July 30, 2020

Office of Regulations and Interpretations
Employee Benefits Security Administration
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC  20210

Re:  Financial Factors in Selecting Plan Investments Proposed Regulation
RIN 1210AB95

Dear Sir or Madam:

We are writing in response to the above referenced proposed rulemaking by the Department of Labor (the “Department”) on financial factors in selecting plan investments (the “Proposal”), in particular environmental, social, and governance factors (“ESG”).

This response is based on our expertise in ESG investing, especially ESG investing by trustees and other fiduciaries. We have undertaken several years of scholarly study of ESG investing by fiduciaries, and recently published our conclusions in “Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee,” 72 Stanford Law Review 381 (2020) (“ESG Investing by a Trustee”). We enclose copy of ESG Investing by a Trustee as Exhibit A. In a consulting capacity for Federated Hermes, Inc., moreover, we have prepared several white papers and videos and conducted training sessions on ESG investing for trustees and other fiduciary investors.

Introduction

In general, we are supportive of the Proposal’s central purpose of subjecting ESG investing to the same fiduciary principles of loyalty and prudence that are applicable to any type or kind of investment. For the reasons elaborated in ESG Investing by a Trustee,
doing so is consistent with the fiduciary principles codified by the Employee Retirement Income Security Act ("ERISA"), with the case law interpreting ERISA, and with the background common law of trusts.1

We do, however, have some criticisms of the Proposal. Our aim is to offer these criticisms constructively to assist the Department in revising the Proposal toward a final rule. The thematic point that underpins most of our comments is that the law neither favors nor disfavors ESG investing. Any investment decision by an ERISA trustee or other fiduciary—whether in the context of a direct investment, shareholder engagement (including proxy voting), or menu construction, and whether reliant on ESG factors or otherwise—is subject to the same fiduciary principles embodied in the duties of loyalty and prudence.

As interpreted by the Supreme Court, the ERISA fiduciary duty of loyalty requires a trustee or other fiduciary to be motivated solely by providing financial benefits to the plan participants.2 The ERISA fiduciary duty of prudence as applied to investment matters is elaborated by the prudent investor rule and, as interpreted by the Supreme Court, aligns with ordinary trust law.3 The prudent investor rule requires the trustee or other fiduciary to assess risk and return, diversification, and costs while documenting its decisions and undertaking ongoing monitoring thereafter, making adjustments to the investment program as circumstances require. The statute requires neutral application of these principles of loyalty and prudence to all investment decisions, whether ESG or otherwise. Indeed, one of the key advances of the prudent investor rule was eschewing presumptions for or against any particular type or kind of investment strategy or vehicle.4 Neutral application of fiduciary principles also avoids the morass of defining with precision what activities fall within and without the rubric of ESG investing.

We believe that the Department agrees that background law subjects all types or kinds of investment strategies or vehicles, whether ESG or otherwise, to the same principles of loyalty and prudence. In the words of the Proposal:

The duty of loyalty—a bedrock principle of ERISA, with deep roots in the common law of trusts requires those serving as fiduciaries to act with a single-minded focus on the interests of beneficiaries. And the duty of prudence prevents a fiduciary from choosing an investment alternative that is financially less beneficial than an

---

1 *ESG Investing by a Trustee* elaborates on our analysis in this letter and provides extensive supportive citation to relevant literature and authority.
4 See Unif. Prudent Inv’r Act § 2(e) & cmt. (Unif. Law Comm’n 1994) ("no particular kind of property or type of investment is inherently imprudent"); Restatement (Third) of Trusts § 90 cmt. f (Am. Law Inst. 2007) ("Specific investments or techniques are not per se prudent or imprudent.").
available alternative. *These fiduciary standards are the same no matter the investment vehicle or category.*

Nevertheless, in certain respects the Proposal departs from the foregoing principle of neutrality that “fiduciary standards are the same no matter the investment vehicle or category.” Our chief criticisms, which may be summarized as falling into two categories, generally reflect instances in which the Proposal differentiates or could be construed as differentiating ESG investing from other types or kinds of investment strategies:

- **First**, the Proposal and accompanying commentary could be read to suggest that all manner of ESG investing is inherently suspect, presumably on fiduciary loyalty grounds, and therefore that ESG investing by an ERISA trustee or other fiduciary is always subject to enhanced scrutiny that requires extra process relative to other types of kinds of investment strategies. Such a position is inconsistent with law and sound policy. Use of ESG factors in pursuit of enhanced risk-adjusted returns (what we call “risk-return ESG”) does not categorically trigger a loyalty concern. And the rigor of the duty of prudence applies equally to all modes of investing, whether ESG or otherwise. Departure from neutral application of fiduciary principles also requires drawing distinctions between ESG investing and other investing, a definitional morass that would create uncertainty and invite litigation.

- **Second**, portions of the commentary are unclear or phrased in a manner that could be construed as taking positions, such as with respect to active versus passive investing, that are not consistent with neutral application of the principles of fiduciary investment law. The commentary is also notable for not addressing certain other relevant matters, such as the use of ESG factors in shareholder engagement (sometimes called “stewardship” or “active shareholding”). We identify material instances of such language or omissions and urge appropriate clarification, including to the “tiebreaker” rule for purportedly identical investments.

Finally, anticipating that some commentators may urge the Department to mandate ESG investing, we draw the Department’s attention to the more extensive analysis of that issue in *ESG Investing by a Trustee*, in which we conclude that such a mandate would be contrary to law and sound policy.\(^6\)

\(^{5}\) 85 Fed. Reg. at 39116 (emphasis added).

\(^{6}\) See *ESG Investing by a Trustee* at pp. 448-53.
“ESG investing” resists precise definition. Roughly speaking, it is an umbrella term that refers to an investment strategy that emphasizes a firm’s governance structure or the environmental or social impacts of the firm’s products or practices.

The original motives for ESG investing were moral or ethical, based on third-party effects rather than investment returns (earlier called “socially responsible investing” or “SRI”). More recently, some have asserted that ESG investing could improve risk-adjusted returns, thereby providing a direct benefit to investors. For example, instead of avoiding the fossil fuel industry to achieve collateral benefits from reduced pollution, ESG proponents argued that the fossil fuel industry should be avoided because financial markets underestimate its litigation and regulatory risks, and therefore divestment would improve risk-adjusted return. On this view, ESG investing can be a kind of profit-seeking, active investing strategy. ESG investing may also be implemented via shareholder engagement such as via proxy voting or direct contact with management.

The term “ESG investing” is thus inherently ambiguous as to motive. It can refer either to investing for collateral benefits (classic SRI) or investing to improve risk-adjusted returns (rebranded ESG), and it is widely and confusingly used in the marketplace today to encompass both. In ESG Investing by a Trustee, we clarify the umbrella term ESG investing by differentiating it into two categories. We refer to ESG investing for moral or ethical reasons or to benefit a third party, what had been called SRI, as collateral benefits ESG. We refer to ESG investing for risk and return benefits—that is, to improve risk-adjusted returns—as risk-return ESG. Differentiating between collateral benefits ESG and risk-return ESG provides taxonomic clarity by emphasizing motive—a crucial consideration under ERISA fiduciary law.7

As noted above, the Supreme Court has interpreted the ERISA fiduciary duty of loyalty to require an exclusive focus on plan participants’ financial benefits. Because by definition collateral benefits ESG does not solely consider financial benefits for plan participants, it is plainly impermissible under the ERISA fiduciary duty of loyalty. As such, we generally endorse the Proposal’s proscription of use of ESG factors for other than pecuniary reasons. In the words of the Department:

The fundamental principle is that an ERISA fiduciary’s evaluation of plan investments must be focused solely on economic considerations that have a material effect on the risk and return of an investment based on appropriate investment horizons, consistent with the plan’s funding policy and investment policy objectives. The corollary principle is that ERISA fiduciaries must never

---

7 As explained in ESG Investing by a Trustee at pp. 398-99, the distinction is also meaningful as a matter of financial economics, given the tension between increasing risk-adjusted returns while obtaining collateral benefits from increasing a firm’s cost of capital.
sacrifice investment returns, take on additional investment risk, or pay higher fees to promote nonpecuniary benefits or goals.\textsuperscript{8}

Risk-return ESG, by contrast, is consistent with the ERISA fiduciary duty of loyalty, because by definition its motive is to improve risk-adjusted returns (i.e., pursuit of financial benefits for the plan participants). However, all investment strategies, whether ESG or otherwise, must also satisfy the duty of prudence. As such, we generally endorse the Proposal’s application of prudence principles to the use of risk-return ESG. In the words of the Proposal, “the Department intends, by this proposal, to reiterate and codify long-established principles of fiduciary standards for selecting and monitoring investments.”\textsuperscript{9}

In materials prepared in a consulting capacity for Federated Hermes, Inc., we illustrated the power of the risk-return/collateral benefits dichotomy by way of case studies of fund prospectuses thus:\textsuperscript{10}

- **Fund A**: “Our investment objective is to seek the highest total return consistent with our prescribed environmental criteria. We seek to invest in companies that have positive environmental impacts and avoid companies with negative environmental impacts. These environmental criteria exclude securities of certain issuers for nonfinancial reasons.”

- **Fund B**: “Our investment objective is to seek the highest level of current income consistent with generating environmental benefits via investment in so called ‘green bonds’ that finance projects that will have positive environmental impacts.”

- **Fund C**: “Our investment objective is to seek the highest total return. We employ a responsible and sustainable investing philosophy that aligns with environmental, social, and governance values. We integrate ESG factors into our fundamental analysis to identify investment opportunities, manage risk, and pursue alpha, and we integrate ESG factors into proxy voting guidelines to minimize risk and maximize return.”

- **Fund D**: “Our investment objective is to maximize total return consistent with environmental, social, and governance values. We invest across Funds A, B, and C, allocating among them in light of our analysis, which integrates ESG factors.”

Because funds A and B consider nonfinancial effects—in particular, both give consideration to environmental impacts without connection to risk and return—they employ collateral benefits ESG and therefore are impermissible under the ERISA fiduciary

\textsuperscript{8} 85 Fed. Reg. at 39116.

\textsuperscript{9} Id. at 39116.

\textsuperscript{10} See Max M. Schanzenbach & Robert H. Sitkoff, “Use of ESG Factors in ERISA Menu Construction,” enclosed as Exhibit B, on which this discussion freely draws.
duty of loyalty. Fund C, by contrast, integrates ESG factors for the purpose of improving risk-adjusted returns, what in our dichotomy is risk-return ESG, hence C is permissible under the ERISA fiduciary duty of loyalty (but remains subject to the fiduciary duty of prudence). Fund D invests variously in funds A, B, and C. Because fund D includes collateral benefits ESG to some extent (via its investment in A and B), D is impermissible under the ERISA fiduciary duty of loyalty. On our reading of the Proposal, the Department would agree with our analysis of these case studies.

Risk-Return ESG is Not Inherently Suspect

As elaborated by the prudent investor rule, the ERISA fiduciary duty of prudence requires portfolio-level attention to risk and return objectives reasonably suited to the purpose of the account, diversification, cost-sensitivity, documentation, and ongoing monitoring.11 These principles apply neutrally to any investment decision by a trustee or other fiduciary, whether in the context of a direct investment, shareholder engagement (including proxy voting), or menu construction. Provided that the trustee or other fiduciary’s motive is pursuit of financial benefits for the plan participants, the fiduciary principles arising under the duty of prudence apply neutrally regardless of whether the trustee or other fiduciary relied on ESG factors.

Accordingly, although we generally endorse the Proposal’s application of prudence principles to use of ESG factors for pecuniary reasons (what we call risk-return ESG), we are troubled by language in the commentary and the proposed rule that could be construed as requiring application of differing or more rigorous prudence principles to ESG investing relative to other types of kinds of investment strategies.

For example, although at one point the commentary states that the “fiduciary standards” of loyalty and prudence “are the same no matter the investment vehicle or category,”12 at another point it states that “ESG investing raises heightened concerns under ERISA.”13 To be sure, we would agree that if in a given case there was evidence or specific circumstances from which to infer disloyalty, then the prohibitory rules under the duty of loyalty would apply in addition to the regulatory rules under the duty of prudence. However, we cannot agree that, as a general proposition, all investment activity broadly falling within the rubric of “ESG investing” is or should be subject to “heightened” or any other kind of different fiduciary standards. There is no basis in the statute for such a differentiation.

To the contrary, a central contribution of the prudent investor rule—both under ERISA and the Restatement and Uniform Prudent Investor Act (to which the Supreme

11 We canvass the relevant principles in ESG Investing by a Trustee at pp. 426-30.
13 Id. at 39115.
Court has looked in interpreting ERISA)—is to eschew picking and choosing among investment vehicles or categories. The prudent investor rule prescribes neutral principles that require portfolio-level attention to risk and return objectives reasonably suited to the purpose of the account, diversification, cost-sensitivity, documentation, and ongoing monitoring.

More concerning, subsection (c)(1) of the proposed rule could be construed as imposing additional requirements for ESG investing not otherwise applicable to other types or kinds of investment strategies:

Fiduciaries considering environmental, social, corporate governance, or other similarly oriented factors as pecuniary factors are also required to examine the level of diversification, degree of liquidity, and the potential risk-return in comparison with other available alternative investments that would play a similar role in their plans’ portfolios.

These criteria ordinarily would apply to all modes of investment, whether involving ESG or otherwise, via subsection (b)(2) and background prudent investor principles. By identifying these criteria separately in subsection (c)(1) as “also” factors and tying them exclusively to “environmental, social, corporate governance, or other similarly oriented factors,” the proposed rule could be construed as applying these criteria uniquely (or at least more rigorously) to ESG and “other similarly oriented” investment strategies. In all events, we hasten to add that, owing to search costs and the infinite number of potential portfolios, the obligation to consider “other available alternatives” should be understood to require consideration of a reasonable number of alternatives. As the Seventh Circuit has noted, “nothing in ERISA requires every fiduciary to scour the market.”

