SOLE INTEREST VS. BEST INTEREST: MODELING FUTURE ANTI-ESG LEGISLATION OFF OF INDIANA CODE § 5-10.2-14-2 TO PROTECT THE FIDUCIARY DUTIES OWED BY TRUSTEES BY REQUIRING SOLE INTEREST IDEOLOGY

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INTRODUCTION

When deciding when and where to invest their money, most people consider several factors, such as a business's financial performance or evidence-based market trends. Others may consider the risk of the investment or the potential for return on investment. If someone hires a fiduciary to make investment decisions on his/her behalf, he/she expects the fiduciary to consider the beneficiary's interest over the fiduciary's interest. The investment world is evolving, and new factors outside of the traditional risk of investment and market trends are starting to influence investment decisions made by fiduciaries. Environmental, Social, and Governance (ESG) investing has quickly grown in popularity in the investment sector since 2020.[1] ESG investing is an investment strategy that stresses a company's governance structure and the environmental and social impacts of the company's products or services.[2] ESG ratings are used to evaluate a company's performance in terms of environmental, social, and governance issues within their organization.[3]

Measuring a company's ESG goals, initiatives, and impacts is not transparent or regulated. Several different international and private organizations have attempted to create systems that accurately measure a company's ESG rating.[4] For example, Global Reporting Initiative, an international group, seeks to enable organizations to self-report their company's "impact . . . on the economy, environment and people in a manner that is both credible and comparable."[5] Furthermore, MSCI, a private organization known for rating companies' ESG performances, aims "to measure the 'company's

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1. *See* Joan Michelson, *ESG Investing is 'Soaring.' What Does it Mean?*, FORBES (Nov. 18, 2022, 5:01 PM), https://www.forbes.com/sites/joanmichelson2/2022/11/18/esg-investing-is-soaring-what-does-it-mean/?sh=6cedd351bcd3 [https://perma.cc/Z9CK-BL3J] ("Investors globally are embracing Environment, Social and Governance (ESG) investing on a massive scale" with trends suggesting ESG investing will be responsible for nearly 21.5% of total assets under management.).

2. *See* Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeting Investments, 80 Fed. Reg. 65135 (Oct. 26, 2015) (to be codified at 29 C.F.R. pt. 2509).

3. *See* Gabriela Camacho, *Anti-Corruption in ESG Standards,* TRANSPARENCY INT'L ANTI-CORRUPTION HELPDESK ANSWER 1 (May 31, 2022), https://knowledgehub.transparency.org/assets/uploads/kproducts/Anti-corruption-in-ESG-standards_Final_15.06.2022.pdf [https://perma.cc/24PT-FDQN].

4. *Id.*

5. *Id.* at 5.

resilience to long-term industry material environmental, social and governance (ESG) risks.'"[6]

Trends have suggested that investors consider a company's values and ESG ratings when making investment decisions.[7] With the increase in popularity of ESG investing, fiduciaries are under increasing pressure to consider a corporation's ESG factors in their investment decisions.[8] However, considering ESG factors as a fiduciary could lead to a breach of the fiduciary duties of prudence, impartiality, and loyalty owed by a fiduciary to a beneficiary under United States Trust Law if the fiduciary is considering ESG factors for their own self-interest when making investment decisions on behalf of the beneficiary.

According to the Restatement (Third) of Trusts, "a trustee has a duty to administer the trust solely in the interest of the beneficiaries" and "the trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests."[9] Historically, fiduciaries and trustees have a strict duty to act in the sole interest of their beneficiary.[10] Duty of loyalty in trust law has "traditionally placed strict obligations on fiduciaries to act not in their own self-interest, but in the sole interest of their beneficiaries."[11]

Because of the heightened interest and presence of ESG investing, state and federal legislatures have drafted legislation to ensure that fiduciary duties are preserved. Republican-led state legislatures around the country aggressively fought to protect fiduciary duties by introducing 156 anti-ESG bills in thirty-seven states in the first six months of 2023.[12] Indiana is one of several states that successfully passed an "anti-ESG investing" bill in 2023 to prevent state pension fiduciaries from considering ESG factors while making investment decisions.[13] Indiana's law utilizes the sole interest rule ideology, which takes the position that state pension fiduciaries must act in the sole interest of their beneficiaries or else they are breaching their fiduciary duty.[14]

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6. *Id.* at 6.

7. *Id.* at 4.

8. *See* 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, 384 (2020).

9. RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. L. INST. 2007).

10. Richard R.W. Brooks, *Loyalty and What Law Demands: Self Interest, Sole Interest or Best Interest*, NW. UNIV. 1 (Sept. 1, 2019), https://wwws.law.northwestern.edu/research-faculty/events/colloquium/law-economics/documents/fall19brooks.pdf [https://perma.cc/Y6C6-FNXX].

11. *Id.*

12. Joan Michelson, *Wave of 'Anti-ESG' Investing Legislation, New Study Found*, FORBES (Aug. 29, 2023, 7:45 AM), https://www.forbes.com/sites/joanmichelson2/2023/08/29/wave-of-anti-esg-investing-legislation-new-study-found/?sh=3686e14f7286 [https://perma.cc/79XF-PBF2].

13. Tom Davies, *Indiana Lawmakers Give Approval to Anti-ESG Investing Bill*, AP NEWS, (Apr. 24, 2023, 6:31 PM), https://apnews.com/article/indiana-republicans-esg-investing-ban-a2f8bd032dcdc83a43cba2a422608058#:~:text=House%20members%20voted%2066%2D29,principles%20in%20their%20investment%20decisions [https://perma.cc/K59L-82LY].

14. IND. CODE § 5-10.2-14-2 (2023).

This Note argues that states interested in passing anti-ESG regulation should model their bills after Indiana's anti-ESG legislation because Indiana's law requires fiduciaries and trustees of state pension plans to act in the sole interest of the beneficiary. The sole interest ideology, as opposed to the best interest ideology, is the only way to preserve the trustees' duties of prudency, impartiality, and loyalty that are owed by the trustee to the beneficiaries. This Note further argues that it is currently impossible to ensure that ESG investments are within the sole interest of the beneficiary because there is insufficient evidence and research to support the notion that ESG investing leads to higher returns on investment and better financial outcomes compared to non-ESG-focused investing.

Part I of this Note gives a more detailed explanation of ESG investing, including ESG investing origins and current opinions on ESG investing. Part II identifies relevant trust law explaining fiduciary duty and what is required of fiduciaries by law. Part III provides an explanation of the current political landscape of ESG investing in the United States, including a detailed analysis of how Indiana is approaching ESG investing decisions in state pension plans. Part IV analyzes the sole interest rule and the best interest rule in trust fiduciary law, including an analysis of why the sole interest rule should be the standard for anti-ESG statutes. Part V argues that states wishing to pass anti-ESG legislation should follow the sole interest rule ideology to prevent state pension plan trustees from violating their fiduciary duties by considering ESG factors in investment decisions.

I. OVERVIEW OF ESG INVESTING

A. What Is ESG Investing?

ESG investing stands for Environmental, Social, and Governance investing.[15] Although there are several working definitions of what ESG investing entails, the common understanding is that ESG investing is an umbrella term that "refers to an investment strategy that emphasizes a firm's governance structure or the environmental or social impacts of the firm's products or practices."[16] Ultimately, ESG assessments on companies "evaluate a company's performance on environmental, social and corporate governance issues," and these assessments "thus inform investing decisions."[17]

15. Marty Hart-Landsberg, *Don't Believe the Hype, Big Finance Continues to Threaten our Survival*, REP. FROM THE ECON. FRONT (Feb. 21, 2022), https://economicfront.wordpress.com/2022/02/21/dont-believe-the-hype-big-finance-continues-to-threatens-our-survival/ [https://perma.cc/ND2Q-J2JQ].

16. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 72857 (Nov. 13, 2020) (to be codified at 29 C.F.R. pt. 2509, 2550).

17. *See* Camacho, *supra* note 3.

