THE PROBLEMATIC STATUS OF EMPLOYEE COMPENSATION AND RETIREE PENSION SECURITY: RESISTING THE STATE, REFORMING THE CORPORATION

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I. INTRODUCTION

Public employee pension plan funds at the city, county, and state levels in the United States control about one trillion dollars.[1] Increasingly, however, both current compensation and pension security are put at risk by politicians desperate to avoid accelerating budget deficits. Public sector workers[2] must vigilantly resist short-term political manipulations of current compensation obligations to active workers, and must also vigorously protect the retirement pension security of retired government workers.[3] In 1992 and 1993, four criti-

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[1] Approximately $3.4 trillion was vested in private and public employee pension plans in the United States in 1993. Leslie Wayne, *Seeking Investment With Principle*, N.Y. TIMES, Aug. 10, 1993, at C1 ($2.3 trillion is accumulated in private pension plans of fifty million persons today). Martin Slate, *Protecting Pensions*, 44 LAB. L.J. 659 (1993) (underfunded pension plans are an increasing problem; total underfunding grew from $27 billion in 1987 to $45 billion in 1992); David L. Gregory, *Public Sector Pension Plans: A Cautionary Essay*, 41 LAB. L.J. 700 (1991) (advocating that public employee pension plans refrain from high risk, high return investments).

[2] I conceptually prefer the more holistic term of "workers," rather than perpetuate the largely artificial statutory bifurcations of "employees" and "retirees." The classic bifurcation is statutorily based in Section 2 of the National Labor Relations Act, 29 U.S.C. § 152 (1973 & Supp. 1994), and it has spawned unfortunate fractures in, *inter alia*, collective bargaining. For example, pension retirement security for current workers ("employees") is a mandatory subject of bargaining. Inland Steel Co. v. NLRB, 170 F.2d 247 (7th Cir. 1948), *cert. denied on this issue*, 336 U.S. 960 (1949); *aff'd on other grounds*, American Communications Ass'n. v. Douds, 339 U.S. 382 (1950). Meanwhile, pension retirement security for former workers ("retirees") is a permissive subject of bargaining. Allied Chemical & Alkali Workers of America v. Pittsburgh Plate Glass Co., 404 U.S. 157 (1971). For a recent critique of these dichotomies, see Susan J. Stabile, *Protecting Retiree Medical Benefits In Bankruptcy: The Scope Of Section 1114 Of The Bankruptcy Code*, 14 CARDOZO L. REV. 1911 (1993).

[3] I have previously cautioned against public employee pension plan funds investing

cally important and sharply divided decisions were issued by the highest state

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in highly speculative, junk bond rated investments. *See* Gregory, *supra* note 1. For example, the state of Connecticut has written off approximately $17 million in lost state pension plan assets, resulting from the purchase of majority ownership and effective control of Colt Industries, a Chapter 11 bankrupt. Colt Industries has manufactured weapons since before the Civil War, and it has historically been a significant private sector employer in Connecticut. Connecticut became one of the first states in the nation to ban assault weapons, such as Colt's popular Sporter semiautomatic rifle.

See Brooks Egerton, *In Connecticut's 'Gun Valley,' Industry Becomes the Focus of Anti-Crime Debate*, DALLAS MORNING NEWS, Feb. 6, 1994, at 1A; Kirk Johnson, *Exemption for Colt is Weighed As Weapons-Ban Vote Nears*, N.Y. TIMES, May 27, 1993, at B5 (legislature considered exempting Colt rifles from assault weapon ban); Kirk Johnson, *on One Side of Gun Control, She Puts Connecticut on the Other*, N.Y. TIMES, Apr. 16, 1992, at B5 (gun control advocate concludes Connecticut has "pro-assault weapons policy" resulting from pension fund ownership of Colt).

Especially given Connecticut's increasing problems with highly armed youth gangs in its core cities, it is truly a Faustian bargain for the state to endeavor to retain these particular private sector jobs, one direct consequence of which will be to enhance the already proliferating supply of weapons in the wrong hands. *See* Constance L. Hays, *State's Big Stake in Colt Clouds Debate on Guns*, N.Y. TIMES, July 5, 1992, at A23 (shooting of kindergarten pupil caught in New Haven gang war ignites debate over Colt buyout); John T. McQuiston, *Three Youths Shot as Gangs Clash at Courthouse*, N.Y. TIMES, Dec. 13, 1989, at B1 (court employees and lawyers on lunch break sought cover during gang battle on steps of New Haven Superior Courthouse).

The U.S. Bankruptcy Court continues to hear investment proposals to resurrect Colt from bankruptcy. *See* Andrew Julien, *Deal in Works to Pull Colt's from Bankruptcy*, HARTFORD COURANT, Mar. 8, 1994, at D1.

This, fortunately, is not yet the norm when the state invests state pension funds to support the state's economy and to attract and retain private sector businesses to create and to keep private sector jobs within the state. Most commentators have have found that the majority of state ventures involving the use of pension funds have a prudent and efficient basis. *See* Richard M. Buxbaum, *New Owners and Old Managers: Lessons from the Socialist Camp*, 18 DEL. J. CORP. L. 867 (1993); Patrick S. Cross, *Economically Targeted Investments - Can Public Pension Plans Do Good and Do Well?*, 68 IND. L. J. 931 (1993). There are very few pertinent court decisions regarding such state investments. *See* Board of Trustees of the Village of Barrington Police Pension Fund v. State Department of Insurance, 570 N.E.2d 622 (Ill. App. Ct.. 1991) (finding that investment of funds in a below market home mortgage loan program was not sufficient standing alone to hold that it was an imprudent investment). The California Public Employees Retirement System (Calpers), along with other state pension funds, recently announced it will commit $340 million from its $81 billion pension fund to support construction of 5,000 apartments, townhouses, and homes for renters and first time home buyers in California. *Booster Shots for Affordable Housing*, L.A. TIMES, Mar. 20, 1994, at M4. Some have suggested that federal, state, and local public employee pension plan funds should be subjected to federal regulation by amending the Employee Retirement Income Security Act (ERISA). See, for example, Norman Stein, *ERISA and the Limits of Equity*, 56 LAW & CONTEMP. PROBS. 71 (1993); Gregory S. Alexander, *Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 111 (1993) (noting, courts of New York,[4] Oregon,[5] and Maine[6] and by the United States Court of Appeals for the Fourth Circuit[7] regarding state and local governments' fundamental current compensation and pension security obligations to public sector workers and retirees.[8]

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however, that ERISA's trust-based statutory structure fosters passive, rather than self-governing, responsible, active ownership, by pension plans); Bruce A. Wolk, *Comment: Pensions and Passivity*, 56 LAW & CONTEMP. PROBS. 141 (1993).

[4] Association of Surrogates and Supreme Court Reporters within the City of New York v. New York, 588 N.E.2d 51 (N.Y. 1992).

[5] Hughes v. Oregon, 838 P.2d 1018 (Or. 1992).

[6] Spiller v. Maine, 627 A.2d 513 (Me. 1993).

[7] Baltimore Teachers Union v. Mayor of Baltimore, 6 F.3d 1012 (4th Cir. 1993), *cert. denied*, 114 S.Ct 1127 (1994).

[8] The highest courts of New York and of Minnesota have disagreed as to whether various methods of state funding of public employee pension plans are constitutional. In McDermott v. Regan, 587 N.Y.S.2d 533 (1992), *aff'd*, 599 N.Y.S.2d 718 (1993), *aff'd*, 604 N.Y.S.2d 890 (1993), the plaintiffs, the working and retired members of the Retirement Systems and officers of the major unions representing the public employees, sought summary judgment, claiming that Chapter 210 of the Laws of 1990 was unconstitutional because it violated Article V, Section Seven of the New York State Constitution.

The Common Retirement Fund (CRF) maintained the assets and income of the New York State Local Employees' Retirement System (Retirement Systems). The Comptroller of the State of New York is the Trustee of the CRF. N.Y. RETIRE. & SOC. SEC. LAW § 422 (McKinney 1987). Since 1921, the State Comptrollers have used the Aggregate Cost Method (AC method) to determine actuarially the annual contributions to be made by public employees to the CRF. Considered fairly conservative in nature, the AC method resulted in a surplus in the CRF of between seven and nine billion dollars by the late 1980's.

Prior to amending the law in 1990, employer contributions to employee pensions would be at a uniform and constant rate percentum of the annual compensation. 1990 N.Y. LAW 210, replacing N.Y. RETIRE. & SOC. SEC. LAW § 23(b)(1) (McKinney 1987). Although no method for funding the CRF was expressly stated, all Comptrollers used the AC method.

In 1986, the government presented regulations that would use the Projected Unit Credit method (PUC method) with regard to financial reportings of pension systems, allowing comparisons between systems nationwide, thereby reflecting under-funding or over-funding. Using this method, the State Comptroller was able to report a surplus for N.Y. State and Local Retirement Systems in excess of $7 billion. By using the PUC method, the State and local governments, faced with effects of the recession and general economic crises, were empowered to forego funding the pensions for up to ten years because of the surplus. Thereafter, it was predicted that contributions would increase dramatically. The State Comptroller opposed the PUC method, predicting that it would deprive the Retirement Systems of $800 million in employer contributions in 1991 fiscal year alone.

The court found that Section 210 of the Laws of 1990 contravened the contractual relationship between public employees and their employers pursuant to Section 7, Article V of the N.Y. State Constitution: "After July first, nineteen hundred forty, mem-

Public workers' active compensation and the pension security of public sector retirees have been put at risk by elected politicians seeking to balance budgets on the backs of public sector workers. As Professor Peter Drucker grimly states in his latest book, THE POST-CAPITALIST SOCIETY, "no safeguards at all exist against the most serious danger: the looting for political purposes of the pension funds of government employees."[9] In 1992, two such political initiatives were rendered unsuccessful and pronounced unconstitutional by the highest state courts of New York[10] and Oregon;[11] but Maine's highest court followed in 1993 with a decision in favor of the state,[12] as did the United States Court of Appeals for the Fourth Circuit, in favor of the City of Baltimore, Maryland.[13]

Public employee pension plan funds are also becoming very proactive forces in corporate governance reform initiatives. For example, the California Public Employees Retirement System (Calpers), with over $80 billion in assets, has been instrumental in effectuating the replacement of inept chief executives of poorly performing corporations, such as those of IBM, General Motors, Eastman Kodak, and American Express.[14] Calpers' international corporate reform initiatives are now beginning to pressure transnational corporations headquartered outside the United States.[15]

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bership in any pension or retirement system of the state or of a civil division thereof shall not be diminished or impaired." Consequently, New York was forced to repay four billion dollars to its pension funds, to make up for the state's withholding of funding contributions in order to make up for state budgetary shortfalls.

