September 5, 2013

Federalism and Fiduciaries: A New Framework for Protecting State Benefit Funds

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STATE BENEFIT FUNDS

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I. Introduction

Even before panic hit world financial markets in 2007, experts on pension and other benefit plans[1] established by states and their instrumentalities[2] for their employees showed growing concern for the actual or potential inability of such funds to make the payments required by the plans.[3] The financial crisis has made it clear that this is a major problem for the entire United States,[4] as municipalities led by Detroit[5] have been forced to file petitions under Chapter

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[1] For purposes of this Article, "benefit plans" include all employer-provided plans for employee welfare, including most notably pension, disability, health insurance, and long-term care plans.

[2] For purposes of this Article, state "instrumentalities" include counties, municipalities, and organizations enjoying their sponsorship, including school systems, hospitals, and other service organizations such as police and fire departments. The benefit plans covered include those directly sponsored by states and their instrumentalities, and plans established for by organizations for the benefit of state employees, such as unions.

[3] *See, e.g.,* David Evans, *Banks Sell "Toxic Waste" CDOs to Calpers, Texas Teachers Fund, Texas Teachers Fund,* BLOOMBERG (June 1, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW5vEJn3LpVw (Prevailing low yields on traditional financial instruments led public pension funds to invest in risky, complex instruments backed by subprime mortgages). Almost all full-time employees of the states, their subdivisions, and instrumentalities, are covered by benefit plans provided by their employers. These plans have a long history and have expanded in scope over time. *See* Robert Clark, *Evolution of Public-Sector Retirement Plans*, 27 ABA JOURNAL OF LABOR & EMPLOYMENT LAW 257, 257-59 (2012).

[4] THE ECONOMIST, a leading British news magazine, made it the cover story for its July 27 – August 2, 2013 issue, in which it argues that underfunding for state and local pension funds, led by Detroit, is a major national problem for the U.S. *See The Unsteady States of America,* THE ECONOMIST, July 27 – August 3, 2013, leading editorial at 9 and news stories at 23-26. *See also,* Charlie LeDuff, *Come See Detroit, America's Future,* THE NEW YORK TIMES, July 25, 2013.

9 of the federal Bankruptcy Code.[6] Public employees, including those directly employed by states and those employed by their subdivisions, lack even the basic protections provided to the beneficiaries of private pension plans under the federal Employee Retirement Income Security Act ("ERISA"),[7] which both establishes minimum standards for protecting investments by

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[5] Detroit is the largest U.S. city to file for bankruptcy, eclipsing the largest city to file previously—Stockton, California. Its bankruptcy followed an apparently failed attempt to restructure its debt under a state-appointed emergency manager, Kevyn Orr. City of Detroit, E.D. Mich. No. 13-bk-53846, July 18, 2013. Unlike many other cities filing previously, Detroit's financial difficulties are only partly due to unfunded pension liabilities, estimated at about $3.5 billion out of total claims of $18 to 20 billion; its losses are largely due to a catastrophic erosion of its tax base, with a population that declined from 1.8 million in 1950 to about 700,000 as of this writing, with a median income near the poverty line. *See* Steven Church, Dawn McCarty & Margaret Cronin Fisk, *Detroit Slides from Industrial Might to Bankruptcy*, BLOOMBERG, July 19, 2013, http://www.bloomberg.com/news/print/2013-07-18/detroit-becomes-biggest-u-s-city-to-file-for-bankruptcy.html.

[6] 11 U.S.C. §§ 901ff. *See also* In re Stockton, CA, Case No. 2012-32118-c-9 (Bankr. E.D. Cal. April 1, 2013)(order approving Stockton's petition for bankruptcy protection under Chapter 9). Stockton's plight illustrates the lesser scope of California's pension system, CalPERS, than the system proposed in this Article; CalPERS covers state employees directly and subdivisions such as municipalities by contract, so that CalPERS is a creditor in Stockton's bankruptcy. Three other California municipalities have already filed under Chapter 9. *See* Rex Sinquefield, *Stockton, CA: One of America's Most Miserable Cities Just Got More Miserable,* FORBES, April 5, 2013, http://www.forbes.com/rexsinquefield/2013/04/05/stockton-ca-americas-most-miserable-city-just-got-a-lot-more-miserable (Stockton was just the latest and largest of more than 33 municipal bankruptcies in the past three years, largely caused by "unmanageable employee pension debt"). In addition to federal bankruptcy under Chapter 9, many state instrumentalities are having their insolvencies administered by state officials. *See id; see also,* CalPERS, *Facts at a Glance: General*, June 2012, http://www.calpers.ca.gov/eip-docs/about/facts/general.pdf.

[7] *See* 29 U.S.C. § 1003(b)(1)(governmental plans exempt from ERISA coverage); *see also,* Amy B. Monahan, *Statutes as Contracts? The California Rule and its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029, 1035 (public pension funds are almost universally tax-qualified retirement funds under the Internal Revenue Code, but the protection of pension benefits is left almost entirely to state law).

private funds, and establishes the Pension Benefit Guaranty Corporation ("PBGC") to insure the continuation of benefits to employees whose funds have been terminated.[8]

The problems that have emerged for benefit plans, particularly in the wake of the financial crisis, include (1) systematic underfunding, both by employee and employer contributions;[9] (2) investment of plan funds in high-risk, complex, and often illiquid instruments,[10] many of which lost all or most of their value during and after the financial crisis;[11]

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[8] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, § 4002, 88 Stat. 829, 1004, codified as amended at 29 U.S.C. § 1001(c) (2006), and as elaborated by regulations of the Department of Labor's Employee Benefits Security Administration ("EBSA") and the Internal Revenue Service ("IRS").

[9] *See* The Pew Center on the States, *The Widening Gap Update*, June, 2012, http://www.pewstates.org/state-pensions-update (states, their subdivisions, and employees were making grossly inadequate contributions to fund promised retirement and disability pensions, health insurance, and other promised benefits—some public employers failing to make required contributions entirely—in part because of the loss in tax revenues and increases in spending on other programs such as Medicaid during the crisis and subsequent recession).

[10] "Liquid" investments are those that are traded on a regular market, and can therefore be easily disposed of at need. "Illiquid" investments, on the other hand, have no ready market and are therefore more difficult to dispose of. They include unregistered securities, which may be traded only if the transaction complies with exemptions for private sales such as the 1933 Act's Rule 144A, 17 C.F.R. § 230.144A, and non-security investments such as real estate.

[11] The Pew Center on the States found that investment losses since the 2007 financial crisis were a key factor in the underfunding of state benefit plans. *See* Pew, *Widening Gap Update, supra* n. [8] at 3-4. *See also,* Richard E. Mendales, *Fitting an Old Tiger with New Teeth: Protecting Public Employee Funds Investing in Complex Financial Instruments,* 96 MARQ. L. REV. 241 (2012). In New York's well-managed Common Retirement System, which provides pension benefits both to state and local employees in a manner that resembles some of the proposals in this Article, investment income provided 82% of the system's income from April 1, 1992 through March 31, 2012. *See* New York State and Local Retirement System, *What Every Employer Should Know* [referring to every employer of a state subdivision or instrumentality electing to join the state system], http://www.osc.state.ny.us/retire/employers/employer_partnership/contribution_rates/the_big_picture.php.

(3) inadequate fiduciary supervision of investments;[12] and (4) failure to disclose to state authorities and beneficiaries the risks they faced, especially as the world financial crisis substantially increased those risks from traditional levels.[13] These problems are closely related, and although some of the problems relating to high-yield financial instruments are now being addressed, at least in part, by suits against those who employed misrepresentations as to safety in peddling them,[14] a more comprehensive legislative solution will be required going forward. Failure to do so will result not only in the loss by public employees of promised benefits and higher funding costs for public employers sponsoring the plans, but higher general borrowing costs for states sponsoring insolvent plans[15]—and ultimately higher borrowing costs for states regardless of the adequacy of their funding of benefit plans.[16]

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[12] This includes not only fiduciaries for plans but also the investment advisers they retain. *See, e.g.,* S.E.C. v. MayfieldGentry Realty Advisers, LLC, et al., No. 13-cv-12520 (E.D. Mich. June 10, 2013)(S.E.C. charged that investment advisers who had taken millions of dollars in advisory fees from the Police and Fire Retirement System of the City of Detroit stole nearly $3.1 million of the funds entrusted to them). The SEC, overwhelmed as it is with regulatory demands in excess of what its staff can handle, cannot deal with all defalcations of this nature; and it has no jurisdiction in cases where fiduciaries mishandle funds without violating federal law.

[13] *See infra,* n. [48-49], TAN [81-82].

[14] *See, e.g.,* S.E.C. v. MayfieldGentry Realty Advisers, *supra* n. 11 (SEC action against investment advisers for alleged theft from benefit fund); Mississippi Pub. Emps.' Ret. System v. Boston Scientific Corp., 523 F.3d 75 (1st Cir. 2008)(action by benefit fund for alleged fraud under 1934 Act and Rule 10b-5).

[15] *See, e.g.,* Associated Press, *Illinois: Pension Woes Cause Downgrade to Credit,* THE NEW YORK TIMES, June 3, 2013, http://www.nytimes.com/2013/06/04/us/illinois-pension-woes-cause-downgrade-to-credit.html (Illinois' failure to adequately fund five employee pension systems caused Fitch Ratings to downgrade Illinois' state government rating—increasing the state's cost of borrowing even for non-pension purposes).

[16] *See, e.g.,* Brian Chappatta & Tim Jones, *Illinois Losing Rally as State Fails to Fix Pension: Muni Credit*, BLOOMBERG, June 3, 2012, http://www.bloomberg.com/news/print/2013-06-04/illinois-losing-rally-as-state-fails-to-fix-pension-muni-credit.html (Illinois' inability to fix five

Federal legislation is not a realistic basis for addressing this set of problems. Many of the key problems to be addressed by this legislation, including adequate state funding, protecting state credit, and the ability of states to offer attractive benefit packages to their employees, differ from those addressed by ERISA, which is designed primarily to protect individual beneficiaries of privately sponsored benefit plans.[17] Federal legislation to deal with these issues—especially the problem of funding—would not only be difficult but is probably barred by genuine issues of federalism. Congress itself appears to have believed that such issues precluded the application of ERISA to the states when it was originally passed in 1974.[18]

Since 1976, a series of Supreme Court decisions has underlined Congress's lack of power to legislate for the states concerning state employees. The Court has, after an initial false start, progressively narrowed the scope of federal authority over the states' ability to regulate their own affairs in recent years.[19] Moreover, federal legislation appears too broad a brush to deal

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pension funds caused state's credit downgrade—symptomatic of increasing spread between interest rates paid by states and U.S. Treasury for 10-year borrowing).

[17] *See* U.S. Department of Labor, Employee Benefits Security Administration ("EBSA"), *Mission Statement*, http://www.dol.gov/ebsa/aboutebsa/org_chart.html#mission.

[18] ERISA expressly exempts from its coverage plans sponsored by states, their subdivisions, or instrumentalities thereof. 29 U.S.C. §§ 1002(32), 1003(b)(1). Congress has considered federal regulation of state and local government plans on several occasions, but has never acted to do so. *See* Amy B. Monahan & Renita K. Thukral, *Federal Regulation of State Pension Plans: The Governmental Plan Exemption Reconsidered,* 28 ABA JOURNAL OF LABOR & EMPLOYMENT LAW 291, 292 (2013).

[19] The Court originally held that Commerce Clause jurisdiction did not extend over states' control of their employees' wages and hours in National League of Cities v. Usery, 426 U.S. 833 (1976). While the Court overruled that case in Garcia v. San Antonio Metropolitan Transit Authority, et al., 469 U.S. 528 (1985), it has since returned to a narrower view of the federal government's ability to regulate the states, *see* New York v. United States, 505 U.S. 144 (1992)(Tenth Amendment bars Congress from directly mandating state regulation); *see also,* Printz, Sheriff/Coroner, Ravalli County, Montana v. U.S., 521 U.S. 898 (1997).

with the complex variety of benefit funds that protect the employees of states and their instrumentalities. Even without these issues, comprehensive federal legislation would be difficult to pass given the partisan deadlock that currently blocks significant action by Congress.[20]

This Article therefore proposes a solution by state legislation: the enactment of a uniform state code drawing on the success of other uniform state legislation such as the Uniform Commercial Code ("UCC").[21] This code, which differs fundamentally from the far less comprehensive Uniform Management of Public Employee Retirement Systems Act (UMPERSA),[22] would require that all benefit funds maintained by a state, its subdivisions, and

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[20] *See generally* ROBERT G. KAISER, ACT OF CONGRESS: HOW AMERICA'S ESSENTIAL INSTITUTION WORKS, AND HOW IT DOESN'T (2013); THOMAS E. MANN & NORMAN J. ORNSTEIN, IT'S EVEN WORSE THAN IT LOOKS: HOW THE AMERICAN CONSTITUTIONAL SYSTEM COLLIDED WITH THE NEW POLITICS OF EXTREMISM (2012).