B. Origins of ESG Investing

The first known usage of the term "ESG" was by UN Secretary-General Kofi Annan in 2004.[18] In a UN Global Compact, Secretary General Annan encouraged financial institutions and companies to "develop guidelines and recommendations on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services and associated research functions."[19] The Secretary also encouraged investors, pension fund trustees, consultants, and financial advisers to consider environmental, social, and governance principles in their areas of expertise.[20]

In 2018, BlackRock, one of the largest asset management companies in the world, expressed opinions on ESG investing.[21] Chief Executive Officer (CEO) Larry Fink said in a letter to the board of directors that he was seeking support from leading global investment firms to prioritize ESG issues, as well as promote diversity on boards and clarify long-term strategies.[22] This statement created a shift in emphasis toward ESG-related goals in the world's leading organizations and investment firms. In 2019, Business Roundtable released a new "Statement on the Purpose of a Corporation" signed by 181 CEOs of America's largest companies.[23] The fundamental commitment each of these companies made to their stakeholders included protecting the environment by embracing sustainable practices and fostering diversity and inclusion in the workforce.[24]

ESG investing intensified drastically in 2020[25] and 2021.[26] "ESG funds captured $51.1 billion of net new money from investors in 2020, a record and more than double" the amount from 2019.[27] In 2019, only roughly $21 billion

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18. Rep. of the U.N. Global Compact, *Who Cares Wins: Connecting Financial Markets to a Changing World* (2004), https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf [https://perma.cc/TVP7-7LND].

19. *Id.*

20. *See id.*

21. *See* Letter from Laurence D. Fink, Chairman/CEO, BLACKROCK (Jan. 12, 2018), http://www.wlrk.com/files/2018/BLKCEOLetter2018.pdf [https://perma.cc/V4V8-6VU8].

22. *Id.*

23. *See Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans,'* BUS. ROUNDTABLE (Aug. 19. 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/G67S-56W4].

24. *See id*.

25. *See* Jonathan R. Macey, *ESG Investing: Why Here? Why Now?*, 19 BERKELEY BUS. L.J. 258, 261 (2022).

26. *See* Ross Kerber & Simon Jessop, *How 2021 Became the Year of ESG Investing*, REUTERS (Dec. 23, 2021, 4:20 PM), https://www.reuters.com/markets/us/how-2021-became-year-esg-investing-2021-12-23/#:~:text= [https://perma.cc/TY82-FMUN].

27. Greg Iacurci, *Money Invested in ESG Funds More Than Doubles in a Year*, CNBC (Feb. 11, 2021, 12:44 PM), https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html [https://perma.cc/9ENE-KLTD].

was funneled into ESG Funds.[28] The challenges during 2020, such as the COVID-19 pandemic and the social justice issues brought to light during the George Floyd protests, fostered society's focus on social justice and environmental issues. [29] ESG goals continued to top the agenda of investors, companies, and policymakers in 2021 because of this shift in society's focus to social justice and environmental issues.[30] The trend of ESG investing is still on the rise and shows no signs of slowing down, as "the sale of [ESG] investments is now the fastest-growing segment of the global financial services industry."[31] ESG Funds accounted for 10% of the worldwide fund assets in 2021, with the total monetary value of worldwide ESG Fund assets climbing to $649 billion.[32] This was a $107 billion increase from 2020.[33]

C. Current Opinions on ESG Investing: Corporations as Vehicles for Change

With the boom of ESG investing over the past few years, there is no shortage of opinions from the corporate world, consumers, investors, fiduciaries, and countless others. Some argue that ESG investing is a statement "that government no longer has credibility as an engine of social change."[34] Proponents of this viewpoint opine that the "government has failed to produce results" of social change and "failed to even offer hope of achieving meaningful and effective policies" to meet ESG goals in the future.[35] Thus, people must rely on large corporations and investments to create meaningful change in the world.

In the past, the government routinely had a hand in furthering ESG-type issues, including passing legislation.[36] Environmental advancements can be seen in the Clean Air Act,[37] Clean Water Act,[38] and the Comprehensive Environmental Response, Comprehension, and Liability Act.[39] Each of these acts imposed environmental regulations on corporations and businesses within the United States to further environmental goals. Businesses are still held to these restrictions to this day. Examples of social issues that the government has

28. *Id.*
29. *See* Kerber & Jessop, *supra* note 26.
30. *Id.*
31. Cam Simpson et al., *The ESG Mirage*, BL (Dec. 10, 2021), https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line/ [https://perma.cc/3L9E-5JUF].
32. Kerber & Jessop, *supra* note 26.
33. *Id.*
34. *See* Macey, *supra* note 25, at 262.
35. *See id.*
36. *Id.* at 267.
37. 42 U.S.C. § 7401 et. seq. (1970).
38. 33 U.S.C. § 1251 et. seq. (1972).
39. 42 U.S.C. § 9601 et. seq. (1980).

actively had a hand in include labor laws and regulations such as the Occupational Safety and Health Act[40] and the Family and Medical Leave Act.[41]

Traditionally, the corporation's role in social and environmental change was to obey the laws the government passed while ensuring they were maximizing profits.[42] However, with the sudden emphasis on ESG investing, some argue that ESG provides an opportunity for corporations, not government, to be "the main source of solutions to the grave social and moral problems that plague the nation."[43] The divisive political environment and recent mistrust in the government have led people to turn to corporations to solve some of the politically divisive social issues in the country.[44] The shift toward ESG investing and governance in corporate law is vitally important because it "reflects a new, broad societal perspective that corporations, not government, are the main source of solutions to the grave social and moral problems" in the United States.[45]

Another viewpoint on ESG investing is that ESG is largely a fraud.[46] Tariq Fancy, former Chief Information Officer of BlackRock, stated that sustainable investing boiled down to little more than a "marketing hype, PR spin, and disingenuous promises from the investment community."[47] Some argue that ESG investing is a fraud because it "allows leading asset management companies to dramatically boost their profits, and the rest of the business community to continue on with their destructive business practices without fear of bad publicity or public action."[48]

D. Fallacious ESG Rating Systems

ESG rating systems "measure a company's exposure to environmental, social and governance risks."[49] A high score means that a company generally is focused on how environmental, social, and governance factors impact the

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40. 29 U.S.C. § 651 et. seq (1970).

41. 29 U.S.C. § 2601 et. seq (1993).

42. *See* Macey, *supra* note 25, at 263.

43. *Id.*

44. *Id.*

45. *Id.*

46. Hart-Landsberg, *supra* note 15, at 3.

47. Tariq Fancy, *Financial World Greenwashing the Public with Deadly Distraction in Sustainable Investing Practices*, USA TODAY (Mar. 16, 2021, 4:00 AM), https://www.usatoday.com/story/opinion/2021/03/16/wall-street-esg-sustainable-investing-greenwashing-column/6948923002/ [https://perma.cc/Q9SZ-TDDD].

48. Hart-Landsberg, *supra* note 15, at 3.

49. Jess Ullrich & Farran Powell, *What is an ESG Score for Investing?*, USA TODAY (Mar. 1, 2023, 5:01 AM), https://www.usatoday.com/money/blueprint/investing/what-is-esg-investing/ [https://perma.cc/T9X3-JVBC].

company's financial performance.[50] A lower ESG score could indicate that a company is less focused on considering these factors.[51]

There are two understandings of how these ESG rating systems work.[52] One maintains that ESG measures the "impact a company has on the welfare of its stakeholders."[53] A company's ESG score could benefit from discontinuing activities that could harm stakeholders or enhancing business practices to benefit stakeholders.[54] The other understanding of ESG ratings is that ESG measures social and environmental factors impact on a company.[55] Under this understanding, "an ESG framework provides a set of risk factors that the company can plan for or mitigate through strategic planning, targeted investment, or a change in operating activity."[56] This understanding of the rating system does not "measure a company's impact on the Earth and society."[57] Rather, the ESG rating merely gauges "the potential impact of the world on the company and its shareholders."[58]

International systems have developed guidelines and established frameworks for calculating ESG ratings.[59] Internationally, the two biggest ESG framework providers are the United Nations Global Compact and the Global Reporting Initiative.[60] The Global Compact provides a reference point for action and leadership within the corporate sustainability movement.[61] Specifically, the Global Compact supplies frameworks that corporations can adopt to embed all ten principles of the UN Global Compact into their operations.[62] The ten principles cover topics such as human rights, labor rights, and the environment.[63]

Through the Global Compact, the UN created the Principles for Responsible Investment (PRI).[64] The PRI is another international network that helps set standards for a group of "international investors working together to put the six

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50. *See id.*

51. *See id.*

52. *See* Brian Tayan, *ESG Ratings: A Compass Without Direction*, HARV. L. S. F. ON CORP. GOVERNANCE (Aug. 24, 2022), https://corpgov.law.harvard.edu/2022/08/24/esg-ratings-a-compass-without-direction/ [https://perma.cc/33EU-G983].

