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Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion

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INTRODUCTION

FEW issues have proved as controversial in recent years as the question of how America should respond to the tragedy of apartheid in South Africa. Apartheid is utterly repugnant, brutally inhumane, and contrary to America's most fundamental notions of human rights and dignity. Whether people should oppose apartheid has an obvious answer. How people should oppose apartheid is the difficult question.

One way to oppose apartheid is to attempt to persuade United States corporations that have operations in South Africa to withdraw from the country.[1] Some view divestment—selling stock in companies that fail to adhere to an articulated standard of socially acceptable behavior—as an effective way to influence corporate actions. Others believe divestment is morally compelled even if corporate behavior is not influenced.[2] Whatever their motive, those

[1] Corporate withdrawal is proceeding apace at this time. *See infra* note 21.

[2] This viewpoint asserts that owning stock in United States corporations with operations in South Africa is tantamount to condoning apartheid. Therefore, the only proper

who ask trustee-investors[3] to divest are requesting fiduciaries to impose political and social constraints on their investment decisions, instead of basing their decisions solely on the risk and return characteristics of the particular investments. This request raises a substantial legal question: whether the trustee-investor violates his fiduciary duties if his investment decisions are based on political or social criteria.[4]

"Social investing," as it is called, has received considerable scholarly attention.[5] Most of the legal commentaries have examined so-

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course of conduct is to break all ties with the corporations, even if no tangible benefits will result. For an overview of the practical and moral questions raised by divestment, see Jerry, *U.S. Colleges and the Response to Apartheid*, Chron. of Higher Educ., Apr. 3, 1985, at 88.

3 A trustee-investor is one who invests property held in trust for the benefit of another. A "trust" is a fiduciary relationship with respect to property whereby the person who has title to the property (the trustee) is obligated to deal with the property for the benefit of another. *See* RESTATEMENT (SECOND) OF TRUSTS §§ 2-3 (1959). The concept of "fiduciary" is very broad; it exists whenever one person is under a duty to act for the benefit of another as to matters within the scope of the relationship. Common fiduciary relationships are trustee and beneficiary, guardian and ward, agent and principal, and attorney and client. *See id.* § 2 comment b.

4 The question of the legality of social investing can arise only when the trustee-investor makes an investment decision about which the beneficiary or the trustor (the person who puts the property in trust) does not receive full disclosure and to which the beneficiary or trustor does not consent. If the beneficiary and trustor give express consent, the decision is either authorized or ratified, depending on whether the consent is given before or after the investment decision. If neither the beneficiary nor the trustor objects to the decision, the question of the validity of the trustee's action will not arise. Yet, investor-trustees, because of the potential of personal liability, avoid taking action that might later be subject to legal challenge. Therefore, they are not likely to undertake a social investing strategy without first considering the potential legal ramifications.

5 *See, e.g.*, 3 A. SCOTT, THE LAW OF TRUSTS § 227.17 (3d ed. Supp. 1985); Langbein, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal*, in J. LANGBEIN, SCHOTLAND & BLAUSTEIN, DISINVESTMENT: IS IT LEGAL? IS IT MORAL? IS IT PRODUCTIVE? 1 (1985) [hereinafter J. LANGBEIN]; Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209 (1986); Ennis & Parkhill, *South African Divestment: Social Responsibility or Fiduciary Folly?*, 42 FIN. ANALYSTS J. 30 (July-Aug. 1986); Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340 (1980); Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980); Lanoff, *The Social Investment of Private Pension Plan Assets: May It Be Done Lawfully Under ERISA?*, 31 LAB. L.J. 387 (1980); Lynn, *Investing Pension Funds for Social Goals Requires Changing the Law*, 53 U. COLO. L. REV. 101 (1981); Murphy, *Regulating Public Employee Retirement Systems for Portfolio Efficiency*, 67 MINN. L. REV. 211 (1982); Pederson, *Divestment of Securities in Companies Doing Business in South Africa: Conflicting Moral and Legal Imperatives*, INQUIRY & ANALYSIS 1 (Jan. 1986); Posner, *Law and the Theory of Finance: Some Intersections*, 54 GEO. WASH. L. REV. 159, 171-73 (1986); Ravikoff & Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CALIF. L. REV. 518 (1980); Schotland, *Should Pension Funds be Used to Achieve "Social" Change? (pts.*

cial investing without reference to the body of empirical research on its practical implications. These abstract analyses have reached mixed conclusions as to the permissibility of social investing.[6] During the past few years, various financial researchers have explored the extent to which a social investing strategy may adversely affect the profitability and riskiness of a portfolio.[7] It is now appropriate to examine those results in conjunction with the legal rules that

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1, 2 & 3), TRUSTS & ESTATES 10 (Sept. 1980), TRUSTS & ESTATES 27 (Oct. 1980), TRUSTS & ESTATES 26 (Nov. 1980); Troyer, Slocombe, & Boisture, *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 GEO. L.J. 127 (1985); Comment, *Nontraditional Investments of Fiduciaries: Re-examining the Prudent Investor Rule*, 33 EMORY L.J. 1067 (1984); Note, *Socially Responsible Investment of Public Pension Funds: The South Africa Issue and State Law*, 10 N.Y.U. REV. L. & SOC. CHANGE 407 (1980-81); Note, *Fiduciary Responsibility: Prudent Investments Under ERISA*, 14 SUFFOLK U.L. REV. 1066 (1980); Comment, *The South African Divestment Debate: Factoring "Political Risk" into the Prudent Investor Rule*, 55 U. CIN. L. REV. 201 (1986); Note, *Divestiture Resolutions: University Director Liability Under the Emerging Corporate Standard*, 15 U.S.F. L. REV. 261 (1980-81).

6 *Compare* Ravikoff & Curzan, *supra* note 5, at 519 ("existing case law, though quite sparse, can be read to permit [trustee pursuit of nontraditional investment objectives at the expense of adequate return and corpus safety]") and 3 A. SCOTT, *supra* note 5, § 227.17, which states,

> Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles,

with Langbein, *Social Investing of Pension Funds and University Endowments: Unprincipled, Futile, and Illegal*, in J. LANGBEIN, *supra* note 5, at 16 ("A trustee who sacrifices the beneficiary's financial well-being for any social cause violates both his duty of loyalty to the beneficiary and his duty of prudence in investment") and Murphy, *supra* note 5, at 259, who states,

> Governmental control of public retirement plans should seek the maximization of financial return on the investment of funds assets within a risk level which is appropriate to the fulfillment of the financial purposes of the pension system. In short, efficiency in the selection of an investment portfolio should be the sole objective of pension fund regulation.

For legal commentaries making some reference to the empirical research, see *infra* note 8.

7 *See* Grossman & Sharpe, *Financial Implications of South African Divestment*, 42 FIN. ANALYSTS J. 15 (July-Aug. 1986); Investor Responsibility Research Center, Inc., The Impact of South Africa-Related Divestment on Equity Portfolio Performance (Jan. 1985) [hereinafter IRRC Report] (summary and evaluation of nine different studies); Rudd, *Divestment of South African Equities: How Risky?*, 6 J. PORTFOLIO MGMT. 5-10 (Spr. 1979); Sutton, Gustavson, & Trieschmann, *Portfolio Performance Using Social Investment Strategies: Some Empirical Evidence*, 3 J. OF INS. REG. 30 (Sept. 1984); Wagner, Emkin & Dixon, *South African Divestment: The Investment Issues*, 40 FIN. ANALYSTS J. 14 (Nov.-Dec. 1984).

limit the investment discretion of trustee-investors.[8] This Article reconsiders these rules in light of what is known about the effect of South Africa divestment on portfolio performance.[9]

Part I of this Article defines social investing and briefly reviews the South Africa divestment movement which has brought questions about the legality of social investing to the fore. Part II comments upon existing statutory and common law limitations on the discretion of trustee-investors to adopt policies of social investing. Part III analyzes the empirical research on the extent to which preclusion of a set of investment opportunities may impair the performance of a typical trustee-investor's portfolio, both with respect to rate of return and risk. Part IV explores the implications of the empirical evidence analyzed in Part III for the legal standards surveyed in Part II. We conclude that it is neither necessary nor appropriate to apply the legal standards limiting fiduciary discretion so as to prohibit social investing strategies no more restrictive than one requiring divestment of all stocks held in any company doing business in South Africa.

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[8] J. LANGBEIN, *supra* note 5, briefly discusses "the economics of social investing." However, this discussion contains no empirical evidence to validate the conclusion that the only possible outcomes from a social investing strategy are both "futile" and "wealth-impairing." *Id.* at 12-16. Langbein and Posner are responsible for the most significant effort to date to integrate economic and legal analysis. *See* Langbein & Posner, *supra* note 5. The authors' 1980 article provides an excellent analysis of the economic relationships involved in the social investing calculus. Unfortunately, the empirical substantiation for their conclusions is sketchy, largely because the authors did not have access to the research published subsequent to their article. *See id.* at 83-96. In a 1986 essay on the same subject, Posner, *supra* note 5, referred to the 1984 Wagner, Emkin and Dixon study, *supra* note 7, but even this recent essay predates the publication of significant financial research. Troyer, Slocombe and Boisture, *supra* note 5, at 138-40, cite some of the finance literature but explicitly decline to express an opinion on the financial effect of divestment, simply noting that views on the subject are diverse. Pederson, *supra* note 5, contains a brief discourse on modern portfolio theory but makes no reference to the available empirical research. Hutchinson and Cole, *supra* note 5, briefly note some of the early studies and recognize their implications for the legal standards, but the commentators, by their own admission, do not explore the precise significance of the studies. *See id.* at 1386.

[9] In this Article, we express no opinion on the merit (or lack thereof) of any particular social investing strategy, including South Africa divestment. Rather, we recommend a modification of the law which currently requires that the donor-trustor specifically insist that the trustee follow a social investing strategy. In its place, we offer a rule which would require the donor-trustor who wishes that the trustee not follow a social investing strategy to specifically insist that such a strategy not be implemented. Under this revised rule, absent the imposition of such a restriction on the trustee's discretion by the donor-trustor, the trustee would be free, subject to constraints discussed more fully in Part III and Part IV, to implement a social investing strategy.

I

SOCIAL INVESTING AND SOUTH AFRICA DIVESTMENT

The term "social investing" was aptly defined by Professors Langbein and Posner as "excluding the securities of certain otherwise attractive companies from an investor's portfolio because the companies are judged to be socially irresponsible, and including the securities of certain otherwise unattractive companies because they are judged to be behaving in a socially laudable way."[10] As these authors stated, "The reader will not go far wrong if he understands social investing to be pursuit of an investment strategy that tempers the conventional objective of maximizing the investor's financial interests by seeking to promote nonfinancial social goals as well."[11]

Social investing is either negative or positive. In its positive form, the investor chooses to invest only in certain kinds of companies, effectively targeting certain investments for social reasons. An investor's decision to purchase only the stock of local companies because of their beneficial effect on local employment is an example of positive social investing. In its negative form the investor begins with an unconstrained, diverse portfolio and identifies those companies in which he will not invest due to their disfavored social policies. The South Africa divestment movement, which calls for avoiding companies with ties to South Africa, primarily addresses the conduct of managers of large, diversified funds. Thus, South Africa divestment is an example of negative social investing.

Although the divestment campaign sparked by the debate over South African apartheid and the role of American companies that do business in that nation is unparalleled in significance, earlier examples of social investing strategies do exist. In the 1930s, Wisconsin enacted a statute requiring that at least seventy percent of all trust monies be invested within Wisconsin. The statute was repealed in 1945, however.[12] In the 1960s, Congress considered legislation that would have required private pension funds to invest a percentage of their assets in low- and middle-income housing and to pursue

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[10] Langbein & Posner, *supra* note 5, at 73. This definition necessarily excludes social share voting from the scope of the inquiry, as well as the question of whether corporations should behave in a socially responsible manner.

[11] *Id.*

[12] *See* Schotland, *Should Pension Funds Be Used to Achieve "Social" Goals?*, TRUSTS & ESTATES (pt. 1) 10, 11 (Sept. 1980). The Wisconsin statute, purposely designed to support local interests, prioritized small loans on improved farm property, loans to cooperative and mutual organizations, and town mutual insurance company mortgages. *See id.*

"socially responsible" investments.[13] In the early 1970s, union representatives and consumer advocates urged Congress to allow pension fund managers to invest a portion of fund assets in socially useful enterprises.[14] In 1979, the United Auto Workers negotiated a three-year labor contract with the Chrysler Corporation which allowed up to ten percent of new pension contributions to be invested in "socially desirable projects."[15] Currently, at least thirteen mutual funds claim to adhere to social investment strategies.[16] These funds have no unusual fiduciary difficulties because the investor consents to the social investing strategy—and whatever possible gains or losses that strategy entails—when depositing money with the fund.

Although apartheid has provoked the most significant interest ever in social investing, divestment is but a small aspect of the larger debate over how the United States should respond to apartheid. The most important debate in the United States today focuses upon the substance of U.S. foreign policy. The Reagan Administration has encouraged the dismantling of apartheid through a policy of "constructive engagement."[17] Dissatisfaction with the ineffectiveness of that policy led to calls for the imposition of sanctions upon South Africa. In October 1986, Congress enacted sanctions, overriding President Reagan's veto.[18] If conditions in

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13 *Id.*

14 *See* Hutchinson & Cole, *supra* note 5, at 1343-44.

15 Langbein & Posner, *supra* note 5, at 72.

16 Wall St. J., Aug. 5, 1986, at 33, col. 4. Between 1982 and 1986, the six largest social investing funds grew from $102 million in assets from 22,000 investors, to $450 million in assets from 66,000 investors. TIME, Oct. 27, 1986, at 74, col. 3. According to one recent estimate, over $350 billion is currently invested in "socially screened" securities. Capital Dist. Bus. Rev., Nov. 2, 1987, § 1, at 20 (citing Social Investment Forum, a Boston-based professional association of brokers, bankers, and analysts).

17 *See* Crocker, *Reagan Administration's Africa Policy: A Progress Report*, 84 DEPT. ST. BULL. 38, 43-44 (Jan. 1984). This policy is widely perceived as a failure. *See* Wall St. J., Jan. 12, 1987, at 28, col. 1 (reporting that meeting between Secretary of State Shultz and Oliver Tambo, head of the African National Congress, "marks the failure of an old policy, not the beginning of a new one"); Lugar, *Promoting True Democracy in South Africa*, BUS. & SOC'Y REV. 7 (Spring 1986) (concept of constructive engagement was good but implementation was not); Wolpe, *The Double Standard of American Foreign Policy*, BUS. & SOC'Y REV. 12, 13-14 (Spring 1986) (constructive engagement has had counterproductive consequences in South Africa and for U.S. interests).

18 Comprehensive Anti-Apartheid Act of 1986, 22 U.S.C.A. §§ 5001-5116 (Supp. 1987). This legislation banned all new investments and bank loans to South Africa, made it unlawful to import uranium, coal, iron, steel, and other designated products produced in South Africa, placed an embargo on the export of oil, oil products, and munitions to South Africa, and restricted the landing rights of South African airlines. *See generally* UNITED STATES GENERAL ACCOUNTING OFFICE, SOUTH AFRICA STA-

South Africa do not improve, tougher sanctions, perhaps including the mandated withdrawal of American business interests still present in South Africa,[19] are likely to be proposed.

A second arena of debate is the corporate boardroom. As conditions worsen in South Africa, corporate managements argue over whether to remain in the country or depart (i.e., "disinvest").[20] This debate, of course, would be moot if the federal government were to require the termination of all business dealings in and with South Africa. However, it is not likely that either the President or Congress will soon mandate the termination of all economic ties with South Africa. The current trend definitely favors voluntary corporate withdrawal from South Africa: thirty-nine United States companies pulled out of South Africa in 1985, forty-nine companies cut their South African ties in 1986, and fifty-one companies withdrew in 1987.[21] Additional companies are certain to leave as the

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TUS REPORT ON IMPLEMENTATION OF THE COMPREHENSIVE ANTI-APARTHEID ACT (GAO/NSIAD-88-44) (Oct. 21, 1987).

[19] In July 1986, the Republican-dominated Senate Foreign Relations Committee defeated by a party-line vote of 9 to 7 a proposal to mandate the withdrawal of all American investment from South Africa. N.Y. Times, Aug. 1, 1986, at 1, col. 2.

[20] *See* Wall St. J., July 11, 1986, at 1, col. 6; Smith, *South Africa: Time to Stay — or Go?*, FORTUNE, Aug. 4, 1986, at 46.

[21] L.A. Times, Jan. 19, 1987, pt. 1, at 1, col. 5 (reporting information provided by the Investor Responsibility Research Center); L.A. Times, Dec. 24, 1987, pt. 1, at 1, col. 5 (reporting updated information); *see also* Christian Sci. Monitor, April 20, 1987, at 1, col. 2 (reporting that nearly 100 companies have withdrawn from South Africa since 1985). In late October 1986, General Motors Corporation and International Business Machines, two of the largest American businesses in South Africa, announced plans to sell their interests there. *See* N.Y. Times, Oct. 21, 1986, at 1, col. 3; *id.* Oct. 22, 1986, at 1, col. 4. These two pullouts fueled speculation about an imminent exodus of United States corporations from South Africa. A number of other significant companies have since announced plans to withdraw, including Eastman Kodak Company, N.Y. Times, Nov. 20, 1986, at D1, col. 6; Revlon and Honeywell, N.Y. Times, Dec. 5, 1986, at D1, col. 6; Dow Chemical Company, L.A. Times, Feb. 14, 1987, pt. 1, at 3, col. 3; McGraw-Hill, Inc., L.A. Times, Feb. 27, 1987, pt. 1, at 9, col. 4 (announcing the company would stop selling its products in the country); Xerox Corporation, N.Y. Times, Mar. 24, 1987, at D1, col. 1; Ford Motor Company, N.Y. Times, June 15, 1987, at 1, col. 3; Citicorp, Wall St. J., June 17, 1987, at 2, col. 3; and International Business Machines, Wall St. J., Aug. 24, 1987, at 1, col. 6. In August 1987, the last remaining foreign bank in South Africa withdrew. AMERICAN BANKER, Aug. 10, 1987, at 3. As of January 1, 1988, U.S. companies doing business in South Africa will no longer be able to deduct taxes paid to the South African government from their U.S. tax bill. This significant increase in the cost of doing business is likely to accelerate the withdrawal of U.S. companies from South Africa. Wash. Post, Dec. 24, 1987, at C7, col. 1; L.A. Times, Dec. 24, 1987, pt. 1, at 1, col. 5.

Assessments of the impact and desirability of the corporate withdrawal are varied. *See, e.g.*, Wall St. J., Dec. 23, 1986, at 1, col. 1 (reporting on anger and bitterness of South African blacks over corporate withdrawal); Christian Sci. Monitor, Apr. 20, South African government becomes more repressive and the situation there worsens.

