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**Markus Lieberknecht**

# **Institutional Investors as Climate Activists Curb Your Enthusiasm**

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ABSTRACT

*Institutional investors control a sizable portion of all votes in major public corporations. In contrast to their traditional deference to management, some institutional investors have begun to lobby portfolio companies for reductions in greenhouse gas (GHG) emissions because even broadly diversified portfolios are vulnerable to the systemic risks associated with climate change. In theory, this logic could align the interests of diversified investors and those of society at large, resulting in welfare-enhancing climate activism. However, because of the chasm between the portfolio-level goal of GHG reduction and the company-level goal of value maximization, climate activism by institutional investors is bound to trigger conflicting fiduciary duties on several levels. This paper analyzes how these economic and legal limitations make it unlikely that the enormous financial power wielded by institutional investors will ultimately translate into similarly massive decarbonization effects.*

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<sup>1</sup> Senior researcher at the the European Legal Studies Institute, University of Osnabrück, as well as at the Institute for Comparative Law, Conflict or Laws and International Business Law, University of Heidelberg. This working paper is a revised version of a thesis submitted at Harvard Law School under the supervision of Prof. Jesse Fried. It is also available under <https://ssrn.com/abstract=4198042>

## INTRODUCTION

Climate change is a collective action problem of existential proportions. While most national governments have accepted the scientific consensus that rapid decarbonization is critically important, the same states have, so far, largely failed to advance the transition to a net zero economy. The reasons for this failure include political short-termism fueled by election cycles and intergenerational present bias, the political influence wielded by GHG-emitting companies, and the fact that individual countries and firms have little to gain from the difficult transition to carbon neutrality unless there is a critical mass of actors changing the regulatory playing field. It would seem that this global tragedy of the commons calls for an intervention by powerful and rational actors who are invested in the world economy at large and incentivized to minimize long-term systemic risks. Large institutional investors arguably fit this description, and indeed, this group is increasingly embracing climate activism.

In Part I, I explain why diversified investors are incentivized to address systemic risks such as climate change. I analyze concrete examples of climate activism by institutional investors and show which potential effects of such activism we can already observe on a portfolio-company level. In this context, I also discuss potential ramifications of firms pursuing emissions targets which cast doubt on the hope that climate activism by institutional shareholders will be effective in decarbonizing industries which are inherently dependent on GHG emissions.

In Part II, I analyze legal guardrails which will likely constrain this type of climate activism. By lobbying portfolio companies to embrace climate-friendly policies even against their own economic interests, institutional investors would trigger conflicting fiduciary duties on several different levels. These conflicts provide a serious disincentive for managerial decision-makers to engage in aggressive climate activism.

I conclude that, while institutional investors are indeed incentivized to promote climate-friendly policies, we must curb our enthusiasm. Investors engaging in climate activism face serious structural and legal hurdles which make it unlikely that their massive financial power will translate into similarly massive decarbonization efforts among portfolio companies.

## I. INSTITUTIONAL INVESTORS AS CLIMATE ACTIVISTS

Institutional investors have obtained an unprecedented level of concentrated control over major corporations (A.). While broadly diversified stockholders traditionally abstain from using this position to pursue activist agendas (B.), they have made concerted efforts to promote climate-friendly policies among portfolio companies in recent years (C.).

### A. *The Rise of Institutional Ownership*

Largely due to the advent of modern portfolio theory, institutional shareholders<sup>2</sup> have assumed a dominant position as equity-holders in large companies. BlackRock, Vanguard, and State Street Global Advisors, the world's largest asset managers – often dubbed The Big Three – alone collectively command a quarter of the votes in S&P 500 companies.<sup>3</sup> Retail investors have been reduced to a relatively insignificant force in the U.S. stock market<sup>4</sup> and even the recent success of trading platforms such as Robinhood is unlikely to reverse this shift.

This concentration of equity is one of the most striking economic phenomena of the first quarter of the 21<sup>st</sup> century. At the same time, the 'Specter of the Giant Three'<sup>5</sup> has sparked concerns, ranging from the notion that horizontal shareholding hampers competition<sup>6</sup> to the eerie prediction that an oligopoly consisting of a few asset managers will eventually control virtually all of the largest public companies.<sup>7</sup> If these giants decided to flex their muscles, they would

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<sup>2</sup> 'Institutional investor' is a catch-all term. The paradigmatic cases are intermediary investors, i.e., institutions which manage and invest other people's money on a large scale. Pension funds, investment funds including large asset managers, and insurance companies can be characterized as 'traditional' institutional investors, hedge funds, private equity firms, exchange-traded funds and sovereign wealth funds as 'alternative' institutional investors, *see*, Serdar Çelik & Mats Isaakson, *Institutional Investors as Owners: Who Are They and What Do They Do?*, OECD Corporate Governance Working Paper No. 11 7 (2013), <https://perma.cc/V5UD-94K3>.

<sup>3</sup> *See*, Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B. U. L. REV. 721 (2019) [hereinafter Bebchuk & Hirst, *Specter*].

<sup>4</sup> Institutional shareholders in a broader sense own around 80% of all stock in S&P 500 corporations, cf. Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267, 1268 (2016). As of 2020, index funds held 14% of the U.S. stock market, cf. INVESTMENT COMPANY INSTITUTE, 2021 INVESTMENT COMPANY FACT BOOK 50 (2021), <https://perma.cc/KXM7-AXK2>.

<sup>5</sup> *See*, Bebchuk & Hirst, *Specter*, *supra* note 2.

<sup>6</sup> *See*, Elhauge, *supra* note 3; Eric A. Posner, Fiona M. Scott Morton, & E. Glen Weyl, *A Proposal to Limit the Anticompetitive Power of Institutional Investors*, 81 ANTITRUST L. J. 669 (2017).

<sup>7</sup> John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* (Sept. 20, 2018) <https://perma.cc/A4XM-BGJC>. A 2019 study predicts that the Big Three can be expected to command as many as 40% of the votes in S&P 500 companies within two decades, cf. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2069 (2019) [hereinafter Bebchuk & Hirst, *Index Funds*].

wield unprecedented economic power. But the problem cuts both ways: If the major mutual funds remained sleeping giants,<sup>8</sup> their reluctance to exert influence over portfolio companies could undermine managements' accountability to shareholders, which is an integral element of corporate governance.<sup>9</sup> Against this background, index funds and common ownership are said to be "a new and first-order challenge to the existing scheme of corporate governance"<sup>10</sup> and among "the most discussed governance issues of our time"<sup>11</sup>.

*B. The Norm: Institutional Investors as Passive Shareholders*

The basic concept of portfolio investment implies a deferential attitude towards the managers of portfolio companies. Broadly diversified funds – and index funds in particular – do not primarily claim to spot the best companies, nor do they make it their mission to make good companies better. The economic incentive to generate governance gains is usually too limited to invest vast resources in overseeing the managements of countless portfolio firms.<sup>12</sup> Large mutual funds also want to avoid the appearance of activism because it is not far-fetched to suspect that open competition does not thrive where the largest shareholders in virtually all major public companies are identical.<sup>13</sup> This notion spells the danger of increased antitrust scrutiny and the most solid line of defense for institutional investors is to emphasize that they do

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<sup>8</sup> To be sure, institutional investors are still in a better position to hold management accountable than retail investors, cf. Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992). In the future, the situation might again change significantly if the Big Three implement mechanisms to hand voting power to investors. BlackRock has recently granted participation rights in proxy votes to certain institutional clients, but its stated long-term goal is to give every individual investor the option to participate in the proxy voting process.

<sup>9</sup> On the latter point, see Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 Geo. L. J. 439, 441 (2001) (arguing that the best way to pursue aggregate social welfare is "to make corporate managers strongly accountable to shareholder interests").

<sup>10</sup> Coates, *supra* note 6, at 21.

<sup>11</sup> Vittoria Battocletti, Luca Enriques, & Alessandro Romano, *Dual Class Shares in the Age of Common Ownership*, ECGI Working Paper No. 628/2022 1 (2022), <https://perma.cc/93XM-PGWM>.

<sup>12</sup> See Lucian Bebchuk, Alma Cohen, & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 103 (2017) (noting that "[g]iven the limited economic incentive that investment managers have to generate governance gains in portfolio companies, and their strong economic interest in attracting more business, choosing a pro-management approach within the range of the legitimate choices available to them may seem the safest approach to investment managers."). Because of the baseline assumption of passivity, engaging in interventionist behavior also carries a significant risk of public backlash, see Bebchuk & Hirst, *Index Funds*, *supra* note 6, at 2069.

<sup>13</sup> See authors cited *supra* in note 5. For a skeptical perspective on the claim that institutional investors can influence firm-level decisions, see Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L. J. 729, 761-64 (2017).

not exert market-level influence on portfolio firms.<sup>14</sup> Thus, some powerful factors disincentivize institutional investors from engaging in shareholder activism.

