



# Divestment laws, fiduciary duty, and pension fund management: an empirical examination

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Divestment  
laws and  
fiduciary duty

29

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## Abstract

**Purpose** – This paper aims to conduct an empirical analysis of subnational laws of the USA that require public pension funds to divest from companies that are in business with Cuba, Iran, Syria, and Sudan and explores whether public fund officials may be in violation of their fiduciary duty responsibilities toward pension system beneficiaries as they execute state-mandated divestment schemes.

**Design/methodology/approach** – A database search was conducted for specific federal laws, presidential executive orders, and departments, offices, and terminology relevant to the topic of the research to explore the extent by which states employ public pension divestment regimes inspired by the federal governments designation of the four countries labeled as state sponsors of terrorism. Quantitative and financial calculations were used to conduct the cost analysis of divestment laws.

**Findings** – Divestment laws are costly for the beneficiaries. In the majority of the states that have divestment laws, the public funds, rather than the states, must cover the losses associated with divestment, resulting in pension fund trustees and managers having to take action that are in violation of their fiduciary duty responsibilities.

**Research limitations/implications** – The study recommends a major overhaul of the current divestment laws.

**Practical implications** – Divestment legislations must be revised as they cause a divergence of interests between state-driven political gestures, the fiduciary responsibilities of pension system trustees, and the financial interests of the beneficiaries.

**Originality/value** – This is the first study that recommends specific legislative action that would resolve the divergence of interests between state-driven political gestures, the fiduciary responsibilities of pension system trustees, and the financial interests of the beneficiaries.

**Keywords** Divestment laws, Pension fund governance, Public pension funds

**Paper type** Research paper

## Introduction

Public pension fund managers in the USA are legally required to uphold common law fiduciary duty standards, to proceed with prudence, and to act in the best interest of their beneficiaries. This paper examines whether foreign policy-inspired state-imposed divestment requirements may cause a conflict for public pension fund trustees and managers in that they may be required to take actions that breach their fiduciary duties. The paper undertakes a cost-benefit analysis of divestment laws and closely examines the differences between the various divestment regimes across the states. The paper concludes that divestment laws should either be repealed or significantly modified.

## Methodology

A database search was conducted for specific federal laws, presidential executive orders, and departments, offices, and terminology relevant to the topic of the research



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to explore the extent by which states employ public pension divestment regimes inspired by the federal government’s designation of the four countries (Cuba, Iran, Sudan, and Syria) labeled as state sponsors of terrorism (SST) (US Department of State, 2011) as well as those that fall under a separate sanctions program administered by the US Department of the Treasury’s Office of Foreign Assets Control (OFAC) (2011)[1]. The focus of the paper is state legislative action. This project does not explore non-legislative divestment policies of the states or individual public funds.

### Findings

#### *Which states require divestment?*

Sudan and Iran are, respectively, the primary countries that divestment laws target. Twenty states require public fund divestment from companies that do business with Sudan, 13 from Iran, four from Cuba, and three from Syria. The states use two methods: the country-specific targeting approach or the SST approach. The majority of the states employ the country-specific targeting approach. Three states (Arizona, Indiana, and Michigan) utilize the SST approach, under which the states require divestment of public funds from companies that have business relations with countries listed by the federal government as SST (Table I).

#### *Divestment cost analysis*

Two major factors contribute to the cost of divestment: lower earnings and monitoring and compliance costs.

	Sudan	Iran	Cuba	Syria
Arizona	✓ ±	✓ ±	±	±
California	✓	✓	×	×
Colorado	✓	×	×	×
Florida	✓	✓	✓	×
Georgia	×	✓	×	×
Hawaii	✓	×	×	×
Illinois	✓	✓	×	×
Indiana	✓ ±	±	±	±
Iowa	✓	×	×	×
Kansas	✓	×	×	×
Maryland	✓	✓	×	×
Michigan	✓ ±	✓ ±	±	±
Minnesota	✓	✓	×	×
New Hampshire	✓	×	×	×
New Jersey	✓	✓	×	×
North Carolina	✓	×	×	×
Ohio	✓	✓	×	×
Oregon	✓	×	×	×
Pennsylvania	✓	✓	×	×
South Carolina	✓	×	×	×
South Dakota	×	✓	×	×
Texas	✓	×	×	×
Total	20	13	4	3

**Table I.**  
States that require public fund divestment from Sudan, Iran, Cuba, or Syria

**Notes:** ✓ – specific targeting method; ± – SST method

On the former, as Nicholl and Shapiro (2012) note:

[...] if each pension system currently holds an investment portfolio that it believes provides the highest possible expected return for their level of risk tolerance, then it follows that any material change to the investments that does not increase risk will lower the expected earnings.

