

The Trouble with Tibble:
Environmental, Social, and Governance (ESG) and Fiduciary Duty

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Introduction

The aggressive expansion of Environmental, Social, and Governance (ESG) factors in financial investments over the past decade has challenged prior concepts of corporate responsibility. A conflict has developed amongst lawmakers and advocates over the responsibility of corporate directors and fund managers relating to ESG, most notably, whether implementing ESG is a breach of fiduciary duty. To address this question, this article will look at the international origins of ESG, provide an overview of fiduciary duty, and examine possible conflicts between ESG and fiduciary duty.

The differences in the role, as well as the regulatory schemes, of a director of a corporation and that of a fund manager may appear to show a divergence in fiduciary duty. One may assume that an analysis of both roles in a singular work leads to a conflation of principles, however the broad reaching nature of ESG has created a comingling of principles that are so intertwined in official documents they cannot be differentiated. Proponents of ESG apply the same fiduciary duty principles, and arguments, to both corporate directors and fund managers. Legislative and regulatory advancements in ESG, both generally and as it relates to fiduciary duty, will impact directors and

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managers similarly. Therefore, for the purposes of this article, the two will be addressed jointly, with diversions noted.

History of ESG

The phrase Environmental, Social, and Governance (ESG) finds its origins in the 2004 United Nations Global Impact Report *Who Cares Wins: Connecting Financial Markets To A Changing World*.² However, the concept of ESG goes back much further. For instance, the roots of ESG in the United Kingdom (UK) can be found in a 2000 HM Treasury taskforce that analyzed how entrepreneurship could combine financial and social returns.³ Some surmise that some form of ESG existed as far back as the 1960s.⁴

Generally, ESG is a way to measure a company's impact and positive actions relating to environmental standards, for example the use of clean energy, social concerns like affordable housing, and its governance relating to equality and inclusion. ESG Investing is financial investing in institutions and corporations that meet ESG metrics.⁵

In the 2006 United Nations project, Principles for Responsible Investment (PRI), signors pledged to six principles for the advancement of ESG in investing.⁶ Those principles included a pledge that the signors “will incorporate ESG issues into investment analysis and decision-making processes.”⁷ Since its original adoption, PRI has grown from 20 original signatories to 1,184

² https://www.unglobalcompact.org/docs/issues_doc/Financial_markets/who_cares_who_wins.pdf, last accessed May 2022.

³ HM Treasury, also referred to as Her Majesty's Treasury or the Exchequer, is the treasury department of the government of the United Kingdom. *See generally* HM Treasury, A Report to the Chancellor of the Exchequer from the Social Investment Task Force (2000). Available at https://static1.squarespace.com/static/5a6f0b584c0dbf370367c95a/t/5b27ccd803ce643d6e7ccb10/1529335005229/SI_TF_Oct_2000.pdf

⁴ *See* Robert Eccles, Linda-Eling Lee, Judith Stroehle, *The Social Origins of ESG? An Analysis of Innovest and KLD* (2018). Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318225

⁵ Growing a Culture of Social Impact Investing in the United Kingdom (2017). Available at https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/664321/Full_Report_Growing_a_Culture_of_Social_Impact_Investing_in_the_UK.pdf

⁶ <https://www.unpri.org/about-us/about-the-pri>, Last accessed May 2022.

⁷ *Id.*

institutional investors.⁸ ESG has continued to grow and develop since the first 2006 introduction, with the creation of multiple investment tools, such as green bonds, a government bond designated for use on green initiatives, ESG review in credit ratings, and ESG implementation plans by transnational corporations.⁹

Controversy

Advocates claim that ESG is an opportunity for socially conscious individuals to place their investments into corporations that align with their values.¹⁰ There is arguably a market for such investments.¹¹ Opponents claim that ESG is a way for left leaning activists to impose their political ideals on corporations.¹²

One serious issue facing ESG is a lack of clarity: lack of clarity as to how funds are used, availability of investments, and, most significantly, what exactly ESG investing is. Multiple terms and concepts overlap, even in official government studies and reports. The terms environmental, social and governance investing (ESG); impact investing; social impact investing; social investing; and sustainable investing are conflated depending on the author. For instance, there is a general lack of clarity as to whether ESG investing is a subsidiary of impact investing, is a standalone form of investment, or if ESG is the catch-all phrase.

Over the past decade, multiple organizations, both IGO and NGO, have become involved in the development of ESG, however their publications typically produce general principles, rather than

⁸ <https://www.unpri.org/about-us/about-the-pri>, Last accessed May 2022.

