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RECONCILING FIDUCIARY DUTY AND SOCIAL CONSCIENCE:
THE LAW AND ECONOMICS OF ESG INVESTING BY A TRUSTEE

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Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee

Max M. Schanzenbacht†
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Abstract

Trustees 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. Recently, these trustees have come under increasing pressure to use environmental, social, and governance (ESG) factors in making investment decisions. ESG investing is common among investors of all stripes, but many trustees have resisted its use on the grounds that doing so may violate the fiduciary duty of loyalty. Under the "sole interest rule" of trust fiduciary law, a trustee must consider only the interests of the beneficiary. Accordingly, a trustee's use of ESG factors, if motivated by the trustee'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 prudence. Against this backdrop of uncertainty, this paper examines the law and economics of ESG investing by a trustee. We differentiate "collateral benefits" ESG from "risk-return" ESG, and we provide a balanced assessment of the theory and evidence 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 trustee reasonably concludes that ESG investing will benefit the beneficiary directly by improving risk-adjusted return, and (2) the trustee's exclusive motive for ESG investing is to obtain this direct benefit. In light of the current theory and evidence on ESG investing, we accept that these conditions could be satisfied under the right circumstances, but we reject the claim that the duty of prudence either does or should require trustees to use ESG factors. We also consider how the duty of loyalty should apply to ESG investing by a trustee if authorized by the terms of a trust or a beneficiary or if it would be consistent with a charity's purpose, clarifying with an analogy to whether a distribution would be permissible under similar circumstances. We conclude that applying the sole interest rule (as tempered by authorization and charitable purpose) to ESG investing is normatively sound.

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Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee

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Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee

I. Introduction

Trustees 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.¹ Trustees 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). A trustee who breaches these duties is subject to make-whole damages and other remedies, thus containing the agency costs that arise from the separation of ownership and control inherent to the trust form.²

Over the past decade, trustees have come under increasing pressure to consider environmental, social, and governance (“ESG”) factors in their investment decisions, for example by divesting from fossil fuel, tobacco, or firearms companies, or otherwise accounting for social or environmental costs in making investment decisions. A group convened by the United Nations, the Principles of Responsible Investing (“PRI”), along with a growing and influential group of scholars and practitioners, has even taken the position that fiduciary principles require a trustee to use ESG factors.³ Yet many American trustees continue to resist explicit use of ESG factors on the grounds that to do

¹ For simplicity, we use the term “trustee” to refer to any decisionmaker subject to fiduciary duties with respect to a pension, charity, or personal trust without regard to whether the decisionmaker is formally a trustee. Thus, for example, we use the term to include a “functional fiduciary” in a pension plan; a “trust director” or an agent of a trustee in a personal trust; and members of the board and officers of a charity. *See, e.g.* Dana M. Muir, *Fiduciary Principles in Pension Law*, in *The Oxford Handbook of Fiduciary Law* 170-172 (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2019) (describing fiduciary status of a functional fiduciary); John D. Morley & Robert H. Sitkoff, *Making Directed Trusts Work: The Uniform Directed Trust Act*, 44 *ACTEC L.J.* 3, 32-35 (2018) (describing fiduciary status of a trust director in a private trust); Restatement (Third) of Trusts § 80 cmt. g (Am. Law Inst. 2007) (describing fiduciary status of an agent of the trustee); Restatement of Charitable Nonprofit Organizations § 2.01 (Am. Law Inst. T.D. No. 1, 2016) (describing parties with fiduciary status in a charity).

As of late 2018, U.S. pension and retirement accounts held the staggering sum of \$29.2 trillion dollars. *See Inv. Co. Inst., Release: Quarterly Retirement Market Data, Third Quarter 2018* (Dec. 20, 2018). Data on personal trusts, which arise by private agreement without a public filing, is patchy, but the available data point to over a trillion dollars in such trusts. *See* Robert H. Sitkoff & Jesse Dukeminier, *Wills, Trusts, and Estates* 393 (10th ed. 2017) (reporting figures). In 2015, nonprofits required to file with the IRS reported revenues of \$2.54 trillion and assets of \$5.79 trillion. *See* Brice S. McKeever, *The Nonprofit Sector in Brief 2015: Public Charities, Giving, and Volunteering* 1 (Urban Inst. 2018).

² *See* Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, in *Philosophical Foundations of Fiduciary Law* (Andrew Gold & Paul Miller eds., 2014) (hereafter “Sitkoff, Economic Theory”); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 *Cornell L. Rev.* 621 (2004) (hereafter “Sitkoff, Agency Costs”).

³ On the PRI, see United Nations, *Principles for Responsible Investment, The Six Principles*, available at <https://www.unpri.org/about/the-six-principles>. On the claim that ESG investing is mandatory under fiduciary principles, see *infra* notes 22-24 and text accompanying and Part III.F.

so would entail consideration of collateral benefits to third parties in breach of the sole interest rule imposed by the trust law fiduciary duty of loyalty.⁴

This article reconciles these contrasting views by undertaking a balanced assessment of the law and economics of ESG investing by a trustee of a pension, charity, or personal trust.⁵ We show that, in general, ESG investing is permissible for a trustee of a pension, charity, or trust only if: (1) the trustee reasonably concludes that the ESG investment program will benefit the beneficiary directly by improving risk-adjusted return, and (2) the trustee's exclusive motive for adopting the ESG investment program is to obtain this direct benefit.

Given the current state of the theory and evidence on ESG investing, we conclude that an ESG strategy can satisfy these conditions under the right circumstances. However, a particular ESG strategy will not necessarily satisfy a trustee's fiduciary duties and, even if such a strategy is permissible in a particular circumstance, the strategy must be regularly reassessed and updated as circumstances change. Moreover, contrary to the PRI and others, we show that a trustee is not required to consider ESG factors. Our analysis therefore challenges both the current zeitgeist in favor of ESG investing by a trustee and common knee-jerk reactions that ESG investing necessarily violates the duty of loyalty.

Clarifying the law and economics of ESG investing by a trustee is of critical importance. With the investment of tens of trillions of dollars at stake, the conflicting commentaries and advisories – including by regulators – require resolution. For example, 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 a pension trustee subject to federal law, each purporting to clarify the prior one.⁶ Despite these bulletins, in 2018 the Government Accountability Office (“GAO”) urged the DOL to issue still further guidance.⁷ In 2019, the President ordered

⁴ See CFA Institute, *Environment, Social, and Governance Issues in Investing: A Guide for Investment Professionals* (2015), available at <https://www.cfapubs.org/doi/pdf/10.2469/ccb.v2015.n11.1> at 33 (finding that 22% of investment professionals who do not consider ESG factors are reluctant to do so owing to concern about fiduciary constraints).

⁵ In these contexts, the trustee has discretionary investment authority over a captive pool of assets held for the benefit of others, or authority over the menu of investments available to others within that captive pool. We differentiate this question from the distinct question of whether 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. 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 a mutual fund for failing to abide by its “zero tolerance” policies regarding alcohol, fossil fuels, and arms production).

⁶ See DOL, *Interpretive Bulletins 2016-1, 2015-01, 2008-01, 2008-2, 94-1, and 94-2; Field Assistance Bulletin 2018-01*.

⁷ 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>.

the DOL to review its existing guidance “to ensure consistency with current law and policies that promote long-term growth and maximize return on ERISA plan assets.”⁸ Meanwhile, in 2018 Delaware amended its trust code to address specifically ESG investing by a trustee, becoming the first state to do so.⁹ But because this amendment deviates from traditional trust fiduciary law, its instructiveness outside of Delaware is uncertain at best.¹⁰ Casting a glance abroad, we find that regulators in the United Kingdom and European Union have also taken up the question of ESG investing by trustees, but with conclusions that conflict with those of American regulators.¹¹

Confusion about the propriety of ESG investing by a trustee has been amplified by the growing salience of ESG investing generally. Almost 2,000 asset managers have signed the PRI’s statement of principles on ESG investing, including many of the world’s leading institutional investors.¹² Hundreds of commercial ESG indices provide ESG ratings of individual companies,¹³ and an S&P 500 ESG index is in preparation.¹⁴ Even index funds, such as those managed by Vanguard and BlackRock, which traditionally avoid consideration of firm-specific factors, are increasingly focusing “on issues ranging from executive pay to climate change.”¹⁵ In the words of Goldman Sachs, “ESG investing, once a sideline practice, has gone decisively mainstream.”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. 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

⁸ Exec. Order No. __, __ C.F.R. __, available at <https://www.whitehouse.gov/presidential-actions/executive-order-promoting-energy-infrastructure-economic-growth/>.

⁹ See Del Code tit. 12, §§ 3302(a), 3303(a)(4) (2018 amendments).

¹⁰ We discuss the amendments at *infra* text accompanying notes __-__ and __-__.

¹¹ See, e.g., The Pensions Regulator, *A Guide to Investment Governance* 8, July 2016 (U.K.) (stating that “the law is sufficiently flexible to allow you to take other, non-financial concerns 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”).

¹² 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>.

¹³ 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.

¹⁴ See Maitane Sardon, *S&P Dow Jones Indices to Launch Sustainable-Investment Index*, *Wall St. J.*, Apr. 8, 2019.

¹⁵ See Andrea Vittorio, *Bloomberg BNA, BlackRock, Vanguard Show Passive Investing’s Activist Streak*, *Dec. 13, 2017*.

¹⁶ Goldman Sachs, *What is Powering the ESG Surge?*, available at <https://www.goldmansachs.com/citizenship/environmental-stewardship/market-opportunities/clean-energy/power-purchase-agreement/>.

apartheid regime.¹⁷ Other labels for the practice include ethical investing, economically targeted investing, sustainable or responsible investing, and impact investing. In accordance with prevailing contemporary usage, we will use the term “ESG investing.”¹⁸

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.¹⁹ 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.²⁰ 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 is a kind of profit-seeking, active investment strategy that can be consistent with the fiduciary duties of loyalty and prudence.²¹

On the assumption that ESG investing can provide risk and return benefits, an influential 2005 report sponsored by the PRI and prepared by the international law firm Freshfields Bruckhaus Deringer argues that ESG investing is consistent with fiduciary duty and, even more, that considering ESG factors “is arguably required in all jurisdictions.”²² In a 2015 follow up report, 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.”²³ Other commentators have argued likewise.²⁴ Nonetheless, many American trustees remain skeptical about the permissibility of ESG investing, probably owing to its association with the moral- and ethical-based practices of what had been called SRI.

¹⁷ 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.B.

¹⁸ 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*.

¹⁹ *See* *infra* Part II.A.

²⁰ *See* *infra* Part I.C.

²¹ *See* *infra* Parts II and III.

²² UNEP Finance Initiative, *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* 13 (2005) (“*Freshfields Report*”).

²³ UNEP Finance Initiative, *Fiduciary Duty in the 21st Century* 9 (2015).

²⁴ For example, 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 argued “that a prudent investor may, and should, consider material ESG factors as part of a robust financial analysis.” Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, __ *Colo. L. Rev.* __ (forthcoming 2018) (“*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*”); *infra* Part III.F.

Our analysis makes four main contributions. *First*, 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*. This taxonomic clarity, which differentiates between kinds of ESG investing based on motive, cuts through the existing noise and clutter by tracking the duty of loyalty in trust fiduciary law, which likewise emphasizes motive.²⁵ We show that collateral benefits ESG violates the sole interest rule of trust fiduciary law,²⁶ subject to certain special rules for charities and for settlor or beneficiary authorization in personal trusts.²⁷ Risk-return ESG investing, by contrast, can be permissible on the same terms as any other kind of active investment strategy that seeks to exploit market mispricing (what we will call *active investing*) or shareholder control rights (what we will call *active shareholding*) for profit.²⁸

Second, because the plausibility of risk-return ESG rests on the claim that it can provide superior risk-adjusted returns, we provide a balanced assessment of the current theory and empirical evidence on that question.²⁹ We conclude that there is indeed theory and evidence in support of risk-return ESG. However, 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 conflated evidence of a relationship between an ESG factor and firm performance with evidence that such a relationship, if it exists, can be exploited by an investor for profit. They have also failed to appreciate the instability and lack of robustness in academic findings of asset mispricing. Nonetheless, because current theory and evidence admits of the possibility that risk-return ESG could improve risk and return, we show that a trustee could undertake a program of ESG investing via active investing, provided that the trustee has a documented, reasonable analysis showing expected return benefits that offset any associated costs, and that the trustee updates this analysis periodically in light of experience with actual costs and returns.³⁰ We provide a similar assessment of the growing use of ESG factors in active shareholding.³¹

Third, we reject on both positive and normative grounds the claim by the PRI and others that risk-return ESG is or ought to be mandatory for a trustee. To the contrary, both passive and contrarian investment strategies are also permissible for a trustee and likewise have significant theoretical and empirical support. A deep irony, previously unremarked upon in the literature, is that the same conceptual logic that motivates risk-

²⁵ See *infra* Part II.A.

