All the Best Intentions v. Real World Realities: A Cost Based ESG Method for Managing Securities Disclosure and Greenwashing Risk

*By James A. Deeken**

In current news and events we sometimes see companies espouse a supposed socially conscious message yet at the same time, often in a less publicized manner, due to cost considerations, opt to maximize their financial interests when they conflict or at least create tension with their public statements. The gap between rhetoric and actions that sometimes presents itself leads to charges of "greenwashing"—the espousing of ESG principles that are pronounced by a corporate actor but not actually followed. However, "greenwashing" does not explain why the gaps exists and how corporations can manage the legal risks that its presents. A framework that a corporation could potentially use for managing greenwashing and other ESG risks is to consider the role that costs and financial interests play into its decision making and to acknowledge that the financial realities that it operates under lead to some degree of moderation in its ability to articulate ESG principles. A consideration of both costs and benefits of pursuing ESG may allow a corporation to act in a manner that is consistent with the best interest of its stockholders while at the same time pursuing ESG policies that are mutually beneficial for the financial interests of shareholders and the larger community at the same time. Adopting a cost-based approach may also allow corporations to adopt a more realistic ESG narrative that betters focuses its attention on ESG initiatives that are realistic for it and thus, reducing greenwashing risk in the process.[1]

The Securities Law and Greenwashing Risks of ESG

Greenwashing has been a central focus of the Securities and Exchange Commission across the securities statutes and poses significant risks of SEC enforcement and securities liabilities for corporations that make broad sweeping aspirational ESG statements that vary from actual corporate practices.[2] The SEC has

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gone as far as setting up a Climate and ESG Task Force with its Division of Enforcement "to develop initiatives to proactively identify ESG-related misconduct consistent with increased investor reliance on climate and ESG-related disclosure and investment."[3] The task force has the stated purpose to use "sophisticated data analysis to mine and assess information across registrants, to identify potential violations including material gaps or misstatements in issuers' disclosure of climate risks under existing rules, and disclosure and compliance issues related to investment advisers' and funds' ESG strategies."[4]

SEC Greenwashing Enforcement Activity

The SEC has in recent actions brought ESG enforcements against parties for allegedly:

- failing to "adequately" implement all requirements set forth in ESG policies disclosed to investors;[5]
- not having internal ESG practices that matched statements used in advertising;[6]
- not adopting policies and procedures to ensure that representations about ESG were not misleading[7] or publicly stated practices were not followed;[8]
- making statements about compliance with laws that did not match actual practices[9] or making statements about having the "strictest" and best international practices for safety in contravention of actual practices.[10]

The Possible Accented Greenwashing Risk Resulting from the SEC's Climate Disclosure Rule

The above situations largely involve ones where public companies allegedly made false statements about ESG practices in their public disclosures or ones where investment managers allegedly failed to follow investment-related ESG processes that were disclosed to investors. However, the SEC direction in this area will likely be further empowered by the SEC's recently adopted Enhancement and Standardization of Climate-Related Disclosures for Investors Rule (the "Climate Disclosure Rule").[11] The Climate Disclosure Rule will be phased in over the coming years and will require disclosure of, among other things,

- specified disclosure regarding a company's activities, if any, to mitigate or adopt to a material climate-related risk, including the use, if any, of transition plans, scenario analysis or internal carbon prices;
- any oversight by the board of directors of climate-related risks and any role by management in assessing and managing client-related risks;

- information about a company's climate-related targets or goals; and
- for certain large companies, disclosure about carbon emissions.

The Climate Disclosure Rule arguably breaks new ground when it comes to greenwashing risk and the potential of the SEC to undertake enforcement actions related thereto. Under current securities law, before giving effect to the Climate Disclosure Rule, there is nothing that generally requires a public company to proactively make statements about its climate-change related initiatives, goals and plans—assuming that the omission of such statements would not constitute a material omission or otherwise fraudulent disclosure. Under current law, if a company wants to make affirmative statements about its intentions with respect to climate-change, it could do so knowing that in doing that it was voluntarily undertaking greenwashing risk and the need to make sure that it actions matched its sometimes-aspirational public statements.

If a company did not want to do that, it did not need to. A number of companies have voluntarily made such statements for goodwill or public or investor relationships. Often companies could decide not to take the "greenwashing" risk and remain silent.

