Original Article

Public pensions, international affairs and divestment regulations: A critical analysis and call for a model law

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ABSTRACT This article undertakes a critical examination of the state laws of the United States requiring public pension funds to divest from companies that do business with Cuba, Iran, Syria and Sudan, countries that are currently listed as 'state sponsors of terrorism' by the federal government. The article finds that divestment statutes contain legal and public policy deficiencies that are worth revisiting and rectifying. The article argues that a model law that addresses the divestment schemes' statutory deficiencies be drafted. The project posits that the voluntary adoption of the proposed model law by the states would ensure the constitutionality of the divestment statutes and would also protect pension fund employees, retirees and government employees. The project, to the best of the author's knowledge, is the first study that analyses the substance of state divestment statutes and places them in a comparative perspective to highlight the laws' strengths and weaknesses.

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INTRODUCTION

Several states require their public pension funds to divest from companies that do business with Cuba, Iran, Syria and Sudan, hence engaging in sub-national foreign policy through the state employees' retirement plans and affecting, for better or worse, the administration and management of the funds. Previous studies have addressed the role of state and local governments in foreign policy from various perspectives, ranging from highlighting the role of local and state actors in making policies that transcend their own jurisdictions, thus challenging traditional notions of federalism[1] to arguing that courts should protect state and local government actions that affect foreign relations when such action has not been barred by the two elected branches or the Constitution[2] or proposing that 'the world in which the federal government will not ratify human rights treaties, local human rights internationalism may provide a second best option'.[3] The dialogue has often entailed the analysis of state and local divestment laws and procurement sanctions, assessing their constitutionality and effectiveness. The analyses have included conclusions that the states' divestment movement against Sudan can be effective in addressing the situation in Darfur,[4] that state procurement sanctions 'should usually be held to be constitutional, at least when the states align their procurement policies with substantive international legal norms that reflect

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the settled consensus of the community of nations, and to which the United States has committed itself by treaty',[5] or, conversely, that state and local sanctions that are foreign policy measures are suspect because '[t]he power to decide the national interest in foreign affairs is vested by the Constitution exclusively in the federal government'.[6]

This article attempts to build on previous scholarship by examining and comparing what the specific sub-national divestment laws affecting public pension fund management entail, what they have in common and what they lack. The article concludes that the existing set of state statutes contain legal and public policy limitations that should be examined and rectified. To that end, the article recommends a model law that state legislatures should consider adopting.

METHODOLOGY

The statutes, administrative codes and judicial documents of the 50 states were searched for individual country names that are currently listed as 'state sponsors of terrorism' by the US Department of State (Cuba, Iran, Sudan and Syria) or fall under another sanctions programme as administered by the US Department of the Treasury's Office of Foreign Assets Control (OFAC).[7] In addition, I searched 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 the states align their foreign policy intentions with the federal government.[8] I also created numerous phrase combinations that I believed would narrow the search.[9] I found, however, that the latter approach excluded the statutes of a number of states that make heavy usage of cross-referencing in their law-making processes. Accordingly, I took into consideration cross-referencing issues and also searched for specific numbered codes and statutes to ensure thoroughness. During the course of the research, I came across a report by the US Government Accountability Office (GAO Report) addressing Sudan-related divestment questions posed by congressional requesters. Although I did not rely on the report's legal findings and exclusively depended on original research to examine specific state actions, I found the report helpful in other aspects, and, from time to time, used it as a roadmap. Of course, as with other sources, the report will be credited whenever utilized. Lastly, I should note that the focus of this article is state legislative action. This project does not explore non-legislative divestment policies of the states or individual public funds.

LEGAL FINDINGS

Federal exception

Mindful of potential objections to the constitutionality of their divestment laws, many states have incorporated what I will refer to as the 'federal exception' in order to shield the laws from judicial challenge. A good example of a federal exception can be found in an Arizona provision, which provides that a 'company that the United States 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 …'.[10]

Although legally sound, the federal exception has some implementational challenges, however. In addition to the frequency of exceptions granted or revoked by the US Department of the Treasury's Office of Foreign Assets Control, a major challenge is that the exceptions are not always publicly disclosed by the federal government. According to Becker,[11] for instance, OFAC has so far granted nearly 10 000 exception licences, the details of which only became public when *The New York Times* obtained limited and heavily redacted access to the exception list by litigating a Freedom of Information Act case, a process that lasted for 3 years. Nonetheless, numerous states have, rightly, included a federal exception clause in their divestment laws.