⁹ See Jonathan McGowan, *The United Kingdom's Green+ Gilt*, The Year In Review, The International Law Journal of American Bar Association/ International Law Section, 56 ABA/ILS YIR (2022). See also Jonathan McGowan *Impact Investing in the United Kingdom*, Chapter in *Impact Investing and Social Enterprises*, edited by Robert Brown and Alan Gutterman, ABA Publishing, 2022. See also <https://news.samsung.com/global/samsung-electronics-releases-2021-sustainability-report>. See also <https://www.businesswire.com/news/home/20210713005792/en/Moodys-Launches-First-of-Its-Kind-ESG-Score-Predictor-to-Provide-Transparency-on-ESG-Risk-for-Millions-of-SMEs-Worldwide>

¹⁰ See The Impact Investor, *8 Reasons Why ESG Investing is Important* (April 24, 2022). Available at <https://theimpactinvestor.com/why-esg-investing-is-important/>

¹¹ Scottish Widows, *ESG – What Resonates with pension Investors* (June 2020). Available at <https://adviser.scottishwidows.co.uk/assets/literature/docs/60242.pdf>

¹² See Nathan Crooks, *Ron DeSantis Takes Aim at Woke CEOs*, Bloomberg (July 27, 2022). Available at <https://www.bloomberg.com/news/articles/2022-07-27/desantis-takes-aim-at-woke-esg-investing-singles-out-paypal>

actual hard guidance. For example, PRI Principle 1 includes as “possible actions” by signors that they “support development of ESG-related tools, metrics, and analyses.” Following their 2015 study, PRI released a series of country specific guidance publications called roadmaps, yet even those specific plans reverted to general principles and calls for action.¹³ The European Law Institute currently has a project on Corporate Sustainability, Financial Accounting and Share Capital, however that project is also focused primarily on principles, not hard metrics.¹⁴

In February 2021, the United States Securities and Exchanges Commission (SEC) directed the Division of Corporate Finance to create guidance for funds and corporations relating to ESG disclosures of climate change matters.¹⁵ However, that directive and subsequent SEC action has been focused on a singular element of ESG, the environmental piece, and only as it relates to how certain investment advisors and funds present their climate change actions in shareholder reports.¹⁶ The final action offered no guidance as to ESG factors or definitions, acknowledging that “there’s currently a huge range of what asset managers might disclose or mean by their claims.”¹⁷ It only required advisors and funds to declare how they determined their ESG ratings.¹⁸

While positioning to be a leader in the ESG market, Germany has also encountered struggles with the lack of clarity. A 2022 study by Faire Fonds found that only 10% of German ESG funds included “noncontroversial” investments, with 40% investing in “defence.”¹⁹ In 2021, the German government released their Sustainable Finance Strategy, *Shifting the Trillions – A sustainable financial system*

¹³ <https://www.fiduciaryduty21.org/country-roadmaps.html>

¹⁴ <https://www.europeanlawinstitute.eu/projects-publications/current-projects/current-projects/corporate-sustainability/>

¹⁵ Commissioner Allison Herren Lee, Statement of Review of Climate-Related Disclosure, U. S. Securities and Exchange Commission, February 24, 2021. Available at <https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure>

¹⁶ Chair Gary Gensler, Statement on ESG Disclosure Proposal, U.S. Securities and Exchange Commission, May 25, 2022. Available at <https://www.sec.gov/news/statement/gensler-statement-esg-disclosures-proposal-052522>

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Sandra Heistrüvers, *Only 10% of German ESG funds shun controversial assets, activists claim*, Financial Times, May 25, 2022. Available at: <https://www.ft.com/content/372c9402-4702-4a45-940e-02d60f7d79d6>

for the great transformation, in which they outlined a 31-point plan that included the development of regulatory requirements and definitions for ESG reporting.²⁰ The regulatory plan was met with anticipation from asset managers and regulators who believed the German regulations would set a global framework.²¹ However, in the wake of the Russian invasion into Ukraine and the subsequent energy crisis, the regulatory development was postponed indefinitely as a result of instability in the market.²²

The Corporate Sustainability Reporting Directive (CSRD) adopted by the European Parliament in November 2022, provides an update to the 2014 non-financial reporting directive to expand it for more detailed reporting requirements relating to ESG by January 2024.²³ The reports shall be “understandable, relevant, representative, verifiable, comparable, and ... represented in a faithful manner.”²⁴ However, the proposal still falls short of clear definitions and methodology and is similar to those of the SEC.

