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**PUBLIC PENSION FUNDS, CHARITABLE FUNDS, AND THE  
SOCIAL SECURITY TRUST FUND: WHEN THE STATE GETS INTO  
THE INVESTMENT BUSINESS, SOCIAL INVESTING IS INEVITABLE  
AND THERE IS LITTLE THE LAW CAN DO ABOUT IT**

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Executive Summary

Social investing is a precarious investment philosophy that cannot help but reflect the personal, financial, social and/or political predilections of the investor. Human nature being what it is, trustees will always be tempted to practice social investing in derogation of their fiduciary duty of undivided loyalty. Rarely, however, does a private trustee of a non-charitable personal trust, such as a trust that a parent in the estate planning context might establish for his or her children, succumb to the temptation. Why then do those in the private sector tend to behave differently from those in the public sector when it comes to the administration of other people's money? There are two reasons.

The first reason is that the private trustee would be subject to suit in state court by the beneficiaries for breach of his, her or its duty of undivided loyalty, and any liability would be personal to the trustee.<sup>1</sup> Moreover, internal fiduciary liability insurance for private trustees can be prohibitively expensive.<sup>2</sup> Often it cannot be obtained at all.

The second reason is that the public sector is not involved in the administration of the private non-charitable trust, other than as judicial arbiter of the rights, duties and obligations of the parties. In other words, there are multiple legal safeguards in place to check a private trustee's impulses to practice social investing. The beneficiaries serve as independent private watchdogs of the activities of the private trustee and the state court insures that these watchdogs have nice sharp teeth.<sup>3</sup>

When the U.S. government or a state government gets involved in the actual administration of a trust, however, legal checks and balances melt away and the judicial watchdog loses his teeth. It is inevitable when the "state" becomes a party to a legal relationship, as well as the regulator and adjudicator of that relationship. Take Calpers whose board is under fire for conflicts of interest so brazen that if it "were held to the same standards it demands of corporate America, ..[it]...might have to fire itself."<sup>4</sup>

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<sup>1</sup> See generally Rounds, Loring A trustee's Handbook §3.5.4.1 (2004 ed.) (discussing the personal liabilities of a private trustee)..

<sup>2</sup> *Id.* at §3.5.4.2 (discussing the limitations on a personal trustee's ability to insure against internal breaches of fiduciary duty).

<sup>3</sup> *Id.* at §7.2.3 (discussing the panoply of equitable remedies available to a trust beneficiary if the trustee breaches his, her, or its fiduciary duties to the beneficiary).

<sup>4</sup> Neil Weinberg, *Forbes*, May 10, 2004, at pg. 52.

Marbled throughout its enabling legislation are checks and balances that look good on paper, but legally are not worth the paper they are printed on. These paper safeguards against social investing include statutory self-dealing proscriptions<sup>5</sup>; adoption of a prudent investor rule similar to that found in ERISA<sup>6</sup>, the rigorous federal legislation governing the administration of private pension plans; and the establishment of a trust fund.<sup>7</sup>

When the government gets into the investment business, social investing and political patronage go hand in glove and there is nothing much the law can do about it. In a recent article in Forbes magazine, with the provocative title “*Sanctimonious in Sacramento: California public pension fund is making a big stink about little problems in the governance of companies these days... What about the stench from its own self-dealing?*”, its author makes just that point:

*The theory behind Calpers’ attack on corporate boards is that directors should focus solely on maximizing returns. Yet Calpers has invested billions in “economically targeted investments” aimed at providing “collateral benefits to targeted geographic areas, groups of people or sectors while providing pension funds with prudent investment” If such investments fall short, of course, California taxpayers can be forced to pick up the tab.*<sup>8</sup>

The “state” is deeply involved in the administration of charitable funds as well. As a consequence, legal safeguards to prevent breaches of fiduciary duty such as social investing are for all intents and purposes as illusory in the charitable sector as they are in the public sector. Here is why. With a few exceptions, it falls to a state’s attorney general, a politician, to oversee the administration of charitable funds.<sup>9</sup> In many states neither the donor of the charitable funds nor the prospective charitable recipients of the donor’s largesse would have standing to bring an action in state or federal court to enjoin the trustees of the charitable trust, or the directors of the charitable corporation as the case may be, from engaging in abusive socially investing.<sup>10</sup> Only the state attorney general may bring the action; and if the attorney general, himself, is somehow complicit, then he may with impunity exercise his inherent discretionary authority not to bring the matter before the court. Then, the public’s only recourse is to try to interest the press in the matter, a time-consuming and often futile endeavor, or to wait until election day, an even less practical option.

The recent controversy over the Hershey charitable trust is an example of a state attorney general actually promoting social investing. In 1909, chocolate industrialist Milton S. Hershey and his wife Catherine S. Hershey created and endowed the Milton

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<sup>5</sup> West’s Ann.Cal.Gov.Code § 20150.

<sup>6</sup> *Id.* at § 20151.

<sup>7</sup> *Id.* at § 20170.

<sup>8</sup> Neil Weinberg, Forbes, May 10, 2004, at pg 52.

<sup>9</sup> See generally Rounds, Loring A Trustee’s Handbook § 9.4.2 (2004 ed.) (discussing who has standing to enforce charitable trusts).

<sup>10</sup> *Id.*

Hershey School.<sup>11</sup> The trust is currently worth approximately \$10 million with approximately 50% of the trust portfolio being in Hershey stock.

The Pennsylvania attorney general sent signals to the board of trustees, which controlled 76% of the voting stock of the Hershey Foods Company, that it ought to consider prudently diversifying the portfolio of the charitable trust. In response, the board put the Company on the auction block. In September, 2002, the board in the face of intense public outcry by the local Hershey, Pennsylvania community took the company off the auction block. It did so because the attorney general, who had set the whole process in motion, reversed his position and pulled the rug out from under the governing board. In fact, he had begun actively opposing in the courts and through public pronouncements their good faith efforts to do the right thing. There is nothing but trouble when the state is involved. There is the old adage: “[R]etaining investments is in effect making them.”<sup>12</sup> The state attorney general, yielding to public pressure, had essentially forced the private fiduciaries to engage in social investing against their better judgment.