Shortly after the court's opinion in *McDermott*, State Comptroller H. Carl McCall, the sole trustee of the state pension system, devised a plan for New York State and its local governments to repay $4 billion to the pension system. McCall's plan gives the state at least 12 years to reimburse the state pension fund, requiring that small sums be paid in 1994 with gradual increases through the rest of the decade. However, not until 1999 will the state make larger payments into the pension fund than it would have if the New York Court of Appeals had not changed the accounting methods.

McCall indicated that his plan would help local governments avoid "budgetary chaos" and potentially save the jobs of the state employees whose pensions he protects. Union leaders and Republican legislators note that backended repayments help New York Governor Mario M. Cuomo, McCall's former running mate and fellow Democrat, by delaying the fiscal strain until after the 1994 gubernatorial election. *See* Kevin Sack, *McCall Seeks Repayments For Pension*, N.Y. TIMES, Dec. 7, 1993, at B1.

The Minnesota Court of Appeals found otherwise, in Minneapolis Teachers Retirement Fund Ass'n, et al v. State, 490 N.W.2d 124 (Minn. Ct. App. 1992).

[9] PETER DRUCKER, THE POST-CAPITALIST SOCIETY 75 (1993).

[10] Association of Surrogates and Supreme Court Reporters, 588 N.E.2d 51.

[11] Hughes, 838 P.2d 1018.

[12] Spiller, 627 A.2d 513.

[13] Baltimore Teachers Union, 6 F.3d 1012, *cert. denied*, 114 S.Ct 1127.

[14] *See infra* Part II.

[15] Saul Hansell, *How Success Spoiled The European Currency System*, N.Y. TIMES, Aug. 8, 1993, sec. 4, at 3. ("The pension funds of American workers now have $150 billion invested overseas, 20 times the level of a decade ago.") *See also* Patrick E.

This Article will critically examine these important and broadly related defensive and offensive initiatives by public sector active workers and retirees and their pension plan funds, primarily from the policy perspectives of labor and employment law.[16] By affirmatively resisting the manipulations of politicians,[17] and by concurrently militating successfully for transitions in the chief executive leadership of poorly performing corporations, public sector workers and their pension plan funds have the potential to become positive and forceful instruments for social change[18] and for social justice.[19] Part I of the Article will analyze the two most salient state court decisions from New York and

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Tyler, *Big Funds Giving China a First Look*, N.Y. TIMES, Sept. 7, 1993, at D1 (United States based pension funds now investing about ten percent of their capital overseas).

[16] Most commentators have evaluated these issues from primarily a corporate law perspective. *See* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993). *But see* Michael A. Calabrese, *What Labor Wants: A Union Perspective On Pension Fund Shareholder Activism*, THE CORPORATE GOVERNANCE ADVISOR, January/February, 1994, at 24.

Earl A. Wilson, *Social Investing Under ERISA: Can it Be Used to Help Rebuild Our Inner Cities?*, N.Y.S.B.A. LABOR AND EMPLOYMENT LAW SECTION NEWSLETTER, March 1994, at 36 (arguing that ERISA's liability standards for pension plan trustees permit socially-conscious investments).

[17] Secretary of Labor Robert Reich has urged corporations to decelerate layoffs, and to reconsider alternatives, in remarks to the Council of Institutional Investors, a trade group representing large corporate and public pension funds. "I am questioning whether we have gone too far in corporate downsizing . . . [c]utting payrolls may not be the most effective way of improving corporate performance. There are a lot of nonfinancial criteria that don't show up on a balance sheet and are hard to get your hands on." Leslie Wayne, *U.S. Official in Plea to Pension Funds*, N.Y. TIMES, Oct. 12, 1993, at D2. The economy continues a jobless malaise. *See* Richard Barnet, *The End of Jobs?*, HARPER'S, Sept. 27, 1993, at 47; Christopher Byron, *The Big Hurt: Corporate America's Crash Diet*, NEW YORK, Oct. 18, 1993, at 26.

[18] I do not naively believe that these recent initiatives will alone radically transmogrify or collapse the prevailing control-ownership dichotomy in the corporate law regime of capitalist political economy. *See* ADOLPH. BERLE & GARDNER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933). Morton Horwitz has incisively presented an intellectual platform for furthering deep critiques of the prevailing historical bifurcation between ownership and effective control in, and of, the modern corporation. *See* MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860 (1977); MORTON HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY (1992). I suspect that the bifurcation between ownership and control essentially will continue for the foreseeable future, although perhaps evolving in unusual ways. Peter Drucker, for example, has long advocated and critiqued mediated ownership by investors, usually by major institutional investors such as pension funds. *See* DRUCKER, *supra* note 9.

[19] For a comprehensive discussion of social justice in capitalist political economy, see MICHAEL NOVAK, THE CATHOLIC SOCIAL ETHIC AND THE SPIRIT OF CAPITALISM (1993).

Oregon in 1992, protecting public workers' current compensation and future pension retirement security. Part II will examine the two decisions in 1993 from Maine and from the Fourth Circuit, both in favor of the state. The analysis will focus especially on the problematic renaissance of the Contracts Clause of the United States Constitution, which provides: "No state shall pass any law impairing obligations of Contracts."[20] Part III will focus on corporate reforms through public pension fund activism. A largely narrative chronology will be followed by assessments of the proactive stance of public employee pension plan funds, which have had the effect of spurring major changes in corporate executive leadership and in corporate governance.

Public workers and their pension plan funds can and must resist the short-term expediency of politicians, by holding the state as employer to its fundamental contractual promises. Public pension plan funds can also be powerful instruments for reform in corporate governance. Because these recent developments are very dynamic and have not yet been definitively resolved, the final sections of the Article will be presented in both narrative and critical formats.

II. Resisting The State: Preserving Current Compensation and Pension Retirement Security

A. *Association of Surrogates and Supreme Court Reporters Within the City of New York v. State of New York*[21]

New York State unconstitutionally attempted to offset anticipated state budget shortfalls for its 1991-92 fiscal year by effecting a payroll lag upon union-represented and unrepresented nonjudicial employees of the unified court system. Through state Finance Law § 200 (2-b), New York attempted to pay certain state employees for nine days instead of ten in biweekly salary paychecks over five payroll periods. The ten days of unpaid wages would be deferred and payable at an employee's separation from service. The state valued the deferred wages at $10.7 million.[22] In the courts below,[23] the plaintiffs were granted summary judgment and the statute was declared an unconstitutional violation of the Contracts Clause of the United States Constitution.[24]

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[20] U.S. Const., art. I, § 10.

[21] This decision culminated a series of litigation. *See* Association of Surrogates and Supreme Court Reporters v. New York, 749 F. Supp. 97 (S.D.N.Y. 1990), *rev'd*, 940 F.2d 766 (2nd Cir. 1991), *cert. denied*, 112 S.Ct. 936 (1992); 24 P.E.R.B. P. 7546 (Sup.Ct. 1991), *aff'd*, 577 N.Y.S.2d 386 (1st Dept. 1991), *aff'd*, 588 N.E.2d 51 (N.Y. 1992).

[22] 588 N.E.2d at 52.

[23] *See supra* note 21. For a discussion of this earlier litigation history, see Mary Helen Moses, *Scope of Bargaining And the Triborough Law: New York's Collective Bargaining Dilemma*, 56 Alb. L. Rev. 53, 89-95 (1992).

[24] Article I (10)(1) provides that "No state shall . . . pass any . . . law impairing the Obligation of Contracts." This fundamental freedom of contract principle has had an interesting evolution in constitutional law. At its most notorious, the clause was used

The New York Court of Appeals affirmed.[25] The court determined that the plaintiffs had a valid existing contract at the time of the payroll lag statute's enactment. While the collective bargaining agreement technically expired on March 31, 1991, before the statute's enactment, the continuation of benefits clause in the State Civil Service Law operated to extend the substantive provisions of the labor contract until the new agreement was reached.[26] This legal fiction created by statute prevented any lapse in the substantive provisions of the expired labor contract. The continuation of benefits clause protects the labor relations bargaining power of state employees with their public employers, a quid pro quo since public sector employees in New York are forbidden to strike.

After establishing the existence of a contract, the court measured the payroll lag statute against the Contracts Clause of the United States Constitution and found it to be constitutionally deficient.[27] The court balanced the constitutionally protected contract rights of the public sector workers against the "'essential attributes of sovereign power . . . necessarily reserved by the states to safeguard the welfare of their citizens.'"[28] The New York statute substantially impaired the constitutionally protected right to contract in a fashion that was unreasonable and unnecessary to accomplish the state's

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by the Court's reactionary majority to vindicate their personal political choices in the paradigm substantive due process case, Lochner v. New York, 198 U.S. 45 (1905). *Lochner* spawned a huge body of highly critical legal literature. For one recent study of the *Lochner* regime, see HOWARD GILMAN, THE CONSTITUTION BESEIGED: THE RISE AND DEMISE OF LOCHNER ERA POLICE POWERS JURISPRUDENCE (1993). For other influential critiques, see, for example, Felix Frankfurter, *Hours of Labor and Realism in Constitutional Law*, 29 HARV. L. REV. 353 (1916); Robert Hale, *The Supreme Court and the Contract Clause*, 57 HARV. L. REV. 621 (1944); Learned Hand, *Due Process of Law and the Eight Hour Day*, 21 HARV. L. REV. 495 (1908); Morton J. Horwitz, *Foreword: The Constitution of Change: Legal Fundamentality Without*, 107 HARV. L. REV. 30 (1993); Roscoe Pound, *Liberty of Contract*, 18 YALE L.J. 454 (1908-1909); Stephenson, *The Supreme Court and Constitutional Change: Lochner v. New York Revisited*, 21 VILL. L. REV. 317 (1975-1976). In addition to the pertinent cases analyzed in this article, a federal district court in Minnesota most recently invoked the Contracts Clause to strike down as unconstitutional a Minnesota law that retroactively changed the terms of a workers' compensation insurance fund. *In re* Workers' Compensation Refund, 842 F. Supp. 1211 (D.Minn. 1994).

[25] *See supra* note 21.