[21] The Uniform Law Commission, formerly known as the National Conference of Commissioners on Uniform State Laws ("NCCUSL"), consists of judges, lawyers, and other jurists appointed by state governments. It was constituted in 1892, and, working together with the American Law Institute ("ALI"), has proposed both highly influential bodies of law such as the Uniform Commercial Code, adopted by most or all the states, and uniform laws that have received little state acceptance, such as the Uniform Computer Information Transactions Act. The ULC and ALI have had to work hard to restrain states from adopting individual provisions that tend to make the uniform acts less uniform. *See* Uniform Law Commission website, http://www.uniformlaws.org.

[22] *See infra,* n. [44] and TAN [54-60]. The UMPERSA is much more limited in scope than the statewide code proposed here, providing a skeletal set of rules for managing individual funds such as those adopted by municipalities or school systems, without integrating them into state-wide systems, providing for systematic controls such as required audits, or providing for backup protection such as the emergency fund described *infra* at § IV.

instrumentalities, be subsumed under common administration by state agencies selected in a non-political way, and be subject to uniform rules on financing and accountability.[23]

This would accomplish a number of purposes. First, it would provide a complete model of legislation for states to enact governing benefit funds for state and local employees, making it easier for states to pass without separately drafting and wrangling over individual programs for different groups of employees. The problems in obtaining state action on a one-off basis to deal with the issues involved in funding benefit plans was recently demonstrated when the two chambers of the Illinois legislature failed to agree on bills for adequate funding of the state's pension systems, despite Democratic control of both chambers. This resulted in the downgrade of the state's overall credit and consequent increases in its borrowing costs—despite strong statutory provisions for payment of general state obligations.[24]

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[23] It should be noted that this is a totally different approach from the proposal made by Sen. Orrin Hatch, which would essentially privatize state and local pensions by having them buy their pension plans from insurance companies. *See* Mary Williams Walsh, *Pension Proposal Aims to Ease Burden on States and Cities,* THE NEW YORK TIMES, July 9, 2013. This Article would substantially reform rather than overturn the existing system. It is beyond its scope to argue point by point with the Hatch proposal, except to note that only would the latter convert most public pension systems from defined benefit plans to defined-contribution plans—a radical change which most systems and their beneficiaries have rejected, *see infra* n. [85]—but it would add major costs to the public pension system. Studies have shown that insurance company administrative costs run as high as 30% of total spending on health care. *See* Jeffrey Pfeffer, *The Reason Health Care is So Expensive: Insurance Companies,* BLOOMBERG BUSINESSWEEK, April 19, 2013, http://www.businessweek,com/articles/2013-04-10/the-reason-why-health-care-is-so-expensive-insurance-companies. By comparison, the benchmark for public health insurance, Medicare, incurs administrative costs running from 1.4 to 6%--and the latter figure includes payments to private insurance companies. *See* Don McCanne, *Important: What are Medicare's true administrative costs?* PHYSICIANS FOR A NATIONAL HEALTH PROGRAM, Feb. 19, 2013, http://www.pnhp.org.blog/2013/02/19/important-what-are-medicares-true-administrative-costs/

[24] *See* Chappatta & Jones, *supra* n. [16].

The code would enable states to provide, based on standard, ongoing provisions, for adequate funding to assure the payment of promised benefits.[25] This would include requirements to employ qualified actuaries to match contributions and investment returns with predicted payouts to beneficiaries.[26] Equally important, it would serve to provide for adequate supervision of fiduciaries charged with the prudent investment and management of funds thus collected and to supervise investment performance, and an Office of the Inspector General to police the integrity of plan fiduciaries[27] and their advisors. To accomplish these goals, it would include provisions to provide for common funding, investment and administration of funds administered by states, their subdivisions such as municipalities, and their instrumentalities such as police and

[25] Common funding would broaden the base of contributions for benefit funds and thereby increase the ability of a common fund to meet demands placed on it by payment of benefits, even when faced by exigencies such as the financial crisis that began in 2007. Congress has acted similarly to assure the long-range soundness of the Social Security trust fund by including more categories of employees required to pay into it, as in the 1983 amendments to the Social Security Act, Pub. L. 98-21. Common funding at the state level would also reduce the cost of funding promised benefits for smaller municipalities and their instrumentalities such as police and fire departments, based, inter alia, on lower costs of administration and greater bargaining power with investment intermediaries. *See* Mary Williams Walsh, *The Burden of Pensions on States,* THE NEW YORK TIMES, March 10, 2011; National Education Association, *Does Scale Matter for Public Benefit Plans? Evidence of the Relationship Among Size, Investment Return & Plan Expense, April 2009,* http://www.nea.org/assets/docs/HE/DoesScaleMatter_RetirementSystems09.pdf; *see infra,* TAN [54].

[26] ERISA requires actuaries for qualifying private benefit plans to meet standards set by the Joint Board for the Enrollment of Actuaries. *See* 19 U.S.C. §§ 1241-42.

[27] This Article refers to all persons charged with the collection, investment, management, allocation, and disbursement of plan funds (including supervisory personnel, plan employees, and third parties such as brokers and investment advisers) as "fiduciaries."

fire departments.[28] For local funds, this would both permit the employment of more sophisticated financial personnel, permit greater diversification of investments, and enhance bargaining power vis-à-vis securities issuers and intermediaries—a need demonstrated by the insolvency of many smaller state instrumentalities since the financial crisis that began in 2007.[29]

The code would also borrow from ERISA and the securities laws to protect the funds and their beneficiaries. These would, inter alia, provide minimum standards for the conduct of plan fiduciaries;[30] minimum vesting requirements for beneficiaries to acquire rights under defined benefit plans;[31] mandatory accounting and auditing standards for plans;[32] required disclosure

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[28] Police and fire departments, as well as school systems, often have their own benefit plans, in part because their employees' unions engage in separate negotiation of plan terms with state and municipal authorities. *See, e.g.,* Clark, *supra* n. [3], at 258.

[29] *See, e.g., SEC Hearing on The State of Municipal Securities Market*, Birmingham, AL, July 29, 2011 (prepared remarks of Andrew Kalotay), *available at* http://www.sec.gov/spotlight/municipalsecurities072911/kalotay.pdf (sophisticated securities valuation was beyond the skills of most municipal decision-makers, nor were they served well by professional advisors, and municipalities purchased such securities without full awareness of their cost and risk).

[30] *See* ERISA, 29 U.S.C. §§ 1101-12.

[31] *See* ERISA, 29 U.S.C. § 1053. Vesting requirements are not required for defined contribution plans, where a beneficiary is entitled simply to contributions actually made plus return on this investment.

[32] Accounting would be universally required to conform to standards set by the Governmental Accounting Standards Board ("GASB"), an independent organization of experts that has set accounting standards for public entities since 1984. These standards are roughly comparable to the Generally Accepted Accounting Principles set by the Financial Accounting Standards Board ("FASB") for use by securities issuers registered with the SEC, and in fact are called by the same name, even though, unlike the GAAP required by the SEC, they lack supervision by a central government agency such as the SEC. Nonetheless, they are required by state law to be used by public entities in several states. *See* GASB, FACTS ABOUT GASB, http://www.gasb.org. The SEC, while it lacks authority to directly regulate the issuance of securities by state governments and their subdivisions, does so indirectly through its authority to regulate brokers and dealers who sell municipal securities to the general public. *See* Securities Exchange Act (hereinafter

concerning plan assets, liabilities, and return on investments;[33] and other protective provisions such as requirements for continuing coverage of employees leaving their employment. This would be enforced by measures such as audited accounting supervised by a State Office of the Inspector General according to national standards, to be established by each state as a key component of enforcement of the uniform code.[34]

This accounting would be used, inter alia, to assure fair disclosure to beneficiaries on the cost, risk, and expected returns on investments made on their behalf, including the reasonably anticipated ability of their funds to make good on promised benefits. Disclosure would not only directly inform beneficiaries of the status of their promised benefits, but would also reduce the cost of borrowing funds by states and their instrumentalities, by giving prospective purchasers of municipal securities improved information on the risks underlying such securities.

"1934 Act") § 15B, 78 U.S.C. § 78o-4; In re Illinois, 1933 Act Release No. 9389, March 13, 2013, at 9 (GASB standards applied by Illinois cited by SEC in cease-and-desist order against Illinois for misleading disclosures in bond offerings to finance state pensions).

[33] Since existing plans are not subject to uniform accounting and auditing requirements, those who have studied U.S. plans have commented that regulation of U.S. pension plans is "relatively opaque" compared to those of other countries, leaving it difficult to determine the adequacy of their matching of contributions, return on investment, and promised benefits. *See* Aleksandar Andonov, Rob Bauer, & Martijn Cremers, *Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Pension Plans? at* 2, http://www.ssrn.com/abstract=2070054. The expense of satisfactory accounting and auditing is another reason why this Article recommends mandatory integration of plans operated by state subdivisions and instrumentalities into overall state plans.

[34] *See infra,* § II.D. New York's Retirement and Social Security Law ("NYRSSL") provides for this function to be performed by the New York State Office of the State Comptroller, Division of Pension Investments and Cash Management. *See* New York Code, Retirement and Social Security Law, Article 2, Title 2, § 11. New York's system, however, is large and long-established. States establishing a uniform code of this kind for the first time might well prefer to establish a more specialized office, with a supervisory and enforcement role more directly comparable to the federal Securities and Exchange Commission.

A uniform code, designed to be adopted individually by most or all of the states, would be desirable for a number of reasons. First, just as the UCC provides a detailed template for state legislation dealing with complex questions of commercial law, a uniform code dealing with pension funds would provide a template making it easier to for legislatures to deal with difficult issues such as funding, investing and administering trust funds, structuring benefits, and assuring the integrity of benefit funds.[35] Moreover, like all uniform state laws, it would provide for minimal variation from state to state, creating greater predictability both for beneficiaries and for creditors investing in securities issued by the states and municipalities in question—an advantage not only to the creditors, but to municipal bond issuers, who will pay lower rates to borrow.

A potential further benefit would be that the uniformity provided by a code of this sort would make it easier for states to enter compacts, subject to Congressional approval, to invest and administer funds jointly,[36] giving them additional leverage with securities issuers and financial intermediaries, and the ability to minimize the number of administrators needed to assure the integrity and efficiency of fund and benefit administration. All of this would have the further benefit of reducing the cost of funds to states seeking to borrow, whether privately or on public markets—a deadweight loss to the states.[37]

[35] State legislatures have difficulty agreeing on measures to strengthen state benefit funds when done on a one-off basis, even absent partisan infighting, as Illinois has demonstrated. *See* n. [15], *supra.*

[36] Article I, § 10 of the Constitution permits states to enter compacts with each other, subject to the consent of Congress. Compacts of this kind could not be included in a uniform act, but the common adoption by several states of a uniform act would facilitate their entry into such a compact. *See* § V, *infra.*

[37] *See* Chappatta & Jones, n. [16], *supra* (failure by Illinois to correct underfunding of five of its pension systems undermined state's credit rating, increasing its general cost of borrowing).

There are clear limits to the proposed code. First, no state may be required to adopt it—and states have often failed to adopt proposed uniform laws and proposed changes to established uniform laws.[38] Moreover, even though the code includes provisions designed to maintain uniformity among the states,[39] it cannot prevent states from amending it in ways that will cause state laws to diverge—although this Article suggests provisions that will help to keep the code uniform and give state legislatures incentives not to go off on their own paths.[40]

It should be stressed that the proposed code is intended solely to ensure that funds established by states and their subdivisions meet minimum standards designed to protect their beneficiaries and to prevent wider scale financial disasters such as municipal bankruptcies. It does not require states or their subdivisions to establish benefit funds of any kind—just as ERISA does not require private entities to establish benefit funds for their employees, but simply

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[38] For example, in the less politically charged sphere of commercial law, only two states have adopted the proposed Uniform Computer Transactions Act ("UCITA"). The NCCUSL and ALI promulgated a set of amendments to Article 2 of the UCC in 2003, which would have clarified earlier provisions that had caused divergent interpretations among the courts in various jurisdictions, but after no state adopted them, they were withdrawn in 2011. *See* DOUGLAS J. WHALEY & STEPHEN M. MCJOHN, PROBLEMS AND MATERIALS ON COMMERCIAL LAW (10th ed. 2012) at 10-11.

