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# ESG Investing: Theory, Evidence, and Fiduciary Principles[*]

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**Executive Summary**

Trustees and other investment fiduciaries of pensions, charities, and personal trusts, and those who advise them, face increasing pressure to rely on ESG factors in the investment management of tens of trillions of dollars of other people's money. At the same time, however, confusion abounds about the intersection of fiduciary principles and ESG investing. This article cuts through that confusion to provide guidance about when and how ESG investing by trustees and investment fiduciaries is permissible. We make four interrelated points: (1) we provide a clarifying taxonomy on the meaning of ESG investing, differentiating between *risk-return ESG* (i.e., using ESG factors to improve risk-adjusted returns) and *collateral benefits ESG* (i.e., using ESG factors for third-party effects); (2) we discuss the subjectivity inherent to identifying and applying ESG factors, which complicates assessment of ESG investing strategies; (3) we summarize the current theory and evidence on whether ESG investing can improve risk-adjusted returns, finding the results to be mixed and contextual; and (4) we show that American trust fiduciary law generally prohibits collateral benefits ESG, but risk-return ESG can be permissible if supported by a reasoned and documented analysis that is updated periodically.

## Introduction

The term "ESG investing" resists precise definition. Roughly speaking, it is an umbrella term that encompasses any investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices. Investor interest in ESG investing is booming. In 2019, ESG-themed mutual

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[*] This article is adapted from Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee,* 72 STANFORD LAW REVIEW 381 (2020).

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funds experienced $20 billion in net inflows, smashing the prior year's record by a factor of four.[1] During the first months of the COVID-19 pandemic in 2020, inflows to ESG funds increased even more, with supporters claiming that ESG has fulfilled its promise of superior risk-adjusted returns.[2]

The broader societal push for corporate social responsibility and the perennial search for improved risk-adjusted returns has put pressure on the trustees and other investment fiduciaries of pensions, charities, and personal trusts to make use of ESG strategies. These fiduciaries, who invest tens of trillions of dollars of other people's money, face competing claims by those advocating or opposing ESG investing, including polar-opposite claims about whether ESG investing is permissible or even somehow required of fiduciaries.

We cut through the confusion about the intersection of ESG investing and fiduciary principles to provide guidance about when and how ESG investing by a trustee or other investment fiduciary is permissible. Such guidance will be of ever-increasing importance not just for trustees and other investment fiduciaries but also for their financial advisors. In brief, as we explain below and elaborate more extensively in other work, a trustee or other investment fiduciary who reasonably concludes that use of ESG factors will provide risk and return benefits, and is solely motivated by those benefits, should have no hesitation in using those ESG factors.[3]

**Motive Matters: Risk and Return or Collateral Benefits?**

The original motives for ESG investing were moral or ethical, based on third-party effects rather than investment returns. 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.[4] Other familiar labels for the practice include ethical investing, economically targeted investing, sustainable or responsible investing, and impact investing.[5]

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[1] *See* Jon Hale, *Sustainable Fund Flows in 2019 Smash Previous Records,* MORNINGSTAR (Jan. 10, 2020), https://perma.cc/SGV3-T9LD.

[2] *See* John Authers, *ESG Investing Is Having a Good Crisis. It's Also Killing Jobs,* BLOOMBERG OPINION (May 21, 2020), https://perma.cc/8ECW-967E.

[3] *See* Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee,* 72 STAN. L. REV. 381, 398-99 (2020).

[4] *See, e.g.*, DAVID HAUCK ET AL., TWO DECADES OF DEBATE: THE CONTROVERSY OVER U.S. COMPANIES IN SOUTH AFRICA 1-5 (1983) (describing the divestment debate and positions for and against divestment). Universities felt particular pressure to divest, and many did so. *See* Hunter Bosson, *Shorting the Devil*, CORNELL BUS. REV., Spring 2016, at 5, 5 (reporting that 155 universities had divested from companies doing business with South Africa by the time apartheid ended).

[5] *See, e.g.,* Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. at 65,135 ("Various terms have been used to describe this and related investment behaviors, such as socially responsible investing, sustainable and responsible

In the late 1990s and early 2000s, proponents of SRI rebranded the concept as ESG by adding corporate governance factors (the G in ESG).[6] Moreover, some asserted that ESG investing could improve risk-adjusted returns, thereby providing a direct benefit to investors. For example, instead of avoiding the fossil fuel industry to achieve collateral benefits from reduced pollution, ESG proponents argued that the fossil fuel industry should be avoided because financial markets underestimate its litigation and regulatory risks, and therefore divestment would improve risk-adjusted return. On this view, ESG investing can be a kind of profit-seeking, *active investing* strategy. ESG investing may also be implemented via shareholder voting or other engagement with management (we call this *active shareholding* or *stewardship*, in contrast to active investing by picking and choosing securities).

