

The Singular Role of Public Pension Funds in Corporate Governance

Law Working Paper N° 847/2025

May 2025

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We are grateful to Ernest Lim, Ann Lipton, Amelia Miazad, Sergio Alberto Gramitto Ricci, Paul Rose, Greg Shill, Natalya Shnitser, Amir Licht, and participants at the 2025 IESE - ECGI Corporate Governance Conference, the University of Coimbra Workshop on Corporate Governance Discoveries and Innovations, the Bocconi University Workshop on Corporate Governance and Reputation, the BYU 2025 Winter Deals Conference, the Tulane Corporate and Securities Law Roundtable, the University of Hong Kong 19th AIIFL Distinguished Public Lecture, the Colloquium for Cardozo's Heyman Center on Corporate Governance, and the University of Iowa Corporate Governance Workshop for helpful comments.

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Abstract

With more than \$5 trillion in assets, public pension funds are significant players in financial markets. Like private asset managers, public pension fund managers are typically expected to exercise their discretion over investing and engagement to serve the interests of the funds' beneficiaries exclusively, a model that we term "beneficiary primacy." To this end, beneficiary primacy imposes fiduciary duties on fund managers to maximize the economic value of the fund. We argue that the application of beneficiary primacy to public pensions is wrong. It misapprehends the nature of public pension plans and leads to misguided public policy. Public pension funds differ from private funds along a variety of critical dimensions. Most importantly, their beneficiaries receive a defined benefit that does not vary based on the fund's economic performance, and their investment policies are subject to political and market accountability. Because of these differences, we maintain that public pension funds should be understood as principals serving a broader public interest that is informed by the goals and values of plan beneficiaries, public employees, taxpayers, government officials, and local communities. In serving as agents for the fund—and not its beneficiaries—fund managers can and should balance the sometimes-competing interests of the fund's multiple stakeholders. The most significant consequence of our retheorization of public pension funds is that their managers would no longer have a narrow mandate to focus exclusively on maximizing portfolio value. Beneficiary primacy is problematic because it delegitimizes values-based fund management decisions. Under the beneficiary-primacy model, fiduciary principles create litigation risk for fund managers who include environmental and social values or local interests in their investing and engagement activities. Beneficiary primacy has also led prominent commentators to criticize the political dimension of public pensions and to suggest ways to better align fund manager incentives with economic value creation. But the political nature of public pensions is a feature, not a bug. As principals with a uniquely public dimension, public pensions are valuable players in financial markets and corporate governance and provide a distinctive source of accountability for corporate leadership. Unlike private asset managers, public pension funds have embraced their role as engaged owners. They also give voice to typically disenfranchised groups and provide a mechanism for incorporating public objectives into the capital markets. Once we recognize the distinctive structure and singular role of public pension funds, it becomes clear that fund managers should not be constrained by inapposite fiduciary principles but instead should invest and engage in accordance with the broader interests they represent, interests that include dimensions of both economic value and societal values.

Keywords: public pension funds, financial markets, fiduciary duties, beneficiary-primacy model, fund managers, environmental and social values, corporate governance, shareholders, securities litigation, ESG

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JILL FISCH* & JEFF SCHWARTZ**

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ABSTRACT

With more than \$5 trillion in assets, public pension funds are significant players in financial markets. Like private asset managers, public pension fund managers are typically expected to exercise their discretion over investing and engagement to serve the interests of the funds' beneficiaries exclusively, a model that we term "beneficiary primacy." To this end, beneficiary primacy imposes fiduciary duties on fund managers to maximize the economic value of the fund. We argue that the application of beneficiary primacy to public pensions is wrong. It misapprehends the nature of public pension plans and leads to misguided public policy. Public pension funds differ from private funds along a variety of critical dimensions. Most importantly, their beneficiaries receive a defined benefit that does not vary based on the fund's economic performance, and their investment policies are subject to political and market accountability.

Because of these differences, we maintain that public pension funds should be understood as principals serving a broader public interest that is informed by the goals and values of plan beneficiaries, public employees, taxpayers, government officials, and local communities. In serving as agents for the fund—and not its beneficiaries—fund managers can and should balance the sometimes-competing interests of the fund's multiple stakeholders. The most significant consequence of our retheorization of public pension funds is that their managers would no longer have a narrow mandate to focus exclusively on maximizing portfolio value.

Beneficiary primacy is problematic because it delegitimizes values-based fund management decisions. Under the beneficiary-primacy model, fiduciary principles create litigation risk for fund managers who include environmental and social values or local interests in their investing and

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But the political nature of public pensions is a feature, not a bug. As principals with a uniquely public dimension, public pensions are valuable players in financial markets and corporate governance and provide a distinctive source of accountability for corporate leadership. Unlike private asset managers, public pension funds have embraced their role as engaged owners. They also give voice to typically disenfranchised groups and provide a mechanism for incorporating public objectives into the capital markets.

Once we recognize the distinctive structure and singular role of public pension funds, it becomes clear that fund managers should not be constrained by inapposite fiduciary principles but instead should invest and engage in accordance with the broader interests they represent, interests that include dimensions of both economic value and societal values.

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INTRODUCTION

U.S. Public pension funds manage more than \$5 trillion in assets.¹ The law, policy, and public debates about how they should manage this money are based on a theoretical model that is descriptively inaccurate and yields policy proposals that render corporations less accountable to the public. This Article provides an alternative model that reflects the institutional design of public pension funds, recognizes their significant and distinctively public role in corporate governance, and provides them greater latitude to serve their constituents.

Public pension funds have had a paradigm-shifting impact on corporate governance. They led the push to make boards more accountable to shareholders and to incorporate environmental and social considerations into corporate decision-making.² Their pathbreaking engagement led to the widely accepted proposition that it is desirable, and even obligatory, for institutional investors to engage actively in “stewardship” at their portfolio companies.³ From public pension funds, engagement spread to mutual funds, private pension funds and other institutions. Countries and stock exchanges around the world adopted stewardship codes encouraging or mandating institutional investor stewardship.⁴ The UK led this effort, starting with its 2010 Stewardship Code.⁵ Similarly, the 2019 EU Shareholder Rights Directive requires institutional investors to explain how they carry out their stewardship obligations.⁶

At the same time, commentators recognized a potential dark side to institutional investor activism. Some warned of potential conflicts of interest.⁷ A growing

¹ See *National Data*, PUB. PLANS DATA, <https://publicplansdata.org/quick-facts/national/> (last visited April 25, 2025).

² See *infra* Part I.C.; Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 797 (1993) (“Public funds have, in fact, been more active than other institutional investors in corporate governance over the past few years, offering shareholder proposals and engaging in other highly publicized activities to influence management actions.”).

³ See, e.g., Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2139 (2019) (criticizing “the Big Three’s failure to use certain potentially-valuable stewardship tools”).

⁴ GLOBAL SHAREHOLDER STEWARDSHIP (Dionysia Katelouzou & Dan W. Puchniak eds., 2022).

⁵ See *The UK Stewardship Code 2020*, FIN. REPORTING COUNCIL 8 (Oct. 23, 2019), https://media.frc.org.uk/documents/The_UK_Stewardship_Code_2020.pdf [hereinafter *UK Code 2020*] (advocating “stewardship that creates long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society”).

⁶ See *Shareholders’ Rights Directive Q&A*, EUR. COMM’N (March 14, 2017), https://ec.europa.eu/commission/presscorner/detail/en/MEMO_17_592.

⁷ See, e.g., Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B.U. L. REV. 1151 (2019); Romano, *supra* note 2, at 796 (“public pension funds face distinctive investment conflicts”).

literature raised antitrust issues related to institutions' common ownership of multiple companies in the same industry.⁸ In other work, we have emphasized that institutional investors typically act as intermediaries, raising potential agency concerns in connection with their stewardship role.⁹

The expansion of institutional engagement beyond traditional governance issues heightens these concerns. Today institutional investors increasingly focus on political, social and environmental topics. These topics raise a variety of challenges, including how corporations should weigh non-economic considerations,¹⁰ and determining what, if any, relationship exists between environmental, social and governance (ESG)¹¹ factors and long-term profits. For many institutions, engagement in such issues raises accountability problems because fund managers may act in ways that are inconsistent with the interests of their beneficiaries.¹² Engagement can also raise legitimacy concerns, particularly when it is defended as a solution to perceived failures of the political system.¹³

This commentary aggregates the actions of public pension funds with those of other institutional investors. Asset managers are uniformly conceptualized under what we term a “beneficiary primacy” view. Under this view, funds are understood as intermediaries; fund managers owe strict fiduciary duties to maximize fund economic value for the benefit of the funds' beneficiaries—fund investors in the private context and government employees and retirees in the public context.¹⁴

The beneficiary primacy view is appropriate for mutual funds and other private asset managers. In these cases, fund managers have been entrusted with responsibility for managing other people's money, usually with the purpose of

⁸ See, e.g., José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (exploring the effects of common ownership in the airline industry); José Azar, Sahil Raina & Martin Schmalz, *Ultimate Ownership and Bank Competition*, 2021 FIN. MGMT. 1 (analyzing the effects of common ownership in the banking industry).

⁹ See generally Jill E. Fisch & Jeff Schwartz, *Corporate Democracy and the Intermediary Voting Dilemma*, 102 TEX. L. REV. 1 (2023).

¹⁰ See Robert G. Eccles & Jill E. Fisch, *The Politics of Values-Based Investing*, HARV. L. SCH. F. ON CORP. GOV. (Sept. 7, 2022), <https://corpgov.law.harvard.edu/2022/09/07/the-politics-of-values-based-investing/>.

¹¹ The term ESG is fraught, and we use it here with caution. See Elizabeth Pollman, *The Making and Meaning of ESG*, 14 HARV. BUS. L. REV. 403, 407 (2024) (reporting that “[i]n a survey of institutional investors, three-quarters of respondents said there is a lack of clarity around ESG terminology”).

¹² See Fisch & Schwartz, *supra* note 9, at 5.

¹³ See, e.g., *id.* at 28 (“It is undemocratic to rely on unelected, largely unaccountable, financial institutions to set public policy without any input from the public.”).

¹⁴ As discussed *infra* Part III.A., the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001 et seq. (ERISA) is the key regulation in this area. It imposes a fiduciary duty to maximize fund value for the benefit of “participants” and “beneficiaries,” terms that encompass both employees and retirees. *Id.* § 1002(6), (7).

generating economic returns.¹⁵ Public pension funds, however, are different. A key distinction is that beneficiaries of mutual funds are residual claimants, meaning that they benefit from investment decisions that increase the value of the fund and suffer from decisions that sacrifice value. Because public pension funds typically operate under a defined benefit structure, their beneficiaries are, instead, fixed claimants whose retirement benefits do not fluctuate with the value of the pension fund.

Public pensions, unlike private pension funds and mutual funds, also have tools that significantly mitigate the risk that economic returns will be insufficient to provide the promised benefit. Unlike private actors, the obligations of public pension funds are ultimately backed by the fiscal authority of the state or local government that set up the plan, which can, among other things, require increased contributions from current employees or direct more tax revenue to the plan to ward off breach.¹⁶

Unlike mutual funds, public pension funds are structured to serve public goals. Legislation and investment policies direct fund managers to back state and local programs and instruct them on the extent to which environmental and social considerations should affect portfolio selection and engagement.¹⁷ These sources of guidance are a result of the democratic process, and as such reflect the public's goals and values. Fund boards and staff inevitably exercise discretion in balancing the divergent views of the public, for which they are politically accountable. Voters can, if they disagree with a plan's investment activities, remove both the elected officials who oversee public pension plans and the legislators who set or constrain the plan's investment policies and make the budgetary decisions about how the plan is funded.

Whereas mutual funds are correctly viewed as soulless passthroughs, the distinctive features of public pension funds warrant treating them as principals¹⁸

¹⁵ A mutual fund may identify an investment policy that, in some cases, proposes to sacrifice economic value in favor of other objectives. See, e.g., *CATH Factsheet*, CATH 2 <https://www.globalxetfs.com/content/files/CATH-factsheet.pdf> (“CATH’s consideration of the Guidelines in its investment process may result in choices not to purchase, or sell, otherwise profitable investments in companies that have been identified as being in conflict with the Guidelines. This means that the Fund may underperform other similar funds that do not consider the Guidelines when making investment decisions.”).

¹⁶ See Amy Monahan, *When a Promise Is Not a Promise: Chicago-Style Pensions*, 64 UCLA L. REV. 356, 360 (2017).

¹⁷ See *infra* note 216 and accompanying text; Kevin E. McCarthy, *Targeting State Fund Investments*, CONN. GEN. ASSEMBLY (Jan. 5, 2005), <https://www.cga.ct.gov/2005/rpt/2005-R-0028.htm>; Romano, *supra* note 2, at 809 tbl 1.

¹⁸ We recognize that in the mutual fund context, the fund is technically considered the principal. See *Goldstein v. SEC*, 451 F.3d 873, 881 (D.C. Cir. 2006) (“The adviser owes fiduciary duties only to the fund, not to the fund’s investors.”). Regardless, the adviser’s duties have been understood to require that fund managers maximize the fund’s economic value for the benefit of its beneficiaries. See Fisch & Schwartz, *supra* note 9, at 8 (“The primary mission of fund managers is typically to maximize the value of their portfolios through sound investment decisions.”). As discussed *infra* note 246 and

imbued with public values informed by the state or local government that launched and oversees them. Under this view, fund managers, whether they be government employees or external advisers, are agents of the fund and, as such, owe fiduciary duties only to the fund.¹⁹ This view extinguishes beneficiary primacy and its problematic corollary—the legal obligation to focus exclusively on the economic interests of fund beneficiaries.

Recognizing the public pension fund as a principal carries important policy implications. Our theory frees fund managers to make investments in state and local initiatives (like low-income housing), divest from certain industries (like firearms, tobacco, or oil) or certain countries (like Sudan or Russia), engage with portfolio firms on ESG issues (like carbon neutrality), and more – decisions that under the current approach provide fodder for lawsuits alleging fiduciary breach. Instead, the choice about these issues would be guided by the public entity’s vision for the fund, mediated and legitimized through the political processes to which the fund is subject. Some government entities may view these issues as distractions; others may view them as central. Most importantly, the entity’s interests, rather than solely the economic interest of fund beneficiaries, would drive the objectives of the fund. Managers’ fiduciary duties to the fund would continue to serve as a backstop to ensure that they balance such interests in good faith and do not act selfishly, but, as with corporate fiduciaries, their decisions would receive great deference.²⁰

There are further policy payoffs. A longstanding and influential line of scholarship argues that public pensions are too political and that their actions should be constrained by the obligation to focus exclusively on fund economic value.²¹ This is wrong. That public pension funds are embedded in the political structure is a feature, not a bug. The political structure is what holds public pension funds accountable for representing the public’s values—and their publicness makes them a crucial component of corporate governance. By giving voice to a wide range of

accompanying text, our view recognizes that the fund has goals distinct from any individual fund constituency and, as such, is similar to the “entity” theory of the corporation.

¹⁹ We include as a public pension “fund manager” anyone who exercises authority over the fund’s investment and engagement policy, including its board of trustees, appointed or elected investment officials and staff, and any external managers to which such authority is delegated.

²⁰ Such deference may be analogized to the application of the business judgment rule in corporate law. See, e.g., Julian Velasco, *Structural Bias and the Need for Substantive Review*, 82 WASH. U. L. Q. 821, 830 (2004) (“The business judgment rule universally is acknowledged to demonstrate great deference to directors’ business decisions and to provide a strong shield from liability for those decisions.”). On this point, we disagree with T. Leigh Anenson, who maintains that “Courts (or legislatures) should refrain from adopting the deferential business judgment rule found in the law of corporate governance” for public pensions. T. Leigh Anenson, *Public Pensions and Fiduciary Law: A View from Equity*, 50 U. MICH. J.L. REFORM 251, 281 (2017).

²¹ See, e.g., Romano, *supra* note 2.

constituents, many of whom would otherwise have no say in corporate affairs, public pension funds make corporate democracy more democratic.

Our approach also explains public pension funds' leadership role in making executives more accountable and bringing ESG to the fore. Their activism reflects their concern for the public's interest in these issues. Our model also explains why litigation challenges to ESG investing and engagement by public pension funds on the grounds that they depart from maximizing long-term value should, and usually do, fail. Historically, courts have viewed these suits skeptically but stopped short of rejecting the fiduciary principles on which they stand. Rejecting beneficiary primacy would render the law in this area more analytically coherent.

Finally, our approach highlights the role of principals in corporate governance. The startling rise and concentration of the mutual fund industry has rightly captured scholarly attention. Scholars have observed that, even though bound to do so, these intermediaries cannot fully represent their beneficiaries' diverse interests, particularly with respect to ESG.²² This is where retail investors and institutional principals, like public pension funds, come in. They bring the public's voice to corporate governance.

In Part I, we describe how public pension funds are organized and their history of activism and engagement. Part II considers the criticisms of public pension funds for investing and engagement decisions that potentially sacrifice beneficiary primacy in favor of public values, and how these criticisms underpin court challenges and restrictive legislation. In Part III, we show why beneficiary primacy is an inappropriate way to think about public pensions and, in Part IV, we explain that treating public pension funds as principals is more apt. Part V discusses the legal and policy implications of shifting paradigms, and Part VI considers and responds to potential counterarguments.

I. AN OVERVIEW OF PUBLIC PENSION FUNDS

Public pension funds stand apart from other institutional investors in their structure, their long history of corporate engagement, and their support for state and local initiatives and businesses. In this part, we explain the distinctive aspects of public pension funds and describe their expansive investing and engagement activities.²³

²² See, e.g., Fisch & Schwartz, *supra* note 9, at 20.

²³ Public pension funds also engage in a variety of advocacy activities, including taking positions on proposed legislation and participating in administrative agency rulemaking. See, e.g., *Advocacy Activities*, NAT'L CONF. ON PUB. EMP. RET. SYS., <https://www.ncpers.org/advocacy-activities> (last visited Aug. 26, 2024).

A. Structure and Scope

The scale and diversity of public pension plans is incredible. Public pension funds are the retirement vehicle for public sector employees, including federal, state, and local workers. Our focus is on state and local plans.²⁴ There are more than 5,500 such plans (Pennsylvania alone has over 1,500) and the plans cover almost 21 million people, including both active employees and retirees.²⁵ State and local pension plans account for 21% of US retirement savings.²⁶

Public pension funds, typically organized as trusts, collect contributions from public employers and employees and invest these contributions.²⁷ In 2021, 5.1% of states' general expenditures went toward funding public pensions.²⁸ Funds then pay pensions to retired public employees based on a formula that typically considers the employee's average salary over a certain period and length of employment.²⁹ State constitutions protect this promised benefit, meaning that the government is obligated to make up any potential shortfalls.³⁰ Because public pension funds involve

²⁴ We do not include the Federal Employees Retirement System in our analysis, nor do we include the investment activities of foreign sovereigns, though some of our discussion can reasonably be extended to foreign pension and sovereign wealth funds. For example, see Paul Rose, *What Responsibilities Do Sovereign Wealth Funds Have to Other Investors?*, 52 WAKE FOREST L. REV. 889 (2017) (applying fiduciary principles to analyze sovereign wealth funds' responsibilities to co-investors); Bruce E. Aronson, *A Japanese CalPERS or a New Model for Institutional Investor Activism? Japan's Pension Fund Association and the Emergence of Shareholder Activism in Japan*, 7 N.Y.U. J.L. & BUS. 571 (2011) (discussing the activism of the Pension Fund Association in Japan).

²⁵ *State and Local Backgrounders*, URB. INST., <https://www.urban.org/policy-centers/cross-center-initiatives/state-and-local-finance-initiative/projects/state-and-local-backgrounders/state-and-local-government-pensions> (last visited Dec. 26, 2024).

²⁶ *Id.*

²⁷ From 1994 to 2023, employer contributions constituted more than double employee contributions, but the majority of public pension fund revenue came from earnings on fund investments. See NASRA, *NASRA Issue Brief: Employee Contributions to Public Pension Plans* (Nov. 2024), <https://www.nasra.org/files/Issue%20Briefs/NASRAContribBrief.pdf>.

²⁸ *State and Local Backgrounders*, *supra* note 25.

²⁹ Public pension funds may also have vesting requirements, meaning that an employee must work for a minimum number of years to be eligible for any benefit. These vesting requirements, which are often longer than those in the private sector, mean that a substantial percentage of public employees do not receive any pension benefits. Jen Sidorova, *New York Shifts More Public Pension Costs to Taxpayers*, REASON FOUND. (Aug. 31, 2022), <https://reason.org/commentary/new-york-shifts-more-public-pension-costs-to-taxpayers/>.

