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THE LAW AND ECONOMICS OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE INVESTING BY A FIDUCIARY

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# The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary

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**Abstract**

*The use of environmental, social, and governance (ESG) factors in investing is increasingly common and widely encouraged by investment professionals and non-government organizations. However, trustees and other fiduciary investors in the United States, who manage trillions of dollars, have raised concerns that using ESG factors violates the fiduciary duty of loyalty. Under the "sole interest rule" of trust fiduciary law, a trustee or other investment fiduciary must consider only the interests of the beneficiary. Accordingly, a fiduciary's use of ESG factors, if motivated by the fiduciary's own sense of ethics or to obtain collateral benefits for third parties, violates the duty of loyalty. On the other hand, some academics and investment professionals have argued that ESG investing can provide superior risk-adjusted returns. On this basis, some have even argued that ESG investing is required by the fiduciary duty of care. Against this backdrop of uncertainty, this paper examines the law and economics of ESG investing by a fiduciary. We differentiate "collateral benefits" ESG from "risk-return" ESG, and we provide a balanced assessment of the theory and evidence from financial economics about the possibility of persistent, enhanced returns from risk-return ESG.*

*We show that ESG investing is permissible under trust fiduciary law only if two conditions are satisfied: (1) the fiduciary believes in good faith that ESG investing will benefit the beneficiary directly by improving risk-adjusted return, and (2) the fiduciary's exclusive motive for ESG investing is to obtain this direct benefit. We reject the claim that the law imposes any specific investment strategy on fiduciary investors, ESG or otherwise. We also consider how the law should assess ESG investing by a fiduciary if authorized by the terms of a trust or a beneficiary or if it would be consistent with a charity's purpose, clarifying such cases by asking whether a distribution would have been permissible under similar circumstances.*

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# The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary

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# The Law and Economics of Environmental, Social, and Governance Investing by a Fiduciary

## Introduction

Trustees and other fiduciary investment managers are under increasing pressure to consider environmental, social, and governance ("ESG") factors in their investment decisions. Charitable endowment managers, including those at Harvard and Stanford, face demands to divest from fossil fuel companies.[1] Similar pressures extend to institutional investors such as mutual and pension funds. Trust companies, too, are increasingly being asked by settlors and beneficiaries of personal trusts to consider ESG factors. In 2006, a group convened by the United Nations, the Principles for Responsible Investing ("PRI"), issued principles on ESG investing and called on investment firms to pledge adherence to them.[2] Almost 2,000 asset managers have signed the statement, including many of the world's leading institutional investors.[3]

Evidence of the salience of ESG investing abounds. In the words of Goldman Sachs, "ESG investing, once a sideline practice, has gone decisively mainstream."[4] Surveys of investment professionals find that most now incorporate some type of ESG considerations when pursuing an active investment strategy.[5] A recent Bloomberg report pointed to nearly 500 ESG indices that provide ESG ratings of individual companies.[6] Prominent financial institutions, such as Merrill Lynch, Morgan Stanley, and Northern Trust, as well as leading industry groups, such as the CFA Institute, have put out white papers and other materials on ESG investing.[7] Even index funds, such as those managed by Vanguard and BlackRock, which traditionally avoid consideration of

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[1] *See* infra Part II.C.2.

[2] *See* United Nations, Principles for Responsible Investment, The Six Principles, available at https://www.unpri.org/about/the-six-principles.

[3] *See* id., Signatory Directory, available at https://www.unpri.org/directory. Most signatories (929) are European; the second-largest group are from North America (415). *See* id., New and Delisted Signatories, available at http://annualreport.unpri.org/signatories.html.

[4] Goldman Sachs, What is Powering the ESG Surge?, available at http://www.goldmansachs.com/s/esg-report/content/esg-investing/.

[5] *See, e.g.*, CFA Institute, Environment, Social, and Governance Issues in Investing: A Guide for Investment Professionals 8 (2015), available at https://www.cfapubs.org/doi/pdf/10.2469/ccb.v2015.n11.1. (finding that 73% of investment professionals surveyed consider ESG factors).

[6] *See* Bloomberg Professional Services, ESG Indices Are Bringing Environmental, Social and Governance Data to the Fore, July 29, 2016, available at https://www.bloomberg.com/professional/blog/esg-indices-bringing-environmental-social-governance-data-fore-asia-globally/; *see also* Michael T. Dieschbourg & Andrew P. Nussbaum, Environmental, Social, and Governance Investing: No Place to Hide Thanks to Morningstar, Bloomberg, MSCI, and Multiple Global Data Providers, Inv. & Wealth Mon. 29, Nov.-Dec. 2017.

[7] *See* Merrill Lynch, Impact Investing, available at https://www.ml.com/solutions/impact-investing.html; Morgan Stanley, Investing with Impact: Creating Economic, Social and Environmental Value, available at http://www.morganstanley.com/content/dam/msdotcom/en/assets/pdfs/articles/investing-with-impact.pdf; Northern Trust, Responsible Investing for the Modern Fiduciary: Aligning Goals, Duties, Investments and Impact (2015); CFA Institute, supra note __.

firm-specific factors, are nonetheless increasingly focusing "on issues ranging from executive pay to climate change."[8] BlackRock and Vanguard both advertise their use of ESG factors in proxy voting and shareholder advocacy,[9] and Larry Fink, the CEO of BlackRock, has garnered extensive press attention for his advocacy of ESG investing.[10]

Regulators have taken notice. The U.S. Department of Labor ("DOL") has issued a series of bulletins, including three in the last few years (2015, 2016, and 2018), that address the legality of ESG investing by fiduciaries of pension and retirement accounts, each purporting to clarify the prior one.[11] In 2018, the Government Accountability Office (GAO) issued a report on ESG investing by pension fiduciaries that urged the DOL to issue still further guidance.[12] Also in 2018, Delaware amended its trust code to address specifically ESG investing by a trustee, becoming the first state to do so.[13] In 2015, the IRS issued guidance on the permissibility under the Internal Revenue Code of mission-related investing by a charity.[14] Regulators in the United Kingdom and European Union have likewise taken up the question of ESG investing by a fiduciary.[15] Meanwhile, popular media and industry coverage of purported ESG investment success stories has become commonplace.[16]

ESG investing resists precise definition, but roughly speaking it is an umbrella term that refers to an investment strategy that emphasizes a firm's governance structure and the social and environmental impacts of the firm's products or practices. For example, an ESG investment strategy might avoid fossil fuel or tobacco companies as socially and environmentally irresponsible. An ESG strategy might also involve exercising shareholder rights to pressure managers to adopt change. For example, citing "the terrible toll from gun violence in America," earlier this year BlackRock publicized its plans for "engagement with civilian firearms manufacturers and retailers."[17]

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[8] *See* Andrea Vittorio, Bloomberg BNA, BlackRock, Vanguard Show Passive Investing's Activist Streak, Dec. 13, 2017.

[9] *See* Vanguard, Vanguard's Responsible Investment Policy, available at https://about.vanguard.com/investment-stewardship/policies-and-guidelines/; BlackRock, Investment Stewardship, available at https://www.blackrock.com/corporate/about-us/investment-stewardship.

[10] *See, e.g.,* Larry Fink's Mission: How the BlackRock CEO is Leading a Sustainable Revolution on Wall Street, Barron's, June 25, 2018.

[11] *See* DOL, Interpretive Bulletins 2016-1, 2015-01, 2008-01, 2008-2, 94-1, and 94-2; Field Assistance Bulletin 2018-01.

[12] GAO Report 18-1398, Retirement Plan Investing: Clearer Information on Consideration of Environmental Social, and Governance Factors Would be Helpful, https://www.gao.gov/products/GAO-18-398.

[13] *See* Del Code tit. 12, §§ 3302(a), 3303(a)(4) (2008 amendments).

[14] *See* IRS Notice 2015-62, Investments Made for Charitable Purpose.

[15] *See, e.g.*, The Pensions Regulator, A Guide to Investment Governance 8, July 2016 (U.K.) ("Where you think environmental, social and governance (ESG) factors are financially significant you should take these into account."); Sibhan Riding, Brussels Warned Not to "Hardwire" ESG Into Fund Rules, Ignites Europe, Feb. 1, 2018 (noting that a European Commission expert report recommended "an explicit requirement for fund houses to take sustainability into account when managing money").

[16] *See, e.g.*, Asjylyn Loder, A Warning Shot on Equifax: Index Provider Flagged Security Issues Last Year, Wall St. J., Oct. 6, 2017.

[17] *See* BlackRock, BlackRock's Approach to Companies that Manufacture and Distribute Civilian Firearms (Mar. 2, 2018), available at https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/blackrock-approach-to-companies-manufacturing-

ESG investing finds its roots in the socially responsible investing ("SRI") movement that came to the fore in the 1980s as part of a divestment campaign aimed at South Africa's apartheid regime.[18] Other labels for the practice include ethical investing, economically targeted investing, sustainable or responsible investing, and impacting investing. In accordance with prevailing contemporary usage, we will use the term "ESG investing."[19]

The original motives for ESG investing were moral or ethical, based on third-party effects rather than investment returns. Such motives run afoul of the duty of loyalty under trust fiduciary law, which imposes a "sole interest rule" that requires a trustee to consider only the interests of the beneficiary, without regard for the interests of anyone else, whether the fiduciary personally or a third party.[20] Under traditional law, therefore, a trustee or other investment fiduciary subject to trust fiduciary law would be in breach of the duty of loyalty if the fiduciary employed an ESG investment strategy to satisfy the fiduciary's sense of ethics or morals or out of consideration for collateral benefits to third parties.

In the late 1990s and early 2000s, however, proponents of SRI rebranded the concept as ESG by adding corporate governance factors (the "G" in "ESG"), and they asserted that ESG investing could improve risk-adjusted returns, thereby providing a direct benefit to investors.[21] For example, instead of avoiding the fossil fuel industry to achieve collateral benefits from reduced pollution, the new suggestion was that a fossil fuel company should be divested because its litigation and regulatory risks were underestimated by its share price, and therefore divestment would improve risk-adjusted return. On this view, ESG investing is a kind of active investment strategy that seeks to profit from the market's mistaken pricing of ESG-related risk and return factors, or from the use of those factors in shareholder voting or engagement with management.[22]

By way of illustration, CalPERS, the prominent California Public Employees' Retirement System, last year responded to criticism that it was undertaking impermissible social investment by arguing that it relies on ESG factors "as an informed investor … not because [ESG factors] make us feel good but because there is sound

distributing-firearms. Media coverage of this announcement was extensive. *See, e.g.*, Sarah Krouse, BlackRock, a Shareholder in Gun Makers, Ramps Up Pressure on Gun Industry, Wall. St. J., Mar. 2, 2018.

[18] The classic scholarly discussion from that era is John H. Langbein & Richard A. Posner, Social Investing and the Law of Trusts, 79 Mich. L. Rev. 72 (1980); *see also* infra Part I.A.

[19] For example, in Interpretive Bulletins 2015-1 and 2016-1, and Field Assistance Bulletin 2018-1, the DOL shifted to ESG from economically targeted investments, as in its earlier Bulletins.

[20] *See* infra Part II.A-B.

[21] *See* infra Part I.C.

[22] *See* infra Part III.C-D.

economic reasoning to do so."[23] The California Constitution applies the trust fiduciary law sole interest rule to CalPERS and other fiduciaries of public pension plans.[24]

For clarity, we will refer to ESG investing for moral or ethical reasons or to benefit a third party as *collateral benefits ESG*, and ESG investing to improve risk-adjusted returns as *risk-return ESG*.[25] In light of this taxonomic clarity, differentiating kinds of ESG investing based on motive, this paper assesses the law and economics of ESG investing by a trustee or other investment fiduciary subject to American trust fiduciary law.[26] To be clear, we do not resolve the evolving empirical and theoretical claims regarding the investment benefits of risk-return ESG investment strategies. Nor do we pass judgment on the moral or ethical claims made by advocates of collateral benefits ESG. Rather, we consider the economic structure and legal relevance of those claims and assess what a fiduciary must do before relying on them.

Our focus is on fiduciaries with investment discretion in private trusts, pension and retirement accounts, and charitable endowments, which together hold many trillions of dollars and are governed by roughly similar fiduciary principles derived from trust law.[27] In these contexts, a trustee or other investment fiduciary has discretionary investment authority over a captive pool of assets held for the benefit of others. The question we consider is the extent to which the fiduciary may consider ESG factors, whether motivated by collateral benefits or risk and return, in deciding how to invest those assets and exercise any attendant shareholder or other control rights. We differentiate this question from the distinct question of whether a fiduciary of an open-end mutual fund, in which an investor may freely buy or sell shares, may consider ESG factors in investing the assets of the fund.[28]

We undertake this inquiry against a backdrop of confusion about both the law and the economics of ESG investing by a fiduciary. For example, assuming the potential

[23] *See* CalPERS, Slanted "Study" on the Role of ESG Falls Completely Apart, available at https://www.calpers.ca.gov/page/newsroom/for-the-record/2017/slanted-study-esg-falls-apart; *see also* see CalPERS, ESG, available at https://www.calpers.ca.gov/page/investments/governance/sustainable-investing/esg. CalPERS was replying to Tim Doyle, American Council for Capital Formation, Point of No Returns: Taxpayers on the Hook for $1 Trillion as Public Pensions Choose Politics over Performance, available at http://accfcorpgov.org/wp-content/uploads/2017/12/CalPERS-Report-Final.pdf.

[24] Ca. Const. Art. XVI, § 17(b) (public pension fiduciary must act "solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries").

[25] *See* infra Part I.D.

[26] On ESG investing abroad, see, e.g., supra note __; Melanie L. Fein, Social Investing in the United Kingdom (ESG), https://ssrn.com/abstract=3091922.

[27] *See* Max M. Schanzenbach & Robert H. Sitkoff, The Prudent Investor Rule and Market Risk: An Empirical Analysis," 14 J. Emp. Leg. Stud. 129, 130 (2017) (canvassing "trillions" of dollars of fiduciary investment).

[28] Under § 8(b)(3) of the Investment Company Act, a mutual fund's registration statement must include all "matters of fundamental investment policy," and the accuracy of that statement and the fund's prospectus is subject to the usual anti-fraud rules under Rule 10b-5 under the Securities Exchange Act and §§ 11 and 12(a)(2) of the Securities Act. Accordingly, if a fund promises socially responsible investment, under the federal securities laws it must do so. *See, e.g.*, PAX World Settles Charges of Irresponsibility, N.Y. Times, July 31, 2008 (describing SEC fine of PAX for failing to abide by its "zero tolerance" polices regarding alcohol, fossil fuels, and arms production). We also set to the side the question of menu construction in a defined contribution pension plan. *See* infra note __.

for risk-return ESG investing to generate excess risk-adjusted returns, an influential 2005 report sponsored by the PRI and prepared by the British law firm Freshfields Bruckhaus Deringer offers a strong defense of risk-return ESG investing by fiduciaries. The report argues that ESG strategies are consistent with fiduciary duty and, even more, that considering ESG factors "is arguably required in all jurisdictions."[29] In a 2015 follow up, the PRI took the position that that it had "end[ed] the debate about" ESG and fiduciary duty, concluding that "there are positive duties on investors to integrate ESG issues."[30] Professor Susan Gary, who served as the reporter (drafter) for the Uniform Prudent Management of Institutional Funds Act, which governs the fiduciary investment of charitable endowments in almost every state, has likewise argued "that a prudent investor may, and should, consider material ESG factors as part of a robust financial analysis."[31]

Bucking this trend, we show that ESG investing is permissible by a trustee or other fiduciary of a private trust, pension, or charitable endowment only if: (1) the fiduciary believes in good faith that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return,[32] and (2) the fiduciary's exclusive motive for adopting the ESG investment program is to obtain this direct benefit.[33] We show, in other words, that risk-return ESG can be consistent with fiduciary duty but is not required by it, and collateral benefits ESG is generally not consistent with fiduciary duty. We allow, however, for the possibility of overlap between a charity's purpose and certain collateral benefits as well as for authorization of a fiduciary's pursuit of collateral benefits by the terms of a trust or by the beneficiary, clarifying such cases by analogy to whether a distribution would be permissible under similar circumstances.[34]

The simple insight that drives our analysis is that, taking claims about motive at face value, risk-return ESG investing is no different than any other kind of investment strategy that seeks to exploit market mispricing or shareholder control rights for profit. We therefore review the literature from financial economics that examines the relationship of ESG factors to firm performance, and further whether such a relationship, to the extent it exists, can be exploited by trading (what we will call *active investing*) or in exercising shareholder control rights (what we will call *active shareholding*) to improve risk-adjusted return.[35] We conclude that there is theory and evidence in support of risk-return ESG. However, we caution that this support is not conclusive and in all events is subject to change, especially as markets adjust to the growing use of ESG factors.

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[29] UNEP Finance Initiative, A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment 13 (2005) ("Freshfields Report").

[30] UNEP Finance Initiative, Fiduciary Duty in the 21st Century 9 (2015).

[31] Susan N. Gary, Best Interests in the Long Term: Fiduciary Duties and ESG Integration, __ Colo. L. Rev. __ (forthcoming ___) ("Best Interests in the Long Term"); *see also* Susan N. Gary, Values and Value: University Endowments, Fiduciary Duties, and ESG Investing, 42 J. C. & U. L. 247 (2016) ("Values and Value").

[32] *See* infra Part III.

[33] *See* infra Part II.A-B.

[34] *See* infra Part II.C-D.

[35] *See* infra Part III.B-D.

Crucially, nothing in the law or economics of ESG investing requires a fiduciary to use ESG factors. To the contrary, both passive and contrarian investment strategies are also permissible and likewise find support in the financial economics literature. Thus, as we shall see, a trustee or other investment fiduciary could justify a contrarian, anti-ESG investing strategy on the same conceptual and economic logic that the PRI and others have invoked in support of ESG investing.[36] Accordingly, we reject the view taken by the PRI and others that a fiduciary must consider ESG factors, and that the failure to do so is a breach of duty.[37] We also reject the position taken by the DOL (and PRI) that collateral benefits may be considered by a pension fiduciary as a tie breaker in choosing between purportedly equivalent investments. Although the DOL Bulletins are largely in accord with our analysis, in this one respect the Bulletins, which are not notice-and-comment rules entitled to *Chevron* deference, are dubious as a matter of textbook financial economics and are contrary to the controlling statute and U.S. Supreme Court precedent.[38]

The remainder of this paper is organized as follows. Part I summarizes the rise of ESG investing from its roots in the SRI movement through the present day, the shift from emphasizing collateral benefits on moral or ethical grounds (collateral benefits ESG) to improved risk-adjusted returns (risk-return ESG), and the inherent subjectivity to the ESG rubric. Part II assesses the legality of collateral benefits versus risk-return ESG investing by a trustee or other investment fiduciary under the duty of loyalty, and revisits collateral benefits ESG as a tie breaker, in a charity, or if authorized by the terms of a trust or a beneficiary. Part III assesses the legality of ESG investing by a trustee or other investment fiduciary under the duty of care or prudence, disentangling the economic theory and empirical evidence behind the claim that risk-return ESG investing can generate excess risk-adjusted returns from the theory and evidence that ESG factors have a relationship to firm performance. Part III also rejects the claim that ESG investing is or ought to be mandatory for a fiduciary. A brief conclusion follows.

## I. SRI, Collateral Benefits ESG, and Risk-Return ESG

ESG investing grew out of the SRI movement that came to the fore in the late 1970s and early 1980s as part of a divestment campaign aimed at South Africa's Apartheid regime. Despite the strong appeal of the divestment movement, many legal scholars concluded that fiduciary divestment was inconsistent with fiduciary principles. South African divestment was motivated by a desire for social change to benefit others (collateral benefits), and came with the cost of undermining portfolio efficiency. As governance factors were added to SRI in the 1990s, advocates of SRI, now rebranded as ESG investing, began asserting that applying ESG factors to portfolio management could produce excess risk-adjusted returns—that investors could do well by doing good. The argument that ESG investing can have direct benefits to beneficiaries can, as we shall see, change the legal analysis. For clarity, therefore, we differentiate between ESG investing motivated by obtaining collateral benefits, in effect classic SRI, which we will call *collateral benefits ESG*, from ESG investing motivated by improved risk-adjusted

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[36] *See* infra Part III.C.4.