²⁶ See *infra* Part II.B-C.

²⁷ See *infra* Part II.C-D.

²⁸ See *infra* Parts III.D-E. The DOL bulletins are largely in accord with our analysis, except that they allow for collateral benefits as a tie breaker in choosing between purportedly equivalent investments. We show that in this 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. See *infra* Part II.B.3.

²⁹ See *infra* Parts III.C-E.

³⁰ See *infra* Part III.D.

³¹ See *infra* Part III.E.

return ESG investing could alternatively support a contrarian, anti-ESG investment strategy. If a trustee reasonably concludes that firms with high ESG scores are overvalued and firms with low ESG scores are undervalued, the trustee may take the opposite bet, eschewing high ESG firms and favoring low ESG firms. Alternatively, as recognized by the U.S. Supreme Court, a trustee “could reasonably” conclude that she had “little hope of outperforming the market,” and therefore could “prudently rely on the market price” and pursue a passive strategy.³²

Fourth, we consider how current law tempers the sole interest rule for charities and personal trusts (but not pensions), allowing a trustee to consider collateral benefits under certain conditions. Specifically, we show that there is no exception to the sole interest rule for a pension trustee subject to federal pension law,³³ but that a trustee of a personal trust could consider third-party benefits to varying degrees if authorized by the settlor in the terms of the trust or in a consent or release by the beneficiary.³⁴ The trustee of a charitable trust could also consider third-party benefits if they fall within the charity’s purpose (so that the benefits are not “collateral”) or if the charity is organized as a corporation subject to a more liberal “best” interest loyalty rule.³⁵ In cases of authorization or charitable purpose, because pursuit of third-party benefits via the investment program is functionally a substitute for a distribution from the trust, we analogize to whether a distribution would be permissible under similar circumstances. We conclude that the strong fiduciary protections imposed by American law, some mandatory and others default, are rooted in sound public policy. Nothing about ESG investing merits a special exception to existing fiduciary principles.

The remainder of this paper is organized as follows. Part I summarizes the rise of ESG investing from its roots in the SRI movement, taking notice of the recent shift in emphasis from collateral benefits on moral or ethical grounds (collateral benefits ESG) to improved risk-adjusted returns (risk-return ESG). Part II assesses the law and economics of collateral benefits versus risk-return ESG investing by a trustee under the duty of loyalty, noting important differences as applied among trustees of pensions, charities, and personal trusts. Part III assesses the law and economics of ESG investing by a trustee under the duty of prudence, disentangling the economic theory and empirical evidence that ESG factors have a relationship to firm performance from the claim that risk-return ESG can generate excess risk-adjusted returns. A brief conclusion follows.

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

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,

³² *Fifth Third Bancorp v. Dudenhoeffer*, 134 S.Ct. 2459, 2471 (2014).

³³ *See infra* Part II.B.

³⁴ *See infra* Part II.C.3-4.

³⁵ *See infra* Part II.D. We also show that in a charity organized as a corporation rather than a trust, collateral benefits ESG may be permissible in certain circumstances under corporate law’s weaker duty of loyalty. *See id.*

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.³⁶ Some commentators view this exhortation, in effect an investment screen, as the first instance of SRI.³⁷ 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.³⁸ The promise of the Pioneer Fund, however, was to avoid morally questionable investments, not to obtain better risk-adjusted returns.³⁹

SRI funds that eschewed defense firms gained additional prominence in the 1970s as a consequence of the Vietnam War.⁴⁰ 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,⁴¹ 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 their South African operations.⁴² These alternate approaches reflect the perennial debate about whether voice or exit is a better strategy toward motivating change.⁴³

B. SRI and Fiduciary Principles

With the growing salience of SRI, and the obvious importance of pensions, charities, and private (personal) trusts for capital markets, commentators began to consider the propriety of SRI by a trustee in light of the fiduciary duties of loyalty and

³⁶ 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).

³⁷ 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.").

³⁸ 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>.

³⁹ See John C. Harrington, Investing with Your Conscience: How to Achieve High Returns Using Socially Responsible Investing 47 (1992).

⁴⁰ 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).

⁴¹ 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).

⁴² Named for General Motors director Reverend Leon Sullivan. See Hauck, Voorhes & Goldberg, *supra* note 41, 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).

⁴³ The foundational work is Albert O. Hirschman, *Exit, Voice, and Loyalty: Responses to Decline in Firms, Organizations, and States* (1970).

care (or prudence). With respect to the duty of loyalty, which as we shall see requires a trustee to act in the “sole” or “exclusive” interest of the beneficiary,⁴⁴ 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.⁴⁵ 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 trust,⁴⁶ 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).⁴⁷

Most commentators, most prominently John Langbein and Richard Posner, concluded that trustees could not divest from firms in South Africa without breaching their fiduciary duties.⁴⁸ Some investment managers agreed.⁴⁹ Even some commentators who were strongly in favor of divestment on moral grounds conceded that existing law did not permit total divestment and therefore instead advocated for law reform.⁵⁰

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.⁵¹ Because selective divestment would exclude fewer firms,⁵² it would do less damage to portfolio efficiency, a result that was borne out by empirical study.⁵³ On this basis, some commentators argued that selective divestment

⁴⁴ See *infra* Part II.A.

⁴⁵ See Langbein & Posner, *supra* note 17, at 73-75.

⁴⁶ See *infra* Part III.A.

⁴⁷ See Langbein & Posner, *supra* note 17, at 85-86; Richard M. Ennis & Roberta L. Parkhill, *South African Divestment: Social Responsibility or Fiduciary Folly?*, 42 *Fin. An. J.* 30 (1986).

⁴⁸ See Langbein & Posner, *supra* note 17; *see also* Robert J Lynn, *Investing Pension Funds for Social Goals Requires Changing the Law*, 53 *U. Colo. L. Rev.* 101 (1981); Ennis & Parkhill, *supra* note 47; 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.”).

⁴⁹ 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).

⁵⁰ 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).

⁵¹ See *supra* note 42 and text accompanying.

⁵² See Ennis & Parkhill, *supra* note 47, at 32 (finding that only 13% of the S&P 500 would be excluded by Sullivan principles).

⁵³ See Blake R. Grossman & William F. Sharpe, *Financial Implications of South African Divestment*, 42 *Fin. Analysts J.* 15 (1986).

was consistent with the fiduciary duty of care.⁵⁴ But this conclusion sidestepped the loyalty issue raised by the fiduciary acting for the benefit of third-parties. The trust law 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.⁵⁵

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.⁵⁶ Between 1995 and 2005, numerous 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.⁵⁷

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 (the "G" in ESG) 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 lower risk and higher returns.⁵⁸

The addition of governance factors in the 1990s, widely accepted as relevant to firm value,⁵⁹ 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.⁶⁰ In the academy, a highly influential 2003 paper by Paul Gompers, Joy Ishii, and Andrew Metrick developed and applied an index of corporate governance,⁶¹ with many follow-on papers suggesting that

⁵⁴ 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).

⁵⁵ See *infra* Part II.A-C.

⁵⁶ See, e.g., Danny Hakim, *On Wall St., More Investors Push Social Goals*, *N.Y. Times A1*, Feb 11, 2001; Susan Sherriek, *A Conscience Doesn't Have to Make You Poor*, *Bus. Wk.* 204, May 1, 2000.

⁵⁷ See Social Investment Forum, *Trends in Socially Responsible Investing 9* (2010), available at https://www.ussif.org/files/Publications/10_Trends_Exec_Summary.pdf.

⁵⁸ 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 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").

⁵⁹ See *infra* Part III.C.

⁶⁰ See Sparkes, *supra* note 37. 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)..

⁶¹ See Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 *Q. J. Econ.* 107 (2003).

identifiable and measurable governance factors have a significant effect on firm performance. Other indices followed, including a prominent index measuring managerial entrenchment in 2009 by Lucian Bebchuk, Alma Cohen, and Allen Ferrell.⁶² 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.⁶³

D. Differentiating Collateral Benefits ESG from Risk-Return ESG

The term “ESG investing” is inherently ambiguous as to whether the investor’s purpose is collateral benefits (in effect, classic SRI) or improved risk-adjusted returns (rebranded ESG), and it is widely and confusingly used today to encompass both.⁶⁴ 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*. The distinction turns on the investor’s motive. By way of illustration, CalPERS, the prominent California Public Employees’ Retirement System, recently responded to criticism that it was undertaking what we would call collateral benefits ESG by arguing that it employed risk-return ESG, that is, it used ESG factors “as an informed investor ... not because [ESG factors] make us feel good but because there is sound economic reasoning to do so.”⁶⁵

Collateral benefits ESG often operates as a screen on investment activity, with the investor eschewing firms or industries identified as unethical or falling below a certain ESG threshold. For example, a collateral benefits ESG investment strategy might avoid investment in a fossil fuel company for the collateral benefit of reducing pollution. Collateral benefits ESG can also be implemented via shareholder voting or engagement, with the aim of inducing a firm to change its practices toward providing collateral benefits apart from improvement to investor risk and return.

⁶² See Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance*, 22 *Rev. Fin. Stud.* 783 (2009).

⁶³ 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 Nofsinger & 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”).

⁶⁴ See, e.g., GAO Report, *supra* note __, at 5 (noting “terminology is not consistently defined in the industry”); Douglas M. Grim & Daniel B. Berkowitz, *ESG, SRI, and Impact Investing, A Primer for Decision-making 4* (noting “confusion” in terminology) (Vanguard 2018).

⁶⁵ 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 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://accfcorgov.org/wp-content/uploads/2017/12/CalPERS-Report-Final.pdf>.

Risk-return ESG investing, by contrast, entails use of ESG factors as metrics for assessing expected risk and return toward improved return with less risk. A typical risk-return ESG strategy is to use ESG factors to pick stocks or other securities on the theory that those factors can identify market mispricing and therefore profit opportunities (we'll call this *active investing*).⁶⁶ For example, a risk-return ESG analysis of a fossil fuel company might conclude that the company's litigation and regulatory risks are underestimated by the its share price, and therefore that reducing or avoiding investment in the company will improve risk-adjusted return. Risk-return ESG investing can also be implemented via shareholder voting or other engagement with management in a manner that improves firm performance and therefore investment returns (we'll call this *active shareholding*; others have called it *stewardship*).⁶⁷

Our taxonomy of collateral benefits versus risk-return ESG is meaningful in light of trust fiduciary law's emphasis on motive, as we shall see below.⁶⁸ In addition, our taxonomy is also relevant as a matter of financial economics for at least two reasons.⁶⁹ First, a screen or other form of active investing cannot in fact achieve collateral benefits while increasing returns. The theory behind a collateral benefits ESG screen is that by eschewing investment in bad ESG firms, investors will raise the cost of capital to those firms, inducing them to change their practices. But necessarily this strategy, if successful, entails sacrificing returns (and with reduced diversification to boot), because a higher cost of capital is just another way of saying that the firm offers better returns. In other words, a successful collateral benefits ESG screening strategy depends on low-ESG firms offering better returns.⁷⁰

Second, increasing the cost of capital to a public company is unlikely given the depth and liquidity of modern financial markets. The capital lost to a firm from a screening strategy employed by even a large number of trustees will tend to be replaced by other capital that rushes in to take advantage of the opportunity. In this event, a collateral benefit ESG investor will not achieve any collateral benefit but will still bear a diversification cost.

II. Fiduciary Loyalty and ESG Investing

The heart of trust governance is fiduciary accountability: a beneficiary may always call the trustee to account, requiring the trustee to show that she acted in

⁶⁶ See *infra* Part III.D.

⁶⁷ See *infra* Part III.E.

⁶⁸ See *infra* Part II.A.

⁶⁹ Others have made these points or similar ones but without our clarifying taxonomy. See, e.g., Paul Brest, Ronald J. Gilson & Mark A. Wolfson, How Investors Can (and Can't) Create Social Value, at 25 (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> (noting that it is "virtually impossible" for socially conscious investors to affect the behavior of firms that trade public markets); Knoll, *supra* note __, at 704-10 (showing that affecting corporate behavior through investment screens requires heroic assumptions about the elasticity of capital supply); see also Cliff Asness, Virtue is its Own Reward: Or, One Man's Ceiling is Another Man's Floor (2017), available at <https://www.aqr.com/Insights/Perspectives/Virtue-is-its-Own-Reward-Or-One-Mans-Ceiling-is-Another-Mans-Floor>.

⁷⁰ We take up this possibility in connection with "sin" or "contrarian" investment. See *infra* Part III.D.4.

accordance with her fiduciary duties of loyalty, care (called prudence in trust parlance), and the other duties of trusteeship.⁷¹ The Restatement (Third) of Trusts characterizes this as “a basic principle of trust administration,” namely, that “all powers held in the capacity of trustee must be exercised ... in accordance with the trustee’s fiduciary obligations.”⁷² Fiduciary accountability contains agency costs by inducing the trustee to act in the interests of the beneficiary on pain of liability for make-whole damages, disgorgement of profits, and other remedies.⁷³ Any investment program by a trustee, whether reliant on ESG factors or otherwise, must be consistent with the trustee’s fiduciary duties.