[39] As noted previously, *see supra,* n. [30], accounting would be uniformly required to conform to standards set by the Governmental Accounting Standards Board ("GASB"). Additional teeth could be added for states publicly issuing securities by making the GASB, like FASB, its private counterpart, subject to SEC supervision. This would make sense not only because the SEC has the greatest accounting experience and resources of any government agency, but can be justified on the basis of the SEC's authority to regulate brokers and dealers selling municipal bonds under 1934 Act § 15B, 15 U.S.C. § 78o-4, and to act against fraud in the sale of state and municipal securities under Securities Act § 17, 15 U.S.C. § 77o (although these securities are exempt from SEC registration under § 3(a)(2)) and 1934 Act § 10(b), 15 U.S.C. § 78j. *See* In re State of Illinois, March 11, 2013, 1933 Act Release No. 9389 (Illinois agreed to cease-and-desist order in SEC action charging that it misled investors on the risks created by the state's underfunding of its pension system).

[40] *See infra,* §§ III-V.

requires those who do so to meet minimum standards established by applicable statutes and regulations.[41]

Additionally, it does not require states establishing plans to provide particular types of benefits such as retirement and health insurance, although all states offer some type of retirement plans at least to their direct employees.[42] It would give state subdivisions freedom to establish the types and amounts of benefits they will provide, so long as contributions are made to the common state fund according to state requirements; that benefit levels comply with contribution levels set by actuaries of the state system; and that local systems comply with state requirements for accounting, auditing, and disclosure. This freedom to establish types and levels of benefits makes sense both because costs vary from area to area within each state, and different state subdivisions will employ persons requiring different types and levels of skills, requiring different benefits to make employment with them competitive with comparable private sector jobs.

One special problem for the system will be benefits negotiated by states and their subdivisions in collective bargaining agreements with state and local employees. The system will make it possible for such agreements to create benefit packages that will vary from employer to employer. The packages will, however, have to fund the benefits they offer with contributions based on actuarial rates established by the state, though the code will allow the negotiation of terms offered to employees so long as they are adequately funded by employer and employee contributions invested with the central state fund at realistic rates of return.

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[41] *See* United States Department of Labor, The Employee Retirement Income Security Act (ERISA), Overview, http://www.dol.gov/compliance/laws/comp-erisa.htm.

[42] *See* Clark, *supra* n. [3], at 258-59, 262-63.

The code is thus designed to assure that when states or their subdivisions establish employee benefit plans, substantially all benefits under such plans are paid from a common state fund, and that, based on required contributions to that fund, plans are adequately funded to pay the benefits they have promised. This will require states to establish overall administrative mechanisms to assure the integrity of the collection, investment, and expenditure of the common state funds, along with adequate disclosure concerning the financial health of the funds to their beneficiaries. This raises a final problem: since most states and their subdivisions already have plans, it will be necessary, in implementing the proposed code, to provide for transition from established plans to the framework established under the code.[43]

II. Beyond Better Investments: A Uniform Code to Consolidate and Protect Employee Benefit Funds

A uniform state code will accomplish several important purposes. First, it provides a detailed framework for states and their instrumentalities that will eliminate the need for complex one-off drafting, complicated by legislative inabilities to agree on key provisions, on a state-by-state basis.[44] Moreover, being designed for states and public entities under state control, it can deal with issues that federal statutes such as ERISA, intended for private employers, are not designed to cope with. Equally important, it will overcome problems of federalism that would make federal legislation comparable to ERISA both constitutionally questionable and practicably

[43] *See infra,* § IV.D.

[44] *See supra,* n. [33].

impossible for Congress to pass.[45] These include problems connected with raising revenues; maintaining, investing, and supervising the use of funds for a diverse collection of entities ranging from entire states to municipalities and their schools, police forces, and fire departments; providing adequate disclosure on funds collected, invested, and disbursed; and assuring long-term stability in state ability to borrow funds when necessary. The code would also establish a common framework for the rights of beneficiaries and mechanisms to aid them in asserting those rights.

A. Why a Uniform Code is Desirable.

The states currently administer or are ultimately responsible for a wide variety of employee benefit funds—covering pensions, medical, and other benefits—for their employees and those of state subdivisions and instrumentalities such as municipalities, school systems, fire and police departments, and hospitals. While some are administered directly by state

[45] *See supra*, TAN [18-21].

governments as part of overall state retirement systems,[46] many are independently administered,[47] though ultimately subject to state authority.[48]

Localized plans are more vulnerable than state plans to political pressure to underestimate the long-term costs of benefits and thus of required employer and employee contributions than are statewide plans. While local plans are subject primarily to political pressure from their beneficiaries to keep benefits high in proportion to their contributions, state plans are subject to countervailing pressure from other voters with interests in keeping state credit ratings high and taxes low.[49] Moreover, funds administered by state instrumentalities such as municipalities,

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[46] New York's state-administered system, which includes many of the features suggested by this Article, includes state employees and those of municipalities and other electing units such as police and fire departments. *See* NY Code, Retirement and Social Security Law, Article 2, Title 4, Participation in System by Political Subdivisions and Other Organizations. Other states, such as Massachusetts and Indiana, have less comprehensive systems that cover only employees of the state itself and certain other entities or groups of employees such as teachers and firefighters. *See* Massachusetts State Retirement Board, Benefit Guide for the Massachusetts State Employees' Retirement System, http://www.mass.gov/treasury/docs/retirement/retguide.pdf; Indiana Public Retirement System, *Public Employees, History,* http://www.in.gov/publicemployees.htm.

[47] Massachusetts has a large, long-established independent school pension system that nonetheless appears to be significantly underfunded in proportion to its benefit commitments. *See* Craig Douglas, *Massachusetts school pension payments exceed $183M a month (Data Center)*, BOSTON BUSINESS JOURNAL, September 26, 2012, http://www.bizjournals.com/boston/blog/bbj_research_alert/2012/09/massachusetts-school-pension-payments.html. Many other systems are much smaller and more vulnerable to economic downturns, such as that of Central Falls, Rhode Island—but larger systems suffering from long-standing decline, such as Detroit, have found themselves dealing with the need for drastic cutbacks in benefits based on the financial crisis that began in 2007. *See* Mary Williams Walsh, *Pension Funds Wary as Bankruptcy City Goes to Trial,* THE NEW YORK TIMES, March 24, 2013.

[48] One of the reasons why the UMPERSA is insufficient to deal with the problems of benefit plans, aside from the important fact that it deals only with retirement plans, is that it is designed primarily to deal with smaller plans for state subdivisions such as municipalities, rather than state plans that subsume plans for state subdivisions and instrumentalities. *See infra*, TAN [54-60].

[49] A good recent example is the statewide political struggle over collective bargaining for state benefits in Wisconsin. *See* Frances Denmark, *Wisconsin's Public Pension Works to Spread the*

police and fire departments, and school systems are relatively small. Their administrative expenses are therefore disproportionately high compared to larger funds.[50] Moreover, they not only lack the bargaining power with financial intermediaries enjoyed by larger funds,[51] but they are administered by unsophisticated fiduciaries, who are likely to jump at higher yields offered to them by financial intermediaries peddling complex and/or illiquid financial assets,[52] which are

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Cheddar, INSTITUTIONAL INVESTOR, March 13, 2013, http://www.institutionalinvestor.com/Article/3166909/Investors/Wisconsin-Public-Pension-Works-to-Spread-the-Cheddar.html#Ucsxh9.

[50] The U.S. Social Security Administration, the largest provider of retirement and disability benefits in the U.S., estimated its administrative expenses as 0.8% of its total expenditures for 2012. U.S. Social Security Administration, *Social Security Administrative Expenses,* January 29, 2013, http://www.ssa.gov/OACT/STATS/admin.html. Rhode Island, a smaller but still largish retirement system, incurred administrative and investment expenses of 2.5% for fiscal 2012. These included major fees to financial intermediaries, which larger funds such as CalPERS avoid or have sufficient leverage to bargain down. *See* Stephen Beale, *Investigation: Despite Reform, Pensions Will Cost RI More in 2013*, June 27, 2013, GOLOCALProvNews, http://www.golocalprov.com/news/investigation-despite-reform-pensions-cost-state-more-in-2013/. A more general study made at the depths of the financial crisis showed that for 58 relatively large systems, larger systems obtained better investment results than smaller ones except in an unusual down market. *See generally,* National Education Association, *Does Scale Matter for Public Sector Defined Benefit Plans? Evidence of the Relationship Among Size, Investment Return and Plan Expense*, April 2009, http://www.nea.org/assets/docs/HE/DoesScaleMatter_RetirementSystems09.pdf.

[51] Financial intermediaries have proven expensive not only to small funds but to much larger state funds, not only through high fees but corrupt practices. *See* Edward Siedle, *Rhode Island State Pension Admits History of 'Pay to Play' and SEC Inquiry,* FORBES April 29, 2013, http://www.forbes.com/sites/edwardsiedle/2013/04/29/rhode-island-state-pension-admits-history-of-pay-to-play-and-sec-inquiry/. The code proposed by this Article would preclude such practices, not only by mandating fund investment by state-employed fiduciaries, but by imposing strict conflict of interest rules subject to enforcement by an Inspector General. *See infra,* § II.E.

[52] *See* Kalotay remarks, *SEC Hearing on The State of Municipal Securities Market, supra* n. [29] at 7 (valuation of complex financial instruments "is not in the skill set" of fiduciaries for municipal plans, and they have not been served well by advisers); Siedel, *supra* n. [44] (even state plans paid excessive fees to intermediaries to purchase unconventional instruments not traded on exchanges—something this Article proposes to remedy in part by its enforcement provisions—*see infra,* § II.E.).

frequently unregistered with the SEC and sold with at best sketchy disclosure,[53] without being aware of the higher level of risk carried by such investments.[54]

A uniform code providing for the integrated funding and administration of all state-sponsored benefit plans within a state would provide a ready-made structure for states to adopt, ending the plan-by-plan, section-by-section wrangling that now exists—sometimes too late, after one or more plans under the authority of a state have gone insolvent.[55] Moreover, the successful administration of uniform provisions by a set of adopting states would strengthen their credit and

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[53] Even unregistered financial instruments are prohibited by federal law to be sold with materially misleading disclosure under Securities Act §§ 11(a) and 17; 15 U.S.C. § 77k(a) and 77q; 1934 Act §10(b), 15 U.S.C. § 78j(b); and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5. An important difference between registered and unregistered securities is that only registered securities are subject to the SEC's Plain English Rules, 17 C.F.R. § 230.420-21, which require material disclosure in registered securities to stated in "plain English." Unregistered securities, not subject to these rules, often disclose their risks in convoluted verbiage and can therefore, without readily apparent deception, mislead unsophisticated buyers as to their risks and costs. The author has therefore recommended that the Plain English disclosure rules be made mandatory for all securities-related disclosure. *See* Mendales, *Fitting an Old Tiger with New Teeth, supra* n. [11], at 312-13.

[54] Rule 501(a)(1), 17 C.F.R. § 501(a)(1), promulgated by the SEC as part of Regulation D pursuant to the 1933 Act, classifies any plan administered by a state, its political subdivisions, and any instrumentality thereof, with assets of at least $5 million as "accredited investors," which may invest in securities exempt from registration under Rule 506, 17 C.F.R. § 506. Fiduciaries of funds this small are lack the skills needed to invest in complex unregistered securities, *see* n. [29]. Nonetheless, Rule 506, 17 C.F.R. § 230.506, allows them to invest in unregistered securities, although these may be quite complex and beyond the abilities of small-fund fiduciaries to understand as to true costs, benefits, and risks. While the author of this Article has proposed elsewhere that Rule 506 be modified to prevent this kind of investment, *see* Mendales, *supra* n. [11], small funds could obtain higher rates and lower costs for their investments by administration as parts of much larger state funds, with investments managed by trained and experienced experts.

[55] *See, e.g.,* The Associated Press, *Illinois: Pension Woes Cause Downgrade to Credit,* THE NEW YORK TIMES, June 3, 2013 (Fitch Ratings downgraded Illinois' state credit rating because its legislature could not agree on a solution to the insolvency of five of its pension funds).

bargaining power with financial intermediaries, enable them to obtain higher returns on their investments by diversification among different types of investments, and prevent the increase of credit costs to one state caused by the insolvency of one or more funds in another.[56]

Establishing a uniform code governing benefit funds throughout a state, as this code proposes to do, would prevent the contagion that weakens the finances of an entire state when some of its funds, or those of its subdivisions such as municipalities, become clearly underfunded or insolvent.[57] This code is thus far more comprehensive than the proposed Uniform Management of Public Employee Retirement Systems Act (UMPERSA). The latter, released in 1997, deals only with retirement funds and fails to deal, as does this Article, with benefit funds, inter alia, that protect public employees with disability, survivorship, and medical

[56] *See* Darrell Preston, Michelle Kaske and Martin Z. Braun, *Detroit Case Scrutinized by $900 Billion G.O. Market*, BLOOMBERG, July 19, 2013, http://www.bloomberg.com/news/print/2013-07-19/detroit-scrutinized-by-900-million-g-o-market.html (proposal by Detroit's emergency financial manager to persuade holders of its general obligation bonds to accept less than their full value could impose higher interest costs on other state and local issuers, starting with Michigan)*;* Chappatta & Jones, *supra* n. [16](losses by Illinois funds and funds in other states with low contribution rates raised overall spread between state borrowing rate and similar-maturity U.S. Treasury notes).

