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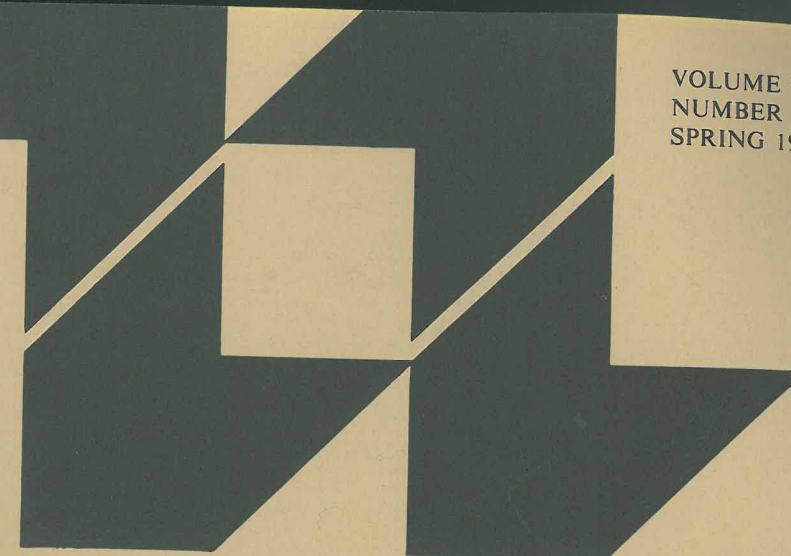
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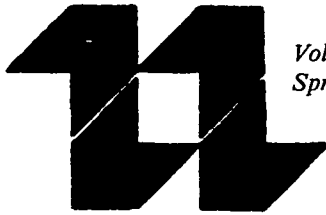
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Development Linkage
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Fiduciary Standards: Can the Trustee Ever Be
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Mandatory Tithes: The Legality of Land Development Linkage

Fred P. Bosselman* and Nancy E. Stroud**

At the end of every three years you shall bring forth all the tithe of your produce in the same year, and lay it up within your towns; and the . . . sojourner, the fatherless and the widow, who are within your towns, shall come and eat and be filled; that the Lord your God may bless you in all the work of your hands that you do.¹

I. Introduction

The voluntary tithe, as a moral obligation designed to encourage successful people to contribute to charitable causes, has ancient roots in the Judeo-Christian tradition. In recent years, the idea of a mandatory tithe for land developers has appeared in the form of local regulations that condition the approval of certain types of land development on the developer's agreement to contribute to certain other types of development that further particular public purposes. For example, someone who wants to build a downtown office building is allowed to do so only by also contributing to the construction of new housing. These programs are often described as "linkage" programs.

This article will review the legal issues posed by linkage programs. To do so it will first look at the historical trends out of which linkage programs evolved. The article describes in more detail the linkage programs in a few communities and compares these programs to related regulatory schemes such as inclusionary zoning, incentive zoning and transfer of development rights. The article then examines federal con-

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1. Deuteronomy 14: 28-29 (Rev. Standard ed.).

stitutional issues raised by linkage programs in light of evolving Supreme Court doctrine. Finally, the article reviews the ways in which the courts of different states are likely to approach linkage.

In view of the concern expressed by most developers toward linkage programs, it is ironic that these programs have evolved out of two trends in land use regulation that have been strongly supported by the development industry: (1) the replacement of pre-set zoning regulations with flexible impact analysis techniques, and (2) the search for ways to avoid the exclusionary effect of traditional zoning policies.

II. The PUD Movement

In the 1950's and 1960's one of the most common complaints of the development industry was that traditional zoning regulations were too rigid. The regulations were designed to replicate the development patterns of the 1920's, the era when zoning was born and when the previous boom in land development took place. These regulations assumed that most residential development would take the form of single family houses on individual lots. Office buildings and retail stores would be located in the central business district radiating out from the "prime" corner. Apartments, which were sometimes thought of as a commercial rather than a residential use, were limited to the fringes of the central business district.²

The development industry quickly saw that the postwar auto-oriented society was seeking a different product. Inflated land costs were pricing the detached house out of the reach of most potential buyers and creating a demand for clustered housing. The new outlying shopping centers were only the first evidence of a demand for a wide range of commercial, office and light industrial development in areas far from traditional urban cores.³ Zoning was not designed to encourage the type of development the market then demanded. Minimum lot size and yard requirements made housing expensive.⁴ Standard commercial bulk

2. See Babcock & Bosselman, *Suburban Zoning and the Apartment Boom*, 111 U. PA. L. REV. 1040, 1060-61 (1963).

3. See TASK FORCE ON LAND USE AND URBAN GROWTH, *THE USE OF LAND: A CITIZENS' POLICY GUIDE TO GROWTH* 82-88 (1973) [hereinafter cited as Task Force]; G. FUQUITT, P. VOSS & J. DOHERTY, *GROWTH AND CHANGE IN RURAL AMERICA* 9-12 (1979); ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, *URBAN AND RURAL AMERICA: POLICIES FOR FUTURE GROWTH* (1968) [hereinafter cited as ADVISORY COMMISSION].

4. W. WHYTE, *THE LAST LANDSCAPE* 201-02 (1968).

and layout rules gave little guidance for developments that were not tied to existing commercial districts, and rigid use-separation rules often prevented the type of mixed-use development that made the most sense.⁵

The development industry's response was to promote the planned unit development, or PUD, concept.⁶ Its proponents argued that once developments achieved a certain size (often five acres) the interrelationship of the various parts of the development became of equal if not greater importance than the relationship to surrounding uses. Because the entire development was being planned as a whole it was possible to control the development through the approval of a master development plan. The availability of this control opportunity meant that traditional yard, lot, bulk and even use regulations could be abandoned, or at least relaxed, in favor of the more flexible evaluation of the proposed master plan in accordance with more general planning principles.⁷

As acceptance of the PUD concept grew, developments in rapidly growing areas increasingly took advantage of this technique.⁸ In some instances the PUD concept swallowed up the zoning ordinance that gave it birth and regurgitated it in the form of standards for evaluating the impact of proposed PUDs. These standards carried names such as impact zoning or performance zoning and were designed to replace traditional zoning regulations.⁹

The key policy of the PUD concept was that each development of substantial size deserved to be evaluated on its own merits. The popularity of environmental and fiscal impact analysis during the 1970's led to the evaluation of new development not only on the basis of traditional zoning concerns, such as the impact on immediate neighbors, but on broader environmental policies and on the fiscal health of the community. Such regulatory techniques that use impact analysis as a major

5. 2 N. WILLIAMS, JR., *AMERICAN LAND PLANNING LAW* 229-34 (1974).

6. See generally Krasnowiecki, *Planned Unit Development: A Challenge To Established Theory and Practice of Land Use Control*, 114 U. PA. L. REV. 4 (1965); D. MANDELKER, *CONTROLLING PLANNED RESIDENTIAL DEVELOPMENTS* (American Society of Planning Officials Series 1967); *FRONTIERS OF PLANNED UNIT DEVELOPMENT: A SYNTHESIS OF EXPERT OPINION* (R. Burchell ed. 1973).

7. Vladeck, *Large Scale Developments and One House Zoning Controls*, 20 LAW & CONTEMP. PROBS. 255 (1955).

8. See R. ELLICKSON & A. TARLOCK, *LAND USE CONTROLS* 265-269 (1981).

9. See, e.g., KENDIG, CONNER, BYRD & HEYMAN, *PERFORMANCE ZONING* (1980); Yannocone, Jr., Rahenkamp & Cerchione, *Impact Zoning: Alternative to Exclusion in the Suburbs*, 8 URB. LAW. 417 (1976).

component effectively delay the land use controls until the developer's intentions are known.¹⁰

This new "wait-and-see" type of regulation required a major change in the theory of land use regulation. As originally conceived, land use regulation was to be based on a map dividing the jurisdiction into zoning districts. An ordinance would set forth the criteria under which development could take place in each district. A developer would only need to read the map and ordinance to determine the rules applicable to any particular tract of land.¹¹ The proponents of this system of regulation justified it because the preparation of a map based on an overall plan of the entire community would provide a reciprocity of benefits to all property owners.¹² Even though use of a particular tract was restricted, the owner obtained the benefits of living in a more orderly and efficient community.¹³

The importance of an overall plan was such a significant element in defense of zoning regulations that the proponents of zoning vigorously opposed any efforts to encourage significant change in the plan through administrative variance.¹⁴ Amendments to the map were permitted, but only under rules designed to discourage changes in small parcels.¹⁵ And regulations devised in response to specific development proposals were prohibited under the label of "contract zoning."¹⁶

In practice, however, the creation of an "end-state plan" setting forth the future use of land proved extremely difficult.¹⁷ Rapid changes in economic and social conditions forced planners to reevaluate plans regularly or see them become obsolete. It became popular to say that planning should be a process of controlling change rather than a map.¹⁸

10. Task Force, *supra* note 3, at 189.

11. E. BASSETT, *ZONING: THE LAWS, ADMINISTRATION, AND COURT DECISIONS DURING THE FIRST TWENTY YEARS*, 50 (2d ed. 1940).

12. *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393 (1922)("[A]n average reciprocity of advantage . . . has been recognized as a justification for various laws"). See Lefcoe, *California's Land Planning Requirements: The Case for Deregulation*, 54 S. CAL. L. REV. 447, 457-58 (1981).

13. D. MANDELKER, *LAND USE LAW* 21-22 (1982). See S. TOLL, *ZONED AMERICAN* 124-26 (1969); R. BABCOCK, *THE ZONING GAME* 116-20 (1966).

14. See E. BASSETT, *supra* note 11, at 121.

15. 1 R. ANDERSON, *AMERICAN LAW OF ZONING* § 5.17 (2d ed. 1976).

16. See E. BASSETT, *supra* note 11, at 184.

17. See MODEL LAND DEV. CODE art. 3 commentary (Official Draft 1975).

18. 1 N. WILLIAMS, JR., *supra* note 5, at at 26-27. See Rose, *Planning and Dealing: Piecemeal Land Controls As a Problem of Local Legitimacy*, 71 CALIF. L. REV. 837, 874-78 (1983).

Moreover, many elected local government officials learned that the map was a handicap. If all the rules were pre-established by the map and accompanying regulations, the developer would not need the approval of the local legislative body before undertaking a project. And if the project proved unpopular with the public the elected official would take the heat without having been able to stop the project.¹⁹

This handicap could be avoided, however, by preparing a map classifying most undeveloped land into some relatively restricted category, forcing each developer to seek an amendment from the legislative body. When the National Commission on Urban Problems studied the subject in the late 1960's, they discovered a dramatic shift toward this type of wait-and-see zoning.²⁰

Because wait-and-see zoning was hard to square with the overall plan theory on which zoning was originally based,²¹ new techniques such as planned unit development were devised to legitimize the process.²² But many communities continued to rely on the process of re-zoning in response to each major development, knowing that potential challenges to the legitimacy of the process would be difficult and time-consuming.²³

Bargaining between developer and local government became the way the regulatory process worked. It evolved in that way because both sides get some benefits out of a bargaining process. The developer benefits by being able to buy land that is not predesignated for intensive development and thus does not command as high a price as it otherwise would. The elected official benefits by retaining legislative discretion to discourage development disliked by the voters and to obtain contributions from developers toward the construction of public facilities. The process of bargaining over the impact of each development proposal has become so common that some respected commentators have suggested that zoning be abolished and replaced with a more tightly regulated bargaining process.²⁴

As bargaining became a way of life, however, the predictability of land use regulation obviously declined. From the perspective of the lo-

19. See R. ELLICKSON & A. TARLOCK, *supra* note 8, at 59.

20. ADVISORY COMMISSION, *supra* note 3, at 206-07.

21. *Id.* at 223-24.

22. See *supra* note 6 and accompanying text.

23. C. PETERSON & C. MCCARTHY, *HANDLING ZONING AND LAND USE LITIGATION: A PRACTICAL GUIDE* 234-45 (1982).

24. See Krasnowiecki, *Abolish Zoning*, 31 SYRACUSE L. REV. 719 (1980).

cal government, wait-and-see regulation would work only if the government retained legislative discretion to approve or deny the developer's request. Such discretion would give the government the flexibility to ask for an unlimited range of design changes, contributions or other "sweeteners" from the developer without being bound by any set of prearranged rules. The local governing body would merely need to suggest that the absence of such sweeteners would mean disapproval of the development proposal. The developer was left with the unenviable choice of complying or challenging on the basis of an abuse of legislative discretion.²⁵

While some communities dealt with developers on a purely *ad hoc* basis, others took the initiative to define in advance the types of sweeteners they were looking for by names such as "incentive zoning." Incentive zoning is the term usually used to define those regulations that permit a developer to exceed the bulk or density standards otherwise controlling if the development is designed to include some specific feature that promotes a particular government policy.²⁶

The desired feature that started the incentive zoning trend was the downtown plaza. Seeing a need for more open spaces in the "canyons" of Manhattan, New York City's planners allowed the developers of Lever House to exceed the height limitations in exchange for the installation of a plaza at street level.²⁷ A decade later windswept plazas at the base of Miesian slabs became the norm.²⁸ Dazzled by their success, New York City's planners began giving similar incentives or bonuses to developers who put shopping arcades, theaters, and a wide range of other uses in their buildings.²⁹

An outgrowth of incentive zoning is transfer of development rights (TDR), a term used to describe a wide variety of programs. The more

25. Task Force, *supra* note 3, at 189-91. See J. JUERGENSEMEYER & J. WADLEY, ZONING ATTACKS AND DEFENSES: THE LAW IN FLORIDA 31-33 (1980).

26. Mandelker, *The Basic Philosophy of Zoning: Incentive or Restraint*, in THE NEW ZONING: LEGAL, ADMINISTRATIVE AND ECONOMIC CONCEPTS AND TECHNIQUES 14 (N. Marcus & M. Groves eds. 1970).

27. Elliott & Marcus, *New Directions In Land Development Controls*, 1 HOFSTRA L. REV. 56 (1973).

28. See A. SPIRN, THE GRANITE GARDEN: URBAN NATURE AND HUMAN DESIGN 77-79, 247 (1984); C. WEAVER & R. BABCOCK, CITY ZONING: THE ONCE AND FUTURE FRONTIER 61-62 (1979).

29. Weaver & Babcock, *supra* note 28, at 300-02. See Weinstein, *How New York's Zoning Has Changed To Induce the Construction of Legitimate Theaters* in THE NEW ZONING, *supra* note 26, at 131.

sweeping TDR systems demand that developers seeking to build more than certain specified quantities of development in a particular "transfer" area must buy up the equivalent rights to develop property from a "preservation" area that the government is trying to protect from development.³⁰ These TDR programs seek to make the development industry bear the cost of preserving landmarks or agricultural land by apportioning a relatively small share of those preservation costs to each developer who seeks to build at the density levels designed for the transfer areas.³¹

In many communities, the bargaining process is much more free-wheeling than in these more structured systems, and the actual power wielded by the local government is much greater than the case law might lead one to believe.³² This has led to a number of proposals for change in the system to reduce the extent of legislative discretion in reviewing individual development proposals.³³ The desire for change was stimulated in a large part by the exclusionary nature of many of these regulations.

III. Exclusionary Zoning

The highly discretionary land use controls encouraged by the PUD movement helped those who sought to keep minorities out of rapidly growing areas by making it extremely difficult to challenge the exclu-

30. D. HAGMAN & D. MISCZYNSKI, WINDFALLS FOR WIPEOUTS: LAND VALUE CAPTURE AND COMPENSATION 533-51 (1978); Costonis, *Development Rights Transfer: An Exploratory Essay*, 83 YALE L.J. 75 (1973); Carmichael, *Transferable Development Rights As a Basis for Land Use Control*, 2 FLA. ST. U.L. REV. 35 (1974); Bozung, *Transfer Development Rights: Compensation For Owners Of Restricted Property*, 6 ZONING & PLANNING L. REP. 129 (1983).

31. For a more critical evaluation of the TDR concept see Note, *The Unconstitutionality of Transferable Development Rights*, 84 YALE L.J. 1001, 1113-21 (1975); Gale, *The Transfer of Development Rights: Some Equity Considerations*, 14 URB. L. ANN. 81, 88, 96 (1977); R. ELLICKSON & A. TARLOCK, *supra* note 8, at 701. Professor Norman Williams suggests that such programs "clearly open up increased opportunities for either (a) carrying out a rational program on the allocation of density, or (b) graft and corruption on really large scale." WILLIAMS, *supra* note 5, at 376.

32. See R. ELLICKSON & A. TARLOCK, *supra* note 8, at 234-80.

33. See, e.g., *Fasano v. Bd. of Comm'rs of Washington County*, 264 Or. 574, 507 P.2d 23 (1973); COUNCIL FOR DEVELOPMENT CHOICES IN THE '80s, THE AFFORDABLE COMMUNITY: GROWTH, CHANGE AND CHOICE IN THE '80s 88-90 (1981); HOUSING FOR ALL UNDER LAW 408-10 (R. Fishman ed. 1978) [hereinafter cited as HOUSING FOR ALL]; J. JUERGENSEMEYER & J. WADLEY, *supra* note 25, at 77-79; MODEL LAND DEV. CODE §2-201-§2-212 (Proposed Official Draft 1975).

sionary aspect of the regulations. The standing hurdles, the problems of proof and the high cost of such cases has meant that exclusionary zoning can be proven only in cases where the violations were repeated and blatant,³⁴ despite the fact that the Supreme Court interpreted the Civil Rights Act of 1968 to permit actions against communities that employed a pattern of zoning practices designed to exclude minorities.³⁵

As the issue of exclusionary zoning became a subject of general public discussion, some of the more rapidly growing local governments concluded that their exclusionary zoning policies were having an adverse effect on their own communities. When they discovered that they could not hire policemen, firemen and school teachers from within their own boundaries, some of the larger jurisdictions began to ask developers to reserve a specific, small fraction of new units in each development for federally subsidized housing. Such a policy became known as "inclusionary zoning."

The policy basis for this approach grew out of the "critical mass" and "tipping point" theories that had been propounded by observers of racial and ethnic population movements. A modest number of minority group members could be integrated into a neighborhood without having substantial adverse effect, but if the numbers reached a "tipping point" the original residents would flee. When this theory was applied to housing there was an assumption that so long as the great majority of the housing stock could be maintained at a price and quality level sufficient to form a "critical mass" the introduction of a small percentage of subsidized housing for lower income groups would not cause a substantial decline in neighborhood property value.³⁶

34. *Warth v. Sedlin*, 422 U.S. 490 (1975); *Hope, Inc. v. County of Du Page*, 738 F.2d 797 (7th Cir. 1984) (en banc); *United States v. City of Parma*, 494 F. Supp. 1049 (N.D. Ohio 1980), *modified*, 661 F.2d 562 (6th Cir. 1981), *cert. denied*, 456 U.S. 926 (1982). Compare *HOUSING FOR ALL*, *supra* note 33, at 126-31, with Silverman, *Housing for All Under Law: The Limits of Legalist Reform*, 27 U.C.L.A. L. REV. 99, 114-20 (1979). See also Lamb & Lustig, *The Burger Court, Exclusionary Zoning, and the Activist-Restraint Debate*, 4 U. PITT. L. REV. 169 (1978); Mandelker, *Racial Discrimination and Exclusionary Zoning: A Perspective on Arlington Heights*, 55 TEX. L. REV. 1217 (1977). See generally D. MOSKOWITZ, *EXCLUSIONARY ZONING LITIGATION* (1977).

35. *Village of Arlington Heights v. Metropolitan Housing Development Corp.*, 429 U.S. 252 (1977).

36. See Kleven, *Inclusionary Ordinances—Policy and Legal Issues in Requiring Private Developers to Build Low Cost Housing*, 21 U.C.L.A. L. REV. 1432 (1974). A recent summary of local inclusionary ordinances is found in A. MALLACH, *INCLUSIONARY HOUSING PROGRAMS: POLICIES AND PRACTICES* 196-264 (1984).

Inclusionary zoning ordinances were adopted by a number of the larger local governments where substantial growth was taking place during the early 1970's. These ordinances required (or in some case, offered incentives for) the inclusion of a percentage of subsidized low income housing in each housing development. Among the communities adopting this type of ordinance were a number of the jurisdictions surrounding Washington, D.C. and a number the large and growing southern California communities.³⁷ Inclusionary zoning received a setback in 1973 when the Virginia Supreme Court found the Fairfax County ordinance to be invalid under the Virginia Constitution.³⁸ Because of the Virginia Supreme Court's long history of antipathy to local government regulation,³⁹ the decision wasn't treated very seriously in states like California where the state courts were at the opposite end of the spectrum.⁴⁰ But in more conservative states, the Virginia decision was viewed as a roadblock to experimentation with inclusionary zoning.⁴¹

The withdrawal of federal housing subsidies under the Reagan administration eliminated any pretense that inclusionary zoning could be accomplished in a cost-free manner.⁴² In the absence of subsidies, inclusionary zoning would subject developers to a major financial burden.⁴³ Searching for a more satisfactory approach, local governments have begun the transformation of inclusionary zoning from a regulatory tool imposed on the residential development industry to an exaction imposed on non-residential development.

37. Kleven, *supra* note 36, at 1439-46.

38. Bd. of Supervisors of Fairfax Co. v. DeGroff Enter., 214 Va. 235, 198 S.E.2d 600 (1973).

39. Richards, *Zoning for Direct Social Control*, 1982 DUKE L.J. 761, 831.

40. Hagman, *Taking Care of One's Own through Inclusionary Zoning: Bootstrapping Low- and Moderate-Income Housing by Local Government* 5 URB. L. & POL. 169 (1982).