For the most part, trust law supplies the relevant fiduciary 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.⁷⁴ The widely adopted Uniform Prudent Management of Institutional Funds Act (UPMIFA) applies trust investment law to charitable endowments as a matter of state law.⁷⁵ We therefore draw primarily on trust fiduciary law, relying on canonical sources such as the Restatements of Trusts. Courts commonly treat the Restatements of Trusts as authoritative in both trust and ERISA disputes.⁷⁶ At the same time, we take notice of subtle but important variation across trust, pension, and charity law, both in the applicable fiduciary principles and in their default versus mandatory character. We focus in this Part on ESG investing by a trustee under the fiduciary duty of loyalty. We defer the fiduciary duty of prudence until Part III.

A. “Sole” Versus “Best” Interest

Roughly speaking, the fiduciary duty of loyalty comes in two flavors. One is a “sole interest” rule under which a trustee must “administer the trust *solely* in the interest

⁷¹ See Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, in *The Oxford Handbook of Fiduciary Law* (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2019), on which portions of the ensuing discussion draw without further attribution.

⁷² Restatement (Third) of Trusts § 70 cmt. A (Am. Law Inst. 2007).

⁷³ See Sitkoff, *Economic Theory*, supra note __.

⁷⁴ See ERISA § 403(a), 29 U.S.C. § 1103(a) (mandating that “all assets of an employee benefit plan shall be held in trust”). Many public pension plans are subject to similar state laws. The California Constitution, for example, imposes on a public pension trustee a sole interest rule similar to that under ERISA. See Ca. Const. Art. XVI, § 17(b) (public pension trustee must act “solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries”). On the different kinds of pension and retirement accounts, see Sitkoff & Dukeminier, supra note __, at 480-81.

⁷⁵ 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).

⁷⁶ On ordinary trust matters, see Robert H. Sitkoff & Jesse Dukeminier, *Wills, Trusts, and Estates* 387-91 (10th ed. 2017) (describing the relevance of the Restatements as sources of American trust law). On ERISA matters, 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).

of the beneficiaries.”⁷⁷ The sole interest rule is sometimes also called the “sole benefit” or “exclusive benefit” rule.⁷⁸ Under this 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.”⁷⁹ “The trustee,” in other words, “is under a duty to the beneficiary in administering the trust not to be guided by the interest of any third person.”⁸⁰ Acting with a mixed motive triggers “an irrebuttable presumption of wrongdoing,”⁸¹ full stop.⁸²

Because the sole interest rule is prohibitory rather than regulatory, to prove a breach a beneficiary need only prove the fact of a trustee’s mixed motives.⁸³ Under the sole interest rule, a trustee 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. As we shall see, the sole interest rule is mandatory under ERISA and is default in trust law.⁸⁴

The other flavor of the duty of loyalty is “best interest.” Under this conception of loyalty – which is typical of corporate law (including charities organized as corporations) and is applicable under trust law if the sole interest rule is waived – a fiduciary is not categorically prohibited from acting with a conflict of interest, but rather must act in the “best interest” of the principal notwithstanding the conflict.⁸⁵ The best

⁷⁷ 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).

⁷⁸ *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).

⁷⁹ Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007).

⁸⁰ Restatement (Second) of Trusts § 170 cmt. q (Am. Law Inst. 1959).

⁸¹ Fischel & Langbein, *supra* note __, at 1114-15.

⁸² There is scholarly debate on the soundness of the sole interest rule. *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 __. There is also scholarly debate about the soundness of assessing motive in fiduciary matters more generally. *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).

⁸³ 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 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 §§ 1001-02 (Unif. Law Comm’n 2000); Sitkoff, *supra* note __; Samuel L. Bray, Fiduciary Remedies, *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2019).

⁸⁴ *See infra* Part II.B-C.

⁸⁵ *See* Julian Velasco, Fiduciary Principles in Corporate Law, *in* The Oxford Handbook of Fiduciary Law (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2019).

interest rule is typically implemented by way of an “entire fairness” test. The entire fairness test is sometimes expressed in corporate law as requiring fair price and fair dealing.⁸⁶ Likewise, a trustee must still “act fairly, in good faith, and in the interest of the beneficiaries” even if the sole interest rule is waived.⁸⁷

Whereas the sole interest rule allows no defense at all to an unauthorized conflict, the best interest rule permits a fiduciary to defend a conflicted action as entirely fair. That is, the sole interest rule imposes a categorical prohibition, with “no further inquiry” into whether a conflicted transaction was fair.⁸⁸ By contrast, the best interest rule regulates conflicted transactions by testing them for fairness. The different rules reflect the different contexts in which they are applied.

The sole interest rule’s policy of prophylaxis fits contexts in which a conflicted transaction is unlikely to be beneficial and beneficiary monitoring is weak. Even if in a given case an undisclosed conflict might be fair to the beneficiaries, the policy judgment is that “these deals are so frequently undesirable that the costs of extirpating the entire class of transaction (a rule) are less than the costs of case-by-case adjudication (the fairness standard).”⁸⁹ In the words of the Restatement, “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.”⁹⁰

Under the best interest rule, by contrast, the policy judgment is that a conflicted action will be in the best interests of the beneficiaries with sufficient frequency that the beneficiaries are better off with a regulatory rather than prohibitory rule. This is especially likely if the fiduciary was chosen for professional expertise that overlaps with the fiduciary’s personal interests.⁹¹ Thus, rather than categorically banning all transactions in which the fiduciary might have an interest, the best interest rule permits them but subjects them to judicial review under a fairness test.

B. ESG and Loyalty in ERISA Law

In making direct investment of plan assets, voting shares or otherwise exercising shareholder control rights associated with plan assets, or designing a menu of investment choices (typically mutual funds) from which a plan participant can choose to invest, a trustee of a pension or retirement plan must act in accordance with the

⁸⁶ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); see also Andrew S. Gold, *The Fiduciary Duty of Loyalty*, in *The Oxford Handbook of Fiduciary Law* (Evan Criddle, Paul Miller & Robert H. Sitkoff eds., forthcoming 2019).

⁸⁷ Restatement (Third) of Trusts § 78 cmt. b (Am. Law Inst. 2007).

⁸⁸ *Id.*

⁸⁹ Robert H. Sitkoff, *Trust Law, Corporate Law, and Capital Market Efficiency*, 28 *J. Corp. L.* 565, 573-74 (2003) (emphasis removed).

⁹⁰ Restatement (Third) of Trusts § 78(1) cmt. b (Am. Law Inst. 2007).

⁹¹ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 140-42 (1991).

fiduciary duty of loyalty.⁹² The question thus arises, can reliance on ESG factors in making such decisions be consistent with the duty of loyalty?

1. Solely for “Financial “Benefits

ERISA codifies the trust law sole interest rule by mandating that a pension trustee act “*solely* in the interest of the plan participants and beneficiaries” and for the “*exclusive* purpose” of benefitting them.⁹³ At common law, these terms have long been understood to mean 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.”⁹⁴

As applied under ERISA, the Supreme Court has held that the relevant purpose to which a pension trustee must attend “solely” and “exclusively” is pursuit of “*financial* benefits” for the plan beneficiaries.⁹⁵ The “exclusive purpose” of an ERISA trustee 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.⁹⁶

Under controlling Supreme Court precedent, therefore, a pension trustee breaches the duty of loyalty whenever the trustee acts other than to benefit the beneficiaries financially. Acting under any other motive, even without direct self-dealing, is a breach of the duty of loyalty. Indeed, even if the terms of a 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 to act with the sole or exclusive purpose of providing benefits, meaning financial benefits, to the plan’s participants.⁹⁷

The exclusive and mandatory focus under ERISA on financial benefits distinguishes American pension law from that in the United Kingdom, which is more tolerant of non-financial investment factors.⁹⁸ The American position reflects a paternalistic public policy of protecting the financial security of a retired worker against

⁹² In *Tibble*, 135 S. Ct. 1823, the Supreme Court confirmed that menu construction is a fiduciary act subject to the same fiduciary principles as direct investment and exercise of shareholder rights.

⁹³ ERISA § 404(a)(1)(A)(i), 29 U.S.C. § 1104(a)(1)(A)(i) (emphasis added).

⁹⁴ Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007).

⁹⁵ Dudenhoeffer, 134 S.Ct. at 2468 (emphasis in original).

⁹⁶ *Id.* (quoting ERISA § 404(a)(1)(A)(i)-(ii), 29 U.S.C. § 1104(a)(1)(A))i)-(ii) (emphasis in original).

⁹⁷ 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”).

⁹⁸ *See* Melanie L. Fein, *Social Investing in the United Kingdom (ESG)*, at 2, <https://ssrn.com/abstract=3091922>. (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, *supra* note __.

poor spending and investment decisions by her younger self.⁹⁹ The worker is induced by substantial tax benefits to save for retirement,¹⁰⁰ and until then the investment of those savings is subject to a fiduciary framework that makes financial returns the “sole” or “exclusive” objective. In this way, the American rule also avoids costly and unwieldy aggregation of beneficiary preferences in multiparticipant plans. In all events, whatever the policy merits of this position,¹⁰¹ the Supreme Court has held that the text of ERISA mandates it.

2. Applied to ESG Investing by a Pension Trustee

The foregoing discussion points irresistibly to the legal conclusion that ERISA forbids collateral benefits ESG investing by a pension trustee. Under the Supreme Court’s current interpretation of ERISA, a pension trustee may not consider collateral benefits in any investment decision, whether making direct investment of plan assets, proxy voting or otherwise exercising control rights associated with plan assets, or designing a menu of investment choices among which a plan participant can choose to invest. 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. In this respect, we agree with the consensus from the prior generation of scholarship that classic SRI, typified by total divestment from South Africa out of consideration for the oppressed South African black majority, would breach the trust law duty of loyalty.¹⁰² Collateral benefits ESG, after all, is little more than a rebranding of classic SRI.

A helpful analogy is to suppose a distribution from the pension for the same collateral benefit. Just as a pension trustee could not, consistent with the duty of loyalty, distribute pension plan assets for the purpose of advancing an ESG goal held by the

⁹⁹ See, e.g., Ryan Bubb, Patrick Corrigan & Patrick L. Warren, A Behavioral Contract Theory Perspective on Retirement Savings, 47 *Conn. L. Rev.* 1317, 1337-38 (“The primary motivation for federal retirement savings policy... is the view that many households, if left to their own devices, will make mistakes in planning and saving for retirement.”).

¹⁰⁰ See, e.g., John H. Langbein, The Twentieth-Century Revolution in Family Wealth Transmission, 86 *Mich. L. Rev.* 722, 743 (1988) (describing the “three crucial advantages to conducting retirement saving through a tax-qualified pension plan”).

¹⁰¹ One objection is that today the paradigmatic private pension is a defined contribution plan in which a worker chooses how to invest her pension account from among a menu of mutual funds and other investment vehicles selected by the trustee. See Sitkoff & Dukeminier, *supra* note __, at 480-81. In such a plan, the problem of aggregating preferences is attenuated because each participant retains some measure of individual choice, but the paternalistic policy remains applicable. In future work we plan to take up the question of fiduciary principles and public policy in menu construction by a pension trustee. A second objection is that as a matter of practice reality, pension and retirement accounts are today used more as “a tax-sheltered vehicle for saving and investing than a true retirement fund.” Dukeminier & Sitkoff, *supra* note __, at 480; see also John H. Langbein, Social Security and the Private Pension System, *in* *In Search of Retirement Security: The Changing Mix of Social Insurance, Employee Benefits, and Individual Responsibility* 109, at 112 (Teresa Ghilarducci et al. eds., 2005) (arguing “that the private pension system is only incidentally about [promoting] retirement income,” and rather “the system is best understood as part of a group of tax shelters that are designed to abate the progressivity of the income tax for the affluent”).

¹⁰² See *supra* Part I.B.

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."¹⁰³ In the context of ERISA, in which the Supreme Court has held that the "sole" or "exclusive" purpose of the trustee must be the plan participant's "financial benefits,"¹⁰⁴ this conclusion seems inescapable.

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. But this objection applies to any motive test in the law, of which there are many. More importantly, as we shall see, prudence requires a documented analysis showing realistic risk-and-return estimates and periodic revisiting of those estimates, which provides a check against hidden disloyalty.¹⁰⁵ 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 demonstrate that she is pursuing risk-return ESG, abandoning it or perhaps even embracing an anti-ESG strategy when the numbers go the other way.¹⁰⁶ In a telling admission, the Chair of the PRI, Martin Skancke, lamented a few years back 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."¹⁰⁷

In contrast to collateral benefits ESG, risk-return ESG can be consistent with the duty of loyalty under ERISA, 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 even as glossed by the Supreme Court under ERISA to refer to "financial benefits." Of course, the strategy would also have to satisfy the duty of prudence, which we take up later.¹⁰⁸ For now the point is that risk-return ESG investing satisfies the ERISA duty of loyalty, whereas collateral benefits ESG investing does not.

