COMMENT

# CAN'T WE ALL JUST GET ALONG?: HOW DIVERSIFIED INVESTORS AND COMPANIES CAN MAINTAIN THEIR FIDUCIARY DUTY IN A CLIMATE CRISIS

by Natasha Lamb

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Madison Condon's *Externalities and the Common Owner*[1] warrants serious attention and consideration by a broad variety of stakeholders—investors, public policymakers, academics, and citizens concerned about the systemic risks climate change pose to our economy, wealth, and sustainability. I am honored to have the opportunity to comment on her work from the perspective of an active investor and portfolio manager integrating Environmental, Social, and Governance (ESG) risks and opportunities into Arjuna Capital's client investment portfolios. Therefore, I will comment from the perspective of a practitioner engaging in many of the practices observed by Condon.

Arjuna Capital is a sustainable investment manager with a long history engaging with oil and gas companies on issues of climate risk—including carbon asset risk. That is, the risk that up to two-thirds of all fossil-fuel reserves could be stranded, unburnable, and devalued in the low-carbon future necessary to avoid catastrophic climate change. And while we have substantially divested our clients' assets from fossil fuels because of this serious and accelerating risk, we believe continuing oil company engagements as "universal" diversified investors is critical. Active/diversified investors can challenge conventional thinking within the companies and press companies to transition to a world where global temperatures rise less than 1.5 degrees Celsius—the threshold that scientists estimate triggers catastrophic climate change. It is critical to do so because no company operates in a silo—and the externalities of a few companies will have an outsized impact on most companies, and our economy broadly.

As diversified investors and fiduciaries, Arjuna recognizes the short-, medium-, and long-term impacts of climate change and addresses them in three ways, by: (1) substantially **Divesting** from fossil-fuel investments; (2) **Engaging** with companies to improve efficiency and adaptability; and (3) **Investing** in solutions to our climate challenges.

The choice to divest from fossil fuels reflects the potentially insurmountable risks facing the fossil-based energy market. These risks include increasing regulation, competition from renewable sources, and a corresponding decrease in long-term fossil fuel demand. As investors, we also recognize the discouraging trends in corporate responses, ranging from climate denial and lobbying to a lack of comprehensive transition planning and net-zero emission goals. As diversified investors, we are concerned about the outsized impact these companies' externalities will have on the climate crisis, GDP, and therefore our clients' diversified investment portfolios.

As divestment does not mitigate systemic climate risk, for the last seven years, we have exercised our clients' share ownership to press for corporate change at the country's largest oil companies, Exxon and Chevron, as well as collaborated with European investors and companies to address this existential crisis. Our 2014 landmark negotiation with ExxonMobil led to the company's first report on carbon asset risk, and subsequent shareholder proposals have challenged the company's capital investments in high-cost, high-carbon reserves, their readiness to transition to a carbon-constrained future, and the preparedness of their boards to address the transition. This spring, hedge fund Engine No. 1, echoing our concerns, won two board seats at Exxon's annual meeting and gained support from Blackrock in its bid for better climate governance.

Condon's paper documents evidence showing we are not alone, and that "diversified investors seek to maximize profits at the portfolio, rather than firm, level and explains how this portfolio perspective can be extended to explain

1. Madison Condon, *Externalities and the Common Owner*, 95 Wash. L. Rev. 1, 9 (2020).

why institutional investors seek to internalize harmful climate-change externalities."[2] As institutional investors working in the fiduciary duty of our clients to minimize risk (beta) and maximize return (alpha), Arjuna Capital views investment portfolios in the same way—as a chess board, where performance is measured by the whole, not necessarily the sum of its parts. And when a few bad apples spoil the bunch, it needs to be addressed, which requires active ownership. In fact, as Condon contends: "If a subset of firms in a portfolio impose costs on the broader portfolio through the generation of negative externalities, a portfolio-wide owner should be motivated to curtail those externalities at the source."[3] "Rational owner[s]" with "economy-mirroring portfolios" are therefore motivated to eliminate those externalities and can work to do so through active engagement.[4]

In that vein, our clients filed a proposal at Chevron this year asking the company to amend its certificate of incorporation to become a Public Benefit Corporation. The rationale being: the majority of Chevron's shareholders are beneficial owners with broadly diversified portfolios, who are unalterably harmed when the company follows the "shareholder primacy" model, operates outside of a 1.5-degree Celsius climate model, and imposes serious environmental costs that lower economic productivity. Therefore, it is in investors' interest to press for a governance model and business plan that can "maximize returns" within a 1.5-degree Celsius global-temperature-rise threshold, but not beyond it.