Finally, in the context of the social security privatization debate there have been calls for the federal government to invest FICA payments in the private sector:

*In the past few weeks, proponents of Social Security privatization, including members of the president’s commission on Social Security reform, have introduced a new argument for dramatically restructuring the system. They claim that the assets contained in the Social Security trust fund are not “real” but merely IOUs from the government. The assertion is wrong—and would be obviously so if Social security were able to acquire corporate equities and bonds in the same way that private pension funds, public employee pension funds and the Canada Pension Plan (the Canadian equivalent of Social Security ) do.*<sup>13</sup>

First, the Social Security Bonds that are ostensibly in the so-called social security trust fund are neither legally “real”<sup>14</sup> nor are they enforceable IOUs.<sup>15</sup> As a matter of law, neither they nor the trust fund exist. Second, if social investing is rampant in Calpers whose enabling legislation is marbled with paper checks and balances and nice-sounding fiduciary language, then as surely as water flows down hill, it would be rampant if the federal government through its agents were to get into the business of investing FICA receipts.

In this article we explain why it is that in the U.S. when the “state” as that term is employed generically gets into the business of administering or supervising the administration of other people’s money, any legal safeguards designed to deter improper social investing are not worth the paper they are printed on. They are, in lawyer’s

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<sup>11</sup> See generally Rounds, Loring A Trustee’s Handbook §8.35 (2004 ed.) (discussing the Hershey Trust).

<sup>12</sup> Dickerson v. Camden Trust Co., 140 N.J.Eq. 34, 42, 53 A.2d 225, 231 (1947).

<sup>13</sup> Alicia H. Munnell & R. Kent Weaver, How to Privatize Social Security, The Washington Post, Jul. 9, 2001, at pg. A19 (editorial).

<sup>14</sup> 42 USCA s 401(a).

<sup>15</sup> Flemming v. Nestor, 363 U.S. 603 (1960); Helvering v. Davis, 301 U.S. 619 (1937).

parlance, illusory. It is a structural problem that cannot legally be corrected unless there are fundamental structural reforms that remove the “state” from the equation. Because the legal and political traditions of continental Europe and the U.S. are so different--in most European jurisdictions, for example, the trust is not even recognized<sup>16</sup>--, the European experience with money management by public entities can inform the U.S. social investing debate only at the margins.<sup>17</sup>

In the case of Calpers, for example, unless funds are entrusted to an independent private trustee, for example a bank or trust company, such that the entity assumes the actual legal title, “explicit organizational mandates to maximize return on contributors’ investment,” “independent boards of trustees,” and “contracting out portfolio management on a competitive basis,”<sup>18</sup> are safeguards in form only. There is no legal substance to them as the Calpers experience is so amply demonstrating.

In the case of a fund to be established for charitable purposes, there are some things that a prospective benefactor and his lawyer can do at the document drafting stage to deter the fiduciaries, be they directors of a charitable corporation or trustees, from engaging in social investing. Essentially they can put into the governing corporate or trust documentation provisions the effect of which is to substantially privatize oversight of the fund’s administration. Once the horse is out of the barn, once the gift is completed, however, it is usually too late to tweak the documentation. A benefactor who discovers that a fiduciary has been socially investing his entrusted charitable gift would then have little recourse other than to jawbone the press--or to make another contribution, this time to the attorney general’s political war chest.

With respect to the investment of Social Security tax receipts, if one is concerned that there be a modicum of legal accountability for abusive social investing, then to entrust the U.S. and/or its agents with the responsibility of investing the receipts in corporate equities and bonds is not the way to go. In fact it would be asking for real trouble. Calpers meet Hershey. One who proposes that the federal government get into the investment business appreciates neither the limits of the law nor the fallibility of human nature.

If meaningful fiduciary accountability for social investing is a desirable societal goal, then Social Security privatization is the only option that brings with it legal safeguards that have teeth. FICA payments must be segregated. Either private trustees who are amenable to the law or the taxpayers themselves must take legal title to the property. There is precedent for the latter in the Individual Retirement Account (IRA) context. And finally, unlike the present Social Security welfare<sup>19</sup> scheme, the taxpayers must have ownership rights in the property. Without these reforms, social investing is an

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<sup>16</sup> See generally Rounds, Loring A Trustee’s Handbook §8.12.1 (2004 ed.) (discussing civil law alternatives to the trust).

<sup>17</sup> But see Alicia H. Munnell & R. Kent Weaver, How to Privatize Social Security, The Washington Post, Jul. 9, 2001 (editorial at pg. A17) (suggesting otherwise).

<sup>18</sup> See generally *id.*

<sup>19</sup> See *Helvering v. Davis*, 301 U.S. 619 (1937) (in which the U.S. Supreme Court confirmed that Social Security as it is currently structured is a welfare program that creates no private rights).

inevitable by-product of the government getting into the investment business. It comes with the territory. This is because there are no legally meaningful legal checks and balances that would inject a measure of accountability into the process.