The Climate Disclosure Rule requires all public companies to "get off the fence" and affirmatively make statements about its policies with respect to climate change. At least when it comes to climate change, greenwashing risk will not be the exclusive province of companies who voluntarily make ESG-related statements about climate change. Rather, all public companies will need to assess greenwashing risks even if they otherwise would voluntarily wish to be restrained or remain silent. A public company can no longer "play off it safe" by staying on the sidelines. All reporting companies will encounter some degree of greenwashing risk. In the current regulatory environment, coupled with new regulations, greenwashing may be one of the most significant, yet under-appreciated, securities liability risks that a company faces.

The Rise of Private Securities Litigation Alleging Greenwashing

The SEC is not the only potential adversary that a company may have when it comes to securities liability risk related to alleged greenwashing. A number of private securities litigation cases have been brought alleging that sustainability statements made by a company constituted false statements to investors under applicable federal securities law.[12]

On the "other side of the aisle," it is possible that future litiga-

tion may focus on companies who did not adequately disclose how following an ESG principle may have caused it to achieve reduced financial performance, even if the ESG principle itself was successful.

Over the coming years, there is a heightened and mature need for public companies to actively put in place policies for monitoring greenwashing risks. For non-public companies, such as many investment advisers, there is no reason to believe that the SEC will be any less aggressive in potential greenwashing crackdowns.

The Securities Related Greenwashing Risks for Investment Advisers

As referenced earlier, a number of the SEC greenwashing enforcement actions have been brought against investment advisers for statements made in connection with marketing funds and registered investment companies that they manage. Similar to how public companies, before giving effect to the Climate Disclosure Rule, could from a legal standpoint "stay on the sideline" and avoid any greenwashing risk by avoiding ESG statements, investment advisers can to a large degree take a similar position under applicable U.S. law. In practice, investment advisers regularly make voluntary statements about ESG to investors in response to investor questions, investor "side letter" provisions and for marketing purposes. To the extent that a fund's managers funds are marketed in the European Union, in most cases they already need to make statements about how their investment impacts sustainability risks.[13] However, unless there are ESG risks to the fund manager or its investment advice, there is generally nothing in U.S. federal law that requires affirmative ESG statements.

However, it is possible that pending proposed SEC regulations may increase that risk for investment advisers. Regulations proposed in May 2022 (the "Proposed ESG Disclosure Rules") would, if adopted, have the effect of requiring investment advisers to make public statements in their Form ADV filings with the SEC with respect to their consideration of ESG factors on investors.[14]

For example, an investment manager of a private fund would be required to state whether it considers "ESG factors as part of one or more significant strategies or methods of analysis in the advisory services provided" to a private fund.[15] A fund manager answering "yes" to that question will be then required to state whether it (i) considers ESG factors alongside other, non-ESG factors, such that ESG factors are generally no more significant than other factors and not necessarily determinative or (ii) considers ESG factors as a significant or main consideration in advising

the fund.[16] Further, each private fund manager would required to statement whether it considers each of the following factors when advising a private fund:

- environmental factors
- social factors
- governance factors.[17]

In the "brochure" portion of Form ADV that is generally provided to investors along with fund documents, fund managers would be required to provide a narrative disclosure describing, among other things, a description of the ESG factors considered, how those factors are incorporated and whether they are considered as main factors or alongside other factors that may be equally important. To the extent that a private fund manager uses a criteria or methodology for applying ESG factors, it is required to disclose in the narrative disclosure the criteria or methodology used and must include: (i) whether an internal or external methodology is used and how the quality of any third party data is evaluated; (ii) screens used; and (iii) any indexes used.[18]

For investor relations reasons, few investment advisers might check "no" that they do not consider ESG factors. The practical consequence of the Proposed Rules is that it may force investment advisers to make affirmative statements about ESG that the SEC can later enforce against them. The scope of that potential enforcement is unclear. Will be it limited to cases where managers disclose in the Form ADV that go through certain procedures on ESG matters and then fail to follow those procedures? Conversely, will enforcement rest on subjective factors. For example, if an investment manager states that it values sustainable investments, will it risk an enforcement action if it invests in one oil and gas investment or an investment in a company that makes gasoline powered cars?

The Challenges and Costs of ESG

The effective defense is "truth." That can be tricky since sometimes the truth of a statement is subjectively rather than objectively determined. However, truth when it comes to ESG centers about an understanding of reality. Part of that lies in understanding (i) the costs and challenges of ESG; (ii) the benefits of ESG and (iii) an appreciation of how ESG practices are impacted in situations where the costs of an ESG practice outweigh its financial benefits to a corporation. An appreciation of the third situation in particular gives companies an opportunity to mold their public statements in a manner that would be reasonably to be expected with their real work practices. An understanding of these factors serves as a good starting place for a company to manage and minimize greenwashing risks.

