Environmental Investment: A Proposal for State Legislation

INTRODUCTION

Few issues loom larger today than the problem of environmental degradation due to human activity. The United States has made considerable progress over the course of the past twenty years in reducing pollution from industrial sources. It has also seen the development of far-reaching and complex local, state, and federal regulatory structures designed to address this issue. Yet environmental irresponsibility continues in force worldwide, resulting in massive costs to life, property, and aesthetic values.

One of the many ways to encourage corporations to minimize their adverse effects on the environment is to require public employee pension fund trustees to consider the environmental responsibility of a company before investing capital in its securities. Public pension funds control over 700 billion dollars of investment capital.[1] Their size allows these funds to exercise tremen-

1. The most recent estimate of the total amount of investment capital controlled by public employee pension funds is $734.2 billion. Telephone interview with Michael Clowes, editor of PENSIONS & INVESTMENTS (Mar. 28, 1991)(PENSIONS & INVESTMENTS is considered to be the bi-weekly bible of the investment industry). Another less recent source put the total at $700 billion. *See* Dolan, *'Social Investing:' Pressure grows to pump pension money into 'worthy' causes*, 31 AARP BULLETIN, No. 9, Oct. 1990, at 17.

As of April 1985, the estimated asset value of public employee pension funds was $340 billion, representing 18% of United States publicly traded stocks, while university endowment funds were estimated at $40 billion (2%) and corporate and union pension funds at $980 billion (52%). Jerry & Joy, *Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion*, 66 OR. L. REV. 685, 731 (1987)(citing Smith, *American Stocks Shrug Off Anti-Apartheid Pressure*, Wall St. J., Apr. 30, 1985, at 34, col. 1). Combined, these three types of funds comprised 72% of publicly traded stocks. One source estimated the total combined assets of public and private pension fund assets in the late 1980s at $2.3 trillion. E. JUDD, INVESTING WITH A SOCIAL CONSCIENCE 11 (1989).

The growth in size and importance of pension funds is demonstrated by comparing more recent figures with those from 1980. In that year, public and private pension funds combined totalled just over $550 billion, which translated into ownership of about 25% of all publicly traded stock and control of around 40% of all debt capital in the United States. Troyer, Slocombe & Boisture, *Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds*, 74 GEO. L.J. 127, 154 n.98 (1987) [hereinafter Troyer & Slocombe] (citing McCarroll, *Socially Responsible Investment of Public Pension Funds: The South Africa Issue and State Law*, 10 REV. L. & SOC. CHANGE 407 (1981)).

dous influence on corporate behavior. It also makes their investment policies an issue of great public importance.[2]

While a vast array of excellent articles has been written about divestment from corporations with operations in South Africa,[3] very little scholarship has emerged regarding the use of environmental criteria to make investment decisions. And what little has been written is relatively cursory.[4] This Note attempts to fill this gap. It proposes state legislation which mandates that environmental criteria enter the investment process of public pension funds. In so doing, it seeks to promote the adoption of this legislation and to encourage corporate managers, who now enjoy considerable discretion in shaping and responding to social demands, to fulfill their social responsibilities at a time when action beyond current regulatory requirements is largely voluntary.[5]

Part I of this Note defines environmental investment, explains how criteria are used to make investment decisions, and traces the development of social investment to the present, where social investment legislation is commonplace. Part II analyzes the three state legislative proposals which have, at this writing, been put forward and makes recommendations for future adoption. Part III examines the legal limitations which define the scope of environmental investment legislation by looking at the legislation's relationship to state law defining fiduciary obligations and by evaluating potential legal challenges based on federal law. Since no empirical evidence exists on the effects of environmental investment alone on portfolio performance, Part IV bases much of its treatment of this issue on available analyses of other forms of

2. Troyer & Slocombe, *supra* note 1, at 154. *See* Lynn, *Investing Pension Funds for Social Goals Requires Changing the Law*, 53 U. COLO. L. REV. 101, 114 (1981); Murrmann, Schaffer & Wokutch, *Social Investing by State Public Employee Pension Funds*, 35 LAB. L.J. 360, 366 (1984).

3. For an excellent list of sources dealing with South Africa divestment and social investment generally, see Jerry & Joy, *supra* note 1, at 687-88 n.5.

4. *See, e.g.*, A. SIMPSON, THE GREENING OF GLOBAL INVESTMENT (Economist Publications Special Report No. 2108, 1991) (dealing mainly with environmental issues in the European investment industry); Goldinger, *Investing in the Earth*, USAIR, Nov. 1990, at 18 (short article geared towards individual investor interest in mutual funds); Current Development, *The Valdez Principles: A Corporate Self-Governance Code on Environmental Conduct*, 2 GEO. INT'L ENVTL. L. REV. 237 (1989)(brief discussion of Valdez Principles).

5. *See* Silverstein, *Managing Corporate Social Responsibility in a Changing Legal Environment*, 25 AM. BUS. L.J. 523, 566 (1987)(encouraging early perception of and imaginative responses to potential legal problems by corporate managers in order to avoid more costly and burdensome regulation in the future).

social investment. Part V looks at some likely effects of the proposed legislation, if adopted. The Note concludes that environmental investment legislation is not only legally permissible; it is also a good idea that should be enacted into law.

I. Environmental Investment and Public Pension Funds

"Environmental investment" is, very generally, the incorporation of environmental criteria into the investment decision making process. As a form of "social investment,"[6] it benefits from being part of an investment strategy which has gained considerable support from the investment community over the last twenty years.

A. *Social Investment*

Most accounts of the development of the socially responsible investment industry as a major force begin in the early 1970s. At that time, religious groups commonly refused to invest in "sin stocks," securities of companies which manufactured tobacco or alcohol or which reaped profits from gambling.[7] In 1971, a number of religious groups joined together to form the Interfaith Council on Corporate Responsibility and began voting proxies in blocks.[8] The first socially responsible mutual fund appeared as early as 1928,[9] but most of these funds appeared in the 1970s and 1980s.[10] In the mid-1980s, popular support for the divestment of institutional funds from corporations doing business in South Africa transformed the socially responsible investment industry from a fringe activity into what is now a critical aspect of the money management industry.[11] At that time, trustees of private

6. Social investment is simply the incorporation of social or ethical criteria into the investment decision making process.

7. E. Judd, *supra* note 1, at 10; *Franklin Research and Development Corporation*, Harvard Business School Publication No. 9-390-027 at 3 (1989) [hereinafter *FRDC*]; Proffitt, *Ethical Investment Funds Proliferate; Set Tenor for Social Investing in the 1990s*, IRRC News for Investors, Dec. 1990, at 233, 235.

8. *FRDC*, *supra* note 7, at 3.

9. The Pioneer Fund was the first mutual fund designed specifically to accommodate the social objectives of religious groups. E. Judd, *supra* note 1, at 10; Proffitt, *supra* note 7, at 235.

10. *See* Dunnan, *Investing in Good*, A.B.A. J., Aug. 1990, at 102; Proffitt, *supra* note 7, at 236-37.

11. E. Judd, *supra* note 1, at 11; Bromberg, *Social Investing: The Good Guys Finish First*, Bus. & Soc'y Rev., Fall 1988, at 32; Harvey & Conner, *South Africa Turmoil Spawns Social Investment Growth Industry*, Strategy Weekly (a publication of Prudential-Bache Securities),

mutual funds and state and municipal retirement funds began to pull investments out of "South Africa-related" companies, and even mainstream money managers offered "South Africa-free" investment plans.[12]

Today, various public pension plans, union pension plans, private mutual funds, and churches regularly use non-financial investment criteria in their investment decisions.[13] Many of these investors have actually divested their portfolios of certain securities for ethical reasons.[14] Social investment is now commonplace across the United States, and it will continue to greatly affect both investment trends and corporate activity in the 1990s.[15]

Feb. 28, 1990, at 29; Sypher, *Some Investors Seek Clean Yields*, Burlington Free Press, May 17, 1987, at E1, col. 1.

12. E. JUDD, *supra* note 1, at 11; *FRDC, supra* note 7, at 3-4; Murrmann, Shaffer & Wokutch, *supra* note 2, at 361. An example of a mainstream money-management firm offering South Africa screens for its clients is The Boston Company, which offered its SAFE (South Africa-Free Equity) index. E. JUDD, *supra* note 1, at 11.

13. About $625 billion are currently invested using ethical criteria by public and private pension funds, mutual funds, and individual portfolios, up from about $40 billion just seven years ago. Wang, *You Can Be Clean and Green by Investing in Ecology; Peace and Social Harmony and Still Finish First*, MONEY, June 1991, at 130.

The capital invested in socially screened mutual, money market, and trust funds totals just over $8 billion, a small fraction of the $625 billion figure. Proffitt, *supra* note 7, at 238. More than 80 percent of this $625 billion screened assets total is controlled by institutional investors, like public pension funds, many of which are required by law to screen for South Africa connections. *Id. See also infra* note 15.

14. Playing leadership roles in the South Africa divestment trend were the retirement funds for the states of California, Minnesota, New York, and Wisconsin, and the cities of New York, Philadelphia, and Washington, D.C. E. JUDD, *supra* note 1, at 11; Dobris, *Arguments in Favor of Fiduciary Divestment of "South African" Securities*, 65 NEB. L. REV. 209, 217-18 (1986); Williams, *In Support of Azania: Divestiture of Public Pension Funds as One Answer to United States Private Investment in South Africa*, 9 BLACK L.J. 167, 178 (1985); Wise, *City Pension Fund Upheld on Anti-Apartheid Policy*, N.Y.L.J., Mar. 20, 1986, at 1, col. 3. For a more detailed discussion of several state and local divestment initiatives, see Note, *The Constitutionality of State and Local Governments' Response to Apartheid: Divestment Legislation*, 13 FORDHAM URB. L.J. 763, 773-78 (1985).

15. Harvey & Conner, *supra* note 11, at 29. The extensive influence of the social investment industry is evidenced by the following data, compiled in February 1990:

— Mutual and money market funds claiming to be socially conscious investment vehicles (all including South Africa-related guidelines) managed an estimated $7.6 billion, up from $5.5 billion two years previously;
— A total of 25 states had passed legislation placing restrictions on the investment of public funds in firms with business ties in South Africa. These states accounted for over half of the $700 billion in tax-exempt state government employee benefit funds;
— At that time, 17 counties and 73 cities had placed South Africa-related restrictions on the management of their funds;
— Major universities, labor unions, and private endowments were following suit, and demand for South Africa-free portfolio management by individual investors was growing steadily.

B. *Environmental Investment*

The first example of environmental criteria being used for investment decisions is the Pax World Fund, a mutual fund organized in 1970. Pax uses a number of criteria in its investment decisions, one of which is pollution control. At present, there are five "environmental" funds on the Barron's/Lipper Gauge,[16] a relatively comprehensive list of mutual funds that provides financial performance information for each listed fund. However, due to Barron's definition of an "environmental" fund,[17] this figure is misleading. A much larger number of funds actually use environmental criteria to make investment decisions.[18] The Barron's/Lipper Gauge's usefulness for environmentally responsible investment is also limited because of a distinction which is not included in Barron's definition.[19] Some "environmental" funds buy stocks according to the environmental services a company of-

Id. at 29-30.

More specifically, these data demonstrate the institutionalization of the Sullivan Principles in the investment community. *Id.* at 30. Developed in 1977 by Reverend Leon Sullivan, these principles served as a means to guide corporate behavior in South Africa. *Id.* *See* Weedon, *The Evolution of Sullivan Principle Compliance*, BUS. & SOC'Y REV., Spring 1986, at 56; Williams, *supra* note 14, at 176. Entities which subscribe to the principles agree to an annual evaluation of their efforts to positively affect the quality of life of "Blacks, Coloureds, and Asians" in and out of the workplace and to promote a more democratic government. *Id.* The Principles have been formally incorporated into many state and local South Africa-related investment laws and regulations. Harvey & Conner, *supra* note 11, at 30.

Twelve states have similar legislation related to the MacBride Principles governing corporate activity in Northern Ireland. Melcher, *Social Investing: The Changing Face of the Investment Community*, STRATEGY WEEKLY, Feb. 28, 1990, at 28.

The interest in social investing is so widespread that a national non-profit professional association was established in Boston in 1981 and incorporated in 1985. The 700-member Social Investment Forum is made up of money managers, brokers, bankers, analysts, and other social investors. It encourages social investing and serves as a clearinghouse of information on the subject. *See generally* SOCIAL INVESTMENT FORUM, SOCIAL INVESTMENT SERVICES: A GUIDE TO FORUM MEMBERS (May 1, 1990 ed.).

16. Barron's, Nov. 12, 1990, at M38.

17. Barron's defines an "environmental" mutual fund as a fund which "invests at least 65% of its portfolio in stock and convertible securities of companies contributing to a cleaner environment, such as waste management and pollution control firms." Barron's, Nov. 12, 1990, at M41, col. 4. These five funds are: Fidelity Select Environment Fund, Freedom III Environmental Fund, Oppenheimer Global Environment Fund, Schield Progressive Environmental Fund, and SFT: Environmental Awareness Fund. *Id.* at M42-61.