The term "ESG investing" is thus inherently ambiguous. It can refer either to investing for collateral benefits (in effect, classic SRI) or to improve risk-adjusted returns (rebranded ESG), and it is widely and confusingly used in the marketplace today to encompass both. We clarify the umbrella term ESG investing by differentiating it into two categories. We refer to ESG investing for moral or ethical reasons or to benefit a third party, what had been called SRI, as *collateral benefits ESG*. We refer to ESG investing for risk and return benefits—that is, to improve risk-adjusted returns—as *risk-return ESG*. Differentiating between collateral benefits ESG and risk-return ESG provides taxonomic clarity that cuts through the noise and clutter in the marketplace by emphasizing *motive*.

For a typical investor, the motive or purpose for using ESG factors is highly salient, but for a trustee or other fiduciary investor it is of critical legal significance.[7] As we shall see, in general collateral benefits ESG violates the fiduciary duty of loyalty under ERISA and state trust law.[8] Risk-return ESG investing, by contrast, can be permissible under the duties of loyalty and prudence on the same terms as any other kind of active investment or active shareholding strategy that seeks to exploit market mispricing or shareholder control rights for profit.[9]

## Identifying and Applying ESG Factors

investing, environmental, social and governance (ESG) investing, impact investing, and economically targeted investing (ETI).").

[6] *See* Susan N. Gary, *Values and Value: University Endowments, Fiduciary Duties, and ESG Investing*, 42 J.C. & U.L. 261-72 (2016) [hereinafter, Gary, Values and Value]; *see also* LAUREN CAPLAN ET AL., COMMONFUND INST., FROM SRI TO ESG: THE CHANGING WORLD OF RESPONSIBLE INVESTING (2013).

[7] The distinction is also meaningful as a matter of financial economics, given the tension between increasing risk-adjusted returns while obtaining collateral benefits from increasing a firm's cost of capital. *See* Schanzenbach & Sitkoff, *supra* note 3, at 398-99.

[8] *See* id. at 399-425.

[9] *See* id. at 425-453.

Active investing and active shareholding, whether based on ESG factors or otherwise, necessarily involves subjective judgments in the identification of relevant factors, assessing whether those factors are good or bad from an investor's perspective, and how much weight to give each factor. The fluidity of the ESG rubric—including the meaning of "environmental," "social," and "governance"—adds additional subjectivity, making the application and empirical evaluation of ESG investing challenging and highly contextual.[10]

There is, to be sure, a rough consensus on core ESG factors. Unhealthy products and poor labor practices are bad social factors. Strong compliance records on environmental and labor regulations are good environmental and social factors. Poorly incentivized and entrenched management are bad governance factors. However, even at this level of abstraction, an investor will have to make subjective judgments about how much weight to give E versus S versus G factors so that they may be traded off against each other. For example, an environmentally sound firm could have weak corporate governance or mistreat its workforce. How are these ESG factors to be balanced in evaluating such a firm?

When moving from abstract principles to specific implementation, the inherent subjectivity of the ESG rubric itself becomes even more apparent. There is no exhaustive or universal list of ESG considerations,[11] and there is no consistency in the labels used to describe investment strategies that consider ESG factors.[12] There are hundreds of ESG ratings services and ESG-themed mutual funds,[13] and they often disagree.

Consider the often-contentious debates around environmental harms. There is broad abstract agreement about the environmental costs of coal and oil, but some types of coal may be cleaner than others, and some forms of oil production are less harmful than others.[14] There is similar dispute about the environmental impact of natural gas and

[10] *See, e.g.*, James Mackintosh, *Is Tesla or Exxon More Sustainable? It Depends Whom You Ask*, WALL ST. J. (Sept. 17, 2018, 11:58 AM ET), https://perma.cc/Y7P4-3XKD.

[11] *See* CFA INST., ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING: A GUIDE FOR INVESTMENT PROFESSIONALS 4 (2015), https://perma.cc/GU5Q-8L7A. The extent of a company's ESG disclosure is itself a factor in the ESG scoring of the company by some ratings services. *See* Michael T. Dieschbourg & Andrew P. Nussbaum, *No Place to Hide Thanks to Morningstar, Bloomberg, MSCI, and Multiple Global Data Providers,* INV. & WEALTH MONITOR, Nov.-Dec. 2017, at 30.

[12] *See* CFA INST., *supra* note 11, at 5.