Conversely, for ESG proponents, an understanding of the costs and pressures that corporate actors face allow them to enhance the effectiveness of their ESG message, especially when it comes to focusing on how a number of ESG measures not only have altruistic benefits but also have the potential to benefit a company's "bottom line."

When the cost of an ESG stance is low or non-existent, few will be hesitant to engage in very vocal support of the ESG principle or issue at hand. Where however, there is a cost that exceeds the public relations benefits of articulating the ESG principle or other benefits of following an ESG principle, even socially conscious corporations might shriek from it.

For example, it is easy for corporations to condemn countries in the developing world that have abysmal human rights records. Yet, much more difficult when that same country offers an ability to produce goods at low labor and other legal compliance costs than those that might be currently incurred in a more regulated jurisdiction. The costs of ESG are also easier to bear when they are borne by someone else other than the person articulating the message. However, it can be much harder for a corporation to advocate an ESG principle would require it to increase employee costs or to incur others costs to accomplish a stated ESG objective.

The Non-Altruistic Benefits of ESG and the Potential for "Profit Maximizing ESG"

Other than altruistic benefits, there are two types of benefits a corporation may derive from following ESG principles.

The first is a public relations benefit. This is broadly defined and includes such things as benefits from customer goodwill, increased employee enthusiasm to positive press coverage. The desire to capture this benefit is why so many corporations tout their charitable giving and why so many consumer products-oriented companies publicize that they are going "carbon neutral" in their advertisements.

The second benefit is that, in many cases, acting in an altruistic manner also correlates with the best financial interests of a business. For example, a company may as part of an "ESG" initiative undertake increased environmental scrutiny of its operations. It may very well be the case that the costs of doing that are matched or outweighed by the benefits that the company receives in a lower risk of government fines, tort lawsuits, reduced risk of employee exposure to hazards and related compensation claims and illness and, related to the preceding point, increased public relations. A company that focuses on employee wellness might have receive benefits in employee retention and morale and in fewer employee absences due to illnesses and medical procedures.

Both of these benefits have the potential to produce financial benefits that outweigh the costs of adopting the ESG measures at issue, and in cases where they do, they increase net profits for a company.

When the Costs of ESG Outweigh the Non-Altruistic Benefits

The more difficult area with ESG is where an ESG principle does not align with public relations benefits or other financial benefits to a corporation. Will a corporation in such a case pursue an ESG principle? The areas where the costs of ESG outweigh the benefits to a corporation may explain the odd dichotomy of companies loudly proclaiming their social conscious, regardless of specific ESG principles, but yet at the same time opposing efforts of employees to unionize, closing stores in areas that serve underserved communities, engaging in corporate layoffs, paying their top executives a wage differential that dwarfs what most employees makes, relocating factories overseas where production is cheaper due to lower wages, reduced employee protections and laxer environmental laws. If a corporation pursued "pure ESG" it may do none of those things.

However, that is why "pure ESG" may be rare. It is possible that a number of corporations might pursue "profit maximizing ESG"—ESG in cases where the pursuit of ESG otherwise aligns with their efforts to maximize profits, but in practice retreat from practicing "pure ESG"—the pursuit of ESG in a manner that is devoid of applicable profit considerations. It may be hard to find any example where a corporation of any significant size operating in a competitive industry pursues pure ESG.

Legal Implications of "Profit Maximizing ESG" and its Impact on "Greenwashing"

An acknowledgment that a number of corporations practice profit maximizing ESG over pure ESG is not grounds for disparaging ESG but rather presents a framework for improving ESG, but with practical considerations in mind. A blind adherence to the view that a corporation, however well-intentioned and however it may publicly position its rhetoric, pursues pure ESG may create legal risks and blinds ESG proponents to constructive opportunities to improve ESG pursuits.

By admitting and acknowledging that corporations operate to make profit, that they have costs to consider, pricing pressures and competitive factors to consider, a proponent of ESG can potentially act more effectively. Not admitting to the practical considerations of ESG also creates a risk that ESG proponents

naively might buy in corporate "propaganda," public relation stunts, and greenwashing.

Secondly, a practical view helps ESG proponents position ideas to corporations in a manner where they are more likely to be adopted in a genuine sense rather than being merely appeased with public relations statements and greenwashing gestures. For example, if activists are trying to get a corporation to adopt employee welfare measures they might do better by focusing on the employee retention benefits of such programs rather than purely on social responsibility. The other side coin is that ESP proponents might need to acknowledge that ESG ambitions are, rhetoric aside, constrained by costs and benefits and that may not get everything that want or that they would otherwise attain if corporations practiced pure ESG.