[57] *See* Mary Williams Walsh, *Woes of Detroit Hurt Borrowing by Its Neighbors*, THE NEW YORK TIMES, August 8, 2013 (other cities in Michigan and even in other states suffer increased borrowing costs and have in some cases had to postpone municipal bond offerings because of Detroit's bankruptcy); Preston, Kaske and Braun, *Detroit Case Scrutinized by $900 Billion G.O. Market*, BLOOMBERG, July 19, 2013, *supra* n. [56]; Larry Swedroe, *Municipal bonds are looking better and better,* CBS NEWS March 20, 2013 (top-rated bonds issued by states and their subdivisions still yielding higher rates than Treasury securities of similar maturity, despite having recovered from high premiums at peak of financial crisis), http://www.cbsnew.com/8301-505123_57575334/municipal-bonds-are-looking-better-and-better/; Chappatta & Jones, *supra* n. [16](not only did financial weakness of five Illinois funds result in downgrading of the entire state's credit, but, as a result of that weakness and similar financial weakness of funds across the country, the interest rates paid by states to finance their debt had increased for the entire U.S.).

insurance.[58] Moreover, UMPERSA is directed primarily at funds administered below the state level[59]—its provisions indicate that it is aimed primarily at funds maintained by smaller state subdivisions and instrumentalities[60]—and fails to provide, as does this Article, that all benefit funds provided by a state and its subdivisions be subsumed into a common fund primarily managed by state authorities unless certain limited exceptions apply.[61] Moreover, UMPERSA provides only for simplified administration, accounting, and disclosure concerning the financial records of retirement systems.[62] It does not require auditing, nor does it include the enforcement

[58] These are common features of state and local benefit funds. *See, e.g.,* CalPERS, *Facts at a Glance: General,* June, 2012, http://www.calpers.ca.gov (CalPERS provides retirement, survivor, and disability benefits, and manages health care benefits with third party providers).

[59] *See* UMPERSA § 2(18)("public employer" subject to UMPERSA defined as a state or any political subdivision, agency, or instrumentality thereof whose employees participate in a retirement program).

[60] *See* UMPERSA §§ 2(2)("agent grouping of programs" defined as cost-sharing grouping of state retirement programs); (22)("retirement system" defined as an entity established by a public employer to manage or invest in one or more retirement programs); 6(a)(trustee or administrator of a retirement program authorized to delegate functions that a prudent trustee or administrator could properly delegate—hardly something that a statewide system could do); 6-9 (UMPERSA provides for generally described duties of "a trustee" who may delegate management duties to a selected fiduciary; 17(2)(annual disclosure of name and business address of the administrator—a clear reference to smaller plans administered by individuals with other businesses, and not applicable, except by a long stretch, to full-time members of a full-time administrative board for a major fund).

[61] *See* Uniform Law Commission, Uniform Management of Public Employee Retirement Systems Act (1997), http://www.nasra.org/umpersa.pdf.

[62] The rationale for this seems to be that it avoids major legal, accounting, and auditing expenses for smaller systems. This is analogous to similarly simplified duties for the issuance of securities exempt from registration with the SEC, chiefly the Securities Act's Regulation D, Rules 501-507, 17 C.F.R. § 230.501-07, the principal set of rules under which smaller businesses enjoy exemptions from the elaborate and fully audited accounting the SEC requires to register securities for sale to the general public. As with Regulation D, this rationale does not justify simplified regulation of larger systems. *See* John C. Coffee, Jr. & Hilary A. Sale, SECURITIES REGULATION: CASES AND MATERIALS (12th ed. 2012) at 351.

provisions proposed by this Article.[63] Finally, it fails to include an emergency fund to provide backup coverage for plans whose ability to pay benefits has been threatened or blocked by an unforeseen emergency outside the actuarial assumptions on which its mandated contributions and benefits have been predicated, such as the financial crisis of 2007 and the subsequent recession. This Article proposes that state codes include emergency funds for such contingencies, filling a role somewhat comparable to what the PBGC plays for private plans under ERISA.[64]

B. Essential Components of the Proposed Uniform Code.

1. A code should require all funds sponsored by a state and its subdivisions to be subject to common funding and administration.

A uniform code should first define the benefit plans that it covers. These would include all public plans covering employee benefits, including not only those plans directly sponsored by states, but all plans covering the employees of state subdivisions and their instrumentalities, ranging in size from counties and municipalities down to schools and hospitals.[65] New York's

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[63] *See infra,* § II.E.

[64] *See infra,* § IV.

[65] Many states, including most notably New York, California, and Indiana, provide for at least voluntary participation of state subdivisions and instrumentalities in their benefit plans. They thus parallel ERISA, which provides for multiemployer plans, under which unrelated employers combine funds for employee benefits and thus, by increased size and diversity, reduce administrative costs and required contributions per employee. *See* Pension Benefit Guaranty Corporation, *Multiemployer Program Fact Sheet*, http://www..gov/res/factsheets/page/multi-facts.html; 29 U.S.C. § 1002(37).

current plan covers retirement and related plans for state and municipal employees, including fire and police departments, but other state instrumentalities must elect coverage.[66] The code proposed by this Article would reverse that feature: state employees and all employees of a state's subdivisions and instrumentalities would be covered by the proposed law unless a subdivision met exacting standards for opting out. It also proposes to improve on the New York model by providing for an emergency fund roughly comparable to the federal PBGC to permit payment of benefits for unforeseeable short-term financial emergencies such as the one commenced by the financial crisis that began in 2007.[67]

Several reasons dictate that the code include financing for both state benefit plans and the plans offered by state's subdivisions and their instrumentalities, even though plans for municipalities and other collective bargaining entities would retain freedom to decide what their plans would cover and the benefits to be offered—as long as contributions by employers and

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[66] *See* NY Code, Retirement and Social Security Law, Article 2, Title 4, Participation in System by Political Subdivisions and Other Organizations. Once a subdivision or instrumentality elects to join the system, it may not withdraw.

[67] *See infra,* § IV. New York's own disclosure comparing actuarial value of assets and the present value of benefits for its state and local retirement system from 2000-2012 shows a sharp drop in net assets during the heart of the financial crisis during 2009, followed by a sharp recovery through 2012. While New York's deep pockets made it unnecessary to draw on a hypothetical insurance fund, the fact that crises may create difficulties for states in paying benefits makes the need for it—like the need that Congress anticipated in creating the PBGC—a desirable feature of a complete uniform code. *See* New York State & Local Retirement System, *Comparison between Actuarial Assets and Present Value of Benefits (2000-2012), How Contribution Rates Are Determined,* at 3, http://www.osc.state.ny.us/retire/employers/employer_partnership/contribution_rates/rates_determination.php.

beneficiaries, invested at a reasonable rate of return, matched benefits projected according to guidelines set by actuaries for the statewide funds.[68]

This structure would allow the common administration of all funds being managed for plan beneficiaries, reducing administrative costs.[69] Moreover, statewide hiring of sophisticated investment personnel would avoid the unattractive alternatives facing smaller funds at present: management by in-house personnel with minimal investment sophistication on the one hand,[70] and retention of outside professionals charging high management fees and with potentially harmful conflicts of interest.[71] It would also maximize the bargaining power exercised by the funds in their investments, leading to lower costs, both in fees charged by intermediaries, and in the purchase of services for beneficiaries, especially in terms of medical plans.[72]

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[68] In other words, retirement benefits of specified amounts, commencing after set periods of employment and based on specified salaries, would have to be paid for by total employer and employer contributions that, according to the plan's actuaries using a reasonable rate of return on investment, would permit their predictable payment over time.

[69] *See generally,* National Education Association, *Does Scale Matter, supra* n. [50].

[70] *See* Kalotay, *SEC Hearing of July 29, 2011, supra* n. [29] (lack of investment sophistication by plan fiduciaries placed them at disadvantage in understanding complex securities and bargaining with their sellers).

[71] *See id.; see also,* National Education Association, *Does Scale Matter,* at 8, *supra* n. [50](investment management costs decrease as scale increases).

[72] CalPERS, the largest fund currently administered by a U.S. state, is known for its leverage both with its investments and ability to force down the price of services offered to affiliated employees. *See, e.g.,* Kevin Roose, *Are Pension Funds Getting Smart About Passive Investments*? NEW YORK MAGAZINE, March 25, 2013, http://www.nymag.com/daily/intelligencer/2013/pension-funds-are-going-passive.html (CalPERS influencing other public pension funds to invest in passively managed investment funds rather than more expensive actively managed funds); Halah Touryalai, *Calpers Votes Against Jamie Dimon, Again,* FORBES, May 20, 2013, http://www.forbes.com/sites/halahtouryalai/2013/05/20/calpers-votes-against-jamie-dimon-again (CalPERS, a major shareholder at JPMorganChase, voted to split roles of CEO and Chairman at the bank); Chad Terhune, *Hospitals cut some surgery prices after CalPERS caps*

Finally, centralized management of funds would prevent the undermining of sound local plans by contagion from less well managed plans within a state. It would thus ease political pressures in state subdivisions to keep funding low, benefits high, or to use plan contributions for non-plan purposes, eventually resulting in inability to pay promised benefits and thereby not only face insolvency themselves, but undermine the credit ratings of other plans within a state.[73]

The code would permit certain state subdivisions, such as larger municipalities, to offer variations such as benefits not available to state employees generally as components of their plans. Such variations, however, would be permissible only on a showing of a minimum of assets under administration,[74] appropriateness of the variations, funding provisions adequate to pay the benefits promised over a reasonable future period—plus approval by a common nonpartisan Administrative Council to be established by each state.[75] Thus, a large and provably solvent municipality could offer higher and additional benefits compared to its state and smaller

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reimbursements, June 23, 2013, LATIMES.COM, http://www.latimes.com/business/money/la-fi-mo-calpers-hospital-surgery-prices-20130623,0,6571991.story (40 higher priced California hospitals cut knee/hip surgery prices after CalPERS capped its reimbursement rate at $30,000 per procedure). Nonetheless, even a fund as large and presumably sophisticated as CalPERS has seen its share of imprudent investments, especially during the period immediately before the 2007 crash. *See* Evans, *Banks Sell "Toxic Waste" CDOs to Calpers, supra* n. [3].

[73] *See, e.g.,* Chappata & Jones*, supra* n. [16](failure of Illinois legislature to agree on funding of five of the state's pension plans, despite common party affiliation of both legislative houses and the state Governor, resulted in downgrading of state and increase in its cost of borrowing).

[74] $1 billion seems advisable as an absolute minimum; but factors such as a dramatic decline in population of a municipality such as Detroit (resulting in major erosion of the tax base and number of employees available to make contributions)—*see* Steven Yaccino, *Detroit's Creditors Are Asked to Accept Pennies on the Dollar,* THE NEW YORK TIMES, June 14, 2013—suggest that a state's Administrative Council may set a higher bar, or, as part of a transition to a new code, decline to accept a hopelessly insolvent benefit plan into the statewide plan created by the code.

[75] *See* § II.E., *infra.*

state subdivisions. Benefits of this kind might be necessary to recruit and retain talented employees in high-cost cities—but would be allowed only based on a showing of adequate funding by contributions to the state fund at the rate of return established by the state.

2. Protective provisions

Protective provisions established by the code fall into several principal categories: First, required contributions by employers and employees, invested at a reasonable rate, must meet minimum actuarial standards to assure that promised benefits will be paid.[76] These standards would be established by the state's nonpartisan Council of Actuaries according to generally accepted actuarial rules, and subject to approval by the state's Administrative Council. They would be reviewed both at prescribed intervals and on the occurrence of events such as the crash of 2007, whose impact could affect long-term macroeconomic conditions.

Management, investment, and expenditures of funds established for the plans should meet certain key rules. Fiduciaries charged with investing and managing investments for the funds should meet mandatory qualifications for education and experience, particularly in the types of investments that they will supervise.[77] Furthermore, fiduciaries charged with investment

[76] ERISA provides rules of this kind under 29 U.S.C. §§ 1081-84 and regulations thereunder. It is significant that these rules funding for multiemployer plans (a model for the inclusive state and local plans advocated for this Article) in § 1084, increased funding for anticipated deficiencies in § 1083(c), and additional funding for endangered multiemployer plans in § 1085. All of these rules can, in suitably modified form, be incorporated in a proposed state code.