We acknowledge that trust fiduciary law recognizes that there are circumstances, mainly authorized conflicts of interest, that call for enhanced scrutiny of the substance of fiduciary’s decision. But we are unaware of any authority in fiduciary investment law, ERISA or otherwise, for categorically subjecting a particular type or kind of investment strategy to different and more rigorous principles of prudence. In this respect the Proposal appears in effect to presume without foundation that, in spite of the theory and evidence that allows for the possibility of enhanced risk-adjusted returns from ESG investing, any investment involving an ESG consideration is tainted by hidden disloyal motives.

---

14 See supra note 4.
15 We canvass the relevant principles in ESG Investing by a Trustee at pp. 426-30.
16 85 Fed. Reg. at 39127 (emphasis added).
17 Hecker v. Deere & Co., 556 F.3d 5575, 586 (7th Cir. 2009).
19 We canvass the theory and evidence in ESG Investing by a Trustee at pp. 433-48.
We appreciate that some may harbor doubt about the true motives of a trustee or other fiduciary. In particular, statements about risk and return, or “doing well by doing good,” could be pretextual assertions of motive or purpose via cheap talk. Concerns over hidden motives, however, are not unique to ESG investing. Fiduciary investment law addresses these concerns through the rigor of the duty of prudence, which requires that a trustee’s investment decisions to be supported by a documented reasonable analysis and subject thereafter to ongoing monitoring. If an investment strategy (whether ESG or otherwise) fails to yield its promised benefits, if other strategies present new opportunities, or if quantitative analysis of ESG factors changes, under the duty of prudence the trustee or other fiduciary will have to adapt accordingly.

A pragmatic concern also militates strongly in favor of adhering to the principle, expressed elsewhere in the commentary, that “fiduciary standards” of loyalty and prudence “are the same no matter the investment vehicle or category.” By prescribing principles applicable uniquely to ESG investing, the rule creates uncertainty and invites litigation over whether a given investment program falls within the ESG rubric—a problem that is aggravated by the fluidity and plasticity of the term “ESG investing.” As the Department recognized in the Proposal, ESG and related “terms do not have a uniform meaning and the terminology is evolving.” To take one example, virtually all mutual funds have proxy voting guidelines that consider corporate governance factors. Does this mean that those funds would fall within the “also” rules of subsection (c)(1) by virtue of their consideration of “G” factors?

All told, apart from inconsistency with the statute, we see no practical benefit to offset the uncertainty and litigation costs of creating separate categories of investment with different applicable principles. We would therefore urge revision to (c)(1) to focus on prohibiting non-pecuniary goals; to apply that rule to all investment strategies, whether ESG or otherwise; and not to state additional (“also”) principles of prudence that would apply uniquely to ESG or “similarly oriented factors.”

The foregoing analysis pertains to subsection (c)(3)(i)-(ii), which likewise could reasonably be construed as prescribing additional or different requirements for use of ESG factors in menu construction. We agree that in constructing a prudent menu for plan participants to choose from, an ERISA trustee or other fiduciary should consider “objective risk-return criteria, such as benchmarks, expense ratios, fund size, long-term investment returns, volatility measures, investment manager investment philosophy and experience, and mix of asset types” (per (c)(3)(i)) and should “document[] its selection and monitoring” processes (per (c)(3)(iii)). However, subsection (c)(3)(i)-(ii) ties those criteria specifically to funds that use “environmental, social, corporate governance, or similarly oriented assessments,” rather than unambiguously applying them neutrally to all menu

21 Id. at 39114.
construction, whether ESG or otherwise. Thus, the rule as currently drafted could be read to diminish fiduciary obligations for non-ESG investment strategies by implying that long-standing principles of prudent investing do not apply to them.

The foregoing analysis also pertains to subsection (c)(3)(iii), which excludes funds that use ESG or “similarly oriented” factors from inclusion as a Qualified Default Investment Account. In this instance, the Proposal unambiguously subjects ESG investing to a different rule than other modes of investing. Such a differentiation is not supported by the statute, is contrary to the nature of the prudent investor rule (which was meant to eschew per se categories), and invites uncertainty and litigation over whether a given investment strategy falls within the ESG investing rubric.

Suggested Clarifications

Shareholder Engagement (i.e., Active Shareholding or Stewardship). We read the Proposal, both the commentary and the proposed rule, as speaking primarily to fund or asset selection, as compared to shareholder engagement. However, as we discuss in ESG Investing by a Trustee, shareholder engagement is an increasingly common and rapidly growing area of ESG investing. Indeed, the theory and evidence in support of ESG factors in shareholder engagement is at least as strong as that in support of active investing. In our view, the same principles of prudence applicable to fund or asset selection apply to shareholder engagement, in particular cost sensitivity. We would therefore apply the rule also to shareholder engagement. At a minimum, we urge that the Department clarify its intent about the applicability of the Proposal to engagement activities generally, and the relationship of the rule to earlier sub-regulatory guidance on proxy voting specifically. But the better outcome would be to apply the rule to shareholder engagement, that is, to confirm that the same neutral principles of loyalty and prudence apply equally to all shareholder engagement, ESG or otherwise.

Active versus Passive Investing. There is language in the commentary that could be construed as expressing a preference for passive index funds relative to actively managed funds. Specifically, the commentary suggests that a shift from ESG investing may lead to more investment in “mutual funds with lower fees or passive index funds,” and in consequence, “the societal resources freed for other uses due to lessened active management … would represent benefits of the rule.” Canonical authority and case law under ERISA, however, recognizes that a trustee may employ active management strategies, such as picking and choosing among different investments. "Prudent

---

22 See ESG Investing by a Trustee at pp. 444-48.
24 See Restatement (Third) of Trusts § 90 cmt. e(1) (Am. Law Inst. 2007); Davis v. Washington University in St. Louis, 960 F.3d 478, 485 (8th Cir. 2020) (“It is true that some analysts think it is better for investors to put their money in real estate investment trusts rather than real estate itself. And it might even be better still to do
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.”25 Under the prudent investor rule, the question is whether the costs associated with a given active strategy are outweighed “by realistically evaluated return expectations.”26

“Generally Accepted Investment Theories.” The Proposal references “generally accepted investment theories,” both in the commentary and in subsection (c)(1) of the proposed rule. By this term we understand the Department to be referencing the objective and relational nature of the duty of prudence, and not an intent to freeze investment practice as of the date of the rule. A key clarification, therefore, would be to explain that a soundly reasoned and supported strategy can be prudent, leaving room for innovation and improved models of asset pricing.27

In all events, in accordance with our discussion above, we would revise the portion of subsection (c)(1) that references “generally accepted investment theories” to apply to all investment considerations. That is, all factors, whether ESG or otherwise, should be subject to the same requirements to qualify as a “pecuniary” factor (i.e., “only if they present economic risks or opportunities that qualified investment professionals would treat as material economic considerations under generally accepted investment theories”).

“Economically Indistinguishable Investments.” For the reasons given in ESG Investing by a Trustee, we believe that the statute does not allow for fiduciary reliance on a nonpecuniary factor even in the case of “economically indistinguishable investments.”28 Setting this disagreement to the side, we believe subsection (c)(2) is a clarifying step forward from the Department’s prior sub-regulatory guidance. Crucially, by allowing a trustee or other fiduciary to rely on a non-pecuniary benefit, the rule of subsection (c)(2) involves a potential conflict of interest and so the duty of loyalty. For this reason, as noted above heightened scrutiny would be consistent with traditional principles of trust fiduciary law.29

To clarify the operation of subsection (c)(2), however, we would urge further commentary and perhaps reworking of the text. We understand “economically indistinguishable investments” to mean two investments that have the same risk and return attributes. But economic equivalence requiring a tie-breaker in liquid markets is all

---

25 Restatement (Third) of Trusts § 90 cmt. h(2) (Am. Law Inst. 2007).
26 Id.
28 See ESG Investing by a Trustee at pp. 408-11.
29 See supra note 18 and text accompanying.
but impossible. The risk of any two assets, even if identical on some risk metric, will nonetheless not be perfectly correlated. Thus, if there is no liquidity constraint and trading costs are low, textbook financial economics teaches that in the event of two economically equivalent investments so defined, the investor should buy both of them and achieve improved diversification. Under the portfolio-as-a-whole standard, as required by the prudent investor rule (and subsection (b)(2)(ii)(A) of the proposed rule), so-called “economically equivalent investments” do not exist in liquid financial markets.

Outside of liquid financial markets, a claim of economically indistinguishable investments must turn on a liquidity or transaction cost explanation. In other words, there must be some reason why the fiduciary cannot make both investments and thereby achieve improved diversification. In such circumstances, putting the burden on the trustee or other fiduciary to justify a finding of economic equivalence necessitating a non-pecuniary tie-breaker is an appropriate policy response.

To this we would urge an additional requirement, consistent with the policy values of the duty of loyalty, that the non-pecuniary tie-breaker be related to the interests of the plan participants, as compared to the personal views of the trustee or other fiduciary.

**ESG Investing Cannot be Mandatory**

Finally, anticipating that some commentators may urge the Department to mandate ESG investing, we draw the Department’s attention to the more extensive analysis of that issue in *ESG Investing by a Trustee*, in which we conclude that such a mandate would be contrary to law and sound policy.\(^30\)

In brief, with respect to law, the great innovation of the prudent investor rule was to eschew categorical rules of permissible or impermissible investments. There is no basis in the statute or background trust investment law to privilege or mandate a particular type or kind of investment strategy. As a matter of policy, there is the practical difficulty that the ESG rubric is too fluid, and the application of ESG factors too subjective, to lend itself to a mandate. Moreover, even if an investment strategy works now, there is no guarantee that it will work indefinitely. In particular, if ESG factors become increasingly reflected in market prices because of increased investor focus on them, the benefit to ESG investing will be reduced over time. Finally, even if ESG factors have relationship to firm performance, a prudent trustee could conclude that she cannot cost-effectively exploit them for profit. As recognized by the Supreme Court, an ERISA trustee could opt for a passive rather than an active investment strategy.\(^31\)

---

\(^30\) See *ESG Investing by a Trustee* at pp. 448-53.

* * *

Please do not hesitate to contact us if we may be of further assistance in amplification of the foregoing or otherwise.

Very truly yours,

/s/ Max M. Schanzenbach  
Seigle Family Professor of Law  
Northwestern Pritzker School of Law  
m-schanzenbach@law.northwestern.edu  
(312) 503-4425

/s/ Robert H. Sitkoff  
John L. Gray Professor of Law  
Harvard Law School  
rsitkoff@law.harvard.edu  
(617) 384-8386
Exhibit A
ARTICLE

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

Max M. Schanzenbach & Robert H. Sitkoff*

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

* Max M. Schanzenbach is the Seigle Family Professor of Law, Northwestern University. Robert H. Sitkoff is the John L. Gray Professor of Law, Harvard University.

The authors thank Cliff Asness, Lucian Bebchuk, Tom Brennan, John Campbell, Einer Elhauge, Melanie Fein, Allen Ferrell, Ronald Gilson, Jeffrey Gordon, Oliver Hart, J.B. Heaton, Howell Jackson, Kim Kamin, Louis Kaplow, John Langbein, Alex Lee, Eugene Maloney, James Marion, Dylan Minor, John Morley, Dana Muir, Donald Myers, Mark Ramseyer, Michael Richman, Edward Rock, Mark Roe, Steve Shavell, Holger Spaman, Kathy Spier, Matthew Stephenson; and workshop participants at Bank of America, Bessemer Trust, Greenwich Roundtable, Northwestern, Harvard, the 2019 Delaware Trust Conference, the Symposium on ESG Investing and Stewardship: Risk-Return, Conscience, and Fiduciary Duty (2019), the Ninth Annual Employee Benefits & Social Insurance Conference at Boston College (2019), the 2018 Trust and Wealth Executive Seminar sponsored by the Trust Management Association, the 2018 ESG and Investors conference at NYU, and the 2018 Fiduciary Law Workshop at Washington University for helpful comments and suggestions; and Alex King, Jeannette Leopold, James Mulhern, Joseph Ruckert, Erin Thomas, and Catherine Wiener for superb research assistance.

This Article draws on the authors' work in a consulting engagement with Federated Investors, Inc. In accordance with Harvard Law School policy, Sitkoff discloses certain outside activities, one or more of which may relate to the subject matter of this paper, at https://perma.cc/FDB4-B937.
investing is required by the fiduciary duty of prudence. Against this backdrop of uncertainty, this Article 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 American trust fiduciary law 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 such investing is authorized by the terms of a trust or the beneficiaries, or is 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.
Table of Contents

Introduction ............................................................................................................................................................ 384

I. Socially Responsible Investing, Collateral Benefits ESG, and Risk-Return ESG............................................ 392
   A. The Rise of SRI ........................................................................................................................................ 392
   B. SRI and Fiduciary Principles .............................................................................................................. 393
   C. From SRI to ESG ................................................................................................................................ 395
   D. Differentiating Collateral Benefits ESG from Risk-Return ESG .......................................................... 397

II. Fiduciary Loyalty and ESG Investing ........................................................................................................... 399
   A. “Sole” Versus “Best” Interest ............................................................................................................. 400
   B. ESG and Loyalty in ERISA Law ........................................................................................................ 403
      1. Solely for “financial” benefits .................................................................................................. 403
      2. Applied to ESG investing by a pension trustee ..................................................................... 405
      3. Collateral benefits as a tiebreaker? ......................................................................................... 408
   C. ESG and Loyalty in Trust Law ............................................................................................................ 411
      1. The “sole” interest rule by default ......................................................................................... 411
      2. Applied to ESG investing in a private trust ............................................................................ 412
      3. Collateral benefits and the terms of a trust ............................................................................ 414
      4. Collateral benefits and authorization by the beneficiary ....................................................... 418
   D. ESG and Loyalty in Charity Law ......................................................................................................... 420
      1. The “sole” interest rule and “charitable purpose” ................................................................. 420
      2. “Best” rather than “sole” interest applies to many charities .................................................... 422

III. The Duty of Prudence and ESG Investing .................................................................................................. 425
   A. The Prudent Investor Rule ................................................................................................................ 426
   B. Identifying and Applying ESG Factors ............................................................................................ 430
   C. ESG Factors and Firm Performance ............................................................................................... 433
   D. ESG Factors in Active Investing .................................................................................................... 437
      1. Questioning market efficiency ............................................................................................. 437
      2. Screens and stock picking .................................................................................................... 439
      3. The usual caveats about stock picking .................................................................................. 441
      4. Contrarian and anti-ESG strategies ......................................................................................... 443
   E. ESG Factors in Active Shareholding ............................................................................................... 444
   F. ESG Investing Is Permissible but Not Mandatory ........................................................................ 448

Conclusion ................................................................................................................................................................ 453
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 loyalty²) and construct a diversified portfolio with risk and return objectives reasonably suited to the purpose of the trust (the duty of prudence³). 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.⁴

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

---

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 agent of a trustee in a personal trust, and members of the board or officers of a charity. See RESTATEMENT OF CHARITABLE NONPROFIT ORGS. § 201 (AM. LAW INST., Tentative Draft No. 1, 2016) (describing parties with fiduciary status in a charity); 3 RESTATEMENT (THIRD) OF TRUSTS § 80 cmt. g (AM. LAW INST. 2007) (describing the fiduciary status of an agent of the trustee); John D. Morley & Robert H. Sitkoff, Making Directed Trusts Work: The Uniform Directed Trust Act, 44 ACTEC L.J. 3, 32-35 (2019) (describing the fiduciary status of a trust director in a private trust); Dana M. Muir, Fiduciary Principles in Pension Law, in THE OXFORD HANDBOOK OF FIDUCIARY LAW 167, 170-72 (Evan J. Criddle, Paul B. Miller & Robert H. Sitkoff eds., 2019) (describing the fiduciary status of a functional fiduciary).