Thus, an acknowledgment that ESG is cost based also would help corporations avoid legal issues that otherwise arise unbridled proclamations of ESG. As noted earlier, one of the principal legal traps that corporations, even when well-intentioned, make is that there may often be a gulf between their public statements regarding ESG and what they actually do. The resulting gap, as noted earlier, is referred to as "greenwashing."

As discussed earlier, public companies run the risk of SEC enforcement actions and possibly civil litigation claims if there their statements are overly optimistic and private investment fund managers face similar risks with the SEC, and depending on ESG provisions that may be in agreements with investors, possible risks from investors themselves.

Managing Down Resulting Greenwashing Risk

Corporations could avoid or minimize greenwashing risk while be admitting to a more realistic expectation of the ESG principles it is able to obtain. If there is a desire to make pure ESG statements unencumbered by costs and benefits, it may be best to limit to those to a few areas where the corporation is 100% certain that it can apply those principles without taking costs into consideration.

Secondly, corporations should generally view any proposed superlative statements that they might be tempted to make about ESG principles with beady eyes. For example, the use of expressions such as "best in class" should be restrained. Those and similar statements seem powerfully aspirational and inspiring but there is a substantial risk that they don't match reality. Given the multitude of various companies and the vast amount of differentiated ways of doing things, let alone variances in how different companies apply cost considerations, it may be overly aggressive to state that someone is the best at something, i.e. that

no one else is better or that no one else applies ESG more stridently or more effectively.

Ironically, companies that face little, if any competition may be best positioned to be the best in their class with respect to ESG, as they do not face the competitive pressures that other firms to keep costs down and prices competitive—factors that often conflict with pure ESG aspirations.

Likewise, statements that a company operates in the safest manner or with the best practices should generally be avoided. For example, a mining company should never say that it maintains its properties in the safest manner possible. The safest way to maintain its properties would be to shut down the mines and reduce the risk of worker injury to zero. However, no one would suggest that a mining company do that, putting aside ardent opponents of mining.

Another example is that a company should never say that it operates in the safest manner possible or that it operates at the highest safety standards. A manufacturing company could operate at a higher standard if it had a safety officer assigned to each employee on an assembly line carefully monitoring everything the employee did to further reduce the risk of on the job injury. In that example, the theoretical incremental safety benefit is likely outweighed by the costs.

Rather than to use unhemmed superlatives, a corporation may be better served to say that it takes what it considers to be reasonable safety measures.

Would it actually be appropriate for corporations in their ESG statements to say that they consider a multitude of various socially focused initiatives, taking into account their benefits to the corporation, their costs and impact on profitability-and further stating that the initiatives do not require the corporation to forgo or reduce profits? Public relations consultants would likely recoil at the latter parts of those statements. However, they would seem to be closely aligned with what a number of corporations actually do.

When it comes to expressing ESG ambitions, those statements should not be solely written by marketers, community development officers, investor relations staff and executives. They should be scrutinized by lawyers as well with a view to confining the statements to actual practice and to minimizing or avoiding greenwashing legal liability.

In short, it can sound good but also needs to be truthful, practical and in a number of cases for companies that operate in competitive industries, financially viable as well.

Two Recent Critiques of ESG and Related Lessons for Greenwashing

Two recent books merit consideration by proponents of ESG: (i) *The Profit Motive: Defending Shareholder Value Maximization* by USC law professor Stephen M. Bainbridge (Cambridge University Press, 223 pages) and (ii) *The Case for Shareholder Capitalism: How the Pursuit of Profits Benefits Us All* by Georgetown University business law professor R. David McLean (Cato Institute, 229 pages). Each of them seems to take a dim view of "stakeholder capitalism," a view that corporations should take into consideration the social impacts of their actions and broader constituencies rather than to act solely in the best interests of their stockholders through "shareholder capitalism." Proponents of ESG might be turned off from studying these works given their thesis.[19]

However, that view undermines the usefulness of studying the works. Even if someone disagrees with the conclusion of the books, each has valuable insights and lessons that merit consideration by ESG proponents. Proponents need to be aware of counter arguments that are made and to the extent that any counter arguments make valid criticisms they need to be taken into account in determining whether any adjustments to ESG implementation should be made. It would be easy for an ESG proponent to be comforted by reading something that they agree with. However, reading a book that merely parrots already existing views held by a reader has little value. Some of the most valuable books for a movement are ones that cross examine the movement and that is exactly the foil that *Profit Maximizing* and *Shareholder Capitalism* play with respect to the ESG movement.

The books also serve a valuable role in helping to explain why greenwashing is prevalent and the related economic and financial reasons that often drive companies to vary in their business practices from publicly proclaimed ESG statements.