### C. *The Exception: Institutional Investors as Climate Activists*

Contrary to this convention of relative passivity, many institutional shareholders have positioned themselves as active advocates of decarbonization in recent years.<sup>15</sup> BlackRock CEO Larry Fink noted in his 2022 Letter to CEOs that "the decarbonizing of the global economy is going to create the greatest investment opportunity of our lifetime" and asked companies "How are you preparing for and participating in the net zero transition? As your industry gets transformed by the energy transition, will you go the way of the dodo, or will you be a phoenix?"<sup>16</sup>

#### 1. *The Underlying Economic Rationale: Portfolio Primacy*

The driving force behind this acquired taste for climate consciousness is not environmentalism but capitalism.<sup>17</sup> On the level of individual firms, the economic and ecological aims will often diverge. After all, many GHG-intensive ventures remain very profitable<sup>18</sup> and the resulting externalities are borne almost entirely by the public at large. On the contrary, the portfolio as a whole, with its long-term orientation and broad diversification, may approximate the interests of society at large.<sup>19</sup> This alignment is a potential win-win situation for firms and society.<sup>20</sup>

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<sup>14</sup> See Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 7 (2020).

<sup>15</sup> Cf. Dorothy S. Lund, *Asset Managers as Regulators*, 171 U. PENN. L. REV. (forthcoming 2022), 2-3, 22-29 (Dec. 1, 2021), <https://perma.cc/FHU7-M6RL>. John C. Coffee, *The Coming Shift in Shareholder Activism: From "Firm-Specific to "Systematic Risk" Proxy Campaigns (and How to Enable Them)* 5 (August 26, 2021), <https://perma.cc/AH7A-GLEE>.

<sup>16</sup> Larry Fink, *The Power of Capitalism* (Jan. 18, 2022), <https://perma.cc/WY4B-UTNB>. On BlackRock's role as a catalyst of sustainable finance in particular, see Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' Role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. ONLINE, art. 3, 2021, at 5-10 (calling the letter a "sustainability-centered tectonic shift").

<sup>17</sup> Cf. Fink, *supra* note 15 (stressing that "[w]e focus on sustainability not because we're environmentalists, but because we are capitalists and fiduciaries to our clients"). Understandably, many investor firms choose to emphasize altruistic reasons in their public communication. A survey among institutional investors on reasons for embracing climate-friendly policies shows the most wide-spread agreement on the protection of investors' reputations, moral and ethical considerations, as well as legal and fiduciary duties, followed by the idea that incorporating climate risks improves returns and reduces portfolio risks, cf. Philipp Krueger, Zacharias Sautner & Laura T. Starks, *The Importance of Climate Risks for Institutional Investors*, 33 THE REVIEW OF FINANCIAL STUDIES 1067, 1070 (2020).

<sup>18</sup> Cf. Patrick Bolton & Marcin Kacperczyk, *Do Investors Care about Carbon Risk?*, ECGI Finance Working Paper No. 711/2020 (2020), <https://perma.cc/Y4XX-XNN9> (finding that there is a 'carbon premium' in the sense that stocks of U.S. firms with higher total carbon emissions earn higher returns).

<sup>19</sup> However, see Lund, *supra* note 14 (arguing that asset managers are ultimately subject to market forces, most notably client support for their policies, and regulatory constraints).

<sup>20</sup> This idea is encapsulated in the slogan of "doing well by doing good", see Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1, 9-10 (2010).

Climate change – including associated regulatory measures to combat global warming – has and will continue to impact the performance of individual firms in many ways. Agricultural producers might incur heavy losses due to extreme weather events, while others, such as car producers, will have to grapple with the transition to a carbon-neutral economy. Still others, such as firms focusing on renewable energy, could profit greatly from sweeping policy measures enacted to facilitate the transition to a net-zero economy.<sup>21</sup> The precise impact of these factors resists calculation, such that it may not be accurately reflected in current markets.<sup>22</sup> But the general direction is clear enough: the current trajectory is bound to result in broad negative effects.<sup>23</sup> Put bluntly, the destruction of the planet is bad for the global economy.

Thus, the "universal owners"<sup>24</sup> of that economy have a serious incentive to keep it healthy.<sup>25</sup> Applied to the portfolio perspective, GHG-emitting companies cause negative externalities not only to the environment or the public at large, but also to a multitude of other portfolio companies.<sup>26</sup> In general, there is no structural reason why the interests of each individual portfolio company and those of the entire portfolio would necessarily be aligned. For similar reasons, there are generally forks in the road where the interests of diversified shareholders and

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<sup>21</sup> Cf. Krueger et al., *supra* note 16.

<sup>22</sup> Cf. Harrison Hong, Frank Weikai Li & Jiangmin Xu, 208 *JOURNAL OF ECONOMETRICS* 265 (2019) (arguing that climate risks may be mispriced in financial markets).

<sup>23</sup> See Ravi Bansal, Marcelo Ochoa, Dana Kiku, *Climate Change and Growth Risks*, NBER Working Paper No. w23009, <https://perma.cc/TR26-CZSB> (2016) (showing the impact on climate risks on asset pricing and other welfare implications); Nora Pankratz, Rob Bauer & Jeroen Derwall, *Climate Change, Firm Performance, and Investor Surprises*, <https://perma.cc/DZ99-MXSP>; Jawad M. Addoum, David T. Ng & Ariel Ortiz-Bobea, *Temperature Shocks and Establishment Sales*, 33 *THE REVIEW OF FINANCIAL STUDIES* 1331 (2020) (highlighting the adverse effect of extreme temperatures on corporate earnings); Matthias S. Kruttli, Brigitte Roth Tran & Sumudu W. Watugala, *Pricing Poseidon: Extreme Weather Uncertainty and Firm Return Dynamics*, Federal Reserve of San Francisco Working Paper 2021-23 (2021), <https://perma.cc/5AGN-QGV6> (demonstrating effects of extreme weather in stock prices).

<sup>24</sup> Cf. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. REV.* 561, 583 (2006); Robert G. Hansen & John R. Lott Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholders/Consumers*, 31 *J. FIN. & QUANTITATIVE ANALYSIS* 43, 47-49 (1996); JAMES P. HAWLEY & ANDREW T. WILLIAMS, *THE RISE OF FIDUCIARY CAPITALISM* 3 (2000).

<sup>25</sup> Recent scholarship has questioned this theory by pointing out that even index funds do not in fact invest "universally" in the global economy but in a subset of it. This subset can be relatively resilient to the effects of climate change and relatively vulnerable to the costs of transforming to carbon neutrality, incentivizing investors to underinvest in climate mitigation, see Roberto Tallarita, *The Limits of Portfolio Primacy*, Working Draft 25-39 (Mar. 22, 2022), <https://perma.cc/4QYW-8MZ4>. While this finding provides a strong argument that effects of portfolio primacy are weaker than we might like them to be, it does not obviate the fact that investors are incentivized to prioritize climate mitigation at all.

<sup>26</sup> On this general theory, see Coffee, *supra* note 14, at 1-4 (theorizing that, as a result, we are witnessing a shift from 'firm-specific activism' to 'systematic activism' by diversified shareholders).

undiversified shareholders diverge.<sup>27</sup> In the abstract, this fault line is not a novel discovery,<sup>28</sup> but climate change provides a particularly consequential and topical example.

Under this theory, diversified investors have a rational interest that portfolio companies with high GHG emissions internalize intra-portfolio externalities resulting from such emissions.<sup>29</sup> In fact, diversified investors should even favor heavy blows to individual portfolio companies, provided that the positive effects on the portfolio outweigh the investors' shares in the internalized costs.<sup>30</sup> While no institutional investor would publicly announce intentions to actively sabotage portfolio companies for the greater good of the portfolio, some do refer to the long-term value of their entire portfolio when outlining their expectations as to the sustainability policies of portfolio companies.<sup>31</sup> In principle, this incentive structure could help to remedy the enormous market failure that is propelling climate change by giving influential actors an incentive to effect welfare-increasing measures.<sup>32</sup>

On a conceptual level, this theory of portfolio primacy constitutes a noteworthy exception from the widely accepted paradigm of shareholder primacy,<sup>33</sup> under which rational shareholders exercise their governance rights with the singular and homogeneous goal of maximizing

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<sup>27</sup> See Henry T. C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 299-300 (1990).

<sup>28</sup> See Anabtawi, *supra* note 23, at 583-585 (noting that "unlike less well-diversified investors, universal owners can be expected to feel the impact of actions by one company in their portfolio on their other portfolio companies. In other words, through its extensive holdings, the universal shareholder internalizes many of the externalities generated by the companies in which it invests. Universal owners are thus likely to favor activities of firms in which they own shares that minimize negative externalities ... to the extent that those activities impose costs on ... other firms in which they own an interest").