Finally, the concept that the “state” for all intent and purposes is legally unaccountable is not a new one. As far back as 1830, Justice Putnam, in the landmark Massachusetts trust case *Harvard College v. Amory*, raised concerns about governmental accountability in the context of investment selection:

*There is one consideration much in favor of ... [private trustees] ... investing in the stock of private corporations. They are amenable to the law. The holder may pursue his legal remedy and compel them or their officers to do justice. But the government can only be supplicated.*<sup>20</sup>

## **I. Introduction**

A trustee who socially invests trust property seeks to use the investment process “to promote nonfinancial social goals.”<sup>21</sup> That is the lawyer’s definition. Whether in any given situation a particular social investment in some way undermines the beneficiary’s equitable or economic interest is legally irrelevant. What is legally relevant is that the loyalties of the trustee are divided. For good or for ill, the trustee is not acting “solely in the interest of the beneficiary.”<sup>22</sup> Even if it is economically feasible for a trustee without “sacrificing returns” to indulge his, her, or its own personal social and political predilections with other people’s money, even if for every politically incorrect investment there is an economically comparable politically correct ETI, we are still haunted by Justice Cardozo’s admonition against the adoption of “particular exceptions” to a fiduciary’s duty of undivided loyalty:

*A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions.*<sup>23</sup>

Moreover, even though the occasional pension or charitable trust may emerge economically unscathed from a trustee’s foray into the realm of social investing, there is still the overarching societal implications of having vast concentrations of economic wealth, and the political power that goes with it, being concentrated in the hands of a relatively few fiduciaries with social and political agendas.

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<sup>20</sup> *Harvard College v. Amory*, 26 Mass. (9 Pick) 446, 460 (1830).

<sup>21</sup> Langbein and Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 73 (1980).

<sup>22</sup> Uniform Trust Code §802(a); Restatement (Third) of Trusts §170(1) (1992); 2A Scott on Trusts §170; Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§1104(a)1, 404 (1974).

<sup>23</sup> *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

The question then becomes for those of us who look upon social investing with a jaundiced eye: Is there is anything that *legally* can be done to deter a trustee from either socially investing public pension and charitable trust funds altogether; or if social investing is inevitable, from at least sacrificing returns in the pursuit of the trustee's personal and political goals. Without an answer to this threshold question, one cannot have a rationale debate about how to reform social security, how to de-politicize state pension programs, or how to shore up the principle of donor intent when it comes to the investment of endowment funds, or funds held in charitable trusts and corporations.

In this article, we conclude that for the most part legal safeguards intended to prevent the states from socially investing their pension funds, private fiduciaries from socially investing charitable funds, and the U.S. from socially investing the phantom Social Security trust fund are or would be illusory without major structural reforms that have the effect of taking the "state" out of the investment game. Under the auspices of its judiciary, the "state" should merely act as a referee, and it should do so from the sidelines. In the case of Calpers and its ilk, safeguards in the absence of structural reform are illusory because title to the trust funds remains in the "state" or its instrumentalities.<sup>24</sup> In the case of charitable funds, it is because the state attorney general, a politician, is currently charged by law with primary, and often exclusive, oversight responsibility. In the case of social security as it is currently structured, it is because the government owns the FICA tax payments, not the taxpayers.<sup>25</sup>

## **II. State Pension Funds**

The debate among the politicians, economists and opinion makers over whether the United States should be authorized to invest FICA tax payments in private equities and/or public and private debt often seems surrealistically divorced from any constitutional and legal reality. Supporters and opponents of a portion of the so-called social security trust fund in equities, for example, have suggested that there are lessons to be learned from an examination of the social investment practices of state governments<sup>26</sup>. Those who advocate partial privatization suggest that there has been rampant social investing at the state and local levels:<sup>27</sup>

*Yucaipa's managing partner, Ronald W. Burkle, is a billionaire and has been a substantial donor to many politicians, including Mr. Clinton and several past and present trustees of Calpers. In 2001, Calpers voted to commit \$450 million to three Yucaipa private investment funds, which were designed to generate returns*

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<sup>24</sup> See, e.g., West's Ann.Cal.Gov.Code § 20170 (confirming that California's Public Employees' Retirement Fund is operated out of the State Treasury); § 20171(providing that the California Board of Administration of the Public Employees' Retirement System has the *exclusive control* of the administration of the retirement fund).

<sup>25</sup> Helvering v. Davis, 301 U.S. 619 (1937).

<sup>26</sup> See generally Munnell and Sunden, Investment Practices of State and Local Pension Funds: Implications for Social Security Reform, Prepared for presentation at the First Annual Joint Conference for the Retirement Consortium "New Developments in Retirement Research," May 20-21, 1999.

<sup>27</sup> *Id.*

*and societal benefits, by financing neglected businesses in poor neighborhoods and companies that treat workers conscientiously. Calpers' most recent annual report showed that these funds have drawn about \$51 million in total investments and related fees, and have so far not produced returns.*<sup>28</sup>

Opponents of privatization question how much actual social investing has actually been going on:<sup>29</sup>

*The latest effort to promote government investment... [of social security funds]... is an op-ed in the Washington Post by Alicia Munnell and R. Kent Weaver. Munnell... they propose that the Social Security trust fund be allowed to invest in "corporate equities and bonds in the same way that private pension funds, public employee pension funds and the Canada Pension Plan do." Doing so, they argue, "offers the advantage of individual accounts without the risk and costs."*<sup>30</sup>

The problem is that in many respects each side is comparing entities that legally are apples and oranges. The U.S. and the State of California are neither legally nor constitutionally comparable. Social security is a federal welfare program. Calpers is not. Calpers ostensibly if not actually creates private property rights under the auspices of a state-sponsored retirement program.

Calpers is an acronym for California's Public Employees' Retirement System. Unlike Congress when it "created" the phantom social security trust fund, the California legislature created the Public Employees Retirement Fund "solely for the benefit of the members and retired members of ...[the]...system and their survivors and beneficiaries."<sup>31</sup> Moreover, by law the pension rights of a California public employee "may not be destroyed, once vested, without impairing a contractual obligation of the employing public entity."<sup>32</sup> Unlike a participant in Social Security, which is legally a welfare program that creates no private property rights<sup>33</sup>, a California public employee would have a property right in his accrued pension benefits that would warrant the protections of the taking clause of the 5<sup>th</sup> amendments to the U.S. Constitution, the United States Constitution under its Article I, §10(1) having prohibited a state from passing a law impairing the obligations of contracts. Moreover, unlike the Social Security

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<sup>28</sup> Mary Williams Walsh, Concerns Raised Over Consultants to Pension Funds, Sunday NY Times, Mar. 21, 2004.