However, some have not. New Jersey and Pennsylvania, for example, are among the states that target Sudan explicitly (requiring divestments and prohibiting future investments in Sudan-related companies), but have not incorporated a federal exception clause into their statutes. Another state, Louisiana, that does not require

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divestments but prohibits future investments in companies that do business with Sudan, Iran, North Korea and Syria also lacks a federal exception provision. Likewise, Connecticut, Georgia, Louisiana, New Jersey and Pennsylvania lack a federal exception clause in their Iran-related divestment statutes. As will be discussed in a later section, these states should devise a federal exception provision either individually or by adopting a model law proposed by this study.

Immunity and indemnification

A previous study has stressed the importance of providing public pension fund officials with immunity from divestment-related lawsuits.[12] Unlike private pension funds, which are governed by the standards of the Employee Retirement Income Security Act of 1974 (ERISA), public pension funds must generally exercise the traditional common law fiduciary responsibilities towards their beneficiaries.[13] To protect public fund officials from potential lawsuits arising out of the officials' actions to comply with the state-imposed divestment laws, most states have explicit clauses addressing some level of lawsuit protection in case of breach of fiduciary duty claims brought by the beneficiaries.[12]

Accordingly, there are states that severely restrict lawsuits against fund officials and their consultants. For instance, in addition to providing indemnification for governmental officials, employees and others involved in Sudan-related divestment compliance decisions,[14] Texas does not allow beneficiaries, retirees and others to at all sue those in charge of complying with divestment laws.[15]

There are also states that explicitly use the term 'immune' or 'immunity' in their divestment-related statutes to protect fund officials. Arizona, for instance, 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'.[16] In addition to immunity, Arizona provides fund officials with an exemption from their traditional fiduciary duty obligations and also indemnifies them in case of litigation.[16]

Surprisingly, however, a minority of states does not address the immunity/indemnification issue as related to the public fund officials' divestment decisions. For instance, although most of the states that have divestment laws explicitly targeting Sudan include an immunity/indemnification clause especially tailored for those laws, Illinois, New Jersey and Oregon do not.[17] This may potentially be a cause for concern among the states' fund officials whose divestment decisions may otherwise be in violation of their fiduciary duty responsibilities.

Interestingly, every state that has an Iran-related divestment requirement on its public fund also addresses lawsuit protection, immunity and indemnification issues.[18] One possible explanation for this dichotomy might be legislative inexperience. The Sudan-related laws in Illinois and New Jersey, which do not address public fund lawsuit protection issues, are older than the Iran-related ones. The current Illinois statute requiring Sudan divestments, for instance, went into effect in 2007,[19] whereas the Iran divestment law went into effect a year later.[20] Likewise, the New Jersey statute requiring Sudan divestments went into effect in 2005,[21] whereas the Iran-related one went into effect 3 years later.[22]

History may also explain why Florida addresses lawsuit protection in its Sudan and Iran-related divestment statute,[23] but does not do so for it divestment requirements against Cuba. The state's Cuba divesture law originally went into effect in 1993,[24] whereas its Iran-Sudan divestment statute became effective in 2007.[25]

PUBLIC POLICY FINDINGS

This section examines two major issues. The first is whether there are states that have what I will refer to as a 'performance exception' in their divestment requirement, allowing their public fund to not divest from scrutinized companies if it may reduce the fund's value. The second is who pays divestment costs: the state or the fund?

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Performance exception

The states that have a performance exception address the topic using one of two methods: the specific percentage method and the fiduciary duty approach.