<sup>29</sup> See Hansen & Lott, *supra* note 23; Coffee, *supra* note 14.

<sup>30</sup> See also Condon, *supra* note 13, at 6-8, 10-17. Whether these effects are significant enough to support a business case for climate activism is not at all clear, cf. Tallarita, *supra* note 24, at 17-25 (arguing that stock markets are mispricing climate risks and that, as a result, investors would not reap the benefits of climate mitigation, at least in the short term, which they tend to prioritize in their calculations).

<sup>31</sup> PRINCIPLES FOR RESPONSIBLE INVESTMENT, CONVERGING ON CLIMATE LOBBYING: ALIGNING CORPORATE PRACTICE WITH INVESTOR EXPECTATIONS 8 (2018), <https://perma.cc/A5QW-9VTR> (noting that companies should "ensure any engagement conducted on their behalf or with their support is aligned with our interest in a safe climate, in turn protecting the long-term value in our portfolios across all sectors and asset classes").

<sup>32</sup> For a comprehensive treatment of this theory, see Jeffrey N. Gordon, *Systematic Stewardship*, ECGI Law Working Paper No. 566/2021 (2021), <https://perma.cc/HM9M-U5L8>.

<sup>33</sup> On that paradigm, see, e.g., Hansmann & Kraakman, *supra* note 8, at 440-441 (describing a "standard shareholder-oriented model" which is centered, *inter alia*, around the assumption that "the market value of the publicly traded corporation's shares is the principal measure of its shareholders' interests"). Some authors suggest that the goal should instead be maximization of shareholder welfare, which may include factors besides than share price maximization, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. ACCT. 247 (2017).



corporate value.<sup>34</sup> Broad diversification skews shareholders' interests away from maximizing the value of every single portfolio firm and towards maximizing the value of the portfolio, which can, to a considerable extent,<sup>35</sup> correspond with the prosperity of the economy at large. To be sure, this alignment is only an indirect effect, a lucky coincidence, as it were. Diversified investors do not abandon value maximization for non-financial and indirect interests.<sup>36</sup> The goal of maximizing corporate value – in the shape of portfolio value – remains their north star.<sup>37</sup> Nevertheless, this development poses a challenge to the traditional explanatory framework because, when viewing a portfolio firm in isolation, that model may fail to adequately predict or explain the behavior of today's pre-eminent class of shareholders.

## 2. *Climate-Related Initiatives by Institutional Shareholders*

Institutional investors expect climate risks to have significant financial implications for the performance of portfolio firms in the near future and even today.<sup>38</sup> By now, nearly every investment firm claims to have a strategy to deal with climate risks.<sup>39</sup> In general, investors who aim to mitigate such risks could react by prioritizing environmental policies in their investment decisions and shifting assets to sectors which are comparatively resilient to global warming.<sup>40</sup> But even for sophisticated investors, implementing this strategy in practice poses a number of challenges stemming from the systematic nature of climate risks,<sup>41</sup> a lack of disclosure by

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<sup>34</sup> See Condon, *supra* note 13, at 3-9.

<sup>35</sup> Even if we adopted a stylized view in which index funds owned the entire stock market, their portfolio interests would only mirror the interests of (certain) public companies, which are by no means completely identical to those of humanity at large, *see supra* note 24.

<sup>36</sup> On the admissibility of such decisions, *see, e.g.,* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, N.Y.U. L. REV. 733, 776-818 (2005) (arguing that an operational discretion of management to sacrifice corporate profits in the public interest is desirable and even efficient).

<sup>37</sup> *See supra* note 16 and accompanying text.

<sup>38</sup> Krueger et al., *supra* note 16, at 1069-1070 (noting that fewer than 10% of the investors surveyed believe that climate risks will materialize only in 10 years or more, whereas 50% state that climate risks related to regulation have already started to materialize).

<sup>39</sup> *Id.* at 1070 (noting that only 7% of institutional investors surveyed in their study have chosen no approach to manage their climate risks during the 5 years preceding the survey).

<sup>40</sup> See Andreas G.F. Hoepner, Ioannis Oikonomou, Zacharias Sautner, Laura T. Starks & Xiao Y. Zhou, *ESG Shareholder Engagement and Downside Risk*, ECGI Working Paper No. 671/2020 (2022), <https://perma.cc/UK2H-MBVU>; Rajna Gibson Brandon & Philipp Krüger, *The Sustainability Footprint of Institutional Investors*, ECGI Working Paper No. 571/2018 (2018), <https://perma.cc/P99N-8M5Q>; Ravi Jagannathan, Ashwin Ravikumar & Marco Sammon, *Environmental, Social, and Governance Criteria: Why Investors are Paying Attention*, NBER Working Paper 24063 (2017), <https://perma.cc/92KB-9FG9>.

<sup>41</sup> See Gordon, *supra* note 31, at 3 (listing climate change as a particularly salient form of systematic risk because "[t]he disruptions associated with various realizations of climate risk will ramify across the

portfolio firms,<sup>42</sup> and the difficulty of identifying hedging instruments to offset climate-related threats.<sup>43</sup> In particular, index funds would be inherently unable to engage in strategic divestment even if they were able to identify the proverbial "dodos".<sup>44</sup> In order to mitigate climate-related risks, a substantial number of institutional investors engage with their portfolio firms through different channels, such as discussions with management, submitting shareholder proposals and exercising their voting power.<sup>45</sup> To facilitate this type of engagement, investors increasingly join forces in initiatives such as Climate Action 100+, the Portfolio Decarbonization Coalition, or the Global Investor Coalition on Climate Change.

Even the established notion that institutional investors rarely resort to the heavy-handed instrument of proxy fights has become harder to maintain in the context of climate activism. Most notably, the activist hedge fund Engine No. 1, which is pushing for a carbon-conscious agenda,<sup>46</sup> recently scored a virtually unprecedented victory by putting two dissident directors on ExxonMobil's board.<sup>47</sup> Engine No. 1 did not rely on its own voting power, which amounted to a mere 0.02%. Rather, it first secured the backing of two major pension funds, which translated into a favorable recommendation by proxy advisors and, perhaps by extension,<sup>48</sup> into support by a majority of shareholders, including BlackRock, State Street, and Vanguard.<sup>49</sup>

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entire economy and thus across a diversified stock portfolio"); Coffee, *supra* note 14, at 5 (noting that "[t]he clearest example today of a major systematic risk is the risk of adverse climate change.")

<sup>42</sup> On institutional investors' push for climate-risk disclosure, *see* Lund, *supra* note 14, at 22-29. The SEC has recently proposed a rule mandating such disclosure, cf. U.S. SEC. & EXCH. COMM'N, THE ENHANCEMENT AND STANDARDIZATION OF CLIMATE-RELATED DISCLOSURES FOR INVESTORS, 17 CFR 2010, 229, 232, 239, and 249, <https://perma.cc/59ZL-4A35>. Some commentators criticize that this type of disclosure is alien to the SEC's mandate, cf. Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840 (2021).

<sup>43</sup> Krueger et al., *supra* note 16, at 1069.

<sup>44</sup> Cf. *id.* (also noting that only 17% of investors exited due to dissatisfaction with portfolio firms' response to engagement on climate risks).

<sup>45</sup> *Id.* at 1071 (noting that 43% discussed climate risks with management, with 32% proposing specific actions, around 30% submitted shareholder proposals, and close to 30% voted against management on proposals due to climate-risk concerns; 25% report successful engagements).

<sup>46</sup> Cf. Engine No. 1, *Reenergize ExxonMobil* (May 2021) 14-18, <https://perma.cc/X52H-EMBN>. For a critical analysis of this approach, *see* Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE, art. 3, 2021, at 1.

<sup>47</sup> Cf. *ExxonMobil loses a proxy fight with green investors*, THE ECONOMIST (May 29, 2021), <https://perma.cc/NY4P-VFRY>.

<sup>48</sup> Relying on proxy advisors is a common way to alleviate conflicts of interest within mutual fund families, cf. U.S. SEC. & EXCH. COMM'N, PROXY VOTING BY INVESTMENT ADVISORS, 68 Fed. Reg. 6585, 6587 (Feb. 7, 2003) [hereinafter SEC, PROXY VOTING].