18. *See, e.g.*, Social Investment Forum, Socially Responsible Mutual Funds (Aug. 1990) (Unpublished information compiled from fund prospectuses) [hereinafter SIF information].

19. Proffitt, *supra* note 7, at 238.

fers.[20] These "environmental sector" funds are not particularly socially or politically conscious and should not be confused with "green" funds.[21] Environmental sector funds do not examine the pollution records or policies of the companies whose stocks make up their portfolios so as to avoid the firms with poor environmental records.[22] Green funds, on the other hand, are funds which avoid investing in firms that pollute or which seek out firms with pollution control policies.[23] At present, two mutual funds consider only environmental and financial factors, and not other social factors, in making their investment decisions.[24]

Interest in the field of environmental investment is growing.[25] Financial advisors and investment managers involved in portfolio screening now claim that the environment has replaced South Africa as the most widespread ethical concern of investors.[26]

20. Examples of such services include garbage and hazardous waste removal, paper recycling, pollution control response, water technology improvements and alternative energy sources. *See* Dunnan, *supra* note 10, at 104. For a discussion of the growing profitability of companies offering these services, see Heller, *Know-How Cleans Up*, CHEMICAL WEEK, May 2, 1990, at 26.

21. Dunnan, *supra* note 10, at 104; Rauber, *The Stockbroker's Smile*, SIERRA, July - Aug. 1990, at 18-19.

22. *See* Fenn & Opheim, *Environmental Sector Funds*, IRRC INVESTOR'S ENVTL. REP., Winter 1991, at 11. In addition to the Fidelity Select, Freedom III, and Oppenheimer Global funds, *see supra* note 17, the Alliance Global Environment Fund, Kemper Environmental Services Fund, and Merrill Lynch Environmental Technology Trusts 1 and 2 are of the "environmental sector" variety. *See* Dunnan, *supra* note 10, at 104; Fenn & Opheim, *supra*, at 10; Proffitt, *supra* note 7, at 245.

23. The green funds, other than Progressive Environmental and Environmental Awareness, *see supra* note 17, are: New Alternatives Fund (equity fund), Pax World Fund (balanced stock and bond fund), Parnassus Fund (equity fund), Calvert-Ariel Appreciation and Growth Funds, Calvert Social Investment Funds (equity, bond, managed growth, money market funds), Working Assets Fund (money market fund), Dreyfus Third Century Fund (equity fund), Merrill Lynch Ecological Trust, Alpine Catholic Income Trust, and Domini Social Index Trust. *See* Dunnan, *supra* note 10, at 104; Proffitt, *supra* note 7, at 239, 244; Rauber, *supra* note 21, at 18-19; SIF information, *supra* note 18. These funds use environmental protection, pollution control, or energy efficiency as one of a set of investment criteria. SIF information, *supra* note 18.

24. They are Schield Progressive Environmental Fund (positive and negative environmental screens) and SFT: Environmental Awareness Fund (positive environmental screens only). SIF information, *supra* note 18.

25. Harvey & Conner, *supra* note 11, at 31. *See* Burns, *Socially Responsible Investing*, Portsmouth Herald (N.H.), Sept. 8, 1989, at C1, col. 1.

26. *See* Fenn & Opheim, *supra* note 22, at 10; Proffitt, *supra* note 7, at 233; P. Kinder, The Domini Social Index: Its Composition and Performance 12 (Address delivered at the Social Investment Forum Workshops on Performance Evaluation, March 4, 1991).

C. *The Valdez Principles*

One major step in the development of environmental investment was the introduction in early 1989 of the Valdez Principles. Authored by the Coalition for Environmentally Responsible Economies (CERES)[27] and modeled after the Sullivan Principles,[28] the Valdez Principles received their name from and were adopted shortly after the Exxon Valdez tanker oil spill in Alaska on March 24, 1989. The Principles establish standards and procedures for evaluating the activities of corporations that directly or indirectly affect the Earth's biosphere.[29] Such information is designed to aid investors in making informed decisions with regard to complex environmental issues.[30]

With the Valdez Principles, CERES intends to establish a voluntary mechanism of corporate self-governance that maintains business practices consistent with the goals of sustaining the natural environment for future generations.[31] Some writers claim that the Principles work by inducing companies to become signatories or risk losing investment dollars,[32] but this is not a stated mission of the code. Each signatory pays a first-year fee based upon gross revenues and an annual administration fee, neither of which exceeds $15,000.[33] Then, each year, signatories complete an environmental report which is returned to CERES to be summarized and made available to the public.[34]

One of the main attractions of the Valdez Principles is their potential use by fund managers and individuals as investment criteria. Researching the environmental records of individual companies can be a complex and costly process. It is especially burdensome for smaller funds and individual investors. Once perfected and accepted by a critical mass of companies,[35] the

27. Formed by the Social Investment Forum, *see supra* note 15, along with national environmental organizations including the Sierra Club and the National Audubon Society, CERES was created in order to draft the Valdez Principles.

28. *See supra* note 15.

29. CERES, 1990 GUIDE TO THE VALDEZ PRINCIPLES 7 (1990) [hereinafter VALDEZ GUIDE]. For the full text of the Valdez Principles, see appendix *infra*.

30. VALDEZ GUIDE, *supra* note 29, at 7.

31. *Id.*

32. *See* Current Development, *supra* note 4, at 240; Sternberg, *New Pressure for Good Conduct*, CHEMICAL WEEK, Sept. 20, 1989, at 23.

33. VALDEZ GUIDE, *supra* note 29, at 21.

34. *Id.* at 7.

35. CERES worked closely with United States industry to assure that the guidelines were reasonable, and the signatory list is now growing. *See* Harvey & Conner, *supra* note

Valdez Principles are likely to fulfill their intention to "help investors make informed decisions around environmental issues."[36] CERES will collect, monitor, and verify environmental compliance information so that social investors may use a signatory list as a simple test for environmentally responsible investment.

Opponents of the Principles have raised a number of criticisms. Industry opposition has cited immediate adverse economic effects due to implementation costs, the nonexistence of an acceptable audit requirement, and the Principles' duplication of existing internal environmental programs.[37] But while these arguments may keep firms from signing, they do not discredit the Principles' utility when used by fund managers to judge environmental responsibility. Other criticisms include the vagueness of the Principles, the possibility that signatories will receive a disproportionate amount of negative media attention as compared with nonsignatories, and the potential for litigation arising from disclosure.[38] The problems identified by many of these criticisms would be addressed if an environmental investment statute were to consider whether a company is in compliance with the Principles rather than whether or not a company is a signatory.

D. *The Use of Criteria in Environmental Investment*

The Valdez Principles are only one example of a standard for evaluating the environmental responsibility of companies. Other criteria that might be used to make environmental investment de-

11, at 31. At the end of 1990, however, only 17 small companies had actually signed on. *See* Cogan, *Shareholders Launch Valdez Principles Campaign*, IRRC INVESTOR'S ENVTL. REP., Winter 1991, at 5. Interest at the state level continues to expand. *See infra* notes 53-56 and accompanying text.

36. VALDEZ GUIDE, *supra* note 29, at 7.

37. *GM Shareholders Reject Adoption of Valdez Environmental Principles*, 22 Env't Rep. (BNA) 260 (May 31, 1991); Kiesche, *Facing Up to Hidden Liabilities*, CHEMICAL WEEK, Feb. 14, 1990, at 58; Current Development, *supra* note 4, at 241-44; Feder, *Who Will Subscribe to the Valdez Principles?*, N.Y. Times, Sept. 10, 1989, at F6.

38. Current Development, *supra* note 4, at 241-44; Feder, *supra* note 37, at F6. Presumably as a response to some of these criticisms, the Global Environmental Management Initiative (GEMI), a coalition of 21 blue chip U.S. companies, is working to devise another code of corporate environmental conduct. Naimon, *GEMI: The Corporate Response*, IRRC INVESTOR'S ENVTL. REP., Winter 1991, at 8. Under the GEMI-sponsored code, companies make their own decisions about implementing the code, compliance information is not shared with the public, and the principles themselves are likely to be even more broad than the Valdez Principles. *Id.*

cisions include pollution records;[39] the existence or efficacy of a company's policy for waste minimization; the existence or effectiveness of a company policy for employee and community information about toxic or hazardous materials used or manufactured by the firm; or a signatory list for a set of principles put forth by an industry association.[40] The severity of a given investment criterion may determine the degree to which environmental investment affects portfolio performance.[41] It may also determine its legality.[42]

Absent an environmental screen using criteria that can be answered with a simple "yes" or "no," environmental investment poses special problems for the investor.[43] Making decisions about the relative environmental soundness of different compa-

39. For example, an investor could discover the total amount of fines levied against the company for environmental infractions or the total amount of pollutants generated by the company as compared with other companies in the same industry.

40. For example, in 1988, the Chemical Manufacturers Association (CMA) adopted its Responsible Care program. CMA, RESPONSIBLE CARE: A PUBLIC COMMITMENT (1990) (CMA brochure). Responsible Care has six elements:

1. Guiding Principles. A statement of the philosophy and commitment by all member companies regarding environmental, health and safety responsibilities in the management of chemicals.
2. Codes of Management Practices. Codes focus on management practices in specific areas of chemical manufacturing, transporting and handling that CMA member companies are to make continuous good-faith efforts to attain.
3. Public Advisory Panel. A group of environmental, health and safety thought leaders assists the industry in identifying and developing programs and actions that are responsive to public concerns.
4. Member Self-Evaluations. Reports, measurements and other demonstrations of program implementation document progress toward improved environmental, health and safety performance in the responsible management of chemicals.
5. Executive Leadership Groups. In periodic regional meetings, senior industry representatives review Codes of Management Practices under development, discuss progress on implementing existing codes and identify areas where assistance from CMA or other companies is needed.
6. Obligation of Membership. Bylaws obligate member companies to ascribe to the Guiding Principles, to participate in the development of the codes and programs, and to make good-faith efforts to implement the program elements of the Responsible Care initiative.

Id. This program is strikingly similar in form and content to the Valdez Principles. Another such set of principles is GEMI, discussed *supra* note 38.

41. For a detailed discussion of the effects of environmental investing on portfolio performance, see *infra* Part IV.

42. For a detailed discussion of the legal limitations on environmental investing, see *infra* Part III.

43. Proffitt, *supra* note 7, at 244-46. *See* P. Kinder, *supra* note 26, at 10.

nies can be complex and difficult.[44] For example, certain industries pollute more than others, regardless of their managers' responsibility and diligence. Even when dealing with comparable companies, researching their environmental performance often requires reporting and monitoring schemes that are hard for both investors and individual companies to implement.[45] These difficulties argue for the desirability of a simple criterion such as whether a company has signed the Valdez Principles.[46] They also point to the necessity of a thorough analysis of a company's environmental record, such as that incorporated in the Valdez Principles.[47]

Once a set of criteria has been chosen, there are three ways in which those criteria can be used to make investment decisions.[48]

44. Proffitt, *supra* note 7, at 244-46. Because assessing a firm's degree of commitment to the environment can be difficult, Franklin Research and Development Corporation, an investment management firm for clients concerned with socially responsible investing, attempts "to distinguish those companies that stand out within their industry for exceptional initiatives or consistent neglect." *FRDC*, *supra* note 7, at 17. The four questions which guide its analysis are:

1. Is the company in compliance with state and federal environmental regulations? Does it have major environmental lawsuits pending? Does it have a record of environmental controversy? Has it gone beyond the letter of the law in dealing with pollution problems?
2. Where comparative environmental studies of an industry have been conducted, how has the company in question performed relative to others in its industry?
3. What efforts has the company made in reducing the generation of hazardous, toxic and hazardous [sic] wastes and in the proper disposal of those wastes it generates?
4. Does the company contribute to, or otherwise support, non-profit environmental protection organizations?

Id. The group rates the company on a scale of 1 to 5. *Id.* These ratings are then used to screen out firms that are environmentally irresponsible. An investor's choice of which number to use as a cut-off point determines the severity of this investment criterion.

Some of Franklin's sources are the Center for Environmental Management of Tufts University, corporate annual reports and 10-K forms, and the Office of Technology Assessment. *Id.*

45. For example, irregularities and inadequacies in SEC disclosure requirements for 10K forms and similar filings make using these sources for environmental responsibility information unreliable. Biersach, *Inside the 10K*, IRRC INVESTOR'S ENVTL. REP., Winter 1991, at 1, 12-13. Investors must consult third party sources such as nonprofit research groups and government regulatory agencies, in addition to collecting their own information, in order to obtain the information they need. See *FRDC*, *supra* note 7, at 6.