Profit Maximizing argues that corporations should focus on maximizing shareholder value. Some of Professor Bainbridge's criticisms merit evaluation and consideration, especially ones that address corporate hypocrisy and greenwashing, the lack of ESG expertise of corporate executives, the lack of clear standards, competing interests, differences of opinion about what is socially beneficial and how stockholders can often end up bearing costs of non-value maximizing initiatives.

However, if a view that corporations should act to maximize shareholder value were applied consistently it could possibly raise difficult issues.

For example, what if there is a retail business that concludes

that it can increase profits by selling and distributing pornography. Let's assume that to make the issue more complicated that it is unconverted that the pornography at issue lacks any merit other than to appease prurient concerns and further assume that it is also unconverted that portrays women in a misogynistic light. Under a value maximizing theory of corporate action should a corporation distribute and sell the materials with no regard for the potential social effects of what it is doing? In reality, a corporation could always decide not to do it and claim that it was still acting in a value maximizing manner. It could claim that it would hurt its image and diminish its brand name. That is where a corporation might look for "cover." However, if those are just excuses, the value maximizing theory would seem to possibly indicate that a corporation should not relent in moving ahead.

To use another example, assume that a corporation operates in a developing world country. Under the environmental laws of the country that it operates under it can maintain low costs by discharging a pollutant that is linked to the development of cancer. Assume further that the company operates the plant through a third party operator so any risk of bad public relations is isolated and that local tort law is undeveloped so there is no practical risk of legal liability. Under the value maximization theory would the corporation possibly have to go ahead with pollution knowing that it could result in the local populace likely developing cancer?

Putting aside the label and semantics of "ESG," does the value maximizing theory possibly lead to situations where corporations act, and should act, in a manner that is devoid of basic "morals"? It is possible that some advocates of value maximization would accommodate some exceptions in such extreme cases.

A Possible Balanced Approach to ESG

The balance may lie somewhere in the middle where corporations follow profit maximizing ESG with allowances for pure ESG to followed in certain extreme cases. Any view that a corporation could not make allowances for any social considerations of its business operations and instead most solely act in a manner that maximizes value or profit could be viewed as extreme.

Not even the most ardent capitalist would hold that the people always should act or should act in a manner to maximize their financial interests devoid of any social conscious. Adam Smith himself went to great pains to point out that people acting in their own interests do and should consider their own altruistic interests and motivations as well as their own financial interests.

However, while a balanced approach may seem appealing, is it

actually followed in practice? We can go back to that example of the corporation responsible for a plant operation creates carcinogens. That seems shocking and egregious but is that far removed from what a lot of even ESG vocal corporations do? For example, the cancer scenario may be a little extreme and sound unusual. However, it is not unusual for a US corporation to relocate a factory or plant overseas where labor costs lower and environmental regulations are not as stringent or costly. Nor it is unusual for a corporation that engages a third party to manufacture on its behalf to contract with a party overseas for the same reason.

However, before we throw condemnation at them it might be useful to put ourselves "in the shoes of" one of those corporations. Let's assume that you ran a corporation that manufactured shoes in the United States and your competitors were undercutting you on cost and price by producing their products either directly or through parties, in each in developing world countries were worker conditions, environmental regulations are not as strong but where costs are dramatically lower. Assume further that unless you lower your costs by relocating operations overseas that your corporation will rapidly lose market share with a substantial risk that it will go out of business. What would you do? Do the right thing, in accordance with pure ESG principles of worker safety, rights, welfare and environmental protections and risk going bankrupt as a result or relocate and stay in business? The point is not to take a "side" on this hypothetical but merely to point out that the decisions implicated by ESG or other nonfinancial considerations are not as simple as they may seem at an initial glance.

Professor Bainbridge argues that companies operating in competitive industries will face pressure to retreat from policies that are not designed at maximizing the value of a corporation. He used the example of a public corporation which he argues subordinated maximizing value for non-value maximizing social goals. The result was the activist stockholders took over the public company and re-steered on a different path more focused on maximizing value.[20] In his view, a corporation will likely face this pressure even if publicly espouses non-value maximizing ideals.