[13] *See ESG Indices Are Bringing Environmental, Social and Governance Data to the Fore,* BLOOMBERG PROF. SERVICES (July 29, 2016), https://perma.cc/ZVS2-EWJM; *see also* Michael T. Dieschbourg & Andrew P. Nussbaum, *No Place to Hide Thanks to Morningstar, Bloomberg, MSCI, and Multiple Global Data Providers,* INV. & WEALTH MONITOR, Nov.-Dec. 2017, at 29, 29-31.

[14] *See, e.g.,* Ian Urbina, *Short Answers to Hard Questions About Clean Coal Technology,* N.Y. TIMES (July 5, 2016), https://perma.cc/9P2Z-P7ZW (discussing the optimistic view that clean coal can "play a vital role in slowing climate change" as well as skepticism that it can be cost effective); Press Release, Bd. of Trs., Stanford Univ., Stanford and Climate Change (April 25, 2016), https://perma.cc/P77GJHHQ (noting that the

nuclear power.[15] The use of social factors is often dependent on social norms and is therefore perhaps more fraught than environmental factors.

Governance factors are also disputed, or at least are contextual. Consider a "staggered" or "classified" board in which the directors are elected for staggered multi-year terms. A staggered board structure makes a change in control more difficult, because it requires multiple elections to turnover a majority of the board. Thus, a staggered board might entrench bad management or dull incentives, diminishing firm value. On the other hand, a staggered board might instead provide the stability necessary to attract better managers and allow them to focus on long-term growth, enhancing firm value. The empirical evidence suggests that the effect of a staggered board on firm value is contextual, with some studies finding a negative effect on firm value and others finding a positive effect in specific contexts.[16]

**Does the Evidence Support Risk-Return ESG?**

We draw particular attention to the crucial but often overlooked distinction between (a) whether ESG factors relate to firm value on the one hand, and (b) whether such a relationship can be exploited by an investor for profit via active investing or active shareholding on the other hand. ESG investing enthusiasts have sometimes conflated these distinct questions. But both must be true for a successful risk-return ESG strategy.

*A. ESG Factors and Firm Value*

Our review of the current literature leads us to conclude that there are indeed sound theoretical arguments that various ESG factors may be related to firm performance. Some empirical evidence validates these arguments, although the findings are mixed and contextual, and dependent on the research design. Corporate governance (i.e., G) factors have straightforward theoretical relationships to firm performance. There is disagreement, however, about the extent to which existing studies have reliably measured the relationship between governance and firm value.[17] Moreover, as previously noted,

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extraction of petroleum from oil sands releases more greenhouse gas emissions than other forms of fossil fuel extraction).

[15] *See, e.g.*, Sarah Zielinski, *Natural Gas Really Is Better than Coal*, SMITHSONIAN MAG (Feb. 13, 2014), https://perma.cc/9B65-N4J6; Mark Diesendorf, Accidents, Waste and Weapons: Nuclear Power Isn't Worth the Risks, CONVERSATION (May 18, 2015, 4:04 PM EDT), https://perma.cc/C93F-2JHF (arguing that nuclear power contributes to the creation of weapons, results in serious accidents, leads to more greenhouse gas emissions, and is expensive); Melanie Windridge, Fear of Nuclear Power is Out of All Proportion to the Actual Risks, GUARDIAN (Apr. 4, 2011, 7:40 AM EDT), https://perma.cc/WY45-ZGVM (noting that nuclear power is relatively safe and may be important in shifting to carbon-free energy production).

[16] *See* Michael Klausner, *Empirical Studies of Corporate Law and Governance: Some Steps Forward and Some Steps Not, in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 184, 198-99 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018).

[17] *See* id., at 184-85.

optimal corporate governance might be contextual, that is, differences between firms may require differences in governance.

Environmental and social (i.e., E and S) factors, though perhaps less obviously related to firm value than governance factors, may affect firm value through at least two mechanisms. First, environmental and social 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. Second, environmental and social factors may serve as proxies for management quality, an important investment consideration that is hard to observe directly.[18] Well-run firms may have better compliance programs, and high-quality managers may be attracted to firms that have pro-environmental or socially responsible policies.[19]

The theoretical relationship between firm value and environmental and social factors has some empirical support, though not as strong as that in favor of governance factors. 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.[20] Moreover, there is evidence that firms can build goodwill through socially responsible activities, which can protect against reputational harm from adverse events.[21]

The favorable empirical results regarding environmental and social factors, however, are not uniform. A significant concern is that managers may invoke ESG factors to enact their own policy preferences at the expense of shareholders—an agency problem for which there is also some empirical evidence.[22] Another concern is that the extent of a

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[18] Survey evidence indicates that many investors believe that ESG factors are proxies for managerial quality. *See* CFA INST., ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) SURVEY 11 (2017), https://perma.cc/2YLA-8LAN (reporting that of those who used ESG factors in 2017, 41% reported one reason for doing so is as a proxy for management quality.)