The specific percentage method is when the law explicitly tells the public fund that it may not have to divest from a scrutinized company in its portfolio if such divestment may cause the value of the fund to drop under a specific percentage. Indiana, for instance, provides that 'the fund shall be permitted to cease divesting and to reinvest in certain scrutinized companies on the scrutinized company list with active business operations in Sudan 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 per cent) of the value of all assets under management by the fund …'.[26]

The fiduciary duty method is when the state does not provide specific percentage decline guidelines for the public fund, but demands that the fund's divestment actions meet the fund's fiduciary duty standards. California, for instance, demands that the public funds' divestments must be 'consistent with the [retirement] board's fiduciary responsibilities as described in Section 17 of Article XVI of the California Constitution'.[27] This section of the California Constitution partly 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'.[28]

Some states do not address the performance exception issue at all. Pennsylvania's approach to the topic is particularly unique and noteworthy: not only does the state lack a performance exception of any kind, but it even reimburses the public fund for its 'net losses, costs and expenses incurred as a result of compliance'.[29]

Who pays divestment costs?

The vast majority of states that have divestment laws require the public fund to bear the related costs. While in most of these states the public fund's responsibility for the costs is implied, one state, Colorado, explicitly places the responsibility on the individual public funds, providing by statute 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'.[30]

Another state, Georgia, which mandates that the public fund, rather than the state, pays for divestment costs, has, in the state's legislative notes regarding Iran divestments, expressed serious concerns concerning the costs, providing that

> 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 … .[31]

Despite the cost concerns for the public funds, only two states, Pennsylvania and South Carolina, require that divestment costs be shared among all taxpayers. As noted earlier, Pennsylvania even provides reimbursements for losses and costs associated with the divestment requirements.[29] South Carolina provides that '[n]othing 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'.[32]

DRAFTING A MODEL LAW

A number of the existing state statutes contain legal and public policy deficiencies that can be addressed by the adoption of a model law that addresses those concerns. The model law should:

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Include a federal exception provision to ensure constitutionality

The majority of the states that have divestment laws provide that if the federal government excludes a company from its sanctions list, then that company can no longer be subject to the state's divestment or investment prohibition requirements. As such, my discussion of the state divestment laws' constitutionality focuses on the narrow issue of whether the lack of a federal exception in some state statutes renders those statutes unconstitutional based on any constitutional doctrines or existing case law.

The resolution of this question partly lies on which of the following two competing theories the courts should adopt in order to address it: on the one hand, there is the traditional 'one voice' view, which posits that the nation must speak with a singular voice when it comes to international affairs. The view is well summarized by Justice Felix Frankfurter's concurrence in *United States v. Pink*, noting that 'in our dealings with the outside world the United States speaks with one voice and acts as one, unembarrassed by the complications as to domestic issues which are inherent in the distribution of political power between the national government and the individual states'.[33]

On the other hand, there is the dialogic federalism perspective. The term, coined by Powell,[34] posits that dialogue in intergovernmental relations can 'link national and sub-national governments in a dialogue about human rights by "creat[ing] areas of overlap in which neither system can claim total sovereignty"'.[35] According to some commentators, this is a more pluralistic conception than the one voice view and one that accepts that 'the federal government has the dominant voice in foreign affairs, but it has the option to tolerate, encourage, and even listen to and benefit from other speakers', allowing the states 'to speak on matters of foreign policy subject to federal constraints'.[4] Proponents also advance the notion that allowing state and local governments to engage in foreign policy encourages grassroots democratic participation.[2]

Whichever view the courts adopt in addressing the federal exception, the Constitution and its interpretations by the judiciary make it clear that the federal government trumps state laws in matters related to foreign policy. The Constitution's Article I, Section 8, which highlights Congress' enumerated powers, includes a provision granting Congress the sole power to 'regulate Commerce with foreign Nations'. The Commerce Clause has been interpreted to mean that international commerce is 'preeminently a matter of federal concern'.[36] Furthermore, Article I, Section 10 explicitly prohibits the states to engage in foreign policy by entering into treaties, alliances or confederations, and only allows the states to enter into agreements or compacts with a foreign power with the consent of Congress. Article II gives the president the authority to make treaties with foreign nations and to appoint ambassadors, provided that the president has the advice and consent of the Senate. Together, the Constitution's first two articles permit the elected federal branches to 'conduct foreign relations through the enactment of federal statutes, treaties, and executive agreements'.[37]