[37] *See* infra Part III.E.

[38] *See* infra Part II.B.3.

returns, which we will call *risk-return ESG*. At the same time, we take notice of the subjectivity in and plasticity to the ESG rubric, which has been a further source of confusion.

**A. The Rise of SRI**

Today's ESG investing phenomenon traces its roots to SRI practices that avoided investment in firms that made antisocial products. In an eighteenth century sermon, John Wesley, the founder of the Methodist Church, called on his followers to avoid profiting from businesses harmful to one's neighbors, particularly the alcohol and slave trades, or to one's workers, such as chemical production.[39] Some commentators view this exhortation, in effect an investment screen, as the first instance of SRI.[40] As financial markets developed, some mutual funds applied social screens to their investment programs, providing an investment vehicle that avoided certain businesses on moral grounds. The first SRI fund, the Pioneer Fund, began in 1928 as an ecclesiastical investment fund committed to social justice, and it remains in existence today.[41] The promise of the Pioneer Fund, however, was to avoid morally questionable investments, not to obtain better risk-adjusted returns.[42]

SRI funds that eschewed defense firms gained additional prominence in the 1970s as a consequence of the Vietnam War.[43] During the late 1970s and into the 1980s, the policies of South Africa's apartheid government put SRI more clearly into the spotlight as activists called for a boycott of firms that did business in South Africa. Some activists called for complete divestment from any firm doing business in South Africa,[44] while others suggested that investments should be permitted in firms if they agreed to abide by certain principles (known as the Sullivan principles) of non-discrimination in

[39] *See* John Wesley, Sermon 50: The Use of Money, *in* 2 The Works of John Wesley: Sermons II 34-70, at 266, 266-67 (Albert C. Outler ed., 1985). Some trace the origins of SRI to seventeenth century Quakers. *See* Amy L. Domini, What Is Social Investing? Who Are Social Investors?, in The Social Investment Almanac 6 (Peter D. Kinder et al. ed., 1992).

[40] *See, e.g.*, Russell Sparkes, Socially Responsible Investment: A Global Revolution 46-47 (2002) (describing Wesley as a "precursor who anticipated [social investing's] modern forms.").

[41] *See* BusinessWire, Pioneer Investments Commemorates 80 Years in Asset Management with the Closing Bell Ringing at New York Stock Exchange, Feb. 12, 2008, http://www.businesswire.com/news/home/20080212005979/en/Pioneer-Investments-Commemorates-80-Years-Asset-Management.

[42] *See* John C. Harrington, Investing with Your Conscience: How to Achieve High Returns Using Socially Responsible Investing 47 (1992).

[43] *See, e.g.*, Sarah M. Gantz, Luther E. Tyson, 85: Applied Social Activism to Mutual Fund Investing, Bos. Globe, May 22, 2008 (history of PAX Fund and avoiding defense firms during Vietnam War).

[44] *See, e.g.*, D. Hauck, M. Voorhes & G. Goldberg, Two Decades of Debate: The Controversy Over U.S. Companies in South Africa (1983). Universities felt particular pressure to divest, and many did so. *See* Hunter Boson, Shorting the Devil, Cornell Bus. Rev. 5-7 (Spring, 2016) (reporting that 155 universities divested from all companies doing business with South Africa).

their South African operations.[45] These alternate approaches reflect the perennial debate about whether voice or exit is a better strategy toward motivating change.[46]

## B. SRI and Fiduciary Principles

With the growing salience of SRI, and the obvious importance of pensions, charities, and trusts for capital markets, commentators began to consider the propriety of SRI by a fiduciary in light of the duties of loyalty and care (or prudence). With respect to the duty of loyalty, which as we shall see requires a trustee or other investment fiduciary to act in the "sole" or "exclusive" interest of the beneficiary,[47] the concern was that giving consideration to the welfare of the oppressed black majority in South Africa would be taking account of an interest other than that of the beneficiary.[48] With respect to the duty of care, which as we shall see requires a diversified portfolio with risk and return objectives reasonably suited to the purpose of the fiduciary account,[49] the concern was that complete divestment from any firm doing business in South Africa would undermine diversification by skewing portfolios away from large-cap firms with an international presence and toward small-cap firms and certain domestic industries (such as utilities).[50]

Most commentators, most prominently John Langbein and Richard Posner, concluded that fiduciaries could not divest from firms in South Africa without breaching their fiduciary duties.[51] Some investment managers agreed.[52] Even some commentators

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45 Named for General Motors director Reverend Leon Sullivan. *See* Hauck, Voorhes & Goldberg, supra note __, at 147. Sullivan eventually came to favor total divestment from South Africa. *See* Sullivan Principle's Author Hopes for Change, N.Y. Times (Oct. 22, 1986).

46 The foundational work is Albert O. Hirschman, Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States (1970).

47 *See* infra Part II.A.

48 *See* Langbein & Posner at 73-75, supra note __.

49 *See* infra Part III.A.

50 *See* Langbein & Posner, supra note __ at 85-86; Ennis & Parkhill, supra note __ at 34-35.

51 *See* Langbein & Posner, supra note __; *see also* Robert J Lynn, Investing Pension Funds for Social Goals Requires Changing the Law, 53 U. Colo. L. Rev. 101 (1981); Richard M. Ennis & Roberta L. Parkhill, South African Divestment: Social Responsibility or Fiduciary Folly? 42 Fin. An. J. 30 (1986); Robert H. Jerry & O. Maurice Joy, Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion, 66 Or. L. Rev. 685 (1987); *but see* Ann-Catherine Blank, The South African Divestment Debate: Factoring Political Risk into the Prudent Investor Rule, 55 U. Cin. L. Rev. 201, 216 (1986) (arguing that fiduciary investors should consider political risks, which could make investments in South Africa unattractive, thus making a risk-return ESG point); Thomas A. Troyer, Walter B. Slocombe & Robert A. Boisture, Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds, 74 Geo. L. J. 127, 148-49 (1985) ("More traditional trust law principles suggest that a trustee who approves a divestment policy breaches his or her duty of loyalty because he or she is pursuing an objective extraneous to the purposes of the trust. However, this analysis fails to account for the various ways in which divestment may advance a trust's charitable purposes.").

52 *See* A Wary Reception for the Sullivan Stand, N.Y. Times, June 8, 1987, at 26 (reporting that some fund managers, citing fiduciary obligation, refuse divestment).

who were strongly in favor of divestment on moral grounds conceded that existing law would require reform to permit a fiduciary to participate in total divestment.[53]

As an alternative to total divestment, some advocated "selective divestment" based on whether a company doing business in South Africa abided by the Sullivan non-discrimination principles.[54] Because selective divestment would exclude fewer firms,[55] in theory it would be less damaging to portfolio efficiency, a result that was borne out by empirical study.[56] On this basis, some commentators argued that selective divestment was consistent with the fiduciary duty of care.[57] But this conclusion sidestepped the loyalty issue raised by the fiduciary acting for the benefit of third-parties. The duty of loyalty has not typically been understood to allow a de minimus or no harm defense to an improper motive, as we shall see.[58]

### C. From SRI to ESG

Following Apartheid's collapse, the fiduciary law issues surrounding SRI largely laid dormant in the legal literature across the next couple of decades. Investment professionals, however, developed a renewed interest in SRI as investor demand for socially responsible funds increased in the 1990s and further into the 2000s.[59] Between 1995 and 2005, many new SRI funds were launched and their assets under management increased substantially, growing by one estimate from 55 funds to 201 funds and from $12 billion to $179 billion.[60]

At the same time, SRI advocates shifted both their investment strategies and their marketing in two related ways. First, SRI funds began explicitly to incorporate corporate governance into their investment strategies, tying sound governance to their social mission and rebranding SRI as ESG. Second, SRI funds began appealing to investors' financial interests, as well as their ethical sense, by asserting that SRI funds could be both morally and financially superior to other funds, offering excess risk-adjusted returns.[61]

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[53] *See, e.g.*, Joel C. Dobris, Arguments in Favor of Fiduciary Divestment of South African Securities, 65 Neb. L. Rev. 209, 233-36 (1986); Joel C. Dobris, SRI—Shibboleth or Canard (Social Responsible Investing, That Is), 42 Real Prop. Probate & Trust J. 755, 788-790 (2008).

[54] *See supra* note 45 and text accompanying.

[55] *See* Ennis & Parkhill, supra note __, at 32 (finding that only 13% of the S&P 500 would be excluded by Sullivan principles).

[56] *See* Blake R. Grossman & William F. Sharpe, Financial Implications of South African Divestment, 42 Fin. Analysts J. 15 (1986).

[57] *See, e.g.*, Maria Hylton, Socially Responsible Investing, 42 Am. U. L. Rev. 1, 43 (1992); Robert H. Jerry & O. Maurice Joy, Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion, 66 Oregon L. Rev. 685, 746-748 (1987).

[58] *See* infra Part II.A-B.

[59] *See, e.g.*, Danny Hakim, On Wall St., More Investors Push Social Goals, N.Y. Times Al, Feb 11, 2001; Susan Sherriek, A Conscience Doesn't Have to Make You Poor, Bus. Wk. 204, May 1, 2000.

[60] *See* Social Investment Forum, Trends in Socially Responsible Investing 9 (2010), available at https://www.ussif.org/files/Publications/10_Trends_Exec_Summary.pdf.

[61] *See* Michael S. Knoll, Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment, 75 Bus. Lawyer 681, 682 (2002) (noting "SRI industry's steady

The addition of governance factors in the 1990s, widely accepted as relevant to firm value,[62] brought theoretical and empirical credibility to claims regarding excess return. At the same time, massive corporate bankruptcies such as WorldCom and Enron, tied to misconduct and weak governance, drew further attention to governance factors in investing and were followed by regulatory reforms.[63] In the academy, a highly influential 2003 paper by Paul Gompers, Joy Ishii, and Andrew Metrick developed and applied an index of corporate governance,[64] with a many follow-on papers suggesting that identifiable and measurable governance factors have a significant effect on firm performance. Other indices followed, including a prominent entrenchment index in 2009 by Lucian Bebchuk, Alma Cohen, and Allen Ferrell.[65] A further prod for ESG investing came as a result of the financial crisis of 2007 and the Great Recession, which led to a search for better risk measures, with some suggesting that ESG factors better identify risk.[66]

### D. Collateral Benefits ESG versus Risk-Return ESG

ESG investing arose out of an SRI approach that focused on providing collateral social or environmental benefits, but that more recently has come to include corporate governance and to emphasize improved risk-adjusted returns. In consequence, the term ESG investing has confusingly become an umbrella term covering both concepts. A reference to an "ESG investing strategy" is inherently ambiguous as to whether the investor's purpose is collateral benefits (in effect, classic SRI) or improved risk-adjusted returns.[67]

For clarity, we will refer to ESG investing motivated by providing a benefit to a third party or otherwise for moral or ethical reasons as *collateral benefits ESG*, and ESG investing to improve risk-adjusted returns as *risk-return ESG*. For example, a collateral benefits ESG investment strategy might avoid investment in the fossil fuel industry for

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promotion of ethical screening" via claim "that investors who use both social and economic criteria to make investment decisions can make a profit while improving the world").

[62] *See* infra Part III.B.2.

[63] *See* Sparkes, supra note __. The most salient reform was the Sarbanes-Oxley Act, enacted by Congress in 2002. There is reason to doubt the efficacy of the Sarbanes-Oxley reforms. *See* Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521 (2005)..

[64] *See* Paul A. Gompers, Joy L. Ishii & Andrew Metrick, Corporate Governance and Equity Prices, 118 Q. J. Econ. 107 (2003).

[65] *See* Lucian Bebchuk, Alma Cohen & Allen Ferrell, What Matters in Corporate Governance, 22 Rev. Fin. Stud. 783 (2009).

[66] *Compare* Karl V. Lins, Henri Servaes, & Ane Tamayo, Social Capital, Trust, and Firm performance: The Value of Corporate Social Responsibility During the Financial Crisis, 72 J. Fin. 1785 (2017) (finding that, during the Great Recession, firms with high ESG factors outperformed, but no difference outside the financial crisis); John Nosfinger & Abhishek Varma, Socially Responsible Funds and Market Crises, 48 J. Bank. & Fin. 181, 192 (2013) (finding that SRI funds outperform non-SRI funds during crises, but non-SRI funds perform better otherwise), *with* Pieter Jan Trinks & Bert Scholtens, The Opportunity Cost of Negative Screening in Socially Responsible Investing, 140 J. Bus. Ethics 193, 202 (2017) (finding that "[n]early all combined controversial [low-social score or "sin stocks"] portfolios beat the market during the recessionary period in an economically significant way").

[67] *See, e.g.,* GAO Report, supra note __, at 5 (noting "terminology is not consistently defined in the industry").

the collateral benefit of reducing pollution. Risk-return ESG investing, by contrast, is an active investment strategy that employs ESG factors as metrics in assessing expected risk and return. A risk-return ESG analysis of a fossil fuel company might conclude that the company's litigation and regulatory risks are underestimated by the company's share price, and therefore that reducing or avoiding investment in the company will improve risk-adjusted return. The distinction between collateral benefits ESG and risk-return ESG turns on the investor's motive, as does the analysis under the fiduciary duty of loyalty, as we shall see.[68]

In application, risk-return ESG investing typically follows one of two patterns. In the first, an investor uses ESG factors to pick stocks or other securities on the theory that those factors can be used to identify market mispricing and therefore profit opportunities (we'll call this *active investing*).[69] In the second, an investor uses ESG factors to guide the investor's shareholder voting or other engagement with management in a manner that improves firm performance and therefore investment returns (we'll call this *active shareholding*).[70] In both applications, the investor uses ESG factors as metrics for assessing expected risk and return—that is, they are additional tools for pursuing better returns and less risk. This use of ESG factors, what we are calling risk-return ESG, is to be differentiated from using ESG factors to identify on moral or ethical grounds investments that will provide collateral benefits to third parties (in effect, classic SRI), what are calling collateral benefits ESG.

**E. What Counts as an ESG Factor?**

The move from classic SRI to risk-return ESG, and the campaign by the PRI and others to urge fiduciaries to adopt ESG investing on grounds of risk and return, puts pressure on identifying which factors qualify as "ESG" factors.

At a high level of abstraction, there is a rough consensus on core ESG factors. Unhealthy products and poor labor practices are bad social factors. A strong compliance record on environmental and labor regulations are good environmental and social factors. Poorly incentivized and entrenched management are bad governance factors. However, when moving from abstraction to details in implementation, there is a lack of consensus on both whether a given consideration qualifies as an ESG factor and whether the factor is a plus or a minus from an investor's perspective. As the professional association for Chartered Financial Analysts has explained, "there is no exhaustive list of ESG issues,"[71] and there is no consistency in the labels used to describe investment strategies that consider ESG factors.[72]

Consider, for example, environmental factors. Although there is broad abstract agreement about the environmental costs of coal and oil, some types of coal may be

[68] *See* infra Part II.

[69] *See* infra Part III.C.

[70] *See* infra Part III.D.

[71] CFA Institute, supra note__, at 4. The extent of a company's ESG disclosure is itself a factor in the ESG scoring of the company by some ratings services. *See* Dieschbourg & Nussbaum, supra note __, at 30.

[72] *See* id. at 5.

cleaner than others, and some forms of oil production are less harmful than others.[73] There is likewise significant dispute about the environmental impact of natural gas.[74] Nuclear power is perhaps an even harder question.[75] On the one hand, nuclear power is desirable if one is concerned about carbon emissions. On the other hand, the "tail risk" of a catastrophic meltdown,[76] such as in Three Mile Island or Chernobyl, is greater for a nuclear power plant than a fossil fuel plant.[77] In undertaking an ESG investment program, should a firm's exposure to nuclear power be a plus or a minus on environmental grounds? What if a single utility company owns both good and bad power plants?

The use of social factors is perhaps even more fraught than environmental factors. What constitutes an unfair labor practice or whether alcohol is a social ill hardly commands universal agreement.[78] Moreover, whether a given social factor is a positive, negative, or neutral may change over time as norms and values evolve. One of the oldest ESG funds, the PAX Fund, today invests in firms that conduct alcohol and gambling business, reasoning that society is now more receptive to these products.[79]

A social factor that has been of particular focus lately is race and gender diversity, often in the context of the composition of a company's board of directors, making this a governance factor as well.[80] For example, BlackRock takes the position that

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[73] *See, e.g.*, an Urbina, Short Answers to Hard Questions About Clean Coal Technology, N.Y. Times (July 5, 2016), https://www.nytimes.com/interactive/2016/07/01/science/what-is-clean-coal.html (suggesting that clean coal will "play a vital role in slowing climate change"); Stanford and Climate Change: A Statement from the Board of Trustees (April 25, 2016), https://news.stanford.edu/2016/04/25/stanford-climate-change-statement-board-trustees/ (concluding that oil sands are much worse for greenhouse gas emissions and other pollutants).

[74] *See, e.g.*, Sarah Zielinski, Natural Gas Really Is Better Than Coal: If Too Much Methane Leaks During Production, Though, the Benefits will be Lost, Smithsonian.com (Feb. 13, 2014), https://www.smithsonianmag.com/science-nature/natural-gas-really-better-coal-180949739/.

[75] See, e.g., Melanie Windridge, Fear of Nuclear Power is Out of All Proportion to the Actual Risks, The Guardian (April 4, 2011), https://www.theguardian.com/science/blog/2011/apr/04/fear-nuclear-power-fukushima-risks (arguing that nuclear power is safe and critical to fighting climate change); Mark Diesendorf, Accidents, Waste and Weapons: Nuclear Power Isn't Worth the Risks, The Conversation (May 18, 2015), http://theconversation.com/accidents-waste-and-weapons-nuclear-power-isnt-worth-the-risks-41522 (arguing that nuclear power contributes to creation of weapons, results in serious accidents, leads to more greenhouse gas emissions, and is expensive).

[76] We take up "tail risk" infra Part III.C.1.

[77] *See* Spencer Wheatley, Benjamin K. Sovacool & Didier Sornette, Reassessing the Safety of Nuclear Power, 15 Energy Res. & Soc. Sci. 96 (2016) (summarizing statistical analyses, finding a 50% chance of a Fukushima event every 60-150 years); *but see* Stan Gordelier, Comparing Nuclear Accident Risks with Those from Other Energy Sources, Nuclear Energy Agency Organization for Economic Co-Operation and Development (2010), https://www.oecd-nea.org/ndd/reports/2010/nea6861-comparing-risks.pdf (comparing severe accident data "from a wide range of energy sources" and concluding that "nuclear energy risks are often much lower than in other industries").

[78] *See, e.g.*, Saabira Chaudhuri, Lawmakers, Alcohol Industry Tussle Over Cancer Labels on Booze, Wall St. J., Feb. 9, 2018 (discussing regulatory debate over warning labels on alcohol).

[79] *See* Daniel Akst, Mutual Funds Report; The Give and Take of "Socially Responsible," N.Y. Times, Oct. 8, 2006.

[80] *See, e.g.*, Ernst & Young, 2018 Proxy Season Preview: What We're Hearing from Institutional Investors, available at http://www.ey.com/us/en/issues/governance-and-reporting/ey-2018-proxy-season-preview#section1.