As of late 2019, U.S. pension and retirement accounts held the staggering sum of $30.1 trillion dollars. See Frequently Asked Questions About 401(k) Plan Research, INVESTMENT COMPANY INST. (Dec. 2019), https://perma.cc/7WML-KFS2. 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 $918 billion in trust assets held by federally reporting banks, reporting $226 billion in trust assets held by South Dakota reporting trust companies, and noting that these figures underestimate total trust assets). 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 2018, URB. INST.: NAT’L CTR. FOR CHARITABLE STATS. (Dec. 13, 2018), https://perma.cc/7VMF-4S8W.

2. See infra Part I.A.

3. See infra Part III.A.

firearms companies, or otherwise accounting for environmental or social costs in making investment decisions.\(^5\) A group convened by the United Nations, the Principles for Responsible Investment (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.\(^6\) Yet many American trustees continue to resist explicit use of ESG factors on the grounds that to do 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.\(^7\)

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.\(^8\) We show that, in general, ESG investing is permissible for a trustee of a pension, charity, or trust subject to American

---


6. On the PRI, see About the PRI: What Are the Principles for Responsible Investment?, PRINCIPLES FOR RESPONSIBLE INVESTMENT, https://perma.cc/FY32-V5GD (archived Dec. 22, 2019). On the claim that ESG investing is mandatory under fiduciary principles, see infra text accompanying notes 28-30; infra Part III.F.

7. See Amir Amel-Zadeh & George Serafeim, Why and How Investors Use ESG Information: Evidence from a Global Survey, FIN. ANALYSTS J., Dec. 2018, at 87, 91-92, 91 tbl.2 (finding that 22% of surveyed U.S. investment professionals not using ESG factors believe that doing so would violate fiduciary duty); see also CFA INST., ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING: A GUIDE FOR INVESTMENT PROFESSIONALS 33 (2015), https://perma.cc/GU5Q-8L7A (finding that 22% of investment professionals who do not consider ESG factors suggested they would do so if they had clarity it would not conflict with fiduciary constraints); Fi360, ESG Survey for Fi360 Designees 2 (2019) (on file with authors) (finding that, of 310 fiduciaries responding, 47% believed that using ESG factors conflicts or may conflict with default fiduciary duty). We discuss the sole interest rule in Part II below.

8. 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 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 the Investment Company Act, a mutual fund’s registration statement must include all “matters of fundamental [investment] policy,” Investment Company Act of 1940, Pub. L. No. 76-768, tit. I, § 8(a)(2), 54 Stat. 789, 804 (codified as amended at 15 U.S.C. § 80a-8(b)(3) (2018)), and the accuracy of that statement and the fund’s prospectus is subject to the usual antifraud rules under Rule 10b-5 under the Securities Exchange Act, 17 C.F.R. § 240.10b-5 (2019), and sections 11 and 12(2) of the Securities Act of 1933, Pub. L. No. 73-22, tit. I, §§ 11, 12(2), 48 Stat. 74, 82-84 (codified as amended at 15 U.S.C. §§ 77k, 77l(a)(2)). Accordingly, if a fund promises socially responsible investment, under the federal securities laws it must do as it says. See, e.g., Pax World Settles Charges of Irresponsibility, N.Y. TIMES: DEALBOOK (July 31, 2008, 7:06 AM), https://perma.cc/SS6V-4ZCB (describing an SEC fine of a mutual fund for failing to abide by the fund’s own “off-limits” polices regarding gambling, alcohol, and fossil fuels).
trust fiduciary law 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 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. 9 Despite these bulletins, in 2018 the Government Accountability Office (GAO) urged the Department of Labor to issue still further guidance. 10 In 2019, the President ordered the Department of

---


Labor to review its existing guidance “to ensure consistency with current law and policies that promote long-term growth and maximize return on [pension] plan assets.” Meanwhile, in 2018, Delaware amended its trust code to specifically address ESG investing by a trustee, becoming the first state to do so. But because this amendment deviates from traditional trust fiduciary law, its instructiveness outside of Delaware is uncertain at best. 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.

Confusion about the propriety of ESG investing by a trustee has been amplified by the growing salience of ESG investing generally. As of November 2019, over 1,900 asset managers have signed the PRI’s statement of principles on ESG investing, including many of the world’s leading institutional investors. Hundreds of commercial ESG indices provide ESG ratings of individual companies, and an S&P 500 ESG index is in preparation. Even index funds, such as those managed by Vanguard and BlackRock, which traditionally avoid consideration of firm-specific factors, are increasingly


13. We discuss the Delaware amendments at text accompanying notes 191-92 and 201-02 below.


15. See Principles for Responsible Inv., Signatory Directory Updated 11 2019 (2019), https://perma.cc/R66R-72LU. Most signatories (1,033) are European; the second-largest group is from North America (508).


focusing “on issues ranging from executive pay to climate change.” In the words of Goldman Sachs, “ESG investing, once a sideline practice, has gone decisively mainstream.”

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 or the environmental or social 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 apartheid regime. 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.”

The original motives for ESG investing were moral or ethical, based on third-party effects rather than investment returns. Such motives ran 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.


22. See, e.g., Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. at 65,135 (“Various terms have been used to describe this and related investment behaviors, such as socially responsible investing, sustainable and responsible investing, environmental, social and governance (ESG) investing, impact investing, and economically targeted investing (ETI).”).

23. The Department of Labor, for example, has shifted from “economically targeted investments” in earlier bulletins to “ESG” in more recent bulletins. Compare, e.g., Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734 (Oct. 17, 2008), with, e.g., 2018 Field Assistance Bulletin, supra note 9, and 2015 Interpretive Bulletin, supra note 9.

24. See infra Part II.A.
investors. For example, instead of avoiding the fossil fuel industry to achieve collateral benefits from reduced pollution, ESG proponents argued that the fossil fuel industry should be avoided because financial markets underestimate its litigation and regulatory risks, and therefore divestment would improve risk-adjusted return. On this view, ESG investing is a kind of profit-seeking, active investment strategy that can be consistent with the fiduciary duties of loyalty and prudence.

On the assumption that ESG investing can provide risk and return benefits, an influential 2005 report sponsored by the UN working group that preceded 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.” In a 2015 follow-up report, the PRI took the position that it had “end[ed] the debate about” ESG and fiduciary duty, concluding that “there are positive duties on investors to integrate ESG issues.” Other commentators have argued likewise. Nonetheless, many American trustees remain skeptical about the permissibility of ESG investing, probably owing to its association with the morality- and ethics-based practices of what had been called SRI.

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

25. See infra Part I.C.
26. See infra text accompanying notes 293-94.
27. See infra Parts II-III.
30. 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, 90 U. COLO. L. REV. 731, 734, 736 (2019) [hereinafter Gary, 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, 252 (2016) [hereinafter, Gary, Values and Value] (“[F]iduciaries responsible for university endowments can adopt investment policies directing the use of ESG factors . . . .”); infra note 387 and accompanying text.
31. See infra Parts I.A-.C.
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.\textsuperscript{32} We show that collateral benefits ESG violates the sole interest rule of trust fiduciary law,\textsuperscript{33} subject to certain special rules for charities and for settlor or beneficiary authorization in personal trusts.\textsuperscript{34} 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.\textsuperscript{35}

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.\textsuperscript{36} 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.\textsuperscript{37} 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. Both conditions must be true for an ESG strategy to provide improved risk-adjusted returns. 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

\textsuperscript{32}. See infra Part II.A.
\textsuperscript{33}. See infra Parts II.B-.C.
\textsuperscript{34}. See infra Parts II.C-.D.
\textsuperscript{35}. See infra Parts III.D-.E. The Department of Labor bulletins are largely in accord with our analysis, except that they allow for collateral benefits as a tiebreaker 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.
\textsuperscript{36}. See infra Parts III.C-.E.
\textsuperscript{37}. We canvass the theoretical and empirical literature as applied to active investing and active shareholding, respectively, in Parts III.D and III.E below.
light of experience with actual costs and returns. 38 We provide a similar assessment of the growing use of ESG factors in active shareholding. 39

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 subject to American trust fiduciary law. To the contrary, both passive and contrarian investment strategies are also permissible for a trustee and likewise have significant theoretical and empirical support. 40 A deep irony, previously unremarked upon in the literature, is that the same conceptual logic that motivates risk-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. 41

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, 42 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. 43 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. 44 In cases of authorization or charitable purpose, we analogize to whether a distribution would be permissible under similar circumstances, reasoning that pursuit of third-party benefits via the investment program is functionally a substitute for a distribution from the trust. 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.

38. See infra Part III.D.
39. See infra Part III.E.
40. See infra Parts III.D.3-.4.
42. See infra Part II.B.
43. See infra Parts II.C.3-.4.
44. See infra Part II.D.
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

The remainder of this Article 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. Socially Responsible Investing, Collateral Benefits ESG, and Risk-Return ESG

We begin by tracing the rise of SRI and its transformation into ESG in the late 1990s, and by differentiating collateral benefits ESG from 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, 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 oneself or one's workers, such as the production of dangerous chemicals.45 Some commentators view this exhortation, in effect an investment screen, as an early instance of SRI.46 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, Pioneer Investments, began in 1928 as an ecclesiastical investment fund committed to the Christian values of


its founder, and it remains in existence today.47 Pioneer Investments and other early SRI funds, however, emphasized the avoidance of morally questionable investments, not the pursuit of better risk-adjusted returns.48

SRI funds that eschewed defense firms gained additional prominence in the 1970s as a consequence of the Vietnam War.49 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,50 while others suggested that investments should be permitted in firms if they agreed to abide by certain principles (known as the Sullivan Principles) of nondiscrimination in their South African operations.51 These alternate approaches reflect the perennial debate about whether voice or exit is a better strategy toward motivating change.52

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

48. See SPARKES, supra note 46, at 48-52.
50. See, e.g., DAVID HAUCK ET AL., TWO DECADES OF DEBATE: THE CONTROVERSY OVER U.S. COMPANIES IN SOUTH AFRICA 1-5 (1983) (describing the divestment debate and positions for and against divestment). Universities felt particular pressure to divest, and many did so. See Hunter Bosson, Shorting the Devil, CORNELL BUS. REV., Spring 2016, at 5, 5 (reporting that 155 universities had divested from companies doing business with South Africa by the time apartheid ended).
52. The foundational work is ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 1-43 (1970). Hirschman analyzed the choices of a member of a deteriorating organization. The member could stay and try to effect change internally (“voice”) or leave and join a better organization (“exit”). Id. at 3-4. In the context of ESG investing, “exit” typically manifests as divestment and “voice” typically manifests as voting or other stewardship activities.
duties of loyalty and 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,53 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.54 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,55 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 energy firms).56

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.57 Some investment managers agreed.58 Even some commentators who were strongly in favor of divestment

53. See infra Part II.A.
55. See infra Part III.A.
57. See Ennis & Parkhill, supra note 56, at 35 (concluding that divestment from South Africa would violate the exclusive purpose test); Langbein & Posner, supra note 21, at 88, 96; see also Robert H. Jerry, II & O. Maurice Joy, Social Investing and the Lessons of South Africa Divestment: Rethinking the Limitations on Fiduciary Discretion, 66 OR. L. REV. 685, 747-48 (1987) (concluding that trustees may consider collateral benefits if alternative investments are “economically equal” but predicting that trustees would not do so given lack of clear law); Robert J. Lynn, Investing Pension Funds for Social Goals Requires Changing the Law, 53 U. COLO. L. REV. 101, 109-10 (1981) (concluding that “there is little support from traditional sources for using social criteria for investment”). But see Thomas A. Troyer et al., Divestment of South Africa Investments: The Legal Implications for Foundations, Other Charitable Institutions, and Pension Funds, 74 GEO. L.J. 127, 149-50 (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.” (footnotes omitted)); Ann-Catherine Blank, Comment, The South African Divestment Debate Factoring “Political Risk” into the Prudent Investor Rule, 55 U. CIN. L. REV. 201, 213-16 (1986) (arguing that fiduciary investors should consider political risks, which could make investments in South Africa unattractive, thus making a risk-return ESG point without using that term).
on moral grounds conceded that existing law did not permit total divestment and therefore instead advocated for law reform.59

As an alternative to total divestment, some advocated “selective divestment” based on whether a company doing business in South Africa abided by the Sullivan Principles.60 Because selective divestment would exclude fewer firms, it would do less damage to portfolio efficiency, a result that was borne out by empirical study.62 On this basis, some commentators argued that selective divestment was consistent with the fiduciary duty of care.63 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 minimis or no harm defense to an improper motive, as we shall see.64

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 the 2000s.65 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.66 Today such funds are experiencing yearly net inflows in the billions of dollars, with net inflows from the first half of 2019 exceeding full-year net inflows from 2018 by more than $3 billion.67


60. See supra note 51 and accompanying text.

61. Ennis & Parkhill, supra note 56, at 31-32, 32 tbl.III (finding that divestment from nonsignatories to the Sullivan Principles would exclude only 13% of the S&P 500).