Those companies which have sold their operations in South Africa, however, typically continue to sell their products to the independent, locally owned operations they leave behind.[22] It is probable that those who have urged divestment of stock in companies with operations in South Africa will now urge divestment of stock in companies that sell goods in South Africa, even if those companies have no affiliates or subsidiaries there.[23] Thus, corporate

1987, at 1, col. 2 ("the divestment push has at least so far missed its mark"); L.A. Times, Mar. 13, 1988, pt. 4, at 1, col. 6 (reporting on contention of South African businessmen, economists, and government officials that sanctions have failed and that, as a result, South Africa need not fear further sanctions); N.Y. Times, Oct. 1, 1987, at 1, col. 5 (report of Reagan Administration to Congress states that economic sanctions failed to achieve any desired changes in South Africa); Bandow, *Break Relations with South Africa*, N.Y. Times, Feb. 27, 1987, at A27, col. 2 (commentator opines that sanctions have been "at best, ineffective"; blacks in South Africa have felt sanctions' greatest impact; urges termination of sanctions but breaking diplomatic relations with government of South Africa); Wash. Post Nat'l Weekly Ed., Dec. 22, 1986, at 18, col. 1 (commentary on "vanishing" social programs in South Africa as U.S. firms withdraw); J. Silbur, South Africa: The Failure of Sanctions, Address to World Affairs Council of Maine, Portland, Me. (Mar. 16, 1987). A BBC radio broadcast from South Africa reported that "there have been few visible signs of sanctions having an impact." *Summary of World Broadcasts*, Brit. Broadcasting Co., Jan. 20, 1987 (Nexis).

22 *See* BARRON'S, Oct. 27, 1986, at 18; TIME, Nov. 3, 1986, at 32, col. 1; N.Y. Times, July 27, 1987, at 21, col. 3; Wall St. J., Oct. 24, 1986, at 2, col. 2. By one account, more than 35% of the 106 U.S. subsidiaries sold in 1986 and early 1987 continue to sell their goods in South Africa through licensing, distribution, franchising, or trademark agreements. TIME, June 29, 1987, at 44 (citing Mitchell Investment Management figures). An exception is Eastman Kodak Company, which announced that it would not only withdraw from South Africa, but it would also stop all shipments of its products to that country. N.Y. Times, Nov. 20, 1986, at D1, col. 6.

23 *See* TIME, Nov. 3, 1986, at 32, col. 1; Wall St. J., Oct. 24, 1986, at 2, col. 2 (reporting on continued public criticism of IBM and General Motors after each company announced plans to shed its South African subsidiary because no plans were announced to stop selling goods to the unit). In fact, many divestment mandates arguably proscribe investment in any company with any sort of business tie in South Africa. Very few companies that have left South Africa have cut off all business ties, and therefore only a few companies could meet such a test. *See* BARRON'S, Oct. 27, 1986, at 18; N.Y. Times, Feb. 9, 1987, at D1, col. 6 (reporting on growing pressure on U.S. firms to sever all business ties with South Africa, not just sell their subsidiaries to local operators); Wash. Post, Mar. 20, 1987, at A26, col. 1 (reporting that sales of Eastman Kodak products in South Africa were uninterrupted after the company announced in November that it was pulling out of South Africa).

This has caused a number of anti-apartheid groups in the United States to promulgate new guidelines for determining whether companies have "ceased operating" in South Africa. The new definition of doing business in South Africa includes holding franchising, licensing, management, or credit agreements with entities in South Africa, or having more than 5% of its stock controlled by a South African company. *See* L.A. Times, Jan. 19, 1987, pt. 1, at 1, col. 5.

"withdrawal" alone is unlikely to mollify advocates of divestment, and opposition to corporate policies is likely to continue. The debate in corporate boardrooms will only shift focus; corporate managers will now consider, not whether to withdraw, but whether they will continue to sell their products in South Africa.

Yet another arena of debate focuses upon investors in companies that do business in South Africa. Individual stockholders, institutions, and trustees have considered, upon their own initiative or upon prompting by trust beneficiaries or third parties, whether they should divest their ownership interests in companies that do business in South Africa.[24] Divestment is sometimes promoted as a way to force companies to withdraw from South Africa. The numbers themselves suggest that the potential force of public opinion that Americans might assert through divestment is large. As of 1985,

[24] Such a consideration resulted in litigation in Oregon. The Oregon Board of Higher Education issued a directive to the Oregon Investment Council ("OIC"), which is responsible for managing the Oregon Higher Education Endowment Fund, to divest the fund's common stock holdings in companies doing business in South Africa. The Board's resolution expressed the opinion that divesting would not violate the prudent investor rule. The OIC refused to follow the request. Four University of Oregon students who were recipients of Endowment Fund scholarships, the student governments of the University of Oregon and Portland State University, and various other student organizations sought a declaratory judgment that the OIC could not ignore the Board's directive. The OIC moved to dismiss the complaint on the ground that plaintiffs lacked standing, and the motion was denied.

The trial court ultimately held that the OIC must follow the Board's resolutions. Moreover, the Board's divestment resolution could not be enforced because it violated the Oregon "prudent investor" statute. OR. REV. STAT. § 128.057 (1984). Plaintiffs appealed, and the OIC filed a cross-appeal claiming that the trial court erred in denying the motion to dismiss the suit for lack of standing. On appeal, the Oregon Court of Appeals agreed with OIC that the plaintiffs lacked standing. The court declined to reach the merits of the trial court's prudent investor ruling. Associated Students of Univ. of Or. v. Oregon Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986), *rev. denied*, 303 Or. 74, 734 P.2d 354 (1987).

Two other cases have considered the validity of mandated divestment, but neither case reached the prudent investor issue. In Regents of the Univ. of Mich. v. State, 166 Mich. App. 314, 419 N.W.2d 773 (1988), the Michigan Court of Appeals held unconstitutional a state statute which mandated divestment by educational institutions, including public universities, under the logic that the state legislature lacked authority under the Michigan Constitution to regulate the investments of state universities. In Board of Trustees of the Employees' Retirement Sys. of Baltimore v. Mayor of Baltimore, Case No. 86365056/CE-59858 (July 17, 1987), a Maryland trial court upheld the validity of a Baltimore ordinance requiring its public employee retirement funds to divest from companies doing business in South Africa. The trustees challenged the ordinance on the ground that it unreasonably burdened the interstate sale of securities, interfered with the federal government's power to conduct foreign policy, was preempted by the federal anti-apartheid statute, and impaired contractual pension rights. The trial court rejected all of these contentions. An appeal is expected. *See* 14 Pens. Rep. News (BNA) 972 (July 27, 1987); Nat'l Law J., Aug. 3, 1987, at 8, col. 1.

university endowment funds, public employee pension funds, and corporate and union pension funds held approximately seventy-two percent of all publicly held United States stock.[25] Alternatively, those who doubt that divestment will influence corporate policy sometimes advocate divestment as the only proper ethical response to apartheid.[26] Still others, who doubt both the efficacy of divestment *and* reject the proposition that total divestment is morally compelled, urge selective divestment as a last resort. Under this view, it is conceded that divestment is appropriate after efforts to influence corporate management through shareholder voting campaigns and other means are exhausted and it is clear that a particular corporation's management will not participate in the struggle against apartheid.[27] In sum, the question of how American investors should respond to the tragedy of apartheid is highly controversial.[28]

In the short run, the question of how best to respond to apartheid in South Africa will remain controversial. In the long run, most observers agree that apartheid will fall, and this will end once and for all the debate over South African divestment.[29] However, the larger question of the extent to which trustee-investors are constrained by law from following social investing strategies will not be mooted by termination of the South Africa divestment debate. Issues other than apartheid, such as the employment of nonunion labor, defense contracting, and the sale of alcohol and tobacco products, have prompted interest in social investing in the past.

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25 Smith, *American Stocks Shrug Off Anti-Apartheid Pressure*, Wall St. J., Apr. 30, 1985, at 34, col. 1.

26 *See, e.g.*, *President Spells Out Policy Concerning South Africa*, Princeton Weekly Bull., May 13, 1985, at 3 (remarks of Princeton University President William G. Bowen); Lewis, *What Can We Do? (2)*, N.Y. Times, Mar. 28, 1985, at A31, col. 1.

27 *See President Bok's Statement on Investment Policy*, Harv. Gazette, Oct. 5, 1984, at 8.

28 For example, during July 1986, the University of California Board of Regents voted to sell $3.1 billion worth of holdings in companies that do business in South Africa. At the same time, the Teachers Insurance and Annuity Association and College Retirement Equities Fund (TIAA-CREF) urged the 160 United States corporations in which they have investments to pull out of South Africa. Chron. of Higher Educ., July 30, 1986, at 1, col. 2. For a survey of various approaches to divestment, see Gosiger, *Strategies for Divestment from United States Companies and Financial Institutions Doing Business With or In South Africa*, 8 HUMAN RIGHTS Q. 517 (1986).

29 Also, if a complete rupture of economic and diplomatic relations with the minority-controlled government of South Africa were to occur, the current divestment debate would be mooted. Such a development, though not beyond imagination, is probably not likely to occur in the foreseeable future.

Similar issues will probably arise in the future.[30] Therefore, when, for whatever reason, trustee-investors are urged to implement a strategy of social investing, they must consider the legal implications of their actions.[31]

II

EXISTING LEGAL LIMITATIONS ON INVESTOR DISCRETION

When creating a trust, the trustor has the discretion to impose duties on and grant authority to the trustee. If these duties and powers do not violate a rule of statutory law or public policy, the

[30] Indeed, it is possible that the South Africa divestment movement, simply because of the attention it has focused on social investing, will cause interest groups to advocate social investing more often in the future. *See* L.A. Times, May 13, 1987, pt. 1, at 3, col. 4 (reporting on proposed California legislation that would halt state pension fund investments in U.S. companies that do not agree to abide by a set of anti-discrimination principles in Northern Ireland).

[31] If a trustee breaches a duty owed to the trust beneficiary, the trustee is personally liable for resulting losses. *See* RESTATEMENT (SECOND) OF TRUSTS § 201 (1959) (a breach of trust is a violation by the trustee of any duty which the trustee owes the beneficiary); *id.* § 205 (trustee liable for any loss or depreciation in value of the trust estate resulting from breach of trust). The University of California Board of Regents requested the California legislature to absolve them of liability for breach of their fiduciary obligations should divestment cause financial losses. Chron. of Higher Educ., *supra* note 28, at 22, col. 3. Obviously, potential liability is of considerable concern to trustees.

With respect to a private trust, however, remedies exist only in favor of a beneficiary. The beneficiary, or one suing on the beneficiary's behalf, is the only person with standing to enforce a trust. *See* 3 A. SCOTT, *supra* note 5, § 200.

Charitable trusts lack individual beneficiaries. As a result, standing to enforce such trusts usually resides in the state attorney general. Such a suit can be brought on the attorney general's own initiative or upon the initiative of a third person. 4 A. SCOTT, THE LAW OF TRUSTS § 391, at 3003 (3d ed. 1967). If there are cotrustees, one of them can bring an action against the others to enforce the trust. *See id.* at 3006; *see also* Holt v. College of Osteopathic Physicians and Surgeons, 61 Cal. 2d 750, 394 P.2d 932, 40 Cal. Rptr. 244 (1964). Also, a person who is entitled to receive a "special benefit" under the trust may be allowed to enforce the trust. 4 A. SCOTT, *supra*, § 391, at 3007. However, in the absence of such a relationship, a person cannot maintain the suit in the individual's own capacity. *See id.* at 3010. Standing is a potentially difficult hurdle for one seeking to challenge a social investment strategy. *See, e.g.*, Associated Students of Univ. of Or. v. Oregon Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986), *rev. denied*, 303 Or. 74, 734 P.2d 354 (1987).

Of course, if state law were amended to authorize social investing with regard to a specific issue or as a general matter, a social investing strategy may not offend traditional common law duties. However, with respect to pensions governed by ERISA, the federal law preempts state laws. Thus, it is unlikely a state statute could authorize an investing strategy that offends ERISA's minimum requirements. *See infra* text accompanying notes 76-91. For a discussion of the likelihood of litigation under ERISA challenging social investing, see Hutchinson & Cole, *supra* note 5, at 1380-84.

trustor's choices will not be disturbed. In the absence of an express provision in a trust document on a particular point, the rules of trust law supplement the provisions of the trust document.[32] Thus, the common law is an important source of limitations on the discretion of trustees. In addition, statutes in many states and some federal laws impose additional or different duties on trustees.

A. Common Law

The fundamental duty owed by the trustee to the beneficiary is to administer the trust.[33] In managing the trust, "the trustee is required to manifest the care, skill, prudence, and diligence of an ordinarily prudent man engaged in similar business affairs and with objectives similar to those of the trust in question."[34] Ordinarily, the trustee's obligation is to make the trust assets productive,[35] and the trustee is expected to exercise his investment authority in a manner consistent with his general management obligations.[36] As explained by the *Restatement*, the duty owned to the beneficiary is, absent specific provisions in the terms of the trust or a statute, "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived."[37]

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[32] *See* 1 A. SCOTT, THE LAW OF TRUSTS § 4, at 46-47 (3d ed. 1967).

[33] *See* RESTATEMENT (SECOND) OF TRUSTS § 169 (1959).

[34] G. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 541, at 157 (2d rev. ed. 1978); *see also* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959).

[35] *See* G. BOGERT, *supra* note 34, § 611, at 3.

[36] *See id.* § 612, at 12. Section 174 of the RESTATEMENT (SECOND) OF TRUSTS (1959) provides that "if the trustee has or procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, he is under a duty to exercise such skill." The prudent investor rule actually constituted a liberalization of the extremely conservative limitations on trustee investment discretion prevalent in the eighteenth century. For a discussion of the development of the law governing trustees' investment authority, see Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. B. FOUND. RES. J. 1, 3-6.

[37] RESTATEMENT (SECOND) OF TRUSTS § 227(a) (1959). The prudent investor rule's generality necessarily means that the rule subsumes other principles. For example, it is sometimes said that a trustee has a duty to diversify. *See, e.g.*, Hamilton v. Nielsen, 678 F.2d 709, 712 (7th Cir. 1982); *In re* Estate of Collins, 72 Cal. App. 3d 663, 669, 139 Cal. Rptr. 644, 648 (1977); RESTATEMENT (SECOND) OF TRUSTS § 228 (1959). This simply means that a prudent person ordinarily would diversify in order to reduce the risk of diminution of the trust's assets. If, however, a prudent person would not have diversified under the circumstances, the trustee has violated none of its duties. *See* Green v. Lombard, 28 Md. App. 1, 8, 343 A.2d 905, 911 (1975). Similarly, it is said that the trustee has a duty to use reasonable care and skill to preserve trust property. *See, e.g.*, Nedd v. United Mine Workers, 506 F. Supp. 891, 900 (M.D. Pa. 1980); *In re* Estate of

The *Restatement* formulation of the trustee's investment obligations indicates that the duty of prudent investing actually has two components: producing income and preserving the trust corpus. These twin goals were recognized in an 1830 Massachusetts case, *Harvard College v. Amory*,[38] which is widely credited with devising the prudent investor rule:

> All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.[39]

Producing income requires that the trustee evaluate possible and comparative rates of returns; preserving the estate requires that the trustee evaluate the risk of possible investments.

The prudent investor rule establishes two separate standards which measure the trustee's exercise of discretion in pursuit of the goals of income maximization and corpus preservation. The first is a requirement that the trustee act with due care. The trustee must make an "investigation as to the safety of the investment and the probable income to be derived therefrom."[40] This investigation must examine such matters as would a prudent person; the trustee is to exercise judgment in considering any advice upon which a prudent person would rely. The second requirement is one of skill. The trustee must exercise at least the skill of a person of ordinary intelligence. If the trustee has greater skill or represents that he has greater expertise, the trustee must exercise that enhanced degree of skill.[41]

The basic difficulty confronting the trustee is that the dual objectives of maximizing return and minimizing risk are to some extent incompatible. The higher the risk, the greater the rate of return; in

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Hamill, 7 Pa. 592, 599, 410 A.2d 770, 773 (1980); RESTATEMENT (SECOND) OF TRUSTS § 176 (1959). This duty, although sometimes given the status of a separate duty, is merely another aspect of prudence; a prudent fiduciary would not squander the trust's assets. *See generally* B. LONGSTRETH, MODERN INVESTMENT MANAGEMENT AND THE PRUDENT MAN RULE (1986).

[38] 26 Mass. (9 Pick.) 446 (1830).

[39] *Id.* at 461. Nothing, of course, prevents a state legislature from altering the prudent investor rule through statutory enactment. For one such alteration which draws heavily on the prudence standard of ERISA, see CAL. CIV. CODE § 2261 (West 1985).

[40] RESTATEMENT (SECOND) OF TRUSTS § 227 comment b (1959).

[41] *See id.* comment c.

other words, investors receive higher rates of return in exchange for accepting the higher risk that an invested asset will decline in value. If the trustee were to give unreasonably disproportionate weight to the goal of income maximization, the trustee would run an unacceptable risk of diminishing the trust's corpus. Yet, if the trustee were to give excessive favor to guaranteed investments in order to maximize safety, the trustee would be vulnerable to the charge that he failed to pursue with sufficient vigor the objective of maximizing income. The proper balance of return and risk depends on many circumstances.[42] Nevertheless, it is widely understood, despite some opinions to the contrary,[43] that achieving the maximum rate of return and avoiding undue risk are the sole and exclusive objectives of the trustee.[44]

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[42] Which objective is primary depends on the circumstances:

> In some circumstances the amount and regularity of the income may be more important than the preservation of the principal; under other circumstances the preservation of the principal may be of primary importance. It is impossible to lay down a hard-and-fast rule as to what is a prudent investment, since much may depend upon the time and place of the administration of the trust, and much may depend upon the character of the particular trust.

Id. comment e.

[43] Professor Scott opined:

> Trustees in deciding whether to invest in, or to retain, the securities of a corporation may properly consider the social performance of the corporation. They may decline to invest in, or to retain, the securities of corporations whose activities or some of them are contrary to fundamental and generally accepted ethical principles. They may consider such matters as pollution, race discrimination, fair employment and consumer responsibility. . . . Of course they may well believe that a corporation which has a proper sense of social obligation is more likely to be successful in the long run than those which are bent on obtaining the maximum amount of profits. But even if this were not so, the investor, though a trustee of funds for others, is entitled to consider the welfare of the community, and refrain from allowing the use of the funds in a manner detrimental to society.

3 A. Scott, *supra* note 5, § 227.17 (footnote omitted). Professor Scott offered little support for his conclusion. Moreover, the authority that does exist, as sparse as it is, points the other direction, as the discussion in the text indicates. Ravikoff and Curzan, *supra* note 5, at 522-24, also argue that some existing case law on the prudent investor standard permits social investing, even when the objectives of maximizing return and corpus safety are sacrificed.

[44] Langbein & Posner, *supra* note 5, at 98 ("[t]he duty of prudent investing . . . reinforces the duty of loyalty in forbidding the trustee to invest for any object other than the highest return consistent with the preferred level of portfolio risk"); *see also* Ravikoff & Curzan, *supra* note 5, at 518 (courts have traditionally evaluated the prudence of an investment exclusively in terms of these two objectives); 38 Op. Or. Att'y Gen. 2017, 2031 (1978) (interpreting Oregon statute codifying prudent investor rule as limiting trustee to consideration of "safety of the investment and probable return [such that other] considerations, such as political or moral judgments, are not relevant and should not deflect investment managers from their legal duty") (footnote omitted); Op. Fla.

If maximizing income and preserving the corpus are the only objectives a trustee can pursue, it would appear that invoking social criteria in choosing among alternative investments is impermissible. Yet if the trustee is faced with two alternative investments of equal risk and return, the prudent investor rule gives the trustee no instruction on how to choose between the investment opportunities. In such a case, it would seem that—all else being equal—opting for one investment over the other based on a social preference would not offend the prudent investor rule.[45] Unfortunately, no reported case has decided or even explored the question of whether a trustee can pursue a social investing strategy without violating the prudent investor rule.