41. See, e.g., Note, *Board of Supervisors v. DeGroff Enterprises, Inc.: A Case of Inclusionary Zoning*, 60 IOWA L. REV. 413, 418 (1974); H. FRANKLIN, D. FALK & A. LEVIN, *INZONING: A GUIDE FOR POLICY-MAKERS ON INCLUSIONARY LAND USE PROGRAMS* 33, 139 (1974); R. BURCHELL, *MT. LAUREL II: CHALLENGE AND DELIVERY OF LOW COST HOUSING* 351 (1984); J. JUERGENSEMEYER & J. WADLEY, *supra* note 25, at 148-53 (1980).

42. See Baade, *Required Low-Income Housing in Residential Developments: Constitutional Challenges to a Community Imposed Quota*, 16 ARIZ. L. REV. 439, 445, 460 (1974).

43. See A. MALLACH, *supra* note 36, at 86-103; Muth, *Redistribution of Income Through Regulation in Housing*, 32 EMORY L.J. 691, 707-10 (1983).

IV. Linkage Programs

Job-generating facilities, such as office parks or industrial development, can more easily be shown to create a need for low-income housing than residential development does. If an exaction is to be imposed, should not commercial and industrial development pay rather than residential development?⁴⁴ Should communities be allowed to encourage development that would create jobs but forbid the housing needed by the workers?

In 1980 the City of San Francisco began implementing a linkage program to encourage office developers to build housing.⁴⁵ Specifically, under the Office Housing Production Program developers of office buildings containing more than 50,000 square feet are required to build or finance the amount of new housing in the City that will be needed to house the office workers generated by the development. The requirement is based on the following assumptions: office use generates one employee per two hundred and fifty square feet; forty percent of all office employees in San Francisco reside in San Francisco; and 1.8 working adults occupy each residential unit. This generates a requirement of approximately nine new dwelling units per 10,000 square feet of office space.⁴⁶

The new housing can be for people of any income level, but the developers are given incentives to produce modestly priced housing by allowing them to provide fewer units if the units are for moderate income people. There are no restrictions on the location in San Francisco in which the housing must be built. As alternative to building housing, the developer may contribute to a municipal housing trust — known as the Shared Appreciation Mortgage Pool. The amount of contribution is 6,000 dollars for each housing unit required. The trust funds are used to reduce mortgage payments of low and middle income house buyers.⁴⁷ As of April 1984, the City of San Francisco states that its pro-

44. See Ellickson, *The Irony of Exclusionary Zoning*, 54 S. CAL. L. REV. 1167 (1981).

45. A. MALLACH, *supra* note 36, at 180-85; Tegeler, *Developer Payments and Downtown Housing Trust Funds*, 18 CLEARINGHOUSE REV. 679, 682-83 (1984); Diamond, *The San Francisco Office-Housing Program: Social Policy Underwritten by Private Enterprise*, 7 HARV. ENVTL. L. REV. 449 (1983).

46. D. MARINO, STRATEGIES FOR LINKED DEVELOPMENT: AN EXAMINATION OF APPROACHES IN OTHER CITIES 3 (Chicago Dept. of Planning Report, Dec. 6, 1984); Diamond, *supra* note 45, at 428.

47. For example, (a) two housing credits per affordable unit for moderate-in-

gram has generated almost 3000 units of housing, a majority of which were for low and moderate income families. In addition, the trust fund has accrued approximately five million dollars.⁴⁸ Despite its success, critics have continued to argue that San Francisco's program ought to be oriented exclusively toward moderately priced housing, and studies are currently underway that may lead to revision of the program.⁴⁹

Boston has now adopted a linkage program based on a somewhat similar analysis. The Boston program applies to developers of office, retail, hotel and institutional facilities and to developers of any use which will reduce the amount of existing low and moderate income housing. The threshold for application of the program is 100,000 square feet of floor area. Each such developer must pay a fee of forty-two dollars per square foot of floor area at the time the certificate of occupancy is issued, and must contract to pay a similar fee in each of the subsequent eleven years.⁵⁰ The fee is to be turned over to a neighborhood housing trust to be used for the development of low and moderate income housing. The fee amounts to five dollars per square foot spread out over a twelve-year period in equal payments.⁵¹ The first major project to which the fee is being applied is a 326 million dollar

come households built using governmental financial assistance, provided the developer contributes to the construction costs; (b) three housing credits per affordable unit for moderate-income households provided without government operating subsidies; and (c) four housing credits for low-income households provided without government operating subsidies. A. MALLACH, *supra* note 36, at 181-83; Diamond, *supra* note 45, at 458-59.

48. D. MARINO, *supra* note 46, at 4; Sedway, Inclusionary Zoning Conference Presentation on the San Francisco Office Housing Production Program (Oct. 4, 1983) (unpublished manuscript available from the authors). The impact of office development in downtown San Francisco has been a source of other litigation. See *San Franciscans for Reasonable Growth v. City and County of San Francisco*, 151 Cal. App. 3d 61, Cal. Rptr. 634 (1984). For a historical perspective see Svirsky, *San Francisco: The Downtown Development Bonus System in THE NEW ZONING*, *supra* note 26 at 139.

49. D. MARINO, *supra* note 46, at 5. In December 1983, the city of Santa Barbara adopted a housing mitigation policy with emphasis on low and moderate income housing. See Burch, Bozung, Miller & Hill, *Land Use Controversies: Public Use and Private Beneficiaries*, 16 URB. LAW. 713, 719-21 (1984).

50. Tegeler, *supra* note 45, at 684; D. CONNERS & E. WODLINER, DEVELOPMENT EXACTIONS: ATTACK AND DEFENSE 375-79 (Land Use Regulation and Litigation Course of Study Materials 1984); ADVISORY GROUP, LINKAGE BETWEEN DOWNTOWN DEVELOPMENT AND NEIGHBORHOOD HOUSING, (Report to the Mayor of Boston, Oct. 1983).

51. Werth, *Tapping Developers*, PLANNING, Jan. 1984, at 21, 23. Because the payments are spread out over such a long term no actual housing is expected to be built until 1986. D. MARINO, *supra* note 46, at 7.

International Place office complex built by the Chiofaro Company in downtown Boston.⁵²

In both San Francisco and Boston there has been considerable concern about the extent to which state law authorizes these cities to undertake linkage programs. The contributions in San Francisco have been negotiated by the planning commission as part of the site plan review process; there do not appear to have been any cases testing the validity of this exercise of the power.⁵³ In Boston, the program was established by an ordinance creating a development impact district, but the advisory group recommended a number of state statutory changes to assure that the program has proper authorization. An earlier inclusionary program in a suburb of Boston was found to lack statutory authorization.⁵⁴

V. Federal Law

Linkage programs and their close relatives all involve exactions imposed on developers for the purpose of solving problems far broader than any problems created by a particular development. As a vehicle for examining the federal law issues arising out of linkage programs it is appropriate to examine in detail a recent Ninth Circuit case arising out of the City of Klamath Falls, Oregon.

The plaintiff asked Klamath Falls to rezone his land to permit the construction of 214 garden apartments. Before the plaintiff could develop the property, however, the city needed to vacate some paper streets that had been dedicated to the city years ago. During negotiations with the city over the plaintiff's request for a street vacation, the city asked him to dedicate a strip of land for the widening of a city

52. According to an article in the New York Times, this project is expected to contribute \$8.5 million over the next twelve years to the housing trust for neighborhood development. N.Y. Times, Mar. 21, 1984, at 16, col. 1.

53. See D. CONNERS & E. WODLINGER, *supra* note 50, at 377. The fact that the program may be used to construct housing at any price level means that the city must argue that the construction of any type of housing is a public purpose, even if the housing is for wealthy people, because of a filter-down process. See Diamond, *supra* note 45, at 470.

54. D. MARINO, *supra* note 46, at 8. See *Middlesex of Boston St. Ry. Co. v. Bd. of Alderman of Newton*, 371 Mass. 849, 359 N.E.2d 489 (1976). For a discussion of potential statutory authority in New York see Comment, *Zoning New York City To Provide Low and Moderate Income Housing: Can Commercial Developers Be Made To Help?*, 12 FORDHAM URB. L.J. 491 (1984).

street adjacent to his property. Located on this land was a geothermal well from which plaintiff hoped to obtain steam to heat the apartments he would be constructing. He offered to dedicate to the city an easement on the surface of the property which would allow the city to widen the street, but he refused to convey to the city the rights to the underground well. The city was attempting to set up a geothermal utility district to provide heat and power to the public generally, and the city refused to vacate the street unless plaintiff conveyed his geothermal well to the city.

The plaintiff brought a section 1983 action in the federal district court, which ruled in favor of the city on motion for summary judgment. The Ninth Circuit Court of Appeals reversed, remanding the case back for trial on all of the major issues. In the process, the court interpreted the relevant law in a manner quite favorable to the plaintiff, finding that he had stated a valid complaint under the constitutional clauses protecting against the taking of property without compensation, against violations of due process of law, and against denial of equal protection of the laws.⁵⁵

The court treated the case as equivalent to a subdivision exactions case in which a developer is being asked to contribute land or money in exchange for needed governmental permission. Citing Supreme Court decisions on "unconstitutional conditions," the court stated that the government cannot condition a privilege on a requirement that the applicant give up constitutional rights. In this instance, said the court, the plaintiff was being asked to give up his property rights in a geothermal well in exchange for a street vacation. Such a condition would be acceptable only if there were some reasonably identifiable connection between the city's need for the geothermal well and the purpose underlying the law requiring permits for street vacations. Finding no such relationship, the court ruled that plaintiff had stated a valid claim under section 1983 of the Civil Rights Act of 1964 for violations of due process, equal protection and taking of property without just compensation.

The court's rationale effectively transforms every subdivision exaction case into a potential claim under section 1983, which can be used to obtain damages and attorney's fees for successful plaintiffs and can be brought in either the state or federal courts. The availability of damages and attorney's fees substantially increases the stakes for local

55. *Parks v. Watson*, 716 F.2d 646 (9th Cir. 1983).

governments in exactions cases. Formerly, if local governments incorrectly predicted which exactions a court would approve, the penalty was usually only the return to the developer of the property or money exacted. Moreover, in states like California, which is within the jurisdiction of the Ninth Circuit Court of Appeals, the state courts have been highly unreceptive to developers' complaints about the dramatic increases in development fees and taxes that have been instituted following Proposition 13. Under the logic of the Parks opinion, these cases can now be brought in the federal courts where the developer may find a more sympathetic ear.⁵⁶

The majority's analysis in *Parks v. Watson*⁵⁷ is substantially identical under both the taking and equal protection clauses. In *Parks* a taking was found because the well donation requirement "had no rational relationship to any public purpose related to the vacation of the public streets,"⁵⁸ and a violation of equal protection was found because the well donation requirement "is totally unrelated to [the City's] statutorily defined interest in determining whether to . . . [vacate the streets]."⁵⁹

Surprisingly perhaps, the court did not consider whether under the *Loretto* test a "permanent physical occupation" of the well was being demanded by the city.⁶⁰ Ironically, the application of such a test might have the effect of inhibiting some of the most traditional forms of exactions, including the dedication of internal streets in a subdivision, while leaving linkage programs untouched.⁶¹ Instead, the court applied the taking clause indirectly, through the unconstitutional conditions doctrine, by analogizing the case to one involving subdivision exactions. The court discussed the older Illinois rule and, as its counterpart, a

56. See also *Martino v. Santa Clara Valley Water Dist.*, 703 F.2d 1141 (9th Cir. 1983), *cert. denied*, ___ U.S. ___, 104 S. Ct. 151 (1983). In regard to potential abstention by the Ninth Circuit in land use cases, compare *Playtime Theaters, Inc. v. City of Renton*, 748 F.2d 527, 532-33 (9th Cir. 1984), *cert. granted*, ___ U.S. ___, 105 S. Ct. 2015 (1985), with *Kollsman v. City of Los Angeles*, 737 F.2d 830 (9th Cir. 1984).

57. 716 F.2d 646 (9th Cir. 1983).

58. *Id.* at 655.

59. *Id.* The dissenting judge viewed the street vacation as a conveyance of public property rather than the issuance of a permit, and would have upheld the city's actions under the broad discretion given to a public body to negotiate the price of property it sells. *Id.* at 665-69 (Wallace, J., concurring in part and dissenting in part).

60. *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982).

61. See Costonis, *Presumptions and Per Se Takings: A Decisional Model For the Taking Issue*, 58 N.Y.U. L. REV. 465, 494 and n.120 (1983).

California case that requires only that the exaction have some relationship to the needs created by the subdivision. The court summarized its discussion by saying that "there is agreement among the states 'that the dedication should have some reasonable relationship to the needs created by the sub-division.'"⁶² The court cited as examples of interests having at least some relationship to street vacation the "control of traffic, pollution or access."⁶³

Whether the *Parks* opinion is part of an emerging trend toward more serious analysis of the rational relationship of governmental regulations to the purposes they purport to serve remains to be seen. Recent Supreme Court decisions, such as *Zobel v. Williams*,⁶⁴ in which the court found no rational basis for an Alaska law apportioning surplus mineral income among the state's residents on the basis of the length of time they have lived in the state, and *City of Cleburne v. Cleburne Living Center*,⁶⁵ in which the court found no rational basis for special restrictions on homes for retarded people, can be analyzed as cases in which the Court saw no adequate linkage between the government regulation and the public purpose to be served.⁶⁶ Professor John Costonis has also recently argued that the Supreme Court's taking clause decisions pay special attention to the linkage between the purpose of the regulation and the use of the affected property.⁶⁷ When such a linkage is absent, he argues, the Court is more likely to find a regulation invalid because it is "loading up on one individual more than his just share of the burdens of government. . . ."⁶⁸

62. *Parks*, 716 F.2d at 653 (quoting *Call v. City of West Jordan*, 606 P.2d 217, 220 (Utah 1979)).

63. *Parks*, 716 F.2d at 651 n.1.

64. 457 U.S. 55 (1982). See also *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 442 (1982) (Blackmun, J., concurring). See also *id.* at 444 (Powell, J., concurring).

65. 53 U.S.L.W. 5022, 105 S. Ct. ____ (1985).

66. See also *Hooper v. Bernalillo County Assessor*, 53 U.S.L.W. 4827 105 S. Ct. ____ (1985); *Williams v. Vermont*, 53 U.S.L.W. 4659, 105 S. Ct. ____ (1985); *Metro-politan Life Insurance Co. v. Ward*, 53 U.S.L.W. 4399, 105 S. Ct. ____ (1985).

67. Costonis, *supra* note 61, at 486-88. But see Tarlock, *Regulatory Takings*, CHI. KENT L. REV. 23, 33 (1984). Professor John Humbach would find no taking whenever linkage-related affirmative obligations were imposed on a developer. Humbach, *A Unifying Theory For the Just-Compensation Cases: Takings, Regulation and Public Use*, 34 RUTGERS L. REV. 243, 278-79 (1982).

68. *Monongahela Navigation Co. v. United States*, 148 U.S. 313 (1893), quoted in Costonis, *supra* note 61, at 486. Professor Costonis cites *Prune Yard Shopping Center v. Robins*, 447 U.S. 74 (1980) and *Penn Central Transport Co. v. City of New*

Although neither of these trends can be described as well established, they suggest that it is at least worthwhile to examine developer exactions against a more rigorous standard of "reasonable relationship" to determine whether certain types of exactions are more likely to be at risk than others.

The conventional forms of developer exactions seem relatively safe under this type of scrutiny, assuming that the cost to the developer does not reach the degree of magnitude necessary to constitute a denial of all beneficial use of the land — a test not easily found to be violated.⁶⁹ Even exactions for less traditional public services might well be upheld if the services were in fact needed by the proposed development. If an impact fee for geothermal heat distribution were imposed at the time of development approval, and if the city were in fact proposing to supply geothermal heat to the development, a court might well find a reasonable relationship between the regulation and the exaction.⁷⁰

In summary, more rigorous scrutiny of the rational relationship test may make it difficult to justify exactions designed to resolve broad public problems for which the specific development proposal of the particular developer bears no real blame in a cost accounting sense. And, whether by coincidence or otherwise, this construction of the constitutional standard seems to parallel a similar trend in the state courts toward putting some real teeth in the rational nexus standard.

VI. State Law

In a field such as land use law, where the courts of different states take widely varying positions, it is risky to generalize on the prospects of a new regulatory technique. Nevertheless, there do seem to be some common trends in the analysis of development exactions by the courts of a number of prominent states. An examination of these trends may yield some useful speculation on the way that state courts will deter-

York, 438 U.S. 104 (1978) as the only recent "affirmations of this principle.

69. *Agins v. City of Tiburon*, 447 U.S. 355 (1980); *Goldblatt v. Town of Hempstead*, 369 U.S. 590 (1962). *But cf.* *Hamilton Bank of Johnson County v. Williamson County Regional Planning Comm'n*, 729 F.2d 402 (6th Cir. 1984), *cert. granted*, 53 U.S.L.W. 3235 (Oct. 1, 1984). If the court were to treat these exactions as permanent physical occupations, however, the result might not be the same. *See Loretto*, 458 U.S. at 419.

70. In *Parks v. Watson*, the city had granted the plaintiff's petition to rezone the property to allow more residential use, apparently without imposing any exactions at the time. 716 F.2d at 649.

mine the validity of linkage programs. In addition, recent decisions from Utah, Texas and Florida will be examined as precursors of a new level of analysis may have a significant impact on the validity of the various types of linkage programs.

Over the past twenty years the courts of virtually all of the states have come to use the term "rational nexus" to describe the test used to measure the validity of development exactions. The early court decisions adopting the rational nexus formulation were viewed by most commentators as a liberation of local governments from the strictures of earlier rules.⁷¹ The scholars who first proposed the test saw it as a "cost-accounting approach" that would make it "possible to determine the costs generated by new residents and thus to avoid charging the newcomers more than a proportionate share."⁷² The succeeding years witnessed a number of opinions, particularly in California, that applied the rational nexus test to uphold exactions using the loosest possible type of nexus.⁷³ This led some commentators to treat the rational nexus test much like the rational basis test for equal protection—as a test the government always passes.⁷⁴ At other times the court decisions incorporating the rational nexus test seemed to use it in such a widely varying manner that the term seems to represent nothing more than a loosening of the more restrictive standards used to evaluate the financing of local improvements through special assessments. More recently, however, courts have begun to put more meat on the rational nexus bones so that it becomes the basis for fairly rigorous analysis, in the manner that its original proponents intended, rather than a slogan used to justify any currently popular municipal policy.

The more rigorous version of the rational nexus test, as currently applied, requires a two-part analysis. First, it requires some real showing that the particular development will create a "need" and that the amount of the exaction bears some roughly proportional relationship to

71. See R. FREILICH & P. LEVI, MODEL SUPERVISION REGULATIONS: TEXT AND COMMENTARY 124-28 (1975).

72. Heyman & Gilhool, *The Constitutionality of Imposing Increased Costs on New Suburban Residents Through Subdivision Exactions*, 73 YALE L.J. 1118, 1137 (1964).

73. See, e.g., *Liberty v. Calif. Coastal Comm'n*, 113 Cal. App. 3d 491, 170 Cal. Rptr. 247 (1981); *J.W. Jones Co. v. City of San Diego*, 157 Cal. App. 745, 203 Cal. Rptr. 580 (1984); *Kalaydjian v. City of Los Angeles*, 149 Cal. App. 3d 690, 197 Cal. Rptr. 149 (1983).

74. See, e.g., Ellickson, *supra* note 44, at 1212-13; Williams, *Planning Law In the 1980's: What Do We Know About It?*, 7 VERMONT L. REV. 205, 228 (1982).

the share of the overall need that is contributed by this particular development.⁷⁵ The second part of the test requires that the funds or property exacted from the developer be earmarked to be used in a way that provides some degree of "benefit" to the development from which the exaction was received.⁷⁶ When the exaction relates to traditional public services and facilities usually provided to new residential development, the courts have generally accepted the proposition that the new development causes some need for new facilities such as streets, sewers, water, parks, and schools.⁷⁷ Where the exaction is for some more exotic service or facility, such as the geothermal well involved in *Parks*, the courts may conclude that no need exists and reject the validity of the exaction without going further.⁷⁸

If some need is found, however, the court proceeds to analyze the relationship between the amount of the exaction and the share of the overall need contributed by the particular development. Using this analysis, recent court decisions have tended to scrutinize closely one commonly-practiced type of development exaction: the demand that developers contribute right-of-way for major thoroughfares adjoining their developments. Thus, where the government seeks to build or widen a major highway through a developing area and the landowners are asked to contribute the right-of-way as a condition to receiving development approval, the courts are increasingly willing to measure the share of total traffic to be carried by the highway that is to be contributed by the proposed development. If there is not some reasonable degree of proportionality between the amount of land exacted for the

75. See, e.g., *Billings Properties Inc. v. Yellowstone County*, 144 Mont. 25, 30-31, 394 P.2d 182, 187-88 (1964); *Associated Home Builders of Greater East Bay Inc. v. City of Walnut Creek*, 4 Cal. 3d 633, 484 P.2d 606, 94 Cal. Rptr. 630 (1971); *Call v. City of West Jordan*, 606 P.2d 217 (Utah 1979); *Jordan v. Village of Menomonee Falls*, 28 Wis. 2d 602, 137 N.W.2d 442 (1965).

76. *Hayes v. City of Albany*, 7 Or. App. 277, 280, 490 P.2d 1018, 1020 (1971); *City of College Station v. Turtle Rock Corp.*, 680 S.W.2d 802 (Tex. 1984); *Contractors and Builders Ass'n v. City of Dunedin*, 329 So. 2d 314 (Fla. 1976); *Call v. City of West Jordan*, 606 P.2d 217, 220 (Utah 1979); *Coulter v. City of Rawlins*, 662 P.2d 888, 900 (Wyo. 1983). See Juergensmeyer & Blake, *Impact Fees: An Answer To Local Governments' Capital Funding Dilemma*, 9 FLA. ST. U.L. REV. 415, 432 (1981).

77. *City of West Jordan*, 606 P.2d at 217; *Billings Properties, Inc.*, 144 Mont. at 25, 394 P.2d at 182; *City of Dunedin*, 329 So. 2d at 314.