³⁰ *Id.* ("Public pension benefits are typically constitutionally protected, meaning the government—and taxpayers—must ultimately be the backstop if projected contributions to a pension system are not enough to cover the benefits promised to workers."); Rod Crane, *Examining the Control State and Local Governments Have over Public Pension Plans*, REASON FOUND. (Sept. 12, 2023), <https://reason.org/commentary/examining-the-control-state-and-local-governments-have-over-public-pension-plans/> ("Reductions of pension benefits for current employees and retirees create the most problems for plan sponsors and give rise to the most litigation, given that accrued public pension

public employers, the employer contribution ultimately comes from taxpayers, and any shortfall is made up through taxpayer money.³¹

According to US Census data, at the end of 2022, public pension funds had \$5.3 trillion in assets.³² They invest these assets in diversified portfolios, including traditional assets like equity and bonds, and alternative assets like private equity and hedge funds, real estate and commodities.³³ As further discussed in Part I.D., public pension funds also invest locally, in infrastructure, real estate, and startups within their state (so-called ETIs).³⁴ Some states legislatively encourage such investments.³⁵ While some, particularly larger pension funds, may internally manage a portion of their assets, the bulk of fund assets are typically externally managed by mutual funds, hedge funds, and other asset managers.³⁶ On average, the largest state pension funds manage 44% of their assets internally.³⁷ Pension funds tend to manage the indexed portion of their portfolios internally because it is the least complex.³⁸

State and local governments organize the management of pension funds in manifold ways.³⁹ Some governments structurally separate the administrative and

benefits are almost ubiquitously protected from diminishment by federal and state constitutional provisions related to contracts.”); Alicia H. Munnell & Laura Quinby, *Legal Constraints on Changes in State and Local Pensions*, CTR. FOR RET. RSCH. BOS. COLL., #25 (Aug. 2012), https://crr.bc.edu/wp-content/uploads/2012/08/slp_25.pdf (surveying the types of legal protections for public pension plan beneficiaries).

³¹ See Crane, *supra* note 30.

³² *Supra* note 1. The roughly 5,500 state and local retirement systems had 14.9 million active (working) members and 12 million retirees. *Id.*

³³ *Id.*

³⁴ See Alvin D. Lurie, *ETIs: A Scheme for the Rescue of City and Country with Pension Funds*, 5 CORNELL J.L. & PUB. POL’Y 315 (1996) (“ETI is basically a scheme for using the funds of both public and private pensions to invest in, say, community projects like building bridges.”); Brian R. Talcott, Comment, *Economically Targeted Investments: Using Public Pension Fund Dollars to Close Capital Gaps in Oregon*, 74 OR. L. REV. 1031, 1033 (1995) (“Such programs cover a wide range of investments, including backing real estate mortgages, developing affordable housing, and providing venture capital for in-state businesses.”).

³⁵ See Romano, *supra* note 2, at 808, 809 tbl 1. (“The most prevalent legislation recommends that investments be made to enhance the economic climate or general welfare of the state or to increase local employment.”).

³⁶ See Jean-Pierre Aubry & Kevin Wandrei, *Internal vs. External Management for State and Local Pension Plans*, CTR. FOR RET. RSCH. BOS. COLL. (Nov. 2020), https://live-crr1.pantheonsite.io/wp-content/uploads/2020/11/SLP75_.pdf.

³⁷ Randy Miller & Rick Funston, *Public Pension Governance That Works*, FUNSTON ADVISORY SERV. 10 (March 2014), <https://www.nasra.org/Files/Topical%20Reports/Governance%20and%20Legislation/FunstonGovernance1403.pdf>.

³⁸ See Aubry & Wandrei, *supra* note 36, at 2.

³⁹ See, e.g., Miller & Funston, *supra* note 37, at 3 (describing four basic models of fund governance); Alexander Dyck, Paulo Manoel & Adair Morse, *Outraged by Compensation: Implications for Public Pension Performance*, 53 REV. FIN. STUD. 2928, 2933 (2022) (describing fund governance structures).

investment functions of their funds, while others combine them.⁴⁰ In some funds, a board makes investment decisions; for others that responsibility is vested in an investment officer; and still other funds are run by an elected official with the assistance of an investment support staff.⁴¹ Where investment decisions are made by a board, the composition of that board varies as well, and may include elected officials, employee and public representatives, investment professionals and others.

A key feature of public pension funds is that legislation and legislators typically determine their fundamental attributes. Generally, policymakers determine or have final approval over plan design, the level of benefits, budgets, hiring and firing of staff, employee salaries, and most importantly, funding.⁴² Legislation also frequently provides guidance on appropriate investments.⁴³ The fund's board of trustees and investing staff manage the fund's portfolio subject to these significant constraints.

Because public pension plans typically promise a fixed monthly amount to retirees, they are referred to as defined benefit plans.⁴⁴ Defined benefit plans can be distinguished from two alternatives—pay as you go systems and defined contribution plans. Social security is an example of a pay as you go system; employees pay social security taxes and that money immediately flows back out to beneficiaries, who receive fixed monthly payments.⁴⁵ In such a system, there is no investing or investment income. In defined contribution plans, which are typical of the private sector, employees have independent accounts into which they contribute a portion of their salary.⁴⁶ Some employers also match a portion of employee contributions.

⁴⁰ See *State Retirement System Governing Authority Arrangements*, NAT'L ASS'N STATE RET. ADM'RS. 1 (July 2024), <https://www.nasra.org/files/Topical%20Reports/Governance%20and%20Legislation/NASRA%20governing%20entities%20final.pdf>.

⁴¹ See *id.*

⁴² See NASRA, OVERVIEW OF PUBLIC PENSION PLAN GOVERNANCE 3-5 (NOVEMBER 2019), <https://www.nasra.org/files/Topical%20Reports/Governance%20and%20Legislation/NASRA%20governance%20overview.pdf>, 3-5; Natalya Shnitser, *Trusts No More: Rethinking the Regulation of Retirement Savings in the United States*, 2016 B.Y.U. L. REV. 629, 677-88 (2016) (outlining different funding structures).

⁴³ See, e.g., Danilo Risteski, Note, *Politics Before Pensions: How New ESG Rules Expose Public Pension System Vulnerabilities*, 95 U. COLO. L. REV. 805, 822 (2024) (describing Maine's adoption of legislation "requiring state pension funds to divest from fossil fuel investments").

⁴⁴ *Plan Design*, NASRA, <https://www.nasra.org/plandesign> (last visited Dec. 10, 2024) ("According to the U.S. Bureau of Labor Statistics, approximately 85 percent of employees of state and local government participate in a [defined benefit] plan").

⁴⁵ *What is Social Security?*, NAT'L ACAD. SOC. INS., <https://www.nasi.org/learn/social-security/what-is-social-security/#:~:text=As%20a%20pay%2Das%2Dyou,today's%20workers%20when%20they%20retire> (last visited July 30, 2024).

⁴⁶ At one time, defined benefit plans were the dominant form of pension plan offered by both public and private employers. See Ian Ayres & Quinn Curtis, *Beyond Diversification: The Pervasive Problem of*

Employees choose from the plan's investment options and own the balance in their accounts at retirement. Defined contribution plans shift market and investment risk to employees. Employers bear no responsibility if employee contributions or investing returns provide less than what was hoped.⁴⁷

For public pension fund managers, ensuring that there is enough money coming from employers, employees, and investment returns to pay current retirees is no easy feat. One problem is that the fund has promised fixed payments, but the value of the fund's portfolio depends on volatile markets. Another is that the fund cannot depend on steady contributions from its government sponsor. As noted above, the amount of funding it receives is allocated as part of the government's annual budgeting process.⁴⁸ When dividing resources, governments often shortchange their pensions. As a result, underfunding of public pension funds is a perennial issue.⁴⁹ According to one report, "the average funded ratio for American pension plans was 78.1%,"⁵⁰ but some are in far worse condition.⁵¹

Excessive Fees and "Dominated Funds" in 401(k) Plans, 124 YALE L.J. 1476, 1484 (2015) ("The last three decades have seen a marked shift from pension plans, which guarantee a defined retirement benefit for life, to defined-contribution plans, in which employees save for retirement through contributions to tax-advantaged retirement accounts."). Today most public pension funds are structured as defined benefit plans, although some have shifted to defined contribution plans, largely in response to concerns about underfunding. See Natalya Shnitser, *Trusts No More: Rethinking the Regulation of Retirement Savings in the United States*, 2016 B.Y.U. L. REV. 629, 636 (2016) (observing that "public-sector pension plans [mostly] still take the traditional defined-benefit form"). Our analysis is limited to defined benefit plans in which beneficiaries are fixed claimants.

⁴⁷ See Jeff Schwartz, *Rethinking 401(k)s*, 49 HARV. J. LEG. 53, 57-73 (2012) (critiquing this structure).

⁴⁸ See Amy Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 1015 ILL. L. REV. 117, 128 (2014).

⁴⁹ See, e.g., Angela Cai, *U.S. Public Pension Fund Diversity Initiatives: Practices, Rationales, and Constitutionality*, 13 DEPAUL BUS. & COMM. L.J. 107, 123-24 (2014) (describing the underfunding problem). A "[funding] ratio measures the extent to which a plan's required payouts are covered by what is currently held as assets." Council of State Governments, *Unfunded Pension Liabilities: The Growing Cost of Retirement* (May 3, 2023), <https://www.csg.org/2023/05/03/unfunded-pension-liabilities-the-growing-cost-of-retirement/>. A plan is considered underfunding if its assets are insufficient to meet those payments. *Id.*

⁵⁰ Matt Toledo, *Most US Public Pension Funds Are Distressed, per Equable Report*, CHIEF INV. OFFICER (Jan. 10, 2024), <https://www.ai-cio.com/news/most-us-public-pension-funds-are-distressed-per-equable-report/>.

⁵¹ The Chicago Teachers' Pension Fund, for example, reported a funded ratio of 47.2% as of June 30, 2023. Chicago Teachers' Pension Fund Releases 2023 Annual Comprehensive Financial Report (Jan. 31, 2024), [https://ctpf.org/news/chicago-teachers-pension-fund-releases-2023-annual-comprehensive-financial-report#:~:text=The%20funded%20ratio%20for%20pension,return\)%20in%20Fiscal%20Year%202023.](https://ctpf.org/news/chicago-teachers-pension-fund-releases-2023-annual-comprehensive-financial-report#:~:text=The%20funded%20ratio%20for%20pension,return)%20in%20Fiscal%20Year%202023.)

B. Examples of Large Public Pension Funds

A few examples illustrate how public pension funds operate and how they are structured. There are six major public pension funds in the state of New York.⁵² The largest is the New York State Common Retirement Fund (NYSCRF).⁵³ The New York State Comptroller manages the investment and engagement decisions of NYSCRF, which handles the pensions for the over one million people who are members of the New York State and Local Retirement System.⁵⁴ The fund is one of the nation's largest with almost \$268 billion in assets.⁵⁵ As of March 2023, it was 90.3% funded.⁵⁶ The NY State Comptroller is an elected official, who is the state's chief fiscal officer.⁵⁷ The current comptroller, Thomas P. DiNapoli, does not have a background in finance.⁵⁸ He was a member of the state assembly and was selected in 2007 to replace the former comptroller, "Alan Hevesi, [who] pleaded guilty to a felony fraud count and resigned."⁵⁹ In November 2023, Mr. DiNapoli was elected to his fourth term.⁶⁰

The State Comptroller has sole discretion over NYSCRF's investing and engagement decisions, with input from staff, including a chief investment officer, as well as advisory committees on investing, real estate, actuarial matters, among others.⁶¹ The comptroller's investing activities are formally constrained by a statutory "legal list" of approved investments, but the list provides the comptroller with

⁵² *State and Local Backrounders*, *supra* note 25.

⁵³ E.J. McMahon, *NY's Biggest Public Pension Fund Gained Nearly 12% in FY 2024*, EMPIRE CTR. BLOG (June 28, 2024), <https://www.empirecenter.org/publications/nys-biggest-public-pension-fund-gained-nearly-12-in-fy-2024/>. The New York State Teachers' Retirement System is also a statewide plan, with \$137.2 billion in assets as of June 30, 2023. *NYSTRS by the Numbers*, NYSTRS, <https://www.nystrs.org/about-us/press-room/nystrs-by-the-numbers/> (last visited July 30, 2024).

⁵⁴ *New York State Common Retirement Fund*, OFF. N.Y. STATE COMPTROLLER, <https://www.osc.state.ny.us/common-retirement-fund> (last visited July 31, 2024).

⁵⁵ McMahon, *supra* note 53.

⁵⁶ *NYSLRS Announces Employer Contribution Rates for 2024-25*, OFF. N.Y. STATE COMPTROLLER (Aug. 31, 2023), <https://www.osc.ny.gov/press/releases/2023/08/nyslrs-announces-employer-contribution-rates-2024-25>.

⁵⁷ *About the New York State Comptroller's Office*, OFF. N.Y. STATE COMPTROLLER, <https://www.osc.state.ny.us/about/about-comptrollers-office> (last visited Aug. 30, 2024).

⁵⁸ See *New York State Comptroller Thomas P. DiNapoli*, OFF. N.Y. STATE COMPTROLLER, <https://www.osc.state.ny.us/about/comptroller-biography> (last visited Aug. 30, 2024); *Special Report: Public Pension Fund Activism*, PROXY MONITOR (2013), <https://www.proxymonitor.org/forms/2013Finding3.aspx> (describing DiNapoli as "[a] lifelong politician with no previous investment-management experience").

⁵⁹ *Special Report: Public Pension Fund Activism*, *supra* note 58.

⁶⁰ Joseph Konig, *State Comptroller Dinapoli Secures Fourth Term*, SPECTRUM NEWS (Nov. 9, 2022, 4:00 AM), <https://ny1.com/nyc/all-boroughs/politics/2022/11/07/state-comptroller-dinapoli-secures-fourth-term>.

⁶¹ NYSCRF, *General Investment Policies for the New York State Common Retirement Fund* 6 (Dec. 19, 2023), <https://www.osc.ny.gov/files/common-retirement-fund/pdf/general-investment-policies.pdf>.

significant discretion in how to allocate fund assets.⁶² As is typical, the fund invests in a wide range of public and private assets, including alternative investments.⁶³ The comptroller also sets the fund's engagement priorities, which can vary from year to year.⁶⁴

The other five New York pension funds fall under the umbrella of the New York City Public Pension Funds.⁶⁵ As of August 2024, these funds collectively held \$242 billion in assets.⁶⁶ The city comptroller, an elected official who serves as the city's chief financial officer, oversees and acts as trustee for each of the funds,⁶⁷ each of which has its own board. The board at each of the funds makes investing decisions with advice from the comptroller.⁶⁸ For example, the New York City's Employees Retirement System (NYCERS) manages the pension fund for 350,000 municipal employees.⁶⁹ Its 11-member board consists of "the Mayor's Representative, the City Comptroller, the Public Advocate, the heads of the three unions with the largest number of participating employees, and the five Borough

⁶² *Id.* at 3 ("The Comptroller is expressly permitted to invest the assets of the CRF [Common Retirement Fund] in specific types of investments enumerated in section 235 of the State Banking Law and several sections of the RSSL [Retirement and Social Security Law], including sections 13, 313, and 177. These investments are the so-called "legal list" investments.").

⁶³ See Robert Steyer, *New York Public Pension Funds Can Add More Alternative Investments Under New Law*, PENSIONS & INVS. (Jan. 3, 2023, 3:45 PM), <https://www.pionline.com/pension-funds/new-york-public-pension-funds-can-add-more-alternative-investments-under-new-law#:~:text=The%20%22legal%20list%22%20includes%20public,investment%20trusts%2C%20among%20other%20investments> (describing adoption of legislation authorizing New York pension funds to increase their alternative investment allocations from 25% to 35%).

⁶⁴ See, e.g., Palash Ghosh, *New York State Comptroller Spells Out Stewardship Guidelines*, PENSIONS & INVS. (Apr. 4, 2024, 2:20 PM), <https://www.pionline.com/esg/new-york-state-comptroller-spells-out-stewardship-guidelines#:~:text=DiNapoli%2C%20trustee%20of%20the%20%24259.9,governance%20issues%3B%20board%20diversity%3B%20executive> (describing the fund's "stewardship priorities for 2024, which include establishing expectations related to climate risks; diversity, equity and inclusion; workforce management; governance issues; board diversity; executive compensation; and political spending disclosure, among other matters").

⁶⁵ *Pension/Investment Management: Overview*, N.Y. CITY COMPTROLLER BRAD LANDER, <https://comptroller.nyc.gov/services/financial-matters/pension/overview/> (last visited July 30, 2024).

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Pension/Investment Management: Asset Performance*, N.Y. CITY COMPTROLLER BRAD LANDER, <https://comptroller.nyc.gov/services/financial-matters/pension/asset-performance/> (last visited Aug. 30, 2024) ("Each of the five New York City retirement systems has its own Board of Trustees. These Trustees, working with the Bureau of Asset Management and the Board's consultants, make decisions on the funds' asset allocations based on factors including economic risk, return, performance, and beneficiary distributions.").

⁶⁹ *About NYCERS*, NYC EMPS.' RET. SYS., <https://www.nycers.org/about> (last visited Aug. 30, 2024).

Presidents.”⁷⁰ Maintaining five separate funds is likely inefficient, but plans to consolidate the investment function have been scrapped in light of opposition from local unions that would lose clout.⁷¹

The California Public Employees’ Retirement System (CalPERS) manages the largest public pension fund in the country with 2 million members⁷² and about \$463 billion in assets under management.⁷³ CalPERS is run by a 13-member board, four of whom are ex officio. The state controller, the state treasurer, a member of the department of human resources, and a representative of the state personnel board are all ex officio members of the board. Six board members are elected by plan members.⁷⁴ For example, retiree members elect one board member.⁷⁵ Finally, the governor appoints two board members (an insurance representative and a representative of a local government), and the Speaker of the Assembly and the State Senate Rules Committee jointly select a public representative. The size of this board belies the significant influence individual board members can wield. For example, during his tenure as California Treasurer from 1999 to 2007, Phil Angelides played a major role in directing CalPERS to pursue a labor-oriented agenda and to pursue social investing even though technically only an ex officio board member.⁷⁶

The State Department of Finance sets employer and employee contribution rates,⁷⁷ subject to board approval and adjustment by the California legislature.⁷⁸ The fund has a widely diversified portfolio, including an increasing allocation to private

⁷⁰ *Board of Trustees*, NYC EMPS.’ RET. SYS., <https://www.nycers.org/board-trustees> (last visited Aug. 30, 2024).

⁷¹ See Martin Z. Braun, *New York City’s Pension-Fund System Plagued by Inefficiencies*, BLOOMBERG (Mar. 10, 2023, 11:31 AM), <https://www.bloomberg.com/news/articles/2023-03-09/nyc-pension-fund-system-inefficiencies-create-growing-costs>.

⁷² See *CalPERS Story*, CALPERS, <https://www.calpers.ca.gov/page/about/organization/calpers-story> (last updated Apr. 21, 2023).

⁷³ See *Investments*, CALPERS, <https://www.calpers.ca.gov/page/investments> (last updated Aug. 2, 2024).

⁷⁴ See Ed Mendel, *CalPERS President Loses Board Seat to Policeman*, CALPENSIONS (Oct. 5, 2018), <https://calpensions.com/2018/10/05/calpers-president-loses-board-seat-to-policeman/> (describing composition of CalPERS board).

⁷⁵ See *Board Members*, CALPERS, <https://www.calpers.ca.gov/page/about/board/board-members> (last updated July 31, 2024).

⁷⁶ See Steven Malanga, *A Grandstanding Politician Investigates Wall Street*, MANHATTAN INST. (Sept. 23, 2009), <https://manhattan.institute/article/a-grandstanding-politician-investigates-wall-street>.

⁷⁷ *2023-24 State Employer and Employee Contribution Rates*, CALPERS (Apr. 19, 2023), <https://www.calpers.ca.gov/page/employers/policies-and-procedures/circular-letters/200-020-23>.

⁷⁸ See *id.* (“The California State Legislature may adopt higher contribution rates in the annual Budget Act than those shown in the table above. . . . The Legislature has approved rates greater than the actuarially determined rate every year since FY 2013-14 and it is anticipated that the Legislature will continue to do so while an unfunded liability remains.”).

equity.⁷⁹ CalPERS internally manages much of its portfolio.⁸⁰ It posted returns of 7.5% in 2022, and in June 2023, was 72% funded.⁸¹

The Employees Retirement System of Texas (ERS) manages the public pension fund for employees of Texas state agencies.⁸² Participation by enumerated state employees, including police officers, elected officials and judges, is mandatory.⁸³ Created by the Texas State Constitution in 1946,⁸⁴ the pension fund has been the subject of ongoing financing challenges and recent bipartisan efforts to improve its solvency.⁸⁵

A six-member Board of Trustees oversees the fund. Three trustees are appointed, one each by the Governor, the Speaker of the House of Representatives, and the Chief Justice of the Texas Supreme Court.⁸⁶ The other three are elected by current and former ERS members. The Investment Advisory Committee, which consists of seven individuals with financial expertise, advises the board on investments. The board has the authority to set and to modify the ERS investment

⁷⁹ See, e.g., *CalPERS Will Increase Private Markets Investments*, CALPERS (Mar. 19, 2024), <https://www.calpers.ca.gov/page/newsroom/calpers-news/2024/calpers-will-increase-private-markets-investments> (describing CalPERS' Board's approval of proposal to increase fund's allocations in private equity and private debt).