While disclosure of methodology will improve both the investors and corporations understanding of how ESG ratings are calculated by advisors and funds, the acknowledged inconsistency of the methodology not only feeds the critics, but justifies their concerns. Funds may weigh social and governance factors more heavily than environmental factors, resulting in environmentally friendly companies not being considered ESG compliant. Tesla CEO Elon Musk

²⁰ Available at: <https://sustainable-finance-beirat.de/en/publications/>

²¹ Natasha Turner, *Sustainable Finance Strategy looks to mandate non-financial corporate reporting*, *ESG Clarity*, May 7, 2021.

Available at: <https://esgclarity.com/germany-announces-sustainable-finance-strategy/>

²² Nicholas Comfort and Steven Arons, *German Regulator Shelves ESG Rules After Russia Energy Fears*, *Bloomberg*, May 3, 2022. Available at: <https://www.bloomberg.com/news/articles/2022-05-03/german-watchdog-shelves-esg-investing-rules-on-energy-price-jump#xj4y7vzkg>

²³ Press Release, Council of the EU, *New rules on corporate sustainability reporting: provisional political agreement between the Council and the European Parliament*, June 21, 2022. Available at: <https://www.consilium.europa.eu/en/press/press-releases/2022/06/21/new-rules-on-sustainability-disclosure-provisional-agreement-between-council-and-european-parliament/> ; See also, *Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL*,

European Commission. Available at: <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52021PC0189&from=EN> ; See also, <https://www.europarl.europa.eu/news/en/press-room/20221107IPR49611/sustainable-economy-parliament-adopts-new-reporting-rules-for-multinationals>

²⁴ *Id.*

recently expressed his frustration over S&P Global leaving Tesla off their ESG list, calling ESG a “scam.”²⁵

In August 2022, the Missouri Attorney General launched an investigation into Morningstar for their ESG products.²⁶ The investigation is looking into if Morningstar’s methodology violates the state consumer fraud protections. It is also looking to see if any of their ESG products are tied to the Boycott, Divestment, Sanctions Campaign (BDS), which boycotts Israeli companies in support of the Palestinian people, in violation of the Anti-Discrimination Against Israel Act passed in 2020.²⁷

This lack of clarity becomes more problematic when credit rating companies use the non-financial factors of ESG to calculate bond ratings. For instance, cities in Florida face the possibility of a reduction in their Moody’s municipal bond rating based on unclear ESG standards relating to climate change.²⁸

Until a standardized methodology is implemented, most likely through regulatory action, ESG will fail to provide the aspired benefits and continue to face sharp criticism and uncertainty.

Fiduciary Duty

Even if standardization of methodology is established, the looming issue of ESG is its interaction with fiduciary duty. This interaction is dependent on jurisdictional regulations. Whether we are looking at the fiduciary duty of a fund manager or that of a corporate director, the principle is the same. The person given authority to act on behalf of others, must act in the best interest and in the manner of the person or persons they are representing.²⁹ Arguably, a fiduciary duty includes an

²⁵ Andrew Ross Sorkin, et. al, *Elon Musk’s Next Target*, The New York Times, May 19, 2022, Available at: <https://www.nytimes.com/2022/05/19/business/dealbook/elon-musk-tesla-esg.html>

²⁶ Ross Kerber, *Missouri attorney general investigates Morningstar over ESG ratings*, Reuters, August 3, 2022. Available at <https://www.reuters.com/business/sustainable-business/exclusive-missouri-attorney-general-investigates-morningstar-over-esg-ratings-2022-08-03/>

²⁷ See <https://bdsmovement.net/>; Mo. Rev. Stat. §34.600.

²⁸ Alex Brown, *Climate Change Could Make Borrowing Costlier for States and Cities*, Pew, October 1, 2019. Available at: <https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2019/10/01/climate-change-could-make-borrowing-costlier-for-states-and-cities>

²⁹ https://www.law.cornell.edu/wex/fiduciary_duty

obligation to maximize shareholder and investor profits.³⁰ However, there are jurisdictional variations as to whom a fiduciary duty is owed and what factors may be considered by directors and managers. Understanding the differences can illuminate how ESG developed globally and the problems it may face in the United States.