78. For background on the planning implications of geothermal energy, and in particular the resources of Klamath Falls, see Pasqualetti, *The Site Specific Nature of Geothermal Energy: The Primary Role of Land Use Planning in Nonelectric Development*, 23 NAT. RESOURCES J. 795, 802-03 (1983).

highway and the share of the traffic demand contributed by the proposed development the courts will invalidate the exaction.⁷⁹ One court recently adopted a rule-of-thumb that developers may be asked to contribute land for highways transecting their development but not for highways on the fringes thereof, a test which would hardly withstand rigorous economic analysis but may bear some common-sense relationship to the type of distinction the court is seeking to draw.⁸⁰

Although the demand for proportionality has resulted in the invalidation of some exactions, the widespread use of the rational nexus test as a means of evaluating all exactions has broadened the scope of facilities and services for which exactions can be used. Instead of applying a particular rule for streets and another rule for parks, courts have effectively held that an exaction can be levied for any service or facility for which a proportional share of need can be proven.⁸¹ This broadening of the scope of exactions plays an important role in the development of linkage programs.

As the second part of the rational nexus test, the courts have been insisting that the local government demonstrate that the exacted funds or property will actually be used for the benefit of the development. In a recent case the Supreme Court of Arkansas declined to enforce an exaction for parks because the local government had not demonstrated that it had a plan to spend the funds. The Court, therefore, could not ascertain whether the funds would be spent for the benefit of the development.⁸² Similarly, a Florida court approved an exaction for parks only after examining extensive evidence demonstrating that the funds would be allocated in a manner that would provide a reasonably proportional degree of benefit to all persons contributing to the fund.⁸³

The test described above is a rough generalization which ignores nuances of state law even in those states that seem to conform to the rational nexus test—not to mention the peculiar legal rules that still may be applicable elsewhere. It is worthwhile, therefore, to look individually at a few states. Texas, Utah and Florida are each rapidly

79. *Land/Vest Properties, Inc. v. Town of Plainfield*, 117 N.H. 817, 821, 379 A.2d 200, 204 (1977).

80. *Cupp v. Bd. of Supervisors of Fairfax County*, ___ Va. ___, 318 S.E.2d 407, 414-15 (1984). See *Howard County v. JJM Inc.*, ___ Md. ___, 482 A.2d 908, 920-21 (1984).

81. *Juergensmeyer & Blake*, *supra* note 76, at 419.

82. *City of Fayetteville v. IBI, Inc.*, 280 Ark. 484, 659 S.W.2d 505 (1983).

83. *Hollywood Inc. v. Broward County*, 431 So.2d 606, 612 (Fla. 4th Dist. Ct. App. 1983).

growing Sun Belt states in which there have been a number of significant development exaction decisions in the last three years.

An intermediate Texas court of appeals attracted national attention in 1980 when it held that "parks are not necessarily beneficial to a community or neighborhood" and therefore struck down as invalid on its face an ordinance imposing an exaction for parks.⁸⁴ The case apparently eventually attracted the attention of the Supreme Court of Texas because, when in 1984 the court of appeals issued another similar opinion, the Supreme Court of Texas granted a writ of error and reversed the court of appeals.⁸⁵

In its opinion the Texas Supreme Court upheld the general principle of development exactions and announced that it would use the rational nexus test in evaluating them. It remanded the case to the trial court to allow the developer to present evidence that the exaction created a disproportionate burden on its particular development. The court set out guidelines for the trial court in making that determination, saying that the developer must demonstrate that there is no reasonable connection between the increased population arising from the development and the increased park and recreational needs of the neighborhood.⁸⁶ In addition, the trial court was instructed to consider the benefit to the subdivision from the exactions in order to constrain the reach of the municipality and ensure that the subdivision receives relief from a perceived need. The court noted that "unless the court considers the benefit, a city could, with monetary exactions, place a park so far from the particular subdivision that the residents receive no benefit,"⁸⁷ citing as examples of the type of evidence that the trial court may consider "size of lots in the subdivision, the economic impact on the subdivision," and "the amount of open land consumed by the development."⁸⁸

The Utah Supreme Court has recently gone even further in analyzing the factors that should be considered in evaluating the validity of a development exaction. In *Banberry Development Corp. v. South Jordan City*,⁸⁹ the court stated that the total depreciated value of the existing capital system for providing the particular service or facility

84. *Berg Dev. Co. v. City of Missouri City*, 603 S.W.2d 273 (Tex. Civ. App. 1980).

85. *City of College Station v. Turtle Rock Corp.*, 680 S.W.2d 802 (Tex. 1984), *rev'g* 666 S.W.2d 318 (Tex. Ct. App.).

86. *City of College Station*, 680 S.W.2d at 806-07.

87. *Id.* at 807.

88. *Id.*

89. 631 P.2d 899 (Utah 1981).

should be the starting point in determining the validity of any exaction, whether for a centralized facility like a sewage treatment plant or for dispersed facilities like parks.⁹⁰ The exaction must bear some relationship to the size of the new development as a proportion of all developments served by the facilities, except that "extraordinary costs in serving the new development" may also be considered.⁹¹ In a subsequent opinion the court emphasized that the methods of financing the existing capital facilities needed to be examined to ensure that new development would be credited with any other contributions that they would be making to the cost of the services or facilities, such as through tax revenue user charges or other payments collected from the entire municipality (including the new development).⁹²

The Florida courts have also recently decided a series of important cases relating to development exactions. The Florida courts have adopted a rational nexus standard akin to that used now in the majority of states and have made it clear that they will examine the evidence in some detail to determine whether an appropriate nexus exists. A 1976 Florida Supreme Court decision involving a fee for a proportional share of the capital expansion costs of a sewage treatment plan, *Contractors and Builders Association of Pinellas County v. City of Dunedin*,⁹³ and a subsequent district court decision on remand,⁹⁴ set forth the tests that have subsequently been applied to uphold the validity of impact fees of Florida.⁹⁵

In *Dunedin*, the city ordinance imposing an impact fee of \$325 per dwelling unit for water facilities and \$375 per dwelling unit for sewer facilities was challenged as an ultra vires attempt by the city to tax. In upholding the concept of impact fees, the Florida Supreme Court made clear that local government may require a new user of public facilities to pay a fair share of the costs imposed by new use of the system. More specifically, the Supreme Court established three standards for a valid impact fee ordinance:

1. New development must require that the present system of pub-

90. *Id.*

91. *Id.* at 904.

92. *Lafferty v. Payson City*, 642 P.2d 376, 379 (Utah 1982); *Banberry Dev. Corp.*, 642 P.2d at 904.

93. 329 So. 2d 314 (Fla. 1976).

94. *Contractors and Builders Ass'n of Pinellas County v. City of Dunedin*, 358 So. 2d 846 (Fla. 2d Dist. Ct. App. 1978).

95. See generally J. JUERGENSMEYER & J. WADLEY, *FLORIDA LAND USE RESTRICTIONS* ch. 17 (1984).

lic facilities be expanded;

2. The fees imposed on users must be no more than what the local government unit would incur in accommodating the new users of the system; and

3. The fees must be expressly earmarked for the purposes for which they were charged.⁹⁶

The Supreme Court rejected older Florida cases, which had used a standard more appropriate to special assessments, by authorizing an impact fee for a proportionate share of public facilities that benefitted the public generally. Three district court of appeal opinions handed down in 1983 extended the permissible uses of local government impact fees and more clearly established the tests under which local impact fees in Florida will be held valid.

*Hollywood, Inc. v. Broward County*⁹⁷ involved a fee required to be paid to the county as a condition of plat approval, to be used for the capital costs of expanding the county-wide park system. Under the challenged ordinance, a subdivider has the option (with the agreement of the county) of dedicating land, a fee-in-lieu of land which otherwise would be dedicated, or a fee determined by a schedule based on the number and size of dwelling units to be built.

Under the standards established by *Dunedin*, the court found the ordinance to be a valid exercise of the police power. Impact fees or dedication requirements are permissible, the court found, if they show a "reasonable connection" or "rational nexus" in two ways: (1) the fees offset needs sufficiently attributable to the growth in population generated by the subdivision, and (2) the funds collected are sufficiently earmarked for the substantial benefit of the subdivision residents. By adhering to these two tests, "local governments can shift to new residents the reasonable capital costs incurred on their account."⁹⁸

*Town of Longboat Key v. Lands End, Ltd.*⁹⁹ involved an ordinance requiring developers to deed land or pay a fee before final approval of development plans for the purpose of acquiring open space and park land. The Second District Court of Appeal remanded the case to the trial court to apply the tests established in *Hollywood, Inc.* The court specifically stated that the fees must be shown to offset, but not exceed,

96. *City of Dunedin*, 329 So. 2d at 317-18 (1976).

97. 431 So. 2d 606 (Fla. 4th Dist. Ct. App.), *petition for review denied*, 440 So. 2d 352 (Fla. 1983).

98. *Id.* at 611.

99. 433 So. 2d 574 (Fla. 2d Dist. Ct. App. 1983).

reasonable needs attributable to the new subdivision residents, and must be adequately earmarked for capital assets that will sufficiently benefit the new residents.¹⁰⁰

*Home Builders and Contractors Ass'n. of Palm Beach County v. Board of Palm Beach County Commissioners*¹⁰¹ was decided seven months after *Hollywood, Inc.* In this case the Fourth District upheld an impact fee for road improvements. The Palm Beach ordinance required new land development activity generating road traffic (including residential, commercial and industrial uses) to pay a fair share of the cost of expanding new roads attributable to the new development. The developer could pay according to a formula based on the costs of road construction and the number of motor vehicle trips generated by different types of land use. Alternatively, a developer could submit his own study of his fair share of the road costs. Funds collected were placed in a trust fund for expenditure in one of forty zones established throughout the county in which the development is located.

The court found that the draftsmen of the Palm Beach County ordinance had "*Dunedin's* lessons in mind." The court adopted the principles set forth in the leading article by Juergensmeyer and Blake, and stated that it saw no reason why the same principles should not apply to roads.¹⁰² The court held that the improvements paid for by the ordinance need not be used exclusively or overwhelmingly for those who pay so long as they bear a reasonable relationship to the needs created by the subdivision. The Palm Beach County expenditure zone system met this test.¹⁰³

The validity of the fees, as recognized by Florida cases, is judged by methods of assessment and expenditure. The local government must demonstrate that the need for the fee is created by new growth (and the fee does not exceed the cost of the new growth) and that the funds collected are earmarked for the benefit of the new residents who pay. At the same time, the courts have accepted the use of a generalized methodology to meet these tests. For example, the Palm Beach County

100. *Id.* at 576 (case settled prior to a new trial).

101. 446 So. 2d 140 (Fla. 4th Dist. Ct. App. 1983).

102. *Id.* at 145 (quoting Juergensmeyer & Blake, *supra* note 76, at 440-41). The Florida Supreme Court had earlier held that both sewage treatment and county roads had countywide benefit for the purpose of interpreting a state constitutional provision allowing counties to use property taxes from incorporated areas only for services and facilities of countywide benefit. *See City of St. Petersburg v. Briley, Wild & Assoc.*, 239 So.2d 817 (Fla. 1970); *Burke v. Charlotte County*, 286 So. 2d 199 (Fla. 1973).

103. *Home Builders*, 446 So.2d at 145.

zone system was sufficient, as was the Broward County proof of park usage patterns, to show that new residents would be sufficiently benefited by the fees.

The Florida legislature has reinforced these court decisions with new legislation encouraging local governments to use development exactions to meet local facility needs. Local governments that seek to attract major developments will be required to exact from each new development its proportionate share of all facilities needed "to accomodate any impacts having a rational nexus" to the development.¹⁰⁴ Failure to impose such requirements on all developers will prevent local governments from approving developments of regional impact unless either the developer or the local government remedy all impacts themselves¹⁰⁵ — a condition unlikely to be feasible if major facilities are involved.

Texas, Utah and Florida have grown more rapidly between 1980 and 1983 than any other state having a population over one million.¹⁰⁶ Each of these states has recognized that development exactions can be a valid and effective means of coping with that growth, but that judicial supervision is needed to ensure that exactions remain within reasonable limits. The courts of these states have followed the modern trend of limiting exactions not by any arbitrary rules regarding the nature of the facilities or the type of development, but by requiring a showing that the exaction is proportionate to the share of need for new facilities created by the new development.

VII. The Nexus of Linkage

How will linkage programs fare under the more rigorous analysis required by the evolving test of rational nexus? Those local governments that merely see the development industry as a deep pocket for general government program are likely to be disappointed. But local governments which carefully analyze the development process and limit their demands to those that can be justified by that analysis should be able to expand exactions beyond their traditional usage for streets, sewers and parks to include housing-related programs. In determining whether the rationale of the exactions cases will support linkage pro-

104. FLA. STAT. § 380.06(15)(e)(1) (1985).

105. FLA. STAT. § 380.06(15)(e)(2) (1985).

106. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES (1985).

grams, it is first necessary to determine whether housing is for some reason an inappropriate public program for which an exaction may be levied. If not, the linkage programs need to be tested against the traditional nexus methodology.

Modern courts have suggested few limitations on the range of public facilities and services for which exactions may be used. The separate line of cases regarding parks, street and utilities have now fused into a single theory applied to all public services and facilities.¹⁰⁷ Although some types of public service, such as police and fire protection, are much less capital-intensive than streets and parks, and thus tend to generate only modest exactions, the capital component of even such "diffuse" services can be analyzed under the rational nexus test.¹⁰⁸ In any event, housing is as capital-intensive as the programs for which exactions have traditionally been used. Therefore, the underlying rational nexus theory itself poses no limitations on the range of public facilities and services to which it can be applied.

Even though the methodology can be applied, it can be argued that public policy or specific constitutional guarantees should limit the use of exactions for certain types of facilities. For example, some services such as police and fire protection are so basic or essential to public safety that too precise an apportionment of their cost might detract from a uniform commitment to protection.¹⁰⁹ Other services such as public education have traditionally been "free" to the users and state constitutional guarantees of free education may affect the validity of any fee or user charge for education.¹¹⁰ It is clear, however, that there is no similar right to housing under the federal constitution¹¹¹ or under the constitutions of states other than New Jersey.¹¹² Thus a constitu-

107. Exactions cases originated in separate lines involving subdivision exactions and utility charges, but modern courts now regularly apply the same principles to both areas. *See, e.g., Billings Properties, Inc.*, 144 Mont. at 30-31, 394 P.2d at 187-88; *Lafferty*, 642 P.2d at 379; *Town of Longboat Key*, 433 So. 2d at 574.

108. In dicta the California Supreme Court has questioned whether exactions should be used to finance "the more general or diffuse need created for such areawide services as fire and police protection." *Associated Homebuilders of Greater East Bay, Inc.*, 4 Cal. 3d at 633, 484 P.2d at 606, 94 Cal. Rptr. at 630.

109. *See Emerson College v. City of Boston*, ___ Mass. ___, 462 N.E. 2d 1098, 1106 (1984).

110. *See, e.g., FLA. CONST. art. IX, § 1* ("Adequate provision shall be made by law for a uniform system of free public schools. . .").

111. J. NOVAK, R. ROTUNDA & J. N. YOUNG, *CONSTITUTIONAL LAW* 825-26 (1983).

112. The New Jersey Constitution has been interpreted to require local govern-

tional claim based on a right to have new housing constructed seems to have little chance of success.

Could it be argued that public policy requires that low-income housing be constructed with funds derived from general revenue sources? Public construction of housing for the poor is so recent a phenomenon that no such tradition exists. Some commentators suggest, in fact, that it is bad policy for the government to construct subsidized housing at all, arguing that such subsidies reduce the mobility that lower income families need in order to follow job opportunities.¹¹³ The federal government is currently instituting a housing voucher program based on this rationale.¹¹⁴ But state and local governments, with federal support, continue to subsidize housing through such programs as mortgage revenue bonds, which increasingly benefit the middle range of the market as well as the lower range.¹¹⁵ Even the strongest opponents of the policy behind such housing programs would be unlikely to claim that they exceed government powers.¹¹⁶ Given the wide range of sources from which housing is subsidized there seems to be no policy reason why exactions could not be used as another source.

On balance, although one may question the wisdom of subsidizing housing construction through linkage programs, the fact that the output is housing does not present any compelling legal reason why the tests used to evaluate other development exactions may not be applied to such programs.

ments to undertake "affirmative measures" to meet lower income housing needs. *Southern Burlington County NAACP v. Twp of Mt. Laurel*, 92 N.J. 158, 456 A.2d 390, 442 (1983). No other state seems to impose such a requirement. Although the California Supreme Court has expressed concern about the effect of land use controls on regional housing needs, *Associated Home Builders of Greater Eastbay, Inc. v. City of Livermore*, 4 Cal. 3d 633, 557 P.2d 473, 135 Cal. Rptr. 41 (1976), and the legislature of that state has mandated planning to meet housing needs. CALIFORNIA GOVERNMENT CODE §§ 65580 ff. (1983), the local governments of that state are under no real pressure to undertake affirmative measures to provide housing. See *Building Industry Ass'n of Southern California v. City of Camarillo*, 213 Cal. Rptr. 816 (1985). See also the New York judicial rhetoric most recently expressed in *Blitz v. Town of New Castle*, 463 N.Y.S. 2d 832 (1983).

113. See generally R. STRUYK & M. BENDICK, *HOUSING VOUCHERS FOR THE POOR: LESSONS FROM A NATIONAL EXPERIMENT* (1981).

114. 42 U.S.C. § 1437 f(o) (1984).

115. Peterson & Muller, *Housing Cost Reduction Through The Tax Exempt Market* in *HOUSING SUPPLY & AFFORDABILITY* 249, 251-53 (Urban Land Inst. 1983).

116. Ellickson, *Inclusionary Housing Programs: Another Misguided Urban Policy* (unpublished paper for CUNY Symposium, Nov. 14, 1983).

The extent to which exactions may be imposed for housing-related linkage programs should depend on the local government's ability to show (1) that there is a need for housing, (2) that the need is caused by new development, (3) that the exaction is proportional to the need caused, (4) that the exaction will be used to remedy the need, and (5) that the remedy will benefit the occupants of the new development.

Both Boston and San Francisco experience a high demand for housing, and few would argue that these cities meet any objective test for housing need.¹¹⁷ Other cities, however, may have a difficult time meeting such a test, particularly if they are experiencing a net outflow of population.¹¹⁸

Assuming that a need for housing exists, what is its cause? Proof of causation in the development process is no simple matter and can be the source of endless debate. The key issue is the determination of what causes a need for new housing. San Francisco and Boston both believe that the need for housing is stimulated by the new employment that results from the construction of new office buildings.¹¹⁹ This argument has been challenged at both tiers of its logic. Does the construction of office buildings create jobs? Do jobs create a need for housing?

San Francisco economist Claude Gruen argues that "additions to the supply of office space don't make office employment any more than cribs made babies."¹²⁰ Any private developer of speculative facilities,

117. See Griffin, Jr., *Inclusionary Housing and Linkage in Boston and Cambridge, Mass.* 12 (unpublished paper presented at Urban Land Institute conference on "Downtown Linkage," New York City, April 11, 1985); Gruen, *A Case History of the San Francisco Office-Housing Linkage Program 2-4* (unpublished paper presented at Urban Land Institute conference on "Downtown Linkage," New York City, April 11, 1985).

118. The Chicago planning department, in exploring the advantages and disadvantages of an exactions program, reported that between 1970 and 1980 the City of Chicago lost roughly 6,100 dwelling units per year to fire and demolition and gained 5034 units per year of new construction, for a net loss of 1066 units per year, while population declined at the rate of about 36,500 people per year. CITY OF CHICAGO DEPARTMENT OF PLANNING, *STAFF REPORT ON EXACTIONS 13-14* (June, 1985).

119. See Agnost, *Conditioning Approval of Commercial Development on the Construction of Affordable Housing — The San Francisco Experiment* (unpublished paper for the National Institute of Municipal Law Officers Conference, October 30, 1984).

120. Gruen, *The Economics of Requiring Office Space Development to Contribute to the Production and/or Rehabilitation of Housing*, 8 (unpublished paper presented at Urban Land Institute conference on "Downtown Linkage," New York City, April 11, 1985).

whether office or retail or housing, can argue that the facilities themselves do not create the demand — they are only responding to a demand caused by overall economic conditions. The argument is reminiscent of the slogan “guns don’t kill people, people kill people,” which suggests that an instrumentality is being forced unfairly to bear the blame that should be attached to the operator. The equivalent of the trigger-puller is the in-migrant. Is it the in-migrant who causes the impact? If so, should he or she bear the burden directly?

In a chain of causation it is always possible to argue that the preceding link should bear responsibility. An argument that development does not cause economic impact, however, would also undermine the public purpose behind such programs for subsidizing development as industrial revenue bonds and tax increment financing. Whatever philosophical merits this argument may or may not have, it has garnered little judicial support.¹²¹ The Supreme Court has exhibited increasing concern about discrimination against out-of-state residents, but has thus far restricted its concern to regulations having a direct rather than an indirect impact on outsiders.¹²² Should the court begin to examine the indirect effect of development financing methods on interstate migration it will be necessary to re-examine not only linkage programs but other well accepted types of user charges and development exactions.¹²³

If the argument that development creates new jobs is accepted, one reaches the issue of whether the new jobs create a need for new housing. The answer is not as simple as it appears. Jobs come and go in a never-ending stream as businesses open and close, expand and contract. The peculiar value of cities may stem from the very flexibility with which their job market can respond to constant change.¹²⁴ In such an environment, the addition of any new job does not necessarily mean that the net number of jobs is increased because the job may have been transferred from another location in the community. If the business is moving to promote efficiency in operation, on balance more jobs may have been lost than gained, which would suggest that future out-migra-

121. See, e.g., *Loup-Miller Constr. Co. v. City and County of Denver*, 676 P.2d 1170, 1173-75 (Colo. 1984); *J. W. Jones Co. v. City of San Diego*, 203 Cal. Rptr. at 588; *Home Builders*, 446 So. 2d at 144. See generally J. NOWACK, R. ROTUNDA & J. N. YOUNG, *supra* note 111, at 812-16.