Professor Bainbridge backs up his views by a study of corporate proxy statements that show none of them, although they involved purchases of companies at a premium and many of them involved protections for corporate executives, contained provisions for providing for continued employment or severance benefits for rank and file employees, protection for suppliers or customers or for the environment. The conclusion being that rhetoric aside, when push came to shove the corporations looked for the interests of executives and shareholders, with none of the purchase price

premium being applied for the benefit of "stakeholders."[21]

He also asserts that a number of the Business Roundtable signatories to its statement on stakeholder capitalism have large amounts of stockholder buybacks and a questionable correlation between CEO pay and performance.[22] He explains that stock compensation gives corporate directors an incentive to pursue stockholder capitalism rather than shareholder capitalism.[23]

Professor Bainbridge also points to a study showing that portfolio companies in ESG fund portfolios were more likely to do business with Russia and have labor and environmental violations than those who were not.[24] He also makes reference to another study showing that companies with high ESG ratings were less likely to cut CEO pay in a financial hardship than others and another showing that oil and gas companies with low ESG ratings were more likely to produce high quality green energy patents than highly rated ESG companies engaged in green research.[25]

Professor Bainbridge recognizes that in many cases corporate actions that benefit "stakeholders" (groups broader than stockholders and sometimes including social constituencies) can also drive profits. Although he does not use the terminology he seems to be agreeing that there can be such a thing as "value maximizing ESG".[26] His main issue seems to be dealing with situations where stakeholder actions benefit stakeholders but are disadvanteous to shareholders. In his view that a corporation should, in such a case, prefer shareholders.[27]

Professor Bainbridge acknowledges that corporations can and must follow the law and still be value maximizing. For example, a plant needs to comply with pollution laws even if it could make more by engaging in illegal pollution.

Bainbridge believes that stakeholder capitalism leads to unclear results. He uses the example of a plant closing and relocating to a different part of the country. It harms the current employees but would help the employees in a new area of the country?[28] Thus, in his view it can be difficult to tell what course of action actually is in the best interests "stakeholders" due to different competing interests.[29] He worries that to the extent that corporate executives are judged based on how they achieve stakeholder goals that there will be a lack of clear standards that could used by executives to undermine accountability and justify under performance.

He is particularly critical of using stakeholder capitalism to pursue public policy goals. As he explains, executives might have expertise in analyzing the financial benefits but likely have no experience or expertise in setting public policy goals and no ability to determine the costs that should be pursued by their

shareholders in pursuing public policy goals.[30] He further asserts to the detriment of stockholders corporations and executives find themselves being pressured to achieve goals that could not be achieved through a legislative process.[31]

Analytical Points from Shareholder Capitalism

Professor McLean begins *Shareholder Capitalism* with an in-depth description of how capitalism works and its impact on corporate incentives and decisions. His analysis can serve as a "touchstone" for ESG proponents to understand the economic rationales pursuant to where many corporate leaders operate.

Professor McLean takes issue with any argument that shareholder capitalism is incompatible with acting in the best interests of employees and customers. McLean points out that an exchange between employees, customers and a corporation is voluntary and that those relationships are only entered into if the exchange is mutually beneficial, which in his view creates value for both sides.[32] He expands his point by arguing that a corporation can only make consistent profits by consistently serving stakeholders other than its shareholders.[33] For example, it must make products that customers want to buy, it needs to offer employment terms and conditions that employees want to work under, it needs to buy from suppliers at prices that create profit for those suppliers and it must follow laws.[34] Although he does not use the phrase, he seems to alluding to a type of "profit maximizing ESG."

He echoes some of the same concerns articulated by Professor Bainbridge with respect to difficulty in defining who speaks for the ESG community under stakeholder capitalism. In contrast, he suggests that employees, suppliers, customers and governmental entities that it interacts with are a sufficient community that arises by virtue of pursuing shareholder capitalism.

His point about voluntary exchange is worth consideration. Assumedly, a corporation could for example provide jobs to an underserved community on mutual agreeable terms that the employees find acceptable. In such a case, a corporation would be pursuing profits and the interests of the community at the same time.

Although he does not get into this degree of analysis specifically, it would seem that paying employees in excess of what was necessary or desirable for business purposes would tip away from the corporation's interests in pursuing the best interest of its shareholders. Any incremental compensation paid in excess of "market" compensation would perhaps constitute a pursuit of "pure ESG."

In Professor McLean's view if corporate management enters into arrangements that come at the expense of shareholders than

they are transferring wealth from shareholders to other stakeholders. Such arrangement he argues is not mutually beneficial and thus creates no value.[35] Assumedly such an arrangement would transfer value rather than create value.