Two cases, however, have considered the question of whether a trustee can, consistent with the duty of care, manage trust assets to achieve purposes unrelated to the maximization of income and the preservation of the trust corpus. These cases have figured prominently in commentaries on social investing. *Blankenship v. Boyle*[46] involved a fund established by numerous employers to provide pension, medical, hospital, work-related illness and disability, and other benefits for coal miners, most of whom belonged to the United Mine Workers Union. The fund's trustees bought large blocks of stock of certain electric utilities in an effort to induce the utilities' managements to burn union-mined coal.[47] Some of the beneficiaries of the fund sued the trustees. The federal district court eventually enjoined the trustees "from operating the Fund in a manner designed

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Att'y Gen., No. 85-30 (Apr. 17, 1985) (Westlaw) (no statute authorizes the State Board of Administration to adopt a divestment rule based on ethical ideals or standards; the only permissible investment criteria are yield, risk, and diversification; if the location of an investment in an unstable part of the world makes the investment risky, divesting the asset based on that criterion is within the discretionary authority of the Board).

To achieve these twin objectives of maximizing return and minimizing risk, the Restatement's drafters identified ten criteria that the trustee should consider in selecting a given investment. RESTATEMENT (SECOND) OF TRUSTS § 227 comment o (1959). "Social values" does not appear on the list. An Oregon trial court held that South Africa divestment violates the prudent investor rule, although this conclusion was vacated on appeal without a ruling on the merits. Associated Students of Univ. of Or. v. Oregon Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986), *rev. denied*, 303 Or. 74, 734 P.2d 354 (1987); *see supra* note 24. Overall, reported court decisions evaluating the prudence of novel investment strategies are very sparse. *See* B. LONGSTRETH, *supra* note 37, at 16-22.

45 *But see* 38 Op. Or. Att'y Gen. 2017, 2018 (1978) ("It is inappropriate and irrelevant for the investment managers to consider any factors other than the probable safety of, and the probable income from, the investments as required by the statute.").

46 329 F. Supp. 1089 (D.D.C. 1971), *aff'd mem.*, 511 F.2d 447 (D.C. Cir. 1975).

47 *Id.* at 1105-06.

in whole or in part to afford collateral advantages to the Union or the [employers]."[48]

The court's holding in *Blankenship*, if taken literally, constitutes a very narrow construction of a trustee's discretion: it is not lawful for a trustee to take factors unrelated to risk and return into account when choosing among alternative investments.[49] Managing a fund to secure collateral advantages or promote collateral objectives is impermissible, even if the paramount objectives of maximizing return and minimizing risk are not compromised.

It is highly doubtful the court meant for its holding to reach so far, however. Instead, the court probably meant to hold only that the trustees could not *sacrifice* return or corpus safety to secure collateral advantages. In describing the breach of trust, the court noted that "these particular challenged stock purchases were made *primarily for the collateral benefits* they gave the Union."[50] It was almost certainly the sacrifice of the pension fund's profitability, caused by the decline in value of the utility stock,[51] that concerned the plaintiffs, not the fact that the unions were benefiting from the investment strategy. If it were clear that the fund's risk and return were not adversely affected by the trustees' investment strategy, it is doubtful the plaintiffs would have asserted a claim. If in such a situation a claim were asserted, it would have made little sense to hold that the trustees could not choose to favor the stock of companies purchasing union-manufactured products over that of companies employing nonunion labor, all else being equal.

In the second case, *Withers v. Teachers' Retirement System*,[52] a federal district court upheld the decision of a fund's trustees to purchase New York City bonds as part of the plan that ultimately prevented that city's bankruptcy in late 1975. The pension fund in question was not fully funded; its main asset was New York City's contractual liability to pay benefits out of future tax revenues. The trustees were nearly certain the city's payments to the fund would

48 *Id.* at 1113. The court also enjoined the trustees from engaging in practices it regarded as breaches of trust. *Id.*

49 *See* Ravikoff & Curzan, *supra* note 5, at 522.

50 329 F. Supp. at 1106 (emphasis added). The court in Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979), similarly read *Blankenship* as "a case in which the trustees pursued policies which may incidentally have aided the beneficiaries of the fund but which were intended, primarily to enhance the position of the Union and the welfare of its members." 447 F. Supp. at 1256.

51 *See* 329 F. Supp. at 1105.

52 447 F. Supp. 1248 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979).

cease if the city entered bankruptcy. Therefore, the trustees joined with four other municipal-employee pension funds to purchase $2.5 billion in city obligations over a thirty-month period in order to help the city avoid bankruptcy.

The fund beneficiaries, retirees of the New York City schoolteachers' pension fund, claimed that the trustees acted more for the benefit of the city than in the interest of the beneficiaries themselves. Indeed, the bonds had an extremely high risk of default, the purchase was of an excessive amount, and the purchase left the pension fund underdiversified. The court, however, rejected the retirees' claim, concluding that

> [N]either the protection of the jobs of the City's teachers nor the general public welfare were factors which motivated the trustees in their investment decision. The extension of aid to the City was simply a means—the only means, in their assessment—to the legitimate end of preventing the exhaustion of the assets of the [pension fund] in the interest of all the beneficiaries.[53]

At first glance, *Withers* and *Blankenship* seem inconsistent because, as Ravikoff and Curzan argued, "There is little distinction between saving a city that guarantees a pension fund and protecting union jobs that serve to bolster an existing pension fund."[54] Yet, *Withers* is distinguishable because the fund trustees perceived the bond purchase as essential to the preservation of the trust corpus, while in *Blankenship*, the fund had a "predictable steady income in the form of monthly royalty payments."[55] Had the trustees in *Withers* failed even to consider such a purchase, it is conceivable the trustees could have been in breach of their duty to use reasonable care and skill to preserve trust property.[56]

In short, *Blankenship* does not, by itself, present an imposing case against a trustee's decision to pursue a social investing strategy, at least where social investing does not impair return or increase risk.

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[53] 447 F. Supp. at 1256. The trustees in *Withers* also made their commitment to purchase city bonds conditional on the enactment of federal legislation providing for the financing needs of New York City, the enactment of state legislation clarifying the legal status of the pension funds and the responsibilities of the trustees, a commitment from the New York Governor to introduce legislation the trustees believed would strengthen the funding of the pension plans, and a ruling from the Internal Revenue Service (or, alternatively, the enactment of a federal statute) providing that the purchases of city obligations would not jeopardize the fund's tax-exempt status under the exclusive-benefit rule. *See* 447 F. Supp. at 1253.

[54] Ravikoff & Curzan, *supra* note 5, at 523.

[55] 329 F. Supp. at 1096.

[56] *See* RESTATEMENT (SECOND) OF TRUSTS § 176 (1959); Ravikoff & Curzan, *supra* note 5, at 528 ("the trustee must, at a minimum, preserve the trust corpus").

At the same time, it cannot be said that *Withers* significantly undercuts the traditional view that the trustee must uncompromisingly pursue the dual goals of maximizing return and minimizing risk. Thus, until clearer authority exists concerning a trustee's discretion to practice social investing, the trustee who chooses to base investment decisions on social, moral, or political factors assumes the risks: first, that a disgruntled beneficiary will later claim that the trustee breached the duty of prudent investing; and, second, that a court, lacking the benefit of clear precedents or legislative guidance, will agree with the beneficiary's argument.[57]

One other potentially relevant duty owed by a trustee to the beneficiary is the duty of loyalty.[58] According to the *Restatement*, it is the trustee's fiduciary obligation to manage trust property "for the benefit of" the trust's beneficiary.[59] Moreover, "[t]he trustee is under a duty to the beneficiary to administer the trust *solely* in the interest of the beneficiary."[60] In most situations where the duty is claimed to have been violated, the trustee has allegedly administered the trust for his own financial benefit.[61] Occasionally, it is argued the trustee administered the trust for the financial benefit of a third party, to the beneficiary's detriment.[62] Because social investing involves the promotion of social, moral, or political values, and not the bestowal of a pecuniary benefit on the trustee or some third party, the duty of loyalty, as it has developed in the cases, arguably has no relevance whatsoever to the permissibility of social investing. Nevertheless, the underlying principle in the duty of loyalty cases appears to be that the trustee must be guided, not by the

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[57] Fear of these risks has affected the behavior of some trustee-investors. Concern over potential liability apparently prompted the Baltimore lawsuit, where trustees for the city's employee retirement plan sought a declaratory judgment in order, among other reasons, to insulate themselves from potential liability. *See* Board of Trustees of the Employees' Retirement Sys. of Baltimore v. Mayor of Baltimore, Case No. 86365056/CE-59858 (July 17, 1987); *supra* note 24; BUS. WEEK, July 6, 1987, at 53. Some trustees have cited their fiduciary obligations in explaining decisions not to divest. *See* N.Y. Times, June 8, 1987, at 26, col. 5 (fund managers state that they cannot support Rev. Sullivan's plea for divestment, as a means to cause corporate withdrawal from South Africa, because of their legal obligation to manage funds prudently).

[58] *See* RESTATEMENT (SECOND) OF TRUSTS §§ 169-185 (1959) (includes duty to administer trust; duty not to delegate the trustee's responsibilities; duty to keep and render accounts).

[59] RESTATEMENT (SECOND) OF TRUSTS § 2 (1959).

[60] RESTATEMENT (SECOND) OF TRUSTS § 170(1) (emphasis added).

[61] *See generally* 2 A. SCOTT, THE LAW OF TRUSTS § 170.17 (3d ed. 1967).

[62] *See, e.g.*, Ahuna v. Department of Hawaiian Home Lands, 64 Haw. 327, 640 P.2d 1161 (1982); *In re* Saeger's Estate, 340 Pa. 73, 16 A.2d 19 (1940). *Withers* and *Blankenship* also fall into this category.

desires of third parties, but by the interests of the beneficiary.[63]

Plainly, the wishes of third parties regarding trust administration ought not take precedence over the beneficiary's interest. Yet, it is far from clear that the duty of loyalty prevents a trustee from considering collateral factors in circumstances where there is no possibility the beneficiary's interests will be compromised. *Blankenship* can be read to mean that a trustee cannot loyally serve the beneficiaries of a trust while simultaneously promoting objectives collateral to maximization of return and minimization of risk. However, it is unlikely the court meant that taking any factor other than return or risk into account in investment decision-making automatically constitutes disloyalty to the beneficiary. On the other hand, *Withers* does not directly support a trustee giving deference to objectives unrelated to return and risk, since the trustees' efforts in *Withers* to promote the solvency of the city appeared consistent with the beneficiaries' interests.

In the final analysis, we found no cases that definitively decide whether a trustee's promotion of goals collateral to return and risk objectives, in circumstances not involving pecuniary remuneration to third parties or the trustee personally, automatically constitutes disloyalty to the beneficiary. As long as this uncertainty persists, the trustee who pursues social values as part of an investment strategy runs the risk of subsequently being held to have violated the duty of loyalty.

In short, the duty of prudent investing, as currently understood, appears to prohibit an investment strategy that compromises the objectives of maximizing the rate of return and preserving the safety of the trust corpus in order to further other interests, such as social or political goals. If, however, it can be demonstrated that social investing does not compromise either of the dual aims of the prudent investor rule, social investing should not be proscribed under the authority of that rule. In addition, the trustee's duty of loyalty to the beneficiary is arguably violated in circumstances where the trustee seeks to promote social or political values through investment policies. If, however, social investing does not impair the interests of trust beneficiaries by either reducing the rate of return or increasing the risk of loss of the trust's corpus, no justification exists for interpreting the duty of loyalty as absolutely proscribing a trustee from taking political and social values into account in investment decision making.

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63 *See* RESTATEMENT (SECOND) OF TRUSTS § 170 comment q (1959).

B. Statutory Law

1. The UMIFA

The Uniform Management of Institutional Funds Act (UMIFA)[64] has been adopted in twenty-eight states and the District of Columbia.[65] The Act's purpose is to clarify for governing boards of eleemosynary institutions, particularly colleges and universities,[66] the legal limitations on their authority to invest the funds they manage. The UMIFA not only specifies the investment authority of covered institutions but also specifies standards for the exercise of investment discretion.

Section 6 of the UMIFA states a "business care and prudence" standard of conduct for investors:

> In the administration of the powers to appropriate appreciation, to make and retain investments, and to delegate investment management of institutional funds, members of a governing board shall exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision. In so doing they shall consider long and short term needs of the institution in carrying out its educational, religious, charitable, or other eleemosynary purposes, its present and anticipated financial requirements, expected total return on its investments, price level trends, and general economic conditions.[67]

The purpose of inserting the business care and prudence standard into section 6 was to free governing boards to some extent from the constraining effects of the common law obligations imposed on private trustees. The comment to section 6 states that the UMIFA's standard of care "is generally comparable to that of a director of a business corporation rather than that of a private trustee."[68] Cases in the corporate area recognize that some charitable contributions by corporations are justifiable on the ground the corporation furthers its own long-term interests by providing benefits to society as a whole.[69] To this extent, the Act countenances some social invest-

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64 UNIF. MGMT. OF INSTITUTIONAL FUNDS ACT [hereinafter UMIFA], 7A U.L.A. 705 (1985). This statute was approved by the National Conference of Commissioners on Uniform State Laws in 1972.

65 UMIFA, 7A U.L.A. 143 (Supp. 1988).

66 The statute applies to organizations, whether incorporated or unincorporated, operated exclusively for educational, religious, charitable, or other eleemosynary purposes. UMIFA § 1(1), 7A U.L.A. 712 (1985).

67 UMIFA § 6, 7A U.L.A. 721 (1985).

68 UMIFA § 6 comment, 7A U.L.A. 721 (1985).

69 *See* Ravikoff & Curzan, *supra* note 5, at 537-38.

ing, but it does not redirect a governing board's obligation to serve the interests of the institution.

Perhaps the most important effect of section 6 is its easing of the standard for the fiduciary's liability. Many courts have recognized that the standard of care imposed upon a trustee is more strict than that imposed upon a corporate director.[70] One court explained the difference as follows:

> Both trustees and corporate directors are liable for losses occasioned by their negligent mismanagement of investments. However, the degree of care required appears to differ in many jurisdictions. A trustee is uniformly held to a high standard of care and will be held liable for simple negligence, while a director must often have committed "gross negligence" or otherwise be guilty of more than mere mistakes of judgment.[71]

This means, in effect, that corporate directors have much greater freedom to exercise their discretion than do private trustees.[72] Because the UMIFA imports the more lenient standard applicable to corporate directors to the managers of eleemosynary institutions, the UMIFA should reduce the extent to which their investment decisions are subject to judicial second-guessing. Accordingly, the decision of the governing board of an eleemosynary institution to engage in a strategy of social investing is more likely to pass muster than the same decision of a private trustee, at least as long as the board's decision is arguably in the institution's interest.

The tempering effect of the UMIFA on a trustee's fiduciary obligation is underscored by section 4 of the Act. Section 4 provides that a fiduciary may "invest and reinvest an institutional fund in any real or personal property deemed advisable by the governing board, whether or not it produces a current return . . . ."[73] This

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[70] *See, e.g.*, Selheimer v. Manganese Corp. of Am., 423 Pa. 563, 224 A.2d 634, 642 (1966); Litwin v. Allen, — Misc. —, 25 N.Y.S.2d 667, 678 (N.Y. Sup. Ct. 1940).

[71] Stern v. Lucy Webb Hayes Nat'l Training School for Deaconesses and Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974) (citations omitted); *see also* Beard v. Achenbach Memorial Hosp. Ass'n, 170 F.2d 859, 862 (10th Cir. 1948); Kamin v. American Express Co., 86 Misc. 2d 809, 383 N.Y.S.2d 807, 811, *aff'd*, 54 A.D. 2d 654, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976); Troyer, Slocombe & Boisture, *supra* note 5, at 136-38.

[72] This is an important observation for charitable corporations, as distinct from private charitable trusts, in states that have not enacted the UMIFA. The investment decisions of directors of such corporations are likely to be evaluated under the more lenient rules applicable to corporate directors generally. *See* Troyer, Slocombe & Boisture, *supra* note 5, at 131-32 & n.11. The more lenient standard of the UMIFA applies to all charitable organizations, whether or not incorporated.

[73] UMIFA § 4(1), 7A U.L.A. 719 (1985).

provision clarifies the authority of governing boards to hold donated property, even though it may not be the best investment, in the hope of obtaining additional contributions.[74] Additional contributions are, of course, in the institution's interest, which remains the overriding objective of the trustee-investor.

Overall, then, the UMIFA gives a governing board of an eleemosynary institution more investment flexibility. However, because the board's duties of care and loyalty are owed to the institution, the UMIFA stops considerably short of giving them blanket authority to implement social investing strategies.[75]

2. *ERISA*

In 1974, Congress passed the Employee Retirement Income Security Act (ERISA).[76] This massive statute, which substantially supersedes state laws relating to private employee benefit plans, imposes rules on the investment of pension fund assets. Rather than specifically enumerate all powers and duties of trustees and fiduciaries, Congress "invoked the common law of trusts to define

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[74] *See* UMIFA § 4 comment, 7A U.L.A. 719 (1985).

[75] *See* Ravikoff & Curzan, *supra* note 5, at 539.

> To the extent that fiduciaries use institutional funds to undertake limited charitable activities, their actions will probably be viewed as prudent. But should these endeavors grow in scope and reduce not only achievable current return, but also long-term portfolio growth, fiduciaries will have to justify these activities as in the self-interest of the institution.

Id. *See also* B. LONGSTRETH, *supra* note 37, at 29 (the UMIFA and other developments of last 15 years "should significantly lessen the discomfort of a charitable corporation investment manager contemplating investments that would be suspect under the law governing trustees of private trusts"; but for nonconventional investment products and techniques not specifically permitted by UMIFA, the dearth of case law is likely to discourage their use unless they become widely accepted by similar institutions); Op. Kan. Att'y Gen. No. 85-153 (Nov. 12, 1985) (LEXIS) (fiduciary under UMIFA may consider "the political and economic situations existing in [South Africa] *as they affect the security of the investment*") (emphasis added).

As discussed earlier, *supra* note 24, an Oregon trial court held that the Oregon Board of Higher Education's order that the Oregon Investment Council divest the Oregon Higher Education Endowment Fund's common stock holdings in companies doing business in South Africa violated the prudent investor rule. Associated Students of Univ. of Or. v. Oregon Inv. Council, 82 Or. App. 145, 728 P.2d 30 (1986), *rev. denied*, 303 Or. 74, 734 P.2d 354 (1987). Oregon has enacted the UMIFA, OR. REV. STAT. §§ 128.310-.355 (1987), but this was not enough in the trial court's view to validate the Board's divestment decision. The Oregon Court of Appeals disposed of the case on the ground the plaintiffs lacked standing and declined to reach the merits of the trial court's prudent investor ruling. *Associated Students of Univ. of Or.*, 82 Or. App. 145, 728 P.2d 30.