¹⁰³ 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).

¹⁰⁴ Dudenhoeffer, 134 S.Ct. at 2468 (emphasis removed).

¹⁰⁵ *See* Part III.A.

¹⁰⁶ *See* *infra* Part III.A, D.4. 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." 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. *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).

¹⁰⁷ 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.

¹⁰⁸ *See* *infra* Part III.

The DOL Bulletins, including the most recent 2018, 2016, and 2015 Bulletins, are largely in agreement with the foregoing analysis.¹⁰⁹ In each, the DOL concluded that collateral benefits ESG by a fiduciary is ordinarily unlawful. 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.”¹¹⁰ In the 2018 Bulletin, the DOL again reaffirmed “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.”¹¹¹

At the same time, the DOL has indicated that risk-return ESG investing can be consistent with the duty of loyalty. In the 2015 Bulletin, for example, the DOL clarified that, because a pension trustee “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,” the trustee may consider such factors in a risk-and-return framework.¹¹² “In these instances,” the DOL explained, ESG factors “are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”¹¹³ The DOL emphasized that in such circumstances the trustee acts “solely on economic considerations.”¹¹⁴

In the 2018 Bulletin, the DOL likewise recognized that “there could be instances when otherwise collateral ESG issues present material business risk or opportunities to companies that company officers and directors need to manage as part of the company’s business plan and that qualified investment professionals would treat as economic considerations under generally accepted investment theories.”¹¹⁵ However, because “ERISA fiduciaries must always put first the economic interests of the plan in providing retirement benefits,” even if “ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors.”¹¹⁶

3. Collateral Benefits as a Tie Breaker?

¹⁰⁹ See DOL, Interpretive Bulletins 2016-1, 2015-01, 2008-01, 2008-2, 94-1, and 94-2; Field Assistance Bulletin 2018-01.

¹¹⁰ DOL, IB 2015-01, 80 Fed. Reg. at 65135.

¹¹¹ DOL, FAB 2018-01, at 2.

¹¹² DOL, IB 2015-01, 80 Fed. Reg. at 65136.

¹¹³ Id.

¹¹⁴ Id.

¹¹⁵ DOL, FAB 2018-01, at 2.

¹¹⁶ Id.

Our analysis diverges from that of the DOL, however, in one significant respect. The DOL has taken the position, since embraced by the PRI and others, that if a pension trustee has two investment options with otherwise identical risk and return attributes, the trustee may consider collateral benefits as a tie breaker without violating the duty of loyalty.¹¹⁷ 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.¹¹⁸

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."¹¹⁹

This tie-breaker position is contrary to controlling law and dubious as a matter of textbook financial economics. With respect to law, the tie-breaker is irreconcilable with the strict "sole interest" or "exclusive benefit" rule.¹²⁰ At common law, this rule was understood to impose on a trustee "a duty ... not to be influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust."¹²¹ And under ERISA, the Supreme Court has held that the "sole" and "exclusive" interest to which a pension trustee must attend is provision of "financial benefits ... for the trust's beneficiaries."¹²² Thus, as other commentators have noted, the tie-breaker position is in deep tension with the text of ERISA as read by the Supreme Court and in view of its common law background.¹²³

The Bulletins do not acknowledge this doctrinal tension, much less address it in a persuasive manner. Yet as a legal and a conceptual matter, authorizing a pension trustee to consider collateral benefits in making a fiduciary decision is no different than authorizing the trustee to consider the preferences of the President of the United States, the trustee's spouse, or the trustee's own heart. Each is a violation of the sole interest rule.

¹¹⁷ 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). On the PRI and others, see, e.g., Freshfields Report, *supra* note __, at 12.

¹¹⁸ DOL, IB 2015-01, 80 Fed. Reg. at 65136.

¹¹⁹ FAB 2018-1, at 2.

¹²⁰ See *supra* Part II.A.

¹²¹ Restatement (Third) of Trusts § 78(1) cmt. f. (Am. Law Inst. 2007).

¹²² Dudenhofer, 134 S.Ct. at 2468 (emphasis removed).

¹²³ See Muir, *supra* note __, at __ (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").

Moreover, if two investments in fact have identical risk and return attributes, textbook financial economics teaches that, liquidity constraints and transaction costs to the side, the investor should invest in both on diversification grounds.¹²⁴ 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,¹²⁵ because a joint investment improves diversification, thereby reducing overall portfolio risk without a loss in the portfolio's expected return.¹²⁶

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 purport to 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."¹²⁷ So 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 to diversify.¹²⁸

Suppose, however, that a trustee claims that she had two identical investments but could invest in only one on liquidity or other transactions cost grounds. We would still not permit the trustee to consider collateral benefits to break the purported tie. Given the inherent subjectivity in active investing, the risk and return attributes of a given investment will be highly contestable. In allowing for the possibility of the unicorn that is a pair of identical investments, the DOL tie-breaker position opens the door to a trustee defense for a mixed motive. Such a defense is contrary to the controlling statute and the common law's prophylactic policy that underpins the statute.¹²⁹

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.¹³⁰ Instead, reflecting a need to balance of

¹²⁴ See, e.g., Zvi Bodie, Alex Kane & Alan J. Marcus, *Investments* 194-221 (9th ed. 2011).

¹²⁵ See *infra* Part III.A.

¹²⁶ See Bodie, Kane & Marcus, *supra* note __, at 195-202.

¹²⁷ DOL, IB 2015-01, 80 Fed. Reg. 65135, 65136.

¹²⁸ See ERISA § 404(a)(1), 29 U.S.C. § 1104(a)(1)(C). 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." 29 C.F.R. § 2550.404a-1(b)(ii)(A). And under the duty of prudence, normally a trustee must have a documented analysis of "realistically evaluated return expectations" to justify a diversification sacrifice. See *infra* Part III.A.

¹²⁹ See *supra* Part II.A.

¹³⁰ See *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984). Even with *Chevron* deference, the defects in law and economics identified above could be fatal. 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).

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.¹³¹ The tie-breaker position is therefore vulnerable to court challenge.

C. ESG and Loyalty in Trust Law

As with a pension trustee, in making direct investment of trust assets or voting shares or otherwise exercises shareholder control rights associated with trust assets, the trustee of a private (personal) trust must act in accordance with the fiduciary duty of loyalty. However, unlike under ERISA, in which the sole interest rule is mandatory and the relevant interest is provision of financial benefits, under trust law the sole interest rule is default, and the beneficiary's interest is as prescribed by the settlor in the terms of the trust.¹³²

1. The "Sole" Interest Rule by Default

Under settled principles of trust fiduciary law, by default a trustee must "administer the trust *solely* in the interest of the beneficiaries."¹³³ A familiar teaching example involving mixed motives – that is, a conflict of interest – without self-dealing is *In re Rothko*.¹³⁴ In that case, the executors of Mark Rothko's estate sold or consigned nearly 800 of Rothko's paintings to a single gallery.¹³⁵ Because one executor was an officer of 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 each had a conflict of interest in violation of the duty of loyalty.¹³⁶ The court characterized the argument that the executors were not conflicted by reason of their mixed motives as "sheer fantasy."¹³⁷ The court awarded damages measured by the lost appreciation value on the paintings, equivalent to unwinding the transaction.¹³⁸

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

¹³¹ 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).

¹³² Another difference is that fiduciary administration in a private trust does not involve menu construction, as in a defined contribution pension plan. See *supra* notes __ and text accompanying.

¹³³ 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).

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

¹³⁵ An executor is subject to the same fiduciary loyalty principles as a trustee. See Sitkoff & Dukeminier, *supra* note __, at 596.

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

¹³⁷ *Id.*

¹³⁸ *Id.* at 297-98.

violates the duty of loyalty because such a motive or desire is something other than the sole interest of the beneficiary.¹³⁹ 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.¹⁴⁰

2. Applied to ESG Investing in a Private Trust

As under ERISA, risk-return ESG investing can be consistent with the trust law duty of loyalty, provided that the trustee’s “sole” or “exclusive” motive is benefiting the beneficiary. And as under the mandatory sole interest rule under ERISA, a trustee of a private trust subject to the default sole interest rule under ordinary trust law may not lawfully undertake collateral benefits ESG. By definition, collateral benefits ESG entails consideration of interests other than the sole interest of the beneficiary. As such, collateral benefits ESG runs afoul of the sole interest rule under ordinary trust law.

The Restatement (Third) of Trusts agrees. It provides that collateral benefits ESG investing would “ordinarily” violate the sole interest rule:

[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.¹⁴¹

By insisting on zero tolerance for collateral benefits ESG under the sole interest rule of trust fiduciary law, our analysis (and that of the Restatement) departs from that of some in the prior generation.¹⁴² In particular, some had 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.¹⁴³

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

¹³⁹ *Conway v. Emeny*, 96 A.2d 221, 225 (Conn. 1953).

¹⁴⁰ *Uzyel v. Kadisha*, 116 Cal. Rptr. 3d 244, 276 (Cal. App. 2010).

¹⁴¹ 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.

¹⁴² *Compare* 4 Austin Wakeman Scott et al., *Scott and Ascher on Trusts* § 19.1.13, at 1425 (5th ed. 2007) (presenting as “plausible the argument that moral considerations are an appropriate concern of trustees in making investment decisions,” but recognizing that the Restatement and other modern authority take the contrary position), *with* III Austin Wakeman Scott et al., *Scott on Trusts* § 227.17 (4th ed. 1987) (taking the position that a trustee “may properly consider the social performance of the corporation ... and generally accepted ethical principles”).

¹⁴³ *See supra* Part I.B.

motive on the grounds that the conflict did not harm the beneficiaries or that the additional motive was laudable.¹⁴⁴ Accordingly, a fiduciary's adherence to the Sullivan principles out of consideration for collateral benefits, like any 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.

To be sure, in contrast to an ERISA plan, which must be for the purpose of providing financial benefits to the plan beneficiaries,¹⁴⁵ in a private trust the settlor has broad autonomy to prescribe the terms and purpose of the trust.¹⁴⁶ In consequence, the terms of a trust can provide for a beneficial interest other than portfolio efficiency and provision of maximum financial benefits. 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.¹⁴⁷

Thus, unlike an ERISA trustee, a trustee of a personal trust is not necessarily required to consider only direct “financial benefits.”¹⁴⁸ Depending on the terms of the trust, the trustee may also consider non-financial benefits to the beneficiary. The question thus arises, could a trustee of a personal trust lawfully take the position that an investment strategy motivated by, say, collateral environmental benefits is permissible because the beneficiary lives on the earth and therefore will be indirectly benefited? We think no for at least two reasons.

First, because such an investment strategy is in function a substitute for an outright distribution, it ought to be tested as such. If a trustee could not consistent with the terms of the trust make an outright distribution to achieve the same collateral environmental benefit, then the trustee ought not be allowed to circumvent that limit by pursuing the same purpose via the trust's investment program. In the words of the Restatement, “an abuse of discretion occurs when a trustee acts from an improper even though not dishonest motive, such as when the act is undertaken in good faith but for a purpose other than to further the purposes of the trust.”¹⁴⁹

Second, even if the investment satisfies this substitute-for-distribution test, under the duty of prudence, which we take up more fully below,¹⁵⁰ the trustee would further have to reasonably conclude that the investment was an efficacious means to provide the particular benefit to the beneficiary. But given the depth and liquidity of modern financial markets, a trustee of a personal trust is unlikely to affect a firm's cost of capital,

¹⁴⁴ See *supra* Part II.A.

¹⁴⁵ See *supra* Part II.B.1.

¹⁴⁶ See, e.g., Robert H. Sitkoff, *Trusts and Estates: Implementing Freedom of Disposition*, 58 *St. Louis L.J.* 643 (2014).

¹⁴⁷ See, e.g., Sitkoff & Dukeminier, *supra* note __, at 641-42.

¹⁴⁸ See *supra* Part II.B.1.

¹⁴⁹ Restatement (Third) of Trusts § 87 cmt. c (Am. Law Inst. 2007).

¹⁵⁰ See *infra* Part III.

but is likely to incur diversification and transaction costs.¹⁵¹ As such, an investment motivated by pursuit of a collateral environmental benefit is likely to be inferior to a direct expenditure for the same benefit, for instance in this example obtaining weatherproofing or solar panels for the beneficiary's home.¹⁵²

3. Collateral Benefits and the Terms of a Trust

Unlike under ERISA, however, under ordinary trust law the sole interest rule is default rather than mandatory. 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.”¹⁵³ In such circumstances, the best interest rather than sole interest flavor of the duty of loyalty applies. Again in the words of the Restatement, “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.”¹⁵⁴

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.”¹⁵⁵ 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.”¹⁵⁶

So 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 best interest scrutiny for whether the investment program was prudent, in good faith, and fairly made in the best interest of the beneficiary. Under this test, a trustee’s adherence to the Sullivan principles could well be sustained, if the trustee could show no more than a *de minimus* effect on the beneficiary’s interest.

