To: UN Working Group on Business and Human Rights

From: Karen Liu

Re: Call for Input Related to Investors, ESG and Human Rights

Date: September 28, 2023

The following is submitted in response to the Call for Input issued by the UN Working Group on Business and Human Rights in connection with the Working Group’s Report to be presented to the UN Human Rights Council in June 2024. The Call for Input related to Investors, ESG and Human Rights and interested parties were invited to all or selected questions as per expertise, relevance or focus of work.

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In this submission I will provide input on the question of to what extent do ESG approaches present constraints or opportunities for investors and businesses overall (General Question 3 in the Call for Input).

**I. Constraints Presented by ESG Approaches**

1. **Constraints for Businesses**

Most constraints presented by ESG approaches for businesses are due to ESG approaches’ disturbance of the current status quo of corporate governance, energy mainstay and businesses’ externalities, ambiguities of ESG taxonomy, and ESG litigation and enforcement actions, as detailed below.

1. **Corporate Governance - Fiduciary Duties**

Firstly, ESG approaches call into question as to whether directors’ fiduciary duties would require them to consider ESG-related risks and opportunities pertinent to their company’s business. In the U.S., fiduciary duties under state corporate law and case law have no specific coverage of ESG. Whether or not to consider ESG factors would be subject to the directors’ business judgement. Directors’ business decisions are protected by the business judgement rule. Under the guidance of the landmark *Caremark* case[[1]](#footnote-1) decided by the Delaware Court of Chancery, claims against corporate directors over breaches of duty of care and failures of sufficient board oversight typically have been [dismissed](https://www.reuters.com/legal/judge-dismisses-lawsuit-vs-mcdonalds-board-over-firing-ex-ceo-2023-03-01/) or [settled](https://news.bloomberglaw.com/esg/esg-pressure-raises-ante-on-board-duty-breach-claims-in-delaware) because the court will generally not overturn the business decisions of directors who have demonstrated that they have performed their duties (i) in good faith; (ii) with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and (iii) in a manner the directors reasonably believe to be in the best interests of the corporation. Admittedly, however, certain U.S. legislation or regulations have imposed on businesses compliance obligations in ESG-related areas such as human resources, the environment, or workplace safety. In those statutory areas, directors’ fiduciary duties require them to ensure that their business establish compliance and monitoring programs such as those required under the Occupational Safety and Health Act.

The traditional “shareholder primacy model” typified by Milton Friedman’s theory[[2]](#footnote-2) deems that directors’ fiduciary duties should be limited to maximizing corporate performance and thereby shareholders’ wealth, instead of considering ESG factors or satisfying other stakeholders’ concerns. Critics of the consideration of ESG factors have argued, often ignoring evidence to the contrary, that ESG factors are not financially material, and in their recent papers[[3]](#footnote-3) some U.S. scholars firmly claimed that directors’ fiduciary duties did not include oversight of ESG-related risks and aspirational goals.

There are divergent approaches in different jurisdictions as to whether and how to factor ESG into directors’ fiduciary duties, and this would especially affect businesses that have subsidiaries or branches operating globally. For example, it is worth noting that in many jurisdictions, ESG reporting obligations will soon phase in from 2024 and onwards. Notably, all EU member states will need to implement ESRS. In addition, jurisdictions like the UK, Canada, Australia, Japan, Singapore, and Nigeria have expressed their willingness to gradually align with the ISSB Standards. Once such sustainability reporting becomes businesses’ mandatory obligations, directors’ fiduciary duties in such jurisdictions would require them to ensure businesses’ compliance with such reporting obligations. At the micro level, however, different interpretations of how ESG may relate to directors’ business judgement could continue to leave room for potential claims and lawsuits.

1. **Energy Mainstay**

Secondly, ESG approaches could shift the energy mainstay in most jurisdictions. Fossil fuels (including coal, oil, and natural gas) currently supply about [80%](https://www.eesi.org/topics/fossil-fuels/description#:~:text=Overview,percent%20of%20the%20world's%20energy.) of the world’s energy. For businesses, one constraint caused by ESG is that environmental-unfriendly businesses (such as those in fossil fuels industries) may be excluded or disinvested by certain environmental-aware investors, worrying such assets would become [straddled assets](https://www.nature.com/articles/s41558-022-01356-y). For some local economies, fossil fuel industries remain their major sources of government revenues and employment opportunities. It is important for the world to find alternative solutions to make better use of fossil fuels and avoid them becoming straddled assets or being wasted. This would also motivate fossil fuel businesses to push for their energy transition, and empower fossil-fuel-rich localities to play their part in the global process of decarbonization with their natural endowment.