In looking at the fiduciary duty of corporate directors, interested parties are divided into two categories: shareholders and stakeholders. As implied by the name, the shareholders are parties who own a direct share of the investment.³¹ Stakeholders are parties who do not have an ownership interest in a company, but have an interest in the actions of the company.³² The definition of a stakeholder varies by jurisdiction, but can include employees, customers, suppliers, the community, and the government.³³ In a jurisdiction which adopts stakeholder theory, directors owe a fiduciary duty to the shareholders, but may consider the interests of the stakeholders. In a jurisdiction which adopts shareholder primacy, fiduciary duty and considerations are limited to those of the shareholders.³⁴ Generally, European countries, where ESG finds its origins, are stakeholder jurisdictions.³⁵ The United States is a shareholder jurisdiction.³⁶

Similarly, the fiduciary duty of fund managers is owed to the beneficiaries or investors; those who own a direct interest in the fund. Unlike corporate directors, there is not a separate stakeholder category. However there is a divergence in what factors may be considered to determine the limits of

³⁰ Stephen Bainbridge, *A Duty to Shareholder Value*, The New York Times, April 16, 2015. Available at: <https://www.nytimes.com/roomfordebate/2015/04/16/what-are-corporations-obligations-to-shareholders/a-duty-to-shareholder-value>

³¹ Black's Law Dictionary 1586 (10th ed. 2014)

³² Black's Law Dictionary 1623 (10th ed. 2014)

³³ <https://www.law.cornell.edu/wex/stakeholder>

³⁴ See generally, Michele Jurgens, Pierre Berthon, Lisa Papania, Haseeb Ahmed Shabbir, *Stakeholder theory and practice in Europe and North America: The key to success lies in a marketing approach* (2010). Available at https://www.academia.edu/43978629/Stakeholder_theory_and_practice_in_Europe_and_North_America_The_key_to_success_lies_in_a_marketing_approach?auto=citations&from=cover_page

³⁵ *Id.*

³⁶ See generally, Fabian Brandt Fabian and Konstantinos Georgiou, *Shareholders vs Stakeholders Capitalism* (2016). Available at https://scholarship.law.upenn.edu/fisch_2016/10?utm_source=scholarship.law.upenn.edu%2Ffisch_2016%2F10&utm_medium=PDF&utm_campaign=PDFCoverPages

a fund managers fiduciary duties. The prudent person rule, which requires fund managers invest as a prudent person would, is generally applied.³⁷ However, there is a lack of clarity as to how this standard should be applied.. Some jurisdictions operate under a sole interest rule, where the only consideration for fund managers is financial interests.³⁸ Other jurisdictions allow flexibility under the prudent person rule to consider non-financial factors in parallel with financial factors.³⁹

Looking at the prudent person rule in the United States, the Court stated in *Tibble v. Edison International* (2015): the “fiduciary normally has a continuing duty of some kind to monitor investments and remove imprudent ones.”⁴⁰ This decision was reinforced in *Hughes v. Northwestern University* (2022).⁴¹ Further, the United States follows the sole interest rule, with some exceptions.⁴²

Fiduciary Duty and ESG

Looking at the duty of corporate directors, in jurisdictions where the fiduciary duty includes both shareholder and stakeholder interests, there is an argument to be made that ESG is not in conflict with the fiduciary duty. However, this is not absolute, depending on how broadly stakeholder is defined.

In jurisdictions where fiduciary duty is extended only to shareholders, the justification of a tradeoff of profits for ESG priorities becomes less viable. The concept of shareholder supremacy was addressed by Delaware Supreme Court Justice Leo Strine when he stated: “a clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make

³⁷ See generally, Paul G. Haskell, *The Prudent Person Rule for Trustee Investment and Modern Portfolio Theory*, 69 N.C. L. Rev. 87 (1990). Available at: <http://scholarship.law.unc.edu/nclr/vol69/iss1/9>

³⁸ *A Legal Framework for Impact: Sustainable Impact In Investment Decision Making*, Principles for Responsible Investment, UN Environment Programme Finance Initiative (UNEP FI), and The Generation Foundation, 87, (2021). Available at: <https://www.unpri.org/policy/a-legal-framework-for-impact/4519.article>

³⁹ *Id* at 377.

⁴⁰ *Tibble v. Edison Int'l*, 575 U. S. 523, 530 (2015).