"in order to create a constructive debate of competing views and opinions in the boardroom, a board of directors must "be comprised of a diverse selection of individuals," including "normally … at least two women directors on every board."[81] But would not an investment program that favored firms with at least one woman or at least three women on a board also qualify as an ESG investing strategy? Some of this subjectivity reflects the mixed results in the empirical studies on the relationship between board diversity and firm value.[82]

Governance factors apart from board diversity are subjective too. Consider a classified or staggered board. On the one hand, a classified board might entrench bad management, diminishing firm value. On the other hand, a classified board might provide the stability necessary to attract better managers and allow them to focus on long-term growth, enhancing firm value. The empirical evidence on the effect of a classified board on firm value suggests that the effects of classification are contextual,[83] with some finding that a classified board could be value-enhancing in some contexts, in particular for "firms that rely on long-term investment or long-term relationships."[84] In undertaking an ESG investment program, when should a classified board be a plus or a minus?

Still another area of subjectivity is in how much weight to give a particular ESG factor. Which among various environmental, social, and governance factors are the most important factors? What if different factors point in opposite directions? For example, how should an investor rate the ESG status of a firm that has a strong environmental record but poor governance?

The fluidity of the ESG rubric and the subjectivity in applying ESG factors helps to explain why the umbrella term ESG captures so broad an array of investment factors, and why surveys of investment professionals now find that most report incorporating some type of ESG factors when pursuing an active investment strategy.[85] Subjectivity, we hasten to add, is not unique to ESG investing. Like any form of active investing, risk-return ESG investing necessarily involves subjective judgments in the identification of ESG factors, assessing whether they are good or bad from an investor's perspective, and

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[81] BlackRock, Proxy Voting Guidelines for U.S. Securities 4, Feb. 2018, available at https://www.blackrock.com/corporate/en-br/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf.

[82] *See* Deboarah L. Rhode & Amanda K. Packel, Diversity on Corporate Boards: How much Difference Does Difference Make?, 39 Del. J. Corp. L. 377, 383 (2014) ("despite increasing references to acceptance of the business case for diversity, empirical evidence on the issue is mixed."); *see also* Donald C. Langevoort, Commentary: Puzzles About Corporate Boards and Board Diversity, 89 N.C. L. Rev. 841, 842 (2011) ( "we have no coherent, consistent explanation for how boards themselves add value to the firm, … it is hard to develop and test any useful hypothesis about their diversity").

[83] *See, e.g.,* Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, Settling the Staggered Board Debate, 166 U. Pa. L. Rev. __ (forthcoming 2018); Emiliano M. Catan & Michael Klausner, Board Declassification and Firm Value: Have Shareholders and Boards Really Destroyed Billions in Value?, NYU School of Law, Law and Economics Research Paper Series Working Paper No. 17-39, available at https://ssrn.com/abstract=2994559.

[84] Michael Klausner, Empirical Studies of Corporate Law and Governance: Some Steps Forward and Some Steps Not, *in* Oxford Handbook of Corporate Law and Governance (2018).

[85] *See* supra note 5 and text accompanying.

how much weight to give each factor. But this subjectivity makes application and evaluation of ESG investing both challenging and highly contextual. As some astute commentators recently noted, "the breadth and vagueness of the factors as a whole, and the likelihood that different factors bear on different investments, present barriers to their widespread use as investment guides."[86]

## II. Fiduciary Loyalty and ESG Investing

Having canvassed the evolution from SRI to ESG, disentangled collateral benefits ESG from risk-return ESG, and (to the extent possible) defined ESG investing, we are now in a position to assess whether a trustee or other fiduciary of a private trust, pension fund, or charitable endowment may pursue ESG investing. For the most part, trust fiduciary law supplies the controlling principles, not only for trusts, but also for pensions and charitable endowments. The Employee Retirement Income Security Act of 1974 (ERISA), imposes a mandatory trust structure on most private pension and retirement accounts as a matter of federal law,[87] and the widely adopted Uniform Prudent Management of Institutional Funds Act (UPMIFA) likewise applies trust investment law to charitable endowments as a matter of state law.[88] Accordingly, we draw primarily on trust fiduciary law, relying on canonical sources such as the Restatements of Trusts.[89] Where appropriate, we also take note of corresponding or deviating ERISA and charitable endowment authorities, though we hasten to add that the U.S. Supreme Court has relied on the Restatements of Trusts as authoritative in ERISA disputes.[90]

Any investment strategy by a trustee or other fiduciary, whether ESG or otherwise, must satisfy both the duty of loyalty and the duty of care or prudence. We focus in this Part on ESG investing by a trustee under the duty of loyalty. We defer the duty of care or prudence until Part III.

Our loyalty analysis proceeds in two steps. First, we consider the fiduciary duty of loyalty, which requires a trustee to act in the "sole" or "exclusive" interest of the beneficiary, and therefore proscribes collateral benefits ESG, even as a tie-breaker, but would allow risk-return ESG (Sections A and B). Second, we consider whether our general conclusion that collateral benefits ESG is impermissible under the duty of

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[86] Paul Brest, Ronald J. Gilson & Mark A. Wolfson, How Investors Can (and Can't) Create Social Value, at 23-24 (2018), Columbia Law and Economics Working Paper No. 583; Stanford Law and Economics Olin Working Paper No. 520, available at https://ssrn.com/abstract=3150347.

[87] *See* ERISA § 403(a), 29 U.S.C. § 1103(a) (mandating that "all assets of an employee benefit plan shall be held in trust").

[88] *See* UPMIFA § 3 (Unif. Law Comm'n 2006) (applying the trust law prudent investor rule to charitable endowments); Uniform Law Commission, Prudent Management of Institutional Funds Act, http://www.uniformlaws.org/Act.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act (depicting enactment status across the states).

[89] *See* Robert H. Sitkoff & Jesse Dukeminier, Wills, Trusts, and Estates 387-91 (10th ed. 2017) (describing sources of American trust law).

[90] *See, e.g.*, Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015) (relying on the Restatement (Third) of Trusts); Fifth Third Bancorp v. Dudenhoeffer, 134 S.Ct. 2459, 2469 (2014) (relying on the Restatement (Second) of Trusts).

loyalty may yield for a charitable endowment (Section C) or if authorized by the terms or the beneficiary of a trust (Section D).

**A. The "Sole Interest" Rule**[91]

The trust law fiduciary duty of loyalty prohibits a trustee from considering the interests of persons other than trust beneficiaries. A trustee must "administer the trust *solely* in the interest of the beneficiaries."[92] This principle is sometimes called the "sole interest," "sole benefit," or "exclusive benefit" rule.[93] ERISA codifies this trust law rule, providing that an ERISA fiduciary must act "*solely* in the interest of the plan participants and beneficiaries" and for the "*exclusive* purpose" of benefitting them.[94] The duty of loyalty in a charity is more variable, sometimes departing from the sole interest rule in favor of a best interests rule, a complication to which we return below.[95]

In elaborating on the sole interest rule, the Restatement (Third) of Trusts explains that "the trustee has a duty to the beneficiaries not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust."[96] The Restatement (Second) of Trusts is to similar effect. A "trustee is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person."[97] A trustee thus violates the duty of loyalty, even in the absence of self-dealing, if the trustee has any motive or rationale for undertaking an action other than the "sole interest" or "exclusive benefit" of the beneficiary. A trustee who is influenced by his own or a third party's interests is disloyal, because the trustee is no longer acting solely in the interest of the beneficiaries.

The "sole interest" rule is not without controversy. Scholars have debated the soundness of the rule, with some arguing that trust law should switch to a "best interest" rule that would allow trustees to defend a conflicted action as being in the best interest of the beneficiary.[98] In corporate law and several other fiduciary fields, including as we shall see certain forms of charity,[99] the duty of loyalty is framed as a "best interest" rule that is more tolerant of mixed motives.[100] For example, directors of a corporation

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[91] Portions of this section draw on Robert H. Sitkoff, Fiduciary Principles in Trust Law, *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018), without further attribution.

[92] Restatement (Third) of Trusts § 78(1) (Am. Law Inst. 2007) (emphasis added); *see also* Unif. Trust Code § 801(a) (Unif. Law Comm'n 2000) (same).

[93] *See, e.g.*, Daniel R. Fischel & John H. Langbein, ERISA's Fundamental Contradiction: The Exclusive Benefit Rule, 55 U. Chi. L. Rev. 1105, 1108 (1998).

[94] ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (emphasis added). The California Constitution provides likewise for a public pension fiduciary. *See* supra note __.

[95] *See* infra Part II.C.

[96] Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007).

[97] Restatement (Second) of Trusts § 170 cmt. q (Am. Law Inst. 1959).

[98] *Compare* John H. Langbein, Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?, 114 Yale L.J. 929 (2005), *with* Melanie B. Leslie, In Defense of the No Further Inquiry Rule: A Response to Professor John Langbein, 47 Wm. & Mary L. Rev. 541 (2005); *see also* Fischel & Langbein, supra note __.

[99] *See* infra Part II.C.2.

[100] *See* Gold, supra note __, at [ms].

can defend an interested transaction under an "entire fairness test,"[101] although the good faith of the directors' motives remains relevant.[102] There is also scholarly debate about the proper role of motive in fiduciary matters more generally.[103]

In spite of this debate, however, settled trust and ERISA law are unambiguous: A trust or pension trustee or other fiduciary must act "solely" in the interest of the beneficiary. The policy rationale is containing agency costs by way of prophylaxis.[104] "The idea is to prevent misbehavior by erecting an irrebuttable presumption of wrongdoing whenever the trustee engages in conflict tainted transactions."[105] The Restatement explains:

> The rationale begins with a recognition that it may be difficult for a trustee to resist temptation when personal interests conflict with fiduciary duty. In such situations, for reasons peculiar to typical trust relationships, the policy of the trust law is to prefer (as a matter of default law) to remove altogether the occasions of temptation rather than to monitor fiduciary behavior and attempt to uncover and punish abuses when a trustee has actually succumbed to temptation. This policy of strict prohibition also provides a reasonable circumstantial assurance (except as waived by the settlor or an affected beneficiary) that beneficiaries will not be deprived of a trustee's disinterested and objective judgment.[106]

On a practical level, the sole interest rule avoids difficult ex post counterfactual disputes about the relative influence of a trustee's mixed motives. Acting with a mixed motive is a conflict of interest and therefore disloyal, full stop. Direct self-dealing or profit to the trustee is not necessary. A trustee cannot defend a conflicted action on the grounds that the conflict did not harm the beneficiaries, that the action was "fair" to the beneficiaries, or that the action was in the best interest of the beneficiaries.[107] To establish a breach of loyalty, a beneficiary need only establish the fact of the mixed motive.

To be sure, a trustee may not be liable for make-whole compensatory damages if a beneficiary cannot prove a loss from the trustee's mixed motive with reasonable certainty. However, even in such circumstances, the trustee's breach of the duty of

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[101] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983); *see also* Julian Velasco, Fiduciary Principles in Corporate Law [ms], *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018).

[102] Hillary Sale, Fiduciary Law and Good Faith [ms], *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018) (discussing Stone v. Ritter, 911 A.2d 362 (Del. 2006) and In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006)).

[103] *See, e.g.*, Lionel Smith, The Motive, Not the Deed, *in* Rationalizing Property, Equity, and Trusts: Essays in Honour of Edward Burn 20-22 (Joshua Getzler ed., 2003); Ethan J. Leib & Stephen R. Galoob, Fiduciary Political Theory: A Critique, 125 Yale L.J. 1820, 1829–34 (2016); Stephen A. Smith, The Deed, Not the Motive: Fiduciary Law Without Loyalty, *in* Contract, Status, and Fiduciary Law (Paul B. Miller and Andrew S. Gold eds., 2016), Evan J. Criddle, Liberty in Loyalty: A Republican Theory of Fiduciary Law, 95 Tex. L. Rev. 993, 1033, 1046–47 (2017).

[104] *See* Robert H. Sitkoff, An Economic Theory of Fiduciary Law 201, *in* Philosophical Foundations of Fiduciary Law (Andrew Gold & Paul Miller eds., 2014) (hereafter "Sitkoff, Economic Theory").

[105] Fischel & Langbein, supra note __, at 1114-15.

[106] Restatement (Third) of Trusts § 78(1) cmt. b (Am. Law Inst. 2007).

[107] Id.

loyalty would entitle the beneficiary to other relief such as trustee removal, an injunction, disgorgement of profits, unwinding the transaction by way of equitable lien, constructive trust, or otherwise, or even punitive damages.[108]

A familiar teaching example involving mixed motives—that is, a conflict of interest—without self-dealing is *In re Rothko*.[109] In that case, the executors of Mark Rothko's estate sold or consigned nearly 800 of Rothko's paintings to a single gallery.[110] Because one executor was an officer in the gallery with a motive to seek "aggrandizement of status," and because another executor was an artist with a motive to "curry favor" with the gallery, the court held that in undertaking the transaction each had a conflict of interest in violation of the duty of loyalty.[111] The court characterized the argument that the executors were not conflicted by reason of their mixed motives as "sheer fantasy."[112] The court awarded damages measured by the lost appreciation value on the paintings, equivalent to unwinding the transaction.[113]

In *Rothko* the conflicted motives of the executors were selfish. But a selfish mixed motive is not required; the result would have been the same even if their mixed motives were benign or even laudable. The fact of a mixed motive by itself violates the trust law duty of undivided loyalty. Thus, for example, a trustee who does "not act for personal advantage," and instead is "motivated by a desire to assist a worthy project," still violates the duty of loyalty because such a motive or desire is something other than the sole interest of the beneficiary.[114] Likewise, that a transaction "might have been in the best interests of the trust, or even compelled by the duty to invest prudently," does not save the trustee for a "breach of the duty of loyalty" if the trustee's motive for the transaction was other than the sole interest of the beneficiary.[115]

To sum up, the sole interest rule requires a trustee to exclude not only "all selfish interest," but also "all consideration of the interests of third persons."[116] A mixed motive breaches the duty of loyalty even if "the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee."[117] The purpose is to ensure that the beneficiary obtains "the trustee's independent and disinterested administration of the trust."[118]

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[108] *See* Unif. Trust Code §§ 1001-02 (Unif. Law Comm'n 2000); Sitkoff, supra note __, at [ms]; Samuel L. Bray, Fiduciary Remedies, *in in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018).

[109] 372 N.E.2d 291 (N.Y. 1977); *see also* Sitkoff & Dukeminier, supra note __, at 596 (excerpting *Rothko*).

[110] An executor is subject to the same fiduciary loyalty principles as a trustee. *See* Sitkoff & Dukeminier, supra note __, at 596.

[111] 372 N.E.2d at 296. The third executor was imprudent but not conflicted.

[112] Id.

[113] Id. at 297-98.

[114] Conway v. Emeny, 96 A.2d 221, 225 (Conn. 1953).

[115] Uzyel v. Kadisha, 116 Cal. Rptr. 3d 244, 276 (Cal. App. 2010).

[116] George Gleeson Bogert et. al, The Law of Trusts and Trustees § 543 (2018 Update).

[117] Restatement (Third) of Trusts § 78 cmt. b (Am. Law Inst. 2007).

[118] Bogert, supra note __.

**B. Application to ESG Investing**

1. Collateral Benefits versus Risk-Return ESG

In view of the foregoing, it is quite obvious that collateral benefits ESG investing is forbidden by the trust law fiduciary duty of loyalty. By definition, collateral benefits ESG entails consideration of interests other than the sole interest of the beneficiary. Even if the trustee's motive is mixed, seeking both to benefit the beneficiary and to obtain a collateral benefit, the trustee violates the sole interest rule. The trust law duty of loyalty does not allow for mixed motives, period.

By contrast, risk-return ESG investing can be consistent with the duty of loyalty, provided that the fiduciary's "sole" or "exclusive" motive is benefiting the beneficiary by improved risk-adjusted returns. Taking recent claims about the motive for risk-return ESG investing at face value, by definition the purpose of risk-return ESG is to obtain better returns with less risk. If motivated solely by this purpose, a risk-return ESG investing strategy (or any other investment strategy) satisfies the sole interest rule under the duty of loyalty. Of course, the strategy would also have to satisfy the duty of care or prudence, as we shall see.[119]

But first there is more to say about collateral benefits ESG and loyalty. To begin, in a provision published in 2007, the Restatement (Third) of Trusts agrees that collateral benefits ESG investing "ordinarily" violates the sole interest rule of trust fiduciary law:

> [T]he trustee must act with undivided loyalty and solely in the interests of the beneficiaries. ... The prohibition [i.e., the duty of loyalty] … applies to investing in a manner that is intended to serve interests other than those of the beneficiaries or the purposes of the settlor. Thus, for example, in managing the investments of a trust, the trustee's decisions ordinarily must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes.[120]

The DOL is largely in agreement. Under ERISA, the Secretary of Labor has certain rulemaking and enforcement powers.[121] The DOL has issued seven Bulletins, including most recently in 2018, 2016, and 2015, to provide guidance on the DOL's view on ESG investing by a fiduciary.[122] In each Bulletin, the DOL concluded that collateral benefits ESG by a fiduciary is ordinarily unlawful.[123]

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[119] *See* infra Part III.

[120] Restatement (Third) of Trusts § 90 cmt. c (Am. Law Inst. 2007). The hedge in the word "ordinarily" allows for a different outcome if the terms of the trust or the beneficiary allow otherwise or if the trust is charitable in nature, nuances to which we turn below. *See* infra Part II.C-D.

[121] *See* ERISA § 435, 29 U.S.C. 1135 (rulemaking); ERISA § 432, 29 U.S.C. § 1132 (enforcement); ERISA § 434, 29 U.S.C. § 1134 (investigation).

[122] *See* DOL, Interpretive Bulletins 2016-1, 2015-01, 2008-01, 2008-2, 94-1, and 94-2; Field Assistance Bulletin 2018-01.

[123] The hedge in the word "ordinarily" allows for the DOL's position, which we contest below, that collateral benefits may be used as a tie-breaker. *See* infra Part II.C-D.

In the 2015 Bulletin, for example, the DOL reaffirmed that it had "consistently stated," including in its earlier Bulletins, "that the focus of plan fiduciaries on the plan's financial returns and risk to beneficiaries must be paramount. … ERISA do[es] not permit fiduciaries to sacrifice the economic interests of plan participants in receiving their promised benefits in order to promote collateral goals."[124] Likewise, in the 2018 Bulletin, the DOL reaffirmed "its longstanding view that, because every investment necessarily causes a plan to forego other investment opportunities, plan fiduciaries are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals."[125]

In this respect, we (and the Restatement and the DOL) concur with the consensus conclusion of the prior generation that classic SRI, typified by total divestment from South Africa out of consideration for the oppressed black majority, would breach the fiduciary duty of loyalty.[126] Collateral benefits ESG, after all, is little more than a rebranding of classic SRI.

A helpful analogy is to suppose a distribution from the trust fund for the same purpose. Just as a trustee of a private trust or pension fund could not distribute trust funds for the purpose of advancing an ESG goal held by the trustee, so too the trustee cannot allow such a goal to influence the trustee's investment management of the trust property. A trustee is in breach if the trustee acts "for a purpose other than to further the purposes of the trust," and this is true even if "the act is undertaken in good faith."[127] To repeat, a mixed motive breaches the duty of loyalty even if "the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee."[128]

2. Zero Tolerance for Collateral Benefits

Our analysis departs from some in the prior generation, and in one respect from the DOL as we shall see,[129] by insisting on zero tolerance for a mixed motive. Some in the prior generation argued that selective divestment under the Sullivan principles would be permissible because, in contrast to total divestment, selective divestment would have little effect on portfolio efficiency.[130] But the sole interest rule does not allow for a de minimus exception. The rule does not allow consideration of other interests even if the beneficiary's interest is not subordinated or there is no concession in returns. A trustee cannot defend a mixed motive on the grounds that the conflict did not harm the beneficiaries or that the additional motive was laudable. Accordingly, a fiduciary's adherence to the Sullivan principles out of consideration for collateral benefits, like any

[124] DOL, IB 2015-01, 80 Fed. Reg. at 65135.