⁸⁰ In 2019, for example, CalPERS fired “almost all its external and emerging equity managers,” moving the money “into several different internally run equity index strategies.” Randy Diamond, *Almost \$14 Billion Pulled From CalPERS Equity Managers*, CHIEF INV. OFFICER (Dec. 16, 2019), <https://www.ai-cio.com/news/almost-14-billion-pulled-calpers-equity-managers/>.

⁸¹ Arleen Jacobius, *CalPERS Funded Status Inches up from 2022 Plunge*, PENSIONS & INVS. (Nov. 17, 2023), https://www.pionline.com/pension-funds/calpers-funded-status-inches-2022-plunge?adobe_mc=MCMID%3D24689791461561770191400269571911222435%7CMCORGID%3D138FFF2554E6E7220A4C98C6%2540AdobeOrg%7CTS%3D1722367087&CSAuthResp=1722367135501%3A0%3A501262%3A391%3A24%3Asuccess%3A01163A94DF8622A04B517C85C6D9322E.

⁸² *About ERS*, ERS, <https://www.ers.texas.gov/about-ers> (last visited July 30, 2024). Texas has a separate retirement system for its teachers, the Teachers Retirement System of Texas (TRS). The TRS is the largest public retirement system in Texas, serving 2 million people. *About TRS*, TRS, https://www.trs.texas.gov/Pages/about_trs.aspx (last visited July 30, 2024).

⁸³ *State of Texas Retirement for Active Employees*, ERS, <https://www.ers.texas.gov/Active-Employees/Retirement/State-of-Texas-Retirement#:~:text=The%20State%20of%20Texas%20Retirement,Texas%20agencies%2C%20with%20mandatory%20participation> (last visited July 30, 2024).

⁸⁴ *Employees Retirement System of Texas, Investment Policy Statement*, ERS 1 (Aug. 23, 2023), <https://www.ers.texas.gov/about-ers/ers-investments-overview/investments-division/ers-investment-policy.pdf>.

⁸⁵ See Steven Gassenberger, *Texas Legislature Continues Bipartisan Push to Modernize Public Retirement Benefits*, REASON FOUND. (Sept. 11, 2023), <https://reason.org/commentary/texas-legislature-continues-bipartisan-push-to-modernize-public-retirement-benefits/>.

⁸⁶ *ERS Trustees*, ERS, <https://www.ers.texas.gov/about-ers/ers-board-of-trustees/members> (last visited Aug. 30, 2024).

policy,⁸⁷ which sets out permissible parameters for both investment and stewardship.⁸⁸

C. Public Pension Funds and Corporate Governance

Public pension funds have long received attention for their active involvement in corporate governance.⁸⁹ They engage with portfolio companies through their voting and communications with corporate management, their participation in investor organizations, and through litigation.⁹⁰ Public pension funds were also among the first socially responsible investors, screening investments based on social or political considerations and divesting from companies on such grounds.⁹¹

As early as the 1970s, “several states passed laws to screen out ‘sin stocks’ such as tobacco, alcohol and gambling” from their pension funds.⁹² In the 1980s, many state and local legislatures adopted legislation prohibiting or restricting public pension fund investments in firms doing business with South Africa and Sudan.⁹³ The New York City Public Pension Funds were at the forefront of this movement.⁹⁴

More recently, divestment efforts have focused on firearms and fossil fuels.⁹⁵ The California State Teachers Retirement System (CalSTRS) divested from publicly

⁸⁷ See *Employees Retirement System of Texas, Investment Policy Statement*, ERS 3 (Aug. 23, 2023), <https://www.ers.texas.gov/about-ers/ers-investments-overview/investments-division/ers-investment-policy.pdf>. The Texas Government Code requires the development of a written investment policy but does not specify the types of permissible investments. See *Investment Policies*, TEX. PENSION REV. BD., <https://www.prb.texas.gov/investments/investment-policies/> (last visited Aug. 30, 2024).

⁸⁸ See *Employees Retirement System of Texas*, *supra* note 87, at addendum 1.

⁸⁹ See, e.g., Stephen J. Choi & Jill E. Fisch, *On Beyond CalPERS: Survey Evidence on the Developing Role of Public Pension Funds in Corporate Governance*, 61 VAND. L. REV. 315, 316 (2008) (“Academics, regulators, and policymakers have looked to the examples of CalPERS and several other public pension funds to support the claims that institutional investors can use their substantial equity stakes and sophistication effectively to ... improve corporate performance.”).

⁹⁰ *Id.*

⁹¹ As Maria O’Brien explains, public pension funds were the initial drivers of what was termed “socially responsible investing.” Maria O’Brien, *Socially Responsible Investing in an Inefficient Market: Doing Good Versus Doing Well*, 42 AM. U. L. REV. 1 (1992); *but see* Amelia Miazad, Faith Investors (Dec. 2024) (unpublished manuscript) (on file with authors) (describing a similar and longstanding engagement by faith investors similar investing strategies).

⁹² Jean-Pierre Aubry et al., *ESG Investing and Public Pensions: An Update*, CTR. FOR RET. RSCH. BOS. COLL. 1 (Oct. 2020), <https://crr.bc.edu/wp-content/uploads/2020/10/SLP74.pdf>.

⁹³ See Kevin Lewis, *Dealing with South Africa: The Constitutionality of State and Local Divestment Legislation*, 61 TUL. L. REV. 469, 471–72 (1987) (describing passage of divestment bills during the mid-1980s).

⁹⁴ *Special Report: Public Pension Fund Activism*, *supra* note 58.

⁹⁵ See, e.g., *Connecticut to Stop Investing Pension Money in Gun Manufacturers*, CBS NEWS (Dec. 3, 2019, 4:00 PM), <https://www.cbsnews.com/news/connecticut-pension-fund-to-divest-30-million-from-gun-companies/> (describing decision by Connecticut’s treasurer, who oversees the state’s public

traded gun manufacturers in 2013 in response to the mass shooting at Sandy Hook Elementary School.⁹⁶ Three of the New York City Public Pension Funds completed divestment from fossil fuels in 2022.⁹⁷ In 2021, Maine became the first state to require that its state pension fund do the same.⁹⁸ More broadly, in April 2023, the New York City comptroller, together with the boards of the New York City Employees' and Teachers' Retirement Systems, announced that they had jointly agreed to adopt implementation plans to reach a goal of net zero emissions in their investment portfolios by 2040.⁹⁹

ESG screening complements fund divestment efforts. CalPERS, for instance, has carefully managed the environmental and social aspects of its portfolio. According to Proxy Monitor, by "2011, CalPERS had adopted 111 different policy statements on the environment, social conditions, and corporate governance, all dictating or restricting how its funds could be invested."¹⁰⁰ And CalPERS is not alone. According to a Boston College study, "public pensions applied ESG [criteria] to at least \$3 trillion in assets, which represents more than half of all assets in public pension funds."¹⁰¹ Public pension funds have also actively participated in and, in

pension funds, "to divest \$30 million worth of shares in civilian firearm manufacturers while banning similar future investments and creating incentives for banks and financial institutions to enact gun-related policies when lending to companies"); Liz Moyer, *New York City Pension Fund to Divest Itself of Gun Retailer Stock*, N.Y. TIMES (July 14, 2016), <https://www.nytimes.com/2016/07/15/business/dealbook/new-york-city-pension-fund-to-divest-itself-of-gun-retailer-stock.html> (reporting announcement by New York City Employees' Retirement System to sell its holdings of three retail companies because they sell guns).

⁹⁶ Yuki Noguchi, *Pension Funds Under Pressure to Sell Investments in Gun-Makers*, NPR (Feb. 26, 2018, 5:34 PM), <https://www.npr.org/2018/02/26/588810413/pension-funds-under-pressure-to-sell-off-investments-in-gun-makers>. CalSTRS has also divested from coal. *Id.*

⁹⁷ Press Release, NYC Comptroller Lander Proposes Excluding Future Private Markets Investments in Midstream and Downstream Fossil Fuel Infrastructure by the New York City Retirement Systems (Oct. 22, 2024), <https://comptroller.nyc.gov/newsroom/nyc-comptroller-lander-proposes-excluding-future-private-markets-investments-in-midstream-and-downstream-fossil-fuel-infrastructure-by-the-new-york-city-retirement-systems/>.

⁹⁸ Joshua Lichtenstein, Michael Littenberg & Reagan Haas, *ESG and Public Pension Investing in 2023: A Year-To-Date Recap and Analysis*, HARV. L. SCH. F. ON CORP. GOV. (Nov. 22, 2023), <https://corpgov.law.harvard.edu/2023/11/22/esg-and-public-pension-investing-in-2023-a-year-to-date-recap-and-analysis/>.

⁹⁹ Press Release, NYC Comptroller Brad Lander, New York City Pension Funds Adopt Implementation Plan to Achieve Net Zero Investment Portfolio by 2040 (Apr. 5, 2023), <https://comptroller.nyc.gov/newsroom/new-york-city-pension-funds-adopt-implementation-plan-to-achieve-net-zero-investment-portfolio-by-2040/>.

¹⁰⁰ *Special Report: Public Pension Fund Activism*, *supra* note 58.

¹⁰¹ Aubry et al., *supra* note 92, at 3.

some cases, founded investor organizations designed to promote good governance and responsible investing.¹⁰²

In addition, public pension funds pioneered active use of shareholder voting power. Regulatory pressure caused mutual funds and private pensions to increase their attention to voting the shares of their portfolio companies.¹⁰³ Public pensions needed no such push. For example, CalPERS, the NYSCRF, and other public pensions were among the first institutional investors to use public “vote no” campaigns to indicate dissatisfaction with management.¹⁰⁴ In one such campaign, in 2004, CalPERS withheld its vote for directors at hundreds of companies that were permitting auditors to perform non-audit services.¹⁰⁵ That same year, the fund led an ultimately unsuccessful campaign to defeat Safeway’s CEO, Steven Burd, alleging a lack of board independence.¹⁰⁶ More recently, NYSCRF withheld votes on DEI grounds. Its 2022 voting guidelines indicated that the fund would vote against “[a]ll incumbent board nominees at companies with no board directors identifying as an underrepresented minority.”¹⁰⁷

¹⁰² For example, CalPERS co-founded Climate Action 100+, an organization of more than 700 institutional investors focused on addressing climate change. See Communications & Stakeholder Relations Off. Pub. Affairs, *CalPERS to Lead Committee Governing Climate Action 100+*, CALPERS (Apr. 16, 2024), <https://www.calpers.ca.gov/page/newsroom/calpers-news/2024/calpers-to-lead-committee-governing-climate-action-100-plus>. A number of public pension funds are part of the Investor Stewardship Group which is “a sustained initiative to establish a framework of basic investment stewardship and corporate governance standards for U.S. institutional investor and boardroom conduct.” *About the Investor Stewardship Group and the Framework for U.S. Stewardship and Governance*, INV. STEWARDSHIP GRP., <https://isgframework.org/> (last visited Aug. 30, 2024).

¹⁰³ In 1988, the DOL promulgated its “Avon letter” advising private pension fund managers that “the decision[s] as to how proxies should be voted ... are fiduciary acts of plan asset management.” Letter from Alan D. Lebowitz, Deputy Assistant Sec’y, Dep’t Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Prods., Inc. (Feb. 23, 1988), in 15 PENS. REP. (BNA) 371, 391 (Feb. 29, 1988). In 2003, the SEC adopted a rule requiring mutual funds to develop voting policies and to vote the shares of their portfolio companies in the best interests of their beneficiaries. 17 C.F.R. § 275.206(4)-6 (2003).

¹⁰⁴ Joseph A. Grundfest, *Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates*, 45 STAN. L. REV. 857, 867 (1993).

¹⁰⁵ Heather Gillers, *CalPERS Plans to Vote to Replace Warren Buffett as Berkshire Hathaway’s Chairman*, WALL ST. J. (Apr. 20, 2022, 5:04 PM), <https://www.wsj.com/articles/calpers-plans-to-vote-to-replace-warren-buffett-as-berkshire-hathaways-chair-11650468931>. The fund has also frequently aligned with activist challenges to incumbent boards. Randall Smith, *Some Big Public Pension Funds Are Behaving Like Activist Investors*, N.Y. TIMES (Nov. 28, 2013, 8:48 PM), <https://archive.nytimes.com/dealbook.nytimes.com/2013/11/28/some-big-public-pension-funds-are-behaving-like-activist-investors/>.

¹⁰⁶ See James F. Peltz, *CalPERS Blasts Safeway Decision to Retain Burd*, L.A. TIMES (May 4, 2004), <https://www.latimes.com/archives/la-xpm-2004-may-04-fi-safeway4-story.html>.

¹⁰⁷ NYSCRF, *New York State Common Retirement Fund Proxy Voting Guidelines* 9–10 (2022), <https://www.osc.ny.gov/files/common-retirement-fund/corporate-governance/pdf/proxy-voting-guidelines-2022.pdf>.

Public pension funds have also introduced and supported ESG-related shareholder proposals for many years. They were among the first to push for corporate governance reforms, including majority voting, separation of the CEO and board chairman positions, and proxy access, efforts that have successfully increased managerial accountability to shareholders.¹⁰⁸

Public pension funds also led the push for corporate managers to take environmental and social issues seriously.¹⁰⁹ There are numerous well-known examples. The SEC’s controversial no-action letter to Cracker Barrel authorizing the company to exclude a shareholder proposal seeking to have the company add sexual orientation to its non-discriminatory hiring policy, which subsequently led to the SEC’s high profile revision of its shareholder proposal policy, responded to a 1992 shareholder proposal submitted by NYCERS.¹¹⁰ More recently, in 2022, NYSCRF filed shareholder proposals at Tesla, Starbucks, and Activision/Blizzard related to the #MeToo movement.¹¹¹ In 2023, the NYSCRF filed shareholder proposals related to DEI at nine companies.¹¹²

Somewhat less known is the active role that public pension funds have taken, especially since the *Citizens United* decision,¹¹³ in sponsoring shareholder proposals seeking greater disclosure of corporate political spending and voting in support of such proposals sponsored by others.¹¹⁴ The NYSCRF has filed 185 political spending proposals since *Citizens United* and reports that it was able to persuade 61 companies to agree to adopt the requested disclosures.¹¹⁵

¹⁰⁸ See, e.g., Gillers, *supra* note 105; Holly J. Gregory, Rebecca Grapsas & Claire Holland, *Proxy Access: A Five-Year Review*, HARV. L. SCH. F. ON CORP. GOV. (Feb. 4, 2020), <https://corpgov.law.harvard.edu/2020/02/04/proxy-access-a-five-year-review/> (describing New York City Public Pension Funds’ campaign for proxy access).

¹⁰⁹ See, e.g., *Special Report: Public Pension Fund Activism*, *supra* note 58 (reporting that “64 percent of all shareholder proposals sponsored by state and local employee pension funds” have been social and policy issues).

¹¹⁰ Phillip R. Stanton, *SEC Reverses Cracker Barrel No-Action Letter*, 77 WASH. U. L. Q. 979, 987–88, 104 (1999).

¹¹¹ Michael Katz, *NY Pension Calls on Firms to Report Abuse, Harassment, Discrimination*, CHIEF INV. OFFICER (Feb. 22, 2022), <https://www.ai-cio.com/news/new-york-demands-political-disclosure-from-twitter-six-other-companies-2/>.

¹¹² Michael Katz, *New York State Comptroller Files Diversity Proposals*, CHIEF INV. OFFICER (Feb. 21, 2023), <https://www.ai-cio.com/news/new-york-state-comptroller-files-diversity-proposals/>.

¹¹³ *Citizens United v. FEC*, 558 U.S. 310 (2009).

¹¹⁴ See, e.g., Jill Fisch & Adriana Z. Robertson, *Political Disclosure Proposals* (Dec. 2024) (unpublished working paper) (on file with authors) (reporting substantial differences between public pension funds and mutual funds regarding their support of political disclosure proposals).

¹¹⁵ Press Release, Off. N.Y. State Comptroller, DiNapoli Files Shareholder Proposals with Six Companies on Political Spending (Jan. 23, 2024), <https://www.osc.ny.gov/press/releases/2024/01/dinapoli-files-shareholder-proposals-six-companies-political-spending>.

Moreover, public pension funds have played a distinctive role as virtually the only type of institutional investor to respond to Congress's call to serve as lead plaintiffs in securities class actions.¹¹⁶ Studies have documented that public pension fund engagement in securities litigation is correlated with improved returns to plaintiffs, and, in some cases, lower attorneys' fees.¹¹⁷

Finally, although the allocation of public pension fund assets to private equity is controversial, some funds are using their power to bring ESG to this opaque part of financial markets. In July 2024, NYCERS, led by New York City Comptroller Brad Lander, an elected official, adopted new rules that require the private equity funds in its portfolio to honor protections for tenants in residential real estate properties owned by the funds.¹¹⁸

D. Public Pension Funds and ETIs

Another unique feature of public pension funds is their investments in ETIs. ETIs provide capital for local and state projects, including infrastructure development, low-income housing, small businesses, and entrepreneurs.¹¹⁹ In 1975 the New York City public pension funds played a critical role in helping the city to avoid bankruptcy by committing to buy \$2.5 billion of city debt that was sufficiently risky that it could not be sold to the public.¹²⁰

Today, the large California and New York pension plans discussed above include ETIs in their portfolios. According to the NYSCRF website, "Whenever possible, the Comptroller guides the Fund to invest in New York-based business

¹¹⁶ David Webber, *Is Pay-to-Play Driving Public Pension Fund Activism in Securities Class Actions - An Empirical Study*, 90 B.U. L. REV. 2031, 2034 (2010).

¹¹⁷ See, e.g., Michael Perino, *Institutional Activism Through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions*, 9 J. EMPIR. STUD. 368, 390 (2012) (reporting that "Cases with public pension fund lead plaintiffs settle for greater amounts. . . and the fees courts ultimately award are significantly lower."); Stephen J. Choi, Jill E. Fisch & A. C. Pritchard, *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 WASH. UNIV. LAW Q. 869, 872 (2005) (finding "that public pension funds are significantly correlated with high-value outcome cases, defined as outcomes involving a settlement of more than five percent of the stakes.").

¹¹⁸ H. Claire Brown, *A New York City Pension Makes Renters' Rights an Investment Priority*, WALL ST. J. (July 17, 2024, 5:30 AM), <https://www.wsj.com/articles/a-new-york-city-pension-makes-renters-rights-an-investment-priority-26534abd>.

¹¹⁹ See Jayne Elizabeth Zanglein, *Protecting Retirees While Encouraging Economically Targeted Investments*, 5 KAN. J.L. & PUB. POL'Y 47 (1996) (describing "the ongoing debate over economically targeted investments"); James P. Hawley, *Political Voice, Fiduciary Activism, and the Institutional Ownership of U.S. Corporations, the Role of Public and Noncorporate Pension Funds*, 38 SOCIO. PERSPS. 415, 426 (1995) ("ETIs vary dramatically, from bail-outs of state governments in fiscal crisis to real estate and construction investments, infrastructure investments, job training, export promotion, and all forms of local and regional investment.").

¹²⁰ Donna E. Shalala & Carol Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119, 1129.

ventures, companies and other programs that spur economic growth and create and retain jobs.”¹²¹ In addition, the fund provides credit financing to NY-based companies and funds affordable housing in New York.¹²² Similarly, according to the New York City Public Pension Funds’ website, the funds “have been successfully and prudently invested in many Economically Targeted Investments (ETIs), which are designed to benefit low-, moderate- and middle- income New Yorkers. These investments, in addition to financing the renovation or new construction of affordable housing, create thousands of construction jobs.”¹²³

CalPERS explains that “[t]o support our members, we also invest in the health and infrastructure of the Golden State itself – building portfolios that bolster local business and funding enterprises that directly influence and stimulate our economy.”¹²⁴ Total investments in California projects and California-based companies totaled \$53.7 billion in 2022.¹²⁵ As part of these activities, CalPERS has a California Initiative, “a \$1 billion private equity, economically targeted investment (ETI), [which] seeks to invest in companies located in traditionally underserved markets, primarily, but not exclusively, located in California.”¹²⁶

The above discussion highlights the defining features of public pension funds: they are public institutions, enmeshed in the state or local governments that formed them; they have been leaders in socially responsible investing and shareholder engagement, first focusing on management accountability to investors and later, on ESG; and they invest locally in projects that foster public objectives. Despite their significant accomplishments, they are widely condemned, and usually for doing the very things that make them special.

II. CHALLENGES TO THE ROLE OF PUBLIC PENSION FUNDS

Instead of celebrating public pensions for modeling engaged and effective stewardship, politicians, commentators, and litigants have criticized them for lack of focus on economic returns. They have challenged pension fund investment and engagement decisions that favor local priorities, protect public employment, or

¹²¹ *Investing in New York*, OFF. N.Y. STATE COMPTROLLER, <https://www.osc.state.ny.us/common-retirement-fund/investing-new-york> (last visited Aug. 30, 2024).