46. *Cf.* Slater, *Companies that Hide Behind the Sullivan Principles*, BUS. & SOC'Y REV., Spring 1984, at 15, 16, 18 (arguing against the use of a signatory list for investment decisions because of its inaccuracy as an indicator of social responsibility).

47. *See id.* at 18.

48. A. DOMINI & P. KINDER, ETHICAL INVESTING 2 (1986); E. JUDD, *supra* note 1, at 9. *Cf.* Jerry & Joy, *supra* note 1, at 690 (mentioning only positive and negative investing);

The first is positive investment. This form of investment involves seeking out companies that have made exceptional strides on the environmental issues that concern the investor, thereby including only desirable companies in the portfolio.[49] For example, an investor concerned about waste disposal might invest in companies with progressive waste reduction policies.

A second way in which an environmental criterion can be used is called negative investment. This kind of investing entails the avoidance or selling of stocks of companies that have products or practices incompatible with the values of the investor.[50] The South African divestment campaign is a good example of this kind of investment strategy.

Shareholder activism is the third way to invest with environmental principles. It involves creating change through filing shareholder resolutions and voting proxies.[51] This form of investing could mean including the securities of a company with an unattractive environmental record in order to exercise ownership rights to effect desired changes in corporate management behavior.[52]

II. Proposed Legislation

A. *Current Developments*

At this writing, interest in environmental investment and specifically in using the Valdez Principles for this purpose is growing.[53] For example, in 1990, major corporations including American Express, Atlantic Richfield, Exxon, Kerr-McGee, and Union Pacific were targets of shareholder resolutions requiring that the companies report on their compliance with the Valdez

Langbein & Posner, *Social Investing and the Law of Trusts*, 79 Mich. L. Rev. 72, 73 (1980) (mentioning two forms of social investing, basically positive and negative investing).

49. *FRDC*, *supra* note 7, at 5. *See* A. Domini & P. Kinder, *supra* note 48, at 2; E. Judd, *supra* note 1, at 9; Jerry & Joy, *supra* note 1, at 690; Langbein & Posner, *supra* note 48, at 73.

50. *FRDC*, *supra* note 7, at 5. *See* A. Domini & P. Kinder, *supra* note 48, at 2; E. Judd, *supra* note 1, at 9; Jerry & Joy, *supra* note 1, at 690; Langbein & Posner, *supra* note 48, at 73.

51. E. Judd, *supra* note 1, at 10; *FRDC*, *supra* note 7, at 5. *See* A. Domini & P. Kinder, *supra* note 48, at 9. United States securities law allows any stockholder who holds at least 1% or $1,000 in market value of shares of a company for a year to introduce a proposal at that company's annual meeting. Securities and Exchange Act of 1934 Rule 14a-8(a)(1), 17 C.F.R. § 240.14a-8(a)(1) (1990).

52. *FRDC*, *supra* note 7, at 5.

53. *See* Cogan, *supra* note 35, at 5; Harvey & Conner, *supra* note 11, at 29-32; *Preliminary Listing of 1991 Shareholder Resolutions*, 1990 IRRC News for Investors 254, 254-59 (December).

Principles.[54] The vote totals were surprisingly high, ranging from 8.5 to 16.7 percent.[55] The resolutions' success is due at least in part to the votes of public pension and mutual funds, which are major shareholders in these companies.[56]

Among the proponents of the Principles are three public employee pension funds — the New York City Retirement System, California Public Employees' Retirement System, and California State Teachers' Retirement System.[57] Controlling large sums of investment capital, these funds are able to exercise considerable influence over the companies in which they invest.

Legislation requiring state fund managers to "give preference" to companies that are in compliance with the Valdez Principles has been introduced in New Jersey and New York.[58] California has passed a Concurrent Resolution[59] requesting fund managers to take shareholder action respecting the Valdez Principles. In addition, Connecticut, Michigan, and Wisconsin are reportedly

54. CERES, Valdez Principles Shareholder Resolutions Garner Record-breaking Totals 1 (June 7, 1990) (press release). Other corporations that have been similarly targeted include Kodak and Polaroid. Snow, *Putting Mother Earth in the Boardroom*, WorldPaper, June 1990, Worlddiary sec., at 15. More than 50 such resolutions have been filed for the 1991 proxy season asking companies to sign or report on the Valdez Principles. Cogan, *supra* note 35, at 5; *Preliminary Listing*, *supra* note 53, at 254-59.

55. CERES, *supra* note 54, at 1. The totals were as follows: American Express, 8.5% (representing 35.5 million shares voting for the resolution); Atlantic Richfield, 14.2% (23.3 million shares); Exxon, 9.5% (119.8 million shares); Kerr-McGee, 16.7% (8.4 million shares); and Union Pacific, 13.6% (13.6 million shares). *Id.* According to CERES, a vote total exceeding three percent on a resolution introduced without company support is considered a success. *Id.* The average support level for these resolutions was 12.5%, the highest of any first-year shareholder initiative in the twenty-year history of proxy voting on social issues. Cogan, *supra* note 35, at 5.

56. For example, the Valdez referendum introduced at Exxon's annual meeting resulted primarily from the votes of the controller of California and comptroller of New York State. Snow, *supra* note 54, at 15. The Washington State Investment Board and trustees of public pension funds in Alaska also supported the motion. *Washington Fund Says Exxon's Environmental Record Jeopardizing Its Investment*, 68 PLATT'S OILGRAM NEWS, No. 69, Apr. 9, 1990, at 4. Another participant was the public employee pension fund of Massachusetts. Heller, *The Buck Starts Here*, CHEMICAL WEEK, Apr. 18, 1990, at 28 (Special Report). Institutional support for the 1991 initiatives is likely to be influential as well. *See supra* note 54.

57. Cogan, *supra* note 35, at 5; Dolan, *supra* note 1, at 17.

58. The New Jersey Bill, N.J. Ass. No. 2861, 204th Leg. Sess., was introduced on January 22, 1990. It was referred to the State Operations Committee, and it is still being considered there. The New York Bill, N.Y. Ass. No. 9127—A, 213th Leg. Sess., was introduced on January 29, 1990. After being referred to the Government Employees Committee, which reported favorably on the Bill, it was recommended to Ways and Means. Before any action was taken, the two year bill period elapsed, so it is now dead. It is not clear whether it will be reintroduced next session.

59. Cal. S. Con. Res. 84, 1989-90 Leg. Sess. (1990).

studying the Principles, and several other states are known to be looking at the idea.[60] Over fifty cities, including New York, Los Angeles, and Philadelphia are also researching the possibility of adopting the investment code for their pension fund assets.[61]

B. *Existing Proposals*

Four principal areas are covered by the New York and New Jersey Bills and the California Resolution. First is an investment preference for companies in compliance with the Valdez Principles. Second is shareholder action, in which the fund exercises shareholder rights in order to force the company to adopt the Principles. The next area is the use of environmental experts to determine a company's compliance with the Principles. Lastly, these legislative proposals include some reporting mechanism which allows the results of the first three activities to be compiled and updated. Both of the Bills address all four of these items; the Resolution only deals with shareholder action and reporting.

1. Investment Preference

An investment preference is exercised by the trustee of a state pension or annuity fund. Often more than one of these funds exists for state employees,[62] so a bill might address either a Division of Investment of a state Treasury Department, as the New Jersey Bill does, or individual fund managers, as the New York Bill does. The New Jersey Bill describes the process as follows:

> when choosing corporations in which to invest the assets of any pension or annuity fund under its control, [the trustee] shall give preference to the stocks, securities or other obligations of corporations which have formally adopted and are complying with the Valdez Principles . . . or which are pursuing corporate policies which [the trustee] determines are in compliance with the Valdez Principles.[63]

While New Jersey's Bill does not offer a definition of an investment preference, New York's Bill does:

> when, after the various financial and other benefits of investing a portion of the assets of a fund in the stocks, securities and

60. Harvey & Conner, *supra* note 11, at 31.

61. *Politicians Support Valdez Principles*, PENSIONS & INVESTMENT AGE, Feb 19, 1990, at 43.

62. New Jersey, for example, has seven. N.J. Ass. No. 2861, 204th Leg. Sess. § 2(a) (1990).

63. *Id.* § 3(a).

> other obligations of two or more corporations have been estimated to be comparable, similar or approximately equal, the fund . . . invest[s] in the . . . corporation or corporations which have adopted or are in compliance with the Valdez [P]rinciples.[64]

New Jersey's failure to include a definition of preference could be seen as either a fiduciary shortcoming or an environmental benefit. As a fiduciary shortcoming, this absence leaves open the possibility of investment in companies with inferior financial records. The New York definition fills this gap by defining the preference as a non-financial means of making an investment decision between two financially comparable investments. On the other hand, the absence of a definition could allow more leeway for a trustee to pursue environmental goals with the fund's resources.[65]

Neither of the Bills requires divestment of any assets.

2. Shareholder Action

All three proposals include similar versions of shareholder activity as a means of encouraging compliance with the Valdez Principles. The New York Bill explains that when a fund invests in a company that is not complying with the Principles,

> such fund shall, through formal written communications and through any other action deemed appropriate by such fund, encourage such corporation to comply with such [P]rinciples. Whenever feasible, such fund shall sponsor, cosponsor or support shareholder resolutions designed to encourage such corporations to adopt or to comply with the Valdez [P]rinciples.[66]

The California Resolution merely requests its funds to consider using shareholder action to encourage the adoption of the Principles and to include the Principles "in the existing criteria for responsible voting of corporate shares owned by the [funds]."[67]

3. Environmental Experts

In the New Jersey Bill, the State Investment Council, which is part of the Division of Investment of the Treasury Department, is

64. N.Y. Ass. No. 9127—A, 213th Leg. Sess. § 2(1) (1990).

65. For a detailed discussion of the financial aspects of environmental investing, see *infra* Part IV.

66. N.Y. Ass. No. 9127—A, 213th Leg. Sess. § 2(2) (1990).

67. Cal. S. Con. Res. 84, 1989-90 Leg. Sess. at 3 (1990).

increased in size from ten to fifteen members.[68] All five of the new members must have experience or expertise in at least one of a series of environmental subjects. These subjects include environmental protection, environment science, land conservation, ecology, and waste management.[69]

Similarly, the New York Bill directs the State Comptroller to consult with the Commissioner of Environmental Conservation before promulgating rules and regulations that "establish guidelines by which corporations shall be evaluated regarding their compliance with such [P]rinciples."[70] In addition to outlining investigation procedures, these rules and regulations would presumably set forth a rating system allowing trustees to rate the degree of compliance of individual companies.[71] The trustees may decide to use only their own compliance data or to supplement their information with data published by CERES.[72]

4. Annual Report

The New Jersey Bill directs the State Investment Council to report on its compliance with the provisions of the act in its annual report to the Governor, the Legislature and the State Treasurer.[73] Similarly, the California Resolution requires submission of proposed stockholder resolutions to the administrative board of the state pension funds.[74]

Providing much more specific guidance, the New York Bill directs each of its pension funds to compile and publish an annual list of corporations in whose stocks, securities or other obligations the fund has invested a portion of its assets.[75] The list must contain information on (a) whether each corporation has adopted or is in compliance with the Valdez Principles; (b) for corporations which have not adopted or are not in compliance with the Principles, an assessment of whether the corporation has taken significant action to comply with the Principles during the preced-

68. N.J. Ass. No. 2861, 204th Leg. Sess. § 6 (1990).

69. *Id.*

70. N.Y. Ass. No. 9127—A, 213th Leg. Sess. § 2(3) (1990).

71. For an example of such a rating system, see *supra* note 44.

72. For an explanation of CERES, see *supra* note 27 and accompanying text. For a discussion of potential legal problems arising when certain functions are legislatively delegated to private parties, see *infra* Part III(A).

73. N.J. Ass. No. 2861, 204th Leg. Sess. § 5 (1990).

74. Cal. S. Con. Res. 84 1989-90 Leg. Sess. at 3 (1990).

75. N.Y. Ass. No. 9127—A, 213th Leg. Sess. § 2(4) (1990).

ing year; and (c) whether the fund has taken any action to encourage each listed corporation to adopt or to comply with the Valdez Principles during the preceding year.[76]

C. *Recommendations*

A drafter of environmental investment legislation may choose to include less than all four of these elements in order to more easily obtain bipartisan support in a state legislature.[77] A case in point is California's Resolution. Merely calling for shareholder activism and minor reporting, it is the only legislation of this kind which has been passed. However, divestment is a far more effective way of achieving corporate environmental responsibility than shareholder activism or investment preferences.[78] Therefore, divestment should at least be considered for legislative proposals, especially in cases where it will not harm the financial performance of the fund.[79]

The scheme used by the New York and New Jersey Bills involves using investment preferences to choose new investments and using shareholder activism to request companies already invested in to comply with the Valdez Principles. A more effective strategy would be to employ investment preferences to choose new investments, specifying the degree of strictness of the preference in an unambiguous definition, and then embarking on a careful policy of divestiture from irresponsible companies only after shareholder activism fails to influence irresponsible firms over a given period of time.