[125] DOL, FAB 2018-01, at 2.

[126] *See* supra Part I.B.

[127] Restatement (Third) of Trusts § 87 cmt. c (Am. Law Inst. 2007); *see also* id. § 76(1) (duty to adhere to the terms of the trust).

[128] Restatement (Third) of Trusts § 78 cmt. b (Am. Law Inst. 2007).

[129] *See* infra Part II.B.3.

[130] *See* supra Part I.B.

form of collateral benefits ESG, violates the sole interest rule—even if there is no reduction in portfolio efficiency—because such consideration entails a mixed motive.

In the context of a private trust, a trustee must conduct the trust's investment program in the sole interest of the beneficiary as defined by the terms and purpose of the trust. To be sure, in some cases the terms and purpose of the trust might point to an objective for the investment program other than portfolio efficiency. For example, the terms and purpose of a trust might allow for a programmatic investment that substitutes for a distribution to a beneficiary, such as in a trust that is meant to hold a family vacation home, the family farm, or other residence for use by the beneficiary.[131] But the key in such a case is that the trustee acts in the sole interest of the beneficiary as prescribed by the terms of the trust, not out of the trustee's interest in collateral benefits to third parties. Setting aside authorization by the terms of a trust or a beneficiary, complications to which we turn below,[132] a trustee may not consider collateral benefits from ESG investing; the trustee must act in the sole interest of the beneficiary as prescribed by the terms of the trust.

For a trustee or other fiduciary of a pension fund, controlling Supreme Court precedent on the application of ERISA's statutory "sole" or "exclusive" purpose language is even stricter. Tracking the text of ERISA, in 2014 the Court held that the "exclusive purpose" of an ERISA trustee or other fiduciary must be

> "providing benefits to participants and their beneficiaries" while "defraying reasonable expenses of administering the plan." Read in the context of ERISA as a whole, the term "benefits" in the provision just quoted must be understood to refer to the sort of *financial* benefits (such as retirement income) that trustees who manage investments typically seek to secure for the trust's beneficiaries.[133]

Even if the terms of a pension plan's governing instrument set forth a "specific nonpecuniary goal," such a provision would be trumped by ERISA's imposition of a mandatory fiduciary duty on pension trustees and other fiduciaries to act with the sole or exclusive purpose of providing benefits, meaning financial benefits, to the plan's participants.[134]

Against this it might be argued that, because we cannot read minds, the effect of the sole interest rule is merely to limit what a trustee may say. On this view, a trustee interested in pursuing collateral benefits ESG can safely do so as long as the trustee calls it risk-return ESG. But this objection applies to any motive test in the law, of which there are many. And keeping up a motive façade is hard. For example, at a 2015 conference

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[131] *See, e.g.*, Sitkoff & Dukeminier, supra note __, at 641-42.

[132] *See* infra Part II.D.

[133] Dudenhoeffer, 134 S.Ct. at 2468 (quoting ERISA § 404(a)(1)(A)(i)-(ii), 29 U.S.C. § 1104(a)(1)(A))i)-(ii)) (emphasis in original). The exclusive focus on financial benefits distinguishes ERISA from pension law in the U.K., which is more tolerant of non-financial factors. *See* Fein, supra note __, at 2 (quoting The Pensions Regulator, A Guide to Investment Governance (U.K.), July 2016). The different legal framework makes inapt some of the foreign comparisons in the GAO Report. *See* GAO Report 18-1398, supra note __.

[134] Dudenhoeffer, 134 S.Ct. at 2468-69; *see also* Central States, Southeast & Southwest Areas Pension Fund, 472 U.S. 559, 568 (1985) ("trust documents cannot excuse trustees from their duties under ERISA").

the Chair of the PRI, Martin Skancke, lamented that "proponents of responsible investing may have focused too much on excess returns and might need to focus on aligning its activities with broader societal objective."[135]

Moreover, in this particular context, the rigor of the duty of care or prudence, which as discussed below requires a documented analysis showing realistic risk-and-return estimates and periodic revisiting of those estimates, provides a check against backdoor disloyalty.[136] Even if a trustee is motivated in her heart by pursuit of collateral benefits, to keep up the façade of a risk-return motive, she must in fact pursue risk-return ESG, abandoning it or perhaps even embracing an anti-ESG strategy when the numbers go the other way.[137] By way of illustration, a recent study by three quantitative financial analysts at Bessemer Trust found that including ESG factors into their investment models caused "underperformance" that in some specifications was "statistically significant."[138] In light of this study, it would be hard in the near term for Bessemer Trust to claim in good faith that its use of ESG factors was motivated by superior risk and return.

3. Collateral Benefits as a Tie Breaker?

In the teeth of the sole interest rule, the PRI and others have taken the position that if a fiduciary has two investment options with otherwise identical risk and return attributes, the fiduciary may consider collateral benefits as a tie breaker without violating the duty of loyalty.[139] The leading authority for this position are the DOL Bulletins.[140] The 2015 Bulletin, for example, takes the position that

> fiduciaries may consider such collateral goals as tie-breakers when choosing between investment alternatives that are otherwise equal with respect to return and risk over the appropriate time horizon. ERISA does not direct an investment choice in circumstances where investment alternatives are equivalent, and the economic interests of the plan's participants and beneficiaries are protected if the selected investment is in fact, economically equivalent to competing investments.[141]

The 2018 Bulletin "reiterated the view that when competing investments serve the plan's economic interests equally well, plan fiduciaries can use such collateral considerations as tie-breakers for an investment choice."[142]

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135 PRI, Does ESG Pay Off Financially?, PRI Academic Network: RI Quarterly 4-5 (Oct. 2015), https://www.unpri.org/Uploads/z/u/j/riquarterlyvol8_744947.pdf.

136 *See* Part III.A.2.3.

137 *See* infra Part III.C.4.

138 *See* Edward N.W. Aw, Stephen J. LaPerla & Gregory Y. Sivin, A Morality Tale of ESG: Assessing Socially Responsible Investing, 19 J. Wealth Management (Spring 2017).

139 *See, e.g.*, Freshfields Report, supra note __, at 12.

140 *See* supra note __. On the influence of the DOL Bulletins, see, e.g., Unif. Prudent Inv. Act § 5 cmt. (Unif. Law Comm'n 1994) (relying on DOL IB 94-1).

141 DOL, IB 2015-01, 80 Fed. Reg. at 65136.

142 FAB 2018-1, at 2.

This tie-breaker position is dubious as a matter of law and textbook financial economics. *First*, the tie-breaker position is contrary to the common law understanding of the strict "sole interest" or "exclusive benefit" rule codified by ERISA.[143] Under the sole interest rule, the fact of a mixed motive is a disloyal conflict of interest, full stop. Thus, as other commentators have noted, in this respect the Bulletins are in deep tension with the text of ERISA,[144] which under controlling Supreme Court precedent is to be read in light of the common law of trusts, and refers to "financial benefits … for the trust's beneficiaries."[145] The Bulletins do not acknowledge this doctrinal tension, much less address it in a persuasive manner. Even with *Chevron* deference, this defect could be fatal.[146]

*Second*, textbook financial economics teaches that, liquidity constraints and transaction costs to the side, if an investor has two investment opportunities with identical risk and return attributes, the investor should invest in both.[147] To invest in just one entails a diversification sacrifice without a compensating increase in expected return. Put otherwise, if two companies have the same expected risk and return, but their managers and products are not identical, then investing in both is more efficient in the technical sense of portfolio efficiency required by the duty of prudence,[148] because a joint investment improves diversification, thereby reducing overall portfolio risk without a loss in the portfolio's expected return.[149]

Of course, investing in both might not be feasible owing to a liquidity constraint. Possibly the added transaction costs of a split investment, including additional monitoring or proxy voting, could offset the diversification benefits. But the Bulletins are not crafted so narrowly. They are not limited to a fiduciary's investment choice under these or other such constraints. Instead, they apply to any circumstance in which an investment with a collateral benefit is "economically equivalent, with respect to return and risk to beneficiaries in the appropriate time horizon, to investments without such collateral benefits."[150]

In sum, the Bulletins do not attend to the economic costs from reduced portfolio diversification under the tie-breaker rule. Yet the text of ERISA imposes an explicit duty

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143 *See* supra Part II.A.

144 *See* Dana M. Muir, Fiduciary Principles in Pension Law [ms], *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018) (arguing that ESG "as a tie breaker departs from the trust law 'sole interest' standard, which bars the fiduciary from considering any interest other than that of the participants and beneficiaries"); Edward Zelinsky, The Continuing Battle Over Economically Targeted Investments: An Analysis of the Department of Labor's Interpretive Bulletin 2015-012016 Cardozo L. Rev. De Novo 161 (2016) (arguing that the DOL's position "replaces ERISA's strong statutory standard of loyalty ('solely' and 'exclusive') with a weaker rule of nonsubordination").

145 *See* supra note __.

146 *See, e.g.*, Chamber of Commerce of U.S.A. v. U.S. Department of Labor, 885 F.3d 360 (5th Cir. 2018) (striking down under *Chevron* review DOL notice-and-comment fiduciary rule as inconsistent with ERISA).

147 *See, e.g.*, Bodie, Kane & Marcus, supra note __, at 194-221.

148 *See* infra Part III.A.1.

149 *See* id. at 195-202.

150 DOL, IB 2015-01, 80 Fed. Reg. 65135, 65136.

to diversify.[151] In a prior notice-and-comment rulemaking, the DOL elaborated on ERISA's diversification provision by requiring specifically that an ERISA fiduciary give consideration to the "composition of the portfolio with regard to diversification."[152] And under the duty of prudence, normally a trustee must have a documented analysis of "realistically evaluated return expectations" to justify a diversification sacrifice.[153]

As a matter of administrative law, because the DOL Bulletins are guidance documents rather than rules produced through a formal notice-and-comment process, they are not entitled to *Chevron* deference.[154] Instead, reflecting a need to balance of agency experience and expertise against the absence of a notice-and-comment process, under current Supreme Court precedent the Bulletins are subject to an intermediate level of review that is something less than de novo but something more than *Chevron* deference.[155] The Bulletins are therefore vulnerable to court challenge.

**C. The Special Case of a Charity**

Let us now consider the special case of a charity. ESG investing by a fiduciary of a charitable endowment is a special case for two reasons: (1) a charity must be for a charitable purpose rather than an ascertainable beneficiary, and (2) a charity may be organized as an entity that has a "best interests" rather than "sole interest" loyalty rule.

1. Charitable Purpose

Unlike a private trust, which must be for one or more ascertainable beneficiaries,[156] or a pension plan, which must be for the plan's participants,[157] a charitable trust or other form of charity must be for the benefit of a recognized *charitable purpose*.[158] The list of permissible charitable purposes, which was codified by a statute enacted by Parliament more than 400 years ago,[159] is "the relief of poverty, the advancement of education or religion, the promotion of health, governmental or municipal purposes, or other purposes the achievement of which is beneficial to the community."[160]

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151 *See* ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1)(C).

152 29 C.F.R. § 2550.404a-1(b)(ii)(A).

153 *See* infra Part III.A.2-3.

154 *See* Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

155 *See* United States v. Mead Corp., 533 U.S. 218 (2001) (applying Skidmore v. Swift & Co., 323 U.S. 134 (1944), to such cases). For an illustration involving a DOL interpretive bulletin, see In re WorldCom Inc. ERISA Litig., 354 F. Supp. 2d 423 (S.D.N.Y. 2005).

156 *See* Sitkoff & Dukeminier, supra note __, at 418.

157 *See* Fischel & Langbein, supra note __.

158 *See* Restatement of Charitable Nonprofit Organizations § 1.01(a) (Am. Law Inst. T.D. No. 1, 2016).

159 The Statute of Charitable Uses Act 1601, 43 Eliz. I, c. 4 (Eng.). On the reception of this statute into American law, see Vidal v. Girard's Executors, 43 U.S. 127 (1844), and Steven P. Brown, The Girard Will and Twin Landmarks of Supreme Court History, 41 J. S. Ct. Hist. 7 (2016).

160 Uniform Trust Code § 405(a) (Unif. Law Comm'n 2000); *see also* Restatement (Third) of Trusts § 28 (Am. Law Inst. 2003) (similar); Restatement of Charitable Nonprofit Organizations § 1.01(b) (Am. Law Inst., T.D. No. 1, 2016) (similar).

That a charity must be for a charitable purpose rather than for ascertainable beneficiaries changes the application of the sole interest rule under the duty of loyalty. Whereas a trustee of a private trust or pension fund must act "solely in the interest of *the beneficiaries*,"[161] a trustee of a charitable trust must act "solely in furtherance of *its charitable purpose*."[162] Thus, investing a charitable endowment to obtain third-party benefits is permissible if those benefits are within the charity's charitable purpose. By definition, such benefits are not "collateral." Instead, the trustee has acted in the "sole" interest of furthering the charitable purpose.

Recall the analogy earlier to a distribution from the trust for an ESG purpose.[163] Pursuit of a charity's charitable purpose by way of third-party benefits from the charity's investment program, sometimes called "mission-related investing" or "program-related investing,"[164] is a permissible substitute for direct expenditure by the charity on that purpose. The Restatement (Third) of Trusts elaborates:

> [S]ocial considerations may be taken into account in investing the funds of charitable trusts to the extent the charitable purposes would justify an expenditure of trust funds for the social issue or cause in question or to the extent the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.[165]

Thus, by way of illustration, the Sierra Club or other charity with a purpose of protecting the environment could divest from fossil fuel companies on a theory of substituting for direct expenditure. A charity's pursuit of third-party benefits via ESG investing, no different than an outright expenditure, is policed by the requirement that the benefits fall within the charity's charitable purpose, and is subject also to the duty of care or prudence,[166] albeit enforcement of charities by the state attorneys general is notoriously weak.[167]

In 2015, the IRS agreed with this analysis. More specifically, it took the position that program- or mission-related investing would not trigger the excise tax applicable to a charity that invests its endowment "in such a manner as to jeopardize the carrying out of any of its exempt purposes."[168] In reaching this conclusion, the IRS took notice of the tolerance under state fiduciary principles of "consideration of the charitable purposes of

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[161] Restatement (Third) of Trusts § 78 (Am. Law Inst. 2007) (emphasis added).

[162] Id. (emphasis added).

[163] *See* supra Part II.B.1.

[164] *See* Gary, Values and Value, supra note __, at 268-71.

[165] Id. § 90 cmt c.

[166] *See* infra Part III. Returning, therefore, to the Sierra Club example, we observe that such divestment is unlikely to affect the fossil fuel industry's cost of capital. *See* Brest, Gilson & Wolfson, supra note __, at 25 (noting that it is "virtually impossible" for socially conscious investors to affect the behavior of firms that trade public markets); Knoll, supra note __, at 704-710 (showing that affecting corporate behavior through investment screens requires heroic assumptions about the elasticity of capital supply).

[167] *See, e.g.*, Jonathan Klick & Robert H. Sitkoff, Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off, 108 Colum. L. Rev. 749 (2008).

[168] IRS Notice 15-62 (interpreting I.R.C. § 4944, 26 U.S.C. § 4944).

an organization … in properly managing and investing the organization's investment assets."[169]

2. "Best Interest" versus "Sole Interest"

So long as the purpose of a charity falls within the list of recognized charitable purposes, the legal form of the charity does not matter. "A charity may be organized as a nonprofit corporation, trust, unincorporated association, or other legal form recognized by law."[170] Thus, unlike a private trust or a pension fund subject to ERISA, which necessarily are subject to trust fiduciary law, a charity can be organized as an entity subject to corporate or other fiduciary law with a "best interest" rather than the "sole interest" rule of trust law.[171] And a best interest loyalty rule is tolerant of mixed motives, subjecting conflicted actions to a fairness test rather than categorical prohibition.[172] Accordingly, for a charity organized as a corporation or other form with a best interest loyalty rule, the fiduciary responsible for investment of the charity's endowment could consider collateral benefits—that is, could have a mixed motive—if doing so does not compromise investment returns.

Let us return to the familiar example of divestment from South Africa, which preoccupied the prior generation of commentators.[173] Suppose a charity with a recognized charitable purpose that was not broad enough to encompass benefiting South Africa's oppressed black majority. Even with a best interest test more tolerant of a motive outside of the charity's purpose, total divestment might still be impermissible given the evidence that it would compromise portfolio efficiency. By contrast, selective divestment under the Sullivan Principles would likely be upheld given the evidence that the effect on portfolio efficiency would be trivial. In both cases, the effect on portfolio efficiency becomes relevant only because under a best interest rule a mixed motive outside of the charity's purpose would not be a per se breach, as it would be under the sole interest rule.

A similar analysis pertains to the more contemporary question of divestment by a charity from fossil fuel companies. Let us suppose a charity with charitable purpose that does not encompass fighting climate change, such as a university instead of the Sierra Club. Under a best interest rather than sole interest test, the university could divest from fossil fuel companies only if, in accordance with acting in the best interest of its recognized charitable purpose, it reasonably concluded that divestment would not compromise portfolio efficiency. In this respect, we observe that Stanford's much celebrated divestment from fossil fuels was in fact limited by precisely such an

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[169] Id.

[170] Restatement of Charitable Nonprofit Organizations § 1.02 (Am. Law Inst., Tentative Draft No. 1, 2016).

[171] *See* Lloyd Hitoshi Mayer, Fiduciary Principles in Charities and Other Nonprofits, *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018); Restatement (Third) of Charitable Nonprofit Organizations § 2.02 cmt. b (Am. Law Inst. T.D. No. 1 2016).

[172] *See* supra Part II.A.

[173] *See* supra Part I.

analysis.[174] The same is true for the announcement by a Harvard investment manager of a "pausing" in fossil fuel investment.[175]

## D. Authorization in Private Trust

A final complication is authorization of collateral benefits ESG investing in a private trust by the terms of the trust or a beneficiary. Unlike an ERISA pension plan, for which controlling Supreme Court precedent holds that a trustee or other fiduciary must always act solely to advance the participants' financial interests,[176] in a private trust (1) the settlor may authorize a conflict of interest, opting out of the sole interest rule in favor of a best interest test for loyalty, and (2) a beneficiary may authorize conduct by a trustee that would otherwise be a breach of trust.

### 1. Authorization by the Terms of a Trust

In accordance with the principle of freedom of disposition, American law grants the settlor of a trust broad autonomy to prescribe the terms and purpose of the trust.[177] Thus, as we have seen, the terms of a trust may allow for a programmatic investment that substitutes for a distribution to a beneficiary, such as holding a vacation home.[178] In such a case, acting in the sole interest of the beneficiary as prescribed by the terms of the trust might point to an investment objective other than portfolio efficiency.

The terms of a trust may also override the sole interest rule. As Restatement (Third) of Trusts explains, "[a] trustee may be authorized by the terms of the trust, expressly or by implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty."[179] However, "no matter how broad the provisions of a trust may be in conferring power to engage in … transactions involving a conflict of fiduciary and personal interests, a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly."[180] A trustee must always "act in the interest of the beneficiaries and … exercise prudence in administering the trust."[181]

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174 *See* Stanford and Climate Change, supra note __ (observing that Stanford avoids "sands oil" on grounds of "economic attractiveness" based on an "investment framework" that considers how "pricing for fossil fuels will reflect" anticipated "transition away from carbon-based energy"; declining to divest from "the fossil fuel industry more broadly"; concluding that "it could not evaluate whether the social injury caused by the fossil fuel industry outweighs the social benefit it provides").

175 *See* Brandon J. Dixon, Despite Divest Cheers, Harvard Maintains Investment Approach, Harvard Crimson, Apr. 28, 2017 (attributing the "pausing" to an "analysis of investments within the natural resources portfolio and how they contribute to the financial strength of the endowment").

176 *See* supra Part II.B.2.