¹²² *Id.*

¹²³ *Pension/Investment Management: FAQs*, N.Y. CITY COMPTROLLER BRAD LANDER, <https://comptroller.nyc.gov/services/financial-matters/pension/faqs/> (last visited Aug 30, 2024).

¹²⁴ *CalPERS Story*, *supra* note 72. For more on CalPERS’ infrastructure investments, see *CalPERS Infrastructure Investment Outreach Review: Laying the Groundwork for Collaboration*, CALPERS (Oct. 15, 2012), <https://www.calpers.ca.gov/docs/forms-publications/infrastructure-investment-outreach.pdf>.

¹²⁵ CALPERS, CALPERS FOR CALIFORNIA REPORT (2022), https://www.calpers.ca.gov/docs/board-agendas/202311/invest/item04i-01_a.pdf.

¹²⁶ *California Initiative 2016 Report*, PAC. CMTY. VENTURES (June 19, 2017), <https://www.pacificcommunityventures.org/2017/06/19/california-initiative-2016-report/>.

incorporate ESG considerations for deviating from beneficiary primacy's returns mandate.¹²⁷ Because these activities focus on “collateral benefits,”¹²⁸ they have served as grounds for litigation and legislative pushback.

A. Litigation

Public pension funds always face the threat of litigation when they pursue collateral benefits.¹²⁹ One of the earliest such challenges involved the decision by certain New York City funds, described above, to purchase billions of dollars in bonds “to stave off the City's potential bankruptcy.”¹³⁰ In *Withers v. Tchrs.’ Ret. Sys. of New York City*, fund beneficiaries sued, arguing that the purchases violated the fund manager’s fiduciary obligations because the objective of the investment was “rescuing the City, rather than enhancing the soundness of the fund.”¹³¹ The court disagreed, holding that bolstering the city’s finances was in the best interests of the fund because the City was “a major contributor” to the fund’s assets and “the ultimate guarantor” of the fund’s obligations.¹³² It also warned, however, that “had the City’s potential bankruptcy not been a factor,” the investments “would have

¹²⁷ See, e.g., Romano, *supra* note 2; Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381 (2020); Polly Bindman, *US Public Pension Funds Caught in the Crossfire of the War on “Woke” Investing*, ENERGY MONITOR (Oct. 16, 2023), <https://www.energymonitor.ai/regulation-policy/us-public-pension-funds-caught-in-the-crossfire-of-anti-esg-laws/?cf-view> (quoting West Virginia State Treasurer Riley Moore as stating that “states must collectively stand up against ESG proxy voting activism with our public retirement funds”); Matt Cole, *Fiduciary Duties of Public Pension Systems and Registered Investment Advisors*, HARV. L. SCH. F. ON CORP. GOV. (Mar. 1, 2023), <https://corpgov.law.harvard.edu/2023/03/01/fiduciary-duties-of-public-pension-systems-and-registered-investment-advisors/>. (“Accordingly, public pension system fiduciaries are prohibited from choosing investments, adopting investment strategies, or exercising appurtenant voting rights based on ESG considerations.”) (emphasis added).

¹²⁸ See Schanzenbach & Sitkoff, *supra* note 127, at 397 (distinguishing between “collateral benefits” investing and “risk-return” investing). The term, collateral benefits, has been in use in this area since at least the 1990s. See, e.g., Dept. of Labor, Interpretive Bulletin Relating to the Employee Retirement Income Security Act of 1974 (June 23, 1994) (“While the Department has stated that a plan fiduciary may consider collateral benefits in choosing between investments that have comparable risks and rates of return, it has consistently held that fiduciaries who are willing to accept expected reduced returns or greater risks to secure collateral benefits are in violation of ERISA.”).

¹²⁹ See, e.g., Lizzy Lees, What’s Next for Public Pensions and ESG?, National Conference on Public Employee Retirement Systems, Jan. 1, 2024, https://www.ncpers.org/blog_home.asp?display=310 (explaining that public pension funds’ “pro- and anti-ESG policies have resulted in several key lawsuits—the results of which will likely have lasting implications for public pensions across the country.”)

¹³⁰ *Withers v. Tchrs.’ Ret. Sys. of New York City*, 447 F. Supp. 1248 (S.D.N.Y. 1978).

¹³¹ *Id.* at 1254.

¹³² *Id.* at 1256.

violated traditional notions of prudence as developed by the New York Court of Appeals.”¹³³

A similar but more limited challenge involved legislation directing the West Virginia public pension fund to invest in an ETI. In *State of West Virginia v. State of West Virginia Investment Management Board*, the state pension board challenged a bill directing it to invest \$150 million of the fund’s assets in jail authority bonds for “construction and renovation projects, arguing that the instruction was inconsistent with its fiduciary duties.”¹³⁴ The court found that the mandate was lawful because state law gave the power to the legislature to establish “guidelines...for the prudent investment of such funds.”¹³⁵ The direction to invest in jail bonds was just one such mandate.

Divestment has also spawned legal challenges. The leading case is *Board of Trustees v. Mayor & City Council of Baltimore City*.¹³⁶ Because of concerns about apartheid, Baltimore enacted two city ordinances requiring its public pension plans to divest from companies doing business in or with South Africa. The trustees of the pension plans challenged the ordinances, claiming that they caused the trustees to violate their fiduciary duties of prudence and loyalty.¹³⁷

The trustees argued that the ordinances were problematic under the duty of loyalty because they “radically reduc[ed] the universe of eligible investments.”¹³⁸ The court disagreed, concluding that the trustees could still prudently manage the investment portfolio because “economically competitive, substitute investments remain[ed] available” and “the Ordinances permit the Trustees to construct an almost perfectly diversified portfolio.”¹³⁹ For the same reason, the court dismissed the trustees’ argument that the “Ordinances alter[ed] the duty of prudence by mandating the consideration of social factors unrelated to investment performance.”¹⁴⁰

The trustees further argued that the ordinances contravened the duty of loyalty “by requiring them to consider the interests of persons other than the beneficiaries and by requiring them to manage the systems for purposes other than providing benefits.”¹⁴¹ The court rejected these arguments, reasoning that the costs of

¹³³ *Id.* at 1255.

¹³⁴ *State ex rel. W. Va. Reg’l Jail & Corr. Facility Auth. v. W. Va. Inv. Mgmt. Bd.*, 508 S.E.2d 130 (W. Va. 1998).

¹³⁵ *Id.* at 418.

¹³⁶ *Bd. of Trs. v. Mayor & City Council of Balt. City*, 562 A.2d 720 (Md. App. Ct. 1989).

¹³⁷ *Id.* at 733, 738.

¹³⁸ *Id.* at 735.

¹³⁹ *Id.* at 735.

¹⁴⁰ *Id.* at 736.

¹⁴¹ *Id.* at 738.

divestiture were small¹⁴² and that social investing was permissible in circumstances where trustees “may believe that” such investments “will in the long run best serve the beneficiaries’ interests and most effectively secure the provision of future benefits.”¹⁴³

As with the ETI cases, *City of Baltimore* applied beneficiary primacy but upheld a socially motivated investment. Rather than overrule the doctrine, the court found limited space for non-economic considerations within it, acknowledging that “[t]he Mayor and City Council of Baltimore were motivated to enact the Ordinances, in part, because the Trustees’ prior investment practices offended a growing number of the systems’ beneficiaries and residents of the City,” and concluding that such motivations were lawful, at least where the economic cost of complying with the ordinances was *de minimis*.¹⁴⁴

Today, we are in the midst of a new wave of litigation.¹⁴⁵ The recent high-profile case brought by beneficiaries challenging the decision by three New York City Pension Funds to divest from fossil fuels is illustrative.¹⁴⁶ The suit alleged that the decision breached the funds’ fiduciary obligations and increased underfunding.¹⁴⁷ In July 2024, the court dismissed the lawsuit, concluding that the plaintiffs had contractual claims that were not impaired by divestment, and that “plaintiffs’ allegations regarding their plans’ potential inability to meet their payment obligations

¹⁴² *Id.* at 737 n. 36 (“[T]he costs [of divestiture] are *de minimis* when viewed in relation to the systems’ total assets.”).

¹⁴³ *Id.* at 738.

¹⁴⁴ *Bd. of Trs. v. Mayor & City Council of Balt. City.*, 562 A.2d at 108–09.

¹⁴⁵ See Amy Roy, Joshua Lichtenstein & Robert Skinner, *The New Battleground in the Fight over ESG’s Role in Public Pension Investments: The Courtroom*, HARV. L. SCH. F. ON CORP. GOV. (Dec. 17, 2024), <https://corpgov.law.harvard.edu/2024/12/17/the-new-battleground-in-the-fight-over-esgs-role-in-public-pension-investments-the-courtroom/>. Although we focus on challenges based on beneficiary primacy, public pension fund activism, especially as it relates to ESG proposals, could also be challenged as representing compelled speech on behalf of the fund’s beneficiaries. See, e.g., Paul S. Miller, *A Right for Retirement: Unconscionable Contracts, the Right (Not) to Associate, and Citizens United*, 71 AM. U. L. REV. 177 (2021) (arguing that participation by retirement plans in political activity violates the First Amendment rights of plan participants not to associate). The First Amendment issues reflected in this argument are beyond the scope of this Article, but they similarly result from a beneficiary-primacy model. To the extent that a public pension fund is a principal, it does not speak on behalf of its beneficiaries. See *infra* Part IV.

¹⁴⁶ See Complaint, *Wong v. New York City Emps.’ Ret. Sys.*, No. 652297/2023 (N.Y. Sup. Ct. May 11, 2023). See also Saijel Kishan, Martin Z. Braun & Bloomberg, *Three New York City Pension Funds Are Being Sued for Divesting from Fossil Fuels as Republican Politicians Take Aim at Anti-ESG Investing*, FORTUNE (May 12, 2023, 2:36 PM), <https://fortune.com/2023/05/12/new-york-pension-fund-lawsuit-anti-esg/> (describing lawsuit); The Editorial Board, *A Lawsuit to Protect Pensions From Climate Politics*, WALL. ST. J. (May 23, 2023, 6:39 PM), <https://www.wsj.com/articles/new-york-city-workers-lawsuit-pension-fund-investment-climate-politics-bill-de-blasio-ae9ba435> (same).

¹⁴⁷ *Wong v. New York City Emps.’ Ret. Sys.*, No. 652297/2023 (N.Y. Sup. Ct. July 2, 2024), https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=XzXiqEYyz_PLUS_12WFxIC774Fg=&system=prod.

are speculative.”¹⁴⁸ The court explicitly rejected plaintiffs’ effort to frame their claims under the law of trusts, stating that “plaintiffs’ circumstance is not analogous to that of a trust beneficiary.”¹⁴⁹ This holding is in harmony with *Thole v. U.S. Bank, N.A.*, where the US Supreme Court held, in 2020, that beneficiaries of private pensions lacked standing because they were promised fixed payments.¹⁵⁰

In *Keenan v. Russ*, an Oklahoma state district court reached a contrary result.¹⁵¹ A state employee challenged Oklahoma’s Energy Discrimination Elimination Act, which enabled the state Treasurer to blacklist firms that discriminate against the oil and gas industry.¹⁵² In addition to alleging that the Act will cost the pension system at least \$10 million, Keenan argued that the Act violated the First Amendment and the “exclusive purpose” rule that state pension funds must not be diverted for purposes other than the benefit of pensioners.”¹⁵³ The court agreed and granted a permanent injunction in July 2024.¹⁵⁴ The attorney general is appealing.¹⁵⁵

Although our focus is U.S. public pensions, beneficiary primacy and the litigation risk it entails is an international issue. In 2020, the UK Supreme Court held that the Secretary of State for Housing, Communities and Local Government lacked the authority to issue guidelines to UK public pension funds with respect to investment policies that promoted boycotts, divestments or sanctions against foreign countries.¹⁵⁶ The guidelines were a response to the anti-Israel activity associated with the Boycott, Divestment, and Sanction (BDS) movement and were challenged on the

¹⁴⁸ *Id.* at 2, 3.

¹⁴⁹ *Id.* at 3.

¹⁵⁰ *Thole v. U.S. Bank*, 590 US 538 (2020).

¹⁵¹ See *Keenan v. Russ*, Case No. 23-CV-1121-D (W.D. Okla. 2023). See Amanda Albright, *Oklahoma Sued over Anti-ESG Law*, BLOOMBERG, (Nov. 21, 2023), <https://www.bloomberg.com/news/articles/2023-11-21/oklahoma-sued-over-anti-esg-law-targeting-blackrock-jpmorgan> (describing litigation).

¹⁵² See Margarida Correia, *Oklahoma Hit with Suit over Anti-ESG Blacklist Barring Blackrock, Others, PENSIONS & INVS.* (Nov. 21, 2023), <https://www.pionline.com/esg/oklahoma-hit-suit-over-anti-esg-blacklist-barring-blackrock-others>.

¹⁵³ *Keenan v. Russ*, 23-CV-1121-D at 2-3 (W.D. Okla. 2024).

¹⁵⁴ Lamar Johnson, *Oklahoma Judge Permanently Blocks State’s Anti-ESG Law*, ESG DIVE (July 23, 2024), <https://www.esgdive.com/news/oklahoma-anti-esg-law-permanently-blocked-keenan-russ/722148/>.

¹⁵⁵ Jerry Bohnen, *Next Stop for Anti-ESG Act in Oklahoma—the State Supreme Court*, OK ENERGY TODAY (Nov. 5, 2024), <https://www.okenergytoday.com/2024/11/next-stop-for-anti-esg-act-in-oklahoma-the-state-supreme-court/>; Gentner Drummond, Press Release, Drummond Appeals Permanent Injunction Against State’s Anti-ESG Law (Dec. 3, 2024), <https://oklahoma.gov/oag/news/newsroom/2024/december/drummond-appeals-permanent-injunction-against-states-anti-esg-law.html>.

¹⁵⁶ *R. on Application of Palestine Solidarity Campaign Ltd. v. Secretary of State for Communities & Local Government*, 2020 U.K.S.C. 16, https://supremecourt.uk/uploads/R_on_the_application_of_Palestine_Solidarity_Campaign_Ltd_v_SSCLG_445834ab92.pdf.

basis that they interfered with fund trustees' ability to adhere to their fiduciary duties.¹⁵⁷

The Court concluded that the guidelines were invalid. The Court explained that pension fund trustees owed their primacy fiduciary duty to fund members.¹⁵⁸ Although trustees were permitted to take non-financial considerations into account in determining their investment policy, doing so was only permitted if it would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.¹⁵⁹ Further, the decision about the appropriate role of nonfinancial considerations was for the fund trustees and could not be superseded by a government minister.¹⁶⁰

B. Legislation

The role and importance of collateral benefits in public pension fund decision-making has expanded substantially with the growth of ESG, as has the controversy over the legitimacy of using pension fund assets to such ends. In response, many states have adopted anti-ESG legislation, arguing that such investments violate the fund managers' fiduciary duty because they compromise returns.¹⁶¹

Twenty states had adopted such legislation as of July 2024.¹⁶² A 2021 Texas statute, for example, "requires public pensions to divest from financial companies that have been labeled as 'boycotting' fossil fuels" and some legislators have pushed for additional measures.¹⁶³ A Kansas law "restricts the \$24.3 billion Kansas Public Employees Retirement System, Topeka, from entering into any contracts with

¹⁵⁷ Amir Licht, *Harami and Konami – Consideration of Social Considerations and Government Policy by an Institutional Investor*, Notes on Trust Law and Corporate Governance, 2020, <https://amirlicht.wordpress.com/2020/05/03/174/>.

¹⁵⁸ R. on Application of Palestine Solidarity Campaign Ltd. v. Secretary of State for Communities & Local Government, 2020 U.K.S.C. 16, 14 (opinion of Lord Wilson) ("The fund represents [the money of public employees;] it is not public money.")

¹⁵⁹ Jana Blahova & Imtiyaz Chowdhury, Case Comment: R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government [2020] UKSC 16, Sept. 2, 2020, <https://uksblog.com/case-comment-r-on-the-application-of-palestine-solidarity-campaign-ltd-and-another-v-secretary-of-state-for-housing-communities-and-local-government-2020-uksc-16/>.

¹⁶⁰ *Id.*

¹⁶¹ See, e.g., Cole, *supra* note 127.

¹⁶² Avani Kalra, *Red State Anti-ESG Laws Seen as Continuing Obstacle by Companies*, BLOOMBERG LAW (July 10, 2024), <https://news.bloomberglaw.com/esg/red-state-anti-esg-laws-seen-as-continuing-obstacle-by-companies>.

¹⁶³ Shelly Hagan & Nic Querolo, *Texas Anti-ESG Push Is Coming for Insurers and Pensions in New Bills*, BLOOMBERG (Mar. 3, 2023, 8:30 AM), <https://www.bloomberg.com/news/articles/2023-03-03/texas-anti-esg-bill-targets-public-pensions-insurers?embedded-checkout=true>.

money managers that consider environmental, social and governance factors.”¹⁶⁴ Other states require that fund managers only consider financial returns when making investing decisions. Florida’s legislation, HB 3, mandates that public pension funds make investment decisions “solely on the basis of pecuniary factors.”¹⁶⁵ Legislation introduced in New Hampshire proposes to make it a felony to invest New Hampshire public pension fund assets “in investment funds that consider environmental, social, and governance criteria.”¹⁶⁶

These measures sometimes meet resistance from fund managers. Oklahoma’s Energy Discrimination Elimination Act, at issue in *Keenan* discussed above, required the Oklahoma Public Employees Retirement System (“OPERS”) cease doing business with firms perceived as hostile to the fossil fuel industry.¹⁶⁷ The OPERS board voted 9-1 to ignore the law, taking advantage of the law’s “fiduciary exemption” that allows the board to do so if it finds compliance would violate its fiduciary duty.¹⁶⁸ The Oklahoma state legislature is now considering legislation that would remove that exemption.¹⁶⁹

C. The Hollowness of the Beneficiary Primacy Debate

The debate about collateral benefits investing centers on the motivations of fund managers: critics of public pension funds argue that fund managers pursue collateral benefits at the expense of returns in violation of beneficiary primacy; public pensions counter that they pursue socially minded investment strategies to maximize economic value.¹⁷⁰ This debate is irresolvable and disingenuous.

¹⁶⁴ Rob Kozlowski, *Kansas Anti-ESG Bill to Become Law After Governor Declines to Veto*, PENSIONS & INVESTMENTS (Apr. 28, 2023), <https://www.pionline.com/esg/kansas-anti-esg-bill-become-law-after-governor-declines-veto>.

¹⁶⁵ Joshua A. Lichtenstein et al., “Where Woke Goes to Die”? – New Florida Restrictions on ESG to Create Challenges and Additional Requirements for Asset Managers and Other Financial Institutions, ROPES & GRAY (Apr. 26, 2023), <https://www.ropesgray.com/en/newsroom/alerts/2023/04/where-woke-goes-to-die-new-florida-restrictions-on-esg-to-create-challenges-and-additional>.

¹⁶⁶ Robert Steyer, *It’s a Felony: N.H. Bill Would Make it a Crime to Knowingly use ESG Criteria in Investing Taxpayer Dollars*, PENSIONS & INVESTMENTS (Jan. 16, 2024), https://www.pionline.com/esg/new-hampshire-bill-would-make-it-felony-knowingly-use-esg-criteria-investing-taxpayer-dollars?utm_content=hero-headline&CSAuthResp=1706120873868%3a0%3a78082%3a0%3a24%3asuccess%3a1C67781CEF13BECEF4BEC14AC6D0775C#/cci_r=.

¹⁶⁷ Margarida Correia, *Oklahoma PERS Weighs Next Move in Tussle over ESG-Blacklist Law*, PENSIONS & INVS. (Oct. 20, 2023), <https://www.pionline.com/esg/esg-blacklist-fight-between-oklahoma-treasurer-pension-fund-reaches-new-stage>.

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ For example, CalSTRS chief investment officer Christopher Ailman defended the fund’s decision to divest from tobacco and other industries as financial rather than moral. See Noguchi, *supra*

Because the internal motivations of fund managers are unknowable, their claims that they pursue socially minded investments to maximize returns are both unprovable and irrefutable. As Caleb Griffin has explained, a shareholder wealth maximand is inherently subjective.¹⁷¹ Existing research has not even reached consensus that governance proposals or interventions increase shareholder wealth.¹⁷² The same is true for many socially responsible investment decisions. Empirical literature finds mixed results as to whether ESG investing, for example, underperforms or outperforms the market.¹⁷³

One reason for the empirical difficulty is that, as with any investment strategy, the impact of ESG criteria on economic performance is inevitably time and context specific.¹⁷⁴ As a result, it is likely impossible for either fund trustees or courts to make a reliable determination that a strategy motivated by social or ethical considerations sacrifices economic value. For example, shortly after the New York City Pension Funds divested from fossil fuels, Russia invaded Ukraine, sending related stocks soaring.¹⁷⁵ This does not mean that the funds intended to sacrifice economic value when they originally made their decision.

