. *See infra* text accompanying notes 127-36.

67. 11 NYCRR § 136.6(h). Section 136.6(h) of the Insurance Regulations provides:

The administrative head, and its consultants, agents and employees, shall not:

- 1) deal with the assets of a system for their own account;
- 2) act in any capacity in any transaction involving a system on behalf of a party whose interests are adverse to a system or its members;

ary responsibility results when a trustee or other agent of a pension fund, subject to supervision by the Superintendent of Insurance, wilfully violates or knowingly participates in a violation of the Insurance Regulations or fails to implement any other applicable law.⁶⁸ This provision directly incorporates the requirements specified in other sections of the Insurance Regulations regarding accounting practices,⁶⁹ supervision of delegated investment authority,⁷⁰ reporting of investments and other administrative duties.⁷¹ It also gives the Superintendent of Insurance the power to investigate and report to the Attorney General possible violations of the Insurance Regulations or any other statute applicable to the pension fund.⁷²

D. *Internal Revenue Code Requirements*

Currently, the most important federal statute directly applicable to the fiduciary aspects of investments of public pension funds is the Internal Revenue Code of 1954, as amended (IRC).⁷³ Through its provisions, Congress confers favorable tax treatment on public pension plan trusts and plan participants and beneficiaries when criteria relating to employer function,⁷⁴ purpose,⁷⁵ funding,⁷⁶ participation,⁷⁷

-
- 3) receive any consideration from any party in connection with a transaction involving a system's funds or its assets; or
 - 4) own or maintain any indicia of ownership or personal interest in any assets of a system other than an interest in the system as a member or beneficiary.

68. *Id.* § 136.9(a)-(b).

69. *Id.* § 136.4.

70. *Id.* § 136.6(d).

71. *Id.* § 136.6(c).

72. *Id.* § 136.6(c). These statutes include the New York City Administrative Code, the New York State Banking and Retirement and Social Security Laws and, arguably, the Internal Revenue Code.

73. 26 U.S.C. §§ 1-9602 (1976). Unless otherwise indicated, all references to sections of the IRC are to the Internal Revenue Code of 1954, as amended.

74. IRC § 115 (1976).

75. Section 401(a) of the IRC provides, in pertinent part:

A trust created or organized in the United States and forming part of a stock bonus, pension or profit-sharing plan of an employer *for the exclusive benefit of his employees or their beneficiaries* shall constitute a qualified trust under this section—

- 1) if contributions are made to the trust by such employer, or employees, or both, . . . *for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund* accumulated by the trust in accordance with such plan;
- 2) if under the trust instrument it is impossible, at any time prior to the satis-

vesting,⁷⁸ maximum benefits⁷⁹ and distribution of benefits⁸⁰ are satisfied.

Briefly, three major tax benefits may be accorded public employees and their pension plans under the Internal Revenue Code:

(1) exemption from federal income taxation of pension fund trusts' earnings;⁸¹

(2) deferred taxation of an employee on contributions to a plan made on his behalf by his employer, even if the contributions are vested and therefore ordinarily imputable to the employee for income tax purposes;⁸² and

(3) favorable treatment of various kinds of distributions to plan participants and beneficiaries.⁸³

fraction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the corpus or income to be . . . used for or diverted to, purposes other than *for the exclusive benefit of his employees or their beneficiaries* (emphasis added).

76. IRC § 401(a)(7) (as in effect Sept. 1, 1974). ERISA took effect September 1, 1974. Because governmental plans were excepted from the provisions amending requirements of the IRC previously applicable to both public and private qualified pension plans, in effect those requirements were "frozen" for public plans as they were in effect on September 1, 1974. See H.R. REP. NO. 1280, 93d Cong., 2d Sess. 291 (1974), reprinted in 3 LEGISLATIVE HISTORY OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974, at 4558 (1976) [hereinafter cited as ERISA LEGISLATIVE HISTORY].

77. *Id.* §§ 401(a)(4), 401(a)(5); IRC § 401(a)(3) (as in effect Sept. 1, 1974). See H.R. REP. NO. 1280, 93d Cong., 2d Sess. 261 (1974), reprinted in 3 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 4528.

78. IRC § 401(a)(7) (as in effect Sept. 1, 1974). See H.R. REP. NO. 1280, 93d Cong., 2d Sess. 267 (1974), reprinted in 3 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 4534.

79. IRC § 415 (Supp. IV 1980).

80. *Id.* §§ 401(a)(9), 401(a)(10), 401(a)(11).

81. IRC § 501(a) (1976). This section provides that "[a]n organization described in . . . Section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503."

This tax benefit also may be independently available to a public pension trust by reason of § 115 of the Internal Revenue Code, which provides that "[g]ross income does not include—1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof. . . ." See S. REP. NO. 956, 95th Cong., 2d Sess. 4 n.2 (1978). See also *infra* text accompanying notes 85-92.

82. *Id.* §§ 402(a)(1) (voluntary and involuntary nondeductible employee contributions and employer contributions); 401(k), 402(a)(8) (amounts attributable to salary reduction); 72(o)(1), 402(a)(1) (deductible employee contributions).

83. *Id.* §§ 101(b) (favorable income tax treatment for death benefits paid from

These tax benefits are substantial, and a fiduciary's approval of any investment transaction that jeopardizes the tax benefits received by the public pension fund's participants and beneficiaries would almost certainly constitute breach of his fiduciary duty.⁸⁴

It is unclear whether public pension funds must "qualify" by complying with the provisions of IRC sections 401 and 415 in order to receive the first benefit listed above, exemption of earnings on trust assets.⁸⁵ Statutorily established public pension plans may be able to claim exclusion of their ordinary income⁸⁶ and capital gains⁸⁷ from

qualified plans); 2039(c) (exclusion from estate taxes of annuity distributions to named beneficiaries); 219(e)(2) (deductibility of voluntary employee contributions); 402(a)(2) (capital gains treatment of lump sum distributions to employees); 402(a)(5) (deferral of taxation on lump sum distributions); 402(e) (10-year averaging of lump sum distributions). Private pension plans may receive a fourth major benefit whereby the employer's contributions to the plan are deductible when made, even if the employee's interest is not vested at that time. IRC § 404 (Supp. IV 1980). This benefit is irrelevant for public pension plans, because the contributing employers are governmental entities exempt from federal taxation. *New York v. United States*, 326 U.S. 572, 576 (1946). See IRC § 115 (Supp. IV 1980).

84. Under the law of express trusts, a trustee will be charged for any interest or penalty assessed for late payment of taxes of the trust. *Matter of Smith*, 123 Misc. 69, 71-72, 204 N.Y.S. 475, 477 (Sur. Ct. 1924); 2 A. SCOTT, *supra* note 12, at § 176. See also *Title Guarantee & Trust Co. v. Wilby*, 78 Ohio App. 183, 193, 69 N.E.2d 429, 435 (1946).

85. See *supra* note 75. "Qualify" does not mean "apply." While the Internal Revenue Code appears to require a public employees' pension plan to satisfy all relevant conditions contained in § 401(a) in order to receive favorable tax treatment for itself and its participants and beneficiaries, there is no requirement that a pension trust receive a favorable determination letter from the Internal Revenue Service in order to claim favorable tax treatment. Rev. Proc. 80-30, § 2.15, 1980-81 C.B. 685. In contrast, § 501(c)(3) exempt organizations are subject to § 508(a) of the Internal Revenue Code, which requires these exempt organizations to give notice of their application for recognition of their exempt status.

As of 1976, 76.5% of all state and local governmental retirement systems either were not familiar with the process of applying for determination letters of qualified status or had simply not made an application. Only 13.9% of nonfederal governmental plans had received favorable determination letters from the Internal Revenue Service as of that date. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 213, app. I, Table 13. In addition, in 1977 the Internal Revenue Service stopped trying to enforce the provisions of § 401(a) with respect to governmental plans. IR-1869, Aug. 10, 1977. See *infra* notes 99-100.

86. Ordinary income includes any gain from the sale or exchange of property that is neither a capital asset nor property used in a trade or business, as defined in IRC 1231(b). IRC § 64 (1976).

87. Capital gains include any gain from the sale or exchange of property that is a capital asset, as defined in the Internal Revenue Code. IRC § 1222 (Supp. IV 1980).

federal income taxation under section 115 as income accruing to a political subdivision of a state.⁸⁸ If so, violation of qualification requirements under section 401(a) would not necessarily result in taxation of trust income.⁸⁹ For example, NYCERS could claim that as a separate and distinct "body corporate"⁹⁰ established by New York State enactment of title B of chapter 3 of the Administrative Code,⁹¹ it qualifies as a political subdivision of New York State for these purposes. If it were not deemed to be a separate legal entity for these purposes, it might seek federal income tax treatment under section 115 as an agency of The City of New York.⁹² Finally, in either capacity, NYCERS could argue for exemption from federal income taxation under the constitutional rule of *New York v. United States*.⁹³

Participants and beneficiaries of public pension funds exempt under section 115 do not necessarily enjoy the second and third federal income tax benefits listed above. Those benefits are available only to participants and beneficiaries of qualifying pension plans. They are conferred upon the distributees of "any employees' trust described in section 401(a) which is exempt from tax under section

88. IRC § 115 (1976). There are no regulations under this provision that shed light on whether a pension fund for governmental employees is considered an essential governmental function, or whether the income earned on investments of such pension funds is deemed to accrue to a state or its political subdivision. The pertinent case law and rulings deal with entities other than public employee pension plans and therefore are not clearly dispositive. *See, e.g.,* City of Bethel v. United States, 594 F.2d 1301 (9th Cir. 1979); Omaha Pub. Power Dist. v. O'Malley, 232 F.2d 805 (8th Cir. 1956); Rev. Rul. 77-261, 1977-2 C.B. 45.

The applicability of § 115 to public pension funds is indirectly supported by the regulations under IRC § 892. Section 892 provides that the income of a foreign government from investments within the United States is excluded from gross income and exempt from taxation. IRC § 892 (1976). The Internal Revenue Service interprets this provision as excluding the income of pension plans of foreign governments. Treas. Reg. § 1.892-1(b)(4), T.D. 7707, 1980-2 C.B. 213, 215.

89. *See* IRC § 501(a) (1976).

90. *See* 1975 N.Y. Laws, ch. 890, § 3, as amended by 1978 N.Y. Laws, chs. 448 & 785.

91. NEW YORK CITY ADMIN. CODE ch. 3, tit. B (1976).

92. NEW YORK CITY CHARTER § 1150(2) (Supp. 1981).

93. 326 U.S. 572 (1946) (states are immune from federal taxation when they act as governments and possibly whenever the taxation would unduly interfere with their functions as governments). *See also* National League of Cities v. Usery, 426 U.S. 833 (1976) (extension under commerce clause of Fair Labor Standards Act minimum wages and hours provisions to state employees impermissibly interferes with integral state government functions). *See infra* note 123.

501(a)⁹⁴ unless such exemption is denied under section 503 for engaging in a prohibited transaction.⁹⁵ Consequently, it appears that a public pension fund must comply with the requirements of section 401(a) in order to entitle its participants and beneficiaries to favorable tax treatment.⁹⁶

Certainly, the Internal Revenue Service thinks IRC section 401(a) controls exemption of trust income and capital gains for public⁹⁷ as

94. IRC § 402(a)(1) (1976).

95. *Id.* §§ 501(a), 503. Participants and beneficiaries receive favorable tax treatment under § 402 only if the trust distributing their retirement benefits is both described in § 401(a) and exempt from tax under § 501(a). Exemption under § 501(a) may be denied under § 503. Section 503(a)(1)(B) provides that an organization described in § 401(a) and referred to in § 4975(g)(2), *i.e.*, a "governmental plan," shall not be exempt under § 501(a) if it engages in a "prohibited transaction," as defined in § 503(b). A "governmental plan" is defined in § 414(d) as "a plan established and maintained for its employees . . . by the government of any State or political subdivision thereof, or by any agency or instrumentality of the foregoing." As we have seen, this analysis governs the participants' tax benefits regardless of whether the pension plan's trust income is exempt because of § 115 or § 401(a). *See supra* note 88 and text accompanying notes 86-94.

96. Certainly, Congress assumed the tax benefits of participants and beneficiaries of New York State and City pension plans were in jeopardy in 1975 and 1978. *See* Act of Mar. 19, 1976, Pub. L. 94-236, 90 Stat. 238; Act of Oct. 21, 1978, Pub. L. 95-497, 92 Stat. 1665; S. REP. NO. 956, 95th Cong., 2d Sess. 4 n.2 (1978). *See also* CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 33. Under current versions of the proposed Public Employee Pension Plan Reporting and Accountability Act of 1982 (PEPPRA) that contain amendments to the Internal Revenue Code, § 401(a) would be amended to be inapplicable to trusts of public pension plans covered by PEPPRA and to provide that any such trust meeting the requirements of PEPPRA would be considered a qualified trust described in § 401(a) and exempt from federal income taxation under § 501(a). *See* H.R. 4928, 97th Cong., 2d Sess. §§ 1312-13 (1981); S. 2105, 97th Cong., 2d Sess. §§ 1312-13 (1981).

97. The Internal Revenue Service has stated, in the only pertinent Revenue Ruling, that when a retirement system is established pursuant to a state statute, "the trust fund and beneficiaries thereunder are not entitled to the Federal tax treatment applicable with respect to a trust described in § 401(a) of the Code unless the trust meets the requirements for qualification under that section." Rev. Rul. 72-14, 1972-1 C.B. 106.

On August 15, 1977, the Internal Revenue Service wrote Representative John Dent in connection with the study of the pension task force of the House Committee on Education and Labor. Representative Dent had asked whether public pension systems need to be qualified under § 401(a) in order for their participants to receive the same tax treatment as participants in qualified private plans and for plan contributions and earnings to be exempt from federal taxation. The Service responded that governmental plans must comply with pre-ERISA qualification standards to receive favorable tax treatment, but pointed out its August 10, 1977 announcement of a moratorium on enforcing those standards pending reconsideration of the issues. Letter from Fred J. Ochs, Director, Employee Plans Division, Internal Revenue Service, to

well as private⁹⁸ pension plans. At this time, the Internal Revenue Service is not attempting to enforce the requirements of sections 501 and 401(a) as to public pension funds and their participants.⁹⁹ If and when some level of enforcement is undertaken, it seems likely that good faith compliance with those provisions of the IRC that are most directly related to the trustees' fiduciary duties, if not with all structural requirements for pension trusts, should serve to mitigate any sanctions imposed upon the trustees and/or pension funds.¹⁰⁰

Accordingly, it behooves public pension fund fiduciaries to take into account the exclusive-benefit-of-employees provisions of IRC section 401(a) and the prohibited transaction provisions of section 503 when formulating their investment policies. As we shall see, section 401(a)¹⁰¹ codifies the common law duty of loyalty and circumscribes the purposes for which investments of a pension trust fund may be selected by requiring the fund's trustees to invest for the exclusive benefit of the participants and beneficiaries.¹⁰² IRC section 503(b) prohibits specific transactions between the pension trust and its creator or any substantial contributor, among others, which do not meet the arm's length standards established by its provisions.¹⁰³

The interaction between compliance with sections 401(a) and 503(b) and pension fund trustees' fiduciary responsibilities led the trustees of NYCERS and another New York City pension fund to seek rulings¹⁰⁴ from the Internal Revenue Service and passage of spe-

The Honorable John H. Dent (Aug. 15, 1977), *reprinted in* CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 673 app. X. *See* IR-1869, Aug. 10, 1977.

98. Private pension plans that satisfy the fiduciary requirements of ERISA § 404 are thereby deemed to qualify under § 401 of the Internal Revenue Code and accorded exemption under § 501(a) from federal income taxation with respect to their ordinary income and capital gains. *See* H.R. REP. No. 1280, 93d Cong., 2d Sess. 302 (1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 4569.

99. In 1977, the Internal Revenue Service issued an information release stating that the Service was reconsidering whether or not state and local governmental pension plans are subject to tax on their income. It will not raise issues under existing plans until the reconsideration is completed. IR-1869, Aug. 10, 1977.

100. Issues relating to such taxation are to be resolved in favor of the taxpayer or governmental unit pending completion of the reconsideration. IR-1869, Aug. 10, 1977. The Internal Revenue Service has issued no further pertinent releases or rulings.

101. *See supra* note 75.

102. *See infra* text accompanying notes 218-31.

103. *Cf.* H.R. REP. No. 528, 97th Cong., 2d Sess. 44 (1982).

104. *See infra* text accompanying notes 249 & 315.

cial federal tax legislation in connection with their purchase of securities issued by New York City and the Municipal Assistance Corporation for the City of New York (MAC) during the City's fiscal crisis. Such special legislation was enacted in 1975 as Public Law 94-236 and in 1978 as Public Law 95-497.¹⁰⁵ Each statute provides that if certain New York State and City pension funds, including NYCERS, took certain actions, they nevertheless would not be deemed to have failed to satisfy the requirements of section 401(a) or to have engaged in prohibited transactions under section 503(b) of the Internal Revenue Code. These actions include entering certain securities purchase agreements and purchasing, under such agreements, securities of the City and MAC. Under Public Law 94-236, the New York State and City pension plans were permitted to consider, for purposes of making or retaining such investments, the extent to which those investments of the pension plan would enable the City to make future employer contributions and to act as guarantor for benefits of the pension funds.¹⁰⁶ Public Law 95-497 contained numerous conditions to the pension funds' purchase of New York City and MAC securities which, among other things, insured that the percentage of the pension funds' assets invested in securities of MAC and the City would decline even during the term of the securities purchase agreements authorized under the statute.¹⁰⁷

105. Act of Mar. 19, 1976, Pub. L. 94-236, 90 Stat. 238; Act of Oct. 21, 1978, Pub. L. 95-497, 92 Stat. 1665. Pub. L. 94-236 and Pub. L. 95-497 are entitled identically: "An Act Relating to the application of certain provisions of the Internal Revenue Code of 1954 to specified transactions by certain public employee retirement systems created by the State of New York or any of its political subdivisions."

106. Act of Mar. 19, 1976, Pub. L. 94-236, §§ 1(a)(2) & (3), 90 Stat. 238. *See* 1975 N.Y. Laws, ch. 890, § 1, subd. b:

For the purchase of the obligations . . . as described in this act, the trustees of such retirement systems and funds in determining investments by such systems and funds may consider, in addition to other appropriate factors recognized by law, the extent to which such investments will (a) maintain the ability of the city of New York (1) to make future contributions to such systems and funds and (2) to satisfy its future obligations to pay pensions and retirement benefits to members and beneficiaries of such systems and funds and (b) protect the sources of funds to provide retirement benefits for members and beneficiaries of such systems and funds.

107. Act of Oct. 21, 1978, Pub. L. 95-497, § 2, 92 Stat. 1665. Bonds purchased under both statutes are still outstanding. Interview with Jack R. Meyer, Deputy Comptroller, Asset Management, The City of New York (Nov. 19, 1982). This raises the question of whether Pub. L. 94-236 and particularly the more detailed requirements of Pub. L. 95-497 have any continuing application to such bonds. *See* Letter

E. *Proposed Federal Regulation: PEPPRA*

Private pension law was revolutionized by the Employee Retirement Income Security Act of 1974, as amended (ERISA).¹⁰⁸ Since 1975, several bills seeking enactment of statutes modeled on ERISA covering public employee pension plans have been introduced in Congress.¹⁰⁹ The bills most recently under consideration in the House were entitled the "Public Employee Pension Plan Reporting and Accountability Act" (PEPPRA) to avoid confusion with ERISA. These bills are designed to give participants in governmental pension plans protection similar to that enjoyed by members of private pension plans under ERISA in the areas of reporting, disclosure to participants and fiduciary standards applicable to plan fiduciaries.