<sup>49</sup> BlackRock voted for three, and State Street and Vanguard each voted for two, of Engine No. 1's board candidates, cf. BlackRock, *Vote Bulletin: ExxonMobil Corporation 1* (May 26, 2021)

### 3. Decarbonization Efforts Among Portfolio Companies

Commitments to emissions reductions have become commonplace even in industries that are ill-positioned to transition to a net-zero economy, such as the fossil fuel sector.<sup>50</sup> One prominent example is Royal Dutch Shell's announcement of such targets in December 2018, which were adopted against initial opposition by management.<sup>51</sup> The content of the statement – Shell's intention to cut 20% of the company's emissions, including emissions from its products, by 2035, and 50% by 2050 – was notable, but so was the context: the announcement was made in a joint statement with Climate Action 100+, a coalition of institutional shareholders pushing for climate-friendly policies.<sup>52</sup>

Shell is also a case in point for other forces which push companies towards setting GHG targets. One such factor is executive compensation.<sup>53</sup> In 2020, Shell severed the link between bonuses and the volume of fossil fuel production.<sup>54</sup> Another factor to consider is the rising risk of climate litigation, since Shell's voluntary commitments pale in comparison to the May 2021 judgment of a Dutch District Court ordering Shell to reduce its global net carbon emissions by 45% of 2019 levels by 2030.<sup>55</sup>

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<https://perma.cc/RU82-CMFZ>; Ross Kerber, *Top Exxon investors State Street, Vanguard backed activist nominees*, REUTERS (May 27, 2021), <https://www.reuters.com/business/energy/state-street-backed-two-activist-hedge-fund-nominees-exxon-board-2021-05-27/>.

<sup>50</sup> About half of the world's major oil and gas producers have set meaningful emission targets, cf. Simon Dietz, Dan Gardiner, Valentin Jahn, & Jolien Noels, *How ambitious are oil and gas companies' climate goals?*, 374 SCIENCE 405 (2021) (presenting a study on the world's top 50 public oil and gas producers by free-float market capitalization: taking into account GHG intensity both from operational emissions and emissions down the value chain from use of sold products). By now, all of the largest Western oil companies – which, besides Shell, include BP, Exxon, and Chevron – have made "net-zero" commitments to reduce or offset net GHG emissions, see Christopher M. Matthews, *Exxon Pledges to Reduce Carbon Emissions From Operations to 'Net Zero'*, THE WALL STREET JOURNAL (Jan. 18, 2022), <https://perma.cc/EE7L-DBGH>.

<sup>51</sup> See Sarah Kent, *Shell to Link Carbon Emissions Targets to Executive Pay*, THE WALL STREET JOURNAL (Dec. 3, 2018), <https://perma.cc/TAT8-GA5R> (noting that just half a year before the announcement of the targets, Shell's CEO had opposed firm targets for being "onerous and cumbersome").

<sup>52</sup> Cf. Joint statement between institutional investors on behalf of Climate Action 100+ and Royal Dutch Shell plc (Shell) (Dec. 3, 2018), <https://perma.cc/8B6Z-VPD5> [hereinafter Joint Statement].

<sup>53</sup> As of 2020, climate metrics made up 8% of CEO's short-term incentive plans at the world's largest energy companies, cf. Robert A. Ritz, *Climate targets, executive compensation, and corporate strategy*, EPRG Working Paper 2029 (2020), <https://perma.cc/L7CX-5MHK>.

<sup>54</sup> Cf. *Shell to link executive pay more closely to group's climate performance*, REUTERS (Mar. 29, 2021), <https://perma.cc/GCK4-GVGY>.

<sup>55</sup> Cf. Rechtbank Den Haag, docket no. C/09/571932 / HA ZA 19-379 (May 26, 2021), <https://perma.cc/5RR3-SHMR>. Shell is appealing the judgment, cf. Shell, *Shell confirms decision to appeal court ruling in Netherlands climate case* (Jul. 20, 2021), <https://perma.cc/723M-KGSR>.

Far-reaching GHG cuts by companies whose businesses inherently depend on GHG emissions are counter-intuitive and there are obvious incentives for window dressing. In fact, independent studies show that, while some companies have set notably ambitious end-targets, most targets fall short of what the scientific community deems environmentally desirable.<sup>56</sup> In any case, most targets do not prescribe detailed incremental steps for the immediate future. Given that gas prices are currently at a 22-year high,<sup>57</sup> Western oil companies must be tempted to capitalize on the spike in demand, even as they outwardly maintain their commitment to reach certain emissions goals decades into the future.

#### 4. *What if They Are Serious?*

It is worth contemplating what practical ramifications it would have if GHG-sensitive companies such as fossil fuel producers actually followed through on their net zero commitments. Serious emissions cuts require divestment from current operations. Assuming that there remains an appreciable market for carbon-emitting products in the foreseeable future,<sup>58</sup> it is difficult to imagine how such divestment would consist of anything else but selling off GHG-intensive assets to third parties who are less scrupulous with regard to climate matters.<sup>59</sup> After all, it is implausible that fossil fuel companies would refrain from realizing the value of these assets or that they would even incur ongoing costs in order to maintain retired facilities and dormant concessions. In all likelihood, the new owners of carbon-emitting operations would generate GHG in much the same way as the now-reformed fossil fuel producers. Another plausible alternative, which is to take fossil fuel corporations private in order to evade the influence of zealous climate stewards,<sup>60</sup> would equally keep emissions on an identical level.

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<sup>56</sup> Cf. Dietz et al., *supra* note 49, at 406-407 (2021) (noting that the median target equates to just a 6.4% reduction in GHG intensity by 2037, but this unweighted average is heavily skewed by the ambitious targets of six companies, namely Occidental Petroleum [100% by 2050], Royal Dutch Shell [65% by 2050], Total [58% by 2050], Eni [55% by 2050], Repsol [52% by 2050], and BP [20% by 2050]; only one company's targets align with a 2°C benchmark and a 1.5°C benchmark, respectively).

<sup>57</sup> Cf. Scott Patterson, *Gasoline Prices Surge Above \$4 a Gallon, With No End in Sight*, THE WALL STREET JOURNAL (March 7, 2022), <https://perma.cc/C4PV-5BYH>.

<sup>58</sup> If there were to be no such market, emissions cuts through divestment would, in lieu of buyers, indeed consist of unilaterally retiring operations. In this case, even ambitious emissions targets would only spell out the inevitable. However, this extreme scenario does not appear likely at the moment.

<sup>59</sup> Cf. Lund, *supra* note 14, at 43 (noting the example of BP meeting its climate targets by selling its Alaska oilfields to the private company Hilcorp).

<sup>60</sup> Cf. Tallarita, *supra* note 24, at 48-51.

Hence, nothing might change but the corporate entities doing the carbon economy's dirty work, even if the current emitters meet their targets. At the same time, it is possible that the same climate-friendly mutual funds are also major shareholders of prospective buyers, and that they could dissuade those companies from moving into the fossil fuel sector. Likewise, it could prove consequential if some of the world's most potent allocators of capital denied financing to certain industries and diverted their resources to others.<sup>61</sup> Thus, there are different conceivable outcomes, but it would be naïve to assume that economically viable industries would cease to exist because established firms choose corporate retirement.

In addition, we must also recognize that investors' spheres of influence are limited to their portfolios.<sup>62</sup> Even major index funds do not own the market for carbon production and climate-sensitive assets.<sup>63</sup> Rather, their portfolios only reflect a certain subset of the world economy, namely large public companies from predominately Western countries, while excluding a sizable portion of the world's major firms, namely private and state-owned companies as well as many major non-Western firms.<sup>64</sup> What is more, portfolios regularly include companies with a controlling shareholder, which further diminishes the prospect of successful activism of any sort.<sup>65</sup> Thus, when measured against the global economy, even the largest portfolios have blind spots where climate activism is virtually impossible, and these blind spots harbor many of the most prolific GHG emitters, in particular state-run fossil fuel producers.<sup>66</sup>

In summary, portfolio investors are incentivized to pursue climate-friendly policies even at the expense of individual portfolio companies. This incentive should not be overstated, but it exists in principle, and we can already observe traces of it in how investors interact with portfolio companies. Still, there are good reasons to remain cautious as to the real impact this

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<sup>61</sup> On this dynamic, see Mahoney & Mahoney, *supra* note 41, at 850.

<sup>62</sup> This is with the exception that companies which are not part of an investor's portfolio might, in order to *become* part of that portfolio, adjust their behavior to align with the investor's expectations.

<sup>63</sup> Cf. Mahoney & Mahoney, *supra* note 41, at 855.

<sup>64</sup> Tallarita, *supra* note 24, at 48-50.

<sup>65</sup> *Id.* at 50-53.

<sup>66</sup> State-owned companies are particularly dominant in the oil sector which is critical for GHG emissions. Some industry experts expect the global market share of the 23 nations that belong to OPEC Plus, a group that includes predominately countries with state-owned oil industries, to grow from currently around 55% to 75% by 2040, cf. Clifford Krauss, *As Western Oil Giants Cut Production, State-Owned Companies Step Up*, NEW YORK TIMES (Oct. 14, 2021), <https://perma.cc/GD5N-TH75>.

approach has or will ever have. Even if both institutional investors and portfolio companies made serious commitments and followed through on them, this type of climate activism could not be a silver bullet that rids the world of climate change.