Furthermore, pension funds that heavily utilize indexing strategies may either be forced to change their strategies altogether or suffer portfolio losses and imbalances since “many large indices will contain at least one prohibited company” (Nicholl and Shapiro, 2012).

On monitoring and compliance costs, many public pension funds simply do not have the in-house resources and expertise to actively monitor from which companies they must divest. Accordingly, they are forced to hire outside consulting firms and investment management companies in order to remain compliant.

One particular compliance challenge arises in those states that have adopted what I will refer to as the “federal exception clause” in their divestment laws. One example of such clause is an Arizona provision that provides that a:

[...] company that the US Government affirmatively declares to be excluded from its present or any future federal sanctions regime relating to Sudan shall not be subject to divestment or investment prohibition [...] (Ariz. Rev. Stat. § 35-391.02).

While legally-sound and necessary because US federal law trumps conflicting state statutes, such clauses face serious implementational challenges. One challenge is the frequency with which the US Department of the Treasury’s Office of Foreign Assets Control (OFAC) grants or revokes such exceptions. Another challenge is that the exceptions are not always publicly disclosed by the federal government. According to Becker (2010), for instance, OFAC has so far granted nearly 10,000 exception licenses, the details for which became known only when *The New York Times* acquired limited and heavily-redacted access to the list by initiating a Freedom of Information Act lawsuit, a process that lasted for three years.

In short, divestment regimes are costly. For instance, in one quarter alone, the Teachers’ Retirement System of the State of Illinois incurred \$1.2 million in costs to implement the (later-found unconstitutional, now defunct) Illinois law requiring Sudan-related divestments (Teachers’ Retirement System, 2006).

As Coronado *et al.* (2003) have argued, political interference in public pension systems, including divestment legislation, are in many cases damaging to the funds and can cause them to earn considerably lower returns than their private counterparts. As the researchers discovered, for instance, the California legislature’s Apartheid-era requirement that the California Public Employees’ Retirement System (CalPERS) divest from companies that did business in South Africa may have cost the fund’s beneficiaries about \$500 million. Similarly, Barber (2007) estimates that CalPERS’ self-initiated decision to divest all of its holdings from tobacco companies may have led to a \$650 million loss between 2000 and 2006. While the latter example is not one of political interference, it demonstrates how nonfinancially-based decisions can significantly impair returns.

The US Government Accountability Office (GAO) survey results have also shown that state fund managers are alarmed with the financial risks associated with divestment. For instance, 69 percent of the managers who had divested or had plans to divest from Sudan and 44 percent of those who had not divested “were concerned to a large or moderate extent that divestment could cause their funds to incur high transaction costs, earn reduced returns on investment, or both” (GAO Report, 2010).

Nicholl and Shapiro (2012) estimate that lost earnings due to divestment may range from no impact to approximately 30 basis points (Table II). To demonstrate the potential costs, they use the following example:

The state of Ohio has four statewide pension systems, with combined assets of nearly \$170 billion as of the end of their 2006 fiscal years. Using an estimate of 15 basis points of lost investment return and additional investment expense, the Ohio pension systems would lose over \$250 million of investment return annually. If the investment restrictions remain in place for ten years, the total cost of the divestment bill could exceed \$3 billion. Assuming these losses are funded using 10-year level percent of payroll amortization beginning with the passage of the bill, the annual cost would represent approximately 1 percent of total payroll.

*Responsibility for divestment costs*

Most states that require divestment demand that the public fund bear the related costs (Appendices 1 through 5). Only Pennsylvania and South Carolina require that divestment costs be shared among all taxpayers. South Carolina provides that:

[...] nothing in this [divestment law] requires the commission to take action as described in this section unless [...] there are appropriated funds of the State to absorb the expenses of the commission to implement this section (S.C. Code Ann. § 9-16-55).

Pennsylvania provides reimbursements for all losses and costs associated with the divestment requirements (72 Pa. Stat. Ann. § 3837.9).

In many instances the public funds' responsibility for the costs is implicit in statute. However, Colorado law explicitly imposes the financial costs on the individual public funds, providing that:

[e]ach public fund shall be responsible for bearing the costs of complying with [divestment requirements], and the general assembly shall not appropriate or expend any moneys to assist a public fund in bearing such costs (Colo. Rev. Stat. § 24-54.8-109).