Two versions of PEPPRA were introduced in each house of Congress during the 1982 session.¹¹⁰ All of these bills contain standards

from NYCERS to Secretary of the Treasury (Aug. 23, 1982) (on file with the *Journal of Urban and Contemporary Law*).

108. 29 U.S.C. §§ 1001-1461 (1976 & Supp. IV 1980). Governmental plans are exempted by sections 2 and 402 of ERISA from the coverage of its titles I and IV, *i.e.*, from all but those provisions that govern enforcement and some that amend the Internal Revenue Code. *See supra* note 76. ERISA-like requirements were extended to pension plans for federal government employees by Act of Nov. 4, 1978, Pub. L. No. 95-595, 92 Stat. 2541 (codified at 31 U.S.C. §§ 68-68d (Supp. III 1979)). H.R. REP. NO. 528, 97th Cong., 2d Sess. 39 (1982).

109. L. KOHLMEIER, CONFLICTS OF INTEREST: STATE AND LOCAL PENSION FUND ASSET MANAGEMENT 8 (1976). *See, e.g.*, H.R. 6525, 96th Cong., 2d Sess. (1980). Each of the proposed statutes was originally named the Public Employee Retirement Income Security Act (PERISA).

While support for enactment of the Public Employee Pension Plan Reporting and Accountability Act (PEPPRA) strongly continues among many unions representing public employees, most municipal and state governments oppose PEPPRA as an unjustified infringement of their power to govern. *See* National League of Cities v. Usery, 426 U.S. 833 (1976); ADVISORY COMM'N ON INTERGOVERNMENTAL RELATIONS, STATE AND LOCAL PENSION SYSTEMS—FEDERAL REGULATORY ISSUES 4-5 (1980).

Enactment of PEPPRA is uncertain. *See* 390 PENS. REP. (BNA) 113 (Jan. 25, 1982); 390 PENS. REP. (BNA) 611 (Apr. 26, 1982). In any event, PEPPRA would not take effect for more than two and possibly five years following enactment by Congress. *See* S. 2105, 97th Cong., 1st Sess. §§ 1308, 1315 (1981); S. 2106, 97th Cong., 1st Sess. §§ 307, 312 (1981); H.R. 4928, 97th Cong., 1st Sess. §§ 307, 312 (1981); H.R. 4929, 97th Cong., 1st Sess. §§ 307, 312 (1981).

110. *See* S. 2105, 97th Cong., 1st Sess. (1981); S. 2106, 97th Cong., 1st Sess. (1981). The House bills were amended to eliminate all differences except those pertaining to tax treatment of governmental plans, which would remain unchanged under one version. 91 Daily Exec. Rep. (BNA) G-2 (May 11, 1982). Following that amendment,

of fiduciary responsibility identical to those in ERISA,¹¹¹ substantially identical "prohibited transactions,"¹¹² and similar limitations on acquisitions of securities, other obligations and real property of any employer of participants of the pension plan.¹¹³ Like ERISA, each bill would include some generally available prohibited transaction exemptions¹¹⁴ and establish a procedure¹¹⁵ whereby particular transactions, otherwise prohibited, may be exempted by the pertinent enforcement authority.¹¹⁶ Because the PEPPRA fiduciary standard is taken directly from ERISA and its related provisions are also based upon ERISA, interpretations of ERISA in regulations, prohibited transaction exemption letters, and other rulings may indicate PEPPRA's likely interpretation if and when enacted.

The provisions of PEPPRA defining a trustee's fiduciary duties substantially declare the duties of prudence and loyalty under existing law.¹¹⁷ Therefore, its enactment is unlikely to have much immediate effect upon most public pension funds. One likely change, however, is in the standard of skill and care applicable to trustees'

most section numbers in the House versions are identical to those in S. 2106. Hereinafter the House bills will be cited separately only where they differ from S. 2106.

111. S. 2105, 97th Cong., 1st Sess. § 1204 (1981); S. 2106, 97th Cong., 1st Sess. § 204 (1981). *Cf.* ERISA § 404.

112. S. 2105, 97th Cong., 1st Sess. § 1206 (1981); S. 2106, 97th Cong., 1st Sess. § 206 (1981). *Cf.* ERISA § 406.

113. S. 2105, 97th Cong., 1st Sess. § 1207 (1981); S. 2106, 97th Cong., 1st Sess. § 207 (1981). *Cf.* ERISA § 407.

114. S. 2105, 97th Cong., 1st Sess. § 1208(b) (1981); S. 2106, 97th Cong., 1st Sess. § 208(b) (1981). *Cf.* ERISA § 408(b).

115. S. 2105, 97th Cong., 1st Sess. § 1208(a) (1981); S. 2106, 97th Cong., 1st Sess. § 208(a) (1981). *Cf.* ERISA § 408(a).

116. Under S. 2105, enforcement authority would be vested in the Board of Directors of a proposed Employee Benefit Administration. *Id.* §§ 1301-03, 2001-05. The Secretary of Labor, now the responsible official under ERISA, ERISA §§ 501-505, would enforce PEPPRA under S. 2106 and both House bills, as amended, S. 2106, 97th Cong., 1st Sess. §§ 301-03 (1981).

117. H.R. REP. NO. 533, 93d Cong., 1st Sess. 11 (1973), *reprinted in* 2 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 2358. The general requirements relating to fiduciary duties are expressed as follows:

[A] fiduciary shall carry out such fiduciary's functions with respect to a plan solely in the interest of the participants and beneficiaries and—

(1) for the exclusive purpose of—

(A) providing benefits to participants and their beneficiaries; and

(B) defraying reasonable expenses of administering the plan;

(2) with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such

investment decisions. Under PEPPRA, the standard probably would be that of an expert in making investments for pension funds rather than of an ordinary prudent person or prudent investor.¹¹⁸ PEPPRA is also likely to affect in two additional respects the law in states which, like New York, do not require diversification yet apply the prudent person standard to each particular investment.¹¹⁹ First, PEPPRA generally mandates diversification of investments to eliminate the risk of large losses.¹²⁰ This may preempt a state's permissive view of diversification. Secondly, if, as is likely, PEPPRA is interpreted in the same way as ERISA, courts in these states may find it difficult to insist that trustees scrutinize each investment individually rather than judging the performance of a portfolio as a whole.¹²¹

To the extent that state laws applicable to public pension funds conflict with PEPPRA, there will be an issue under the tenth amendment of the United States Constitution and other constitutional restraints upon congressional power,¹²² as to whether or not PEPPRA does and may regulate the terms of employment for state and municipal employees. The sponsors of PEPPRA appear to have taken pains to draft its provisions within the guidelines established by recent case law.¹²³ Numerous groups of state and municipal officers argue, however, that application of at least some parts of PEPPRA, and perhaps

matters would use in the conduct of an enterprise of a like character and with like aims;

(3) 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; and

(4) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this Act.

S. 2106, 97th Cong., 1st Sess. § 204(a) (1981). *See* S. 2105, 97th Cong., 1st Sess. § 1204(a) (1981).

118. S. 2105, 97th Cong., 1st Sess. § 1204(a)(2) (1981); S. 2106, 97th Cong., 1st Sess. § 204(a)(2) (1981). *See infra* text accompanying notes 320-27.

119. *See infra* text accompanying notes 291-95.

120. S. 2105, 97th Cong., 1st Sess. § 1204(a)(3) (1981); S. 2106, 97th Cong., 1st Sess. § 204(a)(3) (1981).

121. *See* 29 C.F.R. § 2550.404a-1(b) (1982); Nat'l Coordinating Committee for Multiemployer Plans, Dep't of Labor Op. Letter No. 81-012A (Jan. 15, 1981).

122. *See* *New York v. United States*, 326 U.S. 572 (1946).

123. *See* *Hodel v. Virginia Surface Mining & Reclamation Ass'n*, 452 U.S. 264 (1981); *National League of Cities v. Usery*, 426 U.S. 833 (1976). *See also* *Federal Energy Regulatory Comm'n v. Mississippi*, 102 S. Ct. 2126 (1982) (decided after PEPPRA was introduced in the 97th Congress). *But see* *EEOC v. Wyoming*, No. 81-554, slip op. at 9-12, 15 (U.S. Mar. 3, 1983).

enactment of the entire statute, would be an unconstitutional invasion of state power by Congress.¹²⁴

IV. STANDARDS OF LOYALTY AND PRUDENCE

Most of the state and local pension fund statutes incorporate the common law standards of loyalty and prudence in a general way, without providing much independent content to those standards through statutory definition or interpretation by regulatory agencies. The Internal Revenue Service and Department of Labor actively issue regulations and interpretations of ERISA. Of course, the Internal Revenue Service actively interprets the Internal Revenue Code. To some extent, all these statutory standards build on the common law standards.¹²⁵ This section examines each of the two basic duties as they have been construed and supplemented by the various sources of law.

A. *Loyalty*

A trustee's duty of loyalty to pension fund participants and their beneficiaries is the duty to act for or solely in the interests of the participants and beneficiaries.¹²⁶ The duty of loyalty is a component of all fiduciary relations, but it is particularly intense in the case of a trust created to provide economic support for specific beneficiaries.¹²⁷

Loyalty considerations may arise in several contexts. First, a conflict of interests may occur when a trustee's personal interests as well as the interests of the fund's beneficiaries are at stake in a decision he is making.¹²⁸ Secondly, the conflict with the beneficiaries' interests may involve the interest of another entity or individual to whom the trustee also owes a duty. This may be a corporation of which he is a

124. See Dissenting Views, H.R. REP. No. 528, 97th Cong., 2d Sess. 62-65 (1982).

125. Cf. *Donovan v. Bierwirth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 103 S. Ct. 488 (1982).

126. 11 NYCRR § 136.6(a) ("solely in the interests of the members and beneficiaries"); 2 A. SCOTT, *supra* note 12, § 170 at 1298. See ERISA § 404(a)(1) ("solely in the interest of the participants and beneficiaries"); IRC § 401(a) (1976) ("exclusive benefit of [an employer's] employees or their beneficiaries").

127. 2 A. SCOTT, *supra* note 12, § 170 at 1298. See also *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.) ("The fiduciary obligations of the trustees to the participants and beneficiaries of the plan are those of trustees of an express trust—the highest known to the law."), cert. denied, 103 S. Ct. 488 (1982); RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959).

128. See, e.g., *In re Ryan*, 291 N.Y. 376, 52 N.E.2d 909 (1943).

director or officer,¹²⁹ a union representing participants and beneficiaries of the pension fund of which he is an officer or employee,¹³⁰ or the corporation or governmental entity which employs some or all participants and beneficiaries of the pension fund as well as the trustee.¹³¹ Finally, conflicts may arise between the interests of one group of beneficiaries and those of another. In all such situations, a trustee's duty of loyalty is to the trust, and among the beneficiaries he must show impartiality or equal loyalty to all, i.e., current pensioners and current employees who are future pensioners.¹³²

The first described situation involves the rule prohibiting trustee self-dealing. The other situations either potentially or necessarily involve the corollary rule that a trustee may not seek to benefit directly or indirectly from trust transactions. As we shall see, some of these potential conflicts are inherent in the composition of the boards of trustees of many public pension funds.¹³³

The general rule of loyalty for fiduciaries is a flat prohibition of all transactions involving personal conflicts of interests.¹³⁴ The most often quoted description of the standard of loyalty to which fiduciaries are held is that of Chief Judge Cardozo of the New York Court of Appeals: "A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."¹³⁵ One statutory expression of this basic rule is contained in the "prohibited transactions" provisions of the New York City Administrative Code¹³⁶ and the Insurance Regulations,¹³⁷ which proscribe all

129. See *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd*, 680 F.2d 263 (2d Cir.), *cert. denied*, 103 S. Ct. 488 (1982); *In re Hubbell*, 302 N.Y. 246, 97 N.E.2d 888 (1951); *Berardi v. W.T. Lane, Inc.*, 39 A.D.2d 936, 333 N.Y.S.2d 226 (2d Dep't 1972).

130. See *Blankenship v. Boyle*, 329 F. Supp. 1089 (D.D.C. 1971).

131. See *Sgaglione v. Levitt*, 37 N.Y.2d 507, 337 N.E.2d 592, 375 N.Y.S.2d 79 (1975).

132. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1257-58 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979); *In re Dwight*, 204 Misc. 204 (N.Y. Sup. Ct. 1952). Cf. *Allied Chem. and Alkali Workers v. Pittsburgh Plate Glass Co.*, 404 U.S. 157 (1971).

133. See *infra* notes 146-80 and accompanying text.

134. *In re Ryan*, 291 N.Y. 376, 52 N.E.2d 909 (1943).

135. *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

136. NEW YORK CITY ADMIN. CODE § B3-27.0 (1976). This provision states: [T]he trustees and employees of [the board of trustees] are prohibited from having any interest, directly or indirectly, in the gains or profits of any investment of

self-dealing by the fiduciaries of New York public pension plans and their agents. The prohibited transaction rule that is most likely to be applicable to consideration of divergent investments by public pension fund trustees is the proscription against participating in a transaction with the pension plan on behalf of a party whose interests are adverse to the plan.¹³⁸

The common law does not, however, prohibit all transactions when fiduciaries represent two or more conflicting interests. When the same person owes fiduciary obligations to two separate, coequal trusts, he will not be presumed conclusively to have elevated the interests of one over the other.¹³⁹ Such a transaction, however, will be closely scrutinized¹⁴⁰ and, if unfair to the beneficiaries of one of the trusts, will be set aside by the court at the behest of those beneficiaries.¹⁴¹

A trustee may also act in spite of a conflict of interests when the trustee's participation in the transaction has been sanctioned by the trust instrument¹⁴² or by statute.¹⁴³ When fiduciary relationships involve conflicts of interests authorized by trust instrument or statute, a trustee is obligated to act with fairness to his beneficiaries and not

the retirement system. . . . The trustees and employees of [the board of trustees], directly or indirectly, for themselves or as agents or partners of others, shall not borrow any of its funds or deposits or in any manner use the same except to make such current and necessary payments as are authorized by such board; nor shall any [trustee] become an endorser or surety or become in any manner an obligor for moneys loaned by or borrowed of such board.

137. 11 NYCRR § 136.6(h).

138. *Id.* § 136.6(h)(2).

139. *In re Van Deusen's Will*, 34 Misc. 2d 173, 228 N.Y.S.2d 542 (Sur. Ct. 1962); *In re Kramer's Estate*, 172 Misc. 598, 15 N.Y.S.2d 700 (Sur. Ct. 1939); 2 A. SCOTT, *supra* note 12, § 170.16. *Contra* *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979) (under ERISA).

140. *In re Van Deusen's Will*, 34 Misc. 2d at 174-75, 228 N.Y.S.2d at 544.

141. *In re James' Estate*, 86 N.Y.S.2d 78 (Sur. Ct. 1948).

142. *In re Ridings*, 297 N.Y. 417, 79 N.E.2d 735 (1948); *In re Hammer*, 16 A.D.2d 111, 225 N.Y.S.2d 868 (1st Dep't 1962), *aff'd mem.*, 12 N.Y.2d 893, 188 N.E.2d 266, 237 N.Y.S.2d 1001 (1963).

143. *See* *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd*, 680 F.2d 263 (2d Cir.), *cert. denied*, 103 S. Ct. 488 (1982) (ERISA); *Westchester Chapter, Civil Serv. Employees Ass'n v. Levitt*, 37 N.Y.2d 519, 521, 337 N.E.2d 748, 749, 375 N.Y.S.2d 294, 295 (1975) (state statute designating state comptroller as sole trustee of state employees' pension funds); *Culinary Workers and Bartenders Union v. Gateway Cafe, Inc.*, 91 Wash. 2d 353, 588 P.2d 1334 (1979) (Labor Management Relations Act of 1947).

merely on an arm's-length basis.¹⁴⁴ A court will scrutinize such transactions carefully for evidence of the trustee's good faith.¹⁴⁵

The duty of loyalty prescribed for all fiduciaries deserves even more attention in the case of public pension funds than in other fiduciary situations. In 1978 over three-quarters of all state and local pension systems had employee representatives on their boards of trustees.¹⁴⁶ Almost eighty percent had one or more government officials on their boards.¹⁴⁷ While some boards do have members appointed from outside of government, such as financial experts, those trustees with dual roles, representing the governmental employer or an employees' organization in addition to the pension fund, appear to account for a substantial majority of all public pension fund trustees.¹⁴⁸

The potential conflicts of interests are numerous. Brokerage business and investment advisory contracts may be channeled to favored regional firms with political influence or friends in the city or state government.¹⁴⁹ Government officials may lend to their employers by directing the investment of pension fund assets in state or local government securities.¹⁵⁰ Even where outside financial experts are appointed as trustees, brokerage may be allocated to firms with which they have commercial relationships.¹⁵¹

In *Westchester Chapter, Civil Service Employees Association v. Levitt*,¹⁵² the plaintiff, a member of the Civil Service Employees' Association, contested the propriety of the New York State Comptroller acting simultaneously as the state officer responsible for issuing securities on behalf of New York State and as the sole trustee of the

144. See *In re James' Estate*, 86 N.Y.S.2d 78 (Sur. Ct. 1948).

145. See *Donovan v. Bierwirth*, 538 F. Supp. at 472-75; *Heyman v. Heyman*, 33 N.Y.S.2d 235 (Sup. Ct. 1942).

146. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 206-07 app. I, Table 8.

147. *Id.*

148. *Id.*

149. L. KOHLMEIER, *supra* note 109, at 9.

150. In 1975-76, 2.8% of all assets held by state and local plans were invested in state and local government securities. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 134 (Table F3).

151. L. KOHLMEIER, *supra* note 109, at 10. See *Murphy*, *supra* note 13, at 232 (lists some inherent conflicts of interests faced by *ex officio* trustees of public pension plans).

152. 37 N.Y.2d 519, 337 N.E.2d 748, 375 N.Y.S.2d 294 (1975).

funds of certain state employee retirement systems purchasing those state securities. The New York Court of Appeals held that, because the Comptroller's conflict of interests was created by statute, he was not disqualified from acting on behalf of one or both parties to the transaction. The potential conflict of interests created for the Comptroller, however, as trustee of the state retirement systems' funds, "an especial obligation to act fairly on behalf of those concerned with the results of the action taken."¹⁵³

NYCERS also has trustees with statutorily sanctioned conflicts of interests. The New York City Administrative Code specifies the system's trustees.¹⁵⁴ Seven of the eleven trustees are statutorily designated New York City public officers,¹⁵⁵ one is the representative to the board of the Mayor of the City, and three are chief executive officers of unions that represent participants for purposes of collective bargaining on pension matters.

Each of the trustees, other than the representative appointed by the Mayor,¹⁵⁶ have some inherent conflicts of interests between his or her responsibilities as a trustee of NYCERS and as an officer of the City¹⁵⁷ or as an officer of the union.¹⁵⁸ Actual conflicts of interests arise whenever the interests of the City or a union, as the case may be, are not identical with those of the pension fund and its participants and beneficiaries *qua* recipients of retirement benefits. Instances of conflict for the City officials serving as trustees abound. For example, there is tension between the City's desire to save money

153. *Id.* at 521, 337 N.E.2d at 749, 375 N.Y.S.2d at 295. *Cf.* *Donovan v. Bierwirth*, 680 F.2d 263, 276 (2d Cir.) (although ERISA permits officer of sponsoring corporation to serve as plan fiduciary when plan acquires stock of corporation, incompatible conflicts may arise between fiduciary duties to corporation and to plan, which require officer's resignation from trusteeship), *cert. denied*, 103 S. Ct. 488 (1982).