177 *See* Restatement (Third) of Property: Wills and Other Donative Transfers § 10.1 (Am. Law Inst. 2003); Robert H. Sitkoff, Trusts and Estates: Implementing Freedom of Disposition, 58 St. Louis L.J. 643 (2014).

178 *See* supra Part II.B.2.

179 Restatement (Third) of Trusts § 78 cmt. c(2) (Am. Law. Inst. 2007).

180 Id.

181 Id.

By way of illustration, the sole interest rule would normally prohibit a corporate trustee from trading in its own shares.[182] However, a well-drafted trust instrument would typically include boilerplate that authorizes a corporate trustee to trade in its own stock. In such a trust, a corporate trustee would not be categorically prohibited from trading in its own stock. Instead the trustee would be subject to scrutiny for whether the trade was prudent, in good faith, and fairly made in the best interest of the beneficiary.

In this light, recall the Restatement provision quoted earlier that a "trustee's decisions *ordinarily* must not be motivated by a purpose of advancing or expressing the trustee's personal views concerning social or political issues or causes."[183] In the next sentence, the Restatement goes on to say that "[s]uch considerations, however, may properly influence the investment decisions of a trustee to the extent permitted by the terms of the trust."[184] The Restatement thus expressly acknowledges the power of a settlor to opt out of the sole interest rule and to include collateral benefits from ESG factors as permissible considerations in fashioning a trust's investment program.

In other words, a settlor may by the terms of a trust authorize a trustee to have a mixed motive in the form of considering collateral benefits from ESG factors in investing the trust property. With such authorization, consideration of collateral benefits from ESG factors would not be a per se breach of the duty of loyalty. Instead, the trustee would be subject to scrutiny for whether the investment program was prudent, in good faith, and fairly made in the best interest of the beneficiary. The analogy to the example above of a charitable endowment that is subject to a best interest rather than sole interest loyalty rule is straightforward.[185]

A harder question arises if the terms of a trust authorize or even mandate that a trustee pursue collateral benefits from ESG investing even if doing so sacrifices portfolio efficiency—that is, if the terms of the trust subordinate the interests of the beneficiary to the pursuit of those collateral benefits. This question is harder, because it collides with unsettled questions regarding the limits of settlor freedom of disposition by way of a trust. Under traditional law, a trust must be for the benefit of a recognized charitable purpose (a charitable trust) or for one or more ascertainable beneficiaries.[186] A trust for any other purpose is not valid. For this reason, upholding a trust for a pet animal or the maintenance of a grave, which lack an ascertainable person beneficiary and are not charitable, required judges to invent an "honorary trust" concept, later codified by statute.[187]

Returning, then, to a term of a trust that purports to authorize or mandate that a trustee pursue collateral benefits from ESG investing, the hard question is whether such a provision prioritizes those collateral benefits over the interests of the beneficiary, crossing the line into an impermissible noncharitable purpose trust. This question has

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182 *See* id. cmt. e(2).

183 Id § 90 cmt. c (emphasis added), quoted supra text accompanying note __.

184 Id.

185 *See* supra Part II.C.2.

186 *See* Restatement (Third) of Trusts § 27 (Am. Law Inst. 2003).

187 *See* id. § 47; Sitkoff & Dukeminier, supra note __, at 426, 428.

been most extensively considered, both doctrinally in the cases and conceptually in the literature, in the context of trust terms that authorize or mandate an undiversified portfolio.[188] The question in that context, as in this one, is the extent to which a settlor of a private trust may privilege a noncharitable purpose (retaining a concentration or pursuing collateral benefits) over the interests of the beneficiary.

The common law answer differentiates between a permissive and a mandatory provision.[189] "The prevailing view is that a permissive authorization to retain an undiversified portfolio does not excuse the trustee from liability if not diversifying was imprudent. … Even if a trustee has a power to retain assets irrespective of diversification, the exercise of that power must be prudent and in the best interests of the beneficiaries."[190] We therefore predict that a permissive provision in the terms of a trust authorizing a mixed motive toward collateral benefits in a trustee's program of ESG investing would not protect a trustee against liability under a best interest test if the investment program injures the beneficiary's interest, such as by sacrificing returns or increasing risk, in favor of a collateral benefit.[191]

But what about a mandate to pursue collateral benefits ESG investing? The common law answer with respect to a mandate not to diversify is that the trustee must comply with the mandate unless doing so will harm the beneficiaries, in which event the trustee must petition the court for permission to deviate from that provision.[192] A trustee's "duty to conform to the terms of the trust directing or restricting investments by the trustee" is subject to the trustee's duty to petition the court for deviation if conforming will "cause substantial harm to the trust or its beneficiaries."[193] We would expect the same rule to be applied to a mandatory direction in the terms of a trust to consider collateral benefits from ESG investing.

The foregoing analysis tracks the common law as reflected in the Restatement. But where exactly to draw the line on a settlor's freedom to balance the beneficiary's interest against other interests is contested. Commentators are by no means in agreement that the common law as reflected in the Restatement has struck the right

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188 *See* Sitkoff & Dukeminier, supra note __, at 650-54 (surveying law and commentary on permissive and mandatory portfolio concentration).

189 *See* id. at 650.

190 Id. at 651.

191 *See* Uniform Prudent Investor Act § 5 cmt. (Unif. Law Comm'n 1994) ("No form of so-called 'social investing' is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of trust beneficiaries—for example, by accepting below-market returns—in favor of the interests of the persons supposedly benefitted by pursuing the particular social cause.").

192 *See* Sitkoff & Dukeminier, supra note __, at 652.

193 Restatement (Third) of Trusts §§ 66(2), 91(b) (Am. Law Inst. 2003); *see also* Sitkoff & Dukeminier, supra note __, at 652.

balance.[194] And some states, including the prominent trust state of Delaware,[195] have enacted statutes that depart from the common law by mandating enforcement of a settlor's direction not to diversify,[196] or that allow trusts for a wide array of noncharitable purposes.[197] In such a state, arguably public policy grants a settlor broader freedom to balance other interests, including perhaps to favor collateral benefits from ESG investing.

Against this backdrop, we observe that in 2018 Delaware became the first state to address this issue by specific legislation. As amended, the Delaware trust code makes enforceable a term of a trust that prescribes a "sustainable or socially responsible investment strateg[y] … with or without regard to investment performance."[198] Taken literally, this provision departs from the common law by validating an authorization or mandate in the terms of a trust to undertake an ESG investment program that sacrifices returns to achieve a benefit for a third party or for moral or ethical reasons.[199] This amendment thus appears to answer the question of the extent of a settlor's autonomy in a manner that, although inconsistent with common law, is consistent with other outlying Delaware positions.[200]

2. Authorization by the Beneficiary

In contrast to authorization by the settlor in the terms of a trust, authorization by a beneficiary of a conflicted transaction, if fully informed and properly obtained, will fully insulate the trustee from liability.[201] Under prevailing law, a beneficiary who has

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194 With respect to diversification, compare John H. Langbein, Burn the Rembrandt? Trust Law's Limits on the Settlor's Power to Direct Investments, 90 B.U. L. Rev. 375 (2010), with Jeffrey A. Cooper, Shades of Gray: Applying the Benefit-the-Beneficiaries Rule to Trust Investment Directives, 90 B.U. L. Rev. 2383 (2010); Jeffrey A. Cooper, Dead Hand Investing: The Enforceability of Trust Investment Directives, 37 ACTEC L.J. 365 (2011). With respect to a noncharitable purpose trust, see, e.g. Adam J. Hirsch, Trusts for Purposes: Policy, Ambiguity, and Anomaly in the Uniform Laws, 26 Fla. St. U.L. Rev. 913 (1999); Adam J. Hirsch, Bequests for Purposes: A Unified Theory, 56 Wash. & Lee L. Rev. 33 (1999).

195 *See, e.g.,* Robert H. Sitkoff & Max M. Schanzenbach, Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes, 115 Yale L.J. 356 (2005).

196 *See* Del. Code tit. 12, § 3303(a)(3); Sitkoff & Dukeminier, supra note __, at 653 (collecting examples).

197 *See* Del Code tit. 12, § 3556; Adam J. Hirsch, Delaware Unifies the Law of Charitable and Noncharitable Purpose Trusts, 36 Est. Plan. 13 (2009).

198 Del. Code tit. 12, § 3303(a)(4).

199 A complicating wrinkle is the "provided, however," clause at the end of id. § 3303(a). That clause, which appears to qualify all subparagraphs within § 3303(a), provides that "nothing contained in this section shall be construed to permit the exculpation or indemnification of a fiduciary for the fiduciary's own wilful misconduct." Arguably, a trustee would be in breach of trust in spite of settlor authorization of an ESG investment program if the specific program implemented by the trustee amounted to "willful misconduct." Delaware elsewhere provides that "'wilful misconduct' shall mean intentional wrongdoing, not mere negligence, gross negligence or recklessness and 'wrongdoing' means malicious conduct or conduct designed to defraud or seek an unconscionable advantage." Id. § 3301(g).

200 The most apposite is Delaware's authorization of a perpetual non-charitable purpose trust. *See* supra note 197.

201 In the jargon, a beneficiary authorization is called a *consent* if made before the fact and a *release* if made after the fact. *See* Restatement (Third) of Trusts § 97 cmt. b (Am. Law Inst. 2012).

properly authorized "an act or omission that constitutes a breach of trust cannot hold the trustee liable for that breach."[202]

Beneficiary authorization does not touch on the unsettled limits on settlor autonomy. If a beneficiary releases the trustee from liability, the beneficiary has waived his or her own rights. However, given the fiduciary nature of the relationship, and given that the act of a trustee's obtaining a consent or release is necessarily a conflicted action, trust fiduciary law imposes substantive and procedural safeguards to ensure that a beneficiary's waiver is knowing and voluntary. A beneficiary's consent or release is enforceable only if the beneficiary "was aware of the beneficiary's rights and of all material facts and implications that the trustee knew or should have known relating to the matter," and if it "was not induced by improper conduct of the trustee."[203]

Applied to a trustee's program of collateral benefits ESG investing, there is no reason why, at least in theory, a beneficiary could not give a consent or release that would bind that beneficiary, protecting the trustee against liability. The Restatement, for example, is express in noting that a beneficiary may authorize collateral benefits ESG investing by a trustee.[204] The difficulties for effective authorization of collateral benefits ESG by a beneficiary are practical rather than conceptual—namely, the challenges in obtaining authorization in the presence of multiple beneficiaries, incompetent beneficiaries, and future beneficiaries, and the uncertain temporal scope of a specific beneficiary's consent or release.

The first practical difficulty, lack of authorization from all beneficiaries, reflects the rule that a consent or release "by one or more of the beneficiaries of a trust ordinarily does not preclude other beneficiaries of the trust—that is, nonconsenting present or future beneficiaries—from holding the trustee liable for a breach of trust."[205] Given the typicality of multiple beneficiaries in modern trust practice, including minor or unborn future beneficiaries, as a practical matter a trustee who wishes to rely on a consent or release will need to attend carefully to the rules governing representation of such beneficiaries.[206]

To make this point more concrete, suppose a trust for the benefit of *A* for life, remainder to *A*'s daughter, *B*. Suppose further that *B* is a minor, and therefore without capacity to give a consent or release. Even if *A* properly authorizes the trustee to sacrifice return to obtain collateral benefits from a program of ESG investing, the trustee would still have liability exposure to *B* (upon *B*'s reaching majority). *A* would not be a suitable representative who could bind *B*. In effect, *A* is asking the trustee to diminish

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202 Id.

203 Id. § 97.

204 *See* id. § 90 cmt. b ("Such considerations, however, may properly influence the investment decisions of a trustee to the extent permitted … by consent of the beneficiaries.").

205 Id. § 97 cmt. b.

206 *See, e.g.,* id. cmt. d (discussing applicability of "virtual representation" to a consent or release).

*B*'s remainder interest to advance *A*'s objectives, putting them in a conflict that would disable *A* from representing *B* in granting the trustee a consent or release.[207]

The second difficulty, the uncertain temporal scope of an authorization, reflects the rule that a consent or release does not protect against a subsequent breach of trust, even one involving similar conduct.[208] How long a consent can protect a trustee in undertaking a program of collateral benefits ESG investing is therefore an open question. In the comparable context of a consent to a concentrated portfolio, there are cases in which the trustee was held liable for failing to diversify notwithstanding a consent to the concentration because of the passage of too long a period of time since the consent.[209] We are told that, in consequence of this uncertainty, bank and other corporate trustees are uncomfortable with a consent to a lack of diversification. We would expect the same discomfort to emerge regarding collateral benefits ESG investing.

Finally, a word about Delaware. In 2018 Delaware amended its trust code to provide that, "when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries."[210] The import of this amendment is uncertain. On the one hand, it could be read as welcoming collateral benefits ESG if that is a beneficiary's desire. On the other hand, it says only that a trustee "may take into account … the beneficiaries' personal values." Nothing in the amendment privileges those values against the terms and purpose of the trust as prescribed by the settlor. Nor does the amendment address disagreement among the views of multiple beneficiaries. Our best guess therefore, is that this provision will provide a thumb on the scale for a trustee that undertakes an ESG investing program with beneficiary endorsement, and possibly it will incline Delaware courts toward resolving the legal uncertainty regarding the effect of a beneficiary release in the trustee's favor, but we acknowledge that this is conjecture.

## III. Fiduciary Prudence and ESG Investing

We now consider whether risk-return ESG investing by a trustee or other fiduciary of a private trust, pension, or charitable endowment can satisfy the duty of care or prudence. As we have just seen, risk-return ESG motivated solely to benefit the beneficiaries is permissible under the duty of loyalty. But any investment program subject to trust fiduciary law, whether ESG or otherwise, must also pass muster under the duty of care or prudence.

Because the foundation of the movement in support of risk-return ESG is the claim that it can provide superior risk-adjusted returns, we provide a balanced assessment of the current theory and empirical evidence. We attend in particular to the

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[207] *See, e.g.*, Unif. Trust Code § 304 (Unif. Law Comm'n 2000) (requiring "a substantially identical interest with respect to the particular question or dispute" and "no conflict of interest" for a binding virtual representation).

[208] *See* Restatement (Third) of Trusts § 97 cmt c(3) (Am. Law Inst. 2012).

[209] *See* In re Saxton, 712 N.Y.S.2d 225 (App. Div. 2000).

[210] Del Code tit. 12, § 3302(a).

crucial distinction between the existence of a relationship between ESG factors and firm value and whether such a relationship can be exploited by an investor for profit via active investing or active shareholding.[211]

The PRI and others have argued that the evidence in favor of risk-return ESG investing is so overwhelming that it should be required by the duty of care.[212] Our review of the theory and evidence suggests that the picture is much more mixed, and furthermore there is no guarantee that a favorable result for any particular risk-return ESG investing strategy will persist over time. To the contrary, as an investment method becomes widely adopted, the possibility that it will generate excess returns diminishes. Moreover, if over time ESG factors become overvalued in the market, perhaps because they become widely popular, then a contrarian strategy of avoiding or underweighting firms with high ESG ratings could offer superior risk and return.

Our analysis proceeds in four steps. First, we consider the duty of care or prudence as elaborated by the prudent investor rule and related principles, most prominently the subsidiary duties of cost sensitivity, ongoing monitoring, and recordkeeping (Section A). Second, we examine the theory and evidence on the relationship between ESG factors and firm value (Section B). Third, we examine the theory and evidence on whether such a relationship, to the extent it exists, can be exploited by an investor for profit by way of active investing (Section C) or active shareholding (Section D). Fourth, we conclude that risk-return ESG can be permissible under the duty of care or prudence, but we reject the dubious argument, advanced by the PRI and others, that ESG investing is or ought to be mandatory for a fiduciary (Section E).

### A. The Duty of Care or Prudence

The duty of care, commonly called prudence in trust and ERISA parlance, prescribes an objective standard of care that it is informed by industry norms and practices. Thus, a common law trustee "has a duty to administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust," exercising "reasonable care skill and caution."[213] A trustee or other fiduciary of a pension or retirement fund under ERISA must act "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 matters would use in the conduct of an enterprise of a like character and with like aims."[214] And "[a] fiduciary of a charity has a duty to act in good faith with the care a person of ordinary prudence in a like position would exercise under similar circumstances."[215]

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[211] The distinction is often overlooked, as in the GAO Report, supra note __, at 7-8 (confusing "relationship between ESG Factors and financial performance" with "investment performance"); *see also* id. at 17-18 (same).

[212] *See* infra Part II.E.2.

[213] Restatement (Third) of Trusts § 77(1)-(2). (Am. Law Inst. 2007); *see also* Uniform Trust Code § 804 (Unif. Law Comm'n 2000) (similar).

[214] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[215] Restatement (Third) of Charitable Nonprofit Organizations § 2.03 (Am. Law Inst. T.D. No. 1 2016).

### 1. The Prudent Investor Rule

As applied to investment management, not only for trusts but also under ERISA and for charitable endowments, the duty of care or prudence has been elaborated by the *prudent investor rule*.[216] Under the prudent investor rule, a fiduciary must (i) "invest and manage the funds of the trust as a prudent investor would" toward "an overall investment strategy" with "risk and return objectives reasonably suited to the trust," and (ii) "diversify the investments of the trust unless, under the circumstances, it is prudent not to do so."[217] As we have explained elsewhere, these two requirements reflect the learning from modern portfolio theory about the relationship between market risk and returns (point i), and about the possibility of diversifying away idiosyncratic risk (point ii), toward what in financial economics is known as an "efficient portfolio."[218]

Structurally, the prudent investor rule is a facts-and-circumstances standard that calls for "subjective judgments that are essentially unavoidable in the process of asset management, addressing the appropriate degree of risk to be undertaken in pursuit of a higher or lower level of expected return from the trust portfolio."[219] As such, "[s]pecific investments or techniques are not per se prudent or imprudent."[220] Instead, "[a] trustee may invest in any kind of property or type of investment" so long as the investment is "part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[221] This is an application of the fundamental distinction in trust fiduciary governance between *power* and *duty*.[222] A trustee has plenary power to invest in any manner of investment, subject to the trustee's fiduciary duties of loyalty, prudence, and the other duties of trusteeship.

### 2. Active Strategies

Given the rejection of categorical rules of prudent investment, the authorities are uniform in recognizing that a trustee has power to employ an active investment strategy that involves picking and choosing among different investments. "Prudent investment

[216] On the subsidiary rules that implement the duties of loyalty and care, see Robert H. Sitkoff, Other Fiduciary Duties: Implementing Loyalty and Care, *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2018).

[217] Restatement (Third) of Trusts § 90 (Am. Law Inst. 2007); *see also* Uniform Prudent Investor Act §§ 2-3 (Unif. Law Comm'n 1994) (similar). With respect to pension and retirement accounts, ERISA § 404(a), 29 U.S.C. § 1104(a), as interpreted in 29 C.F.R. § 2550.404a-1(b), imposes a comparable prudent investor rule. The Supreme Court has relied on the Restatement (Third) of Trusts and the Uniform Prudent Investor Act in applying the prudent investor rule under ERISA. *See* Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015). With respect to charitable endowments, UPMIFA § 3, adopted in nearly every state (see supra note __), applies the trust law prudent investor rule to charitable endowments.

[218] *See* Schanzenbach & Sitkoff, supra note __, at 134-37; *see also* John H. Langbein, The Uniform Prudent Investor Act and the Future of Trust Investing, 81 Iowa L. Rev. 641 (1996).

[219] Restatement (Third) of Trusts § 90 cmt e(1) (Am. Law Inst. 2007).

[220] Id. cmt. f(2).

[221] Unif. Prudent Inv'r Act § 2(b) (Unif. Law Comm'n 1994).