64. See infra Parts II.A-.C.


footnote continued on next page
At the same time, SRI advocates have 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.

The addition of governance factors in the 1990s, widely accepted as relevant to firm value, 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. In the academy, a highly influential 2003 paper by Paul Gompers, Joy Ishii, and Andrew Metrick developed and applied an index of corporate governance, with many follow-on papers suggesting that identifiable and measurable governance factors have a significant effect on firm performance. Refinements to the Gompers, Ishii, and Metrick index followed, including a prominent index measuring managerial entrenchment.
by Lucian Bebchuk, Alma Cohen, and Allen Ferrell in 2009. 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 considering ESG factors improves risk assessment.

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 as ESG), and it is widely and confusingly used today to encompass both. 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.”

---

74. Id. at 788-800. For a recent example, see Bernard Black et al., *Corporate Governance Indices and Construct Validity*, 25 CORP. GOVERNANCE INT’L REV. 397, 399-408 (2017) (constructing and evaluating governance indices for several emerging markets).

75. Compare Karl V. Lins et al., *Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility During the Financial Crisis*, 72 J. FIN. 1785, 1787-88 (2017) (finding that, during the Great Recession, firms with high ESG factors outperformed low-ESG firms, with no such difference outside the financial crisis, and linking the findings to investor trust in the management of high-ESG firms), and John Nofsinger & Abhishek Varma, *Socially Responsible Funds and Market Crises*, 48 J. BANKING & FIN. 180, 192 (2013) (finding that SRI funds outperform non-SRI funds during crises, but that 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, [sic] all combined controversial [low-social score or ‘sin stock’] portfolios beat the market during the recessionary period in an economically significant way”).


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.78

Risk-return ESG investing, by contrast, entails the use of ESG factors as metrics for assessing expected risk and return with the aim of 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).79 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 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).80

Our taxonomy of collateral benefits ESG versus risk-return ESG is meaningful in light of trust fiduciary law’s emphasis on motive, as we shall see below.81 It is also meaningful as a matter of financial economics for at least two reasons. 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.82

78. See infra Part III.E.
79. See infra Part III.D.
80. See infra Part III.E.
81. See infra Part II.A.
82. We take up this possibility in connection with “sin” or “contrarian” investment. See infra Part III.D.4.
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 accordance with her fiduciary duties of loyalty, care (called prudence in trust parlance), and the other duties of trusteeship. The Restatement 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.” 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. 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

84. Others have made these points or similar ones but without our clarifying taxonomy. See, e.g., id. at 210 (noting that it is “virtually impossible” for socially conscious investors to affect the “behavior of firms whose securities trade in public markets”); Oliver Hart & Luigi Zingales, Companies Should Maximize Shareholder Welfare not Market Value, 2 J.L. FIN. & ACCT. 247, 264 (2017) (discussing conditions under which “the strategy of divesting from stocks of companies engaging in unethical/sinful/polluting behavior seems at best ineffective, at worst counterproductive”); Knoll, supra note 69, at 704-11 (showing that affecting corporate behavior through investment screens requires heroic assumptions about the elasticity of capital supply); Cliff Asness, Virtue Is Its Own Reward: Or, One Man’s Ceiling Is Another Man’s Floor, AQR (May 18, 2017), https://perma.cc/MD5Z-7ED4 (arguing that “[d]o good and make the same return or more” is “mostly wrong and . . . at odds with the very point of ESG investing”).
85. See Robert H. Sitkoff, Fiduciary Principles in Trust Law, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, supra note 1, at 41, 44-46, on which portions of the ensuing discussion draw without further attribution.
86. 3 RESTATEMENT (THIRD) OF TRUSTS § 70 cmt. a (AM. LAW INST. 2007).
87. See Sitkoff, Economic Theory, supra note 4, at 206-07.
a matter of federal law. The widely adopted Uniform Prudent Management of Institutional Funds Act (UPMIFA) applies trust investment law to charitable endowments as a matter of state law. 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. At the same time, we take notice of subtle but important variations 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 below.

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 of the beneficiaries.” The sole interest rule is sometimes also called the “sole benefit” or “exclusive benefit” rule. 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.”

88. Pub. L. No. 93-406, tit. I, § 403(a), 88 Stat. 829, 876 (codified as amended at 29 U.S.C. § 1103(a) (2018)) (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. Compare 29 U.S.C. § 1104(a)(1) (“[A] fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries . . . .”), with CAL. CONST. art. XVI, § 17(b) (“[Fiduciaries] of a public pension or retirement system shall discharge their duties with respect to the system 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 1, at 480-81.


91. 3 RESTATEMENT (THIRD) OF TRUSTS § 78(1) (emphasis added); see also UNIF. TRUST CODE § 802(a) (UNIF. LAW COMM’N 2000).


93. 3 RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. f.
administering the trust not to be guided by the interest of any third person.”94 Acting with mixed motives triggers “an irrebuttable presumption of wrongdoing,”95 full stop.96

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.97 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 the default in trust law.98

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.

94. 1 RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. q.
95. Fischel & Langbein, supra note 92, at 1114-15.
97. To be sure, a trustee may not be liable for make-whole compensatory damages if a beneficiary cannot prove a loss from the trustee's mixed motives with reasonable certainty. However, even in such circumstances, the trustee's breach of the duty of loyalty would entitle the beneficiary to other relief such as trustee removal; an injunction; disgorgement of profits; unwinding the transaction by way of equitable lien, constructive trust, or otherwise; or even punitive damages. See UNIF. TRUST CODE §§ 1001-1002 (UNIF. LAW COMM’N 2000); Samuel L. Bray, Fiduciary Remedies, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, supra note 1, at 449, 451, 454-56, 459-62; Sitkoff, supra note 85, at 58-59.
98. See infra Parts II.B-.C.
notwithstanding the conflict.\textsuperscript{99} The best 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.\textsuperscript{100} 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.\textsuperscript{101}

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.\textsuperscript{102} By contrast, the best interest rule regulates conflicted transactions by testing them for fairness.\textsuperscript{103} 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).”\textsuperscript{104} 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.”\textsuperscript{105}

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


\textsuperscript{101} 3 \textit{Restatement (Third) of Trusts} § 78(1)-(2) cmt. c (AM. LAW INST. 2007).

\textsuperscript{102} Id. § 78(1)-(2) cmt. b.

\textsuperscript{103} See Weinberger, 457 A.2d at 711 (describing “fairness” as having “two basic aspects: fair dealing and fair price”); 3 \textit{Restatement (Third) of Trusts} § 78(1)-(2) cmt. c(2) (noting that even if a conflict is authorized by the terms of a trust, “a trustee violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly”).


\textsuperscript{105} 3 \textit{Restatement (Third) of Trusts} § 78(1)-(2) cmt. b.
professional expertise that overlaps with the fiduciary's personal interests. 106 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 fiduciary duty of loyalty. 107 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 participants and beneficiaries” and for the “exclusive purpose” of “providing benefits” to them. 108 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.” 109

Furthermore, in “providing benefits” under ERISA, the Supreme Court has held that the relevant purpose to which ERISA’s sole interest rule applies is “financial benefits” for the plan beneficiaries. 110 That is, 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

---

106. This point is implicit in the exception to trust law’s sole interest rule for a trustee’s self-employment in certain circumstances of “special skills and facilities that are useful in trust administration.” Id. § 78(1)-(2) cmt. c(5).
107. In Tibble v. Edison International, 135 S. Ct. 1823 (2015), the Supreme Court confirmed that menu construction is a fiduciary act subject to the same fiduciary principles as direct investment and the exercise of shareholder rights. Id. at 1826, 1828.
109. 3 Restatement (Third) of Trusts § 78(1) cmt. f.
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

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.111

Under 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.112

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 nonfinancial investment factors.113 The American position reflects a paternalistic public policy of protecting the financial security of a retired worker against poor spending and investment decisions by her younger self.114 The worker is induced by substantial tax benefits to save for retirement115 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,

111. Id. (quoting 29 U.S.C. § 1104(a)(1)(A)(i)-(iii)). Current doctrine, therefore, is decisively contrary to the argument by some commentators in favor of considering public or other interests. See, e.g., Rose, supra note 96, at 893.


114. See, e.g., Ryan Bubb et al., Response, A Behavioral Contract Theory Perspective on Retirement Savings, 47 CONN. L. REV. 1317, 1337-38 (2015) (responding to Daniel Shaviro, Multiple Myopias, Multiple Selves, and the Under-Saving Problem, 47 CONN. L. REV. 1215 (2015)) ("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.").

whatever the policy merits of this position, 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 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. 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 trustee, so too under the sole interest rule the same trustee cannot allow such a goal to influence his 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

---

116. One objection is that today the typical 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 1, 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, a pension or retirement account today is used more as “a tax-sheltered vehicle for saving and investing than a true retirement fund.” Id. 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, 112 (Teresa Ghilarducci et al. eds., 2005) (arguing that “[t]he private pension system is only incidentally about [promoting] retirement income,” and rather that “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”).

117. See supra notes 110-12 and accompanying text.

118. See supra Part IB.
even if “the act is undertaken in good faith.”119 In the context of ERISA, in which the Supreme Court has held that the “exclusive purpose” of the trustee must be the plan participant’s “financial benefits,”120 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.121 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.122 Even if a trustee is motivated in her heart by pursuit of collateral benefits, to keep up the facade 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.123 In a telling admission, the Chair of the PRI, Martin Skancke, suggested 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 objectives.”124

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. If motivated solely by this purpose, a risk-return ESG investing strategy satisfies the sole interest rule under the duty of loyalty, even under the Supreme Court’s strict “financial benefits” interpretation under ERISA.125 Of course, the strategy would also have to satisfy the duty of prudence, which we take up later.126 For now the point is that risk-return ESG investing satisfies the ERISA duty of loyalty, whereas collateral benefits ESG investing does not.

119. 3 RESTATEMENT (THIRD) OF TRUSTS § 87 cmt. c (AM. LAW INST. 2007); see also id. § 76(1) (“The trustee has a duty to administer the trust . . . in accordance with the terms of the trust and applicable law.”).
120. See supra note 111 and accompanying text.
121. Of course, sometimes a trustee may be express in acknowledging a nonfinancial motive. See, e.g., Mark Miller, Bit by Bit, Socially Conscious Investors Are Influencing 401(k)’s, N.Y. TIMES (Sept. 27, 2019), https://perma.cc/ET8E-FXS3 (quoting a business executive as stating that, in crafting her business’s 401(k) menu, “we don’t make decisions based just on financial return—we’re always looking at it through the lens of sustainability”).
122. See infra Part III.A.
125. See supra notes 111-12 and accompanying text.
126. See infra Part III.
The U.S. Department of Labor’s position on ESG investing by a pension trustee, which it has stated in various bulletins across the years, including the most recent 2018, 2016, and 2015 Bulletins, is largely in agreement with the foregoing analysis. In each, the Department concluded that an ERISA fiduciary ordinarily may not lawfully pursue collateral benefits ESG. In the 2015 Bulletin, for example, the Department 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.”

In the 2016 Bulletin, the Department again reaffirmed that “plan fiduciaries may not increase expenses, sacrifice investment returns, or reduce the security of plan benefits in order to promote collateral goals.” And in the 2018 Bulletin, the Department yet again reaffirmed that “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.”

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

In the 2018 Bulletin, the Department 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.” 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.”

3. Collateral benefits as a tiebreaker?

Our analysis diverges from that of the Department of Labor, however, in one significant respect. The Department has taken the position, since embraced by the Freshfields Report 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 tiebreaker without violating the duty of loyalty. 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.

The 2018 Bulletin reiterated the Department’s “longstanding 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.” This tiebreaker position is contrary to controlling law and dubious as a matter of textbook financial economics.

With respect to law, the tiebreaker is irreconcilable with the strict “sole interest” or “exclusive benefit” rule. At common law, this rule was

135. Id. at 2.
137. 2015 Interpretive Bulletin, supra note 9, at 65,136.
139. See supra Part II.A.
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

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.” And under ERISA, the Supreme Court has held that the “exclusive purpose” to which a pension trustee must attend is provision of “financial benefits . . . for the trust’s beneficiaries.” Thus, as other commentators have noted, the tiebreaker position is in deep tension with ERISA’s codification of the sole interest rule as glossed by the Supreme Court and in view of its common law background.

The bulletins do not acknowledge this doctrinal tension, much less address it in a persuasive manner. Yet authorizing a pension trustee to consider collateral benefits in making a fiduciary decision is conceptually and legally no different from 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.

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. 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, because a joint investment improves diversification and thereby reduces overall portfolio risk without a loss in the portfolio’s expected return.

