The Temporal Dimension of Fiduciary Duty

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Susan N. Gary, *Best Interests in the Long Term: Fiduciary Duties and ESG Integration*, 90 **U. of Colo. L. Rev.** __ (forthcoming 2018), available at SSRN.

What is the time frame of fiduciary duties? In other words, what time horizon should fiduciaries have in mind as they execute their responsibilities? This is an underexamined aspect of fiduciary law, and Professor Susan Gary's piece, *Best Interests in the Long-Term: Fiduciary Duties and ESG Integration*, provides a thought-provoking entry point using the lens of socially responsible investing (SRI). Gary argues that if prudent investing evolves to encompass a longer-term understanding of value creation, then consideration of environmental, social, and governance (ESG) factors may become not only possible, but legally required. If this occurs, we may witness a tectonic shift in investor behavior similar to that produced by enshrining modern portfolio theory (MPT) in fiduciary law.

Gary starts by reviewing the different terminologies and strategies of SRI. The goal is to differentiate ESG integration—Gary's primary object of analysis—from other types of SRI. ESG integration is a holistic investment strategy that considers traditional financial factors alongside material ESG factors, with materiality defined as the likelihood that the ESG factor has some relationship with financial outcomes. Environmental factors might include a company's energy efficiency policies, while social factors can run the gamut from human rights to labor conditions to community relations. Governance factors, in turn, involve such issues as board diversity, executive compensation, and transparency policies. Gary contrasts ESG integration with early forms of SRI that employed negative screening mechanisms to exclude certain socially undesirable companies or classes of assets from an investment portfolio. She also distinguishes it from a more modern form of SRI called impact investing, which typically involves a sacrifice of economic return in exchange for a measurable social impact.

With those definitions in place, Gary turns to investment theory. MPT currently dominates this space, with its focus on maximizing returns by diversifying the portfolio to manage risk. Early theoretical work examining the relationship between MPT and SRI concluded that SRI was undesirable for two reasons. First, it hinders attempts at diversification by removing certain classes of assets from portfolios for non-financial reasons. Second, the screening required by SRI theoretically increases administrative costs as compared to non-SRI alternatives. Gary contends that the first objection conflates SRI with negative screens, when certain types of SRI like ESG integration do not employ such screens. As for the second objection, she believes that it carries less weight today as SRI information has become more readily available. She devotes one section of the paper to detailing the numerous governmental and non-governmental entities that now require or collect ESG information.

As SRI has matured, researchers have produced more data to help resolve this debate. Unfortunately, the empirical studies on the costs of SRI are not entirely conclusive. However, Gary highlights several studies finding that SRI has no effect or a positive effect on returns. She uses these findings to explore the financial case for ESG integration, which is tied to a critique of short-termism in current financial thinking. Specifically, some theorists posit that MPT has led to a focus on short-term risk and return as opposed to longer-term systemic risk because the former is theoretically manageable by investors while the latter is not. Thus, financial markets have become too focused on quarterly evaluations of companies as well as maximization of short-term profit. In contrast, ESG factors are by their nature more systemic and long-term. They hedge against longer-term concerns such as access to fresh water or the stability and credibility of financial markets. This helps explain why studies showing positive results from ESG integration tend to have longer time horizons.

This is all a prelude to the legal analysis in the article, which concerns how SRI interfaces with fiduciary duties. The fiduciary duty of care requires that fiduciaries manage assets with reasonable care, skill, and caution. Gary observes that this standard is malleable and has in the recent past been subject to reinterpretation with the legal adoption of the principles of MPT. She argues that a similar evolution is underway as we learn more about ESG integration, which appears to pose no threat to financial returns and may in fact enhance them. An even more radical change in mindset may be in the offing as well, with a shift from a short-term to a long-term understanding of value creation. This potential temporal shift is the most intriguing element of the piece, and it surfaces more explicitly in Gary's consideration of the fiduciary duty of impartiality. This duty requires fiduciaries to consider adequately the interests of differently-situated beneficiaries, and it is heavily implicated when fiduciaries manage assets for beneficiaries across generations. In this case, it may be necessary to contemplate ESG factors in order to respect the interests of future sets of beneficiaries. In other words, reflexive short-termism might be prohibited. This fiduciary duty seems to the most fertile ground for Gary's arguments.

I was curious to what degree Gary predicates her case for ESG integration on long-term financial thinking, given that longer-term studies provide her strongest evidence. To the extent that she does, it may be necessary to lay out a normative case for long-termism, which raises its own set of thorny questions. Why should we evaluate financial returns on a quarterly, yearly, or longer basis? Are there not scenarios in which a shorter time horizon might make sense? Some beneficiaries may have short-term needs, and others might not live long enough to see a longer time horizon. If different temporal scopes for fiduciary duty are desirable based on the circumstances, how should we set the default rule for the prudent investor? However one thinks fiduciary duties should be structured, Gary has made a forceful case that ESG factors can no longer be ignored. Her piece compels us to reckon with fundamental questions about the temporal scope of fiduciary duty and the relevant time frame for investor behavior. These are not small questions, and Gary provides a valuable analysis that will jumpstart a dialogue on these important issues.

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