[222] *See* Restatement (Third) of Trusts § 70 cmt. a (Am. Law Inst. 2007); Unif. Trust Code § 815(b) (Unif. Law Comm'n 2003); Sitkoff, supra note __, at [ms].

principles," the Restatement (Third) of Trusts confirms, "also allow the use of more active management strategies by trustees."[223]

However, because active strategies tend to "entail investigation and analysis expenses" that increase costs, and because the exclusion of some investments tends to entail a diversification cost, as a matter of prudence these "added costs" must be offset "by realistically evaluated return expectations."[224] Thus, taking notice of "the importance of market-efficiency concepts and differences in the degrees of efficiency and inefficiency in various markets," the Restatement expressly sanctions "active management strategies" that "involve investigation expenses and other transaction costs" if those costs are reasonable "in relation to the likelihood of increased return from such strategies."[225]

3. Cost Sensitivity, Monitoring, and Recordkeeping

The prudent investor rule's emphasis on balancing costs and benefits in investing is a specific application of a more general duty of a trustee or other such fiduciary to be *cost sensitive*,[226] that is, to "incur only costs that are reasonable in relation to the trust property, the purposes of the trust, and the skills of the trustee."[227] The rationale is obvious: "Minimizing costs and expenses preserves trust assets for the beneficiaries."[228] Thus, in addition to balancing costs and benefits in determining whether to employ an active investment strategy, a trustee must likewise be cost sensitive in undertaking active shareholding by way of proxy voting or other engagement with management.[229]

Moreover, because a trustee has a duty of *ongoing monitoring*, the prudent investor rule and the duty to be cost sensitive apply not only to a "trustee's decisions respecting new investments," but also to the trustee's "continuing responsibility for oversight of the suitability of investments already made."[230] A trustee must "make portfolio adjustments if and as appropriate" in light of changing market conditions and the beneficiary's circumstances.[231] As the Supreme Court put the point in a recent ERISA dispute, "a trustee has a continuing duty to monitor trust investments and remove imprudent ones. This continuing duty exists separate and apart from the trustee's duty to exercise prudence in selecting investments at the outset."[232] Accordingly, after

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[223] Restatement (Third) of Trusts § 90 cmt. h(2) (Am. Law Inst. 2007).

[224] Id.

[225] Id. pt. 6, ch. 17, intro. note.

[226] *See* id. § 88 cmt. a.

[227] Unif. Trust Code § 805 (Unif. Law Comm'n 2000); *see also* Unif. Prud. Investor Act § 7 (Unif. Law Comm'n 1996) (similar); ERISA § 404(a)(1)(A)(ii), 29 U.S.C. 1104(a)(1)(A)(ii) (duty of cost sensitivity for an ERISA fiduciary, framed as "defraying reasonable expenses of administering the plan").

[228] Sitkoff & Dukeminier, supra note __, at 660-61.

[229] *See, e.g.*, DOL FAB 2018-1, at 4 (shareholder engagement permissible for an ERISA fiduciary if the expected benefit outweighs "the costs involved").

[230] Uniform Prudent Investor Act § 2 cmt. (Unif. Law Comm'n 1994).

[231] Restatement (Third) of Trusts § 90 cmt. e(1) (Am. Law Inst. 2007).

[232] Tibble v. Edison Int'l, 135 S. Ct. 1823, 1828 (2015).

implementing a program of active investment or active shareholding (whether based on ESG factors or otherwise) with an expectation of returns that outweigh the associated costs, a trustee must monitor those costs and returns, and adjust the program in light of actual performance.

Finally, a trustee must maintain *adequate records* of "the administration of the trust," documenting important decisions.[233] The normal practice among professional trustees is to establish a written investment policy statement for each fiduciary account.[234] In the context of an active investment program, whether ESG or otherwise, a trustee would be expected to document its analysis of realistic expected returns sufficient to offset any attendant transaction and diversification costs, and to document its periodic review and adjustments to the program over time. A trustee's failure to do so would entitle a reviewing court "to resolve doubts against the trustee."[235]

4. Application to Risk-Return ESG

Taking recent claims about motive at face value, risk-risk return ESG is a kind of active strategy meant to benefit the beneficiary by obtaining better returns with less risk. Conceptualizing risk-return ESG investing in this manner elides the problem of subjectivity and lack of standardization in identifying and applying ESG factors,[236] at least so long as ESG investing is not mandatory.[237] A program of risk-return ESG investing by a trustee or other fiduciary of a personal trust, pension, or charitable endowment, like any other investment program, will stand or fall under the duty of care or prudence based on the trustee's compliance with the contextual, facts-and-circumstances prudent investor rule and the subsidiary principles of cost sensitivity, monitoring, and recordkeeping.

The questions thus arise: What is the theory and evidence for risk-return ESG? How does that theory and evidence intersect with the process-oriented requirements of the duty of care or prudence? Could a trustee or other such fiduciary plausibly conclude in a reasonable, documented analysis that a risk-return investment program is prudent? Even if a trustee could reach such a conclusion, could that conclusion be sustained across periodic reconsiderations in accordance with the ongoing monitoring duty? To answer these questions, we consider next the theory and evidence on the relationship of ESG factors to firm performance (Section B), and the theory and evidence on whether such a relationship can be exploited for profit by active investing (Section C) or active shareholding (Section D).

**B. ESG Factors and Firm Performance**

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233 Restatement (Third) of Trusts § 83 (Am. Law Inst. 2007); *see also* Muir, supra note __, at [ms] (ERISA fiduciary must "document[] the reason for its decision").

234 *See* id. at 640-41; Schanzenbach & Sitkoff, *supra* note __ at 138-39.

235 Id. § 83 cmt. a(1).

236 *See* supra Part I.E.

237 *See* infra Part II.E.2.

Without a relationship between ESG factors and firm performance, those factors could not possibly be relevant for an investment analysis. Our review of the literature leads us to conclude that there are indeed plausible theoretical arguments, supported by empirical evidence, that ESG factors are positively related to firm performance. The potential for such a relationship is perhaps most obvious for governance factors. The connection between environmental or social factors and firm performance is less obvious, but also has theoretical and empirical support.[238]

1. Environmental and Social Factors

Environmental and social factors might relate to firm performance through at least two mechanisms. *First*, these factors may help identify specific risks. Firms with weak internal controls, poor compliance records, or in socially unpopular or environmentally risky industries may face greater political, regulatory, and litigation risks. Consider the fossil fuel industry, which is disfavored in collateral benefits ESG investing for a variety of reasons. Some supporters of risk-return ESG investing argue that these same environmental factors predict litigation and regulatory risk, such as from a catastrophic environmental disaster,[239] and the risk of large fixed investments becoming "stranded" following a clean energy breakthrough or dramatic regulatory change.[240]

*Second*, social and environmental factors may proxy for management quality, an important factor for investors but hard to observe directly.[241] Well-run firms may have better compliance programs, and high-quality managers may be attracted to firms that have pro-social or environmental policies.[242] A firm that is better at regulatory compliance and managing environmental and social risks may be better managed and governed in general, making environmental and social factors a useful proxy for better management.[243] It is also possible that the causation works in reverse. Perhaps firms with pro-social and environmental policies attract a higher quality of management. High-quality managers may be especially concerned about protecting their reputational capital, or perhaps socially and environmentally responsible behavior is correlated with other attributes of sound management.

[238] To be clear, we are only speaking of the possibility of a relationship between ESG factors and firm performance. We defer the distinct question of whether such a relationship, if it exists, could be exploited for profit by active trading or active shareholding to Sections C and D respectively.

[239] Sparkes, supra note __, at 60-62 (discussing the Exxon Valdez oil spill and subsequent harm to investors).

[240] *See, e.g.*, Atif Ansar, Ben Caldecott & James Tilbury, Stranded Assets and the Fossil Fuel Divestment Campaign: What Does Divestment Mean for the Valuation of Fossil Fuel Assets? 22-28 (2013), available at http://www.smithschool.ox.ac.uk/publications/reports/SAP-divestment-report-final.pdf.

[241] Survey evidence indicates that many investors believe that ESG factors are proxies for managerial quality. *See* CFA Institute, Environmental, Social, and Governance (ESG) Survey (2017) (reporting that of those who use ESG factors, 41% do so as a proxy for management quality).

[242] *See, e.g.*, Roland Benabou & Jean Tirole, Individual and Corporate Social Responsibility, 77 Economica 19 (2009) (arguing that corporate social responsibility may prevent short-sighted managerial decision making).

[243] *See* Allen Ferrell, Hao Liang & Luc Renneboog, Socially Responsible Firms, 122 J. Fin. Econ. 585 (2016) (finding that corporate social responsibility increases as firm governance improves).

The theoretical relationship between firm value and ESG factors has some empirical support. In general, studies of firm performance find that firms with high environmental and social scores enjoy higher earnings with lower risk than firms with low environmental and social scores.[244] Moreover, there is evidence that firms can build goodwill through socially responsible activities, which can protect against reputational harm from adverse events.[245]

These conclusions, however, are not universally accepted. One concern is that managers may invoke ESG factors to enact their own policy preferences at the expense of shareholders—an agency cost problem for which there is some empirical evidence.[246] Another concern is that firms with high ESG scores can face political and regulatory risks as well. For example, companies pursuing alternative energy sources may score high on ESG factors but still face significant governmental or regulatory risk owing to heavy reliance on government subsidies.[247] Sales of Tesla electric vehicles dropped precipitously in Hong Kong and Denmark after those jurisdictions repealed tax provisions that had favored electric vehicles.[248] And in late 2017, Tesla's share price took a hit after the Republican majority in Congress proposed elimination of the U.S. tax subsidy for electric cars.[249]

2. Governance Factors

A variety of objective corporate governance factors have straightforward theoretical relationships to firm performance. For example, whether a firm has a controlling shareholder, the entrenchment of management (such as by a classified board[250] or other antitakeover devices), and CEO and other executive compensation are familiar governance factors routinely considered by active investors. A robust empirical literature confirms that identifiable governance factors can have a significant effect on firm performance.[251]

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[244] *See* John Peloza, The Challenge of Measuring Financial Impacts from Investments in Corporate Social Performance, 35 J. Management 1518, 1521 (reviewing 159 studies, finding that "[t]he majority … show a positive relationship between CSP and financial performance (63%); 15% of studies report a negative relationship, and 22% report a neutral or mixed relationship" (2009).

[245] *See* Paul C. Godfrey, Craig B. Merrill & Jared M. Hansen, The Relationship Between Corporate Social Responsibility and Shareholder Value: An Empirical Test of the Risk Management Hypothesis, 30 Strat. Management J. 425 (2009).

[246] *See* Ronald W. Masulis & Syed W. Reza, Agency Problem of Corporate Philanthropy, 28 Rev. Fin. Stud. 592 (2015) (finding that corporate philanthropy is correlated with CEO preferences and reduces firm value); Philipp Krüger, Corporate Goodness and Shareholder Wealth, 115 J. Fin. Econ. 304 (2015) (finding negative shareholder reaction to positive corporate social responsibility announcements).

[247] *See, e.g.*, Mark Chediak & Chris Martin, Say Goodbye to Solar Power Subsidies, Bloomberg News (November 5, 2015) available at https://www.bloomberg.com/news/articles/2015-11-05/say-goodbye-to-solar-power-subsidies; Michael Kavanaugh, A World Map of Subsidies for Renewable Energy and Fossil Fuels, Fin. Times, July 25, 2017.

[248] *See* Alex Schiffer, Tesla's Sales Stall in Hong Kong as Tax Breaks End. Could the U.S. be Next?, Wash. Post, July 10, 2017.

[249] *See* Russ Mitchell, Tesla Stock Takes a Hit as GOP Unveils Tax Plan that Eliminates Electric Care Subsidy, L.A. Times, Nov. 2, 2017.

[250] *See* supra notes 83-84 and text accompanying.

[251] *See, e.g.*, Lucian Bebchuk, Alma Cohen & Charles C.Y. Wang, Learning and the Disappearing Association Between Governance and Returns, 108 J. Fin. Econ. 323 (2013).

To be sure, there is disagreement about the extent to which existing studies have reliably measured the relationship between governance and firm value.[252] Moreover, optimal corporate governance is contextual; heterogeneity among firms may require heterogeneity in governance. Put in more general terms, the prevailing view is that the role of corporate law is to enable tailor-made governance for a wide variety of contexts.[253] For example, as we have seen, there is some evidence that for many firms a classified board is a minus, but for certain kinds of firms it may be a plus.[254] Although investors and academics are generally hostile to poison pills, most acknowledge that there are circumstances in which defensive tactics may be beneficial to shareholders, depending on the design of the pill and the firm's circumstances.[255]

But the contextual nature of optimal governance speaks to the need for subjective judgments in applying governance factors within an active investment strategy. And subjectivity, as we have seen, is inherent to any active investment strategy, ESG or otherwise.[256] For now it is enough to observe the broad consensus that there are sound theoretical reasons, supported by empirical evidence, to suppose a relationship between firm governance and firm value.

## C. Active Investing

Plausible theories, supported by significant empirical evidence, suggest that ESG factors relate positively to firm performance. It does not follow, however, that identifying this relationship creates an opportunity to obtain excess risk-adjusted returns in thick public markets. An active investment program, whether based on ESG factors or otherwise, can generate improved risk-adjusted returns only if those factors are not already reflected by market prices, i.e., the market must be consistently "inefficient" in valuing ESG factors.[257] But because ESG investing is widely used, with literally hundreds of ESG indices and ratings services,[258] there is a strong probability that salient ESG factors will be reflected in market prices. Indeed, some contrarian trading strategies

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[252] *See* Kausner, Empirical Studies, supra note __.

[253] For a classic exposition, see Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Columbia L. Rev. 1416 (1989).

[254] *See* supra notes 83-84 and text accompanying.

[255] *See, e.g.*, Blackrock, Proxy Voting, supra note __, at 9 ("[O]ur policy is to examine [poison pill] plans individually. Although we oppose most plans, we may support plans that include a reasonable 'qualifying offer clause.'")

[256] *See* text accompanying supra notes 85-86.

[257] The classic work is Burton Malkiel, A Randon Walk Down Wall Street: The Time-Tested Strategy for Successful Investing (11th ed. 2015); *see also* Zvi Bodie, Alex Kane & Alan J. Marcus, Investments 380 (9th ed. 2011) ("The bulk of the evidence, however, suggests that any supposedly superior investment strategy should be taken with many grains of salt. The market is competitive *enough* that only differentially superior information or insight will earn money; the easy pickings have been picked.").

With respect to SRI or collateral benefits ESG, see Brest, Gilson & Wolfson, supra note __, at 23-24 (2018); Knoll, supra note __, at 711. With respect to governance factors, see Bebchuk, Cohen & Wang, supra note __; John E. Core, Wayne R. Guay, and Tjomme O. Rusticus, Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations, 61 J. Fin. 655 (2006).

[258] *See* supra note 6 and text accompanying.

are based on the possibility that prices might overcompensate for ESG factors.[259] Against this backdrop, we now consider the possibility of obtaining excess risk-adjusted returns from using ESG factors in picking stocks or other securities, that is, in an active investing strategy. We defer until Section D the use of such factors in active shareholding.

1. Questioning Market Efficiency

An active investing strategy based on ESG factors is conceptually no different than any other active investing strategy that purports to identify stocks or other securities that are mispriced, and to generate risk-adjusted excess returns by placing bets for or against those stocks or securities. The hard question is whether profits can be obtained by predicting such mispricing. The literature on risk-return ESG investing, both academic and practice-oriented, tends to make two related arguments toward predictable market inefficiencies that could be exploited by an active investing strategy using ESG factors.

*First*, supporters of ESG investing point to general disagreement about the extent of capital market efficiency, and therefore the possibility in general of a profitable active trading strategy.[260] *Second*, supporters of risk-return ESG investing argue that consistent market inefficiency is more likely with respect to ESG factors. Traditional measures of risk tend to be backward looking, relying on historical share price variances (standard deviation) or current firm financial characteristics.[261] ESG strategies, by contrast, aspire to forecast risk not reflected in historical variance or a firm's financials. For example, supporters of ESG investing suggest that those factors can be used to identify a change in a firm's risk profile before the firm's stock price adjusts to that change.[262]

A particular focus of risk-return ESG investing strategies are on so-called "tail-risks,"[263] meaning low-probability but high-impact events that by definition would be poorly reflected in historical data, and therefore perhaps not accurately priced even in an otherwise efficient market.[264] Some tail risks are firm or industry specific, such as a nuclear plant meltdown, a massive oil spill, or a paradigm-shifting technological breakthrough, while other tail risks affect the entire economy, such as a financial

[259] *See* infra Part III.C.4.

[260] *See, e.g.*, Gary, supra note __, at 274 (arguing that market inefficiency justifies ESG investing); Maria O'Brien Hylton, "Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 Am. U.L. Rev. 1 (1992) (arguing that inefficient markets can produce returns to SRI).

[261] *See* Bodie, Kane & Marcus, supra note __, at 117.

[262] *See* Christoph M. Klein, Integrating ESG into the Fixed-Income Portfolio, CFA Inst. Conf. Proc. Quarterly 48 (2015) ("Incorporating ESG factors into the investment process advances analysis far beyond the traditional Markowitz approach of focusing on only historical risk-and-return measures. For example, an in-depth understanding of a company's ESG [key performance indicators] will allow a portfolio manager to react quickly to negative information and sell a security before its price moves in response to an impending adverse event.").

[263] *See* Nassim Nicholas Taleb, The Black Swan: The Impact of the Highly Improbable (2007).

[264] *See* Bodie, Kane & Marcus, supra note __, at 117 ("No matter how long the historical record, there is never a guarantee that it exhibits the worst (and best) that nature can throw at us in the future."); *but see* Brian Kelly & Hao Jiang, Tail Risk and Asset Prices, 27 Rev. Fin. Stud. 2841 (2014) (concluding that firms with large tail risks return significantly more than firms with low tail risks, suggesting that markets price tail risk).

crisis.[265] Thus, for example, some supporters of ESG investing argue that the tail risks to a fossil fuel company include a catastrophic environmental disaster such as a major oil spill or of stranded large fixed investments owing to a clean energy breakthrough discovery.[266] Others contend that firms with high ESG ratings are less sensitive to tail-risks. There is some empirical evidence that firms with high-ESG factors may perform better during financial crises,[267] but the evidence is not uniformly in favor of this conclusion.[268]

An emphasis on tail risk may also be more appropriate for some investors than traditional measures of risk such as variance in returns. Return variance, normally measured by standard deviation, is perhaps the most typical measure of risk, but it is not the only one.[269] For technical reasons, using the standard deviation to measure risk will not fully capture risk if the distribution of returns includes a lot of extreme events.[270] Thus, inclusion of ESG factors may provide a particular benefit to investors who are especially averse to tail risk, such as an investor for whom capital at risk is highly salient.

2. Screens and Stock Picking

Supposing that ESG factors are consistently mispriced, how can an investor exploit that mispricing? Roughly speaking, there are two broad categories of strategies for using ESG factors on public exchanges: *screens* and *stock picking*.[271]

A negative screening strategy involves applying ESG factors to screen out firms with low ESG scores. An investor could apply her own screen, or she could invest in an ESG screened fund, which may resemble an index fund but with low ESG score companies screened out.[272] For example, such a fund might buy shares in all firms with an ESG score above a specified threshold that are traded in a particular exchange. Or for

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[265] *See, e.g.*, MSCI Research Bulletin, The BP Oil Spill and ESG, June 2010, available at https://www.msci.com/documents/10199/5b94cf49-421e-4c71-b65c-39b446d6dab3.

[266] *See* supra notes 239-240 and text accompanying.

[267] *See* John Nosfinger & Abhishek Varma, Socially Responsible Funds and Market Crises, 48 J Banking & Fin. 1880 (2014) (suggesting that funds using ESG factors performed better in the bear markets of 2000 and 2008).

[268] *Compare* id., *with* Dan Dibartolomeo & Lloyed Kurtz, The Long Term Performance of a Social Investment Universe, 20 J. Investing 95 (finding that SRI-favored stocks outperformed the S&P 500 during the 1990s but underperformed during the 2000s, arguing this result traces to SRI skew toward smaller firms and green tech stocks).