Of course, investing in both might not be feasible owing to a liquidity constraint, that is, insufficient readily available capital to make both investments at the same time. Possibly the added transaction costs of a split investment, including additional monitoring or proxy voting, could offset the diversification benefits. But the Department of Labor Bulletins are not crafted

140. 3 RESTATEMENT (THIRD) OF TRUSTS § 78(1) cmt. f (AM. LAW INST. 2007).
142. See supra note 1, at 176-77 (arguing that the use of ESG factors “as a tiebreaker 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 A. Zelinsky, The Continuing Battle over Economically Targeted Investments: An Analysis of the Department of Labor’s Interpretive Bulletin 2015-01, 2016 CARDOZO L. REV.: DE NOVO 197, 202 (arguing that the Department of Labor’s position “replaces ERISA’s strong statutory standard of loyalty (‘solely’ and ‘exclusive’) with a weaker rule of nonsubordination”).
143. Cf. ZVI BODIE ET AL., INVESTMENTS 194-221 (11th ed. 2018) (discussing how a portfolio of less than perfectly correlated assets always offers some amount of diversification, which leads to improved portfolio efficiency).
144. See infra Part III.A (discussing the prudent investor rule).
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

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."146 So the Bulletins do not attend to the economic costs from reduced portfolio diversification under the tiebreaker rule. Yet the text of ERISA imposes an explicit duty to diversify.147

Finally, even if a trustee claimed that she had two identical investments but could invest in only one on liquidity or other transaction-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 Department of Labor’s tiebreaker position opens the door to a trustee defense for a mixed motive. Such a defense is contrary to the controlling statute and the prophylactic policy that underpins the statute.148

As a matter of administrative law, because the Department of Labor Bulletins are guidance documents rather than rules produced through a formal notice-and-comment process, they are not entitled to Chevron deference.149 Instead, reflecting a need to balance 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

146. 2015 Interpretive Bulletin, supra note 9, at 65,136.
148. See supra Part II.A.
149. See Christensen v. Harris County, 529 U.S. 576, 587 (2000). Even with Chevron deference, the defects in law and economics identified above could be fatal. See, e.g., Chamber of Commerce of the U.S. v. U.S. Dep’t of Labor, 885 F.3d 360, 368-69, 372-73, 388 (5th Cir. 2018) (striking down a Department of Labor notice-and-comment fiduciary rule under Chevron review on the grounds that it was inconsistent with the statutory language of ERISA).
something less than de novo but something more than Chevron deference.\textsuperscript{150} The tiebreaker position is therefore vulnerable to court challenge.

\section*{C. ESG and Loyalty in Trust Law}

Like a pension trustee, in making direct investment of trust assets, voting shares, or otherwise exercising 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 the provision of financial benefits, under trust law the sole interest rule is a default, and the beneficiary’s interest is as prescribed by the settlor in the terms of the trust.\textsuperscript{151}

\subsection*{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.”\textsuperscript{152} A familiar teaching example involving mixed motives—that is, a conflict of interest—without self-dealing is \textit{In re Estate of Rothko}.\textsuperscript{153} In that case, the executors of Mark Rothko’s estate sold or consigned nearly 800 of Rothko’s paintings to a single gallery.\textsuperscript{154} 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.\textsuperscript{155} The court characterized the argument that the executors were not conflicted by reason of their mixed motives as “sheer fantasy.”\textsuperscript{156} The court awarded damages

\begin{flushright}

\textsuperscript{151} 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 107, 116 and accompanying text.

\textsuperscript{152} 3 \textit{RESTATEMENT (THIRD) OF TRUSTS} § 78(1) (emphasis added); see also \textit{UNIF. TRUST CODE} § 802(a) (UNIF. LAW COMM’N 2000).

\textsuperscript{153} 372 N.E.2d 291 (N.Y. 1977); see also \textit{SITKOFF \& DUKEMINIER, supra} note 1, at 602-09 (excerpting Rothko).

\textsuperscript{154} See \textit{Rothko}, 372 N.E.2d at 293; see also Roberta Smith, \textit{Frank Lloyd, Prominent Art Dealer Convicted in 70’s Rothko Scandal, Dies at 86}, \textit{N.Y. TIMES} (Apr. 8, 1998), https://perma.cc/625N-Z4SS. An executor is subject to the same fiduciary loyalty principles as a trustee. See \textit{SITKOFF \& DUKEMINIER, supra} note 1, at 596.

\textsuperscript{155} \textit{Rothko}, 372 N.E.2d at 294, 296. The third executor was imprudent but not conflicted. \textit{Id.} at 294.

\textsuperscript{156} \textit{Id.} at 296.
\end{flushright}
measured by the lost appreciation value on the paintings, equivalent to unwinding the transaction.157

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. A mixed motive by itself violates the trust law duty of undivided loyalty. Thus, for example, a trustee who does “not act for personal advantage,” and instead is “motivated by a desire to assist a worthy project,” still violates the duty of loyalty because such a motive or desire is something other than the sole interest of the beneficiary.158 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 from a “breach of the duty of loyalty” if the trustee’s motive for the transaction was other than the sole interest of the beneficiary.159

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 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.160

---

157. *Id.* at 297–98.
158. Conway v. Emeny, 96 A.2d 221, 225 (Conn. 1953).
159. Uzyel v. Kadisha, 116 Cal. Rptr. 3d 244, 276 (Ct. App. 2010). Even if make-whole damages were not available in such a case, a variety of other remedies would be available. *See supra* note 97.
160. 3 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. c (A M. LAW INST. 2007) (citation omitted). The hedge in the word “ordinarily” allows for a different outcome if the beneficiary or the terms of the trust allow otherwise or if the trust is charitable in nature, nuances to which we turn below.
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. 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.

But the sole interest rule does not allow for a de minimis exception. The rule does not allow consideration of other interests even if the beneficiary’s interest is not subordinated or there is no concession in returns. A trustee cannot defend a mixed motive on the grounds that the conflict did not harm the beneficiaries or that the additional motive was laudable. Accordingly, a fiduciary’s adherence to the Sullivan Principles out of consideration for collateral benefits, like any 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, in a private trust the settlor has broad autonomy to prescribe the terms and purpose of the trust. In consequence, the terms of a trust can provide for a purpose other than portfolio efficiency and 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, justifying the sacrifice in portfolio efficiency with the direct benefits to the beneficiary from the investment.

161. Compare, e.g., 4 AUSTIN WAKEMAN SCOTT ET AL., SCOTT AND ASCHER ON TRUSTS § 19.1.13, at 1425–26 (5th ed. 2007) (presenting as a “plausible 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, e.g., 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 227.17, at 500 (4th ed. 1988) (taking the position that a trustee “may properly consider the social performance of the corporation . . . and generally accepted ethical principles”).

162. See supra Part I.B.

163. See supra Part II.A.

164. See supra Part II.B.1.


166. See, e.g., SITKOFF & DUKEMINIER, supra note 1, at 641-42 (noting trusts to hold a family vacation home, a surviving spouse’s residence, or a family farm as instances that might warrant not diversifying).
Thus, unlike an ERISA trustee, a trustee of a personal trust is not necessarily required to consider only direct financial benefits. Depending on the terms of the trust, the trustee may also consider nonfinancial 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.”

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

3. Collateral benefits and the terms of a trust

Unlike under ERISA, under ordinary trust law the sole interest rule is default rather than mandatory. As the Restatement of Trusts explains, “[a] trustee may be authorized by the terms of the trust, expressly or by

167. On the rule under ERISA, see Part II.B.1 above.
168. 3 Restatement (Third) of Trusts § 87 cmt. c (Am. Law Inst. 2007).
169. See infra Part III.
170. See supra note 84 and accompanying text.
171. The example of Swarthmore College (though a nonprofit corporation) is instructive. Swarthmore declined to divest from fossil fuels, and instead undertook direct policies to reduce pollution and carbon emissions. See Michael Katz, Swarthmore Endowment Will Not Divest from Fossil Fuels, Chief Investment Officer (June 15, 2018), https://perma.cc/3U89-XAMQ.
implication, to engage in transactions that would otherwise be prohibited by the rules of undivided loyalty.” 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.”

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.” 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.”

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 of 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 minimis 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. 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. 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

172. 3 Restatement (Third) of Trusts § 78(1)-(2) cmt. c(2).
173. Id.
174. Id. § 90 cmt. c (emphasis added); see supra note 160 and accompanying text.
175. 3 Restatement (Third) of Trusts § 90 cmt. c.
176. See 2 Restatement (Third) of Trusts § 27(1) & cmt. a (AM. LAW INST. 2003).
177. See, e.g., Clark v. Campbell, 133 A. 166, 168, 170-71 (N.H. 1926) (holding a trust for “my friends” invalid for want of ascertainable beneficiaries); Marsh v. Frost Nat’l Bank, 129 S.W.3d 174, 176-79 (Tex. App. 2004) (holding invalid for want of a charitable purpose a trust to provide “a million dollar trust fund for every American 18 years or older” by accumulating income for 346 years).
ascertainable person beneficiary and are not charitable, required judges to invent an "honorary trust" concept, later codified by statute. 178

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. 179 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 of assets or pursuing collateral benefits) over the interests of the beneficiary.

The common law answer differentiates between a permissive and a mandatory provision: 180

The prevailing view is that a permissive authorization to retain an undiversified portfolio does not excuse the trustee from liability if not diversifying was prudent. . . . 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. 181

By analogy, 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. 182

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. 183 A trustee’s "duty to conform to the terms of the trust directing or restricting investments by the trustee" 184 is subject to the trustee’s duty to petition the court for deviation if conforming will "cause

178. See 2 Restatement (Third) of Trusts § 47 & cmt. a; Sitkoff & Dukeminier, supra note 1, at 426, 428.
179. See Sitkoff & Dukeminier, supra note 1, at 650-54 (surveying law and commentary on permissive versus mandatory concentration retention language in the terms of a trust).
180. See id. at 650.
181. Id. at 651.
182. See Unif. Prudent Inv’r 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.").
183. See Sitkoff & Dukeminier, supra note 1, at 652.
184. 3 Restatement (Third) of Trusts § 91(b) (Am. Law Inst. 2007).
substantial harm to the trust or its beneficiaries.  185 We would expect the same rule to be applied to a mandatory direction in the terms of a trust to consider collateral benefits from ESG investing.

A caveat is in order. The foregoing analysis tracks prevailing common law as reflected in canonical authority such as the Restatement and as codified by the Uniform Trust Code. 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.  186 And some states, including the prominent trust state of Delaware,  187 have enacted statutes that depart from the common law by mandating enforcement of a settlor’s direction not to diversify,  188 or that allow trusts for a wide array of noncharitable purposes.  189 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.  190 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."  191 Taken literally, this provision departs from the common law by validating an authorization or

185. 2 RESTATEMENT (THIRD) OF TRUSTS § 66(2) (AM. LAW INST. 2003); see also SITKOFF & DUKEMINIER, supra note 1, at 652.


189. See DEL CODE ANN. tit. 12, § 3556(a); see also Adam J. Hirsch, Delaware Unifies the Law of Charitable and Noncharitable Purpose Trusts, EST. PLAN., Nov. 2009, at 13, 16-18.  

190. See Act of July 11, 2018, ch. 320, § 4, at 3, 81 Del. Laws (codified at DEL. CODE ANN. tit. 12, § 3303(a)(4)).

191. DEL CODE ANN. tit. 12, § 3303(a)(4).
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.\footnote{A complicating wrinkle is the “provided, however,” clause at the end of section 3303(a). That clause, which appears to qualify all subparagraphs within section 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.” \textit{Id.} § 3303(a). 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.” \textit{See id.} Delaware elsewhere provides that “wilful misconduct’ shall mean intentional wrongdoing, not mere negligence, gross negligence or recklessness.” \textit{Id.} § 3301(g).}

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 of trust via advance consent or subsequent release or ratification.\footnote{\textit{See 4 Restatement (Third) of Trusts} § 97 (AM. LAW INST. 2012). The difference between a consent on the one hand, and a release or ratification on the other, is in whether the beneficiary granted the authorization before or after the trustee’s conduct. \textit{See id.} § 97 cmt. b.} A beneficiary who has properly authorized “an act or omission that constitutes a breach of trust cannot hold the trustee liable for that breach.”\footnote{\textit{Id.} § 97.} Moreover, because beneficiary authorization involves a waiver by the beneficiary 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 settlor in 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.”\footnote{\textit{Id.} § 97(b)-(c).}

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 of Trusts, for example, suggests that a beneficiary may
authorize collateral benefits ESG investing by a trustee.\textsuperscript{196} The difficulties for effective authorization of collateral benefits ESG by a beneficiary are practical rather than conceptual.

The first practical difficulty is 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.”\textsuperscript{197} 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.\textsuperscript{198}

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 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.\textsuperscript{199}

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.\textsuperscript{200} How long a beneficiary authorization can protect a trustee in

\textsuperscript{196} See 3 Restatement (Third) of Trusts § 90 cmt. c (A.M. Law Inst. 2007) (providing that social causes “may properly influence the investment decisions of a trustee to the extent permitted . . . by consent of the beneficiaries”).

\textsuperscript{197} 4 Restatement (Third) of Trusts § 97 cmt. c.

\textsuperscript{198} See, e.g., id. § 97(a)-(c) cmt. d & cmt. d reporter’s note (discussing applicability to a consent or release of “virtual representation,” under which a party may be bound by another party with a substantially identical interest).

\textsuperscript{199} See 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).

\textsuperscript{200} See 4 Restatement (Third) of Trusts § 97 cmt. c(3) (“Even a beneficiary who has consented to or ratified the trustee’s misconduct can terminate that approval and, in any event, can hold the trustee liable for subsequent misconduct that involves a new breach of trust, such as the trustee’s failure to dispose of an improper but ratified investment that later becomes imprudent or otherwise improper because of a change of circumstances.” (emphasis omitted)).
undertaking a program of collateral benefits ESG investing is therefore an open question.

Finally, a word about Delaware. In 2018, Delaware amended its trust code to provide:

[W]hen 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.  

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 interest" rather than "sole interest" loyalty rule by default.

1. The "sole" interest rule and "charitable purpose"

Unlike a private trust, which must be for one or more ascertainable beneficiaries, or a pension plan, which must be for the plan’s participants, a charitable trust or other form of charity must be for the benefit of a...
The list of permissible charitable purposes, which derives from a codification in Britain more than 400 years ago, 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.”