<sup>29</sup> See generally Munnell and Sunden, Investment Practices of State and Local Pension Funds: Implications for Social Security Reform, Prepared for presentation at the First Annual Joint Conference for the Retirement Consortium "New Developments in Retirement Research," May 20-21, 1999

<sup>30</sup> Michael Tanner, Munnell Pushes Government Investing, Cato Institute Project on Social Security Choice, (July 18, 2001)<http://www.socialsecurity.org/daily/o7-18-01.html>.

<sup>31</sup> West's Ann.Cal.Gov.Code § 20170.

<sup>32</sup> Valdes v. Cory, 139 Cal.App.3d 773, 783-784, 189 Cal.Rptr. 212, 221 (1983).

<sup>33</sup> Helvering v. Davis, 301 U.S. 619 (1937).

welfare recipient<sup>34</sup>, he would have standing to seek redress in the courts should California interfere with those contractual property rights.<sup>35</sup>

Accordingly, when it comes to social investing assets in the Calpers fund, the worker, a private citizen, in theory would have standing to go into court and seek to enjoin the Calpers board from continuing to abuse its trust. His or her counsel would argue that “the interest of the employee at issue is in the security and integrity of the funds to pay future benefits.”<sup>36</sup> Moreover, the California cases suggest that a Calpers beneficiary would also have a cause of action against the state were the Calpers board’s social investment practices actually to interfere with his or her defined benefit. In other words, the beneficiary could sue the State of California for breach of contract. But the victory could well be a pyrrhic one:

*It does not necessarily follow, however, that the pensioner possesses the ability to compel the payment of benefits as they mature. If the Legislature fails to appropriate sums from the general fund for the purpose of funding the special retirement account or otherwise paying the state’s indebtedness to pensioners, a court of this state is powerless to compel the Legislature to appropriate such sums or to order payment of the indebtedness.*<sup>37</sup>

The problem is that it is hugely expensive and time-consuming for a member of the public to take on the full might of the state in an action for breach of fiduciary duty. In California, the cards are particularly stacked against the petitioner. On June 5, 2003, for example, California’s attorney general rendered a legal opinion that Calpers may allow its fiduciaries to purchase “waivers of recourse” coverage from its own self-insurance program thus effectively enabling them to socially invest with impunity.<sup>38</sup> Bottom line: When the government gets involved in investing the property of others, the law talks loudly but carries a very small stick. As a practical matter, the beneficiary is left with either waiting until election day or going to the press.

Those charged with administering the Calpers fund are politicians, political appointees, agents of politicians and agents of political appointees.<sup>39</sup> The state attorney general, of course, is a politician as well. When a governmental entity gets into the business of investing, to social invest or not to social invest in the last analysis depends upon the inclinations of the politicians in office from time to time.

And as to the press option, mounting a citizens’ campaign to interest the fourth estate in shining a spotlight on a public retirement board’s social investing practices can be time-consuming; and in the few instances when the press has gotten involved, successes have been modest, fleeting, and generally at the margins:

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<sup>34</sup> See *Flemming v. Nestor*, 363 U.S. 603 (1960).

<sup>35</sup> See *Valdes v. Cory*, 139 Cal.App.3d 773, 189 Cal.Rptr. 212 (1983).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.*

<sup>38</sup> 86 Ops. Cal. Atty. Gen. 95, 2003 WL 21672836 (Cal.A.G.).

<sup>39</sup> West’s Ann.Cal.Gov.Code § 20090.

*Despite Calpers' frequent calls for full disclosure by companies, it can be a little reticent itself. Two years ago the fund refused to release details on the returns racked up by its private equity investments, which total some \$7.8 billion. The San Jose Mercury has to go to court to get hold of the data. Calpers argued it wanted to disclose the data but was prevented by a confidentiality agreement with Grove Street Advisors, a firm it hired to assemble private equity funds. A judge disagreed. A year ago the Mercury News disclosed that one director, Angelides, had received political contributions from some Grove Street-related funds.<sup>40</sup>*

### **III. Charitable Funds**

It is in the nature of the typical charitable trust, unlike a personal trust that a parent might establish for a child, that the “beneficiaries” are so numerous and their interests are so contingent and tangential that, as a practical matter, no beneficiary possesses a sufficient interest to seek its enforcement in the courts. This applies as well to charitable corporations. While each of us, for example, is a direct and indirect contingent beneficiary of endowed medical research, in essence it is all of us *collectively*—the *public*, as it were—who is the beneficiary. Thus, for hundreds of years both in the U.S. and in England the “duty of maintaining the rights of the public, and of a number of persons too indefinite to vindicate their own, has vested in the [state] and is exercised ...through the [state] attorney general.”<sup>41</sup> This is a practical solution to the enforceability dilemma inherent in the charitable trust and corporation. The alternative—vesting everyone with standing to seek judicial enforcement—would be intolerably chaotic and impractical. The downside, of course, is that the state attorney general is a politician.

To say, however, that a state attorney general “oversees” public charities is not to suggest that he or she “audits” them. In fact, until relatively recently most overworked and understaffed attorneys general had no idea even how many charitable trusts they were supposed to be “overseeing.” Many a charitable trust was going unperformed for one reason or another, including indifference, neglect, or death of the trustee. In an effort to get an accurate running head count of how many charitable trusts are running or supposed to be running at any given time, and to maintain as well a depository of basic information regarding them, many states have enacted statutes requiring that charitable trustees, and directors of charitable corporations, make certain periodic filings with their respective attorneys general. In some states, the reporting and licensing function is handled by a separate agency altogether, e.g., the office of secretary of state or some consumer protection bureaucracy. In ten states, there is no general system of registration and reporting whatsoever.