154. NEW YORK CITY ADMIN. CODE § B3-2.1(b) (1976).

155. The New York City public officers who serve *ex officio* as trustees of NYCERS are the President of the City Council, the Comptroller, and the presidents of the five boroughs of the City. *Id.*

156. The Mayor's representative may or may not face some conflict, depending on his duties of loyalty. *See infra* text accompanying notes 169-70.

157. *See Westchester Chapter, Civil Serv. Employees Ass'n v. Levitt*, 37 N.Y.2d 519, 337 N.E.2d 748, 375 N.Y.S.2d 294 (1975).

158. Under the Labor Management Relations Act of 1947, officers of labor organizations occupy a position of trust with respect to members of their organizations. 29 U.S.C. § 501(a) (1976).

by reducing its employer contributions¹⁵⁹ and the amounts it pays for administrative expenses of NYCERS¹⁶⁰ on the one hand and, on the other, the interest of NYCERS' participants and beneficiaries in increased retirement benefits and increased expenditures for administration of the system to improve its service of their needs.¹⁶¹ Since the potential conflicts of these City and union officer trustees are sanctioned by statute, the conflicts will not, by themselves, disqualify these officials from acting as trustees.¹⁶² But any actual conflict of interests between a duty of a NYCERS trustee as an officer of the City or as a fiduciary to union members and his fiduciary responsibility as a trustee will give rise to "an especial obligation to act fairly"¹⁶³ on behalf of the system's participants and beneficiaries.¹⁶⁴

159. NEW YORK CITY ADMIN. CODE §§ B3-17.0 (Supp. 1982), -18.0, -19.0 (1976).

160. The Expense Budget of the City annually includes appropriations for payment of administrative expenses of NYCERS. *E.g.*, THE CITY OF NEW YORK EXPENSE BUDGET FOR THE FISCAL YEAR 1982, at 29E. The Administrative Code appears not to provide for payment of administrative expenses out of the trust funds of NYCERS. Administrative expenses clearly may be paid from the assets of NYCERS if the City of New York is in bankruptcy proceedings and fails to provide funds for payment of such administrative expenses as they fall due. 1975 N.Y. Laws, ch. 890 § 3(b), *as amended by* 1978 N.Y. Laws, chs. 488 and 785. Apart from this specific authorization, expenses necessarily incurred in acquiring, managing and protecting investments of NYCERS' funds may be paid from any income, interest or dividends derived from deposits or investments of its funds. NEW YORK CITY ADMIN. CODE § E49-5.0(b).

161. The designated representatives of the NYCERS trustees are in the same position as their principals. They are authorized by statute to "act in the place" or as an agent of the trustee designating him or her. Each designee must be an officer or employee under the control of the trustee. NEW YORK CITY CHARTER § 82(1) (rev. 1976) (president of borough may appoint his deputy or executive assistant to discharge his powers); NEW YORK CITY CHARTER § 94(b) (Supp. 1981) (comptroller may appoint deputy comptroller to act in his place as a member of pension board); NEW YORK CITY ADMIN. CODE § B3-2.1(b)(2) (1976) (president of city council may designate officer or employee appointed by her to act in her place as trustee of NYCERS); NEW YORK CITY ADMIN. CODE § B3-2.1(b)(5)(c) (1976) (chief executive officer of each union may designate person, if authorized under by-laws or constitution of union, to act in his place).

162. *See* *Donovan v. Bierwirth*, 538 F. Supp. at 468; *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. at 1256; *Westchester Chapter, Civil Serv. Employees Ass'n v. Levitt*, 37 N.Y.2d at 521, 337 N.E.2d at 749, 375 N.Y.S.2d at 295.

163. *Westchester Chapter, Civil Serv. Employees Ass'n*, 37 N.Y.2d at 521, 337 N.E.2d at 749, 375 N.Y.S.2d at 295.

164. *See* *NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981) (NLRA's exclusive-benefit-of-employees rule requires LMRA authorized employer or employee nominated trustees to give individual loyalty to beneficiaries).

New York City agencies and officers, such as the Office of Economic Development and the Comptroller, recently have developed economic development investments "targeted" to the City and New York State. If these efforts continue, some NYCERS trustees may find themselves in the position of being architects and advocates of a particular investment at the same time they are making a fiduciary decision as trustees whether or not to make that investment. In such situations, it would appear that the authorization by the pension systems chapters of the City's Administrative Code,¹⁶⁵ which are state enacted, of the conflicts of interests of the *ex officio* trustees¹⁶⁶ would override the proscriptions in the regulations issued by the New York State Insurance Commissioner.¹⁶⁷ The trustees would still have to comply with the *Westchester Chapter* standard of fairness for statutorily sanctioned conflicts of interests.¹⁶⁸

The statutes and plan instruments applicable to each public pension fund must be separately examined for each trustee to determine whether particular conflicts of interests may be authorized. For example, in NYCERS the representative of the Mayor appears to be in a different position from the other trustees. The Mayor's "representative" is not appointed "to act in the place of" the Mayor and need not be an officer or employee of the City,¹⁶⁹ although generally he is. Thus, the Mayor's representative is the only trustee who does not serve *ex officio*. It is doubtful whether the duty owed by the Mayor's NYCERS representative to the public by virtue of any other public office he may hold coincidentally carries with it the degree of fiduciary obligation that he owes to the fund's participants and beneficiaries in his capacity as a trustee. Therefore, there may arise situations in which a Mayor's representative would be disqualified

165. NEW YORK CITY ADMIN. CODE § B3-2.1(b) (1976).

166. See *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. at 1256-57. See also *supra* text accompanying notes 156-61.

167. Cf. NEW YORK CITY CHARTER § 2604(b) (rev. 1976).

No . . . salaried officer or employee of the city or any city agency:

(i) shall be or become interested directly or indirectly in any manner whatsoever *except by operation of law* in any business dealings with the city or any city agency.

Id. (emphasis added).

168. *Westchester Chapter, Civil Serv. Employees Ass'n*, 37 N.Y.2d at 521, 337 N.E.2d at 749, 375 N.Y.S.2d at 295.

169. NEW YORK CITY ADMIN. CODE § B3-2.1(b)(1) (1976).

from acting both as a trustee and in his public office.¹⁷⁰ Indeed, the proscription in the Insurance Regulations, as well as the conflict of interests provisions in the New York City Charter,¹⁷¹ may bar that trustee from acting as a member of the NYCERS board of trustees in such situations.

Other types of potential conflicts may arise for other public officers serving *ex officio* as trustees of public pension funds. For example, the President of the Council of the City of New York is a statutorily designated trustee of NYCERS. She is also a gubernatorily appointed member of the Metropolitan Transportation Authority (MTA), a New York State agency whose employees are participants in NYCERS. The MTA failed to pay its fiscal year 1981 employer contribution to NYCERS before the end of that fiscal year as required. When the NYCERS trustees considered commencing an action against the MTA to enforce its obligation to make timely contributions, the President of the Council sought advice on whether to abstain from voting as a trustee to authorize commencement of such an action.

The President of the Council was advised not to abstain. The potential conflict of interests in this situation was not between the President of the Council's obligations as a trustee of NYCERS and her obligations as President of the Council. If that had been the case, no abstention would have been necessary under the holding of *Westchester Chapter* concerning public officers who *ex officio* hold other public offices that may be characterized as classic trusteeships.¹⁷² Instead, the Council President's potential conflict was between her obligations as a NYCERS trustee and as a member of the MTA. The President of the Council is a member of the MTA by virtue of gubernatorial appointment for a term.¹⁷³ It would seem that a legislative

170. If the Mayor's representative abstains from a vote of the NYCERS board because of a conflict arising from his own public office, it seems probable that the member of the Mayor's office designated to act in the absence of the Mayor's representative, NEW YORK CITY ADMIN. CODE § B3-2.1(b)(1) (1976), would preside and vote in his place. Even though the Mayor's representative need not be a member of the Mayor's Office, the Administrative Code clearly provides that the designee to act in his absence must be. *Id.* Therefore, the designee would possess the same statutory sanction to act in spite of conflicts of interests that is possessed by other public officer members of the board. See *supra* text accompanying notes 162-64.

171. NEW YORK CITY CHARTER § 2604(b)(1) (rev. 1976). See *infra* note 184.

172. *Westchester Chapter*, Civil Serv. Employees Ass'n v. Levitt, 37 N.Y.2d 519, 521, 337 N.E.2d 748, 749, 375 N.Y.S.2d 294, 295 (1975).

173. N.Y. PUB. AUTH. LAWS § 1263(1)(a) (McKinney 1982).

determination that she should be an *ex officio* trustee of NYCERS is entitled to greater weight than executive appointment to a public office unrelated to her elective office. Other considerations support this conclusion. By statute the President of the Council is permitted, although not required, to hold the MTA membership and her New York City office simultaneously.¹⁷⁴ She could resign her MTA membership, however, or even be removed under certain conditions.¹⁷⁵ But she could not resign her NYCERS trusteeship unless she also gave up her office as President of the Council, one of only three city-wide elected offices.¹⁷⁶

Also relevant is the classic nature, in common law terms, of the NYCERS trusteeship of identified funds for the benefit of a defined class of beneficiaries.¹⁷⁷ While trust concepts are inherent in the public office of a member of the MTA,¹⁷⁸ they are probably not trust concepts in the same sense.¹⁷⁹ Nor do they appear to relate to an identifiable fund or funds or to a defined class of beneficiaries in the same sense. It is likely that participants and beneficiaries of NYCERS can sue the fund's trustees to surcharge them.¹⁸⁰ Whether or not New York metropolitan area subway, bus and train riders could seek to surcharge the members of the MTA for breach of their responsibilities to the MTA ridership is less likely. Consequently, the Council President's obligation as a trustee to act in the best interests of NYCERS participants and beneficiaries should come before her obligation to act as a member of the MTA.

Another conflict of interests situation that arises for public pension funds involves the retention of independent legal counsel for any in-

174. *Id.* § 1263(6).

175. *Id.* § 1263(7).

176. NEW YORK CITY CHARTER § 23(a) (rev. 1976). The other city-wide officials are the mayor, *id.* § 4, and the comptroller, *id.* § 91.

177. See I A. SCOTT, *supra* note 12, §§ 2.3, 3.1, 112, 122.

178. See N.Y. CONST. art. VI, § 20. See also *Prescott v. Ferris*, 251 A.D. 113, 119-20, 295 N.Y.S. 818 (4th Dep't 1937).

179. See *Seymour v. Ellison*, 2 Cow. 13, 29 (N.Y. Err. 1823); *In re Wood*, Hopk. Ch. 6, 8 (N.Y. 1823) ("The terms 'office' and 'public trust' have no legal or technical meaning distinct from their ordinary signification. An office is a public charge or employment The words 'public trust,' still more comprehensive, appear to include every agency in which the public, reposing special confidence in particular persons, appoint them for the performance of some duty or service.").

180. See, e.g., *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1250 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).

vestment in securities issued or recommended by the public employer or one of its affiliates.¹⁸¹ Again using New York City as an example, its Corporation Counsel is by law the legal advisor to all City agencies.¹⁸² Similar statutes are applicable in other states and municipalities.¹⁸³ There may be an issue of whether or not a public pension fund is an agency for this purpose, especially if the independent counsel is to be paid out of public pension fund assets rather than public employer appropriations.¹⁸⁴ Assuming that it is a city agency for this purpose, courts have implied, from the existence of conflicting interests between a public agency and the overall governmental entity, authority in the public agency to retain independent counsel, even in the absence of specific statutory grants, and notwithstanding the presence of statutes making a public law officer the lawyer for all city agencies.¹⁸⁵

A public officer lawyer may argue that the enactment setting forth his duties resolves the conflict as it did in *Westchester Chapter*.¹⁸⁶ As noted previously, in that case the court permitted the state Comptroller to sell state obligations to himself as trustee of two state public pension plans, despite his obvious conflict of interests. That case, however, is clearly distinguishable. The two functions that the Comptroller exercised were specifically conferred on him, as Comptroller, by separate state enactments. Furthermore, each enactment antedated the constitutional provision alleged to invalidate his dual capacity in the transaction. Moreover, no case applying such an argument to a public officer lawyer has been found. Indeed, one bar association opinion rejects its application to a city corporation

181. Cf. *infra* text accompanying notes 357-58.

182. NEW YORK CITY CHARTER §§ 394-95 (rev. 1976).

183. See ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1433 (1978); ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1282 (1973).

184. The New York City Charter defines "city agency" as an "agency of government, the expenses of which are paid in whole or in part from the city treasury." NEW YORK CITY CHARTER § 1150a(2) (rev. 1976). See *supra* note 160.

185. *Cahn v. Town of Huntington*, 29 N.Y.2d 451, 278 N.E.2d 908, 328 N.Y.S.2d 672 (1972); *Fleischmann v. Graves*, 235 N.Y. 84, 138 N.E. 745 (1923); *Hanna v. Rewkowski*, 81 Misc. 2d 498 (N.Y. Sup. Ct. 1975); *Zablow v. Incorporated Village of Freeport*, 41 Misc. 2d 803 (N.Y. Sup. Ct. 1975).

186. 37 N.Y.2d 519, 337 N.E.2d 748, 375 N.Y.S.2d 294 (1975). See *supra* notes 152-53 and accompanying text.

counsel.¹⁸⁷

The formal ethical considerations applicable to lawyers also come into play. Committees of professional ethics of bar associations recognize that states or municipalities may have separate and distinct interests from their constituent agencies. The Committee on Professional Ethics of the New York State Bar Association stated in a different context:

When a governmental body is organized into a number of separate departments or agencies, such department or agency, and not the parent governmental unit, should be treated as the client for purposes of the rule which forbids the concurrent representation of one client against another.¹⁸⁸

Several bar association ethics committees have opined, citing Disciplinary Rule 5-105 of the Code of Professional Responsibility or its antecedents, that where the relationship between two agencies has become antagonistic, counsel fully independent of the government should be retained for at least one of the agencies,¹⁸⁹ perhaps even in the absence of any statutory authorization for appointment of special counsel.¹⁹⁰ Indeed, the American Bar Association's Committee on Ethics and Professional Responsibility has opined that, notwithstanding a municipal charter provision establishing the municipality's law department as counsel for the municipality and all its departments and officials, when a true conflict exists there is:

no way that, consistent with the Model Code [of Professional Responsibility], these opposing positions can be properly advocated in the same litigation by members of the same law department, who work from the same office and who are responsible to and presumably subject to the supervision and direction of the same department head.¹⁹¹

As expressed by the Attorney General of New York State, a municipi-

187. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1282 (1973).

188. N.Y. State Bar Ass'n Comm. on Professional Ethics, Op. 447 (1976). *See also* Ass'n of the Bar of the City of N.Y., Comm. on Professional and Judicial Ethics, Op. 894 (1978). *See, e.g.,* United States v. ICC, 337 U.S. 426, 430 (1949) (United States may sue United States agency).

189. N.Y. State Bar Ass'n Comm. on Professional Ethics, Op. 501 (1979).

190. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1282 (1973).

191. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1433 (1978).

pal attorney in such a position of conflict is "ethically bound to decline to participate" on behalf of the municipal officer or agency.¹⁹² In such situations, the duty of the law department to the "preeminent authority" of the municipality itself will preclude the department from representing the officer or agency rather than the municipality.¹⁹³ When the municipality's law department is privy to relevant confidences of the agency or its employees as well as the municipality due to its statutory status as counsel for both, or when appointment of special counsel for the agency is not possible, the law department may not represent either the municipality or the agency when their interests come into conflict.¹⁹⁴ Furthermore, whether a public agency, or an officer acting on its behalf, can consent to dual representation in the event of a conflict is not clear.¹⁹⁵

Once a public pension plan's right to representation by independent counsel is established,¹⁹⁶ its power to select that counsel should be unfettered. The relationship of a public agency to its pension plan is akin to that of a grantor to its trust. The law of trusts protects a private trustee's right to employ counsel of his own choice, despite any instruction in the trust instrument.¹⁹⁷ It "would interfere with the proper administration of the trust if the trustee were compelled to

192. 1974 Op. N.Y. Att'y Gen. 211, 212 (1974).

193. N.Y. State Bar Ass'n Comm. on Professional Ethics, Op. 501 (1979).

194. ABA Comm. on Ethics and Professional Responsibility, Informal Op. 1282 (1973).

195. Compare ABA Comm. on Ethics and Professional Responsibility, Op. 1433 (1978) (municipality and agency cannot consent to dual representation by municipal attorney in adversary proceeding between them) and N.Y. State Bar Ass'n Comm. on Professional Ethics, Op. 143 (1970) (a municipal attorney may not represent private clients in matters before administrative agencies of the municipality even if the municipality purports to consent to such representation) with Ass'n of Bar of City of N.Y. Comm. on Professional and Judicial Ethics, Op. 894 (1978) (city may consent to representation by private lawyers acting *pro bono* on city's behalf and simultaneously representing, in different matters, clients with interests adverse to city).

196. While the existence of a conflict creates for the public officer lawyer an affirmative ethical obligation to refuse to represent one of the parties to the conflict, it would appear that the client, and ultimately the court, must make the final determination whether a conflict exists. Cf. N.Y. PUB. OFF. LAW §§ 17, 18 (McKinney Supp. 1981) (authorizing indemnification of public officers and employees and appointment of independent counsel when the appropriate public officer lawyer has a conflict of interest and providing for court to resolve any dispute as to existence of conflict).

197. *Matter of Caldwell*, 188 N.Y. 115, 80 N.E. 663 (1907) (dictum); *In re Folsom's Will*, 155 N.Y.S.2d 140 (Sur. Ct. 1956), *aff'd on other grounds*, 6 A.D.2d 691, 174 N.Y.S.2d 116 (2d Dep't 1958), *aff'd sub nom. In re Folsom's Estate*, 6 N.Y.2d 886, 160 N.E.2d 857, 190 N.Y.S.2d 381 (1959); *Matter of Lawless' Will*, 194 Misc. 844, 861,

rely upon the advice of an attorney not selected by him, since the relationship is highly fiduciary in character."¹⁹⁸

As noted above, courts require fairness to both parties in transactions by fiduciaries involving authorized conflicts. They understand that investments or other transactions negotiated at arm's length usually result in benefits to both parties. Fairness to one party will generally be matched by fairness to the other.¹⁹⁹ Strict application of the sole benefit rule, barring benefits to trustees or other interested parties under any circumstances, would effectively prohibit all such transactions, even when such transactions were authorized and clearly in the interest of the beneficiaries of the trust. Accordingly, so long as transactions involving authorized conflicts of interests are fair to the beneficiaries, and only incidental benefits accrue to other inter-

87 N.Y.S.2d 386, 405 (Sur. Ct. 1949), *aff'd mem.*, 277 A.D. 1045, 100 N.Y.S.2d 537 (2d Dep't 1950).

198. RESTATEMENT (SECOND) OF TRUSTS § 126 (1959).

From the power to select independent counsel flows the power to compensate such counsel. A grantor may not limit the power of a private trustee to incur all expenses necessary or appropriate to effectuate the purpose of a trust, including reasonable attorneys' fees. *In re Folsom's Will*, 155 N.Y.S.2d at 152 (Sur. Ct. 1956); *Matter of Olney*, 255 A.D. 195, 7 N.Y.S.2d 89 (4th Dep't 1938), *appeal dismissed*, 281 N.Y. 98, 22 N.E. 252 (1939); *In re Estate of Thaw*, 60 Misc. 2d 184, 302 N.Y.S.2d 661, 662 (Sur. Ct. 1969). *Cf.* *Shadis v. Beal*, 685 F.2d 824 (3d Cir.) (state cannot require Legal Services Society to forego attorney's fees in civil rights suits brought against state or its employees by Society), *cert. denied sub nom.*, *O'Bannon v. Shadis*, 103 S. Ct. 300 (1982). See also 3 A. SCOTT, *supra* note 12, § 188. In the case of a private trust, such expenses will be discharged from the assets of the trust. 3 A. SCOTT, *supra* note 12, § 188. If the trust has two or more trustees, as do most public pension funds, each co-trustee can employ his own counsel, see *Matter of Bloomingdale's Estate*, 172 Misc. 218, 14 N.Y.S.2d 845 (Sur. Ct. 1939), and seek reimbursement from the trust for his counsel's fees, see 3 A. SCOTT, *supra* note 12, § 244. Even when the trustee did not properly incur the expenses for his own counsel, he is entitled to reimbursement to the extent that the trust and its beneficiaries benefit from the representation. *Id.* § 245. Payment of a public pension fund's independent counsel fees raises additional issues such as whether an appropriation for the payment is necessary, a question answered in the negative by at least one court. *Fleischmann v. Graves*, 235 N.Y. 84, 138 N.E. 745 (1923); *Barry v. City of New York*, 175 Misc. 712, 22 N.Y.S.2d 867 (Sup. Ct.), *aff'd*, 261 A.D. 957, 27 N.Y.S.2d 425 (1st Dep't 1941). Given the inherent conflict concerning the amount to be spent on administrative expenses between any public pension fund and the state or municipal employer, in the absence of an explicit statute to the contrary, these principles of trust law should apply to afford protection to the participants and beneficiaries of the fund.