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,” a trustee of a charitable trust must act “solely in furtherance of its charitable purpose.” 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 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. Pursuit of a charity’s charitable purpose by way of third-party benefits from the charity’s investment program, sometimes called “mission-related” or “program-related” investing, is a permissible substitute for direct expenditure by the charity on that purpose. The Restatement of Trusts elaborates:

Social 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

---

205. See Restatement of Charitable Nonprofit Organizations §§ 1.01(a)-(b), 1.02 cmt. b (Am. Law Inst., Tentative Draft No. 1, 2016).
207. Unif. Trust Code § 405(a) (Unif. Law Comm’n 2000); see also Restatement of Charitable Nonprofit Organizations § 1.01(b); 2 Restatement (Third) of Trusts § 28 (Am. Law Inst. 2003).
208. 3 Restatement (Third) of Trusts § 78(1) (Am. Law Inst. 2007) (emphasis added).
209. Id. (emphasis added).
210. See supra note 119 and accompanying text.
211. See Gary, Values and Value, supra note 30, at 268-71.
the investment decision can be justified on grounds of advancing, financially or operationally, a charitable activity conducted by the trust.213

By way of illustration, the Sierra Club or another 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, although enforcement of fiduciary duty in the case of charities largely rests with state attorneys general and is notoriously weak.215

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.”216 Thus, unlike private trusts or pension funds 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.217 And in fact, charities are more typically organized as corporations or unincorporated associations than as trusts.218

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.219 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

213. 3 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt c.
214. See infra Part III.
216. RESTATEMENT OF CHARITABLE NONPROFIT ORGANIZATIONS § 1.02 (AM. LAW INST., Tentative Draft No. 1, 2016).
217. See Lloyd Hitoshi Mayer, Fiduciary Principles in Charities and Other Nonprofits, in THE OXFORD HANDBOOK OF FIDUCIARY LAW, supra note 1, at 103, 111; see also RESTATEMENT OF CHARITABLE NONPROFIT ORGANIZATIONS § 2.02 cmt. b.
218. See SITKOFF & DUKEMINIER, supra note 1, at 759.
219. See supra Part II.A.
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

divestment in the case of a charity with a charitable purpose that did not encompass promoting racial equality in South Africa.\textsuperscript{220} Even under a 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 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 would be 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 would trigger a 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 a 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 materially compromise portfolio efficiency.

Of course, such an analysis still entails a measure of fiduciary risk that could be avoided if exclusion could be justified on risk-return grounds. In this respect, let us consider the ESG and fossil fuel practices of the Harvard and Stanford endowments. With respect to Harvard, after one of its investment managers spoke publicly of “pausing” the endowment’s investment in certain fossil fuels, a spokesperson for the Harvard Management Company (HMC) followed up with a clarification that the manager was “referring solely to his analysis of investments within the natural resources portfolio and how they contribute to the financial strength of the endowment.”\textsuperscript{221} The controlling HMC policy on ESG investing, which speaks of the role of ESG factors in assessing “economic value,” is framed as risk-return ESG.\textsuperscript{222}

\textsuperscript{220.} See supra Part I.B.


\textsuperscript{222.} Harvard Mgmt. Co., Sustainable Investment Policy (2016), https://perma.cc/P7NT-2P7L (“HMC commits to consider material ESG factors in the course of our underwriting, analysis, and monitoring of investments to the extent reasonably practical under the circumstances. For the purpose of this policy, HMC defines material ESG factors as those that we have determined, in our sole discretion, have, or have the potential to have, direct impacts on a company or asset’s ability to create, preserve, or erode economic value.”); see also Investing for the Long-Term, HARV. MGMT. COMPANY (2019), https://perma.cc/9CN9-M8X2 (“As a long-term investor, HMC focuses on environmental, social, and governance (ESG) factors that may impact the performance of our investments.”).
Stanford is a more nuanced case. The controlling Stanford Management Company (SMC) policy on “ethical investment,” which speaks of an obligation “to place proper weight on ethical issues that can have a bearing on economic results,” is likewise framed as an embrace of risk-return ESG. Indeed, referencing “state and federal laws governing trust fiduciaries,” the policy rejects “use [of] the endowment to pursue other agendas.” However, as recognized by the policy, the Stanford Board of Trustees has taken the position “that very rare occasions may arise when companies’ actions or inactions are so abhorrent and ethically unjustifiable as to warrant the University’s dissociation from those investments.” Stanford has thus embraced risk-return ESG with a safety valve for “abhorrent” practices such as “apartheid, genocide, human trafficking, slavery, and violations of child labor laws.”

As applied to fossil fuel divestment, an advisory panel to the trustees recommended divestment under these criteria for “companies whose primary business is oil sands extraction.” The trustees took “no action” on this recommendation, however, because the Stanford endowment had “no direct exposure to companies whose primary business is oil sands extraction.” In other words, as a consequence of following ordinarily applicable fiduciary prudent risk management principles, SMC had already not included such companies in the Stanford endowment. As for the fossil fuel industry more broadly, the trustees decided against divesting on the grounds that Stanford’s criteria for divestment (i.e., “abhorrent and ethically unjustifiable”) were not met.

All told, therefore, the actions of Harvard and Stanford with respect to fossil fuel investments, at least as Harvard and Stanford describe those actions, fit into a risk-return ESG frame. Of course, these cases raise the possibility of pretextual assertions of motive or purpose via cheap talk. The answer in trust

224. Id.
225. Id. (“In rare instances, the University’s Board of Trustees may elect to divest specific companies or categories of investment that are deemed abhorrent and ethically unjustifiable.”).
227. Id.
229. Id.
230. See id.
Reconciling Fiduciary Duty and Social Conscience
72 STAN. L. REV. 381 (2020)

fiduciary law is the rigor of the duty of prudence, which requires that a
trustee’s asserted motive be backed up by a documented reasonable analysis
updated periodically, to which we turn next.

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.”231 The duty of prudence under ERISA and charity law is the
same.232

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.233
Moreover, because there is no equivalent in trust law to corporate law’s
“business judgment rule,”234 the trust law duty of prudence subjects all trustee
actions (or inactions) to substantive judicial review.235 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 as discussed in Subpart A.236

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 in Subpart B, and undertake a balanced review of the current

231. 3 RESTATEMENT (THIRD) OF TRUSTS § 77(1)-(2) (AM. LAW INST. 2007); see also UNIF.
TRUST CODE § 804 (UNIF. LAW COMM’N 2000).

232. 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.” 29 U.S.C. § 1104(a)(1)(B) (2018). 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 OF: CHARITABLE NONPROFIT ORGANIZATIONS § 2.03(a) (AM. LAW INST.,
Tentative Draft No. 1, 2016).

233. See Sitkoff, Agency Costs, supra note 4, at 655.

234. See, e.g., STEPHEN M. BAINBRIDGE, CORPORATE LAW §§ 6.2-.3 (2d ed. 2009).

235. See Sitkoff, Agency Costs, supra note 4, at 656-57; see also Sitkoff, supra note 85, at 41.

236. See infra note 239 and accompanying text. On the implementation of duties 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, supra note 1, at 419, 419-20.
theory and empirical evidence on the risk-return benefits of ESG investing in Subparts C and D. 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, discussed in Subpart C, and whether such a relationship can be exploited by an investor for profit via active investing, discussed in Subpart D, or active shareholding, discussed in Subpart E, on the other.237 We conclude that risk-return ESG investing can, but does not necessarily, satisfy the duty of prudence. Finally, contrary to the PRI and other proponents of ESG investing, the prudent investor rule does not mandate that a trustee use ESG factors, as discussed in Subpart 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.”238 The prudent investor rule thus points to what in modern portfolio theory is known as an “efficient portfolio,” meaning a portfolio that maximizes return for a given level of market risk,239 and it requires aligning overall risk and return with the

---

237. A variety of commentators have confused the existence of a relationship between ESG factors and firm value with the distinct question of whether such a relationship, if it exists, can be exploited by an investor for profit. See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, supra note 10, at 7-8 (confusing “relationship between ESG Factors and financial performance” with “investment performance”); see also, e.g., id. at 17-18 (same). As we show in Part III.F below, confusion about this distinction is especially common among those who advocate for an ESG investing mandate for fiduciaries.

238. UNIF. PRUDENT INV’R ACT §§ 2(b), 3 (UNIF. LAW COMM’N 1994); see also 3 RESTATEMENT (THIRD) OF TRUSTS § 90(a)-(b) (AM. LAW INST. 2007). On circumstances in which not diversifying might be justifiable, see SITKOFF & DUKEMINIER, supra note 1, at 641-42.

The prudent investor rule applies also to charities and to private pensions subject to ERISA. 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. Under the prudent investor rule, by contrast, “[s]pecific investments or techniques are not per se prudent or imprudent.” 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-return objectives reasonably suited to the trust. 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.”

Given the rejection of per se rules of prudent investment, canonical authority recognizes that a trustee may employ active management strategies, such as picking and choosing among different investments. “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.” It follows, therefore, that an ESG investing strategy that involves

---

243. 3 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. f.
244. UNIF. PRUDENT INVR’R ACT § 2(b), (e) (UNIF. LAW COMM’N 1994).
245. 3 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. e(1).
246. See id.
247. Id. § 90 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” and that “[t]hese efforts may involve searching for advantageous segments of a market, or for individual bargains within the highly

footnote continued on next page
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,” and a stock-picking strategy tends to reduce diversification by narrowing the range of the portfolio’s holdings or over-weighting certain holdings. Under the prudent investor rule, these added costs must be offset “by realistically evaluated return expectations.” The trustee must reasonably conclude that improved expected returns “can reasonably be expected” to offset the “additional costs and risks” and “the trustee . . . or the manager of a particular activity” must have “a credible basis for concluding that [she] possesses or has access to the competence necessary to carry out the program.”

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, 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.” The rationale is obvious: “Minimizing costs and expenses preserves trust assets for the beneficiaries.” 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.

The duty of prudence also requires ongoing monitoring. The prudent investor rule, and its subsidiary principle of cost sensitivity, therefore apply to efficient markets as well as in the less efficient ones.”

248. See id. cmt. h(2).
249. See id. (noting “the possible acceptance of a relatively high degree of diversifiable risk” in an active investment strategy).
250. Id.; see also id. ch. 17, introductory note (“[A]ctive 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.”).
251. Id. cmt. h(2).
252. See id. § 88 cmt. a.
254. SITKOFF & DUKEMINIER, supra note 1, at 660-61.
255. See, e.g., 2018 Field Assistance Bulletin, supra note note 9 (permitting ERISA fiduciaries to engage in shareholder activities if the expected benefit outweighs “the costs involved”).

428
a “trustee’s decisions respecting new investments” as well as the trustee’s “continuing responsibility for oversight of the suitability of investments already made.” In the words of the Supreme Court, “a trustee has a continuing duty to monitor trust investments and remove imprudent ones” and “[t]his continuing duty exists separate and apart from the trustee’s duty to exercise prudence in selecting investments at the outset.” 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 those decisions. A typical practice regarding investment decisions is to establish a written investment policy statement. 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.”

A common teaching example is In re Estate of Janes. In that case, a bank trustee was found to be in breach of the duty of prudence for not divesting a concentration in a publicly traded stock. In reaching this conclusion, the court drew attention to the bank trustee’s process failures, including a failure “initially to undertake a formal analysis of the estate and establish an investment plan” as well as a failure “to conduct more than routine reviews” or to “consider[] alternative investment choices” during the period at issue.

By imposing an objective standard of care, the duty of prudence also provides a check against disloyalty covered by pretextual claims of motive. By way of illustration, consider CalPERS’s decision to divest from tobacco stocks.

---

256. UNIF. PRUDENT INV’R ACT § 2 cmt.; see also 3 RESTATMENT (THIRD) OF TRUSTS § 90 cmt. e(1) (noting a trustee’s duty to “make portfolio adjustments if and as appropriate”).


258. 3 RESTATMENT (THIRD) OF TRUSTS § 83; see also Muir, supra note 1, at 174 (noting that an ERISA fiduciary must “document[] the reason for its decision”).

259. See SITKOFF & DUKEMINIER, supra note 1, at 640-41; Schanzenbach & Sitkoff, supra note 239, at 138-39.

260. 3 RESTATEMENT (THIRD) OF TRUSTS § 83 cmt. a(1).


262. Id. at 338-39.

263. Id.
In 2000, CalPERS divested from tobacco on a risk-return ESG theory. However, a 2018 analysis by CalPERS's investment consultants concluded that this divestment was bad for the portfolio, costing roughly $3 billion in returns and reducing diversification. The consultants recommended ending the divestment policy and CalPERS is still grappling with the issue of ESG investment generally. In light of the investment consultants’ advice, and in the absence of a compelling countervailing analysis, CalPERS would be in breach of the duty of prudence if it continues its divestment policy. In such circumstances, a claim that the policy was based on a risk-return analysis would be seen as pretextual.

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. Strong compliance records on environmental and labor regulations are good environmental and social factors. Poorly incentivized and entrenched management are bad governance factors. However, even at this level of abstraction, an investor will have to make subjective judgments about how much weight to give E versus S versus G factors. 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 even more apparent. As the professional association for Chartered Financial Analysts has explained, “[t]here is no one exhaustive list of ESG issues,” and there is no consistency

264. See Randy Diamond, CalPERS Decision to Divest from Tobacco Is Costly, CHIEF INVESTMENT OFFICER (Dec. 12, 2018), https://perma.cc/SKV6-LYPC (reporting that CalPERS’s divestment decision was due to anticipated financial turmoil from tobacco litigation).

265. Id.

266. A member election unseated the pro-ESG president of CalPERS, replacing her with a candidate who emphasized risk-return investing. See Paul S. Atkins, Opinion, California Public Employees Vote Against Pension-Fund Activism, WALL ST. J. (Oct. 18, 2018, 7:07 PM ET), https://perma.cc/EC9E-GXGN.

267. By way of further illustration, a recent study by three quantitative financial analysts at Bessemer Trust found that adding ESG factors into their investment models caused “underperformance” that in some specifications was “statistically significant” at the 10% level. See Edward N.W. Aw et al., A Morality Tale of ESG: Assessing Socially Responsible Investing, J. WEALTH MGMT., Spring 2017, at 14, 19-21. 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.