These reforms have enhanced somewhat the oversight of charitable trusts if only because these informational filings are generally available for public inspection. In other words, an element of privatization has been injected into the process. Still, most state

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<sup>40</sup> Neil Weinberg, Sanctimonious in Sacramento, *Forbes*, May 10, 2004, at pg. 52, 54.

<sup>41</sup> *Jackson v. Phillips*, 96 Mass. (14 Allen) 539, 579 (1867).

attorneys general lack the staffing, resources, and organizations to properly oversee charities. There are only eleven offices that have designated sections staffed by three or more full-time attorneys. “Staffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent.”<sup>42</sup>

Well then, what if anything can be done to rein in fiduciaries bent on socially investing charitable funds when the state attorney general is either busy doing other things or intentionally looking the other way? There is some case law to the effect that private persons having a special interest in the performance of a charitable trust can maintain a suit for its enforcement. They, however, must show that their interest is not merely derived from their status as members of the general public. One, also, may have standing if one is entitled to a preference under the terms of the trust, is a member of a small class of identifiable beneficiaries, or is certain to receive trust benefits. Thus, the holder of an endowed chair at a medical research facility would have standing to seek enforcement of the endowment trust. Rights to seek enforcement would also accrue to a minister entitled to income distributions from a clergy support trust. Some states (California, for example) by statute allow for some donor-involvement in the fiduciary oversight process by granting a donor access to the courts to seek the removal of a trustee for breach of the trustee’ fiduciary duty, for example, socially investing the trust property.<sup>43</sup>

In the absence of a statutory grant of standing, however, the donor of a charitable gift will have an uphill battle attempting to obtain it from a court. If standing is denied, the donor’s only recourse is then to importune the state attorney general to get involved. Most donors, however, will not have the requisite political clout to force a dilatory or reluctant attorney general to do the right thing. In one case, the Connecticut attorney general actually stood on the sidelines and watched a donor charity and a donee charity battle it out in the courts over whether the donor charity had standing to seek enforcement of certain grant restrictions that were allegedly being ignored by the donee charity.<sup>44</sup> The trial court determined that the Connecticut attorney general, not the donor charity, was vested with standing to seek enforcement of the restrictions in the courts. And with that, the case was thrown out of court. The actions of the trial court were upheld on appeal. Courts are even disinclined to grant institutional charitable donors with standing to seek enforcement of charitable trusts.

Although the default law of trusts and charitable corporations will not be particularly solicitous of any efforts on the part of a donor of a charitable gift to prevent the fiduciary, be it a trustee or a charitable corporation, from socially investing the donation, the benefactor, unlike the Calpers beneficiary or the participant in the Social Security welfare scheme, may be able to take some prophylactic measures. A charitable donor may be able legally to privatize some of the fiduciary oversight responsibilities, provided he or she does so before the gift is made. While there are no guarantees, here are some counter-measures that the benefactor and counsel may want to consider taking

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<sup>42</sup> James J. Fishman, *Improving Charitable Accountability*, 62 Md. L. Rev. 218, 262 (2003).

<sup>43</sup> Cal.Prob. Code §15642 (West 1991).

<sup>44</sup> *See* Carl J. Herzog Foundation Inc. v. University of Bridgeport, 243 Conn. 1, 699 A.2d 995 (1997).

in an effort to prevent the fiduciary from indulging his, her or its social and political predilections with the donation:

- Establish the charitable trust in a state whose courts look at social investing with a jaundiced eye.
- Establish the charitable trust in a state whose Office of the Attorney General has a good track record of taking seriously its responsibility of overseeing charities and of reining in charitable fiduciaries who are practicing social investing without express authority to do so in the governing documentation.
- Avoid unrestricted gifts to charitable corporations.
- Avoid making a charity the trustee of a restricted gift for the benefit of the charity.
- Avoid making a governmental entity the trustee of a charitable gift.
- Put a sunset provision into the governing documentation, or provide that the donation shall be consumed with a reasonable period of time.
- Make sure that the charitable purposes are articulated with precision in the governing documentation, to include inserting express prohibitions against social investing.
- Appoint more than one fiduciary to administer the donation, e.g. independent co-trustees
- Draft the documentation in a way that bestows on the donor standing to seek enforcement of the trust in the courts.
- Draft the documentation in a way that bestows standing on persons other than the donor to seek enforcement of the fiduciary's charitable obligations so that the attorney general is not the only one with oversight responsibilities.
- Designate an independent non-governmental "trust protector" in the governing documentation.

#### **IV. Social Security**

The current social security system, unlike Calpers, is a welfare program.<sup>45</sup> It bestows no property rights on those who make FICA tax payments to the U.S. Treasury.<sup>46</sup> Moreover, the so-called social security bonds on file in some federal government office are mere accounting euphemisms.<sup>47</sup> A bond in the hands of its issuer is a nullity because one may not contract with oneself. Any congress may repudiate these phantom instruments with impunity and no citizen would have "standing" to seek redress in the courts. It is a matter internal to the government. Because the current social security system makes no enforceable promises or guarantees to the FICA taxpayer in exchange for the FICA tax payments, neither the social security statutes nor the U.S. constitution afford the taxpayer any legal or constitutional safeguards. This is because under the

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<sup>45</sup> *Helvering v. Davis*, 301 U.S. 619 (1937).

<sup>46</sup> *Flemming v. Nestor*, 363 U.S. 603 (1960).

<sup>47</sup> 42 USCA s 401(a).

current system, there is nothing to safeguard. Moreover, because the U.S. has and does commingle FICA tax payments with its general revenues, as is its legal right, it is nonsensical to accuse the U.S. of socially investing the FICA tax payments. True, it is spending the funds on purposes unrelated to social security. But spending is not investing.