[26] § 209-a(1) (e). This feature of public sector labor relations in New York, which generally continues the provisions of the public sector collective bargaining agreement in effect beyond the labor contract's expiration date, is known as the "Triborough Doctrine." For extensive discussion, see *supra* note 23. *See also* Stephen F. Befort, *Public Sector Bargaining: Fiscal Crisis and Unilateral Change*, 69 MINN. L. REV. 1221, 1268-69 (1985); Michael T. Boyce, *New York's Triborough Doctrine: Unilateral Changes in the Terms and Conditions of Employment During a Contractual Hiatus in the Public Sector*, 9(4) J. COLLECTIVE NEGOTIATIONS 361 (1980).

[27] Association of Surrogates and Supreme Court Reporters, 588 N.E.2d at 54.

[28] *Id.* (quoting United States Trust Co. v. New Jersey, 431 U.S. 1, 21 (1977)).

immediate fiscal purpose. The burden imposed on the public workers by immediately witholding ten percent of their earned compensation over a period of months and until their separation from employment was very substantial, particularly in light of the workers' "monthly debt payments and daily expenses for food and the other necessities of life."[29] The court concluded that the state could meet its fiscal austerity goal of achieving a reduced budget through less harmful alternatives.[30]

The court also protected the compensation of the adversely affected public sector employees who were not represented by a union and not covered by a collective bargaining agreement. Noting that it would be foolish to "invalidate the dog, while preserving the tail," the court found that the legislature could not burden so disproportionately such a small segment of the state's employees with the payroll lag statute.[31] Thus, the workers' compensation rights were construed to be constitutionally grounded, beyond the terms of any particular collective bargaining agreement.

B. *Hughes v. Oregon*[32]

In 1992, the Oregon Supreme Court nullified a state law[33] that removed state income tax exemptions for Oregon public employee retirement benefits, to the extent the new law related to benefits accrued or accruing for work performed before the statute's enactment. In light of the promissory language of an earlier Oregon statute[34] and in the context of that statute's enactment as part of the Public Employees' Retirement System (PERS), the public employees had a contract with the state of Oregon which entitled them to receive PERS pension benefits free from Oregon state and local taxation. The 1991 amendment purporting to subject their Oregon PERS pensions to Oregon state taxation unconstitutionally impaired the contract.[35]

In 1945, the Oregon legislature enacted the Public Employees' Retirement Act, which explicitly provided that public employee pension annuities, retirement allowances, and death benefits "shall be exempt from all state, county, and municipal taxes."[36] This was an obviously holistic, integrated view of compensation. Pensions were regarded as an important, deferred component of compensation, rather than an entirely separate and distinct gratuity at the suf-

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29 *Id.*

30 *Id.* Unfortunately, the court's suggestions were not specific.

31 *Id.*

32 838 P.2d 1018 (Or. 1992). For an earlier case, see Herrick v. Lindley, 391 N.E.2d 729 (Ohio 1979) (holding that the tax exemption for state pension was not a vested right and could be rescinded, due to the government's fundamental power to tax).

33 1991 Or. Laws 823, § 1.

34 OR. REV. STAT. § 237.201 (1989).

35 Article I (10)(1) of the United States Constitution and Article 1 (21) of the Oregon Constitution were involved. The latter provides that "No . . . law impairing the obligation of contracts shall ever be passed." OR. CONST., Art. I, § 21.

36 1945 Or. Laws 401, § 23.

ferance of the state. In 1969, the statute was amended to provide that the tax exemption be applied to "all state, county and municipal taxes heretofore or hereafter imposed."[87] This language was essentially maintained in the 1989 amendments. The statute disputed in this case provided:

> The right of a person to a pension, an annuity or a retirement allowance, to the return of contribution, the pension, annuity or retirement allowance itself, any optional benefit or death benefit, or any other right accrued or accruing to any person under the provisions of ORS 237.001 to 237.315, and the money in the various funds created by ORS 237.271 and 237.281, shall be *exempt from garnishment and all state, county and municipal taxes heretofore and hereafter imposed* . . . [88]

In *Davis v. Michigan Dept. of Treasury*,[89] the United States Supreme Court

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[87] 1969 Or. Laws 640, § 13.

[88] OR. REV. STAT. § 237.201 (1989) (emphasis added).

[89] 489 U.S. 803 (1989). *See also* Harper v. Virginia Dep't of Taxation, 113 S.Ct. 2510 (1993), where the Court invalidated a Virginia statute denying federal employees retroactive relief for refund claims made in light of *Davis*. After the Virginia Supreme Court upheld the statute, the Court vacated and remanded, relying on James B. Beam Co. v. Georgia, 501 U.S. 529 (1991), where the Court ordered that an earlier decision prohibiting a state from imposing higher excise taxes on imported alcoholic beverages than on its own products applied retroactively "to claims arising from facts predating that decision." Harper, 113 S.Ct. at 2515.

On remand, the Virginia Supreme Court again reversed, reasoning that *Davis* would not apply retroactively to the present case because Michigan did not contest the *Davis* plaintiffs' entitlement to a tax refund. Upon granting certiorari a second time, the Court again reversed. "Far from reserving the retroactivity question, our response to (Michigan's) concession constituted a retroactive application of the rule announced in *Davis* to the parties before the Court. Because a decision to apply solely prospective effect to *Davis* would have foreclosed any discussion of remedial issues, our 'consideration of remedial issues' meant 'necessarily' that we retroactively applied the rule we announced in *Davis* to the litigants before us." *Id.* at 2518 (citations omitted). The Court also rejected the Virginia Department of Taxation's argument that independent and adequate state grounds relieved the state's obligation to apply *Davis* retroactively. *Id.*

In July 1994, the Virginia General Assembly voted to refund $340 million to 186,000 retired federal workers as part of a package that will prove $713 million in retirement benefits and tax cuts over the next five years to Virginians over 62. *See* Peter Baker, *Va. to Repay Pension Tax*, WASHINGTON POST, July 9, 1994, at Al. As part of the refund settlement, leaders of the retiree organizations agreed to sacrifice interest payments. *Id.* Virginia officials will probably have to scale back plans to build prisons and improve education to pay for the reforms. *Id.*

The post-*Davis* and post-*Harper* lines of cases promise to become even more complex. On February 22, 1994, the Supreme Court granted certiorari to decide whether the state of Georgia provided clear refund remedies to federal retirees who paid state income taxes that were illegal under the doctrine of intergovernmental immunity. Reich v. Collins, *cert. granted*, 114 S. Ct. 1048 (1994). However, West Virginia's highest court recently held that a state law exempting from state tax computation the penheld that states which make pension benefits paid by state and local governments exempt from state taxation must similarly make pension benefits paid by the federal government to retired federal workers also exempt from state taxation. A failure of the state to tax state and federal pensions alike, or to exempt alike, violates constitutional principles of intergovernmental tax immunity. Oregon's response to this decision, predictable in this age of fiscal austerity, was to subject PERS pension benefits of retired state workers to state taxation, rather than to exempt federal pension benefits from state taxation.

The retired Oregon public employees argued that PERS constituted an offer by Oregon for a unilateral contract. Thus, when they originally accepted employment with either the state or a political subdivision of the state, they also accepted the contract of pension benefits exempt from taxation in Oregon. They contended that the pension tax exemption is a contract term with the state. Finally, the employees argued that the 1991 amendments purporting to rescind the prior law's exemption unconstitutionally impaired the state's obligation not to tax PERS retirement benefits. In the alternative, they contended that taxing PERS benefits would be an unconstitutional, uncompensated governmental taking of their property.[40]

Oregon conceded the existence of a contract, but contended that the state may not contract away its sovereign power of taxation and that the state law[41] was not intended to be a promissory or contractual statute. Oregon further argued that the state's removal of the tax exemption for its state pensions is, at most, a mere breach of the contract, not an unconstitutional impairment. The state repudiated the employees' compensation deprivation argument as premature, because the active employees had not yet sought their pension compensation free from state taxation.

The Oregon Supreme Court commenced its analysis by recognizing that although a state may not contract away its police power,[42] the police power does not preclude a state from binding itself to a contract that provides tax exemptions.[43] The state maintained that its power to tax was analogous to the state's police power, and therefore was noncontractual. According to the court,

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sions of retired state and local police officers and firefighters, but no other government retirees, did not discriminate against federal retirees. In Brown v. Mierke, 443 S.E.2d 462 (W.Va. 1994), the court reversed a circuit court's decision that the statute violated the doctrine of intergovernmental tax immunity. The court held that statute did not implicate the *Davis* rationale because state and federal retiree pensions are not fully taxed in West Virginia, and only the pensions of police officers and firefighters are exempt.

[40] Hughes, 314 Or. at 11.

[41] *Id.* at 11-12.

[42] *Id.* at 14 (citing Eckles v. State of Oregon, 306 Or. 380, 399 (1988)).

[43] *Id.* at 15 (citing The Piqua Branch of the State Bank of Ohio v. Knoop, 57 U.S. (16 How.) 369 (1853)) (expressly allowed state to enter into contract to provide a tax exemption); New Jersey v. Wilson, 11 U.S. (7 Cranch) 164 (1812) (New Jersey repeal of tax exemption on land grant violated federal Contract Clause)).

although a state may not be contractually bound absent legislation that unambiguously expresses an intention to create a contract, succeeding legislatures may be constained by contracts formed by their predecessors, including those providing tax benefits for pensioners.[44]

The court concluded that Oregon unambiguously expressed an intention to create a contract for tax exempt PERS retirement benefits. In 1953, the legislature repealed the 1945 Act but made careful provision to account for and guarantee payments of all rights accrued under the pre-1953 retirement system, including tax exemptions. The court referred to the Attorney General's positive response to the 1953 change, preserving the vested retirement rights of public employees. The Attorney General noted that "a pension right is an integral right of contemplated compensation . . . protected by the contract clause of the Constitution . . . [and] cannot be destroyed by a repeal of a statute without the enactment of a substitute."[45] Thus, the court concluded that when the legislature in 1953 enacted changes to the 1945 law, PERS continued to constitute an offer for a unilateral contract.[46] When this offer is accepted by the employee's tender of part performance, the employee obtains a vested property right which can only be terminated prospectively by the employer.[47]

After establishing the contractual intent of the legislature, the Oregon Supreme Court determined that the tax exemption for Oregon state pensions was intended to be a term of the PERS contract. The court looked to the context and purpose of the PERS contract and especially noted that the facial language of the 1989 law manifested promissory, contractual legislative intent.[48] The law in 1989 provided that PERS benefits paid "shall be exempt from all state, county and municipal taxes *heretofore or hereafter imposed* . . . ." Thus, the 1989 language was virtually identical to the earlier 1945 and 1953 legislation, which also was promissory and contractual upon enactment. The court concluded that the 1989 law likewise was a term of the PERS contract. Therefore, Oregon was constitutionally prohibited from impairing the terms of the contract without the consent of the PERS beneficiaries.