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 autonomy and freedom of disposition.

¹⁵¹ See *supra* note 69 and text accompanying.

¹⁵² The example of Swarthmore College (though a non-profit corporation) is instructive. Swarthmore declined to divest from fossil fuels, and instead undertook direct policies and investments to reduce pollution and carbon emissions. See Michael Katz, Swarthmore Endowment will not Divest from Fossil Fuels, Chief Investment Officer, June 15, 2018.

¹⁵³ Restatement (Third) of Trusts § 78 cmt. c(2) (Am. Law. Inst. 2007).

¹⁵⁴ *Id.*

¹⁵⁵ *Id.* § 90 cmt. c (emphasis added), quoted *supra* text accompanying note __.

¹⁵⁶ *Id.*

Under traditional law, a trust must be for the benefit of a recognized charitable purpose (a charitable trust, which we take up below) or for one or more ascertainable beneficiaries.¹⁵⁷ 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.¹⁵⁸

Accordingly, the hard question is whether a provision that prioritizes collateral benefits over the interests of the beneficiary crosses the line into an impermissible noncharitable purpose trust. This question has been most extensively considered, both in the case law and in the literature, in the context of trust terms that authorize or mandate an undiversified portfolio.¹⁵⁹ 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.¹⁶⁰ “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.”¹⁶¹ Thus, even with a provision in the terms of a trust authorizing collateral benefits ESG, a trustee would remain subject to a best interest loyalty test. And the trustee would likely fail the best interest test if the collateral benefits ESG program injures the beneficiary’s interest by materially sacrificing returns or increasing risk.¹⁶²

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.¹⁶³ 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.”¹⁶⁴ We would

¹⁵⁷ See Restatement (Third) of Trusts § 27 (Am. Law Inst. 2003).

¹⁵⁸ See *id.* § 47; Sitkoff & Dukeminier, *supra* note __, at 426, 428.

¹⁵⁹ See Sitkoff & Dukeminier, *supra* note __ at 650-54 (surveying law and commentary on permissive and mandatory portfolio concentration).

¹⁶⁰ See *id.* at 650.

¹⁶¹ *Id.* at 651.

¹⁶² 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.”).

¹⁶³ See Sitkoff & Dukeminier, *supra* note __, at 652.

¹⁶⁴ Restatement (Third) of Trusts §§ 66(2), 91(b) (Am. Law Inst. 2003); *see also* Sitkoff & Dukeminier, *supra* note __, at 652.

expect the same rule to be applied to a mandatory direction in the terms of a trust to consider collateral benefits from ESG investing.

A caveat is in order. The foregoing analysis tracks prevailing 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 in both law and policy. Commentators are by no means in agreement that the common law has struck the right balance.¹⁶⁵ And some states, including the prominent trust state of Delaware,¹⁶⁶ have enacted statutes that depart from the common law by mandating enforcement of a settlor's direction not to diversify,¹⁶⁷ or that allow trusts for a wide array of noncharitable purposes.¹⁶⁸ In such a state, public policy arguably grants a settlor broader freedom to balance other interests, including perhaps to favor collateral benefits from ESG investing over the interest of the beneficiary.

In this regard, we observe that in 2018 Delaware became the first state to address by statute terms of a trust that authorize ESG investing. 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."¹⁶⁹ 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.¹⁷⁰

4. Collateral Benefits and Authorization by the Beneficiary

Another important difference from ERISA is that under ordinary trust law a beneficiary may authorize conduct by a trustee that would otherwise constitute a breach

¹⁶⁵ 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).

¹⁶⁶ 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).

¹⁶⁷ See Del. Code tit. 12, § 3303(a)(3); Sitkoff & Dukeminier, *supra* note __, at 653 (collecting examples).

¹⁶⁸ See Del Code tit. 12, § 3556; Adam J. Hirsch, *Delaware Unifies the Law of Charitable and Noncharitable Purpose Trusts*, 36 Est. Plan. 13 (2009).

¹⁶⁹ Del. Code tit. 12, § 3303(a)(4).

¹⁷⁰ 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 "wilful 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).

of trust.¹⁷¹ A beneficiary who has properly authorized “an act or omission that constitutes a breach of trust cannot hold the trustee liable for that breach.”¹⁷² Moreover, because beneficiary authorization involves a waiver of the beneficiary’s own rights, it does not touch on the unsettled limits on settlor autonomy. Beneficiary authorization is therefore conceptually simpler than authorization by the terms of a trust.

However, given the fiduciary nature of a trust relationship, and given that the act of a trustee’s obtaining authorization from a beneficiary is necessarily a conflicted action, trust law imposes substantive and procedural safeguards to ensure that the beneficiary’s waiver is knowing and voluntary. A beneficiary’s authorization of conduct that would otherwise constitute a breach of trust 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.”¹⁷³

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 (Third) of Trusts, for example, is express in noting that a beneficiary may authorize collateral benefits ESG investing by a trustee.¹⁷⁴ The difficulties for effective authorization of collateral benefits ESG by a beneficiary are practical rather than conceptual.

The first practical difficulty is of the need for authorization from all beneficiaries. This difficulty arises from the rule that an authorization “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.”¹⁷⁵ 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 beneficiary authorization will need to attend carefully to the rules governing representation of such beneficiaries.¹⁷⁶

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). The life beneficiary *A* would in this case not be a suitable representative who could bind remainder

¹⁷¹ 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).

¹⁷² *Id.*

¹⁷³ *Id.* § 97.

¹⁷⁴ 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.”).

¹⁷⁵ *Id.* § 97 cmt. b.

¹⁷⁶ See, e.g., *id.* cmt. d (discussing applicability of “virtual representation” to a consent or release).

beneficiary *B*. In effect, *A* is asking the trustee to diminish *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.¹⁷⁷

A second difficulty is the uncertain temporal scope of an authorization. This difficulty arises from the rule that beneficiary authorization does not protect against a further breach of trust, even one involving similar conduct.¹⁷⁸ How long a beneficiary authorization 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 authorization of the concentration because of the passage of too long a period of time since the authorization.¹⁷⁹ We are told that, in consequence of this uncertainty, corporate trustees are uncomfortable with a consent not to diversify. We would expect the same discomfort about temporal scope 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."¹⁸⁰ 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." Crucially, nothing in this provision 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 the 2018 Delaware amendment will put a thumb on the scale for a trustee that undertakes an ESG investing program with beneficiary endorsement. Possibly it will also incline Delaware courts toward resolving the legal uncertainty regarding the effect of a beneficiary release in the trustee's favor.

D. ESG and Loyalty in Charity Law

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

¹⁷⁷ 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).

¹⁷⁸ See Restatement (Third) of Trusts § 97 cmt c(3) (Am. Law Inst. 2012).

¹⁷⁹ See *In re Saxton*, 712 N.Y.S.2d 225 (App. Div. 2000).

¹⁸⁰ Del Code tit. 12, § 3302(a).

1. The “Sole” Interest Rule and “Charitable Purpose”

Unlike a private trust, which must be for one or more ascertainable beneficiaries,¹⁸¹ or a pension plan, which must be for the plan’s participants,¹⁸² a charitable trust or other form of charity must be for the benefit of a recognized *charitable purpose*.¹⁸³ The list of permissible charitable purposes, which was codified by Parliament more than 400 years ago,¹⁸⁴ 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.”¹⁸⁵

That a charity must be for a charitable purpose rather than for ascertainable beneficiaries changes the application of the sole interest rule. Whereas a trustee of a private trust or pension fund must act “solely in the interest of *the beneficiaries*,”¹⁸⁶ a trustee of a charitable trust must act “solely in furtherance of *its charitable purpose*.”¹⁸⁷ 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. In other words, a third-party benefit obtained via a charity’s investment program that is within the charity’s charitable purpose is not a “collateral” benefit but rather is a benefit that falls within the “sole” interest of the charity’s purpose.

Recall the analogy earlier to a distribution from a pension or a trust for an ESG purpose.¹⁸⁸ 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,”¹⁸⁹ is a permissible substitute for direct expenditure by the charity on that purpose.¹⁹⁰ 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

¹⁸¹ See Sitkoff & Dukeminier, *supra* note __, at 418.

¹⁸² See Fischel & Langbein, *supra* note __.

¹⁸³ See Restatement of Charitable Nonprofit Organizations § 1.01(a) (Am. Law Inst. T.D. No. 1, 2016).

¹⁸⁴ 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).

¹⁸⁵ 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).

¹⁸⁶ Restatement (Third) of Trusts § 78 (Am. Law Inst. 2007) (emphasis added).

¹⁸⁷ *Id.* (emphasis added).

¹⁸⁸ *See supra* note __ and text accompanying.

¹⁸⁹ *See Gary, Values and Value, supra* note __, at 268-71.

¹⁹⁰ The IRS agrees that a charity may give “consideration [to its] charitable purposes ... in properly managing and investing the organization’s investment assets.” IRS Notice 15-62.

the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.¹⁹¹

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 also subject to the duty of care or prudence,¹⁹² albeit enforcement of fiduciary duty in the case of charities largely rests with state attorneys general and is notoriously weak.¹⁹³

2. "Best" Rather Than "Sole" Interest Applies to Many Charities

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."¹⁹⁴ 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 law with a "best interest" rather than "sole interest" version of the duty of loyalty.¹⁹⁵ And in fact, charities are more typically organized a corporation than as a trust.¹⁹⁶

The difference matters, because a best interest loyalty rule is more tolerant of mixed motives, subjecting conflicted actions to a fairness test rather than categorical prohibition.¹⁹⁷ Accordingly, for a charity organized as a corporation, the fiduciary responsible for investment of the charity's endowment may consider collateral benefits – that is, may have a mixed motive – if doing so meets the entire fairness test by not compromising investment returns.

Let us return to the familiar example of divestment from South Africa, which preoccupied the prior generation of commentators, and consider divestment in the case of a charity with a charitable purpose that did not encompass promoting racial equality in South Africa.¹⁹⁸ Even under best interest standard, total divestment might still be impermissible under the entire fairness test given the evidence that it would compromise portfolio efficiency. By contrast, selective divestment under the Sullivan

¹⁹¹ *Id.* § 90 cmt c.

¹⁹² *See infra* Part III.

¹⁹³ *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).

¹⁹⁴ Restatement of Charitable Nonprofit Organizations § 1.02 (Am. Law Inst., Tentative Draft No. 1, 2016).

¹⁹⁵ *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 2019); Restatement (Third) of Charitable Nonprofit Organizations § 2.02 cmt. b (Am. Law Inst. T.D. No. 1 2016).

¹⁹⁶ *See* Sitkoff & Dukeminier, *supra* note __, at 759.

¹⁹⁷ *See supra* Part II.A.

¹⁹⁸ *See supra* Part I.B.

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, but rather triggers fairness review.

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 arguably 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 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 analysis.¹⁹⁹ The same is true for the announcement by a Harvard investment manager of a "pausing" in fossil fuel investment.²⁰⁰

III. The Duty of Prudence and ESG Investing

As we have just seen, the trust fiduciary law duty of loyalty generally prohibits collateral benefits ESG but would allow for risk-return ESG. By definition, the purpose of risk-return ESG is to benefit the beneficiary by obtaining better returns with less risk. However, a trustee's conduct must also satisfy the fiduciary duty of *care*, called *prudence* in trust law, which requires a trustee to act "as a prudent person would," exercising "reasonable care, skill, and caution."²⁰¹ The duty of prudence under ERISA and charity law is the same.²⁰²

By baselining against what a prudent person would do in like circumstances, the duty of prudence imposes an objective and relational standard of care that resembles the reasonable person test of tort law.²⁰³ Moreover, because there is no equivalent in trust

¹⁹⁹ See 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/> (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").

²⁰⁰ 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").

²⁰¹ Restatement (Third) of Trusts § 77(1)-(2). (Am. Law Inst. 2007); see also Uniform Trust Code § 804 (Unif. Law Comm'n 2000) (similar).

²⁰² ERISA provides that a pension trustee 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." ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B). Likewise, "[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." Restatement (Third) of Charitable Nonprofit Organizations § 2.03 (Am. Law Inst. T.D. No. 1, 2016).

²⁰³ See Sitkoff, *Agency Costs*, supra note __, at 655.

law to corporate law’s “business judgment rule,”²⁰⁴ the trust law duty of prudence subjects all trustee actions (or inactions) to substantive judicial review.²⁰⁵ With respect to investment matters, the content of this substantive review is prescribed by the “prudent investor rule,” which codifies risk management principles rooted in modern portfolio theory (Section A).²⁰⁶

To assess whether risk-return ESG investing by a trustee can pass muster under the prudent investor rule, we address the inherent subjectivity to the ESG rubric (Section B), and undertake a balanced review of the current theory and empirical evidence on the risk and return benefits of ESG investing. 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 trustee must do before relying on them.

