FEDERALISM AND FIDUCIARIES: A NEW FRAMEWORK FOR PROTECTING STATE BENEFIT FUNDS

*Richard E. Mendales**

ABSTRACT

The financial crisis has underlined the difficulties states and localities face in paying benefits to their employees. The most spectacular example is Detroit's bankruptcy, but across the country, state and local employees face sharp cuts in benefits as their employers fight for solvency. A federal solution such as the Employee Retirement Income Security Act (ERISA), which protects private pensions, is precluded both by considerations of federalism and the practical impossibility of getting major legislation through Congress. This Article proposes an alternative: a uniform state code, like other uniform laws such as the Uniform Commercial Code, that states could adopt to govern both state and local benefit plans. The proposed uniform code is based on common, statewide financing. Funds would be administered by a nonpolitical council that would employ actuaries and inspectors to protect the integrity of funds invested and disbursed according to standards set by the code. Statewide funding for state and local plans has advantages already enjoyed by states such as New York, including more sophisticated fiduciaries to supervise investments, reduced costs imposed by financial intermediaries, and greater diversification of investments. The code would go beyond existing state and local plans in creating state emergency funds paralleling the federal Pension Benefit Guaranty Corporation to ensure payment of benefits during unexpected crises. Making the code uniform would enable adopting states to follow each other's practices and interpretations of code provisions. Moreover, with congressional approval, it would facilitate compacts among groups of states to pool benefit and emergency funds, giving them greater overall safety, ability to diversify, and leverage over financial intermediaries.

* Associate Professor of Law, Charleston School of Law. Supreme Court Fellow, 1999–2000. J.D., Yale Law School, 1981; M.A., University of Chicago, 1970; B.A., University of Chicago, 1969. This Author would like to thank his colleagues at the Charleston School of Law for their helpful comments on this Article. All errors, of course, are his own.

TABLE OF CONTENTS

I. INTRODUCTION

Even before panic hit world financial markets in 2007, studies of benefit plans[1] established by states and their instrumentalities[2] for their

1. For purposes of this Article, "benefit plans" include all employer-provided plans for employee welfare, including 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 those established by organizations for the benefit of state

employees showed growing concern for the funds' actual or potential inability to make the payments required by the plans.[3] This concern exploded into reality with the financial crisis, which made it clear that public plans' inability to pay scheduled benefits was a crisis of national dimensions,[4] as municipalities—most prominently Detroit[5]—were forced to file petitions under Chapter 9 of the federal Bankruptcy Code.[6] Public

employees, such as unions.

3. *See, e.g.*, David Evans, *Banks Sell 'Toxic Waste' CDOs to Calpers, Texas Teachers Fund*, BLOOMBERG (June 1, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aW5vEJn3LpVw (providing examples of public pension funds that invested in risky, complex instruments backed by subprime mortgages—and that "would be the first to take losses" should those risky instruments default). Almost all full-time employees of the states, their subdivisions, and instrumentalities, are covered by benefit plans provided by their employers. Robert Clark, *Evolution of Public-Sector Retirement Plans: Crisis, Challenges, and Change*, 27 A.B.A. J. LAB. & EMP. L. 257, 257 (2012). These plans have a long history and have expanded in scope over time. *Id.* at 258–59.

4. *The Economist*, a leading British news magazine, made the crisis the cover story for its July 27, 2013 issue. *The Unsteady States of America*, ECONOMIST, July 27, 2013, http://www.economist.com/news/leaders/21582258-it-not-just-detroit-american-cities-and-states-must-promise-less-or-face-disaster. The article argues that under-funding for state and local pension funds, led by Detroit, is a major national problem for the United States. *Id.* ("Detroit . . . is a flashing warning light on America's fiscal dashboard."); *see also* Charlie LeDuff, Op-Ed., *Come See Detroit, America's Future*, N.Y. TIMES, July 25, 2013, http://www.nytimes.com/2013/07/26/opinion/come-see-detroit-americas-future.html?_r=0.

5. Detroit is the largest U.S. city to file for bankruptcy, eclipsing the largest city to file previously—Stockton, California. *See* Steven Church et al., *Detroit Slides from Industrial Might to Bankruptcy*, BLOOMBERG (July 19, 2013), http://www.bloomberg.com/news/2013-07-18/detroit-becomes-biggest-u-s-city-to-file-for-bankruptcy.html. Its bankruptcy followed an apparently failed attempt to restructure its debt under a state-appointed emergency manager, Kevyn Orr. *See* Declaration of Kevyn D. Orr in Support of City of Detroit, Michigan's Statement of Qualifications Pursuant to Section 109(c) of the Bankruptcy Code at 1, 11, *In re* City of Detroit, No. 13-bk-53846, 498 B.R. 776 (Bankr. E.D. Mich. 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. *See* Church et al., *supra*. 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. *Id.*

6. 11 U.S.C. § 901 (2012); *see also In re* City of Stockton, 493 B.R. 772, 798 (Bankr. E.D. Cal. 2013) (finding that Stockton "ha[d] prevailed on its contention that chapter 9 relief is appropriate"). Stockton's plight illustrates the lesser scope of California's pension system, the California Public Employees' Retirement System (CalPERS), as compared to the system proposed in this Article; because CalPERS covers state employees directly and covers employees of state subdivisions—such as

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 private funds and establishes the Pension Benefit Guaranty Corporation (PBGC) to ensure that benefits continue going to employees whose funds have been terminated.[8]

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

municipalities—by contract, CalPERS is a creditor in Stockton's bankruptcy. *See Health Benefits Overview*, CALPERS, https://www.calpers.ca.gov/index.jsp?bc=/about/benefits-overview/health/benefits-overview.xml (last updated Apr. 5, 2012). Three other California municipalities have already filed under Chapter 9. *See* Rex Sinquefield, Op-Ed., *Stockton, CA: One of America's Most Miserable Cities Just Got More Miserable*, FORBES, Apr. 5, 2013, http://www.forbes.com/sites/rexsinquefield/2013/04/05/stockton-ca-americas-most-miserable-city-just-got-a-lot-more-miserable/ (including Stockton on a list that also included Atwater, San Bernardino, and Mammoth Lakes). Stockton was just one of dozens of municipal bankruptcies in the past three years, largely caused by "unmanageable public employee pension debt." *Id.*; *see Bankrupt Cities, Municipalities List and Map*, GOVERNING, http://www.governing.com/gov-data/municipal-cities-counties-bankruptcies-and-defaults.html (last updated Dec. 3, 2013) (counting 38 filings since 2010). In addition to federal bankruptcy under Chapter 9, many state instrumentalities are having their insolvencies administered by state officials. *See* Sinquefield, *supra*.

7. *See* 29 U.S.C. § 1003(b)(1) (exempting governmental plans 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 (2012) ("[T]he protection of [public pension] participant benefits . . . is left entirely to state law.").

8. *See* Employee Retirement Income Security Act of 1974 (ERISA) §§ 301–305, 4002, 29 U.S.C. §§ 1081–1085, 1302(a) (providing minimum funding standards and establishing the PBGC). The applicable minimum standards have been elaborated by regulations of the Department of Labor's Employee Benefits Security Administration (EBSA) and the Internal Revenue Service (IRS). *See generally* 29 C.F.R. pt. 2530 (2013).

9. *See* PEW CTR. ON THE STATES, THE WIDENING GAP UPDATE 1, 4 (2012), *available at* http://www.pewstates.org/uploadedfiles/pcs_assets/2012/pew_pensions_update.pdf.

10. "Liquid" investments are those that are traded on a regular market and can therefore be easily sold or converted to cash as needed. BLACK'S LAW DICTIONARY 1014 (9th ed. 2009). Liquidity is an important measure of an institution's ability to meet claims against it. *See, e.g.*, Daniel Pruzin, *Basel Committee Cites Need*

all or most of their value during and after the financial crisis;[11] (3) high transaction costs incurred by investments in unconventional securities;[12] (4) inadequate supervision of investments by plan fiduciaries;[13] and (5) failure to disclose to state authorities and beneficiaries the risks they faced, especially as the world financial crisis substantially increased those risks

for Rules on Liquidity Stress Testing, INT'L BUS. & FIN. DAILY, Oct. 25, 2013 (reporting findings that, "during the 2007-2009 financial crisis," several banks that failed or nearly failed had liquidity calculations that were "clearly inadequate in hindsight" (internal quotation mark omitted)). "Illiquid" investments, on the other hand, have no ready market and are, therefore, more difficult to convert to cash, especially during financial crises when the cash is most needed. *See* BLACK'S LAW DICTIONARY, *supra*, at 134 (categorizing "illiquid asset" as a subheading under the definition of "asset"). Illiquid investments include nonsecurity investments, such as real estate and unregistered securities, which may be traded only if the transaction complies with exemptions for private sales. *See* 17 C.F.R. § 230.144(c)–(d).

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 CTR. ON THE STATES, *supra* note 9, 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, 244 (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 80 percent of the system's income from April 1, 1993 through March 31, 2013. *See What Every Employer Should Know: The Big Picture*, N.Y. ST. & LOC. RETIREMENT SYS., http://www.osc.state.ny.us/retire/employers/employer_partnership/|contribution_rates/the_big_picture.php (last visited Mar. 18, 2014).

12. *See* Gretchen Morgenson, *How to Pay Millions and Lag Behind the Market*, N.Y. TIMES, Oct. 19, 2013, http://www.nytimes.com/2013/10/20/business/how-to-pay-millions-and-lag-behind-the-market.html?_r=2&; Gretchen Morgenson, *Wall Street's Tax on Main Street,* N.Y. TIMES, Aug. 6, 2011, http://www.nytimes.com/2011/08/07/business/wall-streets-tax-on-main-street.html?adxnnl=1&adxnnlx=1390241030-sqDhZISyi7NigZvSjLKwYA.

13. This includes not only fiduciaries for plans but also the investment advisors they retain. *See, e.g.*, Complaint at 1–2, U.S. SEC v. MayfieldGentry Realty Advisors, LLC, No. 13-cv-12520, 2013 WL 6008255 (E.D. Mich. Nov. 13, 2013) [hereinafter MayfieldGentry Complaint] (alleging that investment advisors who had received 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); Complaint at 1–3, U.S. SEC v. Stifel, Nicolaus & Co., No. 11-C-0755, 2012 WL 4069346 (E.D. Wis. Sept. 14, 2012) (charging a broker-dealer and its former Senior Vice President with defrauding five Wisconsin school districts by selling them unsuitably risky and complex financial instruments). The U.S. Securities and Exchange Commission (SEC), overwhelmed with regulatory demands exceeding what its staff can handle, cannot deal with all fraudulent transactions of this nature. Moreover, the SEC has no jurisdiction in cases in which fiduciaries mishandle funds without violating federal law.

from traditional levels.[14] 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 investment safety in peddling them,[15] a more comprehensive legislative solution will be required going forward. Failure to do so will result in public employees losing promised benefits,[16] higher funding costs for public employers sponsoring the plans,[17] higher general borrowing costs for states and municipalities with insufficiently funded plans,[18] and ultimately higher borrowing costs for states regardless of how adequately their benefit plans are funded.[19]

Federal legislation modeled on ERISA is not a realistic basis for dealing with this set of problems. Many of the key issues that need to be addressed, including adequate public funding, protecting state credit, and states' ability 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.[20] Moreover, federal legislation to deal with these issues—especially the problem of funding—would not only be difficult to pass given the current partisan deadlock in Congress, but is perhaps barred by genuine issues of federalism.[21] Congress itself believed that it could not apply ERISA to the

14. *See* Mendales, *supra* note 11, at 247–48 (discussing investments that were "often deceptively marketed as offering safety").