Moreover, framing this debate in terms of finances and fiduciary duties is disingenuous. This is not a dispute about the best way to maximize returns. The political affiliations of the two sides demonstrate that it is really about values and politics. Pension funds are often inclined toward liberal political views, explaining their support for issues like climate sustainability, racial justice, and international

note 96. Similarly, CalPERS, which divested from tobacco in 2001, claimed that it did so because the industry had poor financial prospects. Paul Verney, *Tide May Be Turning for Tobacco as CalPERS Reveals Its 2001 Divestment Is Finally Making Money*, RESPONSIBLE INV. (Nov. 30, 2020), <https://www.responsible-investor.com/tide-may-be-turning-for-tobacco-as-calpers-reveals-its-2001-divestment-is-finally-making-it-money/#:~:text=CalPERS%20decision%20to%20divest%20tobacco,information%20by%20some%20tobacco%20firms.>

¹⁷¹ Caleb Griffin, Mass Corporate Governance (working paper dated 2025).

¹⁷² *Id.* (analyzing studies).

¹⁷³ Compare, for example Madison Sargis & Patrick Wang, *How Does Investing in ESG Companies Affect Returns?* Morningstar, <https://www.morningstar.com/views/blog/esg/esg-portfolios-returns> (finding slight cost to ESG investing in US markets) with Morgan Stanley, Sustainable Funds Outperformed Peers in 2023, Feb. 29, 2024, <https://www.morganstanley.com/ideas/sustainable-funds-performance-2023-full-year> (reporting that “sustainable funds generated median returns of 12.6%, almost 50% ahead of the 8.6% returns of traditional funds”).

¹⁷⁴ See, e.g., Quinn Curtis, Jill Fisch & Adriana Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 442 n. 186 (2021) (noting that analysis of the economic performance of ESG funds occurred during a time in which the oil and gas sector experience poor performance).

¹⁷⁵ See Saijel Kishan et al., *supra* note 145, Martin Z. Braun & Bloomberg, *Three New York City Pension Funds Are Being Sued for Divesting from Fossil Fuels as Republican Politicians Take Aim at Anti-ESG Investing*, FORTUNE (May 12, 2023, 2:36 PM), <https://fortune.com/2023/05/12/new-york-pension-fund-lawsuit-anti-esg/>.

human rights.¹⁷⁶ Conservative states, on the other hand, are enacting anti-ESG legislation to prevent public pension funds from investing and engaging on these topics.¹⁷⁷

State opposition to ESG investing may also reflect industry capture rather than a concern for beneficiary welfare. Phillip Morris appealed to beneficiary primacy in its lobbying campaign that sought to stop CalPERS from divesting from tobacco.¹⁷⁸ Louisiana State Treasurer John Schroder's defended his decision to stop investing state pension money with BlackRock as "necessary to protect Louisiana from actions and policies that would actively seek to hamstring our fossil fuel sector."¹⁷⁹

Beneficiary primacy underpins litigation and legislation that seeks to constrain public pensions. Ostensibly about fiduciary compliance, these efforts are truly about politics and values. Better to bring this to the fore.

III. THE SHORTCOMINGS OF BENEFICIARY PRIMACY

As is evident from Part I, public pension funds are fundamentally distinct from other institutional investors. Their differences warrant reconsideration of the rationale for beneficiary primacy and the extent to which it should apply to public pension funds.

A. The Flawed Law and Logic of Beneficiary Primacy

Institutional investors are regulated based on their organizational form. ERISA regulates private pension funds and their managers; the Investment Company Act

¹⁷⁶ See, e.g., Aysha Gilmore, *New York Pension Fund Highlights Climate Risk as Top Voting Engagement Priority*, NET ZERO INV. (June 4, 2024), <https://www.netzeroinvestor.net/news-and-views/briefs/new-york-pension-fund-highlights-climate-risk-as-top-voting-engagement-priority> (identifying climate risks and diversity, equity and inclusion as among the New York State Common Retirement Fund's top voting and engagement priorities).

¹⁷⁷ Some may argue that they oppose consideration of ESG by public pension funds because these issues should be addressed through the political process. See Danilo Risteski, *supra* note 43, at 837 ("To the extent that ESG considerations are irrelevant to the pecuniary interests of pension fund beneficiaries, they properly belong to the policy sphere."). We argue that public pension fund investment decisions are properly understood as part of the political process.

¹⁷⁸ See generally N. Wander & R. E. Malone, *Fiscal Versus Social Responsibility: How Philip Morris Shaped the Public Funds Divestment Debate*, 15 TOBACCO CONTROL 231 (2006), <https://pmc.ncbi.nlm.nih.gov/articles/PMC2596576/>.

¹⁷⁹ Letter from John Schroder, La. State Treasurer, to Larry Fink, Blackrock CEO (Oct. 5, 2022) https://a4de8bd9-8c02-4b69-8f48-7792cfcaf8fd.usrfiles.com/ugd/a4de8b_38fdc8b7e3c04c9490bf332ce14f8d2f.pdf; see also Michael Katz, *Louisiana Divests Nearly \$800 Million from BlackRock to Protect Fossil Fuel Industry*, CHIEF INV. OFFICER (Oct. 10, 2022), <https://www.ai-cio.com/news/louisiana-divests-nearly-800-million-from-blackrock-to-protect-fossil-fuel-industry/>.

regulates mutual funds; and the Investment Advisors Act (“IAA”) regulates mutual fund managers.¹⁸⁰ Beneficiary primacy runs through them all.

The IAA requires that fund managers act in the “best interests” of their beneficiaries,¹⁸¹ while ERISA enshrines beneficiary primacy in the so-called “exclusive benefit rule,” which requires that fund managers act “solely in the interests of the participants and beneficiaries.”¹⁸² Both are formulations of beneficiary primacy, demanding that fund managers focus solely on the interests of the fund’s beneficiaries and defining those interests solely in financial terms.¹⁸³ Activities that promote collateral benefits are conceptualized as conflicts of interest.¹⁸⁴

Notably, although some commentators argue that public pension fund managers who favor social responsibility or other nonfinancial objectives may be motivated by self-dealing or an effort to engage in personal aggrandizement,¹⁸⁵ under ERISA, a conflict of interest exists whenever their actions are motivated by collateral benefits even in situations in which fund managers are acting in good faith.¹⁸⁶ The modern-day rationale for this strict obligation is to ensure sound investment practices on behalf of retired workers.¹⁸⁷ But this was not the original intent of the rule. The exclusive benefit rule was a response to the risk of looting, self-dealing, and corruption by fund managers, not an effort to preclude publicly-minded investing.¹⁸⁸

¹⁸⁰ Investment Company Act of 1940, ch. 686, tit. I, 54 Stat. 789, 789 (codified as amended at 15 U.S.C. §§ 80a-1 to 80a-64).

¹⁸¹ See SEC v. Tambone, 550 F.3d 106, 146 (1st Cir. 2008) (“Section 206 imposes a fiduciary duty on investment advisers to act at all times in the best interest of the fund...”); SEC v. Moran, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) (“Investment advisers are entrusted with the responsibility and duty to act in the best interest of their clients.”); Commission Interpretation Regarding Standard of Conduct for Inv. Adv., 84 Fed. Reg. 33669, 33671 (July 12, 2019). Technically, fiduciary duties are owed to the fund, but the investors are the ultimate beneficiaries of those fiduciary duties. See *supra* note 18.

¹⁸² Letter from Dep’t of Labor to William M. Tartikoff, Senior Vice President and Gen. Couns., Calvert Group Limited (May 28, 1998), reprinted in 25 PENS. & BEN. REP. (BNA) 1328 (June 8, 1998); Schanzenbach & Sitkoff, *supra* note 127, at 403.

¹⁸³ Schanzenbach & Sitkoff, *supra* note 127, at 403–04. In the context of private pension funds that are subject to ERISA, the Supreme Court has grounded this obligation in the text of the statute. Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014).

¹⁸⁴ Schanzenbach & Sitkoff, *supra* note 127, at 405 (explaining that “total divestment from South Africa out of consideration for the oppressed South African black majority, would breach the trust law duty of loyalty”); Romano, *supra* note 2 at 803–05 (describing political pressure on pension funds to engage in social investing as “conflicts of interest”).

¹⁸⁵ See, e.g., John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1335 (1991) (explaining that “the public pension fund offers an attractive vehicle by which political leaders, or would-be candidates, can present themselves to the public”).

¹⁸⁶ Schanzenbach & Sitkoff, *supra* note 127, at 405.

¹⁸⁷ *Id.*, at 404.

¹⁸⁸ See Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427, 1110 (1993).

Nevertheless, while the Department of Labor (DOL), which oversees ERISA, has wavered on the precise contours of the relationship between collateral-benefits investing, ESG, and ERISA’s exclusive benefit rule,¹⁸⁹ the agency has consistently maintained that the core job of a pension fund manager is to maximize economic returns.¹⁹⁰ In its most recent rule, adopted in 2022, the DOL stated that, while investment decisions “must be based on factors that the fiduciary reasonably determines are relevant to a risk and return analysis,” those factors may include ESG factors.¹⁹¹ Twenty-six states challenged the rule in court, claiming that it violated ERISA by improperly allowing fund managers to focus on nonfinancial considerations.¹⁹² In 2023, the Northern District of Texas rejected the challenge, holding that the rule still directed managers to focus exclusively on the economic risk and return of a potential investment.¹⁹³ According to the court, the 2022 Rule “provides that where a fiduciary reasonably determines that an investment strategy will maximize risk-adjusted returns, a fiduciary may pursue the strategy, whether pro-ESG, anti-ESG, or entirely unrelated to ESG.”¹⁹⁴

In the mutual fund context, it makes sense to impose fiduciary obligations on fund managers to represent the best interests of fund investors. Most importantly, fund investors are residual claimants—their return is based on the fund manager’s expertise and the performance of the fund.¹⁹⁵ Variable returns are the quintessential feature of a fiduciary relationship. Because investors look to mutual funds primarily for financial returns, it also makes sense that fund managers prioritize fund value, at least in the absence of clear direction by the beneficiaries to do otherwise.¹⁹⁶

Similarly, it is appropriate that ERISA applies beneficiary primacy to defined contribution plans, which constitute the bulk of private pensions. Beneficiaries of

¹⁸⁹ See Curtis, et al., *supra* note 174, at 414–18 (describing shifts in DOL’s ESG investing policies between 1994 and 2021).

¹⁹⁰ Dana M. Muir, *Sustainable Investing and Fiduciary Obligations in Pension Funds: The Need for Sustainable Regulation*, 59 AM. BUS. L.J. 621, 662 (2022).

¹⁹¹ 2022 Investment Duties Rule, 87 Fed. Reg. 73885 (Dec. 1, 2022); 29 C.F.R. § 2550.404a-1 (2022).

¹⁹² *Utah v. Walsh*, 2023 U.S. Dist. LEXIS 168696 (N.D. Tex. Sept. 21, 2023).

¹⁹³ *Id.*

¹⁹⁴ *Id.* at *17.

¹⁹⁵ See Paul Rose, *Public Wealth Maximization: A New Framework for Fiduciary Duties in Public Funds*, 2018 U. ILL. L. REV. 891, 894 (2018) (“Under this logic, plan participants are owed fiduciary duties because they are the primary beneficiaries when the fund is managed well and the primary victims when it is managed poorly.”); see also *id.* at 907 (“Fiduciary duties are generally owed to the “residual claimant” who, as the ultimate risk-bearer, has the best incentives to maximize the value of the trust.”).

¹⁹⁶ Some funds explicitly disclose to potential investors their intention to invest in accordance with nonfinancial objectives that may result in the sacrifice of financial returns. Investment in such funds should be understood as an agreement to sacrifice maximization of fund economic value in accordance with those objectives. See, e.g., *CATH Factsheet*, *supra* note 15 (discussing CATH ETF). Engagement different, Fisch & Schwartz, 55 (represent goals of beneficiaries when value unclear).

such plans are likewise residual claimants who contribute money to the fund while they are employed and, when retired, receive a payout based on those contributions.¹⁹⁷ The amount received by beneficiaries depends on the investment performance of their defined contribution plan, which in turn depends on the investment options offered by the plan sponsor and the fees charged.

Neither ERISA nor the IAA directly applies to public pension plans, which are instead governed by a variety of state and local laws.¹⁹⁸ Nonetheless, ERISA's exclusive benefit rule is the *de facto* legal standard.¹⁹⁹ This was not always the case. Prior to the 1950s, the investment discretion exercised by public pension fund managers was extremely limited. Rather than policing pension fund managers through fiduciary duties, state legislatures specified the types of securities in which managers were authorized to invest through "legal lists."²⁰⁰ These lists typically limited investment to federal bonds and those issued by the local state or a political

¹⁹⁷ By 2021, only 11% of private sector workers participated in a defined benefit plan. See JOHN J. TOPOLESKI & ELIZABETH A. MYERS, PRIVATE-SECTOR DEFINED CONTRIBUTION PENSION PLANS: AN INTRODUCTION (2022), <https://crsreports.congress.gov/product/pdf/R/R47152>.

¹⁹⁸ Shnitser, *supra* note 46, at 647 ("ERISA explicitly does not cover public pension plans, but the trust form is statutorily mandated by most state and local governments, who both make the pension promises and are also in charge of putting aside the money to fund such long-term obligations."). Some states have also codified the Uniform Management of Public Employee Retirement Systems Act of 1997. See *Basic Legal Protections Vary Widely for Participants in Public Retirement Plans*, PEW ISSUE BRIEF (Nov. 21, 2017), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/11/basic-legal-protections-vary-widely-for-participants-in-public-retirement-plans> (reviewing state codification of fiduciary standards for public pension funds).

¹⁹⁹ See David Webber, *The Use and Abuse of Labor's Capital*, 89 N.Y.U. L. REV. 2106, 2188–89 (2014) (showing that the vast majority of states either copy ERISA's exclusive benefit rule or have very similar language). In addition, the tax status of public pension funds requires them to comply with the IRS version of the exclusive benefit rule. See James V. Cole II, *The Demise Dilemma*, 2 GEO. MASON L. REV. 377, 410 n. 141 (1995). According to NY State Investment Policies, the exclusive benefit rule is driven by taxes. *Id.* States have also replicated ERISA's duty of prudence. See, e.g., Rose, *supra* note 195 ("In many cases, states apply ERISA's prudent-man standard to state-managed funds.").

²⁰⁰ See Sean H. Vanatta, *The Financialization of US Public Pension Funds, 1945–1974*, 82 REV. SOC. ECON. 261, 270 (2024); National Conference on Public Employee Retirement Systems (NCPERS), *The Evolution of Public Pension Plans, Past, Present and Future*, 4 (2008), <https://www.ncpers.org/files/ncpers-research-the-evolution-of-public-sector-pension-plans.pdf> ("Before the 1980s, many plans restricted plan investments using 'legal lists' specifying the portion of plan assets that could be invested in various securities."); The Pew Charitable Trusts & the Laura and John Arnold Foundation, *State Public Pension Fund Investments Shift over Past 30 Years*, June 2014, at 2, https://www.pewtrusts.org/~media/assets/2014/06/state_public_pension_investments_shift_over_past_30_years.pdf ("States, for example, were previously limited in their investment options by restrictive 'legal lists' that were also used to regulate insurance and savings banks, for which safety was the principal concern.").

subdivision thereof. The result, termed “fiscal mutualism” by some commentators,²⁰¹ led to a synergy between the funds and local governments.²⁰²

In the 1950s and 1960s, state and local governments began to broaden the scope of managers’ investment authority to allow public funds to invest a larger proportion of their portfolios in equities so as to increase returns and funding levels.²⁰³ To facilitate this, public plans began to incorporate the prudent person rule from trust law, which demands careful portfolio oversight,²⁰⁴ and “emphasize[s] manager discretion in trust investments in order to maximize financial returns.”²⁰⁵ The lobbying efforts of professional asset managers, who saw liberalization as a tool that would enable them to provide their investment services to pension funds, accelerated this shift.²⁰⁶ After ERISA was adopted in 1974, public pension funds incorporated its likeminded fiduciary structure.²⁰⁷ Thus, history suggests that beneficiary primacy arose, not out of concern for beneficiary welfare, but as a side-effect of expanding pension fund investment discretion and lobbying by investment professionals.

This history helps explain why beneficiary primacy is such a poor fit. The doctrine is fundamentally at odds with public pensions because, as defined benefit plans, their beneficiaries are fixed rather than residual claimants. Beneficiaries have contractual claims to certain payments, and the size of those payments does not depend on the skill and effort of the fund manager but is instead based on formulas, which in public pensions are set by state and local rules. If a public pension plan outperforms, its beneficiaries have no claim to the surplus. If a fund earns more than required to pay retirees, the surplus belongs to the government. There is no

²⁰¹ Michael Glass & Sean H. Vanatta, *The Frail Bonds of Liberalism: Pensions, Schools and the Unraveling of Fiscal Mutualism in Postwar New York*, 2 CAPITALISM: A JOURNAL OF HISTORY AND ECONOMICS, 427 (2021).

²⁰² Vanatta, *supra* note 200, at 268 (“Under fiscal mutualism, pension trustees balanced the interests of pensioners, who wanted safe, guaranteed returns and of local governments, that wanted low-cost finance.”).

²⁰³ *Id.* at 281. The trend accelerated in the 1980s. The Pew Charitable Trusts & the Laura and John Arnold Foundation, *supra* note 200, at 1 (“In a bid to boost investment returns, public pension plans in the past several decades have shifted funds away from fixed-income investments such as government and high-quality corporate bonds. During the 1980s and 1990s, plans significantly increased their reliance on stocks, also known as equities.”).

²⁰⁴ The trust law standard is to invest as “men of prudence, discretion and intelligence manage their own affairs.” *Harvard Coll. v. Armory*, 26 Mass. (9 Pick.) 446 (1830).

²⁰⁵ Vanatta, *supra* note 200, at 263; NCPERS, *supra* note 200 at 4 (“starting in the 1980s, many public plans began applying the ‘prudent person’ rule to govern investments.”).

²⁰⁶ See, e.g., Vanatta, *supra* note 200, at 274 (“Drawing on experience managing private pension plans, commercial bankers, investment bankers, and other asset managers increasingly positioned themselves as experts on public pension investment.”).

²⁰⁷ *Id.* at 282.

requirement that the surplus benefit retirees or current employees.²⁰⁸ Instead, government officials regularly revise contribution levels, vesting requirements, and tax subsidies as part of the budget process, creating winners and losers among different constituencies.²⁰⁹

Another key distinction is that investors in both mutual funds and defined contribution plans can select investments that align with their economic and non-economic preferences.²¹⁰ Investors choose what type of fund to invest in, and although fund managers exercise discretion, they must adhere to the investment and engagement mandate of that fund.²¹¹ Investors' limited capacity to oversee whether fund manager decisions align with those expressed principles warrants the application of fiduciary principles.²¹² In contrast, participants in defined benefit plans choose to work for public employers, which enroll them in the employer's plan. Participants do not choose plans that align with their preferences with respect to either value or values. Accordingly, their participation in the pension cannot be

²⁰⁸ This is consistent with the courts' reasoning in *Wong v. New York City Emps.' Ret. Sys.*, No. 652297/2023 (N.Y. Sup. Ct. July 2, 2024), https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=XzXiqEYyz_PLUS_12WFxIC774Fg=&system=prod, and *Thole v. U.S. Bank*, 590 US 538 (2020). See *supra* note 148 and accompanying text.

²⁰⁹ See, e.g., Sidorova, *supra* note 29 (explaining how change in 2022 New York state budget "transfers more costs [away from higher-salaried employees] to future state budgets and taxpayers").

²¹⁰ See, e.g., Jill E. Fisch, Annamaria Lusardi, & Andrea Hasler, *Defined Contribution Plans and the Challenge of Financial Literacy*, 105 CORNELL L. REV. 741, 749–50 (2020) (explaining that, under ERISA, employers in a defined contribution plan are protected by a safe harbor from liability for participant losses if they comply with section 404(c) of ERISA, which requires employers to offer a broad range of investment options). In addition, as noted *supra* note 196, some mutual funds offer investors the opportunity to choose an investment policy that potentially sacrifices economic value in favor of values. Oliver Hart and Luigi Zingales propose that funds similarly allow investors to choose their preferred voting policy. See Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. CHI. BUS. L. REV. 195, 213 (2022) ("The third strategy is for mutual funds companies to offer investors funds with a very clear and predetermined voting strategy and let investors choose among them.").

²¹¹ Even in passively-managed funds, fund managers have a substantial degree of investment discretion, and empirical research has demonstrated that the exercise of this discretion leads to significant differences among funds tracking the same index. Peter Molk & Adriana Z. Robertson, *Discretionary Investing by 'Passive' S&P 500 Funds*, 41 YALE J. ON REG. 248 (2024). Investor returns may also vary depending on fund fees and tracking error, both of which are within the control of the fund manager.