It would be wise to use an environmental selection criterion that includes enough relevant factors to be a meaningful test of the environmental responsibility of a firm. The criterion of compliance with the Valdez Principles certainly examines a considerable variety of matters relating to environmental responsibility,[80]

76. *Id.*

77. *See State May Ask Firms to Use Valdez Rules*, L.A. Times, Feb. 28, 1990, at D7, col. 1.

78. Compare, from the point of view of a publicly traded company which depends upon investment capital, the threat of an unsuccessful (though significant) shareholder resolution to adopt or comply with the Valdez Principles with a threat of withdrawal of many millions of dollars in investment capital unless the company signs and/or follows the Principles.

79. For a detailed discussion of the effects of environmental investing on portfolio performance, see *infra* Part IV.

80. *See* Valdez Principles in appendix *infra*.

but other guidelines, such as the factors used by the Franklin Research and Development Corporation,[81] would suffice.

The two remaining aspects of environmental investment legislation also merit discussion. Implementation of an annual reporting provision like the one in the New York Bill would require additional resources, but would serve a critical role in monitoring the progress of the enactment. In addition, it would not be politically self-defeating if compliance data were not released to the public.[82] For these reasons, the reporting provision should be included in any proposal. Similarly, including environmental experts in the investment decision process is an easily implemented and effective way of helping trustees make informed decisions about compliance with investment criteria. Consequently, it is also an important element to include in any legislative proposal for environmental investment.

III. LEGAL LIMITATIONS ON ENVIRONMENTAL INVESTMENT BY PUBLIC PENSION FUNDS

State environmental investment legislation directs fiduciaries to employ non-financial factors in their investment decisions. As state legislation, it is not subject to an attack based upon the violation of state common law on the subject of fiduciary duties.[83] It is nevertheless subject to a variety of relatively weak federal and state constitutional challenges and indirect trust law arguments.[84]

81. *See supra* note 44.

82. As of February 1990, one of California's pension funds, the Public Employees Retirement System, had agreed to ask 27 major companies it invested its funds with to report how their policies compared to the Valdez Principles. *State May Ask Firms to Use Valdez Rules*, *supra* note 77, at D7, col. 1. At that time, eight companies had consented to this reporting plan. *Id.* They were such household names as Aetna, Amoco, Chevron, Eastman Kodak, Mobil, Texaco, and Union Carbide. *Id.*

83. State environmental investing legislation thus avoids many of the arguments that would be available against analogous local enactments.

84. One example of a state constitutional constraint is contained in article V, section 7 of the New York State Constitution's "nonimpairment clause." Campbell & Josephson, *Public Pension Trustees' Pursuit of Social Goals*, 24 WASH. U.J. URB. & CONTEMP. L. 43, 118 (1983). That clause provides that "membership in any pension or retirement system of the state or of a civil division thereof shall be a contractural [sic] relationship, the benefits of which shall not be diminished or impaired." Such a clause entitles benefits under applicable plans to protection under the Contracts Clause of the Federal Constitution. *Id.* *See infra* Part III(B).

There is some variation among state constitutions, but most state constitutional provisions parallel the federal provisions. This section, therefore, addresses the legal constraints on the proposed environmental investment legislation using the language of the

All of these challenges are tempered by the fact that states have broad authority in dealing with their own funds.[85] Moreover, courts, wherever reasonably possible, will construe and apply statutes to avoid casting doubt upon their constitutionality.[86] It should be noted that there is little case law dealing with challenges to social investment legislation and none addressing attacks upon environmental investment legislation.

A. *Impermissible Delegation*

If a statute uses the Valdez Principles as an investment criterion and uses CERES' reports to determine which companies are environmentally responsible, it is subject to a challenge based on the argument that such reliance on the report of a private organization is an impermissible delegation of legislative power to a private entity. The reasoning is that delegation of legislative authority to private persons unaccountable to the general pubic is improper.[87]

The impermissible delegation argument is rarely successful. However, *Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore*[88] is an example of one state court's willingness to apply the doctrine in certain circumstances. In that case, a city public employee pension fund's South Africa divestment statute was in issue. The court upheld the use of a private organization's list of companies "doing business in or with the Republic of South Africa,"[89] on the ground that the trustees of the fund were not bound by the organization's list.[90] The list was "merely a reference."[91] According to the Court of Appeals of Maryland, there is no impermissible delegation when a legislature simply adopts a fixed standard promulgated by a private entity, because the entity's influence does not continue.[92] However, the adoption of a

federal document. Differences in state constitutional language could nevertheless be determinative in a legal dispute.

85. *See* Tron v. Condello, 427 F. Supp. 1175, 1187-89 (S.D.N.Y. 1976); Campbell & Josephson, *supra* note 84, at 118-19 (citing Sgaglione v. Levitt, 37 N.Y.2d 507, 513, 337 N.E.2d 592, 595, 375 N.Y.S.2d 79, 84 (1975)); Troyer & Slocombe, *supra* note 1, at 158.

86. *See* Ashwander v. Tennessee Valley Auth., 297 U.S. 288, 346 (1936).

87. *See, e.g.*, Bd. of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 94, 562 A.2d 720, 730 (1989), *cert. denied*, 110 S. Ct. 1167 (1990).

88. *Id.*

89. *Id.* at 92, 562 A.2d at 730.

90. *Id.* at 98, 562 A.2d at 732.

91. *Id.*

92. *Id.* at 95, 562 A.2d at 731.

list that is subsequently revised by the private organization may constitute impermissible delegation.[93] Nevertheless, periodically revised standards may be used "in limited circumstances such as where the standards are issued by a well-recognized, independent authority, and provide guidance on technical and complex matters within the entity's area of expertise."[94] This language suggests that the use of a signatory list periodically updated by CERES may be permissible. As a project of the Social Investment Forum, composed of financial managers and experts in the field of social investment, CERES probably satisfies this standard.

By using only the guidelines that CERES created and not the private entity's research services, the bills proposed in Part II completely avoid the impermissible delegation problem. These bills allow the trustees themselves, with the help of environmental experts, to determine whether a company is in compliance with the Principles. Further, the bills do not require companies to actually sign the code, but allow them to merely comply with it. By employing careful language, drafters of state legislation can easily steer clear of the impermissible delegation argument.

B. *Contract Clause*

If the environmental investment statute impairs obligations of the beneficiaries' pension contracts with the state, it may violate the Contract Clause of the United States Constitution.[95] Analysis of a claim that a government action is invalid because it impairs contractual obligations involves a series of steps.[96] First, a contractual obligation must be found.[97] The court must then determine whether the obligation under that contract was impaired.[98] If so, the court must ask whether the impairment violates the Contract Clause, "[f]or it is not every modification of a contractual promise that impairs the obligation of contract under federal law."[99]

93. *Id.* at 95-96, 562 A.2d at 731.

94. *Id.* at 96-97, 562 A.2d at 731-32, and cases cited.

95. U.S. CONST. art. I, § 10 ("No State shall . . . pass any . . . law impairing the obligation of contracts").

96. *See* United States Trust Co. v. New Jersey, 431 U.S. 1, 17-21 (1977).

97. *See id.* at 17.

98. *See id.* at 21.

99. City of El Paso v. Simmons, 379 U.S. 497, 506-07 (1965).

The threshold issue is whether any contractual duties exist for trustees or beneficiaries of pension plans.[100] State common law will usually determine whether pension plans create contractual duties toward persons with vested rights under the plans.[101] Statutes may also expressly recognize the existence of a contractual relationship.[102] Of course, if the court determines that no contractual obligations exist, then the Contract Clause is not violated.

The Supreme Court, in *Home Building and Loan Association v. Blaisdell*,[103] enunciated the constitutional standard for impairment of contracts: "[t]he obligations of a contract are impaired by a law which renders them invalid, or releases or extinguishes them."[104] This Constitutional prohibition is not absolute, because "the State also continues to possess authority to safeguard the vital interests of its people. It does not matter that legislation appropriate to that end 'has the result of modifying or abrogating contracts already in effect.' "[105] Despite the existence of a few more recent cases with broader readings of the Contract Clause,[106] the Supreme Court has remained reluctant, as it was in *Blaisdell*, to use the Contract Clause to invalidate state statutes.[107]

Since the state legislation proposed in Part II does not alter the provisions in the pension plans concerning the amount of bene-

100. This issue was cursorily addressed by the Supreme Court in United States R.R. Retirement Bd. v. Fritz, 449 U.S. 166 (1980), which held that railroad retirement benefits, like social security benefits, were not contractual. *Id.* at 174. Although that case dealt with a Fifth Amendment Takings Clause challenge to a federal enactment and not a Contract Clause challenge to a state law, the Court was unanimous in its characterization of these benefits as non-contractual.

101. *See, e.g.*, Bd. of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 100, 562 A.2d 720, 733 (1989), *cert. denied*, 110 S. Ct. 1167 (1990). The states of Washington and Massachusetts have characterized benefits promised under public employee pension plans as contractual in nature. *See* Campbell & Josephson, *supra* note 84, at 118.

102. *See, e.g.*, BALTIMORE CITY CODE art. 22, § 42 (1983).

103. 290 U.S. 398 (1933).

104. *Id.* at 431 (footnotes omitted).

105. *Id.* at 434-35 (footnote omitted) (quoting Stephenson v. Binford, 287 U.S. 251, 276 (1932)).

106. *See, e.g.*, Allied Structural Steel v. Spannaus, 438 U.S. 234 (1978); United States Trust Co. of New York v. New Jersey, 431 U.S. 1 (1977).

107. *See, e.g.*, Exxon Corp. v. Eagerton, 462 U.S. 176 (1983); Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400 (1983); United States R.R. Retirement Bd. v. Fritz, 449 U.S. 166 (1980); Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976).

fits a beneficiary is entitled to receive,[108] such an act does not directly change the state's pension contracts with the system's beneficiaries. The statute may indirectly alter these contractual obligations by changing the manner in which the pension funds are invested.[109] Only an evidentiary inquiry can determine whether the ongoing costs of the statute will significantly jeopardize the amount or payment of defined benefits or future variable benefits.[110] Some changes are permissible: insignificant changes do not unconstitutionally impair the obligations of a contract.[111] In *Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore*, discussed above, the trial court, after hearing extensive testimony, found the initial cost of divestiture to the beneficiaries to be so minimal that it did not even approach the constitutional standard for impairment.[112]

Another possible challenge is that the contracts incorporate common-law trust duties of prudence and loyalty and that the statute alters those duties. For example, the *Baltimore* court agreed with the trustees that the pension contracts incorporated the trustees' fiduciary duties and assumed that "if legislation substantially alters those duties, the legislation should be viewed as changing the obligations of contract."[113] The trustees in that case did not convincingly prove such change.[114]

The common-law duty of prudence provides that "[i]n his management of the trust, the trustee is required to manifest the care, skill, prudence, and diligence of an ordinarily prudent man en-

108. More specifically, the proposed legislation does not change or replace explicit provisions in the plans which guarantee minimum earnings or which concern future benefits. *See infra* note 110.

109. *See* Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 100, 562 A.2d 720, 734 (1989), *cert. denied*, 110 S. Ct. 1167 (1990).

110. Future variable benefits represent earnings in excess of any defined (guaranteed) minimum earnings. Defined benefits are fixed, and if they exist in a fund, they are explicitly guaranteed. Variable benefits fluctuate with market performance and thus cannot be guaranteed. Beneficiaries may claim contractual rights to both fixed and future variable benefits. *See id.* at 100 n.26, 562 A.2d at 733 n.26.

111. Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411 (1983); Allied Structural Steel v. Spannaus, 438 U.S. 234, 244-45 (1978).

112. *Baltimore*, 317 Md. at 101, 562 A.2d at 734. The court found the initial cost of divestiture to the beneficiaries to be $750,000, which represented 1/32 of 1% of the total returns from the funds' invested assets, and the ongoing cost to be $1.2 million, which represented 1/20 of 1% of the total returns. *Id.*

113. *Id.* at 102, 562 A.2d at 734.

114. *Id.*

gaged in similar business affairs and with objectives similar to those of the trust in question."[115]

Another version of the duty of prudence adopted by some states is that set forth in the Employee Retirement Income Security Act (ERISA).[116] ERISA's "prudent expert" standard is substantially similar to the common law standard, except that it assumes that the "prudent person" is "familiar with such matters."[117] In order to show an alteration of the duty of prudence, an opponent might allege that the statute substantially reduces the universe of eligible investments, thereby diminishing returns.[118] However, even under rigid divestiture programs, which are more radical than the New York or New Jersey Bills, economically competitive substitute investments remain available,[119] allowing for the construction of a well-diversified portfolio that does not imprudently increase risk or decrease returns.[120] And as

115. G.G. BOGERT & G.T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES, § 541 (rev. 2d ed. 1978).

There is considerable authority for the view that the duty of prudence (and also the duty of loyalty) is not obligatory, but that it can be set aside explicitly in the pension trust instrument or implicitly by consent of the beneficiaries to the fund's investment strategy. *See* 3 A. SCOTT, THE LAW OF TRUSTS §§ 174, 227.14 (3d ed. 1967); Dobris, *supra* note 14, at 218, 236; Langbein & Posner, *supra* note 48, at 105-07; Lynn, *supra* note 2, at 110; Ravikoff & Curzan, *Social Responsibility in Investment Policy and the Prudent Man Rule*, 68 CAL. L. REV. 518, 544-45 (1980). For one set of authors' thorough analysis of the prudent person standard applicable to a public pension fund, see Campbell & Josephson, *supra* note 84, at 48-50, 87-109.