## II. FIDUCIARY DUTIES AS LEGAL GUARDRAILS FOR CLIMATE ACTIVISM

As demonstrated above, institutional shareholders have a rational incentive to push portfolio companies for substantial GHG reductions. This incentive is purely economic, and it does not exist in a legal vacuum. Attempts by institutional investors to adopt a climate-friendly agenda and inject such aims into portfolio companies' policies affect the interests of a number of groups, entities, and individuals whose interests are not aligned when it comes to the desirability of GHG emissions cuts. Fiduciary duties under corporate and trust law<sup>67</sup> address these conflicts and guide decision-making processes. At least in principle,<sup>68</sup> investors owe no such duties to other shareholders,<sup>69</sup> but fiduciary duties do operate between different actors on the levels of portfolio firms (A.), large mutual funds (B.), and other institutional asset owners (C.).

### A. *Fiduciary Duties on the Level of Portfolio Firms*

There is no such thing as the prototypical portfolio company, and the impact of climate change and decarbonization varies across firms and sectors. For instance, there will be winners and losers among car manufacturers,<sup>70</sup> but a market for vehicles will exist in a net zero economy. This does not hold true for the industries that are literally fueling the carbon economy.

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<sup>67</sup> Fiduciary duties in American trust law and corporate law both serve the same function, namely addressing agency conflicts, but do not operate identically, cf. Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 656-657 (2004).

<sup>68</sup> There is some room for imagining an application of the controlling shareholders doctrine in this context, but this would seem to require an adjustment of the current Delaware doctrine, and arguably more extensive coordination between investors. On this idea, see Tallarita, *supra* note 24, at 45-46. On the doctrine in general, see STEPHEN M. BAINBRIDGE, CORPORATE LAW 184-186 (3<sup>rd</sup> ed. 2015) [hereinafter BAINBRIDGE, CORPORATE LAW].

<sup>69</sup> See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36, 45 (3d Cir.1947).

<sup>70</sup> The necessity to navigate this transition successfully, and not portfolio primacy, is likely the motivating force behind the shareholder pressure that moved major car manufacturers like Volkswagen and Daimler to commit to making their fleets carbon neutral by 2050 and 2039, respectively, cf. CLIMATE ACTION 100+, 2019 PROGRESS REPORT 39 (2019), <https://perma.cc/AR2S-95UN>. In any case, large mutual funds can, based on their investment strategies and market power, expect to become major shareholders in whichever companies emerge as the champions of a transformed automotive sector.

Yet, some fossil fuel producers have committed to drastic long-term emissions targets,<sup>71</sup> which begs the question of whether such initiatives violate management's fiduciary duties.

### 1. *Decarbonization Commitments as an Issue of Fiduciary Duties*

Put briefly, the business judgment rule insulates corporate directors from liability for negligence "unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available."<sup>72</sup> This is a famously high bar to meet for plaintiffs, but in the curious case of fossil fuel producers swearing off fossil fuel production, potential D&O liability cannot be dismissed out of hand. The "rational business purpose" is not obvious in this context because it is difficult to conceive of a scenario in which drastic emission cuts would not result in equally drastic revenue cuts for producers of fossil fuels.<sup>73</sup> In these cases, it is not an overstatement that an earnest commitment to become carbon neutral would be akin to a commitment to putting fossil fuel companies – in their current form – out of business.

Assuming that portfolio primacy lies at the root of net-zero commitments, this would be a drastic case of companies prioritizing diversified shareholders over less-diversified shareholders. Traditionally, most commentators contend that the interests of the former should prevail over those of the latter, arguing that diversified shareholders' interests are most closely aligned with the goal of long-term value creation.<sup>74</sup> But this position rests on an isolated view of the shareholder's position in the individual company, which cannot accommodate the concept of

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<sup>71</sup> See *supra* I. C. 3.

<sup>72</sup> *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del.2000). There are different doctrinal conceptions of the business judgment rule, see, e.g., BAINBRIDGE, *CORPORATE LAW*, *supra* note 67, at 107.

<sup>73</sup> See Condon, *supra* note 13, at 49 (noting that "for those companies whose sole profit comes from the sale of fossil fuels, emissions levels are inextricably linked to product sales, and significant emissions reductions can only be achieved through reduced sales of their product.").

<sup>74</sup> Cf. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003) (advocating an obligation of directors "to make decisions based solely on the basis of long-term shareholder gain"); Hansmann & Kraakman, *supra* note 8, at 439 (noting that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value"). There is considerable opposition to that view, see Jesse M. Fried, *The Uneasy Case for Favoring Long-Term Shareholders*, 124 YALE L. J. 1554, 1575-1627 (2015) (arguing that the intuition that managers serving long-term shareholders would be likely to generate more value over time than managers serving short-term shareholders is flawed, at least for the typical U.S. firm which heavily buys and sells its own shares).

portfolio primacy.<sup>75</sup> Thus, regardless of which side one takes in the general debate on this issue, decarbonization cannot be justified on the grounds that it creates benefits for diversified shareholders *outside* the corporation by internalizing costs *inside* the corporation.<sup>76</sup> Rather, deliberately foregoing profits by pushing decarbonization in the interest of diversified investors would violate fiduciary duties.<sup>77</sup> Given that such violations often go unpunished by courts and regulators, some managers may still prioritize the interests of diversified shareholders,<sup>78</sup> but those managers would need to conceal their rationale to avoid liability.<sup>79</sup>

A more presentable business rationale could be that decarbonization commitments simply acknowledge the economic and regulatory trajectory of the fossil fuel industry. A charitable reading might liken oil companies in 2022 to manufacturers of horse carriages in 1922 who, had they committed to phase out production of their core product until 1950, would have acted prudently and with foresight, not with disregard for value maximization. To that end, announcements by fossil fuel companies tend to refer, albeit in rather vague terms, to the economic necessity to transition to new products.<sup>80</sup> Whether or not such statements reflect reality – both with regard to the accuracy of the prediction and with regard to the company's true motivation – cannot be determined with certainty. But it is generally more plausible that managers would strive for traditional value maximization than for portfolio primacy since their personal incentives are usually<sup>81</sup> more closely aligned with their own company's success.<sup>82</sup> Therefore, stating

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<sup>75</sup> See *supra* notes 28-31 and accompanying text.

<sup>76</sup> See Tallarita, *supra* note 24, at 47.

<sup>77</sup> A similar conclusion on a more general level is drawn by Condon, *supra* note 13, at 56; O'Brien & Waehrer, *supra* note 12, at 765-766; Thomas A. Lambert & Michael E. Sykuta, *Calm Down About Common Ownership*, 41 REGULATION 28, 31 (2018).

<sup>78</sup> Cf. Condon, *supra* note 13, at 57.

<sup>79</sup> See also Tallarita, *supra* note 24, at 47-48 (pointing out that courts might very well be compelled to stop corporate managers from systematically choosing value-decreasing strategies to cater to the portfolio interests of large shareholders).

<sup>80</sup> Cf. Joint statement, *supra* note 51 (stating Shell's ambition to "thrive through the energy transition by providing the mix of products its customers need as the energy system evolves" and to invest "in assets that will be essential in the energy transition, and where it sees growth in demand over the next decades.").

<sup>81</sup> Some executive compensation structures are now geared toward incentivizing decarbonization, see *supra* notes 52-53 and accompanying text.

<sup>82</sup> Cf. Lambert & Sykuta, *supra* note 76, at 31.



a rationale along the lines of 'We are proactively anticipating a net zero economy' is likely to satisfy the lenient standard of the business judgment rule.<sup>83</sup>

## 2. *Fiduciary Duties as a Reality Check for Net Zero Commitments*

The analysis above implies that directors are shielded against liability as long as their *stated* motivation is reasonably well crafted. This leaves their *actual* motivation unclear, but fiduciary duties can help triangulate the actual impact of portfolio primacy and the earnestness of net zero commitments by fossil fuel companies.

We can imagine three scenarios: (i) The commitments are earnest, and their underlying rationale is (perceived) economic necessity. In this case, we are not witnessing the internalization of externalities but simply companies' attempts at value maximization in a changing world. Management does not violate fiduciary duties and portfolio primacy is not actually the force at work. (ii) The commitments are earnest and driven by portfolio primacy. In this scenario, there is a strong case that management violates fiduciary duties by voluntarily internalizing externalities. (iii) The commitments are not earnest, and companies merely engage in window dressing. In this case, management does not violate fiduciary duties and portfolio primacy has no effect.