The court next addressed those PERS benefits specifically exempt from state taxation. Without the aid of an extensive legislative history, the court focused primarily on the express language of the statute: "[t]he right of a person to a pension, an annuity or a retirement allowance, to the return of contribution, the pension, annuity or retirement allowance itself, any optional benefit or death benefit, or any other right *accrued* or *accruing* to any person . . . ."[49] According to the court, the statute unambiguously addressed benefits that had accrued or were accruing under PERS, but did not refer to benefits that may accrue in the future. From this, the court inferred that "[b]ecause

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[44] *Id.* at 13 (citing Fletcher v. Peck, 10 U.S. (6 Cranch) 87 (1810)).

[45] *Id.* at 19-20 (citing 26 Op. Att'y. Gen. 81 (1953)).

[46] *Id.* at 20.

[47] *Id.*

[48] OR. REV. STAT. § 237.201 (1989).

[49] 314 Or. at 20.

the legislature did not include benefits that may accrue in the future as compensation for work not yet performed within the scope of the tax exemption, we may not include them."[50] Thus, the 1989 law permanently exempted only PERS benefits that accrued or were accruing for work performed so long as the 1989 law remained in effect.[51] The amendments on September 28, 1991 marked the end of that protection for pension benefits accruing for work performed after that date. Significantly, the court found that the legislature did not contract away in perpetuity its ability to tax PERS benefits that may accrue in the future, based on work not yet performed. Thus, any taxation of unaccrued PERS benefits would not constitute an impairment or breach of the state's contractual obligation.

Section 1 of the 1991 law was found to impair unconstitutionally an obligation of the PERS contract, because it unilaterally eliminated the state's obligation to exempt income tax on benefits accrued on or before the effective date of the 1991 Act. Thus, the state's attempt to subject formerly exempt PERS benefits without contractual liability to the affected public employees is directly prohibited by Article I, section 21 of the Oregon Constitution.[52]

Section 3, however, was found not to violate the Contract Clause of either the federal or state constitution. The court noted that Section 3 "deals with the tax exemption that arises out of the contractual obligation. The exemption in the tax laws is only a mirror of the obligation; it is not the obligation itself."[53] Under the power of eminent domain, the state may breach a contract without violating the Constitution.[54] According to the court, Section 3 repealed the tax exemption[55] and therefore breached the tax exemption term of the PERS contract the state had with the public employees. As a result of this breach by the state, the employees were entitled to a remedy, although the breach itself did not rise to the level of unconstitutionality.

III. The Power of the State: The Erosion of Public Sector Retirement Pension Security and Current Compensation

A. *Spiller v. Maine*[56]

The Maine State Retirement System was created in 1942 to encourage "qualified persons to seek public employment and to continue in public employment during their productive years." Membership in the retirement system is mandatory for state employees, including teachers. For certain

[50] *Id.*

[51] *Id.* at 29.

[52] *Id.* at 31. The Contracts Clause of the U.S. Constitution, Art. I (10)(1), was not violated because the court found that the state violated its contract with the workers.

[53] *Id.* at 32.

[54] *Id. See also* West River Bridge Co. v. Dix, 47 U.S. (6 How) 507 (1848); Ogden v. Saunders, 25 U.S. (12 Wheat) 213 (1827).

[55] Or. Rev. Stat. § 316.680(1)(d) (1989).

[56] 627 A.2d 513 (Me. 1993).

elected or appointed officials, membership is optional. In addition, judges are required to be members of the Maine Judicial Retirement System and legislators must belong to the Maine Legislative Retirement System. Employees contribute 6.5% to 7.5% of their salaries to the fund and the state provides additional contributions to maintain funds sufficient to discharge pension obligations. State employees do not qualify to receive service retirement benefits until they have at least ten years of creditable service. Employees also may qualify for service retirement benefits if they were in state service for one year immediately before the statutory age for retirement. Members of the system are entitled, at a minimum, to the return of their contributions, together with interest, if their service terminates prior to vesting. In addition, the legislature provided that certain benefits offered by the retirement system, such as life insurance and disability retirement benefits, are immediately vested and due, regardless of the employee's length of service.

In 1991, the state government experienced a significant shortfall in revenue. As part of an effort to reduce state expenditures, the legislature modified the prospective retirement benefits for all state employees with fewer than seven years of creditable service as of December 1, 1991. These statutory changes excluded from the definition of "earnable compensation" payment received for unused sick or vacation leave; raised the minimum age for retirement with full benefits by two years to age sixty-two; and increased the penalty via reduced benefits for retirement before the minimum age. The total savings from these and other modifications not at issue in the present case were estimated at $8,850,000 for fiscal year 1991-92 and $25,550,000 for fiscal year 1992-93.

Plaintiffs, the Maine State Employees Association and a certified class of all current and former state employees whose employment commenced prior to the enactment of the modifications and who did not have seven years of creditable service on December 1, 1991, brought action in the Kennebec County Superior Court. The plaintiffs sought injunctive relief, as well as a declaratory judgment that the modifications violated the contract clauses of both the Maine and United States Constitutions. The parties stipulated to the essential facts and moved for summary judgment. Although the plaintiffs alleged a taking of property without compensation and without due process, the court decided the case on the basis of the contract clauses. The court construed the retirement statute to give, on acceptance of employment, contractual rights to pension benefits and concluded that the state's modifications substantially impaired those rights. While the court agreed that the state's goal of reducing its deficit was a significant and legitimate public interest, it found that the solution proposed was neither reasonable nor necessary to accomplish that task. Accordingly, the court held that the statutory modifications violated the contract clauses of both the Maine and United States Constitutions and enjoined the enforcement of the modifications.

On appeal, the Maine Supreme Judicial Court, in a 5-2 decision, vacated the decision and remanded the case. The majority held that statutes establishing pension benefits for the state employees did not create contractual rights. Accordingly, the modifications violated neither the right of due process nor the contractual obligations of either constitution.

The Maine Court justified its holding by citing the Supreme Court in *National R.R. Passenger Corp. v. Atchison, Topeka & Santa Fe Ry. Co.*,[57]

> Absent some clear indication that the legislature intends to bind itself contractually, the presumption is that "a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the legislature shall ordain otherwise." This well-established presumption is grounded in the elementary proposition that the principal function of a legislature is not to make contracts, but to make laws that establish the policy of the state. Policies, unlike contracts, are inherently subject to revision and repeal, and to construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body.[58]

The court found no clear indication of a legislative intent to create immutable contractual rights, but rather, only a statement of general policy principles. In support of this proposition, the majority opinion cited section 17801 of the statute, which provides "only those retirement benefits that would be due a member on the date immediately preceding the effective date of the amendment cannot be reduced." Since none of the benefits at issue in this case were due to any plaintiff on the effective date of the legislation, the court found this action to be constitutional.

The court recognized the legislature's fundamental prerogative to reserve to itself the implicit power of statutory amendment and modification. Implicitly noting a desire not to "unduly restrict the power of the legislature," the court declined to imply contractual rights in the absence of a clear statutory intention to create such rights. However, the court noted that state employees do have certain legitimate retirement expectations that are more than a gratuity to be granted or withheld arbitrarily at the whim of the sovereign state. The court suggested two possibilities: either pension expectations may constitute property rights that the legislature cannot deprive people of without due process of law, or the state may be estopped from changing certain benefit provisions. The court nevertheless rejected both.

The dissent found that the plaintiffs had a contractual right to benefits under the state pension system. Whereas the majority found that a statute must expressly provide for a contract, the dissent posited a more complex analysis. Although a clear statement in a statute that it constitutes a contract would be helpful, the dissent did not find it an absolute requirement. Instead, the dissent reasoned that consideration should be paid to the generally accepted theory of pensions as deferred compensation, the legislature's statement of intent in creating the State Retirement system, and the expectations that the legislature had fostered among public employees. Quoting *Indiana ex*

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[57] Natl. R.R. Passenger Corp. v. Atchinson, Topeka & Santa Fe Ry. Co., 470 U.S. 451 (1985).

[58] 627 A.2d. at 515 (quoting 470 U.S. at 465-66 (1985)).

rel. Anderson v. Brand,[59] the dissent noted:

> The principal function of a legislative body is not to make contracts but to make laws which declare the policy of the state and are subject to repeal when a subsequent legislature shall determine to alter that policy. Nevertheless, it is established that a legislative enactment may contain provisions, which when accepted as the basis of action by individuals, become contracts between them and the State or its subdivisions within the protection of the contract clause of the United States Constitution.[60]

According to the dissent, although no express contract for pension benefits existed, the statutes and the historical record should give rise to an implied contract requiring the state to discharge its obligation to pay deferred compensation by providing pension benefits. The state's ability to pay this deferred compensation in the future was assured by the employees' contributions and the state's obligation to contribute to the pension fund. By providing services and deferring compensation, plaintiffs acquired contractual rights to a pension conditioned upon remaining in state employment for the required length of time.

Moreover, the dissent noted that the legislature historically treated pension benefits as deferred compensation when making changes to the retirement system, citing comments from a 1984 floor debate on prospective changes in pension benefits.[61] Although the dissent recognized the state's authority to discharge employees in times of financial stress, as well as its right to substitute benefits of equal value, the dissent argued that the state had no right to diminish the level of benefits while employment continued.

The majority considered the question of whether there was a contract. By contrast, the dissent suggested the question was whether the statutory modifications to the pension plan substantially impaired the contractual relationship between plaintiffs and the State. It answered this question affirmatively, relying on caselaw from other jurisdictions where substantial impairment was found to result from legislation that increased the minimum age at which retirement benefits may be paid; required state employees to take unpaid leave; deferred employees' pay; and doubled employee contributions to a pension plan without an increase in benefits.

Noting that the state may impair the contractual relationship if it has a

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[59] 303 U.S. 95 (1938).

[60] 627 A.2d at 516 (quoting 303 U.S. at 100 (1938)).