[76] Employee Retirement Income Security Act [hereinafter ERISA], 29 U.S.C. §§ 1001-1461 (1985).

the general scope of their authority and responsibility."[77] Specifically, Congress defined the fiduciaries' responsibility by reference to the common law's duty of loyalty and standard of care.[78]

Section 404(a) of ERISA provides that a fiduciary shall administer a plan "solely in the interest of the participants and beneficiaries"[79] and "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries; and (ii) defraying reasonable expenses of administering the plan."[80] This section, though not free from ambiguity, was probably intended as a restatement of the traditional interpretation of the common law duty of loyalty; the trust is established for the benefit of retirees and not to "provide collateral or speculative 'benefits' to plan participants or appeal to the philosophical leanings of the plan sponsor or other parties associated with the plan."[81]

Section 404(a) also codifies the prudent investor rule. The section provides that the fiduciary shall administer the plan "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[82] Section 404(a) also imposes a duty on the fiduciary to diversify the plan's investments unless it is "clearly prudent" not to do so.[83]

In some respects, ERISA departs from the common law duties. For example, one aspect of ERISA's prudence requirement appears stricter than the common law rule. Under the common law, a fiduciary must exercise the skill and care that a prudent person would use in managing his own property. Under ERISA, the fiduciary is required to exercise a higher degree of skill and care—basically the skill and care of an expert in trust management matters.

Another aspect of the ERISA prudence requirement seems less stringent than the common law rule. Under an approach sometimes followed by courts when applying the common law's prudence requirement, fiduciaries are required to defend the

[77] Central States, S.E. & S.W. Areas Pension Fund v. Central Transp., Inc., 472 U.S. 559, 570 (1985).

[78] *Id.*

[79] ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1).

[80] ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A).

[81] Hutchinson & Cole, *supra* note 5, at 1371; *see also* Lanoff, *supra* note 5, at 389.

[82] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[83] ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C).

performance of each investment,[84] despite the fact that examining each investment on its own merits is nonsensical in light of what is now known about the financial marketplace and portfolio theory.[85] In contrast, ERISA requires that the evaluation of the prudence of an investment decision relating to a particular asset focus upon the role the asset plays in the entire portfolio. The ERISA rule acknowledges that the performance of the entire portfolio, the sum total of its individual components, is paramount, not the performance of a particular asset viewed in isolation.[86] Thus, the ERISA rule probably allows fiduciaries to take greater risks with individual investments than the constrained view of the prudent investor rule, so long as the entire portfolio is adequately balanced. This means that ERISA may make it easier for a fund manager to justify a particular investment decision based on social factors if the entire portfolio remains in balance.

In one significant respect, ERISA is stricter than the common law: it abolishes the common law principle of authorization. At common law, a trustor can authorize the trustee to pursue investment strategies that would otherwise violate the prudent investor

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84 *See* Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248, 1255 (S.D.N.Y. 1978), *aff'd mem.*, 595 F.2d 1210 (2d Cir. 1979); *In re* Bank of New York, 35 N.Y.2d 512, 323 N.E.2d 700, 364 N.Y.S.2d 164 (1974); Hutchinson & Cole, *supra* note 5, at 1355. The tendency of some courts to focus on the performance and risk of individual investments has retarded the common law's acceptance of modern portfolio theory and other insights of economists and finance scholars on how markets operate. *See* B. LONGSTRETH, *supra* note 37, at 83-86, 110-16, 154-59; Gordon, *The Puzzling Survival of the Constrained Prudent Man Rule*, in B. LONGSTRETH, *supra* note 37, at 195-231.

85 One of "the principal lessons of modern portfolio theory for fiduciaries" is that,

> [b]y holding a well-diversified portfolio, one can remove issuer-specific risks, leaving only the systemic risk of the particular market for which the securities in the portfolio are a proxy. The lesson for prudence is that the standard should be applied to the portfolio as a whole, rather than . . . to each security in the portfolio. The volatility of each individual security is only important in its impact on the volatility of the whole portfolio and should be so tested in evaluating the prudence of holding it.

B. LONGSTRETH, *supra* note 37, at 82 (conclusion drawn from Elton & Gruber, *The Lessons of Modern Portfolio Theory*, in B. LONGSTRETH, *supra* note 37, at 161). *See* Langbein & Posner, *supra* note 5, at 77 ("The portfolio is the relevant security."). *See generally* Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. BAR FOUND. RES. J. 1 (1976); Note, *The Regulation of Risky Investments*, 83 HARV. L. REV. 603 (1970).

86 If the common law approach to prudence that requires each investment to be analyzed separately were understood to mean that each investment must be analyzed separately in light of its impact on the entire portfolio, the common law approach would be virtually identical to the ERISA standard, which is consistent with the lessons of modern portfolio theory. *See* B. LONGSTRETH, *supra* note 37, at 84; Gordon, *supra* note 84, at 200-02.

rule. ERISA specifically prohibits "any provision . . . which purports to relieve a fiduciary from responsibility or liability."[87] Therefore, "the plan documents cannot authorize a policy of social investment that would otherwise be impermissible under the fiduciary standards of the Act."[88] This does not mean that social investing is per se imprudent. In fact, one former ERISA administrator has opined that social criteria could be considered in choosing among investments with otherwise equal financial indicators.[89] However, it does mean that, unlike the common law, the plan documents cannot authorize an investment strategy that sacrifices rate of return or unreasonably increases risk.[90]

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[87] ERISA § 410(a), 29 U.S.C. § 1110(a).

[88] Hutchison & Cole, *supra* note 5, at 1372. The legislative history of ERISA confirms this interpretation of the Act. *Id.* at 1372-74. Similarly, an article by the chief ERISA Administrator stated that both the duty of loyalty and the prudent investor rule would be violated if a fiduciary were to make an "investment decision based on other objectives, such as to promote the job security of a class of current or future participants." Lanoff, *supra* note 5, at 389.

Ravikoff and Curzan claim that ERISA's statutory requirement that the fiduciary invest "for the exclusive purpose of . . . providing *benefits* to participants and their beneficiaries," ERISA § 404(a)(1)(A), 29 U.S.C. § 1104(a)(1)(A) (emphasis added), can be read broadly. They state: "The concept of 'benefits' . . . need not be limited to payments that a participant or beneficiary would receive upon retirement, i.e., pure economic return to an investment. It is arguably broad enough to include numerous types of positive returns, e.g., job security and improved working conditions." Ravikoff & Curzan, *supra* note 5, at 532. However, this analysis is inconsistent with Hutchinson and Cole's careful construction of the statute. They suggested

> that ERISA trusts are to be established and maintained for the limited purpose of providing retirement benefits and not for other, socially desirable purposes which provide collateral or speculative 'benefits' to plan participants or appeal to the philosophical leanings of the plan sponsor or other parties associated with the plan.

Hutchinson & Cole, *supra* note 5, at 1371 (noting that "the issue is not free from doubt").

[89] The ERISA Administrator stated in a 1980 article that the Labor Department's 1979 approval of provisions in a Chrysler-UAW collective bargaining agreement authorizing some social investing of pension fund assets was based on the understanding that the investments would be "economically competitive with other investment opportunities which may not contain similar socially beneficial features." Lanoff, *supra* note 5, at 392. *See also* Hutchison & Cole, *supra* note 5, at 1355 ("[S]ocially sensitive investing by a defined contribution plan may not be imprudent if a thorough analysis of the plan's portfolio demonstrates that the risk and return associated with the investment complement the remainder of the plan's portfolio in meeting the plan's investment objectives.").

[90] Certain provisions of the Internal Revenue Code also impose common law duties on pension plan managers. To qualify for tax-exempt status, an employer's pension plan must be maintained for "the exclusive benefit of his employees or their beneficiaries," and the plan documents must make it impossible for any part of the pension fund to be diverted for other purposes. I.R.C. § 401(a)(2) (1982). Because depriving a

In the final analysis, ERISA gives paramount importance to the interests of pension fund beneficiaries.[91] This is not surprising, since the statute's fundamental purpose is to protect the retirement benefits of employees in the private sector. Thus, ERISA gives overriding—and perhaps exclusive—weight to the criteria of income production and avoiding undue risk in the management of pension fund assets.

3. *Issue-Specific State Statutes*

In recent years, public outrage over apartheid has resulted in the enactment of statutes in at least ten states mandating divestment by state-owned or state-managed funds in companies doing business in South Africa.[92] These statutes vary in scope and focus,[93] but the

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pension plan of tax-exempt status would have terrible consequences for the participants, the Internal Revenue Service has interpreted the exclusive benefit rule to allow some collateral benefit to other persons so long as the primary purpose of the fund is to benefit employees or their beneficiaries. The courts have concurred with this interpretation. Hutchison & Cole, *supra* note 5, at 1347-48.

[91] *See* NLRB v. Amax Coal Co., 453 U.S. 322, 332-34 (1981); White v. Distributors Ass'n Warehousemen's Pension Trust, 751 F.2d 1068, 1071 n.2 (9th Cir. 1985); Donovan v. Bierwirth, 680 F.2d 263 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982). In an advertisement, TIAA-CREF, a major pension plan for university staff and faculty nationwide, reported on the decision of its Board of Trustees to initiate shareholder resolutions demanding that companies doing business in South Africa adhere to the Sullivan Principles. (For a discussion of the Sullivan Principles, see *infra* note 108.) The advertisement also explained the reasons for opposing total divestment:

> Currently ERISA's fiduciary standards . . . are widely interpreted as prohibiting the purchase, holding or sale of securities for nonfinancial reasons. . . . Total divestment, with its risks as to investment performance, and its considerable transaction and brokerage costs, would violate these standards. It is clear that CREF, its trustees and management are fiduciaries under ERISA. As such, CREF must act solely in the interest of participants . . . . Thus, although the social outlook and policies of a portfolio company are factors to be considered in evaluating an investment decision, there is no question that the buy/sell decision ultimately must be based on what is financially best for the participants.

Chron. of Higher Educ., Dec. 5, 1985, at 24.

[92] *See* American Committee on Africa, Public Investment and South Africa (Oct. 1986) (compilation of state and county divestment actions, with amounts affected; reports on statutes requiring divestment in California, Connecticut, Iowa, Maryland, Massachusetts, Michigan, Nebraska, New Jersey, Rhode Island, Vermont, and the Virgin Islands). One news report indicates that 19 states, 13 counties, and 70 cities now prohibit investment of public monies in South Africa. N.Y. Times, Feb. 9, 1987, at 25, col. 6.

Other anti-apartheid actions at the state and local level also evidence American opposition to apartheid. While legislation in Louisiana did not order divestment, it did prohibit the deposit of state funds in banks that make loans to the South African government or its agencies. *See* LA. REV. STAT. ANN. § 49:308.2 (West Supp. 1986). State agencies of one sort or another in several additional states are reported to have most common formulation requires divestment of funds invested in companies failing to conduct their business in South Africa in accordance with articulated standards.[94] These statutes do not au-

made a prodivestment decision of one kind or another. *See* American Committee on Africa, *supra*, at 1-5 (Colorado, Kansas, Maine, Minnesota, North Dakota, West Virginia, Wisconsin). Moreover, eighty-nine cities and counties are reported to have enacted some sort of prodivestment ordinance or resolution. *Id.* at 6-17.

For the argument that these state statutes and local ordinances are unconstitutional on federal commerce and foreign affairs grounds and are vulnerable to federal preemption, see Note, *State and Local Anti-South Africa Action as an Intrusion Upon the Federal Power in Foreign Affairs*, 72 VA. L. REV. 813 (1986); Comment, *The Constitutionality of State and Local Governments' Response to Apartheid: Divestment Legislation*, 13 FORDHAM URBAN L.J. 763 (1985); G. Smith, *Apartheid Act Casts Doubt on Local Laws*, L.A. Times, Mar. 16, 1987, pt. 2, at 5, col. 3 (arguing that the Anti-Apartheid Act preempts state and local anti-apartheid laws).

[93] *See, e.g.*, CAL. GOV'T CODE §§ 16640-16650 (West Supp. 1987) (mandating a one-year ban on investment by the State Teachers Employment Fund and the Public Employees Retirement Fund in companies making new investments in South Africa, with a three-year phased divestment plan, to be completed in 1991); MD. STATE FIN. & PROC. CODE ANN. § 6-208 (1985) (prohibiting the deposit of state funds in banks making loans to the South African government or national companies); MD. STATE FIN. & PROC. CODE ANN. § 18-902 (Supp. 1986) (prohibiting, effective January 1, 1987, state agencies from knowingly purchasing supplies produced or manufactured in South Africa); MASS. GEN. LAWS ANN. ch. 32, § 23(ii) (West Supp. 1986) (prohibiting the state employee and teachers' retirement funds from investing in any bank or financial institutions making loans to the Republic of South Africa or its instrumentalities, and requiring divestment of stocks in companies doing business in or with South Africa); MICH. COMP. LAWS ANN. § 37.2402(1)(f) (West 1985) (requiring Michigan educational institutions to divest any investments held in companies operating in South Africa. This statute has been declared unconstitutional; *see supra* note 24); MICH. COMP. LAWS ANN. § 21.145(5) (West 1981) (prohibiting the deposit of state funds in financial institutions making loans to the government of South Africa, a national corporation of South Africa, or an American corporation operating in South Africa); N.J. STAT. ANN. § 52:18A-89.1-89.2 (West 1986) (prohibiting any state pension or annuity fund from investing in any bank or financial institution loaning money to the South African government or its instrumentalities and from investing in stocks of companies engaged in business in or with the Republic of South Africa, and requiring divestment within three years); N.J. STAT. ANN. § 17B:20-1(f) (West Supp. 1986) (prohibiting domestic insurers from investing in obligations issued by the African Development Bank that go to or are to be used in South Africa). Some of the statutes address issues other than doing business in South Africa. *See, e.g.*, CONN. GEN. STAT. ANN. § 3-13(g) (West Supp. 1986) (requiring review of the state's investment policies regarding corporations engaged in business in Iran); MASS. GEN. LAWS ANN. ch. 32, § 23(iii) (West Supp. 1986) (imposing restrictions on investment in stocks held in companies that manufacture munitions used or deployed in Northern Ireland); MICH. COMP. LAWS ANN. § 37.2402(1)(g) (West 1985) (requiring divestment by Michigan educational institutions of any investments held in companies operating in the Soviet Union).

[94] *See, e.g.*, ARK. STAT. ANN. § 24-3-416 (Supp. 1987) (requiring divestment within four years by fiduciaries for the public employee retirement systems of funds invested in any company doing business in or with South Africa); CONN. GEN. STAT. ANN. § 3-13(f) (West Supp. 1988) (requiring divestment of all state funds invested in a company doing business in South Africa; prior to July 1, 1987, the statute required divestment

thorize investor-trustees generally to exercise their discretion to promote political or social objectives of their own choosing. Rather, they prohibit for political and social reasons certain kinds of investments by state agencies or by entities managing state funds.

When the legislature orders trustees of state funds to invest those funds in certain ways, the legislature implicitly, if not expressly, immunizes the trustee-investor from liability on a claim that the social investing policy violates the duty of loyalty or the prudent investor rule.[95] This grant of immunity is not tantamount to giving blanket authority to pursue social investing strategies. State legislatures cannot authorize the managers of pension funds subject to ERISA to undertake social investing strategies, since ERISA preempts all state statutes regulating such funds. However, as for funds outside the scope of ERISA, nothing prohibits a state legislature from im-

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only if the corporation had not achieved one of the top two ratings for compliance with the Sullivan Principles, the corporation did not supply "strategic products or services" for the South African government, military, or police, and the corporation recognized the right of all South African employees to organize and strike for economic or social objectives); IOWA CODE ANN. § 12A.1-12A.5 (West Supp. 1986) (requiring divestment of state government, education, and retirement funds invested in banks making loans to or companies doing business in South Africa, unless the companies have achieved one of the top two Sullivan Principles performance ratings); ME. REV. STAT. ANN. tit. 5, § 1951 (Supp. 1987) (requiring divestment of all state funds, including trust funds, invested in banks which directly or indirectly have loans to South Africa, and in the stocks of corporations doing business in or with South Africa); MD. ANN. CODE art. 73B, § 161 (Lexis) (placing a moratorium on the investment of state retirement and pension funds in companies that do not meet the top two categories of the Sullivan Principles); MO. ANN. STAT. § 105.686 (Vernon Supp. 1988) (requiring divestment, within five years, of state employees' retirement and other public trust funds of monies invested in banks or companies that have "substantial investment" in South Africa); NEB. REV. STAT. § 72-1270-1276 (Supp. 1984) (prohibiting the investment of any state funds in companies not complying with the highest performance rating of the Sullivan Principles or in stocks or bonds of financial institutions that make loans to the South African government or its instrumentalities); R.I. GEN. LAWS § 35-10-12 (1985) (preventing the investment of state monies or pension funds in companies doing business in South Africa, and requiring divestment within four years of any such holdings, unless the company is rated in the highest category of the Sullivan Principles and does not supply strategic products to the South African military or police).

[95] *See, e.g.*, ARK. STAT. ANN. § 24-3-416(g) (Supp. 1987) (providing for indemnification of fiduciaries of public employee retirement system in connection with claims, actions, etc. commenced as result of divestment); MO. ANN. STAT. § 105.686(2) (Vernon Supp. 1988) (providing for immunity for trustees of retirement funds or school undertaking voluntary divestment for losses resulting from the divestment required or suggested by state statute). The New Jersey Attorney General reached this conclusion when expressing an opinion on what constitutes "doing business" in South Africa under the New Jersey statute requiring certain pension funds to divest. He opined that the statute modified the prudent investor rule. Op. N.J. Att'y Gen., No. 1 1985 (Dec. 19, 1985) (Westlaw).

munizing private trustees from liability for divesting trust assets from South Africa-related investments or for following a more general social investing strategy. Where South Africa divestment has occurred without specific statutory authorization, divesting trustees have presumably calculated the risk that their actions might be challenged and concluded that the risk is insignificant.

III

THE EFFECT OF DIVESTMENT ON PORTFOLIO PERFORMANCE: A FINANCIAL ANALYSIS

A trustee-investor's decision to divest stock held in companies that do business in South Africa may affect several aspects of the portfolio, including composition, risk and return, transaction, liquidity, and administrative costs, and management style. Each of these potential effects was addressed in one or more of the ten previously published empirical studies on the effects of divestment.[96]

Most of these studies were summarized and reviewed in a 1985 report published by the Investor Responsibility Research Center (IRRC).[97] Four of the studies are particularly significant: the 1979 Rudd study;[98] a series of four investigations in 1983 and 1984 by Trinity Investment Management Corporation;[99] the 1984 Wagner, Emkin, and Dixon study (hereinafter Wagner);[100] and the 1986 Grossman and Sharpe study.[101] The other studies suffer from one or more significant empirical defects and therefore will not receive significant attention here.[102]

Before proceeding with a synthesis and analysis of these studies and a discussion of their significance, two points are noteworthy.

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96 *See* citations *supra* note 7.

97 IRRC Report, *supra* note 7. The IRRC study performed no independent empirical work, but instead drew conclusions and inferences from existing empirical studies about the advisability of divesting South Africa-related securities.

98 *See* Rudd, *supra* note 7.

99 The four studies are titled Structuring Portfolios from a South Africa-Free Universe (March 1983); Presentation to a Conference on South Africa-Free Investment Policy (December 1983); Trinity's Insights about Managing Money under a South Africa-Free Policy (May 1984); Investment Implications of South Africa Divestiture (October 1984). These four studies are based on Trinity's experience in managing a small South Africa-free portfolio for Michigan State University and its examination of the divestment impact on two larger pension funds—those of Washington, D.C. and the State of New Jersey. *See* IRRC Report, *supra* note 7, at 14-18.

100 *See* Wagner, *supra* note 7.

101 *See* Grossman & Sharpe, *supra* note 7.

