Date: April 12, 2023

To: Thomas Golonka, Chairman
Vermont Pension Investment Commission

Eric Henry, Chief Investment Officer
Vermont Pension Investment Commission

From: Robert D. Klausner
Fiduciary Consultant

Re: Liability Concerns Arising from S.42

This is in response to your request for an analysis of the fiduciary liability concerns arising from S. 42. For the reasons which follow, the current language of the bill provides inadequate protections from liability for Vermont Pension Investment Commission (VPIC) members and staff.

The proposed legislation mandates divestment of a substantial portion of the VPIC portfolio based on environmental, social and governance (ESG) matters to the potential exclusion of the economics applicable to VPIC's mission as the investment fiduciary for the state's retirement systems.

Vermont subscribes to the Uniform Prudent Investor Act, 14A V.S.A. § 901, et. seq. Those statutory provisions expressly outline the factors a fiduciary must consider in the investment of trust assets. Specifically, Section 902 outlines multiple considerations, all related to the primary purpose of the trust. In the case of a retirement plan, the overarching goal is to manage the plan in such manner as to assure the participants that their retirement benefits will be paid in full as and when they arise.

Section 902 provides:

(*a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution.*

(b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.

(c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
(5) the expected total return from income and the appreciation of capital;
(6) other resources of the beneficiaries;
(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

(d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this chapter.

Nowhere in those standards is the idea of applying ESG principles as the primary investment *raison d 'etre* applied. For the last century, American fiduciary practice has been defined by the standard articulated by the New York Court of Appeals in *Meinhard v. Salmon,* 249 N.Y. 458 (1928). In that decision, cited with approval on several occasions by the Supreme Court of Vermont, Justice Cardozo wrote that conduct permitted in the "workaday world" are forbidden to fiduciaries who must have undivided loyalty to the beneficiaries of the trust to the exclusion of "disintegrating erosion of particular exceptions." Said more plainly, concerns external to the financial security of

the assets underlying the pension benefits should not be given greater significance than sound investment practices.

That does not mean that a fiduciary cannot “do good” while also “doing well.” The language in S.42, however, leaves no discretion to VPIC as fiduciary to act in the best financial interests of the participants of the retirement plans. I am advised that the actuarial impact of the required divestment will mandate a substantial reduction in the assumed rate of investment return. This will result in a material increase in the taxpayer supported employer contributions and at the same time will result in a reduction in the funded ratio of the retirement systems. This latter event will take place as a direct consequence of the lower rate of investment return being applied to future expected earnings. If the expected future income of the plan is reduced, the current funded ratio must be reduced to meet it.

California mandated divestment of thermal coal in 2015 for the state funded retirement systems (CalPERS and CalSTRS) with the adoption of California Government Code Section 7513.75. However, the law also provided that the CalPERS Board was not required to take any action which they believed, in good faith, was contrary to their fiduciary duty under California law. In addition, to protect the Board, staff, and outside advisors and managers, the California Legislature amended Section 16642 of the Government Code to provide absolute immunity from any claimed causes of action arising from the divestment.

The California discussion is critical for two reasons. First, it recognized the ultimate fiduciary responsibility of the plan fiduciary to act in the best interest of the members and beneficiaries. S..42 has no such language. Second, California provided absolute immunity in tort or contract from any claim arising from the act of divestment and its consequences. S.42 has no such protection and as explained below, Vermont’s waiver of sovereign immunity may create an *enhanced* liability.

Vermont has waived sovereign immunity in tort to be consistent with liability in the private sector. *Stocker v. State*, 215 Vt. 432 (2021). To undertake the course of action mandated by S.42 in the private sector would likely give rise to liability in the ERISA context as set forth in 29 U.S.C. § 1104. The current state sovereign immunity would not adequately protect VPIC commissioners and staff from liability. To follow the Prudent Investor Act, VPIC would have to violate S.42. If it follows S.42, it violates the Prudent Investor Act. To expect staff or commissioners to take that risk with legal protection that is non-existent at worst, and inadequate at best, should give a prudent person pause for thought.

As employer contributions will dramatically increase and likely result in adverse consequences on future wages for covered workers and less secure retirement plans for retirees, it is foreseeable that VPIC could simultaneously face litigation from employers, labor unions and retiree advocacy groups. At the time VPIC could face suits from environmental or other public interest groups seeking to force divestment without regard to its adverse impact on the retirement plans.