If the U.S. were authorized under the social security system as it is currently structured to invest FICA tax payments in the private equity and debt markets, the FICA taxpayer would still be no better off. While the U.S. might acquire an ownership interest in a healthy chunk of corporate America, the FICA taxpayers themselves would not. As for them, it would be status quo. That could not be said for corporate America, however. The danger, of course, is that that power in the U.S. to take title to and vote massive blocks of stock could lead to rampant, hyper-politicized social investing, that is to say a form of back-door socialism. While one congress might attempt to put in place statutory safeguards against the politicization of the investment process -- for example, by requiring that the U.S. shall have no power to vote the stock it invests in, or that investments be indexed, or that respected private-sector entities such as the Fidelity or Vanguard serve as investment agents of the U.S.--, another congress could easily dismantle these “safeguards” and the FICA taxpayers would be without recourse. One congress may not bind another congress when it comes to such internal matters. Moreover, even if these paper “safeguards” were to remain on the statute books, the FICA taxpayer would have no standing to seek their enforcement in the courts in the event governmental entities charged with administering and overseeing the investment process chose to ignore them.<sup>48</sup> Nor likely would an outraged member of Congress.<sup>49</sup>

In an era when the ends justify the means, when hyper-politicized courts,<sup>50</sup> attorneys general,<sup>51</sup> and executive officers at all levels of government<sup>52</sup> with impunity are picking and choosing what laws shall be enforced, it would be naive in the extreme to expect that federal politicians and bureaucrats would refrain from inflicting their political and social predilections on corporate America if given half a chance, particularly if the U.S. and only the U.S. were the legal title-holder and the beneficial owner of the securities. The temptation would be too great.

Under the social security system as it is currently structured, there is no trust fund as that term is commonly understood. Because there is no trust fund, neither the U.S. nor any other entity is serving other than euphemistically as trustee. What if Congress were to require that going forward the U.S. or an agent of the U.S., take title as trustee of a segregated fund of FICA payments and administer the funds for the benefit of the FICA taxpayers? There are two problems with this approach.

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<sup>48</sup> See *Lujan v. Defenders of Wildlife*, 504 U.S. 555 (1992).

<sup>49</sup> See *Raines v. Byrd*, 521 U.S. 811 (1997).

<sup>50</sup> See, e.g., *Palm Beach County Canvassing Board v. Harris*, 772 So.2d 1220 (Fla. 2000); *Palm Beach County Canvassing Board v. Harris*, 772 So.2d 1273 (Fla. 2000).

<sup>51</sup> See, e.g., *Carl J. Herzog Foundation v. University of Bridgeport*, 243 Conn 1, 699 A.2d 995 (1997)

<sup>52</sup> See, e.g., *Lockyer v. City and County of San Francisco*, 2004 WL 473257.

The first is the enforceability hurdle. One may not enforce a trust against the Crown absent the Crown's permission. It is highly unlikely that a congress would grant every FICA taxpayer standing to litigate against the U.S. for breaches of trust of the common law variety, for example, breaching the duty of loyalty by socially investing to the economic detriment of his or her equitable interest. It would simply be too chaotic.<sup>53</sup> That the U.S. has been such an abysmal steward of the property of others does not help matters. Just ask the Native Americans. And to bestow that right on the U.S. Attorney General or some politically appointed watchdog group or commission is merely asking the fox to guard the hen house.

The second problem is that under fundamental principles of trust law, a trustee takes the legal title to the trust property. As to the world, the trustee is the owner of the property. From the perspective of corporate America, whether the U.S. is engaging in rampant hyper-social investing as trustee or as outright owner is a distinction without a difference. In either case it is a form of back-door socialism. The fact that the U.S. would be a trustee in name affords the private corporate sector little more than a paper safeguard against government abuse of the voting power.

Were Congress to allow a FICA taxpayer to retain some of what would otherwise be his or her FICA tax payments and to privately invest those funds in an IRA-type account, then there would be less of a risk of politics infecting the investment process than if the U.S. or its agents were to do the investing. This is because property rights would then accrue to the taxpayer and title to that property would then be in the taxpayer. This corona of private ownership rights would substantially reduce the opportunity and temptation of government to engage in social investing and other such mischief-making, particularly as the takings clause of the 5<sup>th</sup> Amendment to the U.S. Constitution would be implicated.<sup>54</sup> Thus, were the U.S. or any of its agents to attempt to violate those rights, the taxpayer would have standing to seek redress in the courts.<sup>55</sup>

But the constitutional safeguard of the taking clause would not be foolproof. The power of the U.S. to levy taxes would remain intact and virtually limitless.<sup>56</sup> As the U.S. could be expected to heavily regulate the privately administered commingled funds that would be on Social Security's menu of permissible investment vehicles, social investing could rear its ugly head in the regulatory context.<sup>57</sup> Still, possession--and certainly ownership-- is nine tenths of the law. Under the current Social Security system, all FICA payments are owned by the U.S. and therefore fair game for political exploitation. A politician is likely to think twice, however, before indulging his or her social and political predilections with private property, that is property that does not belong to the U.S.

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<sup>53</sup> It presumably could do so. Congress, for example, has bestowed on private citizens the right to bring actions under the federal False Claims Act. *See Vermont Agency of Natural Resources v. U.S.*, 529 U.S. 765 (2000).

<sup>54</sup> *See generally* *Lynch v. U.S.*, 54 S.Ct.840 (1934).

<sup>55</sup> *See, e.g.*, *Hodel v. Irving*, 481 U.S. 704 (1987).

<sup>56</sup> *See, e.g.*, *Minor v. United States*, 396 U.S. 87, 98 n. 13 (1969).

<sup>57</sup> *See* Rounds, *Loring A Trustee's Handbook* §6.1.3.4, n. 168 (2004 Edition) (discussing an initiative of the Department of Labor to "encourage" private pension trustees to invest in economically targeted investments (ETIs)).