102 The various studies and their methodological flaws are discussed in the IRRC Report, *supra* note 7, at 5-21.

First, although the empirical findings of these studies exhibit a fair amount of consistency, including unanimity on some questions, major differences on important issues exist. Differences regarding transaction costs are particularly significant. Moreover, while empirical results on historical portfolio risk and return have been fairly consistent, interpretation of those results has not. As a result, conclusions about the overall effect of South Africa divestment on portfolio performance vary. However, we believe that some of these differences in conclusions can be reconciled, and some of the conclusions can be disregarded altogether. Ultimately, as we shall demonstrate, a clearer picture of the effect of South Africa divestment on portfolio performance emerges.

Second, most studies have analyzed divestment's effect on portfolio risk and return only from a historical perspective. Of course, only the past is subject to empirical investigation. However, most studies fail to take the next, and crucial, step of considering the effects of South African divestment itself on *future* portfolio performance. In particular, most studies do not take into account the effect of ongoing divestment on the market, which is important since most divestments will occur only after other investors have already begun to implement a divestment strategy. Two studies did speculate on the impact of divestment on equilibrium risk and return features,[103] and these forecasts deserve special attention. In the sections which follow, we consider both the historical evidence and the potential effects of ongoing divestment activities on portfolio performance. First, however, we examine divestment's effect on portfolio composition.

A. The Effects of Investment on Portfolio Composition

South African divestment's most obvious impact is its effect on portfolio composition. When a large portion of the investment universe is excluded, a question arises as to whether viable portfolios can be constructed from the unexcluded securities. For example, a divestment strategy requiring the investor to ignore all corporations except those domiciled in Douglas County, Kansas, makes construction of a diverse portfolio impossible. A divestment strategy's impact on portfolio composition ultimately depends on that strategy's characteristics, including the number of stocks excluded, the kinds of stocks excluded, the operating and financial characteristics of excluded and nonexcluded stocks, and whether the excluded

[103] *See* Grossman & Sharp, *supra* note 7; Rudd, *supra* note 7.

stocks have common characteristics that would distort portfolio composition in some irreparable way.

A threshold difficulty in evaluating South Africa divestment impact on portfolio composition is determining exactly what "divesting from South Africa-related companies" means. South Africa divestment's commonly stated purpose is to sell stock in companies that "do business" in South Africa, but there is no agreement on which companies fit this description.[104] Various compilations include anywhere from 201 to 539 companies;[105] the figure of 6,000 companies has appeared in some discussions.[106] Also, the number is fluid, since companies enter and leave South Africa over time.[107] Thus, determining precisely how many companies will be excluded by a South Africa divestment strategy is not possible. Nonetheless, the term "doing business" in South Africa usually connotes direct investment in the country, meaning the physical presence of affiliates or subsidiaries, and somewhere between 200 and 350 United States companies fit this description.

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[104] In New Jersey, confusion over this matter resulted in a request to the Attorney General for an opinion on what constitutes "doing business" in South Africa under the New Jersey statute. He concluded that "doing business" required a continuous business presence in the country. Thus, merely sending goods to or receiving goods from South Africa would not constitute doing business. *See* Op. N.J. Att'y Gen., No. 1-1985 (Dec. 19, 1985) (Westlaw). Yet, considerable uncertainty exists over how many companies have a continuous business presence there. *See infra* note 105.

[105] The United States Consulate General's List of companies doing business in South Africa, which was relied upon in Meidinger Asset Planning Services, Inc., District of Columbia Special Investment Study South Africa Proposal (Mar. 31, 1983), listed 201 companies. However, Arthur D. Little, Inc., in its Eighth Report on the Signatory Companies to the Sullivan Principles (1984), named 281 companies and noted that 40 more companies probably belonged on the list. The Investor Responsibility Research Center published a list in 1982 which identified approximately 272 companies as doing business in South Africa, although the report also stated that approximately 400 companies operate subsidiaries or affiliates in South Africa. IRRC, IRRC Directory of U.S. Corporations in South Africa (May, 1982). A January 1985 IRRC list identified 284 U.S. companies as having operations in South Africa. IRRC Report, *supra* note 7, App. A. In 1984 the IRRC reportedly identified between 30 and 300 companies, depending on how the South African prohibition is imposed, as "South Africa-related." An undated list distributed in 1984 by the Conference in Solidarity with the Liberation Struggles of the Peoples of South Africa listed 539 companies. *See generally* R. SCHOTLAND, DIVERGENT INVESTING OF PENSION FUNDS AND UNIVERSITY ENDOWMENTS: KEY POINTS ABOUT THE PRAGMATICS, AND TWO CURRENT CASE STUDIES, in J. LANGBEIN, *supra* note 5, at 46-47 (reporting that various lists have identified 281, 229, 287, 270, and 201 companies as doing business in South Africa).

[106] *See* IRRC, IRRC Directory of U.S. Corporations in South Africa (May, 1982) ("more than 6,000 do business there through sales agents or licensing agreements").

[107] In recent months, new investment in South Africa has dwindled to virtually nothing. The only significant movement comes from firms leaving the country.

Thus, one divestment strategy might be to sell stock in all companies that have direct investment in the country, utilizing one of the established lists of United States corporations doing business in South Africa. Less restrictive strategies are possible as well, such as divesting stock in companies having direct investment in the country and which do not comply with one of the two top compliance categories of the Sullivan Principles rating system.[108] Another strategy might be to divest stock held in companies that sell goods or services to the South African government. In short, various ways exist to determine whether a particular stock is "South Africa-related," and this choice directly affects the ease of constructing a South Africa-free portfolio.

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108 The Sullivan Principles are a code of conduct developed by Rev. Leon Sullivan in 1977 for companies doing business in South Africa. Companies that voluntarily agree to adhere to the code are expected to meet certain standards concerning desegregation of workplaces, pay, medical care, housing, nondiscriminatory hiring, training for nonwhites, and the promotion of trade unions. The companies' activities are monitored by Arthur D. Little, Inc., which annually releases a compliance report. Of the 238 United States companies doing business in South Africa, 153 have signed the Principles. Approximately 110 of those companies reported their activities during the last reporting period. Of those 110 companies, 34 companies were "Category I," which means "making good progress," 65 were "Category II," which means "making progress," and 18 were "Category III," which means "needs to become more active." Some companies were listed in multiple categories. *See* Chron. of Higher Educ., Dec. 17, 1986, at 39, col. 1.

Recently, the Principles were strengthened to require that signatory companies do more to oppose apartheid. As revised, the Principles contemplate corporate civil disobedience against apartheid laws and increased efforts to eliminate laws and customs that oppress nonwhite workers. *See* N.Y. Times, Oct. 22, 1986, at D22, col. 1. *See generally* Sullivan, *Agents for Change: The Mobilization of Multinational Companies in South Africa*, 15 LAW & POL'Y INT'L BUS. 427 (1983).

Controversy exists over whether the Principles have assisted the struggle against apartheid. *See, e.g.*, Myers, *U.S. Domestic Controversy over American Business in South Africa*, in THE AMERICAN PEOPLE AND SOUTH AFRICA: PUBLICS, ELITES, AND POLICYMAKING PROCESSES 74-75 (1981) (Principles have had limited beneficial effect); Paul, *The Inadequacy of Sullivan Reporting*, BUS. & SOC'Y REV. 61 (Spring 1986) (Sullivan Principle reporting system is "seriously flawed"); Weedon, *The Evolution of Sullivan Principle Compliance*, BUS. & SOC'Y REV. 56 (Spring 1986) (Sullivan Principles signatory program has been "catalyst" in the struggle to end inequalities in South Africa).

In December 1986, Rev. Sullivan vowed to mount a full-scale divestment campaign if apartheid were not abolished by May 31, 1987. *See* Chron. of Higher Educ., Dec. 17, 1986, at 39, col. 1. In June 1987, Rev. Sullivan urged all U.S. firms to leave South Africa within nine months and recommended that the Reagan Administration break its remaining trade and diplomatic ties with that country. N.Y. Times, June 4, 1987, at 1., col. 6; Wall St. J., June 4, 1987, at 2, col. 2; N.Y. Times, June 1, 1987, at 23, col. 1. Rev. Sullivan's changed strategy received a cautious response from institutional investors. According to one report, fund managers claimed they could not support total divestment as a means to spur corporate withdrawal, because of legal obligations imposed by the prudent investor rule. N.Y. Times, June 8, 1987, at 26, col. 5.

Table 1 presents a summary of South Africa divestment's possible portfolio effects.[109] The universes typically employed in the various studies are the Standard and Poor's 500 (S&P 500) or the entire New York Stock Exchange (NYSE). Although the studies' analytical procedures differ, divestment's overall impact on portfolio composition is qualitatively consistent across the studies. Furthermore, that impact is dramatic. As Table 1 shows, if all South Africa-related firms were divested, about forty percent of the NYSE would be eliminated. The IRRC estimates that about one-third of the market value of all stocks in the United States corporations would be eliminated.[110] The typical American firm with operations in South Africa is a very large, relatively stable, multinational company whose stock has a below-average level of risk. Approximately thirty of the top fifty S&P 500 stocks by market value would be ineligible for investment under the broadest definition of a South Africa-related company. As Table 1 indicates, in some industries, virtually all of the largest firms would be ineligible for investment.

TABLE 1
SUMMARY OF EFFECT OF EXTREME SOUTH AFRICAN DIVESTMENT ON PORTFOLIO COMPOSITION CHARACTERISTICS

Study	Findings
Harvard (1978)	Almost all stocks in six major U.S. industry groups were excluded.
Rudd (1979)	Forty-three percent of the S&P 500 market capitalization was excluded. Thirty-nine percent of the NYSE market capitalization was excluded.
U.S. Trust of Boston (1982)	More than eighty percent of the companies in the following industry groups were excluded: aerospace, autos and trucks, chemicals, drugs, hospital supplies, office and business equipment, international oil.

[109] Since the estimates cited in Table 1 were prepared, some very significant companies have withdrawn from South Africa (for example, CBS, Eaton, GTE, General Electric, and Phillips Petroleum), and other significant companies have announced plans to withdraw (e.g., Coca-Cola, General Motors, Procter & Gamble). N.Y. Times, Oct. 21, 1986, at D30, col. 1. *See supra* note 21. Thus, the composition effects set forth in Table 1 are more severe than those which would exist now or which will exist in the future, due to the trend favoring withdrawal from South Africa.

[110] *See* IRRC Report, *supra* note 7, at 22.

Capital Management Sciences (1982)	Excluded companies tended to have lower debt levels, lower earnings variability, lower betas (risk), and larger market capitalization than South Africa-free companies.
Meidinger Asset Planning Services (1983)	Twenty-nine of the top fifty S&P companies were excluded. Forty percent or more of the companies in the following S&P industries were excluded: major electrical equipment, machinery (construction and material handling), automobiles, chemicals, beverages (soft drinks), hospital supplies, drugs.
Trinity Investment Management (1983-84)	More than fifty percent of all U.S. traded equities were excluded. Excluded securities were about twice as large, from a market capitalization and trading volume standpoint, than South Africa-free stocks. More than eighty percent of the market capitalization in the following industries were excluded: international oil, drugs, office equipment, chemicals, automobiles.
Wagner et al. (1984)	Thirty-one of the largest fifty U.S. companies were excluded. Forty-nine of the largest 100 U.S. companies were excluded.
Grossman and Sharpe (1986)	Forty-six percent of the S&P 500 market capitalization was excluded. Thirty-seven percent of the NYSE market capitalization was excluded. The average South Africa-free stock was almost thirty percent smaller than the average NYSE firm. Excluded stocks tended to be in technological capital goods and consumer growth stocks.

At first glance, Table 1 seems to show that investor-trustees forced to exclude South Africa-related stocks have a hopeless task in attempting to achieve a sufficiently diverse portfolio. Several facts weigh against that inference, however. First, the studies reported in Table 1 exclude South Africa-related companies in an extreme way. Typically, nonbanking firms having *any* direct investments in South Africa were excluded regardless of whether the firms had signed the Sullivan Principles. Bank holding companies reporting any outstanding South African loans or failing to respond to the IRRC query about their South African loan activities were also excluded. According to Grossman and Sharpe, if firms complying with the top two Sullivan Principles categories are excluded from the South Africa-related category, the percentages of market capitalization eliminated from the investment universe drops to about seven percent for the NYSE and nine percent for the

S&P 500.[111] Thus, for portfolios whose South Africa restrictions are less constrained, the impact of the exclusionary limitations on portfolio composition are enormously reduced.

A second factor mitigating the facial significance of Table 1 is that the universe of securities available to portfolio managers is broader than that shown in the table. American equity markets are large and varied. Therefore, results like those in Table 1 showing exclusions of large percentages of a particular market segment (such as the S&P 500) overstate the divestment effect because the studies have not examined all equity markets. The American Stock Exchange and unlisted securities in over-the-counter markets are also important to portfolio managers. Furthermore, the existing studies ignore all foreign securities except those traded in United States markets. Obtaining information about foreign securities and ascertaining the extent to which foreign companies are involved in South Africa is considerably more difficult. Nevertheless, the fact remains that large groups of available and interesting securities have not been analyzed closely in the divestment studies performed thus far.[112]

Finally, and most important, even if the most severe form of divestment is undertaken, the information in Table 1 does not guarantee that South Africa-free portfolios will be materially disadvantaged from the standpoints of risk and return. As discussed more fully in the following two sections, portfolio theory, which describes the effects of combining securities into portfolios, frequently confounds intuition. Even within overly narrow stock universes, such as those excluding smaller exchanges, foreign markets, and unlisted securities, the empirical evidence shows that the remaining South Africa-free stocks can be combined into portfolios that provide risk and return levels competitive with those of the unrestricted universe of stocks. Therefore, it is erroneous to conclude that South Africa-free portfolios are materially disadvantaged in terms of risk and return based solely on the fact that portfolio composition is constrained.[113]

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[111] Grossman & Sharpe, *supra* note 7, at 17.

[112] *See* Pensions & Investment Age, Dec. 14, 1987, at 31 (reporting that the South Africa-free Morgan Stanley Capital International Europe Australia Far East index developed by Alliance Capital Management would have boosted international equity returns by over 300 basis points during the past four years; Alliance treasurer states that "there are enough stocks in the [South Africa-free] universe to cope" and that investing on a global basis further reduces the impact of investment restrictions).

[113] It is on this proposition that our analysis departs from the inference drawn by

In short, the fact that a divestment strategy constrains the investor-trustee in constructing a portfolio says nothing about constraints on profitability or effects on risk. The more important question concerns how divestment affects portfolio risk and return. In the next section, we consider whether portfolios free of South Africa-related stocks can earn rates of return competitive with unrestricted portfolios, without incurring additional risk.

B. *Historical Risk and Return Results*

A modicum of consistency exists in the evidence used in the studies of the risk and return impact of South African divestment. However, the diversity of approaches and particular weaknesses in the methodology of each make comparison of the studies difficult and sometimes impossible. Moreover, the consistency in the evidence does not carry over to the conclusions.

Substantial controversy exists with regard to the effect of divestment on portfolio risk and return. On a more fundamental level, the controversy has two aspects: first, disagreement over what constitutes an appropriate experimental design; and second, disagreement about the impact of divestment on *future* portfolio results. The arguments over experimental design concern whether the existing studies were conducted in ways that truly reflect the impact of divestment on portfolio risk and return. The second area of disagreement concerns issues necessarily more speculative because they relate to future events. The experimental design controversy is covered in this section, and the disagreement over future results is deferred to the next.

Each empirical study published to date followed one of two paths. One approach, followed in the 1979 Rudd study and the 1980 study by the Council on Economic Priorities commissioned by

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Langbein and Posner in their important article in the *Michigan Law Review*. *See* Langbein & Posner, *supra* note 5. They agree that a social-investing portfolio will have the same return as an unconstrained portfolio. *Id.* at 92-93. However, they do not believe that a social-investing portfolio can be created that would not have "a substantial increment in risk." *Id.* at 89. Langbein and Posner did not provide the details of the study they commissioned, which they cited in support of their conclusion, *see id.* at 88-89; thus it is not possible to appraise the study's methodology. It should, of course, be noted that Langbein and Posner did not have the benefit of the analysis in the empirical studies published after 1980, which this Article discusses. *See id.* at 92 (referring to the "(very limited) empirical studies that have been made of social-investment portfolios" as of the date of their publication).

the State of California Retirement Systems,[114] attempted to construct portfolios of South Africa-free stocks that mimicked a market index portfolio. If the mimicking could be done perfectly, the implication was that South Africa divestment restrictions are harmless to portfolios. Both studies used a financial modeling program designed to construct an optimal portfolio from a given set of stocks that would closely track a designated market index. Both studies chose the S&P 500, and both created a South Africa-free subset of stocks from S&P 500 stocks. The main empirical results from the two analyses appear in Table 2, which follows.

TABLE 2
PORTFOLIO MIMICKING RESULTS

	South Africa-free Portfolio	
Study	Beta	Standard Deviation of Residual Risk
Rudd (1979)	1.00	2.21%
Council on Economic Priorities	1.01	1.90%

Beta is a financial risk measure that reflects how risky an asset (here, the South Africa-free portfolio) is relative to a market index (here, the S&P 500). A portfolio with a beta of 1.00 has risk equal to the market index and would be expected to closely track price movements in the market index. Standard deviation of residual risk is another measure of tracking precision. The closer the standard deviation of residual risk is to zero, the better the tracking. Commercial index funds are reported to have standard deviations of residual risk of between 0.5 percent and 1.5 percent. As the data in Table 2 show, both studies ultimately achieved South Africa-free portfolios that tracked the S&P 500 closely. The mimicking was not perfect, as the standard deviation of residual risk exceeded the norms for commercial index funds. However, the South Africa-free tracking error was not substantial, leading Rudd to conclude that "the effect on portfolio risk of excluding the companies operating in South Africa, 'the 150 to 200 major U.S. companies', is, contrary to intuition, not particularly important."[115]

[114] *See* Rudd, *supra* note 7; Report by the Council on Economic Priorities (1980), summarized in IRRC Report, *supra* note 7, at 8-9.

[115] Rudd, *supra* note 7, at 9 (emphasis omitted).

The significance of the two studies' results is diminished by the fact that, as Rudd acknowledged in his own paper[116] and as the IRRC noted in commenting on both studies,[117] the research focused on *passive* as opposed to *active* portfolio management styles.[118] Accordingly, it is difficult to infer from these studies how active portfolio managers would fare under divestment. This important question is addressed in a later section.[119]

The approach followed by the rest of the published studies compared the performance of "unconstrained" portfolios and "South Africa-free" (and sometimes "South Africa-related") portfolios.[120] This comparison is a more direct means of assessing the effects of divestment. Unlike the market index-mimicking approach, the portfolio comparison allows investigation of active portfolio management styles. Table 3, which follows, summarizes the risk and return findings of six representative studies.

TABLE 3
PORTFOLIO RISK/RETURN RESULTS

A. Risk = Beta	South Africa-Free Portfolio		South Africa-Related Portfolio		Unconstrained Portfolio	
Study	Average Annual Return	Beta	Average Annual Return	Beta	Average Annual Return	Beta
Daniels & Bell Capital Mgt (1977-81)	6.70%	1.35	......	....	6.30%	1.26
U.S. Trust of Boston (1972-81)	10.74%	0.94	......	....	7.92%	1.00
Trinity Investment Mgt (1974-81)	15.40%	1.16	13.6%	1.12	14.00%	1.10

[116] *Id.* at 5-6.

[117] IRRC Report, *supra* note 7, at 7-9.

[118] Passive management refers to strategies with low trading frequency; active management refers to strategies with high trading frequency.

[119] *See infra* note 187 and accompanying text.