[77] New York's Common Retirement Fund, for example, is massive enough to be diversified across investments in debt and equity securities, international securities, and real estate—each of which requires specialized expertise, not only in the type of investment, but, particularly in illiquid assets such as real estate and unregistered securities, in deal-making skills. *See* New

and management of plan funds would be required to comply with strict conflict of interest rules, subject to civil and criminal penalties. The funds collected must be safely invested and the investments carefully monitored to assure adequate safe return on capital to protect plan beneficiaries.[78]

This monitoring should include accounting compliant with national GASB standards,[79] performed quarterly, annually, and on the occurrence of events causing major changes in the state economy.[80] Moreover, as with issuers of securities registered with the SEC, accounting results would have to be audited at regular intervals according to standards set by GASB.[81]

York State and Local Retirement System, *What Every Employer Should Know, About the Common Retirement Fund, Investment Strategies,* http://www.osc.state.ny.us/retire/employers/employer_partnership/the_fund/investment_strategies.php.

[78] This will be accomplished not only through the actuarial rules described *supra*, TAN [76], but through the regular accounting and auditing under GASB rules described *infra* at n. [80].

[79] *See supra,* n. [32].

[80] *See supra,* n. [32]. It should be noted that GASB itself, which is a private nonprofit organization, should be placed under federal government supervision, like FASB, which sets GAAP accounting standards for private businesses. Given the fact that the SEC has far more experience in accounting and auditing than does the EBSA, and that EBSA is part of the politically sensitive Labor Department while the SEC is independent, this Article suggests that supervision of GASB, like that of FASB, be delegated to the SEC. SEC jurisdiction in supervising GASB could be predicated on the fact that GASB standards apply to accounting and auditing requirements relating to the sale of municipal securities offered to the general public. *See* 1934 Act § 15B, 15 U.S.C. § 78o-4. Compliance with accounting/auditing standards would be enforced by an Office of the Inspector General, to be created within a state Attorney General's office. *See infra*, TAN [116].

[81] This would create a transparency previously found absent in U.S. public pension plans generally, *see* Andonov, Bauer & Cremers, *supra* n. [33], at 2 (regulation of U.S. public pension funds is "relatively opaque"), and more comparable to that required for regular and event-based reporting under the federal securities laws. *See* SEC Regulation S-K, 17 C.F.R. § 229 (financial reporting for registration statements and periodic reporting).

Additionally, the plans should provide sufficient disclosure to beneficiaries, enforcement officials, and potential buyers of bonds issued by states and their subdivisions to ensure compliance with the requirements just stated. The disclosure would be made quarterly on an unaudited basis and yearly after auditing, and would follow the SEC's requirement that it be made in "Plain English."[82]

Enforcement of the protective provisions must be delegated to officials with sufficient authority to assure compliance. The state should have primary responsibility to bring compliance actions, acting on investigations brought by the Office of Inspector General proposed by this Article,[83] and brought by the state Attorney General.[84] In view of the shortage of personnel available to state attorneys general to bring such actions,[85] however, both fiduciaries of plans for particular subdivisions and unions representing beneficiaries should have the right to bring enforcement actions; and even individual beneficiaries should have rights of action to redress misconduct by fiduciaries under established plans.[86]

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[82] *See supra*, n. [52].

[83] *See infra,* TAN [122].

[84] The state Attorney General could receive assistance from the SEC, particularly in actions based on deceptive or manipulative accounting and disclosure practices connected with the purchase of securities. *See, e.g.,* Mendales, *supra* n. [11], TAN 368.

[85] This is true even with assistance by the SEC, since the SEC is itself chronically understaffed. *See* J. I. Case v. Borak, 377 U.S. 426, 432-33 (1964)(Supreme Court allowed private right of action for violation of 1934 Act, in part based on brief by SEC arguing it lacked time and personnel to redress all violations itself—a shortage that has grown since the case was argued).

[86] *See, e.g.,* J. I. Case Co. v. Borak, *supra* n. [85]; *see also,* LaRue v. DeWolff, Boberg & Associates, 552 U.S. 248 (2008)(more limited holding authorizing beneficiary to sue fiduciary under ERISA § 502(a)(2) for breach of duty impairing value of beneficiary's own account in a benefit plan).

As a preliminary step, each state's governor, or other appropriate official, should appoint an Administrative Council to undertake general supervision of the state's plans and their performance. This council would in turn appoint a more specialized and equally independent Council of Actuaries to establish the requirements for funding plans sufficiently to pay promised benefits, based on reasonable estimated investment returns on employer and employee contributions to plans. Members of each council should be considered civil servants rather than political appointees, and should therefore be required to meet minimum educational and experiential requirements. They should also, like the fiduciaries charged with investing, managing, and disbursing plan funds, be subject to strict conflict of interest rules.[87]

3. What types of benefits should be included in a uniform code

Pension, disability, survivors,' and medical insurance are the most important categories of benefits now provided for by states and their instrumentalities.[88] Since the first three categories of benefits are subject primarily to actuarial computation over the long term, while medical benefits involve different factors such as the availability of insurance coverage within a state and the rapidly rising cost of medical care, and are thus short-term in nature, the latter benefits need to be dealt with separately. This would include medical benefits to retirees.[89] In all cases, however, the availability of a single state system will help maximize the benefits

[87] *See supra,* TAN [78].

[88] *See, e.g.,* NY Code – Retirement and Social Security (NY provides many types of benefits for employees in electing subdivisions and instrumentalities); CalPERS, *Facts at a Glance: General*, June 2012, http://www.calpers.gov.

[89] *See infra,* TAN [100-102].

available in proportion to contributions by states and their instrumentalities, and the employees and their dependents who are the beneficiaries of the plans.

Pension and survivors' benefits were among the first categories of benefit plans, dating back to the colonial period in U.S. history.[90] Because of their long-term character, the adequacy of their funding is among the most hotly disputed issues in municipalities where financial problems make required contributions to and benefits offered by such plans some of the hottest issues under contention where municipalities appear unable to pay their creditors unless the plans are restructured.[91] Part of this problem arose from simple misconduct: misrepresentation of the safety of complex investments to benefit funds at a time when interest rates on high-grade securities had fallen to low levels;[92] dishonesty by investment advisers, ranging from bad advice on investments[93] to outright theft of municipal funds by investment advisers;[94] "pay to play" schemes under which state officials invested in securities purchased from financial sources who

[90] *See* Clark, n. [3] *supra,* at 258.

[91] *See* Pew Center on the States, *The Widening Gap Update*, *supra* n. [8](most states have reduced benefits or increased employee contributions to some degree in the three prior years; some have made deeper cuts, but most will have to make farther-reaching changes).

[92] *See* Evans, *supra* n. [3]; Mendales, *supra* n. [11], TAN 127-30.

[93] *See* Mendales, *supra* n. [11], TAN 99-103, (asset-backed securities sold to funds based on supposed security despite high failure rate compared with conventional securities). The bad advice was not confined to sellers; it also included high ratings based on unproven assumptions by the rating agencies that concealed much higher failure rates than similarly rated securities given the same ratings, but also failure by rating agencies to downgrade asset-backed securities promptly when their vulnerability became clear. *See id.,* TAN 129-30, 141-42; U.S. v. Standard & Poor's Rating Agency Litigation, S.D.N.Y., No. 13-02446; U.S. v. McGraw-Hill Cos. et al., C.D.Ca., No.13-00779; In re Standard & Poor's Rating Agency Litigation, Transfer Order, June 6, 2013, U.S. Jud. Panel on Multidistrict Litigation, MDL No. 2446 (U.S., 14 state attorneys general, and the District of Columbia sued Standard & Poor's for allegedly misleading ratings on complex structured finance securities).

[94] *See, e.g.,* SEC v. MayfieldGentry Realty Advisers, LLC, et al., *supra* n. [12].

had made political contributions to them;[95] failure by states and their subdivisions to make contributions required under the terms required by their benefit plans;[96] and misrepresentations by state and local officials concerning the funding of the benefit funds under their supervision.[97]

Another part of the problem has been simple underfunding. States have made contributions too small to pay promised benefits, based on unrealistically high estimates of the rate of return on the investment of contributions, in order to use required contributions for other state purposes instead of making politically difficult decisions to raise taxes. As this has become clear, many states have made cuts in promised benefits, some painfully deep but others still too small, leading to the prospect of more in the future.[98]

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[95] *See* Edward Siedle, *Rhode Island State Pension Admits History of 'Pay to Play' and SEC Inquiry,* FORBES, April 29, 2013, http://www.forbes.com/sites/edwardsiedle/2013/04/29/rhode-island-state-pension-admits-history-of-pay-to-play-and-sec-inquiry/ (state pension fund managers in several states engaged financial intermediaries at excessive fees to invest state funds, who may have paid kickbacks for the business in the form of political contributions).

[96] *See* Pew, *The Widening Gap Update, supra* n. [9], at 6 (as of 2010, 17 states had set aside no money for retirees' health care, and only 7 had funded at least 25% of projected obligations).

[97] *See* State of Ill., Sec. Act Release No. 9389 (March 11, 2013)(cease-and-desist order by SEC)(Illinois deliberately underfunded its obligations under five pension plans so that they covered only 43% of liabilities, and failed to disclose the underfunding and consequent risk to its overall financial position); State of NJ, Sec. Act Release No. 9135 (August 18, 2010)(cease-and-desist order by SEC)(New Jersey alleged to have underfunded its two largest pension plans, and failed to disclose the underfunding in bond offerings).

[98] Most states have used the unrealistically high rate of 8% of return on invested funds, resulting in failure to make contributions needed to pay promised benefits. *See infra,* TAN [111-18]; Pew Center, *Widening Gap Update, supra* n. [9], at 1-3 (most states have used 8% projected rate of return on invested contributions, leading to contributions insufficient to pay promised benefits, and forcing sometimes painful cuts in the years since the financial crisis).

C. Contribution Rules

Contribution rules lie at the core of the uniform code. While each state and subdivision should be free to determine what benefits are payable under each plan that it establishes, it is essential that the combination of contributions by employers and employees, suitably and safely invested under conditions foreseeable over the life of each plan, should be sufficient to pay the benefits promised to each beneficiary.[99]

This would apply to plans differing in basic funding needs. Retirement and survivors' funds, for example, have fundamentally different funding needs from those required for medical insurance benefits,[100] and should therefore be funded with different required contributions by employers and beneficiaries (as in fact they are under present systems). Retirement, disability, and survivors' funds can readily be established by states themselves, based on long-term actuarially computable needs and based on whether the benefits provided are to be provided under defined benefit plans or defined contribution plans. Defined benefit pension plans provide fixed benefits when such benefits become payable, based on factors such as the employee's years of service and his/her highest years' compensation, beginning at a stated age.[101] They are

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[99] One of the important roles of the code will be to assure that contributions are based on regularly revised and realistic estimates of the rate of return on contributions to each plan. The use of high rates of return that became unrealistic with the onset of the financial crisis beginning in 2007 is one of the important reasons for the current crop of plan insolvencies.

[100] *See infra,* TAN [105-107].

[101] The number of high years used in this computation varies from plan to plan. Generally, the more years used in computing benefits, the lower the benefits will be, since most employees receive their highest compensation in their last years of service. Unrealistically high benefits have been granted when too few years are used in this computation (in some cases a single year), especially when employees raise their total pay—with higher pensions in mind—by practices such as "spiking" (taking unusually high overtime and other compensation in addition to normal

therefore subject to potential insolvency if contributions and the return on investment of such contributions proves inadequate when benefits become payable.[102]

Defined contribution plans, on the other hand, are distributions based solely on the amount contributed by employees, often matched by their employers, plus investment income thereon (often with the investments determined at least in part by the employees).[103] They therefore do not normally pose the risk of mismatch between contributions, investment income, and benefits that can cause plan insolvency, though they share some of their risks (chiefly of poor investments and misconduct by fiduciaries) with defined benefit plans.[104] However, although most private employers have switched to defined contribution plans,[105] most state and local plans are defined benefit plans. A few states have switched,[106] and a few others such as Rhode Island are trying out hybrids between traditional defined benefit plans and defined

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wages in the last one to three years of employment). *Who Pays the Bill?* THE ECONOMIST, July 27, 2013, at 25.

[102] *See* Mary Williams Walsh, *The Burden of Pensions on States,* THE NEW YORK TIMES, March 10, 2013.

[103] *See* 29 U.S.C. § 1002(34).

[104] *See* Walsh, *id.;* Melissa Strickland, *Defined Benefits, Undefined Costs: Moving Toward a More Transparent Accounting of State Public Employee Pension Plans,* 3 WM. & MARY POL'Y REV. 129, 134-35 (2013).

[105] *See Retirement Benefits: Who Pays the Bill?,* ECONOMIST, *supra* n. [4] at 25.