In the U.S., one added complexity is that ESG has been politicalized in certain circumstances. By contrast, other jurisdictions such as the EU and the UK have less internal debate on fossil fuel related ESG issues and some have implemented concrete energy transition roadmaps[[4]](#footnote-4).

1. **Businesses’ Externalities**

Thirdly, investors are becoming increasingly aware of businesses’ externalities, because more and more investors have adopted responsible investing strategies. For example, those that are signatories of UN Principles for Responsible Investment (UNPRI) commit to incorporate ESG issues into investment practice. As a result, to attract capital, more and more businesses have begun to consider not only short-term profits, but also externalities and stakeholders affected by their businesses.

This raises two concerns:

1. Does a business’ license to operate include corporate social responsibilities (CSR)? If so, what CSR are involved? The traditional “shareholder primacy model” referenced above is based on the assumption and belief that to increase profits is the only one social responsibility of business. However, many investors concern not only a business’s short-term profits but also its long-term profitability. A business’ externalities may impact the latter or both.
2. Externalities issues relate to “system” questions, where **each** business is a component of the entire system and a contributor to the system’s problems. For example, a single business can be a drag on the global efforts of combating climate change if its externalities of greenhouse gas emissions are legally or illegally let go. Global problems call for concerted efforts.
3. **Alphabet Soup - Ambiguities of ESG Taxonomy**

Fourthly, the alphabet soup of “E,” “S” and “G” poses various challenges for businesses.

Because the concept of “ESG” encompasses multiple aspects of “E”, “S” and “G” factors, even if a business considers ESG, its focus may not necessarily be aligned with the ESG factors that are most important to its various shareholders and [stakeholders](https://corpgov.law.harvard.edu/2022/04/26/how-would-directors-make-business-decisions-under-a-stakeholder-model/). A business may have a mix of investors with divergent interests and priorities. For example, institutional investors and individual investors may have different short-term and long-term priorities. Among institutional investors, asset managers and asset owners may have different level of fiduciary duties to their respective beneficial owners. A business’ stakeholders can include shareholders, employees, suppliers, customers, communities, governments, and the general public. There is no consensus as to what stakeholders’ interests count and to what extent. Although, the standardization of sustainability reporting such as SASB, ISSB and ESRS could help each business identify material ESG factors specific to its industry, each business still needs to build up a common understanding among its various shareholders and stakeholders about specific ESG factors material to its unique business.

Sustainability standards also differ. For example, SASB and ISSB standards focus on financial materiality with information mainly intended for investors; while ESRS and GRI standards focus on both financial materiality and impact materiality, and provide information intended for not only investors but also other stakeholders. If a business operates in multiple jurisdictions that require different types of sustainability reporting, it will not only have heavier reporting burden, but also face challenges of interoperability of different standards and consistency of reporting.

1. **ESG Litigation and Enforcement Actions**

Finally, false ESG information risks accusations and liability. ESG disclosure may exert extra duties and [risks](https://www.americanbar.org/groups/business_law/resources/business-lawyer/2022-summer/the-unintended-consequences-of-mandatory-esg-disclosures/) to businesses, because inaccurate disclosure may result in “greenwashing” [enforcement actions and litigation claims](https://corpgov.law.harvard.edu/2023/08/10/trends-in-esg-litigation-and-enforcement/). Some businesses took a “green hushing” approach but thereafter faced claims from activists.

In addition, since investors increasingly use ESG disclosures/concerns in evaluating their investment decisions, [ESG-related litigations](https://corpgov.law.harvard.edu/2023/08/10/trends-in-esg-litigation-and-enforcement/) and [activism initiatives](https://corpgov.law.harvard.edu/2021/05/29/shareholder-activism-and-esg-what-comes-next-and-how-to-prepare/) have increased in recent years, which challenges businesses’ existing business models and marketing endeavors.