122. See *supra* notes 64-66 and accompanying text.

123. See Juergensmeyer & Gregg, *Limiting Population Growth in Florida and the Nation: The Constitutional Issues*, 26 U. FLA. L. REV. 758, 778-83 (1974).

124. JACOBS, *THE ECONOMY OF CITIES* 91-100 (1969).

tion might cause a decline in housing demand.

Even if the total number of jobs does increase, the demand for housing does not necessarily increase along with it. A city's population is constantly changing through in-migration and out-migration, birth and death. Recent years have seen dramatic decreases in average household size, which has to some extent been accompanied by the splitting up of larger dwelling units.¹²⁵ The existing housing stock is constantly changing as people build additions or convert housing to non-residential use or vice versa. New housing units are built while others are demolished. Few large cities have trustworthy statistical measures that keep tract of such small-scale changes in the housing supply as conversions and abandonments.

The complexity of the housing market does not mean that a relationship between jobs and housing cannot be shown, but it does mean that a fairly sophisticated analysis will be needed to meet the emerging tests in states like Utah, Texas and Florida. Whether the office-housing linkage in cities like San Francisco or Boston would be able to pass the causation element of a modern rational nexus test will depend on whether the documentation by the planning department of the relationship between office development and the need for housing can survive the scrutiny of litigation.

The causal connection needed to justify inclusionary zoning programs — that new housing creates a need for new low income housing — is even less clear. Its proponents argue that if developers can be required to provide streets, sewers and other facilities needed to service their development they should also be required to provide housing for the workers who would be needed to operate these facilities and services? If a state accepts even the loosest causal connection as a basis for development exactions this argument may be satisfactory,¹²⁶ so it is

125. For example, the average household size in Chicago went from 2.91 people in 1970 to 2.70 people in 1980 and is projected to go to 2.15 people in 1990. CITY OF CHICAGO DEPT. OF PLANNING, *supra* note 118, at 13.

126. Fox & Davis, *Density Bonus Zoning to Provide Low and Moderate Cost Housing*, 3 HASTINGS CONST. L.Q. 1015, 1033 (1976); Kleven, *supra* note 36, at 1497-98; Hill, *Governmental Manipulation of Land Values to Build Affordable Housing: The Issue of Compensating Benefits*, 13 REAL ESTATE L.J. 3, 25-26 (1984). But see King, *Inclusionary Zoning: Unfair Response To the Need for Low Cost Housing* 4 W. NEW ENG. L. REV. 597, 615-28 (1982); Ellickson, *The Irony of Inclusionary Zoning*, 54 SO. CAL. L. REV. 1167 (1981); A. MALLACH, *supra* note 36, at 36-37; Costonis, *supra* note 61, at 489-90. The fact that a "bonus" is offered in connection with the exaction may be of some value in supporting its validity. See Willams, Jr., On the

not surprising to find that California is the site of many inclusionary zoning programs.¹²⁷ Other states might find it harder to accept the argument that new housing causes a need for jobs for lower income people.¹²⁸

If a causal relation between the development and the need for housing is established, the next step is to measure the proportional share of the need attributed to the particular development. Would the linkage programs in Boston and San Francisco meet a test of proportionality? Neither program explicitly credits the new development with any of the property tax or other revenue it will generate toward potential housing programs. On the other hand, the city may be able to argue that the exaction is so small in relation to the need that even with

Inclination of Developers to Help the Poor: Designing Affirmative Measures to Induce the Construction of Lower Income Housing after Mt. Laurel II 17-19 (unpublished paper for Nov. 14, 1983, CUNY Graduate School Symposium); Kleven, Inclusionary Zoning and the Nexus Issue 8-9 (unpublished paper, CUNY Graduate School Symposium, Nov. 14, 1983).

127. See S. SCHWARTZ & R. JOHNSTON, LOCAL GOVERNMENT INITIATIVES FOR AFFORDABLE HOUSING: AN EVALUATION OF INCLUSIONARY HOUSING PROGRAMS IN CALIFORNIA (Inst. of Governmental Affairs, Univ. of California at Davis, Environmental Quality Services No. 35, December, 1981). The inclusionary program in Orange County, California, has been frequently cited as an effective one. See Burton, *California Legislature Prohibits Exclusionary Zoning, Mandates Fair Share*, SAN FERN. VALLEY L. REV. 19, 34-37 (1981); Bozung, *A Positive Response to Growth Control Plans: The Orange County Inclusionary Housing Program*, 9 PEPPERDINE L. REV. 819 (1982). In 1983, however, the county board voted to phase out the program. See R. ELICKSON & A. TARLOCK, *supra* note 8, at 141 (Supp. 1984), A. MALLACH, *supra* note 36, at 251.

128. See Costonis, *supra* note 61, at 489-91; Ellickson, *supra* note 44, at 1212; Tegeler, *supra* note 45, at 694. Some states, however, have justified inclusionary programs not as an exaction but as an attempt to control the price of housing through establishment of zoning criteria. Under this theory, the requirement that a certain share of the housing be for low and moderate income people is merely a "criterion" of the zoning, just like a requirement that the housing be set back fifty feet from the street or less than fifty feet high. As the late Donald Hagman put it, if you could downzone a place so that birds could sing why couldn't you downzone it so that poor people could sing? Hagman, *supra* note 30, at 175. See Kleven, *supra* note 36, at 1502-06. The Supreme Court of New Jersey, relying on such a theory, explicitly upheld inclusionary zoning and encouraged its use by New Jersey municipalities. In the matter of Egg Harbor Associates, 94 N.J. 358, 365, 464 A.2d 1115, 1123 (1983); Southern Burlington County NAACP v. Mt. Laurel Two, 92 N.J. 158, 456 A.2d 390 (1983). See A. MALLACH, *supra* note 36, at 30-32, 226-33. For a discussion of the effect of the Mt. Laurel case on exactions in New Jersey see Rose, *New Additions to the Lexicon of Exclusionary Zoning Litigation*, 14 SETON HALL L. REV. 851, 874-76 (1984).

such credits the fee is not disproportionately high.

Finally, the earmarking test must be met. Whether the housing to be built by the San Francisco and Boston programs will mitigate the need for low-income housing, and do so in a way that benefits the developments that make the contributions, remains to be seen. In those states that demand strict assurance in advance on these issues, the programs of both cities may be excessively loose. A more cautiously designed linkage program would earmark the funds collected in a manner that guarantees that the funds are used to meet the identified need, and are used in accordance with an overall plan that ensures that the funds will be spent in a manner that benefits the developments from which they are collected. It should not be necessary to identify the specific capital project to which each dollar will be devoted, and the lawyer's desire for precise evidence of linkage will undoubtedly need to be balanced against the administrator's need for flexibility in the use of funds and the administrative costs associated with the required analysis. These costs can probably be reduced to the extent that the factors identified can be converted into data that can be automatically processed.

VIII. Conclusion

In summary, linkage programs should be required to meet the same tests that have evolved for measuring the validity of other forms of development exaction. Under those tests a housing program would probably be a legally acceptable candidate for an exaction process. The important factual question that remains to be evaluated is whether an appropriate method can be established to relate housing need to other types of development, and for assuring that housing will be built in a way that provides a reciprocal benefit to that development. Like other factual questions arising from a judicially-created standard, the answer can only be found through additional litigation.

Beyond these legal issues, however, important policy questions remain. Charitable giving, whether through the ancient tithe or more modern institutions, has been enforced through social pressures rather than legal constraints. Many of the same business institutions that have been relied on to provide support for housing programs through charitable gifts are now being required to support such programs through mandatory linkage programs. If the idea of a mandatory tithe becomes commonplace, it will remain to be seen whether our existing network of

charitable programs can co-exist effectively with a compulsory system having similar goals.

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Conflicts of Interest Arising Under ERISA's Fiduciary Standards: Can the Trustee Ever be Prudent, As Long As He Faces Dual Loyalties?

I. Introduction to the Conflict of Interest Problem

The drafters of the Employment Retirement Income Security Act¹ faced the formidable task of restructuring the regulation of private pension plans throughout America. It would be unreasonable to assume that all of the problems inherent to the pre-ERISA pension system would be resolved by the ERISA enactment and its 1976 amendments. While Congress did take great steps to establish uniform guidelines imposing fiduciary standards over the plan trustee,² it failed to curb all trustee misconduct.

This note centers on section 408(c)(3) of ERISA,³ a provision which permits corporate officers to act as trustees to ERISA pension plans. Because of the enactment of section 408(c)(3), the potential for conflicts of interest exists for corporate trustees whose loyalties are divided between the administration of the pension trust fund and the company's business interests. This problem will continue to expose ERISA pension plan assets to loss of funds at the hands of an officer/trustee, who because of his loyalty to his corporation disregards his duties to plan participants. Indeed, an original drafter of ERISA noted that "even now, despite ERISA, the temptation of parties-in-interest to attempt to manipulate the assets of Employee Pension Funds for their own personal or institutional advantage is very great, and especially great when funds for making capital investment or serving other corporate objectives are in short supply."⁴

1. Hereinafter referred to as ERISA.

2. See *infra* notes 23-51 and accompanying text.

3. ERISA § 408(c)(3), 29 U.S.C. § 1108(c)(3) (1982).

4. *Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Sub. Comm. on Labor of the Senate Comm. on Human Resources*, 97 Cong., 1 Sess. 846-54 (1982)(statement by Michael S. Gordon).

In fact, Congress was aware of numerous examples of "party-in-interest" corruption and abuse prior to ERISA. Accordingly, Michael S. Gordon, an original drafter of ERISA, recalled the following conflict of interest involving Genesco, Inc.:

In 1962 Genesco, Inc. used its employee pension fund to acquire Flag-

Section 404 of ERISA, the fiduciary standards section, represents one-half of the dual loyalty that the officer faces and this section commands him to disregard his obligations to the management of the corporation (the second half of his dual loyalty) and act in a prudent fashion to the pension plan.⁵ In application it is likely that section 408(c)(3) requires the officer/trustee to ignore corporate profit maximizing goals to better serve the ERISA trust participants.⁶ This artificial expectation asks the officer/trustee to exchange the proverbial activist derby worn by the corporate manager for the more conservative top hat belonging to Cardozo's prudent man.⁷ This role change from

Utica Corp., a knitwear manufacturing concern. Flagg-Utica wanted Genesco stock rather than cash for cash payment to its stockholders would have been taxable immediately. But rather than buy on the open market, Genesco dipped into the pension fund for 150,000 shares; it paid the fund \$5,250,000, or an average between the high and low Big Board quotes on the day chosen for the transaction. By buying the stock from its pension fund, Genesco probably saved money; if the company had bought so heavily on the stock exchange the market price per share probably would have climbed, increasing the cost of the purchase. And because management controlled the fund, Genesco kept control of the \$5,250,000; that sum remained available for further acquisitions. Subsequently, Genesco agreed with the SEC that it would restrict transactions in Genesco securities on behalf of its Employee Stock Bonus Trust and pension plan as well as restricting purchase by the Company from the stock bonus or pension plans during negotiations with other companies. Again, the IRS never sought to challenge the tax-exempt basis of the Genesco pension funds on the basis of the prohibited transaction rules in the IRS tax regulations that then existed. Subsequently, hearings before this Subcommittee disclosed that Genesco had used pension fund assets to finance similar corporate acquisitions, involving complex real estate leaseback transactions. Ultimately, some of these transactions resulted in serious losses to the plan.

Id. at 853, citing *Private Welfare and Pension Plan Study*, 1971, Part II, Hearings Before the Subcommittee on Labor of the U.S. Senate Committee on Labor and Public Welfare, 92d Cong., 1st Sess., at 599 *et seq.*

5. ERISA § 404, 29 U.S.C. § 1104 (1982).

6. With primary emphasis on a profit maximization goal, the aspiring corporate officer may take actions and make decisions in a manner that would be judged imprudent under § 404 ERISA, 29 U.S.C. § 1104. *See generally* R. BREALEY AND S. MEYERS, *Principles of Corporate Finance* 637-47 (1981).

7. *See* S. REP. NO. 93-127 93d Cong., 2d Sess. 3, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84. Judge Mishler, in *Donovan v. Bierwith*, 538 F. Supp. 463, 470 (E.D.N.Y. 1981), *modified*, 680 F.2d 263 (2d Cir. 1982), *cert. denied*, 459 U.S. 1069 (1982)(quoting Chief Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458, 164 N.E. 545 (1928)), observed:

[M]any forms of conduct permissible in a work a day world for those act-

corporate officer to the prudent trustee cannot reasonably occur without traces of corporate profit maximizing goals impacting upon each investment decision by the officer/trustee. A conflict of interest occurs when the officer/trustee succumbs to prudent corporate investment decisions that are deemed imprudent under ERISA. This note examines this dual loyalty problem.⁸ First, this discussion concerns the historical background to ERISA's fiduciary standards section. Second, the focus centers on the fiduciary standard section. Third, the discussion of the dual loyalty problem turns to common business conditions that create conflict of interest. Fourth, in contrast to the dual loyalty problem, the note examines a standard of review that gauges an officer/trustee's administrative decisions. After a consideration of this standard, the study reviews the potential for inadequate compensation to plan participants resulting from fiduciary breach. Finally, this note advocates the repeal

ing at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. 'Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.' As to this there has been a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions.

Id.

8. The cases discussed in this note involve two types of ERISA pension plans: (1) the profit sharing plan and (2) the Employee Stock Ownership Plan (ESOP or Qualified Pension Plan). The court in *Durkee v. Welch*, 49 F.2d 339, 341 (S.D. Cal. 1931), defines a profit sharing plan as follows:

Profit sharing ordinarily signifies the participation of employees with their employer in a given share of the profits of an enterprise by reason of their labor and not by reason of their capital investment therein. . . . The general understanding of a profit-sharing arrangement between employers and workers is that the worker shall share in the earnings and profits of his employer, but is not accountable or liable for losses or deficits in the business, and there is also, generally, present in profit-sharing transactions the element of contribution by the employer to the project.

Id.

See the definition of an ESOP in I.R.C. § 4975(e)(7) (1985), which provides for "a qualified stock bonus plan, or a combination stock bonus plan/money purchase pension plan, that invests in 'qualified employer securities.'" See generally, 29 CFR § 2550.407d-6(1)(1984). All of the examples of fiduciary breach in the following cases concern an officer/trustees' investment in equity securities, as opposed to debt instruments. While it is possible for an officer/trustee to invest in certain debentures, that investment is subject to the Internal Revenue Code's standards set forth in sections 503(e) and 4975(e)(8). Therefore, this note will not discuss the prudence of an officer/trustee's decision to invest in a debt instrument.

of section 408(c)(3) by Congress, and its substitution with a two-tiered investment counseling requirement based on a formula that considers the number of employees and the total assets in the plan.⁹

II. Historical Background to ERISA's Fiduciary Standards Section

Congress passed ERISA in response to years of abuse in the area of private pension and welfare plans.¹⁰ The Act's fiduciary standards section made "applicable the law of trusts . . . [and] established uniform fiduciary standards which prevent transactions that dissipate or endanger plan assets, and provide effective remedies for breaches of trust."¹¹ Historically, misconduct by trustees in the administration of pension trusts often resulted in the dissipation of plan assets.¹² Based on the amount of asset dissipation, the plans lost their tax exempt status, and the I.R.S. imposed penalties which were felt most severely by plan participants and beneficiaries who found their distributions diminished by an even greater tax burden.¹³ In some cases, the entire retirement benefit dissipated as a result of trustee mismanagement.¹⁴ Prior to the enactment of ERISA, Congress had examined these problems associated with the administration of private pension funds.¹⁵ In an attempt to ameliorate these problems, Congress enacted the Welfare and Pension Disclosure Act in 1958,¹⁶ and enacted the Labor Management Reporting Act (Landrum-Griffin Act) in 1959.¹⁷ Both acts failed to provide adequate legislative regulation over a pension trustee's fiduciary responsibility to plan participants and their beneficiaries' assets.¹⁸ In-

9. See *infra* note 169.

10. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

11. *Id.*

12. 19B *Business Organizations*, S. Young, Pension and Profit Sharing Plans § 17.01[1].

13. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4642-43.

14. See *supra* n.12.

15. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4640-41.

16. Priv. L. No. 85-836, 72 Stat. 997 (1958) amended by Priv. L. No. 87-420, 76 Stat. 35 (1962).

17. Priv. L. No. 86-257, 73 Stat. 519 (1959).

18. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4642-43.

stead of direct fiduciary regulation, Congress left the door open for courts to develop common-law trust principles that would constitute the standards by which a plan trustee would be held responsible to pension participants and their beneficiaries.¹⁹

The drafters of ERISA understood that more precise and stricter fiduciary standards were necessary to safeguard qualified pension fund assets.²⁰ Therefore, in 1974, the drafters succeeded in persuading Congress to recognize that neither the individual states nor the federal government safeguarded employee benefit plan assets from such abuses as self-dealing, imprudent investing and misappropriation of plan funds.²¹ With these policy interests in mind, Congress approved the fiduciary standard section of ERISA, and enacted a uniform standard for trustees in the specialized field of employee benefit plans.²²

III. The Fiduciary Standards Section and Codified Exceptions

As private pension plans grew in popularity, Congress recognized the need to regulate a trustee's fiduciary relationship to plan participants.²³ Section 404,²⁴ the ERISA fiduciary standards section, signifies Congress' policy concerns towards curbing runaway trustee mismanagement and misconduct.²⁵ This section requires that every duty carried out by a plan trustee must be "performed with respect to a plan *solely in the interest* of the plan participants and for the exclusive purpose of (i) providing benefits to the participants and beneficiaries; and (ii) defraying reasonable expenses of administering the plan."²⁶ The drafters of ERISA designed this fiduciary standard section based on a

19. See *Freund v. Marshall & Ilsley Bank*, 485 F. Supp. 629, 635 (W.D. Wis. 1979). See also S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

20. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4680-841, 5073-84.

21. *Id.* at 4839-43.

22. *Marshall v. Teamsters Local 282 Pension Trust*, 458 F. Supp. 986, 990-92 (E.D.N.Y. 1978).

23. See, S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84.

24. See *Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Sub. Comm. on Labor of the Senate Comm. on Human Resources*, 97 Cong., 1 Sess. 846-54 (1982)(statement by Michael S. Gordon).

25. See S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 4680-841, 5073-84.

26. ERISA § 404, 29 U.S.C. § 1104 (1982).

model that combines the prudent man rule established of common-law trust and a modern supplement to common-law trust, the diversification rule.²⁷

A. Ambiguity Surrounding the Prudent Man Rule and Diversification Requirement

The court in *Harvard College v. Armory*,²⁸ established the common-law standard that now exists in codified form as the prudent man rule. This rule provides that a trustee:

shall conduct himself faithfully and exercise a sound discretion. . . . [H]e is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.²⁹

Congress modified this common-law standard when it enacted its statutory form in section 404(a)(1)(B) of ERISA. Accordingly, an ERISA plan fiduciary must discharge his investment duties: "with the care, skill and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."³⁰

27. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, reprinted in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5084-85.

28. 26 Mass. (9 Pick.) 446 (1830) (excusing trustee from liability for investing in trade company stock).

29. *Id.* at 461.

30. ERISA § 404(a)(1)(b), 29 U.S.C. § 1104(a)(1)(B) (1982). Section 1104 dealing with ERISA's Fiduciary Standards provides:

(a)(1) Subject to sections 1103(c) and (d), 13423, and 1344 of this title, a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and —

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the

The ERISA plan officer/trustee, abiding by the prudent man rule, must make investments consonant to the stated security level of the trust.³¹ Often, courts look beyond the success of an investment when judging whether a trustee has violated the prudent man rule.³² These courts recognize that "safety in income and principal are usually primary objectives to a qualified pension trust fund . . . [and] . . . a prudent investor will not be solely concerned with capital growth."³³ The courts note that even though a trustee has not lost money on an investment, and in fact has received an "extraordinary" return, that does not preclude a cause of action against the trustee for improperly risking

risk of large losses, *unless* under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan *insofar as such documents and instruments are consistent* with the provisions of this subchapter.

(2) In the case of an *eligible individual account plan* (as defined in section 1107(d)(3) of this title), the diversification requirement of paragraph (1)(C) and the prudence requirement (only to the event that it requires diversification) of paragraph (1)(B) is not violated by *acquisition or holding of qualifying employer real property* or qualifying employer securities (as defined in section 1107(d)(4) and (5) of this title).

(b) Except as authorized by the Secretary by regulations, no fiduciary may maintain the indicia of ownership of any assets of a plan outside the jurisdiction of the district courts of the United States.

(c) In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary to exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) —

(1) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and

(2) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by reason of any breach, which results from such participant's or beneficiary's exercise of control.

ERISA § 404, 29 U.S.C. § 1104 (1982) (emphasis added).

31. G. BOGERT, *Law of Trusts* § 106, at 388 (1973).

32. See *Marshall v. Glass/Metal Ass'n & Glaziers*, 507 F. Supp. 378, 384 (D. Hawaii 1980). "The application of ERISA's prudence standard does not depend upon the ultimate outcome of an investment, but upon the prudence of the fiduciaries under the circumstances prevailing when they make their decision and in light of the alternatives available to them." *But see American Com. Ass'n v. Retirement Plan*, 488 F. Supp. 479, 483 (S.D.N.Y. 1980), "The mere fact that there may have been a decline in the value of the Plan's portfolio or a diminution of income in a given year does not by itself establish imprudent management."

33. A. SCOTT, *The Law of Trusts* § 227.1 (3d ed. 1967 & 1982 Supp.).

pension trust assets.³⁴ However, the prudent man rule, as it stands in ERISA's fiduciary standard section, provides little help to the officer/trustee faced with business conditions that dictate a managerial decision directly opposite to that officer's responsibilities as a trustee. Added to the problems facing the officer/trustee are the requirements of the diversification rule.