We draw particular attention to the crucial but often overlooked distinction between the existence of a relationship between ESG factors and firm value on the one hand (Section C), and whether such a relationship can be exploited by an investor for profit via active investing (Section D) or active shareholding (Section E) on the other.²⁰⁷ We conclude that risk-return ESG investing can but does not necessarily satisfy the duty of prudence. Furthermore, contrary to the PRI and other proponents of ESG investing, the prudent investor rule does not mandate that a trustee use ESG factors (Section F).

A. The Prudent Investor Rule

Under the fiduciary duty of prudence, a trustee employing a risk-return ESG investing strategy must reasonably conclude that the strategy will in fact provide better returns with the same or less risk. The trustee’s ESG investing strategy, in other words, must satisfy the *prudent investor rule*. Under that rule, a trustee must employ “an overall investment strategy having risk and return objectives reasonably suited to the trust” and, other than in exceptional circumstances, must “diversify the investments of the trust.”²⁰⁸ The prudent investor rule thus points to what in financial economics is known as an “efficient portfolio,” meaning a portfolio that maximizes return for a given level of market risk,²⁰⁹ and it requires aligning overall risk and return with the terms and

²⁰⁴ See, e.g., Stephen M. Bainbridge, *Corporate Law* §§ 6.2-6.3 (2d ed. 2009).

²⁰⁵ See Sitkoff, *supra* note __, at 656-57; see also Sitkoff, *supra* note __, at 41.

²⁰⁶ See Restatement (Third) of Trusts § 77 cmt. a (Am. Law Inst. 2007). On the implementation of loyalty and care in fiduciary law by way of subsidiary principles, 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 2019).

²⁰⁷ See, e.g., 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); *infra* notes __ and text accompanying.

²⁰⁸ Uniform Prudent Investor Act § 2(b), 3 (Unif. Law Comm’n 1994); see also Restatement (Third) of Trusts, § 90(a)-(b) (Am. Law Inst. 2007) (similar). On circumstances in which not diversifying might be justifiable, see Sitkoff & Dukeminier, *supra* note __, at 641-42.

²⁰⁹ See Schanzenbach & Sitkoff, *supra* note __, at 134-37.

purposes of the trust. The prudent investor rule applies also to charities and to private pensions subject to ERISA.²¹⁰

A central purpose of the prudent investor rule was to liberate trustees from the constraints of the prior “prudent man rule,” which had favored conservative investments and disfavored various other investments as speculative.²¹¹ Under the prudent investor rule, by contrast, “[s]pecific investments or techniques are not per se prudent or imprudent.”²¹² Instead, “[a] trustee may invest in any kind of property or type of investment,” provided that the investment fits within a diversified overall investment strategy with portfolio-level risk and return objectives reasonably suited to the trust.²¹³ Structurally, therefore, 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.”²¹⁴

Given the rejection per se rules of prudent investment, the authorities are uniform in recognizing that a trustee may employ *active management strategies*, such as picking and choosing among different investments.²¹⁵ “Prudent investment principles,” in other words, “allow the use of ... active management strategies by trustees. These efforts may involve searching for advantageous segments of a market, or for individual bargains in the form of underpriced securities.”²¹⁶ It follows, therefore, that an ESG investing strategy that involves picking and choosing investments based on ESG factors, or that involves exercising shareholder control rights in light of those factors, could satisfy the prudent investor rule.

However, active investment strategies – whether based on ESG factors or otherwise – usually “entail investigation and analysis expenses and tend to increase general transaction costs,”²¹⁷ and a stock picking strategy tends to reduce diversification

²¹⁰ ERISA § 404(a), 29 U.S.C. § 1104(a), as interpreted in 29 C.F.R. § 2550.404a-1(b), imposes the prudent investor rule on pension trustees. The Supreme Court has relied on the Restatement (Third) of Trusts and the Uniform Prudent Investor Act in applying ERISA’s prudent investor rule. *See* *Tibble v. Edison Int’l*, 135 S. Ct. 1823, 1828 (2015). UPMIFA § 3, adopted in nearly every state (*see supra* note __), expressly applies the trust law prudent investor rule to charitable endowments.

²¹¹ *See* Restatement (Third) of Trusts § 90 pt. 6, ch. 17, intro. note (Am. Law Inst. 2007); 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).

²¹² *Id.* cmt. f(2).

²¹³ Unif. Prudent Inv’r Act § 2(b) (Unif. Law Comm’n 1994).

²¹⁴ Restatement (Third) of Trusts § 90 cmt. e(1) (Am. Law Inst. 2007).

²¹⁵ *See id.*

²¹⁶ *Id.* cmt. h(2). The reporter’s notes acknowledge specifically that the “liberated portfolio concepts” of the prudent investor rule “allow for the introduction of active management strategies. These efforts may involve searching for advantageous segments of a market, or for individual bargains within the highly efficient markets as well as in the less efficient ones.” *Id.* rep. notes.

²¹⁷ *Id.* cmt. h(2).

by narrowing the range of the portfolio's holdings or overweighting certain holdings.²¹⁸ Under the prudent investor rule, these added costs must be offset "by realistically evaluated return expectations."²¹⁹ The trustee must reasonably conclude that improved expected returns "can reasonably be expected" to offset the "additional costs and risks" and that "there is a credible basis for concluding that the trustee – or the manager of a particular activity – possesses or has access to the competence necessary to carry out the program."²²⁰

The prudent investor rule's emphasis on balancing costs and benefits in active investing is a specific application of a more general principle of prudence that requires a trustee to be *cost sensitive*,²²¹ 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."²²² The rationale is obvious: "Minimizing costs and expenses preserves trust assets for the beneficiaries."²²³ A trustee's duty to be cost sensitive pertains to both picking and choosing investments as well as proxy voting or other engagement with management.²²⁴

The duty of prudence also requires *ongoing monitoring*. The prudent investor rule, and its subsidiary principle of cost sensitivity, therefore apply to both a "trustee's decisions respecting new investments" as well as the trustee's "continuing responsibility for oversight of the suitability of investments already made."²²⁵ In the words of the 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."²²⁶ Accordingly, after implementing a prudent investment program, whether based on ESG factors or otherwise, a trustee must continue to monitor the program's costs and returns, and adjust the program in light of actual performance and changing circumstances.

Finally, the duty of prudence requires a trustee to maintain *adequate records* of "the administration of the trust," documenting important decisions and the reasons for

²¹⁸ *Id.* (noting "the possible acceptance of a relatively high degree of diversifiable risk" in an active investment strategy).

²¹⁹ *Id.*; see also *id.* pt. 6, ch. 17, intro. note (observing that "active management strategies involve investigation expenses and other transaction costs (including capital-gains taxation) that must be considered, realistically, in relation to the likelihood of increased return from such strategies").

²²⁰ *Id.* cmt. h(2).

²²¹ See *id.* § 88 cmt. a.

²²² 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").

²²³ Sitkoff & Dukeminier, *supra* note __, at 660-61.

²²⁴ See, e.g., DOL FAB 2018-1, at 4 (shareholder engagement permissible for an ERISA fiduciary if the expected benefit outweighs "the costs involved").

²²⁵ Uniform Prudent Investor Act § 2 cmt. (Unif. Law Comm'n 1994); see also Restatement (Third) of Trusts § 90 cmt. e(1) (Am. Law Inst. 2007) (noting duty to "make portfolio adjustments if and as appropriate").

²²⁶ *Tibble v. Edison Int'l*, 135 S. Ct. 1823, 1828 (2015).

those decisions.²²⁷ A typical practice regarding investment decisions is to establish a written investment policy statement.²²⁸ In the context of an active investment program, whether ESG or otherwise, a trustee is expected to document its analysis of expected risk and return and their relationship to expected transaction and diversification costs, and to document the trustee's periodic review thereafter, including adjustments to the program over time. A trustee's failure to keep such records would entitle a reviewing court "to resolve doubts against the trustee."²²⁹

B. Identifying and Applying ESG Factors

There is, to be sure, 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, 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. For example, an environmentally sound firm could have weak corporate governance or mistreat its workforce. On balance, is such a firm a good or a bad ESG bet?

When moving from abstract principles to specific implementation, the inherent subjectivity of the ESG rubric itself becomes apparent. As the professional association for Chartered Financial Analysts has explained, "there is no exhaustive list of ESG issues,"²³⁰ and there is no consistency in the labels used to describe investment strategies that consider ESG factors.²³¹ There are hundreds of ESG ratings services and ESG themed mutual funds,²³² and they often disagree. For example, the well-known ratings agency, Morningstar, found that ESG mutual funds scored about the same as non-ESG funds on Morningstar's own "sustainability" assessments.²³³

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

²²⁷ 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").

²²⁸ *See* Sitkoff & Dukeminier, *supra* note __, at 640-41; Schanzenbach & Sitkoff, *supra* note __, at 138-39.

²²⁹ Restatement (Third) of Trusts § 83 cmt. a(1) (Am. Law Inst. 2007).

²³⁰ 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.

²³¹ *See id.* at 5.

²³² *See supra* note __ and text accompanying.

²³³ *See* Aime Williams, Ethical Funds Failing Social Responsibility Tests, *Fin. Times*, March 16, 2018.

than others.²³⁴ There is similar dispute about the environmental impact of natural gas.²³⁵ And nuclear power offers low carbon emissions but a potentially substantial “tail risk” in the event of a meltdown.²³⁶

The use of social factors is often dependent on social norms and is therefore perhaps more fraught than environmental factors. By way of illustration, one of the oldest socially responsible mutual funds, the PAX Fund, today invests in firms that conduct alcohol and gambling business after long avoiding them on the reasoning that society is now more receptive to these products.²³⁷

Governance factors are also disputed. 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 suggests that the effect on firm value of classification is contextual,²³⁸ with some finding that a classified board could be value-enhancing in specific contexts, in particular for “firms that rely on long-term investment or long-term relationships.”²³⁹

²³⁴ See, e.g., Ian 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, supra note __ (concluding that oil sands are much worse for greenhouse gas emissions and other pollutants).

²³⁵ 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/>.

²³⁶ 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); 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); 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”). We take up “tail risk” infra Part III.D.1.

²³⁷ See Daniel Akst, Mutual Funds Report; The Give and Take of “Socially Responsible,” *N.Y. Times*, Oct. 8, 2006.

²³⁸ See, e.g., Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, Settling the Staggered Board Debate, 166 *U. Pa. L. Rev.* 1475 (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>.

²³⁹ 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).

A mixed social and governance factor that has been of particular focus lately is race and gender diversity on a firm's board of directors.²⁴⁰ For example, BlackRock takes the position that "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."²⁴¹ But would not an investment program that favors firms with gender parity on the 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.²⁴²

Tesla Motors, the well-known manufacturer of electric cars, is a telling case study in the subjectivity of E, S, and G, and how to weigh them against each other. Because Tesla tends to limit its public disclosures, in light of the sometimes erratic behavior of its founder and controlling shareholder, Elon Musk, and given Musk's close ties to several directors, Tesla often scores low in governance ratings.²⁴³ Tesla also garners low social ratings due to its treatment of its workers.²⁴⁴ The environmental impact of Tesla depends critically on how one weights its inputs (especially rare earth minerals) versus its outputs (low-emission cars).²⁴⁵ Not surprisingly, therefore, two widely used ESG indices from well-respected financial information firms diverge sharply in their assessments of Tesla. MSCI ranks Tesla at the top of the auto industry on ESG factors, whereas FTSE ranks it last in the auto industry and with an overall score even lower than that of Exxon. A further irony regarding Tesla is that, whereas fossil fuel and tobacco companies are often disfavored by ESG proponents on grounds of regulatory and governmental policy risks,²⁴⁶ Tesla also faces regulatory and governmental policy risk owing to its dependence on tax subsidies for electric car buyers.²⁴⁷

²⁴⁰ 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>.

²⁴¹ 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>.

²⁴² See Deborah L. Rhode & Amanda K. Packer, Diversity on Corporate Boards: How much Difference Does Difference Make?, 39 Del. J. Corp. L. 377, 383 (2014) (surveying many empirical studies and concluding that "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").

²⁴³ See, e.g., James Mackintosh, Is Tesla or Exxon More Sustainable? It Depends on Whom You Ask, Wall St. J., Sept. 17, 2018; Kevin Curran, ESG Investors Aren't Riding High With Tesla While Elon is Driving, The Street, Mar. 22, 2019.

²⁴⁴ Id.

²⁴⁵ Id.

²⁴⁶ See supra note __ and text accompanying.

²⁴⁷ See, e.g., Russ Mitchell, Tesla Stock Takes a Hit as GOP Unveils Tax Plan that Eliminates Electric Car Subsidy, L.A. Times, Nov. 2, 2017; Alex Schiffer, Tesla's Sales Stall in Hong Kong as Tax Breaks End. Could the U.S. be Next?, Wash. Post, July 10, 2017.