15. *See, e.g.*, MayfieldGentry Complaint, *supra* note 13, at 1–2 (alleging that investment advisors misappropriated assets from a benefit fund); Miss. Pub. Emps.' Ret. Sys. v. Bos. Scientific Corp., 523 F.3d 75, 94 (1st Cir. 2008) (allowing an action brought by a benefit fund for alleged securities fraud to proceed).

16. *See, e.g.*, Brian Chappatta & Tim Jones, *Illinois Losing Rally as State Fails to Fix Pension: Muni Credit*, BLOOMBERG (June 3, 2013), http://www.bloomberg.com/news/2013-06-04/illinois-losing-rally-as-state-fails-to-fix-pension-muni-credit.html (describing proposed reforms in Illinois that called for benefit cuts).

17. *See, e.g.*, *Illinois: Pension Woes Cause Downgrade to Credit*, N.Y. TIMES, June 4, 2013, http://www.nytimes.com/2013/06/04/us/illinois-pension-woes-cause-downgrade-to-credit.html ("Lower [credit] ratings mean paying higher interest rates on borrowed money.").

18. *See, e.g.*, *id.* (reporting that Illinois's state government credit rating, already "the lowest . . . in the nation," was downgraded yet again).

19. *See, e.g.*, Chappatta & Jones, *supra* note 16 (noting that, in general, lower credit ratings drive up costs).

20. *See* 29 U.S.C. § 1001(b) (2012) ("[T]he policy of [ERISA is] to protect interstate commerce and the interests of *participants* . . . and their beneficiaries . . . ." (emphasis added)).

21. *See* Gavin Reinke, Note, *When a Promise Isn't a Promise: Public*

states based on these issues when it originally enacted the legislation in 1974.[22]

Since 1976, a series of U.S. Supreme Court decisions 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.[23] Moreover, federal legislation appears too broad a brush to deal 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.[24]

This Article 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).[25] This code,

---

Employers' Ability to Alter Pension Plans of Retired Employees, 64 VAND. L. REV. 1673, 1707–08 (2011) (acknowledging federalism concerns and proposing a way to avoid them).

22. ERISA expressly exempts plans sponsored by states, their subdivisions, or their instrumentalities from its coverage. 29 U.S.C. §§ 1002(32) (defining "governmental plan"), 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 Revisited*, 28 A.B.A. J. LAB. & EMP. L. 291, 292 (2013).

23. The Court originally held that Commerce Clause jurisdiction did not extend to states' control of their employees' wages and hours. Nat'l League of Cities v. Usery, 426 U.S. 833, 852 (1976). The Court later overruled that case. Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 531 (1985). However, 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, 166 (1992) ("[The] Constitution . . . confers upon Congress the power to regulate individuals, not States."); *see also* Printz v. United States, 521 U.S. 898, 933 (1997) (holding that the federal government could not compel states to administer federal gun regulations).

24. *See* ROBERT G. KAISER, ACT OF CONGRESS: HOW AMERICA'S ESSENTIAL INSTITUTION WORKS, AND HOW IT DOESN'T 370 (2013) ("Congress still *can* work . . . , but only in extreme circumstances—so extreme that they are unlikely to recur for a long time."); 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 101 (2012) ("[T]he political system has become grievously hobbled at a time when the country faces unusually serious challenges and grave threats.").

25. The Uniform Law Commission (ULC), formerly known as the National Conference of Commissioners on Uniform State Laws (NCCUSL), consists of judges, lawyers, and other jurists appointed by state governments. *About the ULC*, UNIFORM

which differs fundamentally from the far-less-comprehensive Uniform Management of Public Employee Retirement Systems Act (UMPERSA),[26] would require that all benefit funds maintained by a state, its subdivisions, and instrumentalities be subsumed under common administration by state agencies selected in a nonpolitical way and be subject to uniform rules on financing and accountability.[27]

L. COMMISSION, http://www.uniformlaws.org/Narrative.aspx?title=About%20the%20 ULC (last visited Mar. 18, 2014). It was constituted in 1892 and, sometimes working together with the American Law Institute (ALI), has proposed both highly influential bodies of law such as the UCC—which has been adopted, at least in part, by a majority of the states—and uniform laws that have received little state acceptance, such as the Uniform Computer Information Transactions Act (UCITA). *Compare UCC Article 1, General Provisions (2001)*, UNIFORM L. COMMISSION, http://www.uniformlaws.org/Act.aspx?title=UCC%20Article%201,%20General%20Provisions%20(2001) (last visited Mar. 18, 2014) (providing a map showing that a majority of states have adopted UCC Article 1), *with Computer Information Transactions Act*, UNIFORM L. COMMISSION, http://www.uniformlaws.org/Act.aspx?title=Computer%20Information%20Transactions%20Act (last visited Mar. 18, 2014) (providing a map showing that only two states have adopted UCITA). The ULC and ALI have had to work hard to restrain states from adopting individual provisions that make the uniform acts less uniform. *See* Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 583 (1998) ("[Uniform law drafters] must draft a statute that will survive the scrutiny of fifty state legislatures.").

26. UMPERSA merely provides 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. *See generally* UNIFORM MANAGEMENT OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS ACT 1–3 (1997) [hereinafter UMPERSA], *available at* http://www.uniformlaws.org/shared/docs/management_public_employee_retirement_systems/mpersa_final_97.pdf (prefacing the proposed statutory sections with a note explaining UMPERSA's provisions). However, the emergency fund described in Part IV does these things. *See* discussion *infra* Part IV.

27. This is a totally different approach from the proposal made by Senator Orrin Hatch, which would essentially privatize state and local pensions by having the public entities buy their pension plans from insurance companies. *See* Mary Williams Walsh, *Pension Proposal Aims to Ease Burden on States and Cities*, N.Y. TIMES, July 9, 2013, http://dealbook.nytimes.com/2013/07/09/pension-proposal-aims-to-ease-burden-on-states-and-cities/?_php=true&type=blogs&r=0. This Article would substantially reform—rather than overturn—the existing system. It is beyond this Article's scope to argue point by point with the Hatch proposal except to note that the Hatch plan would convert most public pension systems from defined-benefit plans to defined-contribution plans—a radical change that most systems and their beneficiaries have rejected. *See* Clark, *supra* note 3, at 262 (noting only four states offer solely defined-contribution plans). Further, the Hatch plan would add major costs to the public pension system. Studies have shown that insurance company administrative costs run

This would accomplish a number of purposes. First, it would provide a complete model of legislation governing benefit funds for state and local employees, making it easier for states to pass the model act 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 were 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.[28] This resulted in the downgrade of the state's overall credit and consequent increases in its borrowing costs—despite strong state constitutional provisions for payment of general state obligations.[29]

The code would enable states to provide—based on standard, ongoing provisions—for adequate funding to ensure that promised benefits are paid.[30] This would include requirements to employ qualified actuaries

as high as 30 percent of total spending on health care. *See* Jeffrey Pfeffer, *The Reason Health Care is So Expensive: Insurance Companies*, BLOOMBERG BUSINESSWEEK (Apr. 10, 2013), http://www.businessweek.com/articles/2013-04-10/the-reason-health-care-is-so-expensive-insurance-companies. By comparison, Medicare, the benchmark for public health insurance, incurs administrative costs running from 1.4 to 6 percent—and the latter figure includes payments to private insurance companies. *See* Kip Sullivan, *How to Think Clearly About Medicare Administrative Costs: Data Sources and Measurement*, 38 J. HEALTH POL. POL'Y & L. 479, 481 (2013).

28. *See* Chappatta & Jones, *supra* note 16.

29. *See* FID. CAPITAL MKTS., ARE ALL STATE GENERAL OBLIGATIONS CREATED EQUAL? 6 (2011), *available at* http://fiiscontent.fidelity.com/RD_927019.pdf (ranking Illinois in the top tier of states with strong protections for general obligation debt).

30. Common funding would broaden the base of contributions for benefit funds and thereby increase a common fund's ability 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 ensure 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. *See* Social Security Amendments of 1983, Pub. L. No. 98-21, §§ 101–102, 97 Stat. 65, 67–70 (expanding coverage to include newly hired federal employees and employees of nonprofit organizations). 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—by creating, inter alia, lower costs of administration and greater bargaining power with investment intermediaries. *See* NAT'L EDUC. ASS'N, DOES SCALE MATTER FOR PUBLIC SECTOR DEFINED BENEFIT PLANS? EVIDENCE OF THE RELATIONSHIP AMONG SIZE, INVESTMENT RETURN AND PLAN EXPENSE 8 (2009), *available at* http://www.nea.org/assets/docs/HE/DoesScaleMatter_RetirementSystems09.pdf; Mary Williams Walsh, *The Burden of Pensions on States*, N.Y. TIMES, Mar. 10,

to match contributions and investment returns with predicted payouts to beneficiaries.[31] Equally important, it would provide for adequate supervision of fiduciaries charged with prudently investing and managing funds collected—as well as with supervising investment performance—and would also establish an Office of the Inspector General to police the integrity of plan fiduciaries[32] and their advisors. To accomplish these goals, it would include provisions for common funding, investment, and administration of state and municipal funds—including funds for local instrumentalities such as police and fire departments.[33] This would permit local funds to employ more sophisticated financial personnel, would permit greater diversification of investments, and would 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.[34]

The code would also borrow from ERISA and securities law to protect the funds and their beneficiaries. These "borrowed" provisions would, inter alia, dictate minimum standards for the conduct of plan

2011, http://www.nytimes.com/2011/03/11/business/11pension.html?pagewanted=all&_r=0 (noting that increased contributions would "provide immediate relief for struggling towns, school districts, and state agencies"); *see also infra* notes 54–58 and accompanying text.

31. ERISA requires actuaries for qualifying private benefit plans to meet standards set by the Joint Board for the Enrollment of Actuaries. *See* 29 U.S.C. §§ 1241–1242 (2012).