1. **Constraints for Investors**

For investors, ESG approaches challenge understanding of their fiduciary duty owed to beneficial owners of assets in their portfolios, especially for institutional investors that invest for long term. In addition, ESG concerns impact their interactions with other investors. Their ESG endeavors may face political pressure and legal constraints. Also, ESG imposes extra compliance and reporting burdens on investors.

1. **Long Term Investments**

Some investors still question whether their fiduciary duty requires/allows them to implement ESG investing. The 2005 UNEP FI report[[5]](#footnote-5) showed that ESG issues are relevant for financial valuation and thus, failing to consider ESG-related long-term value drivers is a failure of fiduciary duty. This is especially true for institutional investors that invest for long term, because their investment models and projections need to factor in an investee’s long-term sustainability. Also, megatrends such as energy transition and human capital protection may impact investors’ invested capital in the long run if they are not properly planned for in advance. However, directors and managers of investee companies do not always consider long term, and their interests may diverge from shareholders’ interests.

1. **Your “ESG” is Not My “ESG”**

As discussed above, an investee company may have different types of investors. For example, controlling shareholders vs. minority shareholders; active investors vs. passive investors; investors with long-term strategies vs. short-term strategies. Investors may have divergent ESG interpretations, focuses and priorities. For example, pension and endowment investors of a fossil fuel company may worry about the company’s long-term prospects due to climate change and may therefore push for the company’s energy transition; however, investors that invest for short term may be attracted by the fossil fuel company’s current lucrative profits and/or other “E,” “S,” or “G” strengths.

1. **Legal Constraints and Political Pressure**

Many institutional investors are signatories of UNPRI, which obligates them to invest responsibly under [six principles](https://www.unpri.org/about-us/what-are-the-principles-for-responsible-investment). Also, out of their fiduciary duty to their beneficial owners, they have developed different levels of ESG engagement and stewardship during the lifetime of their investee companies. However, some of their ESG engagement and stewardship endeavors may face legal constraints and political pressure. For example, in some jurisdictions, collective engagement may face regulatory constraints against acting in concert, if several investors work together to use their shareholdings as a single bloc.

In the U.S., asset managers such as BlackRock, Vanguard and State Street are facing a dilemma. On the one hand, certain states [tried to prevent](https://thehill.com/policy/energy-environment/3998234-republican-states-move-to-block-giant-asset-managers-esg-push-for-utility-companies/) them from imposing sustainable investing practices on utilities companies, and certain states [divested](https://www.investopedia.com/blackrock-florida-esg-divestment-6835428) from them because of their support of sustainable investing. On the other hand, they scrambled to manage [greenwashing risk](https://www.afr.com/companies/financial-services/blackrock-state-street-scramble-to-manage-greenwashing-risk-20230802-p5dt78) and pressure from [activist investors](https://www.cnbc.com/2022/12/07/activist-investor-calls-for-blackrock-ceo-fink-to-step-down-over-esg-hypocrisy.html). To better suit different local dynamics, some asset managers have designed different ESG investment focuses for different localities.

1. **Compliance and Reporting Burden**

Some investors do not have enough resources to effectively build ESG into their investment process, which may create non-compliance or “greenwashing” issues. Institutional investors may be burdened with ESG reporting like businesses, as detailed in part I.D. above, especially for investors obligated to report in different jurisdictions. In particular, the ISSB standards require asset managers disclose specific information about its Scope 3 “financed emissions” in connection with its portfolio companies and counterparties.

**II. Opportunities Presented by ESG Approaches**

1. **Opportunities For Businesses**

ESG approaches could help business better manage sustainability related risks, identify long term opportunities, and shape sustainable strategies.

1. **Risk Management**

ESG has become a potent [tool](https://www.sustainalytics.com/esg-research/resource/corporate-esg-blog/what-is-esg-why-important-risk-management) to help businesses identify and manage potential and actual sustainability-related risks. So far, no jurisdiction in the world requires businesses to disclose sustainability-related information in financial statements. However, both ISSB Standards and ESRS are effectively internalizing a business’ externalities by factoring in ESG-related risks and opportunities into general purpose financial statements reporting. This could help businesses better manage their long-term and sustainability related risks.