Unfortunately, the diversification rule fails to alleviate the dilemma faced by the officer/trustee in complying with the prudent man rule. In pertinent part, the requirement to diversify provides that a plan trustee must "diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."³⁵ Ostensibly, the requirement to diversify is an attempt by Congress to harness the discretion of the plan trustee who is making investment decisions over the assets in the ERISA plan. Interpreting Congress' intent as enacted in the fiduciary standards section of ERISA, the courts have been unable to produce uniform authority that would clarify the ambiguity surrounding the requirement to diversify.³⁶

Although case precedent lacks uniformity in this area, the requirement to diversify remains the best strategy for prudent maintenance of the trust corpus.³⁷ Theoretically, the officer/trustee should aim to diversify its investment portfolio at a riskless posture, such that high growth and risky potential investments may be offset by low growth

34. See *supra* note 31.

35. ERISA § 404(a)(1)(C), 29 U.S.C. § 1104(a)(1)(C) (1982).

36. The Court in *Marshall v. Teamsters*, 458 F. Supp. at 986, determined that: In some jurisdictions, lack of diversification is a per se breach of the trustees' investment duty of prudence; in others it is not. Section 404(a)(1)(c) requires diversification under circumstances where commitment of a high percentage of the assets of a plan to a particular investment or class of investments casts doubt on the prudence of the investments.

Teamsters, 458 F. Supp. at 990 (citations omitted).

Compare this finding with the rationale of the court in *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, ___ U.S. ___, 103 S. Ct. 1498 (1983):

The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information. The entrepreneur's function is to encounter risks and to confront uncertainty, and a reasoned decision at the time made may seem a wild hunch viewed years later against a background of perfect knowledge.

Id.

37. See generally Markowitz, *Portfolio Selection*, 7 JOURNAL OF FINANCE 77-91. H. MARKOWITZ, *Efficient Diversification of Investments*, (1952). F. REILLEY, INVESTMENTS, 633-54 (1982).

and low risk investments to create a well-balanced base.³⁸ The courts,

38. See F. REILLEY, INVESTMENTS 559-77 (1982).

Markowitz showed that the variance of the [investments] rate of return was a meaningful measure of risk under a reasonable set of assumptions and derived the formulas for computing the variance of the portfolio. . . . The Markowitz model is based on several assumptions regarding investor behavior:

(1) Investors consider each investment alternative as being represented by a probability distribution of expected returns over some holding period.

(2) Investors maximize one-period expected utility and possess utility curves that demonstrate diminishing marginal utility of wealth.

(3) Individuals estimate risk on the basis of the variability of expected returns.

(4) Investors base decisions solely on expected return and risk; ie their utility curves are a function of expected return an variance (or standard deviation) of returns only.

(5) For a given risk level, investors prefer higher returns to lower returns. Similarly, for a given level of expected return, investors prefer less risk to more risk.

Id. at 559. Consider the following computation of the expected return for an individual risky asset and the computation of the expected return of a portfolio.

<u>Probability</u>	<u>Potential Return (P_i)(%)</u>	<u>Expected Return (%)</u>
.25	.08	.0200
.25	.10	.0250
.25	.12	.0300
.25	.14	.0350
		<u>E(R) = .1100</u>
<u>Weight (W_i) (% of the portfolio)</u>	<u>Expected Return (R_i)</u>	<u>Expected Portfolio Return (W_i × R_i)</u>
.20	.10	.0200
.30	.11	.0330
.30	.12	.0360
.20	.13	.0260
		<u>.1150</u>

$$E(R_{\text{portfolio}}) = \sum_{i=1} W_i R_i$$

$$\text{Variance } (\sigma^2) = \sum_{i=1} [R_i - E(R_i)]^2 P_i$$

R_i = possible (individual investment) rates of return

W_i = weight (%) of the investment to the total portfolio

E(R_i) = expected rate of return (per individual investment)

P_i = probability of the possible rate of return

however, apply the ERISA diversification requirement on an investment-by-investment basis,³⁹ which prevents plan trustees from pursuing progressive portfolio management strategies that could ultimately provide greater return to the plan participant at the same low risk level.⁴⁰ Instead of looking at the rate of return earned after the particular investment progresses, courts assess diversification and prudence under prevailing circumstances taken into account when the investment deci-

An envelope curve may be derived and plotted as the result of various combinations of assets and portfolios (given the portfolio expected return and standard deviations of each combination). "The envelope curve that contains the best of all combinations is referred to as the efficient frontier. Specifically, *the efficient frontier is that set of portfolios that has the maximum return for every given level of risk or the minimum risk for every level of return.*"

Id. at 577 (emphasis supplied).

39. The Markowitz portfolio theory considers the aggregate risk factor of the portfolio as a measure of the investment manager's performance. Thus, this theory is not based upon an investment-by-investment analysis. Markowitz, *supra* note 37, at 77-91.

40. *Id.* See the example set forth in *Joy*.

Shareholders can reduce the volatility of risk by diversifying their holdings. In the case of the diversified shareholder, the seemingly more risky alternatives may well be the best choice since great losses in some stocks will over time be offset by even greater gains in others:

INVESTMENT A

Estimated Probability of Outcome	Outcome Profit or Loss	Value
.4	+ 15	6.0
.4	+ 1	.4
.2	-13	-2.6
1.0		3.8

INVESTMENT B

Estimated Probability of Outcome	Outcome Profit or Loss	Value
.4	+ 6	2.4
.4	+ 2	.8
.2	+ 1	.2
1.0		3.4

Although A is clearly 'worth' more than B, it is riskier because it is more volatile. Diversification lessens the volatility by allowing investors to invest in 20 or 200 A's which will tend to guarantee a total result near the value. Shareholders are thus better off with the various firms selecting A over B, although after the fact they will complain in each case of the 2.6 loss.

Joy, 692 F.2d at 886 note 6 (quoting KLEIN, BUSINESS ORGANIZATION AND FINANCE 147-49 (1980)).

sion began.⁴¹ This ambiguity between an accepted theory of finance and judicial practice hinders the progressive officer/trustee seeking high rates of return with slightly higher risk levels, because an investment-by-investment analysis will reject high risk projects at an earlier stage than if the court had viewed that investment's risk factor in light of the overall risk of the portfolio.⁴²

The conflict between prudent trust practices and prudent corporate-profit maximization goals exists despite the issuance of a Department of Labor regulation which attempts to define practical implementation for the diversification requirement.⁴³ Although the Code of Federal Regulations purports to illustrate factors that are consonant with modern portfolio diversification theories, some of these elements are incompatible to the judiciary's investment-by-investment analysis of a trustee's capital spending decisions.⁴⁴ Combined with the prudent

41. *Withers v. Teachers' Retirement System*, 47 F. Supp. 1248, 1255 (S.D.N.Y. 1978).

42. See Markowitz, *supra* note 37 at 77-91.

43. 29 C.F.R. § 2550.404a-1(B)(1) (1984)(investment duties). In pertinent part, this Department of Labor regulation declares that:

(b) Investment Duties. (1) With regard to an investment or investment course of action taken by a fiduciary of an employee benefit plan pursuant to his investment duties, the requirement of section 1104 (a)(1)(B) of the Act set forth in subsection (a) of this section is satisfied if the fiduciary:

- (i) has given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment or investment course of action involved, including the role of investment or investment course of action plays in that portion of the plan's investment portfolio with respect to which the fiduciary has investment duties; and (ii) has acted accordingly.

2(ii) Consideration of the following factors as they relate to such portion of the portfolio:

- (A) The compensation of the portfolio with regard to diversification;
- (B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and
- (C) The projected return of the portfolio relative to the funding objectives of the plan.

44. In particular, § 2550.404a-1(b)(2)(ii)(C), when read alone, might allow clearance to invest in a high risk security that complements the projected (expected) return of the portfolio. But, an "investment by investment" approach could reject the same investment.

Congress' endeavor to clarify its own diversification requirement was noted in the legislative history:

The degree of investment concentration that would violate this require-

man rule, this regulatory contradiction tends to increase the number of the conflicting standards of fiduciary conduct that confront the officer/trustee.⁴⁵

B. Prohibited Transactions - Section 406

In addition to its fiduciary standard section, ERISA is designed to prohibit transactions that involve transfers between an ERISA trustee and a party-in-interest.⁴⁶ Specifically, a fiduciary shall not:

ment to diversify cannot be stated as a fixed percentage, because a prudent fiduciary *must consider the facts and circumstances of each case*. The factors to be considered include (1) the purposes of the plan; (2) the amount of the plan assets; (3) financial and industrial conditions; (4) the type of investment, whether mortgages, bonds or shares of stock or otherwise; (5) distribution as to geographical location; (6) distribution as to industries; (7) the dates of maturity.

S. REP. NO. 93-127, 93d Cong. 2d Sess. 3, *reprinted in* 1974 U.S. CODE CONG. & AD. NEWS 4639, 5084-85 (emphasis added).

45. Compare this finding with *Teamsters*, 458 F. Supp. at 986.

46. 29 U.S.C. § 1002(14) (1982) defines a "party-in-interest" as:

(A) any fiduciary (including but not limited to, any administrator, officer, trustee, or custodian), counsel, or employee of such employee benefit plan;

(B) a person providing services to such plan;

(C) an employer any of whose employees are covered by such plan;

(D) an employee organization any of whose members are covered by such plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting power of all . . .

(ii) the capital interest or the profits interest in a partnership, or

(iii) the beneficial interest of a trust or unincorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a relative (as defined in paragraph 15 of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate of which (or in which) 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or—

(iii) the beneficial trust of such trust or estate is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an employee, officer, director (or an individual having powers or responsibilities similar to those of officers or directors), or a 10 percent or

- (1) deal with the assets of the plan in his own interest or his own account,
- (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
- (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.⁴⁷

more shareholder directly or indirectly, of a person described in subparagraph (B), (C), (D), (E), or (G), or of the employee benefit plan; or
 (I) a 10 percent or more (directly or indirectly in a capital or profits) partner or joint venturer of a person described in subparagraph (B), (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of the Treasury, may by regulation prescribe a percentage lower than 50 percent for subparagraph (E) and (G) and lower than 10 percent for subparagraph (H) or (I). The Secretary may prescribe regulations for determining the ownership (direct or indirect) of profits and beneficial interests, and the manner in which indirect stockholdings are taken into account. Any person who is a party in interest with respect to a plan to which a trust described in § 501(c)(22) of Title 26 is permitted to make payments under § 1403 of this title shall be treated as a party in interest with respect to such trust.

47. ERISA § 406(b)(1-3), 29 U.S.C. § 1106(b)(1-3) (1982). In addition to § 1106, the Internal Revenue Code provides for a tax on prohibited transactions. In pertinent part, the I.R.C. taxes a "disqualified person" on each prohibited transaction.

§ 4975. *Tax on prohibited transactions*

(a) *Initial taxes on disqualified person.* - There is hereby imposed a tax on each prohibited transaction. The rate of tax shall be equal to 5 percent of the amount involved with respect to the prohibited transaction for each year (or part thereof) in the taxable period. The tax imposed by this subsection shall be paid by any disqualified person who participates in the prohibited transaction (other than a fiduciary acting only as such).

(b) *Additional taxes on disqualified person.* - In any case in which an initial tax is imposed by subsection (a) on a prohibited transaction and the transaction is not corrected within the taxable period, there is hereby imposed a tax equal to 100 percent of the amount involved. The tax imposed by this subsection shall be paid by any disqualified person who participated in the prohibited transaction (other than a fiduciary acting only as such).

A 'disqualified person' is defined as:

(2) *Disqualified Person.* - For purposes of this section, the term 'disqualified person' means a person who is —

- (A) a fiduciary;
- (B) a person providing services to the plan;
- (C) an employer any of whose employees are covered by the plan;

Standing alone, section 406 appears to prohibit a trustee from ever engaging in party-in-interest transactions. However, sections 407 and 408 provide the pension trustee an avenue to acquire or retain a limited amount of employer securities for the pension plans.⁴⁸ Unfortunately, the officer/trustee, with ambitions to control the corporation, often misunderstands these sections to imply a clear exception to the prohibited transaction provision.⁴⁹

(D) an employee organization any of whose members are covered by the plan;

(E) an owner, direct or indirect, of 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation,

(ii) the capital interest or the profits interest of a partnership, or

(iii) the beneficial interest of a trust or incorporated enterprise, which is an employer or an employee organization described in subparagraph (C) or (D);

(F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E);

(G) a corporation, partnership, or trust or estate or which (or in which) 50 percent or more of—

(i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of such corporation,

(ii) the capital interest or profits interest of such partnership, or

(iii) the beneficial interest of such trust or estate, is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E);

(H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or

(I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G).

The Secretary, after consultation and coordination with the Secretary of Labor or his delegate, may by regulation prescribe a percentage lower than 50 percent for subparagraphs (E) and (G) and lower than 10 percent for subparagraphs (H) and (I).

I.R.C. § 4975 (a),(b), (f)(2) (1984).

This author does not intend to provide an exhaustive review of the I.R.C. provisions for prohibited transactions of an ERISA trustee. Accordingly, the tax consequences surrounding an ERISA trustee's conflict of interest abuse are beyond the scope of this Note.

48. See ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (1982) ERISA § 408(e)(1), 29 U.S.C. 1108(e)(1) (1982).

49. The court in *Donovan v. Bierwith* rejected appellant's claim that § 1107 pro-

C. Exceptions to the Prohibited Transactions Rule - Sections 407 and 408

Section 407(a)(2) establishes a loophole to ERISA's prohibited transaction section. This loophole permits an ERISA plan trustee to invest in "employer securities up to ten percent of the fair market value of the assets in the plan."⁵⁰ Section 408(e)(1) supplements this proviso by exempting employer securities, if acquired for adequate consideration, from sections 406 and 407.⁵¹ Thus, section 408(e)(1) acts as an exemption to the 406 prohibited transaction rule. It is not surprising that this limited exception is an attractive lure to an officer/trustee facing potential conflicts of interest. Along with the latent interpretational problems presented to the officer/trustee in section 404's prudence standards, this adequate consideration exception adds to the possibility that a trustee will act as an officer to acquire corporate securities, while using the trust corpus to track an imprudent venture in violation of his fiduciary obligation to plan participants.

IV. Common Conflict of Interests Facing Officer/Trustees

A. Breach of Fiduciary Duty: Officer/Trustee's Use of Plan Funds to Purchase Corporation.

In *Eaves v. Penn*,⁵² an officer/trustee acquired employer stock using a mix of his personal and ERISA plan pension capital. The purchase enabled him to establish majority shareholder control.⁵³ The

vides an "unlimited" exception to § 1106's prohibited transaction standards. *Bierwith*, 680 F.2d at 271.

50. ERISA § 407(a)(2), 29 U.S.C. § 1107(a)(2) (1982).

51. ERISA § 408(e)(1), 29 U.S.C. § 1108(e)(1) (1982) provides that:

(e) Sections 1106 and 1107 of this title shall not apply to the acquisition or sale by a plan or qualifying employer securities (as defined in § 1107(d)(5) of this title) or acquisition, sale or lease by a plan of qualifying employer real property (as defined in § 1107(d)(4) of this title—

(1) if such acquisition, sale, or lease is for *adequate consideration* (or in the case of a marketable obligation, at a price not less favorable to the plan than the price determined under § 1107(e)(1) of this title), (emphasis added).

Id.

52. 426 F. Supp. 830 (W.D. Okla. 1976), *modified*, (rem. on attorneys' fees issue) 587 F.2d 453 (10th Cir. 1978).

53. *Eaves*, 587 F.2d at 453, 455.

court examined the propriety of a purchase agreement entered into by the trustee (Penn) of the employee stock ownership plan, and the current majority shareholders (Eaves). As trustee of the pension plan, Penn caused the transfer of \$1,013,134.01 to the Eaveses for 6,807 shares of stock,⁵⁴ to be held by the substituted employee stock ownership plan (ESOP).⁵⁵ Penn used his own capital to purchase the remainder of the majority shares from the Eaveses.⁵⁶ Penn compensated the Eaveses for their stock holdings, and, through an amendment to the company's original profit sharing plan that created an employee stock ownership plan,⁵⁷ he transferred company assets into the new ESOP.⁵⁸ This transfer occurred in the form of an advance payment from the company's assets into the newly formed ESOP.⁵⁹ By virtue of this elaborate transfer, Penn gained control over a majority amount of company shares and designated himself a board member, vice-president and treasurer of the target company, Glenns, Inc.⁶⁰

Before the transfer and purchase, Glenns, Inc. maintained a strong financial condition relative to its market place.⁶¹ However, after Penn's acquisition, leveraged by funds drawn from the ESOP,⁶² the value of Glenns, Inc. shares experienced a decline by approximately \$500,000.⁶³ As a result of Penn's actions stockholder's equity declined from a pre-acquisition value of \$746,711 to a value of \$76,000.⁶⁴ The Tenth Circuit held that the officer/trustee's elaborate buyout scheme, fueled by the amendment to the company's profit sharing plan, constituted a section 404 breach of his fiduciary duties⁶⁵ owed to that company's plan participants and their beneficiaries.⁶⁶

54. *Id.* at 455.

55. *Id.*

56. *Id.* at 456.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. Neither the District Court nor the Court of Appeals label Penn's transaction with the substituted ESOP as a "prohibited transaction." Thus, the outgoing directors were not treated as parties-in-interest with the substituted ESOP.

66. *Id.* at 454.

1. *Does ERISA Hold the Officer/Trustee to Unrealistic Expectations, If Not Inequitable Standards?*

Penn contended on appeal that, as a trustee, his fiduciary duty bound him to the terms of the amended profit sharing plan, the ESOP, and ERISA to "invest the Plan's fund in Employer's securities, unless compliance was impossible, illegal or directly inconsistent with a specific prohibition of ERISA."⁶⁷ The court believed that this attempt to define Penn's fiduciary role to the plan participants was putting the cart before the horse. The court stated: "the premise for such a contention is based on the adoption of a uniform exemption for violations of §1104 fiduciary standards in cases involving the discretionary activities of an ESOP trustee."⁶⁸ Instead, this is really an instance where Penn interpreted the breadth of the section 408(e) prohibited transaction exception to stand as a vanguard over section 404's fiduciary standard section. It is established authority that section 408(e)'s limited exception should act as supplementary capacity in deference to section 404's prudence and diversification requirements.⁶⁹ The court adopted this viewpoint and stated that, "[w]hile an ESOP trustee may be released from certain per se violations . . . , the structure of the Act itself requires that an ESOP fiduciary . . . is governed by the 'solely in the interest' and prudence tests of §§ 404(a)(1)(A) and (B)."⁷⁰

Although the Tenth Circuit found that Penn's capital acquisition strategy violated ERISA's fiduciary standards section, his actions were not uncommon when weighed against liberal principles of corporate finance.⁷¹ Arguably, if Penn had transferred capital from the amended profit sharing plan into the ESOP and successfully gained control of the company, this lawsuit may not have ensued. Although the courts

67. *Id.* at 458.

68. *Id.* at 459. ESOP refers to an employee stock ownership plan. *See*, I.R.C. § 4975(e)(7) (1984).

69. *Eaves*, 587 F.2d at 459, (quoting H.R. Rep. No. 93-1280, 93d Cong., 1st Sess., reprinted in 1974 U.S. CODE CONG. & AD. NEWS, at 5038:

Thus, while a plan may be able to acquire employers securities or real property under the employers security rules, the acquisition must be for the *exclusive benefit of participants and beneficiaries*. Consequently, if the real property is acquired *primarily to finance the employer*, this would not meet the exclusive benefit requirement.

Id. (Emphasis supplied).

70. *Id.*

71. *See generally* Brecher, Lazarus III, & Gray, *The Function of Employee Retirement Plans as an Impediment to Takeovers*, 38 BUS. LAW 503 (1983).

warn that a fiduciary's practices will be judged prospectively,⁷² rather than retrospectively, it is doubtful that a member of a successfully run ESOP⁷³ would sue the trustee of the plan and allege that that trustee gained control of the company in an imprudent fashion.⁷⁴ Thus, it is likely that, had Penn's buyout inured to the benefit of plan participants in the form of enhanced shareholder equity, Penn would still be the vice-president, treasurer and board member of Glenn's, Inc.⁷⁵

Under slightly different circumstances, it is conceivable that an officer/trustee might sidestep a section 404 challenge to his disputed capital transfer by means of better corporate and managerial skills. Favorable financial results, measured by an increase in shareholder's equity, would appease the plan participants. When viewed retrospectively, such a purchase plan might prove "solely to benefit plan participants" thereby satisfying the section 404 fiduciary standards.⁷⁶ Given this hypothetical result, inequity in prosecutorial standards is likely to occur.⁷⁷ As long as corporate officers can act as plan trustees, there will be circumstances when an officer/trustee may be tempted to manipulate the assets of the employee pension plan to suit his own business interests. The trustee will do this with the belief that a somewhat imprudent strategy might result in enhanced wealth for the company shareholders (who are also plan members) as well as advanced personal power, wealth, and prestige for himself.

72. *Withers*, 47 F. Supp. at 1255.

73. The growth in an ESOP can be measured by the rate of return its investments experienced during a given time period.

74. *But see Leigh v. Engle*, 535 F. Supp. 418 (N.D. Ill. 1982), *vacated rem*, 727 F.2d 113 (7th Cir. 1984). In that case, members of a corporate profit sharing plan brought suit for fiduciary breach by the trustees. The trust investments experienced an "extraordinary" return, however, the participants' plan payments were deferred by the trustees.

75. This conclusion is further buttressed by evidence of the District Court's finding of facts. *See Eaves*, 426 F. Supp. at 830, 832-36.

76. Despite the court's holding in *Leigh*, 535 F. Supp. at 418, this author argues that no cause of action would have been filed by the plan participants in the *Eaves* action had: (1) Penn successfully managed the Glenns, Inc. and (2) all payments to retired or withdrawn members were not deferred.