Depending on how likely we deem some of the factors at work, we can assign more or less likelihood to the other ones. Assuming that managers are unlikely to knowingly incur liability, scenario (ii) – which is the only one in which portfolio primacy is actually pulling the weight – is rather unlikely. If one finds it likely that there will be a market for fossil fuels in the foreseeable future, scenario (i) is less likely, and portfolio primacy may or may not be the driving force behind the stated targets. If one maintains both of the aforementioned assumptions and, in addition, thinks it realistic that fossil fuel companies seek to reap reputational benefits in the short term by floating phony long-term commitments, we gravitate towards scenario (iii) in which

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<sup>83</sup> See also Condon, *supra* note 13, at 59. On that lenient standard, see BAINBRIDGE, CORPORATE LAW, *supra* note 67, at 115-116 (summarizing the Delaware doctrine by noting, at 115, that, in *Brehm vs. Eisner*, "even the chief justice's reference to a rational business purpose requires only the possibility that the decision was actuated by a legitimate business reason, not that directors must prove the existence of such a reason", but also noting, at 116, that, in *McMullin v. Beran*, the Delaware supreme court reaffirmed the *Technicolor* approach of the business judgment rule as a standard of substantive review).

portfolio primacy has no actual effect. The modest scope of the short-term obligations – other than reporting<sup>84</sup> – stipulated by current commitments lends plausibility to the latter view.<sup>85</sup>

Of course, we can also imagine a scenario (iv) in which all of the assumptions sketched out above are, to varying extents, true at the same time. In any case, we can summarize the interplay of factors by noting that internalizing externalities carries a meaningful risk of personal liability, which should serve to disincentivize managers to embrace this rationale overtly, or even at all. This, in turn, raises doubts as to whether fossil fuel companies' commitments to drastically reduce GHG emissions in the long term are serious.

### *B. Fiduciary Duties on the Level of Asset Managers*

Conflicting fiduciary duties loom even larger on the level of asset managers who are expected to accommodate diverse constituencies under the umbrella of single financial groups.

#### *1. Sources of Conflicting Duties within Mutual Funds*

Managers of mutual funds are subject to a duty of good faith,<sup>86</sup> and they owe that duty to the investors – more specifically, to all classes of investors.<sup>87</sup> This becomes a thorny issue when asset managers engage in a strategy that provokes industry-specific losses for the net benefit of the portfolio because, more often than not, there is no such thing as "the" portfolio. Large asset managers offer their investors a bouquet of different funds, each of which has individual

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<sup>84</sup> Arguably, self-imposed reporting requirements merely pre-empt the trend towards statutory duties to disclose climate risks. On the SEC's recently proposed rule, *see supra* note 41.

<sup>85</sup> In Shell's case, for instance, only the emissions targets for 2035 and 2050 include emissions generated by customers using Shell's products, whereas the modest short-term targets – 3-4% by 2022 and 6-8% by 2023 – do not, cf. Shell, *Our climate target 1-2* (Mar. 6, 2020), <https://perma.cc/X967-7B5V>. *See also supra* note 55 and accompanying text.

<sup>86</sup> Cf. U.S. SEC. & EXCH. COMM'N, DISCLOSURE OF PROXY VOTING POLICIES AND PROXY VOTING RECORDS BY REGISTERED MANAGEMENT INVESTMENT COMPANIES, 17 CFR Parts 239, 249, 270, and 274, <https://perma.cc/9L7V-SZTM>.

<sup>87</sup> Cf. Investment Company Act § 1(b)(2), 15 U.S.C. 80a-1(b)(2) (declaring that "the national public interest and the interest of investors are adversely affected ... when investment companies are ... managed or their portfolio securities are selected, in the interests of directors, officers, investment advisers, ... , in the interest of other investment companies or persons engaged in other lines of business, rather than in the *interest of all classes of such companies' security holders*") (emphasis added); U.S. SEC. & EXCH. COMM'N, INVESTMENT COMPANY GOVERNANCE, Exchange Act Release No. IC-26520 (Jul. 27, 2004), <https://perma.cc/QHU8-7WG6> (stating that "the paramount principle that must prevail, and should animate all decisions directors are called upon to make, is that a fund must be managed on behalf of its investors rather than on behalf of the adviser or other affiliated persons of the fund.) [hereinafter SEC, INVESTMENT COMPANY GOVERNANCE].

characteristics and interests.<sup>88</sup> Carbon-sensitive companies are overrepresented in some funds and underrepresented in others.<sup>89</sup> Consequently, it is impossible for the asset manager to devise a uniform and coherent climate-activism strategy that satisfies everyone's interests. Imposing costly climate change mitigation measures on some portfolio companies may yield net benefits for investors in index funds whose composition approximates the global economy, but it may disadvantage investors in funds which are more carbon-heavy, for instance because they place more emphasis on the energy sector, or which are less vulnerable to climate change because their portfolios are skewed towards certain geographical areas.<sup>90</sup> Climate change is not the only context in which these diverging interest materialize in theory.<sup>91</sup> But it stands out because asset managers are adopting, or at least signaling, a particularly active attitude with regard to decarbonization. If this attitude involves imposing significant costs on certain companies, industries, and funds within one financial group, it invites more serious charges than the conventional criticism that a one-size-fits-all approach cannot be optimal for each individual fund.

## 2. *Resolving Conflicting Duties – Possible, but Impractical*

While the mutual funds cannot resolve this conflict on a centralized level, managers of individual funds could, and are in fact legally expected to,<sup>92</sup> scrutinize their marching orders and exercise voting powers in ways that further their particular investors' interests. There is no 'hard' structural or legal factor barring different fiefdoms within the realm of one asset manager from exercising their voting rights, let alone from informally engaging the management of

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<sup>88</sup> On the general structure of mutual funds, see Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TRANSACTIONS: TENN. J. BUS. L. 175, 178-179 (2017) (concluding that "the conflicts under which funds labor remain an intractable fact of the industry").

<sup>89</sup> For instance, the Vanguard Energy ETF consists of 20% Exxon Stock, whereas an S&P500 Index Fund only consists of 1.4% Exxon Stock, cf. Condon, *supra* note 13, at 57.

<sup>90</sup> For more instructive examples, see Tallarita, *supra* note 24, at 32-37 (simulating the effects of carbon mitigation measures on different funds).

<sup>91</sup> Other examples include situations in which different funds of the same family are on different sides of a transaction or hold equity and debt, respectively, from the same company, cf. Lipton, *supra* note 87, at 190. On similar scenarios, see Sean J. Griffith & Dorothy S. Lund, *Conflicted Mutual Fund Voting in Corporate Law*, 99 B. U. L. REV. 1151, 1168-1886 (2019).

<sup>92</sup> Cf. SEC, INVESTMENT COMPANY GOVERNANCE, *supra* note 86 (stating that "[d]irectors should be highly skeptical of arguments that merely rationalize the resolution of conflicts in favor of the fund adviser, and should seek results that advance the best interest of fund shareholders.").

portfolio companies in different, and even contrarian, ways.<sup>93</sup> In principle, such fund-specific policies would be the most adequate way to resolve 'family differences' as to the desirability of decarbonization, at least with regard to voting behavior.<sup>94</sup> Still, investing scarce resources in the development and execution of fund-specific policies runs counter to the established practice of mutual funds which rely on centralized policies<sup>95</sup> and almost never exhibit split voting.<sup>96</sup> It appears unlikely that asset managers would accept the impracticality of fragmented strategies across funds in order to resolve conflicting fiduciary duties.

A preference for centralized voting policies does not in itself imply which shape such policies would take with regard to decarbonization. However, with regard to fiduciary duties, engaging in climate activism seems to lead into murkier waters than abstaining from it.<sup>97</sup> Still, asset managers are aware that their decisions are rarely challenged in court and may still favor climate activism driven by portfolio primacy on an institutional level. But lest the same asset managers are prepared to alienate less climate-oriented investors, they would need to toe a fine line between asserting portfolio-oriented policies on an institutional level and downplaying the fact that certain constituencies among their clients bear the brunt of the internalized costs associated with these policies.<sup>98</sup> Thus, mutual funds have no elegant way to resolve the issue of conflicting fiduciary duties, and are disincentivized to push the envelope too far with regard to

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<sup>93</sup> SEC, PROXY VOTING, *supra* note 47 (noting that "[n]othing in the rule prevents an adviser from having different policies and procedures for different clients. Thus, the board of directors of an investment company could adopt and require an investment adviser to use different policies and procedures than the adviser uses with respect to its other clients.").

<sup>94</sup> For a detailed argument, *see* Lipton, *supra* note 87, at 192-197.

<sup>95</sup> *Id.* at 182-188 (noting, at 182, that "conflicts are exacerbated by the nearly universal practice of using a single board, or clusters of boards, to oversee all funds in a family" and, at 187, that "most asset managers have created centralized governance offices that handle the voting and engagement functions of all the funds, or clusters of funds, administered by the manager. These offices articulate a set of corporate governance preferences that guide all proxy voting across the funds. ... As a result, funds administered as part of a single family tend to vote their shares as a block.").