[61] "This bill grandfathers every state employee on the payroll today. . . " *Id.* at 518-19, (quoting 484 Cong. Rec. (1984) (statement of Rep. Paradis)); "T]he bill is no attempt, either to gain revenues from state employees or to break faith in any way with either former employees currently on the retirement rolls or with those that are in the work force today." *Id.* at 519, (quoting 590 Cong. Rec. (1984) (statement of Sen. Collins)). "Those people already in the system, in effect, have a lifetime contract as to the nature of their retirement system. They stay with what we have on the books." *Id.* at 518, (quoting 484 Cong. Rec. (1984) (statement of Rep. Hickey)).

legitimate and significant public purpose, the dissent stressed that no less drastic modification or alternative must be available to achieve the public purpose. Quoting *United States Trust Co. of New York v. New Jersey*, the dissent noted:

> A government entity can always find a use for extra money, especially when taxes do not have to be raised. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all.[62]

When dealing with a general deficit in the state budget, the contract clauses of both the state and federal constitutions limit the state's ability to impair the obligations of its own contracts without resorting to more drastic reductions of noncontractual expenditures or to increasing revenues. The choice to impair contractual rights must not be an equally valid choice among other policy alternatives.

B. *Baltimore Teachers Union v. Mayor of Baltimore.*[63]

In fiscal year 1992, the City of Baltimore negotiated a number of contracts with its teachers and police. Following approval of the contracts, but prior to their expiration, the city found itself unable to meet its financial obligations due a sizable decrease in state funding. In response to this cutback, the city implemented a "furlough plan," under which full-time city employees lost the equivalent of 2.5 days of pay or .95% of their gross annual salary. Several unions representing city employees brought suit, alleging a violation of the Contracts Clause of the United States Constitution. The United States District Court for the District of Maryland ruled in their favor.[64]

On appeal, the City prevailed before the United States Court of Appeals for the Fourth Circuit.[65] Three issues were under consideration: first, whether an impairment of contract occurred; second, if there was an impairment, whether it was substantial; and third, whether a substantial impairment was nonetheless constitutionally permissible.

The Fourth Circuit found that there had been an impairment, because the plaintiffs received less in salary than that to which they were contractually entitled. The state's ability to change its appropriation to the City of Baltimore was, as a matter of law, known to all parties. Therefore, the city had taken a risk when it negotiated agreements and fixed budgets that relied on state aid, without knowing whether that aid would materialize in the necessary amount, especially since the city had been warned that it was likely that it would not. According to the Fourth Circuit:

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[62] United States Trust Co., 431 U.S. at 26.

[63] 6 F.3d 1012 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1127 (1994).

[64] 801 F.Supp 1506 (C.D. Md. 1992).

[65] 6 F.3d 1012 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1127 (1994).

> But into all contracts, whether made between states and individuals, or between individuals only, there enter conditions which arise, not only out of the literal terms of the contract itself; they are superinduced by the pre-existing and higher authority of the laws of nature, or nations, or of the community to which the parties belong; they are always presumed to be known and recognized by all, are binding upon all, and need never therefore be carried into express stipulation, for this could add nothing to their force. Every contract is made in subordination to them, and must yield to their control, as conditions inherent and paramount, wherever a necessity for their execution shall occur.[66]

In a concurring opinion, one judge found no impairment of a contract in the constitutional sense because the City's actions were authorized by statutory and charter provision.[67] Thus, he would have reversed and remanded without further investigation. Nonetheless, the majority disagreed and proceeded to resolve the other issues presented.

Because the Supreme Court has never defined with any certainty the substantiality of an impairment, the second issue was not easily resolved. The court of appeals relied on a series of cases to resolve that, at the very least, where the right impaired was one that induced the parties to enter into the contract and upon which they have especially relied, the impairment must be considered substantial for purposes of the Contracts Clause. Noting that from an employee's perspective, there is likely nothing more central to a contract's formation than the right to compensation at a specified level, the court held that the salary reductions did constitute a substantial impairment of the employees' contract.

The Fourth Circuit did rely on the Supreme Court's decision in *United States Trust Company v. New Jersey*,[68] which held that "the Contract Clause is not an absolute bar to subsequent modification of a State's own financial obligations."[69] In the same opinion, the Court suggested that the function of the judiciary is to foster the reconciliation of "the strictures of the Contract Clause with the 'essential attributes of sovereign power' necessarily reserved by the States to safeguard the welfare of their citizens."[70] Thus, the Fourth Circuit concluded that as long as the response is a reasonable and necessary solution to an enduring public problem, states may constitutionally impair contractual agreements.

Both sides agreed that ensuring the financial integrity of the City was a significant public purpose. The plaintiffs argued, however, that the furlough plan was neither reasonable nor necessary to achieve this purpose. The court disagreed, accepting the City's argument that, in light of its legal requirement

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[66] *Id.* at 1025.

[67] *Id.* at 1025, n.4 (Widener, J., concurring) (quoting Long Island Water Supply Company v. City of Brooklyn, 66 U.S. 685, 692 (1897))

[68] 431 U.S. 1 (1977).

[69] *Id.* at 25.

[70] *Id.* at 21.

to balance its budget, the city took needed and measured steps to absorb extraordinary reductions in revenue. According to the City, since personnel costs constituted a substantial percentage of the plaintiffs' expenditures—91.8% of the Police Department budget and 82.5% of the Public School budget—they could not reasonably be spared.

The court relied on a four-part test announced by the Supreme Court in *Allied Structural Steel Co. v. Spannaus*,[71] to support its conclusion that the furlough plan was a reasonable impairment that survived a Contracts Clause challenge. Under the first prong of the test, the plan must have been designed to "deal with a broad, generalized economic or social problem."[72] The court found that the City, which was "approaching the point where it had to begin cutting basic services and initiating the breakdown of government,"[73] satisfied this element. Second, the court found that Baltimore's plan did not target specific classes of employees because it extended to all city workers.

Under the third prong of the test, the issue is whether the plan affected reliance interests similar to those of private entities in regulated industries which contract subject to future, additional regulations. The court ruled that since city employees are "public servants" and their expectations are defined, at least in part, by the public interest, it should not be wholly unexpected for them to sacrifice first when there is a public necessity.

Finally, the court held that the city's discontinuation of the plan at the first opportunity, and the lack of evidence that similar measures would be employed in the future, indicated that the plan was simply a temporary alteration of the contractual relationship. Accordingly, the court concluded that the furlough plan, although a substantial impairment, satisfied the *Spannaus* test and did not violate the Contract Clause of the United States Constitution.

IV. Reforming The Corporation

This section of the Article will discuss and analyze recent successful corporate governance reform initiatives spurred by public employee pension funds. Special, but not exclusive, attention will be devoted to initiatives of the largest and most aggressive of the state public employee pension funds, the California Public Employees Retirement System (Calpers).

The Calpers model powerfully demonstrates that stockholder activism by public sector pension funds can have very positive influences upon corporate profitability through effective corporate leadership. In 1990, when it initiated its corporate reform agenda, Calpers first targeted the twenty-four poorest performing companies within its stock portfolio. These companies lagged in the Standard and Poor's ("S & P") 500 Index by an average of 86 points between 1985 and 1989. When Calpers threatened to wield its considerable economic power, the performance of these companies improved dramatically,

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[71] 438 U.S. 234, 250 (1978).

[72] *Baltimore Teachers Union*, 6 F.3d at 1021 (quoting *Spannaus*, 438 U.S. at 250).

[73] 6 F.3d at 1021 (quoting Brief of Appellant at 21).

soon exceeding the S & P 500 average performance by 109 percentage points.[74] During the civil rights and anti-war movements of the 1960s and 1970s, shareholder activism focused on these social causes. This pattern remained consistent in the 1980s when "Free South Africa" was the reforming shareholder's battle cry.[75] This pattern has changed dramatically in the 1990s. Shareholder activists are now much more concerned with traditional economic issues, such as corporate strategy, "golden parachutes," and poor executive performance that debilitates corporate profitability and decreases the value of shares. The goals of present-day shareholder activists focus upon regaining control over investments and making corporate directors more accountable to shareholder interests.

The Calpers approach is rapidly becoming the rule of conduct for institutional investors seeking to achieve higher returns from their corporate holdings. In the words of John Pound of Harvard's Kennedy School of Government, "In this decade, politics will replace takeovers as the defining tool of corporate accountability."[76] Pound should know. He was instrumental in the formation of New Foundations, a thirty-member working group of leaders from corporations, institutional investing, and academia that seeks to restructure corporate boards and improve communication between corporate leaders and shareholders.[77] Presently, entities falling within the umbrella term of "institutional investors," including pension funds, mutual funds, banks, insurance companies, foundations, and endowments, own 53.3% of all publicly traded stock in the equity markets,[78] with a value of $3 trillion.[79] Pound predicts that eighty-percent of all stock may be owned by institutional inves-

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[74] Nell Minow, *Do Your Duty, Retirement Managers*, N.Y. TIMES, Jan. 30, 1994, at F11. *See also* Kevin G. Salwen, *Institutions Are Poised to Increase Clout in Boardroom*, WALL ST. J., Sept. 21, 1992, at B1.

[75] *See* Thomas A. Stewart, *The King is Dead*, FORTUNE, Jan. 11, 1993, at 34 (following 1988 Labor Department rules ordering pension funds to vote the shares in their portfolios for exclusive benefit of plan participants, plan administrators advocate pull-out from South Africa); Jay Hopkins, *Money Managers No Longer Blind to Social Investments*, PENSION WORLD, Apr., 1992, at 10 (reporting Maryland court's findings that any costs incurred from law concerning divestment of South Africa-related stocks "would be insubstantial when compared to the salutary moral principles which generated the ordinance"); John Schwartz, *Doing Good and Doing Well*, NEWSWEEK, June 6, 1988, at 48 (reporting socially-conscious funds refusing to invest in South Africa enjoy success, thanks largely to pension funds); Barnaby J. Feder, *Citibank Is Leaving South Africa; Foes of Apartheid See Major Gain*, N.Y. TIMES, June 17, 1987, at A1 (reporting that Citibank then the last American bank operating in South Africa, decides to withdraw); Jerry Edgerton, *Money and Morals*, MONEY, Dec., 1985, at 153 (reporting that mutual funds guided by South African divestment and other social issues largely outperformed Standard and Poor's stock index).

[76] Patrick Houston, *Rebels With A Cause*, WORTH, Oct./Nov. 1992, at 96.

[77] Leslie Wayne, *Calming Investor Discontent*, N.Y. TIMES, Feb. 3, 1993, at D1.

[78] Houston, *supra* note 76.

[79] Salwen, *supra* note 74.

tors by the year 2000.[80]

Despite very significant corporate stock holdings, public institutional investors traditionally have been quite passive and reluctant to assert their economic power, often allowing activist shareholders with far lesser interests to monitor corporate activity. However, as corporate raiders ravaged companies and left devalued or worthless shares in their wake in the 1980s, pension funds realized that they were among the few influential corporate constituencies that could most effectively keep corporate directors accountable to the shareholder ownership. In earlier times, pension funds would join the mad rush of investors trying to liquidate, at a loss, their holdings in poor-performing companies. Now, when faced with senior corporate managers who are running their companies into the ground, institutional investors demand effective change in corporate leadership.