53. *Id.*

54. *See id.*

55. *See id.*

56. *Id.*

57. Simpson et al., *supra* note 31.

58. *Id.*

59. *See* Camacho, *supra* note 3, at 5.

60. *Id.* at 2.

61. *See UN Global Compact Strategy 2021–2023*, UNITED NATIONS GLOB. COMPACT (2021), https://unglobalcompact.org/what-is-gc/strategy [https://perma.cc/3PAU-GSPV].

62. *See id.*

63. *See id.*

64. *See* Camacho, *supra* note 3, at 5.

Principles for Responsible Investment into practice."[65] The investment community devised the PRI to reflect the view that environmental, social, and governance issues must be given appropriate consideration by investors if they are to fulfill their fiduciary duty.[66] The PRI provides "a voluntary framework by which all investors can incorporate ESG issues into their decision-making and ownership practices" to "better align their objectives with those of society at large."[67] Currently, the PRI has over 1,500 investment institutions that "have become signatories, with approximately US $62 trillion assets under management."[68] Through the PRI, the UN created a Global Reporting Initiative (GRI), enabling organizations "to report on the impact their business has on the economy, environment and people."[69] In theory, the reporting system through the GRI allows corporations to report in a manner that is both credible and comparable.[70] There are three types of reporting standards in the GRI: universal (applies to all organizations), sectoral (applies to specific sectors), and topical (dedicated to particular topics).[71] Reporting in accordance with GRI Standards is preferred by GRI.[72] However, corporations can use only selected GRI Standards and report with reference to GRI Standards if that corporation either (1) cannot fulfill some of the reporting requirements or (2) the corporation only wants to report specific information.[73] Thus, corporations are not required to follow GRI standards in their self-made reports; it is only recommended.

Aside from these international frameworks, many private organizations have established ESG rating systems.[74] Some of the most prevalent ESG rating firms include MSCI, Bloomberg, ISS ESG, Sustainalytics, Refinitiv, and FTSE Russell.[75] Bloomberg and Sustainalytics analyze data on audit risks and risk assessments for investors.[76] MSCI ESG Ratings seek to measure a "company's resilience to long-term industry material environment, social and governance (ESG) risks."[77]

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65. *Integrate the Principles for Responsible Investment*, UNITED NATIONS GLOB. COMPACT (2023), https://unglobalcompact.org/take-action/action/responsible-investment [https://perma.cc/LZL3-NX6J].

66. *Id.*

67. *Id.*

68. *Id.*

69. *See* Camacho, *supra* note 3, at 5.

70. *See id.*

71. *Id.*

72. *See A Short Introduction to the GRI Standards*, GLOB. REPORTING INITIATIVE https://www.globalreporting.org/media/wtaf14tw/a-short-introduction-to-the-gri-standards.pdf [https://perma.cc/LE3M-NV8B].

73. *See Id.*

74. *See* Camacho, *supra* note 3, at 1.

75. *See* Tayan, *supra* note 52.

76. Camacho, *supra* note 3, at 6.

77. *Id.*

ESG rating systems "lack clarity, rely on inconsistent criteria, and suffer from conflicts of interest."[78] Generally, ESG rating systems lack standardization, meaning that ESG rating reports vary widely from firm to firm, which impedes comparability and reduces the value of the disclosure.[79] For example, each ESG rating provider uses its own proprietary system, algorithm, metrics, definitions, and sources of non-financial information.[80] A recent study conducted by the Harvard Business School found that the more information a company discloses related to ESG, the larger the discrepancies from the top ESG rating agencies.[81] The study found that "a [ten] percent increase in corporate disclosure is associated with a 1.3 to 2 percent increase in ESG score variation among major rating providers."[82] There is a lack of transparency in the ratings and no agreement on best practices to produce these ratings.[83] The ESG rating systems are also criticized for relying heavily on self-reporting by the companies they rate.[84]

Furthermore, United States companies' ESG disclosure framework remains voluntary at this time.[85] Voluntary disclosure frameworks mean that there is no standardized reporting system that companies and corporations have to follow to prove that they are meeting their stated ESG-related goals.[86] Voluntary disclosure of information has meant that ESG ratings only give part of the picture of a company's ESG performance.[87] There is little to no accountability for US corporations to ensure they follow through with their ESG pledges.

The only thing consumers can base a corporation's ESG goals on is arbitrary ESG ratings from the various ESG rating systems in the world and the United States. These ratings can be a powerful attraction for a significant number of investors.[88] BlackRock and other investment salesmen use these ESG ratings to justify a sustainable label on stocks and bond funds.[89]

The MSCI ESG rating system illustrates how fallacious different ESG rating systems can be. MSCI "dominates a foundational yet unregulated piece of the business: producing ratings on corporate [ESG] practices."[90] MSCI's rating

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78. Kurt Wolfe, *Who Regulates the ESG Ratings Industry?*, BL (Feb. 22, 2022, 4:00 AM), https://www.bloomberglaw.com/bloomberglawnews/esg/X7P9Q90S000000?bna_news_filter=esg#jcite [https://perma.cc/TZ9C-RELN].

79. *See* Akio Otsuka, *ESG Investment and Reforming the Fiduciary Duty*, 15 OHIO ST. BUS. L.J. 136, 160 (2021).

80. *See* Simpson et al., *supra* note 31.

81. *See* Kristen Senz, *What Does an ESG Score Really Say About a Company?*, HARV. BUS. SCH. (July 21, 2021), https://hbswk.hbs.edu/item/what-does-an-esg-score-really-say-about-a-company [https://perma.cc/63LS-HGGZ].

82. *See id.*

83. *See* Macey, *supra* note 25, at 275.

84. *See* Simpson et al., *supra* note 31.

85. *See* Otsuka, *supra* note 79, at 160.

86. *See id.*

87. *See* Camacho, *supra* note 3, at 1.

88. *See* Simpson et al., *supra* note 31.

89. *See id.*

90. *Id.*

practices come with a slew of issues, making the ratings less than reliable. One such issue is the lack of comparability with other ESG-rating companies. MSCI and its competitors in ESG ratings often disagree with each other, sometimes drastically.[91] Another issue with the MSCI rating system is the lack of transparency to consumers. Currently, MSCI rating reports are only available to its financial industry clients.[92]

A larger issue with MSCI's rating system is how the rating is calculated. Of the 155 companies that received upgrades to their MSCI ratings in 2020, half received upgrades because of the changes to the way the score was calculated, not because of changes that they made in their businesses.[93] Furthermore, "MSCI was looking only at whether environmental issues had the potential to harm the company," not whether the company was focused on reducing environmental harm.[94] Of the 155 upgrades to ESG ratings, only one company (International Paper) cited an actual cut in emissions, even though over half of the companies received an increase in MSCI ESG Ratings.[95]

Problems with MSCI rating calculations can be seen in the rating increase given to the McDonald's Corporation in 2020. McDonald's produced fifty-three million metric tons of greenhouse gas emissions in 2019.[96] McDonald's generated more greenhouse gas emissions in 2019 than Portugal or Hungary.[97] Despite the high greenhouse gas emissions, "MSCI gave McDonald's a rating upgrade, citing the company's environmental practices."[98] MSCI focused on McDonald's "mitigating 'risks associated with packaging material and waste' relative to its peers."[99] McDonald's had implemented new recycling bins in restaurants in France and the United Kingdom, and the company could face sanctions if it did not start recycling.[100] MSCI did not consider carbon emissions in the calculation of McDonald's rating because "MSCI determined that climate change neither pose[d] a risk nor offer[ed] 'opportunities' to the company's bottom line."[101]

Another problematic example to illustrate how arbitrary the MSCI Rating system can be found in D.R. Horton, Inc.'s increase in ESG Rating from 2019 to 2020.[102] D.R. Horton, Inc. is one of the leading home construction companies

91. *See id.*
92. *See id.*
93. *See id.*
94. *See id.*
95. *See id.*
96. *See McDonald's Corporation – Climate Change 2020*, CDP DISCLOSURE INSIGHT ACTION (2020), https://corporate.mcdonalds.com/content/dam/sites/corp/nfl/pdf/McDonalds_Corporation_%20CDP_Climate_Change_2020.pdf [https://perma.cc/4Y2P-ML33].
97. *See* Simpson et al., *supra* note 31.
98. *See id.*
99. *See id.*
100. *See id.*
101. *See id.*
102. *See id.*

in the United States.[103] The construction industry is one of the world's highest contributors to greenhouse gas emissions, accounting for nearly 40% of global emissions in 2019.[104] D.R. Horton did not disclose any of its emission statistics in 2019; however, the percentage of D.R. Horton homes that received industry green certifications dropped from 3.8% in 2019 to 3.4% in 2020.[105] Regardless, MSCI upgraded D.R. Horton's ESG rating because of "policies on business ethics and corruption."[106] Although the increase in score was based on another element of the ESG framework, the company still experienced a drastic decrease in environmental advancements.[107] Thus, only part of the picture was considered when assigning the ESG rating.

