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Campaign to Undermine ESG Principles Is About Power—Not Good Investment Policy

Executive Summary

In a recent *Wall Street Journal* op-ed and other media appearances, former U.S. Attorney General William Barr offers a poorly reasoned defense of heavy-handed efforts by 19 attorneys general and others to stop finance professionals and fiduciaries from considering environmental, social and governance (ESG) issues—especially climate change criteria—when making investment decisions.[1]

A commentary by Martin Lipton, based on a memorandum by Wachtell, Lipton, Rosen & Katz (WLRK), one of the world's most influential corporate law firms, offers a strong, carefully reasoned institutional rejoinder to anti-ESG arguments (though not necessarily to Barr).[2] WLRK's compelling arguments on the substantive matter, however, do not address the main political strategy behind the efforts of Barr and his allies. The purpose of the Barr op-ed apparently is not to convince investors but to intimidate them. The op-ed plainly lays out the new way Barr and his allies are using political power to assist the leadership of the fossil fuel industry.

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Investors Beware!

Barr and his allies seek a major power shift within the U.S. system of checks and balances. If they are successful, the current legal consensus on investment principles and fiduciary duty could be stood on its head. Climate change is just a stalking horse for the campaign. Their strategies will spark upheaval and chaos in energy and finance markets.

Barr claims investment trustees and corporate board directors who take ESG principles into account when making investment decisions are contravening their obligations as fiduciaries. He contends, for example, that investment funds that hire advisors who consider climate risks when making investment choices are in legal

[1] *Wall Street Journal*. ESG can't square with Fiduciary Duty: State attorneys general issue a strong warning to investment managers and retirement fund trustees. September 6, 2022.
[2] Harvard Law School Forum on Corporate Governance. ESG, stakeholder governance, and the duty of the corporation. September 18, 2022.

breach of their fiduciary duties. He points to a statement by a group of 19 state attorneys general,[3] which he contends moves the argument from a policy dispute to a litigation risk.

Based on Barr's argument, a charitable trust, pension fund or university board that retains a fund advisor that considers ESG risks—including leading firms such as UBS, Federated Hermes, or BlackRock, for example—may expose those board members to personal liability.

He is wrong.

The WLRK memo soundly refutes Barr's argument, demonstrating that consideration of ESG risks rests well within long-established legal principles of corporate fiduciary duties. WLRK points out that the short-term orientation espoused by ESG opponents rests on their notion that the sole purpose of a company is profit maximization. This view, WLRK argues, is too limited and is inconsistent with a long-term view of company value creation.

The purported consensus Barr and the 19 attorneys general push actually lies outside the broader consensus bounded by existing statutes, case law and corporate practice. WLRK's memo concludes (referring to ESG consideration in the investment decision-making process): "There should be no doubt that the law in Delaware and in every other U.S. jurisdiction empowers boards to follow this course for responsible corporate stewardship and corporate success."[4]

IEEFA makes the following observations on the two positions:

1. **To accept Barr's anti-ESG logic one must deny climate risk is a financial risk—an act which in itself is a breach of fiduciary duty.**

Barr's argument cites *Chao v. Merino,* which holds that a fiduciary who becomes aware of a risk is required to take steps to address the risk.[5] Barr says that fiduciaries face a risk if they take issues like climate change, which he asserts are baseless, into account when making investment decisions. Barr uses the statement by the attorneys general to authenticate this assessment of risk, since they presumably serve as the arbiters of what is and is not law within their states. Barr argues that warning about ESG transcends geography with "seismic implications."

He claims once a fiduciary is aware of the vacuous nature of climate change as a financial risk and of the warnings of the 19 state attorneys general, it is sure to run afoul of the law by investing in ESG-related products.

[3] Arizona Attorney General Mark Brnovich, *et al*. Letter to Laurence D. Fink, CEO, BlackRock, Inc. August 4, 2022. Also see: Texas Attorney General Ken Paxton. AG Paxton Demands BlackRock Account for Its Underperforming, Potentially Illegal 'ESG' State Pension Fund Investments. August 8, 2022.
[4] Harvard Law School Forum on Corporate Governance, *op. cit.*
[5] United States District Court for the Eastern District. *Chao v. Merino*, Docket: N 04-2125. CV, October 8, 2005.