If the U.S. were to invest Social Security FICA tax payments either as the owner of the payments, or as trustee in a segregated fund, any statutory safeguards put in place ostensibly to prevent the U.S. or its agents from engaging in social investing funds would be illusory. This is because under either scenario title to the payments would be in the U.S. or her agents. If title to the payments, on the other hand, were to remain with the FICA taxpayer, or to be lodged in the *taxpayer's* agents, then the taxpayer would have the benefit of the constitutional and legal “safeguards” that come with private ownership.

## **V. Conclusion**

There are many public policy reasons why those charged with investing state pension funds, charitable funds, and the phantom social security trust fund should not be allowed to practice social investing. Social investing subverts a fiduciary's common law duty of undivided loyalty. With respect to Social Security, the practice could serve as a vehicle for functionally nationalizing the U.S. economy. With respect to public pension funds, it serves as a vehicle for political patronage at the expense of the interests of taxpayers. In the charitable context, it can undermine the institution of the trust, as well as the charitable inclinations of the citizenry. But merely outlining the public policy case against social investing is not enough. We must offer legal solutions, as well; otherwise, we are just flailing in the air. In this article we warn that until an element of privatization is injected into the administration and oversight of these funds, any attempt by a legislature to rein in the social investors among us will be an exercise in futility.

## **APPENDIX:**

## Glossary of Terms and Legal Concepts Relating to Social Investing and Social Security

In the debate over whether to partially privatize security or to merely “tweak” the status quo by having the U.S. government invest, perhaps through private financial services agents, some of the “social security trust fund,” both sides need to stay away from the euphemisms if the debate is to have any coherence. Such terms as “property,” “contract,” “insurance,” “bond,” and “trust” have legal meanings that relate to private rights, meanings that were settled decades, in some cases centuries, ago.<sup>58</sup> Today, only at the margins can they in any way be construed as ambiguous.<sup>59</sup> No wonder the public is confused when advocates on both sides of the social security privatization issue employ the terms “property,” “contract,” “account,” and “insurance” as euphemisms for welfare, or the terms “trust” and “bond” as euphemisms for internal accounting gimmicks that neither create nor secure private rights

**Contract.** A contract is an agreement between two or more autonomous parties. One may not enter into a contract, at least an enforceable one, with oneself. An enforceable contract is an agreement whose terms are enforceable in some court. A bond is a contract. One party to the contract is the issuer or debtor. The other party is the bondholder or the creditor. Just as one may not act as one’s own agent, so one may not enter into an enforceable contract with oneself. Thus, the issuer of a bond may not own the bond. If a country or company, for example, were to come into ownership of its own bond, the bond would become a legal nullity. Again, “[a] person cannot owe duties to himself.”<sup>60</sup>

An annuity offered by a private insurance company is another example of a contract.<sup>61</sup> The purchaser receives enforceable contractual rights in exchange for the premium payments.

A savings account is also a contract.<sup>62</sup> The depositor receives contractual rights in exchange for turning ownership of his money over to the bank.<sup>63</sup>

Judicial enforceability is the key. Thus, if Y promises or assures X of a particular outcome, e.g., that Y will see to it that periodic payments shall continue to be made to X

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<sup>58</sup> See, e.g., *Webb’s Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 159, 101 S.Ct. 446, 450 (1980) (where the Court deferred to the long-standing principle of property law that “interest follows principal” in confirming that “a State, by *ipse dixit*, may not transform private property into public property without compensation”).

<sup>59</sup> See, e.g., *id.* See also *Phillips v. Washington Legal Foundation*, 524 U.S. 156, 118 S.Ct. 1925 (1998) (where the Court wrestled with the question of whether interest earned on an IOLTA account is the property of the client for taking law purposes and concluded that it was).

<sup>60</sup> Scott on Trusts § 341 (1939 ed.).

<sup>61</sup> Restatement (Second) of Trusts § 12, cmt. *k*.

<sup>62</sup> Restatement (Second) of Trusts § 12, cmt. *l*.

<sup>63</sup> Restatement (Second) of Trusts § 12, cmt. *l*.

for a specified period no matter what, Y's promise or assurance rises to the level of a legally binding guarantee only if it is enforceable in some court.<sup>64</sup>

**Property.** An item of property is a collection of rights that are enforceable in some court by its owner. "The term 'property' denotes interests in things not the things themselves."<sup>65</sup> If one owns or has a property interest in a bond, for example, one owns a collection of contractual rights that are enforceable in some court. These rights might include the right to be paid interest in the amounts and at the times specified in the governing instrument; the right to sell or give away the bond; and the right to keep third parties from seizing the bond. "Valid contracts are property, whether the obligor be a private individual, a municipality, a state, or the United States."<sup>66</sup>

**Trust.** A trust is a tangle of legal and equitable relationships with respect to property.<sup>67</sup> The trustee has legal title to the property.<sup>68</sup> The property, however, is segregated from the trustee's own property<sup>69</sup>. It is the beneficiary who has the equitable or economic interest in the property, not the trustee.<sup>70</sup> The trustee is a fiduciary which means that the trustee owes to the beneficiary certain duties, such as the duty not to self-deal with the trust property and the duty not to commingle trust property with the trustee's own property.<sup>71</sup> If the trustee breaches a fiduciary duty to the beneficiary, the beneficiary may seek redress in the courts.<sup>72</sup> A trustee who self-deals in breach of his trust, for example, breaches his general duty of undivided loyalty to the beneficiary, that is the duty to act solely in the interest of the beneficiary.<sup>73</sup>

**Social investing.** A trustee who socially invests trust property seeks to use the investment process "to promote nonfinancial social goals."<sup>74</sup> Whether in any given situation a particular social investment in some way undermines the beneficiary's equitable or economic interest is legally irrelevant. What is legally relevant is that the loyalties of the trustee are divided. For good or for ill, he is not acting "solely in the interest of the beneficiary."<sup>75</sup>

**Social security.** Social Security is an umbrella term of no legal significance. The U.S. social security system as it is currently structured is two separate, legally-unrelated

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<sup>64</sup> *Id.*, cmt. *a.*

<sup>65</sup> Restatement (Second) of Trusts § 2 cmt *c.*

<sup>66</sup> *Lynch v. United States*, 54 S.Ct. 840, 579 (1934).