199. *Cf.* Rev. Rul. 69-494, 1969-2 C.B. 88 (a trust fund's purchase of securities, at a price that results in a profit for the seller but does not exceed the fair market value of the securities at the time of purchase, is consistent with the exclusive-benefit-of-employees rule of the Internal Revenue Code).

ested parties, courts do not find trustees guilty of breaches of trust for violating the sole benefit rule.

The New York case of *Heyman v. Heyman*²⁰⁰ provides an example from the common law for private trusts. *Heyman* involved the interpretation of a trust instrument in which the grantor appointed himself as trustee, designated his children as beneficiaries and authorized the purchase or sale of securities by the trust to or through any brokerage firm of which the grantor-trustee was a member. The court acknowledged that the grantor properly authorized securities transactions for the trust by firms "with which he might be personally identified as to whose integrity and skill he would have personal knowledge and in which he reposed the fullest confidence."²⁰¹ The court further stated that "[e]ven in the absence of an express provision requiring a trustee to act in good faith," and regardless of the exact terms in the trust instrument, the law of New York State requires that the trustee implement such transactions in good faith. The court held that the authorization of interested transactions must be construed favorably to the beneficiaries and bar the trustee from purchasing securities from the trust estate at prices below their market values.²⁰² The trustee and his brokerage firm, however, were permitted to earn the same profit on the authorized transactions as any banking or brokerage firm might make in dealing with a prudent trustee in the normal course of business.²⁰³

On the other hand, *Blankenship v. Boyle*²⁰⁴ demonstrates that when the primary purpose of a transaction is to benefit someone other than pension fund participants, trustees act in violation of their fiduciary responsibility even though incidental benefits inure to the trust fund. This case involved a union member's action against the union officer, the employer representative, and the "neutral" plan administrator who were serving as trustees of the United Mine Workers pension fund. The action sought their removal as trustees for violations of their fiduciary duties. In deciding the case, the court drew upon

200. 33 N.Y.S.2d 235 (Sup. Ct. 1942).

201. *Id.* at 241.

202. *Id.* at 239, 243.

203. *Id.* at 241. See *Westchester Chapter, Civil Serv. Employees Ass'n v. Levitt*, 37 N.Y.2d 519, 337 N.E.2d 748, 375 N.Y.S.2d 294 (1975); *Matter of Will of Heidenreich*, 85 Misc. 2d 135, 378 N.Y.S.2d 982 (Sur. Ct. 1976).

204. 329 F. Supp. 1089 (D.D.C.), *stay denied per curiam*, 447 F.2d 1280 (D.C. Cir. 1971), *aff'd mem.*, 511 F.2d 447 (D.C. Cir. 1975).

precedents from the common law of trusts to give content to the Labor Management Relations Act.²⁰⁵ It held that the trustees had breached their fiduciary duty to the participants and beneficiaries by purchasing common stock of certain electric utilities. According to this court, the primary purpose of these investments was to give the union leverage in persuading the utilities to convert to union-mined coal. The trustees argued that such a purpose was proper, because employer contributions to the fund were based upon the production of union-mined coal. The court did not dispute any benefits that accrued to the trust from the investments, yet found that the investments were made primarily for the collateral benefits they gave to the union and the coal operators represented by the employer-trustee.²⁰⁶ It characterized these investments as "a clear case of self-dealing on the part of [the union official and coal operator] trustees and . . . a breach of trust."²⁰⁷

The divided loyalties of pension fund trustees were also at issue in *Donovan v. Bierwirth*.²⁰⁸ In *Bierwirth*, the United States Secretary of Labor challenged purchases of Grumman Corporation stock, at allegedly inflated prices, by the trustees of the Grumman employees' pension plan. The purchases were made while the corporation was defending a hostile takeover attempt. The trustees, who were all officers or employees of the corporation, asserted that they purchased the stock on behalf of the pension plan because they believed that the stock was a good investment for the pension plan and that a successful takeover would be harmful to the pension plan. The Grumman pension plan and its trustees were subject to ERISA.²⁰⁹ For aid in interpreting its codification of the duty of loyalty, the courts looked to

205. Labor Management Relations Act of 1947, § 302(c), 29 U.S.C. § 186(c) (1976).

206. 329 F. Supp. at 1095. In arriving at this conclusion, the court examined the conduct of the trustees in administering the fund, including the absence of regular meetings; the way important matters were resolved by the union trustee, who was chairman of the board, with neither formal meetings nor even informal consultations with the trustee representing the employers; the extreme deference of the plan administrator to the union trustee; and the granting of proxies for the utility stocks held by the fund to union officials involved in the campaign to force utilities to buy union-mined coal.

207. *Id.* at 1106.

208. 538 F. Supp. 463 (E.D.N.Y. 1981), *aff'd*, 680 F.2d 263 (2d Cir.), *cert. denied*, 103 S. Ct. 488 (1982).

209. *Id.* at 467.

common law principles.²¹⁰ The federal district court examined the trustees' decisionmaking process and concluded that the trustees had "manifested an inability to separate their corporate loyalty and their loyalty to the Pension Plan."²¹¹ The court of appeals found it unnecessary to decide whether the trustees' primary purpose had been to benefit the corporation rather than the pension plan, because of the trustees' lack of due diligence in investigating their options.²¹² Nevertheless, the court accepted the trustees' argument that a prudent and loyal decision by trustees with dual loyalties does not violate their duties to a pension plan simply because it incidentally benefits the corporation as well as the participants and beneficiaries.²¹³

Tests of "good faith" and "primary purpose," as enunciated in these cases, necessarily involve subjective assessments of a trustee's motives and intentions. As shown in *Blankenship* and *Bierwirth*, however, a court reviewing a situation involving a trustee's potential conflict of interests will scrutinize all the evidence to insure that the substance of the transaction is fair to the trust's beneficiaries and that the trustee has discharged his duties in a manner that is primarily intended to benefit the trust.

Some special issues may arise for trustees of pension funds from their duty of equal loyalty to all participants—the duty not to favor the interests of one group of beneficiaries of a trust over those of another group.²¹⁴ A potential conflict between participants drawing retirement benefits from NYCERS and participants employed by The City of New York arose in the context of the NYCERS trustees' decision in 1975 to invest in New York City and Municipal Assistance Corporation securities in the hope of preventing municipal bank-

210. See *id.* at 469-71; 680 F.2d at 271. One federal district court judge has stated that the loyalty and prudence provisions of ERISA "establish uniform federal requirements to be interpreted both in the light of the common law of trusts, as well as with a view toward the special nature, purpose, and importance of modern employee benefit plans." *Marshall v. Glass/Metal Ass'n & Glaziers*, 507 F. Supp. 378, 383 (D. Hawaii 1980) (citations omitted).

211. 538 F. Supp. at 476. See also *Eaves v. Penn*, 587 F.2d 453, 459 (10th Cir. 1978) (ERISA employee stock ownership plan subject to "solely in the interest" and "prudence" tests of § 404(a)(1) even though designed to hold employer securities).

212. See *infra* text accompanying notes 336-58.

213. 680 F.2d at 271.

214. See *In re Stillman*, 81 Misc. 2d 747, 366 N.Y.S.2d 934 (Sur. Ct. 1975); *In re Mendelson's Will*, 46 Misc. 2d 960, 261 N.Y.S.2d 525 (Sur. Ct. 1965); 2 A. SCOTT, *supra* note 12, § 183; RESTATEMENT (SECOND) OF TRUSTS § 183 comment a (1959). See *infra* text accompanying notes 277-82.

ruptcy.²¹⁵ It was estimated at that time that if New York City ceased making employer contributions to NYCERS, the then-current assets of NYCERS would enable payment of retirement benefits to then-current retirees for approximately seven or eight years.²¹⁶ Under such circumstances, the participants employed by the City had a greater interest in preventing the City's bankruptcy than did retirees, many of whom were likely to receive all of their retirement benefits within eight years.²¹⁷

Because of the substantial tax benefits potentially available to participants in qualified pension trusts, the body of law relating to the duty of loyalty which is perhaps most important from their perspective pertains to IRC section 401(a).²¹⁸ The duty of loyalty is declared three different ways in section 401(a). First, a qualified trust is required to be "created or organized . . . for the exclusive benefit of [the] employees or their beneficiaries."²¹⁹ Next, subsection (1) requires that any contributions made to the trust by the employer, the employees or an affiliated employer must be "for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust."²²⁰ Finally, subsection (2) requires the trust instrument to make it impossible "for any part of the corpus or income to be . . . used for, or diverted to, purposes other than for the exclusive benefit of [the] employees or their benefi-

215. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1257-58 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979). *See also* *Allied Chem. & Alkali Workers v. Pittsburgh Plate Glass Co.*, 404 U.S. 157, 172-74 (1971).

216. Telephone interview with Jonathan Schwartz, Actuary for the New York City Employees' Retirement System (Dec. 21, 1982).

217. Compare the following statement by the National Retired Teachers' Association and the American Association of Retired Persons following purchase of the City and MAC securities:

Retirees' preference would be to maximize the amount of assets that are invested in the most secure, most liquid, and highest yielding manner possible. On the other hand, a relatively young City employee might be willing to sacrifice the security of the retirement system if the sacrifice might save his or her job and enable the City to contribute to the retirement systems so that plans will be solvent upon his or her retirement. . . . [T]he interests of retirees very often conflict with those of active workers. The active worker is far more concerned with the well-being of his or her present employer than is the retiree.

Hearing on Ownership and Control of Pension Fund Assets before the President's Comm'n on Pension Policy 9-10 (Dec. 10, 1979).

218. *See supra* note 75.

219. IRC § 401(a) (1976).

220. *Id.* § 401(a)(1).

ciaries"²²¹ prior to the satisfaction of all liabilities related to the employees and their beneficiaries, including future contingent benefits as well as present vested benefits.²²²

Not only must the written instrument or plan comply with these requirements, but the plan must achieve in operation the effects mandated by the statute.²²³ If the plan is designed or implemented in a way that amounts to a subterfuge to avoid the requirements of the statute, it will not satisfy the requirements of section 401(a).²²⁴ "All of the surrounding and attendant circumstances and the details of the plan will be indicative of whether it is a bona fide . . . pension . . . plan for the exclusive benefit of employees in general."²²⁵

As construed by the Internal Revenue Service, these criteria establish for trustees a standard of the highest loyalty to the participants and beneficiaries as present or future recipients of pension benefits. Treasury Regulation section 1.401-2²²⁶ interprets purposes of a plan "for the exclusive benefit" of the participants and beneficiaries as excluding "all objects or aims not solely designed" to satisfy contingent and vested "liabilities" to participants and their beneficiaries.²²⁷

This regulation should be read in conjunction with Revenue Ruling 69-494,²²⁸ which outlines the general standards under section 401(a), with which a tax-exempt employees' trust must comply in order to purchase the securities of an employer. It requires the investment of trust funds, as well as other activities of the trust, to be for the "primary purpose" of benefiting participants and beneficiaries. Further, the ruling explains that this test does not preclude transactions from which others also derive some benefit. The Revenue Ruling gives as an example a sale of securities at a fair market value that yields a profit for the trust. The Revenue Ruling established four

221. *Id.* § 401(a)(2).

222. *Id.*; Treas. Reg. § 1.401-2(b)(2), T.D. 6203, 1956-2 C.B. 219, 227.

223. Treas. Reg. § 1.401-1(b)(3), T.D. 6203, 1956-2 C.B. 219, 225.

224. *Id.* § 1.401-1(b)(2), 1956-2 C.B. at 224; § 1.401-1(b)(3), 1956-2 C.B. at 225.

225. *Id.* § 1.401-1(b)(3), 1956-2 C.B. at 225.

226. Regulation 1.401-2 remains applicable to post-ERISA private plans as well as governmental plans. Regulation 1.401(a)-2(a) provides that rules contained in regulation 1.401-2 remain applicable to all plans seeking to qualify for tax-exempt status under section 401(a) "except as otherwise provided." Treas. Reg. § 1.401(a)-2(a) (1980).

227. Treas. Reg. § 1.401-2(a)(3), T.D. 6203, 1956-2 C.B. 219, 226.

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

requirements with which such purchases of employer securities must comply:

(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.²²⁹

These requirements essentially establish an arm's length standard for such securities transactions.

In *Shelby U.S. Distributors v. Commissioner*,²³⁰ the United States Tax Court applied these standards and those of section 401(a) to a series of transactions between a qualified trust and the two employers of the trust beneficiaries. As a result of these transactions, approximately ninety-six percent of the trust's assets consisted of notes or nonvoting preferred stock of the employer corporations. Through these investments the trustees, who were also employees and major shareholders of the employer corporations, enabled the corporations to acquire their businesses and provided additional capital for business operations. The notes were secured, interest payments were made under the notes, and principal payments were made when requested, according to the terms of the notes. Neither the adequacy of the security nor the reasonableness of the interest was questioned by the Internal Revenue Service. The court concluded that the Service had no basis for revoking the trust's exemption.²³¹

Revenue Ruling 69-494 and *Shelby* evidence the recognition by the Internal Revenue Service and the Tax Court of the same realities recognized by the common law. As a practical matter, the test applied to a fiduciary's duty of loyalty must look more to the primary purpose rather than to the exclusive benefit of a transaction.²³²

229. *Id.*

230. 71 T.C. 874 (1979).

231. *Id.* at 885. The court observed:

[I]t is recognized that the investments of a trust may result in some benefit to another without the trust losing its exemption, so long as there is no misuse of the trust funds. . . . Though 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.

232. *Id.* Cf. *Cutaiar v. Marshall*, 590 F.2d 523, 530 (3d Cir. 1979) (in absence of statutorily sanctioned conflict, ERISA entitles participants of private pension funds to have trustees negotiate best possible, and not merely fair, terms for transactions).

The prohibited transaction proscriptions applicable to governmental plans under the Internal Revenue Code take a consistent approach.²³³ Section 503(b) proscribes certain transactions, between the governmental plan and certain affiliated persons, that are unfair to the governmental plan. These affiliated persons include the "creator of [the] organization" and any "person who has made a substantial contribution to [the] organization." A governmental employer is likely to fall under one or both of these categories. The proscribed transactions include any loan by an exempt organization for less than adequate security or for less than a reasonable rate of interest,²³⁴ any purchase of a substantial amount of securities or other property for less than adequate consideration,²³⁵ any sale of a substantial part of the organization's securities or other property for less than adequate consideration,²³⁶ or any other transaction that results in a substantial diversion of the organization's income or corpus.²³⁷ The IRC imposes an extreme penalty upon governmental pension plans that engage in a prohibited transaction under section 503(b)—the organization loses its section 501(a) exemption.²³⁸ Such loss of entitlement to section 501(a) exemption status could jeopardize tax benefits that directly and indirectly accrue to its participants and beneficiaries.²³⁹

233. IRC § 503(a)(1)(B) (1976). At one time § 503 of the Internal Revenue Code applied to all private as well as public pension plans. When ERISA was enacted, § 503 was narrowed to cover only governmental plans, church plans, certain wholly contributory pension plans and certain supplemental unemployment compensation pension plans. Private pension plans are now governed by the prohibited transaction provisions of §§ 406(a) and 406(b) of ERISA and IRC § 4975(c), also enacted as part of ERISA. These provisions prohibit all transactions between the trusts and certain interested parties, regardless of the fairness of their terms, unless the Department of Labor issues a special prohibited transaction exemption. *Cutaiar v. Marshall*, 590 F.2d 523 (3d Cir. 1979).

234. IRC § 503(b)(1) (1976).

235. *Id.* § 503(b)(4).

236. *Id.* § 503(b)(5).

237. *Id.* § 503(b)(6).

238. *Id.* § 503(a). Under ERISA, if a fiduciary of a private pension plan engages in a prohibited transaction, he or she will become an insurer of the losses sustained by the plan, ERISA § 409(a), and will be subject to imposition of an excise tax equal to 5% of the amount involved in the transaction or 100% of that amount if the transaction is not corrected within the taxable period (unless the fiduciary was acting only in his or her fiduciary capacity). IRC § 4975(a), (b) (1976).

239. All versions of PEPRA and PERISA thus far have included prohibited transaction provisions modeled upon either § 503(b) of the Internal Revenue Code,

Thus, the Internal Revenue Code appears to require that the exclusive purpose of trust investments be the payment of retirement benefits to participants, although incidental benefits, not detrimental to that purpose, accrue to the participants and beneficiaries or to other groups. The cases examined above, the language of statutes codifying the duty of loyalty,²⁴⁰ and the Internal Revenue Service's interpretation of IRC section 401(a)²⁴¹ all evidence tension. This tension exists between the benefits to be derived from an investment and the purposes for which the investment is made, between the desire to provide maximum protection for participants and beneficiaries and the multiple benefits and purposes that can be and often are interwoven in a single investment decision. Much of this tension is expressed in the shifting use of the terms "exclusive," "sole" and "primary." Multiple benefits from a trust's investments cannot successfully and should not be proscribed. The attempt to label some benefits as primary and others as incidental involves subjective characterization.

Loyalty is a state of mind. The real concern underlying the duty of loyalty is the fiduciary's purpose for making a particular investment decision. If the purpose is to benefit the pension fund's participants and beneficiaries, the trustees do not breach their duty of loyalty. Consequently, ERISA and PEPPRA appear to express the underlying principle most accurately when they provide that a pension fund trustee must invest trust assets "for the *exclusive purpose* . . . of providing benefits to participants and beneficiaries."²⁴²

B. *Prudence: Permissible Considerations*

Prudence is the other duty inherent in the notion of trusteeship. Trustees of public pension funds are subject to the duty of prudence under the common law and possibly under state codifications such as

with its arm's length standard, or the per se approach of § 406(b) of ERISA. The versions that would amend the Internal Revenue Code would exempt from the operation of § 503 all governmental plans to which PEPPRA applies. See S. 2105, 97th Cong., 1st Sess. § 1313 (1981). Legislation was introduced in the second session of the 97th Congress under which the standards applicable to private pension funds would revert to the arm's length standard contained in § 503(b) of the IRC. See H.R. 4330, 97th Cong., 1st Sess. § 3503(a) (1981). See also H.R. REP. NO. 528, 97th Cong., 2d Sess. 44 (1982).