[19] *See, e.g.*, Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1, 9-10 (2010) (suggesting that corporate social responsibility may prevent short-sighted managerial decisionmaking); Luc Renneboog et al., *The Price of Ethics and Stakeholder Governance: The Performance of Socially Responsible Mutual Funds*, 14 J. CORP. FIN. 302, 304-305 (2008).

[20] *See* Mozaffar Khan et al., *Corporate Sustainability: First Evidence on Materiality*, 91 ACCT. REV. 1697, 1697-70 (2016) (finding that firms with high E and S factors that the authors define as "material" outperform both on stock returns and on accounting performance measures); John Peloza, *The Challenge of Measuring Financial Impacts from Investments in Corporate Social Performance*, 35 J. MGMT. 1518, 1520-21 (2009) (reviewing 159 studies and finding that "[t]he majority . . . show a positive relationship between [corporate social performance] and financial performance (63%); 15% of studies report a negative relationship, and 22% report a neutral or mixed relationship").

[21] *See* Paul C. Godfrey et al., *The Relationship Between Corporate Social Responsibility and Shareholder Value: An Empirical Test of the Risk Management Hypothesis*, 30 STRATEGIC MGMT. J. 425, 441-42 (2009).

[22] *See* Philipp Krüger, *Corporate Goodness and Shareholder Wealth*, 115 J. FIN. ECON. 304, 312- 14 (2015) (finding negative shareholder reaction to both positive and negative corporate social responsibility announcements); Ronald W. Masulis & Syed Walid Reza, *Agency Problems of Corporate Philanthropy*, 28 REV. FIN. STUD. 592, 630-31 (2015) (finding that corporate philanthropy is often tied to CEO-affiliated charities and reduces firm value); Patrick Bolton et al., *Investor Ideology* 2-6 (Eur. Corp. Governance Inst., Law Working

firm's regulatory and political risks may not be reflected in its ESG scoring. For example, companies pursuing alternative energy sources may score high on ESG factors but still face significant political and regulatory risk owing to heavy reliance on current government policy.[23]

*B. Exploiting ESG Factors for Profit*

A relationship between ESG factors and firm value is a necessary but not sufficient condition for a profitable ESG active investment strategy. The crucial further question is whether that relationship can be exploited for profit by (i) active investing or (ii) active shareholding.

*i. Active Investing*

An active investment program, whether based on ESG factors or otherwise, can improve risk-adjusted returns only if those factors are not already reflected by market prices. For an investor consistently to profit by trading on ESG factors, the market must consistently misprice them.[24] An active investing strategy based on ESG factors, in other words, 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 literature identifies two related arguments for why ESG factors may not be reflected in the price of publicly traded securities. 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.[25] Second, supporters of risk-return ESG investing argue that consistent market inefficiency is more likely with respect to ESG factors. A particular focus of risk-return ESG investing strategies are on so-called "tail risks," meaning low-probability but high-impact events that by definition would be

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Paper No. 557/2018, 2019), https://perma.cc/8KWQVNKA (developing an ideological score for institutional investment managers based on shareholder voting records).

[23] *See, e.g.*, Mark Chediak & Chris Martin, *Say Goodbye to Solar Power Subsidies*, BLOOMBERG BUSINESSWEEK (Nov. 5, 2015, 4:00 AM PST), https://perma.cc/48HL-DSK8; Michael Kavanagh, *A World Map of Subsidies for Renewable Energy and Fossil Fuels*, FIN. TIMES (July 25, 2016), https://perma.cc/KYK3-7SGG.

[24] The classic exposition on efficient markets and the difficulty of profitable stock picking is Burton G. Malkiel, A RANDOM WALK DOWN WALL STREET: THE TIMETESTED STRATEGY FOR SUCCESSFUL INVESTING 35-54 (11th ed. 2015). *See also* John E. Core et al., *Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations*, 61 J. FIN. 655, 684-85 (2006) (finding that poorly governed firms exhibit significant operating underperformance but that the market incorporates this information).