At first glance, the changes in the shareholder activist movement are a phenomenon best understood within a corporate law and governance framework.[81] These changes, however, also implicate many interrelated labor and employment law and policy issues, which is the primary focus of this Article.

Public pension funds are now among the most vocal corporate activist shareholders. For many years, Dale M. Hanson, the former Chief Executive Officer of Calpers, was the recognized leader of the public employee pension plan corporate activist movement.[82] Created in 1931, Calpers today is the nation's largest public pension fund with over $80 billion in assets. Calpers manages the pension savings of more than 900,000 current and former California state employees. In addition, the fund has at least a one-percent stock holding in more than one thousand American corporations.[83] Considering that a one per-

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[80] Paul Sweeney, *How Calpers Can Ruin A CEO's Day*, GLOBAL FINANCE., Feb. 1993, at 34.

[81] *See generally*, Roberta Romano, *Public Pension Activism in Corporate Governance Revisited*, 93 COLUM. L. REV. 795 (1993).

[82] Andres, *While Head of Calpers Lectures Other Firms, His Own Board Frets*, WALL ST. J., Jan. 29, 1993, at A1. In May, 1994, Dale M. Hanson resigned his position as Calpers' Chief Executive to run a new private investing firm based in San Diego. Sources reported that Hanson was unhappy with his salary at Calpers, listed at $110,000 plus a maximum bonus of $22,000. Donald Woutat, *Calpers Chief Hanson Leaving to Run His Own Firm*, L.A. TIMES, May 19, 1994, at D1.

On September 16, 1994, Calpers named James E. Burton, the fund's executive officer for investments since 1992 and former aide to several California politicians, as new Chief Executive. Andrea Adelson, *Calpers Chooses a Less Adversarial Voice*, N.Y. TIMES, Sept. 17, 1994, at 37. Burton indicated that he will be a less active corporate watchdog than his predecessor. "My intent is to stay focused a little closer to home," says Burton. *Id.* Burton also said that he will concentrate on increasing the use of automation and telecommunications to provide better service to Calpers' one million beneficiaries as well as investing more capital into California's stagnant economy. *Id.*

[83] Calpers also commits as a social investor some of its pension funds to support below market mortgage opportunities to build more community based housing. Michael J. Ybarra, *Two California Pension Funds Launch Initiative to Build Affordable Hous-*

cent holding in many companies is often a multi-million dollar investment, Calpers' incentive towards corporate shareholder activism is apparent.

Dale Hanson effectively used Calpers' economic strength to focus direct attention on poorly performing companies. In 1991, Calpers selected twelve poorly performing companies as targets for its activist agenda. When its attempts to work "behind the scenes" with the senior managers of these corporations proved ineffective, Calpers publicly produced its investor's "blacklist" on March 20, 1992, which indicated that only two of the cited companies had taken any steps towards reform.[84] Calpers also threatened to vote against all the current members of these companies' boards of directors when they ran for re-election. Within six months, eleven of the twelve companies promised reforms.[85] While the particular directors and many business experts argued that forces such as market conditions stimulated reforms, Hanson's deft manipulation of the media undoubtedly provided a significant impetus for his targeted "Dirty Dozen" corporations to enact reforms.

Despite the success of its corporate reform agenda, Calpers directs relatively very little of its resources to its corporate watchdog activities. Corporate activist campaigns cost Calpers approximately $500,000 annually, a fraction

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ing, WALL ST. J., Mar. 16, 1994, at A12 (to support 5,000 new housing units in California over the next three years). Keith Bradsher, *Large Pension Funds to Back Housing for Those With Low Incomes*, N.Y. TIMES, Mar. 15, 1994, at A21.

[84] Richard W. Stevenson, *Hugh Fund Turns Up Proxy Heat*, N.Y. TIMES, Mar. 21, 1992, at D1. Calpers indicated that American Express, Dial and IBM should change their executive compensation policies; Time Warner, Salomon and Hercules should develop more independent boards of directors; and Calpers sought the formation of shareholder advisory committees to discuss issues with the boards of Chrysler, Control Data, Polaroid and US Air Group. Only Ryder Systems Inc. and ITT Corporation had made changes in accordance with Calpers' suggestions. *Id.*

[85] While labor union shareholder activity is increasing, some maintain that Calpers activity declined in 1994; due to its power, more corporations' officers and directors are amendable to negotiating differences with Calpers. Leslie Scism, *Labor Unions Increasingly Initiate Proxy Proposals*, WALL ST. J., Mar. 1, 1994, at C1. Leslie Wayne, *Have Shareholder Activists Lost Their Edge?*, N.Y. TIMES, June 30, 1994, at F7. But Calpers continues to spur change. It owns forty percent of Catellus Development Corporation, and has two seats on the corporate board of directors. By September 30, 1993, the corporation had a net loss of $34.4 million. Calpers is now seeking the termination of Catellus' chairman of the board. Charles McCoy, *Calpers, In A Show Of Clout, Targets For Ouster The Chairman Of Catellus*, WALL ST. J., Feb. 14, 1994, at B2. In addition, Calpers along with other large shareholders, is suing Citizens Utility Company to protest the unusually generous pay package granted to the company's chairman. Calpers owns 762,000 shares of the company stock, worth $15 million. Since June 1993, it had worked diplomatically and internally to persuade the company to adopt governance changes to protect shareholder interests. When its internal negotiation efforts met with little progress, Calpers joined in the shareholder activists' lawsuit. Alison Leigh Cowan, *California Pension Fund To Join In Suing Utility*, N.Y. TIMES, Dec. 17, 1993, at D5.

of its $129 million budget.[86] Only eight of 800 Calpers staff employees work on corporate governance issues, and none on a full-time basis. Calpers directs its shareholder activist strategy by focusing on twelve poorly-performing companies, by initiating shareholder resolutions (including votes against entire slates of directors) to display dissatisfaction with corporate performance, by lobbying the Securities Exchange Commission and Congress, and finally, by litigating against poor performers. Hanson admits, however, that none of these efforts could succeed without the fund's publicity efforts through the news media.[87]

Calpers selects its twelve target companies through an in-house research unit whose selections are subject to approval by Calpers' thirteen member board. While issues such as executive compensation and poison pills are considerations, poor corporate performance is the most important factor for placement on Calper's list of the corporate Dirty Dozen. Calpers does not issue a list of demands to the boards of these companies, but instead asks that leaders without conflicts of interests serve on corporate boards. "We don't have time to micromanage companies," says Calpers Interim C.E.O. Richard Koppes. "We are interested in independent directors—people who ask critical questions and hold management accountable."[88]

Although Calpers primarily credits its publicity campaign for the greatest achievements in its shareholder activist agenda, the fund's lobbying efforts have also proven effective. In 1992, the SEC approved a set of rules that would allow a company's largest shareholders to pressure directly senior corporate managers, without spending millions of dollars to find and contact all the company's shareholders.[89] The new rules also require greater disclosure by companies regarding executive compensation packages. "[The changes] should make it possible for shareholders collectively to have a greater voice concerning the strategic direction of the companies they own," said former SEC Chairman Richard Breeden. "What better group of people to have more say over their companies than their owners?"[90]

Pension funds and other shareholder advocacy groups regard the new rules as an invitation by the SEC to pressure corporate managers. For example, the Council of Institutional Investors, an organization that advises many of the largest institutional investors, has issued a list of the twenty-five worst corporate investments. Likewise, the New York State and Local Pension System has a program of seventeen factors for judging the quality of its holdings.[91] Former New York State Comptroller Edward Regan indicated that the goal of the program was to "make the system so professional, so credible and so

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[86] Sweeney, *supra* note 80, at 34.

[87] *Id.*

[88] *Id.*

[89] 17 C.F.R §§ 240, 249 (1992) (SEC amendments to proxy rules, regarding regulation of Communications among Shareholders.)

[90] Salwen, *supra* note 74.

[91] *Id.*

fair that the C.E.O. will say 'maybe these people have something here' and use it to improve."[92]

New York City's two largest pension funds, the New York City Employees' Retirement Fund and the New York City Teachers' Retirement System, together controlling over $60 billion in assets, identified twenty-four companies in November, 1992, in their efforts to spur corporate reform. "We've targeted companies that are underperformers, where we think changes in the governance structure could improve their financial performance," said Elizabeth Holtzman, New York City former comptroller and a trustee of the two pension funds. "We don't want to run these companies, but we do want to see structures that will let in a breath of fresh air."[93]

Shareholder groups and institutional investors believe the new SEC rules will foster improved communications with shareholders, which will, in turn, increase the profitability of their holdings. "We'll be able to speak to other shareholders and find out what is not going to fly," said Eric Wollman, the administrative manager for the proxy unit of New York City's Public Pension Retirement System.[94]

While the most recent shareholder activist movement has been motivated primarily by corporate profitability, many stockholder activists also hold more idealistic goals. Two issues that have especially galvanized socially-minded shareholder activists are the environment and executive compensation. CERES, a group that includes environmental organizations, investment firms, and other activist organizations, has used its $150 billion in assets to convince Fortune 500 companies to sign the "Valdez Principle," an environmental equivalent of the anti-apartheid "Sullivan Principle" adopted against the former government of South Africa. Other groups have focused on the financial impact that stems from environmental disasters, such as the $2.5 billion that Exxon was ordered to contribute to clean up the Prince William Sound in 1989, and the $5 billion in damages from the related civil law suits in 1994.

Although executive pay is an economic issue, shareholder activist groups like Calpers have demanded that companies take a more socially-conscious approach towards compensation. For example, Timothy Smith, executive director of the Interfaith Center on Corporate Responsibility, an organization that represents religious groups, regards corporate executive pay as an ethical issue: Why did Lee Iacocca receive $4 million a year in "base" pay, while Chrysler's *maquiladora* workers earned about thirty dollars a week?[95] Activist groups also focus upon the shareholder economics of this issue; here the question is how corporate leaders can continue to receive seven-figure annual incomes, while shareholders earn only pennies on their invested dollars?

While American corporations are not unanimously opposed to greater dis-

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[92] *Id.*

[93] Gilbert Fuchsberg, *New York City Pension Funds Target Firms For Corporate Governance Reform*, WALL ST. J., Nov. 6, 1992, at B6.

[94] Salwen, *supra* note 74.