116. 29 U.S.C. §§ 1001-1461 (1988). Public pension plans are exempt from ERISA, because they qualify as "governmental plans." 29 U.S.C. §§ 1002(32), 1003(b)(1) (1988).

117. 29 U.S.C. § 1104(a)(1) (1988).

118. *See, e.g.*, Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 103, 562 A.2d 720, 735 (1989), *cert. denied*, 110 S. Ct. 1167 (1990); Zelinsky, *The Dilemma of the Local Social Investment: An Essay on "Socially Responsible" Investing*, 6 CARDOZO L. REV. 111, 111 (1984); Dunlap, *Some Trustees Want City Pension Funds to Cut Pretoria Ties*, N.Y. Times, Mar. 7, 1984, at A1, col. 6, B24, col. 6. *See also* Ferris & Rykaczewski, *Social Investment and the Management of Pension Portfolios*, J. AM. SOC'Y CLU & CHFC, Nov. 1986, at 62, 63 (making same argument with regard to private pension funds); *SAG Pension & Health Rejects South Africa Divestiture*, SCREEN ACTOR NEWS, Dec. 1984, at 3 (trustees of private pension plan refused to divest because of imprudence)(cited in Note, *supra* note 14, at 772 n.45).

119. For a discussion of data on this subject, see *infra* Part IV.

120. *See Baltimore*, 317 Md. at 103-04, 562 A.2d at 735; Zelinsky, *supra* note 118, at 111-12; Wise, *supra* note 14, at 16, col. 6. *But see* Broderick, *The Prudent Person vs. Divestment*, DIRECTORS & BOARDS, Summer 1984, at 4 (predicting, without data, lower rates of return and higher risks for pension funds subject to South Africa divestment statutes). Given the financial data available, there may be no reason to believe that companies with substantial ties to South Africa will necessarily have higher rates of return than firms with no ties to that country. *See* Zelinsky, *supra* note 118, at 111-12.

to the alteration of a trustee's management style, it cannot be said that there is a contractual right to a particular management style.[121] In addition, the existence of safeguards, such as the gradual introduction of the social investment strategy or a provision for suspensions, may help to ensure that environmental investment occurs only within the bounds of the trustee's duty of prudence.[122]

Another challenge based on the duty of prudence is that by requiring the consideration of factors unrelated to investment performance, the statute alters that duty.[123] In the traditional formulation, the trustees' overriding purpose must be to provide the beneficiaries with their benefits.[124] Social considerations are permitted only if they have no adverse effect on the fund's finances.[125] This would appear to be the legal framework around which the New York and New Jersey investment preference Bills[126] were drafted: opting for one of two investments with equal risk and return over the other based upon a social preference would not offend the prudent investor rule.[127] But according to trust law experts and several courts, a trustee's duty is not necessarily to maximize the return on investments; it is to obtain a "reasonable" or "just" return while avoiding unnecessary risk.[128] Furthermore, by investing in businesses which exercise prudence in environmental matters, thus avoiding huge fines and long and costly liability disputes, trustees and drafters of legislation may

121. *Baltimore*, 317 Md. at 104, 562 A.2d at 735.

122. *See id.* at 105, 562 A.2d at 736.

123. *See, e.g.*, *id.*; Dolan, *supra* note 1, at 17 ("pension funds are designed for one purpose — income for retirees") (quoting Bernard Jump, a pension expert at Syracuse University); Murrmann, Schaffer, & Wokutch, *supra* note 2, at 360.

124. Campbell & Josephson, *supra* note 84, at 45. *See* Lynn, *supra* note 2, at 102-03; Zelinsky, *supra* note 118, at 111, nn. 19-25 and accompanying text.

125. Langbein & Posner, *supra* note 48, at 98.

126. *See supra* Part II.

127. Campbell & Josephson, *supra* note 84, at 46-47; Jerry & Joy, *supra* note 1, at 700.

128. Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 107, 562 A.2d 720, 737 (1989), *cert. denied*, 110 S. Ct. 1167 (1990). *See* Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248, 1254 (S.D.N.Y. 1978), *aff'd*, 595 F.2d 1210 (2d Cir. 1979); King v. Talbot, 40 N.Y. 76, 86 (1869); 3 A. SCOTT, THE LAW OF TRUSTS, § 227.3 (W. Fratcher 4th ed. 1988); RESTATEMENT (SECOND) OF TRUSTS § 227 comment (e) (1957); Campbell & Josephson, *supra* note 84, at 92; Dobris, *supra* note 14, at 230, 232; Ravikoff & Curzan, *supra* note 115, at 519; Zelinsky, *supra* note 118, at 121-22. *But see* Campbell & Josephson, *supra* note 84, at 48; Langbein & Posner, *supra* note 48, at 98, 103; Lynn, *supra* note 2, at 102-03; Schotland, *Should Pension Funds be Used to Achieve "Social" Goals?* (part 3 of 3), TRUSTS & ESTATES, Nov. 1980, at 33.

reasonably believe that they will best serve the beneficiaries' long-term interests and most effectively ensure the provision of future benefits.[129] As long as environmental investment results in competitive levels of risk and return, it does not alter the duty of prudence.[130]

The duty of loyalty is also established by state judicial decisions and statutes, which commonly adopt the ERISA formulation. A fiduciary must "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to participants and their beneficiaries."[131] A challenger could argue that the environmental investment law alters the duty of loyalty by (1) requiring the trustees to consider the interests of the public rather than only the interests of the beneficiaries and (2) directing them to invest the fund's assets for purposes other than merely providing benefits.[132] But where the costs of environmental investment are negligible, the obligation of loyalty can be reconciled with a trustee taking the environmental implications of the fund's investments into account.[133] Alternatively, it can be argued that the duty of

129. *See Baltimore*, 317 Md. at 106-07, 562 A.2d at 738; 3 A. SCOTT, *supra* note 128, § 227.17; *Do Good Ethics Ensure Good Profits?*, BUS. & SOC'Y REV., Summer 1989, at 4, 9 (comment of Jerome L. Dodson, president of Parnassus Fund), 10 (comment of Maurice L. Shoenwald, president of New Alternatives Fund). *See also infra* note 225 and accompanying text.

Some indirect benefits of environmental investment, such as lowered health care costs or the adoption of an effective local emergency remediation plan, may also inure to the benefit of the fiduciary's beneficiaries, thus increasing the investment's overall rate of return. *See* Zelinsky, *supra* note 118, at 139, 146; Dobris, *supra* note 14, at 235. *See also* Ravikoff & Curzan, *supra* note 115, at 545-46. *But see* Campbell & Josephson, *supra* note 84, at 102 (indicating "no support" for theory permitting trustees of public employee pension funds to consider indirect benefits in the absence of necessity).

130. *Baltimore*, 317 Md. at 107, 562 A.2d at 737. Some writers argue further that decreased fund productivity should be acceptable when lost in pursuit of social gain. *See* Dobris, *supra* note 14, at 230; *FRDC*, *supra* note 7, at 11.

131. 29 U.S.C. § 1104(a)(1) (1988). For a detailed treatment of the duty of loyalty applicable to public pension funds, see Campbell & Josephson, *supra* note 84, at 67-87.

132. *See, e.g.*, *Baltimore*, 317 Md. at 109, 562 A.2d at 738. One author provides an interesting analysis of this problem, attributing to advocates of social investing a desire to redefine the fiduciary relationship as a three-party affair involving the fiduciary, the beneficiary, and society as a whole, as opposed to the bilateral focus of conventional fiduciary jurisprudence only on the relationship between the fiduciary and its beneficiary. *See* Zelinsky, *supra* note 118, at 120.

133. *See Baltimore*, 317 Md. at 110, 562 A.2d at 738; 3 A. SCOTT, *supra* note 128, § 227.17; Campbell & Josephson, *supra* note 84, at 46-47; Dobris, *supra* note 14, at 233; Ravikoff & Curzan, *supra* note 115, at 523. *But see* Langbein & Posner, *supra* note 48, at 96, 98, 102; Lynn, *supra* note 2, at 105, 107 (criticizing Scott's view). While Langbein & Pos-

loyalty only contemplates the prohibition of transactions involving fiduciary conflicts of interest and not the consideration of social interests.[134]

Thus, an environmental investment statute of the form proposed here does not violate the strict common-law duties of prudence and loyalty. Furthermore, under the *Blaisdell* standard for impairment,[135] it can be forcibly argued that since the purpose of the proposed legislation is ultimately to safeguard the vital interests of state citizens, some modification of contractual obligations should be tolerated. Under any analysis, the proposed statute does not violate the Contract Clause.

C. *Takings Clause*

Assuming that a fund continues to deliver any defined minimum benefits,[136] beneficiaries' only plausible challenge under the takings clause would be that the initial and ongoing costs of such legislation reduce the pension fund's future earnings and thus the amount of their variable benefits,[137] amounting to a confiscation by the state. The state having taken their property without just compensation, the beneficiaries would be deprived of their constitutional right to due process under the Takings Clause of the Fifth and Fourteenth Amendments.[138]

Beneficiaries' contractual right to receive benefits, if determined to exist by state law, may constitute property.[139] However, the drafter of environmental investment legislation should under no circumstances assume the existence of these contractual rights. *United States Railroad Retirement Board v. Fritz*,[140] for example, upheld Congress's destruction of statutorily scheduled retirement benefits for a whole class of railroad employees. On the issue of the denial of retirement benefits that the plaintiff benefi-

ner define the duty of loyalty in terms of exclusive benefit to the beneficiary, they go on to say that "some form of social-investing option could be created that would be consistent with the trust investment law and with ERISA." Langbein & Posner, *supra* note 48, at 106.

134. *See* Campbell & Josephson, *supra* note 84, at 68; Ravikoff & Curzan, *supra* note 115, at 531.

135. *See supra* notes 103-105 and accompanying text.

136. For a definition of this term, see *supra* note 110.

137. For a definition of this term, see *supra* note 110.

138. For an analogous, though unsuccessful, attack on South Africa divestment ordinances, see Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 110-11, 562 A.2d 720, 738-39 (1989), *cert. denied*, 110 S. Ct. 1167 (1990).

139. *See, e.g.*, *id.* at 111, 562 A.2d at 739.

140. 449 U.S. 166 (1980).

ciaries had expected and planned on for years, the Supreme Court unanimously held that there was no taking of property, "since railroad benefits, like social security benefits, are not contractual and may be altered or even eliminated at any time."[141] Professor Tribe notes that "for those who invest their time and toil in exchange for statutorily promised government pension benefits, 'the legislative determination provides all the process that is due.' "[142]

If property rights are found to exist and the fund neglects to deliver payments commensurate with the pension fund's earnings, then beneficiaries may be able to claim deprivation of a property right.[143] But a beneficiary's property interest in future benefits above any guaranteed minimum payments is not unconstitutionally taken in every instance in which the fund trustees act in a way that might reduce those additional earnings.[144] As a general matter, unless there is a provision in the law to this effect, beneficiaries have no right to direct the investment of a pension system's assets.[145]

141. *Id.* at 174.

142. L. TRIBE, AMERICAN CONSTITUTIONAL LAW 627 (2d ed. 1988)(quoting *Fritz*, 449 U.S. at 174).

143. *See, e.g.*, *Baltimore*, 317 Md. at 112, 562 A.2d at 739.

144. *Id.*

145. Crown v. Trustees of the Patrolmen's Variable Supplements Fund, 659 F. Supp. 318, 320 (S.D.N.Y. 1987) (citing Withers v. Teachers' Retirement Sys., 447 F. Supp. 1248, 1260 (S.D.N.Y. 1978)), *aff'd*, 819 F.2d 47 (2d Cir. 1987); *Withers*, 447 F. Supp. at 1260 (stating that beneficiaries of a public retirement fund "have no entitlement to, or right to direct the retention of, the particular assets that are held for investment purposes in the pension fund"), *aff'd*, 595 F.2d 1210 (2d Cir. 1979). *See* Tron v. Condello, 427 F. Supp. 1175, 1189-90 (S.D.N.Y. 1976) (beneficiary "has a vested right in receiving his pension benefits, but not in regulating the investment policies set by the Legislature and the Retirement Board").