The MSCI rating system is just one example of how ESG rating systems are unreliable, biased, and untrustworthy in determining whether a company is meeting its pledged sustainability and ESG goals.

II. Fiduciary Duty and What is Required of Fiduciaries Under Trust Law

A. Restatement of Trusts Fiduciary Duty

Although trust law is generally reserved for the states to decide, states often base their legislation on the Restatement of Trusts. The Restatement provides a summary of different states' trust laws. The Third Restatement of Trust law imposes three main duties on trustees in trust administration: the duty of prudence, impartiality, and loyalty.[108]

Under the duty of prudence, the trustee must "administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust."[109] Furthermore, the duty of prudence "requires the exercise of reasonable care, skill, and caution."[110] Additionally, if the trustee "possesses . . . special facilities or greater skill than that of a person of ordinary prudence, the trustee has a duty to use such facilities or skill."[111] "The duty of prudence encompasses the duty to exercise reasonable care and skill in trust administration and the duty to act with a degree of caution suitable to the particular trust and its objectives, circumstances, and overall plan of administration."[112] The general standard of prudent investment states "the trustee has a duty . . . to invest and manage the funds of the trust as a prudent

103. *Id.*
104. *Id.*
105. *Id.*
106. *Id.*
107. *Id.*
108. RESTATEMENT (THIRD) OF TRUSTS §§ 77-78 (AM. L. INST. 2007).
109. *Id.* § 77(1).
110. *Id.* § 77(2).
111. *Id.* § 77(3).
112. *Id.* § 77 cmt. b.

investor would, in light of the purposes, terms, distribution requirements, and other circumstances of the trust."[113]

Under the duty of impartiality, a trustee must "act impartially and with due regard for the diverse beneficial interests created by the terms of the trust."[114] Impartiality can be seen as an extension of the duty of loyalty.[115] Impartiality imposes a duty of the trustee to "reasonably and without personal bias, seek to ascertain and to give effect to the rights and priorities of the various beneficiaries or purposes as expressed . . . by the terms of the trust."[116] Trustees must balance the interests of the income beneficiaries and consider the needs of all current and future beneficiaries.[117]

Under the duty of loyalty, "a trustee has a duty to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose."[118] "The trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests."[119] Furthermore, "whether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to deal fairly and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter."[120] Concerns over conflict of interest and self-dealing are prevalent in the history of the duty of loyalty because "the fiduciary controls the assets and could easily make decisions to garner a private benefit."[121]

B. Employment Retirement Income Securities Act of 1974 (ERISA) and Fiduciary Duty Under ERISA

The Employee Retirement Income Security Act (ERISA) of 1974 is a federal law that sets minimum standards for retirement and health plans in private industry.[122] ERISA is "the primary law that regulates employer-sponsored retirement plan investment decision-making in the United States."[123]

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113. *Id.* § 90.

114. *Id.* § 79.

115. *Id.* § 79 cmt. b.

116. *Id.*

117. *Id.* § 79 cmt. c.

118. *Id.* § 78(1).

119. *Id.* § 78(2).

120. *Id.* § 78(3).

121. *See* Susan N. Gary, *Best Interest in the Long Term: Fiduciary Duties and ESG Integration*, 90 U. COLO. L. REV. 731, 785 (2019).

122. *See ERISA*, U.S. DEP'T OF LAB. (2023), https://www.dol.gov/general/topic/health-plans/erisa#:~:text=The%20Employee%20Retirement%20Income%20Security,for%20individuals%20in%20these%20plans [https://perma.cc/CS9W-HFTQ].

123. *See* Elizabeth S. Goldberg, *Can ERISA Fiduciaries Use ESG? Yes, and Case Law Can Provide Some Guidelines*, LEXISNEXIS (2021), https://www.morganlewis.com/-/media/files/publication/outside-publication/article/2021/canerisafiduciariesuseesgyesandcaselawcanprovidesomeguidelines.pdf [https://perma.cc/3GHX-J2WE].

Although ERISA technically does not apply to public and government-sponsored retirement plans, "many such plans incorporate ERISA's fiduciary standards" into their respective plans.[124]

Under ERISA, fiduciaries are also required to make prudent investment decisions with "loyalty to the interests of the plan and its participants."[125] ERISA provides that "a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries."[126] The fiduciary shall discharge his duties "for the exclusive purpose of providing benefits to participants and their beneficiaries."[127] The fiduciary shall also discharge his duties by:

> [D]efraying reasonable expenses of administering the plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.[128]

Additionally, the fiduciary shall act "in accordance with the documents and instruments governing the plan."[129]

Relevant case law has also weighed in on fiduciary duty and what it entails. The fiduciary duty prohibits fiduciaries from "engaging in transactions that involve self-dealing or that otherwise involve or create conflict between the fiduciary duties and personal interests."[130] "A fiduciary's independent investigation of the merits of a particular investment is at the heart of the prudent person standard."[131] Thus, fiduciaries must ensure they are researching and understanding their investment decisions to meet their fiduciary duty. In assessing prudence, courts evaluate whether the fiduciary "employed the appropriate methods to investigate the merits of the investment" at the time of the transaction.[132] Thus, "the court focuses not only on the merits of the transaction but also on the thoroughness of the investigation into the merits of the transaction."[133]

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124. *See id.*

125. *See id.*

126. Employee Retirement Income Security Act (ERISA) § 404(a) (29 U.S.C. § 1104(a)).

127. *Id.*

128. *Id.*

129. *Id.*

130. Terraza v. Safeway Inc., 241 F. Supp. 3d 1057, 1069 (N.D. Cal. 2017) (quoting RESTATEMENT (THIRD) OF TRUSTS § 78 (AM. L. INST. 2007).

131. Fink v. Nat'l Sav. & Trust Co., 772 F.2d. 951, 957 (D.C. Cir. 1985).

132. Wright v. Oregon Metallurgical Corp., 360 F.3d 1090, 1097 (9th. Cir. 2004) (quoting Donovan v. Mazzola, 716 F.2d 1226, 1232 (9th. Cir. 1983).

133. Howard v. Shay, 100 F.3d 1484, 1488 (9th Cir. 1996).

A fiduciary must "treat beneficiaries of all generations impartially, act in the best interests of the beneficiaries, not in the interest of the fiduciary, and follow prudent investor standards in investing in the assets of a company."[134] These duties are interrelated with long-term trusts, pension plans, and endowments.[135] Investment advisors are bound by law to fulfill their fiduciary duty to put the investor's benefit first at all times. The investor is to decide what benefits they want, in both risk and reward.[136] Risk avoidance and risk reduction are two strategies used to manage risk. Risk avoidance deals with eliminating any exposure risk that poses a potential loss. Risk reduction deals with reducing the likelihood and severity of a possible loss.[137] Both strategies are popularly used by fiduciaries to ensure that they are meeting the interests of their beneficiaries and adhering to their fiduciary duties.