Our view that Chevron needs to operate within the bounds necessary to prevent catastrophic climate change may be different than the view held by shareholders concentrated in Chevron stock or the stock of any single company. But there are very few of those investors out there. As Condon points out, in the age of modern portfolio theory, today's investors are highly diversified. Therefore: "diversified shareholder interests can diverge from both the interests of concentrated shareholders and the objective of maximizing share price."[5] Diversified shareholders and "institutional investors seek to internalize harmful climate-change externalities" because "not only does investor climate action diminish future climate damages, it also reduces the systemic climate risks that cannot be diversified away."[6]

And those systemic climate risks are for real. According to the United States' Commodity Futures Trading Commission, "Climate change poses a major risk to the stability of the U.S. financial system and to its ability to sustain the American economy."[7] The National Bureau of Economic Research warns if greenhouse gases are not cut in line with the Paris Accord, United States' GDP could be cut 10.5 percent by 2100.[8] This climate hit to the economy will ultimately show up in company earnings and investor portfolio returns. The United Nations Environment Programme Finance Initiative (UNEP FI) and Principles for Responsible Investment (PRI) reports in the paper "Universal Ownership" that over 50 percent of companies' earnings are at risk from climate costs, creating systemic risk for diversified investors.[9] "Universal investors"—those with highly-diversified portfolios representative of the broad economy—are exposed to growing and widespread climate costs generated by some companies and ultimately incurred by other companies.

Condon's cost-benefit analysis, like those sighted by the groups above, seeks to demonstrate the costs of these climate damages, asserting it is "enough so that the devaluation of the fossil fuel stock is outweighed by portfolio benefits."[10]

As fiduciaries managing diversified portfolios, the onus is on institutional investors to maximize profit at the portfolio level, not necessarily the company level. Condon cites research asserting "voluntary emissions reduction is at odds with the aim of profit maximization,"[11] and while this may be true in the short-term, it depends on the time line. One can easily argue there are ways to both reduce emissions and maximize profitability and returns to investors while not growing fossil assets, but investors and company executives may have different views.

Condon notes a difference between the perceived fiduciary duty of company managers and directors and the fiduciary duty of institutional investors acting on behalf of their diversified investors/beneficiaries. Company executives may believe that growing fossil fuel assets is in their fiduciary duty, while emissions reductions are not.

To that point, incorporating as a Public Benefit Corporation could relieve this perceived conflict for companies, allowing them to operate for the benefit of all stakeholders, not just shareholders. That is, companies can maximize profits within the constraints of a 1.5-degree Celsius global temperature rise, but not beyond it. For investment managers, pressing for a 1.5-degree Celsius temperature threshold falls squarely in line with their fiduciary duty. And inaction on climate may be in conflict with investors' fiduciary duty. Condon rightly notes that the "intentional passivity" of pension funds and passive investors like the "Big Three" asset managers—BlackRock, Vanguard, State Street—by not pressing for climate action, may actually

2. *Id.* at 9.
3. *Id.* at 6.
4. *Id.*
5. *Id.* at 76.
6. *Id.* at 9.
7. Commodity Future Trading Commission, *Managing Climate Risk in the U.S. Financial System* (September 2020) *available at* https://www.cftc.gov/sites/default/files/2020-09/9-9-20%20Report%20of%20the%20Subcommittee%20on%20Climate-Related%20Market%20Risk%20-%20Managing%20Climate%20Risk%20in%20the%20U.S.%20Financial%20System%20for%20posting.pdf.
8. National Bureau of Economic Research, *Long-Term Macroeconomic Effects of Climate Change: A Cross-Country Analysis* (August 2019), *available at* https://www.nber.org/system/files/working_papers/w26167/w26167.pdf.
9. UNEP Finance Initiative and Principles for Responsible Investment, *Universal Ownership* (2011), *available at* https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf.
10. Condon, *supra* note 1, at 10.
11. *Id.* at 3.

breach "their duties to those clients that invest broadly in a market-mirroring portfolio."[12]

As fiduciaries, we have a history of expressing concerns about returns at both the company level and broad portfolio level. But given the record of inflexibility for companies like Exxon and Chevron to adapt, the latter portfolio-level concern now looms large. For example, at Exxon's annual meeting in 2016, we presented a proposal asking the company to prioritize profitability and value over growth by returning more capital to shareholders, citing a -68 percent drop in profitability the prior decade and a downgrade to Exxon's credit rating. We were squarely in the camp of pressing the company to adapt to protect returns *and* address the climate crisis. But at that meeting, then-CEO and Chairman, Rex Tillerson, noted that if global temperatures increased 4 or even 6 degrees Celsius, that the company would simply adapt. There was no sign of the company adapting to *prevent* such a rise—or accepting culpability in that potential outcome. And that is why investors are so concerned—because a 4- to 6-degree rise is untenable. Perhaps not for Exxon (as they see it), but for diversified "universal" investors invested in an economy that will have to battle catastrophic climate change. As fiduciaries, catastrophic climate outcomes must be the central concern—and a Public Benefit Corporation model could very well assuage both investors' and companies' fiduciary concerns.

Condon's exploration of the evolving nature of fiduciary duty is critical as the climate crisis escalates, and whether it is investors or regulators that press for change, that change is necessary to maintain a healthy, functioning economy that will serve to protect institutional investors' "economy-mirroring" portfolios.

12. *Id.* at 59.