²¹² Fiduciary duties are often justified as a response to the limitations on a principal's ability to monitor its agent. See Easterbrook & Fischel, *Contract and Fiduciary Duty*, *supra* note 188, at 427 (arguing that "a 'fiduciary' relation is a contractual one characterized by unusually high costs of specification and monitoring"); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1424–25 (2002); Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1114 (1988) ("The strict fiduciary duties of trust law act as substitutes for monitoring by the directly interested parties.").

understood as a delegation of authority to the fund managers, and there is no role for fiduciary duties to police conformity with their interests.

Similarly, law and economics scholarship often conceptualizes fiduciary duties as gap fillers.²¹³ Under this view, the law distinguishes between parties to a contract that specifies the terms of performance, and those where parties exercise discretionary power or where the terms of the contract are incomplete. In the latter two contexts, we see fiduciary duties because satisfactory performance cannot be explicitly addressed in the contract or easily assessed.²¹⁴ Fiduciary duties step in to address the uncertainty. Because defined benefit plans offer a contractually specified payout to each beneficiary, there is no such uncertainty and no need for fiduciary duties.

The institutional design of public pension funds is also in tension with beneficiary primacy. In this sense, public pension funds can be contrasted with corporations. Corporate law vests primary operational authority in the board of directors, but shareholders are the residual claimants. As a result, corporate shareholders have oversight powers over the corporation and its managers to ensure that corporate decisions are made in their interests. Shareholders exercise this oversight through their power to elect the board, to vote on certain fundamental matters, and to sell their stock, but because these powers are limited and imperfect, they are supplemented by fiduciary duties that reinforce shareholder primacy—the idea that furthering shareholder interests is the only legitimate goal for corporate managers—which is the dominate theory of corporate law.²¹⁵

In contrast, the structure of public pension fund governance demonstrates that they are not organized solely to serve the interests of fund beneficiaries. While beneficiaries may vote on a few board seats, legislators and elected officials are the key decisionmakers, and they are accountable to the public. Moreover, legislation in some states demands that funds serve social interests, either through ETIs or through ESG investing.²¹⁶ In other states, legislation requires that funds refrain from ESG investing even in cases in which such investment policies might bolster performance. Such requirements flatly contradict beneficiary primacy.

²¹³ See, e.g., Kelli A. Alces, *The Fiduciary Gap*, 40 IOWA J. CORP. L. 351, 353 (2015) (“Some scholars argue that fiduciary duties are gap fillers in some kinds of incomplete contracts.”).

²¹⁴ Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23, 25 (arguing that “fiduciary duties should properly be seen as a method of gap-filling in incomplete contracts”).

²¹⁵ See, e.g., Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006) (defining the objective of shareholder primacy as the maximization of shareholder wealth). Compare Hart & Zingales, *supra* note 210, at 260–61 (arguing that corporate managers should maximize shareholder welfare, not market value).

²¹⁶ See K&L Gates, *2023 ESG State Legislation Wrap Up* (July 25, 2023), <https://www.klgates.com/2023-ESG-State-Legislation-Wrap-Up-7-19-2023>.

Although many of our critiques of beneficiary primacy apply to both private and public defined benefit plans, we focus on the latter for two reasons. First, although their claim is contractual, beneficiaries of private defined benefit pension plans face greater risk.²¹⁷ If a private pension plan is underfunded or mismanaged, and the company itself is financially distressed, pension fund beneficiaries may not receive their designated benefits. If a corporation goes bankrupt, pension fund beneficiaries are similar to other creditors, although some private pension benefits are insured by the Pension Benefit Guaranty Corporation.²¹⁸

Beneficiaries of public pensions have far greater protection. Most importantly, government entities can raise money from taxpayers to meet their pension obligations. This backstop was one reason Congress did not extend ERISA to public pensions.²¹⁹ While it is true that insolvency or bankruptcy could technically provide states or municipalities grounds for avoiding pension obligations, this is exceedingly rare.²²⁰ Detroit’s financial crisis led to the largest municipal bankruptcy in U.S. history,²²¹ but even then beneficiaries were nearly made whole. As part of the “grand bargain” resolving Detroit’s liabilities, pensioners received 95% or more of their promised benefit.²²²

Second, and more importantly, we focus on public pensions because of their publicness. Their deep ties to state and local government means that they are imbued with values that private plans lack and make the imposition of a narrow fiduciary duty particularly troublesome. In other work, we have faulted mutual fund managers for making values-based decisions without reflecting the values of their beneficiaries.²²³ Outside the limited space of values-oriented mutual funds, mutual fund managers lack an authoritative basis for making values-based decisions on

²¹⁷ See Munnell & Quinby, *supra* note 30, at 1 (legal “constraints . . . accord public employees greater protection than their private sector counterparts).

²¹⁸ See Fiona Stewart, *Benefit Protection: Priority Creditor Rights for Pension Funds*, OECD WORKING PAPERS ON INS. AND PRIV. PENSIONS (Jan. 1, 2007), <https://www.oecd-ilibrary.org/docserver/267415864801.pdf?expires=1718894344&id=id&accname=guest&checksum=9884E85518C47BFCA95DAE58D3CE17D5> (“Underfunded pension funds are in the same position as other creditors when their sponsoring firm becomes insolvent, having to join the queue claiming the remaining assets of the firm.”); *General FAQs About PBGC*, PUB. BENEFIT GUAR. CORP., <https://www.pbgc.gov/about/faq/pg/general-faqs-about-pbgc> (last updated August 22, 2023). The PBGC is perpetually underfunded, however. Rose, *supra* note 195, at 908–09.

²¹⁹ See Monahan, *supra* note 16, at 365.

²²⁰ See Sean Myers, *Public Employee Pensions and Municipal Insolvency*, WHARTON SCH. RSCH. PAPER (June 2021), <https://rodneywhitecenter.wharton.upenn.edu/wp-content/uploads/2021/10/Myers-Public-Employee-Pensions-and-Municipal-Insolvency.pdf> (“pension liabilities...are not substantially cut even in bankruptcy”).

²²¹ Monica Davey & Mary Williams Walsh, *Billions in Debt, Detroit Tumbles Into Insolvency*, NY TIMES (June 18, 2013), <https://www.nytimes.com/2013/07/19/us/detroit-files-for-bankruptcy.html>.

²²² See Rose, *supra* note 195, at 911.

²²³ See generally Fisch & Schwartz, *supra* note 9; Jill E. Fisch, *Mutual Fund Stewardship and the Empty Voting Problem*, 16 BROOK. J. OF CORP. FIN. & COM. L. 71 (2021).

behalf of their investors, who likely have heterogeneous values-based preferences.²²⁴ In contrast, a variety of sources—ranging from state statutes, fund investment policies, and the fund’s internal governance structure, including the composition of its board of trustees—provide fund managers with guidance for making values-based decisions.

Our refutation of beneficiary primacy is a significant departure from the conventional wisdom. In a recent comprehensive article on public and private pension law, Professors Schanzenbach and Sitkoff defend the exclusive benefit rule and argue that it properly excludes ESG considerations “in light of the agency costs of managing other people’s money.”²²⁵ For the reasons articulated above, this conclusion is unsound as applied to public pensions. Because beneficiaries are contractual claimants, fund managers are not managing their money. Moreover, the broader investment mandates of many public pension funds and the institutional context in which they operate belie the claim that the funds’ sole objective is, or should be, to maximize fund economic value.

B. Judicial Treatment of Beneficiary Primacy

Judicial treatment of beneficiary primacy supports our thesis. Fiduciary law is typically prophylactic.²²⁶ A manager breaches the duty of loyalty by acting disloyally—by, for instance, engaging in a conflict-of-interest transaction—regardless of whether the act harms the beneficiaries.²²⁷ In contrast, courts have held that fund beneficiaries lack standing to challenge manager actions without a showing that such actions deprived them of their full benefits.²²⁸ Although purporting to apply fiduciary standards, these cases treat beneficiaries like contractual counterparties.

Another way that judicial treatment of beneficiary primacy supports our theory is that courts have treated public pensions as arms of the state. Accordingly, they

²²⁴ See Fisch & Schwartz, *supra* note 9, at 23–24. It is reasonable to assume that investors in ESG mutual funds and faith-based funds agree with values-based investment and engagement decisions by those funds, at least within the scope of the fund’s articulated mandate.

²²⁵ Schanzenbach & Sitkoff, *supra* note 127, at 454.

²²⁶ Fischel & Langbein, *supra* note 212, at 1114–15.

²²⁷ See *id.* at 1115.

²²⁸ See, e.g., *Ramon v. Tchr. Ret. Sys. of Tex.*, No. 01-09-00684-CV, 2010 WL 1241293, at *1 (Tex. Ct. App. Apr. 1, 2010); *Wong v. New York City Emps.’ Ret. Sys.*, No. 652297/2023, at 2–3 (N.Y. Sup. Ct. July 2, 2024), https://iapps.courts.state.ny.us/fbem/DocumentDisplayServlet?documentId=XzXiqEYyz_PLUS_l2WFxIC774Fg=&system=prod; *but see* *Keenan v. Russ*, 23-CV-1121-D (W.D. Okla. 2024). After *Thole*, private pension plan beneficiaries also face standing challenges, although there the DOL retains enforcement authority. See *Thole v. U.S. Bank*, 590 US 538 (2020); *ERISA Enforcement*, EMP. BENEFITS SEC. ADMIN., <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/enforcement/erisa> (last visited Aug. 30, 2024).

have relied on sovereign immunity to block beneficiary litigation.²²⁹ This harmonizes with our view that public pensions should be viewed as state actors with obligations to the state rather than solely to payees.

Finally, the way courts treat cases that reach the merits suggests that they share our skepticism of beneficiary primacy. They nominally apply the doctrine, but typically find a way to support a challenged investment despite a tenuous tie to economic value.²³⁰ In the cases discussed in Part II.A., the courts upheld investment decisions that were motivated by serving public or local interests even though it was unclear that the decisions were motivated by or even consistent with economic value maximization.²³¹ That courts contort themselves to avoid the results of beneficiary primacy illustrates that it is a broken legal doctrine and bolsters our case for abandoning it.

C. Scholarly Treatment of Beneficiary Primacy

The orthodoxy is that beneficiary primacy is solid.²³² For instance, in a foundational article over thirty years ago, Professor Romano characterized ETIs as politically motivated conflict-of-interest transactions that “do not meet prudential fiduciary standards.”²³³ As noted above, more recently Professors Schanzenbach and Sitkoff defend, if not celebrate, the doctrine.²³⁴

But we are not the first to identify its shortcomings. Professors Fischel and Langbein (F&L), for example, argue that a problem with beneficiary primacy is that not all pension fund beneficiaries have the same interests.²³⁵ Current employees want funds to protect their employment; retirees oppose such efforts if they threaten to

²²⁹ *Ernst v. Rising*, 427 F.3d 351, 354 (6th Cir. 2005) (holding that state retirement system is an arm of the state).

²³⁰ *See, e.g., Withers v. Tchrs.’ Ret. Sys. of New York City*, 447 F. Supp. 1248 (S.D.N.Y. 1978), *State ex rel. W. Va. Reg’l Jail & Corr. Facility Auth. v. W. Va. Inv. Mgmt. Bd.*, 508 S.E.2d 130 (W. Va. 1998), *Bd. of Trs. v. Mayor & City Council of Balt. City*, 562 A.2d 720 (Md. App. Ct. 1989).

²³¹ The one case we surveyed where beneficiary primacy prevailed, *Keenan v. Russ*, did not involve collateral benefits investing. Rather, it was a challenge to a rule forbidding the use of investment managers perceived as ESG friendly.

²³² *See, e.g., Thomas J. Fitzpatrick IV & Amy B. Monahan, Who’s Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform*, 66 FLA. L. REV. 1317, 1361 (2014) (“[C]onsideration of collateral benefits goes to the heart of one of the main criticisms of public plans—that they may invest money in a manner that is not in the best interest of plan participants and beneficiaries in order to secure political gain.”).

²³³ *See Romano, supra* note 2, at 796, 804. As a result, Romano recommends reforms to remove the political influence on pension funds. *See id.* at 852-53 (describing various reform proposals including subjecting state pension funds to ERISA).

²³⁴ *See Schanzenbach & Sitkoff, supra* note 127, at 454.

²³⁵ Fischel & Langbein, *supra* note 212, at 1146 (“By incorrectly characterizing the trustees’ decision as being in the interests of all beneficiaries, the court failed to appreciate the conflict between classes of beneficiaries and thus made the case seem easier than it actually was.”).

compromise their payouts. F&L propose, as a solution, that pension law incorporate the trust law “duty of impartiality.”²³⁶ When considering an investment that pits beneficiaries against each other, fund managers would have to be impartial among them.²³⁷

Professor Webber, in contrast, criticizes public pension fund investments that harm the employment prospects of their beneficiaries.²³⁸ He is particularly concerned about the extent to which public pensions invest in private equity funds, a form of investing that is notorious for slashing jobs and pay.²³⁹ Current law, as he sees it, prohibits public pension fund managers from taking job losses into account because doing so is unrelated to the fund’s long-term value. He argues instead for a “member-first” view of fiduciary duties, which would allow fund managers to consider the risk of job losses in their investment decisions.²⁴⁰

As is typical in this area, both F&L and Webber accept the beneficiary primacy model as dogma. Rather than reject it, they would expand the group of beneficiaries. Professor Rose would go further, arguing that because taxpayers guarantee the obligations of public pension funds, fund managers should owe fiduciary duties, not to beneficiaries, but to “the public—the current and future citizens and residents—who will ultimately benefit or suffer from the investment choices of the public fund trustees.”²⁴¹ His view is that this change in focus would enable public pension funds to engage more openly, and more extensively, in ESG investing.²⁴²

While we are sympathetic to the foregoing approaches, they are impractical and overlook the institutional detail of public pensions. Fiduciary duties work best when there is a single principal. As with stakeholder governance, which has gained traction in corporate law,²⁴³ expanding the fiduciary analysis in the ways these commentators

²³⁶ *Id.* at 1121.

²³⁷ *Id.*

²³⁸ See generally Webber, *supra* note 199; see also DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR’S LAST BEST WEAPON, 183 (2018) (“It is an errant view of fiduciary duty that locks labor into using its investment power to undermine its worker interests and overall economic interests.”).

²³⁹ Public pension fund investments in private equity also indirectly contribute to rising rents. See Andrew Khouri & Ben Poston, *The Hidden Role of Public Pensions in Raising Rents in California*, L.A. TIMES (Aug. 1, 2024), <https://www.latimes.com/california/story/2024-08-01/to-help-the-middle-class-retire-public-pensions-are-driving-gentrification-critics-say> (critiquing investments by CalSTRS, the pension for California public school teachers, in private equity funds that raise rents on local tenants).

²⁴⁰ Webber, *supra* note 199, at 2186.

²⁴¹ Rose, *supra* note 195, at 895.

²⁴² See *id.* at 895.

²⁴³ See, e.g., Lenore Palladino & Kristina Karlsson, *Towards Accountable Capitalism: Remaking Corporate Law Through Stakeholder Governance*, HARV. L. SCH. F. ON CORP. GOV. (Feb. 11, 2019), <https://corpgov.law.harvard.edu/2019/02/11/towards-accountable-capitalism-remaking-corporate-law-through-stakeholder-governance/> (describing a theory of stakeholder governance in which “board

suggest does not provide a framework for determining how to weigh different values or beneficiary interests against each other or for when to depart from value maximization. In addition, public pension funds are political creatures and, as a result, they vary in their interests and demands. The job of the manager is to balance competing stakeholder preferences in a way that fits the values of the pension fund the manager serves. Unlike the corporate and mutual fund settings, moreover, the institutional design of public pensions offers ready principles to guide manager decision-making, which we detail in Part IV below.

IV. PUBLIC PENSION FUNDS AS PRINCIPALS

As the prior section explains, it is counterproductive to understand public pension fund managers as bound to serve the sole interest of fund beneficiaries. Rather, public pension funds should be understood as principals and those who work for the funds as their agents. As a principal, the fund has its own goals and interests. Those who manage the fund's assets—trustees, investment managers and other employees—are hired to identify the fund's interests and to exercise their discretion to run the fund in accordance with those interests.

Our approach resembles “entity” theory from corporate law. Under this view, the corporation is “an independent, artificially created entity.”²⁴⁴ Managers have the duty to represent the interests of that entity.²⁴⁵ The Canadian Supreme Court's decision in *BCE Inc v 1976 Debentureholders*²⁴⁶ provides a helpful explanation of entity theory:

“[T]he directors owe a fiduciary duty to the corporation, and only to the corporation. People sometimes speak in terms of directors owing a duty to both the corporation and to stakeholders. Usually this is harmless, since the reasonable expectations of the stakeholder in a particular outcome often coincide with what is in the best interests of the corporation. However, cases ... may arise where these interests do not coincide. In such cases, it is important to be clear that the directors owe their duty to the corporation, not to stakeholders, and that the

“fiduciary duty” [runs] to all stakeholders”). See also Abbye Atkinson, *Commodifying Marginalization*, 71 DUKE L.J. 773, 830–31 (2022) (advancing a claim that public pension funds should be managed to address the broader societal or stakeholder harms that stem from their investment choices).

²⁴⁴ Emily Winston, *Benefit Corporations and the Separation of Benefit and Control*, 39 CARDOZO L. REV. 1783, 1807 n. 140 (2018).

²⁴⁵ This approach is consistent with state constituency statutes, which authorize corporate directors to consider the interests of a wide range of stakeholders but do not impose fiduciary obligations with respect to those stakeholders. See Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467 (2021) (describing constituency statutes and evaluating their impact on corporate decisions).

²⁴⁶ 2008 SCC 69 (CanLII), [2008] 3 SCR 560.

reasonable expectation of stakeholders is simply that the directors act in the best interests of the corporation.”²⁴⁷

While we do not take a position on whether the *BCE* decision is an appropriate approach to corporate law,²⁴⁸ we contend that entity theory is the best way to understand the duties of public pension fund managers whom, we argue, should be obligated to serve the interest of the fund itself. The essence of their job is to ascertain and effectuate the goals of the fund as informed by the views of their constituents and as reflected in state constitutions, laws and regulations, the fund’s governance structure, and investment policies. Doing so requires them to balance the competing demands of taxpayers, current employees, retirees and more in accordance with such guidance.

Note that our theory does not ignore beneficiaries; it rather provides that theirs would no longer be the only interests that matter. Although beneficiaries are contractual claimants with guaranteed benefits, they still care how fund money is invested. Poor returns could result in increased employee contributions or decreased COLAs, both of which indirectly reduce benefits.²⁴⁹ It would be up to the fund manager to take their interests into account and balance them against competing ones.

Our view of public pension fund managers aligns them with other public servants. For instance, the job of public agency leaders is to further the mission of the agency as informed by the values and goals of their constituents, which are reflected, at least in part, in legislation, regulations, and governing documents. Public pension fund managers are similarly situated. A public pension fund is a taxpayer-funded investment pool with a contractual obligation to make payments to beneficiaries. The fund manager’s job is to meet its contractual obligations while investing that money and engaging with portfolio firms in a manner consistent with the goals and values of the fund’s constituents as reflected in similar sources of authority.

Under our model, fund managers would not be under a fiduciary mandate to maximize the fund’s returns or economic value. A fund manager could decide to do so, but this decision would be based, not on a fiduciary obligation, but on the fund’s values and goals. A legitimate fund goal, for instance, might be to reduce

²⁴⁷ *Id.* at [66].

²⁴⁸ The *BCE* decision has been criticized. See, e.g., Edward Iacobucci, *Indeterminacy and the Canadian Supreme Court’s Approach to Corporate Fiduciary Duties*, 48 CAN. BUS. L.J. 232 (2009).

²⁴⁹ See Alicia H. Munnell & Jean-Pierre Aubry & Caroline V. Crawford, *State and Local Pension Reform Since the Financial Crisis*, CTR. FOR RET. RSCH. BOS. COLL. 1, 3 (Jan. 2017), https://crr.bc.edu/wp-content/uploads/2016/12/slp_54.pdf. Some public pension funds also have so-called “investment-based COLAs,” which “increase annuitants’ benefits when the pension fund’s investment performance surpasses a designated benchmark.” NASRA, *Cost-of-Living Adjustments*, <https://www.nasra.org/cola> (last visited, Dec. 24, 2024).

government funding obligations during a state fiscal crunch. The fund manager could effectuate this goal by focusing on returns. It would be up to the fund manager whether to pursue this goal and sacrifice others.

Balancing competing interests may not be easy. Constituents likely have different visions about how to weigh economic and noneconomic considerations. But this is always the case with political decisions, and it is better to acknowledge that this is the fund manager's job than cloak investment and engagement decisions in beneficiary primacy. Moreover, when exercising their discretion about the fund's goals and values, the fund manager does not operate in a vacuum. Guidance comes from the electorate through its choice of government officials, who may rightfully view their election as a public endorsement of the goals and values they campaigned on. The institutional design of the fund, the fund's governing documents, and legislation also provide guidance.

Legislative guidance on the fund's objectives comes in different forms. Some states have legislation providing their public pensions with an approved list of investments.²⁵⁰ Others articulate how the government sponsor wants the fund manager to approach ESG matters or require ETIs.²⁵¹ Connecticut law requires the State Treasurer, in making investment decisions for the Connecticut public retirement plans "to consider the implications of investments in relation to the foreign policy and national interests of the United States."²⁵² Such dictates are problematic under beneficiary primacy, but under our approach they are legitimate sources of authority that reflect the public will.