<sup>96</sup> Cf. Jan Fichtner, Eelke M. Heemskerk, & Javier Garcia Bernardo, *Hidden power of the Big Three? Passive index funds, re-concentration of corporate ownership, and new financial risk*, 19 BUSINESS AND POLITICS 298, 316-317 (2017) (noting that different funds issued by the same asset manager voted consistently in more than 99% of all votes).

<sup>97</sup> However, it is not far-fetched to regard both scenarios as problematic, *see* Condon, *supra* note 13, at 59 (noting that "one could argue that ... intentional passivity breaches [mutual funds'] duties to those clients that invest broadly in a market-mirroring portfolio.").

<sup>98</sup> For a similar conclusion, *see* Tallarita, *supra* note 24, at 44-45.

clients who stand to lose from aggressive decarbonization. It appears likely that these factors will temper mutual funds' appetite to engage in aggressive climate activism.

### *C. Fiduciary Duties on the Level of Asset Owners and Trustees*

While the large asset managers are the towering figures among institutional investors who could engage in climate activism, they are by no means alone. Other entities such as pension funds, sovereign wealth funds, charities, endowments, and personal trusts do not rise to the pervasive level of direct equity ownership achieved by the Big Three<sup>99</sup> but still invest trillions of dollars collectively. Like mutual funds, they typically strive for long-term value creation and rely on diversification to alleviate risks.<sup>100</sup>

#### *1. Capacity of Fiduciary Duties to Accommodate Climate Activism*

Institutional investors regularly cite fiduciary duties as their reason for engaging with climate risks.<sup>101</sup> This is hardly controversial if it means that investors seek information on a major macro-economic development, which is only prudent. In addition, many investors have joined climate-friendly coalitions,<sup>102</sup> and some have even taken sides in proxy fights over climate-related strategies.<sup>103</sup> But if this engagement takes the shape of decisions that are guided by the planet's rather than the beneficiaries' interests – which are not necessarily aligned<sup>104</sup> – the situation becomes peculiar with regard to the acting trustees' fiduciary duties.<sup>105</sup>

The implications of climate-friendly investment are only one aspect of the broader question of how to square a trustee's fiduciary duty with considerations of environmental, social, and

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<sup>99</sup> The investments of both groups overlap because institutional investors can, and very often do, invest in funds offered by large asset managers, which does not make these investors direct shareholders but puts them in a position akin to indirect equity-owners of large public companies. Thus, the positions of institutional clients heavily influence the policies of asset managers, cf. Lund, *supra* note 14, at 27.

<sup>100</sup> On pension funds, see Benjamin J. Richardson, *Do the Fiduciary Duties of Pension Funds Hinder Socially Responsible Investment?*, 22 BANKING AND FINANCE LAW REVIEW 145, 169-170 (2007).

<sup>101</sup> See Krueger et al., *supra* note 16, at 1070.

<sup>102</sup> For instance, the asset owners involved in the Climate Action 100+ initiative include dozens of pension funds, university endowments, state treasurers, and personal trusts, cf. Climate Action 100+, cf. Climate Action 100+, *Investor Signatories* (Apr. 8, 2022), <https://perma.cc/8MNR-ND5K>.

<sup>103</sup> For instance, two pension funds were actively involved in the proxy fight between Exxon and Engine No. 1, cf. *supra* note 47 and accompanying text.

<sup>104</sup> Cf. Richardson, *supra* note 99, at 162.

<sup>105</sup> Only some – albeit a sizable portion – of the relevant institutional investors and their trustees are subject to U.S. law. This article does not take a position on the relevance of ESG factors for fiduciary duties, or the functional equivalent thereof, under other legal regimes.

governance (ESG) factors when devising investments strategies. This question also encompasses investing in (or divesting from), *inter alia*, tobacco companies, producers of firearms, or firms with poor social or environmental track records. A few U.S. states have enacted statutory provisions dealing with the matter.<sup>106</sup> But even those provisions, while clarifying the general permissibility of ESG-informed decisions, hardly spell out specifics. Given the high dollar amounts at stake, the issue is quite consequential because breaches of fiduciary duties render trustees, as agents of the beneficiaries, liable for make-whole damages and other relief.<sup>107</sup>

The views on the permissibility of ESG-informed investment decisions by trustees differ markedly across different camps. While one group suggests that fiduciary principles not only permit but even require trustees to resort to ESG criteria,<sup>108</sup> some scholars advocate a more cautious approach arguing that ESG investment is, under the right circumstances, permissible but not mandatory for trustees.<sup>109</sup> However, surveys show that a sizable number of the trustees

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<sup>106</sup> Delaware and Oregon have amended their trust codes to address the issue, cf. DEL. CODE ANN. tit. 12, §§ 3302(a) and 3303(a)(4) (stating, in § 3302(a), that "when considering the needs of the beneficiaries, the fiduciary may take into account the financial needs of the beneficiaries as well as the beneficiaries' personal values, including the beneficiaries' desire to engage in sustainable investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs of the beneficiaries"); OR. REV. STAT. §§ 130.755(3)(i) and (j) (stating that a trustee "shall consider all relevant circumstances in investing and managing trust assets", including "the settlor's desire to engage in sustainable or socially responsible investment strategies that align with the settlor's social, environmental, governance or other values or beliefs" and "[t]he needs of the beneficiaries, including ... the beneficiaries' personal values and desire that the trustee engage in sustainable or socially responsible investing strategies that align with the beneficiaries' social, environmental, governance or other values or beliefs, as well as the financial needs of the beneficiaries").

<sup>107</sup> Depending on the specifics of the legal relationship and investment decisions, it may prove very difficult for the beneficiary to quantify damages in the scenarios relevant here, cf. Richardson, *supra* note 99, at 164. Other remedies besides make-whole damages include trustee removal, an injunction against further such conduct, or unwinding transactions by way of equitable lien, cf. Robert H. Sitkoff, *Fiduciary Principles in Trust Law*, in THE OXFORD HANDBOOK OF FIDUCIARY LAW 45 (Evan J. Criddle, Paul B. Miller, & Robert H. Sitkoff eds. 2019) [hereinafter Sitkoff, OXFORD HANDBOOK].

<sup>108</sup> See Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 735-736, 784-796 (2019) (arguing, at 735, that "fiduciaries can – and should – consider ESG factors in their investment policies and investment decision-making" and, at 788, that "ESG integration falls squarely within the prudent investor standard and does not implicate the duty of loyalty"); UNEP FINANCE INITIATIVE, A LEGAL FRAMEWORK FOR THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES INTO INSTITUTIONAL INVESTMENT 13 (2005) <https://perma.cc/9HCS-RB5Z> (noting that "integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions").

<sup>109</sup> Cf. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 385-386, 448-453 (2020).

who do not use ESG factors operate under the assumption or suspicion that doing so would indeed violate their fiduciary duty.<sup>110</sup>

The basic rationale to consider here is the so-called sole interest rule, which requires from the trustee undivided loyalty to the beneficiary's interests.<sup>111</sup> Since it is implausible that ESG factors always reflect these interests, the sweeping claim that trustees are required to consider these factors<sup>112</sup> is too crude. On the other hand, it is equally implausible that ESG factors, as a matter of principle, cannot be informative in advancing the beneficiary's interests. Thus, the balanced approach proposed by Schanzenbach and Sitkoff provides a sound foundation grounded in the current state of theory. It specifies two requirements for ESG investing to be permissible for a trustee of a pension, charity, or trust: (i) the trustee reasonably concludes that this strategy will benefit the beneficiary directly by improving risk-adjusted return. (ii) The trustee adopts the strategy with the exclusive motive to obtain this direct benefit.<sup>113</sup>

## 2. *The Necessity to Justify Climate Activism on Economic Grounds*

If we apply this model to the narrower category of climate-activist investment strategies, we cannot hope for a general rule because the assessment relies heavily on individual circumstances.<sup>114</sup> Still, we can conclude two things: First, climate activism aimed purely at benefitting third parties, including future generations, normally violates fiduciary duties. But also, second, climate-friendly strategies are potentially permissible. If we try to assess whether permissibility

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<sup>110</sup> See Amir Amel-Zadeh & George Serafeim, *Why and How Investors Use ESG Information: Evidence from a Global Survey*, 74 FINANCIAL ANALYSTS JOURNAL 87, 91 (2018) (noting that 21.9% of US-based investors who do not use ESG data state as their reason that doing so would violate their fiduciary duties to their stakeholders); CFA INSTITUTE, ENVIRONMENTAL, SOCIAL, AND GOVERNANCE ISSUES IN INVESTING: A GUIDE FOR INVESTMENT PROFESSIONALS 11-12 (2015), <https://perma.cc/8TWK-2U8Q> (noting that 37% of the investors surveyed responded that they consider ESG issues because they viewed it as their fiduciary duty, but 22% of the investors who did not consider ESG issues responded that they would begin doing so if they had clarity that it does not conflict with their fiduciary duty).