Withers is often cited to support socially constrained investments of public pension funds. In that case, the court upheld the decision of a fund's trustees to purchase New York City bonds (which had a high risk of default and which left the pension fund undiversified) as part of the plan that ultimately prevented that City's bankruptcy in late 1975. The beneficiaries had claimed that the trustees acted more in the interest of the city than for the benefit of the beneficiaries themselves. *Withers*, 447 F. Supp. at 1254. The court disagreed, noting that the bond purchases were probably the most advantageous investment the fund could make on purely financial grounds, due to the fact that the City was the main contributor to the fund. *Id.* at 1256, 1259. *See* Jerry & Joy, *supra* note 1, at 701-03; Troyer & Slocombe, *supra* note 1, at 157 n.110. Some writers view *Withers* as an affirmation of traditional law on fiduciary administration. *See* Campbell & Josephson, *supra* note 84, at 99-100; Langbein & Posner, *supra* note 48, at 101-02; Lynn, *supra* note 2, at 109. Others view it as a break from mainstream traditional law. *See* Ravikoff & Curzan, *supra* note 115, at 523.

The Supreme Court has declined to develop any clear test for identifying a taking forbidden by the Fifth Amendment.[146] Instead, it has conducted *ad hoc* factual inquiries into the circumstances of each particular case.[147] In *Penn Central Transportation Co. v. City of New York*, however, the Court identified three factors having "particular significance."[148] They are (a) "[t]he economic impact of the regulation on the claimant;"[149] (b) "the extent to which the regulation has interfered with distinct investment-backed expectations;"[150] and (c) "the character of the governmental action."[151]

The first two factors require an evidentiary inquiry into the degree to which beneficiaries are deprived of benefits they would otherwise receive in the absence of the statute.[152] Any provisions in the legislation which mitigate adverse impacts on benefits make the success of a takings challenge less likely.[153] If the legislation reduces defined benefits, beneficiaries may claim that the statute interferes with distinct investment-backed expectations. But the variable nature of anticipated future benefits above any guaranteed returns weakens an argument that loss of future profits interferes with distinct expectations.[154] The amount of interference necessary to constitute a violation of the Takings Clause is a matter for the court to decide. However, the evidence suggests that

146. Penn Central Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978). *See* C. Berger, Land Ownership and Use 712 (1983)(noting the continuing intractability of the taking issue).

147. *Penn Central*, 438 U.S. at 124.

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *See, e.g.*, Board of Trustees of the Employees' Retirement Sys. v. Mayor of Baltimore, 317 Md. 72, 113, 562 A.2d 720, 739-40 (1989), *cert. denied*, 110 S. Ct. 1167 (1990).

153. *See, e.g.*, Connolly v. Pension Benefit Guar. Corp., 475 U.S. 211, 225-26 (1986) (rejecting such a challenge in part because the statutory imposition of liability for employer withdrawal from a pension plan mitigated the economic impact on the individual employer); *Baltimore*, 317 Md. at 113, 562 A.2d at 739-40 (noting that a provision allowing for the postponement of divestment until it can be done without substantial detrimental impact to the fund would mitigate adverse impacts on benefits).

154. *See* Andrus v. Allard, 444 U.S. 51, 66 (1979) (stating that "loss of future profits—unaccompanied by any physical property restriction—provides a slender reed on which to rest a takings claim"); *Baltimore*, 317 Md. at 113, 562 A.2d at 740 ("Variable benefits are, as their name suggests, speculative and uncertain. Whatever diminution of variable benefits the Ordinances might cause cannot be said to interfere with a 'distinct . . . expectation.' ").

environmental investment will not significantly diminish benefits, if at all.[155]

Finally, in regard to the character of the government action, the proposed environmental investment legislation does not entail government appropriation of the beneficiaries' money for its own use or for the use of others. It attempts to promote the common good by regulating a pension system's investment policy. As stated by Professor Tribe, "[g]overnment regulation—by definition—involves the adjustment of private rights for public benefit. To require compensation whenever the law curtailed the potential for economic exploitation 'would effectively compel the government to regulate by *purchase*.' It has long been recognized that such a regime would be unworkable."[156] Any reduction in benefits, which appears unlikely, is merely an incidental cost of efforts to promote the common good and does not approach the kind of government action that requires compensation.[157]

D. *Preemption*

Another possible attack on environmental investment legislation could be that such laws are preempted by existing federal environmental laws. However, no existing federal statute undertakes to regulate the investment of public monies in the securities of companies according to their level of environmental responsibility.[158]

There are three ways in which federal law preempts local law: express congressional intent to do so,[159] the existence of a scheme of federal regulation sufficiently comprehensive to occupy a given field or to make clear that Congress left no room for sup-

155. For a discussion of the effects of environmental investing on portfolio performance, see *infra* Part IV.

156. L. TRIBE, *supra* note 142, at 596-97 (footnotes omitted).

157. *See Connolly*, 475 U.S. at 225; *Baltimore*, 317 Md. at 113-14, 562 A.2d at 740.

158. *Cf. Baltimore*, 317 Md. at 114-21, 562 A.2d at 740-44 (in which the court held that the city's South Africa divestment ordinance was not preempted by the Comprehensive Anti-Apartheid Act of 1986, Pub. L. No. 99-440, 100 Stat. 1086 (codified in pertinent part at 22 U.S.C. §§ 2151, 2346(d), 5001-5116 (1988)), which sets forth the United States' policy toward the government of South Africa and encourages action through economic, political, and diplomatic measures with the goal of establishing a nonracial democracy).

159. California v. ARC America Corp., 109 S. Ct. 1661, 1665 (1989); Hillsborough County v. Automated Medical Laboratory, Inc., 471 U.S. 707, 713 (1985); *Baltimore*, 317 Md. at 145, 562 A.2d at 740-41.

plementary state legislation,[160] or actual conflict of the state statute with federal law.[161] None of these doctrines applies to environmental investment legislation.

Moreover, in areas traditionally regulated by state and local governments, there is a strong presumption against finding federal preemption.[162] Since the state's proposed regulation of investments by its public employee's pension funds is arguably a matter of traditional local concern, the proposed statute enjoys this presumption against federal preemption. Therefore, a drafter need not work around a possible challenge on these grounds.

E. *Commerce Clause*

One other potential legal limitation on environmental investment legislation is the "dormant" or "negative" Commerce Clause. According to that doctrine, state regulations substantially affecting interstate commerce are impermissible. But by falling within the "market participant" exception, the state may be excepted from the scrutiny of the dormant commerce clause.

When a state government acts as a buyer or seller in a market rather than in its distinct governmental capacity, its behavior is not subject to the limitations of the dormant Commerce Clause.[163] Just as a private merchant may elect to deal with certain companies on the basis of their environmental responsibility,

160. *ARC America*, 109 S. Ct. at 1665; Pacific Gas & Electric v. Energy Resources Comm'n, 461 U.S. 190, 204 (1983); Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947); *Baltimore*, 317 Md. at 115, 562 A.2d at 741.

161. *ARC America*, 109 S. Ct. at 1665; *Hillsborough County*, 471 U.S. at 713; *Baltimore*, 317 Md. at 115, 562 A.2d at 741.

162. *ARC America*, 109 S. Ct. at 1665; *Hillsborough County*, 471 U.S. at 715-16; *Pacific Gas*, 461 U.S. at 206; San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 244 (1959); *Baltimore*, 317 Md. at 116, 562 A.2d at 741.

163. New Energy Co. of Indiana v. Limbach, 108 S. Ct. 1803, 1809 (1988); South-Central Timber Dev., Inc. v. Wunnicke, 467 U.S. 82, 93 (1984); *Baltimore*, 317 Md. at 131-33, 562 A.2d at 749. *See* Wisconsin Dep't of Indus., Labor and Human Relations v. Gould, Inc., 475 U.S. 282, 289-91 (1986); United Bldg. & Construction Trades Council v. Mayor of Camden, 465 U.S. 208, 219-20 (1984); White v. Massachusetts Council of Construction Employers, Inc., 460 U.S. 204, 206-08 (1983); Reeves, Inc. v. Stake, 447 U.S. 429, 434-36 (1980); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 806 (1976); L. TRIBE, *supra* note 142, at 430-34.

It has been suggested that the Supreme Court, in Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985), by overruling Nat'l League of Cities v. Usery, 426 U.S. 833 (1976), repudiated the market participant doctrine. *See* Swin Resource Sys., Inc. v. Lycoming County, 883 F.2d 245, 260-61 (3d Cir. 1989) (Gibbons, C.J., dissenting), *cert. denied*, so may a state pension system make the same choice unhindered by the constraints of the negative Commerce Clause.[164] The limits of the market participant exception were delineated in *South-Central Timber Development, Inc. v. Wunnicke*:[165] "it allows a State to impose burdens on commerce within the market in which it is a participant, but . . . [t]he State may not impose conditions . . . that have a substantial regulatory effect outside of that particular market."[166] Through its ownership of corporate securities, the state retains a continuing proprietary interest[167] in the firms in which it remains invested. By engaging in these ongoing commercial relationships and dealing only in the securities market, a state adopting an environmental investment statute falls within the market participant exception to the dormant Commerce Clause.[168]

In cases where the market participant exception does not apply, the proposed state legislation is subject to dormant Commerce Clause scrutiny under the Supreme Court's test in *Pike v. Bruce Church, Inc.*:[169] "[w]here the statute regulates even-handedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation

110 S. Ct. 1127 (1990); Manheim, *New-Age Federalism and the Market Participant Doctrine*, 22 ARIZ. ST. L.J. 559, 562 (1990).

However, the Court's reiteration of the rule after *Garcia*, *see, e.g.*, Wisconsin v. Gould, 475 U.S. at 289 (holding the doctrine inapplicable to the facts, but not invalidating it); *New Energy*, 108 S. Ct. at 1809 (holding the doctrine inapplicable), and the reasoning of *Garcia* itself indicate that the market participant exception remains a viable doctrine. *See Swin Resource Sys.*, 883 F.2d at 254-55 (summarizing the majority's adoption of the market participant principle and criticism of Judge Gibbons' analysis); Evergreen Waste Sys., Inc. v. Metropolitan Serv. Dist., 643 F. Supp. 127, 132 (D. Or. 1986) (explicitly rejecting the argument that *Garcia* overruled the market participant exception), *aff'd*, 820 F.2d 1482 (9th Cir. 1987); Coenen, *Untangling the Market-Participant Exemption to the Dormant Commerce Clause*, 88 MICH. L. REV. 395, 407 n.86, 429-30 (1989) (arguing that the federalist reasoning in *Garcia* both explains and validates the market participant doctrine).

164. *See* Reeves, Inc. v. Stake, 447 U.S. at 438-39 (noting "the long recognized right of trader or manufacturer, engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal") (quoting United States v. Colgate & Co., 250 U.S. 300, 307 (1919)); *Baltimore*, 317 Md. 133-35, 562 A.2d at 750.

165. 467 U.S. at 97-98.

166. *Id.* at 97.

167. Restrictions on an ongoing commercial relationship are distinct from restrictions on economic activities that take place between parties after their direct commercial obligations have ended. The former fall within the market participant exception; the latter do not. *See South-Central Timber*, 467 U.S. at 99 (distinguishing White v. Massachusetts Council of Construction Employers, Inc., 460 U.S. 204 (1983)).

168. *See Baltimore*, 317 Md. at 137, 562 A.2d at 752; Note, *supra* note 14, at 790-91.

169. 397 U.S. 137 (1970).

to the putative local benefits."[170] The Court clarified when this standard applies in *Maine v. Taylor*,[171] noting that the appropriate standard depends upon whether the statute's effect on interstate commerce is incidental or whether the statute affirmatively discriminates against interstate transactions.[172]

The proposed environmental investment statute neither facially nor in purpose favors residents of the state over residents of any other state.[173] Therefore, the question becomes whether the incidental burden on interstate commerce, if any, caused by the investment policies in the statute are "clearly excessive" in relation to the state's legitimate local interests.[174] A state's regulation of its own employees' pension funds is arguably a local interest appropriately addressed by the state. Whatever burden the investment guidelines adopted in the statute exert on the interstate sale of securities must be weighed against such compelling local interests. Given the financial evidence available, it is doubtful that even a powerful environmental investment statute with a reasonable divestment strategy would burden the securities market enough to be characterized as "clearly excessive" when compared with these local interests.

IV. The Effect of Environmental Investment on Portfolio Performance

No empirical studies have been conducted specifically on environmental investment. Therefore, conclusions about the effect of environmental investment on portfolio performance must be drawn by analogy to studies on the effects of social investment in general and South Africa-related divestment in particular.[175] Information on socially screened mutual, money market, and trust funds, which use various investment criteria including environmental responsibility, indicates that social investment can pro-

170. *Id.* at 142.

171. 477 U.S. 131 (1986).

172. *Id.* at 138. *Accord Baltimore*, 317 Md. at 141-42, 562 A.2d at 754.