C. ESG Investing and Fiduciary Duty

ESG investing has added another layer of analysis in understanding fiduciary duty. Currently, "case law highlights that decisions based solely on ESG factors . . . . are more likely to risk a breach" of fiduciary duty as defined by ERISA.[138] Investments using solely or primarily ESG factors can be considered a breach of the duty of loyalty.[139] However, some case law provides that incorporating ESG factors as additional investment factors or considering ESG impact as a collateral benefit do not necessarily breach the fiduciary duty of trustees.[140]

Blankenship v. Boyle provides an illustration of how focusing investment decisions based solely on social goals is a violation of the duty of loyalty.[141] This case arose under the Labor Management Relations Act (LMRA), which requires a duty of loyalty resemblant to the duty imposed by ERISA.[142] In this case, trustees of a retirement fund purchased stock of certain electric utility companies.[143] These utility companies were on the list of acceptable companies where the trustees could invest the fund's money.[144] However, these investments were challenged on the ground that they were made "primarily for the purpose of benefiting the Union and the operators, and assisting them in their efforts to

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134. Otsuka, *supra* note 79, at 141.
135. *See* Akio Otsuka, *For Institutional Investors, the Alternative of "Exit or Voice," or "Empowerment or Engagement" in the United States and the United Kingdom*, 2 INT'L COMP. POL'Y & ETHICS L. REV. 674, 706-07 (2019).
136. *See* Michelson, *supra* note 12.
137. *See id.*
138. *See* Goldberg, *supra* note 123.
139. *See id.*
140. *See id.*
141. Blankenship v. Boyle, 329 F. Supp. 1089, 1099 (D.C. Cir. 1971).
142. Goldberg, *supra* note 123.
143. *Blankenship*, 329 F. Supp. at 1105.
144. *Id.*

force public utilities to burn Union-mined coal."[145] The court found that "the intimate relationship between the Union's financial and organizing activities and the utility investment activities of the trustees demonstrates that the Fund was acting primarily for the collateral benefit of the Union" and this "clear case of self-dealing on the part of [the] trustees . . . constituted a breach of trust."[146] *Blankenship* is an early example of how investments made because of a likely "social" benefit such as supporting the union, can violate the fiduciary duty of loyalty.[147] Social benefits were not material to the participants' retirement needs.

Davidson v. Cook provides another example of how union retirement plan trustees violated the duty of loyalty.[148] In this case, trustees made an investment decision based on the "desires and needs" of the Union.[149] This investment decision was held to violate the duty of loyalty because the investment was not made for the exclusive purpose of providing plan benefits.[150]

In a more recent case, the Supreme Court interpreted ERISA's benefits and the duty of loyalty. In *Fifth Third Bancorp v. Dudenhoeffer*, the Court held that the term "benefits" under ERISA "does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock."[151] Some have interpreted this holding to mean that social benefits "are not appropriate factors for ERISA fiduciaries to consider" in investment decisions without breaching their duty of loyalty.[152] Others argue that this holding from the Court supports the notion that only financial investment decisions based solely on nonfinancial benefits breach the fiduciary duty of loyalty.[153] Under either interpretation, considering social factors in investment decisions runs the risk of violating the fiduciary duty owed under ERISA.

III. Political Landscape of ESG Investing

With ESG investing gaining popularity in the past several years, government and political institutions have started noticing. While trust law is typically designated for the states to legislate, some federal actors have also been influenced by the influx of ESG talks. This section will provide an overview of the political landscape surrounding ESG investing at the federal and state levels and discuss the recent Indiana anti-ESG legislation.

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145. *Id.*
146. *Id.* at 1106.
147. Goldberg, *supra* note 123.
148. Davidson v. Cook, 567 F. Supp. 225, 237 (E.D. Va. 1983).
149. *Id.* at 236.
150. *Id.*
151. Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 421 (2014).
152. *See* Goldberg, *supra* note 123.
153. *See id.*

A. Nation-Wide Anti-ESG Actions

ESG investing regulation has received some federal attention over the past few years. "Although corporations remain free to pursue additional ESG goals beyond what the law requires, the government carries the burden of ESG regulation, rather than letting it fall to individual actors," such as large corporations.[154] The American Legislative Exchange Council, "an organization of state legislators 'dedicated to the principles of limited government, free markets, and federalism,' has drafted two model bills" for state legislatures to follow.[155] The two model bills included the Fiduciary Duty Bill and the Economic Boycotts Bill.[156] The Fiduciary Duty Bill bans public pension funds' consideration of ESG-related factors because considering those factors is inconsistent with fiduciary duty.[157] The Economic Boycotts Bill prohibits government entities from doing business with firms that boycott highly environmentally harmful corporations, such as coal manufacturers.[158] Several states have modeled anti-ESG legislation based on these model bills.

B. Trends in Anti-ESG State Statutes

While 2020 was the year of ESG investing, 2023 was the year of anti-ESG legislation. Republican-led state legislatures around the country aggressively fought ESG investing by introducing 165 anti-ESG bills in thirty-seven states in the first six months of 2023.[159] Of the thirty-seven states that introduced Anti-ESG legislation across the United States, eleven states[160] have enacted legislation restricting the use of ESG factors in public investments and procurements.[161] There are three main types of anti-ESG statutes that states

154. *See* Macey, *supra* note 25, at 265.

155. David H. Webber et al., *The Liability Trap: Why the ALEC Anti-ESG Bills Create a Legal Quagmire for Fiduciaries Connected with Public Pensions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 27, 2023), https://corpgov.law.harvard.edu/2023/02/27/the-liability-trap-why-the-alec-anti-esg-bills-create-a-legal-quagmire-for-fiduciaries-connected-with-public-pensions/ [https://perma.cc/X7NP-BH26].

156. *Id.*

157. *Id.*

158. *See id.*

159. Karin Rives, *Half of Anti-ESG Bills in Red States have Failed in 2023 as Campaign Pushes On*, S&P GLOBAL (June 28, 2023), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/half-of-anti-esg-bills-in-red-states-have-failed-in-2023-as-campaign-pushes-on-76276575 [https://perma.cc/XD5J-DAP6].

160. *See* Townsend Brown, *Anti-ESG Legislation Proliferated in the States in 2023, but Traditional ESG Still Had Some Wins*, MULTISTATE (Oct. 31, 2023), https://www.multistate.us/insider/2023/10/31/anti-esg-legislation-proliferated-in-the-states-in-2023-but-traditional-esg-still-had-some-wins [https://perma.cc/LD7Q-AFPH] (explaining that the eleven states that successfully passed anti-ESG statutes in 2023 are Alabama, Arkansas, Florida, Indiana, Kansas, Missouri, Montana, North Carolina, New Hampshire, Texas, and Utah).

161. *See* Michelson, *supra* note 12.

passed.[162] One is "no boycott" legislation, which requires "state entities to divest from and refuse to contract with companies that boycott certain industries, such as fossil fuels or firearms."[163] Another popular statute requires a prohibition on ESG discrimination, which "prohibits state entities from contracting with companies that state officials determine are 'discriminating' against certain industries."[164] One other popular type of anti-ESG legislation calls for a prohibition of considering "ESG factors or the pursuit of ESG-related goals when making state-sponsored investments."[165]

Conversely, forty-two pro-ESG bills were introduced in eleven states, but just one pro-ESG bill has become law.[166] Pro-ESG bills "generally direct pension plans to divest from certain industries (e.g., fossil fuels or firearms), . . . or adopt sustainable investment policies."[167]

C. Indiana Anti-ESG Statute Analysis

During the 2023 legislative session, State Representative Ethan Manning proposed an anti-ESG bill to ensure that "financial returns trump[ed] all" in any investment decision made by pension plan fiduciaries.[168] The anti-ESG bill proposed by State Representative Manning closely resembled the Fiduciary Ban Bill proposed by the American Legislative Exchange Council. Manning expressed his main concern was that "large asset managers on Wall Street are using their outsized market power to force decisions on companies when it is not best for them."[169]

The bill's goal is to prevent "leaders of the state's pension funds for teachers and other government workers from investing any of their some $45 billion with firms that consider environmental, social, and governance principles in their investment decisions."[170] Ultimately, the bill passed both chambers and was signed into law by Governor Eric Holcomb.[171] Indiana Code section 5-10.2-14 took effect July 1, 2023.[172]

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162. *See* Mana Behbin et al., *ESG Investing Regulations Across the 50 States*, MORGAN LEWIS (July 21, 2023), https://www.morganlewis.com/pubs/2023/07/esg-investing-regulations-across-the-50-states [https://perma.cc/3725-7KLC].