[95] Houston, *supra* note 76.

closure of executive compensation, many worry that the new SEC rules have the effect of taking decision-making authority and accountability away from corporate boards and into the hands of a few large investors. Many corporate leaders fear that the vast economic power possessed by large institutional investors, such as major pension funds, will force boards to relegate the needs of smaller investors to the wayside. They also insist that increased institutional investor power will impede the ability of corporate investors to take bold, decisive action. "I think these rules are going to change the way companies operate and not necessarily for the better," says Ronald Mueller, a former SEC staffer who now works for the Washington, D.C. law firm Gibson, Dunn & Crutcher. "This is like the Government in the Sunshine Act for companies. Everything will have to be done in the open."[96]

A new generation of leaders for the shareholder activist movement must step forward. Dale Hanson's departure from Calpers created a leadership void among institutional investors and a major individual successor has yet to emerge. Hanson's persistence, media manipulation skills, and engaging personality made him an effective driving force for the movement. As the pioneer activist public employee pension fund, Calpers continues to influence the investment decisions of institutions both here and abroad. "The people at Calpers have consistently been not just the first to identify issues, but the ones with the courage to follow up on them," says Sarah Teslik, head of the Council of Institutional Investors.[97] If Calpers either decides to retreat, or is forced to do so by elected politicians or legislation in California, Calpers' inaction will have a marked effect upon the activist strategies of other pension funds.

Public employee pension plans continue to grow. Pensions include inflation protections and increased health benefits. A decade ago, America's public employee pension funds had net assets of $250 million; in 1992, these assets were over $850 billion.[98] If public pension funds continue the activist course forged by Calpers and Dale Hanson, their positive influence upon corporate policies and profitability will only continue to increase.

Gregg A. Jarrell, a former SEC chief economist and now a professor at the University of Rochester Business School, argues that "[i]f a fund can be sidetracked by politics, the whole reason for shareholder activism goes out the window."[99] However, the activities of public sector pension funds may increasingly be compromised by politics. Since the growth of public pension funds has coincided with vast increases in the budget deficits of both the state and federal governments, public employee pension plan administrators have been forced to defend their funds aggressively against the incursions of eager politicians. During 1990 and 1991, more than a third of the states, including California, Missouri, New York, and Texas, unilaterally reduced their contribu-

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[96] Salwen, *supra* note 74.

[97] Anders, *supra* note 82.

[98] *Id.*

[99] Judith H. Dobrzynski, *Cutting Loose from Shareholder Activists*, BUS. WK., July 8, 1991, at 34.

tions to the pensions of state employees.[100] Calpers found itself vulnerable when California Governor Pete Wilson, a Republican, seized $1.6 billion from the fund to help combat the state's $14 billion deficit. Wilson also asserted his power to appoint a new actuary for the Calpers fund, saying that the investments selected in the past were too cautious and produced small returns. As a result, Wilson said, the taxpayers were forced to contribute excessively for Calpers' lack of investment savvy. According to the Governor, if the assumed earnings from Calpers' investments were to rise one percentage point, taxpayer contributions could decrease by $400 million.[101]

Wilson met a great deal of resistance. In May 1992, the Democratic majority in the California legislature rejected Wilson's appointed actuary for a third time. Public sector unions also sued the state in response to Wilson's action. California's public employees collected one million signatures to put a constitutional amendment on the ballot to prevent Wilson or any other California governor from ever taking similar action again.[102]

Calpers is far from immune to attack in its home state.[103] "Spiking" and worker's compensation are two issues that have California legislators saying that the present system of public sector pensions is too expensive for the state to afford. "Spiking" is the practice of raising an employee's salary just before retirement in order to exact a significantly higher pension. For example, the city of Anaheim raised its chief administrator's salary from $90,000 to $150,000 shortly before retirement.[104] In addition, pursuant to California's workers' compensation disability allowance, an estimated seventy-percent of California Highway Patrol officers who leave their jobs annually receive pensions of approximately half of their yearly salary for life. Furthermore, stories of individual abuses abound. One San Francisco policeman qualified for benefits after losing his trigger finger, while two Long Beach policemen made disability pension claims for "stress" after receiving reprimands for beating a black officer.[105] While Calpers officials note that local officials are to blame for such instances of excessive generosity, Wilson and other opponents have capitalized on this political ammunition to threaten Calpers assets and its shareholder activist agenda.

Governor Wilson's most radical plans would eliminate the traditional public employee pension system altogether. Rather than adopt the present system's focus on promising pensioners fixed benefits, the Governor's plan would adjust the level of employee contributions. The benefits that public sector retirees would receive would vary, depending upon what the fund could afford. Under the present fixed benefits system, employees turn over a fixed proportion of their wages to the fund and the government covers any shortfall, thereby insu-

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[100] Alan Deutschman, *The Great Pension Robbery*, FORTUNE, Jan. 13, 1992, at 76.
[101] *Id.*
[102] *A Wobbly Californian Giant*, THE ECONOMIST, May 30, 1992, at 75.
[103] *Id.*
[104] *Id.*
[105] *Id.*

lating employees from investment risk. Wilson has already reduced the state's contribution to benefits and created new classifications of public employees which cut the state's required contribution for these workers by two-thirds. However, Calpers and California public sector unions have pledged to fight any further reductions in state contribution towards public employee benefits.[106]

If Calpers is to protect itself from further reductions in funding by the Wilson administration, the Calpers leadership must become a political as well as an economic force within California. When Dale Hanson arrived at Calpers in 1987 from Wisconsin, he had no friends in state government; by 1991, few government officials had not become polarized by the Wilson-Calpers struggle. While Hanson had started to work towards reconciliation with state officials prior to his departure from the fund, Calpers' new leaders must work harder to ensure that the fund's interests are adequately represented in Sacramento.

The anemic performance of Calpers' investments over the past few years has also created dissention within the fund's ranks. While most of the directors support the shareholder activism movement, many fear that it may come at the expense of gauging the performance of Calpers' other investments.[107] Calpers has seven percent of its funds invested in real estate and ten percent in foreign stocks, far above the average for pension funds in both categories. Calpers' $5 billion real estate portfolio recorded negligible gains during the poor housing and rental market of the early 90s. Since only about thirty-four percent of Calpers' stock is invested in U.S. corporate stock, Calpers fund participants largely missed the bull market decade of the 1980s on the domestic stock exchanges.[108] "On a comparative basis, our portfolio hasn't done too badly," said DeWitt Bowman, Calpers' leading investor. "On an absolute basis, it's been a disaster."

Calpers has attempted to recoup its relatively poor stock performance in the United States by focusing on its international business holdings. Calpers' still embryonic international campaign has included voting proxies and initial efforts to make itself heard at board meetings across the globe. Calpers has centered its activities in Japan and Great Britain, where Calpers has $2.5 billion and $1 billion invested, respectively.[109] Calpers focuses on the same issues internationally as it does domestically for selecting target companies: financial performance and corporate governance. However, Calpers officials are learning that its tactics internationally must be adopted to satisfy local laws and business customs.

Calpers investment groups in Great Britain have found it imperative to infiltrate the British corporate boards. How Calpers will become an effective behind-the-scenes player in its British corporate holdings has yet to be determined. "Our main effort will be to co-sponsor British institutions like us in

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[106] Dobrzynski, *supra* note 99.
[107] Anders, *supra* note 82.
[108] *Id.*
[109] Sweeney, *supra* note 79.

whatever they are concerned about," said Jose Arau, a Calpers investor focusing on investment equities. "We'd rather do that than act like the ugly American."[110]

Calpers' efforts towards greater shareholder involvement will face more formidable obstacles in Japan, where shareholder interests are subordinated to those of other constituencies. Joseph Lufkin, president of Global Proxy Services, Calpers' overseas agent, asserted that the fund's goal in Japan "is to achieve more profound change, to create avenues for shareholder participation."[111] Lufkin believes that progress in Japan "will be rapid," although the corporate governance structure lags about twenty-five years behind that in the United States.[112] Calpers intends to focus its shareholder activist efforts on Japanese companies that engage in criminal conduct, as well as those with large, ceremonial boards of directors. As in Great Britain, Calpers hopes to join forces with like-minded shareholder activist investment groups in Japan.

On June 29, 1993, 1,901 Japanese corporations provided shareholders with a limited opportunity to express for the first time any dissatisfaction with the performance by holding annual meetings. The problem for Calpers, or any other investor who owned stock in more than one company, was that the Japanese corporations' annual meetings occurred almost simultaneously.[113] Those shareholders who succeeded in passing through stringent corporate security mechanisms found that their time was largely wasted, considering that any questions that they attempted to ask the directors received very curt replies. By severely curtailing dialogue with shareholders, Japanese corporate directors keep annual meetings to about thirty or forty minutes. Shareholder meetings in the U.S., by contrast, often last for hours. While Japanese corporate officials contend that their meeting methods prevent disruptions from outsiders, the authoritarian hierarchical environment at the meetings effectively prevents legitimate shareholder involvement. Because seventy percent of all Japanese corporate shares are owned by other Japanese corporations, independent activist investors will be very hard-pressed to incite change, even if they could raise their concerns at the annual corporate meetings.

Despite these formidable cultural corporate obstacles towards pressing an activist shareholder agenda in Japan, Calpers and other American investment funds recently voted against significant board resolutions, including small dividend payments and increasing the number of members on corporate boards. While the funds do not expect immediate successes, they hope to send a symbolic but important message of increasingly effective shareholder activism and, consequently, to spur other concerned investors into action.

Calpers has also brought its shareholder activist agenda to Germany. In January 1993, Calpers focused upon the German utility RWE. While the Ger-

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[110] *Id.*

[111] *Id.*

[112] *Id.*

[113] James Sterngold, *Japanese Companies Rebuff Mighty U.S. Pensions Funds*, N.Y. TIMES, June 30, 1993, at D1.

man government has just thirty percent ownership of RWE, it controls sixty percent of the utility's voting rights. Although Calpers' resolutions calling for shareholder equality were defeated, there is reason for optimism.[114] Shareholders attending the meeting applauded when the Calpers representative argued that "voting restrictions are an embarrassing anachronism which pulls Germany out of step with international norms."[115] Although Calpers' efforts internationally thus far have produced few concrete results, the fund has indicated that it will continue to militate for shareholder activism abroad.