[106] Alaska, Michigan, Nebraska, and Utah had switched to defined contribution plans, applying primarily to employees hired after the changes were enacted, as of 2011. *See* Clark, *supra* n. [3], at 262. It should be noted that these plans applied primarily to employees directly hired by the states, and not by their subdivisions. Detroit, is a screaming example of subdivisions not affected by Michigan's change in its pension laws, with large unfunded pension liabilities not only for the city itself but for a separate plan for its police and firefighters. *See* Steve Church, Dawn McCarty, and Margaret Cronin Fisk, *Detroit Slides From Industrial Might to Bankruptcy,* BLOOMBERG, July 19, 2013, http://www.bloomberg.com/news/print/2013-07-18/detroit-becomes-biggest-u-s-city-to-file-for-bankruptcy.html.

contribution plans.[107] Changing to defined contribution plans could well reduce retirement benefits to levels far below those now received,[108] and so unions representing public employees strongly favor defined benefit plans. Since the comparative merits of the two types of plans require the more extensive discussion available in an independent article, this Article, when it refers to pension plans, refers primarily to defined benefit plans.

That does not mean that a uniform code should not prevent abuses now found in some defined benefit plans. As noted above, contributions by employers and employees should suffice, based on actuarial data and a rate of return on investment suitable to a diversified portfolio, to meet projected benefits.[109] For traditional defined benefit plans, reasonable minimum vesting requirements should be established, such as a minimum qualification time of five years' employment under a plan. Similarly, minimum ages to qualify for retirement benefits could be established. Moreover, "spiking" could be prevented by rules requiring a minimum of five computation years, and the inclusion of payments beyond ordinary wages or salaries could be capped at reasonable levels for use in the computation of retirement and survivors' benefits.[110]

Medical and long-term care plans, on the other hand, are normally purchased from third-party insurance companies—usually giving beneficiaries some choice—and, because costs have

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[107] *See* Pew Center on the States, *The Widening Gap Update*, *supra* n. [9], at 8.

[108] *See id.* Defined contribution plans tend to deliver retirement benefits of only $4-5,000 per year—not realistic contributions to retirement income—compared to average defined benefit public pensions that, while hardly outrageous, are meaningful, such as the current California average of about $29,000.

[109] *See supra,* TAN [101].

[110] From 2009 to 2011, 43 states moved to reduce benefits in proportion to contributions, using measures including benefit cuts, increased contributions, and increasing the years of service and minimum age required to receive retirement benefits. *See* Pew, *Widening Gap Update, supra* n. [9], at 8.

been rising at an unpredictable rate,[111] need to be funded on a short-term, usually annual, basis.[112] For this reason, while premiums for continuing employees enrolled in state medical plans can readily be changed from year to year and do not present major problems, medical plans for retirees on state and local pensions tend to be subject to a much higher degree of underfunding than retirement funds.[113] Under the code therefore, premiums for retirees need to be subject to the same kind of annual adjustment, deductible from retirement benefits, as premiums charged to current employees. This problem will be diminished as maximum retirement ages are gradually adjusted upward, reducing the time that retirees' medical benefits will not reflect deduction for the availability of federal Medicare, now payable beginning at age 65.[114]

D. Investment Rules

Since a large part of the funding for future benefits will be based on investments, an effective code must both provide basic guidelines to assure that fiduciaries charged with investing contributions must comply with standards that are subject to some tension. On the one hand, they must be reasonably safe and predictable in proportion to anticipated benefits both at

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[111] It should be noted that although medical premium rates have been steadily rising in most jurisdictions, this is not universally true.

[112] *See, e.g.,* CalPERS, *Facts at a Glance, supra* n. [6]; Pew Center on the States, *The Widening Gap Update*, *supra* n. [9] at 6 (health care costs for retirees, unlike pensions, are funded as incurred—while Pew refers to retiree health care, the same is true of health insurance for still-employed workers).

[113] *See* Pew, *Widening Gap Update, supra* n. [9], at 6-7.

[114] 42 U.S.C. § 426(a)(1). Medicare may be available at earlier ages for persons entitled to disability benefits, 42 U.S.C. (b)(2)(A), and who have end-stage renal disease, 42 U.S.C. § 426A.

the time made and when assessed at regular intervals or on the occurrence of events affecting both individual events and the overall economy.[115] On the other hand, particularly given that the code will provide plan fiduciaries with large sums under management, they must have sufficient freedom to place these sums in a diversified portfolio of assets, varying in risk from conservative to moderately speculative, in order to maximize the return on investment both when investments are made and over time as the portfolio and overall economy develop.

This tension can be seen in the estimates of an 8% return on investment for state retirement pensions widely used before the financial crisis—and still used by many funds,[116] despite post-crisis analysis indicating that these rates are too high, giving states an excuse to contribute too little[117]—or in some cases to avoid funding their pension plans entirely. On the

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[115] The failure of contributions by employers and employees to provide promised benefits at realistic levels of return on investments have resulted in widespread political controversies as public employers, faced with insolvency in the wake of the financial crisis that began in 2007, have sought to reduce promised benefits while increasing the contributions required of employees, and, especially in the cases of municipal insolvencies, forcing creditors to take "haircuts" on municipal bonds. *See* Steven Yaccino, *Detroit's Creditors Are Asked to Accept Pennies on the Dollar,* THE NEW YORK TIMES, June 14, 2013; *Pew, Widening Gap Update, supra* n. [9]; Walsh, *The Burden of Pensions on States, supra* n. [24] (newly elected Republican governor Scott Walker used alleged underfunding of state pensions as reason for ending state collective bargaining with employee unions, though the state's public pensions were actually among the best-funded in the U.S.).

[116] *See* Mary Williams Walsh & Danny Hakim, *Public Pensions Faulted for Bets on Rosy Returns,* THE NEW YORK TIMES, MAY 28, 2012, at A1 (public pension funds continued to operate at assumed rate of return of 7 to 8% despite drop of 2% or more in actual rate of return). Some states have started to use lower rates of return based on the recent reduction on yields in most debt securities—CalPERS, for example, lowered its investment target to 7.5%, though its actuary recommended a sharper cut to 7.25%. *See* Andonov, Bauer, & Cremers, *supra* n. [33], at n. 5.

[117] Adjustments are being made based on the drastic general decline in interest rate on high-quality debt securities since the turn of the century. CalPERS' actuary, for example, recently recommended reducing the yield used for contributions and benefits from 7.75% to 7.25%, requiring an increase in contributions or reduction in benefits, although CalPERS' management settled on a reduction to 7.5%. *See* Andonov, Bauer, & Cremers, *supra* n. [33].

other hand, pension funds in places such as the United Kingdom, Canada, and the Netherlands have based benefits on a postulated 3 or 4% return,[118] based solely on current yields (at a time of abnormally low yields) of the most conservative debt instruments issued by national governments and large corporations.

In fact, while the 8% high yield still used by many states to calculate required contributions and benefits appears to be premised on unrealistic yields based to some extent on risky complex financial instruments offered at the height of the pre-crash financial bubble,[119] the 3-4% figure appears to be too low, except for small local funds which, for financing purposes, this Article proposes to subsume into much larger state funds.[120] There are several reasons why the lower rate is as unrealistic as the higher one. First, while the rules governing each state fund should prohibit investment in complex one-off financial instruments,[121] or instruments with high

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[118] *See id. at* 11, 12. Investment of public pension funds at low-yielding sovereign debt may also be mandated by legal rules such as Social Security Act § 201(d), 42 U.S.C. § 401(d), which requires that the Social Security retirement and disability trust funds be invested in obligations of or guarantied by the United States, bearing interest rates among the lowest in the world.

[119] *See* Mendales, *Fitting an Old Tiger with New Teeth, supra* n. [11], TAN 5-7, 62-65.

[120] Small funds, by their nature, cannot afford to diversify their investments either to unconventional instruments or over time, nor are their fiduciaries skilled enough to invest in unconventional instruments themselves or to obtain favorable treatment from financial intermediaries. *See* Kalotay, *supra* n. [29].

[121] During the years leading up to the crash of 2007, even sophisticated funds such as CalPERS invested in complex instruments such as collateralized debt obligations ("CDOs") based largely on high ratings given them by investment rating agencies such as Moody's, although the ratings were given without careful examination of the collateral, especially subprime mortgages, underlying the instruments, and which were changed only too late, when it was clear the instruments faced worthlessness. *See* Mendales, *Fitting an Old Tiger with New Teeth, supra* n. [11], TAN 19-24, 127-30 (top-rated CDOs had default rates ten times as high as conventional securities with similar ratings). Congress attempted to deal with this after the fact by limiting the use of ratings in issuing securities in the Dodd-Frank Act, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified in scattered sections of

risks and low transparency such as derivative securities based on credit default swaps,[122] a pool consisting solely of low-priced debt instruments, with yields currently at historic lows, carries a different set of risks that advocates of investing solely in high-grade debt instruments ignore.[123] Even high-grade debt carries the risk of loss if rates rise from historically low levels such as those now prevailing, to rates more typical of debt historically, or, even worse, to rates prevailing

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the U.S.C.). Dodd-Frank and regulations based on it, however, when carefully examined, have few teeth when applied to the rating agencies. *See id.,* TAN 265-97.

[122] In a credit default swap, the seller of the swap essentially sells an insurance policy promising to pay if the issuer defaults. During the period leading up to the crash of 2007, swaps were widely sold by financial institutions and by municipalities, guarantying payment on financial instruments so complex that default either could not be predicted or was a near certainty, so that investing in the swaps was essentially gambling on the part of the sellers, who suffered heavily when the instruments on which they had sold the swaps defaulted. The problem was compounded because investors based their purchasers largely on high ratings issued by agencies such as Moody's, which gave the instruments in question high ratings until shortly before they defaulted. *See* Floyd Norris, *Deception by Derivative,* THE NEW YORK TIMES, June 27, 2013; Mendales, *Fitting an Old Tiger with New Teeth, supra* n. [11], TAN 131-145, n. 220; Richard E. Mendales; *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It,* 2009 ILL. L. REV. 1359, 1381-82.

[123] *See* Kimberly Amadeo, *Treasury Yields,* ABOUT.COM: US ECONOMY, http://www.useconomy.about.com/od/economicindicators/p/Treasuries.htm?p=1 (Treasury bond yields—normally the lowest on any debt instrument because of the perceived safety of Treasury securities—are at historically low levels, but are rising and expected to rise further); Pimco, *Yield Curve,* September 2004 (bond prices will fall as yield rises until bonds approach maturity), http://www.faculty.baruch.cuny.edu/ryao/fin3710/PIMCO_YIELD_CURVE_PRIMER.pdf.
Also, if benefits are indexed for inflation, low-yield bonds that are not so indexed will not pay sufficient interest to meet benefit demand. *See* BlackRock, STRATEGIC INCOME OPPORTUNITIES FUND, *ONCE THOUGHT SAFE. NOW RISKY. RETHINK YOUR BONDS.* http://www2.blackrock.com/us/individual-investors/products-performance/mutual-funds/strategic-income-opportunities-fund?cmp-=nwretail2013&chn=PPC&C=google&kw=Lowyields&gclid=CPDn3a31mLgCFeRZ7Aod8e4AOw. It is also unrealistic to assume that today's historically low yields will always prevail. It is therefore not necessarily justifiable to criticize "smoothing" present yields with those of debt in non-recession years often do. *See, e.g.,* Andonov, Bauer & Cremers, *supra* n. [33], at 4-5 ("smoothing" criticized as masking volatility of risky investments—which it can do—but its critics fail to recognize that it can also be a realistic blend of low-yield instruments issued during and after a financial crisis with instruments of similar risk issued in more normal times).

in the event of inflation. This is because an increase in rates would cause the prices of such instruments to fall, and any disposition of them to meet a contingency will therefore subject the purchaser to a loss.[124]

There is no good reason to force a statewide fund to take on the low yield and special risks inherent in limiting its investments to a pool of high-rated government and corporate debt.[125] Unlike traditional smaller funds, which cannot afford the risks of higher yielding investments, a large state fund can afford to base its benefits on investments that steer between the risks of complex, non-transparent investments in dubious assets, and the risks and costs of basing benefits solely on high-grade bond yields. It can do this by diversifying its investments to include equity, middle-grade traditional bonds, and even carefully chosen investments that are not traded on exchanges, including unregistered securities[126] and readily marketable real

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[124] *See generally*, BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR (rev'd ed., updated with new commentary by Jason Zweig, 2006), at 47-57 (periods of high and low interest rates have alternated through history, making investments solely in debt instruments undesirable).

[125] This is especially true given the poor performance of ratings issued by the oligopoly of three rating agencies—Moody's, Standard & Poor's, and Fitch—over time. While this was especially true of the ratings given to asset-backed securities during the period preceding the financial crisis, it was also true of ratings given to conventional debt securities. *See generally,* Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies,* 77 WASH. U. L.Q. 619 (1999). Attempts by Congress to regulate the rating agencies have been largely ineffectual. *See* Mendales, *supra* n. [11], TAN 265-88. Despite actions by the SEC and investors allegedly deceived by rating practices before 2007, at least one rating agency, S & P's, is once again winning business by offering higher ratings. *See* Nathaniel Popper, *Banks Find S & P More Favorable in Bond Ratings,* THE NEW YORK TIMES, July 31, 2013. Due diligence by an investor, continuing over the life of an investment, is ultimately the best way for an investor to assure itself of the initial and prospective quality of its investments.