He further asserts that shareholder capitalism does not result in corporations pursuing short term profits at the expense of long-term success as corporations are valued based on their long term prospects.[36] Investors in his view also value corporate governance which impacts stock price and gives corporations incentives for effective governance structures.[37]

He is also skeptical of ESG ratings and labeling, arguing that the ratings reflect what the labelers like and dislike, meaning that the ratings depend on who is doing the ratings and what their preferences are.[38]

On a related note he argues that socially responsibility initiatives have a left of center ideological bent to them by pointing out several examples. This raises an interesting question. Could the ESG movement be more effective and perhaps incorporate for example the Republican State Attorney Generals who have helped provoke an "ESG backlash" by depoliticizing ESG and focusing more instead on how ESG initiatives, at least in the case of profit maximizing ESG, can also increase corporate profits?

The Path Forward Generally

Rhetoric is effusive as it does not need to be constrained by costs. ESG actions however do have real costs associated with them. This leads to a situation where ESG rhetoric can often be more embracing of ESG principles than the actual actions of a corporation. This gap creates a real potential for greenwashing. Thus, companies should be constrained and honest in their ESG rhetoric. This acceptance will require that ESG proponents be cognizant of cost and understand the need for corporations to take cost into account.

Public relations and public action can go a long way to narrowing the gap between profit maximizing ESG, what corporations often do in practice, and pure ESG. However, this will require the public to make sacrifices. To illustrate the point, we can go back to the example of the company that, despite its ESG statements and rhetoric will likely move its manufacturing operations overseas. Recall that such moves are largely made for cost reasons and they allow a corporation to sell products at a competitive price. No company would want to publicly admit this. However, it is important is for greenwashing reasons and related securities law reasons that any company in such situation avoid any public statements to the contrary—unless it really believes it can put its ESG goals above financial interests in such a situation.

Assume however, that consumers (both personal and business consumers) were willing to pay more for appliances, clothing and other goods that were produced in countries that followed high standards for worker's safety, compensation, labor law protections and environmental regulations. Would that be the case? If it were, it would bring about a situation where the gap between profit maximizing ESG and pure ESG would narrow. It would no longer be profitable, or less profitable, for corporations to move their manufacturing operations offshore to more regulatory lax jurisdictions because there would be reduced consumer demand for the products produced there. Greenwashing risk would assumedly be greatly reduced.

However, companies can't assume that will be the case and will likely find situations where they will continue to feel the need to make ESG statements that might conflict their less-publicly discussed profit motives. In essence, companies will likely continue to find themselves trapped between two competing tensions. Thus, a long-term plan for monitoring greenwashing risk for any company that makes ESG-related statements becomes essential.

The Path Forward with Respect to Greenwashing

The adoption of a realistic view of a company's ESG objectives is the first step to minimizing greenwashing risk as an acknowledgment of costs of benefits associated with various ESG actions will hem in a number of purely aspirational statements that a corporate actor might otherwise be tempted to put out to the investing public. However, it just serves as the base for a greenwashing risk limiting strategy. This base, once appreciated, should be expounded upon with the following non-exclusive supplemental risk mitigating steps:[39]

- *Superlative statements*: Given the tendency of the SEC to hold companies to their word,[40] as noted earlier superlative statements should generally be avoided in making ESG statements unless the use of them has been carefully vetted internally. The use of superlatives even poses risk for private securities litigation unless a court rules, in certain cases, that the use of such is "puffery"[41] or part of a "general, aspirational corporate ethos."[42]
- *Tempering statements*: Consider when cost considerations might in practice cause an ESG practice to be scaled back. If there are circumstances where a company believes that it will not follow through an ESG practice, it should disclose those limitations and risks in plain English.
- *Express limits:* Similar to the foregoing, if an ESG concern is not the sole item that a company considers when making a

decision, companies should disclose that fact, including, if true, that the company in question can decided to relegate an ESG position to financial interests or financial necessity in certain circumstances.

- *Policies*: Map and tract all ESG statements, including ones particularly related to methods and policies that are supposedly put in place. This first step should be followed by putting in place an extensive compliance policy to track and ensure that company follow the touted methods and policies. This is particularly important as a number of enforcement actions have been in part based on the lack of internal policies.[43] Secondly, the use of policies helps eliminate risk that there is gap between company actions and company rhetoric. Finally, if through compliance efforts it is shown to be unreasonable that that a touted method will be followed, a company should disclose that it will not be followed in all cases.[44]
- Impact on profits: If following an ESG principle does precedent over profits, companies should, subject to considering their fiduciary duty, disclose that as well to help avoid claims that the financial impacts of following ESG principles were not adequately disclosed.

The foregoing is a start point, but a through a "cross examination" of ESG principles through a lens of realism can be a launching pad for mitigating greenwashing exposure risk in an increasingly regulated environment.

NOTES:

[1]For example, a number of state investment plans requires that funds be managed with solely the financial interests of the plan in mind or in accordance with a similar "prudent investor" standard. Employee plans governed by The Employee Retirement Income Security Act of 1974 (ERISA) are subject to a similar standard.