In addition, the Constitution's Supremacy Clause asserts that the 'Constitution, and the Laws of the United States … and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding'.[38] Accordingly, state actions that are in conflict with federal laws are superseded by federal authority. Ultimately, the Supreme Court's interpretations of these provisions has given the federal government an authority over international relations that 'cannot be subject to any curtailment or interference on the part of the several states'.[39]

Against this backdrop, the state statutes that lack the federal exception clause in their divestment laws raise constitutional questions and may be in violation of the Commerce Clause and preempted by federal law under the Supremacy Clause. The assessment is grounded not only in the text of the Constitution, but also in case law. Throughout the years, the Supreme Court has

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created a dormant foreign affairs power for the president and has held that the power could preempt state laws that affect international relations[40]; has noted that foreign commerce 'is preeminently a matter of federal concern' and that there is a dormant Foreign Commerce Clause similar to the one in the Interstate Commerce Clause, although federal power regarding foreign commerce is more extensive than the one in interstate commerce[36]; has held that a state law that 'either implicates foreign policy issues which must be left to the Federal Government or violates a clear federal directive' is unconstitutional[41]; has struck down a state's selective purchasing law aimed at companies doing business in Burma because the state law interfered with federal sanctions[42]; and has ruled that a state insurance law was unconstitutional because it was preempted by federal executive agreements.[43]

In short, as one commentator has noted, in almost two centuries of case law 'the Supreme Court has voided state regulations that discriminate against or obstruct the free flow of foreign commerce or impede the ability of the federal government to "speak with one voice when regulating commercial relations with foreign governments"'.[44] Thus, a federal exception provision must be included in state divestment laws for them to be constitutionally sound. This assertion is further supported by the fact that the majority of the states that have divestment laws provide for such an exception, suggesting those states' awareness of potential constitutional objections but for the exception provisions.

Provide immunity and indemnification

To protect current and former pension fund officials and their consultants from divestment-related lawsuits, the model law should include a provision providing immunity and indemnification explicitly designed for the divestment statutes. Most states have explicit clauses addressing such protection, and some states severely restrict lawsuits against fund officials and their consultants. However, surprisingly, a minority of states does not address the issue, rendering the public fund officials and their consultants potentially helpless in case of divestment-related legal action against them. In a study conducted by the US GAO, 59 per cent 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"'.[45] The study also discovered that the same concerns existed for 61 per cent of pension fund mangers who had not divested.

A previous study has addressed the issue of divestment-related lawsuits and has ranked the states in order of the level of legal protection that they grant their public fund officials.[12] The study may serve as general guidance for lawmakers.

Include a 'specific percentage method' performance exception

Some states provide for a performance exception in their divestment laws, allowing their public funds to not divest from scrutinized companies if it may reduce the fund's value. The performance exception is addressed through one of two methods: the specific percentage method and the fiduciary duty approach. There are states that do not address the issue at all.

To protect the beneficiaries' interests, the model law should include a performance exception. The method of exception utilized should be the specific percentage approach because it is far more objective than the fiduciary duty method, reducing the public fund officials' reliance on a guessing game as to whether their divestment violates the prudent investor principles as required under the fiduciary duty approach.

Make the state pay for divestment costs and associated losses

In the vast majority of states, the public fund, rather than the state, pays the divestment costs and incurs any associated losses. Even though the divestment laws are supposed to reflect the will of the states' citizens, the majority of the citizens do not have to bear the costs and only the states'

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public employees who rely on the public fund for their retirement do, rendering the approach unfair and discriminatory. Under the approach, any surplus that a public fund has would be spent on monitoring and divestment efforts rather than reinvestment into the fund, biting away at the pensioners' retirement account.

Divestment and monitoring costs are not inexpensive. For instance, in one quarter alone, the Teachers' Retirement System of the State of Illinois incurred US$1.2 million in costs to implement the (found unconstitutional, now defunct) Illinois law requiring Sudan-related divestments.[46] GAO survey results have also demonstrated that state fund managers, regardless of whether they have divested from Sudan, are concerned with the financial risks associated with divestment. Sixty-nine per cent of the managers who had divested or had plans to divest and 44 per cent 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'.[45]

The model law should adopt the Pennsylvania approach to this issue, which reimburses the public funds not only for the divestment costs, but also for any net losses incurred as a result of the state-mandated divestments.[29] The approach better reflects democratic values than claiming them, but not asking the entire state constituency to take responsibility.