[25] *See, e.g.*, Gary, *Values and Value*, *supra* note 6, at 274 (arguing in favor of ESG investing in part based on market inefficiency); Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market,* 42 AM. U. L. REV. 1, 5 (1992) (arguing that inefficient markets can produce returns to SRI).

poorly reflected in historical data and therefore perhaps not accurately priced, even in an otherwise efficient market.[26]

Roughly speaking, there are two broad categories of strategies for using ESG factors in active investment within public exchanges: *screens* and *stock picking*.[27] A negative screening strategy involves applying ESG factors to screen out firms with low ESG scores or even avoid particularly "bad" industries, such as fossil fuels or alcohol. 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 companies screened out.[28]

The efficacy of a screening strategy has a clear theoretical limitation. As the screen is used more broadly, any advantage to it will diminish as share prices adjust. Moreover, with increasing firm-level ESG disclosure over time,[29] 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 as or worse than their benchmark indices.[30] 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.[31] However, this approach involves investment in industries that collateral benefits ESG—that is, classic SRI—would tend to avoid. And if this approach grows more popular, its benefits (if any) should also diminish.[32]

In contrast to a screening strategy, stock picking focuses on applying ESG factors in constructing a portfolio of individual securities.[33] For example, an ESG investor might

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[26] *See* BODIE ET AL., INVESTMENTS 117 (11th ed. 2018) ("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* Bryan Kelly & Hao Jiang, *Tail Risk and Asset Prices,* 27 REV. FIN. STUD. 2841, 2868 (2014) (concluding that firms with large tail risks return significantly more than firms with low tail risks, suggesting that markets price at least some tail risk).

[27] *See, e.g.,* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-18-398, RETIREMENT PLAN INVESTING: CLEARER INFORMATION ON CONSIDERATION OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE FACTORS WOULD BE HELPFUL 20 (2018), https://perma.cc/TA96- N8GR.

[28] *See, e.g., Fidelity Launches Two ESG Index Funds,* INVESTMENTNEWS (May 15, 2017, 1:31 PM), https://perma.cc/4GFX-4DNN.

[29] *See* Michael T. Dieschbourg & Andrew P. Nussbaum, *No Place to Hide Thanks to Morningstar, Bloomberg, MSCI, and Multiple Global Data Providers,* INV. & WEALTH MONITOR, Nov.-Dec. 2017, at 29-31.

[30] *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, 57-60 (2016) (finding little difference between returns for high and low ESG funds in the U.S., though high ESG European funds tend to underperform).

[31] *See, e.g.,* Meir Statman & Denys Glushkov, *The Wages of Social Responsibility,* FIN. ANALYSTS J., July/Aug. 2009, at 33, 41-42 (finding that a positive screen that overweights firms with high ESG ratings can avoid the diversification costs of a negative screen).

[32] *See* Nadja Guenster, *Performance Implications of SR Investing: Past Versus Future, in* SOCIALLY RESPONSIBLE FINANCE AND INVESTING: FINANCIAL INSTITUTIONS, CORPORATIONS, INVESTORS, AND ACTIVISTS 443, 445 (H. Kent Baker & John R. Nofsinger eds., 2012).

[33] For a classic (but critical) discussion of stock picking, *see* MALKIEL, *supra* note 24, at 393-97.

examine a firm's ESG factors and assess qualitatively whether the firm is a good or bad growth bet on that basis. Or the investor might use a firm's ESG score as an additional factor in a Fama-French type multifactor analysis to predict return.[34] There is some empirical evidence that incorporating ESG factors into a Fama-French type model could increase its accuracy, thereby identifying buy and sell opportunities.[35]

All told, there is enough theoretical and empirical evidence in support of risk-return ESG investing to allow for the possibility that risk-return ESG could be prudent for a trustee or other fiduciary in a given case. We hasten to add, however, that the evidence that ESG factors can be used to profit by active investing is weaker than the evidence that ESG factors are related to firm performance. Moreover, the estimated returns, if any, that can be achieved by risk-return ESG investing vary widely and the standard caveats that apply to all active investing strategies also apply. These standard caveats include the well-documented publication bias in asset pricing studies, the challenge in obtaining consistent risk-adjusted returns in public markets net of transaction costs, the difficulty in assessing diversification costs entailed by active strategies, and the tendency of profitable active investing strategies to dissipate over time. Even if an ESG strategy is effective today, there is no guarantee it will continue to be effective tomorrow. There is also evidence for contrarian, anti-ESG strategies.

*ii. Active Shareholding*

In contrast to stock picking, active shareholding seeks to improve corporate policies or prevent bad decisions, thereby improving or at least protecting firm value. All that is necessary for active shareholding to improve investment returns is for the expected benefit of the investor's activism to outweigh its monitoring, investigation, voting, or other costs. Additionally, active shareholding does not tend to entail a diversification cost like active investing. Index fund managers, for example, can engage in active shareholding. Active shareholding has increased significantly over the past two decades,[36] in part facilitated by increasing institutional ownership that facilitates monitoring and coordination among shareholders.[37]

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[34] *See* Eugene F. Fama & Kenneth R. French, *Common Risk Factors in the Returns on Stocks and Bonds,* 33 J. FIN. ECON. 3, 4-6 (1993) (proposing their original three-factor model).