32. For purposes of this Article, "fiduciaries" refers to all persons charged with collecting, investing, managing, allocating, and disbursing plan funds—including supervisory personnel, plan employees, and third parties such as brokers and investment advisers.

33. Police and fire departments, as well as school systems, often have their own benefit plans, in part because their employees' unions separately negotiate plan terms with state and municipal authorities. *See, e.g.*, 62 Ops. Cal. Att'y Gen. 467, 1979 WL 29265, at *4 (Aug. 30, 1979) (concluding that local school district employees were "not entitled to benefits identical to those provided to state employee members").

34. *See, e.g.*, *SEC Hearing on The State of Municipal Securities Market* 7 (2011) (prepared remarks of Andrew Kalotay, President, Andrew Kalotay Associates, Inc.), *available at* http://www.sec.gov/spotlight/municipalsecurities/statements072911/kalotay.pdf (opining that sophisticated securities valuation was beyond most municipal decisionmakers' skill sets, that professional advisors did not serve municipalities well, and that municipalities purchased such securities without full awareness of their cost and risk); *see also* Morgenson, *How to Pay Millions*, *supra* note 12 (describing the consequences after less sophisticated pension funds, having invested with unconventional investment managers such as hedge funds, often underperformed the general market because of high fees, risks, and general lack of transparency).

fiduciaries;[35] set minimum vesting requirements for beneficiaries to acquire rights under defined-benefit plans;[36] impose mandatory accounting and auditing standards for plans;[37] require disclosure concerning plan assets, liabilities, and return on investments;[38] and protect benefits in other ways—for example, by requiring continuing coverage for employees leaving their employment. This would be enforced through audited accounting, done according to national standards, and supervised by a state Office of the Inspector General, to be established by each state as a key component of

35. *See* 29 U.S.C. §§ 1101–1112.

36. *See id.* § 1053. Vesting standards are not required for defined-contribution plans, under which a beneficiary is entitled simply to contributions actually made plus any return on this investment. *What You Should Know About Your Retirement Plan*, U.S. DEP'T LAB., http://www.dol.gov/ebsa/publications/wyskapr.html (last visited Mar. 18, 2014) ("In a defined contribution plan . . . , you are always 100 percent vested in your own contributions . . . .").

37. 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. GASB, FACTS ABOUT GASB 1 (2012), *available at* http://gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176160212168. These standards are roughly comparable to the Generally Accepted Accounting Principles (GAAP) 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. *Compare id.*, *with Facts about FASB*, FASB, http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154526495 (last visited Mar. 18, 2014). Nonetheless, they are required by state law to be used by public entities in several states. GASB, *supra*, at 1. The SEC lacks direct authority to regulate the issuance of securities by state governments and their subdivisions, but does so indirectly through its authority to regulate brokers and dealers who sell municipal securities to the general public. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o-4; Securities Exchange Act Rule 15c2-12, 17 C.F.R. § 240.15c2-12 (2013); State of Illinois, Securities Act Release No. 9389 at 1–2, 9, 2013 WL 873208 (Mar. 11, 2013) (referencing GASB standards applied by Illinois cited by SEC in a cease-and-desist order against Illinois for misleading disclosures in bond offerings to finance state pensions).

38. Because 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, making it difficult to determine the adequacy of their matching of contributions, return on investment, and promised benefits. *See* Aleksandar Andonov et al., Pension Fund Asset Allocation and Liability Discount Rates: Camouflage and Reckless Risk Taking by U.S. Public Plans? 2 (May 1, 2013) (unpublished working paper), *available at* 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.

enforcing the uniform code.[39]

This accounting would be used to ensure fair disclosure to beneficiaries about 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.[40]

A uniform code, designed to be adopted individually by all or most 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 benefit funds would provide a template to assist legislatures in dealing with difficult issues such as funding, investing and administering trust funds, structuring benefits, and ensuring the integrity of benefit funds.[41] Moreover, like all uniform state laws, it would provide for minimal variation from state to state, creating greater predictability for both for beneficiaries and creditors investing in securities issued by the states and municipalities in question—an advantage not only to the creditors, but also to municipal bond issuers, who will pay lower rates to borrow.

A potential further benefit is that the uniformity a code of this sort provides would make it easier for states to enter compacts—subject to congressional approval—to invest and administer funds jointly,[42] giving

39. 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, Division of Pension Investments and Cash Management. *See* N.Y. RETIRE. & SOC. SEC. LAW § 11 (McKinney 1999). New York's system, however, is large and long-established. *See About Us*, N.Y. ST. & LOC. RETIREMENT SYS., http://www.osc.state.ny.us/retire/about_us/index.php (last visited Mar. 18, 2014) (noting the system serves more than 1,000,000 people—more than 600,000 current employees and more than 400,000 pensioners and beneficiaries). 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 SEC.

40. *See* Andonov et al., *supra* note 38, at 29.

41. State legislatures have difficulty agreeing on measures to strengthen state benefit funds when attempted on a one-off basis, even absent partisan infighting—as Illinois has demonstrated. *See* Chappatta & Jones, *supra* note 16.

42. Article I, Section 10 of the Constitution permits states to enter compacts with each other, subject to the consent of Congress. U.S. CONST. art. I, § 10, cl. 3. Compacts of this kind could not be included in a uniform act, but the common

them additional leverage with securities issuers and financial intermediaries and the ability to minimize the number of administrators needed to ensure the integrity and efficiency of fund and benefit administration.[43] All of this would result in the further benefit of reducing the cost of funds to states seeking to borrow, whether privately or on public markets, thus avoiding a deadweight loss to the states.[44]

There are clear limits to the proposed code. First, no state would be required to adopt it—and states have often failed to adopt proposed uniform laws and proposed changes to established uniform laws.[45] Moreover, even though the code would include provisions designed to maintain uniformity among the states,[46] it cannot prevent states from amending it in ways that will cause state laws to diverge—although this Article suggests provisions that will help keep the code uniform and give state legislatures incentives not to go off on their own paths.

The proposed code is intended to ensure that funds established by states and their subdivisions meet minimum standards designed to protect their beneficiaries and to help prevent wider-scale financial disasters such

---

adoption by several states of a uniform act would facilitate their entry into such a compact. *See* discussion *infra* Part V.

43. *See* discussion *infra* Part V.

44. *See, e.g.*, Chappatta & Jones, *supra* note 16 (discussing Illinois's failure to correct the underfunding of five of its pension systems, which undermined the state's credit rating and increased its general cost of borrowing).

45. For example, in the less politically charged sphere of commercial law, only two states—Maryland and Virginia—have adopted the proposed Uniform Computer Information Transactions Act. *Computer Information Transactions Act*, *supra* note 25. 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 they were withdrawn in 2011 after no state adopted them. *See* DOUGLAS J. WHALEY & STEPHEN M. MCJOHN, PROBLEMS AND MATERIALS ON COMMERCIAL LAW 10–11 (10th ed. 2012).

46. As noted previously, accounting would be required to conform to uniform standards set by the GASB. *See supra* note 37. For states that publicly issue securities, additional regulatory teeth could be added by making the GASB, like its private-sector counterpart, the FASB, subject to SEC supervision. *Facts about FASB*, *supra* note 37. This would make sense because the SEC has the greatest accounting experience and resources of any government agency. It can also be justified on the basis of the SEC's authority to regulate brokers and dealers selling municipal bonds, and to act against fraud in the sale of state and municipal securities. 15 U.S.C. §§ 77o, 78o-4(a)(4) (2012); *see* State of Ill., Securities Act Release No. 9389 at 1–2, 2013 WL 873208 (Mar. 11, 2013) (accepting SEC oversight regarding Illinois's municipal bond offerings). *But see* 15 U.S.C. § 77c(a)(2) (exempting "[a]ny security issued or guaranteed by . . . any state" from SEC coverage).

as municipal bankruptcies. Just as ERISA does not require private entities to establish benefit funds for their employees, but simply requires those that do so to meet minimum standards established by applicable statutes and regulations, the proposed code does not require states or their subdivisions to establish benefit funds of any kind.[47]

Additionally, the proposed code 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 plan at least to their direct employees.[48] The proposed plan would give state subdivisions freedom to establish the types and amounts of benefits they will provide, so long as three standards are met: contributions are made to the common state fund according to state requirements; benefit levels comply with contribution levels set by actuaries of the state system; and 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 because different state subdivisions will seek to employ persons with different types and levels of skills and will require different benefits to offer employment 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 vary from employer to employer. The packages will, however, have to fund any 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.

The code would thus be designed to ensure that when states or their subdivisions establish employee benefit plans, substantially all benefits under the plans are paid from a common state fund. The proposed code also ensures that plans are adequately funded to pay the benefits they have promised based on required contributions to that fund. This will require states to establish administrative mechanisms to ensure integrity in collecting, investing, and expending the common state funds, along with mechanisms mandating adequate disclosure to beneficiaries concerning the

47. *See The Employee Retirement Income Security Act (ERISA)*, U.S. DEP'T LAB., http://www.dol.gov/compliance/laws/comp-erisa.htm (last visited Mar. 18, 2014).

48. *See* Clark, *supra* note 3, at 258–59, 262–63.

financial health of the funds. This raises a final problem: because 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.[49]

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 eliminating the need for complex one-off drafting complicated by legislative inabilities to agree on key provisions on a state-by-state basis. Moreover, because the uniform code is 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.[50] Equally important, it will overcome the federalism problem that makes federal legislation comparable to ERISA constitutionally questionable, and it will overcome the practical problem posed by the presently deadlocked Congress's inability to pass any significant legislation.[51] The issues that are better suited to state, rather than federal, legislation include those 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 states' ability to borrow funds when necessary. The code proposed here would also establish a common framework for beneficiaries' rights 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 for employees of their subdivisions and instrumentalities, such as municipalities, school systems, fire departments, police departments, and hospitals.[52] While some are

49. *See* discussion *infra* Part IV.

50. *See* 29 U.S.C. § 1003(b)(1) (exempting government plans from ERISA coverage).

51. *See* Reinke, *supra* note 21, at 1707–08.

52. 29 U.S.C. § 1002(32) (defining "governmental plan"); *see* CONG. BUDGET OFFICE, THE UNDERFUNDING OF STATE AND LOCAL PENSION PLANS 1 (2011),

administered directly by state governments as part of overall state retirement systems,[53] many are independently administered by local instrumentalities, though ultimately subject to state authority.[54]

Localized plans are more vulnerable than state plans to political pressure to underestimate the long-term costs of benefits and, in turn, required employer and employee contributions. 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.[55] Moreover, funds administered by some

---

available at https://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12084/05-04-pensions.pdf (analyzing "126 state and local pension plans").