[120] A "South Africa-free portfolio" is one that excludes stocks of companies that do business in South Africa; in other words, the South Africa-free portfolio excludes South Africa-related companies. A "South Africa-related portfolio" is one consisting solely of stock in companies that do business in South Africa. Thus, a South Africa-free portfolio and a South Africa-related portfolio are mutually exclusive. An "unconstrained portfolio" is any unfettered combination of the South Africa-free and the South Africa-related stocks. In practice, investment managers operate either an unconstrained portfolio or a South Africa-free portfolio.

Meidinger Asset Planning Services (1973-82)	5.4%	0.88	6.60%	1.00

B. Risk = Standard Deviation

	Average Annual Return	Standard Deviation
Capital Mgt Sciences (1977-81)		
South Africa-free Portfolio	12.8%	10.8%
Unconstrained Portfolio	6.0%	7.2%

	Average Annual Excess Return	Standard Deviation of Annual Excess Return
Grossman & Sharpe (1960-83)		
South Africa-free Portfolio	3.922%	15.071%
Unconstrained Portfolio	3.611%	14.788%

The studies in Panel A of Table 3 measured risk using the concept of beta, as described above; the larger the beta value, the riskier the portfolio. The studies in Panel B used rate of return standard deviations to measure portfolio risk; the larger the standard deviation, the riskier the portfolio.[121] All the studies in Table 3 covered some segment of the 1970s and early 1980s. The Grossman and Sharpe study covered the longest period—from 1960 to 1983. The findings of the studies were consistent: while South Africa-free portfolios were riskier, they earned higher rates of return than the unconstrained portfolios during the time periods studied.[122]

It would be presumptuous to conclude at this point, however, that South Africa-free stocks *outperformed* unconstrained portfolios. As Grossman and Sharpe noted, a *risk-adjusted* comparison of

[121] The standard deviations computed by Capital Management Sciences and by Grossman and Sharpe are technically not the same thing. Consequently, it is incorrect to compare numerical risk levels *between* the Capital Management Services and Grossman and Sharpe studies.

[122] More precisely, the South Africa-free portfolios earned higher rates of return and were riskier than the South Africa-related portfolios during the time periods studied. Since unconstrained portfolios are merely combinations of South Africa-free and South Africa-related stocks, the unconstrained portfolios had lower returns and lower risk than the South Africa-free stocks.

results is necessary.[123] Without such a comparison, it is not possible to determine whether the extra rate of return earned on the South Africa-free portfolios was sufficient to compensate investment managers for the extra risk to which their portfolios were exposed. The only study attempting to furnish an answer to this question is the Grossman and Sharpe study.

Because the South Africa-free portfolio is riskier than the unconstrained portfolio, Grossman and Sharpe mixed United States Treasury bills (which are riskless, except for inflation) into the South Africa-free portfolio up to the point where the South Africa-free and the NYSE portfolios had equal risk (that is, equal standard deviations of excess return). Then they compared the return of the unconstrained portfolio with that of the portfolio of carefully mixed Treasury bills and South Africa-free stocks. Because these two portfolios were designed to have equal risk, a higher rate of return for one portfolio would signify a risk-adjusted rate of return advantage to that portfolio. The results of Grossman and Sharpe's experiment are set forth in Table 4, which follows. After adjusting the

TABLE 4
GROSSMAN AND SHARPE EQUALIZED RISK RESULTS
(1960-83)

	Average Annual Excess Return	Standard Deviation of Annual Excess Return
South Africa-free Equal Risk Portfolio[a]	3.848	14.788%
Unconstrained NYSE Portfolio	3.661%	14.788%
Difference:	0.187%[b]	0.000%

Source: Grossman & Sharpe, *Financial Implications of South Africa Divestment*, 42 FIN. ANALYSTS J. 15, 23 (July-Aug. 1986).
[a] 98.12% original South Africa-free portfolio and 1.88% T-Bills.
[b] Reflecting a rate of return advantage for the South Africa-free Equal Risk Portfolio.

South Africa-free portfolio to make its risk equal to that of the unconstrained portfolio, the South Africa-free portfolio outperformed the unconstrained portfolio by almost twenty basis points per year.[124]

Probing this somewhat surprising conclusion further, Grossman

[123] *See* Grossman & Sharpe, *supra* note 7, at 23.
[124] A basis point is 1/100 of one percent of a portfolio's rate of return.

and Sharpe examined the portfolios using a multiple regression technique to isolate what they called the "South Africa Factor." They estimated how well South Africa-related stocks performed relative to South Africa-free stocks while holding constant the effects of industry classification, dividend yield, beta (risk), and size. Grossman and Sharpe investigated this relationship over their entire time period (1960-83) and over three subperiods. Their results are shown in Table 5, which follows. A positive South Africa factor means South Africa-related stocks performed better than South Africa-free stocks, holding the effects of industry, dividend yield, beta, and firm size constant:

TABLE 5
SOUTH AFRICA FACTOR

Overall Period	Average Annual Return[a]
1960-83	0.77
Subperiods	
1960-75	2.05
1976-79	−0.91
1980-83	−2.69

SOURCE: Grossman & Sharpe, *Financial Implications of South African Divestment*, 42 FIN. ANALYSTS J. 15, 24 (July-Aug. 1986).
[a] A positive (negative) return means South Africa-related stocks performed better (worse) than South Africa-free stocks.

Over the entire period, the South Africa-related stocks outperformed the South Africa-free stocks. The superior performance existed throughout the 1960s and into the mid-1970s, at which time the relationship reversed and the South Africa-free stocks outperformed the South Africa-related stocks. Although the only "statistically significant"[125] results Grossman and Sharpe found were those for the period 1960-75, when the South Africa-related stocks outperformed the South Africa-free stocks, the authors concluded: "The underperformance of [South Africa-related] stocks in the 1980s, while of less significance statistically, is nonetheless of sufficient magnitude to reject any hypothesis that [South Africa-related] stocks have substantially outperformed [other] stocks with similar

[125] Classical statisticians use a "t-statistic" to determine whether the difference between a measured average value and zero is "significant." The rule of thumb is that only values with absolute t-statistics greater than 2.0 are statistically significant. *See* Grossman & Sharpe, *supra* note 7, at 24.

characteristics in the recent past."[126] Thus, the Grossman and Sharpe results refute the claim that South Africa-free stocks have been inferior performers compared to the rest of the market in recent years. More important, their results support the proposition that a South Africa-free portfolio can be managed to achieve competitive rates of return without unacceptable risk levels.

At first glance, Table 5's "South Africa Factor" results for the entire period (1960-83) seem inconsistent with the results in Table 4. Table 5 indicates a rate of return advantage to South Africa-related stocks, while Table 4 indicates an advantage to South Africa-free stocks. Grossman and Sharpe explained this discrepancy by noting that the South Africa-free strategy has a "small stock bias." Recent finance studies have found a puzzling empirical regularity that suggests relatively small stocks earn risk-adjusted rates of return in excess of their expected levels.[127] Since South Africa-free portfolios have a small stock bias, the small stock empirical regularity is automatically incorporated into those portfolios, enhancing their risk/return profiles, as the results in Table 4 show. The South Africa Factor results in Table 5, however, controlled the small stock effect because Grossman and Sharpe manipulated the "firm size" variable.[128]

The conclusions that seem to follow from the empirical studies are counterintuitive, perhaps even startling. It is possible to design a South Africa-free portfolio that tracks the overall market closely. It is also possible to form South Africa-free portfolios with levels of risk and return that are competitive with portfolios unconstrained by South Africa social investment policies.[129]

However, before concluding that divestment of South Africa-related stocks has no adverse financial repercussions, several other matters need consideration. Simply because one can structure a South Africa-free portfolio that is competitive with an unconstrained portfolio does not mean it is costless to do so. Sales in the market pursuant to divestment affect the market itself, thus chang-

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[126] *Id.*

[127] *See* Banz, *The Relationship Between Return and Market Value of Common Stocks*, 9 J. FIN. ECON. 3-18 (Mar. 1981); Cook & Rozeff, *Size and Earnings/Price Ratio Anomalies: One Effect or Two?*, 19 J. FIN. QUANT. ANALYSIS 449-66 (Dec. 1984).

[128] For a further discussion of the importance of the small stock issue, see *infra* notes 157-63 and accompanying text.

[129] It is obvious that restricting the discretion of a fiduciary who makes optimal investment decisions cannot improve the performance of the fiduciary's portfolio. However, the financial empirical evidence shows that South Africa-free portfolios can be managed to achieve competitive returns without increasing risk.

ing the environment in which the costs of divestment must be evaluated. In other words, the *future* impact of divestment on portfolio risk and return must be assessed. Divestment also has transaction costs, tends to reduce portfolio liquidity, and may increase administrative costs. Finally, the relationship between portfolio management issues and divestment must be explored. These topics are considered in the next subsection.

C. *The Potential Effects of Implementing Divestment on Portfolio Performance*

1. *Future Risk and Return Projections*

The previous subsection concerned *historical* risk and return relationships of United States stocks. Data on these relationships are important because they help determine whether social investing strategies are feasible without sacrificing return or incurring additional risk.

The picture that emerges from studying historical relationships is incomplete, however, because it fails to account for the future effects of ongoing divestment activities. Divestment strategies are implemented at various times and in various forms, and each divestment potentially has some effect on the market in which other subsequent divestments will occur. Thus, another important—and extremely difficult—task is assessing what future impact, if any, divestment will have on American stock markets.

The answer to this crucial question is elusive, and diverse opinions have been voiced. At one extreme, it is claimed divestment will have dramatic effects on related stocks and, more generally, on portfolio management.[130] At the other extreme, some believe the divestment movement will not influence stock prices in any major

[130] *See, e.g.*, Broderick, *The Prudent Person vs. Divestment*, 8 DIRECTORS & BOARDS 4 (Summer 1984) (asserting that South Africa divestment will increase risk and reduce return); Love, *On South Africa*, 41 FIN. ANALYSTS J. 14-16 (May-June 1985) (speculates on the probable negative impact on South Africa-free portfolios from a long run perspective); Tell, *The Apartheid Factor*, BARRON'S, Aug. 19, 1985 at 18, 20, 55 (pessimistically considers the possible impact of divestment pressures on South Africa-related stocks); Pensions & Investment Age, Oct. 5, 1987, at 36 (reporting on opposing views on effect of South Africa divestment on portfolio performance); *see also* Reynolds & Cohen, *Divestiture in South Africa May Become an Investment Strategy* (letter to the editor), N.Y. Times, Oct. 31, 1985, at 26, col. 3 (chairmen of District of Columbia Retirement Board and its investment subcommittee opine that widespread divestment by pension funds, endowments, foundations, and employment benefit plans could adversely affect stock prices).

way.[131] Both positions are explored below.

At the outset, it should be noted that in both scenarios, the analysis and results are fully consistent with the empirical evidence related to the "efficient market" theory,[132] a concept capturing one of the prominent features of modern financial markets. The efficient market theory asserts that securities are properly priced by investors, in aggregate, based upon current information available concerning the securities' underlying operating and financial characteristics. As a result, assets are not seriously mispriced in markets with large numbers of well-informed, profit-seeking investors who are relatively free to pursue their investment objectives. The efficient market theory is widely believed to be an accurate description of security pricing, at least to a first approximation.[133] The theory helps explain the impact, both short-run and long-run, of both narrow and widespread divestment.

a. *The Case for No Stock Market Effects*

In an efficient market, narrow divestment would not significantly affect the stock market.[134] Any selling pressure resulting from divestment may momentarily cause price declines in South Africa-

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131 Pittel, *Divested Stocks Aren't Cheap*, FORBES, Feb. 24, 1986, at 136 (observing that South Africa-related stocks have been marginally affected by divestment to date); Rubinstein, *Divestment Injuries No One But the Divestor*, (letter to editor), N.Y. Times, Oct. 18, 1985, at 30, col. 3 (stockbroker opines that divestment only affects the seller of stock, not the company).

132 The classic definition and exposition of market efficiency is found in Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383-427 (May 1970). For a discussion of efficient market theory in another legal context, see Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023, 1036-44 (1976).

133 There is, however, a growing literature on so-called "anomalies" that, at first blush, appear inconsistent with market efficiency. *See, e.g.*, Joy & Jones, *Earnings Reports and Market Efficiencies: An Analysis of the Contrary Evidence*, 2 J. FIN. RES. 51-63 (Spring 1979); *Symposium on Size and Stock Returns, and Other Empirical Regularities*, 12 J. FIN. ECON. (M. Jensen ed. June-Sept. 1983); *Symposium on Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. (M. Jensen ed. June-Sept. 1978). However, the majority of finance scholars argue that these anomalies are not evidence of market inefficiency, but rather are indications that current financial asset pricing models are misspecified. *See, e.g.*, Ball, *Anomalies in Relationships Between Securities' Yields and Yield-Surrogates*, 6 J. FIN. ECON. 103-26 (June-Sept. 1978).

134 An ancillary condition is that economic and/or governmental restrictions placed on South Africa-related companies will not materially affect or be perceived to affect those companies. This latter condition is secondary in the sense that it is a potential cause of widespread divestment and/or changed attitudes towards related stocks. Nonetheless, it is most likely the magnitude of the overt divestment pressure or lack thereof that will determine whether there are future divestment-driven stock market impacts.

related stocks, but any such declines would precipitate immediate buy reactions from divestment-neutral investors. Similarly, excess buying pressure from redeployment of divested funds may momentarily cause price increases in South Africa-free stocks and immediately precipitate not only selling, but also short selling[135] activity from divestment-neutral investors. In short, stock market "bargains" created by divestment, whether underpriced South Africa-related stocks or overpriced South Africa-free stocks, would be eliminated quickly in an efficient market. Moreover, the chance that divestment will occur over long periods of time enhances the likelihood that limited divestment will not affect stock prices because divestment-neutral investors will have more time to adjust to stock price discrepancies.

The foregoing discussion is predicated on a key assumption: that divestment will not be sufficiently widespread to affect stocks in any important way. Estimating the future extent of divestment is impossible, but the composition of publicly traded stock ownership helps establish some limits on possible future divestment. A 1985 estimate of asset values of pension funds and university endowments appears in Table 6, which follows.

Endowment and pension funds comprise over two-thirds of all United States publicly traded stocks. As of August 1987, public employee pension funds in thirteen states and over twenty-five cities had divested, or scheduled for divestment, over $12.1 billion in South Africa-related stocks.[136] As of late 1987, approximately 135 college and university endowments had sold all or part of their holdings in companies with operations in South Africa. Divested funds totaled approximately $4 billion, about ten percent of all university endowment assets.[137] Although these numbers seem large,

[135] A short sale is the sale of a borrowed security; the seller does not own the stock at time of sale.

[136] American Committee on Africa, Public Investment and South Africa, *supra* note 92, at 1-17.

[137] This figure is based on a reported statement of a representative of the American Committee on Africa. N.Y. Times, Dec. 30, 1987, at B8, col. 3. The $4 billion figure includes $3.1 billion worth of holdings in South Africa-related companies that the University of California Board of Regents voted to sell in July 1986. *See* Chron. Higher Educ., July 30, 1986, at 1, col. 2. As of May 1986, about one hundred college and university endowments had sold all or part of their holdings in companies with operations in South Africa, and these divested funds totaled about $445 million. *See* Chron. Higher Educ., May 14, 1986, at 2, col. 3. Recently, the pace of university divestment has slackened. From April 1985 to February 1987, seventy-five colleges divested, but from February through December 1987, no more than a half-dozen have done so. N.Y. Times, Dec. 30, 1987, at B8, col. 3.

TABLE 6
ESTIMATES OF ASSET VALUES AS OF APRIL 1985

	$ Billions	Percentage of U.S. Publicly Traded Stocks
University endowment funds	40	2
Public employee pension funds	340	18
Corporate and union pension funds	980	52
	1,360	72
All U.S. publicly traded stocks	1,900	100

SOURCE: Smith, *American Stocks Shrug Off Anti-Apartheid Pressure*, WALL ST. J., April 30, 1985, at 34, Col. 1.

they represent only a small portion of the total market value of South Africa-related stocks that ranges between $400 and $600 billion.[138]

These figures illustrate the dimensions of the widespread versus narrow divestment question. The institutions most likely to feel divestment pressure are endowment and public employee pension funds. If all endowment and public employee pension funds divested all of their South Africa holdings, the divestment movement would be widespread.[139] If corporate and union pension funds participate to any significant degree in the divestment movement, characterizing divestment as widespread might be an understatement.

Exactly how widespread divestment must become before some price effects of South Africa-related stocks occur is an open question. One commentator opined that divestment would not depress the prices of South Africa-related stocks in a perfectly efficient market unless nearly two-thirds of the market were divested.[140] Currently, approximately $150 billion appears to be invested in stock portfolios held by investors who are in the process of divesting at

[138] On the conservative side, Tell, *supra* note 130, at 20, reported that the 114 S&P 500 stocks with South African ties had a total market value of $448 billion as of June 30, 1984. Grossman and Sharpe, *supra* note 7, at 17, estimated that the 205 companies on the 1984 IRRC list of United States firms doing business in South Africa had a combined market value of $570 billion.

[139] *See* Table 6, *supra* text accompanying note 138. Assuming endowment and public employee pension funds generally hold widely diversified "market" portfolios, these funds today hold almost twenty percent of the aggregate shares of the South Africa-related stocks.

[140] Pittel, *supra* note 131, at 136.

least a portion of their South Africa-related stocks.[141] This figure represents less than eight percent of the aggregate market value of publicly traded United States stocks. It seems fair to say that divestment is, at least for the present, narrow. Yet the divestment movement is clearly gaining momentum that is unlikely to abate soon.[142] Divestment may become more widespread over time. Until then, however, any discernible impact on stock prices and rates of return is unlikely.

b. *The Case for Stock Market Effects*

Many stock market analysts believe widespread divestment would significantly impact stock prices and rates of return. Any appraisal of their analyses must distinguish between the effects of divestment in the short-run and in the long-run. That the divestment movement is or will be sufficiently widespread so as to create some noticeable price effect is assumed. This assumption, as already noted, is perhaps unwarranted.

Some analysts believe that a changing supply-demand balance will provide the primary impetus to divestment-driven stock market changes.[143] During the short-run, incremental selling pressure will push down the price of South Africa-related stocks, and incremental buying pressure will push up the price of South Africa-free stocks. The magnitude of these effects is entirely conjectural.[144]

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[141] N.Y. Times, Sept. 9, 1986, at D5, col. 2 (citing David Hauck, senior analyst at the Investor Responsibility Research Center). Another commentator put the total portfolio of institutions with South Africa-related restrictions on their investment policies at $260 billion. Lazzareschi, *Activists Seeking to Shut 'Loopholes' in Divestiture*, L.A. Times, Jan. 19, 1987, pt. 1, at 8, col. 2 (citing Mitchell Investment Management Co.). At least part of this increase is attributable to the mid-1980s increase in stock prices. However, some of it is undoubtedly attributable to additional institutions adopting some sort of South Africa investment policy.

[142] It is unlikely that all United States corporations will suddenly withdraw from South Africa, thereby mooting the divestment arguments. According to one report, "[b]arring a bloodbath in South Africa, U.S. firms probably won't suddenly shut down en masse and all leave at once. Instead, predicts one official, U.S. investment will endure 'a long, continuing, slow decline.' " Kneale, *Growing Dilemma: U.S. Firms Operating in South Africa Debate Whether to Stay or Go*, Wall St. J., July 11, 1986, at 8, col. 1. It is also not likely that Congress will soon mandate the withdrawal of all United States corporations from South Africa. On July 31, 1986, the Senate Foreign Relations Committee defeated such a proposal on a nine to seven party-line vote. Roberts, *Senate Panel Rejects Divestment But Leans to Other Pretoria Curbs*, N.Y. Times, Aug. 1, 1986, at A1, col. 2.