163. *Id.*

164. *Id.*

165. *Id.*

166. *See* Michelson, *supra* note 12.

167. Lance C. Dial et. al., *2023 ESG State Legislation Wrap Up*, K&L GATES HUB (July 25, 2023), https://www.klgates.com/2023-ESG-State-Legislation-Wrap-Up-7-19-2023 [https://perma.cc/V3WH-3YX8].

168. *See* Davies, *supra* note 13.

169. *Id.*

170. *Id.*

171. Casey Smith, *Holcomb signs new two-year budget, 90 other bills into law*, IND. CAP. CHRON. (May 5, 2023, 6:45 AM), https://indianacapitalchronicle.com/2023/05/05/holcomb-signs-new-two-year-budget-90-other-bills-into-law/ [https://perma.cc/K36Y-7PGQ].

172. *Id.*

Indiana Code section 5-10.2-14 sets out specific requirements for Service providers[173] (investment managers and proxy advisors) of the Indiana Public Retirement System[174] (INPRS) to avoid ESG commitments.[175] ESG commitments were defined as "an action taken or a factor considered by a service provider: (1) with respect to or including the system's assets; and (2) with the nonfinancial purpose to further social, political, or ideological interests based on evidence indicating the purpose."[176]

The new Anti-ESG bill has further specified the fiduciary duty of the INPRS. Under Indiana Code section 5-10.2-14-8, the Board of Trustees "may not make an investment decision with the purpose of: (1) influencing any social or environmental policy; or attempt[t] to influence the governance of any corporation for nonfinancial purposes."[177] According to Indiana Code section 5-10.2-14-9, "the board shall discharge its duties solely in the financial interest of the participants and beneficiaries of the system for the exclusive purpose of: (1) providing benefits to participants and beneficiaries; and (2) defraying reasonable expenses of administering the system."[178]

Because of its duty to act solely in the financial interest of the beneficiaries, the Board of Trustees "shall not: enter into a contract; or modify, amend, or continue a contract with a service provider that has made an ESG commitment."[179] Furthermore, "the board shall replace a service provider that has made an ESG commitment with a service provider that is comparable in financial performance, to not violate the board's fiduciary duty."[180] "If the treasurer of the state has reasonable cause to believe that a service provider has made an ESG commitment, the treasurer of state shall research the matter and make a determination as to whether the service provider has made an ESG commitment."[181]

The INPRS' Board of Trustees released a statement following the new Indiana Anti-ESG statute's passing that the Board "has and will continue to invest the system's assets solely in the interest of our members and beneficiaries."[182] The statement also specifically mentioned the Board's policy on ESG investing.[183] Accordingly, the Board declared that "the System follows fiduciary principles as established by statutes, by the industry, and consistent

173. IND. CODE § 5-10.2-14-2 (2023).
174. *Id.*
175. *Id.*
176. *Id.*
177. *Id.* § 5-10.2-14-8.
178. *Id.* § 5-10.2-14-9 (emphasis added).
179. *Id.* § 5-10.2-14-10(a).
180. *Id.* § 5-10.2-14-10(b).
181. *Id.* § 5-10.2-14-7.
182. *See INPRS' Indiana Investments*, IND. PUB. RET. SYS. (2023), https://www.in.gov/inprs/about-us/board-of-trustees/inprs-indiana-investments/ [https://perma.cc/HK7W-PUPA].
183. *Id.*

with [the INPRS'] Policy to achieve the risk and return objectives of the Retirement Funds."[184] The Board further expressed:

> The investment of system assets, or the use of rights or powers appurtenant to System assets, is not an appropriate or legally permissible instrument for the achievement of public policy objectives. Service Providers contracted by the System that would engage in Nonfinancial Investment Activities derived in whole or in part from the power associated with the System's assets, may be perceived as elevating others' interests above those of the System. Such activities would introduce non-quantifiable risk into the investment of System assets potentially inconsistent with fiduciary obligations.[185]

IV. SOLE INTEREST RULE VS. BEST INTEREST RULE

There are two main understandings of the duties owed by trustees: best interest and sole interest.[186] Under the sole interest rule, the trustee must administer the trust in the sole interest of the beneficiaries.[187] Conversely, under the best interest rule, fiduciaries have more freedom in investment decisions and do not have to adhere to the strict obligations under the sole interest rule. The best interest rule provides that "a fiduciary is not categorically prohibited from acting involving a conflict of interest, but rather must act in the best interest of the principal despite the conflict."[188] The best interest standard "allows fiduciaries to rebut presumptions of disloyalty in conflicted transaction by showing good faith and prudence, care, competence or fairness to beneficiaries."[189] This section provides an overview of different nuances of both the best interest rule and the sole interest rule, as well as arguments for adherence to the sole interest rule in future state anti-ESG legislation.

A. Best Interest Rule

Historically, the best interest rule has been the standard for fiduciaries in charity or non-profit investing.[190] Within charity investment, the fiduciaries must ensure they choose investments based on financial returns and mission-related benefits.[191] Because investment decisions are made partially based on mission-related benefits, there is more leeway for fiduciaries to make decisions

184. *See Investment Policy Statement*, IND. PUB. RET. SYS. (Sept. 8, 2023), https://www.in.gov/inprs/files/INPRS_IPS.pdf [https://perma.cc/PP7Q-K6M4].

185. *Id.*

186. *See* Otsuka, *supra* note 79, at 142.

187. *See id.*

188. *Id.*

189. Brooks, *supra* note 10.

190. *See* Gary, *supra* note 121, at 785.

191. *See id.* at 787.

based on the best interest of their beneficiaries rather than in the sole interest of beneficiaries because the fiduciaries' idea of benefits might differ slightly from their beneficiaries. "Mission-Related benefits" is a broad term that can be interpreted countless different ways, so the fiduciary standard of loyalty for fiduciaries in charity law must be lower than the sole interest rule.[192]

The Internal Revenue Code specifically provides an exception for mission-related investments called the jeopardizing investment rule.[193] The purpose of this rule is to ensure that private foundation managers are allowed to invest using the best interest rule without fear of facing penalties.[194] "The exception for program-related investments took care of investments made primarily for mission-related purposes" and investments that were related to the mission but were not made primarily to carry out the charity's mission.[195]

Although the best interest rule has historically been applied to non-profit and charity investing standards, it is gaining popularity in other investment areas. The best interest rule would allow trustees to make investment decisions, including conflicts of interest and personal gains for the trustee. Proponents of the best interest rule argue that as long as the trustee is acting in the best interest of the beneficiary, any overlap of conflicts of interest should be permitted.[196] The trustee is only required to "prove that the transaction was prudently undertaken in the best interest of the beneficiaries."[197] This test reforms the prudent investment standard provided in the Restatement of Trusts and other relevant trust laws and loosens the standard to the best interest standard. If the fiduciary can show they were acting in a manner with the best interest of the beneficiaries in mind and they were acting prudently while doing so, they are within the scope of the fiduciary duty of loyalty.

Supporters of considering ESG factors in investment decisions argue that ESG factors can help identify potential opportunities and risks.[198] Proponents of the best interest rule defend ESG investing by seeking not only a financial return on investment but a social and environmental return on investment.[199] Under the best interest rule, fiduciaries can consider nonfinancial, third-party impacts when making investment decisions rather than strictly the financial return on investment provided to the beneficiary. "Maximizing shareholder interests in the corporate case should be maximizing shareholder welfare, not market value."[200] In other words, trustees should not only focus on return on investment

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192. *See id.*
193. I.R.C. § 4944(c) (2012).
194. Treas. Reg. § 53.4944-1(a)(2)(i) (1973).
195. *See* Gary, *supra* note 121, at 787.
196. *See* John H. Langbein, *Questioning the Trust Law Duty of Loyalty: Sole Interest or Best Interest?*, 114 YALE. L.J. 929, 933 (2005).
197. *Id.* at 932.
198. *See* Gary, *supra* note 121, at 746.
199. *See id.* at 743.
200. Otsuka, *supra* note 79, at 162.

and increase in monetary value but also consider the beneficiary's overall welfare as they make investment decisions.