53. New York's state-administered system, which includes many of the features suggested by this Article, includes state employees and other instrumentalities that elect to participate. *See* N.Y. RETIRE. & SOC. SEC. LAW §§ 30–32 (McKinney 1999). 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* MASS. STATE RET. BD., BENEFIT GUIDE FOR THE MASSACHUSETTS STATE EMPLOYEES' RETIREMENT SYSTEM 2 (2013), *available at* http://www.mass.gov/treasury/docs/retirement/retguide.pdf; *Public Employees*, IND. PUB. RET. SYS. (INPRS), http://www.in.gov/inprs/publicemployees.htm (last visited Mar. 18, 2014).

54. 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)*, BOS. BUS. J. (Sept. 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's, have found themselves dealing with the need for drastic cutbacks in benefits based on the financial crisis that began in 2007. *See* LeDuff, *supra* note 4; Mary Williams Walsh, *Pension Funds Wary as Bankrupt City Goes to Trial*, N.Y. TIMES, Mar. 24, 2013, http://www.nytimes.com/2013/03/25/business/economy/court-to-decide-on-pensions-in-stockton-calif-bankruptcy.html.

As far as state authority is concerned, one of the reasons why 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 independent plans for state subdivisions, such as municipalities, rather than state plans that subsume plans for state subdivisions and instrumentalities. *See infra* notes 57–59 and accompanying text.

55. A good recent example is the statewide political struggle in Wisconsin over collective bargaining for state benefits. *See* Frances Denmark, *Wisconsin's Public Pension Works to Spread the Cheddar*, INSTITUTIONAL INVESTOR (Mar. 13, 2013), http://www.institutionalinvestor.com/Article/3166909/Investors/Wisconsin-Public-Pension-Works-to-Spread-the-Cheddar.html#Ucsxh9.

state instrumentalities, such as fire departments and school districts, are relatively small. Their administrative expenses are therefore disproportionately high compared to larger funds.[56] Not only do these smaller instrumentalities lack the bargaining power with financial intermediaries that is enjoyed by larger funds,[57] but also are administered by unsophisticated fiduciaries, who are likely to jump at higher yields offered to them by financial intermediaries without being aware of the higher level of risk carried by financial assets that are complex, illiquid, or both;[58] are frequently unregistered with the SEC;[59] and are sold with, at

56. The U.S. Social Security Administration—the largest provider of retirement and disability benefits in the United States—estimated its administrative expenses as 0.8 percent of its total expenditures for 2012. *Social Security Administrative Expenses*, U.S. SOC. SEC. ADMIN., http://www.ssa.gov/OACT/STATS/admin.html (last visited Mar. 18, 2014). Rhode Island's retirement system, which is small compared to some systems but still above the national average, incurred administrative and investment expenses of about 1.6 percent for fiscal year 2012. *See* Stephen Beale, *Investigation: Despite Reform, Pensions Will Cost RI More in 2013*, GOLOCALPROV (June 27, 2013), http://www.golocalprov.com/news/investigation-despite-reform-pensions-cost-state-more-in-2013/. These included major fees to financial intermediaries, which larger funds such as California's CalPERS avoid or have sufficient leverage to bargain down. *See id.* 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 unusually down market. *See generally* NAT'L EDUC. ASS'N, *supra* note 30, at 5.

57. Financial intermediaries have proven expensive to both small and large state funds because of high fees and corrupt practices. *See* Edward Siedle, *Rhode Island State Pension Admits History of 'Pay-to-Play' and SEC Inquiry*, FORBES (Apr. 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 this Article proposes 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* discussion *infra* Part II.E.

58. *See SEC Hearing on The State of Municipal Securities Markets, supra* note 34 (opining that valuation of complex financial instruments "is not in the skill set" of fiduciaries for municipal plans, and advisors have not served these plans well); Siedle, *supra* note 57 (describing a scheme whereby state plans pay excessive fees to intermediaries to purchase unconventional instruments not traded on exchanges). Like its attempt to eradicate corrupt practices, this Article proposes to remedy excessive fees in part through its enforcement provisions. *See* discussion *infra* Part II.E.

59. Federal regulations classify any plan administered by a state, its political subdivisions, or any instrumentality thereof, with assets of at least $5 million as an "accredited investor," which is permitted to invest in securities exempt from registration. 17 C.F.R. § 230.501(a)(1) (2013); *see id.* § 230.506 (creating the accredited investor exception). Fiduciaries of funds this small lack the skills needed to invest in complex unregistered securities. *SEC Hearing on The State of Municipal Securities Markets*, *supra* note 34. Nonetheless, 17 C.F.R. § 230.506 allows them to invest in

best, sketchy disclosure.[60]

A uniform code providing for integrated funding and administration of all state-sponsored benefit plans would provide a ready-made structure for states to adopt, ending the plan-by-plan, section-by-section wrangling that now exists—and that sometimes occurs too late, after one or more plans under the authority of a state have gone insolvent.[61] Moreover, successful administration of uniform provisions by a set of adopting states would (1) strengthen the states' credit and bargaining power with financial intermediaries, (2) enable them to obtain higher returns on their investments by diversification among different types of investments, and (3) prevent increased credit costs to one state caused by the insolvency of one or more funds in another state.[62]

Establishing a uniform code governing benefit funds throughout a state would prevent the contagion that weakens the finances of an entire

unregistered securities, although these may be quite complex and beyond the abilities of small-fund fiduciaries to understand the true costs, benefits, and risks. The Author has proposed elsewhere that section 230.506 be modified to prevent this kind of investment. Mendales, *supra* note 11, at 302–04. Even without that adjustment, small funds could obtain higher rates and lower costs for investments by being administered within much larger state funds, with investments managed by trained and experienced experts.

60. Federal law prohibits even unregistered financial instruments from being sold with materially misleading disclosure. 15 U.S.C. §§ 77k(a), 77q(a), 78j(b) (2012); 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, which require any material disclosure in registered securities to be stated in "plain English." 17 C.F.R. § 230.420–.421. 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 Rules be made mandatory for all securities-related disclosure. *See* Mendales, *supra* note 11, at 312–13.

61. *See, e.g.*, *Illinois: Pension Woes Cause Downgrade to Credit*, *supra* note 17 (reporting that Fitch Ratings downgraded Illinois's state credit rating because its legislature could not agree on a solution to the insolvency of five of its pension funds).

62. *See* Chappatta & Jones, *supra* note 16 (reporting that losses by funds in Illinois and other states with low contribution rates raised the overall spread between state borrowing rates and similar-maturity U.S. Treasury notes); Darrell Preston et al., *Detroit Case Scrutinized by $900 Billion G.O. Market*, BLOOMBERG (July 19, 2013), http://www.bloomberg.com/news/2013-07-19/detroit-scrutinized-by-900-million-g-o-market.html (reporting that the 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).

state when some of its funds or those of its subdivisions become clearly underfunded or insolvent.[63] Thus, the code proposed in this Article is far more comprehensive than the one proposed in UMPERSA. The latter, released in 1997, only deals with retirement funds and fails to deal, unlike this Article's proposed code, with benefit funds that protect public employees with disability, survivorship, and medical insurance.[64] UMPERSA is directed primarily at funds administered below the state level[65]—its provisions indicate that it is aimed primarily at funds maintained by smaller state subdivisions and instrumentalities[66]—and fails to require, unlike this Article's proposed code, 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. Moreover, UMPERSA provides only for simplified administration,[67] accounting,[68] and disclosure[69] concerning the financial records of retirement systems.[70] It does not require auditing, nor does it include the enforcement

63. *See* Preston et al., *supra* note 62; Mary Williams Walsh, *Woes of Detroit Hurt Borrowing by Its Neighbors*, N.Y. TIMES: DEALB%K, Aug. 8, 2013, http://dealbook.nytimes.com/2013/08/08/detroit-blocks-other-cities-from-bond-market/?_r=0 (mentioning other cities in Michigan that have suffered increased borrowing costs and have, in some cases, had to postpone municipal bond offerings because of Detroit's bankruptcy).

64. These are common features of state and local benefit funds. *See, e.g.*, *CalPERS Benefits Overview*, CALPERS, http://www.calpers.ca.gov/index.jsp?bc=/about/benefits-overview/home.xml (last updated Dec. 15, 2010).

65. *See* UMPERSA, *supra* note 26, § 2(18) (defining a "public employer" subject to UMPERSA as a state or any political subdivision, agency, or instrumentality thereof whose employees participate in a retirement program).

66. *See id.* § 2(2) (defining an "agent group of programs" as a cost-sharing grouping of state retirement programs); *id.* § 2(20) (defining "retirement system" as an entity established by a public employer to manage or invest in one or more retirement programs); *id.* § 6(a) (authorizing a trustee or administrator of a retirement program to delegate functions that a prudent trustee or administrator could properly delegate—hardly something that a statewide system could do); *id.* §§ 6–9 (describing duties of "a trustee" who may delegate management duties to a selected fiduciary); *id.* § 17(c)(2) (requiring annual disclosure of the administrator's name and business address—likely a reference to smaller plans administered by individuals with other businesses and less applicable to full-time members of a full-time administrative board for a major fund).

67. *See id.* § 8.

68. *See id.* § 17(c)(8) (merely requiring that annual reports utilize the GAAP).

69. *See id.* §§ 13–14.

70. The rationale for this may be that it avoids major legal, accounting, and auditing expenses for smaller systems. This is analogous to similarly simplified duties for issuing securities exempt from registration with the SEC. *See* 17 C.F.R. § 230.501–

provisions proposed by this Article.[71] 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 comparable to the one the PBGC plays for private plans under ERISA.[72]

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 it covers. The code proposed here would include all public-employee benefit plans sponsored directly by states and all plans covering the employees of state subdivisions and their instrumentalities, such as counties, cities, school districts, and hospitals.[73] New York's current plan covers retirement and related plans for state and municipal employees, including fire and police departments, but other state instrumentalities must elect coverage.[74] The code this Article proposes would reverse that feature: state employees and all employees of a state's subdivisions and instrumentalities would be

.507 (2013) (providing 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). However, this rationale does not justify simplified regulation of larger systems. *Cf.* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION: CASES AND MATERIALS 351 (12th ed. 2012) (noting that "small business issuers" are the principal users of these exemptions).

71. *See* discussion *infra* Part II.E.

72. *See* discussion *infra* Part IV.A.

73. Many states, most notably New York, California, and Indiana, provide for voluntary participation of state subdivisions and instrumentalities in their benefit plans. *See generally* CAL. GOV'T CODE § 31500 (West 2008) (stating the procedure for establishing a retirement system in a county); IND. CODE ANN. § 5-10.3-6-9 (LexisNexis 2013) (same); N.Y. RETIRE & SOC. SEC. Law § 30 (McKinney 1999) (same). 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. 29 U.S.C. § 1002(37) (2012); *Multiemployer Insurance Program Fact Sheet*, PENSION BENEFIT GUARANTY CORP., http://www.pbgc.gov/res/factsheets/page/multi-facts.html (last visited Mar. 18, 2014).