While Barr appears to believe almost all ESG issues are frivolous, his focus on BlackRock, ExxonMobil, PetroChina and oil make it clear that climate change is the prime example in his view. One cannot make sense of Barr's fiduciary argument unless one embraces his underlying argument that denies the financial risks of climate change. Even though climate change is well-recognized as a financial risk,[6] Barr rejects it out of hand.

WLRK, in contrast, concludes that incorporating ESG considerations into investment strategies does not generate risk because statutes and case law indicate that courts will rule in favor of corporate decision-making that considers ESG principles. WLRK recognizes that climate risk is a financial risk, and investment decisions that take climate risk into consideration are protected by the volume of precedent questioned by Barr.

Climate risk is financial risk.

Further to WLRK's point, a careful review of the actions that trustees must take to respond to risk reveals that failing to adopt ESG policies to reduce financial risk is unacceptable. A fiduciary must take "precautionary steps" once a risk becomes known. Adopting a "wait-and-see" approach is imprudent. A trustee must protect the fund from exposure to predictable adverse outcomes. In *Chao v. Merino*, the offending party had taken a chance that the risk would not materialize by allowing a known embezzler to deal with employer contributions to a union healthcare fund—but the risk did materialize, resulting in a finding of negligence and liability.

An investor looking to put money into fossil fuel companies today is stepping into a dilemma wrapped in a quagmire. Climate risk is financial risk, and failing to consider it in investment decision-making is a failure to meet fiduciary obligations.

2. Barr's assertion that ESG funds underperform financially is not supported by his examples.

Citing a *Harvard Business Review* article,[7] Barr states that ESG investments do not show superior performance. The Harvard article relied on an academic study published in the *Journal of Finance*,[8] which looked at investor responses to sustainability ratings. Its treatment of financial performance was a secondary consideration to the research, and a matter for which the authors warn more research is required. The second study cited by Barr addressed whether ESG funds actually selected companies with good ESG track records. Returns were once again a

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[6] See: U.S. Securities and Exchange Commission. SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors. March 21, 2022.
[7] *Harvard Business Review*. An inconvenient truth about ESG investing. March 31, 2022.
[8] S. Hartzmark and A. Sussman. Do investors value sustainability? A natural experiment examining ranking and fund flows. *Journal of Finance* 74(6):2789-2837. 2019.

secondary consideration.[9] Each study lacked a definitive conclusion with regard to ESG fund financial performance.

Barr fails to mention that other treatments of the issue published in the *Harvard Business Review* show positive correlations between ESG and financial performance.[10] Recently, two prominent economists analyzed whether anti-ESG laws like the ones Barr is defending lost money. They found that implementation of the Texas anti-ESG law cost taxpayers hundreds of millions.[11] The economists cited nine articles that positively correlated returns and ESG ratings. Given this information, Barr might have at least said the data related to ESG and investment returns is mixed, but he neglected to discuss it.

Further, Barr attacks ESG generally while ignoring evidence of positive results of fossil fuel divestment specifically. Reviews of institutional fund portfolios that look at divestments of fossil fuels tend to show positive or neutral results.[12] A recent review published by a California fund of its divestment track record showed that overall the fund lost money on tobacco divestments—but it made money on its other ESG-related divestments, including on coal divestment.[13] Similarly MSCI, a major investment research firm, published data showing that over an 11-year period, a fossil fuel-free broad market portfolio outperformed a traditional portfolio.[14]

3. The ESG debate is not about free market—it's about power.

In one important respect, WLRK misses the mark. The law firm's commentary provides an erudite treatment of distinguished scholarship on both sides of the legal thicket involved with ESG issues. It does not, however, examine the political implications of recent anti-ESG strategies. Barr's editorial, rather than grounding itself in an intellectual tradition, appears to rely on the raw power on display when a bevy of attorneys general gang up to tell a money manager or corporation what risks it can or cannot take into account when making investment decisions, threatening dire liability consequences for those who do not comply with their view.[15] That is quite an intrusive use of government power—one that free market public intellectuals would likely have criticized.[16]