Calpers' intention to remain the primary shareholder activist public employee pension plan fund is not universally praised even within Calpers. "Corporate governance has its place but it's just one small part of what we do," says fund director Jake Pestrosino, who believes that Calpers' leaders should "delegate corporate governance work so it does not become a preoccupation."[116] Kathleen Brown, California's former treasurer and Calpers director, agrees. "Where [Calpers C.E.O. Hanson's] strengths are on shareholder issues, he should play to them," said Brown. "But his obligation as a manager is to ensure that people are in place so that other obligations are attended to as well."[117]

Calpers' administrative procedures for its daily operations have been criticized as inefficient and outdated. Because Calpers pays out benefits to a wide range of California state workers, it presently has more than fifty benefit systems operating simultaneously. Calpers' byzantine operations require that the fund overhaul and streamline its present system. Faced with such pressing internal needs, Calpers will be hard-pressed simultaneously to continue to lead the corporate shareholder activist movement with its present fervor.

The media, Calpers' chief ally, has also conveyed news disparaging the fund. The media widely reported rumors that Calpers was selling off the shares of companies that supported Governor Wilson's proposals to limit state contributions to the fund. Calpers has quieted such criticisms through moves simultaneously designed to benefit both the state and the fund's public relations. For example, in January 1993, Calpers promised to invest $225 million in affordable housing in California. After this announcement, Governor Wilson asked Calpers to consider further public investment to stimulate the state's economy. During his last days at Calpers, Hanson announced that the fund would infuse more money into the California economy.

Even if Calpers can stave off public criticism and prevent its own board from splintering into factions, this may not be enough to maintain Calpers' leadership position in corporate shareholder activism. California's budget deficits may subject Calpers to higher taxes. Moreover, if Governor Wilson does not succumb to taxing impulses, the Internal Revenue Service may. Tax-free

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[114] Sweeney, *supra* note 79, at 34.

[115] Leslie Wayne, *Exporting Shareholder Activism*, N.Y. TIMES, July 16, 1993, at D1.

[116] Anders, *supra* note 82, at A1.

[117] *Id.*

pension fund exemptions are likely to be abolished, as the federal government looks for revenue sources to close federal budget deficits. If the growth of public employee pension funds is stymied by direct taxes, the shareholder activist movement will be at least indirectly and partially constrained. Yet the role of the public employee pension fund as a device to challenge state government political looters, while checking poorly performing corporate boards, will probably continue both domestically and internationally well into the twenty-first century.

V. Conclusion

Courts have invalidated laws either raiding or taxing public sector pension funds only when states have attempted to alter the expectations of past plan contributors. Courts that have allowed state legislatures to alter prospectively their relationships with these funds were guided by the parties' contractual expectations, in deciding that these incursions were appropriate exercises of state police power. While it may protect the interests of plan participants who presently receive retiree benefits, this contract-based approach is insufficient to force politicians to resist the short-term budgetary fix at the expense of present and future plan participants.

Among suggested but simplistic solutions is elimination of public sector pension plans altogether. Public sector workers would directly receive the funds that states now contribute to the pension funds, and allow state employees to plan for their own retirements. If this occurs, many of the benefits that public sector pension funds offer public employees, and society in general, would be lost. As a result of their large, institutional size, public sector pension plans offer public employees opportunities to invest in successful and diverse enterprises that would be unavailable for individual investors. In addition, the plans provide participants with the assistance of experienced investment counselors. Removing these significant benefits from public sector workers, simply out of distrust for lawmakers, would be extremely cynical and unnecessary, because less drastic alternatives can be employed.

Plan participants may receive direct or indirect benefits from the institutions where public sector pension plans invest their money. Since they are supported by the taxes paid by their private sector counterparts, public sector employees rely significantly upon the success of private industry. While Connecticut's investment of pension funds in Colt Industries may not have provided much return, the 900 Colt jobs at stake invariably influence employment in the public sector.

Public sector pension plan participants may benefit from careful commitment of assets towards socially-conscious investments. The recent investment of Calpers' funds into low income housing in California provides such an example. While Calpers' officers could have resisted this opportunity in favor of investments with a higher return, the construction of affordable housing may prove more beneficial to plan participants in the long run. The economic and employment spur of construction will reap immediate tax returns. Once the units are complete, potential homeowners will move to or remain in California, thus furnishing additional tax revenue to the state and increase the job security of public sector employees. Further, public sector workers may directly enjoy Calpers' investment through purchasing new homes. Thus, at several levels, Calpers' plan participants benefit from the pension fund investment in affordable housing in California.

Calpers' activist role within the companies it owns also offers many advantages. Calpers' plan participants benefit both as shareholders and citizens, by forcing large companies to increase their profitability through avoiding waste. Smaller investors also benefit from the corporate reform message offered by such large investors who may force a lethargic board of directors to respond actively to shareholder demands. The end result lead to a more streamlined corporate America, attuned to the rigors of competition in a global marketplace.

Since public sector pension funds have the potential to foster both corporate success and social change, their complete elimination simply to check the impulses of eager politicians would be legislative overkill. Instead, a regulatory plan that allows public sector pension funds to continue to benefit their investors and society should be constructed. As indicated earlier, public sector employees benefit from socially-conscious investing. However, while their interests may be closely tied to those of their government employers, it is not enough to say that what benefits government benefits public sector workers. Any statutory scheme must properly balance the benefits offered by socially-conscious state investing with the expectations of plan participants.

The divergent interests present in public sector pension plan investing make the state control of the funds' boards of directors most disturbing. For example, H. Carl McCall's plan for New York's reinvestment into the state's pension plans may arguably have public sector workers' interests at heart. Yet, the potential conflict of interests inherent in his roles as appointed and then, later, elected comptroller, and as the sole judge of state investment of the pension plans should disturb public sector workers. Likewise, California Governor Pete Wilson's ability to appoint directors to the board of the pension plan that he believes should cover his state's budgetary deficit should shock California public employees.

In order to avoid such conflicts of interests, the control of pension funds should be turned over to the people most interested in their performance—the plan participants. Rather than allowing potential raiders to appoint their lackeys, public sector pension plan directors should be elected by plan contributors, just as corporate stockholders select their representatives on the board. As true fiduciaries to their pensions without the concerns of appeasing elected politicians in state government, contributors would know that their interests are paramount.

Since public employees have somewhat different needs than corporate shareholders, public pension fund directors' investment responsibilities are essentially unique. As discussed previously, profit margin is not the only consideration in public sector pension investing. However, investment decisionmakers must be aware that political whims are not the source of prudent investing. By making fund directors the representatives of pensioners rather than government officials, the directors will be in a better position to allocate pension funds responsibly. Investing public sector pension funds is difficult, requiring fund directors to weigh many social and economic factors before any decision is made. Since this process is so arduous, it is imperative that independent-minded leaders with plan participants' ultimate benefit at heart be at the helm of public sector pension funds.

Public sector pension funds have a proactive responsibility to help the society where there participants live and work. However, in fulfilling this role, fund directors must resist politicians seeking to serve the needs of short-term expediency at the expense of plan participants. This objective is impeded by the preponderance of government appointees as pension fund directors, a situation that creates a potentially catastrophic conflict of interests as politicians seek to close increasing budget deficits. As the holders of immense amounts of capital, public sector pension funds have the unique ability to unite financially-minded activity with social responsibility, as well as command the attention of corporate America. However, unless government acts to remove the hands of elected politicians from the public pension fund cookie jar, public pension funds will cease to perform their original function—effectuating retirement security.[118]

Public pension plans continue to be placed at risk by politicians.[119] Certainly no one can minimize the very real and very immediate threat posed to current compensation and pension retirement security. Politicians will always be tempted to manipulate the security of public sector workers in order to alleviate the very pressing and undeniable budget constraints. Aggressive resistance to short-term political manipulations is certainly warranted. If public workers and their pension plans continue only with this short term and immediate crises focus, however, the situation will never transcend the adversarial zero-sum games that continue to afflict much of contemporary labor relations.

As this article has demonstrated, however, proactive pension plans can work creatively to further social justice. Labor must certainly continue to resist vigorously any political incursions into workers' security. Thus far, there have

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[118] *A Wobbly Californian Giant*, THE ECONOMIST, May 30, 1992, at 75.

[119] However, some public officials facing fierce election battles recognize that pensioners are voters, too. In a decision that his foes suggested was politically motivated, New York Governor Mario Cuomo, who failed in his bid for re-election in November 1994, reversed his position before the election by saying that the state would refund $62 million dollars to retired federal employees who paid state income taxes later deemed unlawful by the U.S. Supreme Court in David v. Michigan Dep't of Treasury, 489 U.S. 803 (1989). James Dao, *In a Reversal, Cuomo Will Refund Taxes of Federal Retirees*, N.Y. TIMES, June 28, 1994, at B1. While Lobbyists and lawyers for the retirees indicated that the governor was attempting to eliminate a potentially damaging issue in an election year, Cuomo administration officials said that increased litigation costs motivated the decision to provide the refunds. *Id.*

been several very real achievements of positive changes in corporate government, particularly through such initiatives as the Calpers Fund. For the most part, these initiatives are rich with potential; the actual achievements thus far reflect and signal the proverbial tip of the iceberg.

From a labor and employment law policy perspective, relatively little directly distinguishes the public pension fund initiatives surveyed in this article from the more generic corporate reforms of a conventional corporate law policy perspective. More holistically, however, there are several major distinctions. For example, the Calpers' initiatives focus primarily upon executive pay, with additional concern for environmental improvements in order to militate against environmental racism. By reducing executive compensation from stratospheric, unwarranted levels, public employee pension funds focus upon the spirit of egalitarianism and equity, fundamental policy features that are traditional hallmarks of the labor movement. The focus has also been one of decentralization, with initiatives to remove concentrated corporate power from the hands of a very few officers who exploit corporations for personal gain.

As law and related public policy increasingly assume global perspectives, public employee pension funds in the United States must likewise increase their scope and vision. Calpers' recent initiatives in shareholder reform of transnational corporations headquartered outside the United States represent positive involvement, corresponding to the necessary global perspective. There have not been direct labor relations reforms achieved by the public employee pension funds, such as divestment from corporations which aggressively resist union initiatives by current employees, or from corporations which have notorious records of unresolved unfair labor practices. The labor consciousness of the public employee pension plan funds may increase in the future. No doubt, they will be increasingly concerned with international labor situations, especially as they intersect with related issues of social and environmental justice.

Public workers' resistance to attempts by politicians to weaken their financial security will continue to prompt very serious, visible confrontations. Some already have been fought and won, while others have been unsuccessful. Inevitably, challenges will soon threaten both public workers' current compensation as well as their future retirement security. The historic labor consciousness of equity, egalitarianism, and social justice can continue to propel both aggressive resistance to opportunistic reneging by the state and can spur further positive reforms in corporate governance.