74. *See* N.Y. RETIRE. & SOC. SEC. LAW § 33. Once a subdivision or instrumentality elects to join the system, it may not withdraw.

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.[75]

Several reasons dictate that the code include financing both for state benefit plans and for plans offered by a state's subdivisions and their instrumentalities even though plans for municipalities and other collective-bargaining entities would retain freedom to decide what their plans covered and which benefits were offered as long as contributions by employers and beneficiaries, invested at a reasonable rate of return, matched benefits projected according to guidelines set by actuaries for the statewide funds.[76]

This structure would allow common administration of all funds being managed for plan beneficiaries, reducing administrative costs.[77] 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,[78] and retention of outside professionals who charge high management fees and may have potentially harmful conflicts of interest.[79] It would also maximize the

75. *See* discussion *infra* Part IV.A. New York's disclosure comparing actuarial value of assets and the present value of benefits for its state and local retirement system from 2001 to 2013 shows a sharp drop in net assets during the heart of the financial crisis in 2009, followed by a sharp recovery through 2013. *See What Every Employer Should Know: How Contribution Rates Are Determined*, N.Y. ST. & LOC. RETIREMENT SYS., http://www.osc.state.ny.us/retire/employers/employer_partnership/contribution_rates/rates_determination.php (last visited Mar. 18, 2014). 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 an insurance fund—like the need that Congress anticipated in creating the PBGC—a desirable feature of a complete uniform code. *See id.*

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

77. *See* NAT'L EDUC. ASS'N, *supra* note 30, at 12–13.

78. *See SEC Hearing on The State of Municipal Securities Market*, *supra* note 34, at 7.

79. *See id.*; *see also* NAT'L EDUC. ASS'N, *supra* note 30, at 8; Morgenson, *How to Pay Millions*, *supra* note 12.

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.[80]

Finally, centralized fund management would prevent sound local plans from being undermined due to less well managed plans within a state. It would thus ease political pressures in state subdivisions to keep funding low and benefits high, or to use plan contributions for nonplan purposes—which would eventually create an inability to pay promised benefits, might threaten insolvency and could even undermine the credit ratings of other plans within a state.[81]

The proposed code would permit certain state subdivisions, such as larger municipalities, to offer—as components of their plans—variations or benefits not generally available to state employees. These variations, however, would be permissible only upon showing a minimum of assets under administration,[82] the appropriateness of the variations, and funding

80. CalPERS, one of the largest funds currently administered by a U.S. state, is known for its leverage both with its investments and with its 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?*, N.Y. MAG. (Mar. 25, 2013), http://www.nymag.com/daily/intelligencer/2013/03/pension-funds-are-going-passive.html (suggesting that CalPERS's decision to invest in passively managed investment funds rather than more expensive actively managed funds might influence other public pension funds to do the same); Chad Terhune, *Hospitals Cut Some Surgery Prices After CalPERS Caps Reimbursements*, L.A. TIMES (June 23, 2013), http://www.latimes.com/business/money/la-fi-mo-calpers-hospital-surgery-prices-20130623,0,6571991.story (noting CalPERS's leverage was significant enough to make 40 higher priced California hospitals cut knee and hip surgery prices after CalPERS capped its reimbursement rate at $30,000 per procedure); 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 (reporting that CalPERS, a major shareholder at JPMorganChase, voted to split the roles of CEO and Chairman at the bank). Nonetheless, even a fund as large and sophisticated as CalPERS has seen its share of imprudent investments, especially during the period immediately before the 2007 crash. *See* Evans, *supra* note 3.

81. *See, e.g.*, Chappatta & Jones, *supra* note 16.

82. One billion dollars seems advisable as an absolute minimum, but factors such as a dramatic decline in a municipality's population—which, as evidenced by Detroit, can result in a major erosion of the tax base and the number of employees available to make contributions—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. *See* Steven Yaccino, *Detroit's Creditors Are Asked to Accept Pennies on the Dollar*, N.Y. TIMES, June 14, 2013, http://www.nytimes.com/2013/06/15/us/detroit-financial-problems.html (acknow-

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. Thus, a large and provably solvent municipality could offer higher and additional benefits compared to its state and smaller 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 ensure that promised benefits will be paid.[83] These standards would be established by the state's nonpartisan council of actuaries, according to generally accepted actuarial rules, and would be subject to approval by the state's administrative council. They would be reviewed both at prescribed intervals and upon the occurrence of significant events, such as the 2007 crash, 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.[84] Furthermore, fiduciaries charged

---

ledging that Detroit's bankruptcy woes are exacerbated because there are "700,000 residents now living in a city that once was home to 1.8 million").

83. ERISA provides rules of this kind under 29 U.S.C. §§ 1081–1085 (2012) and its related regulations. These ERISA sections contain rules that cover three significant issues: (1) section 1084 covers funding for multiemployer plans and serves as a model for the inclusive state and local plans advocated in this Article, (2) subsection 1083(c) permits increased funding for anticipated deficiencies, and (3) section 1085 provides for additional funding for endangered multiemployer plans. All of these rules can, in suitably modified form, be incorporated in a proposed state code.

84. 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 both in the specific type of investment and, particularly in illiquid assets such as real estate and unregistered securities, in deal-making skills. *See What Every Employer Should Know: Investment Strategies*, N.Y. STATE & LOCAL RET. SYS., http://www.osc.state.ny.us/retire/employers/employer_partnership/the_fund/investment_strategies.php (last visited Mar. 18, 2014).

with investment and management of plan funds should 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 ensure adequate return on capital to protect plan beneficiaries.[85]

This monitoring should include accounting that is compliant with national GASB standards and is performed quarterly, annually, and upon the occurrence of events causing major changes in the state economy.[86] 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 the GASB.[87]

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. 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.[88]

Enforcement of the protective provisions must be delegated to officials with sufficient authority to ensure compliance. The state should have the primary responsibility to bring compliance actions through its

85. This will be accomplished not only through actuarial rules, but also through regular accounting and auditing under the GASB rules. *See* discussion *supra* note 37.

86. The GASB itself, which is a private nonprofit organization, should be placed under federal government supervision, similar to the FASB, which sets GAAP accounting standards for private businesses. *See Facts about FASB*, *supra* note 37. Because the SEC has far more experience in accounting and auditing than does the EBSA, and because EBSA is part of the politically sensitive Labor Department while the SEC is independent, this Article suggests that supervision of the GASB be delegated to the SEC, which also supervises the FASB. SEC jurisdiction in supervising the GASB could be predicated on the fact that the SEC already supervises sales of municipal securities offered to the general public. *See* 15 U.S.C. § 78o-4. Compliance with accounting and auditing standards would be enforced by an Office of the Inspector General, to be created within the state Attorney General's office. *See infra* notes 146–47 and accompanying text.

87. This would create a transparency previously absent in U.S. public pension plans generally. *See* Andonov et al., *supra* note 38 (calling current regulation of U.S. public pension funds "relatively opaque"). Instead, the level of transparency would be more comparable to that required for regular and event-based reporting under federal securities laws. *See* 17 C.F.R. pt. 229 (2013) (requiring detailed reporting for registration statements and other financial data).

88. *See* 17 C.F.R. §§ 230.420–.421.

Attorney General,[89] acting on investigations initiated by an Office of the Inspector General. However, in view of the shortage of personnel available to state attorneys general to bring such actions,[90] 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.[91]

As a preliminary step, each state's governor—or another appropriate official—should appoint an administrative council to undertake general supervision of the state's plans and performance. In turn, this council would appoint a more specialized and equally independent council of actuaries to establish the requirements for funding plans sufficient to pay promised benefits that are based on reasonable estimates of 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.[92]

3. *What Types of Benefits Should Be Included in a Uniform Code*

Pension, disability, survivor, and medical insurance are the most important categories of benefits now provided for by states and their

89. 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* note 11, at 254.

90. This is true even with assistance by the SEC, since the SEC is itself chronically understaffed. *See* J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (allowing a private right of action for violation of proxy rules, in part because the SEC argued it lacked time and personnel to evaluate and redress all violations—a shortage that has grown since the case was argued).

91. *See, e.g.*, *id.* at 432–33 (calling private rights of action "a necessary supplement" that "make[s] effective the congressional purpose" of securities laws); *see also* LaRue v. DeWolff, Boberg & Assocs., Inc., 552 U.S. 248, 256 (2008) (authorizing a beneficiary to sue a fiduciary under ERISA § 502(a)(2) for a breach of duty that impaired the value of the beneficiary's own account in a benefit plan).

92. *See* 15 U.S.C. § 80b-11(g)(1) (2012) (authorizing administrative rules on the topic and requiring "all brokers, dealers, and investment advisers" to disclose material conflicts of interest).

instrumentalities.[93] The first three categories of benefits are subject primarily to long-term actuarial computation, while medical benefits involve different factors such as the availability of insurance coverage within a state and the rapidly rising cost of medical care.[94] Thus, medical benefits are short term in nature, so they need to be dealt with separately. This would include medical benefits to retirees. In all cases, however, a single-state system will help maximize the benefits available in proportion to contributions by states, their instrumentalities, and the employees and their dependents who are the beneficiaries of the plans.[95]

Pension and survivor benefits were among the first categories of benefit plans, dating back to the colonial period in U.S. history.[96] The adequacy of their funding is among the most hotly disputed issues for municipalities because of their long-term character, which may require relative levels of contributions and benefits to be restructured when municipalities face financial problems.[97] Recently, these problems arose from simple misconduct such as 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;[98] dishonesty by investment advisers, ranging from bad advice on investments[99] to outright theft of municipal

93. *See, e.g.*, N.Y. RETIRE. & SOC. SEC. LAW §§ 30–34 (McKinney 1999); *CalPERS Benefits Overview*, *supra* note 64.

94. *See* PEW CTR. ON THE STATES, *supra* note 9, at 9–10.

95. *See What Every Employer Should Know: The Big Picture*, *supra* note 11 (showing that a majority of New York's available benefits come from investment earnings).

96. *See* Clark, *supra* note 3, at 258.

97. *See* PEW CTR. ON THE STATES, *supra* note 9, at 1–2 (summarizing a trend: most states have reduced benefits or increased employee contributions to some degree in the three prior years, and some have made even deeper cuts, but most will have to make additional changes).

98. *See* Mendales, *supra* note 11, at 247–48; Evans, *supra* note 3.

