

Fiduciary Duty and ESG: A Q&A with Oliver Hart

Oliver Hart and **Chris Borek** — 4 MIN READ

Shareholders are increasingly pushing companies to pursue nonfinancial goals. Is a new approach to evaluating corporate governance needed?

As the environmental, social, and governance (ESG) movement has gained widespread traction in recent years, shareholders have increasingly pushed public companies to pursue objectives related to environmental ends – such as limiting pollution or preserving sustainability – or social goals – such as increasing diversity or protecting worker rights.

While there is broad agreement that corporations continue to have a fiduciary duty to their shareholders, that duty is often interpreted as mandating that corporations act to maximize profit and shareholder returns. However, the question arises whether this narrowly defined view of fiduciary duty still serves to meet broader shareholder demands that companies consider the well-being of society at large in their business decisions and strategies.

To explore this question, Managing Principal **Chris Borek** spoke with Analysis Group academic affiliate **Oliver Hart**, the Lewis P. and Linda L. Geyser University Professor at Harvard University. Professor Hart, who won the Nobel Prize in Economics in 2016, is an expert in contract theory, the theory of the firm, and corporate finance. They discussed Professor Hart's recent research[1] – with Professor Luigi Zingales of The University of Chicago Booth School of Business – on a different approach to corporate governance, one that may be better adapted to accommodate the dramatic rise of ESG issues.

How compatible is the traditional understanding of fiduciary duty with ESG concerns?

At the core of the traditional model of corporate governance is shareholder primacy – the idea that corporations serve the shareholders' interests. This arrangement protects the investors, who, unlike other constituencies such as employees or creditors, do not have contractual provisions to safeguard their interests. This understanding is the foundation of our approach as well.

But what does shareholder primacy mean today? In the traditional framework, the duty is simply to increase share price and make investors wealthier. This approach is known as shareholder value maximization, or SVM. Under SVM, there is no space for the fulfillment of social or environmental goals unless they also advance profit maximization – in other words, "win-win" situations.

But consider proposals that have been made to reduce a company's carbon footprint, or disclose how much plastic waste it releases into the environment, or stop selling assault weapons. Shareholders have pushed for these goals, even though all of them may well reduce corporate profits.

Why is it necessary to think about this paradigm in a different way?

Corporations have changed since the SVM approach rose to prominence decades ago. They are now larger and more complex than they were, and, as a result, their influence on society is greater. Investors certainly seem more attuned than they were in the past to companies' obligations to address certain social problems that governments haven't fixed.



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> OLIVER HART

This is a shift that the SVM approach isn't capable of accommodating. The difficulties relate to the consequences of a company's activities that do not fall on the company and its shareholders but are borne by others, and by society at large.

What economists call externalities.

Exactly. Under the SVM approach, the appropriate response to, for example, a shareholder's concerns about the environment is that the company should return more money to shareholders through an increased share price or a dividend, which the shareholders can then elect to donate to an organization dedicated to environmental causes.

But what about cases in which a company has a comparative advantage in fixing the problem? To take one example: Consider a manufacturer that discharges a lot of plastic waste into the environment. There is no practical way for shareholders to ameliorate or undo the environmental detriment this causes, and even if there were, it would not be nearly as efficient a solution as the company itself could devise.

In sum: Shareholders demonstrably care about more than profit, and the SVM approach's identification of market value as the sole gauge of shareholder value is at least somewhat shortsighted.

So what alternatives are there?

A corporation's fiduciary obligation can be broadened beyond simple profit. Such an approach – which we call shareholder welfare maximization, or SWM – could be used to acknowledge the weight shareholders assign to the nonfinancial interests relevant to the corporation's activity, and it interprets the fiduciary duty of boards of directors as extending to those priorities.

How could a company determine what those priorities are?

One way to do it is through voting on initiatives – in particular, on issues that involve a close connection between the corporation's business and the social goals its investors are trying to achieve.

To echo again the example we discussed earlier: A manufacturer could put it to shareholders to decide by a vote whether to curb the plastic waste it emits, as a way of determining the importance to those shareholders of environmental sustainability. And it's possible to do this both for direct investors and for those who own shares via, say, mutual funds.

What will litigators need to keep in mind if we start examining management decisions through a shareholder welfare lens?

There are several issues that would likely have to be worked out. Judges in the US have traditionally taken a narrow view of fiduciary duty, focusing on SVM. But what happens in a case where a majority of shareholders favor nonfinancial criteria but a minority favor financial criteria? If the corporation's board or an asset manager follows the majority, could they be sued by the minority? Could those who own shares via a mutual fund vote those shares directly? Other aspects are likely to remain the same, however.

It's important to remember as well that SWM doesn't favor any side of the political equation. It simply increases shareholder democracy by broadening the range of interests that investors can direct public companies to pursue. And I think that increase in democracy is worth pursuing. ■

Endnote

1. Hart, Oliver, and Luigi Zingales, "The New Corporate Governance," *The University of Chicago Business Law Review*, vol. 1, pp. 195–216 (2022).