[35] *See, e.g.,* Jeroen Derwall et al., *The Eco-Efficiency Premium Puzzle,* 61 FIN. ANALYSTS J., Mar./Apr. 2005, at 51, 54 (finding that a portfolio of energy-efficient firms outperformed the market in a multifactor model); Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices,* 101 J. FIN. ECON. 621, 633- 34 (2011) (finding a correlation between high employee satisfaction and excess market returns that persists for several years).

[36] *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. GOVERNANCE 1, 2 (2016) (stating that "[h]edge fund activism has recently spiked, almost hyperbolically").

[37] *See, e.g.,* David Yermack, *Shareholder Voting and Corporate Governance,* 2 ANN. REV. FIN. ECON., 103, 108, 117 (2010).

There is evidence that shareholder activism, even in the form of nonbinding resolutions or withholding votes, can affect corporate policy. Firms commonly adopt shareholder proposals that pass[38], and incumbent directors often resign if a large number of votes are withheld.[39] Informal engagement is common and also has been found to influence corporate policies.[40] However, active shareholding has practical and theoretical limits, whether based on ESG factors or otherwise. The core difficulty is that a shareholder receives only a pro rata portion of the benefit of a successful shareholder action, whereas the costs are borne fully by the active shareholder. In consequence, collective action and free-rider difficulties plague active shareholding.[41]

A further challenge to active shareholding is that it 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. Shareholders can be wrong and indeed may be so more often than management. The corporate form, which separates ownership and control, is an efficient form of enterprise organization in part for this very reason. Activist shareholding, if taken too far, can dull managerial incentives[42] and direct scarce managerial time to implementing shareholder proposals or contesting elections.[43]

The evidence is mixed on whether active shareholding, even by institutional investors, improves firm value.[44] Successful shareholder proxy fights have been found to

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[38] Yonca Ertimur et al., *Board of Directors' Responsiveness to Shareholders: Evidence from Shareholder Proposals,* 16 J. CORP. FIN. 53, 54 (2010) (finding that around 40% of shareholder proposals were later adopted by boards).

[39] *See, e.g.,* Jie Cai et al., *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 et al., *Do Boards Pay Attention When Institutional Investor Activists "Just Vote No"?,* 90 J. FIN. ECON. 84, 102 (2008) (concluding that "just vote no" campaigns are associated with subsequent board action and CEO turnover, with positive stock price effects resulting from these events).

[40] *See, e.g.,* William T. Carleton et al., *The Influence of Institutions on Corporate Governance Through Private Negotiations: Evidence from TIAA-CREF,* 53 J. FIN. 1335, 1335-37 (1998).

[41] *See* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law,* 26 J.L. & ECON. 395, 401-03 (1983). Increasing institutional shareholding has mitigated the collective action problems attendant in active shareholding, but some collective action problems persist and may be worsening given the increasing popularity of passive index funds. *See generally* Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy,* 119 COLUM. L. REV. 2029 (2019) (assessing the collective action problems and other issues associated with the voting behavior of passive investment funds).

[42] *See* Philippe Aghion & Jean Tirole, *Formal and Real Authority in Organizations,* 105 J. POL. ECON. 1, 3-5 (1997) (developing a theory of optimal delegation of decisionmaking, motivated in part by corporate structure); Mike Burkart et al., *Large Shareholders, Monitoring, and the Value of the Firm,* 112 Q.J. ECON. 693, 694 (1997) (developing a theory that finds decreased managerial initiative as a result of increased shareholder activism).

[43] See David Yermack, *Shareholder Voting and Corporate Governance,* 2 ANN REV. FIN. ECON. 119-20 (2010) (expressing particular concern about "[s]ocially oriented shareholder proposals").

[44] *See* Matthew R. Denes et al., *Thirty Years of Shareholder Activism: A Survey of Empirical Research,* 44 J. CORP. FIN. 405, 406-07, 416 (2017) (surveying the literature and concluding that the results are mixed, but reporting that relatively recent studies tend to be more supportive of activism particularly if accompanied by larger share ownership); Yermack, *supra* note 43, at 118.

improve firm value,[45] but this approach is costly and risky, and unsuccessful fights can decrease firm value.[46] Shareholder proposals and informal negotiations have, at most, very small positive effects on firm performance, with some studies finding negative effects.[47] There is stronger evidence that activist hedge funds may be successful in achieving excess returns, in part because they do not need to be diversified and so can assemble larger stakes, and in part because they are less regulated than other investment vehicles.[48] There is also some evidence that funds that specialize in shareholder engagement may be successful at improving firm value.