99. *See* Mendales, *supra* note 11, at 261–62 (comparing conventional securities with asset-backed securities sold to funds based on their supposed safety despite a high failure rate). 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, and rating agencies' failure to downgrade asset-backed securities promptly when their vulnerability became clear. *See id.* at 266, 268; *see also* Transfer Order at 2, *In re* Standard & Poor's Rating Agency Litig., 949 F. Supp. 2d 1360 (J.M.P.L. 2013); Complaint for Civil Money Penalties and Demand for Jury Trial at 3, United States v. McGraw-Hill Cos., No. CV 13-0779 (C.D. Cal. Feb. 4, 2013).

funds;[100] "pay to play" schemes under which state officials invested in securities purchased from financial sources who had made political contributions to them;[101] states and subdivisions' failure to make contributions required under the terms required by their benefit plans;[102] and misrepresentations by state and local officials concerning the funding of the benefit funds under their supervision.[103]

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 invested contributions—to use required contributions for other state purposes instead of making politically difficult decisions to raise taxes.[104] 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 cuts in the future.[105]

C. *Contribution Rules*

Contribution rules lie at the core of the proposed 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,

100. *See, e.g.*, MayfieldGentry Complaint, *supra* note 13, at 1–2.

101. *See* Siedle, *supra* note 57 (listing several states where state pension fund managers engaged financial intermediaries at excessive fees to invest state funds and who may have paid kickbacks for the business in the form of political contributions).

102. *See* PEW CTR. ON THE STATES, *supra* note 9, at 6–7 (showing that as of 2010, 17 states had set aside no money for retirees' health care, and only seven had funded at least 25 percent of projected obligations).

103. *See* Illinois, Securities Act Release No. 9389 at 2, 2013 WL 873208 (Mar. 11, 2013) (asserting that Illinois deliberately underfunded its obligations under five pension plans so that they covered only 43 percent of liabilities, and failed to disclose the underfunding and consequent risk to its overall financial position); New Jersey, Securities Act Release No. 9135 at 1–2, 2010 WL 3260860 (Aug. 18, 2010) (alleging that New Jersey underfunded its two largest pension plans and failed to disclose the underfunding in bond offerings).

104. *See* PEW CTR. ON THE STATES, *supra* note 9, at 3 ("Policy makers . . . set aside just 34 percent of what actuaries recommend should be set aside . . . .").

105. *See id.* at 8. Most states have used the unrealistically high rate of 8 percent of return on invested funds, resulting in failure to make contributions needed to pay promised benefits. *Id.* at 2.

should be sufficient to pay the benefits promised to each beneficiary.[106]

This would apply to plans differing in basic funding needs. Retirement and survivor funds, for example, have fundamentally different funding needs from those required for medical insurance benefits[107] and should be funded with different required contributions by employers and beneficiaries—as they are under present systems.[108] Retirement, disability, and survivor funds can readily be established by states themselves, based on long-term actuarially computable needs and based on whether the benefits are to be provided under defined-benefit plans or defined-contribution plans.[109] 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 or her highest compensation, beginning at a stated age.[110] Therefore, they are subject to potential insolvency if contributions plus the return on investment of these contributions proves inadequate when benefits become payable.[111]

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, often with the investments

106. One of the important roles of the code will be to ensure 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. *See id.* (noting most states use a static 8 percent rate).

107. *See id.* at 9–10.

108. *See id.* at 10 (assigning different state ratings for pension funding and health benefits funding).

109. *See* Daniel J. Kaspar, *Defined Benefits, Undefined Costs: Moving Toward a More Transparent Accounting of State Public Employee Pension Plans*, 3 WM. & MARY POL'Y REV. 129, 134–37 (2011) (describing these two types of plans).

110. *Id.* at 134–35. 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, because 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, especially when employees raise their total pay—with higher pensions in mind—by taking unusually high overtime and other compensation in addition to normal wages in the last one to three years of employment—a practice called "spiking." *See Retirement Benefits: Who Pays the Bill?*, ECONOMIST, July 27, 2013, at 25, *available at* http://www.economist.com/news/united-states/21582282-pensioners-are-pushing-many-cities-and-states-towards-financial-crisis-who-pays-bill.

111. *See* Walsh, *supra* note 30.

determined at least in part by the employees.[112] 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 the same risks—chiefly, the risk of poor investments and fiduciary misconduct—as defined-benefit plans.[113] However, although most private employers have switched to defined-contribution plans,[114] most state and local plans are defined-benefit plans.[115] A few states have switched[116] and a few others, such as Rhode Island, are trying out hybrids between traditional defined-benefit plans and defined-contribution plans.[117] Changing to defined-contribution plans could well reduce retirement benefits to levels far below those now received;[118] therefore, unions representing public employees strongly favor defined-benefit plans.[119] Because the comparative merits of the two types of plans require more extensive discussion, 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

112. *See* 29 U.S.C. § 1002(34) (2012).

113. Kaspar, *supra* note 109, at 136.

114. *See Retirement Benefits: Who Pays the Bill?*, *supra* note 110 ("Most public-sector workers can expect a pension linked to their final salary. Only 20% of private-sector workers benefit from such a promise.").

115. *See* Clark, *supra* note 3, at 262.

116. As of 2011, Alaska, Michigan, Nebraska, and Utah had switched to defined-contribution plans, applying primarily to employees hired after the changes were enacted. *Id.* These plans applied primarily to employees directly hired by the states, not by their subdivisions. *Id.* A screaming example of subdivisions not aided by Michigan's change in its pension laws is Detroit, which has large unfunded pension liabilities not only for the city itself but also for a separate plan for its police and firefighters. *See* Church et al., *supra* note 5.

117. *See* PEW CTR. ON THE STATES, *supra* note 9, at 8.

118. *See* Kaspar, *supra* note 109, at 136 (suggesting that states switching to defined-contribution plans might actually exacerbate funding problems). Based largely on experience with private pensions, defined-contribution plans tend to deliver retirement benefits of only $4,000–$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. *See Retirement Benefits: Who Pays the Bill?*, *supra* note 110; *see also* Walsh, *supra* note 30 (estimating the average annual benefit in Wisconsin at $26,500).

119. *See* ALICIA H. MUNNELL ET AL., CTR. FOR RETIREMENT RES., WHY HAVE DEFINED BENEFIT PLANS SURVIVED IN THE PUBLIC SECTOR? 4 (2007), *available at* http://crr.bc.edu/wp-content/uploads/2007/12/slp_2.pdf (explaining the "measure of union preference for defined benefit plans" using public workforce statistics and private-sector figures).

now found in some defined-benefit plans. 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. 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 computing retirement and survivor benefits.[120]

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 been rising at an unpredictable rate,[121] need to be funded on a short-term, usually annual, basis.[122] 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.[123] Under the proposed 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—which is currently payable beginning at age 65.[124]

---

120. *See Retirement Benefits: Who Pays the Bill?*, *supra* note 110 (describing "spiking"). Each of these recommendations has some history; from 2009 to 2011, 43 states moved to reduce benefits in proportion to contributions, using measures including benefit cuts, increased contributions, and increased the years of service and minimum age required to receive retirement benefits. *See* PEW CTR. ON THE STATES, *supra* note 9, at 8.

121. Although medical premium rates have been steadily rising in most jurisdictions, this is not universally true. *See* Roni Caryn Rabin & Reed Abelson, *Health Plan Cost for New Yorkers Set to Fall 50%*, N.Y. TIMES, July 16, 2013, http://www.nytimes.com/2013/07/17/health/health-plan-cost-for-new-yorkers-set-to-fall-50.html?pagewanted=all.

122. *See, e.g.*, PEW CTR. ON THE STATES, *supra* note 9, at 6 (noting that 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.

123. *See id.* at 6–7.

124. 42 U.S.C. § 426(a)(1) (2012). Medicare may be available at earlier ages

D. *Investment Rules*

Because a large part of the funding for future benefits will be based on investments, an effective code must provide basic guidelines to ensure that fiduciaries charged with investing contributions comply with standards that are subject to some tension. On the one hand, investments must be reasonably safe and predictable in proportion to anticipated benefits both at the time they are made and when they are assessed, either at regular intervals or upon the occurrence of events affecting the overall economy.[125] On the other hand, particularly given that the code will provide plan fiduciaries with large sums to manage, fiduciaries 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 percent return on investment for state retirement pensions widely used before the financial crisis and still used by many funds[126]— despite postcrisis analysis indicating that these rates are too high, giving states an excuse to contribute too little, or even to avoid funding their pension plans entirely.[127] On the other hand,

---

for persons entitled to disability benefits and who have end-stage renal disease. *Id.* §§ 426(b)(2)(A), 426-1(a).

125. The failure of contributions by employers and employees to provide promised benefits at realistic levels of return on investments has resulted in widespread political controversies. *See, e.g.*, Walsh, *supra* note 30 (discussing a political battle over public pensions in Wisconsin that culminated in public employees losing collective-bargaining rights). Public employers, faced with insolvency in the wake of the financial crisis that began in 2007, have sought to reduce promised benefits while increasing required employee contributions and, especially in the cases of municipal insolvencies, have sought to force creditors to take "haircuts" on municipal bonds. *See* PEW CTR. ON THE STATES, *supra* note 9, at 8; Yaccino, *supra* note 82.

126. *See* Mary Williams Walsh & Danny Hakim, *Public Pensions Faulted for Bets on Rosy Returns*, N.Y. TIMES, May 27, 2012, http://www.nytimes.com/2012/05/28/nyregion/fragile-calculus-in-plans-to-fix-pension-systems.html?_r=0 (noting public pension funds continued to operate at an assumed rate of return of 7 to 8 percent despite a drop of 2 percent or more in the actual rate of return since 2000).

127. Slight adjustments are being made based on the drastic general decline in interest rates on high-quality debt securities since the turn of the century. CalPERS's actuary, for example, recently recommended reducing the yield used for contributions and benefits from 7.75 to 7.25 percent, requiring an increase in contributions or a reduction in benefits, although CalPERS's management settled on a reduction to 7.5 percent. Michael Corkery, *Calpers Lowers Investment Target to 7.5%*, WALL ST. J. (Mar. 14, 2012), http://online.wsj.com/news/articles/SB10001424052702304692804577281603950185684; Michael B. Marois, *Calpers Should Cut Assumed Return to 7.25%*

pension funds in places such as the United Kingdom, Canada, and the Netherlands have based benefits on a postulated 3 or 4 percent return, 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.[128]

In fact, while the 8 percent 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 precrash financial bubble,[129] the 3–4 percent figure appears to be too low, except for small local funds which, for financing purposes, this Article proposes be subsumed into much larger state funds.[130] 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[131] or instruments with high risks and low transparency, such as derivative securities based on credit default swaps,[132] a pool consisting solely of low-

From 7.75%, Actuary Recommends, BLOOMBERG (Mar. 6, 2012), http://www.bloomberg.com/news/2012-03-07/calpers-may-cut-assumed-rate-of-return-for-first-time-since-2004.html.