268. CFA INST., supra note 7, 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 16, at 30.
in the labels used to describe investment strategies that consider ESG factors.\footnote{269} There are hundreds of ESG ratings services and ESG-themed mutual funds,\footnote{270} and they often disagree. For example, the well-known ratings agency Morningstar found that about half of the ESG mutual funds assessed scored as average or worse than non-ESG funds on Morningstar’s own “sustainability” assessments.\footnote{271}

Consider the often-contentious debates around environmental harms. There is broad abstract agreement about the environmental costs of coal and oil, but some types of coal may be cleaner than others, and some forms of oil production are less harmful than others.\footnote{272} There is similar dispute about the environmental impact of natural gas.\footnote{273} And nuclear power offers low carbon emissions but a potentially substantial “tail risk” in the event of a meltdown.\footnote{274}

The use of social factors is often dependent on social norms and is therefore perhaps more fraught than environmental factors. For example, in 2006, one of the oldest socially responsible mutual funds, the PAX Fund, dropped its longstanding rules barring it from investing in firms that conduct alcohol and gambling business.\footnote{275}

\footnote{269. See CFA INST., supra note 7, at 5.}
\footnote{270. See supra note 16 and accompanying text.}
\footnote{271. See Aime Williams, Ethical Funds Failing Social Responsibility Tests, FIN. TIMES (Oct. 31, 2016), https://perma.cc/UBJ5-RUXD.}
\footnote{272. See, e.g., Ian Urbina, Short Answers to Hard Questions About Clean Coal Technology, N.Y. TIMES (July 5, 2016), https://perma.cc/9P2Z-P7ZW (discussing the optimistic view that clean coal can “play a vital role in slowing climate change” as well as skepticism that it can be cost effective); Stanford and Climate Change Press Release, supra note 228 (noting that the extraction of petroleum from oil sands releases more greenhouse gas emissions than other forms of fossil fuel extraction).}
\footnote{274. See Mark Diesendorf, Accidents, Waste and Weapons: Nuclear Power Isn’t Worth the Risks, CONVERSATION (May 18, 2015, 4:04 PM EDT), https://perma.cc/C93F-2JHF (arguing that nuclear power contributes to the creation of weapons, results in serious accidents, leads to more greenhouse gas emissions, and is expensive); Melanie Windridge, Fear of Nuclear Power is Out of All Proportion to the Actual Risks, GUARDIAN (Apr. 4, 2011, 7:40 AM EDT), https://perma.cc/WY45-ZGVM (noting that nuclear power is relatively safe and may be important in shifting to carbon-free energy production); see also STAN GORDIELER, NUCLEAR ENERGY AGENCY, ORG. FOR ECON. CO-OPERATION & DEV., COMPARING NUCLEAR ACCIDENT RISKS WITH THOSE FROM OTHER ENERGY SOURCES 3 (2010), https://perma.cc/9U6E-4HYS (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”); Spencer Wheatley et al., Short Communication, Reassessing the Safety of Nuclear Power, ENERGY RES. & SOC. SCI., May 2016, at 96, 98 (summarizing statistical analyses and finding a 50% chance of a Fukushima event every 60-150 years). We take up “tail risk” in Part III.D.1 below.}
Governance factors are also disputed. Consider a classified or staggered board, that is, a board in which the directors have staggered terms, requiring multiple rounds of shareholder elections to change a majority of the 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, with some studies finding a negative effect on firm value and others finding a positive effect in specific contexts.276

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.277 BlackRock takes the position that “in order to create a constructive debate of competing views and opinions in the boardroom,” a board of directors should “be comprised of a diverse selection of individuals,” including “at least two women directors on every board.”278 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.279

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, because of the sometimes erratic behavior of its founder and controlling shareholder, Elon Musk, and because Musk has close ties to several directors, Tesla often scores low in governance ratings.280 Tesla also garners low social ratings due to its

---


279. See Deborah L. Rhode & Amanda K. Packel, Diversity on Corporate Boards: How Much Difference Does Difference Make?, 39 DEL. J. CORP. L. 377, 383 (2014) (observing that “[d]espite 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) (“[W]e 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.”)

The environmental impact of Tesla depends critically on how one weights its inputs (emissions from its factories) versus its outputs (low-emission cars). 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, Tesla also faces regulatory and governmental policy risk to the extent that its sales are dependent on tax subsidies for electric car buyers.

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 both application and empirical evaluation of ESG investing 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.”

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. Some empirical evidence validates these arguments, although

---

281. See Mackintosh, supra note 280.
282. See id.
283. Id.
284. See infra notes 293-94 and accompanying text.
287. 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 Parts III.D and III.E below respectively.
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. The entrenchment of management, executive compensation arrangements, and whether a firm has a controlling shareholder 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.288

On the other hand, there is disagreement about the extent to which existing studies have reliably measured the relationship between governance and firm value.289 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.290

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.291 Although investors and academics are generally hostile to poison pills, most acknowledge that there are circumstances in which a pill may be beneficial to shareholders, depending on the design of the pill and the firm’s circumstances.292

288. See, e.g., supra note 73 and accompanying text.
289. See Klausner, supra note 276, at 184-85 (canvassing “challenges” in undertaking reliable empirical studies of corporate governance).
291. See supra note 276 and accompanying text.
292. “Poison pills” refer to a variety of defensive tactics used by corporate boards to defeat a share purchase offer made directly to shareholders that would result in a controlling shareholder by granting the other shareholders rights to purchase additional shares. See, e.g., STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 680-90 (2002). As a general matter, poison pills have been met with academic skepticism because they undermine the market for corporate control. The theory of the market for corporate control posits that the ability of shareholders to sell their shares to third parties (exit) instead of trying to effect change internally (voice) further disciplines boards by giving rise to a constant takeover threat. See Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. POL. ECON. 110, 112-13 (1965); see also Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1164 (1981). On the other hand, a poison pill or other such defensive measure could be used by a board to protect against a hasty sale of the company or as leverage to negotiate a higher price. See Lucian A. Bebchuk, Comment, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028, 1030 (1982) (commenting on Easterbrook & Fischel, supra) (arguing that competing offers can

footnote continued on next page
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 disaster or the risk of large fixed investments becoming “stranded” following a dramatic regulatory change.

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

generate higher bids and thereby benefit shareholders while ensuring that a firm goes to whoever values it the most). Not all professional investors categorically oppose poison pills. See, e.g., BLACKROCK, supra note 278, 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.’”).

293. See SPARKES, supra note 46, at 60-62 (discussing the Exxon Valdez oil spill and subsequent harm to investors).


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


297. See Allen Ferrell et al., Socially Responsible Firms, 122 J. FIN. ECON. 585, 586 (2016) (finding that corporate social responsibility increases as firm governance improves).
The theoretical relationship between firm value and environmental and social factors has some empirical support, though not as strong as that in favor of governance factors. In general, studies of firm performance find that firms with high environmental and social scores enjoy higher earnings with lower risk than firms with low environmental and social scores. Moreover, there is evidence that firms can build goodwill through socially responsible activities, which can protect against reputational harm from adverse events.

The favorable empirical results regarding environmental and social factors, however, are not uniform. A significant concern is that managers may invoke ESG factors to enact their own policy preferences at the expense of shareholders—an agency problem for which there is also some empirical evidence. Another concern is that the extent of a firm’s regulatory and political risks may not be reflected in its ESG scoring. For example, companies pursuing alternative energy sources may score high on ESG factors but still face significant political and regulatory risk owing to heavy reliance on current government policy. Indeed, one of the Commissioners on the Securities and Exchange Commission (SEC) has suggested that the SEC has not yet taken a position on ESG disclosure in part because defining ESG factors is value laden and would involve confronting contentious political issues.

---

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


302. See Hester M. Peirce, SEC Commissioner Airs Her Beef with Stakeholders, CLS BLUE SKY BLOG (Sept. 26, 2018), https://perma.cc/PV6N-R9LT (suggesting that E and S factors “seem to be included in the ESG rubric because they hew to a what a select group of
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.\(^{303}\) 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."\(^{304}\)

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 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.\(^{305}\) 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.\(^{306}\) ESG strategies, by contrast, aspire to forecast risk

---

\(^{303}\) The classic exposition on efficient markets and the difficulty of profitable stock picking is BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET: THE TIME-TESTED STRATEGY FOR SUCCESSFUL INVESTING 35-54 (11th ed. 2015). See also John E. Core et al., Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors’ Expectations, 61 J. FIN. 655, 684-85 (2006) (finding that poorly governed firms exhibit significant operating underperformance but that the market incorporates this information).

\(^{304}\) 3 RESTATEMENT (THIRD) OF TRUSTS ch. 17, introductory note (AM. LAW INST. 2007).

\(^{305}\) See, e.g., Gary, Values and Value, supra note 30, at 274 (arguing in favor of ESG investing in part based on market inefficiency); Maria O’Brien Hylton, “Socially Responsible” Investing: Doing Good Versus Doing Well in an Inefficient Market, 42 AM. U. L. REV. 1, 5 (1992) (arguing that inefficient markets can produce returns to SRI).

\(^{306}\) See, e.g., BODIE ET AL., supra note 143, at 117.
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.\footnote{307}

A particular focus of risk-return ESG investing strategies are on so-called “tail risks,” meaning low-probability but high-impact events that by definition would be poorly reflected in historical data and therefore perhaps not accurately priced, even in an otherwise efficient market.\footnote{308} 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.\footnote{309} 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 breakthrough clean energy discovery.\footnote{310} 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, but the evidence is not uniformly in favor of this conclusion.\footnote{311}

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

\footnote{307. See Christoph M. Klein, Integrating ESG into the Fixed-Income Portfolio, CFA INST. CONF. PROC. Q., Fourth Quarter 2015, at 46, 48 (“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.”).}

\footnote{308. See BODIE ET AL., supra note 143, 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 Bryan Kelly & Hao Jiang, Tail Risk and Asset Prices, 27 REV. FIN. STUD. 2841, 2868 (2014) (concluding that firms with large tail risks return significantly more than firms with low tail risks, suggesting that markets price tail risk).}

\footnote{309. See, e.g., Roger Urwin, MSCI, The BP Oil Spill and ESG 1-2 (2010), https://perma.cc/T7JM-V9D3.}

\footnote{310. See supra notes 293-94 and accompanying text.}

\footnote{311. Compare Nofsinger & Varma, supra note 75, at 184-88 (suggesting that funds using ESG factors performed better in the bear markets of 2000 and 2008, although the difference was not statistically significant at conventional levels), with Lloyd Kurtz & Dan diBartolomeo, The Long Term Performance of a Social Investment Universe, J. INVESTING, Fall 2011, at 95, 98 (finding that SRI-favored stocks outperformed the S&P 500 during the 1990s but underperformed during the 2000s and arguing this result traces in part to an SRI skew toward stocks in the technology industry).}
of risk, but it is not the only one.\textsuperscript{312} 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.\textsuperscript{313} 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.\textsuperscript{314}

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.\textsuperscript{315} 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.\textsuperscript{316}

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.\textsuperscript{317} Moreover, with increasing firm-level ESG disclosure over time,\textsuperscript{318} implementing an ESG screen has become less costly, which invites more competition, reducing any payoff to the strategy. Not surprisingly, most

\textsuperscript{312} Value at risk, expected shortfall, and lower partial standard deviation are other textbook measures of risk. See Bodie et al., supra note 143, at 138-39.

\textsuperscript{313} See id. at 136-40.

\textsuperscript{314} See, e.g., U.S. Gov’t Accountability Office, supra note 10, at 20. We treat proxy voting and other shareholder engagement under the rubric of active shareholding in Part III.E below.

\textsuperscript{315} See, e.g., Fidelity Launches Two ESG Index Funds, InvestmentNews (May 15, 2017, 1:31 PM), https://perma.cc/4GFX-4DNN.

\textsuperscript{316} The Dow Jones Sustainability Index takes a best-in-class approach. See RobecoSAM, DSJI 2017 REVIEW RESULTS 3, 7 (2017), https://perma.cc/V4H5-8DBP; see also Meir Statman & Denys Glushkov, The Wages of Social Responsibility, Fin. Analysts J., July/Aug. 2009, at 33, 41-42 (finding that a positive screen that overweights firms with high ESG ratings can avoid the diversification costs of a negative screen).

\textsuperscript{317} See, e.g., Does ESG Pay Off Financially?, supra note 124, at 4-5.

\textsuperscript{318} See Dieschbourg & Nussbaum, supra note 16, at 29-31.
empirical studies find that, on a risk-adjusted basis, employing ESG screens leads to performance about the same as or worse than their benchmark indices.319

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.320 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.321

In contrast to a screening strategy, stock picking focuses on applying ESG factors in constructing a portfolio of individual securities.322 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 multifactor analysis to predict return.323 Eugene Fama and Kenneth French developed their model by observing that the capital asset pricing model, commonly called CAPM, which looks solely to market risk to predict returns based on an asset’s correlation with the broader market, was empirically inadequate.324 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,325 and additional factors have been added over time.326 In a similar vein, risk-return ESG investors sometimes use a multifactor model that includes ESG factors, an


320. See, e.g., Statman & Glushkov, supra note 316, at 41-42.


322. For a classic (but critical) discussion of stock picking, see Malkiel, supra note 303, at 393-97.

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

324. Id. at 4.

325. Id. at 4-5.

326. See Eugene F. Fama & Kenneth R. French, A Five-Factor Asset Pricing Model, 116 J. FIN. ECON. 1, 2 (2015) (developing a five-factor model that adds investment and profitability to the prior three-factor model).
approach that seems to be endorsed by recent PRI publications. 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.

All told, 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, however, 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.

3. The usual caveats about stock picking

Separate from ESG-specific considerations, all the standard caveats that apply to active investing strategies in general pertain also to ESG investing. 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 transaction costs is hard, and even harder to do consistently. Only a subset of actively managed mutual funds outperforms benchmark indices on a regular basis, and most actively managed funds have typically underperformed passive index funds. As a leading investments text puts it, "the easy pickings have been picked."

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,

---

327. See PRINCIPLES FOR RESPONSIBLE INV., A PRACTICAL GUIDE TO ESG INTEGRATION FOR EQUITY INVESTING 6 (2016), https://perma.cc/3CQZ-M86N.