## ESG Investing by a Trustee or Other Investment Fiduciary

Trustees and other fiduciary investment managers of pensions, charities, and personal trusts invest tens of trillions of dollars of other people's money subject to a sacred trust known in the law as fiduciary duty. Such fiduciaries must act in the sole interest of the beneficiaries (the *duty of loyalty*) and construct a diversified portfolio with risk and return objectives reasonably suited to the purpose of the trust (the *duty of prudence*).

The trust law fiduciary duty of loyalty requires a trustee or other such fiduciary to consider only the interests of the beneficiary, and not to give any consideration to the interests of any third party.[49] This principle is often called the "sole interest" or "exclusive benefit" rule.[50] Under that rule, "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."[51] The decisions of a trustee or other such fiduciary "must be made with an eye single to the interests of the participants and beneficiaries."[52] For an ERISA trustee or other fiduciary, moreover, the U.S. Supreme Court has held that the relevant purpose to which ERISA's sole interest rule applies is "*financial* benefits" for the plan beneficiaries.[53]

The sole interest or exclusive benefit rule is prohibitory rather than regulatory. Acting with a mixed motive is a breach of the duty of loyalty, full stop. A trustee who is influenced by his own or a third party's interests is disloyal, because the trustee is no

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[45] *See* Denes et al., *supra* note 44, at 407, 410.

[46] *See id.* at 410.

[47] *See id.* at 407-10; Elroy Dimson et al., *Active Ownership*, 28 REV. FIN. STUD. 3225, 3229, 3231 (2015) (finding abnormal positive returns from adopting ESG shareholder proposals, but noting difficulty in determining causation).

[48] *See* Yermack, *supra* note 43, at 118-19.

[49] *See* RESTATEMENT (THIRD) OF TRUSTS § 78(1) (Am. Law Inst. 2007); UNIF. TRUST CODE § 802(a) (UNIF. LAW COMM'N 2000).

[50] *See, e.g.*, Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV. 1105, 1108 (1988).

[51] RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. f (Am. Law Inst. 2007).

[52] Donovan v. Bierwirth, 680 F.2d 263, 271 (2d Cir. 1982).

[53] Fifth Third Bancorp v. Dudenhoeffer, 134 S. Ct. 2459, 2468 (2014) (emphasis in original).

longer acting solely in the interest of the beneficiaries. To prove a breach, a beneficiary need only prove the trustee's mixed motives.[54]

The foregoing discussion points irresistibly to the conclusion that the sole interest or exclusive benefit rule forbids collateral benefits ESG investing by a trustee or other such fiduciary. By definition, collateral benefits ESG entails consideration of interests other than the financial interests of the beneficiary. Even if the trustee's motive is mixed, seeking both to benefit the beneficiary financially and to obtain a collateral benefit, the trustee violates the sole interest rule.

A helpful analogy is to suppose a distribution from the trust for the same collateral benefit. Just as a trustee could not, consistent with the duty of loyalty, distribute trust assets for the purpose of advancing an ESG goal held by the trustee, so too under the sole interest rule the trustee cannot allow such a goal to influence the trustee's fiduciary investment decisions regarding the trust property. A trustee is in breach of trust 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."[55]

Risk-return ESG, by contrast, can be consistent with the duty of loyalty. By definition, risk-return ESG is an active investing strategy motivated by pursuit of improved risk-adjusted returns. If motivated solely by this purpose, a risk-return ESG investing strategy satisfies the sole interest or exclusive benefit rule. The issue for risk-return ESG by a trustee or other such fiduciary, therefore, is not loyalty but prudence—whether the trustee's particular ESG strategy satisfies the fiduciary duty of prudence as elaborated by the prudent investor rule.[56]

Crucially, the prudent investor rule neither favors nor disfavors any particular type or kind of investment strategy.[57] No type or kind of investment is categorically required, permissible, or impermissible. As such, the competing claims by ESG enthusiasts and ESG opponents that risk-return ESG investing is variously mandatory or

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[54] 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 motives with reasonable certainty. However, even in such circumstances, the trustee's breach of the duty of 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. *See* UNIF. TRUST CODE §§ 1001-1002 (UNIF. LAW. COMM'N 2000); Samuel L. Bray, *Fiduciary Remedies*, *in* THE OXFORD HANDBOOK OF FIDUCIARY LAW 449, 451, 454-56, 459-62 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019) [hereinafter THE OXFORD HANDBOOK OF FIDUCIARY LAW]; Robert H. Sitkoff, *Fiduciary Principles in Trust Law, in* THE OXFORD HANDBOOK OF FIDUCIARY LAW, at 58-59.