128. *See* Andonov et al., *supra* note 38, at 11–12. Investment of public pension funds in low-yielding sovereign debt may also be mandated by legal rules such as the Social Security Act, which requires that the Social Security retirement and disability trust funds be invested in obligations of or guaranteed by the United States, bearing interest rates among the lowest in the world. 42 U.S.C. § 401(d).

129. *See* Mendales, *supra* note 11, at 244–45, 255.

130. 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 SEC Hearing on The State of Municipal Securities Market*, *supra* note 34.

131. During the years leading up to the 2007 crash, even CalPERS and other sophisticated funds invested in complex instruments, such as collateralized debt obligations (CDOs), based largely on high ratings given to them by investment rating agencies, even though the ratings were given without careful examination of the collateral—especially subprime mortgages—underlying the instruments and were changed too late, only after it was clear the instruments faced worthlessness. *See* Mendales, *supra* note 11, at 247–48, 265–66. Through the Dodd–Frank Act, Congress attempted to deal with this after the fact by limiting the use of ratings in issuing securities. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 935, 124 Stat. 1376, 1884 (2010). However, when carefully examined, Dodd–Frank and regulations based on it have few teeth when applied to the rating agencies. *See* Mendales, *supra* note 11, at 291–96.

132. In a credit default swap, the seller of the swap essentially sells an insurance policy promising to pay if the issuer defaults. *See* Floyd Norris, *Wielding*

priced debt instruments, with yields currently at historic lows, carries a different set of risks that is ignored by those who advocate for investing solely in high-grade debt instruments.[133] 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 during times of inflation.[134] This is because an increase in

Derivatives as a Tool for Deceit, N.Y. TIMES, June 27, 2013, http://www.nytimes.com/2013/06/28/business/deception-by-derivative.html?pagewanted=1&_r=1. During the period leading up to the 2007 crash, swaps were widely sold by financial institutions and municipalities, guaranteeing payment on financial instruments so complex that default either could not be predicted or was a near certainty, which in turn made investing in the swaps essentially a gamble on the sellers' part, causing them to suffer heavily when the instruments on which they had sold the swaps defaulted. Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), http://content.time.com/time/business/article/0,8599,1723152,00.html. The problem was compounded by investors basing their purchases 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* Richard E. Mendales, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix It*, 2009 U. ILL. L. REV. 1359, 1382.

133. *See* PIMCO, YIELD CURVE 1 (2004), *available at* http://faculty.baruch.cuny.edu/ryao/fin3710/PIMCO_YIELD_CURVE_PRIMER.pdf (identifying an inverse relationship between bond prices and yields); Kimberly Amadeo, *Treasury Yields*, ABOUT.COM: US ECONOMY, http://www.useconomy.about.com/od/economicindicators/p/Treasuries.htm?p=1 (last updated Aug. 20, 2013) (noting that 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 are expected to rise further). 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* Luis M. Viceira, *Inflation-Indexed Bonds*, NBER REP. (Nat'l Bureau of Econ. Res.), no. 3, 2013, at 16, 17, *available at* http://www.nber.org/reporter/2013number3/2013no3.pdf ("[I]nflation-indexed bonds, not cash instruments, are the riskless asset for conservative investors who care about financing their long term spending plans or liabilities, such as . . . traditional pension funds . . . ."). 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 yields from debt in nonrecession years. *See, e.g.*, Andonov et al., *supra* note 38, at 4–5 (criticizing "smoothing" as masking the volatility of risky investments). Smoothing certainly can mask volatility, but its critics fail to recognize that it can also be a realistic blend between low-yield instruments issued during and after a financial crisis and instruments of similar risk issued in more normal times, collected to avoid excessive adjustments based only on short-term returns. *See What is Smoothing?*, SGI MGMT., http://www.sgi-management.com/SGIM/eng/about sgi/smoothing_explain.htm (last visited Mar. 18, 2014).

134. *See* BENJAMIN GRAHAM, THE INTELLIGENT INVESTOR 47 (rev. ed. 2006) (recognizing that future changes to the rate of inflation create uncertainty that may lead to potential losses).

rates would cause instrument prices to fall, and any disposition of them to meet a contingency will therefore subject the purchaser to a loss.[135]

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.[136] 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, nontransparent investments in uncertain 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[137] and readily marketable real estate.[138] The chief degree of caution that the code should impose in this respect is to require that no more than a certain percentage 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

135. *See generally id.* at 47–57 (explaining that periods of high and low interest rates have alternated throughout history, making investments solely in debt instruments undesirable).

136. This is especially true given the poor performance of securities with high ratings from the oligopoly of the three rating agencies—Moody's, Standard & Poor's, and Fitch. Poor performance was especially commonplace during the period preceding the financial crisis, but 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, 623–24 (1999). Congressional attempts to regulate the rating agencies have been largely ineffectual. *See* Mendales, *supra* note 11, at 291–96. Despite actions by the SEC and investors allegedly deceived by rating practices before 2007, at least one rating agency, Standard & Poor's, is once again winning business by offering higher ratings. *See* Nathaniel Popper, *Banks Find S.&P. More Favorable in Bond Ratings*, N.Y. TIMES: DEALB%K, July 31, 2013 http://dealbook.nytimes.com/2013/07/31/an-analysis-finds-a-bias-for-banks-in-s-p-ratings/. 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.

137. The code would, however, exclude investment in complex securities based at least in part on financial derivatives, such as credit default swaps, because 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, *supra* note 132, at 1397–98.

138. 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) (2012).

be widely diversified, has done this by investing in, inter alia, domestic and foreign equity securities, private equity,[139] debt (including cash and mortgages), and commercial real estate.[140] This diversification, along with the diversification a larger fund has over time—i.e. investments yields that will vary depending on the economy, with especially low yields during and after a financial crisis and above-average yields during times of high inflation—means that a larger fund will be able to achieve yields closer to 7 percent than the 3–4 percent that smaller funds—which are unable to diversify very much either in classes of assets or over time—can achieve with some assurance of safety.[141]

E. *Enforcing the Code*

To be effective in each adopting state, the code will need to include provisions for enforcement and for the appointment of personnel to facilitate and enforce compliance. Two types of misconduct are likely to require enforcement activity: misconduct by sellers, financial intermediaries, and plan officials in purchasing plan assets, which is subject to enforcement both by state and federal officials,[142]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 it results in a state misrepresenting the assets available

139. "Private equity" means equity investments that are exempt from registration with the SEC and, hence, not traded on exchanges but directly invested in corporate shares. *See, e.g.*, *Private Equity*, INVESTOPEDIA, http://www.investopedia.com/terms/p/privateequity.asp (last visited Mar. 18, 2014). The mere fact that private equity securities 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. *See id.* ("The majority of private equity consists of institutional investors and accredited investors who can commit large sums of money for long periods of time.").

140. *See What Every Employer Should Know: Investment Strategies*, *supra* note 84.

141. *See id. See generally* GRAHAM, *supra* note 134, at 56–57 (recommending a diversified and actively managed portfolio for individual investors, given swings in rates of return for both debt and equity investments over time).

142. Both the SEC and state attorneys general have taken action against misconduct in the sale of assets to, mismanagement of, and misleading disclosure concerning benefit funds. *See, e.g.* Miss. Pub. Emps.' Ret. Sys. v. Bos. Scientific Corp., 523 F.3d 75, 78 (1st Cir. 2008); Illinois v. McGraw-Hill Cos., No. 13 C 1725, 2013 WL 1874279, at *1 (N.D. Ill. May 2, 2013); MayfieldGentry Complaint, *supra* note 13, at 1–2.

to meet its benefit fund obligations.[143]

To begin with, each state's nonpartisan administrative council, roughly comparable to the Labor Department's EBSA, should have the general responsibility for enforcing the provisions of the code. Administrative councils would be primarily composed of senior civil servants, but could also include independent experts drawn from the private sector. 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.[144] Their terms would be staggered, again to avoid appointment of a majority based on political pressures predominant at any one time.[145]

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.[146] The Inspector

143. *See* Illinois, Securities Act Release No. 9389 at 1–2, 2013 WL 873208 (Mar. 11, 2013); New Jersey, Securities Act Release No. 9135 at 2, 2010 WL 3260860 (Aug. 18, 2010); *see also* Complaint at 1–2, SEC v. City of Miami, No. 13-22600-CIV, 2013 WL 6842072 (S.D. Fla. Dec. 27, 2013).

144. The term could 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. *Cf.* Rubeor v. Town of Wright, No. 1:13-cv-0612 (LEK/CFH), 2014 WL 636323, at *4 (N.D.N.Y. Feb. 18, 2014) ("[A] six-year term . . . serve[s] as a guarantee to the public that the [officeholder] will be insulated from political pressures."). Seven years appears to be a good compromise between terms too short to attract qualified members from the private sector and terms so long that they would facilitate capture by outside political forces.

145. A model for a staggered board of this kind is the Board of Governors of the Federal Reserve System. *See* Federal Reserve Act, 12 U.S.C. §§ 241–242 (2012).

146. New York's Retirement and Social Security Law provides for this oversight function to be performed by the New York State Office of the State Comptroller. N.Y. RETIRE. & SOC. SEC. LAW § 11 (McKinney 1999). 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 modeled after the SEC would have advantages over giving the oversight function to state offices subject to political selection and control. *See* Press Release, SEC, SEC Charges Illinois for Misleading Pension Disclosures (Mar. 11, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513202#.Uw15ivmuRd0; Press Release, SEC, SEC Proposes Measures to Curtail "Pay to Play" Practices (July 22, 2009),

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

The Inspector General's office would not only have the responsibility of dealing with complaints about improprieties concerning assets, but also would 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, the auditors chosen should be free of conflicts of interest and subject to regular rotation.[147]

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[148] and economic conditions. Otherwise, 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.

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 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 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 paying benefits currently due. While the fund established by each state

available at http://www.sec.gov/news/press/2009/2009-168.htm (acknowledging that political influence has been a problem and proposing ways to curb such influence).

147. *See* Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7213(a)(2)(B).

148. An example of a demographic condition is increased retiree lifespans, resulting in longer payouts of retirement benefits.

would primarily be intended to avoid plan insolvency under the state's common administration, the emergency fund would offer each plan the positive incentive of being able to overcome immediate crises without going through insolvency administration and the negative incentive of having 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 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 centrifugal effect that would foreseeably drive states into major variations, undermining the important goal of uniformity.[149] 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 should be offered to supplement the council's stick and keep states within the code's framework. This would be a common emergency fund created as a backup for each state fund, somewhat like the federal PBGC.[150] It would differ significantly from the PBGC in several respects, however. Unlike the PBGC, it must be self-sufficient because it could not draw on the unlimited credit of the U.S. government.[151]

Additionally, the primary purpose of this fund would differ from that of the PBGC, which is intended to protect private pension beneficiaries whose funds have been terminated.[152] Rather, the emergency fund's

149. *See* UCC § 1-103(a) (expressing the purposes of the UCC, including uniformity). While the basic reforms this Article proposes would be beneficial even if states were to adopt significant variations, too much variation could lead benefit plans down the primrose path to underfunding, could interfere with one of the key advantages of uniformity—enabling courts in one jurisdiction to rely on decisions in other states—and could make it impossible for states to combine funds through interstate compacts. For a discussion of interstate compacts in this context, see discussion *infra* Part VI.