An illustration of how the best interest rule is applied to ESG investment decisions is visible in how some fiduciaries invest based on climate change concerns. Focusing investment decisions on combatting the impact of climate change is a conflict of interest for the fiduciary. The fiduciary is then focusing their investment decisions on reducing the impacts of climate change, so they have an interest in making the best investment that will have the most beneficial impact. Under the best interest rule, as long as the fiduciary can show the investment decision was made prudently, with the best interest of the beneficiaries in mind, the fiduciary duty of loyalty remains intact despite consideration of ESG factors in the investment decision.

Using the same climate change illustration, proponents of the best interest rule also argue that investing to reduce the impact of climate change will be in the best interest of all beneficiaries because of the adverse effects climate change will have on everyone.[201] For example, investing in a company that supports and implements several climate-saving initiatives would be in the best interest of the beneficiary because it would allow for a financial return on investment as well as an environmental return on investment because, in theory, those initiatives would help reduce the impacts of climate change on everyone.

One downfall of the best interest rule is that it can be hard for fiduciaries to obtain the necessary information to ensure that the investments will result in a return on investment and a return on the social cause. It is important that beneficiaries obtain sufficient information by monitoring and disclosure to examine the transaction before they make the investment decision accurately.[202] Because of the lack of accurate ESG rating systems, it can be difficult to ensure that investment decisions based on ESG factors will actually result in a return on investment and returns on social and environmental change.[203]

B. Sole Interest Rule

The sole interest rule is widely regarded as the most fundamental rule of trust law and is often regarded as the "default rule" of trust law.[204] Sole interest was created to ease concerns that "a trustee operating under a potential conflict could easily conceal wrongdoing."[205] The rule continues to be present in several trust and financial investment-related statutes. The sole interest rule is also prominent in the Third Restatement of Trusts, specifically in the duty of loyalty, which states that a trustee must "administer the trust solely in the interest of the

201. *Id.* at 158.
202. *See id.*
203. *Id.* at 160.
204. Schanzenbach & Sitkoff, *supra* note 8, at 401.
205. Langbein, *supra* note 196, at 932.

beneficiaries."[206] This language requires investment decisions to be made solely in the beneficiary's interest, which is also mandatory under ERISA.[207]

Under the sole interest rule, a trustee violates the duty of loyalty, even in the absence of self-dealing, if the trustee has any motive or rationale for undertaking an action other than the beneficiary's sole interest or exclusive benefit.[208] The duty of loyalty in trust law has traditionally placed strict obligations on fiduciaries to act not in their own self-interest but in the sole interest of their beneficiaries.[209]

The sole interest rule prohibits a trustee from placing himself in a position where his personal interests conflict or may conflict with the beneficiary's interests. The Joint Economic Committee Republicans have warned against considering outside factors in investment decisions since the mid-1990s because "[o]nce an investment manager ceases to focus exclusively on maximizing the return for beneficiaries, it is very difficult to avoid social or even political considerations."[210] Investment decisions become inherently political in nature when fiduciaries start considering ESG factors and social goals over the simple return on investment. For example, suppose a public pension plan fiduciary decides to invest in Company A because Company A shows strong intentions to reduce its annual carbon emissions. This investment decision may be viewed as political if some beneficiaries do not value reducing carbon emissions or consider protecting the environment necessary. Thus, the fiduciary's decision to invest in Company A based on the company's environmental goals could lead to beneficiaries being unhappy with investment decisions and debates over whether the fiduciary has the sole interest of the beneficiaries in mind when making decisions.

The meaning of the sole interest rule has become even more important in understanding ESG investing and how fiduciary duties are influenced. Under the sole interest rule, a trustee's use of the ESG factors violates the duty of loyalty if motivated by the trustee's own ethics or used to obtain collateral benefit to a third party.[211] A fiduciary is not in a position to consider related, nonfinancial issues when making investment decisions without violating the duty of loyalty.

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206. RESTATEMENT (THIRD) OF TRUSTS § 78(1) (AM. L. INST. 2007).

207. *See generally* 29 U.S.C. § 1104(a)(1).

208. *See* Schanzenbach & Sitkoff, *supra* note 8, at 388.

209. *Id.* at 381.

210. *See* JOINT ECON. COMM. REPUBLICANS, 104TH CONG., ECONOMICALLY TARGETED INVESTMENTS (ETIS) (June 7, 1995), https://www.jec.senate.gov/public/_cache/files/40c6425b-59ae-432c-ad1c-aa60606c0370/economically-targeted-investments-etis-june-7-1995.pdf [https://perma.cc/RA9Z-4JXA].

211. *See* Schanzenbach & Sitkoff, *supra* note 8, at 381.

C. States Should Follow the Sole Interest Rule Over the Best Interest Rule

States interested in passing anti-ESG legislation similar to Indiana's should require trustees to follow the sole interest rule ideology in the legislation. The sole interest rule protects both fiduciaries and beneficiaries in investment decisions because fiduciaries know what is expected of them, and beneficiaries are protected from opportunistic fiduciaries making investment decisions the beneficiaries do not agree with. Furthermore, adhering to the sole interest rule in investing is the best way to ensure fiduciary duties of prudency, impartiality, and loyalty are met. Additionally, the Indiana anti-ESG statute uses clear and concise language that requires using the sole interest rule ideology in state pension plan investment schemes that other states can easily model.

Straying from the sole interest rule will allow third-party considerations and factors to influence investment decisions, contradicting the long-standing history of sole interest ideology in United States trust law. Proponents of the sole interest rule are hesitant to abandon the default standard in trust law relating to fiduciary duty. Society should not be so quick to discard a rule that protects beneficiaries against opportunists and fiduciaries, against their self-doubt, temptation, moral hazard, and uncertainty.[212] The sole interest rule protects the fiduciary because it sets out strict standards that the fiduciary must follow. There is no question about how the fiduciary is supposed to approach a situation in investing because they know that they must act in the sole interest of the beneficiary and without influence from third parties or self-interest. The sole interest rule also protects the beneficiary because they know the fiduciary acts are in their sole interest and are not conflicted by outside influence. Additionally, the sole interest rule allows beneficiaries to hold the fiduciary responsible if the fiduciary is not acting in the sole interest of the beneficiary.

To act prudently, a trustee must "administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust," and the trustee must "exercise [] reasonable care, skill, and caution."[213] A trustee would not be exercising reasonable care, skill, and caution if he or she based their investment decisions on fallacious ESG rating systems. Without a uniform ESG rating system in place, it is difficult to ensure investments into companies that pledge certain ESG objectives are, in fact, meeting objectives and leading to greater returns for investors. As illustrated in the MSCI McDonald's rating, just because a company pledges to make environmental changes does not mean it is doing it. Additionally, just because a company's ESG rating increased does not necessarily mean that the company is drastically improving or working toward improving ESG-related goals. A company's ESG score can increase based on environmental practices as long as climate change neither poses a risk nor offers opportunities to the company's bottom line. By utilizing the sole interest rule, fiduciaries and trustees cannot consider questionable ESG ratings

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212. Brooks, *supra* note 10.
213. RESTATEMENT (THIRD) OF TRUSTS §§ 77(1), 77(2) (AM. L. INST. 2007).

and investment factors because they must focus on the beneficiaries' sole interests.

Common law emphasizes that courts determine whether a fiduciary duty was broken by evaluating whether the fiduciary employed appropriate methods to investigate the merits of an investment decision at the time of the investment.[214] Courts focus on both the merits of the transaction and the thoroughness of the investigation into the transaction's merits.[215] As previously stated, if there is no standard ESG rating system and enforcement method actually to hold businesses accountable for their pledged ESG goals, then a trustee cannot ensure that they used appropriate methods to investigate the merits of their decisions. Ultimately, there is no proven method to ensure that ESG investment decisions actually lead to a beneficial return on investment.

Some have opined that ESG investing is not a violation of duties required under American Trust Law if two conditions are met, "(1) the trustee reasonably concludes that ESG investing will benefit the beneficiary directly by improving risk-adjusted return; and (2) the trustee's exclusive motive for ESG investing is to obtain this direct benefit."[216] However, this argument is weak considering the lack of conclusive evidence that ESG investing leads to higher returns on investment.[217] Countless studies have been conducted to look at the relationship between ESG investing and return on investment, and the studies have yet to come to a consensus on the effects of ESG investing on return on investment. A study by Charles Schwab did not find convincing evidence that "ESG funds are reliably better than non-ESG funds" and that the differences between the two tended to be small.[218] Even where differences in the funds were suitable for ESG funds, some ESG funds did worse.[219] Although this study went on to mention that there is no evidence to support the notion that "choosing ESG funds puts investors at any kind of disadvantage when it comes to risks or returns,"[220] there is no guarantee that investing in ESG-focused funds will increase your return on investments, and there are several studies that support the premise that ESG investing can negatively impact return on investments. One study examining the relationship between ESG factors and financial performance found a

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214. Wright v. Oregon Metallurgical Corp., 360 F.3d 1090, 1097 (9th. Cir. 2004).