The institutional design of the fund also defines its goals. If the fund has an elected official at the head, that official is directly accountable to the electorate and, as such, those interests weigh heavily.²⁵³ For example, as noted above, the NYSCRF entrusts the fund to the state's elected controller, who is also the state's chief fiscal officer.²⁵⁴ This person's job in running the fund is to represent the interests of the

²⁵⁰ See *supra* note 62 and accompanying text.

²⁵¹ See McCarthy, *supra* note 17; Romano, *supra* note 2, at 808 ("[N]umerous states have enacted statutes to encourage local investment by public pension funds.").

²⁵² Overview – Corporate Governance, OFF. TREASURER ERICK RUSSELL, <https://portal.ct.gov/ott/about-the-treasury/corporate-governance> (last visited Aug. 30, 2024).

²⁵³ That public officials believe the investment and engagement decisions they make on behalf of their pension funds are subject to political accountability is reflected by their decisions to publicize those decisions. See, e.g., Press Release, State Comptroller DiNapoli Details Progress on Corporate Political Spending Disclosure, Office of the New York State Comptroller Thomas P. DiNapoli, Aug. 12, 2024, <https://www.osc.ny.gov/press/releases/2024/08/state-comptroller-dinapoli-details-progress-corporate-political-spending-disclosure> (reporting on efforts by the New York State Common Retirement Fund to seek disclosure of corporate political spending through the shareholder proposal process).

²⁵⁴ *Id.*

state's voters. If discretion is vested in a board elected by various constituencies—as in California—then the board represents those constituencies' interests.

The concept is analogous to the role of constituency or specialist directors in corporate governance.²⁵⁵ Some corporations have a director who represents the interests of constituencies other than the common stockholders, such as creditors or other share classes. The job of these directors is to represent the group that designated them.²⁵⁶ Similarly, under the German system of codetermination, the role of employee-appointed directors on the supervisory board of directors is to serve employee interests.²⁵⁷ Codetermination signals that corporations are to take employee interests seriously. In the same way, the institutional design of the fund guides how fund managers should represent the interests of different groups.

Guidance also comes from the fund's investment policy and related documents, which may direct the fund to invest in certain types of assets, prioritize certain state objectives, or divest from asset classes that run contrary to particular policy objectives.²⁵⁸ These documents may instruct a fund to pursue goals such as funding low-income housing, promoting in-state employment, combating climate change or encouraging diversity. Individual states (and localities) can differ with respect to these objectives, and fund managers are accountable to those objectives. Within these general constraints, the fund delegates to the fund manager discretion in how to balance the complex and competing interests of the state and its constituents while meeting the fund's contractual obligation to its beneficiaries.

The expectation that fund managers balance competing interests is reminiscent of stakeholder theory in corporate law, which would require that corporate boards of directors weigh the needs of the corporation's stakeholders in making decisions. Our approach differs, however, in important respects. Stakeholder theory envisions that boards have direct obligations, even fiduciary duties, to the corporation's stakeholders.²⁵⁹ As noted above, under our approach, fund managers would have no direct obligations to retirees, employees, taxpayers, or any other stakeholder. Their

²⁵⁵ See Roy Shapira & Yaron Nili, *Specialist Directors*, 41 YALE J. ON REG. 652 (2024).

²⁵⁶ See Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309 (2013) (describing the function of "constituency directors").

²⁵⁷ See Jens Dammann & Horst Eidenmuller, *Codetermination: A Poor Fit for US Corporations*, 2020 COLUM. BUS. L. REV. 870, 889 (2020) ("German codetermination law ... requires that one of the two boards, namely the supervisory board, includes employee representatives.").

²⁵⁸ See, e.g., CalPERS, CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM TOTAL FUND INVESTMENT POLICY (2024), <https://www.calpers.ca.gov/docs/total-fund-investment-policy.pdf> ("The purpose of this Policy ... is to provide a framework for the management of CalPERS assets. The Policies outline objectives, benchmarks, restrictions and responsibilities so that the Committee, staff, consultants, managers, members, and beneficiaries, and all other CalPERS stakeholders, clearly understand the objectives and policies of the CalPERS investment program.").

²⁵⁹ See Ann Lipton, *Will the Real Shareholder Primacy Please Stand Up*, 137 HARV. L. REV. 1584, 1590 (2024).

only obligation would be to represent the interests of the fund, and they would only owe fiduciary duties to the fund. More importantly, the chief criticisms of stakeholder theory are that it provides no guidance to corporate executives in their decision-making and no way to hold them accountable.²⁶⁰ As detailed above, public pension fund managers have ample guidance in how to balance the preferences of their constituents. Their job would be to adhere to the laws, regulations, policies, and features of institutional design that inform the fund's values and goals, and they would be held accountable through the political process for deviations.

We acknowledge that our approach conflicts with state constitutions, legislation, regulations, and caselaw that incorporates beneficiary primacy. We argue that these laws are flawed and should be changed. The status quo's nominal adherence to beneficiary primacy contradicts many existing policies and practices, and its application requires fund managers and courts to make artificially constrained choices among legitimate and competing fund objectives. Treating public pension funds as principals and acknowledging the broad range of constituency interests that inform the funds' objectives is more consistent with traditional fiduciary principles and the realities of fund structure. As we explain further in the next section, our approach has important implications for the role and power of public pension funds in corporate governance.

V. IMPLICATIONS FOR LAW AND POLICY

Models matter. Discarding beneficiary primacy in favor of our approach enables public pension funds greater latitude to protect employee and local interests. It also frees them to invest, vote and engage with respect to new challenges such as the environment, corporate political expenditures, and diversity. Our foregoing discussion has highlighted the importance of these efforts. At the same time, distinguishing between those institutional investors that, like public pension funds, should be understood as principals, and those like mutual funds, that are intermediaries, has important implications for the broader debate over institutional investor stewardship.

A. Public Pension Controversies Reimagined

As discussed in Part II, public pension fund investments that potentially sacrifice economic value have been criticized under the beneficiary primacy model as a breach of fiduciary duty. ETIs are a prominent example. Understanding public pension funds as principals extinguishes the critique. Since the fund managers would have no fiduciary duty to maximize fund value, their decision to invest in ETIs would be permitted. Supporting ETIs (or not) reflects state or local government

²⁶⁰ See *id.* at 1591; Robert T. Miller, *How Would Directors Make Business Decisions Under a Stakeholder Model?*, 77 BUS. LAW. 773, 778–79 (2022).

policy. Some states explicitly require public pension funds to invest a portion of their assets in ETIs.²⁶¹ These laws are directly in tension with beneficiary primacy, but they are policy decisions that should either be respected or revised through the political process.

Our analysis parts ways with Professor Romano and others who condemn ETIs and wish to strip politics out of public pensions.²⁶² Under our approach, ETIs are not politically compromised conflicts of interest; they are part of how public pensions are constructed. Romano proposes reforms to depoliticize public pensions and thereby align the actions of fund managers more closely with fiduciary duties to beneficiaries.²⁶³ But these fiduciary duties are inappropriate for this context. Better to drop this artificial fiduciary construct and allow pensions to function as they are intended.

A fund manager's choice to invest in local infrastructure is a policy decision to favor the state's prerogative to fund the project through the pension system rather than directly through taxes or other sources. One could argue, as Romano does, that this is an inefficient way to fund such projects.²⁶⁴ This may be true. But the answer is in the political process. Politicians who make poor capital allocation decisions risk voter blowback.

Romano theorizes that politicians fund projects through pension investments to hide their costs.²⁶⁵ Again, this may be right. But it is the beneficiary-primacy model that allows for this legerdemain. The siloed nature of the model allows politicians to blame public pensions for underfunding and poor policy choices without

²⁶¹ See Romano, *supra* note 2, at 801, table 1; see generally KENDRA STRAUSS ET AL., U.S. PUBLIC SECTOR PENSION FUNDS AND URBAN REVITALIZATION: AN OVERVIEW OF POLICY AND PROGRAMS (2004).

²⁶² A variety of scholars, including Romano, have found that public pension funds that are subject to greater political pressure have inferior economic performance compared to funds that are more insulated. See Romano, *supra* note 2, at 826–27 (finding that “the higher proportion of beneficiary-elected board members [and] [t]he smaller the proportion of board members who are appointees and ex officio members, the higher a fund’s returns”); David Hess, *Protecting and Politicizing Public Pension Fund Assets: Empirical Evidence on the Effects of Governance Structures and Practices*, 39 U.C. DAVIS L. REV. 187, 216–17 (2005) (“Member-elected trustees’ dedication to their duties also appears to be beneficial to plan financial performance.”); Aleksandar Andonov, Yael V. Hochberg & Joshua D. Rauh, *Political Representation and Governance: Evidence from the Investment Decisions of Public Pension Funds*, 73 J. FIN. 2041 (2018) (reporting that representation by state officials on public pension plan boards is negatively related to plan performance); Simon C.Y. Wong, *Public Pension Funds Perform Better When They Keep Politics at Bay*, HARV. BUS. REV. (July 19, 2016), <https://hbr.org/2016/07/public-pension-funds-perform-better-when-they-keep-politics-at-bay> (“Interference by elected officials . . . has contributed to poor investment choices, higher total costs, diminished organizations, and disappointing performance.”). While these scholars view such findings an indictment of fund managers, we see them as the natural result of a policy-driven tradeoff between value and values.

²⁶³ See Romano, *supra* note 2, at 852–53.

²⁶⁴ See *id.* at 812.

²⁶⁵ *Id.*

confronting the political system that results in these choices. Our approach recognizes that public pensions are just an arm of the government, thereby increasing the accountability of public officials who deploy this tactic.

Understanding public pensions as principals also addresses the proclivity of pension funds to support worker rights. Our approach acknowledges that public pension funds have a legitimate interest in supporting worker rights both at the public employers that contribute to the funds and at their portfolio companies, including job protection, workplace safety, and anti-discrimination policies. As noted above, Professor Webber would expand fiduciary duties to include the employees contributing to the fund. But employees are only one of several groups whose interests may reasonably warrant consideration by public pension plans. Understanding public pensions as principals would not only eliminate the conflict of interest that beneficiary primacy imagines between employee interests and value maximization but also positions funds to balance the needs of all of their constituents.

At the same time, our analysis offers a powerful rebuttal to public pension fund managers who rely on fiduciary principles to defend their decision to refrain from engaging on employment-related policies. Both the Arizona and Florida state pension plans have defended their lack of involvement in labor practices on the basis that, as fiduciaries, their sole obligation is to maximize returns.²⁶⁶ We expose the hollowness of this fiduciary-based rationale. Theirs is a policy choice and should be acknowledged as such. Under our model, fund managers would be required to consider the interests of the fund, which may include social considerations.

The same analysis applies to private equity. Funds would be unable to dismiss critiques of such investments as necessitated by fiduciary duties.²⁶⁷ They would be obligated to consider the broader interests of the fund. Moreover, because public pension funds invest heavily in private equity,²⁶⁸ they can affect industry practices in the same ways that they have impacted public companies—through investment,

²⁶⁶ See Rachel Phua, *Workers Funding Other Workers' Misery*, AM. PROSPECT (Oct. 4, 2023), <https://prospect.org/labor/2023-10-04-workers-funding-misery-private-equity-pension-funds/>.

²⁶⁷ This argument is also empirically dubious. See, e.g., *id.* (“[S]tudies have shown that private equity doesn’t outperform public markets.”). See also Jean-Pierre Aubry & Yimeng Yin, *How Do Public Pension Plan Returns Compare to Simple Index Investing?*, CTR. FOR RET. RSCH. BOS. COLL. (June 18, 2024), <https://crr.bc.edu/how-do-public-pension-plan-returns-compare-to-simple-index-investing/> (finding that despite increased allocations to private equity and other alternative assets, “pension funds’ annualized aggregate returns since 2000 have been virtually identical to a simple 60-40 index portfolio”).

²⁶⁸ See William W. Clayton, *How Public Pension Plans Have Shaped Private Equity*, 81 MARYLAND L. REV. 840, 842 (2022) (“Historically, public pension plans invested nearly all their capital in traditional stocks and bonds, but they have collectively become the largest investors in the modern private equity fund industry”).

divestment, and engagement—as illustrated by NYCERS’s demand for fair rental housing practices from the private equity funds it invests in.²⁶⁹

In this way, our approach could have a transformative effect on private equity. Driven by beneficiary primacy and a hunger for returns, public pension funds are the largest backer of an industry many decry for deleterious local impacts—on jobs, on prices, on quality.²⁷⁰ Under our approach, fund managers would no longer face the same pressure to maximize returns. Instead, they would be obligated to represent the interests of the fund and its constituents. This shift should cause fund managers to reevaluate the role of private equity in their portfolios and to insist on operational changes at the funds they back, potentially shrinking and reforming the industry.

More broadly, the paradigm shift would allow fund managers to address the issues their constituents value. The beneficiary primacy model poses difficulties for ESG investing and engagement by imagining a conflict of interest between pursuing ESG goals and fiduciary duties. To address such critiques, many public pension funds disingenuously attempt to defend ESG-oriented decisions in terms of economic value. Rejecting the premise that public pension fund managers have a fiduciary duty to maximize fund value allows them to drop the act and frees them to invest, divest, and engage on moral grounds consistent with the fund’s interests.

At the same time, our approach demands respect for legislation, because it is a key source of authority with respect to how managers determine these interests. If state law prohibits pension fund managers from taking ESG into account, or if states enact such legislation, these measures tie the hands of the fund managers. Similarly, if the law compels managers to adopt certain ESG investing policies, such as divesting from fossil fuels, managers cannot legitimately resist on the basis that divestment will reduce fund returns.

If adopted, our approach may increase legislative attention to the investment and engagement decisions of public pensions as lawmakers seek to provide clear guidance to fund managers. Our proposal demands that such efforts be explicit. Rules instructing the pension fund manager to act in the sole financial benefit of the fund’s beneficiaries do not clearly exclude ESG, because a fund manager can plausibly argue that ESG serves its beneficiaries’ financial interests. If states want their pension fund managers to reject or consider ESG, they should say so directly rather than obliquely referencing economic value. Explicit legislation is a more straightforward way of incorporating the state’s values into its pension fund investing decisions and providing efficient direction to those who manage the fund. It would also further public debate. If the legislature or a fund’s chief investment officer decides that the fund should divest from fossil fuels, for example, that decision should not be discussed and defended in purely economic terms but rather through

²⁶⁹ See *supra* note 118 and accompanying text.

²⁷⁰ See Clayton, *supra* note 268, at 842.

identifying and describing the potential costs and benefits—both economic and non-economic—from the decision. Such transparency would allow ESG to be debated on its merits rather than through insincere appeals to fiduciary duties.

Reimagining these debates has significant ramifications for corporate governance. As noted above, public pension funds have been leaders in this arena—using their voting power and the shareholder proposal process to increase management accountability and shareholder rights and to further ESG goals like climate-change mitigation and board diversity. Beneficiary primacy has no explanation for this, and poses an impediment to it, because such efforts must be justified in terms of economic value. As further described below, our analysis not only understands these efforts as a reflection of the fund's values but also recognizes their contribution to the quality of corporate governance and allows fund managers to engage freely.

Moreover, our approach resolves the difficulties with public pension fund support for ESG by shifting the focus from beneficiary interests to the state and local government interests that inform the pension fund's goals and values. This gives voice to the public. State policymakers that set ESG rules are accountable to the electorate, and the political process further renders fund managers accountable. By representing the views of state taxpayers, employees, and union members, public pension fund managers give clout to groups that would otherwise have little say on the fundamental policy questions at stake in the ESG debates.

B. The Role of Principals in Corporate Governance—Toward a More Nuanced Theory of Institutional Investors

Our analysis more broadly highlights the critical distinctions between those who invest as principals and those who invest as intermediaries. Public pension fund activism has led some commentators to demand similar engagement by other types of institutional investors, such as mutual funds. In a recent article, Professors Bebchuk and Hirst harangue mutual funds for their lack of corporate governance activism.²⁷¹ Their critique is based largely on a comparison of mutual funds to public pension funds, observing that, in contrast to mutual funds, CalPERS and CalSTRS have filed many more comment letters on SEC rulemaking,²⁷² have filed many more amicus briefs in securities litigation cases,²⁷³ and have served as lead plaintiffs in securities class actions.²⁷⁴

This argument implicitly and incorrectly views public pension funds and mutual funds as similarly situated. The typical mutual fund rightly focuses on the economic

²⁷¹ See generally, Bebchuk & Hirst, *supra* note 3.

²⁷² *Id.* at 2107, 2144.

²⁷³ *Id.* at 2109.

²⁷⁴ *Id.* at 2113.

value of the fund. It is not clear that engagement in corporate governance furthers that goal.²⁷⁵ The task becomes even more fraught with governance issues that implicate values because mutual funds, acting as intermediaries, cannot adequately reflect the diversity of views held by their investors. Economic value maximization serves as a rough proxy for addressing pluralistic and irreconcilable preferences along non-economic dimensions. Although investors can, in theory, select into funds that align with their non-economic preferences,²⁷⁶ market imperfections and information constraints limit their ability to do so efficiently.²⁷⁷ Thus, mutual funds are typically asked to vote and engage on values-based initiatives without knowing their beneficiaries' values.

As a result, engagement, particularly on ESG, is an awkward fit for private asset managers. Critiquing them based on a comparison to public pensions obscures this analysis and results from wrongly viewing public pensions under the beneficiary primacy model. In fact, public pension fund activism is yet another indication that beneficiary primacy is inaccurate. If public pension fund managers were focused solely on maximizing value for their beneficiaries—as the beneficiary-primacy model instructs—they would struggle with the same issues as mutual funds. To satisfy their beneficiaries, they would have to keep returns high and fees low, and stewardship is not a clear way to achieve these goals and may detract from them. The beneficiary primacy model thus fails to explain why public pension funds eagerly participate.

Viewing public pension funds as principals, however, explains their active engagement across a wide range of issues. Under this view, it is the public pension fund managers' job to engage, consistent with their view of the fund's values and goals, and the conception of those goals is a product of political and social forces, rather than purely economic considerations. Moreover, unlike mutual fund managers, managers of pension funds have numerous sources of authority as to the values they should represent. And, because fund managers are either elected officials or report to them, they are ultimately accountable to the public for doing so.

This accountability structure is bolstered by intrinsic motivations. Public pension fund managers may actively participate in corporate governance to further their political careers or because they share the values of their constituents. As Professor Romano points out, public pension funds may be run by “political

²⁷⁵ Fisch & Schwartz, *supra* note 9, at 21 (“Stewardship, it turns out, is relatively hard, potentially costly, and generates little—if any—profit for fund managers.”); *see also* Jeff Schwartz, *Stewardship Theater*, 100 WASH. U. L. REV. 393, 410–12 (considering costs and benefits of mutual fund stewardship).

²⁷⁶ *See* Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. CHI. BUS. L. REV. 195, 213 (2022); *see generally* Curtis, et al., *supra* note 174 (documenting differences in investment and voting policies between funds that brand themselves as “ESG” and other mutual funds).

²⁷⁷ *See* Fisch & Schwartz, *supra* note 9, 42–43; *see* Jill E. Fisch & Adriana Robertson, *What's in a Name? ESG Mutual Funds and the SEC's Names Rule*, 96 S. CAL. L. REV. 1417, 1417 (2024) (discussing “the limitations of fund names in conveying the extent of information necessary to ensure that a fund meets the expectations of its investors”).

entrepreneurs,” like “Elizabeth Holtzman, [a former] New York City comptroller and a trustee for the city’s pension funds, [who] publicized her active approach to corporate governance while campaigning for the Democratic party’s nomination for U.S. Senator.”²⁷⁸ Similarly, Phil Angelides, former California state treasurer and CalPERS board member, said he wanted to “mobilize the power of the capital markets for public purpose.”²⁷⁹ Critics views such motivations as problematic, but they are part of why public pension funds have been so influential.

Moreover, the inherent structural obstacles to meaningful engagement by institutional intermediaries increase the importance of institutional principals. Despite the conceptual and legal framework that has wrongly cast them as intermediaries, public pension funds have transformed corporate governance and operations. Our analysis frees public pension fund managers from misplaced critiques and potential liability for their valuable role in financial markets.

Recognizing the distinction between institutional principals and institutional intermediaries creates friction between the two because the latter manage assets for, and vote on behalf of, the former. Under beneficiary primacy, their interests were aligned, but if public pensions are recognized as having more wide-ranging interests, then institutional intermediaries cannot represent them by voting in a way that maximizes the value of portfolio firms. One solution is for pensions to put their money with intermediaries that represent their values. Public pensions may choose ESG funds, for instance, if they want more sustainably minded stewardship activities.