240. See *supra* notes 67, 75, 117, & 136.

241. See *supra* text accompanying notes 218-32.

242. ERISA § 404(a)(1)(A); S. 2105, 97th Cong., 1st Sess. § 1204(a)(1)(A) (1981); S. 2106, 97th Cong., 1st Sess. § 204(a)(1)(A) (1981) (emphasis added).

the New York Insurance Regulations.²⁴³ In addition, the Internal Revenue Service appears to be in the process of incorporating a prudence standard into the requirements of IRC section 401(a).²⁴⁴ These common law and statutory standards establish outer boundaries for investment decisions of public pension fund trustees. This section examines the primary elements of the prudence standard: risk considerations, yield, and diversification requirements.

1. Risk Considerations

Safety of the trust corpus is the single most important factor for the trustees to consider, although that does not mean they may take no risks whatsoever.²⁴⁵ As expressed in *Harvard v. Amory*, "[d]o what you will, the capital is at hazard."²⁴⁶ Safety of the investment will receive the greatest weight, however, when balanced against other permissible investment considerations.

The most widely cited case involving an investment of trust fund assets that allegedly failed to meet the established standard of safety arose in connection with the 1975 fiscal crisis of The City of New York. To help the City avoid bankruptcy, NYCERS, the Teachers' Retirement System of the City of New York, and several other New York State and City pension systems purchased hundreds of millions of dollars worth of securities issued by the City of New York and the Municipal Assistance Corporation (MAC), and entered commitments to invest a substantial percentage of their assets in such securities. These purchases were challenged in *Withers v. Teachers' Retirement System*²⁴⁷ as a breach of the trustees' fiduciary duty. Because the decision in this case explicitly rested on special factors other than risk of the investments, it is discussed at length in a later section of this article.²⁴⁸

The purchases of New York City and MAC securities litigated in *Withers* also were the subject of Internal Revenue Service scrutiny. While section 401(a) primarily articulates the duty of loyalty owed participants and beneficiaries by a pension trust's trustees, diversion

243. 11 NYCRR § 136.6(a), *supra* note 64.

244. See Detroit Letter Ruling, 371 PENS. REP. (BNA) J-9 to J-10 (Dec. 7, 1981). See also *infra* text accompanying notes 259-61.

245. 3 A. SCOTT, *supra* note 12, § 227.3 at 1812.

246. 26 Mass. (9 Pick.) 446, 461 (1830).

247. 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).

248. See *infra* text accompanying notes 303-08.

of financial benefits from the trust to third parties necessarily affects the fund's safety and yield. These factors in turn affect the benefits accruing to the participants and beneficiaries. Consequently, the trustees of NYCERS and the Teachers' Retirement System asked the Internal Revenue Service to rule that purchases of MAC and City securities by the two retirement systems constituted neither prohibited transactions under section 503(b)(1) nor violations of the exclusive-benefit-of-employees rule contained in section 401(a).

The Internal Revenue Service issued two letters of intent to rule on December 5, 1975 and December 15, 1975.²⁴⁹ Neither letter demonstrated the Service's acceptance of any relaxation of the trustees' duty to invest the retirement systems' assets in accordance with traditional standards of safety. In fact, the Service explicitly assumed that all four requirements for investments in employer securities, set forth in Revenue Ruling 69-494,²⁵⁰ would be met before it confirmed its intent to rule that the purchases would not violate the exclusive-benefit-of-employees rule of section 401(a). As described above,²⁵¹ these requirements include the receipt of a fair return by the trust on its purchase of securities and the presence of safeguards that a prudent investor would require.²⁵² Thus, the letters of intent to rule afforded little assurance to the retirement systems that was not already available to them.²⁵³

The assumption by the Internal Revenue Service that the purchases of City securities by NYCERS and the Teachers' Retirement System would be accompanied by the safeguards of a prudent investment strongly suggests that the Service interprets the exclusive-benefit-of-employees rule to preclude a less than "prudent" level of safety for investments of qualified public pension plans. Thus, their purchases of City and MAC securities might have jeopardized the tax

249. On file with the *Journal of Urban and Contemporary Law*.

250. 1969-2 C.B. 88.

251. See *supra* text accompanying notes 228-29.

252. 1969-2 C.B. 88.

253. Rulings were never issued to NYCERS and the Teachers' Retirement System. The 1975-1978 purchases of City securities probably were prohibited transactions. See GCM 38972, IRS POSITIONS (CCH) ¶ 1174 (June 30, 1982). Instead, from March 19, 1976, Pub. L. 94-236 provided exemptions from § 401(a) and § 503(b) for purchases, between August 20, 1975 and December 31, 1978, of MAC or New York City securities by the two retirement systems and certain other City pension funds. In 1978, Pub. L. 95-497 was enacted to provide for similar exemptions for purchases of MAC or City securities between July 1, 1978 and June 30, 1982. See *supra* text accompanying notes 105-07.

exempt status of NYCERS and the Teachers Retirement System without the enactment of special legislation for the express purpose of preserving this status.²⁵⁴

Nevertheless, at least one commentator²⁵⁵ has pointed to a published private letter ruling, issued on October 31, 1981 to the City of Detroit, Michigan,²⁵⁶ as evidence that the standard of safety implicit in the exclusive-benefit-of-employees rule of section 401(a) may have been relaxed by the Service.²⁵⁷ Analysis does not support this suggestion. The City of Detroit requested this ruling on behalf of two employee pension funds under circumstances similar to, but not as extreme as, those presented by the New York letters discussed above. The City is the major contributor to the funds and the ultimate obligor of financial benefits due their participants. It incurred substantial budget deficits in fiscal year 1980 and was delinquent in making its employer contributions to the funds. Only after the two funds instituted legal action, Detroit entered into and then defaulted on a consent agreement and the funds reinstated their litigation, did Detroit make late payments for that fiscal year. In order to make its contributions to the pension funds for fiscal year 1981, Detroit proposed to issue general obligation bonds, use the proceeds from the sale of half the issue to a syndicate of banks to pay half of its delinquent contributions, and tender cash plus 25 percent of the issue of bonds to the funds in satisfaction of its remaining obligation to make contributions.

Two factors distinguish this request from the New York situation. First, one of the major rating agencies rated the Detroit bond issue as investment grade. Second, Detroit did not request a ruling that the proposed transactions satisfied the requirements of section 401(a). It asked the Service to rule that, in determining whether to accept the bonds for half of the delinquent contributions, the economic circumstances of Detroit, as principal contributor to the pension funds and

254. Pub. L. 94-236 and Pub. L. 95-497 each state that any pension plan covered by the legislation "shall not be considered to fail to satisfy the requirements of § 401(a) of the Internal Revenue Code of 1954, and shall not be considered to have engaged in a prohibited transaction described in § 503(b) of such Code" if its actions fall within the safe-harbor provisions of the legislation. Act of Mar. 19, 1976, Pub. L. 94-236 § 1(a), 90 Stat. 238; Act of Oct. 21, 1978, Pub. L. 95-497 § 1(a), 92 Stat. 1665.

255. M. LEIBIG, SOCIAL INVESTMENT AND THE REGULATION OF PENSION INVESTMENTS: AN OUTLINE OF BASIC MATERIALS 37 (1982) (prepared for AFL-CIO Lawyers' Meeting, Minneapolis, Minn., May 5-8, 1982).

256. 371 PENS. REP. (BNA) J-9 (Dec. 7, 1981).

257. M. LEIBIG, *supra* note 255, at 37.

the ultimate obligor of their benefits, could be taken into account by the funds "in establishing the terms for the portion of the delinquent contributions to be satisfied by the bonds accepted by the [funds]."²⁵⁸

In ruling affirmatively, the Internal Revenue Service expressly adhered to the exclusive-benefit-of-employees rule and indeed explicitly incorporated the prudent person rule into section 401(a). The letter ruling stated:

In determining whether a course of action is for the exclusive benefit of the employees within the meaning of section 401(a) of the Code, the trustees of the two plans must discharge their duties with the care, skill, prudence, and diligence under all 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 like character and with like aims.²⁵⁹

This language is taken verbatim from the fiduciary provisions of ERISA.²⁶⁰ The prudent person rule does not appear in either section 401(a) or its regulations. Yet, section 401(a), not ERISA, was the subject of this ruling. The Service did not address the fundamental question of the safety of Detroit's bonds and, consequently, may have ruled only that if the bonds are prudent investments, the factors mentioned in the request for a ruling also may be taken into account.²⁶¹

Since the Detroit ruling was a private letter ruling, its apparent incorporation of the prudent person standard into section 401(a) is supposed to be without precedential value.²⁶² It is contrary to the holding in *Shelby* that requirements of liquidity and diversification and the rule of prudence have not acquired the force of law under section 401(a).²⁶³ The Detroit ruling may indicate, however, that the ERISA standards applied to private plans by the Department of Labor are influencing the Internal Revenue Service's approach in enforcing section 401(a) requirements for public employee plans.

258. 371 PENS. REP. (BNA) J-9 (Dec. 7, 1981) (emphasis added).

259. *Id.* J-10 to J-11.

260. See ERISA § 404(a)(1). See also S. 2105, 97th Cong., 1st Sess. § 1204(a) (1981); S. 2106, 97th Cong., 1st Sess. § 204(a) (1981).

261. See *supra* note 15 and accompanying text. See also GCM 38972, IRS POSITIONS (CCH) ¶ 1174 (June 30, 1982).

262. IRC § 6110(j)(3) (1976).

263. 71 T.C. 874, 880-82 (1979). The tax years in question in this case were 1971, 1972 and 1973, all prior to the enactment of ERISA in 1974. See *supra* text accompanying notes 230-31.

2. Yield

Return on investment is the second mandatory aspect of the prudent person rule. Most New York cases require the fiduciary to procure a reasonable and regular amount of income or that level of income that will not require the fiduciary to incur undue risks with the capital of the trust.²⁶⁴ Some cases have held or implied that trustees are duty-bound to make the maximum productive investment for their beneficiaries within the allowable range of risk,²⁶⁵ but these cases generally involve conflicts of interests on the part of the trustees,²⁶⁶ or investment decisions based on other impermissible factors,²⁶⁷ casting into doubt the general appropriateness of the standard they attempted to set.

As noted earlier, the exclusive-benefit-of-employees rule of IRC section 401(a) encompasses considerations of the expected safety and yield on a pension fund's investments as well as the traditional questions of loyalty. Michael Leibig implies that under Revenue Ruling 70-536,²⁶⁸ the Internal Revenue Service relaxed the original strict view of the statutory language and the regulation with respect to the return that must be sought from investments of trust assets.²⁶⁹ This Revenue Ruling, however, does not appear to provide sufficient authority for the trustees of a public pension fund to make trade-offs between a "prudent" rate of return on trust assets and other benefits not directly related to the financial health of the pension fund.

Revenue Ruling 70-536 involved a trust exempt from federal income taxation by virtue of IRC section 501(c)(17) rather than as a result of qualification under section 401(a). Section 501(c)(17) exempts trusts for payment of supplemental unemployment compensation benefits if, among other things, it is impossible under the applicable benefits plan "for any part of the corpus or income to be

264. *See, e.g., In re Will of Newhoff*, 107 Misc. 2d 589, 435 N.Y.S.2d 632 (Sur. Ct. 1980).

265. *E.g., Stern v. Lucy Webb Hayes Nat'l Training Schools for Deaconesses and Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974) (dictum). *See also* J. McLAUGHLIN, *INVESTING AS PRUDENT EXPERT*, FINANCIAL EXECUTIVE 23-29 (1975).

266. *E.g., Cheyenne-Arapaho Tribes of Indians v. United States*, 512 F.2d 1390 (Ct. Cl. 1975).

267. *See In re Soss's Estate*, 71 N.Y.S.2d 23 (Sur. Ct. 1947) (trustee invested in government bonds yielding two percent rather than two and one-half percent solely because he was annoyed at the beneficiary).

268. 1970-2 C.B. 120.

269. Leibig, *supra* note 12, at 388. *See also* M. LEIBIG, *supra* note 255, at 37.

. . . used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits” prior to satisfaction of all liabilities of the plan pertaining to its participants. The language of this provision is identical to that used in section 401(a)(2). Therefore, interpretations of this section may be, but are not necessarily, indicative of the meaning of section 401(a)(2).

The persons making the request which resulted in Revenue Ruling 70-536 proposed to amend a supplemental unemployment benefits plan to allow the trust to invest some of its funds in low-risk investments which would “further projects providing community and social benefits”²⁷⁰ but which were expected to yield a lower rate of return than what might otherwise be available for similar investments in the market place.

The Internal Revenue Service concluded that adoption of the proposed amendment would not affect the trust’s exemption under section 501(c)(17). The Service gave two reasons to support its conclusion. First, under the applicable regulations, trust fund investments were “permitted to the extent allowed by local law” because the statute contained “no specific limitations with respect to investments which may be made by trustees of [exempt] trusts.”²⁷¹ This provision is contained in identical language in the regulations applicable to section 401(a).²⁷² Secondly, although the proposed amendment expanded the factors that could be considered by the trust in formulating its investment policy, the amendment did not affect the purpose of the trust, which remained the provision of supplemental unemployment compensation benefits.²⁷³ One should note, moreover, that the regulations under section 501(c)(17) do not include any provision that parallels the regulation, which excludes from the permissible purposes of a section 401(a) trust “all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or their beneficiaries.”²⁷⁴

Although the position taken in Revenue Ruling 70-536 is consistent with the general discussion of “primary purpose” contained in

270. 1970-2 C.B. 120. The amendment was subject to approval by both the employer and the union, which had negotiated the supplemental benefits plan under a collective bargaining agreement.

271. Treas. Reg. § 1.501(c)(17)-2(h), T.D. 6972, 1968-2 C.B. 222, 229.

272. Treas. Reg. § 1.401-1(b)(5)(i), T.D. 6203, 1956-2 C.B. 219, 225.

273. Rev. Rul. 70-536, 1970-2 C.B. 120.

274. Treas. Reg. § 1.401-2(a)(3), T.D. 6203, 1956-2 C.B. 219, 226.

Revenue Ruling 69-494,²⁷⁵ the Revenue Ruling governing investments in employer securities, it is not consistent with the strict arm's length requirements for purchases of employer securities established by that ruling.²⁷⁶ It is also inconsistent with the section 401(a) requirement that the trust's exclusive purpose must be payment of benefits to the participants and beneficiaries. While Revenue Ruling 70-536 does not appear to have been cited by any subsequent revenue rulings or cases, Revenue Ruling 69-494 has been cited and followed extensively.

When there are successive beneficiaries to a trust, additional factors, stemming from the fiduciary's duty of impartiality, must be considered in determining what return on investment is prudent. When one beneficiary is entitled to receive the income of an express trust during his life and on his death another will receive the principal, the interests of the two beneficiaries are necessarily antagonistic in many respects. The trustee's duty is to administer the trust to maintain a fair balance between them.²⁷⁷ The trustee may not overemphasize preservation of the trust property to the detriment of its current productivity.²⁷⁸ Nor may he invest it in wasting assets or property that is likely to depreciate in value, although current income may be high. When the trust corpus includes assets that are rapidly depreciating or being depleted, the trustee must provide for amortization of the principal by allocating to assets a portion of the "income" realized currently²⁷⁹ or selling those assets and investing in property that will both yield a reasonable income and maintain the value of the principal.²⁸⁰

The potential for divided loyalties that trustees of a pension fund

275. 1969-2 C.B. 88.

276. See *supra* text accompanying note 229.

277. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. 1248, 1257-58 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979); *In re Mendelson's Will*, 46 Misc. 2d 960, 261 N.Y.S.2d 525 (Sur. Ct. 1965); *In re Dickson*, 38 Misc. 2d 678, 237 N.Y.S.2d 572 (Sur. Ct. 1963). See also RESTATEMENT (SECOND) OF TRUSTS § 232 (1959); 3 A. SCOTT, *supra* note 12, § 232 at 1895.

278. *In re Hubbell*, 302 N.Y. 246, 97 N.E.2d 888 (1951). See RESTATEMENT (SECOND) OF TRUSTS § 240 (1959); 3 A. SCOTT, *supra* note 12, § 240.

279. *In re Hottinger*, 115 N.Y.S.2d 79 (Sup. Ct. 1952).

280. *Id.*; *In re Haldeman*, 208 Misc. 419 (N.Y. Sur. Ct. 1955). See RESTATEMENT (SECOND) OF TRUSTS § 239 (1959). Cf. N.Y. NOT-FOR-PROFIT CORP. L. § 513(d) (1970) (permits the inclusion in income of "so much of the realized appreciation as the board [of directors] may deem prudent").

face is accentuated by the fact that the participants are overlapping as well as successive beneficiaries. The pension fund simultaneously includes current employees and retirees as participants. There is no one point at which the benefits of the trust are transferred from one group of beneficiaries to another because of the continuous influx of participants and flow of participants from the employee group into the retiree group. Within each group, the relative interests of various participants in current income from, and capital appreciation of, the assets vary because of the range of retirement dates and life expectancies of those participants. It seems safe, however, to conclude that when the yield on fixed income instruments may not both provide a reasonable return on investment and cover the value lost through inflation, trustees, in order to deal impartially with all participants, presumably should invest part of the corpus in investments with potential for appreciation of capital. This is particularly true in an inflationary economy.

The need to achieve higher returns through capital appreciation, as well as income from public pension fund investments, has been used by some as an argument for the propriety of investments in small businesses and venture capital investments.²⁸¹ Investments in new and small businesses usually involve greater risks than securities in which public pension funds traditionally invest. Under current formulations and interpretations of the prudent person standard, higher potential return will not justify an investment that fails to satisfy the safety component of that standard.²⁸²

3. Diversification

One factor, widely considered in making investment decisions and mandatory under ERISA,²⁸³ PEPPRA²⁸⁴ and the common law of several states,²⁸⁵ is diversification of the investments in a trust portfo-

281. Committee on Governmental Employees, *A Path to Increased Worker Benefits and Economic Revitalization*, Hearing Before the New York State Assembly 25 (Sept. 12, 1979); GOVERNOR'S OFFICE OF DEVELOPMENT PLANNING, *supra* note 4, at 7-23, 40-42; GOVERNOR'S PUBLIC INVESTMENT TASK FORCE, *supra* note 4, at 35-42, 46-49; L. LITVAK, *supra* note 8, at 31-34.

282. Note, *The Regulation of Risky Investments*, 83 HARV. L. REV. 603, 615, 619 (1970).

283. ERISA § 404(a)(1)(C).

284. S. 2105, 97th Cong., 1st Sess. § 1204(a)(3) (1981); S. 2106, 97th Cong., 1st Sess. § 204(a)(3) (1981).

285. Professor Scott lists nine states as having imposed liability on a trustee for

lio. The purpose of diversification is to distribute the risk of loss more widely, thereby minimizing the risk of large losses.²⁸⁶

ERISA and PEPPRA mandate diversification of pension trust assets unless the responsible plan fiduciaries can show why their failure to diversify was prudent.²⁸⁷ No percentage guidelines are contained in either statute, or in the legislative history or regulations for ERISA. Fiduciaries subject to ERISA are required to consider the facts and circumstances of each case, including:

- (1) the purposes of the plan; (2) the amount of plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise;
- (5) distribution as to geographical location; (6) distribution as to industries; and (7) the dates of maturity.²⁸⁸

Diversification is apparently not mandatory in New York²⁸⁹ and some other jurisdictions.²⁹⁰ Whether or not a state requires diversification of investments, it is the common law view that the prudence of each individual investment is weighed separately and that gains from one investment may not be used to excuse losses from another, imprudent investment.²⁹¹ Consequently, a fiduciary in a state adhering to this common law principle is not permitted to diversify among in-

failing to diversify: California, Hawaii, Illinois, Kentucky, Massachusetts, Missouri, New Jersey, Tennessee and Wisconsin. 3 A. SCOTT, *supra* note 12, § 228.