Georgia, which also mandates that the pension system, and not the state, pay for divestment costs, has expressed serious concerns regarding the expenses, with the state legislature noting:

[...] the members of this body have serious concerns regarding the efficacy of requiring the divestment of Georgia's retirement funds in large companies with fiscally sound histories and enviable histories of returns, and whether any effect on world-wide business activities might be too insubstantial as to warrant the cost to the state and to public retirees of divestment [...] Further, the members of this body are concerned about the cost of compliance, both in terms of the necessity of employing additional administrative staff to ferret certain companies out of the investment pool and in the potential for lost investment revenue caused by a possibly ineffective but costly investment policy [...] (Ga. Code Ann. § 47-20-83.1; 2008 Ga. Laws Act 761, §§ 1 and 2).

**Table II.**  
Ohio pension systems' cost sensitivity to the amount of lost investment earnings

Lost investment earnings	Estimated total cost over ten years (billion \$)	Estimated cost as a percentage of payroll
Five basis points	1	0.3
15 basis points	3	1.0
30 basis points	6	2.0

*Protecting performance*

Some states ask their pension systems to not divest from scrutinized companies if such divestment may reduce the funds' value. States that have these provisions (what I will refer to as a "performance exception") address the topic using one of two methods: the specific percentage method and the fiduciary duty approach (Appendices 1 through 5).

The specific percentage method explicitly guides public funds to not divest if such divestment may cause the value of the fund to drop under a specific percentage. Indiana, for instance, leaves it to the discretion of the public fund to cease divesting and to reinvest in companies on the scrutinized company list if:

[...] evidence shows that the value for all assets under management by the fund becomes equal to or less than ninety-nine and five-tenths percent (99.5 percent) of the value of all assets under management by the fund [...] (Ind. Code Ann. § 5-10.2-9-34).

The fiduciary duty method is more subjective than the specific percentage method. It does not provide percentage decline guidelines for the funds but requires that the funds divestment actions meet common law fiduciary duty standards. As an example, California requires that the state's public funds' divestment actions must be "consistent with the [retirement] board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution" (Cal. Gov't Code § 7513.6), which in turn provides that:

[...] the members of the retirement board [...] shall diversify the investments of the system so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so (Cal. Const. art. 16, § 17).

There are states that have not adopted either one of the performance exception methods. Among them, Pennsylvania's approach is particularly significant. The state reimburses the public funds for "net losses, costs and expenses incurred as a result of compliance" (72 Pa. Stat. Ann. § 3837.9). The approach is noteworthy because it implies that if the state's divestment scheme causes a massive loss to the state's pension system the state would be willing to cover all costs.

*Protecting fund officials*

In order to protect pension system officials from divestment-related fiduciary duty lawsuits brought by beneficiaries, the majority of state legislatures provide some level of protection by either providing immunity from suit, indemnifying the officials sued, or both. As an example, Arizona provides that:

[w]ith respect to all actions taken in good faith compliance with [Sudan divestment requirements], a public fund, its board of directors and individual board members, agents, attorneys, trustees, officers, employees, custodians, fiduciaries, research firms and investment managers under contract with the public fund are immune from any liability (Ariz. Rev. Stat. § 35-391.04).

Additionally, Arizona offers the officials an exemption from their traditional fiduciary duty responsibilities and pays for their court costs (Ariz. Rev. Stat. § 35-391.04). Another example is Texas, which forbids beneficiaries, retirees and others to sue those in charge of complying with divestment laws (Tex. Gov't Code § 806.007). A minority of states do not offer protection to their officials (Appendices 1 through 5).

I should note that I examined whether any fund manager or pension system has ever been sued for divestment action. Utilizing Lexis-Nexis, I searched through state and federal cases to conduct the inquiry. I found that no such lawsuit has been brought, which could be due to several reasons including the beneficiaries' unawareness of divestment laws and their prospective costs as well as the possibility of a potential plaintiff's attorney discouraging litigation as a result of the existing immunities provided to fund officials in most jurisdictions.

### Conclusions

Data suggest that divestments can be costly to present and future retirees. No evidence was found that divestment legislation benefits pension system beneficiaries. Accordingly, state-imposed divestment schemes are in essence forcing public pension fund trustees and managers to displace their common law fiduciary duty responsibilities with government-mandated political decisions that may harm the beneficiaries. In fact, in a survey administered to public pension fund officials, the GAO found that 59 percent of fund managers who had:

[...] divested or frozen their Sudan-related assets, or planned to do so, said they were concerned to a moderate or large extent that "it would be difficult to divest while ensuring that fiduciary trust requirements were not breached and my office/state was not made vulnerable to law suits" (GAO Report, 2010).