[143] *See* Tell, *supra* note 130, at 55.

[144] *Id.* Steven Leuthold, the principal of a Minneapolis investment-strategy firm, recently said: "Anybody who's got any brains is going to stay away from those stocks until (the divestment selling) goes away." Id.

However, buying pressure will likely affect South Africa-free stocks more than selling pressure will affect South Africa-related stocks because, on average, South Africa-related stocks have very large capitalizations, and South Africa-free stocks have smaller capitalizations.[145] In effect, some divesting portfolios will reallocate capital to stocks with much smaller capitalizations.

Grossman and Sharpe advanced a more subtle version of the selling pressure theory in justifying their prediction of future short-run price declines in South Africa-related stocks. They reasoned that South Africa-neutral investors could only be induced to "overload" their portfolios with South Africa-related stocks by price incentives.[146] Consequently, according to Grossman and Sharpe, share prices of South Africa-related stocks will fall until the divestment movement is completed,[147] whereas share prices of South Africa-free securities will rise during the divestment disequilibrium period.[148]

Regardless of which explanation for short-run price changes one accepts, the final result is the same: prices of South Africa-related stocks will be pushed downward, and prices of South Africa-free stocks will be pushed upward. South Africa-free stocks would reflect favorable relative prices and rates of return in the short-run. Accordingly, on the issue of the prudence and feasibility of divestment, divesting portfolio managers will not be disadvantaged in the short-run. Indeed, those managers who do not divest will suffer the negative aspects of the relative price movements during this period.

Whether explicitly stated or not, the principal concern over the effects of divestment relates to the *long-run* investment horizon. Two postdivestment, long-run scenarios seem plausible. In the final analysis, neither scenario implies any major long-term disadvantage to South Africa-free portfolios.

Two kinds of long-run pressure will probably raise share prices of South Africa-related stocks. First, the government and the public will continuously pressure the management of South Africa-related firms to divest.[149] When a firm's management responds favorably to the pressure to divest, the firm's stock should respond positively. If divestment by management became widespread, an upward price

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145 *See* Table 1, *supra* text accompanying note 111.

146 Grossman & Sharpe, *supra* note 7, at 26.

147 *Id.* at 27.

148 *Id.*

149 *See supra* note 18 and accompanying text.

impact on what are now South Africa-related stocks should result. By virtue of the arguments previously advanced concerning short-run results,[150] some decline in South Africa-free prices should also occur.

The second source of long-run pressure results from the natural attraction of South Africa-neutral investors for South Africa-related stocks because of the risk and return advantages of these stocks relative to South Africa-free stocks. If divestment in the short-run causes South Africa-related stock prices to fall and the South Africa-free stock prices to rise, all while the underlying financial and productive characteristics of firms are unchanged, investors indifferent to divestment would be induced to buy undervalued South Africa-related stocks because long-run expected returns would be high relative to risk. This pressure to buy would tend to boost prices of South Africa-related stocks to predivestment levels, resulting in long-run equilibrium, *ceteris parabis*.

Consider now the South Africa-free stocks. As discussed above, shifting investor supply and demand functions and reallocation resulting from divestment would probably drive South Africa-free stock prices above their long-run equilibrium levels in the short-run. However, in a perfect market,[151] short-selling of overvalued South Africa-free securities would reduce their prices to levels that would yield a return consistent with their risk levels in the long-run.[152] Therefore, price premiums created by divestment would not last long.

In actuality, short-selling is restricted by the requirement that trustees maintain costly escrow accounts.[153] In addition, thinly traded securities are difficult to short-sell because brokers are often unable to borrow the required certificates.[154] By definition, many thinly traded securities will be South Africa-free stocks. As a result,

150 These arguments involve shifts in investor supply and demand functions and portfolio rebalancing considerations.

151 A perfect market contains no transactions costs and imposes no restrictions on investors' operations.

152 Unrestricted short-selling is an important arbitrage activity in a perfect market because it puts downward pressure on prices. Overvalued securities will attract short-selling until prices are reduced to their proper risk-return levels. Restrictions on short-selling retard the process of downward price movement. The only arbitrage force left in this latter situation is reduced demand.

153 Proceeds from short sales are not available to the investor, and margin deposits are required.

154 Thinly traded securities also exacerbate another problem with short-selling: potential losses on short-selling are unlimited. *See* W. SHARPE, INVESTMENTS 25 (2d ed. 1985).

restricted short-selling of South Africa-free stocks would create price "superpremiums" in long-run equilibrium.[155] Finally, even if no long-run price movements back toward predivestment levels of either South Africa-free or South Africa-related stocks occurred, South Africa-related stocks would probably enjoy some advantage over South Africa-free stocks. Specifically, their expected cashflows relative to their prices would be greater in the postdivestment period than in the predivestment period.

Grossman and Sharpe estimate a long-run rate of return advantage to South Africa-related stocks of about forty-two basis points per year, *in extremis*, as a result of divestment, *ceteris parabis*.[156] Additionally, they estimate that South Africa-free portfolios will inherently reap the advantages of the anomalous small firm effect. Therefore, the small firm advantage should provide a counterbalancing gain to South Africa-free portfolios of about thirty-five basis points per year. This counterbalance almost fully compensates for whatever long-run rate of return advantage South Africa-related stocks enjoy.[157]

Grossman and Sharpe's estimates of the prospective effects of divestment are more useful qualitatively than quantitatively. In essence, they propose that gains from the small firm effect will offset losses from induced portfolio rebalancing.[158] However, two recent studies on the small firm effect suggest that the abnormally large return attributable to small firm stocks are merely compensation for market and firm characteristics peculiar to small firms. Stoll and Whaley argue that the additional transaction costs associated with investment in small firms negate much of the anomalous small firm stock advantage.[159] Chan, Chen, and Hsieh conclude that the small firm effect is essentially explained by differences in failure risk across firm sizes.[160] Therefore, the anomalous extra return received by small firms is merely a risk premium earned for holding stocks

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155 *See* Glenn, *Super Premium Security Prices and Optimal Corporate Financing Decisions*, 31 J. FIN. 507, 508-09 (May 1976).

156 Grossman & Sharpe, *supra* note 7, at 27.

157 *Id.*

158 *Id.* at 25, 27.

159 Stoll & Whaley, *Transactions Costs and the Small Firm Effect*, 12 J. FIN. ECON. 57-59 (June 1983). Transactions costs are discussed in more detail at *infra* notes 164-83 and accompanying text.

160 *See* Chan, Chen & Hsieh, *An Exploratory Investigation of the Firm Size Effect*, 14 J. FIN. ECON. 451, 470 (Sept. 1985).

with greater risk of failure.[161]

Whether these explanations[162] justify conclusions such as those drawn by Grossman and Sharpe may be determined by reference to efficient market theory.[163] Despite the results of Grossman and Sharpe's study, if markets are efficient, investing in small firms should not add anything to portfolio returns after adjusting for all types of risk. Therefore, the extra return that South Africa-free portfolios earn because of their inherent small firm bias constitutes fair compensation for extra transaction costs or extra risk bearing. On the other hand, if markets are inefficient, divestment portfolios tend to reap the benefits of the small firm bias, an outcome consistent with Grossman and Sharpe's results.

Thus, regardless of which of these two scenarios one accepts, returns should be higher in divestment portfolios. In one instance, higher return is fair compensation for incremental increased risk; in the other instance, higher return is unaccompanied by increased risk. In neither instance does divestment disadvantage the portfolio.

To summarize, if the divestment movement does not become widespread, divestment will have no price or rate of return impact in either the short run or the long run. Therefore, divesting managers will not be penalized for pursuing a strategy of social investing. If the divestment movement does become widespread, the main short-run consequences of divestment are the imbalance of supply and demand conditions for both South Africa-free and South Africa-related stocks and disaffection with portfolio overweighing of South Africa-related stocks by divestment-neutral investors. Both conditions favor South Africa-free stocks relative to South Africa-related stocks in the short-run. Therefore, South Africa-free portfolios reward portfolio managers in the short-run. The main long-run consequences in the widespread divestment scenario are more complicated. *Ceteris parabis*, South Africa-related stocks may be advantaged relative to South Africa-free stocks. However, the long-run, small firm bias inherent in South Africa-free portfolios would tend to dissipate that advantage. Thus, even in the long-run, divest-

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161 Analyses like those reported in Tables 2 through 5 use some form of variability risk, which may not fully capture the risk failure dimension.

162 It is not yet clear whether the arguments advanced either by Stoll and Whaley or by Chan, Chen, and Hsieh are empirically valid. More research is required before the question can be resolved. Nevertheless, both studies provide believable explanations of the small firm effect.

163 *See supra* notes 132-33 and accompanying text.

ing managers will not experience any adverse effects on portfolio performance as a result of divestment.

2. *Potential Additional Costs*

Divestment's identifiable effects are not limited to impacts on risk and return. Divestment potentially entails additional costs, some of which are interdependent and most of which have not yet been estimated with any precision. In this section, we examine transaction costs, liquidity costs, administrative costs, and portfolio size relative to management style considerations, to determine whether some qualification of our conclusion that divestment has no adverse effects on portfolio performance is necessary.

a. *Transaction Costs*

Divestment entails two transaction costs.[164] First, the one-time divestment of South Africa-related stocks and the subsequent purchase of substitute South Africa-free stocks result in transaction costs. Second, divestment causes ongoing, repetitive transaction costs attributable to differences in the management of a South Africa-free portfolio and an unconstrained portfolio.

In 1983, Loeb surveyed transaction costs associated with block trades.[165] He found that both the market spread component of transaction costs and total transaction costs were inversely related to market capitalization.[166] As market capitalization declined, the spread and transaction costs rose sharply. Furthermore, as the ratio of block size traded to market capitalization rose, transaction costs increased. While these relationships are intuitively not surprising, the accuracy of Loeb's data affects the divestment debate. Table 7, which follows, is an excerpt from Loeb's study.[167]

Using Loeb's data, Wagner, Emkin, and Dixon computed the

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[164] The total transactions costs of trading stocks on a national exchange equal the sum of brokerage commissions, market maker spreads, and price concessions. Brokerage commissions are the price of making stock trades. The market maker's spread is the bid-ask spread for a one hundred share (round lot) transaction. The price concessions represent the incremental cost of trading more than one hundred shares. Significant disagreement exists over the actual magnitude of transactions costs.

[165] Loeb, *Trading Cost: The Critical Link Between Investment Information and Results*, 39 FIN. ANALYSTS J. 39 (May-June 1983).

[166] *Id.* at 42. This finding is consistent with that of Stoll and Whaley, *supra* note 160, at 59.

[167] If accurate, Table 7 shows that the cost to extremely small firms of trading very large blocks is prohibitive. This observation is relevant to the discussion below on portfolio size.

TABLE 7

Size of Equity (millions of dollars)	Market Maker's Spread	Total Transactions Cost — Block Size of Trade $25,000	$500,000	$2,500,000
50-75	1.86%	5.8%	16.9%	31.5%
500-1,000	0.76%	2.0%	4.0%	7.7%
Over 1,500	0.52%	1.2%	1.7%	2.8%

SOURCE: Loeb, *Trading Cost: The Critical Link Between Investment Information and Results*, 39 FIN. ANALYSTS J. 39, 42 (May-June 1983).

transaction cost of divesting hypothetical portfolios of all South Africa-related stocks.[168] Wagner used the S&P 500 as the original portfolio and replaced each of the 152 South Africa-related stocks with its largest South Africa-free industry substitute. Because Wagner replaced each divested stock with its closest substitute, in terms of both size and industry type, the resulting alternative portfolio closely resembled the original portfolio. Assuming equal dollar weighting of stocks within the portfolio,[169] Wagner estimated the transaction costs of divestment and redeployment for three different size assumptions of the South Africa-related positions. Their results appear in Table 8, which follows.

TABLE 8
AVERAGE TRANSACTIONS COST (AS A PERCENTAGE OF THE SIZE OF THE POSITION)

	Position Size $25,000	$250,000	$2,500,000
Divestment of South Africa-related stocks	0.8%	1.0%	2.3%
Replacement with South Africa-free stocks	1.0%	1.5%	3.7%

SOURCE: Wagner, Emkin & Dixon, *South African Divestment: The Investment Issues*, 40 FIN. ANALYSTS J. 14, 18 (Nov.-Dec. 1984).

Wagner's hypothetical results have implications for both types of transaction costs involved in divestment. First, the initial divestment and redeployment costs can be quite large in some circumstances. Second, South Africa-free stocks are more costly to trade

168 Wagner, Emkin & Dixon, *supra* note 7 [hereinafter Wagner].

169 Under this assumption, the dollar values of the total holdings of each stock in the portfolio were equal.

than South Africa-related stocks because they have, on average, smaller equity capitalizations.

Grossman and Sharpe found trading costs substantially lower than Wagner's calculations indicated.[170] Grossman and Sharpe performed a similar divestment and redeployment exercise. They assumed a $1 billion portfolio and divested the thirty-seven percent market value position in the portfolio that represented South Africa-related stocks.[171] Estimated transaction costs equaled 2.57% of the aggregate divestment amount.[172] Transaction costs were 0.95% of the entire portfolio.[173]

Grossman and Sharpe's key assumption was that securities would be divested and the money reinvested on the basis of market value percentages rather than Wagner's equal weighting percentages.[174] Grossman and Sharpe estimated that Wagner's equal weighting assumption erroneously increased the overall transaction costs for their market value weighted portfolio from 0.95% to 2.28%.[175] In short, Grossman and Sharpe concluded that Wagner's artificial weighting scheme erroneously overstated the actual transaction costs a typical portfolio manager would incur as a result of divestment.

Furthermore, Grossman and Sharpe questioned the accuracy of Loeb's data. They noted that the dealers responding to Loeb's survey did not consider the hypothetical investors' trading motives.[176] A dealer's price concessions and spreads depend on, among other things, whether the dealer is interacting with an "insider." To protect themselves, dealers increase spreads and demand greater concessions if they believe they are interacting with an insider who may have superior information. Grossman and Sharpe believed that Loeb's cost estimates included information-motivated spreads and concessions which caused the data to overstate the cost of trading in

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170 The differences between the South Africa-free replacement costs and South Africa-related divestment costs reflect the repetitive incremental transactions costs incurred in South Africa-free portfolios.

171 Grossman & Sharpe, *supra* note 7, at 21-22.

172 The thirty-seven percent figure is the portion of the NYSE index that Grossman and Sharpe determined were South Africa-related. *Id.* at 20.

173 *Id.*

174 *Id.*

175 *Id.*

176 The discrepancy is created because an equal weighting scheme causes more of the portfolio to be committed to small capitalization stocks. Realistically, portfolio funds are likely to be distributed according to the size of a stock's capitalization.

situations where no insider trading was suspected.[177] Additionally, Grossman and Sharpe felt that Loeb's study could have reduced transaction costs further by spreading the transactions over several days.[178]

Therefore, in response to Loeb's methodology, Grossman and Sharpe performed an alternative trading costs experiment utilizing a Wells Fargo Investment Advisors data base of over 36,000 actual investment transactions made between November 1984 and May 1985.[179] The Wells Fargo data base reduced the transaction costs of divesting and redeploying the previously described $1 billion portfolio from the earlier estimate of 0.95% to 0.41%.[180] Grossman and Sharpe also used their data to estimate a repetitive incremental transaction cost differential of only nine basis points per year for a $100 million value-weighted portfolio which was managed passively.[181] On balance, Grossman and Sharpe argued that transaction costs were much smaller than previously supposed and that those costs could be recouped by the small firm bias inherent in South Africa-free portfolios.[182] If Grossman and Sharpe are correct, potential transaction costs do not affect our previous conclusion that divestment will not impair portfolio performance.

b. Liquidity Costs

Liquidity costs are price pressure effects resulting from trading activities. Investors incur liquidity costs when they significantly influence a stock's price by either liquidating or establishing a large position in the stock. Because divestment excludes relatively liquid stocks from a portfolio, divestment increases portfolio liquidity costs. The IRRC Report suggests that trading levels below twenty percent of the average daily volume are reasonably free from liquidity costs.[183] However, no definitive empirical evidence on the size or importance of these costs exists. Consequently, the extent to which divestment will cause increased liquidity costs in South Africa-free portfolios is uncertain.[184]

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177 Grossman & Sharpe, *supra* note 7, at 20-21.

178 *Id.* at 21.

179 *Id.*

180 *Id.*

181 *Id.* at 22.

182 *Id.*

183 *Id.* at 27.

184 IRRC Report, *supra* note 7, at 26-27.

c. Administrative Costs

Divestment may also affect administrative costs associated with research expenses. The IRRC reported that "[a]ctive managers who rely on security analysts to investigate the return prospects of stocks will incur higher research costs under divestment because they will have to follow a larger number of smaller stocks, which may require more intensive research because little 'street' analysis exists for them."[185] However, no quantitative evidence exists which shows the actual impact of divestment on administrative costs.

d. Portfolio Size/Management Style Considerations

Both the management "style" and the size of a portfolio are interrelated with transactions costs, liquidity costs, and administrative costs. All other things being equal, the larger and more actively managed the portfolio, the more adverse the impact of divestment on portfolio performance.

Larger portfolios, meaning those with assets exceeding $50 million,[186] are likely to incur both higher transaction and liquidity costs under divestment due to the change in equity capitalization sizes. Additionally, larger funds encounter difficulties when attempting to take substantial positions in firms with small equity capitalizations. Administrative costs, including research costs, are probably less sensitive to fund size.

Divestment will probably affect passive and active portfolio management styles to varying extents. A passive management style involves buying and holding stocks without adjusting the portfolio. Index funds, for example, are passive; the only trading by such funds is for the purpose of rebalancing the portfolio. By contrast, an active management style involves continuous research, investigation, and trading in an effort to "add value." In very passive portfolios, incremental transactions, liquidity, and administrative costs resulting from divestment will probably be trivial. In extremely actively managed portfolios, however, divestment could greatly increase these costs under certain circumstances.

To take one example of the differential effect of divestment on portfolios with different management styles, consider two funds with equal turnover rates: the relatively passive fund selects stocks

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185 Note that liquidity costs will also be affected by portfolio size and management style, topics discussed below.

186 IRRC Report, *supra* note 7, at 27.

on the basis of mechanical financial screens, like price-to-earnings ratio, while the relatively active fund selects stocks on the basis of fundamental research. If divestment causes each fund to increase its universe of stocks for possible investment, the relatively active fund is likely to experience larger research costs than the relatively passive fund because fundamental research is more costly to apply than mechanical financial screens. Additionally, fundamental research will be especially difficult to apply as portfolio managers consider more small firms for investment.

Unfortunately, it is not possible to determine with precision the additional costs associated with divestment in actively managed, large portfolios. If managers with active styles were willing to adopt more passive strategies,[187] these additional costs could be avoided.

3. *Additional Benefits of Divesting*

In the preceding discussion, we determined that social investing neither adversely affected portfolio returns nor increased portfolio risk. In this section, we advance two potential additional benefits of divestment.