[55] RESTATEMENT (THIRD) OF TRUSTS § 87 cmt. c (Am. Law Inst. 2007).

[56] The Department of Labor is in the process of a rulemaking that, in broad terms, is in accord. *See* Department of Labor, *Financial Factors in Selecting Plan Investments*, 85 Fed. Reg. 39113 (2020); Max M. Schanzenbach & Robert H. Sitkoff, Comment Letter on the Department of Labor's Proposed Rulemaking on Financial Factors in Selecting Plan Investments, available at http://ssrn.com/abstract=3667080.

[57] *See* Max M. Schanzenbach & Robert H. Sitkoff, *The Prudent Investor Rule and Market Risk: An Empirical Analysis*, 14 JOURNAL OF EMPIRICAL LEGAL STUDIES 129 (2017).

forbidden for a trustee or other fiduciary investor are both wrong. Instead, as set forth in the Uniform Prudent Investor Act, the prudent investor rule requires "an overall investment strategy having risk and return objectives reasonably suited to the trust" (a market risk management rule) and, other than in exceptional circumstances, requires a trustee or other such fiduciary to "diversify the investments of the trust" (an idiosyncratic risk management rule).[58] Under the prudent investor rule, therefore, an ESG investing strategy—no different than an anti-ESG investment strategy, some other active strategy, or a passive strategy—may or may not be permissible depending on the circumstances.

All told, a risk-return ESG strategy will be judged under the prudent investor rule on the same terms as any other investment strategy. In light of the current theory and evidence on ESG investing canvassed above, a particular program of risk-return ESG could well satisfy the prudent investor rule, but not necessarily so. No different than an anti-ESG investment strategy, some other active strategy, or a passive strategy, each of which could satisfy the prudent investor rule, but not necessarily so, whether a particular ESG strategy will satisfy the prudent investor rule will depend on the circumstances. The trustee or other such fiduciary must base the strategy on a reasonable analysis concluding that the risk-return benefits of the strategy offset any associated costs and that the risk and return objectives of the strategy are suited to the trust. In accordance with the duty to keep adequate records, the fiduciary's analysis of these considerations must be documented in the trustee or other such fiduciary's files.

The duty of prudence requires also ongoing monitoring. In the words of the U.S. Supreme Court, "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."[59] After implementing a prudent investment program, therefore, whether based on ESG factors or otherwise, a trustee or other such fiduciary must continue to monitor costs and returns and adjust the program in light of actual performance and changing circumstances. The trustee or other such fiduciary's periodic monitoring efforts should be documented.

## Conclusion

ESG investing continues to receive increasing attention, particularly for trustees and other fiduciaries of pensions, charities, and personal trusts. Such fiduciaries have tens of trillions of dollars of other people's money under management. Accordingly, the intersection of ESG investing and fiduciary principles will be of ever-increasing importance for financial advisors. In reviewing the ESG investing phenomenon and its intersection with fiduciary principles, we make four contributions.

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[58] UNIF. PUDENT INV'R ACT §§ 2(b), 3 (UNIF. LAW COMM'N 1994); *see also* RESTATEMENT (THIRD) OF TRUSTS § 90(a)-(b) (Am. Law Inst. 2007 (AM. LAW INST. 2007). On circumstances in which not diversifying might be justifiable, *see* Robert H. Sitkoff & Jesse Dukeminer, WILLS, TRUSTS, AND ESTATES (10th ed. 2017), at 641-42.

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

*First,* we provide a clarifying taxonomy on the meaning of ESG investing, differentiating between risk-return ESG (i.e., using ESG factors to improve risk-adjusted returns) and collateral benefits ESG (i.e., using ESG factors for third-party effects), a distinction that is of particular importance for trustees and other fiduciary investors.

*Second*, we discuss the inherent subjectivity in identifying and applying ESG factors, which complicates assessment of ESG investing strategies.

*Third*, we evaluate the current theory and evidence on whether ESG investing can improve risk-adjusted returns. 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. There is also evidence for contrarian, anti-ESG strategies.

*Fourth*, we consider the permissibility of ESG investing by a trustee or other such investment fiduciary of a pension, charity, or personal trust. In brief, the trust law fiduciary duty of loyalty generally prohibits collateral benefits ESG. Risk-return ESG, by contrast, can be permissible under the duties of loyalty and prudence on the same terms as any other kind of active investment or active shareholding strategy that seeks to improve risk-adjusted returns. The law neither mandates nor prohibits risk-return ESG. Accordingly, a trustee or other such fiduciary who reasonably concludes that use of ESG factors will provide risk and return benefits, and is solely motivated by that conclusion, should have no hesitation in using those factors.