286. *Id.*

287. ERISA § 404(a)(1)(C); S. 2105, 97th Cong., 1st Sess. § 1204(a)(3) (1981); S. 2105, 97th Cong., 1st Sess. § 204(a)(3) (1981); H.R. REP. NO. 1280, 93d Cong., 2d Sess. 304 (1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 4571.

288. H.R. REP. NO. 1280, 93d Cong., 2d Sess. 304 (1974), *reprinted in* 3 ERISA LEGISLATIVE HISTORY, *supra* note 76, at 4571.

289. Lower New York courts have often stated that diversification is not required by New York law. *E.g.*, *In re Mendelson's Will*, 46 Misc. 2d 960, 967, 261 N.Y.S.2d 525, 535 (Sur. Ct. 1965); *In re First Nat'l Bank*, 25 N.Y.S.2d 221, 225 (Sup. Ct. 1941) (not imprudent to invest 68% of trust assets in New York Central Railroad stock and 80% in railroad stocks). On the other hand, at least one lower court has stated in dictum that diversification of a trust's investments is required. *Cobb v. Gramatan Nat'l Bank & Trust Co.*, 261 A.D. 1086, 26 N.Y.S.2d 917, *reargument denied*, 262 A.D. 745, 28 N.Y.S.2d 157, *appeal granted*, 262 A.D. 861, 29 N.Y.S.2d 152 (2d Dep't 1941). The New York Court of Appeals has acknowledged that an investment decision may be properly based in part on considerations of diversification, but it has not ruled directly on the question of whether fiduciaries must consider diversification in making all investment decisions. *In re Bank of New York*, 35 N.Y.2d 512, 517, 323 N.E.2d 700, 703, 364 N.Y.S.2d 164, 168 (1974).

290. *See* 3 A. SCOTT, *supra* note 12, § 228.

291. *King v. Talbot*, 40 N.Y. 76, 90 (1869).

vestments that individually are of less than a prudent level of safety in a belief either that they will yield higher returns or that they will decrease the risk of the portfolio as a whole.²⁹² In contrast, the Department of Labor has interpreted ERISA as adopting a standard whereby prudence is determined by considering the portfolio in its entirety rather than investment by investment.²⁹³ Diversification and this "whole portfolio standard" traditionally have been viewed as separate and distinct issues. However, if the investment managers of the largest pension systems are required by state or federal law to diversify investments and simultaneously to account for the prudence of each individual investment,²⁹⁴ they might not find a sufficient number and dollar value of prudent investments to permit the required diversification. This would be particularly true if the types of investments are limited by a legal list.²⁹⁵

4. Exigent Circumstances

When safety and yield are not clearly established, the authorities have been willing to allow consideration of other factors to establish the prudence of the proposed investment only in the presence of exigent circumstances.

The New York Court of Appeals appears to have accepted one type of indirect benefit in *City Bank Farmers Trust Co. v. Smith*.²⁹⁶ A trustee sought guidance from the court in the early years of the post-1929 depression concerning his power to negotiate a temporary reduction of rent for commercial real property held by the trust. He sought the reduction to prevent the tenant under a twenty-year lease from abandoning the premises. The court implicitly recognized the

292. See *Trustees of Hanover College v. Donaldson, Lufkin & Jenrette, Inc.*, Civ. No. 71-C686, slip op. (S.D. Ind. 1971); Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721, 763-65 (1976).

293. 29 C.F.R. § 2550.404a-1(b) (1982). Another factor that is always proper for pension fund trustees to consider is the liquidity of the invested assets in light of the cash flow needs of the pension fund. See 29 C.F.R. § 2550.404a-1(b)(2)(B) (1982).

294. See, e.g., *Pennsylvania Co. v. Gillmore*, 142 N.J. Eq. 27, 29, 59 A.2d 24, 33, 36-37 (1948) (trustee will be surcharged for losses resulting from failure to diversify sufficiently investments of trust even though trust as a whole showed a profit); 3 A. SCOTT, *supra* note 12, §§ 213.1, 228.

295. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 197; Hamilton, Johnston & Co., *supra* note 54, at 25-27; Murphy, *supra* note 13, at 236.

296. 263 N.Y. 292, 189 N.E. 222 (1934).

possible propriety of a rent reduction under those circumstances, holding that the trustee must seek the court's approval for such a modification of the lease.²⁹⁷

In *Drake v. Crane*,²⁹⁸ the court permitted trustees of a trust consisting largely of commercial property in a deteriorating area of St. Louis to "invest" funds earmarked "to guard against loss or other contingencies" by paying a bonus to developers to induce their construction of a new hotel in the immediate vicinity. Obviously, this payment to the hotel developers earned no direct income for the trust and was at considerable risk because the increased property values sought for the trust property were speculative. Nevertheless, the court held that the payment was a legitimate investment which resulted in a "direct benefit" to the trust and was a proper exercise of the trustees' power under the trust instrument to prevent "losses by shrinkage."²⁹⁹

In *Blankenship v. Boyle*,³⁰⁰ a case discussed earlier, the court did not reject the union's argument that purchase of the utility stocks would benefit the pension fund by increasing the amount of coal mined by the union and the employers' contributions to the pension fund. The court simply held that the trustees had violated their fiduciary obligations, because their primary purpose in purchasing the stock was to benefit the union rather than the fund.³⁰¹ This holding implies that the same investment, if primarily intended to benefit the pension fund, might have been a prudent exercise of the trustees' discretion.³⁰²

*Withers v. Teachers' Retirement System*³⁰³ clearly endorses the consideration of indirect economic benefits to a trust. This was an action by current and retired participants of the Teachers' Retirement Sys-

297. *Id.* at 297, 189 N.E. at 224.

298. 127 Mo. 85, 29 S.W. 990 (1895).

299. *Id.* at 107, 29 S.W. at 995-96.

300. 329 F. Supp. 1089 (D.D.C. 1971). *See supra* text accompanying notes 204-07.

301. 329 F. Supp. at 1106.

302. In response to a recent request for an advisory opinion, the Department of Labor pointed out that indirect financial benefits to an employee benefit trust from increased employer contributions may be too speculative and uncertain of measurement to be considered in comparing the overall yield from the investment designed to result in the increased contributions with the yield of comparable market investments. Annuity Fund of Electrical Industry of Long Island, Dep't of Labor Op. Letter (Mar. 15, 1982).

303. 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).

tem for the City of New York against trustees of the retirement system. They sought money damages for breaches of fiduciary duty, an injunction against additional purchases of New York City and MAC securities by the system, and a declaration of unconstitutionality of recently enacted state legislation (Chapter 890).³⁰⁴ Chapter 890 authorized the trustees of certain New York City retirement systems, including Teachers', to consider, in connection with investments in New York City and MAC obligations, "in addition to other appropriate factors recognized by law,"³⁰⁵ the extent to which such investments would aid the City in fulfilling its obligations as the major contributor to the retirement systems and the ultimate guarantor of benefits from the retirement systems and would protect the sources of funds for participants' retirement benefits.³⁰⁶ The court reviewed the standards of prudence applicable in New York State to investment decisions by fiduciaries, the normal investment policy of the retirement system's trustees and the Comptroller as their investment agent to invest only in high quality securities and to maintain a diversified portfolio, and the testimony of the individual trustees that they would not have purchased the New York City obligations under normal circumstances. The court then stated, "What determined the issue for the trustees was the specter of the City's bankruptcy, and, accordingly, the question becomes the extent to which this was a legitimate concern in the making of their investment decision."³⁰⁷ It concluded that, "under the unique circumstances presented—in which the survival of 'the fund as an entity' necessarily achieved prominence—the trustees' investment decision was such as to fulfill their fiduciary obligations to the [retirement system]."³⁰⁸

Some commentators have echoed this emphasis and concluded that, had there been no emergency or imminent threat to the retirement systems' viability, the trustees would not have been justified in considering any factors other than the traditional factors of safety, return and diversification.³⁰⁹ The trustees' reasons for purchasing the New York City securities, accepted by the court as valid, focused pre-

304. 1975 N.Y. Laws, ch. 890, *as amended by* 1978 N.Y. Laws, chs. 488 & 785.

305. 1975 N.Y. Laws, ch. 890 § 1(a).

306. *Id.*

307. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. at 1255.

308. *Id.* at 1259.

309. *Hutchinson & Cole*, *supra* note 15, at 1363; *Langbein & Posner*, *supra* note 14, at 101-02.

cisely on the payment of pension benefits to the participants, the "sole benefit" or purpose for which the pension fund had been established. The questionable aspect of their investment decision arose from the risk associated with the purchase of New York City obligations, when other investment securities available to the retirement systems satisfied all traditional investment criteria of prudence, including safety.

The question arises whether enactment of Chapter 890³¹⁰ was necessary for the trustees to consider the City's status as contributor and guarantor of the retirement systems and whether the authorization it provided was necessary for the *Withers* court's conclusion that the trustees acted prudently. In its opinion, the court described the main provisions of Chapter 890 when setting out the facts of the case.³¹¹ The court concluded that the trustees' insistence upon passage of the statute tended to show that their actions were motivated primarily by concern for the pension fund rather than to secure their own indemnification, as alleged by plaintiffs.³¹² These are the only times the court discussed Chapter 890 in the portion of the opinion relating to the prudence of the trustees' investment decision. This indicates that enactment of the statute may not have been necessary for a finding that the trustees' decisions were prudent. In the portion of the opinion in which the court discusses the constitutionality of Chapter 890,

310. The major provisions of Chapter 890 will expire on December 31, 1983. The City indemnification of trustees provided by § 2 of Chapter 890 does not, however, diminish. See 1975 N.Y. Laws, ch. 890 § 5. The provisions that terminate include: 1) the subsection authorizing the trustees of New York City pension funds to purchase *and hold* as investments obligations of the City and MAC, without regard to considerations of diversification or percentage of asset limitations under the legal list; 2) the subsection authorizing the trustees to consider, when investing in or holding City or MAC obligations, the impact of their investments on the City as contributor to the pension funds and guarantor of their benefits; and 3) the subsection granting the pension fund's power to borrow money and pledge their assets as collateral for the purpose of purchasing New York State or City or MAC obligations. Although the percentages of the New York City retirement systems' portfolios that these securities constitute have been reduced through the retirement of serial bonds and sales of MAC bonds, the expiration of the trustees' authority to hold the City and MAC obligations may make the issue of whether or not the *Withers* court relied on this legislation one of considerable importance for these trustees.

311. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. at 1253.

312. *Id.* at 1259. Moreover, since this indemnification would have been provided by the City of New York, that provision of Chapter 890 should be regarded as creating an avenue for City and ultimately state support of the City's retirement systems if all else failed.

however, the court stresses that "Chapter 890 was enacted as an integral part of the financial plan to stave off the City's default."³¹³ It also states that "the statute *permits* the trustees to protect a source of their funds through discretionary purchases of City obligations without numerical limit."³¹⁴ Thus, considering the *Withers* decision as a whole, it is not possible to say whether the trustees' decisions to purchase and hold the New York City obligations would have satisfied the prudent person standard absent the authorization provided by Chapter 890.

The letters from the trustees of NYCERS and the Teachers' Retirement System that requested a ruling from the Internal Revenue Service in connection with their purchase of City and MAC securities³¹⁵ also described the financial crisis facing the City of New York and the assertions of City and state officials that purchase of the MAC and City securities was necessary to prevent the City's bankruptcy. The Service relied upon these representations, as well as representations by the two retirement systems, that the proposed purchases of MAC and City securities would reduce the risk of future reductions in levels of benefits paid by the retirement systems to participants and beneficiaries and the risk of termination or delay of the City's future contributions to the retirement systems. In its second letter of intent to rule, which covered several later purchases of securities by the retirement systems, the Service also relied upon the trustees' representation that the New York State legislature had authorized the trustees of City and state retirement systems to purchase securities of the City and MAC without regard to the percentage of the retirement systems' assets invested in such obligations.³¹⁶ The letter also noted that the legislature had authorized the trustees to consider the extent to which investments in City and MAC obligations would aid the City in making future contributions to the retirement systems and in acting as guarantor for all pension benefits and would protect the sources of funds for the retirement benefits.³¹⁷

As shown above, the private letter ruling issued to Detroit by the Internal Revenue Service merely authorizes the Detroit pension fund trustees to consider the economic circumstances of Detroit in negoti-

313. *Id.* at 1260.

314. *Id.* (emphasis added).

315. *See supra* notes 253-54 and text accompanying notes 247-54.

316. On file with the *Journal of Urban and Contemporary Law*.

317. 1975 N.Y. Laws, ch. 890 § 1.

ating the terms of the bonds to be accepted by the pension funds. The facts described in the letter ruling show that the pension funds were not likely to receive a large portion of the required employer contributions unless they accepted part of the contributions in the form of debt obligations.

Thus, all but one³¹⁸ of the existing authorities explicitly permitting the consideration of benefits that are not directly involved in the safety of and return to the trust fund can be explained by the factor of necessity. In each of these cases the trustee only faced bad choices. It might be possible to construct a theory that justifies and permits trustees of public pension funds to consider indirect benefits in the absence of necessity. Except for Revenue Ruling 70-536, which does not appear to have been followed,³¹⁹ there appears to be no support for such a theory under existing statutory, judicial or administrative law.

C. *Prudence: The Exercise of Skill, Care and Caution*

As stated above,³²⁰ prudence is a matter of conduct and a fiduciary's exercise of skill, care and caution, especially in investigating the benefits and detriments an investment may hold for the trust. Under the law applicable to private trusts, a trustee is required to exercise the degree of skill that a reasonably prudent person would exercise in

318. Even that case may be characterized as one of necessity for the national government. *In re London's Estate*, 104 Misc. 372, 171 N.Y.S. 981 (Sur. Ct. 1918), *aff'd*, 187 A.D. 952, 175 N.Y.S. 910 (1st Dep't 1919), involved an action against trustees under a trust instrument directing them to invest solely in bonds of United States railroad corporations yielding at least four percent annually. The trustees had invested part of the trust funds in four and one-half percent bonds of New York City and three and one-half percent United States Liberty Loan bonds. The trustees were surcharged for losses from the investment in New York City bonds but not for losses from the Liberty Loan bonds.

[T]hese are abnormal times. Our country is engaged in a great war, and needs the undivided support, aid and loyalty of every citizen. Under these circumstances the court should not be bound by narrow and restricted rules of law and construction in questions which affect the welfare of our country, but should exercise its best and widest discretion. The investment by the trustees in these Liberty Loan bonds was in aid of our government in its hour of need, and they should be commended rather than condemned therefor.
104 Misc. at 377, 171 N.Y.S. at 983.

319. *See supra* text accompanying notes 275-76.

320. *See supra* text accompanying notes 32-35.

making investment decisions.³²¹ When appropriate, the trustee may consult experts regarding the investment³²² but he will still be held to the same standard³²³ now codified in many states.³²⁴ It seems likely, however, that a trustee or other fiduciary who is in fact more skillful, experienced or otherwise knowledgeable than the average prudent person must exercise the skill he has.³²⁵

Under ERISA and both proposed versions of PEPPRA, trustees are held to the standard of skill that "a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."³²⁶ This language appears to establish a standard of skill of an expert in making pension investments. In a recent case, the court held that pension fund trustees had a fiduciary duty under ERISA to obtain the quantity and quality of information about a proposed real estate loan that a "reasonably competent real estate lender" would have obtained.³²⁷

The NYCERS trustees have delegated to the New York City Comptroller,³²⁸ and the Comptroller has delegated to the Deputy Comptroller, Asset Management,³²⁹ the power to make any investments the NYCERS trustees are authorized by law to make. The Deputy Comptroller has engaged professional investment advisors to advise him concerning various types of investments. The Deputy Comptroller and his advisors are experts and, therefore, are held to the standard of an expert under either the Insurance Regulations or PEPPRA. The NYCERS trustees still may and do authorize particular investments directly. In such cases the degree of skill required of

321. *In re Clark*, 257 N.Y. 132, 177 N.E. 397 (1931); *King v. Talbot*, 40 N.Y. 76 (1869); 3 A. SCOTT, *supra* note 12, § 227.2.

322. *Mills v. Bluestein*, 275 N.Y. 317, 9 N.E.2d 944 (1937); 3 A. SCOTT, *supra* note 12, § 227.1.

323. *In re Clark*, 257 N.Y. 132, 177 N.E. 397 (1931).

324. The prudent person standard for New York public pension funds is codified in the Insurance Regulations. 11 NYCRR § 136.6(a). See *supra* note 64.

325. See *In re Easton's Estate*, 178 Misc. 611, 35 N.Y.S.2d 546 (Sur. Ct. 1942), *aff'd*, 266 A.D. 713, 41 N.Y.S.2d 190 (4th Dep't 1943) (corporate trustee is expected to use as high a degree of care as the most experienced individual).

326. S. 2106, 97th Cong., 1st Sess. § 204(a)(2) (1981).

327. *Donovan v. Mazzola*, 2 E.B.C. 2115, 2125-26 (N.D. Cal. 1981). See also *Marshall v. Glass/Metal Ass'n & Glaziers*, 407 F. Supp. 378, 384 (D. Hawaii 1980).

328. Resolution of NYCERS Board of Trustees, Cal. No. R-93, Sept. 11, 1981. This delegation is authorized by NEW YORK CITY ADMIN. CODE § E49-2.0(a) (1975).

329. NEW YORK CITY CHARTER § 94(a) (Supp. 1981).

them probably would be higher under PEPPRA than under the Insurance Regulations and the common law.

Trustees' duty of prudence requires them to investigate with care each investment that they personally authorize.³³⁰ They must consider both the past history and the future prospects of the investment under consideration. Their duty of care requires trustees to consult experts in fields where any trustee possesses no or limited expertise of his own.³³¹ Such experts may include appraisers, attorneys, bankers, brokers, investment advisors and real estate specialists. Trustees may rely upon each expert as to matters in which the expert possesses expertise and the trustees are inexperienced. Trustees should also take into consideration whether the person giving them advice is disinterested in the investment decision.³³² They must not confuse proper reliance upon the expertise of an advisor with the judgment concerning prudence of the particular investment, which each trustee is himself bound to form.³³³ When personally authorizing investments, each trustee must form his own opinion and act accordingly, lest he improperly delegate his discretionary responsibilities as a fiduciary.³³⁴

Public pension fund trustees may be subjected to liability for losses incurred by their funds through investments that they failed to investigate with the proper care. It has long been clear under the common law that liability may be imposed upon a trustee if he fails to make a proper investigation that would have disclosed that the investment was imprudent or one which the trustee has no power to authorize.³³⁵

The duty of pension fund trustees to investigate with care planned investments is most thoroughly explicated in the court of appeals and

330. *In re Clark*, 257 N.Y. 132, 177 N.E. 397 (1931).