All told, the fluidity of the ESG rubric means that assessment and application of ESG factors will be highly subjective. Like any form of active investing, risk-return ESG investing necessarily involves subjective judgments in the identification of relevant factors, assessing whether they are good or bad from an investor's perspective, and how much weight to give each factor. However, 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."²⁴⁸

C. ESG Factors and Firm Performance

Setting aside the subjectivity inherent to the ESG rubric, there are indeed sound theoretical arguments that various ESG factors may be related to firm performance.²⁴⁹ Some empirical evidence validates these arguments, although the findings are mixed and contextual, and highly dependent on the research design.

Corporate governance (i.e., G) factors have straightforward theoretical relationships to firm performance. Whether a firm has a controlling shareholder, the entrenchment of management (such as by a classified board²⁵⁰ or other antitakeover devices), and executive compensation arrangements 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

On the other hand, 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 might be contextual, that is, heterogeneity among firms may require heterogeneity in governance. What is a good G factor for one firm may not be good for another. Indeed, the prevailing academic view of corporate law is that it should enable tailor-made governance for a wide variety of contexts.²⁵³

The contextual nature of optimal governance speaks to the need for subjective judgments in applying G factors within an active investment strategy. For example, 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 a pill

²⁴⁸ Brest, Gilson, & Wolfson, *supra* note __, at 23-24.

²⁴⁹ 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 until *infra* Sections D and E respectively.

²⁵⁰ See *supra* notes 238-239 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).

²⁵² See Klausner, *supra* note 239.

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

²⁵⁴ See *supra* notes 238-239 and text accompanying.

may be beneficial to shareholders, depending on the design of the pill and the firm's circumstances.²⁵⁵

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. 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 a catastrophic environmental disaster²⁵⁶ or the risk of large fixed investments becoming "stranded" following a dramatic regulatory change.²⁵⁷

Second, environmental and social factors may proxy for management quality, an important investment consideration that is hard to observe directly.²⁵⁸ Well-run firms may have better compliance programs, and high-quality managers may be attracted to firms that have pro-social or environmental policies.²⁵⁹ 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.²⁶⁰ 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.

The theoretical relationship between firm value and environmental and social 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.²⁶¹ Moreover, there is evidence that

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

²⁵⁷ 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>.

²⁵⁸ 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).

²⁵⁹ 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).

²⁶⁰ 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).

²⁶¹ See John Peloza, The Challenge of Measuring Financial Impacts from Investments in Corporate Social Performance, 35 *J. Mgmt.* 1518, 1521 (2009) (reviewing 159 studies, finding that "[t]he majority ... show a

firms can build goodwill through socially responsible activities, which can protect against reputational harm from adverse events.²⁶²

These empirical 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 problem for which there is also some empirical evidence.²⁶³ 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 political and regulatory risk owing to heavy reliance on current government policy.²⁶⁴

D. ESG Factors in Active Investing

A relationship between ESG factors and firm value is a necessary but not sufficient condition for a profitable ESG active investment strategy. Any 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 to be able to profit by trading on ESG factors, the market must consistently misprice them.²⁶⁵ 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 prudent investor rule is sensitive to “differences in the degrees of efficiency and inefficiency in various markets.”²⁶⁶

1. Questioning Market Efficiency

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

positive relationship between CSP and financial performance (63%); 15% of studies report a negative relationship, and 22% report a neutral or mixed relationship”).

²⁶² 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. Mgmt. J.* 425 (2009).

²⁶³ 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).

²⁶⁴ See, e.g., Mark Chediak & Chris Martin, *Say Goodbye to Solar Power Subsidies*, *Bloomberg News*, Nov. 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.

²⁶⁵ The classic work is Burton Malkiel, *A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing* (11th ed. 2015); see also 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).

²⁶⁶ Restatement (Third) of Trusts pt. 6, ch. 17, intro. Note (Am. Law Inst. 2007).

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.²⁶⁷ 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.²⁶⁸ 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.²⁶⁹

A particular focus of risk-return ESG investing strategies are on so-called "tail-risks,"²⁷⁰ 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.²⁷¹ 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 crisis.²⁷² 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.²⁷³ 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,²⁷⁴ but the evidence is not uniformly in favor of this conclusion.²⁷⁵

²⁶⁷ See, e.g., Gary, Values and Value, *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).

²⁶⁸ See Bodie, Kane & Marcus, *supra* note __ at 117.

²⁶⁹ See Christoph M. Klein, Integrating ESG into the Fixed-Income Portfolio, *CFA Inst. Conf. Proc. Q.* 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.").

²⁷⁰ See Nassim Nicholas Taleb, *The Black Swan: The Impact of the Highly Improbable* (2007).

²⁷¹ 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).

²⁷² 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>.

²⁷³ See *supra* notes 256-257 and text accompanying.

²⁷⁴ 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).

²⁷⁵ 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).

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.²⁷⁶ For technical reasons, using the standard deviation to measure risk will not fully capture risk if the distribution of possible returns includes a lot of extreme events.²⁷⁷ Inclusion of ESG factors may therefore provide a particular benefit to investors who are especially averse to tail risk, such as an investor who wishes to avoid large swings in portfolio value.

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*.²⁷⁸

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.²⁷⁹ 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 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.²⁸⁰

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. This point is acknowledged by supporters of ESG investing.²⁸¹ Moreover, with increasing firm-level ESG disclosure over time,²⁸² implementing an ESG screen has become less costly, which invites more competition, reducing any payoff to the strategy. Not surprisingly, most

²⁷⁶ 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.

²⁷⁷ See *id.* at 136-140.

²⁷⁸ 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 E.

²⁷⁹ See, e.g., Fidelity Launches Two ESG Index Funds, InvestmentNews, May 15, 2017, available at <http://www.investmentnews.com/article/20170515/FREE/170519951/fidelity-launches-two-esg-index-funds>.

²⁸⁰ 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).

²⁸¹ 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.

²⁸² See Dieschbourg & Nussbaum, *supra* note __.

empirical studies find that, on a risk-adjusted basis, employing ESG screens leads to performance about the same or worse than their benchmark indices.²⁸³

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.²⁸⁴ 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.²⁸⁵

In contrast to a screening strategy, stock picking focuses on applying ESG factors in constructing a portfolio of individual 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 bet 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.²⁸⁶ Eugene Fama and Kenneth French developed their model by observing 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, and additional factors have been added over time.²⁸⁷ In a similar vein, risk-return ESG investors sometimes use a multifactor model that includes ESG factors, an approach that seems to be endorsed by recent PRI publications.²⁸⁸ 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.²⁸⁹

3. The Usual Caveats About Stock Picking

We have just seen that there is both theory and some empirical evidence that ESG factors can be used by active investors to improve risk-adjusted returns. In our view, the evidence that ESG factors can be used to profit by active investing is much weaker than the evidence that ESG factors are related to firm performance. In addition,

²⁸³ 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).

²⁸⁴ See, e.g., Statman & Glushkov, *supra* note 280, at 41-2 (2009) (finding that overweighting high ESG firms can improve risk-adjusted return and avoid diversification cost of negative screen).

²⁸⁵ See Nadja Guenster, Performance Implications of SR Investing: Past versus Future, *in* *Socially Responsible Finance and Investing* (Kent Baker & John R Nofsinger eds., 2012).

²⁸⁶ 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).

²⁸⁷ See Eugene F. Fama & Kenneth R. French, A Five-Factor Asset Pricing Model, 116 *J. Fin. Econ.* 1 (2015).

²⁸⁸ See PRI Institute, *A Practical Guide to ESG Integration for Equity Investing* (2016), available at <https://www.unpri.org/download?ac=10>.

²⁸⁹ 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).

the standard caveats that apply to active investing strategies in general pertain also to ESG investing specifically. Let us highlight four of these caveats.

First, it is very hard to make money by trading in public exchanges. While the extent of market efficiency is debated, there is consensus that making money by active investing in excess of transactions costs is hard and even harder to do consistently. Only a subset of actively managed mutual funds outperform benchmark indices on a regular basis, and most actively managed funds have typically underperformed passive index funds.²⁹⁰ As the leading investments text puts it, “the easy pickings have been picked.”²⁹¹

Second, 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.²⁹² 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.²⁹³ By the same logic, risk-adjustment for active investing based on ESG could be similarly compromised. Moreover, by definition there are few tail events by which to judge the performance of ESG factors in avoiding such risks.

A particular difficulty in risk-adjustment is assessing the costs of diminished diversification.²⁹⁴ Stock picking tends to incur diversification costs, because by definition such a strategy involves a portfolio narrower than the market as a whole, and it may involve overweighting certain issues, asset classes, or industries.²⁹⁵ A diversification sacrifice is especially likely if entire industries are avoided, such as fossil fuels or tobacco, or if other volatile industries are overweighted, such as high-tech.²⁹⁶

Third, 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 trading.²⁹⁷ For 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.

²⁹⁰ See, e.g., Kenneth French, Presidential Address: The Cost of Active Investing, 63 *J. Fin.* 1537 (2008).

²⁹¹ Bodie, Kane & Marcus, *supra* note __ at 380 (“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.”).

²⁹² See, e.g., Jeremy Seigle, *Stocks for the Long Run* 49-52; 93-94 (6th ed. 2014).

²⁹³ See *supra* Part III.D.1.

²⁹⁴ See Bodie, Kane & Marcus, *supra* note __ at 194-95 (discussing diversification).

²⁹⁵ See Dylan B. Minor, Finding the Financial Cost of Socially Responsible Investing, 18 *J. Investing* 55 (2007).

²⁹⁶ 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 275.

²⁹⁷ See Malkiel, *supra* note 265, at 137, 143, 145, 150, 156.

Fourth, 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, diminishing the benefits to the strategy.²⁹⁸ Likewise, academic studies that find asset mispricing often fail to translate into a profitable trading strategies, an unsurprising result given the public nature of an academic finding,²⁹⁹ the tendency to overstate the magnitude and significance of mispricing owing to publication bias,³⁰⁰ 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.³⁰¹

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. 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.³⁰² 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.³⁰³

4. Contrarian and Anti-ESG Strategies

The same conceptual logic that motivates active investing via ESG factors – identifying a mispriced asset and then trading to profit from the mispricing – could alternatively support a contrarian, anti-ESG investment strategy. There is 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.³⁰⁴ There is also evidence that so-called “sin” or “vice” stocks outperform on a risk-adjusted basis because of investor distaste for the company’s

²⁹⁸ See *supra* note 265.

²⁹⁹ See R. David McLean & Jeffrey Pontiff, Does Academic Research Destroy Stock Return Predictability?, 71 *J. Fin.* 5, 8 (2016).

³⁰⁰ 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).

³⁰¹ See PRI Academic Network: RI Quarterly, *supra* note 281, at 4-5.

³⁰² See *supra* Part III.A.

³⁰³ See *id.*

³⁰⁴ See Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, Contrarian Investment, Extrapolation, and Risk, 49 *J. Fin.* 1541 (1994); Malkiel, *supra* note 265, at 267-68.

products or practices.³⁰⁵ For example, a trustee might reasonably conclude that the market has overreacted to negative ESG factors for a tobacco or oil company, 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 due to investor distaste. 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,³⁰⁶ 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.

E. ESG Factors in Active Shareholding

Another active strategy is to use shareholder control rights or engagement with management to improve firm value. We call this approach *active shareholding*, in contrast to active investing via screens or stock picking (others call it *stewardship*³⁰⁷). By way of illustration, a firm's board may become complacent or might propose changes to the corporate structure that would entrench current management (such as a classified board). Voting against lazy directors or entrenchment can protect firm value.

In contrast to stock picking, active shareholding seeks to improve corporate policies or prevent bad decisions, allowing the active shareholder to reap the reward of improved or at least protected share prices later. 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. Even index fund managers can engage in active shareholding. BlackRock and Vanguard, for example, explicitly identify ESG factors in their proxy voting guidelines.³⁰⁸

Active shareholding has increased significantly over the past two decades,³⁰⁹ in part facilitated by regulatory reforms and increasing institutional ownership that facilitates monitoring and coordination among shareholders.³¹⁰ Much of this activity has been focused on governance factors, such as reducing management entrenchment and

³⁰⁵ See, e.g., Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets*, 93 *J. Fin. Econ.* 15 (2007).

³⁰⁶ 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").

³⁰⁷ See, e.g., Hermes Investment Management, *EOS Stewardship Services*, <https://www.hermes-investment.com/us/stewardship/>.

³⁰⁸ 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/>.

³⁰⁹ 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).