The survey also found that the same unease existed for 61 percent of managers who had not yet divested.

Performance exception clauses are unlikely to soothe the fund managers' unease. The specific percentage method, which, in most states, legalizes the loss of up to 0.5 percent due to divestment decisions, can still lead to substantial losses, especially when compounded over time. The fiduciary duty approach is too subjective and does not provide pension system officials with sufficient guidelines.

Statutory preemptions of common law fiduciary duty responsibilities through the legislative prohibition of lawsuits against pension system officials are also flawed as they take away the beneficiaries' inherent right to protect their financial interest for the golden years and to voice their concerns through actionable legal channels.

Due to the significant defects of the divestment schemes and the intrinsic divergence of politician and beneficiary interests that they create, divestment laws must either be repealed or significantly modified. For political reasons, it is unlikely that divestment laws will be revoked. But there is still one major solution: the state paying for divestment expenses and portfolio losses. If divestment laws are intended to reflect the will of the state's constituency through the democratic process, all of the state's taxpayers must bear the costs and not just the public employees and retirees. In addition to the fact that this approach would better mirror democratic values than the selective imposition of the costs on only a fragment of the population – on the public employees and retirees – the approach would also address the conflict between the fund officials' fiduciary duty responsibilities and their costly divestment mandates as the funds would be reimbursed by the state for any losses.

### Note

1. This includes Belarus, Burma, Côte d'Ivoire/Ivory Coast, Congo, Liberia, Lebanon, North Korea, Somalia, and Zimbabwe.

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(The Appendices follow overleaf.)

Appendix 1

36

	Performance exception		Immunity and/or indemnification from lawsuit	Who pays divestment costs?	
	Specific	Fid. D.		Fund	State
Arizona	✓	×	✓	✓	×
California	×	✓	✓	✓	×
Colorado	✓	×	✓	✓	×
Florida	✓	×	✓	✓	×
Hawaii	✓	×	✓	✓	×
Illinois	×	×	×	✓	×
Indiana	✓	×	✓	✓	×
Iowa	×	✓	✓	✓	×
Kansas	×	✓	✓	✓	×
Maryland	×	✓	✓	✓	×
Michigan	×	×	✓	✓	×
Minnesota	✓	×	✓	✓	×
N. Hampshire	✓	×	✓	✓	×
New Jersey	×	×	×	✓	×
N. Carolina	✓	×	✓	✓	×
Ohio	×	✓	✓	✓	×
Oregon	✓	×	×	✓	×
Pennsylvania	×	×	✓	×	✓
S. Carolina	×	✓	✓	×	✓
Texas	✓	×	✓	✓	×
Total	10	6	17	18	2

**Table AI.**  
Divestment legislation  
summary: action  
explicitly targeting  
Sudan

Appendix 2

	Performance exception		Immunity and/or indemnification from lawsuit	Who pays divestment costs?	
	Specific	Fid. D.		Fund	State
Arizona	✓	×	✓	✓	×
California	×	✓	✓	✓	×
Florida	✓	×	✓	✓	×
Georgia	×	×	✓	✓	×
Illinois	✓	×	✓	✓	×
Maryland	×	✓	✓	✓	×
Michigan	×	×	✓	✓	×
Minnesota	×	×	✓	✓	×
New Jersey	×	×	✓	✓	×
Ohio	×	✓	✓	✓	×
Pennsylvania	×	×	✓	×	✓
South Dakota	×	×	✓	✓	×
Total	3	3	12	11	1

**Table AII.**  
Divestment legislation  
summary: action  
explicitly targeting Iran



Appendix 3

Divestment laws and fiduciary duty

	Performance exception		Immunity and/or indemnification from lawsuit	Who pays divestment costs?	
	Specific	Fid. D.		Fund	State
Florida	×	×	×	×	×
Total	0	0	0	0	0

**Table AIII.**  
Divestment legislation summary: action explicitly targeting Cuba

Appendix 4. No state legislative action explicitly targets Syria

Appendix 5

	Performance exception		Immunity and/or indemnification from lawsuit	Who pays divestment costs?	
	Specific	Fid. D.		Fund	State
Arizona	×	×	×	✓	×
Indiana	×	×	✓	✓	×
Michigan	×	×	✓	✓	×
Total	0	0	2	3	0

**Table AIV.**  
Divestment legislation summary: SST approach

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