77. Specifically, imprudent uses of ESOP assets resulting in successful ventures could not be prosecuted, while unsuccessful investments would instigate actions for fiduciary breach.

B. An Officer/Trustee's Investment Decisions Track Independent Investment Group's Acquisition Plans.

In *Leigh v. Engle*,⁷⁸ the Seventh Circuit Court of Appeals held that two officer/trustees' actions in three separate investment acquisition plans violated the fiduciary standards section of ERISA.⁷⁹ The disputed transactions involved investment decisions that were made by trustees of the Reliance Manufacturing Corporation's Employees Profit Sharing Trust.⁸⁰ The officer/trustees, who were also members of an acquisition group, directed trust capital to finance the acquisition aspirations of the group.⁸¹ Each investment by the trust precluded an attempt by the group to purchase large blocks of that company's stock.⁸² Thus, despite an extraordinary return on investment, the trustees' use of trust capital to track the group's acquisition attempts violated their fiduciary responsibilities pursuant to section 404.⁸³

The investment group consisted of various individuals representing three different corporations: Libco Corporation, GSC Corporation, and Reliable Manufacturing.⁸⁴ The head of the group, a financier, and CEO of Libco and GSC, did not act alone. He received assistance from the chief counsel for Libco, who was the administrator of the Reliable Trust (Employee pension plan), the president of Reliable Manufacturing, who was also co-administrator of the trust, and an investment analyst hired by Libco.⁸⁵ This group centered its acquisition attempts on the three companies: Berkeley Bio Medical, Outdoor Sports Industries, and the Hickory Furniture Company.⁸⁶

As a white knight,⁸⁷ the financier purchased approximately 60,000

78. *Leigh*, 535 F. Supp. at 418.

79. *Leigh*, 727 F.2d at 116.

80. *Id.*

81. *Id.* at 117.

82. *Id.* at 118.

83. *Id.* at 128.

84. *Id.* at 116.

85. *Id.* at 117.

86. *Id.* at 116.

87. White knight is the colloquialism for a third, independent company that is solicited by the firm whose stock is being pursued by the acquiring firm. Usually, the third firm (the white knight) enters into an agreement with the firm that is being pursued. Often the pursued firm negotiates an exchange of its stock for the efforts of the third party to buy a large number of shares and thereby defeat the acquiring firm's attempt at gaining control of the pursued company. *See American General Ins. Co. v. Equitable General Corp.*, 493 F. Supp. 721, 732 n.19 (E.D. Va. 1980).

shares of Berkeley stock prior to the investment group meeting in an attempt to prevent a hostile tender offer⁸⁸ by Cooper Industries, the firm intending to takeover control of Berkely.⁸⁹ Following a meeting of the investment group, the Reliable trust purchased 15,000 shares of Berkeley stock.⁹⁰ After the pension plan's purchase, the financier sent correspondence to other Berkeley block shareholders, in an attempt to solicit either their interests in the stock or their proxy in upcoming Berkeley board meetings.⁹¹ This attempt was the result of opposition to the ongoing talks between Berkeley and Cooper Industries, the company that had set forth its initial tender offer.⁹² Eventually, the financier withdrew his complaint, negotiated the tender of its holdings to Cooper, and realized a "substantial profit for its Berkeley stock interests."⁹³

The group's investment in the OSI Corporation assumed a pattern similar to the Berkeley coup.⁹⁴ Again, the trust administrators tracked the investment group's acquisition plans by purchasing 12,400 shares of OSI stock.⁹⁵ Subsequent to this purchase, the investment group, headed by its financier, battled the present OSI management for managerial control.⁹⁶ The tender fight ended when a white knight sided with OSI management and offered fifteen dollars per share to the investment group for their OSI stock holdings.⁹⁷ The group responded by selling its shares to the white knight at a one hundred forty-one percent profit.⁹⁸ The investment group was less successful in their acquisition of Hickory Furniture. Following the investment group's purchase of 51,400

88. See A. Fleischer, Jr., *Tender Offers: Defenses, Responses and Planning* 99 (1978):

A tender or exchange offer is aimed directly at the shareholders of the target. The bidder may make an offer irrespective of director opposition if it complies with all the legal standards. Unlike the situation in a merger or sale of assets transaction, in which the board of directors must approve and recommend the transaction, the shareholders can respond directly to the offer.

89. *Id.* 727 F.2d at 119.

90. *Id.*

91. *Id.* at 121.

92. *Id.* at 120.

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 121.

97. *Id.*

98. *Id.*

shares, the Reliable trustees bought 8,000 shares of Hickory stock.⁹⁹ After the trust's purchase, the investment group became members of the Hickory Board of Directors, and the trust then sold its shares at a four percent profit.¹⁰⁰

1. *Should a Trustee Refuse to Act Upon Inside Information Made Available to Him Vis-A-Vis His Corporate Position As An Officer?*

The Seventh Circuit in *Leigh* found that ERISA is not concerned with the success of a trust's investment.¹⁰¹ This finding is consistent with the Congressional intent to preserve the trust corpus through common-law trust principles.¹⁰² Indeed, the *Leigh* court found that Reliable trustees' activities were "self dealing" and lacked prudence as required by ERISA's fiduciary standards.¹⁰³ Thus, the investment group's successful investments, resulting in an increase in shareholder equity for plan participants, are suspect to ERISA's prohibited transaction section, as well as to the Act's fiduciary standards.¹⁰⁴ Because the investments were not "made with an 'eye single' to the interests of the Plan participants, they lacked the necessary objectivity and prudence prescribed by ERISA."¹⁰⁵ By labeling the trustees' actions "self-dealing," the court chooses to apply a broad interpretation to "section 406's restriction on officer/trustees of either the 'target' or 'raider' (corporation) who have a significant interest of their own in the outcome of the contests."¹⁰⁶

The *Leigh* court suggested that, the Reliable trustees may have avoided violating ERISA's fiduciary standards if the trustees had consulted with independent counsel, instead of an interested party.¹⁰⁷ Juxtaposed against other case precedent, this suggestion provides little hint of a touchstone by which the officer/trustee may measure future invest-

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* at 122, n.17, 123. S. REP. NO. 93-127, 93d Cong., 2d Sess. 3, *reprinted* in 1974 U.S. CODE CONG. & AD. NEWS 4639, 5186 (Statement of Sen. Harrison Williams).

103. *Id.* at 132.

104. *Id.* at 132-134.

105. *Id.* at 129.

106. *See generally Id.* at 132-36.

107. *Id.* at 132.

ment decisions. Additionally, one authority on the law of trusts observed that:

In reaching his conclusion [the trustee] may take into consideration advice given to him by attorneys, bankers, brokers, and others whom prudent men in the community regard as qualified to give advice. He is not justified, however, in relying wholly upon the advice of others, since it is his duty to exercise his own judgment in the light of the information and advice which he receives.¹⁰⁸

In *Leigh*, the investment group relied solely on the advice solicited from the investment advisor.¹⁰⁹ The court found that this advice came from an interested party and lacked the prudence required by ERISA.¹¹⁰ The *Leigh* decision revitalizes the catch-22 atmosphere surrounding the officer/trustee. Specifically, that atmosphere consists of an improper mix of goal oriented expectations; in one corner stands the profit maximizing employee, while on the other side is the prudent trustee.

The *Leigh* court adopts the Department of Labor suggestion that trustees in this situation should abdicate their roles as trustees and "turn over the administration of the plan to another who can set forth a prudent investment course independent of that trustee's *other* interests."¹¹¹ The Department of Labor's suggestion is theoretically sound, but based on the premise that an officer/trustee will always recognize a situation that constitutes ERISA's fiduciary self-dealing.¹¹² When it is proven that the officer/trustee will ignore standards and use pension funds to self-deal, it follows that logic will not dictate that the same officer/trustee resign his position¹¹³ for the sake of prudence.¹¹⁴ In *Don-*

108. A. SCOTT, *supra* note 33.

109. *Leigh*, 727 F.2d at 132-35.

110. *Id.* at 132.

111. *Id.*

112. Semantic problems arise when the courts struggle to consider whether an action is "self-dealing." Is this an unfair label to affix upon the officer/trustee acting upon confidential information? Had Goldman, Sachs & Company circulated a "buy" opinion sheet to its investing customers suggesting that Berkeley appeared to be an attractive purchase, would the Reliable trustee's purchase be prudent? Here, ERISA and the courts shed little light on the way in which an officer/trustee may ever insulate himself from charges of fiduciary breach, while making an attractive investment for the trust plan.

113. *See Leigh*, 727 F.2d at 132.

114. Congress assesses penalties against breaching fiduciaries by: (1) awarding

ovan v. Cunningham,¹¹⁵ the court adopts section 408(e)'s adequate consideration requirement¹¹⁶ as the test for an officer/trustee's prudence over his investment decisions. The *Cunningham* court held that "ESOP fiduciaries will carry their burden to prove . . . [the payment of] . . . adequate consideration . . . [established by] . . . *prudent* investigation in the prevailing circumstances"¹¹⁷ However, this interpretation unearths little knowledge, because the standard of prudence expected of the officer/trustee is left as an undefined principle. It follows that the adoption of an adequate consideration standard fails to extricate the officer/trustee from the catch-22 situation encountered by the trustees in the *Leigh* case.

C. Fiduciary Breach By an Officer/Trustee in the Midst of a Corporate Tender Offer.

ERISA's fiduciary standards section plays an important role in judging the actions of an officer/trustee's investment decision to tender, or refuse to tender, corporate securities held by the employee stock ownership plan. In *Donovan v. Bierwirth*,¹¹⁸ the court evaluated the prudence of the trustee who refused to tender corporate securities and instead, decided to buy company securities in an attempt to ward off the bid of an acquiring firm.¹¹⁹

Board members of the Grumman Corporation voted to prevent a tender offer by the LTV Corp.¹²⁰ Following this board meeting, all ESOP participants received a memorandum informing them that their

compensatory damages pursuant to ERISA § 1109, *infra* note 158; and (2) assessing tax penalties against "disqualified" persons, I.R.C. § 4975, *supra* n. 45. As these provisions failed to deter the trustees in *Eaves* and *Leigh* from breaching their fiduciary duty to plan participants, it would seem that these provisions are not realistic. Further, these penalties may fail to compensate plan participants in the event that the breaching fiduciary is insolvent. *See, infra* notes 160-2 and accompanying text.

115. *Donovan v. Cunningham*, 541 F. Supp. 276 (S.D. Tex. 1982), *aff'd in part, vacated in part, rev. in part*, 716 F.2d 1455 (5th Cir. 1983), *cert. den.*, ___ U.S. ___, 104 S. Ct. 3533 (1984).

116. *Cunningham*, 716 F.2d at 1465.

117. *Id.* at 1467-68.

118. *Donovan v. Bierwirth*, 538 F. Supp. 463 (E.D.N.Y. 1981), 680 F.2d 263 (2d Cir. 1982), *cert. den.* 459 U.S. 1069 (1982).

119. *Id.* at 466. "In this lawsuit, the ESOP officer/trustee's decision to retain Grumman stock while purchasing additional stock on the open market, did not constitute a prohibited transaction."

120. *Id.*

plan held one third of Grumman outstanding stock. The memorandum provided that "these plans are managed by Grummanites who will look long and hard at how well their fellow members would be served by selling off Grumman stock."¹²¹ One month later, Grumman trustees decided to refuse the tender offer for any of the shares held by the pension plan.¹²² Instead, the trustees voted to purchase an additional 1,275,000 shares of Grumman stock in an attempt to maintain control and defeat LTV's acquisition attempt.¹²³ The trustees based this purchase decision on an investment outlook report by Dillon, Read & Company, an investment banking concern retained by Grumman.¹²⁴ The District Court viewed the recommendation of Dillon, Read & Company as constituting "no real inquiry into the dangers presented to the Pension plan in the event of a takeover. . . [instead]. . . the trustee's imprudence formed a policy of 'conscious avoidance' to any positive effects that the LTV tender offer could enhance shareholder wealth."¹²⁵ The court ruled that "the trustees were not justified in relying upon the advice of Dillon, Read & Co. since that company had provided investment banking services to Grumman in the past, including acting as a manager of an offering of its convertible subordinated debentures in April, 1980."¹²⁶ In support of its finding that Dillon, Read & Company had an "obvious interest in Grumman's continuing independence,"¹²⁷ the court stated that:

In relying upon the advice of another, he [the trustee] should consider whether the person giving the advice is disinterested. Thus, it has been held that in purchasing securities for the trust he is not justified in relying solely on the advice of a broker interested in the sale of the securities."¹²⁸

Accordingly, the Grumman trustees' decision to retain company securities and purchase additional stock, combined with their failure to seek impartial investment advice and constituted a breach of section 404.¹²⁹

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.* at 472.

125. *Id.* at 474 (emphasis added).

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 475 (emphasis added).

On appeal to the Second Circuit Court of Appeals, the Grumman trustees argued that their actions did not arise under §1106's prohibited transactions self-dealing provision.¹³⁰ In support of this argument, the trustees quoted a 1973 statement by the Department of Labor before the Senate Finance Committee.¹³¹ In pertinent part, this statement provided that:

Since such an employer will often be an administrator of his plan, or will function as a trustee or in some other fiduciary capacity, this provision [§1107(a)(3)] creates a limited exception to the listed proscription against self-dealing. The exception is made in recognition of *the symbiotic relationship* existing between the employer and the plan covering his employees.¹³²

Accordingly, the Second Circuit held that the Grumman trustees did not violate the prohibited transaction section of ERISA by following a course of action which "benefits the corporation as well as the beneficiaries."¹³³ However, the Second Circuit did find that the trustees' actions were not made at all times with "an *eye single* to the interests of the plan participants and their beneficiaries," which constituted a breach of §1404's fiduciary standards.¹³⁴

In retrospect, the Grumman officer/trustees' predicament is understandable in light of practical business considerations minimized by the Second Circuit. Realistically, Bierwirth and the other trustees acted in their official capacity as corporate officers when they decided to defeat the LTV tender offer. According to testimony in the district court, this decision is consistent with management's stated belief that LTV, pursuant to a successful tender offer, would replace existing Grumman management with LTV designees.¹³⁵ Under this assumption, Grumman trustees believed that any new management implemented by LTV would create a negative impact on shareholder equity, thereby posing a threat to the Employee Benefit Plan holdings.¹³⁶ The Second Circuit

130. *Bierwirth*, 680 F.2d at 271.

131. *See id.* at 271 (quoting Private Pension Reform: Hearings Before the Subcomm. on Private Pension Plans of the Senate Comm. on Finance, 93 Cong., 1st Sess. 446 (1973) (statement of Department of Labor)).

132. *Donovan v. Bierwirth*, 680 F.2d at 271.

133. *Id.* at 271-72.

134. *Id.*

135. *Id.* at 275.

136. Even though LTV did not announce that Grumman's executives would be displaced upon the success of its tender offer, a majority of hostile takeovers end with

empathized with this concern in light of a debt ridden LTV.¹³⁷ Nevertheless, the Second Circuit focused its attention on the Grumman trustees' decision to purchase additional Grumman stock and cautioned that they:

should have realized that their judgment . . . would be biased and accordingly they should take . . . every feasible precaution to free themselves . . . from any taint of the quick negative reaction characteristic of targets of hostile tender offers . . . (and) consider the huge risks attendant with purchasing additional Grumman shares at a price substantially elevated by the tender offer.¹³⁸

In other words, the Grumman trustees should have insulated themselves from any reaction that might be aligned with the normal reaction of a corporate decision maker.

1. *Bendix-Martin Marietta: A Solution to the Dual Loyalty Problem?*

Another conflict arose when Bendix made a hostile tender offer to acquire outstanding stock in the Martin Marietta corporation.¹³⁹ Thereafter, Martin Marietta counter-offered for Bendix' outstanding stock.¹⁴⁰ During this tender battle, Bendix plan trustees held eleven percent of outstanding Bendix stock, in the Bendix Salaried Employees Savings and Stock Ownership Plan (BSESSOP). The plan trustees sold four million five hundred thousand shares to Martin Marietta, at tender price, thereby "carry[ing] out its fiduciary responsibility by preserving 'all options' for the plan and its participants."¹⁴¹ Citibank of New York acted as the independent manager to Bendix' employee

the acquiring company substituting its chosen officials in place of the acquired company's executives. Note, *The Duties of Employee Benefit Plan Trustee under ERISA in Hostile Tender Offers*, 82 COLUM. L. REV. 1692, 1703 (1982).

137. *Bierwith*, 680 F.2d at 276.

138. *Id.*

139. See *Martin Marietta Corp. v. The Bendix Corp.*, No. 82-7669 (2d Cir., September 21, 1982)). *Wall Street Journal*, Sept. 14, 1982, at 4, col.1; Sept. 17, 1982, at 2, col.2; Sept. 20, 1982, at 2, col.2; Sept. 21, 1982, at 2, col.2.

140. *Wall Street Journal*, Sept. 21, 1982 at 2, col.2. See also *Martin Marietta Corp. v. The Bendix Corp.*, *supra* note 139.

141. *Wall Street Journal*, Sept. 21, 1982, at 2, col.2. See also *New York Times*, Sept. 24, 1982, at D1, col.5.

stock ownership plan.¹⁴² To challenge the independent trustee's decision to tender, Bendix filed for a temporary restraining order in federal district court.¹⁴³ The district court did not issue the temporary restraining order against the Citibank asset plan manager. To the contrary, the district court judge ordered the plan manager to carry out his original decision to tender Bendix stock to Martin Marietta.¹⁴⁴ On a motion for rehearing and modification, Bendix argued that ninety-four percent of the shareholders instructed the Citibank manager to withdraw the tender.¹⁴⁵ The court, however, refused to modify its original order.¹⁴⁶

One could argue that a tender offer made solely in the interest of the plan participants would never have occurred had a Bendix officer/trustee managed the Plan.¹⁴⁷ Instead, an independent qualified asset plan manager accepted the tender, satisfying his fiduciary responsibility to the members of the plan without any outside conflict of loyalties impacting upon that decision. This is the ultimate goal of the fiduciary policy guidelines set forth in ERISA.

V. Judicial Standard of Review that Gauges a Trustee's Prudence in Administering Plan Assets

Federal courts have firmly established that the actions of a trustee over the management of an ERISA Plan are to be analyzed on the basis of "whether those actions were arbitrary and capricious in light of the trustees' responsibility to all potential beneficiaries."¹⁴⁸ In *Fine v. Semet*,¹⁴⁹ for example, a district court held that the actions of the

142. Wall Street Journal, Sept. 21, 1982, at 2, col.2.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. Accordingly, the court in *Leigh* observed that:

Otherwise, the risk is too great that the trustee will come to a crossroads where the interests of the plan and the party-in-interest diverge. For example, while the *party-in-interest may be seeking to accumulate as many shares as possible in order to maintain or acquire control, a plan's interest in maximizing its investment return may require it to tender its shares to a competing bidder for shares.*

Leigh, 727 F.2d at 132 (emphasis added).

148. *Rueda v. Seafarers Union*, 576 F.2d 939, 942 (1st Cir. 1978).

149. *Fine v. Semet*, 514 F. Supp. 34 (S.D. Fla. 1981), *aff'd*, 699 F.2d 1091 (11th Cir. 1983).

trustees are consistent with their fiduciary duties under ERISA.¹⁵⁰ In support of this finding, the court noted that the partner/trustee's concern about the impact of an immediate lump-sum payment to a departing law firm partner was well founded and rested on the consideration "that a sudden loss of some fourteen percent of the Plan's assets, combined with the significant potential for additional requests for immediate payments could not be acts of an arbitrary or capricious nature."¹⁵¹

150. *Id.* at 42-43. The District Court considered the decision of the profit sharing trustee not to allow a departing partner to withdraw his lump-sum benefit from plan assets. The plan documents provided that:

Upon termination of a Participant's employment prior to attaining Normal Retirement Age (for any reason other than death or disability), a Participant may elect, upon the consent of the Advisory Committee, to direct the Trustee to commence payment to the Participant of his Nonforfeitable Accrued Benefit prior to the Participant's attaining Normal Retirement Age. The Advisory Committee must give its direction to the Trustee on or before the last day of the Plan Year in which the Participant first incurs a Break in Service as a result of the termination of his employment. . . . If the terminating Participant is one hundred percent (100%) vested in his Accrued Benefit by the close of the Plan Year in which his employment terminates, the Advisory Committee, in its sole discretion, may direct the Trustee to commence payment to the Participant of his Accrued Benefit within sixty (60) days after the close of the Plan Year in which the Participant's employment terminates without regard to the Participant's incurring a Break in Service. . . .

If the Advisory Committee does not give the Trustee a direction to commence payment, the Trustee shall continue to hold the Participant's Accrued Benefit in trust until the close of the Plan Year in which the Participant attains Normal Retirement Age. At that time, the Trustee shall commence payment of the Participant's Nonforfeitable Accrued Benefit in accord with the provisions of Article VI. . . .

If the Participant terminates employment prior to attaining Normal Retirement Age because of death or disability, the Advisory Committee shall direct the Trustee to commence payment of the Participant's Accrued Benefit to him (or to his Beneficiary if the Participant is deceased), in accord with the provisions of Section 6.02, within sixty (60) days after the close of the Plan Year in which the Participant's employment terminates. [Deleted portions relate to date payment is to be made if directed by Advisory Committee, calculation of benefits at the close of a plan year, and alternative provisions for payment of benefits in case of death or disability].

Fine v. Semet, 514 F. Supp. at 37-38 (emphasis supplied). After it conducted a fair reading of the plan documents, the court determined that the trustee's actions were not "arbitrary or capricious."

151. *Id.*

The fourteen percent reduction that would result from the partner's withdrawal augmented the trustee's concern over assessing future investment goals and over potential financial loss to remaining plan participants.¹⁵² Thus, the retention of the departing employee's funds created a very realistic concern to the maintenance of the trust corpus.