[269] Value at risk, expected shortfall, and lower partial standard deviation are other textbook measures of risk. *See* Bodie, Kane & Marcus, supra note __, at 138-139.

[270] *See* id. at 136-140.

[271] *See, e.g.,* GAO Report, supra note __, at 20. We treat proxy voting and other shareholder engagement under the rubric of active shareholding below in Section D.

[272] *See, e.g.*, InvestmentNews, Fidelity Launches Two ESG Index Funds, May 15, 2017, available at http://www.investmentnews.com/article/20170515/FREE/170519951/fidelity-launches-two-esg-index-funds.

better diversification, the fund might buy shares in only those firms with ESG scores above the firm's industry average score or overweight high-ESG firms.[273]

The efficacy of a screening strategy has a clear theoretical limitation: as the screen is used more broadly, any advantage to it will diminish. This point is acknowledged by supporters of ESG investing.[274] Moreover, with increasing firm-level ESG disclosure over time,[275] implementing an ESG screen has become less costly, which invites more competition, reducing any payoff to the strategy. Not surprisingly, most empirical studies find that, on a risk-adjusted basis, employing ESG screens leads to performance about the same or worse than their benchmark indices.[276]

On the other hand, some recent studies suggest that positive screens, choosing the firms with the best ESG scores in each industry, may be a promising approach and with reduced loss of diversification.[277] However, this approach involves investment in industries that collateral benefits ESG—that is, classic SRI—would tend to avoid. And as this approach grows more popular, its benefits should also diminish.[278]

In contrast to a screening strategy, stock picking focuses on applying ESG factors in constructing a portfolio of individual stocks (or other securities). For example, an ESG investor might examine a firm's ESG factors and assess qualitatively whether the firm is a good or bad growth prospect on that basis. Or the investor might use a firm's ESG score as an additional factor in a Fama-French type multi-factor analysis to predict return.[279] Eugene Fama and Kenneth French noted that the capital asset pricing model (CAPM), which looks solely to market risk to predict returns, was empirically inadequate. By adding the additional factors of book-to-market ratio and company size, they created a three-factor model with improved predictive power toward better identification of mispriced securities.[280] In a similar vein, risk-return ESG investors sometimes use a multifactor model that includes ESG factors, an approach that seems to

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[273] The Dow Jones Sustainability Index takes a best-in-class approach. *See* DSJI 2017 Review Results, available at http://www.robecosam.com/images/review-presentation-2017.pdf; *see also*Mier Statman & Denys Glushkov, The Wages of Social Responsibility, 65 Fin. Analysts J. 33, 41-2 (2009) (finding that a positive screen that overweights firms with high-ESG ratings can avoid diversification costs of a negative screen).

[274] *See, e.g.,* PRI, Does ESG Pay Off Financially?, PRI Academic Network: RI Quarterly 4-5 (Oct. 2015), https://www.unpri.org/Uploads/z/u/j/riquarterlyvol8_744947.pdf.

[275] *See* Dieschbourg & Nussbaum, supra note __.

[276] *See, e.g.*, Benjamin R. Auer & Frank Schuhmacher, Do Socially (Ir)Responsible Investments Pay? New Evidence from International ESG Data, 59 Q. Rev. Econ. & Fin. 51 (2016) (finding little difference between returns for high and low ESG funds in the US).

[277] *See, e.g.*, Mier Statman & Denys Glushkov, The Wages of Social Responsibility, 65 Fin. Analysts J. 33, 41-2 (2009) (finding that overweighting high ESG firms can improve risk-adjusted return and avoid diversification cost of negative screen).

[278] *See* Nadja Guenster, Performance Implications of SR Investing: Past versus Future, *in* Socially Responsible Finance and Investing (Kent Baker & John R Nofsinger eds., 2012).

[279] *See* Eugene F. Fama & Kenneth R. French, Common Risk Factors in the Returns on Stock and Bonds, 33 J. Fin. Econ. 3 (1993) (original three-factor model).

[280] Fama and French have since proposed a five-factor model. *See* Eugene F. Fama & Kenneth R. French, A Five-Factor Asset Pricing Model, 116 J. Fin. Econ. 1 (2015).

be endorsed by recent PRI publications.[281] There is some empirical evidence that incorporating ESG factors into a Fama-French type model increases its predictive power.[282]

3. The Usual Caveats About Stock Picking

As with any active investing strategy meant to exploit market mispricing, whether based on ESG factors or otherwise, three caveats are in order. *First*, risk-adjustment is not an exact science. Risk-adjustment usually relies on historical pricing to predict variations and correlations going forward. But such variations and correlations can change over time, diminishing the predictive power of historical data.[283] Moreover, a key part of the argument toward market inefficiency with respect to ESG factors is that backward-looking measures of risk are inapt for those factors.[284] By the same logic, risk-adjustment for active investing based on such factors could be similarly compromised.

A particular difficulty for risk-adjustment is in measuring the costs of diminished diversification.[285] Any stock picking strategy, whether based on ESG factors or otherwise, entails a potential diversification cost, because by definition such a strategy involves a portfolio narrower than the market as a whole.[286] And there is evidence that diversification has become more difficult over time, requiring a broader range of securities than previously.[287] A diversification sacrifice is especially likely if entire industries are avoided, such as fossil fuels or tobacco, or if other industries are overweighted, such as technology.[288]

*Second*, active investment strategies tend to entail higher transaction costs than a passive strategy. These costs include not only investigation, analysis, and trading costs, but may also include added tax costs, reflecting more frequent realization events.[289] For

[281] *See* PRI Institute, A Practical Guide to ESG Integration for Equity Investing (2016), available at https://www.unpri.org/download?ac=10.

[282] *See, e.g.*, Alex Edmans, Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, 101 J. Fin. Econ. 621 (2011) (finding correlation between high employee satisfaction and excess market returns); Jeroen Derwall et al., The Eco-Efficiency Premium Puzzle, 61 Fin. Analysts J. 51 (2005) (finding firm energy efficiency identified excess returns in a multi-factor model).

[283] *See, e.g.*, Jeremy Seigle, Stocks for the Long Run 49-52; 93-94 (6th ed. 2014).

[284] *See* supra Part III.C.1.

[285] *See* Bodie, Kane & Marcus, supra note __, at [ ] (discussing diversification challenges when pursuing a stock picking strategy).

[286] *See* Dylan B. Minor, Finding the Financial Cost of Socially Responsible Investing, 18 J. Investing 55 (2007).

[287] *See* John Y. Campbell et al., Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk, 56 J. Fin. 1, 43-44 (2001) (finding that idiosyncratic variance has increased over time; whereas about 20 stocks reduced the standard deviation of a portfolio to 10 percent in the 1960s, by early 2000s 50 stocks were needed).

[288] *See, e.g.*, Leonardo Becchetti et al., Socially Responsible and Conventional Investment Funds: Performance Comparison and the Global Financial Crisis, 47 App. Econ. 2541 (2015) (finding that SRI funds outperformed during the financial crisis of 2008 but not during the stock market drop of 2001 likely due to overweighting of financial sector); Dibartolomeo & Kurtz, supra note __.

[289] *See* Malkiel, supra note __, at 137, 143, 145, 150, 156.

a stock picking strategy to be profitable, whether based on ESG factors or otherwise, the returns must be large enough to offset the associated transactions costs.

*Third*, even if an active investment strategy is profitable initially, as the strategy becomes more widely known, other investors may adopt it, causing prices to adjust accordingly, dissipating the benefits to the strategy.[290] Likewise, academic studies that find asset mispricing usually fail to translate into a profitable trading strategies, an unsurprising result given the public nature of an academic finding,[291] the tendency to overstate the magnitude and significance of mispricing owing to publication bias,[292] and diversification and transaction costs. The lack of persistence to profitable active investment strategies is widely recognized, including by proponents of risk-return ESG investing.[293]

To be sure, none of these caveats is unique to risk-return ESG investing. Each applies to any form of active investing by way of stock picking. But they are especially relevant to active investment by a trustee or other fiduciary. For as we have seen, trust fiduciary law emphasizes the need for a documented analysis of realistic return expectations that offset any diversification or transaction costs.[294] Trust fiduciary law also imposes an ongoing duty to monitor an investment program, making portfolio adjustments over time as circumstances evolve, such as if the predicted excess returns to an active investment strategy are not realized or dissipate over time.[295]

4. Contrarian, Anti-ESG Strategies

The same conceptual logic that motivates risk-return ESG investing—identifying a mispriced asset and then trading to profit from the mispricing—could alternatively support a contrarian, anti-ESG investment strategy. There is some evidence that contrarian investment strategies, such as betting that the reduced share price of a firm that has had a run of bad publicity reflects an overreaction to the bad news, can produce excess risk-adjusted returns.[296] There is also some evidence that so-called "sin" or "vice"

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[290] *See* supra note 257.

[291] *See* R. David McLean & Jeffrey Pontiff, Does Academic Research Destroy Stock Return Predictability?, 71 J. Fin. 5, 8 (2016).

[292] Publication bias refers to the preference of peer-reviewed journals for publication of statistically significant results. Inconclusive results or non-findings are less likely to be published, and therefore are underrepresented in the literature. The bias is further reinforced because it incentivizes academic researchers to make modelling choices that result in statistical significance. In consequence, empirical findings may in reality be much weaker than would appear from the published literature. Publication bias is a widely-noted phenomenon, including in finance. *See* Campbell R. Harvey, Yan Liu & Heqing Zhu, … And the Cross-Section of Expected Returns, 29 Rev. Fin. Stud. 5, 36-37 (2016) (suggesting that almost half of significant findings of excess returns reflect data mining and research design choices); K. Hou et al., Replicating Anomalies, NBER working paper No. w23394 (2017) (failing to replicate the majority of excess return findings).

[293] *See* PRI Academic Network: RI Quarterly, supra note __ at 4-5.

[294] *See* supra Part III.A.2-2.

[295] *See* id.

[296] *See* Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, Contrarian Investment, Extrapolation, and Risk, 49 J. Fin. 1541 (1994); Malkiel, supra note __, at 267-68.

stocks outperform on a risk-adjusted basis because of investor distaste for the company's products or practices.[297]

Accordingly, a trustee might reasonably choose to overweight firms with poor ESG scores. Consider the familiar ESG investing example of a tobacco company. A trustee might reasonably conclude that the market has overreacted to negative ESG factors and negative publicity, depressing the firm's stock price, thereby giving rise to a profit opportunity.

We are making two different points here. *First*, there is theory and evidence for the proposition that sin or vice stocks might be undervalued. A trustee could reasonably conclude, therefore, that she should pursue a contrarian investing strategy favoring sin stocks. *Second*, adding ESG factors to a Fama-French type multi-factor asset pricing model is a double-edged sword. Such models, being data driven,[298] could well produce estimates showing that firms with high ESG scores are overvalued and firms with low ESG scores are undervalued, perhaps because the market has overcorrected in reaction to those ESG scores.

Of course, a prudent trustee might also conclude that she cannot beat the market. Such a conclusion finds abundant theoretical and empirical support in the finance literature,[299] and may apply with particular force to an amateur, individual trustee. Such a trustee could reasonably choose to prefer a passive investing strategy, such as by purchasing an index fund, as a low-cost and well-diversified strategy.[300]

### D. Active Shareholding

While the extent of market efficiency is debated, there is consensus that making money by active investing based on predicting mispricing in thick public markets is hard. As a leading text puts it, "the easy pickings have been picked."[301] And yet, as we have seen, there is both theory and evidence that links ESG factors to firm performance.[302] Another strategy, which can be used by active or passive investors, is to use shareholder voice to improve firm value. We call this approach active shareholding, in contrast to active investing via screens or stock picking.

By way of illustration, a firm's board may become complacent or might propose changes to the corporate structure that further entrench current management (such as a staggered board). Voting against lazy directors or entrenchment could protect firm value. In the same way, voting for shareholder proposals to unclassify a board of directors or remove a poison pill could result in improved returns. All that is necessary

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[297] *See, e.g.*, Harrison Hong & Marcin Kacperczyk, The Price of Sin: The Effects of Social Norms on Markets, 93 J. Fin. Econ. 15 (2007).

[298] *See* Eugene F. Fama, Finance at the University of Chicago, 125 J. Pol. Econ. 1790, 1795 (2017) (discussing risk of "factor models … degenerating into mindless data dredging").

[299] *See* supra note 257.

[300] *See* infra Part III.E.2.

[301] Bodie, Kane & Marcus, supra note __, at 380; *see also* supra note 257.

[302] *See* supra Part III.B.

for active shareholding to improve returns is for the expected benefit of the investor's activism to outweigh its monitoring, investigation, voting, or other costs.

Shareholder activism has increased significantly over the past two decades,[303] in part facilitated by regulatory reforms and increasing institutional ownership.[304] Much of this activity has been focused on governance factors, such as reducing management entrenchment and executive pay. But there is also growing attention to social and environmental factors such as "enhanced diversity" in "board composition" and "climate risk and the environment."[305] BlackRock and Vanguard, for example, identify ESG factors in their proxy voting guidelines—that is, they consider ESG factors in a risk-return frame in deciding how to vote shares or otherwise engage with management.[306]

There is evidence that shareholder activism, even in the form of non-binding resolutions or withholding votes, can affect corporate policy. Firms commonly adopt shareholder proposals,[307] and withholding votes from incumbent directors often leads to resignations, executive turnover, and other policy changes.[308] Informal engagement, which may be combined with proxy contests, withholding votes, or the implicit threat of both, likewise can affect corporate policies.[309]

Given the likelihood that market prices will come to reflect ESG factors, prominent advocates of ESG investing, including the chair of the PRI, have argued that ESG-based active shareholding will likely come to supplant active investing strategies.[310] However, there are practical and theoretical limits on active shareholding, whether based on ESG factors or otherwise. And fiduciary investment law, which emphasizes the need for a documented analysis of costs and benefits updated periodically, is sensitive to these limits.

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[303] *See, e.g.*, John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 Annals Corp. Gov. 94 (2016).

[304] *See, e.g.*, David Yermack, Shareholder Voting and Corporate Governance, 2 Ann. Rev. Fin. Econ. 103 (2010)

[305] Ernst & Young, supra note __.

[306] *See* BlackRock, Proxy Voting Guidelines for U.S. Securities, supra note __, at 12; Vanguard, Policies and Guidelines, https://about.vanguard.com/investment-stewardship/policies-and-guidelines/.

[307] *See* Yonca Ertimur, Fabrizio Ferri & Stephen R. Stubben, Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals, 16 J. Corp. Fin. 53, 54 (2010) (finding that that around 40% of shareholder proposals were later adopted by the board).

[308] *See, e.g.*, Jie Cai, Jacqueline L. Garner & Ralph A. Walkling, Electing Directors, 64 J. Fin. 2389, 2391 (2009) (concluding that, though directors are rarely removed by voting, low vote totals reduce CEO compensation and increase turnover, with no effect on share prices); Diane Del Guercio, Laura Seery & Tracie Woidtke, Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?, 90 J. Fin. Econ. 84, 102 (2008) (concluding that "just vote no" campaigns induce board action and CEO turnover with positive stock price effects).

[309] *See, e.g.*, Willard T. Carleton, James M. Nelson, & Michael S. Weisbach, The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF, 53 J. Fin. 1335 (1998).

[310] *See* PRI, Does ESG Investing Pay Off Financially?, supra note __, at 4 (noting likelihood of market prices adjusting to ESG factors and consequent need for "active ownership strategies").

The core difficulty is that collective action and free-rider difficulties plague active shareholding,[311] as acknowledged by the PRI.[312] A shareholder receives only a pro rata portion of the benefit of a successful shareholder action. These uncertain, pro-rata benefits must we weighed against the costs of shareholder activism, which are borne fully by the shareholder. Of course, some forms of active shareholding can be low cost. For example, an investor might hire a proxy advisory firm, such as Institutional Shareholder Services, to flag votes on matters that the advisory firm anticipates might adversely affect firm value.[313] Or an investor might speak directly with management, threatening to sell the investor's shares or vote against incumbents if specific reforms, ESG or otherwise, are not pursued. There is survey evidence that these forms of active shareholding are common, generally low cost, and have had some success.[314]

However, a low-cost approach may be insufficient to defeat a management proposal, remove a director, or pass a shareholder resolution.[315] An investor could try to coordinate with other shareholders, but this entails more costs and risks triggering securities law disclosure rules or a poison pill.[316] The investor could wage an outright proxy fight, soliciting all shareholders to vote in agreement with the investor, but this involves paying costs of a proxy contest,[317] and incumbent managers have powerful incumbency advantages.[318] A more aggressive but expensive tactic is to increase the investor's voting power such as by borrowing shares from other shareholders and voting them.[319] Most daringly, an activist shareholder could identify poorly governed

[311] *See* Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J. L. & Econ. 395 (1983).

[312] *See* PRI, Does ESG Investing Pay Off Financially?, supra note __, at 5 (noting "the problem of freeriding because the returns on the efforts of active owners are shared among all investors").

[313] *See, e.g.*, ISS, Quality Score: Data-Driven Insights for a complete ESG Risk Evaluation, https://www.issgovernance.com/solutions/qualityscore/. For analysis, see Stephen Choi, Jill Fisch & Marcel Kahan, The Power of Proxy Advisors: Myth or Reality, 59 Emory L. J. 869 (2010).

[314] *See* Joseph A. McCahery, Zacharias Sautner, & Laura T. Starks, Behind the Scenes: The Corporate Governance Preferences of Institutional Investors, 71 J. Fin. 2905 (2016) (survey finding significant reliance on ISS and informal discussions, and that 42% of respondents believe that exit threat disciplines management); *see also* Franks M Becht, J.R. Franks & Rossi C. Mayer, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund, 23 Rev. Fin. Stud. 3093 (2009) (case study concluding that informal engagements have generated excess returns).

[315] While shareholders elect directors and have the power to block certain undertakings, such as mergers and amendments to the articles of incorporation, shareholder ability to enact positive changes is limited. *See* Stephen M. Bainbridge, Corporation Law and Economics 193 n.8 (2002). A shareholder resolution, for example to compel a firm to study its carbon output, must still usually be approved by the board of directors to take effect, and, if framed as mandatory, is open to significant challenge. Id. at 495-496, 500-501.

[316] *See* John C. Coates IV, Thirty Years of Evolution in the Roles of Institutional Investors in Corporate Governance, *in* Research Handbook on Shareholder Power (2015); Bernard S. Black, Shareholder Passivity Reexamined, 89 Michigan L. Rev. 520 (1990).

[317] Activist hedge funds are the most willing to wage proxy fights,, but pension funds such as TIAA-CREF have also waged proxy fights with some success. *See* Carleton, Nelson & Weisbach, supra note __.

[318] *See* Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting, 96 Georgetown L.J. 1227 (2007); Yair Listokin, Management Always Wins the Close Ones, 10 Am. L. Econ. Rev. 159 (2008). Firms with significant inside ownership seem to be particularly challenging for proxy contests. *See* McCahery, Sautner & Starks, supra note __, at 2911-2912.

[319] *See* Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 S. Cal. L. Rev. 811, 823-840 (2005); *see also* Yermack, supra note __, at 112-14.

firms or firms with high environmental and social risks, purchase a block share, and try to change firm practices.[320]

In addition to the collective action and free-rider problems, a further difficulty is that shareholder activism may undermine a corporate structure or practice that has other, offsetting benefits. Active shareholding by definition disrupts the separation of ownership and control that is characteristic of the corporate form, and can dull managerial incentives while reduce the quality of managerial decisionmaking.[321] It may also direct scarce managerial resources to implementing shareholder proposals or contesting elections.[322] That a shareholder will be a better decisionmaker than management is hardly a forgone conclusion.