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

329. See, e.g., Kenneth R. French, Presidential Address, The Cost of Active Investing, 63 J. FIN. 1537, 1561 (2008) (concluding that a passive investor from 1980 to 2006 would have beaten an active investor by sixty-seven basis points per year).

330. BODIE ET AL., supra note 143, at 364 ("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.").
diminishing the predictive power of historical data.\textsuperscript{332} 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.\textsuperscript{333} 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.\textsuperscript{334} 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.\textsuperscript{335} 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 technology.\textsuperscript{336}

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.\textsuperscript{337} 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 transaction costs.

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 and thus diminishing the benefits to the strategy.\textsuperscript{338} Likewise, academic studies that find asset mispricing often fail to translate into a profitable trading strategy. This result has been attributed to several factors, including the fact that the public nature of an academic finding

\begin{footnotes}
\item[333] See supra Part III.D.1.
\item[334] See BODIE ET AL., supra note 143, at 194-95 (discussing diversification).
\item[336] See, e.g., Leonardo Becchetti et al., Socially Responsible and Conventional Investment Funds: Performance Comparison and the Global Financial Crisis, 47 APPLIED ECON. 2541, 2556-58, 2560 (2015) (finding that SRI funds outperformed during the financial crisis of 2008 but not during the stock market drop of 2001—likely due to their overweighting of the technology sector); Kurtz & diBartolomeo, supra note 311, at 98.
\item[337] See MALKIEL, supra note 303, at 137, 143-45, 150, 155-56.
\item[338] See, e.g., Lucian A. Bebchuk et al., Learning and the Disappearing Association Between Governance and Returns, 108 J. FIN. ECON. 323, 324 (2013) (finding that corporate governance factors were increasingly reflected in share price due to investor learning).
\end{footnotes}
may prompt a quick price correction, the tendency of academic work to overstate the magnitude and significance of mispricing owing to publication bias, and diversification and transaction costs preventing the successful implementation of active strategies. The lack of persistence of profitable active investment strategies is widely recognized, including by proponents of risk-return ESG investing.

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. Trust fiduciary law also imposes an ongoing duty to monitor an investment program, requiring 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.

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. There is also evidence that so-called "sin" or "vice" stocks


340. Publication bias refers to the preference of peer-reviewed journals for publication of statistically significant results. Inconclusive results or nonfindings 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 modeling 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 et al., . . . And the Cross-Section of Expected Returns, 29 REV. FIN. STUD. 5, 36-37 (2016) (suggesting that between approximately a third to a half of factors found to have significant excess returns reflect data mining and research design choices); Kewei Hou et al., Replicating Anomalies 1 (Nat’l Bureau of Econ. Research Working Paper Series, Working Paper No. 23394, 2017), https://perma.cc/M83L-89P5 (finding that the majority of excess return findings published in the anomalies literature were not replicable).

341. See Does ESG Pay Off Financially?, supra note 124, at 4-5.

342. See supra Part III.A.

343. See supra Part III.A.

344. See Josef Lakonishok et al., Contrarian Investment, Extrapolation, and Risk, 49 J. FIN. 1541, 1574 (1994); see also MALKIEL, supra note 303, at 267-68.
outperform on a risk-adjusted basis because of investor distaste for the company’s products or practices.\textsuperscript{345} 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 multifactor asset pricing model is a double-edged sword. Such models, being data driven,\textsuperscript{346} 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 \textit{active shareholding}, in contrast to active investing via screens or stock picking (others call it \textit{stewardship}).\textsuperscript{347} 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.\textsuperscript{348}


\textsuperscript{346. See} Eugene F. Fama, \textit{Finance at the University of Chicago}, 125 J. POL. ECON. 1790, 1795 (2017) (discussing the risk of “factor models . . . degenerating into mindless data dredging”).

\textsuperscript{347. See, e.g.,} EOS Stewardship Services, \textsc{Hermes Investment Mgmt.}, https://perma.cc/GG25-QPTH (archived Dec. 22, 2019).

Active shareholding has increased significantly over the past two decades, in part facilitated by regulatory reforms and increasing institutional ownership that facilitates monitoring and coordination among shareholders. Much of this activity has been focused on governance factors, such as reducing management entrenchment and executive pay. But there is also growing attention to environmental and social factors such as diversity in board composition and “climate risk and the environment.” 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.

There is evidence that shareholder activism, even in the form of nonbinding resolutions or withholding votes, can affect corporate policy. Firms commonly adopt shareholder proposals, and incumbent directors often resign if a large number of votes are withheld. 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.

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

---

349. See, e.g., John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 ANNALS CORP. GOVERNANCE 1, 2 (2016) (stating that “hedge fund activism has recently spiked, almost hyperbolically”).
351. EY CTR. FOR BD. MATTERS, supra note 277, at 5-6.
352. See Does ESG Pay Off Financially?, supra note 124, at 4 (noting likelihood of market prices adjusting to ESG factors and consequent need for “active ownership strategies”).
353. Yonca Ertimur et al., Board of Directors’ Responsiveness to Shareholder: Evidence from Shareholder Proposals, 16 J. CORP. FIN. 53, 54 (2010) (finding that around 40% of shareholder proposals were later adopted by boards).
354. See, e.g., Jie Cai et al., Electing Directors, 64 J. FIN. 2389, 2391 (2009) (concluding that, though directors are rarely removed by voting, low vote totals reduce CEO compensation and increase turnover, with no effect on share prices); Diane Del Guercio et al., Do Boards Pay Attention When Institutional Investor Activists “Just Vote No?”, 90 J. FIN. ECON. 84, 102 (2008) (concluding that “just vote no” campaigns are associated with subsequent board action and CEO turnover, with positive stock price effects resulting from these events).
consequence, collective action and free-rider difficulties plague active shareholding, as acknowledged by the PRI.

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. 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, are generally low cost, and have had some success.

But a low-cost approach may be insufficient to defeat a management proposal, remove a director, or pass a shareholder resolution. 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. An investor could wage an outright proxy fight, soliciting all shareholders to vote in

---


357. Does ESG Pay Off Financially?, supra note 124, at 5 (noting “the problem of freeriding because the returns on the efforts of active owners are shared among all investors”).


359. See Joseph A. McCahery et al., Behind the Scenes: The Corporate Governance Preferences of Institutional Investors, 71 J. FIN. 2905, 2906-07, 2911-12 (2016) (finding significant reliance on Institutional Shareholder Service and informal discussions, and noting that 42% of survey respondents believe that exit threat disciplines management); see also Marco Becht et al., Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund, 22 REV. FIN. STUD. 3093, 3095-96 (2009) (concluding in a case study that informal engagements have generated excess returns).

360. 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 BAINBRIDGE, supra note 292, at 193 & n.8. 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. See id. at 495-96, 500-01.

agreement with the investor. But this involves paying the costs of a proxy contest, and incumbent directors have powerful structural advantages. 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 with them. 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. 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. Successful shareholder proxy fights have been found to improve firm value, but this approach is costly and risky, and unsuccessful fights can decrease firm value. Shareholder proposals and informal negotiations have, at most, very small positive effects on firm performance, with some studies finding negative effects. There is stronger evidence that activist hedge funds may be successful in achieving excess returns, in part because they do not need to be diversified and so can assemble larger stakes, and in part because they are less regulated than other investment vehicles.

362. Pension funds such as TIAA-CREF have also waged proxy fights with some success. See Carleton et al., supra note 355, at 1336.

363. See Marcel Kahan & Edward Rock, The Hanging Chads of Corporate Voting, 96 GEO. L.J. 1227, 1248-67 (2008) (detailing the various ways corporate voting can be manipulated or go wrong); Yair Listokin, Management Always Wins the Close Ones, 10 AM. L. & ECON. REV. 159, 162-63, 178-80 (2008) (finding that close elections are more likely to break for management and incumbent directors and interpreting the result as evidence of the structural advantages of those in control). Firms with significant inside ownership seem to be particularly challenging for proxy contests. See McCahery et al., supra note 359, at 2921.


366. See Matthew R. Denes et al., Thirty Years of Shareholder Activism: A Survey of Empirical Research, 44 J. CORP. FIN. 405, 406-07, 416 (2017) (surveying the literature and concluding that the results are mixed, but reporting that relatively recent studies tend to be more supportive of activism particularly if accompanied by larger share ownership); Yermack, supra note 350, at 118.

367. See Denes et al., supra note 366, at 407, 410.

368. See id. at 410.

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

370. See Yermack, supra note 350, at 118-19.
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 decisionmaking. It may also direct scarce managerial resources to implementing shareholder proposals or contesting elections. That even a sophisticated shareholder will be a better decisionmaker than management is hardly a forgone conclusion. Shareholders can be wrong and indeed may be so more often than management. The corporate form, which separates ownership and control, is an efficient form of enterprise organization in part for this very reason.

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 Department of Labor has observed, a trustee should “vote proxies on issues that may affect the value of the plan’s investment,” but only if the vote is “expected to have an effect on the value of the plan’s investment that warrants the . . . cost of voting.” 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.”

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 its

371. See Philippe Aghion & Jean Tirole, Formal and Real Authority in Organizations, 105 J. Pol. Econ. 1, 3-5 (1997) (developing a theory of optimal delegation of decisionmaking, motivated in part by corporate structure); Mike Burkart et al., Large Shareholders, Monitoring, and the Value of the Firm, 112 Q.J. Econ. 693, 694 (1997) (developing a theory that finds decreased managerial initiative as a result of increased shareholder activism).
372. See Yermack, supra note 350, at 119-20 (expressing particular concern about “[s]ocially oriented shareholder proposals”).
373. 2016 Interpretive Bulletin, supra note 9, at 95,883.
374. Id. at 95,880.
ongoing assessments of the strategy. 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 Department of Labor, “no different [from] the standards applicable to [fiduciary] investments generally.”

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 Department of Labor) that a trustee must consider ESG factors. 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.” 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.”

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 investments and disfavored other investments as speculative, and aligning the law of prudent trust investment with modern portfolio theory. 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. Ironically, it is the flexibility of the prudent investor rule that allows a trustee to consider ESG factors. The prudent investor rule was meant

375. See supra Part II.A.
376. 2015 Interpretive Bulletin, supra note 9, at 65,137.
377. See 2018 Field Assistance Bulletin, supra note 9 (rejecting the “view that investment policy statements must contain guidelines on ESG investments or integrating ESG-related tools to comply with ERISA”).
378. See supra notes 28-30 and accompanying text; see also infra note 387 and accompanying text.
379. 3 RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. f(2) (AM. LAW INST. 2007).
380. UNIF. PRUDENT INV’R ACT § 2(b), (e) (UNIF. LAW COMM’N 1994).
381. See supra note 242 and accompanying text.
382. See UNIF. PRUDENT INV’R ACT, prefatory note (“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.”).
to get courts and legislatures out of the business of prescribing by category or method per se rules on what investments would and would not be prudent.

Setting aside the deep doctrinal flaw in the argument that the prudent investor rule mandates a particular kind of investment strategy when the rule explicitly states the opposite, there is also the 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 an investor’s perspective, and how much weight to give to different ESG factors. 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; both favoring or disfavoring nuclear power; or both requiring only one woman or requiring at least three women on a board. 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 therefore (3) a trustee must consider ESG factors.

383. See supra Part III.B.

384. See supra text accompanying notes 276, 291-92 (discussing the contextual nature of corporate governance and disagreements over the consequences of poison pills).

385. See supra note 274 and accompanying text.

386. See supra notes 278-79 and accompanying text.

387. See, e.g., FRESHFIELDS REPORT, supra note 28, 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.” (emphasis omitted)); SULLIVAN ET AL., supra note 29, at 9 (“Failing to consider long-term investment value drivers, which include environmental, social and governance issues, in investment practice is a failure of fiduciary duty.”); Laura E. Deeks, Discourse and Duty: University Endowments, Fiduciary Law, and the Cultural Politics of Fossil Fuel Divestment, 47 ENVTL. L. 335, 344-45, 418 (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 30, at 801 (“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.”).
The many errors in this syllogism are readily apparent. To begin with, the syllogism conflates a relationship to firm performance with an investment profit opportunity. But a factor’s relationship to firm performance, whether ESG or otherwise, does not give rise to a profitable trading opportunity unless capital markets consistently misprice the factor in a predictable manner that can be exploited net of any trading and diversification costs. 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.

Accordingly, even if ESG factors have a relationship to firm performance, a prudent trustee could conclude that she cannot cost-effectively exploit them for profit. As we have seen, this conclusion finds abundant theoretical and empirical support in the finance literature. It has also been embraced by the Supreme Court:

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

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. 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 see ‘little hope of outperforming the market,’” and therefore “prudently rely on the market price.”

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.\footnote{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, 1515-17 (2015) (analyzing the fee structure of employer-sponsored 401(k) plans, their welfare losses, and proposing regulation that would encourage passively managed funds).}

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.\footnote{See supra Part III.D.4.} 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 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.\footnote{See \textsc{Malkiel}, supra note 303, at 146-51.} 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.\footnote{See supra Part III.D.3.}

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.\footnote{Susan N. Gary doubles down on this argument by also invoking the duty of impartiality, which requires a trustee to give “due regard” to the interests of current and future beneficiaries, \textsc{3 Restatement (Third) of Trusts § 79(1)(a) & cmt. c (Am. Law Inst. 2007).} See Gary, \textit{Best Interests in the Long Term}, supra note 30, at 795 (“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.} 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.

Finally, 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.

In sum, mandating a long-term ESG perspective for trustees or other investment fiduciaries is contrary to both prevailing law and widely accepted principles of financial 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.”

Conclusion

We have considered the law and economics of ESG investing by a trustee of a pension, charity, or personal trust. Our core takeaways 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.

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.

In contrast, the sole interest rule is mandatory for ERISA trustees, reflecting the context to which ERISA applies. A pension plan 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 exclusively the financial interests of the beneficiaries reflects not just the text of the statute but also sound public policy.