As a whole, the states that wish to address human rights and international relations concerns through their public pension funds have a long way to go in order to make their laws faultless. Their statutes contain legal and public policy deficiencies that are worth revisiting and rectifying. It is time that a model law be drafted by legal and policy scholars and policymakers, addressing these deficiencies and aiming to ensure constitutionality as well as fairness towards pension fund employees, retirees and government employees who depend on the funds for their golden years. The adoption of the model law by the states would of course remain voluntary. However, even its consideration would be a step in the right direction.

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7 Under this criterion, the search included Belarus, Burma, Côte d'Ivoire/Ivory Coast, Congo, Liberia, Lebanon, North Korea, Somalia and Zimbabwe.

8 This task included searching for federal statutes including the Anti-terrorism and Effective Death Penalty Act, Arms Export Control Act, Export Administration Act, Foreign Assistance Act and International Emergency Economic Powers; Exec. Orders 12947, 13099, 13224, 13268 and 13372; variations on the US Department of State, US Department of the Treasury, Office of Foreign Assets Control; variations on the titles of the departments' secretaries; and variations on the phrase state sponsors of terrorism.

9 I combined numerous search terms with variations of the words 'investment' and 'divestment'.

10 Ariz. Rev. Stat. § 35-391.02.

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14 Tex. Gov't Code § 806.006.

15 Tex. Gov't Code § 806.007.

16 Ariz. Rev. Stat. § 35-391.04.

17 Interestingly, however, Illinois and New Jersey do address the issues in their Iran-related divestment statutes. *See, for example*, 40 Ill. Comp. Stat. Ann. 5/1-110.15 (providing, in part, that '[w]ith respect to actions taken in compliance with this Act, including all good-faith determinations regarding companies as required by this Act, the retirement system is exempt from any conflicting statutory or common law obligations, including any fiduciary duties under this Article and any obligations with respect to choice of asset managers, investment funds, or investments for the retirement system's securities portfolios'). *See also*, N.J. Stat. Ann. § 52:18A-89.12 (providing, in part, that '[s]tate Investment Council members, jointly and individually, and State officers and employees involved therewith, shall be indemnified and held harmless by the State of New Jersey from all claims, demands, suits, actions, damages, judgments, costs, charges and expenses, including court costs and attorney's fees, and against all liability, losses and damages of any nature whatsoever that these State Investment Council members, and State officers and employees, shall or may at any time sustain by reason of any decision to restrict, reduce or eliminate investments pursuant to this act').

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18 *See* Ariz. Rev. Stat. § 35-393.04; Cal. Gov't Code § 16642; Fla. Stat. § 121.4501; Fla. Stat. § 175.071; Fla. Stat. § 185.06; Ga. Code Ann. § 47-20-83.1; 40 Ill. Comp. Stat. Ann. 5/1-110.15; La. Rev. Stat. Ann. § 11:264.5; Md. Code Ann., State Pers. & Pens. § 21-123.1; 72 Pa. Stat. Ann. § 3837.8; S.D. Codified Laws § 4-5-60.
19 40 Ill. Comp. Stat. Ann. 5/1-110.6.
20 40 Ill. Comp. Stat. Ann. 5/1-110.15.
21 N.J. Stat. Ann. § 52:18A-89.9.
22 N.J. Stat. Ann. § 52:18A-89.12.
23 See Fla. Stat. § 121.4501 (prohibiting civil, criminal or administrative action against the state board or employees, officers, directors or trustees for Iran and Sudan divestment decisions); Fla. Stat. § 185.06 (prohibiting lawsuits against municipal police pensions' boards, officers and advisors for implementing the state divesture requirements from Iran and Sudan); Fla. Stat. § 175.071 (prohibiting lawsuits against municipal fire fighter pensions' boards, officers and advisors for implementing the state divesture requirements from Iran and Sudan).
24 Fla. Stat. § 215.471.
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