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What, Me Worry?
How to Properly Evaluate ESG Factors in Jurisdictions Hostile to Same

*by Marc Lieberman and Colson Franse**

Environmental, Social, and Governance ("ESG") investing refers to the practice of utilizing a set of social rather than pecuniary factors to vet potential investments. Typically, ESG investors eschew investment in companies doing business in industries they believe impair the climate, cause adverse health effects, or increase violence—such as fossil fuel companies, tobacco companies or arms manufacturers. Other ESG investors avoid investment in Israel because Israel, in their view, is an apartheid state. And still others insist that investors should divest from companies whose boards lack what they perceive to have sufficient diversity. ESG investors comprise a significant portion of the industry; in 2021 alone, $500 billion was invested in ESG-oriented investment funds.

Those who manage money for others owe an unwavering duty of loyalty to their clients, and several attorneys' general have opined (and some states have enacted legislation providing) that those who manage public moneys, such as trustees of government pension systems, are prohibited from making investment decisions based on any factor other than promoting the economic interests of plan members. As a result, state or municipal pension trustees, treasurers or finance officers who invest public money in jurisdictions prohibiting consideration of ESG may incur significant liability if they sacrifice investment returns or take on additional investment risk as a means of achieving what they perceive to be salutary societal aims.

So, let's presume you're a state or municipal government official. As such, you're not subject to recent regulations issued by the U.S. Department of Labor interpreting the federal Employee Retirement Income Security Act to authorize the use of ESG in evaluating the merits of an investment. Let's further suppose you work in a state which specifically requires all investments of public moneys to be based on pecuniary factors instead of the achievement of social goals. Does this mean you cannot use ESG considerations in evaluating the merits of an investment? Respectfully, we don't think that is the case.

It is our thesis that because those who manage public moneys have an obligation to do so prudently, they must weigh the risks inherent in every investment. If factors relating to climate might have a material effect on the risk of a particular investment, investment managers certainly can (and should) evaluate such factors in determining whether that investment is worthwhile. Put another way, those managing public moneys will not be in violation of their fiduciary duty to manage that money prudently by choosing investments based on ESG considerations so long as such considerations are designed to enable their state or municipality to achieve the best rate of risk-adjusted return as opposed to being motivated by the promotion of societal goals.

KUTAKROCK

Scottsdale Corporate and Securities Group

Mark Lasee
480.429.4828
mark.lasee@kutakrock.com

Marc Lieberman
480.429.7103
marc.lieberman@kutakrock.com

Richard Lieberman
480.429.4830
richard.lieberman@kutakrock.com

Emily Smith
480.429.4886
emily.smith@kutakrock.com

Michael Tobak
480.429.5000
michael.tobak@kutakrock.com

Isaiah Wilson II
480.429.7122
isaiah.wilson@kutakrock.com

Ken Witt
480.429.4864
ken.witt@kutakrock.com

Matthew Ditman
480.429.5000
matthew.ditman@kutakrock.com

Colson Franse
480.429.4851
colson.franse@kutakrock.com

Christina Ribble
480.429.4844
christina.ribble@kutakrock.com

Scottsdale Government Relations Group

Marcus Osborn
480.429.4862
marcus.osborn@kutakrock.com

Daniel Romm
480.429.4852
daniel.romm@kutakrock.com

An example:

Let's presume a municipal pension system is considering investments in two petrochemical companies, Company A and Company B.

Company A's operations are headquartered in California, and its aim is to exploit oil and gas leases it has already acquired in California's Imperial Valley and the Alaska Wildlife refuge. Company B is based in Saudi Arabia and its aim is to exploit oil and gas fields it has acquired just offshore of the Saudi coast.

Both companies project equal returns, but because of strong opposition to domestic drilling by the California and federal administrations, as well as U.S. environmental groups, there is a real risk that Company A's efforts to exploit its oil fields in California and Alaska may be stymied by lawsuits as well as government intervention. No such political or legal pressures are being threatened with respect to Company B's fields in Saudi Arabia.

Given these realities, consideration of the political and legal threats affecting each Company are legitimate risks to be considered in deciding which of the two Companies is a most suitable investment, despite the fact that these risks ultimately arise out of environmental concerns.

Thus, ESG considerations can be taken into account when evaluating the risks of an investment in a state precluding investment decisions based on ESG considerations, so long as the ultimate determinant in selecting an investment is not to promote societal goals but instead to achieve the best return possible in the asset class selected.

Correspondingly, while it is true that a government pension system subject to anti-ESG laws should not select an external investment manager whose investment selections are motivated by promotion of societal goals instead of achieving superior returns, there is nothing wrong with an external manager's consideration of ESG-style risks for purposes of determining whether those risks might affect returns. This is because to ignore such risks might jeopardize realizations.

So, bottom line: In those jurisdictions that bar investments of public moneys based on ESG considerations, consideration of ESG factors for purposes of risk analysis is certainly acceptable so long as the ultimate determinant in making the investment is not to promote social goals but to achieve the best risk-adjusted return possible in the circumstances.

*Marc Lieberman and Colson Franse are members of Kutak Rock's Institutional Investments Group.

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