<sup>67</sup> Rounds, *Loring A Trustee's Handbook*, Chap. 1, (2004 Edition) (Aspen Publishers).

<sup>68</sup> *Id.* at §3.5.1 (discussing nature and extent of the trustee's estate).

<sup>69</sup> *Id.* at §6.2.1.2 (discussing trustee's duty to segregate and earmark the trust property).

<sup>70</sup> *Id.* at §5.3.1 (discussing nature and extent of beneficiary's property interest).

<sup>71</sup> *Id.* at Chap. 1.

<sup>72</sup> *Scott on Trusts* § 197.

<sup>73</sup> Rounds, *Loring A Trustee's Handbook* §6.1.3 (2004 Edition) (discussing trustee's duty to be loyal to the trust).

<sup>74</sup> Langbein and Posner, *Social Investing and the Law of Trusts*, 79 *Mich. L. Rev.* 72, 73 (1980).

<sup>75</sup> Uniform Trust Code §802(a); Restatement (Third) of Trusts §170(1) (1992); 2A *Scott on Trusts* §170; Employee Retirement Income Security Act (ERISA), 29 U.S.C. §§1104(a)1, 404 (1974).

schemes, a taxation scheme and a welfare scheme.<sup>76</sup> Tomorrow, Congress could terminate the welfare component and continue the taxation component. Congress does not have, and never has had, a legal obligation to segregate the FICA tax payments, let alone dedicate them to the welfare scheme. The social security trust fund is neither a trust nor a fund.<sup>77</sup> It is an internal accounting gimmick of no external legal significance. The terms trust, contract, guarantee, account, insurance, and bond as they are employed in the social security context are mere euphemisms. Social security bestows no property rights, contractual, equitable or otherwise, on workers.<sup>78</sup>

### **The relevant legal and constitutional principles in the social security debate**

Two legal principles, one embedded in Anglo-American common law jurisprudence and the other in the U.S. Constitution, must inform any discussion of social investing in the social security context. To ignore them is to risk constructing a legal house of cards.

*A use may not be enforced against the Crown.* “At common law it was held that a use or trust could not be enforced against the Crown, since the sovereign could not be held liable in its own courts.”<sup>79</sup> Today, one may transfer title to an item of property to the U.S. in trust for a particular purpose. The problem, however, is enforceability. Under the doctrine of sovereign immunity, those with the equitable or economic interest may not sue the U.S. without its consent.<sup>80</sup> Moreover, in cases where Congress has authorized suits against the U.S. for breach of trust, the record is clear that the U.S. has had an abysmal track record administering trusts. Take the case of the gross mismanagement by the U.S. of 300,000 trust fund accounts totaling \$2.5 billion that had been established over a century go for the benefit of certain Native Americans. In a Wall Street Journal editorial on the subject, Senator John McCain is quoted as saying that if anyone in the private sector had operated the way the government had, “they would be in jail today.”<sup>81</sup> Implicit in his statement is that it will be a long time, if ever, before Indians recover a cent of the squandered funds. Bottom line: Even when a citizen ostensibly has been granted enforceable rights under a trust administered by the U.S., those rights are for all intents and purposes illusory.<sup>82</sup>

*One congress may not bind a future congress.* When the U.S. issues a bond pursuant to the act of one congress, the U.S. enters into a contract with the purchaser. In other words, the U.S. bestows on the purchaser property rights. While one’s rights under a government bond may not be as “enforceable” as one’s rights under a bond issued by a

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<sup>76</sup> *Helvering v. Davis*, 301 U.S. 619 (1937).

<sup>77</sup> *Id.*

<sup>78</sup> *Flemming v. Nestor*, 363 U.S. 603 (1960). *See generally* Rounds, Property Rights: The Hidden Issue of Social Security Reform, SSP No. 19, Apr. 19, 2000, Cato Institute

<sup>79</sup> 1 *Scott on Trusts* § 95 (1939).

<sup>80</sup> *U.S. v. White Mountain Apache Tribe*, 123 S.Ct. 1126, 1131-1132 (2003).

<sup>81</sup> Editorial, *Indian Takers*, *Wall St. J.*, Feb. 23, 1999, at A22, col. 1.

<sup>82</sup> *See generally* Rounds, *Loring A trustee’s Handbook* §9.8.2, n. 25 and accompanying text (2004 Edition) (Aspen Publishers).

private entity, and therefore not as legally secure, they still constitute property. A future congress legally could not take those rights away from the purchaser:

*Having this power to authorize the issue of definite obligations for the payments of money borrowed, the Congress has not been vested with authority to alter or destroy those obligations. The fact that the United States may not be sued without its consent is a matter of procedure which does not affect the legal and binding character of its contracts. While the Congress is under no duty to provide remedies through the courts, the contractual obligation still exists, and despite infirmities of procedure, remains binding upon the conscience of the sovereign.*<sup>83</sup>

On the other hand, if one congress establishes a welfare program, a future congress could terminate that program with impunity. Why? Because no private property rights will have accrued.<sup>84</sup> There would be no one with standing to prevent the program's termination. Being a matter internal to the U.S. government, one congress may not bind a future congress.

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<sup>83</sup> Perry v. United States, 55 S.Ct. 432, 436 (1935).

<sup>84</sup> Bowen v. Gilliard, 107 S.Ct. 3008, 3019 (1987).