When carried its extreme, this type of irreconcilable conflict led to the criminal prosecution of former trustees and staff of the San Diego City Employees' Retirement System. The Board and staff approved an actuarial valuation placing a cost on a City sponsored funding proposal. The prosecutors claimed that the trustees and staff who were participants in the retirement system were acting in their own interest simply by performing their statutory fiduciary duty of adopting an actuarial impact statement on a funding proposal they had no hand in creating. The California Supreme Court set aside the prosecutions, but not before five years of bitter litigation which resulted in the end of careers, divorces, and multiple individual bankruptcies. See, *Lexin v. Superior Court*, 222 P.3d 214 (Cal. 2010). Exposing VIPC staff, advisors, and money managers to this kind of liability would not only discourage anyone from serving VPIC as a commissioners or employee, but it would also discourage professional asset managers from investing VPIC assets.

The essence of VPIC's fiduciary duty is to seek the highest and best return on assets under its control at a reasonable rate of risk. If the achievement of that goal can be accomplished consistent with desired social or environment principles, then VPIC can combine doing well with doing good.

The current text of S.42 presents an overly rigid and unworkable framework for VPIC which, ironically, is comparable to the anti-ESG legislation adopted in those states seeking to forbid investment managers and banks from adopting environmentally or socially progressive policies at the expense of purely financial considerations. If any legislatively mandated form of divestment is to be implemented in a manner consistent with good fiduciary practice, there must be adequate indemnification for all parties in the investment process and the final decision on fiduciary decisions must rest with VPIC. To that end, the attached additional language is recommended for inclusion in S.42.

The following shall be added to S.42 and any companion bill in the House of Representatives:

Sec. XXX Indemnification of State Governmental Entities, Employees, And Others

(a) In a cause of action based on an action, inaction, decision, divestment, investment, financial company communication, report, or other determination made or taken in connection with this chapter, the state shall indemnify, without regard to whether the persons performed services for compensation, indemnify and hold harmless from actual damages, court costs, and attorney's fees adjudged against, and defend:

(1) An employee, member of the governing body, or any other officer of the Vermont Pension Investment Commission (VPIC).
(2) A contractor of VPIC.
(3) A former employee, a former member of the governing body, former contractor, or any other former officer of any state governmental entity who was an employee, member of the governing body, or other former officer or former contractor when the act or omission on which damages are claimed occurred.
(4) VPIC or any other entity of the State of Vermont.

(b) The provisions of this section are in addition to any protections and exclusions of liability in 12 V.S.A. §5601et. seq.

Sec. XXX.1 No Private Cause of Action

(a) A person, including a member, retiree, or beneficiary of a retirement system to which this chapter applies, an association, labor organization, research firm, public interest group however constituted, a financial firm, or any person may not sue or pursue a cause of action against the state, VPIC or any other state governmental entity, a current or former member of the governing body, a current or former employee of the state, VPIC or any other state governmental entity, or a contractor of the state, VPIC, or any other state governmental entity, for any claim or cause of action, including breach of fiduciary duty, or for any violation of any constitutional, statutory, or regulatory requirement in connection with any action, inaction, decision, divestment, investment, financial company communication, report, or other determination made or taken in connection with this chapter.

(b) A person, who files suit against the state, VPIC, any other state governmental entity, a current or former member of VPIC or other governing body, a current of former employee of the state, VPIC or any other state governmental entity, or a current or former contractor of the state, VPIC or any other state governmental entity is liable for paying the costs and attorney's fees of a person sued in violation of this section.

(c) The provisions of this section are in addition to any protections and exclusions of liability in 12 V.S.A. §5601et. seq.

Section XXX.2 Inapplicability of Requirements Inconsistent with Fiduciary Responsibilities and Related Duties.

A state governmental entity, including VPIC, its governing body, employees, and contractors are not subject to the provisions of this chapter if, in the exercise of good faith, any of them determines that that the requirements of this chapter would be inconsistent with their fiduciary responsibility in connection with the administration or investment of the assets under their direction or control, including the standard of care imposed by 14A V.S.A. §901, et. seq.