150. *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. *Id.*

151. The PBGC is supposed to be self-supporting, based on premiums, interest, and other charges to private benefit plan sponsors. *See* 29 U.S.C. § 1305(b). 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 id.* § 1305 (a)–(f).

152. *See id.* § 1302(a)(2).

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.[153] It would be intended only secondarily as a backup source of funding for individual beneficiaries of insolvent funds because 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 1 percent of the total annual contributions from their constituent funds.[154] Because they will be funded by the same contributions as the benefit funds themselves and because the benefit funds will be large and designed to minimize the likelihood of needing to draw on insurance funds, the amounts needed for emergency funds will differ from those required for the PBGC,[155] which is designed to protect against the failure of funds provided by private employers. 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

153. 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 CTR. ON THE STATES, *supra* note 9, at 8 (noting that many states have reduced benefits—in some cases to current as well as newly hired employees). *See generally* Monahan, *supra* note 7, at 1083 (arguing that, contrary to holdings by state courts in California and elsewhere, future benefits for current state employees may be reduced without impairing the obligations of contracts).

154. 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). A similar period of building up should be established for state emergency funds before they can be drawn upon for benefits.

155. Section 1306(a)(3)(A)(i) requires participating plans to pay annual insurance fees of $30 per covered employee to the PBGC for basic benefits in single-employer funds. *Id.* § 1306(a)(3)(A)(i). However, state needs are likely to be more substantial because 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 many plans. Moreover, state plans would not have the PBGC's ability to call on the resources of the U.S. Treasury.

the administrative council to take into account projected changes in future 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 percent 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 because the funds would not be able to draw upon the emergency fund if the Inspector General's Office found 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 strictly limiting conditions. Moreover, the code should expressly provide that, notwithstanding any other provision in state law governing creditors' rights,[156] 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 additional interest equal to 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 percent—to be determined by the administrative council at the time the draw is made. This interest payment is important both for full restitution of the cost to the insurance fund,[157] and to avoid giving states any incentive to draw on the insurance

156. This would include both voluntary liens—primarily, but not exclusively, security interests established under UCC Article 9—and involuntary liens established for purposes such as taxation and the satisfaction of judgments.

157. This would include both the cost of funds and the administrative costs

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 because the code is intended to prevent public plan insolvency—analogous to the kinds of private plan terminations that ERISA covers.[158] If, however, direct draws are required by circumstances meeting statutory conditions specified in the code, they should be capped in the same way that ERISA caps benefits payable under terminated private plans.[159] Beneficiaries thus "orphaned" from their plans could be transferred to receive similar benefits under overall state plans,[160] with liability transfers of this kind dealt with by actuarial planning for the state plans. In turn, being much larger, the state plans could absorb liabilities of this kind with comparatively minimal increases in employer and 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. Nonetheless, 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 state benefit systems actuarially sound,

connected with making the draw.

158. *See* 29 U.S.C. §§ 1322(a), 1322a(a).

159. PBGC benefits for retirement, survivors, and disabilities are subject to maximum amounts payable to beneficiaries. Pension benefits, for example, are based in part on the beneficiary's age at the time of plan determination and include a regular adjustment for inflation. *See Maximum Monthly Guarantee Tables*, PENSION BENEFIT GUARANTY CORP., http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html (last visited Mar. 18, 2014).

160. This would be roughly analogous to employees with terminated health plans who are eligible to transfer to other health plans under the Consolidated Omnibus Budget Reconciliation Act (COBRA), but unlike COBRA, employees would retain the benefit of employer contributions under their general state plans. *See generally* U.S. DEP'T OF LABOR, AN EMPLOYEE'S GUIDE TO HEALTH BENEFITS UNDER COBRA (2012), *available at* http://www.dol.gov/ebsa/pdf/cobraemployee.pdf.

avoiding the trauma faced by localities with catastrophically failing plans such as Detroit and Stockton.[161]

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 one hand, public benefit funds at every level generally have their terms established through collective bargaining between unions—representing beneficiaries—and the state or state-sponsored government units employing the beneficiaries.[162] Most modifications of benefits to fit the new code, even for persons not yet employed, would likely face union resistance. On the other hand, there are significant political forces that believe public employees are overcompensated and oppose even the principle of collective bargaining by public employees.[163] Thus, there will be resistance to any statute that establishes benefits and requires contributions by government units—particularly if the state or municipality has a defined-benefit plan, as most do.[164]

Two provisions can ease the transition. 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, just as they were before the code was enacted. Second, while new employees would be subject to the mandatory employer and employee contributions for their level of benefits, existing employees would have contributions, benefits payable, and other factors—such as a minimum age of retirement—adjusted gradually over time to minimize dislocations suffered by persons already receiving pensions and, to a lesser degree, those within

161. *See supra* notes 4–6 and accompanying text.

162. 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 pension funding and collective bargaining. *See* Walsh, *supra* note 30. Georgia, with only 14 percent of its public employees unionized, is "the third most generous state" for public pensions. *Id.* By contrast, "labor-friendly Vermont" replaces a far lower percentage of a retiree's income even though "more than half the public work force has collective bargaining." *Id.*

163. *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/ (recapping several states' pension reform efforts after Wisconsin Governor Scott Walker successfully defeated a recall attempt instigated after state unions' collective-bargaining rights were curtailed).

164. *See* Clark, *supra* note 3, at 262.

10 years of retirement under existing plans.[165]

The transition should not require drastic changes in the nature of plans—not nearly as drastic as the transition from defined benefits to defined contributions. For existing plans, contributions, benefits, and entitlement dates should be gradually shifted to levels that are actuarially sound—they should be examined by the state's actuarial board—and levels of contributions, dates of earliest entitlement, and maximum benefits should be shifted so that, based on a realistic rate of return on the overall fund's investments, they will be sustainable over a 10-year period.[166] The code would require that public employers make the 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.

165. Congress has made gradual adjustments of this kind 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* Social Security Amendments of 1977, Pub. L. No. 95-216, § 201(a)(6), 91 Stat. 1509, 1527. 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* Social Security Amendments of 1983, Pub. L. No. 98-21, §§ 101–102, 121, 201, 97 Stat. 65, 67–70, 80–81, 107–08. 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. *See* Paul Solman & Larry Kotlikoff, *How Underfunded is Social Security and How Might It Be Fixed?*, PBS NEWSHOUR: MAKING SEN$E (May 6, 2013), http://www.pbs.org/newshour/making-sense/how-underfunded-is-social-secu/ (moderating a point-counterpoint discussion on the topic).

166. "Smoothing"—which involves averaging 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 reasonably projected rates over a limited future period—should be permitted because experience shows that rates do vary significantly over time. *See What is Smoothing?*, *supra* note 133. Smoothing has been criticized by some economists as a means of overestimating the rate of return on fund investment. *See* Andonov et al., *supra* note 38, at 4–5. Critics suspect smoothing 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 id.* at 20 ("[S]moothing . . . may enable the pension fund to better tolerate the volatility of risky investments, present more stable self-reported funding ratios, and keep the contribution level constant even in periods of large market volatility.").

VI. STANDING TOGETHER: INTERSTATE COMPACTS FOR POOLING 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.[167] The ability to raise and invest common funds is one of the advantages of a uniform code. Common funds would include the pooling of funds available for paying actuarially anticipated retirement and survivor benefits, along with independent funds to pay for current benefits requiring bargaining with insurance companies—chiefly medical benefits, but also including benefits for the long-term care of disabled workers. Pooling funds would also be especially useful for the common emergency funds discussed in Part IV because it would diversify risk across several states—especially when the emergency arises from circumstances affecting only a geographically limited area, such as a natural disaster.[168]

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 enough 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. The chief advantage of compacts is that multiple states, acting together, could raise and invest large amounts and could diversify risk among states sharing large metropolitan areas—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

167. Article I, Section 10, Clause 3 of the federal Constitution allows states to enter compacts with each other if specifically permitted by Congress. State compacts have been widely entered into for purposes such as development, use, and conservation of shared natural resources—e.g., eight states are part of the Great Lakes Basin Compact—and for services such as public transportation in metropolitan areas spanning different states—one example is the Port Authority of New York and New Jersey. Great Lakes Basin Compact, Pub. L. No. 90-419, 82 Stat. 414 (1968); Port of New York Authority Compact, 42 Stat. 174 (1921).

168. 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) (2012).

characteristics. They might also be limited, ironically, by considerations of federalism opposite to those 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.[169]

Whether a benefit fund is established by a single state or as a common fund operated by multiple states, it should meet certain minimum requirements, which can be drawn from the experience of the PBGC,[170] with special modifications based on the differences between the private employer funds insured by the PBGC and the public funds dealt with here.[171]

VII. CONCLUSION

The complex problems raised in paying benefits from funds established by states, their subdivisions, and instrumentalities cannot readily be addressed 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 through state law. A uniform state code that would provide a template for states to use when drafting their own statutes—and that 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 that, if approved by Congress, would enable states to fund plans on a multistate basis, increasing the size of funds and thereby amplifying their leverage with investment intermediaries and improving their ability to diversify overall risk.

The law would provide for consolidating funding for all public benefit

---

169. The fact that the Constitution, in Article I, Section 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. *See* U.S. Steel Corp. v. Multistate Tax Comm'n, 434 U.S. 452, 473 (1978) ("[T]he test is whether the Compact enhances state power [at the expense of] the National Government.").

170. The PBGC covers multiemployer plans as well as plans sponsored by individual private employers. *See* 29 U.S.C. §§ 1322(a), 1322a(a).

171. Not only are private employers' funds generally much smaller than the public funds this Article discusses, but most are also now defined-contribution rather than defined-benefit plans, an option that would substantially decrease benefits to public employees and has proven politically difficult to implement. *See supra* notes 112–19 and accompanying text.

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 employment of sophisticated fiduciaries to 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, as long as contributions matched foreseeable expenditures under standards set by a state actuarial board acting under the supervision of a nonpartisan administrative council.

Contributions would be invested, and the investments would be supervised by fiduciaries appointed by the council. The transparency of investments and expenditures would be assured by requiring regular accounting according to GASB standards, 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 ensure comprehension and prevent concealment of irregularities through obfuscatory language.

Statewide consolidation would also enable states to maintain emergency funds in addition to the funds normally invested toward benefits. These would provide a protective function roughly similar to that of the PBGC. 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 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.