<sup>111</sup> See RESTATEMENT (THIRD) OF TRUSTS § 78 comment f. (AM. L. INST. 2007) (stating that a trustee must not be "influenced by the interest of any third person or by motives other than the accomplishment of the purposes of the trust").

<sup>112</sup> See authors cited *supra* in note 107.

<sup>113</sup> See Schanzenbach & Sitkoff, *supra* note 108, at 386, 425-430 (noting, at 426-427, that the first requirement fulfils the 'prudent investor rule' and, at 428-429, that the trustee must regularly monitor and, where necessary, update the strategy).

<sup>114</sup> Cf. *id.* at 448-449 (2020) (calling this issue a "contextual and fact-driven question, one that will turn on the quality of the fiduciary's particular skills, its documented analysis, and its ongoing assessments of the strategy").

is the exception or the norm, it seems that climate activism by comparatively smaller institutional shareholders is rather difficult to square with portfolio interests, even if it has some positive long-term effect on the global economy. This is because such an effect does not constitute a *direct* benefit to the beneficiary. While the breadth of diversification varies, most beneficiaries are not "universal owners" whose portfolio interests approximate those of society at large, or at least the aggregate interests of major public corporations. Therefore, it is doubtful that the resulting net benefits to the portfolio would typically justify incurring the costs associated with the trustee's decision to scale back investment in climate-endangering but otherwise attractive firms,<sup>115</sup> or the trustee's combined decisions to invest in climate-endangering companies but to pressure these companies to cut back emissions (and revenue). In doctrinal terms, these rationales ordinarily<sup>116</sup> violate trust law's sole interest rule unless beneficiaries stipulate that the trustee is authorized to sacrifice portfolio efficiency for environmental impact.<sup>117</sup>

However, such indirect positive effects on the portfolio are not the only conceivable justification for investment decisions guided by climate activism. Trustees could, and increasingly do, argue that investing in companies with a decent track record on climate – or pushing existing portfolio firms to adopt climate-friendly policies – outperforms the alternatives in terms of risk-adjusted returns. To the extent this argument holds water, climate activism is as permissible as any other investment strategy seeking to exploit mispricing.<sup>118</sup> There is indeed some empirical support for a relationship between ESG criteria and firm performance.<sup>119</sup> But the evidence is

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<sup>115</sup> For an opposing view, albeit from a UK perspective, see Alastair Marke, *Establishing the Legal Obligations of Pension Fund Trustees to Divest from Climate-Unfriendly Portfolios*, 12 CARBON & CLIMATE LAW REVIEW 297 (2018).

<sup>116</sup> For reasons of brevity, this article does not expound on particular arrangements governing the structures of some institutional investors, such as charities, including those organized as corporations, or private pension and retirement funds governed by the 1974 Employee Retirement Income Security Act (ERISA). With some qualifications, the analysis applies to trust fiduciary relationships in general.

<sup>117</sup> Such authorization can be conferred through trust's terms, expressly or by implication, cf. Sitkoff, OXFORD HANDBOOK, at 45. Trust law broadly permits authorizations of similar types, see RESTATEMENT (THIRD) OF TRUSTS § 90 comment c. (AM. L. INST. 2007) (stating that social causes "may properly influence the investment decisions of a trustee to the extent permitted" by the beneficiaries' consent).

<sup>118</sup> See Schanzenbach & Sitkoff, *supra* note 108, at 390.

<sup>119</sup> See John Peloza, *The Challenge of Measuring Financial Impacts From Investments in Corporate Social Performance*, 35 JOURNAL OF MANAGEMENT 1518, 1531-1532 (2009) (summarizing that "meta-analyses reveal a positive relationship between CSP and financial performance").



neither uniform nor robust,<sup>120</sup> so the notion that ESG factors are reliable proxies for firm performance and/or managerial quality<sup>121</sup> is not firmly established. Most importantly, even the existence of a positive relationship between ESG and firm performance leaves room for the assumption that the market price already reflects this factor.<sup>122</sup> While there is also some data indicating that stock markets tend to underappreciate climate risks,<sup>123</sup> this finding does not necessarily mean that (specific) institutional investors are able to exploit such systemic mispricing. Therefore, it remains questionable whether trustees could reasonably justify investment strategies based on climate performance over passive approaches.

### 3. *Conclusion: Investors' Climate Activism Rests on Shaky Ground*

Thus, whether climate activism is defensible in terms of a trustee's fiduciary duty ultimately depends on the trustee's strategic considerations and underlying motivation. Absent a formal authorization to prioritize environmental considerations, the decision is acceptable if the trustee aims to improve risk-adjusted returns. However, this does not justify any and all decisions based on the idea that climate-friendly policies yield superior returns. Unlike directors and officers in corporations,<sup>124</sup> trustees do not enjoy the privilege of a safe haven akin to the business judgment rule.<sup>125</sup> Therefore, trust law allows for comparatively close scrutiny of whether individual investment decisions satisfy this standard. As a result, trustees without explicit legal authorization to pursue environmental aims should tread lightly when it comes to climate activism.

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<sup>120</sup> See *id.* at 1531-1532 (adding that "the business case for CSP is somewhat unclear. The relationship is relatively weak; questions of causality are unanswered; and the measures used to examine the business case are inconsistent").

<sup>121</sup> Cf. CFA INSTITUTE, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) SURVEY 11 (2017), <https://perma.cc/EK7J-TNKD> (noting that 41% of respondents cite the idea of ESG factors being a proxy for 'hard' criteria as their reason for considering ESG). The suitability of particular ESG factors in this regard seems to vary. Calling it a management failure that a firm with sub-par boardroom diversity misses out on the benefits of diverse points of view, or assuming that well-run firms have better environmental compliance programs is plausible enough. Assuming, on the other hand, that a well-run fossil fuel producer would not be in the business of producing fossil fuels is not particularly convincing. However, there may be indirect effects, such as a lower inclination of elite managers to join contentious industries.

<sup>122</sup> Schanzenbach & Sitkoff, *supra* note 108, at 437-444, 451 (also giving an overview on the arguments in favor of ESG-based active investing and on scholarship indicating the opposite conclusion, i.e., that 'vice stocks' with low ESG scores may be systematically undervalued).

<sup>123</sup> See *supra* note 29.

<sup>124</sup> Cf. *supra* note 71 and accompanying text.

<sup>125</sup> See Sitkoff, OXFORD HANDBOOK, at 42, 45; RESTATEMENT (THIRD) OF TRUSTS § 78 comment a. (AM. L. INST. 2007). While the sole interest rule is, in doctrinal terms, an aspect of the duty of loyalty, this kind of scrutiny relates to the duty of prudence, cf. *id.*

## CONCLUSION

Climate activism by institutional investors is an interesting concept and a comforting idea for anyone who is frustrated with the misalignment between the necessity to cut GHG emissions on the macro-level and the incentives to keep generating them on the micro-level.<sup>126</sup> It is also, to a certain extent, a phenomenon we can observe in the real world. Indeed, institutional investors demand climate-friendly policies from portfolio companies and even go so far as to take sides in proxy fights to oust managers with a sub-par track record on sustainability. Many portfolio companies appear to respond to these demands by committing to emissions cuts, even where such targets are difficult to square with the goal of long-term profit maximization.

Alas, these observations are no cause for triumphalism because attempts at climate activism by institutional investors will be constrained by a number of structural and legal guardrails. If we take the concept of portfolio primacy seriously, it implies externality-internalizing measures on the part of portfolio companies. However, demanding and adopting such policies would require managements of both mutual funds and portfolio companies to breach their fiduciary duties. Even if managers ignored these contrarian incentives, meeting emissions targets on a company-level would not necessarily result in meaningful net reductions.

Overall, it is unlikely that institutional shareholders are able or willing to act as quasi-regulators and impose sweeping emissions cuts on GHG-emitting portfolio firms against these companies' economic interests.<sup>127</sup> Against this background, the mere possibility of climate activism by institutional investors must not create a false sense of security. Regulatory measures remain a far superior and critically important tool to restrict GHG emissions. Still, the fact remains that the interests of broadly diversified investors tend to approach those of society at large. Thus, although we should moderate our expectations, we can expect institutional investors to remain vocal and influential proponents of decarbonization.

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<sup>126</sup> To be sure, on a broader policy level, there are good reasons to view private regulation based on concentrated ownership as a discomfoting phenomenon, cf. Coates, *supra* note 6; Lund, *supra* note 14, at 39-43 (summarizing, at 7, that "allowing three private investment companies that lack political accountability to set regulatory policies for the U.S. economy is dangerous for our democracy.").

<sup>127</sup> For a similarly skeptical outlook, albeit on economic and practical rather than legal grounds, see Strampelli, *supra* note 15, at 18-20.