331. *See Donovan v. Bierwirth*, 538 F. Supp. 463, 472-75 (E.D.N.Y. 1981), *aff'd*, 680 F.2d 263 (2d Cir.), *cert. denied*, 103 S. Ct. 488 (1982).

332. *Id.* at 475; 3 A. SCOTT, *supra* note 12, § 227.1.

333. *In re Palmer's Will*, 132 N.Y.S.2d 311 (Sur. Ct. 1954); 3 A. SCOTT, *supra* note 12, § 227.3.

334. *In re Osborn*, 252 A.D. 438, 299 N.Y.S. 593 (2d Dep't 1937); *In re Dickson*, 38 Misc. 2d 678, 237 N.Y.S.2d 592 (Sur. Ct. 1963). *See* 2 A. SCOTT, *supra* note 12, § 171; RESTATEMENT (SECOND) OF TRUSTS § 171 (1959).

335. *In re Palmer's Will*, 132 N.Y.S.2d 311 (Sur. Ct. 1954); *Cobb v. Gramatan Nat'l Bank & Trust Co.*, 21 N.Y.S.2d 49 (Sup. Ct. 1940), *aff'd on other grounds*, 261 A.D. 1086, 26 N.Y.S.2d 917, *new trial denied*, 262 A.D. 745, 28 N.Y.S.2d 157, *leave to appeal granted*, 262 A.D. 861, 29 N.Y.S.2d 152 (2d Dep't 1941).

district court opinions in *Donovan v. Bierwirth*.³³⁶ This case involved an action by the Secretary of Labor against three trustees of the pension fund established under ERISA for employees of the Grumman Corporation.³³⁷ The LTV Corporation (LTV) made an unsolicited tender offer for up to seventy percent of Grumman's stock, which the directors of Grumman determined to resist. Prior to the tender offer the pension plan held 525,000 shares of Grumman's outstanding stock. The federal district court found that the three trustees of the Grumman pension plan, who were all executive officers of Grumman, decided after a half-hour discussion attended only by the trustees and in-house counsel for Grumman not to tender the shares already held by the Grumman pension plan.³³⁸ Moreover, they purchased, at an average price over fifty percent higher than the pretender offer price, an additional 1,158,000 shares on behalf of the Grumman pension plan.³³⁹

The district court held that the dual loyalties of each trustee to Grumman and to its employees' pension plan created a potential conflict of interests, requiring the trustees to satisfy a higher standard of care in their investigation of the contemplated investment.³⁴⁰ The trustees' heightened obligation to act fairly required their independent investigation to be intensive, scrupulous, and "discharged with the greatest degree of care that could be expected under all the circumstances by reasonable beneficiaries and participants of the plan."³⁴¹ Both courts declined to rule on whether the trustees, following a proper investigation, could have reasonably concluded that the investment in the Grumman shares was prudent. But both found that the trustees had failed to investigate carefully whether the newly purchased Grumman securities were superior to other investments in the marketplace or whether LTV's success in its tender offer would have an adverse impact upon the Grumman pension plan.³⁴² The courts held that, because of the inadequacy of their investigation, neither the prudence of the investment nor the trustees' good faith

336. 680 F.2d 263 (2d Cir. 1982), *aff'g* 538 F. Supp. 463 (E.D.N.Y. 1981), *cert. denied*, 103 S. Ct. 488 (1982).

337. *See supra* text accompanying notes 208-13.

338. 538 F. Supp. at 466.

339. *Id.* at 467.

340. *Id.* at 469.

341. *Id.* at 470; 680 F.2d at 272.

342. 538 F. Supp. at 473; 680 F.2d at 275-76.

belief in the value of the investment could insulate them from liability for the loss incurred by the pension plan as a result of the investment.³⁴³

A clear picture of the concrete steps that may be necessary for a fiduciary to follow when he investigates a difficult investment opportunity may be gained by comparing the actions of the Grumman trustees³⁴⁴ with the investigation conducted by the trustees whose conduct was challenged in *Withers v. Teachers' Retirement System*:³⁴⁵

(1) The Grumman trustees spent only a few hours over a period of two weeks investigating the Grumman plan's best interests.³⁴⁶ The trustees of the Teachers' Retirement System devoted a significant portion of their time, over a period of five to six months, to their investigation.³⁴⁷

(2) The Grumman trustees' inquiry into the dangers presented to the Grumman pension plan by the tender offer was not adequate.³⁴⁸ The trustees of the Teachers' Retirement System met frequently with the "City Comptroller and Corporation Counsel, to discuss the projected short-falls in the City's budget and the need for long-term financial assistance."³⁴⁹

(3) The record made by the Grumman trustees did not show how the Grumman pension plan could have benefited from tendering its Grumman stock to LTV.³⁵⁰ The trustees of the Teachers' Retirement System believed the purchases of New York City obligations would "insure the survival of the fund, and at a limited cost, since the purchase of the bonds was in effect to be financed by the continuing cash contributions from the City."³⁵¹

(4) The Grumman trustees did not explore alternatives for protecting the Grumman pension plan in the event the tender offer succeeded. They did not test the good faith of LTV's public promise not to merge the Grumman plan with LTV's pension plans. Nor did they investigate alternate methods of gaining the same benefits for the

343. 538 F. Supp. at 471; 680 F.2d at 276.

344. 680 F.2d at 270.

345. 447 F. Supp. 1248 (S.D.N.Y. 1978).

346. 538 F. Supp. at 466.

347. 447 F. Supp. at 1258-59.

348. 538 F. Supp. at 472-73.

349. 447 F. Supp. at 1251.

350. 538 F. Supp. at 472.

351. 447 F. Supp. at 1259.

Grumman pension plan that they sought through the investment.³⁵² The trustees of the Teachers' Retirement System resisted purchasing the New York City securities until they were convinced that the City—and the retirement systems—had no alternative.³⁵³ They also conditioned their "investment in the City bonds on the enactment of federal legislation providing for the seasonal financing needs of the City" during the period the retirement systems would be purchasing the New York City bonds, on state legislation concerning the legal status and the security of the retirement systems' assets, and on procurement of a ruling by the Internal Revenue Service or enactment of federal legislation that would preserve the tax benefits of the participants and beneficiaries of the retirement systems.³⁵⁴

(5) The Grumman trustees did not solicit any expert financial advice on the effect that tendering its stock would have on the Grumman pension plan.³⁵⁵ The trustees of the Teachers' Retirement System initiated meetings with officials of the Municipal Assistance Corporation and independent consultants to review long-range plans that were being developed to meet New York City's fiscal crisis.³⁵⁶

(6) The Grumman trustees did not consult independent outside counsel with expertise in the issues.³⁵⁷ The trustees of the Teachers' Retirement System consulted outside counsel who gave them extensive advice on the legal standards applicable to their investment decisions and their consequences.³⁵⁸

352. 538 F. Supp. at 472-73.

353. 447 F. Supp. at 1252.

354. *Id.* at 1253.

355. 538 F. Supp. at 472.

356. 447 F. Supp. at 1251.

357. 538 F. Supp. at 473.

358. 447 F. Supp. at 1255, 1258; *Withers*, 447 F. Supp. at 1255 (citing W. Josephson, T. Veal and G. Lander, Draft Memorandum, Oct. 24, 1975, on file with the *Journal of Urban and Contemporary Law*). Compare the requirement in *Donovan v. Bierwirth* for independent counsel with the discussion of the status of a public officer lawyer statutorily designated as counsel to both the public employer and the public pension plan, *supra* at notes 181-98.

The Grumman trustees also failed to inquire about the transaction costs of the large and unusual transactions they authorized, 538 F. Supp. at 475, and the limited investment advice upon which they did rely was out-of-date, hurriedly prepared, addressed to a different set of circumstances applicable to a different investor, provided by an investment advisor with a potential conflict of interests requiring greater scrutiny of the advice by the trustees, unsupported by the primary data available to the trustees, and uninterpreted by any representative of the investment advisor, *id.* at 474.

Finally, the obligation of pension fund trustees to make investment decisions prudently requires them to act with caution. Careful independent investigation of the basis of each decision represents one aspect of this caution. Another aspect is represented by the emphasis, under almost all circumstances, on the preservation of the trust corpus as the primary investment consideration. In making investment decisions a fiduciary is required to invest with more caution than a person who is responsible simply for his own well-being. He is "charged with the responsibility of recognizing that the kind of investment which may be appropriate for an individual investor seeking to reap substantial profits is not suitable for a trust."³⁵⁹

The investment analyses required by proposals for targeted investments will always pose questions concerning the value and speculativeness of the intended benefits to the pension fund and may often pose questions of the motivation or intent of its trustees in authorizing such investments. Public pension fund trustees possess considerable discretion in making investment decisions and must exercise that discretion by forming their own judgments.³⁶⁰ If challenged, they may find it is difficult for a court to evaluate the prudence and loyalty of their investment decision as of the time of the decision rather than from hindsight unless they made a clear record of their diligence and care in investigating the investment, the benefits they believed were sufficiently certain to form a basis for their decision, and their motivation for authorizing the investment.

Consequently, it is extremely important that fiduciaries preserve a carefully documented and adequately reasoned investment record whenever they are faced with an unusual or complex investment proposal. The record may include minutes or transcripts of trustee meetings, written recommendations and reports supplied by responsible governmental officials, independent investment advisors and special counsel, and records of the data analyzed and publications or experts consulted in determining whether a proposed investment is likely to have its desired effect. On the other hand, evidence that a fiduciary based his decision on self-interest or "ignored well-documented, factual indications concerning the impact of an investment on any inter-

359. *In re Will of Newhoff*, 107 Misc.2d 589, 593-94, 435 N.Y.S.2d 632, 636 (Sur. Ct. 1980). See RESTATEMENT (SECOND) OF TRUSTS § 227 comment e (1959); 3 A. SCOTT, *supra* note 12, § 227 at 1806, § 227.3.

360. *Mills v. Bluestein*, 275 N.Y. 317, 9 N.E.2d 944 (1937); *In re Osborn*, 252 A.D. 438, 299 N.Y.S. 593 (2d Dep't 1937); 3 A. SCOTT, *supra* note 12, § 227.3.

est of plan beneficiaries or participants will provide a valid basis for challenging fiduciary conduct.”³⁶¹

V. INVESTMENT PROPOSALS

The Comptroller of The City of New York has submitted to the trustees of NYCERS and the other City employee retirement systems three specific proposals for investments designed to provide benefits to the City as well as to NYCERS.³⁶² A review of these proposals will illustrate some of the issues this article discusses.

The first investment recommended by the Comptroller involved mortgage pass-through securities guaranteed by the Government National Mortgage Association (GNMA) and backed by pools of mortgages on one-to-four family homes located within New York City or adjacent counties. Thus, these securities were “targeted” to the New York City area. They were to be issued by GNMA-approved issuers. The guarantee of the securities by GNMA entitles them to the pledge of the “full faith and credit of the United States.”³⁶³ NYCERS had invested in GNMA mortgage pass-through securities, not restricted to mortgages on New York properties, prior to the Comptroller’s recommendation. The targeted GNMA securities are approved legal list investments for NYCERS.³⁶⁴

While it includes the divergent goal of aiding housing in the New York City area, this investment should not be regarded as sacrificing

361. Leibig, *supra* note 12, at 390. Accord Atnally, *The Investment Responsibilities of Fiduciaries: Implications of the Spitzer Decision*, 1975 TR. & EST. 286, 289.

362. “Investments Targeted to New York City,” memorandum from Harrison J. Goldin, New York City Comptroller, to Trustees of the New York City Retirement Systems (Oct. 3, 1980); “Targeted Investments—Phase II,” memorandum from Harrison J. Goldin, New York City Comptroller, to Trustees of the New York City Retirement Systems (Jan. 26, 1982), both on file with the *Journal of Urban and Contemporary Law*.

This discussion is based on several memoranda that the City submitted to the trustees of the New York City retirement systems and conversations with the Deputy Comptroller, Asset Management and the Counsel for Finance to the Comptroller. No independent investigation of the facts has been made.

363. 12 U.S.C. § 1721(g) (Supp. V 1981).

364. Subdivision 1 of § 235 of the N.Y. Banking Law authorizes NYCERS investments in securities for which the “faith of the United States is pledged to provide for the payment of the interest and principal.” These targeted GNMA securities also appear to satisfy the criteria for mortgage pass-through certificates secured by mortgages on one-to-four family residences in New York State authorized by N.Y. RE-TIRE & SOC. SEC. LAW § 177-c (McKinney Supp. 1982).

any yield or safety required by the prudent person standard. Payment of the principal and interest on targeted GNMA securities is secured by the faith and credit of the United States and yields of these securities generally range from one-fourth percent to one percent above those of equivalent duration Treasury bonds.³⁶⁵ It is unlikely, therefore, that their safety or yield could be challenged successfully under the prudent person standard applicable to NYCERS and other public pension fund investments. Consequently, such targeted GNMA mortgage securities have become an attractive way for trustees and managers of public pension funds to invest locally without risking violation of the prudent person standard. Thus, this investment meets the prudent person and other legal standards and also serves other purposes.³⁶⁶

The second program that the Comptroller proposed involves conventional mortgage pass-through securities to be issued by banks or savings and loan associations within New York State and backed by mortgages on one-to-four family residences located in the state. As thus structured, these New York-targeted mortgage securities appear to be authorized under the legal list.³⁶⁷

The Comptroller's proposal provided for the payment of principal of and interest on the targeted conventional mortgage securities to be 100% insured by private mortgage insurers. This insurance is neither required nor explicitly authorized by the relevant legal list provision. The legislative history of this provision, however, indicates the legislature probably assumed such mortgage pass-through securities would be insured to at least five percent of the total indebtedness represented by the securities.³⁶⁸ Consequently, to the extent these

365. Memorandum from Harrison J. Goldin to Trustees of New York City Retirement Systems (Oct. 3, 1980).

366. See *supra* text accompanying note 15.

367. See N.Y. RETIRE. & SOC. SEC. LAW § 177-c (McKinney Supp. 1982).

368. The session law which enacted § 177-c of the Retirement and Social Security Law also amended the New York Insurance Law. 1980 N.Y. Laws ch. 672 § 2. The amendment enlarged the definition of mortgage guaranty insurance to include insurance on pools of mortgage loans and excluded such insurance from the limitation of reinsurance coverage to 25% of the indebtedness. 1980 N.Y. Laws ch. 672 § 2 (codified at N.Y. INS. LAW § 302(1)(b) (McKinney Supp. 1982)). A memorandum from the New York State Teachers' Retirement System concerning this legislation advised the Governor's counsel that the retirement system had no objection to enactment of the legislation but recommended that "the approval memorandum, if one [were] issued, should specify unequivocally that each mortgage pass-through certificate shall be insured by mortgage insurance." Memorandum from H.N. Langlitz, Executive Direc-

targeted conventional mortgage securities might not be considered prudent without at least five percent mortgage pool insurance, the mortgage insurance could be considered to be auxiliary to the legal list even if not actually part of it.

If, as anticipated, these targeted conventional mortgage securities are rated AA or AAA by Standard and Poor's³⁶⁹ and yield approximately one-half percent above similar current coupon GNMA securities, the safety and yield on these investments are likely to withstand any challenge under the prudent person standard. Therefore, this investment, while arguably divergent, does not sacrifice yield or safety.

The third investment proposal of the New York City Comptroller involved construction and development (C&D) financing for real estate projects in New York City. Under this proposal mortgages on the projects secure the C&D loans. As is usual for C&D loans, the funds for each C&D project will be advanced to the real estate developer as the architect or engineer certifies that specified stages of work are completed. Thus, the value of the underlying security will remain roughly proportionate to the loan principal outstanding. Unlike conventional C&D financing, each C&D loan in this program also will

tor, New York State Teachers' Retirement System, to Richard A. Brown, Counsel to the Governor 3 (June 25, 1980). A letter to the Governor's counsel from the Chairman of the New York State Permanent Commission on Public Employee Pension and Retirement Systems states:

[T]he standard mortgage guaranty insurance coverage transacted in this state provides coverage at the rate of 5% of the original indebtedness and . . . such coverage is diminished by the payment of losses. . . . The last three lines in the bill relating to removing limitations on coverage, appears [sic] to have no reasoning in view of the foregoing.

Letter from James F. Regan, Chairman, Permanent Commission on Public Employee Pension and Retirement Systems, to Richard Brown, Counsel to the Governor (June 27, 1980).

These documents can be found in the bill jacket for the session law that enacted these companion provisions of the Retirement and Social Security Law and the Insurance Law. They evidence a general industry practice of partially insuring targeted conventional mortgage securities. The simultaneous amendment of the Retirement and Social Security Law and the Insurance Law implies an expectation of the legislature that from 5% to 25% or more of the total indebtedness in such mortgage securities would or might be insured. While the mortgage insurance contemplated by the Comptroller's proposal technically may not be included in the legal list provision that authorizes the targeted conventional mortgage securities, there does appear to be a statutory connection between the legal list provision and the provision authorizing mortgage insurance on the pool of mortgages.

369. It is not known whether Standard and Poor's would give a AA rating to these securities in the absence of some or all of the insurance discussed above.

be secured by an irrevocable standby letter of credit from Chemical Bank under which NYCERS may demand immediate issuance of a certificate of deposit by the bank upon the borrower's default.

One legal list provision applicable to NYCERS authorizes investments in conventional mortgages that are guaranteed by a New York State bank or trust company with a net worth greater than \$500 million.³⁷⁰ The only element of this provision that the proposed C&D investment program does not clearly satisfy³⁷¹ is the requirement that the mortgages be "guaranteed" by the qualifying state bank. This requirement raises the question of whether a letter of credit issued by a state bank constitutes a guaranty by that bank. After taking into consideration the purpose and function of a letter of credit as well as the lack of formal requirements for a "guaranty" under New York State law, it appears that the Chemical Bank letter of credit should satisfy the guaranty requirement³⁷² and that the proposed C&D in-

370. N.Y. RETIRE. & SOC. SEC. LAW § 177(3) (McKinney 1971).

371. "Conventional mortgage" is defined in the statute to include "any single bond and mortgage or note and mortgage constituting a first lien upon real estate . . . not insured by the federal housing administrator . . . or guaranteed by the United States under the provisions of the national housing act." N.Y. RETIRE. & SOC. SEC. LAW § 176(2) (McKinney 1971). Under documentation developed by the Comptroller's staff, each C&D loan is evidenced by a note and secured by a mortgage constituting a first lien upon the property. Chemical Bank is a state bank. CHEMICAL BANK, 1981 ANNUAL REPORT ON FORM 10-K, 1, 8 (1982). It has a net worth greater than \$500 million. CHEMICAL BANK, 1981 ANNUAL REPORT TO SHAREHOLDERS 44 (1982).