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[9] A Raghunandan and S. Rajgopal. Do ESG funds make stakeholder-friendly investments? *Review of Accounting Studies*. 27:822-863. 2022.
[10] *Harvard Business Review.* Yes, investing in ESG pays off. April 13, 2022.
[11] D. Garrett and I. Ivanov. Gas, guns, and governments: Financial costs of anti-ESG policies. July 11, 2022.
[12] IEEFA. Major investment advisors BlackRock and Meketa provide a fiduciary path through the energy transition. March 22, 2021.
[13] California Public Employees' Retirement System. Five-Year Divestment Review. March 2021, Attachment 1, p. 4.
[14] MSCI. MSCI ACWI ex Fossil Fuels Index (USD) Index Factsheet. August 2022.
[15] A recent review of Claremount, a nonprofit think tank, identifies a trend in certain intellectual circles where the principal goal is to delegitimize the constitutional principles of republic based governments, like that of the United States.. See: New York Times. How the Claremont Institute became a nerve center for the American Right. September 9, 2022.
[16] Bloomberg. Republicans don't appear to understand climate change, capitalism. September 6, 2022.

WLRK cites Nobel Prize-winning economist Milton Friedman's work as the intellectual basis for the recent opposition to ESG. Friedman's view is that companies have only one purpose—to make profits and to use the corporate vehicle solely for that objective. WLRK shows how this position has been reshaped overtime both practically and intellectually, citing landmark studies by Berle, the World Economic Forum and the Business Roundtable. The WLRK analysis presumes the debate is about markets and capitalism. JPMorgan Chase CEO Jamie Dimon and others have pointed out the same flaws in the anti-ESG rationale identified by WLRK.[17]

In IEEFA's view, WLRK errs in assuming that the exchange is only a debate over meritorious ideas about free market capitalism. WLRK may believe the debate is a rational process designed to order the body of facts required for civil discourse over fiduciary duty. It is not. For Barr and his allies, the issue is about the seizure and use of political power by 19 attorneys general who have set out on a course to punish adversaries, using local statutory authority.

For Barr and his allies, the issue is about the seizure and use of political power.

The principles cited by WLRK to support ESG policies are only relevant if the courts adhere to the strictures set out in existing law. Barr warns that a group of attorneys general is willing to take legal action on this issue through the court system to stop investors from considering climate-based financial risk. He is no doubt cognizant of the efforts of the last several years to skew the balance in the court system—especially at the U.S. Supreme Court. WLRK's formulation—however well founded as jurisprudence—is less relevant when the goal of some of the major players is systematic nullification of time-tested precedent.

If a group of attorneys general contest these foundational principles and find support from a pliable judiciary (with judges beholden to political patrons), the end result could very well be a systematic nullification of fundamental investment principles. A major power shift within the U.S. system of checks and balances could occur, and the current legal consensus on investment principles, shareholder rights and fiduciary duty could be stood on its head.

That the oil and gas sector has become the battlefield for this fight adds a level of instability to the industry that it can ill-afford, given the already mounting constellation of risks it faces. For investors seeking a steady, stable source of profits, the anti-ESG campaign's strategic route is fraught with risk. Profits in the oil and gas sector today are driven by price spikes caused by the Russian invasion of Ukraine, a raw use of political power that tramples on basic rules of international governance.

[17] *Financial Times.* Stakeholder capitalism is not 'woke,' says JPMorgan's Jamie Dimon. June 1, 2022.

Barr's argument, though far more subtle and benign, nevertheless repudiates basic principles of governance.

Conclusion

The ESG venue, for all its complications and contradictions, provides a reasonable way to order difficult societal questions like climate risk when they arise in corporate board rooms. Investors should be free to base their decision-making on longstanding principles of prudent investment analysis and fiduciary duty, not on fear of attack by politicized forces of government. The ESG movement is about persuasion. But the anti-ESG movement, as represented by Barr and his allies, is about the unconscionable use of political power. Investors and fund managers should place themselves on high alert: They are in danger of losing control over their own decision-making.

About IEEFA

The Institute for Energy Economics and Financial Analysis (IEEFA) examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy. www.ieefa.org

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Tom Sanzillo, director of financial analysis for IEEFA, is the author of numerous studies on the oil, gas, petrochemical and coal sectors in the U.S. and internationally, including company and credit analyses, facility development, oil and gas reserves, stock and commodity market analysis and public and private financial structures. Sanzillo has experience in public policy and has testified as an expert witness, taught energy industry finance and is quoted frequently in the media. He has 17 years of experience with the City and the State of New York in senior financial and policy management positions. As the first deputy comptroller for the State of New York Sanzillo oversaw the finances of 1,300 units of local government, the annual management of 44,000 government contracts, and over $200 billion in state and local municipal bond programs as well as a $156 billion global pension fund.