[2]Recently adopted Rule 35d-1 promulgated by the SEC under the Investment Company Act of 1940 (requiring that is an investment company, or mutual fund, uses a name that suggests a particular focus that at least 80% of the entity's assets must be invested in accordance with the investment focus suggested by the name, principally intended to target mutual funds with ESG names).

[3] https://www.sec.gov/securities-topics/enforcement-task-force-focused-climate-esg-issues.

[4]*Id*.

[5]In the Matter of DWS Investment Management Americas, Inc., Investment Advisers Act of 1940 Release No. 6432 (Sept. 25, 2023); also see In the Matter of BNY Mellon Investment Advisor, Inc., Investment Advisers Act of 1940 Release No. 6032 (May 23, 2022) (for using disclosures that suggested ESG reviews were done for each investment, when that was allegedly was true in all cases).

[6]In the Matter of Goldman Sachs Asset Management, L.P., Investment Advisers Act of 1940 Release No. 6189 (Nov. 22, 2022).

[7]DWS Investment Management Americas, Inc.; BNY Mellon Investment Adviser, Inc.

[8]In Matter of Wahed Invest LLC, Investment Advisers Act of 1940 Release No. 5959 (Feb. 10, 2022).

[9]In the Matter of Health Insurance Innovations, Inc., Securities Act of 1933 Release No. 11084, Securities Exchange Act of 1934 Release No. 95323 (July 20, 2022).

[10]Securities and Exchange Commission v. Vale S.A. Compliant, Civil Action No. 22-cv-2405 (Apr. 28, 2022).

[11]Securities and Exchange Release Nos. 33-11275, 34-99678 (Mar. 6, 2024).

[12]In re Oatly Group AB Securities Litigation, Consolidated Civil Action No. 1:21-cv-06360-AKH) (S.D.N.Y.) (related to sustainability claims); Fagen v. Enviva Inc., et al., Case No. 8:22-cv-02844-DKC (D. Md.) (related to sustainability claims); In re Danimer Scientific, Inc. Securities Litigation, Case No. 1:21-cv-02708-HG-RLM (E.D.N.Y.) (relating to biodegradable claims).

[13]Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services section (The Sustainable Finance Disclosures Regulation (SFDR)).

[14]Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, Release No. IA-6034; IC-34594 (May 22, 2022) (the "Proposing Release").

[15]*Id*. at 357.

[16]*Id*.

[17]*Id*. at 358–59.

[18]*Id*. at 359–60.

[19]Another recent treatise on ESG deserves mention. KYLE EDWARD WILLIAMS, TAMING THE OCTOPUS: THE LONG BATTLE FOR THE SOUL OF THE CORPORATION (W.W. Norton & Company 2024) is an understanding of the social history of corporations in the United States. Mr. Williams presents an interesting social history of corporations, where the pressure on corporations to act in social presents long predates the recent evolution of modern ESG practices.

[20]STEPHEN M. BRAINBRIDGE, THE PROFIT MOTIVE: DEFENDING SHAREHOLDER VALUE MAXIMIZATION 165.

[21]*Id*. at 109.

[22]*Id*. at 122.

[23]*Id*. at 153.

[24]*Id*. at 87–88.

[25]*Id*. at 103–04.

[26]*Id*. at 10.

[27]*Id*. at 10.

[28]*Id*. at 15.

[29]*Id*. at 136.

[30]*Id*. at 95

[31]*Id*. at 150.

[32]R. DAVID MCLEAN, THE CASE FOR SHAREHOLDER CAPITALISM: HOW THE PURSUIT OF PROFITS BENEFITS US ALL 70.

[33]*Id*. at 72.

[34]*Id*. at 72.

[35]*Id*. at 82.

[36]*Id*. at 110.

[37]*Id*. at 134.

[38]*Id*. at 137.

[39]The following is general guidance. Any specific guidance must be tailored to the operations and risks of any particular company.

[40]Vale S.A. Compliant.

[41]*Dwyer v. Allbirds, Inc.*, 598 F. Supp. 3d 137 (S.D. N.Y. 2022).

[42]*Earth Island Institute v. The Coca-Cola Co.*, 2022 WL 18492133, *4 (D.C. Super. Ct. 2022).

[43]See In the Matter of DWS Investment Management Americas, Inc.; In the Matter of BNY Mellon Investment Adviser, Inc.

[44]See In the Matter of BNY Mellon Investment Advisor, Inc. (related to disclosures that suggested ESG reviews were done for each investment, when that was allegedly was true in all cases).