[126] The code would, however, exclude investment in complex securities based at least in part on financial derivatives such as credit default swaps, since instruments of this kind are abnormally sensitive to changes in macroeconomic conditions, and their lack of transparency brought even sophisticated investors to grief in the financial crisis. *See* Mendales, *Collateralized Explosive Devices, supra* n. [121], at 1397-1400.

estate.[127] The chief degree of caution that the code should impose in this respect is to require that no more than a certain amount of fund assets be placed in any one investment, with more stringent limits placed on illiquid assets such as unregistered securities and real estate.

The New York Common Retirement Fund, with large assets that can be widely diversified, has done this by investing, inter alia, in domestic and foreign equity securities, private equity,[128] debt (including cash and mortgages), and commercial real estate.[129] This diversification, along with the diversification a larger fund has over time—i.e., investments in some times will yield more than others, with especially low yields at times such as the present following a financial crisis, and yields above normal at times of high inflation—mean that a larger fund will be able to achieve yields closer to 7% than the 3-4% that smaller funds, unable to diversify very much either in classes of assets or over time, can achieve with some assurance of safety.[130]

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[127] Successful diversification requires that only a small percentage of each fund be invested in a given asset or class of assets. ERISA requires that private benefit funds be diversified. *See* 29 U.S.C. § 1104(a)(1)(C).

[128] Equity investments exempt from registration with the SEC under Rule 506 or similar exemptions, and hence not traded on exchanges but directly invested in corporate shares. *See, e.g.,* INVESTOPEDIA, *Private Equity,* http://www.investopedia.com/terms/privateequity.asp. The mere fact that they are unregistered does not make them less secure than registered securities, but merely requires a greater degree of sophistication and due diligence by fiduciaries investing in them.

[129] *See* NY State and Local Retirement System, *What Every Employer Should Know, About the Common Retirement Fund, Investment Strategies, supra* n. [77].

[130] *See id.*; *see generally,* GRAHAM, *supra* n. [124](recommending diversified and actively managed portfolio for individual investors, given swings in rates of return for both debt and equity investments over time).

E. Enforcing the Code

The code, in order to be effective in each adopting state, will need to include both provisions for enforcement and to provide for the appointment of personnel to facilitate and enforce compliance. Two types of misconduct are likely to require enforcement activity: misconduct in the purchase of plan assets, by sellers, financial intermediaries, and officials of the plan itself, which are subject to enforcement both by state and federal officials;[131] and misconduct in the administration of the assets of each fund and their disbursement. The latter, while primarily subject to state enforcement, may also be subject to SEC actions when they result in misrepresentation by a state of the assets available to meet its benefit fund obligations.[132]

To begin with, each state's nonpartisan Administrative Council, roughly comparable to the Labor Department's Employee Benefits Security Administration,[133] should have general responsibility for enforcing the provisions of the Code. Administrative Councils would be

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131 Both the SEC and state attorneys general have taken action against misconduct in the sale of assets to benefit funds, their mismanagement, and misleading disclosure concerning the funds. *See, e.g.,* SEC v. MayfieldGentry Realty Advisers, *supra* n. [12]; Mississippi Pub. Emps.' Ret. Sys. v. Boston Scientific Corp., 523 F.3d 75 (1st Cir. 2008)(retirement fund stated claim against issuer under federal securities laws); Ill. v. McGraw-Hill Cos., (cause of action stated against Standard & Poor's for misleading ratings that caused state to purchase risky securities for pension funds).

132 *See* In re State of Illinois, *supra* n. [39]; In re New Jersey, Securities Act Release No. 9135 (August 18, 2010)(New Jersey agreed to cease-and-desist order by SEC concerning underfunding of its two largest pension plans in municipal bond offering); *see also,* SEC v. City of Miami, FL et al., S.D. Fla. July 19, 2013, 1:13-cv-22600-CMA (SEC sued Miami and its Finance Director for misleading investors in its municipal bonds by transfers to its General Fund—from which the bonds were to be paid—from other funds including pension funds).

133 *See supra,* n. [8].

primarily composed of senior civil servants, but could also include independent experts drawn from outside state government. Their members would be appointed by the state governor, subject to confirmation by the senior house of the state legislature. They would be ineligible to occupy any other position while on the Council, and would serve a term of seven years.[134] Their terms would be staggered, again to avoid appointment of a majority based on political pressures predominant at any one time.[135]

Moreover, each adopting state should create, within the office of its Attorney General, an Office of the Inspector General for Public Benefit Plans, roughly comparable to the SEC, to police the fiduciaries actually administering each plan and to bring actions both for internal breaches of trust and for external fraud directed at state plans.[136] The Inspector General would have a permanent staff of lawyers and accountants sufficient in size to conduct random inspections of plan records and to investigate complaints against plan fiduciaries. The office

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[134] The term could in fact vary from state to state, but it should be either more or less than the state's normal cycle of gubernatorial elections to isolate it from politics. Seven years appears to be a good compromise between terms too short to attract qualified members from the private sector, and terms long enough to facilitate capture by outside political forces.

[135] A model for a staggered board of this kind is the Board of Governors of the Federal Reserve System. *See* Federal Reserve Act § 10, 12 U.S.C. § 241.

[136] As noted *supra* at n. [34], New York's Retirement and Social Security Law provides for this function to be performed by the New York State Office of the State Comptroller, New York Code, Retirement and Social Security Law, Article 2, Title 2, § 11. While the New York Comptroller's Office has performed this function for a long time, it is not free of politics, and states newly adopting a uniform pension code are unlikely to have capacity within their existing comptrollers' offices to perform such a function. In any case establishing a new and politically independent Inspector General on the model of the SEC would have advantages over giving this function to state offices subject to political selection and control. *See supra,* TAN [106-07]; SEC, *SEC Charges Illinois for Misleading Pension Disclosures,* March 11, 2013, Release 2013-37, http://www.sec.gov/news/press/2013-37.htm (SEC investigation showed Illinois misled investors concerning the financial soundness of its pension schedule; SEC, *SEC Proposes Measures to Curtail "Pay to Play" Practices,* July 22, 2009, Release 2009-168, http://www.sec.gov/news/press/2009/2009-168.htm.

would also be able to draw on the office of the state Attorney General for special needs such as those arising from litigation.

The Inspector General's office would not only have the responsibility of dealing with complaints concerning improprieties concerning assets, but would also have the responsibility of hiring and supervising auditors to oversee regular accounting that would be required of each plan. As under the federal securities laws,[137] the auditors chosen should be free of conflicts of interest, and subject to regular rotation.

III. Coordinating Administration of the Code

For the code to remain uniform from state to state, it will need to include provisions that reflect the need to adjust to changing demographic[138] and economic conditions, or the benefits of a uniform code will be lost as states diverge over time. For this purpose, even in the absence of a compact between adopting states, Administrative Councils in states adopting the code should appoint members to represent them on an interstate council intended to address common problems faced by the states in administering their respective codes, and for coordinating state efforts to keep their codes uniform on important issues.[139]

In view of the unique public function of the uniform code, the interstate council, composed of administrators representing each state benefit fund, should initiate any changes to

[137] *See* Sarbanes-Oxley Act § 103, 15 U.S.C. § 7203.

[138] *E.g.,* increasing lifespans of retirees, resulting in longer payouts of retirement benefits.

[139] Naturally, the ULC and ALI would also play major roles in considering statutory reforms, as they do with other uniform laws.

be made, subject to approval by state legislatures. As with other uniform laws, they could be assisted, particularly in drafting proposals for changes, by the traditional ULC and ALI.

IV. Carrots and Sticks: A Common Emergency Fund for State and Municipal Benefit Plans.

One important incentive for states to adopt the code is its proposal to establish a common emergency fund for benefit plans administered by the state that, due to temporary financial crises, have come up against obstacles to payment of benefits currently due. While the fund established by each state would primarily be intended to avoid insolvency by benefit plans under the state's common administration, the emergency fund would offer each plan (1) the positive incentive of being able to overcome immediate crises without going through insolvency administration, and (2) the negative incentive of compelling funds to comply with standards required to draw on the insurance fund.

A. Establishing a Common Emergency Fund in Adopting States.

Although some uniform laws such as the Uniform Commercial Code ("UCC") have enjoyed continuing acceptance by the states with only minimal variation, the strong political forces inherent in establishing, funding, and administering benefit funds are likely to have a continuing centripetal effect which would have the readily foreseeable effect of driving states into major variations, undermining the important goal of uniformity.[140] Aside from the Administrative Council, whose influence on state legislatures in maintaining uniformity might turn out to be largely hortatory in nature, an important carrot as well as the Council's stick should be offered to keep states within the framework of the code. This would be a common emergency fund created as a backup for each state fund, somewhat like the federal PBGC.[141] It would differ significantly from the PBGC in several respects, however. Unlike the PBGC, it must be self-sufficient, since it could not draw on the unlimited credit of the U.S. government.[142]

The primary purpose of this fund would differ from that of the PBGC, which is primarily intended to protect private pension beneficiaries whose funds have been terminated.[143] Its primary purpose would be to enable benefit plans to draw funds when faced with unexpected fiscal crises, both to insure the welfare of their beneficiaries and the good credit of adopting states.[144] It would be intended only secondarily as a backup source of funding for individual

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[140] *See, e.g.,* UCC § 1-103. While the basic reforms proposed by this Article would be beneficial even if states were to adopt significant variations, variations (a) could lead benefit plans down the primrose path to underfunding; (b) interfere with one of the key advantages of uniformity—enabling courts in one jurisdiction to rely on decisions in other states; and (c) make it impossible for states to combine funds through interstate compacts as discussed *infra*, § VI.

[141] *See* 29 U.S.C. 1302(a). The PBGC is established within the U.S. Department of Labor, and its Director is appointed by the President with the advice and consent of the Senate.

[142] The PBGC is supposed to be self-supporting, based on premiums, interest, and other charges to private benefit plan sponsors, under 29 U.S.C. § 1305(b), (f); nonetheless, it is a "body corporate" within the Department of Labor, and seven revolving funds have been created within the Treasury by statute to meet its obligations if necessary. *See* 29 U.S.C. § 1305 (a)-(f).

[143] *See* 29 U.S.C. § 1301-1461.

[144] Under the present system, benefit plans have been changed sharply and suddenly under the impact of the financial crisis, depriving beneficiaries of significant parts of current or expected retirement income. *See* Pew, *Widening Gap Update, supra* n. [9] at 1, 7-8 (many states have reduced benefits—in some cases to current as well as freshly hired employees); *see generally,*

beneficiaries of insolvent funds, since it, along with the other protective measures described, would be primarily intended to protect public funds from insolvency. In this context, it could be useful to ease transition from older pension systems by taking over, at least up to specified limits, payments to beneficiaries whose original pension funds were no longer viable and therefore could not be assimilated by new statewide systems.

B. Contributions to the Fund

Emergency funds should be built up gradually with contributions from supported state and local funds, perhaps with a 1% of the total annual contributions from their constituent funds.[145] Since they will be funded by the same contributions as the benefit funds themselves, and the latter will be large and designed to minimize the likelihood of need to draw on insurance funds, the amounts needed will differ from those required for the PBGC,[146] which is designed to

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Amy B. Monahan, *Statutes as Contracts? The California Rule and Its Impact on Public Pension Reform,* 97 IOWA L. REV. 1029 (2012)(arguing that, contrary to holdings by state courts in California and elsewhere, benefits to current state employees may be reduced without impairing the obligations of contracts).

[145] The PBGC, with minimal exceptions, does not guarantee private plans in existence for less than 60 months. *See* 29 U.S.C. § 1322(b)(1), (7). A similar period of building up should be established for state emergency funds before they can be drawn upon for benefits.

[146] 29 U.S.C. § 1306(a)(3)(A)(III) requires participating plans to pay annual insurance fees of $49 per covered employee to the PBGC for basic benefits in single-employer funds; but state needs are likely to be more substantial in view of the fact that emergency funds would begin to build with the enactment of the code, and would have to deal with potential liabilities incurred by years of underfunding of many plans. Moreover, a state plans would not have the PBGC's ability to call on the resources of the U.S. Treasury.

protect against the failure of funds provided by private employers.[147] The size of each emergency fund should therefore top out at a level to be determined by the state's Administrative Council, subject to growth based on investment returns. It should also be annually reviewed by the Administrative Council to take into account changes in possible demand based on factors such as the state's demographics and economic trends.

Because the emergency fund is a last resort, its funds should be invested more conservatively than the general funds. In this case, conservative investment in liquid securities for an anticipated annual return of 4% is not as unreasonable as it is for the general funds.