1. **Sustainability-Related Opportunities**

ESG approaches have created various opportunities for businesses. For example, ESG initiatives have helped some [fossil fuel companies](https://totalenergies.com/transformation) transform their business models. For companies like [Subaru](https://www.forbes.com/sites/steveolenski/2017/06/29/subaru-the-50-year-old-brand-built-on-love/?sh=24499f3d8724), their ESG initiatives enhanced their differential competitiveness and translated brand love into profits. ESG has also aroused management’s awareness of the importance of [corporate culture](https://corpgov.law.harvard.edu/2021/03/29/integrating-esg-into-corporate-culture-not-elsewhere-but-everywhere/) and governance, which could raise employee loyalty and reduce corporate politics. B corporation certification could improve businesses’ accountability and transparency and help businesses doing well while doing good. Globally, ESG approaches have also created sustainability-related new business sectors and employment opportunities for existing and future businesses. Admittedly, however, challenges still exist. For example, US auto companies are confronting the impact of transitioning to electronic vehicles in [negotiations](https://www.wsj.com/business/autos/uaw-says-costly-ev-transition-wont-change-unions-demands-1561a725) with their workers.

1. **Sustainable Strategies Shaping and Shifting**

ESG approaches could help businesses shape their [sustainable strategies](https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Sustainability/Our%20Insights/Profits%20with%20purpose/Profits%20with%20Purpose.ashx). For example, shifting from short-term profit driven to [long-term](https://www.theguardian.com/sustainable-business/short-term-profit-long-term-losses) sustainability [foresighted](https://www2.deloitte.com/xe/en/insights/topics/strategy/sustainability-in-business-staying-ahead-of-the-curve.html); from individual business centric to systematic strategy[[6]](#footnote-6); from “win-lose” to “win-win” mindset[[7]](#footnote-7); from linear development to [circular economy](https://circulareconomy.europa.eu/platform/sites/default/files/17037circulaireeconomie_en.pdf). Companies like [Veolia](https://www.veolia.com/en/pollution) are providing game-changing solutions for ecological transformation by changing wastes into reusable resources in the global recycling ecosystem.

1. **Opportunities For Investors**

ESG approaches could help investors measure investee risks and opportunities, enhance stewardship, and develop alternative investment approaches.

1. **Better Measurement of Investee Risks and Opportunities**

Investors can better assess a business' risk exposure and ESG-factored future financial performance according to ESG data, such as ESG scores, sustainability ratings, and ESG disclosures.

1. **ESG Stewardship**

ESG initiatives encourage or require investors to be active owners and responsible investors. This pushes investors to enhance their stewardship endeavors through efforts such as dialogues, monitoring, engagement, and voting.

1. **Alternative Investment Approaches**

ESG has become an approach of alternative investment in terms of ESG-based investment selection and impact investing. Sustainability ratings have been used by some investors in selecting “best-in-class” stocks in terms of ESG. New investment products/opportunities such as opportunity zone funds, green bonds, green loans, and social impact bonds emerged. New investment techniques such as “green alpha,” portfolio decarbonization, and sustainability-themed investing have been developed. Innovative investment models like social finance, mission-related investments (MRIs) and public-private partnerships (PPPs) are making bigger impacts by linking governments and/or non-profit organizations into investment chains. Many governments, international organizations, and financial institutions also incentivize ESG investing.

1. See *In re Caremark Int'l Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). [↑](#footnote-ref-1)
2. https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html [↑](#footnote-ref-2)
3. <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3899528>

   <https://heinonline.org/HOL/LandingPage?handle=hein.journals/busl77&div=51&id=&page=>

   <https://corpgov.law.harvard.edu/2022/05/09/does-enlightened-shareholder-value-add-value/> [↑](#footnote-ref-3)
4. For example, the European Green Deal, the EU Paris-Aligned Benchmarks, the EU Climate Transition Benchmarks, and the UK’s Carbon Budget Delivery Plan and Ten Point Plan. [↑](#footnote-ref-4)
5. https://www.unepfi.org/fileadmin/documents/freshfields\_legal\_resp\_20051123.pdf [↑](#footnote-ref-5)
6. See Donella H. Meadows, *Thinking in Systems*. [↑](#footnote-ref-6)
7. See Alex Edmans, *Grow the Pie*. [↑](#footnote-ref-7)