173. *Cf.* Dean Milk Co. v. City of Madison, 340 U.S. 349, 353-56 (1951) (regulation in practical effect excluded from local distribution milk produced out of state, thus impermissibly protecting local industry against competition from without the state).

174. *See Baltimore*, 317 Md. at 143, 562 A.2d at 754-55 (citing Pike v. Bruce Church, Inc., 397 U.S. 137 (1970)).

175. A thorough examination of the studies on the effect of South Africa divestment on portfolio performance can be found in Jerry & Joy, *supra* note 1, at 688 n.7, 714-44.

duce solid financial performance.[176] Similarly, according to the data on South Africa divestment, a portfolio may suffer no adverse effect from excluding all South Africa-related stocks.[177]

An environmental investment strategy may affect a portfolio in several ways. These aspects include composition, risk and return, transaction, liquidity and administrative costs, and management style.[178]

A. *Composition, Risk and Return*[179]

The core of the composition issue is whether narrowing the range of potential investments by excluding a class of companies in the securities market will impede the construction of a viable portfolio.[180] Any investment strategy, other than "buying the market" according to an index scheme, reduces portfolio diversity to some extent, because it narrows the universe of potential

176. *See* Bromberg, *supra* note 11, at 32-34; Proffitt, *supra* note 7, at 237. *See also* Meyer, *Ethics in Investing Takes Off*, Kansas City Star, June 5, 1990, at D15, col. 1 (noting that "you can make just as much money or more money by taking a socially responsible approach to investing as by taking a conventional one"). *But see* Wang, *A True Believer Who Does Well by Seeking to Do Good*, MONEY, May 1990, at 177 (citing no data, yet quoting a critic of social investing: "the long-term record of the socially responsible [mutual] funds is mediocre").

177. Jerry & Joy, *supra* note 1, at 745; Williams, *supra* note 14, at 181 (quoting the Franklin Research and Development Corp. and United States Trust Co.). The strength of this conclusion depends upon the severity of the divestment criteria. For example, an extreme position of divesting the stock of any firm doing business in South Africa may give rise to disagreement about the effects of divestment. Jerry & Joy, *supra* note 1, at 744. A mild divestment position, such as excluding only South Africa-related firms not ranked in the top two compliance categories of the Sullivan Principles, would almost certainly cause no adverse effects on portfolio performance. *Id.* For an explanation of the Sullivan Code compliance categories, see Paul, *The Inadequacy of Sullivan Reporting*, BUS. & SOC'Y REV., Spring 1986, at 61-62.

178. *See* Dobris, *supra* note 14, at 233; Jerry & Joy, *supra* note 1, at 714.

179. This discussion of financial performance is limited mainly to the subject of returns from a fund's investments; it does not address other financial advantages, such as tax deductions, exemptions, exclusions, or deferrals available for beneficiaries of qualifying pension plans under the Internal Revenue Code and Treasury Regulations. *See, e.g.*, I.R.C. § 401(a), 26 U.S.C. § 401(a) (1988) (offering favorable tax treatment for pension plans administered "for the exclusive benefit of . . . employees or their beneficiaries"). A discussion of these matters is contained in Campbell & Josephson, *supra* note 84, at 57-63, 83-87.

Other unexamined effects on rate of return in financial as well as non-financial terms include the indirect effects, such as improved health, that an environmental investing strategy confers on its beneficiaries. *See* Dobris, *supra* note 14, at 235; Zelinsky, *supra* note 118, at 139, 146. *See also supra* note 129.

180. *See* Jerry & Joy, *supra* note 1, at 715.

investments.[181] Ultimately, the social investment strategy's impact on portfolio composition depends upon the number of stocks excluded, the kinds of stocks excluded, the operating and financial characteristics of included and excluded stocks, and whether excluded stocks have common characteristics that would irreversibly distort portfolio composition.[182]

There are two facts which suggest that composition will not suffer as a result of environmental investment. First, the universe of securities available to portfolio managers is huge.[183] While the strictness of the environmental criteria used to exclude companies will determine to what extent composition is affected, risk and return may not be harmed.[184] Second, only a few industries or classes of companies are automatically excluded by a potent environmental investment strategy, namely chemicals, specialty chemicals, automobiles, and mineral extraction.[185] After eliminating these industries, the vast array of "clean" firms remaining is more than adequate to construct a well-diversified portfolio.[186]

The studies of South Africa-free portfolio performance found that South Africa-free portfolios were both higher in risk and in return than their unconstrained counterparts.[187] Adjusting these higher risk levels to equal the risk levels of unconstrained portfolios, researchers found that South Africa-free portfolios actually outperformed unconstrained portfolios by about twenty basis points[188] per year.[189] This margin translates into a significant differential in the annual return on the investment of billions of dollars in public pension funds. In summarizing the results of all these studies, one set of authors concluded that in the area of portfolio risk and return, "South Africa-free portfolios can com-

181. *See* Jerry & Joy, *supra* note 1, at 745; Langbein & Posner, *supra* note 48, at 85. Both socially responsible and traditional fund managers commonly operate with their personal "buy lists" from which they choose investments. The universe of potential investments is thus severely narrowed by selecting the stocks which make up this list. Letter from Peter D. Kinder, president of Kinder, Lydenberg, Domini & Co., a social research firm, to Christopher J. McKenzie (Mar. 13, 1991).

182. Jerry & Joy, *supra* note 1, at 715-16. *Cf.* Langbein & Posner, *supra* note 48, at 85 (concluding, based solely upon one hypothetical social investing portfolio study, that "[a] portfolio constructed in accordance with social principles will be less diversified").

183. Jerry & Joy, *supra* note 1, at 720.

184. *See* Jerry & Joy, *supra* note 1, at 717; Langbein & Posner, *supra* note 48, at 87, 89.

185. Letter from Peter D. Kinder, *supra* note 181.

186. *Id.*

187. Jerry & Joy, *supra* note 1, at 724.

188. A basis point is 1/100 of one percent of a portfolio's rate of return. *Id.* at 725.

189. *Id.*

pete effectively with unconstrained portfolios because South Africa-free portfolios do not sacrifice return or increase risk."[190]

The data regarding social investment in general indicate that mutual funds using multiple screens, including environmental criteria, have performed better, the same, and worse than unrestricted portfolios, depending on which fund is examined and over what time period.[191] Although almost all mutual funds performed poorly in 1990, most screened funds remained at or above the benchmark indexes — the Standard and Poor's Index (S&P 500) and the Lipper equity fund average.[192] While three- or five-year results are more useful than a one-year perspective, some of these funds are too new to have produced such a record.[193] Of the funds that have been around long enough, all but a few performed better or equal to the Lipper three- and five-year averages last year.[194]

Under one version of modern finance theory, the method of portfolio selection, whether it be by social criteria or otherwise, will have no effect on the portfolio's expected or average return if one ignores administrative costs, because "stock picking" is futile, and every stock of the same risk class is an equally good investment.[195] Assuming this theory is accurate, it tends to explain the competitive performance of social investment.

One very promising development with respect to the performance of socially screened portfolios is the Domini Social Index (DSI). Designed to represent the market of stocks most social investors buy from, the DSI acts as a standard by which to measure the performance of socially screened portfolios, just as the S&P

190. Jerry & Joy, *supra* note 1, at 743. *See* Langbein & Posner, *supra* note 48, at 92 (admitting that the average rate of return of portfolios using social investing will be the same as that of portfolios designed to maximize the financial well-being of the investment beneficiaries); *More Municipalities Joining Drive to Cut South Africa Links*, N.Y. Times, Sept. 25, 1984, at A1, col. 6, A25, col. 1 (Connecticut and Michigan officials claiming they suffered no financial loss as a result of their South Africa divestment). *But see* Broderick, *supra* note 120, at 4 (concluding, in the absence of data, that South Africa divestment increases risk and decreases returns); Hutchinson & Cole, *Legal Standards Governing Investment of Pension Assets for Social and Political Goals*, 128 U. PA. L. REV. 1340, 1386 (1980)(reaching the conclusion of sacrificed safety or return by mere inference); Note, *Socially Responsible Investment of Public Pension Funds: The South Africa Issue and State Law*, 10 N.Y.U. REV. L. SOC. CHANGE, 407, 416-18 (1980-81).

191. Proffitt, *supra* note 7, at 237.

192. *Id.*

193. *Id.* at 238.

194. *Id.* at 238-39.

195. Langbein & Posner, *supra* note 48, at 92.

500 represents the market of large-capitalization stocks most investors buy from.[196] The DSI is a multi-screened, 400-company common stock index which, due to its screens, eliminates about 250 of the stocks which make up the S&P 500.[197] But despite their differences in composition, the returns of the DSI and the S&P 500 are very closely correlated, with the DSI outperforming the S&P 500 in some months and underperforming it in others.[198] This similarity is based on approximately one year of actual performance data and about four years of backtested results.[199]

One difference between the two indexes is that the DSI appears slightly more volatile than the S&P 500, meaning that it dips somewhat lower in a down market and peaks somewhat higher than the S&P 500 in an up market.[200] When compared with the S&P 500, the DSI's stocks are slightly smaller, though still large, in terms of market capitalization, and this is one explanation for the increased volatility.[201] Although admittedly preliminary, these data suggest that there is no reason why an actively-managed, multi-screened portfolio of large-capitalization stocks should underperform the market.

But these data do not show definitively that funds using only environmental criteria to exclude stocks can achieve levels of risk and return equivalent to those of funds using other constraints. Differences in the size or other characteristics of firms whose stock make up the environmental portfolio could produce different results. For example, a South Africa-free investment strategy tends to exclude many large firms, thus including more stocks from small firms in the portfolio.[202] Curiously, studies of this "small stock bias" show that the stocks of small firms tend to earn higher rates of return than would be expected.[203] This trend works in favor of South Africa-free portfolios. However, if environmental investment strategies are designed so that they pro-

196. P. Kinder, *supra* note 26, at 2.
197. *Id.* at 2-3.
198. *Id.* at 27-28.
199. *See id.* at 27.
200. *Id.* at 27.
201. *Id.*
202. *See* Jerry & Joy, *supra* note 1, at 718; Langbein & Posner, *supra* note 48, at 85.
203. Jerry & Joy, *supra* note 1, at 727.

duce less favorable effects on composition, the performance of the funds using these strategies may suffer.[204]

If environmental investors can track the market as the DSI does, or at least mimic the composition characteristics of other forms of social investment, then there is no reason to suspect that environmental screens will have any significant deleterious effects on risk and return.[205] The challenge for the investment manager of a fund using environmental criteria is to balance the need for a strategy that has enough bite to exert a positive effect on the firms whose stocks are held with the requirement that the strategy not impermissibly sacrifice return. The strategies put forth in the New York, New Jersey, and California bills do not require the exclusion of any potential investments.[206] They are therefore unlikely to affect portfolio performance. However, it remains to be seen whether conservative initiatives like the California resolution, or even the investment preferences in the other bills will have the desired significant positive effects on industry.

B. *Transaction, Liquidity, and Administrative Costs*

In a fund pursuing an environmental divestment strategy, transaction costs are incurred first when the fund sells stocks of companies which do not meet its environmental guidelines, and again when stocks of responsible companies are purchased as replacements.[207] Repeated transaction costs may also occur because of peculiarities in the way an environmental portfolio is managed,[208] such as a preference for large or small transactions. Studies have shown that the transaction costs of South Africa-free

204. An example of a short-term trend of this nature is Calvert's Ariel Growth and Appreciation funds, losing nearly one-fourth of their value in 1990, allegedly due to their investment strategy of pursuing small-capitalization companies, which usually suffer more in a down market. Proffitt, *supra* note 7, at 237. Such short-term trends are not necessarily indicative of long-term performance, however. *Id.*

205. This conclusion finds support even from the critics of social investing. *See, e.g.*, Langbein & Posner, *supra* note 48, at 95-96 (admitting that despite increased administrative costs and decreased diversification, a social investing fund's overall performance will not substantially differ from that of a fund following an optimal (purely financial) strategy).

206. *See supra* Part II(B)(1).

207. *See* Jerry & Joy, *supra* note 1, at 737. It has been suggested that divestment sales can actually take place more cheaply than ordinary institutional sales. Dobris, *supra* note 14, at 234 (citing BALDWIN, TOWER, LITWAK & KARPEN, PENSION FUNDS AND ETHICAL INVESTMENT 114-16 (1980)).

208. Jerry & Joy, *supra* note 1, at 737.

portfolios are smaller than had been previously expected.[209] No data is available on the size of these costs in environmental investment.