The court reasoned that an act can be "arbitrary and capricious" if "invalid preferences" are proven to exist.¹⁵³ Such preferences are established "not merely on a showing of dissimilar treatment, but on dissimilar treatment based on 'improper purpose' or irrational effect."¹⁵⁴ Because the trustees' acts had a valid purpose, grounded in the rational effect that benefitted remaining plan members, they did not act in an arbitrary or capricious nature.¹⁵⁵

The *Fine* court's application of an arbitrary or capricious test in connection with "invalid preferences" or "irrational effects" should provide the judiciary with an uniform test to interpret the actions of an officer/trustee. Although the ERISA fiduciary responsibility section does not expressly mention the arbitrary or capricious standard, the federal judiciary should adopt this standard in conflict of interest cases. Such a uniform standard is clearly lacking in cases like *Donovan v. Bierwirth*,¹⁵⁶ *Eaves v. Penn*,¹⁵⁷ and *Leigh v. Engle*.¹⁵⁸ The arbitrary or capricious standard, however, is only a post facto solution because it fails to curb an officer/trustee's fiduciary breach at its genesis — conflict of interest. Therefore, Congress must adopt a uniform policy that will rid ERISA pension plans of the conflicts that inevitably result when a trustee acts in dual capacities for the plan and in the management of the corporation. This proposed Congressional policy will save company plan assets from the dissipation that results due to an officer/trustee's dual loyalties that eventually lead to fiduciary breach.

VI. ERISA's Provision for Relief from Fiduciary Breach Fails to Protect Plan Participants From Loss

If an officer/trustee's actions are clearly in violation of ERISA's

152. *Id.*

153. *Id.* at 44.

154. *Id.*

155. *Id.*

156. *See Bierwirth*, 538 F. Supp. at 463.

157. *See Eaves*, 426 F. Supp. at 830.

158. *See Leigh*, 535 F. Supp. at 418.

fiduciary standards, it is likely that adequate redress will not be available to plan participants and their beneficiaries. Section 409(a) of ERISA provides in pertinent part that: "Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach".¹⁵⁹

In *Freund v. Marshall & Ilsley Bank*,¹⁶⁰ pension trustees breached their fiduciary duties, and the court ordered that they be jointly and severally liable to restore to the plan \$464,925.95, the amount adjudged to constitute damages of their breach.¹⁶¹ Plan participants' beneficiaries might survive dissipation if the trustees can satisfy the court's judgment. On the average, officer/trustees who are guilty of a breach involving millions of lost plan dollars surely cannot restore such amounts to the plan. The corporation need not indemnify "bad faith" fiduciaries in such cases.¹⁶² Thus plan participants are exposed to catos-

159. ERISA § 409(a), 29 U.S.C.A. § 1109(a) (1982).

160. *Freund*, 485 F. Supp. at 636.

161. *Id.* at 633-35.

162. However, some state corporation acts provide for the indemnification of officers, directors, employees, and agents. Fla. Stat. § 607.014(1)(1984), provides:

607.014 Indemnification. of officers, directors, employees, and agents. -

(1) A corporation shall have power to indemnify any person who was or is a party, or is threatened to be made a party, to any threatened, pending, or completed action, suit, or proceeding, whether civil, criminal, administrative, or investigative (other than an action by, or in the right of, the corporation), by reason of the fact that he is or was a director, officer, employee, or agent of the corporation or is or was serving at the request of the corporation as a director, officer, employee, or agent of another corporation, partnership, joint venture, trust, or other enterprise against expenses (including attorneys' fees), judgments, fines, and amounts paid in settlement actually and reasonably incurred by him in connection with such action, suit, or proceeding, including any appeal thereof, *if he acted in good faith and in a manner he reasonably believed to be in, or not opposed to, the best interests of the corporation* and, with respect to any criminal action or proceeding, had no reasonable cause to believe his conduct was unlawful. The termination of any action, suit, or proceeding by judgment, order, settlement, or conviction or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner which he reasonably believed to be in, or not opposed to, the best interests of the corporation or, with respect to any criminal action or proceeding, had reasonable cause to believe that his conduct was unlawful.

trophic losses if the officer/trustee cannot satisfy a court order that he compensate the plan for his fiduciary breach.

VII. Conclusion

In a statement before the Subcommittee on Labor, United States Representative John Erlenborn of Illinois referred to ERISA as "the subject of derision, inasmuch as the acronym has come to stand for 'Every Ridiculous Idea Since Adam.'" ¹⁶³ It is apparent that Section 408(c)(3)'s provision that allows an officer of a corporation to act as a trustee over that company's pension plan adds impetus to Representative Erlenborn's statement.¹⁶⁴ As the cases reviewed in this note demonstrate, it is often impractical to allow an officer with loyalties divided between the goals of his corporation and the interests of the plan participants open access to a highly liquid source of capital. Specifically, section 404 requires that an officer/trustee set aside his daily corporate obligations (that often include his own job security)¹⁶⁵ and abide by common-law trust prudence standards.¹⁶⁶

Additionally, the trustee cannot gauge his investment decisions with only one uniform standard of conduct. As the "adequate consideration" standard is based upon prudence,¹⁶⁷ it fails to provide one consistent regulatory standard to measure the trustee's investment decisions. Confronted with case precedent and the Department of Labor's diversification standards, the officer/trustee is left with a mass of conflicting standards.

The Department of Labor proposes that a officer/trustee resign his administration upon discovery of possible "self-dealing" circum-

Id. (emphasis added).

Thus, in Florida, if the officer/trustee acts in "good faith" by administering the plan in the "best interests" of the corporation, he may be indemnified for the resultant loss to plan participants. However, the Florida Act has no provision for the corporate indemnification of officer/trustee's "bad faith" breach.

163. Retirement Income Incentives Act of 1981: Hearings on S. 1541 Before the Senate Sub. Comm. on Labor of the Sen. Comm. on Human Resources, 97 Cong., 1 Sess. 846-54 (1982)(statement by U.S. Representative John Erlenborn).

164. Section 1108(c)(3) adds impetus to Representative Erlenborn's statement, as it allows an officer/trustee access to a position where he will surely encounter conflicts of interest that could threaten plan asset security.

165. See *supra* note 136.

166. See ERISA § 404, 29 U.S.C. § 1104 (1982).

167. Compare § 1104 with § 1108(e).

stances.¹⁶⁸ Though this suggestion might avoid fiduciary breach, it is based on the unrealistic supposition that an officer/trustee can recognize situations constituting conflicts of interest. While the judiciary can adopt a uniform "arbitrary and capricious" standard of review to determine whether an officer/trustee actually breached his fiduciary duties, it is a post facto solution.

The best solution available to Congress is to repeal section 408(c)(3) and disallow an officer of the corporation from acting in a dual capacity as an ERISA trustee. In its place, Congress should enact a substitute section that provides for a two-tiered investment counseling requirement. All ERISA plans with assets over \$2,550,000 must employ the services of an ERISA investment manager,¹⁶⁹ while those plans with assets below this mark need not abide by this requirement. As in *Bendix v. Martin Marietta*,¹⁷⁰ such a plan manager will be able to administer plan assets independent of ongoing corporate activity, thereby eliminating the difficulties inherent in allowing an officer access over the administration of an ERISA pension plan. Nevertheless an

168. See *Leigh*, 727 F.2d at 132.

169. This \$2,550,000 allowance is determined by: \$17,000 [I.R.S. Employer/Employee Joint Contribution Allowance to Individual Retirement Account] x 150 employees (average number of employees based upon U.S. Census Report on Employer Benefits in Medium and Large Firms). See I.R.C. §§ 219(a), (b)(1) and (b)(2); 1371(a)(3) (1985). STATISTICAL ABSTRACT OF THE UNITED STATES, 437, (104th ed. 1984). ERISA defines an investment manager as:

any fiduciary (other than a trustee or named fiduciary, as defined in § 1102(a)(2) of this title) —

(A) who has the power to manage, acquire, or dispose of any asset of a plan;

(B) who is (i) registered as an investment adviser under the Investment Advisers Act of 1940; (ii) is a bank, as defined in that Act; or (iii) is an insurance company qualified to perform services described in subparagraph (A) under the laws of more than one State; and)

(C) has acknowledged in writing that he is a fiduciary with respect to the plan.

ERISA § 3(38), 29 U.S.C. § 1002(38) (1982). See also Shilling, *The CFO's Potential Fiduciary Liability under ERISA*, CFO., March 1985, at 65-6. A CFO (Chief Financial Officer) who names an ERISA investment manager to administer plan assets may be liable to plan participants or their beneficiaries for fiduciary breach if: "(1) the CFO participates in or conceals a breach of fiduciary duty; (2) the CFO knows of a breach but does nothing to remedy it; or (3) the CFO's failure to carry out his other duties [i.e. failure to choose the investment manager prudently] made the breach possible." *Id.*

170. See *Wall Street Journal*, Sept. 21, 1982, at 2, col.2.

officer may act as a trustee to plans with assets under \$2,550,000. This allowance is contingent on the stringent requirement that the officer/trustee, upon discovery of a "questionable transaction,"¹⁷¹ seek the advice of an ERISA investment manager. The incentive for this response is a clear exemption from any resultant fiduciary breach or imprudent action that might arise out of the "questionable transaction."

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171. In light of the potential for conflict of interest, this author would define a "questionable transaction" as one that is clearly violative of accepted corporate investment practice; according to Markowitz's portfolio theory, such an investment clearly upsets the balance of risk already maintained in the plan's portfolio. *See generally* Markowitz, *supra* note 7, at 77-91.

Corporate Golden Parachutes: An Executive Bailout from Fiduciary Duty?

I. Introduction to Golden Parachutes

A golden parachute is a potentially lucrative wage contract that compensates officers or other key executives of a corporation in the event of a change in control.¹ They are rapidly becoming a corporation's newest defensive weapon in a takeover battle. For example, if a takeover should occur which results in the replacement of existing management, the golden parachute would assure an ousted officer that he would be compensated. The ousted officer's compensation may be as high as several million dollars. Thus, an executive receives a golden profit when he "bails out" from his position.

Golden parachutes come in many forms, such as specific job titles, bonuses, or pension plans, but most often are simply a lump sum of money.² Although contractual perks for top management are not new, there is a sharp distinction between golden parachutes and other attractive executive compensation plans.³ Golden parachutes are triggered when there is a change in control of the corporation. If control never changes, then the executive never receives the parachute compensation. Thus, although justified as just another type of executive compensation, the frequent implementation of golden parachutes by corporations following a wave of merger and takeover activities in the late 1970's and early 1980's clearly underlies one main objective - to fend off takeovers.⁴

Arguably, golden parachutes are accomplishing that objective. In 1983, for example, tender offers fell to a six year low in terms of frequency and value.⁵ While some analysts partially credit a strong stock market for this decline, other analysts credit the increased use of effec-

1. Note, *Golden Parachutes - Executive Compensation or Executive Overreaching?*, 9 J. CORP. LAW 346 (1984).

2. McLaughlin, *On Golden Parachutes*, 17 MERGERS & ACQUISITIONS, Summer 1982, at 23.

3. *Id.* at 22.

4. *Id.*

5. Austin & Jackson, *Tender Offer Update: 1984*, 19 MERGERS & ACQUISITIONS, Spring 1984, at 63.

tive defensive tactics by target companies as a major factor.⁶ Therefore, it appears as though golden parachutes have had a solid impact in discouraging takeover attempts. With approximately sixty percent of the top one thousand American corporations now using golden parachutes, a strong case can be made that no executive should be without one.⁷

Corporate directors continue to justify golden parachutes mainly on the presumption that they attract and keep top-quality management.⁸ Other directors question this reasoning, claiming that an executive's primary motivation during a tender offer period should derive from fighting to save their own company. Officers want to remain in command and not become part of another company.⁹ This is the attitude that was taken by William Agee, who was the past President of Bendix Corporation. Mr. Agee claimed his golden parachute did not alter his strategy in his takeover battle with Martin Marietta Corporation and Allied.¹⁰ Therefore, the existence of a golden parachute may often attract an "extremely compensation oriented director-officer who can adopt a laissez-faire attitude during a takeover."¹¹ The premise of attracting top-quality management may be just an illusion and the prevalence of golden parachutes may be the result of corporate "follow the leader games".¹²

Whatever the justification may be for a golden parachute, arguably those who are most adversely affected by them are corporate shareholders. A director-officer owes a fiduciary duty to act in the best interest of shareholders, especially during a tender offer period.¹³ A golden parachute may lead a director-officer to become more concerned with his bail out bonus than in representing the best interests of the shareholders. Even with this obvious potential conflict courts and legislatures are reluctant to take any concrete measures to restrict their use. Only the Internal Revenue Service has taken a major active step to limit the

6. *Id.*

7. *See, e.g.,* FORBES, Nov. 22 1982, at 238. However, other surveys have been more conservative, estimating 15-30 percent of major corporations. *See generally* Morrison, *Those Executive Bailout Deals*, FORTUNE, Dec. 13, 1982 at 82.

8. Morrison, *supra* note 7, at 83.

9. *Id.* at 84.

10. *Id.*

11. McLaughlin, *supra* note 2, at 24.

12. *Id.* at 23.

13. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND BUSINESS ENTERPRISES § 207 (1983).

use of golden parachutes.¹⁴ Yet the question remains whether the IRS is the proper agency and is using the proper methods to resolve the issue of golden parachutes.

This note will explore the reasons that the mere existence of a golden parachute can constitute a breach of fiduciary duty and fraud. Special emphasis will be given to examining golden parachutes which are created during a tender offer period. Also, the remedies that a shareholder may have in the form of a derivative lawsuit under state law or an action under the Williams Act¹⁵ under federal law will be set forth. Finally, the 1984 Tax Reform Act¹⁶ will be examined to show its restrictive effect on golden parachutes.

II. The Golden Parachute and the Tender Offer: a Breach of Fiduciary Duty

Corporations have the power to create golden parachutes by virtue of The Model Business Corporation Act.¹⁷ Adopted in full by twenty-five states and in part by virtually every state, the Model Business Corporation Act provides that the power to pay pension, stock option plans, and any other incentive plans for directors, officers and employees are among the express general powers of a corporation.¹⁸ Furthermore, the courts have reinforced this power by continually recognizing the importance of incentive plans to the success of a corporation, and courts will only interfere if an incentive plan is deemed to constitute a waste of corporate assets.¹⁹ To constitute waste, however, there must be a clear misuse of the corporation's assets. This misuse must amount to a gift to a director with no relation to business activities.²⁰ Without such a flagrant abuse of a corporation's funds, courts are reluctant to become involved.

Most courts will simply apply the business judgment rule, a court

14. See *infra* text accompanying notes 86-93.

15. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 n(e)).

16. I.R.C. § 280 (G) (1984) amended by Tax Reform Act of 1984, Pub. L. No. 90-369, § 46, 98 Stat. 588 (1984).

17. MODEL BUSINESS CORP. ACT. ANN. 2D §4(k) (1971).

18. *Id.* "Besides express powers pursuant to statute or the articles of incorporation, corporations enjoy various implied powers." See H. HENN & J. ALEXANDER, *supra* note 13, § 183 (1983).

19. Rogers v. Hill, 289 U.S. 582, 591 (1933).

20. *Id.* at 591.

created concept which states that absent a showing of bad faith, the court will not substitute its judgment for that of the board of directors.²¹ Thus, the business judgment rule allows a corporation much flexibility in managing its activities. The rule probably includes compensation arrangements such as golden parachutes. A board of directors is able to defend its activities on the basis of the business judgment rule and are often successful because courts do not want to be put in the position of "second-guessing management."²² Furthermore, the courts have expanded their use of the business judgment rule by now allowing a board of directors to use the rule not only as an affirmative defense but also as a preemptive weapon for the dismissal of a shareholder's derivative suit.²³ When a corporation can show that a derivative suit is not in the best interest of the corporation the board of directors may be allowed to terminate the shareholder's action.²⁴ Although the preemptive use of the business judgment rule has yet to be implemented in relation to golden parachutes its application seems likely. The Model Business Corporation Act and the business judgment rule allow a corporation much freedom in the use of golden parachutes.

On the other hand, in the area of tender offers, golden parachutes become more than just a form of compensation in line with pension and retirement plans. Golden parachutes become an effective bargaining tool between the target company and the bidder. A conventional tender offer "normally consists of a bid by an individual or group to buy shares of a company usually at a price above the current market price."²⁵ When the tender offeror has acquired a controlling amount of

21. See *Heller v. Boylan*, 29 N.Y.S.2d 653 (N.Y. Sup. Ct. 1941). See also MODEL BUS. CORP. ACT ANN. 2D § 357(1) (Supp. 1977) .

22. F. BALDWIN, *CONFLICTING INTERESTS* 25 (1984). However, the business judgment rule has come under recent criticism with some courts now substituting their judgment for that of a corporation's board of directors. This result has occurred where there has been obvious board bias or where the board or shareholders have not been fully informed. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); *Smith v. Van Gorkom*, FED. SEC. L. REP. (CCH) ¶ 91, 921 at 90,552 (Del. Jan. 29, 1985).

23. Dent, *The Powers of Directors to Terminate Shareholder Litigation: The Death of the Derivative Suit?* 75 NW. U.L. REV. 96, 98 n.14 (1980).

24. However, certain restrictions do apply. A board of directors must show good faith and no bias. Therefore, if the board is named as defendant in a shareholder's derivative suit, they lose their independence. Corporations have gotten around this provision by setting up special litigation committees who make an investigative report and recommend whether the suit should continue. See *Zapata*, 430 A.2d at 784.

25. H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2, reprinted in 1967 U.S. CODE CONG. & AD. NEWS 2811.

shares, a takeover occurs.²⁶ However, in order to accumulate the requisite number of shares, the bidder and the target corporation may negotiate for the tender price of shares of stockholders. Since the bidder's price for the shares of the corporation is usually well above current market price, most shareholders will welcome the offer.²⁷ However, even though a director-officer must always act in the best interests of the shareholders, he may attempt to fight this profitable takeover in order to save his job.²⁸ Within one year of most takeovers the previous management is usually replaced.²⁹ It is during this tender offer period that a director-officer's loyalty may be questioned due to an inherent conflict of interest.³⁰ A breach of fiduciary duty is possible without a golden parachute because a director-officer is put in the position of choosing between his job or securing a profitable deal for his shareholders. However, the existence of a golden parachute is a strong outside factor which further weakens the relationship between a shareholder and a director-officer.

Golden parachutes can lead to breach of fiduciary duty in two main ways. First, one who is in a fiduciary position, such as an officer or key executive, "cannot serve himself first and [shareholders] second."³¹ His loyalty must be undivided and influenced only by corporate considerations.³² However, since an officer will be guaranteed a large sum of money if a takeover occurs, his incentive and motivation to inform and protect shareholders is likely to diminish. Although it is argued conversely that a corporate officer may work harder for shareholders by having the security of a golden parachute, it is questionable whether this type of person should have been hired initially because a "corporation under siege should not be manned by the unsure or insecure."³³ If an officer needs the assurance of a golden parachute in order to fight a takeover perhaps he does not have the self confidence that is necessary to do an effective job. Therefore, golden parachutes insure

26. A tender offer is by no means the only way to acquire a corporation. Other methods which will not be discussed involve exchange of assets, mergers, and proxy fights. See F. BALDWIN, *supra* note 22, at 168.

27. *Id.* at 167.

28. *Id.*

29. McLaughlin, *supra* note 2, at 27.

30. Crane Co. v. Harsco Corp., 511 F. Supp. 294, 305 (D. Del. 1981).

31. Pepper v. Litton, 308 U.S. 295, 311 (1939).

32. *Id.*

33. Note, *Future Executive Bail Outs: Will Golden Parachutes Fill the American Business Skies?*, 14 TEX. TECH. L. REV. 615, 621 (1983).

security but increase self-motivation, not fiduciary motivation.

Furthermore, golden parachutes are a drain on a corporation's assets in purely economic terms. An acquiring corporation may reduce its tender offer price per share to account for the price of the golden parachute.³⁴ Ohio's Senator Howard Metzenbaum believes this is the primary reason for limitations on the use of golden parachutes. He stated that acquiring corporations "are not that stupid to not allow the price of a golden parachute to have an impact on their offering price. . . [and]. . . shareholders wind up paying for no logical reason."³⁵ However, there are those who contend that the price of a golden parachute in relation to the total acquisition price is too minimal to be a decisive factor in discouraging takeovers.³⁶ Gulf Resources Corporation, for example, has golden parachutes totalling thirteen million dollars, an amount which would undoubtedly cause substantial impact on a bidder.³⁷ It is difficult to see how golden parachutes such as these can promote the best interests of a shareholder. A shareholder's major objective is profit. Arguably, the existence of a golden parachute clearly conflicts with this objective when corporate funds are used to pay executives rather than channeled to the shareholders through profits.

III. Shareholder's Remedies for Golden Parachutes

A. Derivative Actions Under State Law

One line of defense a shareholder may have against golden parachutes is a derivative suit. A shareholder has a right to bring an action on behalf of his corporation for the purpose of remedying wrongs to the corporation in the form of a derivative lawsuit.³⁸ A prerequisite

34. Note, *Anti-Takeover Actions and Defenses*, 28 VILL. L. REV. 51 (1982). For example: "[I]f Company X was willing to offer \$20 per share for Company Y's shares, it might offer \$18 instead which would take into account the \$2 per share cost of the severance benefits." *Id.* at 70.

35. 15 SEC. REG. & L. REP. (BNA) 1956 (1983).