372. A guaranty is generally defined as a promise to pay the debt of another, collateral to his primary contract and expressly conditioned upon his default. L. SIMPSON, SURETYSHIP § 14 (1950). A letter of credit, as ordinarily employed in sales transactions, differs somewhat from a guaranty, although it has the same economic effect. The letter of credit is a promise to honor demands for payment upon compliance with the conditions specified in the credit, usually the presentation of one or more documents. N.Y. U.C.C. § 5-103 (McKinney 1964). The letter of credit to be issued for each C&D loan by Chemical Bank provides that, upon submission of proof of the borrower's default on the note, Chemical Bank will issue a certificate of deposit to the City Comptroller on behalf of NYCERS for the outstanding principal and accrued interest. Thus conditioned upon the borrower's default, it appears the Chemical Bank letters of credit would function like absolute guaranties of payment. See 57 N.Y. JUR., *Suretyship and Guaranty* §§ 20, 21 (rev. 1967). Since a guaranty need not take a particular form nor employ particular words, such as "guaranty" or "guarantee," *id.* § 15, the Chemical Bank letters of credit appear to satisfy the legal list requirement that "conventional mortgages" in which NYCERS invests be "guaranteed" by a state bank. Indeed, it has been said that the standby letter of credit constitutes a more solid and certain form of repayment commitment than a guarantee. McLaughlin, *Standby Letters of Credit*, 89 N.Y.L.J., Mar. 9, 1983, at 1, col. 1, and 28, cols. 1-4.

vestment probably is on NYCERS' legal list. In addition, the certificate of deposit that would be substituted for the C&D loan if NYCERS ever draws upon the letter of credit is on NYCERS' legal list.³⁷³

Assuming the equivalence of the letters of credit to a guaranty, this investment, although targeted to New York City, probably would not be considered to be concessionary. The basic factors upon which the NYCERS trustees must rely in assessing the prudence of C&D loan program investments, assuming the authorization of the letter of credit by the legal list, are of the type routinely considered by the trustees and their investment advisors. Each letter of credit to be issued by Chemical Bank will be irrevocable and the certificate of deposit that NYCERS would receive upon a borrower's default will be an unconditional promise to pay the outstanding loan balance. The safety of these investments is dependent on Chemical Bank's creditworthiness. The loan and certificate of deposit are each expected to yield roughly one and one-half percent above equivalent duration United States Treasury securities.

In addition to being a statutorily appointed member of the NYCERS board of trustees,³⁷⁴ the New York City Comptroller exercises investment powers of the NYCERS trustees under a statutorily authorized delegation.³⁷⁵ Consequently, any potential conflict of interests that may arise from the Comptroller's dual role as author of these investment proposals and as a trustee responsible for forming an independent investment judgment of the proposal should be deemed to be statutorily sanctioned.³⁷⁶

VI. LEGISLATIVE SOLUTIONS

The fourth section of this article establishes that public pension fund trustees have authority to relax the prudent person requirements of safety and return only in exigent circumstances and only to protect retirement benefits. Not surprisingly, therefore, at least some public officers have sought explicit legislative authorization. This was true in 1975 when New York City officials asked the trustees of NYCERS, the Teachers' Retirement System of the City of New York and other

373. N.Y. BANKING LAW § 235 (12-a)(b) (McKinney 1971).

374. *See supra* text accompanying note 151.

375. *See supra* note 328 and accompanying text.

376. *See supra* text accompanying notes 142-45 and 152-53.

New York City employee pension systems to purchase its securities and those of MAC.³⁷⁷ Certainly, the trustees' insistence upon first receiving state and federal legislative authorization to consider the effect of the City's status as contributor of funds and guarantor of benefits was in keeping with the law of private trusts. That law requires trustees to seek court approval before making an investment that deviates in any respect from the safety and yield requirements of the prudent person standard.³⁷⁸

Proposals for legislation to expand the investment authority of public pension fund trustees fall into several categories. There have been proposals to drop the legal list and to rely solely upon the prudent person rule for regulating investment decisions of state and municipal pension fund trustees.³⁷⁹ A related approach would be for states to repeal their own statutory constraints on investment of municipal and state pension funds, enacting in their place legislation identical to the fiduciary provisions of PEPPRA and ERISA.³⁸⁰ Still other proposals either permit investment in specified divergent investments³⁸¹ or direct that a specified portion of the public pension

377. See *supra* note 106 and text accompanying notes 104-05 and 303-14.

378. *Curtiss v. Brown*, 29 Ill. 201, 230 (1862); *Will of Pace*, 93 Misc. 2d 969, 400 N.Y.S.2d 488 (Sur. Ct. 1977); *Davison v. Duke University*, 282 N.C. 676, 194 S.E.2d 761 (1973); 2 A. SCOTT, *supra* note 12, §§ 167, 167.1.

379. *E.g.*, GOVERNOR'S OFFICE OF DEVELOPMENT PLANNING, *supra* note 4. See A. 7993, 1981-82 Reg. Sess. N.Y. (1981); NEW YORK PERMANENT COMM'N ON PUBLIC EMPLOYEE PENSION AND RETIREMENT SYSTEMS, REPORT TO GOVERNOR AND MEMBERS OF LEGISLATURE (1982). So far, the legal list has been "repealed" in New York only to the extent of a five percent "basket" for investments that are subject only to the percentage limitations on investments in single enterprises and a new codification of the prudent person rule. 1982 N.Y. Laws ch. 717 § 2. See also S. 6227, 1981-82 Reg. Sess. N.Y. (1981).

380. See *supra* note 117.

381. In 1981 the Comptroller of New York City suggested that a provision be added to the legal list for New York State and City pension funds that would authorize the trustees of those funds to make "geographically targeted investments." "Geographically targeted investments" are defined to include all investments targeted to the City or the state, which a) are in a business that does business in and employs residents of the targeted area, has the potential for job expansion, and will contribute to the targeted area's economic well-being; b) will assist in the promotion or preservation of small businesses in the targeted area; c) will improve its economic viability; or d) will tend to increase the supply of mortgage funds and housing in the targeted area. The proposal would limit the aggregate amount of geographically targeted investments of each pension fund to two percent of the market value of the fund's assets and would require such investments to be made "at competitive rates of return consistent with prudent investment standards." Memorandum from Harrison J. Goldin, Comptroller of the City of New York, to Trustees of New York City Retirement

funds' assets be invested in particular kinds of divergent investments.³⁸²

None of these categories of legislative proposals addresses the major issue raised by divergent investing. The subordination of safety or yield to other goals has been prevented by the prudent person standard, which is applicable to each investment decision whether or not a state also requires a finding that the particular investment is "legal" or authorized.³⁸³

Abolition of the legal list in any state would not, therefore, change the strictures of the prudent person standard. Nevertheless, we are not opposed to repeal or modification of legal list requirements. The strictures of the legal list create a family of problems, only one of which is related to divergent investments. First, the legal list reduces flexibility that the trustees of a public pension fund may desire in order to invest in various kinds of divergent investments that cannot be accommodated within the types of investments now on the legal list for that fund. A number of the states that followed New York in adopting legal lists for public pension fund investments in the early part of this century have now dropped their legal lists as cumbersome, inflexible and too slow to adapt to changing economic environments.³⁸⁴ New York has done the same with the investment standards applicable to trustees of private trusts and executors and administrators of estates.³⁸⁵ Repeal of the legal list would eliminate

Systems (Apr. 21, 1981), on file with the *Journal of Urban and Contemporary Law*. This legislation is not likely to be interpreted by the courts as relaxing the prudent person rule, because it merely adds to the legal list without clearly overriding the pervasive prudent person standard. See *supra* text accompanying note 59.

382. One proposal, introduced in the 1981-82 regular session of the New York State legislature, would have directed the trustees of New York State and City pension funds to invest at least 75% of the total amount invested each year in obligations of the state, a municipality or a public corporation of either, in businesses licensed or certified to do business in the state, or in mortgages on real property located in the state. S. 3185 (A. 4109), 1981-82 Reg. Sess. N.Y. (1981).

383. See *supra* text accompanying note 59.

384. E. COLTMAN & S. METZENBAUM, *supra* note 4, at 43. See CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 194; R. TILOVE, PUBLIC EMPLOYEE PENSION FUNDS 201 (1976).

385. N.Y. EST. POWERS & TRUSTS LAW § 11-2.2(a)(1) (McKinney Supp. 1982) provides in part:

A fiduciary holding funds for investment may invest the same in such securities as would be acquired by prudent men of discretion and intelligence in such matters who are seeking a reasonable income and preservation of their capital, provided, however, that nothing in this subparagraph shall limit the effect of any

the need for new legislation each time a new investment type is developed. Second, the legal list also reduces flexibility which may be needed if sufficient pension fund assets are to be invested with an eye to significant capital appreciation. Such appreciation, as we have seen, is important for maintaining the trustees' impartiality to all participants.³⁸⁶ Third, as public pension fund assets continue to grow, the limitations on types of investments and the extent of investments in single enterprises will become increasingly restrictive, perhaps to the point where trustees of the largest of the funds such as NYCERS are unable to invest prudently within their terms.³⁸⁷

Another reason the legislative proposals made so far do not facilitate divergent investing by public pension fund trustees is the incorporation of the prudent person standard into applicable federal law. The fiduciary provisions of ERISA and PEPPRA, as proposed, follow section 401(a) of the Internal Revenue Code in restricting trustees to the pursuit of one goal only—providing retirement benefits for participants and beneficiaries.³⁸⁸ As we saw in *Donovan v. Bierwirth*,³⁸⁹ federal courts construing these provisions of ERISA look to state court decisions for guidance because the ERISA provisions are derived from common law. A state legislature's modification of the prudent person standard after enactment of ERISA or PEPPRA would not necessarily change the application of the prudent person standard under federal law.³⁹⁰ Furthermore, it would have no effect upon the prohibited transaction provisions of the Internal Revenue Code or PEPPRA.

Nevertheless, state codification of the prudent person standard would have some utility if it tracked ERISA or PEPPRA or existing state codifications such as the New York Insurance Regulations³⁹¹ or

will, agreement, court order or other instrument creating or defining the investment powers of a fiduciary, or shall restrict the authority of a court of proper jurisdiction to instruct the fiduciary in the interpretation or administration of the express terms of any will, agreement or other instrument or in the administration of the property under the fiduciary's care.

386. See *supra* text accompanying notes 277-82.

387. See *supra* note 295.

388. See *supra* notes 75 & 117 and text accompanying notes 226-27.

389. 680 F.2d 263 (2d Cir. 1982), *aff'g* 538 F. Supp. 463 (E.D.N.Y. 1981), *cert. denied*, 103 S. Ct. 488 (1982). See *supra* text accompanying notes 209-10.

390. See Comment, *State Domestic Relations Law and Federal Tax Policy*, 66 COLUM. L. REV. 150 (1966).

391. See *supra* note 385.

the new standard for investment by fiduciaries of private trusts. A wholly new state effort to restate the prudent person rule, however well drafted, probably would result in establishing an additional layer of legal requirements for which existing law would offer minimal guidance.³⁹² Enactment of state standards modeled solely on the ERISA/PEPPRA standard offers several advantages over using other possible models. Unlike many little-interpreted state law provisions, such as the Insurance Regulations, ERISA is interpreted extensively by the courts and the Department of Labor. Because the ERISA rule is contained in all pending versions of PEPPRA, no additional change in investment standards would be needed if federal legislation regulating public pension funds were enacted in its current form. Furthermore, as we have seen, there is evidence that the Internal Revenue Service has begun to apply the ERISA fiduciary standard to trustees of public pension funds even in the absence of specific federal legislation to that effect,³⁹³ so that state enactment of the same

392. The new subdivision 7 of § 177 of the New York Retirement and Social Security Law provides an example of the confusion that may arise when each new codification of the prudent person standard is different. Enacted as part of chapter 717 of the 1982 New York session laws, this provision establishes a five percent "basket" within which trustees of New York State and City pension funds can make investments not otherwise on the legal list, provided:

- a) that such investments by any such fund shall be made as part of a diversified investment course of conduct and that the trustee or trustees have given appropriate consideration to those facts and circumstances, known or should be known [sic], which are relevant to the investment, including the role of the investment in the investment course of conduct and the purpose of such fund;
- b) that in the judgment of the trustee or trustees any such investment by any such fund furthers the purpose of the fund and takes into consideration the risk of loss and opportunity for gain, considering:
 - 1) the diversification of the investments of such fund;
 - 2) the liquidity and current return of such fund relative to the anticipated cash flow requirements of such fund; and
 - 3) the projected return of such investment and investment course of conduct relative to the funding objectives of such funds.

This "standard" is a corrupt version of the Department of Labor regulations for the ERISA fiduciary conduct standard, 29 C.F.R. § 2550.404a-1(b)(2) (1982), which does not appear to incorporate faithfully the substance of the original regulations. If the drafters of this legislation had adopted the ERISA standard, and the state legislative history showed the legislature's intention for that standard to be interpreted in conformity with the pertinent federal regulations, many ambiguities would have been avoided.

393. Detroit Letter Ruling, 371 PENS. REP. (BNA) J-9 to J-10 (Dec. 7, 1981). See *supra* text accompanying notes 259-60.

standard may well conform state and federal fiduciary standards for public pension funds even without enactment of PEPFRA.

If the trustees of a public pension fund desire greater flexibility in pursuing investments that may sacrifice some degree of safety or return in order to achieve other benefits, they should secure the enactment of state and federal legislation expanding their discretion by authorizing consideration of additional investment factors. Such legislation should simply authorize the trustees to make the desired class and/or kind of investment or to consider specified factors in making their investment decisions. Such legislation could, of course, be combined with repeal of the legal list and/or codification of a prudent person rule along the lines suggested above.

Any such state legislative proposals must be examined with possible state and federal constitutional requirements in mind. For example, article V, section 7 of the New York State Constitution, called the "nonimpairment clause," provides that: "[a]fter July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired."³⁹⁴ In *Sgaglione v. Levitt*,³⁹⁵ the New York Court of Appeals invalidated a section of the New York State Financial Emergency Act that directed the trustee of the state pension funds to purchase specified amounts of MAC securities. The court held that the legislature may not direct investment or retention of particular assets because exercise of "prudent person" discretion by trustees is a protected benefit under the nonimpairment clause.³⁹⁶ The court posed the issue as "whether in any significant degree the . . . security

394. The Congressional Pension Task Force reported that numerous states, by constitution, statute or case law, have characterized public pension plan interests or the benefits promised under such plans as contractual in nature and therefore entitled to the protection of constitutional provisions prohibiting the impairment of contracts. CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 43. See, e.g., ILL. CONST. art. XIII, § 5; Opinion of the Justices, 364 Mass. 847, 303 N.E.2d 320 (1973); *Bakenhus v. City of Seattle*, 48 Wash. 2d 695, 296 P.2d 536 (1956). *But cf.* *People ex rel. Illinois Fed'n of Teachers v. Lindberg*, 60 Ill. 2d 266, 326 N.E.2d 749 (state constitutional protection of public employee retirement benefits does not restrict the Governor's authority to reduce or veto a pension appropriation measure), *cert. denied*, 423 U.S. 839 (1975); *Village of Fairport v. Newman*, — A.D.2d —, 457 N.Y.S.2d 145 (4th Dep't 1982) (public employees union may waive members' rights and negotiate reductions in retirement benefits).

395. 37 N.Y.2d 507, 337 N.E.2d 592, 375 N.Y.S.2d 79 (1975).

396. *Id.* at 512, 337 N.E.2d at 595, 375 N.Y.S.2d at 83.

provided [the state pension systems] by reserve funds . . . will be impaired" by the challenged legislation.³⁹⁷

In dictum, however, the court acknowledged the constitutionality of exercise of "the continuing power of the Legislature to expand or restrict the classes and kinds of investment in which [the trustee] may place the funds in his care,"³⁹⁸ a reference to the legislature's power to establish and modify the legal list and, perhaps, its power over the prudent person standard. Thus, Chapter 890 of the 1975 New York session laws did not expand or contract the legal list, but authorized the trustees to consider specified factors in addition to return and safety in deciding whether to purchase and hold New York City and MAC securities.³⁹⁹ Chapter 890 was in fact a modification of the prudent person rule, as were the federal statutes concerning the Internal Revenue Code, Public Law 94-236 and Public Law 95-495, that were enacted at the same time.⁴⁰⁰

The constitutionality of this aspect of Chapter 890 under the state nonimpairment clause has not been authoritatively decided. But its state constitutionality has not been directly challenged or doubted by the courts.

Chapter 890 was challenged in *Withers v. Teachers' Retirement System*⁴⁰¹ on the grounds that it violated the due process,⁴⁰² equal protection⁴⁰³ and impairment of obligation of contract⁴⁰⁴ provisions of

397. *Id.* at 513-14, 337 N.E.2d at 596, 375 N.Y.S.2d at 84. It is unclear whether this constitutional protection would invalidate legislation such as that proposed in New York Senate bill 3185, which does not mandate any particular investment but does require a large proportion of each fund's assets to be invested in a class of investments that comprise only a small portion of the fund's potential investments and that are all more or less dependent on the economic health of one region. *See supra* note 382. Invalidation would be more likely in a jurisdiction that, unlike New York, clearly requires diversification by public pension fund trustees. *See supra* text accompanying notes 283-90.

398. 37 N.Y.2d at 513, 337 N.E.2d at 595, 375 N.Y.S.2d at 84. *See Tron v. Condello*, 427 F. Supp. 1175, 1187-89 (S.D.N.Y. 1976).

399. *See supra* note 106.

400. *See supra* text accompanying notes 104-07. *Cf.* H.R. 1507, 98th Cong., 1st Sess. (1983) (purports to make prudent certain employee benefit fund investments in residential mortgages; *see infra* text accompanying note 408).

401. 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).

402. U.S. CONST. amend. V & XIV, § 1. *See* CONGRESSIONAL TASK FORCE REPORT, *supra* note 3, at 7-13; Murphy, *supra* note 13, at 226-27, n.52.

403. U.S. CONST. amend. XIV, § 1.

404. U.S. CONST. art. I, § 10, cl. 1.

the United States Constitution. The court rejected each of these claims.⁴⁰⁵ The due process argument was rejected on the ground that the plaintiff participants had no property interest under state law to which federal due process protections could attach.⁴⁰⁶ The equal protection claim was rejected because the enactment of Chapter 890 was "an integral part of the financial plan to stave off the City's default" and prevention of the City's default was rationally related to maintenance of the pension funds' solvency as well as the City's.⁴⁰⁷ The court rejected the argument that Chapter 890 violated the contract clause of the federal constitution because the discretion of the trustees to make the authorized purchases of securities was not impaired.⁴⁰⁸ Similar challenges to state legislation modifying the prudent person standard applicable to divergent investments might succeed if the state legislation impaired property rights vested under state law or eliminated all protection afforded by the common law prudent person standard or even, perhaps, if it were enacted apart from any crisis or other circumstances of necessity.

Although enacted in exigent circumstances, Chapter 890 provides a precedent for state legislative modification of the prudent person rule in order to permit a particular type of divergent investment. Public Law 94-236 provides a similar precedent for federal legislation to modify the exclusive-benefit-of-employees requirement and prohibited transaction provisions of the Internal Revenue Code.⁴⁰⁹ This approach also might be applied to the fiduciary provisions of PEPBRA which should not be enacted in their present form if divergent investing is to be encouraged or even permitted.

405. See *Sgaglione v. Levitt*, 37 N.Y.2d at 508, 509 (synopsis of arguments before New York Court of Appeals). Plaintiffs in this suit to invalidate a state's mandatory investment requirement argued that it violated the federal prohibitions against legislative impairment of contracts and deprivation of property without due process. The court did not even advert to these arguments in its opinion, which invalidated the statute under the state constitution's pension impairment prohibition. *Cf. supra* note 394 and text accompanying notes 394-97.

406. *Withers v. Teachers' Retirement Sys.*, 447 F. Supp. at 1261.

407. *Id.* at 1259-60.

408. *Id.* at 1260, following *Tron v. Condello*, 427 F. Supp. at 1175, 1186-89 (§ 1(b) of Chapter 890, which authorizes discretionary purchases of MAC and New York City obligations by trustees of City pension funds, does not violate the federal constitution as an impairment of contract). *Cf. supra* note 405.

409. See Pub. L. 94-236, 90 Stat. 238 (1976); *supra* text accompanying note 106. See also GCM 38972, IRS POSITIONS (CCH) ¶ 1174 (June 30, 1982).

NOTES