Liquidity costs, which are effects on price resulting from trading activities, are incurred when investors influence a stock's price by either buying or selling a large portion of the stock.[210] Liquidity costs could feasibly be affected by a fund's environmental investment strategy, thereby affecting return. But since no quantitative evidence exists on the effects of social investment on these costs, no definitive conclusions can be drawn as to how they will be affected.[211]

Administrative costs include the expenses of relying on securities analysts to investigate the return prospects of stocks, compiling data and issuing reports, monitoring the environmental activities of firms, and organizing shareholder action.[212] They also include governmental fees, interest charges, taxes, fees and expenses of independent auditors and legal counsel, and a host of other expenses.[213] Available estimates of the actual costs of environmental screening are quite low.[214] And, of this amount, what percentage should be assigned to purely social criteria? Today's financial analyst cannot appraise a company without considering its potential environmental liabilities, and even lenders conduct environmental assessments because they have been drawn into the liability picture.[215] Therefore, it would be misleading to label

209. *See id.* at 740. *But see* Chettle, *The Law & Policy of Divestment of South African Stock*, 15 LAW & POL'Y INT'L BUS. 445, 445-46 (1983) ("the brokerage fees required to sell Harvard's shares in companies with South African investments might range from $5.7 million to $16.5 million").

210. Jerry & Joy, *supra* note 1, at 740.

211. *See id.* at 740-41.

212. Shareholder activism is not a normal part of most funds' activities. Letter from Peter D. Kinder, *supra* note 181. It is usually accomplished collectively, thus spreading costs, by such organizations as the Investor Responsibility Research Center (IRRC) or the Interfaith Council on Corporate Responsibility (ICCR). *Id.* However, the proposed legislation calls for the fund to undertake shareholder action.

213. *See* DOMINI SOCIAL INDEX TRUST, PROSPECTUS 15-16 (1990).

214. Peter D. Kinder, of Kinder, Lydenberg, Domini & Co., estimates that the environmental screening costs for a thirty-company large capitalization portfolio will run from between $10-15,000 annually, a modest amount. Letter from Peter D. Kinder, *supra* note 181. *Cf.* Langbein & Posner, *supra* note 48, at 93 (concluding, in the absence of data, that "the administrative costs of a social-investment portfolio will be higher . . . than the administrative costs of a portfolio constructed in accordance with the principles of modern finance theory").

215. *See, e.g.*, United States v. Fleet Factors Corp., 901 F.2d 1550, 1557-58 (11th Cir. 1990), *cert. denied*, 111 S. Ct. 752 (1991).

all environmental research costs as social research costs, as many of these expenses would be incurred in the absence of any social agenda.

As a general matter, the larger and more actively managed the portfolio, the more likely that divestment will increase liquidity and transaction costs, thereby adversely affecting performance.[216] Because state public employee pension funds tend to be large,[217] these increased costs could become significant. On the other hand, a fund with a more passive than active management style[218] will probably incur only minimal transaction, liquidity, and administrative costs.[219]

V. PRESUMED EFFECTS OF ENVIRONMENTAL INVESTMENT LEGISLATION

There are many foreseeable results of the proposed legislation. As explained above, negative investment effects on individual funds are unlikely, as are successful attacks on the legality of the proposed laws. There are several other possible consequences that deserve attention. These include effects in the financial management industry, effects on the likelihood of passage of similar legislation in other states, economic effects on companies which are induced to adopt environmentally responsible policies, and environmental effects from changes in corporate practices.

In the financial management industry, the recent trend toward acceptance of the social investment concept[220] will be heightened by passage of environmental investment legislation. Such laws will allow fiduciaries to follow, rather than lead, others into an

216. Jerry & Joy, *supra* note 1, at 741. This trend is based on empirical data the explanation of which is beyond the scope of this Note. However, one example of this phenomenon is that as the size of the segment of the portfolio requiring divestment and reinvestment increases, so do transaction costs. *See id.* at 737-40.

217. For example, the combined assets of California's two largest pension funds, the Public Employees Retirement System and State Teachers Retirement System, total about $85-90 billion. *State May Ask Firms to Use Valdez Rules*, Los Angeles Times, Feb. 28, 1990, at D7, col. 1; Kirkpatrick, *Environmentalism: The New Crusade*, FORTUNE, Feb. 12, 1990, at 44, 47.

218. "[A]n active management style involves continuous research, investigation, and trading in an effort to 'add value' " to the portfolio. Jerry & Joy, *supra* note 1, at 741. "A passive management style involves buying and holding stocks without adjusting the portfolio," often using a mechanical screen such as price-to-earnings ratio. *Id.* at 741-42.

219. *Id.* at 741-42.

220. *See supra* Part I.

area of uncertain legality.[221] The passage of these statutes should also give environmental investment the boost it needs to become, as have other forms of social investment, a major force for change. If such legislation employs the Valdez Principles, it will also lend credibility to those guidelines and perhaps spur some firms into becoming signatories.

With regard to legislative developments, after one or a few states join California in its pioneering initiative, still other states will be encouraged to follow suit. Similarly, cities and municipalities may find opportunities to put forward their own ordinances. And by rallying public support for the environmental investment idea, these state and local measures could lead to the passage of federal legislation. Federal efforts might involve the regulation of all investment institutions or only federal employee pension plans; both sorts of efforts would be based on Congress's powers under the Interstate Commerce Clause[222] and, presumably, on the model of state initiatives.[223]

Extremely poor voter support for environmental ballot initiatives in November of 1990[224] may lend support to the notion that when the economic climate is poor, people are reluctant to spend for the environment. If the economic slump persists, some of the less environmentally responsible companies that are forced to adopt measures which are costly in the short run could be hard-hit by environmental investment legislation. But over the long term, making these changes can save these firms a great deal of money in manufacturing costs as well as in regulatory fines and cleanup expenses.[225] In the words of Gray Davis, controller of

221. *See* Lynn, *supra* note 2, at 115.

222. U.S. CONST. art. I, § 8, cl. 3.

223. Other related federal proposals could include a statute requiring that all contractors receiving federal funds adhere to a set of environmental guidelines such as the Valdez Principles (based on the Buy American Act, 41 U.S.C. § 10(a)(1933)(requiring, where reasonable, the purchase of American-made products for use by the federal government)) and incorporating the Valdez Principles or a similar guideline into the Federal Acquisition Regulation (FAR), 48 C.F.R.§§ 52.300-53.303-WH-347 (1983), which provides standard procedures and methods for the acquisition of products and services by the federal government. *See* Current Development, *supra* note 4, at 245-46.

224. Pear, *Voters Spurn Array of Plans for Protecting Environment*, N.Y. Times, Nov. 8, 1990, at B1, col. 5.

225. Cairncross, *The Environment: An Enemy and Yet a Friend*, THE ECONOMIST, Sept. 8, 1990, (special survey section) at 9; Kirkpatrick, *supra* note 217, at 47. *See* Brackett, *EPA and Justice Department Step Up Enforcement Against Corporate Environmental Violators*, IRRC INVESTOR'S ENVTL. REP., Winter 1991, at 3-4 (noting record penalty assessments, Superfund contributions, and civil and criminal enforcement efforts in 1990). In fact, saving money is

the state of California, "The first kid on the block to embrace these principles will increase market share and profit substantially."[226] Thus, in the long run, adverse economic effects on companies due to positive changes in industrial hygiene and the like do not appear substantial.[227]

One uncertain yet possible effect of environmental investment statutes is that pension funds may experience difficulty obtaining insurance to protect beneficiaries from suits over the funds' investment practices.[228] If obtaining fiduciary liability coverage does become a problem, it will most likely be due to legal uncertainties in the area of social investment.[229] The passage of environmental investment statutes will help to clarify these legal uncertainties.[230]

Finally, we must consider the social effectiveness of environmental investment legislation. Still in its infancy, the environmental investment idea has hardly been tested. When enacted, environmental investment laws will embody a social consensus that investors are unwilling to use their capital to support destruction of the environment. The degree to which levels of pollution and other measurable effects on the physical environment are affected will depend both on the number of such statutes adopted and on the strictness of the legislation that is passed. Environmental investment will require extensive participation from governments, institutions, individuals, and money managers in order for it to have the impact that the current regulatory regime has in many respects failed to achieve.

the principal reason companies such as Minnesota Mining & Manufacturing (3M) ("Pollution Prevention Pays (PPP)" policy), Chevron ("Save Money And Reduce Toxics (SMART)"), and Dow Chemical ("Waste Reduction Always Pays (WRAP)") have embarked on campaigns to reduce polluting waste. Cairncross, *supra*, at 9. *See* 136 CONG. REC. S4686, 4687 (daily ed. Apr. 20, 1990)(statement of Sen. Kerry); Naimon, *supra* note 38, at 9 (noting savings and efficiency of environmental Total Quality Management (TQM) practices of E.I. DuPont de Nemours Co. and Florida Power & Light). In the fifteen years of its PPP program, 3M claims to have saved in excess of $482 million worldwide. Cairncross, *supra*, at 9.

226. Kirkpatrick, *supra* note 217, at 47.

227. *See* Barbera & McConnell, *The Impact of Environmental Regulations on Industry Productivity: Direct and Indirect Effects*, 18 J. ENVTL. ECON. & MGMT. 50, 62-63 (1990) (concluding that the net impact of environmental regulations on total factor productivity growth of the five most polluting industries is fairly small).

228. *See, e.g.*, Bottorff, *City Pension Board Cannot Get Insurance for Divestiture Plans*, Los Angeles Daily J., Jan. 24, 1986, at B1, col. 1.

229. *See id.*

230. *See supra* note 221 and accompanying text.

CONCLUSION

Huge sums of investment capital in state public employee pension funds create the opportunity for tremendous influence of corporate behavior in the area of the environment. Now is the time to take advantage of this opportunity. After twenty years of development, the concept of social investment has gained considerable acceptance in the investment community. The idea has been tested by individuals, institutions, and public and private pension funds in the context of divestment from companies doing business with South Africa, and the results are encouraging. Through legislation, state public pension funds can exert preferences for companies which are environmentally responsible by subjecting the potential pool of stocks to environmental responsibility criteria. Furthermore, such legislation can be implemented without any serious legal challenges or negative effects on portfolio performance. Three states have taken the initiative: one succeeded, another experienced a setback, and the third is still trying. This Note suggests that other states follow suit. The quality of our air, water, and soil demands it.

Christopher J. McKenzie

APPENDIX

The Valdez Principles

Introduction

By adopting these Principles, we publicly affirm our belief that corporations and their shareholders have a direct responsibility for the environment. We believe that corporations must conduct their business as responsible stewards of the environment and seek profits only in a manner that leaves the Earth healthy and safe. We believe that corporations must not compromise the ability of future generations to sustain their needs.

We recognize this to be a long-term commitment to update our practices continually in light of advances in technology and new understandings in health and environmental science. We intend to make consistent, measurable progress in implementing these Principles and to apply them wherever we operate throughout the world.

The Valdez Principles

1. Protection of the Biosphere. We will minimize and strive to eliminate the release of any pollutant that may cause environmental damage to the air, water, or earth or its inhabitants. We will safeguard habitats in rivers, lakes, wetlands, coastal zones and oceans and will minimize contributing to the greenhouse effect, depletion of the ozone layer, acid rain, or smog.
2. Sustainable Use of Natural Resources. We will make sustainable use of natural resources, such as water, soils and forests. We will conserve nonrenewable natural resources through efficient use and careful planning. We will protect wildlife habitat, open spaces and wilderness, while preserving biodiversity.
3. Reduction and Disposal of Waste. We will minimize the creation of waste, especially hazardous waste, and wherever possible recycle materials. We will dispose of all wastes through safe and responsible methods.
4. Wise Use of Energy. We will make every effort to use environmentally safe and sustainable energy sources to meet our needs. We will invest in improved energy efficiency and conservation in our operations. We will maximize the energy efficiency of products we produce and sell.

5. Risk Reduction. We will minimize the environmental, health and safety risks to our employees and the communities in which we operate by employing safe technologies and operating procedures and by being constantly prepared for emergencies.
6. Marketing of Safe Products and Services. We will sell products or services that minimize adverse environmental impacts and that are safe as consumers commonly use them. We will inform consumers of the environmental impacts of our products or services.
7. Damage Compensation. We will take responsibility for any harm we cause to the environment by making every effort to fully restore the environment and to compensate those persons who are adversely affected.
8. Disclosure. We will disclose to our employees and to the public incidents relating to our operations that cause environmental harm or pose health or safety hazards. We will disclose potential environmental, health or safety hazards posed by our operations, and we will not take any action against employees who report any condition that creates a danger to the environment or poses health and safety hazards.
9. Environmental Directors and Managers. We will commit management resources to implement the Valdez Principles, to monitor and report upon our implementation efforts, and to sustain a process to ensure that the Board of Directors and Chief Executive Officer are kept informed of and are fully responsible for all environmental matters. We will establish a Committee of the Board of Directors with responsibility for environmental affairs. At least one member of the Board of Directors will be a person qualified to represent environmental interests to come before the company.
10. Assessment and Annual Audit. We will conduct and make public an annual self-evaluation of our progress in implementing these Principles and in complying with applicable laws and regulations throughout our worldwide operations. We will work toward the timely creation of independent environmental audit procedures which we will complete annually and make available to the public.