C. Regulations on Draws and Restitution

A benefit plan should be able to draw funds from its state (or multistate) emergency fund only under certain narrowly defined emergency conditions, and only in appropriate amounts specified by the code. The Administrative Council would have to determine that appropriate conditions existed, and authorize the draw in appropriate amounts. These conditions should give state funds additional incentives to comply with the normal rules that the code would impose upon their contributions and investments under normal conditions, since they would not be able to draw upon the emergency fund in the event that the Inspector General's Office should find material noncompliance with the normal rules for contributions and investments.

The emergency fund should not be available for borrowing, whether by beneficiaries, the sponsoring state, or other state instrumentalities subject to the code, except under these strictly limiting conditions. Moreover, the code should expressly provide that, notwithstanding any

[147] *See supra,* TAN [137].

other provision in state law governing creditors' rights,[148] no lien, whether voluntary or involuntary, could attach to the emergency fund or any of its investments.

Once the emergency under which a draw is made is determined by the Administrative Council to have terminated, the plan making the draw should be required to restore the borrowed amount to the emergency fund, paying in addition interest equal to the average of the average rate paid nationally for municipal securities over the period of the draw, plus an appropriate amount of penalty interest—not less than 1%--to be determined by the Administrative Council at the time of the draw. This interest payment is important both for full restitution of the cost to the insurance fund of the state's draw,[149] and to avoid giving states any incentive to draw on the insurance fund for any reason other than a genuine emergency. It would also, of course, serve to build the insurance fund against future emergencies.

A final use of the emergency fund would be more comparable to the role performed by the PBGC. If the uniform code fails to prevent actual insolvency on the part of a state subdivision or instrumentality, the state's Administrative Council could authorize direct draws upon the emergency fund for beneficiaries of the insolvent benefit fund. Draws of this kind should be less frequent than those payable by the PBGC under private plans, since the code is intended to prevent the kinds of private plan termination that ERISA deals with affecting otherwise payable long-term benefits.[150] If, however, they are required by circumstances

[148] This would include both voluntary liens, primarily but not exclusively those established under UCC Article 9, and involuntary liens established for purposes such as taxation and the satisfaction of judgments.

[149] This would include both the cost of funds and the administrative costs connected with making the draw.

[150] *See* 29 U.S.C. § 1322(a).

meeting requirements to be specified in the code, they should be capped similarly to the caps that ERISA places on benefits payable under terminated private plans;[151] and beneficiaries thus "orphaned" from their plans could be transferred to receive similar benefits under overall state plans,[152] with liability transfers of this kind dealt with under actuarial planning for the state plans, which, being much larger, could absorb liabilities of this kind with comparatively minimal increases in employer/employee contributions.

V. The Transition From the Present Patchwork of Benefit Funds

The uniform code described in this Article is a system for benefit plans going forward. States adopting it, however, will also have to make a sometimes painful transition from the multiplicity of benefit plans now in effect; but the difficulties involved in making the transition should not deter states from adopting the new uniform code. The object of a transition should be to make benefit systems throughout a state actuarially sound, with a minimum of the trauma faced by localities with catastrophically failing plans such as Detroit and Stockton.[153]

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[151] PBGC benefits for retirement, survivors, and disabilities are subject to top amounts payable to beneficiaries. Pension benefits, for example, are based in part on the beneficiary's age at the time of plan determination and a regular adjustment for inflation. *See* Pension Benefit Guaranty Corporation, Maximum Monthly Guarantee Tables, http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html.

[152] This would be roughly analogous to the eligibility of employees with terminated health plans to transfer to other health plans under COBRA—but unlike COBRA, they would retain the benefit of employer contributions under their general state plans.

[153] *See supra,* TAN [4-6].

The transition would, in addition to the technical difficulties of consolidating local plans into a common structure administered by the state, carry with it significant political difficulties. On the one hand, public benefit funds at every level generally have their terms established by collective bargaining between unions representing beneficiaries and the state or state-sponsored government units employing the beneficiaries.[154] Most modifications of benefits to fit the new code, even for persons not yet employed, would therefore face union resistance. On the other hand, because there are significant political forces that believe public employees are overcompensated and who have opposed even the principle of collective bargaining by public employees,[155] there will be resistance to any statute establishing benefits requiring contributions by government units, particularly the defined benefit plans that now constitute the overwhelming majority of state and local pension plans.[156]

The transition can be eased by two provisions. First, benefit funds coming into the overall state program should continue to maintain their identity—if unionized, their union members should continue to be represented as before the enactment of the code. Second, while

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[154] Despite political claims blaming the cost of pension funds on collective bargaining—and claims by unions that pension costs are being used politically to frighten people to reduce benefits to unionized workers, in fact there seems to be little correlation between funding of pensions and collective bargaining, since Georgia, with only 14% of its public employees unionized, funds a lower percentage of public pensions than does highly unionized New York. *See* Walsh, *Burden of Pensions, supra* n. [23].

[155] *See, e.g.,* Matt Negrin, *As Unions Reel, Pension Reforms Gain Support,* ABC NEWS, June 6, 2012, http://www.abcnews.go.com/blogs/politics/2012/06/as-unions-reel-pension-reforms-gain-support/ (Newly elected Republican governor Scott Walker successfully faced recall attempt over abolition of collective bargaining with state unions, largely over pension issues, while other states modified their pension plans, and unions and opposing political forces across the country argued over whether state and local pension plans should be modified).

[156] *See supra*, n. [95].

new employees would be subject to the mandatory employer/employee contributions determined necessary for their level of benefits, existing employees would have contributions, benefits payable, and other factors such as minimum age of retirement, adjusted gradually over time, in order to minimize dislocations suffered by persons already receiving pensions and, to a lesser degree, those within ten years of retirement under existing plans.[157]

The transition should not require drastic changes in the nature of plans—as from defined benefits to defined contributions.[158] What should be done, however, is that for existing plans, contributions, benefits, and entitlement dates should be gradually shifted to levels that are actuarially sound—i.e., they should be examined by the state's Board of Actuaries and levels of contributions, dates of earliest entitlement, and maximum benefit levels should be shifted to a level that, based on a realistic rate of return on the overall fund's investments, should be sustainable over a ten-year period.[159] The code should require that public employers make the

[157] Gradual adjustments of this kind have been made by Congress in reducing benefits payable in proportion to contributions over several years, beginning in 1977, when benefits were made to correspond more closely to beneficiary earnings. *See* Pub. L. 95-216 (1977). More recent amendments gradually increased the minimum age for receiving unreduced retirement benefits from 65 to 67, increased the categories of workers subject to Social Security payroll tax withholding, and increased the Social Security payroll tax. *See* Pub. L. 98-21 (1983). Just as it has been claimed that Social Security is still underfunded, plans for states and their subdivisions may need to make greater adjustments over time.

[158] *See supra,* TAN [101-108].

[159] "Smoothing"—i.e., the averaging of current rates on top-rated debt over a period including both rates over a reasonably long period before computation of the rate to be applied and reasonable projection of rates over a limited future period, should be permitted, since experience shows that rates do vary significantly over time. It has been criticized by some economists as a means of overestimating the rate of return on fund investment. *See* Andonov, Bauer, & Cremers, *supra* n. [33], at 4-5, 20-21. Although critics suspect it is used to mask investments in risky assets—*see id.* at 5, in fact it can be justified because of the wide swings of interest rates over time. *See* NY State & Local Retirement System, *What Every Employer Should Know, Investment Strategies, supra* n. [75].

contributions required by each plan, with penalties enforceable by law for noncompliance. Sustainability should be reexamined on an annual basis, based on experience and changes in the overall economy and the state's own financial position.

VI. Standing Together: Interstate Compacts for Pooling of Resources for Benefit Funds

While each adopting state should establish an insurance fund, it is possible that multiple states, acting pursuant to compacts approved by Congress, could establish common funds.[160] The ability to raise and invest common funds is one of the advantages of a uniform code. Common funds would include pooling of funds available for the payments of actuarially anticipated retirement and survivors' benefits, along with independent funds to pay for current benefits requiring bargaining with insurance companies, chiefly medical benefits but also including benefits for long-term care of disabled workers. The pooling of funds would also be especially useful for the common emergency funds discussed in § IV, since it would serve to diversify risk across several states—especially in cases where the emergency would arise from circumstances affecting only a geographically limited area, such as a natural disaster.[161]

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[160] As noted *supra*, n. [36], Article I, § 10 of the federal Constitution allows states to enter compacts with each other if specifically permitted by Congress to do so. State compacts have been widely entered for purposes such as development, use, and conservation of the Great Lakes area by eight states pursuant to the Great Lakes Compact, and for services such as public transportation in metropolitan areas spanning different states such as the Port Authority of New York and New Jersey.

[161] This corresponds to the availability of PBGC funds to private plans affected by a Presidential declaration of disaster in an area where the plans are located. *See* 29 U.S.C. § 1302(i).

It should be stressed that compacts of this kind should govern only contributions to funds and the investment of pools of funds thus raised, and might also extend to emergency funds. States and their subdivisions and instrumentalities—which generally negotiate separately in collective bargaining with employee unions over benefits—differ sufficiently that it does not appear practical to extend compact jurisdiction beyond this level, except for instrumentalities with common purposes shared by multiple states such as the Port Authority of New York and New Jersey.[162] The chief advantages of compacts would be in the amount of funds that multiple states, acting together, could raise and invest, and diversification of risk among states sharing large metropolitan areas,[163] sections of which might suffer particularly in different economic crises. They would be subject to limitations based on practical reasons, such as the difference in benefit plans enacted by state subdivisions in states with different demographic and economic characteristics. They might also be limited, ironically, by considerations of federalism opposite to those that we have considered so far—that cooperation between multiple states on matters more complex than funding might trench on powers vested by the Constitution in the federal government.[164]

Whether a benefit fund is established by a single state or as a common fund operated by multiple states, however, it should meet certain minimum requirements, which can draw upon

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[162] *See id.*

[163] *See supra,* n. [25].

[164] The fact that the Constitution, Article I, § 10, requires Congressional approval for interstate compacts indicates that there are limits to the degree to which states may form agreements with each other without trenching on the powers of the federal government.

the experience of the PBGC,[165] with special modifications based on the differences between the private funds insured by the PBGC and the public funds dealt with here.

VII. Conclusion

The problem of paying for benefit funds established by states, their subdivisions, and instrumentalities cannot readily be overcome by federal legislation, both because of Constitutional considerations of federalism, and due to the practical difficulties of pushing such wide-ranging legislation through Congress. It is therefore necessary to address the problems in funding these benefit programs under state law.[166] A uniform state law, that would provide a template which states could readily use for drafting their own statutes, and which could provide advantages such as the use of one state's precedents by another, appears to be the most effective way of doing this. Moreover, the uniformity would aid adopting states in making compacts which, if approved by Congress,[167] would enable them to fund plans on a multistate basis, increasing the size of funds and thereby amplifying their leverage with investment intermediaries and ability to diversify overall risk.

The law would provide for consolidation of the funding of all public benefit funds operated by a state, its subdivisions, and instrumentalities into a single unit under state authority. This would, by creating large statewide funds, permit the retention of sophisticated fiduciaries to

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[165] The PBGC covers multiemployer plans as well as plans sponsored by individual private employers. *See* PBGC, *Multiemployer Program Fact Sheet*, *supra* n. [65].

[166] *See supra*, TAN [17-18].

[167] *See supra,* TAN [36].

manage the funds, reduce the cost of investment by improving leverage with financial intermediaries, and permit greater diversification of investments. Individual funds for cities and other state subdivisions could continue to offer their own sets of benefits to employees, providing that contributions matched foreseeable expenditures under standards set by a state actuarial board acting under the supervision of a nonpartisan Administrative Council.[168]

Contributions would be invested and the investments supervised by fiduciaries appointed by the council. The transparency of investments and expenditures would be assured by requiring regular accounting according to GASB standards,[169] with annual audits subject to review by a nonpartisan state Office of the Inspector General, which would have the power to investigate irregularities and bring them to the attention of the State Attorney General for corrective legal action. The audited reports on collections, investment returns, and expenditures would have to be disclosed both to beneficiaries and the general public, with reporting following the SEC's "Plain English" Rules to assure comprehension and to prevent concealment of irregularities in obfuscatory language.[170]

Statewide consolidation would also enable states to maintain emergency funds in addition to the funds normally invested toward benefits.[171] These would provide a protective function roughly similar to that of the PBGC.[172] They would be invested according to more conservative rules than routine investments, and would be available to keep up benefit payments in the face of

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168 *See supra,* TAN [75].

169 *See supra,* n. [32], TAN [79-81].

170 *Supra,* n. [82].

171 *Supra,* § IV.

172 *See supra,* n. [8].

unforeseeable contingencies such as the financial crash of 2007 and its aftermath. States could draw on such funds only under narrowly specified circumstances, and draws would have to be refunded as conditions improved from the emergencies that enabled the states to make them.[173]

[173] *Supra*, § IV.