First, divestment avoids short-run reductions, if any, in returns from South Africa-related stocks caused by changes in the underlying operating and financial characteristics of South Africa-related companies. Earlier analyses sometimes assumed that these underlying characteristics of South Africa-related companies would not change during divestment. This assumption is open to question. Although definitive data are elusive, United States firms have reduced their asset base in South Africa sharply; product and service boycotts of South Africa-related companies have occurred. Conceivably, these developments could reduce the returns of South Africa-related stocks, particularly in the short run. The extent to which this will occur, if at all, is difficult to ascertain. Regardless,

[187] No clear distinction exists between sizes of equity portfolios; the term "large fund" is ambiguous in both its general and specific contexts. Trinity Investment Management Corporation estimated "large" as any fund over about $50 million. IRRC Report, *supra* note 7, at 16. Some of the bases for this classification were average daily trading volume, the estimated percent of daily trading volume a single investor could initiate without affecting stock price, and the number of days an investor would require to completely close or open a position. The IRRC Report defined large as somewhere in the $50 million to $200 million range, depending on other circumstances. *Id.* at 31. Grossman and Sharpe, *supra* note 7, at 20, never defined a large fund but used as an example a $1 billion fund.

divestment avoids whatever costs may be associated with maintaining positions in South Africa-related companies.

A second potential benefit of divesting is avoiding the political and social pressures associated with not divesting. Because prodivestment advocates are highly vocal, divestment frees both management and staff from time spent defending fund policies. This benefit has an economic justification similar to that which supports out-of-court settlements and the resulting reductions in the costs of litigation.[188]

D. Summary

We have now considered the main financial issues associated with South African divestment. In the crucial area of portfolio risk and return, we concluded that South Africa-free portfolios can compete effectively with unconstrained portfolios because South Africa-free portfolios do not sacrifice return or increase risk. Less constrained portfolios, such as those that divest stock held in any company doing business in South Africa that does not meet one of the two highest Sullivan Principles, definitely will compete effectively with unconstrained portfolios.

A South Africa-free portfolio could incur some incremental transaction, liquidity, and administrative costs as a result of divestment. The magnitudes of these costs are related to portfolio management issues, like the size of the portfolio and the style of management. The situations in which harm from divestment is most likely involve very large, actively managed portfolios whose managers are unable or uninterested in owning relatively small capitalization stocks. How large and how actively managed a portfolio must be before divestment disadvantages a portfolio is a difficult question to answer. Yet one lesson from the empirical evidence is that funds as large as $1 billion would have much lower transactions costs than previously supposed.[189]

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188 We recognize that this suggestion would be viewed as heresy by most active managers.

189 Giving fiduciaries the discretion, within stated limits, to implement social investing strategies will increase expenses to the extent fiduciaries must allocate time to the process of deciding which public values merit some kind of investment response. *See supra* notes 164-84 and accompanying text. Moreover, just as a defendant's out-of-court settlement has the potential to encourage additional persons to file claims, which could lead to costs exceeding the expenses saved by settlement, it is possible that responding favorably to requests for South Africa divestment may encourage other interest groups to pursue their own causes with more vigor, thereby resulting in additional costs for the trustee. This concern does not seem substantial, however, since the South

In the final analysis, however, divestment will only increase transaction, liquidity, and administrative costs if portfolios contain a combination of characteristics that portfolio managers refuse to change. Individually, any single characteristic will probably not make divestment harmful since a portfolio manager can change any single characteristic unfavorable to divestment. Essentially, only the combination of certain portfolio characteristics and the unwillingness of portfolio managers to alter that combination warrants qualifying our conclusion that divestment does not adversely affect a portfolio's financial performance.

Two final points are noteworthy. First, empirical studies on social investing in general, and South Africa divestment in particular, are not numerous. The most compelling study to date is by Grossman and Sharpe, and we have relied on it heavily. It is a finance study that uses traditional definitions of risk and return. To the extent future studies use nontraditional measures of risk and return, it is possible that results different from those reported here could arise. Nevertheless, we would be surprised if any future research overturns the current findings.

Second, the strength of the conclusion that South Africa divestment is harmless to portfolios is a function of the severity of the divestment criteria. If the extreme position of divesting the stock of any United States firm doing business in South Africa is taken, there is room for some disagreement concerning the effects of divestment.[190] On the other hand, if a mild divestment position is taken, such as excluding only South Africa-related United States firms not ranked in one of the top two Sullivan Principles compliance categories,[191] it is difficult to envision any room for disagreement as to portfolio effect, based on either existing or future empirical studies.

IV

Reconstructing the Prudent Investor Test in Light of the Financial Evidence

The traditional formulation of the prudent investor rule states that the trustee-investor must put the trust's assets to productive uses while simultaneously preserving them. The trustee-investor is

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Africa divestment that has occurred thus far has not prompted other divestment movements of any significance.

[190] Grossman & Sharpe, *supra* note 7, at 27.

[191] *See supra* notes 165-88 and accompanying text.

expected to use both skill and judgment to pursue these objectives for the sole benefit of the trust's beneficiaries. In states that have enacted the UMIFA, the fiduciary has more flexibility, but the precise extent of this increased flexibility is unknown. ERISA codifies the essence of the common law rule. Except in states with statutes authorizing specific kinds of social investing strategies, the extent to which a trustee can pursue such a strategy is unclear. The absence of clear statutory or judicial authority for social investing means that a trustee who implements such a policy runs the risk of violating his fiduciary duty.[192]

In Part II, however, we argued that the rules limiting fiduciary discretion should not be applied in a manner that prohibits a trustee from implementing social criteria in an investment strategy as long as the social criteria neither decrease return nor increase risk, and thus do not compromise the traditional goals of producing income and preserving the trust's corpus. In Part III we demonstrated that a social investing strategy no more restrictive than one which avoids securities of all United States corporations doing business in South Africa need not impair portfolio performance or increase portfolio risk. Therefore, even without a special statute authorizing avoidance of all South Africa-related stocks, investor-trustees who adhere to such a policy of social investing do not violate common law, ERISA, or the less restrictive UMIFA. Similarly, investor-trustees who adhere to the less severe policy of divesting stock in United States companies that do not satisfy the top two compliance categories of the Sullivan Principles, do not violate the common law, ERISA, or the UMIFA. To state the conclusion more generally, social investing strategies no more restrictive than the most severe form of South Africa divestment should not constitute a violation of the common law, ERISA, or the UMIFA.

The qualifier "no more restrictive than the most severe form of South Africa divestment" is important because divestment reduces portfolio diversity to some extent. Thus, while a portfolio may suffer no adverse effect from excluding all South Africa-related stocks, a portfolio may suffer adverse effects by excluding stocks in the larger number of companies that do business in other socially or morally offensive ways.[193] Nevertheless, the zone of social investing strategies that have no adverse effects is much larger than many

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[192] Grossman and Sharpe, *supra* note 7, at 17, estimate that only 7.1% of the total value of the NYSE would be excluded by divesting only these types of firms.

[193] *See supra* note 57 and accompanying text.

commentators have previously thought.[194]

Our conclusion that social investing no more restrictive than South Africa divestment has no adverse effects on portfolio performance means that fund managers can implement social investment strategies without changing the common law's emphasis on rate of return and corpus safety. Ravikoff and Curzan, however, would modify the prudent investor rule. They recommend that courts follow a "corpus preservation" approach—an approach which emphasizes corpus safety but does not require trustees to earn an adequate rate of return.[195] Ravikoff and Curzan presumably sought to facilitate some measure of social investing through a restatement of what the prudent investor rule is widely understood to require. Our analysis shows that some range of social invest-

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194 These adverse effects could accrue with either positive or negative social investing. *See supra* text accompanying notes 11-12. To take an extreme form of positive social investing, suppose the directors of a pension plan mandate that all of the plan's assets be invested in firms located within a ten-mile radius of a city. Such a strategy would require divesting all assets invested in firms outside the designated zone and redeploying those assets in firms within the zone. Such a strategy might entail unacceptable risk to the corpus, because a calamity within the zone (e.g., earthquake, volcano, nuclear accident, toxic chemical spill, or other economic disaster) could jeopardize all of the plan's assets. By the same analysis, compounding indefinitely a South Africa divestment policy with other divestment policies (such as divesting stock in all companies that pollute the environment, employ nonunion labor, contract with the Department of Defense, violate equal employment opportunity laws, manufacture alcohol and tobacco products, publish books communicating the values of secular humanism, support the development of nuclear power, do business in countries that support military activity in Northern Ireland, support terrorism, disregard women's rights (which rules out companies having a business tie to a Muslim country), or call themselves "communist") would prevent maintaining a portfolio of sufficient diversity to achieve a rate of return equivalent to an unconstrained portfolio, controlling for risk. The point at which the compounding of divestment policies diminishes return or increases risk cannot be identified with certainty.

195 See Langbein, *supra* note 5, at 37, who states, "To bar all alcohol and tobacco stocks . . . has little or no investment implications (because of the modest capitalization involved unlike, say, oil stocks)." As to alcohol and tobacco stocks, Langbein is plainly correct. However, since divesting from oil stocks is a less severe strategy than South Africa divestment, it follows that an oil stock divestment program would have no adverse effects on portfolio performance.

Langbein and Posner, *supra* note 5, essentially concede our thesis when they state:

> But because most of the gains from diversification can be achieved with a portfolio significantly smaller than the market portfolio or some approximation thereto such as the S&P 500, it is possible that a portfolio could be constructed in which a significant fraction of the largest U.S. firms were ineligible for inclusion yet which was not grossly underdiversified.

Id. at 87 (footnote omitted). Langbein and Posner suggest that social investing is not feasible by reasoning that the "consistent" social investor would not stop with South Africa but would inevitably proceed to "much greater portfolio exclusions [beyond companies with branches or subsidiaries in South Africa]." *Id.*

ing—a range at least as broad as the most restrictive South Africa divestment strategy—is consistent with the *traditional* formulation of the prudent investor rule, thus requiring no restatement of the traditional rule. Only if fund managers contemplate social investing policies more severe than the most restrictive South Africa divestment strategy would courts and legislators need to consider reformulating the prudent investor standard along the lines that Ravikoff and Curzan propose.

Similarly, fund managers can implement social investing without running afoul of the UMIFA. The UMIFA does not impose stricter burdens on institutional investors than the common law. If anything, the UMIFA allows for more flexible investment decisions. Therefore, South Africa divestment does not violate the prudent investor rule, and divestment by university endowments and other similar organizations does not violate the UMIFA.

In addition, our recommendations do not require any change in ERISA's standards. Fund managers can satisfy ERISA's statutory prudent investor standards while simultaneously pursuing a strategy of social investing. In 1980, the ERISA Administrator opined that fund managers could implement a social investing strategy under conditions of sufficient diversification but that ERISA probably prohibits systematic exclusion.[196] Our analysis shows that systematic exclusion of a large part of the investment universe *can* be accomplished without sacrificing return and without increasing risk. If a fund manager may choose a socially preferred investment when two alternative investments are economically equal,[197] as the Administrator suggested, a fund manager should also be able to choose a socially preferred investment strategy when two invest-

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196 *See* Ravikoff & Curzan, *supra* note 5, at 528.

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> [P]roper regard for the requirement of diversification may provide the key to the social investment puzzle. Fiduciaries have a duty to diversify plan investments to minimize risk. . . . If fiduciaries can assure that a broader range of investment vehicles will be examined, they can more likely also assure that they will be presented with choices among economically equal but socially unequal investments.
>
> On the other hand, ruling out certain investments completely, such as non-union companies or competitors, runs the risk of violating ERISA. It is difficult to square an investment policy of exclusion on the basis of nonobjective economic investment criteria . . . with ERISA standards that plan assets be managed prudently, solely in the interest of the participants, and for the exclusive purpose of paying benefits.

Lanoff, *supra* note 5, at 390-91.

ment strategies are economically equal.[198]

The foregoing analysis does not alleviate all of the inherent uncertainty in existing law regarding the permissibility of social investing. Without specific statutory clarification, the investor-trustee who has implemented a social investing strategy is still vulnerable to a suit alleging breach of the duty of prudent investing and the duty of loyalty, and perhaps alleging violation of statutory law. Indeed, the proposition that courts should apply current legal rules to permit social investing within designated parameters would provide little solace to the investor-trustee who suffered the litigation costs of defending against breach of trust allegations.

Thus, in the final analysis, legislative bodies should clarify the existing law regarding social investing by explicitly authorizing "constrained social investing."[199] Currently, the rules setting the limits of fiduciary discretion are ambiguous. As a result, social investing is not likely to occur unless the donor-trustor specifically insists that the trustee utilize social criteria in investment decisions.[200] If, contrary to the findings in Part III, the data showed that social investing impaired portfolio performance, courts and legislative bodies should proscribe social investing in the absence of the

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[198] Hutchinson and Cole, *supra* note 5, reached the same conclusions: "Assuming total financial comparability under the prudence standard between two investments and assuming further that the fiduciary acts without any trace of self-interest or self-vindication, it is difficult to see any harm in a socially sensitive investment policy that may produce some extra benefits for the participants." *Id.* at 1367. Although sensitive to what they perceived as difficulties in implementing a social investing strategy, *see id.* at 1367-68, it should be noted that they did not have the benefit of the empirical data upon which our analysis is based.

[199] It is significant that the ERISA's Administrator believed that

> a plan policy which excludes investment opportunities for so-called social purposes would be difficult to defend against challenges raised under the "solely in the interest and exclusive purpose tests—the basic duty of loyalty tests in ERISA." Thus, the [argument that the investment universe is so big that excluding a number or class of investments does not violate ERISA] should not be expected to succeed when subjected to legal analysis of the fundamental ERISA fiduciary standards.

Lanoff, *supra* note 5, at 391-92.

If this statement remains true in the face of the analysis that social investing strategies which exclude South Africa-related companies are equivalent to unconstrained strategies, it must follow that the Administrator's view is incorrect because such a policy is inconsistent with the "solely in the interest" and "exclusive purpose" tests.

[200] Presumably, given enough time, courts could develop a more precise demarcation of the limits of prudent social investing through the process of case-by-case adjudication. This process is actually already underway. *See supra* note 20. Yet, the judicial solution provides scant comfort for the investor-trustee whose defense expenses helped create a more precise rule.

trustor's specific authorization. However, the data show that a fund manager can discharge his traditional duties under the common law, ERISA, and the UMIFA while implementing a constrained social investing strategy. Thus, the economic considerations provide no support for a rule requiring the donor-trustor to authorize social investing in advance.

Accordingly, legislatures can, within limits, authorize social investing without financial harm to the retirement fortunes of current employees or retirees. The same conclusion applies with respect to other kinds of trusts. Legislatures need not fear that authorizing social investing will harm the beneficiaries of university endowments, charitable trusts, and other foundations.[201]

Even granting that constrained social investing entails no disadvantages for the productivity and safety of trust assets, state legislatures might still hesitate to authorize social investing on the ground that trustees simply should not take social, political, and moral preferences into account when managing a trust. However, trustees must employ some sort of criteria when choosing among alternative investments. Foreclosing resort to noneconomic criteria when investments or investment strategies are equivalent in terms of return and risk would incapacitate the trustee. For those concerned that trustees might use repugnant social, political, or moral investment criteria, the trust law's public policy doctrine should remedy the trustee's abuse of discretion.[202]

Finally, authorizing social investing within stated parameters does not mean that it will in fact occur. Donors and trustors would still be free to specify trust fund investments and these specifications could include prohibitions on social investing. Our recommendation that the status quo's "default rule" be changed from "no social investing" to "social investing is allowed within stated parame-

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[201] The current pattern of South Africa divestment by university endowment funds, *see supra* notes 135-38 and accompanying text, is arguably an exception to this generalization. Some of these divestments no doubt occurred in jurisdictions adhering to the more liberal rules of the UMIFA. *See supra* notes 64-75 and accompanying text. In other divestments, the funds probably concluded that the risk of a successful legal challenge was small, given the limitations imposed on plaintiffs by standing doctrines. *See supra* note 31. In still other divestments, the funds probably concluded that their actions would be viewed favorably by those closely connected to the funds, and therefore the risk of legal challenge was slight.

[202] Murphy, *supra* note 5, at 218. "If two investments are financially comparable, there can be no objection on economic grounds to the selection of the investment that produces utility gains for nonplan participants, since there is no loss to plan participants or the plan sponsor." *Id.* (footnote omitted).

ters"[203] would irrevocably affect only those trustors who have no control over the discretion of the trustee.

The only remaining issue concerns how to articulate the parameters for a social investing strategy which does not require the trustor's explicit authorization. Unfortunately, due to the lack of empirical evidence regarding the costs of divestment, it is impossible to articulate a definitive test that determines when social investing is or is not permissible.[204] However, for the time being, legislatures inclined to authorize or require divestment of South Africa-related stocks should not refrain from doing so if their only concern is for the economic performance of the divested portfolios. Similarly, legislatures should not ignore future calls for divestment on other issues as long as the effects on diversification are no more severe than the most restrictive South Africa divestment policy.

Beyond authorizing specific divestments in appropriate situations, legislatures should also consider articulating threshold standards for the presumptive validity of social investing strategies. For example, financial evidence shows that a South Africa divestment strategy excluding approximately forty percent of the New York Stock Exchange and the S&P 500 by market capitalization entails no material adverse effects on portfolio performance.[205] Thus, a legislature might enact a statute that declares presumptively valid any social investing plan that excludes no more than forty percent of the New York Stock Exchange or S&P 500 by market capitaliza-

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203 Social, political, and moral preferences can, of course, be diverse: a trustee given the discretion to follow a social investing strategy conceivably might choose to favor racist, sexist, or illegal organizations, or choose an investment strategy that promotes ends inconsistent with public policy. This situation occasionally arises when trustors establish trusts for purposes inconsistent with public policy. On numerous occasions, courts have found certain trusts to be invalid on the ground that their enforcement would offend public policy. *See, e.g.*, Liberman v. Liberman, 279 N.Y. 458, 18 N.E.2d 658 (1939) (condition to bequest that beneficiary marry only with consent of his brother and sister is against public policy); Bettinger v. Bridenbecker, 63 Barb. 395 (N.Y. App. Div. 1865) (trust which provided that funds would be paid to beneficiary on condition that criminal action against trustor would be abandoned was invalid); Hill v. Upper, 119 Wash. 62, 204 P. 1055 (1922) (testator's bequest directing that physicians in medical school use certain obsolete treatises as textbooks held illegal). *See generally* 1 A. SCOTT, *supra* note 32, §§ 62-62.15; 4 A. SCOTT, *supra* note 31, § 377. Under the same logic that a settlor cannot establish a trust for purposes inconsistent with public policy (that is, which departs from moral and ethical societal norms) a trustee presumably can not, under the guise of "social investing," adopt an investment strategy designed to secure objectives inconsistent with public policy.

204 The "default rule" specifies what the trustee is permitted to do in the absence of a specific directive from the donor-trustor.

205 *See supra* notes 164-86 and accompanying text.

tion and otherwise satisfies important financial qualifiers identified earlier (such as portfolio size, management style, and pace of divestment). The statute could then place the burden on the person challenging the social investing strategy to show by clear and convincing evidence that the particular divestment's unique circumstances will impair portfolio performance relative to other investment strategies not similarly constrained. The presumption simply acknowledges that social investing on a limited scale need neither impair a portfolio's rate of return nor increase its risk. Therefore, a person challenging the trustee's exercise of discretion should be required to show that the trustee's investment strategy is inconsistent with his fiduciary duties. A lower threshold for divestment, such as twenty percent, might be used to create a conclusive presumption that a trustee did not violate his fiduciary duties by pursuing a social investing strategy, since divestment at those levels seems eminently safe.