36. See Morrison, *supra* note 7, at 86.

37. McLaughlin, *supra* note 2, at 23. Furthermore, this corporation showed a loss of \$77.9 million in comparison to a net profit of \$12.7 million in 1981. *Id.*

38. See H. HENN & J. ALEXANDER, *supra* note 13 at 1035 which provides: Equity developed the derivative action so that the shareholder derivatively or secondarily could enforce a corporate right against insiders or directors where those in control of the corporation refused to have the corporation sue directly and thereby protect the whole community of corporate interests-creditors and shareholders, including [his] own investment in the cor-

under most state statutes is that the complainant must have been a shareholder of the corporation at the time of the alleged wrongdoing.³⁹ However, the courts have imposed further restrictions on derivative suits by consistently holding that for derivative suit purposes the complainant must have been a shareholder not only at the time of the transaction in question, but also must remain a shareholder throughout the litigation.⁴⁰ In the absence of such status the complainant no longer has standing to proceed with the suit.⁴¹ This standing problem has become the shareholder's nemesis in golden parachute litigation. In the foremost case on golden parachutes to date, *Lewis v. Anderson*,⁴² the Delaware Supreme Court reaffirmed its previous rulings that a plaintiff who ceases to become a shareholder by reason of a merger loses standing to continue a derivative suit.

In *Lewis*, the plaintiff sued on behalf of the shareholders of Conoco, which had been the target of a successful takeover by Dupont.⁴³ The shareholders alleged that the directors, in anticipation of a potential takeover, entered into nine golden parachute contracts with key officers valued at five million dollars each, effective when the takeover occurred.⁴⁴ The shareholders contended that these golden parachutes were "illegal, improper. . . and a waste of corporate assets."⁴⁵ However, because the shareholders had sold their Conoco stock during the takeover, the defendant corporation moved to dismiss the suit for lack of standing. The Delaware Supreme Court affirmed the trial court's granting of the motion and did not address the legality of golden parachutes.⁴⁶

poration. The derivative action, because of its procedural development, is equitable in nature and besides often involves equitable issues of breach of fiduciary duty but can involve law issues of due care and claims for damages.

Id.

39. *Id.* at 1058.

40. See *Braasch v. Goldschmidt*, 199 A.2d 760, 765-66 (Del. Ch. 1964); *Heit v. Tenneco, Inc.*, 319 F.Supp. 884, 886 (D. Del. 1970).

41. *Braasch*, 199 A.2d at 767 holding that "by virtue of the merger. . . the derivative rights [of a shareholder] have passed to the surviving corporation" *Id.*

42. 477 A.2d 1040 (Del. 1984).

43. *Id.* at 1042.

44. *Id.*

45. *Id.*

46. However, the court emphasized that if there was indeed a wrong committed, New Conoco (Dupont, Inc.) could bring an action against the management of Old Conoco on behalf of the shareholders of Old Conoco. But considering that New Conoco

The effect of such a dismissal for lack of standing appears to leave no apparent remedy to the shareholder in the form of a derivative lawsuit under state law. Two cases have made exceptions to the standing prerequisite of continued shareholder status throughout the litigation. One case found that an exception exists when a corporation becomes a subsidiary of another corporation.⁴⁷ The second case created an exception when a corporation is forced to reorganize pursuant to government antitrust laws.⁴⁸ No further exceptions for golden parachutes appear imminent. Despite this pessimistic forecast, distraught shareholders have continued to question the legality of golden parachutes in corporate activities by suing the corporation under a breach of fiduciary duty claim.⁴⁹ In light of these shareholders' absence of success, a better approach may be to attack golden parachutes as a violation of a federal securities law.

B. Actions Under Federal Law for Violations of Section 14(e) of the Williams Act

A shareholder may have a cause of action for violation of a federal securities law under section 14(e) of the Williams Act.⁵⁰ The Williams Act is an amendment to the Securities and Exchange Act of 1934, and the Act's purpose is to require full and fair disclosure to a shareholder in relation to a tender offer.⁵¹ To accomplish this purpose, the Act prohibits fraudulent activities in connection with a tender offer. Only the Securities and Exchange Commission has been granted express authority by Congress to act under section 14(e).⁵² However, the Securities and Exchange Commission has sought action only under section 14(e)

joined Old Conoco in the motion to dismiss, this is an unlikely solution for the shareholders. *Id.* at 1050.

47. *Schreiber v. Carney*, 447 A.2d 17, 22 (Del. Ch. 1982). The merger in question was a mere corporation facelift and the stockholder retained his ownership interest in the corporation.

48. *Helfand v. Gambee*, 136 A.2d 558 (Del. Ch. 1957).

49. *See generally* *Schreiber v. Burlington Northern, Inc.*, 731 F.2d 163 (3rd Cir. 1984); *Wolgin v. Simon*, 722 F.2d 389 (8th Cir. 1983); *Brandon v. Chefetz*, 121 Misc.2d 54, 467 N.Y.S.2d 312 (N.Y. Sup. Ct. 1983); *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984).

50. *Williams Act*, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78n(e)) (1968).

51. H.R. REP. NO. 91-1655, 91st Cong., 2d Sess. 3 *reprinted in* 1970 CONG. & AD. NEWS 5052.

52. *Id.* §5.

on eight occasions,⁵³ while private individuals have brought actions under section 14(e) over 300 times.⁵⁴ Therefore, although the Act does not expressly grant an individual shareholder the power to use section 14(e), the courts have continued to imply a cause of action for the individual shareholder under section 14(e).

Section 14(e) of the Williams Act requires the plaintiff to prove that the target company made a misleading statement or omission of a material fact or an intent to defraud third party investors in relation to tender offers.⁵⁵ Furthermore, the plaintiff must show that he subsequently relied on the misrepresentations and suffered damage.⁵⁶ Therefore, a shareholder who is seeking damages for a golden parachute may either base his Williams Act claim on negligence or fraud.

Courts have struggled with the definition of a misstatement or omission of a material fact under the Williams Act⁵⁷ in relation to a tender offer. Some courts have held that shareholders must prove only negligence⁵⁸ and other courts require the more stringent test of showing a reckless failure by directors of a corporation to make reasonable facts available to shareholders that shareholders could have discovered with reasonable effort.⁵⁹ This distinction may become important when examining the disclosure requirements for golden parachutes and their im-

53. Note, *Securities Law: Implied Causes of Action Under Section 14(E) of The Williams Act*, 66 MINN. L. REV. 865, 870 n.23 (1982).

54. *Id.* at 870 n.23.

55. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 (n)(e)) (1968). § 78 (n)(e) provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative.

Id.

56. See *Chris Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 373 (2d Cir. 1973), *cert. denied*, 414 U.S. 910 (1973). *Panther v. Marshall Field & Co.*, 646 F.2d 271, 283 (7th Cir. 1981), *cert. denied*, 102 S. Ct. 658 (1981).

57. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. § 78 (n)(e)) (1968).

58. See *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

59. *Chris Craft*, 480 F.2d at 363.

pact on the shareholder. A shareholder may be able to discover the existence of golden parachutes with reasonable effort but the question becomes should he have to make such an effort.

The Securities and Exchange Commission is attempting to restrict the use of golden parachutes through specific disclosure provisions. Revised Item 402(e)⁶⁰, an amendment to the Securities and Exchange Act of 1933, requires a separate disclosure for compensation paid to an executive triggered by a change in control.⁶¹ However, there are many loopholes in this provision that may permit an omission of a material fact that would be misleading under the Williams Act. For example, the new disclosure provision requires individual disclosure of golden parachutes only for the top five employees of a corporation, and group disclosure for all executive officers.⁶² However, United Technologies Corporation has golden parachutes for 64 of its employees, Kimberly Clark Corporation protects 80 executives, and Beneficial Corporation maintains golden parachutes for a staggering 250 executives.⁶³ These numbers of covered employees appear way beyond the disclosure requirements. Therefore, the amount of a golden parachute compensation disclosed to a shareholder may be, in reality, a mere fraction of the total price a corporation may be required to pay to its executives upon the triggering event. This omission may be sufficient to constitute a violation of the Williams Act.

Furthermore, although disclosure is required for a change in control agreement, there are many definitions of what constitutes a change of control.⁶⁴ Although acquisition of fifty-one percent of the shares of a corporation is a standard definition, working control in many cases may be obtained with less than a majority of shares.⁶⁵ Therefore, according to the provisions of a particular golden parachute agreement even a twenty percent investment block or smaller percentage of shares could trigger the payoff.⁶⁶ Mohasco Corporation and Olin Corporation are

60. See *Final SEC Rules On Disclosure of Executive Compensation*, 15 SEC. REG. & L. REP. (BNA) at 1852 (Sept. 30, 1983) [hereinafter cited as *Final SEC Rules*].

61. *Id.*

62. *Id.* at 1854.

63. See Morrison, *supra* note 7, at 86.

64. See Berle, "Control" in *Corporate Law*, 58 COLUM L. REV. 1212, 1213-16 (1958).

65. *Id.* at 1213.

66. See generally Meyer, *Lawyer's Lament, Arbitrator's Delight*, FORBES, May 24, 1982, at 31.

examples of two companies in which a twenty percent change of ownership will trigger their respective golden parachutes.⁶⁷ Since the Securities and Exchange Commission's Rule 402(e) doesn't specifically define what constitutes a change in control, the shareholder is basically unaware under what circumstances the parachute may be paid. Although a specific change in control section was proposed, it has not been adopted.⁶⁸ The Commission felt that these disclosed matters were encompassed in other sections. Therefore, disclosure of golden parachutes can remain relatively hidden behind a myriad of ambiguous terms.⁶⁹ The golden parachute becomes lost among other types of bonuses when there is no specific change in control section. A company's failure to disclose its change in control terms that trigger its golden parachutes could further be a misleading omission under the Williams Act.

The major problem, however, with a shareholder pursuing a remedy for golden parachutes is that courts have held that the Williams Act is not applicable to mere breach of fiduciary duty.⁷⁰ A shareholder seeking to hold corporate officers liable for a negligent omission of a material fact in relation to disclosure of a golden parachute may, in reality, be alleging merely a breach of fiduciary duty. The rationale for imposing this restriction on the Williams Act is that state law governs fiduciary duty of corporations and to impose a federal standard of fiduciary duty would constitute an overlap of state and federal law.⁷¹ As previously noted, however, a shareholder will most likely not be able to proceed with a lawsuit under state law because of the standing problem. Since there is no viable state remedy for a shareholder attacking a golden parachute after a takeover has occurred, a Williams Act claim under federal law used would not be usurping a state's power to govern fiduciary duty claims.

A potential problem in using the Williams Act is that courts have

67. See Morrison, *supra* note 7, at 87.

68. See *Final SEC Rules*, *supra* note 60, at 1856.

69. However, at least one court has held that merely disclosing the formula for calculating a golden parachute is inadequate because it did not stress the importance of this compensation. See *Negligence Standard, Not Scierter, Test of Proxy Disclosure's Adequacy*, 15 SEC. REG. & L. REP. (BNA) at 1740 (Sept. 16, 1983) [hereinafter cited as *Negligence Standard*].

70. See *Altman v. Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977). *Berman v. Gerber Products*, 454 F. Supp. 1310 (W.D. Mich. 1978).

71. Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 649 (1983).

ruled that section 14(e) is not applicable to some defensive tactics⁷² because they are not sufficiently manipulative or deceptive to fall within 14(e).⁷³ To maintain an action under section 14(e) of the Williams Act it would appear that a stronger claim than breach of fiduciary duty is needed. Not only would a shareholder have to show a material omission that is misleading, but most likely would have to show fraudulent, deceptive, or manipulative acts in connection with the tender offer. But there are some golden parachutes created in anticipation of a takeover that may be fraudulent and manipulative.

A target company does not have to disclose its merger talks with a bidder.⁷⁴ A shareholder need only be informed once there is an agreement on price and structure.⁷⁵ It is possible that target management could create a golden parachute during these talks since golden parachutes require no shareholder ratification,⁷⁶ and the Securities and Exchange Commission does not require a corporation to disclose whether this plan was ratified by the shareholders.⁷⁷ Arguably then, a corporation may create golden parachutes to forestall the takeover bid or to pay themselves a bonus when the takeover becomes apparent. Although the motive may be self-interest, the result is a reduction in a shareholder's price per share due to the inclusion of the golden parachutes.⁷⁸ In this respect, certain golden parachutes can be viewed as a manipulative device which involves conduct that artificially affects market activity so as to mislead investors.⁷⁹ Market activity must be artificially affected to the extent that the activity is disguised or deliberately concealed from investors.⁸⁰ Therefore, the computations of golden parachutes in the offering price to a shareholder during a tender offer period may be disguised activity because their bargaining effect

72. *Altman*, 431 F. Supp. at 314. *Berman*, 454 F. Supp. at 1318.

73. *See Mobil v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981).

74. *Greenfield v. Heublin, Inc.*, 742 F.2d 751, 756 (3rd Cir. 1984).

75. *Id.*

76. Ratification shifts the burden to the shareholder to prove unfairness of the plan and the business judgment rule then applies. Without ratification, where directors are fixing their own compensation, the burden is on the directors to show good faith and fairness. *See Cohen v. Ayers*, 596 F.2d 733, 739 (7th Cir. 1979).

77. "Ratification disclosure is not material since investors are mainly concerned with the terms of the plan and not its likelihood of shareholder approval." *See Negligence Standard*, *supra* note 69, at 1742.

78. *Wall St. J.*, Dec. 30, 1982, at 6, col. 6.

79. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 199 (1976).

80. *Mobil*, 669 F.2d at 374.

might have depressed the value of a shareholder's stock.

Furthermore, even if there has been full disclosure to shareholders of golden parachutes, section 14(e) can still apply, if the effect of the disclosure gives the shareholders "no real alternative than to accept the offer."⁸¹ This could occur when a corporation has large blocks of institutional investors who are traditionally pro management and ultimately control the outcome of a tender offer at the expense of minority shareholders.⁸² In essence, the minority shareholder is forced into a position of tendering his shares to the acquiring corporation. In this regard, during a tender offer period, golden parachutes can become fraudulent, manipulative devices and a shareholder may be able to maintain a cause of action under the Williams Act. However, the problems with categorizing golden parachutes as a fiduciary matter coupled with the traditional view of the Williams Act as used to control rigged sales, wash sales, or other extremely manipulative activities,⁸³ may make this federal claim more difficult.

The Securities and Exchange Commission's Advisory Committee on Tender Offers is attempting to control the use of golden parachutes during tender offer periods through specific proposals. The Advisory Committee has expressed concern about a board of directors' adoption of golden parachutes after a tender offer period has begun. As a result of this concern, the Committee has proposed a provision which would prohibit a corporation from adopting change in control contracts during a tender offer period.⁸⁴ Furthermore, the Committee recommends that at each annual meeting shareholders should be requested to vote on an advisory basis as to whether the corporation should continue to use golden parachutes.⁸⁵ By restricting the use of golden parachutes during a tender offer period and making the shareholder more aware of their existence, a board of directors may become more reluctant in creating them initially. The Advisory Committee's proposals may be the best solution to the problem of golden parachutes and would reduce the need for after the fact litigation.

81. *Id.* at 377.

82. Note, *supra* note 1, at 356.

83. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 476 (1977).

84. SEC Advisory Committee on Tender Offers Special Report, FED. SEC. L. REP. (CCH) No. 1028 at 40 (Recommendation 38) (July 15, 1983).

85. *Id.* at 39.

IV. Attacking Golden Parachutes from the Back Door: The 1984 Tax Reform Act

Although the Securities and Exchange Commission may be tightening its control of golden parachutes, the Internal Revenue Service has taken an active step in restricting their use as well. The 1984 Tax Reform Act has established that "no deduction is allowed for payments to key officers under golden parachute contracts which exceed reasonable compensation and such excess payments are subject to a twenty percent excise tax".⁸⁶ Prior to this Act, corporations were allowed a deduction for all expenses that were ordinary and necessary to carry on business.⁸⁷ Inclusive in these expenses were reasonable allowances for salaries or other compensations.⁸⁸ Since golden parachutes had not been adjudged to be unreasonable,⁸⁹ the cost to the corporation of paying these change in control bonuses were deducted as an expense.⁹⁰

The reason Congress has enacted this golden parachute provision is two-fold. First, the Senate Finance Committee believed that golden parachutes served no benefit to the corporation but merely permitted an "entrenched management team to stay in control."⁹¹ Second, the Committee believed that golden parachutes may provide corporate funds to subsidize officers or other highly compensated executives when these individuals leave the corporation.⁹² The Committee was "unwilling to let the tax law be used in such a manner that would encourage this subsidy."⁹³ Therefore, it was deemed necessary to impose a penalty when a corporation granted a golden parachute to a key executive.

Under the 1984 Tax Reform Act, no deduction is allowed for any compensation arrangement which is an "excess parachute payment".⁹⁴ An "excess parachute payment" is one that is three times greater than an individual's base amount, which basically entails his average gross

86. I.R.C., §§ 280(G), 4999 (1984), *amended by* Tax Reform Act of 1984, Pub. L. No. 98-369, §46, 98 STAT. 585 (1984) [hereinafter cited as Tax Reform Act of 1984].

87. *Deficit Reduction Tax Bill of 1984*, STAND. FED. TAX. REP. (CCH Special) No. 16 at 195 (April 5, 1984).

88. *Id.* at 195.

89. *See supra* text accompanying notes 41-44.

90. *See Deficit Reduction Tax Bill of 1984*, *supra* note 87.

91. *Id.*

92. *Id.*

93. *Id.*

94. *The RIA Complete Analysis of the 1984 Tax Reform Act*, Fed. Tax Coordinator 2d § 254 (1984).

income over the past five years.⁹⁵ For example, if an individual's base amount is \$100,000, a single payment totalling \$400,000 is an "excess parachute payment" because it exceeds \$300,000 (three times the base amount of \$100,000).⁹⁶ Under the Act, the \$300,000 is nondeductible (\$400,000 minus base amount of \$100,000), not just the \$100,000 that is in excess of what the Committee believes is reasonable compensation.⁹⁷ Also, the recipient of this golden parachute will have to pay \$60,000 in excise taxes (\$300,000 x 20%) in addition to regular income taxes.⁹⁸ However, a corporation will be able to reduce the amount of the "excess parachute payment" if it can show by clear and convincing evidence that the excess portion is reasonable compensation for services actually rendered.⁹⁹ Furthermore, although there is a standard formula for calculating excess parachute payments, any contract which the Securities and Exchange Commission classifies as violative of Federal Securities Laws or Regulations will be subject to the no deduction penalty of the Act.¹⁰⁰

The 1984 Tax Reform Act imposes a heavy tax penalty on a corporation granting golden parachutes. It is difficult to comprehend why Congress has granted this right to the IRS to restrict golden parachutes in the form of a tax penalty. A corporation is taxed for the privilege of doing business as a corporation — a privilege created by the government.¹⁰¹ Therefore, the government is justified in receiving income in order to distribute the cost of government fairly, and to promote economic growth, stability and efficiency which are the basic goals of the tax system.¹⁰² However, the projected revenue that the IRS will receive from golden parachutes is less than five million dollars.¹⁰³ This pales in comparison to the 31.3 billion dollars corporations paid in

95. *Id.* The actual formula is:

the aggregate present value of all such contingent compensation payments that equal or exceeds three times the base amount. The base amount is the average annualized compensation includable in a disqualified individual's gross income in the five-taxable-year period preceding the taxable year in which the change of ownership or control of the corporation occurs.

Id., § 280 (G)(b)(d).

96. *Id.*

97. *Id.*

98. *Id.* at 97.

99. *Id.* at 99.

100. *Id.* at 97.

101. J. PECHMAN, *FEDERAL TAX POLICY* 129 (1983).

102. *Id.* at 5.

103. *Deficit Reduction Tax Bill of 1984*, *supra* note 87, at 196.

taxes in 1982.¹⁰⁴ Furthermore, the underlying reason behind the golden parachute provision in the 1984 Act is a general distain of corporations using golden parachutes as a defensive tactic to remain in control.¹⁰⁵ Arguably, the IRS should not be regulating a corporation's management decisions by imposing a tax penalty. However, it appears that Congress is unwilling to rule that golden parachutes are illegal and is unwilling to grant enforcement rights to the Securities and Exchange Commission which seems to be the proper agency to regulate golden parachutes.

It is still too early to determine whether the 1984 Tax Reform Act will cause a great reduction in the use of golden parachutes by corporations. In the opinion of one treasurer of a major corporation¹⁰⁶ listed on the American Stock Exchange, golden parachutes will continue to be used despite the tax law.¹⁰⁷ This treasurer believes that golden parachutes are still very viable because "as with any tax law there are loopholes".¹⁰⁸ A corporation could avoid the harsh effects of the tax by "basically increasing an executive's base amount thereby allowing a parachute payment to come within the three times limitation".¹⁰⁹ Alternatively, he felt that a corporation that is a frequent target may increase an employee's pension plan which is compensation that does not fall within an individual's base amount.¹¹⁰ Therefore, it appears that just as corporations have managed to side step disclosure provisions regarding golden parachutes, they will also discover alternative methods to escape the 1984 Tax Act.

V. Conclusion

Golden parachutes are created in many forms and encompass varying amounts. Some may be reasonably within a corporation's frame-

104. PECHMAN, *supra* note 97, at 144.

105. *Deficit Reduction Tax Bill of 1984*, *supra* note 87. However, it is possible that this could make golden parachutes a stronger defensive weapon since an acquiring corporation would have to compute twice the amount of the golden parachute since it is not deductible as an expense.

106. This corporation is a public corporation on the American Stock Exchange and a potential target for a takeover.

107. Telephone interview with the treasurer of a corporation listed on the American Stock Exchange (Feb. 1, 1985).

108. *Id.*

109. *Id.*

110. *Id.*

work. However, golden parachutes that are created in relation to tender offers require close scrutiny. An executive who has a golden parachute is likely to have a conflict of interest which may ultimately lead to a breach of fiduciary duty or even fraud. However, an effective remedy is presently unavailable to the shareholder either at the state or federal level. The 1984 Tax Reform Act may have created a deterrence that the shareholder has been unable to accomplish. Yet the fact remains that the golden parachute is still a legal corporate creation whose ultimate victim is the shareholder.

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