215. *See* Tribble v. Edison Int'l, 843 F.3d 1187, 1197 (9th. Cir. 2016).

216. Schanzenbach & Sitkoff, *supra* note 8, at 382.

217. *See Does ESG Investing Generate Higher Returns?*, KENAN INST. OF PRIV. ENTER., (Apr. 20, 2022), https://kenaninstitute.unc.edu/kenan-insight/does-esg-investing-generate-higher-returns/ [https://perma.cc/BF7L-9X59].

218. Michael Iachini, *How Well has Environmental, Social, and Governance Investing Performed?*, CHARLES SCHWAB (Sept. 9, 2021), https://www.schwab.com/resource-center/insights/learn/story/how-well-has-environmental-social-and-governance-investing-performed?cmp=em-QYC [https://perma.cc/BPC2-WFBJ].

219. *Id.*

220. *Id.*

combination of neutral, mixed, and negative relationships.[221] Another study that compared the ESG record of U.S. companies in 147 ESG fund portfolios to 2,428 companies with non-ESG portfolios found no evidence to support that the ESG fund's portfolio outperforms the non-ESG portfolio forms.[222]

The duty of impartiality requires a trustee to "reasonably and without personal bias, to seek to ascertain and to give effect to the rights and priorities of the various beneficiaries or purposes as expressed or implied by the terms of the trust."[223] Trustees must consider the differing interests of current and future beneficiaries.[224] Although trustees are not required to consider all of the beneficiaries equally, they must make informed decisions and consider the various needs of the beneficiaries.[225] State pension plans have thousands of current and future beneficiaries that trustees must consider when making investment decisions. Because of the lack of consensus on how ESG investing influences return on investment, staying impartial as a trustee can be challenging. One study found that firms with high ESG ratings can temporarily increase "realized returns" but decrease expected long-term returns.[226] This means that although investing in companies that currently have high ESG ratings might temporarily increase the return on investment, the long-term effects of that investment could be a lower return on investment. Although a trustee could view the current investment in highly rated ESG companies as beneficial to their beneficiaries, this investment would violate the duty of impartiality because they are not considering the long-term effects of this investment on future beneficiaries.

Similarly, another study found that after 10 years, "a $10,000 ESG portfolio . . . would be 43.9 percent smaller after 10 years compared to a $10,000 investment into an S&P 500 index fund."[227] This study is another example of how ESG investing might seem beneficial in the short run, but the long-term consequences of these investments could lead to issues with impartiality

221. *See generally* Tensie Whelan et al., *ESG and Financial Performance: Uncovering the Relationship By Aggregating Evidence from 1,000 Plus Studies Published between 2015–2020*, NYU STERN CTR. FOR SUSTAINABLE BUS. (2021), https://www.stern.nyu.edu/sites/default/files/assets/documents/NYU-RAM_ESG-Paper_2021%20Rev_0.pdf [https://perma.cc/P9X6-J6T6] (The meta-analysis conducted by NYU Stern found that studies looking at the relationship between ESG and financial performance that used "operational metrics such as ROE [return on equity], ROA [return on assets], or stock price with 13% showing neutral impact, 21% with mixed results . . . and only 8% showing a negative relationship.").

222. *See* Aneesh Raghunandan & Shiva Rajgopal, *Do ESG Funds Make Stakeholder-Friendly Investments?*, REV. OF ACCOUNT. STUD., FORTHCOMING, June 27, 2022, at 3.

223. RESTATEMENT (THIRD) OF TRUSTS § 79 cmt. b (AM. L. INST. 2007).

224. *See id.*

225. *See id.*

226. *See* Rocco Ciciretti et al., *The Contributions of Betas versus Characteristics to the ESG Premium*, 15 CEIS TOR VERGATA 1, 2 (Dec. 2019).

227. Wayne Winegarden, *Environmental, Social, and Governance (ESG) Investing: An Evaluation of the Evidence*, PAC. RSCH. INST. 5 (May 2019), https://www.pacificresearch.org/wp-content/uploads/2019/05/ESG_Funds_F_web.pdf [https://perma.cc/M3CY-6CSY].

because trustees are not fully considering the impact these ESG investments could have on future beneficiaries.[228]

The duty of loyalty, as written, requires a trustee "to administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purpose."[229] No form of social investing is consistent with the duty of loyalty if the investment activity entails sacrificing the interests of the trust beneficiaries.[230] For example, accepting below-market returns in favor of the interests of persons supposedly benefited by pursuing a particular social cause does not meet the fiduciary duty of loyalty.[231] In 1994, the Department of Labor issued an interpretative bulletin reviewing its prior analysis of social investing questions and reiterating that pension trust fiduciaries may invest only in conformity with the prudence and loyalty standards of ERISA sections 403 and 404.[232] Further, common law finds that pension plan investment decisions based solely on social goals violate the duty of loyalty.[233] Courts have held that the term "benefits" under ERISA "does not cover nonpecuniary benefits like those supposed to arise from employee ownership of employer stock." Nonpecuniary benefits can include social benefits to an employee. Thus, considering any type of social benefits in investment decisions is directly contrary to ERISA framework and would lead to a violation of the fiduciary duty of loyalty. The sole interest rule ensures that trustees do not consider nonpecuniary interests in their investment decisions because it would be directly contrary to their fiduciary duty.

States interested in passing anti-ESG legislation should model their bills after Indiana's 2023 law because the code clearly requires the use of sole interest rule ideology. According to Indiana Code section 5-10.2-14-9,

> "[T]he [Indiana Public Retirement System's] board [of trustees] shall discharge its duties solely in the financial interest of the participants and beneficiaries of the system for the exclusive purpose of: (1) providing financial benefits to participants and beneficiaries; and (2) defraying reasonable expenses of administering the system."[234] Under this statute, the Board of Trustees is strictly prohibited from entering into contracts or continuing to contract "with a service provider that has made an ESG commitment."[235]

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228. *Id.*

229. RESTATEMENT (THIRD) OF TRUSTS § 78(1) (AM. L. INST. 2007).

230. *Id.* § 78 cmt. f.

231. *Id.*

232. *See* Interpretive Bulletin Relating to the Fiduciary Standard Under ERISA in Considering Economically Targeted Investments, 59 Fed. Regis. 32606 (June 23, 1994) (to be codified at 29 C.F.R. Pt. 2509.94-1).

233. Fifth Third Bancorp v. Dudenhoeffer, 571 U.S. 409 (2014).

234. IND. CODE § 5-10.2-14-9 (2023) (emphasis added).

235. *Id.* § 5-10.2-14-10(a).

The statute also requires the Board to “replace a service provider that has made an ESG commitment with a in financial performance so as not to violate the board’s fiduciary duty.”[236] This statute’s wording specifically requires the sole interest rule and bans state pension plan trustees from contributing funds to ESG investing to promote meeting their fiduciary duties. The language of this statute can easily be used by other states who wish to pass similar legislation regarding anti-ESG investing in their state pension plans.

V. CONCLUSION

States interested in passing anti-ESG regulation should follow the sole interest rule of fiduciary trust law because the fiduciary duties of loyalty, prudence, and impartiality are broken when fiduciaries consider ESG factors in investments. Until there is a uniform and reliable ESG rating system, ESG factors cannot be relied on to make investment decisions without violating the fiduciary duty because there is no way to ensure that investment decisions based on these fallacious ESG ratings are prudent and conducted in the sole interest of the beneficiary. All states interested in passing anti-ESG legislation to protect the fiduciary duties of loyalty, impartiality, and prudence owed to beneficiaries should model Indiana’s anti-ESG statute because the sole interest rule is the only way to ensure these duties are met and protected.

236. *Id.* § 5-10.2-14-10(b).