Another solution is to give principals more say in how intermediaries vote their shares. The Big 3 mutual fund complexes (Vanguard, State Street, and BlackRock) are already experimenting with pass-through voting and other methods to give pension funds and other investors greater ability to direct how their shares are voted.²⁸⁰ FinTech companies are further aiding this effort. Tumelo, for example, provides a platform for asset owners to vote their shares held through intermediaries.²⁸¹ We anticipate that the market will continue to evolve in ways that expand the ability of public pensions to engage with portfolio firms.

While we focus on public pensions, other principals can also play an important role in corporate governance. Long dismissed as diffuse and apathetic, retail

²⁷⁸ See Romano, *supra* note 2, at 852-53.

²⁷⁹ *Special Report: Public Pension Fund Activism*, *supra* note 58.

²⁸⁰ Since public pension funds are principals, we do not recommend that they adopt mechanisms to ascertain the preferences of their beneficiaries. We have argued for this with respect to mutual funds, as intermediaries, but specifically excluded public pension funds from the analysis for this reason. See Fisch & Schwartz, *supra* note 9, at 32 n.8.

²⁸¹ See *Global Specialists in Pass-Through Voting*, TUMELO, <https://www.tumelo.com/> (last visited Aug. 16, 2024).

investors have received relatively limited scholarly attention.²⁸² But they are becoming more involved, and technological developments offer promising tools for reducing the cost of their participation and aggregating their preferences. Similarly, Professor Amelia Miazad’s work on faith investors, which invest according to religious values, reveals that other institutional investors can function as principals and demonstrates the influence of such investors in corporate governance.²⁸³

Legal scholarship has understandably focused on the role of institutional intermediaries in corporate governance, but in doing so, it has failed to appreciate the essential role that principals play, particularly as values have come to the fore. Public pension funds have had the biggest impact, but other principals, including individuals²⁸⁴ and values-based institutional investors,²⁸⁵ have the potential to become important players as well, particularly as technology reduces the frictions of participating in corporate democracy.

VI. COUNTERARGUMENTS

We acknowledge that the shift away from beneficiary primacy raises important concerns. Critics may worry that relaxing the mandate to maximize returns will exacerbate public pension underfunding, reduce accountability, or lead to unwanted social consequences. Others might question whether the change is legally or practically meaningful given the difficulties associated with fiduciary litigation. In this section, we respond to these counterarguments.

A. Underfunding

Public pension fund underfunding is a significant concern,²⁸⁶ with estimates of underfunding ranging from \$1 to \$4 trillion.²⁸⁷ At the state level, funding levels vary from 120% (Washington) to 52% (Kentucky).²⁸⁸ The beneficiary primacy model views the persistence of underfunding as an indictment of public pension fund management and, in particular, collateral-benefits investing. As one article critically observes, “many public plans face both affirmative investment requirements as well

²⁸² Cf. Jill E. Fisch, *GameStop and the Resurgence of the Retail Investor*, 102 B.U. L. REV. 1799 (2022) (describing the reemergence of the retail investor and analyzing its potential impact on corporate governance); Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51 (2021).

²⁸³ See generally Miazad, *supra* note 91.

²⁸⁴ See Fisch, *supra* note 282.

²⁸⁵ See generally Miazad, *supra* note 91.

²⁸⁶ See Hess, *supra* note 262, at 193 (“[P]ension funds are consistently underfunded.”).

²⁸⁷ *State and Local Backgrounders*, *supra* note 25.

²⁸⁸ *Unfunded Liabilities for State Pension Plans in 2023*, EQUABLE (Aug. 24, 2023), <https://equable.org/unfunded-liabilities-for-state-pension-plans-in-2023/> (stating “some states carry a larger share of pension unfunded liabilities (or pension debt) than others”).

as investment restrictions that have little to do with retirees' best interests.”²⁸⁹ These mandates, including to invest in local or socially responsible projects or to refrain from investing in businesses deemed “undesirable...may lead to suboptimal investment decisions.”²⁹⁰ A provision in the Ensuring Sound Guidance Act, introduced by US Representative Andy Barr in 2023 reflects this perspective, explicitly suggesting that favoring ESG considerations over beneficiary interests contributes to public pension underfunding.²⁹¹

The tie between collateral benefits and underfunding, however, is tenuous. While returns generate 60-65% of public pension funding,²⁹² how collateral-benefits investing affects returns is empirically indeterminate, with some studies supporting pension funds' claims of improved performance.²⁹³ Moreover, state investment mandates do not appear correlated with the degree to which their pension plans are underfunded. For example, Texas has adopted a variety of anti-ESG provisions for its public pension funds and has one of the highest levels of unfunded liabilities in

²⁸⁹ See Fitzpatrick IV & Monahan, *supra* note 232, at 1329.

²⁹⁰ *Id.*

²⁹¹ See Ensuring Sound Guidance Act, H. R. 4237, 118th Cong. § 4 (2023), <https://www.congress.gov/bill/118th-congress/house-bill/4237/text?s=1&r=2> (requiring US Comptroller General to conduct a study on the extent to which underfunded public pension funds “subordinate the pecuniary interests of participants and beneficiaries to environmental, social, governance, or other objectives”). See also Paul Mulholland, *New House Bill Suggests ESG Is to Blame for Underfunded Pensions*, PLAN SPONSOR (June 21, 2023), <https://www.plansponsor.com/new-house-bill-suggests-esg-is-to-blame-for-underfunded-pensions/> (describing proposed legislation implying “that some pension plans could be underfunded in part due to their consideration of ESG factors”).

²⁹² See Keith Brainard & Alex Brown, *Public Fund Survey*, NASRA (Nov. 2023), <https://www.nasra.org/publicfundsurvey>.

²⁹³ See, e.g., Steven Rothstein, *Anti-ESG Legislation Harms Fiduciary Duty*, DIRS. & BDS. (Feb. 1, 2024), <https://www.directorsandboards.com/board-issues/esg/anti-esg-legislation-harms-fiduciary-duty/> (“In state after state, economic and revenue analyses have found that bills that ban the consideration of climate and other responsible investing risks will have negative impacts.”); Hazel Bradford, *Pension Funds Would Have \$21 Billion More Without Fossil Fuel Holdings – Study*, PENSIONS & INVS. (June 28, 2023, 3:43 PM), <https://www.pionline.com/esg/pension-funds-would-have-21-billion-more-without-fossil-fuels> (reporting results of study finding that the value of six public pension funds “would have been 13 percentage points higher on average if they had divested from the energy sector 10 years ago.”); cf. Curtis, et al., *supra* note 174 (finding that ESG oriented mutual funds, over a specific time period, outperformed traditional mutual funds).

the United States.²⁹⁴ Maine, which has adopted pro-ESG policies included a required divestment from fossil fuel, is one of the least underfunded.²⁹⁵

Rather than being attributable to socially oriented investing, the biggest contributor to underfunding is a failure by states and cities to allocate enough money to their public pensions.²⁹⁶ The match between obligations and assets also stems from a raft of administrative choices, including eligibility standards and vesting periods, pension payouts, and contribution levels. A plan could, for example, reduce underfunding by foregoing cost of living adjustments (COLAs) for current beneficiaries, even though that choice would have nothing to do with the fund's investment policy.

Underfunding is related to asset allocation decisions, but not in the way ESG critics contend. Instead, underfunding likely leads pension fund managers to seek higher returns with higher risks, and may explain their growing appetite for private equity.²⁹⁷ One of the drawbacks of beneficiary primacy is that it does nothing to police such risk-taking, and if anything, encourages it.

Our approach would diminish this incentive but is unlikely to contribute to underfunding. Because pension underfunding has received substantial public attention, government officials are under considerable pressure to address funding deficits by focusing on fund returns. As one commentator explains, “While it is unrealistic to expect that asset performance alone will stave off the crisis in underfunded pension funds, there is strong pressure for the asset portfolio to perform as well as possible to prevent the gap from becoming even wider and to minimize the amount of capital the states have to raise to bridge the gap.”²⁹⁸ Public officials are also unlikely to be willing to face the political fallout associated with raising taxes or cutting other programs to meet funding deficits.²⁹⁹ Finally, both fund managers and the funds themselves are evaluated on their performance relative to their peers. Individual fund managers can often obtain more prestigious positions or

²⁹⁴ Danilo Risteski, Note, *Politics Before Pensions: How New ESG Rules Expose Public Pension System Vulnerabilities*, 95 U. COLO. L. REV. 805 (2024) (describing Texas anti-ESG laws); *Unfunded Liabilities for State Pension Plans in 2023*, EQUABLE (Aug. 24, 2023), <https://equable.org/unfunded-liabilities-for-state-pension-plans-in-2023/> (describing Texas plans as having \$96,163,034,496 in unfunded liabilities as of June 30, 2023).

²⁹⁵ Risteski, *supra* note 294, at 822 (describing Maine's pro-ESG laws); *Unfunded Liabilities for State Pension Plans in 2023*, EQUABLE (Aug. 24, 2023), <https://equable.org/unfunded-liabilities-for-state-pension-plans-in-2023/> (reporting that Maine pension funds have a funding ratio of 90% as of June 30, 2023).

²⁹⁶ Monahan, *supra* note 16, at 368.

²⁹⁷ See, e.g., Aaron Brown, *Pension Funds Are Hooked on Private Equity, No Matter the Risks*, BLOOMBERG (July 31, 2024, 3:00 AM), <https://www.bloomberg.com/opinion/articles/2024-07-31/pension-funds-are-hooked-on-private-equity-no-matter-the-risks> (warning that underfunded pension funds are likely to continue to invest in private equity despite its substantial risks).

²⁹⁸ Cai, *supra* note 49, at 123–24.

²⁹⁹ See *id.* at 124 (noting “taxpayers balk at having to make up shortfalls in pension funding”).

bonuses if their fund outperforms, and they can lose their jobs if they underperform.³⁰⁰ These measures provide meaningful checks on the willingness of fund managers to make values-based decisions that substantially sacrifice economic performance. They also serve as a limiting force on the role to which social or public values are likely to play in investment policies.

B. Lack of Accountability

Some may argue that our model gives public pension fund managers excessive discretion to pursue social or political goals. Beneficiary primacy creates liability risk and serves an expressive function that steers the focus of public pensions toward long-term economic value. Removing this dictate could weaken accountability and increase the risk of mismanagement and abuse.

The existing system, however, provides significant constraints on such behavior. Most importantly, public pension fund managers are accountable for their investment policies through the political process. Those that fail to reflect the public's values will be replaced.

One might worry that democratic accountability is an unreliable check on managerial conduct. Perhaps the electorate is unequipped to police for pension fund mismanagement or for activities that do not align with their values. While there is undoubtedly some truth to this critique,³⁰¹ treating public pension funds as principals is an improvement on the status quo. The beneficiary-primacy model imposes an abstract legal concept that obstructs the will of the people. Our approach clears this impediment and aligns fund management more closely with constituent preferences. It further precludes fund managers from resisting political policy choices on the basis that such choices reduce fund returns.

Moreover, pension fund investing and engagement are more politically salient than ever. As noted above, over the last few years, states have introduced a spate of reforms aimed at implementing or restricting socially responsible investment decisions by fund managers,³⁰² including a New Hampshire bill would make it a felony for them to invest based on ESG criteria.³⁰³ Moreover, state attorneys general

³⁰⁰ See *id.* (noting “the pension industry as a whole is concerned by performance peer risk”).

³⁰¹ Turnout for CalPERS elections, for instance are low. See Mendel, *supra* note 74 (“In a typical low-turnout CalPERS board election, only 16,364 votes were cast by the roughly 400,000 eligible local government members, said Brad Pacheco, CalPERS spokesman. The turnout of about 4 percent was below the 6.8 percent in the last election four years ago.”).

³⁰² Joshua Lichtenstein, Michael Littenberg & Reagan Haas, *ESG and Public Pension Investing in 2023: A Year-To-Date Recap and Analysis*, HARV. L. SCH. F. ON CORP. GOV. (Nov. 22, 2023), <https://corpgov.law.harvard.edu/2023/11/22/esg-and-public-pension-investing-in-2023-a-year-to-date-recap-and-analysis/#:~:text=Despite%20the%20increased%20prevalence%20of,a%20re-allocation%20of%20risk.>

³⁰³ See *supra* note 166 and accompanying text.

have publicly weighed in, expressing their view that ESG considerations violate fund fiduciary duties.³⁰⁴ Even before the current wave of attention, the president of the CalPERS board, Priya Mathur, was voted out over concerns that she was prioritizing ESG issues over investment returns.³⁰⁵

Finally, governments concerned about public oversight could take steps to increase transparency and include the public in its decision-making. Fund boards could, for example, hold open meetings and invite the submission of public comments.³⁰⁶ On important topics like divestiture from fossil fuels, fund could engage the public with town halls and open forums. Our model creates space for inclusive measures that are arguably illegitimate under beneficiary primacy.

Pension fund managers are also accountable to the employment market. As one commentator explains, “Pension plans are employee magnets that help keep public employees in jobs for their career, which strengthens public services and lowers workforce costs for cities and states.”³⁰⁷ If such plans become less attractive, workers will flee the public sector in search of alternatives.

The legal system provides further accountability. Importantly, our proposal does not eliminate fund manager fiduciary duties; it simply provides that those duties are owed to the fund, not its beneficiaries. Those duties could be enforced by the fund through its trustees, the governing board, or state attorneys general. Although the duty of care would afford great deference to the exercise of fund manager discretion, akin to the business judgment rule in corporate law, fund managers could be liable for actions such as inadequate diversification.³⁰⁸ While the duty of loyalty would no longer require economic value maximization, it would still mandate that managers act

³⁰⁴ See Cole, *supra* note 127 (describing opinions by various state attorneys general that public pension funds violate their fiduciary duties by investing based on ESG considerations).

³⁰⁵ See Mendel, *supra* note 74. Some might be concerned that political accountability becomes more tenuous at the local level. The opposite, however, may be true. Smaller plans may have greater engagement because people feel like their voice matters.

³⁰⁶ CalPERS board meetings, for example, are open to the general public and broadcast via webcast. In addition, members can submit public comments to the CalPERS board. See *Board Meetings*, CALPERS, <https://www.calpers.ca.gov/page/about/board/board-meetings#:~:text=Board%20meetings%20are%20open%20to,items%20presented%20to%20the%20Board> (last updated Sept. 6, 2024). NYCERS meetings are also webcast. See *About NYCERS*, NYCERS, <https://www.nycers.org/about> (last visited, Dec. 24, 2024).

³⁰⁷ Press Release, New Research Finds Americans Supportive of Pension Benefits for Public Employees, National Institute on Retirement Security, Oct. 29, 2024, <https://www.nirsonline.org/2024/10/new-research-finds-americans-supportive-of-pension-benefits-for-public-employees/#:~:text=%E2%80%9CPension%20plans%20are%20employee%20magnets,costs%20for%20cities%20and%20states.%E2%80%9D> (quoting Dan Doonan, NIRS executive director).

³⁰⁸ See *supra* note 20.

in the fund's interest; they would not be permitted to use their discretion over fund assets to settle political scores, reward friends, or personally profit.

Additional legal guardrails remain in place for self-dealing and gross misconduct. For example, it has been argued that a former New York Comptroller targeted a firm for engagement because it had donated to the opposing political party.³⁰⁹ If true, this likely violates the duty of loyalty. Fund managers who engage in egregious misconduct also face the prospect of criminal liability. Former heads of both CalPERS and the NY state pension funds were found guilty of fraud.³¹⁰ Our approach relies on these well-established accountability tools.³¹¹

C. Ideology

Some might be concerned about the social impact of our proposal. Those against the progressive values that public pensions typically support, or who argue these issues should be regulatory matters, might criticize our proposal for giving fund managers excess discretion to engage in socially oriented investing. Others may have the opposite concern and fear that state entities might use their discretion to curtail ESG investing and engagement. Indeed, as discussed above, many states are seeking to do just that. Our answer to these concerns is to concede that the determination of a public pension fund's investment and engagement priorities involve public expenditures that are inherently a political question. If adopting an anti-ESG policy is a state's prerogative, so be it.

Notably, we acknowledge that the impact of our proposal on the ESG landscape is unclear. Progressive-leaning states would no longer be inhibited from pursuing a social agenda; conservative states could eliminate ESG investing and engagement from their pension funds. How everything would ultimately play out is anyone's

³⁰⁹ See *Special Report: Public Pension Fund Activism*, *supra* note 58 ("The fund's three proposals sponsored at Anadarko, in 2011, 2012, and 2013, each called on the company to issue a report on its political spending. The special focus on Anadarko is unlikely due to a perceived adverse impact of the company's political spending on its performance: over the leading three-year period corresponding to the introduction of these three proposals, Anadarko's share price has outperformed that of its competitors. Instead, DiNapoli's focus on Anadarko is likely political: the company gave 90 percent of its \$244,500 in political action committee federal-candidate donations in 2012 and 79 percent of its \$310,500 in 2010 PAC donations to Republican candidates.").

³¹⁰ See Press Release, U.S. Att'y's Off. N. Dist. Cal., Former CalPERS CEO Sentenced to 54 Months' Imprisonment For Role In Corruption Conspiracy, <https://www.justice.gov/usao-ndca/pr/former-calpers-ceo-sentenced-54-months-imprisonment-role-corruption-conspiracy> (last updated Sept. 21, 2016); Danny Hakim & William K. Rashbaum, *Hevesi Pleads Guilty in Pension Case*, N.Y. TIMES (Oct. 7, 2010), <https://www.nytimes.com/2010/10/08/nyregion/08hevesi.html>.

³¹¹ Legislatures could implement additional formal oversight structures as well. For example, legislation introduced in California proposes creating an inspector general's office for CalPERS. Arleen Jacobius, *California Bill Would Create CalPERS Inspector General*, PENSIONS & INVS. (Feb. 21, 2024), <https://www.pionline.com/pension-funds/california-bill-would-create-calpers-inspector-general>.

guess. Our proposal is not linked to ideology. Its aim is to describe more accurately how public pensions work and to match the legal framework to that description.

A related objection is that, since the state and local statutes and regulations that incorporate beneficiary primacy are themselves a reflection of the public's will, our model collapses into beneficiary primacy. Our answer is that the prevalence of beneficiary primacy, in many cases, likely reflects unthinking and outdated obedience to a flawed legal theory that is so well ingrained that policymakers see no alternative. We introduce that alternative. We suggest that states and localities look at such rules with fresh eyes and consider amending them. If such efforts fail after informed debate, then beneficiary primacy would legitimately converge with the public's will.

D. Practical Significance

Some might accept our theoretical point but argue that it lacks practical relevance because fiduciary-duty claims are rarely successful. The shift we envision, however, carries significant normative implications. Even though fiduciary duties are difficult to enforce, the threat of litigation and potential liability persistently hovers over fund decision-making.³¹² More importantly, beneficiary primacy is the industry's lodestar. If fund managers instead understood their role as public servants, there is good reason to believe they would act far differently. They would approach public policy concerns directly without having to defend their positions based on long-term value.

Embracing our approach exposes that the debate over, for example, ESG investing is properly focused on public values and would legitimize disagreements among state and local governments about the prioritization of those values. While fund managers would be politically accountable to the system in which they operate, it would be for how they reflect the public's values, not for adherence to an artificial legal framework. A false and sterile debate becomes a genuine contest over values. Our approach also has implications for reform. It stands apart from all previous scholarship on the issue—it refutes arguments to depoliticize public pensions, on the one hand, or to make fund managers responsible to all, or certain groups of, stakeholders, on the other.

CONCLUSION

Current laws and policies treat public pension funds like other institutional investors, as intermediaries whose leaders are bound by strict fiduciary duties to

³¹² See, e.g., David J. Berger, David H. Webber & Beth Young, *The Liability Trap: Why the ALEC Anti-ESG Bills Create a Legal Quagmire for Fiduciaries Connected with Public Pensions* (Working Paper, February 15, 2023), <https://ssrn.com/abstract=4360119> (warning that, among other things, pending legislation imposes on fund managers the need to draw an “unworkable distinction between pecuniary and non-pecuniary” interest).

maximize returns on behalf of fund beneficiaries. This approach, however, fails to map onto the history and structure of public pensions, which show a commitment to public values. Nor does this approach reflect the economic realities of the relationship between public pension fund beneficiaries and the fund.

Imposing a mandate of beneficiary primacy imagines conflicts of interest where there are none. Under this model, local investing, employee-conscious investing, ESG investing, and ESG stewardship all present thorny conflicts that have caused confusion and consternation among pension fund managers, state and local governments, courts, and scholars for decades. So far, however, would-be reformers have mostly made piecemeal critiques and suggestions aimed at narrowly reframing beneficiary primacy. This is the wrong approach.

The current conceptual framework ignores the public nature of public pension funds. They should be viewed as public entities with their own distinct interests and objectives. Under this model, what were legally fraught conflicts are now unencumbered choices informed by public values. This reconceptualization enables public pension fund managers to embrace their unique role in markets and corporate governance.

Our approach frees public pension funds to pursue investment and engagement objectives that further the interests of their varied constituents. This freedom is particularly important as investing has become a political arena. Fittingly, the institutional design of public pensions as political bodies means that the source of their investing values would be a group that traditionally has limited say on Wall Street—the public.

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