³¹⁰ See, e.g., David Yermack, *Shareholder Voting and Corporate Governance*, 2 *Ann. Rev. Fin. Econ.* 103 (2010)

executive pay. But there is also growing attention to social and environmental factors such as diversity in board composition and “climate risk and the environment.”³¹¹ 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.³¹²

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,³¹³ and incumbent directors often resign if a large number of votes are withheld.³¹⁴ Informal engagement, which may be combined with proxy contests, withholding votes, or the threat of either or both, is commonly used and also affects corporate policies.³¹⁵

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,³¹⁶ as acknowledged by the PRI.³¹⁷

True, 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.³¹⁸ 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.³¹⁹

³¹¹ Ernst & Young, *supra* note __.

³¹² See PRI, *Does ESG Pay Off Financially?*, *supra* note __ at 4 (noting likelihood of market prices adjusting to ESG factors and consequent need for “active ownership strategies”).

³¹³ 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).

³¹⁴ 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).

³¹⁵ 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).

³¹⁶ See Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 *J. L. & Econ.* 395 (1983).

³¹⁷ See PRI, *Does ESG 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”).

³¹⁸ 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).

³¹⁹ 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

But a low-cost approach may be insufficient to defeat a management proposal, remove a director, or pass a shareholder resolution.³²⁰ 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.³²¹ An investor could wage an outright proxy fight, soliciting all shareholders to vote in agreement with the investor. But this involves paying the costs of a proxy contest,³²² and incumbent directors have powerful incumbency advantages.³²³ A more aggressive but more expensive tactic is to increase the investor's voting power such as by borrowing shares from other shareholders and voting them.³²⁴ Most daringly, an activist shareholder could identify poorly governed firms or firms with high environmental and social risks, purchase a block share, and try to change firm practices.³²⁵ The costs of these more aggressive approaches must be weighed against their expected benefits.

The evidence is mixed on whether active shareholding, even by institutional investors, in fact improves firm value.³²⁶ Successful shareholder proxy fights have been found to improve firm value,³²⁷ but this approach is costly and risky, and unsuccessful fights can decrease firm value.³²⁸ Shareholder proposals and informal negotiations have, at most, very small positive effects on firm performance, with some studies finding

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).

³²⁰ 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.

³²¹ *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).

³²² 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 315.

³²³ *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 319, at 2911-2912.

³²⁴ *See* Henry T.C. Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 *S. Cal. L. Rev.* 811, 823-40 (2005); *see also* Yermack, *supra* note 310, at 112-14.

³²⁵ *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).

³²⁶ *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 310, at 118.

³²⁷ *See* Denes, Karpoff & McWilliams, *supra* note 326, at 407.

³²⁸ *See id.*

negative effects.³²⁹ 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 they are less regulated than other investment vehicles.³³⁰

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, and it could dull managerial incentives while reducing the quality of managerial decision making.³³¹ It may also direct scarce managerial resources to implementing shareholder proposals or contesting elections.³³² That even a sophisticated shareholder will be a better decisionmaker than management is hardly a forgone conclusion. Shareholders, as well as management, can be wrong and indeed may be so more often. The corporate form, which separates ownership and control, is an efficient form of enterprise organization in part for this very reason.

Trust investment law, which emphasizes the need for a documented analysis of costs and benefits updated periodically, accommodates uncertainty about the viability of active shareholding for generating excess risk-adjusted returns. As the DOL has observed, a trustee should “vote proxies on issues that may affect the value of the plan’s investment,” but only if the “expected ... effect on the value of the plan’s investment ... warrants the ... cost of voting.”³³³ A trustee could likewise undertake other forms of shareholder engagement with management if the trustee “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

F. ESG Investing is Permissible but Not Mandatory

Risk-return ESG is conceptually no different from any other form of active investment. And a fair reading of the current theory and evidence admits of the possibility that risk-return ESG could financially benefit beneficiaries. However, this will not necessarily be true in a given case. Whether a particular trustee’s specific program of risk-return ESG investing is prudent is a contextual and fact-driven question, one that will turn on the quality of the fiduciary’s particular skills, its documented analysis, and

³²⁹ See id. 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).

³³⁰ See Yermack, *supra* note 310, at 118-119.

³³¹ See Pierre Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 *J. Pol. Econ.* 1 (1997); Mike Burkart, Denis Gromb & Fausto Panunzi, *Large Shareholders, Monitoring, and the Value of the Firm*, 112 *Q. J. Econ.* 693 (1997).

³³² See Yermack, *supra* note 310, at 119 (expressing particular concern about “socially oriented shareholder proposals”).

³³³ 81 *Fed. Reg.* at 95883.

³³⁴ *Id.* at 95880.

its ongoing assessments of the strategy.³³⁵ In other words, risk-return ESG is within the universe of investment strategies that could plausibly be prudent for a trustee – just like contrarian investing, passive investing, and a host of others. The standards applicable to ESG investing by a trustee are, in the words of the DOL, “no different [from] the standards applicable to [fiduciary] investments generally.”³³⁶

Although we conclude that a trustee *could* engage in risk-return ESG investing, we reject as contrary to both law and sound policy the view suggested by the PRI and others (but not the DOL³³⁷) that a trustee *must* consider ESG factors.³³⁸ We would draw this conclusion no matter how strong the evidence in favor of ESG investing.

As a matter of law, the explicit doctrinal underpinning of the prudent investor rule is that “[s]pecific investments or techniques are not per se prudent or imprudent.”³³⁹ 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.”³⁴⁰ Under the prudent investor rule, therefore, there are no categorical rules of permissible or impermissible investments.

The rejection of categorical rules under the prudent investor rule reflects its purpose of abrogating the constraints of the prior prudent man rule, which had favored conservative investment and disfavored other investments as speculative, and to align the law of prudent trust investment with modern portfolio theory.³⁴¹ The prudent investor rule permits a trustee to undertake any type or kind of investment so long as the resulting overall portfolio is diversified and its overall risk and return align with the terms and purposes of the trust.³⁴² Ironically, it is the flexibility of the prudent investor rule that allows a trustee to consider ESG factors. The prudent investor rule was meant to get courts and legislatures out of the business of prescribing specifically what investments would and would not be prudent in all cases.

Setting aside the deep doctrinal flaw that the prudent investor rule does not mandate any particular kind of investment strategy, there is also a practical difficulty that the ESG rubric is too fluid, and the application of ESG factors too subjective, to lend itself to a mandate. 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

³³⁵ See *supra* Part III.A.

³³⁶ 80 Fed. Reg. at 65137.

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 22-24 and *infra* note 347 and text accompanying.

³³⁹ Restatement (Third) of Trusts § 90 cmt. f(2) (Am. Law Inst. 2007).

³⁴⁰ Unif. Prudent Inv’r Act § 2(b), (e) (Unif. Law Comm’n 1994).

³⁴¹ See *supra* note __ and text accompanying.

³⁴² See Unif. Prudent Inv’r Act pref. note (Unif. Law Comm’n 1994) (“All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.”).

an investor's perspective, and how much weight to give to different ESG factors.³⁴³ 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;³⁴⁴ both favoring or disfavoring nuclear power;³⁴⁵ or both requiring only one woman or requiring at least three women on a board.³⁴⁶ The subjectivity inherent to ESG investing, and the fluidity of the ESG rubric, casts a pall over the practical feasibility of a mandate

So what has led commentators to conclude that ESG investing is mandated by the duty of prudence? 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 prudence requires a trustee to consider material information; and (3) therefore a trustee must consider ESG factors.³⁴⁷

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.³⁴⁸ 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.

³⁴³ See *supra* Part III.B.

³⁴⁴ See *supra* notes 238-239, __-__ and text accompanying.

³⁴⁵ See *supra* note __-__ and text accompanying.

³⁴⁶ See *supra* note __-__ and text accompanying.

³⁴⁷ 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 *Env'tl. 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 Term, *supra* note __ ("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.").

³⁴⁸ An error made by the GAO as well. See *supra* note __.

³⁴⁹ See *supra* Part III.D.

³⁵⁰ See *supra* Part III.E.

As we have seen, this conclusion finds abundant theoretical and empirical support in the finance literature.³⁵¹ It has also been embraced for ERISA trustees by the Supreme Court:

[W]here a stock is publicly traded, allegations that a fiduciary should have recognized from publicly 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

A deep irony is that alongside the push for active ESG investing, there is a contradictory but growing movement that urges fiduciaries to avoid active strategies on grounds of cost.³⁵³

Yet 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 active shareholding. But passive investing, a widely employed strategy, is universally understood to be a permissible fiduciary investment strategy and, in certain contexts, a superior approach.³⁵⁴ 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 trustee “could reasonably” conclude that she had “little hope of outperforming the market,” and therefore “prudently rely on the market price.”³⁵⁵

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.³⁵⁶ Indeed, on the logic of the PRI and others that a trustee 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

³⁵¹ See supra note __ and text accompanying.

³⁵² Dudenhofer, 134 S.Ct. at 2471 (citations and quotations omitted).

³⁵³ See, e.g., 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).

³⁵⁴ See, e.g., Restatement (Third) of Trusts § 90 cmt. h(1) (Am. Law Inst. 2007).

³⁵⁵ Dudenhofer, 134 S.Ct. at 2471.

³⁵⁶ See supra Part III.D.4.

bet for (or against) those factors for the same reasons that a trustee could decide not to bet on other factors found to be correlated with stock returns, such as hemline lengths, the Super Bowl winner, or the month of the year.³⁵⁷ 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.³⁵⁸

Let us conclude with a word about time horizon. A key part of the argument that a trustee must rely on ESG factors is that those factors better assess long-term risk.³⁵⁹ But not all trusts have a long-term time horizon. To the contrary, some trust accounts, such as 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 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.

Moreover, 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. Mandating such a bet therefore assumes both mispricing in one direction and that this mispricing will persist indefinitely. 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.

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.”³⁶⁰

Conclusion

We have considered the law and economics of ESG investing by a trustee of a pension, charity, or personal trust. Our core takeaway conclusions are two. First, risk-return ESG investing is permissible by a trustee on the same terms as any other active investing strategy – no more and no less. Second, the duty of loyalty prohibits collateral benefits ESG as a mandatory rule under ERISA and as a default rule in charities and personal trusts.

³⁵⁷ See Malkiel, *supra* note 265, at 146-51.

³⁵⁸ See *supra* Part III.D.3.

³⁵⁹ 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 Term*, *supra* note __ at (“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.

³⁶⁰ Dudenhofer, 134 S.Ct. at 2471.

Accordingly, a trustee who reasonably concludes that reliance on ESG factors will provide risk and return benefits, and is solely motivated by this possibility, should have no hesitation in using them. But the evidence in favor of ESG investing is hardly one-sided. A prudent and loyal trustee could alternatively conclude that a contrarian, anti-ESG investment strategy is sound. Or a prudent and loyal trustee could conclude that she cannot beat the market, and therefore should pursue a passive strategy.

Our conclusions rest on four simple but clarifying contributions to the literature: (1) a disentangling of risk-return ESG from collateral benefits ESG; (2) a sober assessment of the current theory and empirical evidence on whether ESG investing can provide superior risk-adjusted returns at present or in the long run; (3) a rejection of the growing claim that risk-return ESG is or ought to be mandatory for a trustee; and (4) an assessment of how charitable purpose and authorization in personal trusts tempers the sole interest rule. Each of these contributions resolves an important piece of the profound confusion in the ongoing debate in law and policy over ESG investing by a trustee.

Because so much of the debate has centered on the claim that ESG investing can provide superior risk-adjusted returns, we emphasize our conclusion 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 conflated a relationship between ESG factors and firm value with a profit making opportunity for an investor, have exaggerated the potential for ESG factors 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 conclude that our positive description of the law reflects normatively sound policy choices in light of the agency costs of managing other people's money. The sole interest rule of trust fiduciary law prohibits a trustee from considering the trustee's own social conscience, just as it prohibits consideration of the trustee's own financial or political interests or those of third parties. The fiduciary duty of prudence not only protects against negligence but also backstops the duty of loyalty by requiring a trustee to have a documented, reasonable basis for the trustee's investment (and other) decisions and to update that analysis periodically. At the same time, the sole interest rule's prohibition of collateral benefits ESG is tempered by the availability of settlor or beneficiary authorization in a private trust, by overlap between a charity's purpose and a "collateral" benefit, and by the option for the creator of a charity to organize it as a corporation (with a best interest rule) rather than a trust.

A pension plan, by contrast, could have thousands of beneficiaries with limited voice and exit rights. In such circumstances, untethering a trustee from the objective metric of financial returns may enable the trustee to pursue his own preferences to the detriment of the beneficiaries. Even if the trustee wanted to pursue beneficiary preferences, aggregating those preferences would be costly, if not impossible. Moreover, the public policy underpinning pension fiduciary law and the generous tax subsidies for pension and retirement saving is to safeguard the financial security of retired workers,

protecting them against making imprudent investment and spending decisions earlier in life. Under these circumstances, the Supreme Court's interpretation of ERISA to mandate that a pension trustee consider solely the financial interests of the beneficiaries reflects not just the text of the statute but also sound public policy.