All told, the evidence is mixed on whether active shareholding, even by institutional investors, in fact improves firm value.[323] Successful shareholder proxy fights have been found to improve firm value,[324] but this approach is costly and risky, and unsuccessful fights can decrease firm value.[325] Shareholder proposals and informal negotiations have, at most, very small positive effects on firm performance, with some studies finding negative effects.[326] Nevertheless, precisely because of the unsettled nature of this debate, we must allow for the possibility of improved investment returns from using ESG factors in active shareholding.[327]

## E. ESG Investing Can be Prudent But is Not Mandatory

In view of the foregoing, we conclude that risk-return ESG investing by a trustee or other fiduciary of a personal trust, pension, or charitable endowment is potentially permissible under, but certainly not required by, the fiduciary duty of care or prudence.

### 1. Risk-Return ESG Investing is Potentially (But Not Necessarily) Prudent

As we have seen, a trustee has plenary power to invest in any type of investment, subject to the trustee's fiduciary duties, including the risk-and-return and diversification

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[320] *See* Marco Becht et al., Returns to Hedge Fund Activism: An International Study, 30 Rev. Fin. Stud. 2933 (2017) (finding abnormal, positive returns to successful activist actions but abnormal negative returns to unsuccessful activism).

[321] *See* Pierre Aghion & Jean Tirole, Formal and Real Authority in Organizations, 105 J. Pol. Econ. 1 (1997); Mike Burkart, Denis Gromb, and Fausto Panunzi, Large Shareholders, Monitoring, and the Value of the Firm, 112 Q. J. Econ. 693 (1997).

[322] *See* Yermack, supra note ___, at 119 (expressing particularly concern about "socially oriented shareholder proposals").

[323] *See* Matthew R. Denes, Jonathan M. Karpoff & Victoria B. McWilliams, Thirty Years of Shareholder Activism: A Survey of Empirical Research, 44 J. Corp. Fin. 405, 407 (2017); Yermack, supra note __, at 118.

[324] *See* Denes, Karpoff & McWilliams, supra note __, at 407.

[325] *See* id.

[326] *See* id. There is stronger evidence that activist hedge funds are more successful in achieving excess returns, in part because hedge funds do not need to diversified and so can assemble larger stakes, and are less regulated than other investment vehicles. *See* Yermack, supra note __, at 118-119.

[327] *See* Elroy Dimson, Oğuzhan Karakaş & Xi Li, Active Ownership, 28 Rev. Fin. Stud. 3225 (2015) (finding abnormal positive returns from adopting ESG shareholder proposals, noting difficulty in determining causation).

rules of the prudent investor rule and the further duties of cost sensitivity, ongoing monitoring, and recordkeeping. Accordingly, taking claims about motive in risk-return ESG investing at face value, the question is whether a trustee or other such fiduciary could plausibly conclude in a reasonable, documented analysis that employing ESG factors in a program of active investing, active shareholding, or both will provide expected return benefits in excess of any attendant transaction, diversification, or other costs.

The foregoing survey of the theory and evidence on the relationship between ESG factors and firm value, and the potential for that relationship to be exploited by an investor for profit by way of active investing or active shareholding, suggests that the answer is Yes. In other words, the current theory and evidence on risk-return ESG indicates that use of ESG factors in active investing or active shareholding could possibly generate excess risk-adjusted returns—but not necessarily so, and not indefinitely so.

Perhaps a more useful way to state our conclusion is that, in light of the current theory and evidence, risk-return ESG is within the universe of investment strategies that could plausibly be prudent for a trustee or other investment fiduciary—just like contrarian investing, passive investing, and a host of others. As a matter of theory, risk-return ESG is no different from any other form of active investment management. And a fair reading of the current evidence on risk-return ESG admits of the possibility that risk-return ESG could be a successful strategy. Whether a given fiduciary's specific program of risk-return ESG investing is prudent in a given case, therefore, is a contextual and fact-driven question, one that will turn on the quality of the fiduciary's documented analysis and periodic revisiting of that analysis.

The DOL agrees that risk-return ESG investing can be consistent with the duty of prudence. With respect to active investing, the 2015 Bulletin takes the position that, because a fiduciary "should appropriately consider factors that potentially influence risk and return," and because "[e]nvironmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment," such factors can be "proper components of the fiduciary's primary analysis of the economic merits of competing investment choices" toward "evaluat[ing] the economic benefits of investments and identify[ing] economically superior investments."[328] However, as the DOL elaborated in its 2018 Bulletin, a fiduciary:

> must not too readily treat ESG factors as economically relevant to the particular investment choices at issue when making a decision. It does not ineluctably follow from the fact that an investment promotes ESG factors, or that it arguably promotes positive general market trends or industry growth, that the investment is a prudent choice for retirement or other investors. … A fiduciary's evaluation of the economics of an investment should be focused on financial factors that have a material effect on the return and risk of an investment based on

[328] DOL IB 2015-1, 80 Fed. Reg. at 65136.

> appropriate investment horizons consistent with the plan's articulated funding and investment objectives.[329]

In sum, "if a fiduciary prudently determines that an investment is appropriate based solely on economic considerations, including those that may derive from environmental, social and governance factors, the fiduciary may make the investment."[330] The fiduciary "should maintain records to demonstrate compliance" with these principles.[331]

The DOL also agrees that actives shareholding can be consistent with the duty of prudence. The 2016 Bulletin takes the position that a fiduciary should "vote proxies on issues that may affect the value of the plan's investment," subject to whether the "expected … effect on the value of the plan's investment … warrants the … cost of voting."[332] The "responsible fiduciary would be required to maintain accurate records as to proxy voting."[333] The 2016 Bulletin also takes the position that a fiduciary could undertake other shareholder engagement "where the responsible fiduciary concludes that there is a reasonable expectation that … monitoring or communication with management … is likely to enhance the value of the plan's investment in the corporation, after taking into account the costs involved."[334] For both proxy voting and other shareholder engagement, the 2018 Bulletin reinforces the importance of balancing costs against the expected benefits, and the potential need for a documented analysis of that balance.[335]

In these respects, the Bulletins track traditional trust fiduciary law, and align with the current theory and evidence on the potential for risk-return ESG strategies to produce excess risk-adjusted returns.[336] Like any program of fiduciary investment, a risk-return ESG investment program must be supported by a documented analysis showing reasonably assessed expected returns that counterbalance any diversification, transaction, or other costs. And like any fiduciary investment program, whether active or passive, a risk-return ESG investment program must have risk and return objectives that are reasonably suited to the purpose of the fiduciary account. In view of the current theory and evidence on the plausibility of excess risk-adjusted returns from risk-return

[329] DOL FAB 2018-01, at 2.

[330] DOL IB 2015-1, 80 Fed. Reg. at 65136.

[331] Id.

[332] Id. at 95883.

[333] Id.

[334] Id. at 95884.

[335] DOL FAB 2018-01, at 5.

[336] We set to the side the question, addressed but not fully resolved in DOL FAB 2018-01, of inclusion of an ESG fund in a menu of investment options offered to participants in a defined contribution pension plan. The law and economics of applying the duty of prudence to menu construction by a pension fiduciary is not fully resolved, raising difficult questions that warrant stand-alone treatment. *See generally* Ian Ayres & Quinn Curtis, Beyond Diversification: The Pervasive Problem of Excessive Fees and "Dominated Funds" in 401(k) Plans, 124 Yale L.J. 1476 (2015). Those questions are distinct from our concern here, which involves a beneficiary with little say over how the trustee invests (see supra notes __ and text accompanying), because in a defined contribution plan with a menu the beneficiary can choose among the offerings included within the menu.

ESG, it is within the universe of potentially prudent investment strategies for a fiduciary investor.

2. Risk-Return ESG is Not Mandatory

Although we conclude that a fiduciary may engage in risk-return ESG investing on the terms described above, we reject the view suggested by the PRI and others (but not the DOL[337]) that a fiduciary must consider ESG factors.[338]

To begin with, the ESG rubric is too fluid, and the application of ESG factors too subjective, to lend itself to a mandate. This fluidity and subjectivity, which is elided by the contextual nature of an ordinary prudence analysis, makes the ESG concept too amorphous to give such a mandate meaning. As we have seen, there is a lack of consensus on whether a given consideration qualifies as an ESG factor, whether the ESG factor is a plus or minus from an investor's perspective, and how much weight to give to different ESG factors.[339] It would be peculiar indeed to say that ESG investing is mandatory but then permit as consistent with that mandate both favoring or disfavoring a classified board or poison pill;[340] both favoring or disfavoring nuclear power;[341] or both requiring only one woman or requiring at least three women on a board.[342] The subjectivity inherent to ESG investing, and the fluidity of the ESG rubric, casts a pall over the practical feasibility of a mandate to apply the concept.

A further practical difficulty is that a risk-return ESG investing mandate would prohibit many forms of passive investing. With such a mandate, a fiduciary could not invest in a passive broad market index fund that lacked an ESG screen or ESG active shareholding. But passive investing, a widely employed strategy, is universally understood to be a permissible fiduciary investment strategy.[343] Manifestly, an amateur trustee of a smallish trust fund who seeks to minimize transaction costs and maximize diversification is not in per se breach of trust if the trustee invests the fund in a passive total market index. To the contrary, such a trustee should strongly consider passive investing, given the duty of cost sensitivity. As recognized by the Supreme Court, even an ERISA fiduciary "could reasonably" conclude that she had "little hope of outperforming the market," and therefore "prudently rely on the market price."[344]

Returning to doctrine, the argument that ESG investing is required of a fiduciary is flatly contrary to blackletter law. It bears repeating that under the prudent investor rule, "[s]pecific investments or techniques are not per se prudent or imprudent."[345]

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[337] *See* DOL FAB 2018-01, at 2 (rejecting the "view that investment policy statements must contain guidelines on ESG investments or integrating ESG-related tools to comply with ERISA").

[338] *See* supra notes 29-31, infra note 348, and text accompanying.

[339] *See* supra Part I.E.

[340] *See* supra notes 83-84, 254-255 and text accompanying.

[341] *See* supra note 75-77 and text accompanying.

[342] *See* supra note 80-82 and text accompanying.

[343] *See, e.g.*, Restatement (Third) of Trusts § 90 cmt. h(1) (Am. Law Inst. 2007).

[344] Dudenhoeffer, 134 S.Ct. at 2471.

[345] Restatement (Third) of Trusts § 90 cmt. f(2) (Am. Law Inst. 2007).

Instead, "[a] trustee may invest in any kind of property or type of investment" so long as the investment is "part of an overall investment strategy having risk and return objectives reasonably suited to the trust."[346] Thus, in addition to risk-return ESG investing or passive investing, a fiduciary could also employ an active investment strategy that favors firms with poor ESG ratings, or a contrarian strategy favoring "sin" stocks or a "vice" fund, if the fiduciary reasonably concludes that such offerings are undervalued, perhaps owing to the prominence of ESG investing.[347]

Setting aside these practical and doctrinal objections, the deep conceptual flaw in the argument made by the PRI and others that fiduciary duty mandates risk-return ESG investing is confusion over the theory and evidence in favor of risk-return ESG coupled to a mistaken application of fiduciary principles. The argument usually takes the form of a syllogism as follows: (1) ESG factors are related to a firm's long-term financial performance; (2) the duty of care or prudence requires a trustee to consider material information; and (3) therefore a trustee must consider ESG factors.[348]

The many errors in this syllogism are readily apparent. To begin with, the syllogism conflates a relationship to firm performance with an investment profit opportunity. But a factor's relationship to firm performance, whether ESG or otherwise, does not give rise to a profitable trading opportunity unless capital markets consistently misprice the factor in a predictable manner that can be exploited net of any trading and diversification costs.[349] Nor does identifying such a relationship give rise to a profitable active shareholding opportunity unless it points to improved future returns net of present costs to the investor.[350]

Accordingly, even if ESG factors have a relationship to firm performance, a prudent trustee could conclude that she cannot cost-effectively exploit them for profit. As we have seen, this conclusion finds abundant theoretical and empirical support in the finance literature.[351] It has also been embraced by the Supreme Court: "[W]here a stock is publicly traded, allegations that a fiduciary should have recognized from publicly

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[346] Unif. Prudent Inv'r Act § 2(b), (e) (Unif. Law Comm'n 1994).

[347] *See* supra part III.C.4.

[348] *See, e.g.*, Freshfields Report, supra note __, at 10-11 ("In our view, decision-makers are required to have regard (at some level) to ESG considerations in every decision they make. This is because there is a body of credible evidence demonstrating that such considerations often have a role to play in the proper analysis of investment value. As such they cannot be ignored, because doing so may result in investments being given an inappropriate value."); Fiduciary Duty in the 21st Century, supra note __, at 9 ("Failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty."); Laura E. Deeks, Discourse and Duty: University Endowments, Fiduciary Law, and the Cultural Politics of Fossil Fuel Divestment, 47 Envtl. L. 335, 344–45, 418–19 (2017) (stating that "consideration of ESG factors is increasingly recognized as part of the obligations of universal investors not because it is right to do so from a moral imperative, but because it is right to do so from a risk management and prudent investment imperative," and that "fiduciary law arguably requires the consideration of ESG factors when doing so addresses a material risk to returns."); Gary, Best Interests in the Long Run, supra note __, at [ms] ("The prudent investor standard requires a fiduciary to consider risks that affect the financial assets subject to fiduciary management, and the financial risks of climate change and social upheaval are increasingly relevant to protecting the value of those assets.").

[349] *See* supra Part III.C.

[350] *See* supra Part III.D.

[351] *See* supra note 257.

available information alone that the market was over- or undervaluing the stock are implausible as a general rule, at least in the absence of special circumstances. … In other words, a fiduciary usually is not imprudent to assume that a major stock market … provides the best estimate of the value of the stocks traded on it."[352] It is ironic that alongside the push for active ESG investing, a contradictory movement that urges fiduciaries to avoid active strategies on grounds of cost has also gained traction.[353]

Moreover, the syllogism assumes that ESG factors will always be underpriced and therefore associated with higher returns. But an ESG factor, like any investment factor, can work in both directions: the market might also misprice it by overvaluing it. If a trustee reasonably concludes that firms with high ESG scores are overvalued and firms with low ESG scores are undervalued, perhaps because the market has overreacted to high ESG scores, the trustee could reasonably employ an anti-ESG strategy.[354] Indeed, on the logic of the PRI and others that a trustee or other fiduciary must pursue profit from active use of ESG factors, such an analysis would mandate an anti-ESG strategy.

Put in more general terms, a link between an observed factor and investment return, even if established by historical data or consensus, does not translate into a mandate that a trustee adopt an investment strategy based on that factor. Whatever the evidence on historical returns from ESG factors, a prudent trustee could decide not to bet for (or against) those factors for the same reasons that a trustee could decide not to bet on other findings, such as hemline lengths, the Super Bowl winner, or the January effect, each of which finds support in a study showing a relationship to investment returns.[355] As we have seen, for many reasons (including lack of persistence, publication bias, and transaction costs) efforts to translate academic findings of market mispricing into profitable trading strategies often fail and, if successful initially, tend not to persist.[356]

Let us conclude with a word about time horizon. A key part of the argument that a trustee or other fiduciary must rely on ESG factors is that those factors better assess long-term risk.[357] There are good reasons in practice and in financial economics to be skeptical of these claims. *First*, in practice not all trusts or other fiduciary accounts have a long-term time horizon. To the contrary, some fiduciary accounts, such a trust that is to wind up soon or a pension account for an older person, have a short time horizon. Taken seriously, the argument that ESG factors better assess long-term risk implies that

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[352] Dudenhoeffer, 134 S.Ct. at 2471 (citations and quotations omitted).

[353] *See, e.g.*, Ayres & Curtis, supra note __.

[354] *See* supra Part III.C.4.

[355] *See* Malkiel, supra note __, at 146-51.

[356] *See* supra Part III.C.3.

[357] Gary doubles down on this argument by invoking also the duty of impartiality, which requires a trustee to give due regard to the interests of current and future beneficiaries (see Sitkoff & Dukeminier, supra note __, at 667-74), arguing that consideration of ESG factors may be necessary to satisfy this duty. *See* Gary, Best Interests in the Long Run, *supra* note __, at [ms] ("An investment strategy that fails to consider long-term risk or that shortchanges future beneficiaries financially may implicate the duty of impartiality."). Conceptually, however, Gary's impartiality argument rests on the same time horizon point.

a fiduciary with a short time horizon should favor firms with low ESG scores, as the payoff investment in a high ESG score firm will take too long to realize.

*Second*, the long-term argument rests on the unstated assumptions that financial markets have both mispriced ESG factors and, further, will not adjust for mispricing ESG factors over time. In effect, the argument is that a trustee must bet that by use of ESG factors she can better predict long-term risk and return than markets. Mandating such a bet therefore assumes both mispricing in one direction and that this mispricing will persist indefinitely.

All told, mandating a long-term ESG perspective for trustees or other investment fiduciaries is manifestly contrary to both law and economics. A prudent trustee could opt for an opposite, anti-ESG bet. Or, as the Supreme Court has held, a trustee could alternatively conclude that she had "little hope of outperforming the market," and therefore "prudently rely on the market price."[358]

## Conclusion

This paper assessed the law and economics of ESG investing by a trustee or other investment fiduciary subject to American trust fiduciary law. In capsule summary, our takeaway conclusion is this: ESG investing, the modern successor to the old SRI movement, is permissible by a fiduciary on the same terms as any other active investing strategy—no more and no less.

Accordingly, we conclude that ESG investing is permissible by a trustee or other fiduciary of a private trust, pension, or charitable endowment only if: (1) the fiduciary believes in good faith that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return, and (2) the fiduciary's exclusive motive for adopting the ESG investment program is to obtain this direct benefit. We show, in other words, that risk-return ESG can be consistent with fiduciary duty but is not required by it, and collateral benefits ESG is generally not consistent with fiduciary duty. We also consider the possibility of overlap between a charity's purpose and certain collateral benefits as well as authorization of a fiduciary's pursuit of collateral benefits by the terms of a trust or by a beneficiary, clarifying such cases by analogy to a distribution under similar circumstances.

Our conclusions rest on four simple but clarifying contributions to the literature: (1) disentangling risk-return ESG from collateral benefits ESG; (2) disentangling the duty of loyalty from the duty of care or prudence; (3) disentangling the relationship of ESG factors to firm performance from the distinct question of whether active investing or active shareholding can exploit those factors for profit; and (4) disentangling fiduciary investment from fiduciary distribution. All four of these fundamental distinctions have been confused in the debate over ESG investing by a fiduciary.

Furthermore, because so much of the debate has centered on the claim that ESG investing can provide superior risk-adjusted returns, we undertook to provide a

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[358] Dudenhoeffer, 134 S.Ct. at 2471.

balanced assessment of the current theory and empirical evidence on that question. We conclude that there is theory and evidence in support of risk-return ESG. However, we caution that this support is far from uniform, is often contextual, and in all events is subject to change, especially as markets adjust to the growing use of ESG factors. Proponents of risk-return ESG have therefore exaggerated its potential to generate excess risk-adjusted returns, and have failed to appreciate the instability and lack of robustness in academic findings of asset mispricing.

Finally, we rejected on positive and normative grounds the claim that risk-return ESG is or ought to be mandatory for a trustee or other such fiduciary. On the contrary, we show that the same conceptual logic that motivates risk-return ESG investing could alternatively support a contrarian, anti-ESG investment strategy. Of course, a prudent trustee might also reasonably conclude that she cannot beat the market, and therefore should pursue a passive strategy.

Our findings challenge the current zeitgeist in favor of the soundness of ESG investing by a fiduciary, in particular many of the arguments and conclusions of the PRI. However, we also show that knee-jerk reactions against ESG investing on loyalty grounds are likewise misguided, reflecting a kind of SRI hangover. Fiduciaries who reasonably conclude that ESG factors will improve portfolio performance, and are solely motivated by this possibility, should have no hesitation in using them.