⁴¹ *Hughes v. Northwestern Univ.* 595 U. S. ____ (2022)

⁴² Max M. Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience*, 2 STAN. L. REV. 381, 386 (2020). Available at: <https://review.law.stanford.edu/wp-content/uploads/sites/3/2020/02/Schanzenbach-Sitkoff-72-Stan.-L.-Rev.-381.pdf>

stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare.”⁴³

Similarly, looking at the duty of fund managers, in jurisdictions where managers can consider non-financial factors alongside financial factors, there is room for consideration of ESG in funds. However, in jurisdictions where the sole interest rule applies, it becomes more difficult to say that ESG investing for the sake of ESG investing, or ultimate ends ESG investing, is not a breach of fiduciary duty.

In 2015, PRI, UNEP FI, UNEP Inquiry and UN Global Compact released a publication, *Fiduciary Duty in the 21st Century*, in which they acknowledged that ESG was problematic under shareholder/ sole interest fiduciary standards. In a 2019 report, their argument had changed, stating that ESG should not only be an acceptable consideration under fiduciary duty, but is also a requirement in shareholder/ sole interest jurisdictions.⁴⁴ The report stated, “failing to consider all long-term investment value drivers, including ESG issues, is a failure of fiduciary duty.”⁴⁵

However, this is not widely accepted. In a 2020 statement, PRI announced their intent to aggressively push for this change in philosophy through regulatory action.⁴⁶ Addressing the fiduciary duty of fund managers, even PRI’s own document, *A Legal Framework for Impact*, finds flaws in this argument.⁴⁷ The flaws stem from an acknowledge lack of legal definition of Investing for Sustainability Impact (IFSI), the studies’ umbrella term which includes ESG.⁴⁸ Further, the report stated “the ability of an Asset Owner to or Investment Adviser to engage in ultimate ends IFSI may be curtailed by the fiduciary duties to which they are subject, requiring them to focus on and prioritize financial return.”⁴⁹

⁴³ Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 Wake Forest Law Review 761,768 (2015).

⁴⁴ Available at: <https://www.fiduciaryduty21.org/publications.html>

⁴⁵ *Id.*

⁴⁶ Available at: <https://www.unpri.org/fiduciary-duty/the-modern-interpretation-of-fiduciary-duty/6538.article>

⁴⁷ *A Legal Framework for Impact*, *supra* note 36.

⁴⁸ *Id* at 22.

⁴⁹ *Id* at 511.

In a 2020 Stanford Law Review article, *Reconciling Fiduciary Duty and Social Consciousness*, Max M. Schanzenbach and Robert H. Sitkoff argued that, while ESG is not a part of fiduciary duty, ESG investing may be considered if two factors are met: “(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.”⁵⁰ This aligns with the PRI analysis of ESG investing and fiduciary duty as it relates the fund managers, while simultaneously rejecting the assertion that ESG factors must be considered as part of fiduciary duty.⁵¹

Arguing that ESG investing is not a breach of fiduciary duty becomes more difficult when factoring the financial returns of ESG products. A 2019 University of Chicago study of 20,000 mutual funds found that “none of the high sustainability funds outperformed any of the lowest rated funds.”⁵² Managers who leave underperforming ESG investments in their portfolio, or add new underperforming ESG investments, may be breaching fiduciary duty as defined in *Tibble*.

Conclusion

The slow-moving nature of legal development on both the international and national level leaves it unresponsive to quick growing industries like ESG. As a result, ESG has outgrown the current regulatory scheme and may be operating outside the confines of the current system, creating potential legal challenges to its existence in the current form. The ambiguity of ESG and lack of any clear legal definitions or regulatory standards in reporting, is more than just a problem for advocates. It places corporate directors and fund managers in the precarious position where the utilization of ESG and ESG investing is a breach of fiduciary duty, leaving them liable to civil action.

⁵⁰ Max M. Schanzenbach and Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Consciousness*, 2 STAN. L. REV. 381, 386 (2020).

⁵¹ *Id.* at 448.

⁵² Sanjai Bhagat, *An Inconvenient Truth About ESG Investing*, Harvard Business Review, March 31, 2022. Available at: <https://hbr.org/2022/03/an-inconvenient-truth-about-esg-investing>; Samuel M. Harzmark and Abigale B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74-6 Journal of Finance (2021). Available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3016092

While waiting on broader reforms, individual states may address this issue, through reforms of state level consumer protection laws, blue sky laws, trust management standards, and corporate law. However, such action will only be a temporary fix until a national standard is set, either through Federal regulatory action or by the Court. In the meantime, directors and managers who trade profits for ESG are doing so at their own peril.