Socially Accountable Investing: Applying *Gartenberg v. Merrill Lynch Asset Management*'s Fiduciary Standard to Socially Responsible Investment Funds

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In the past several years, the investment management industry has seen the tremendous growth of mutual funds that invest according to principles of socially responsible investment (SRI). What is missing from this growing sector, however, is any oversight as to whether these funds actually accomplish their socially conscious mission. With the Securities and Exchange Commission reluctant to police "social disclosure," the unregulated promises of these SRI funds present a significant consumer protection risk.

This Note proposes that existing securities laws provide a potential avenue to effective SRI fund regulation without the need for new regulatory action. The rules of fiduciary obligation for mutual fund directors imposed by § 36(b) of the Investment Company Act and the landmark decision Gartenberg v. Merrill Lynch Asset Management*, which until now have largely been applied to funds' financial performance, could easily be adapted by SRI fund investors to ensure a modicum of oversight for those funds' social performance. State laws governing the management of public benefit corporations, which impose on directors a duty to disclose and compare corporate social performance, can provide potential principles for evaluating social performance.*

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I. INTRODUCTION

Politics makes strange bedfellows. In February 2019, *Bloomberg Businessweek* reported that several Wall Street investment professionals had lent their support to the nominally socialist Green New Deal.[1] As surprising as this confluence of interests might be, these investment professionals were simply following the desires of clients "interested in having exposure to green projects and green debt."[2] These environmentally-minded investors are part of a growing trend of socially responsible investing (SRI),[3] an investment approach that considers not only an investment's financial performance, but its ethical and social performance as well.[4] At its core, SRI is based on a simple mantra — by taking into account the social and non-financial aspects of an investment, SRI investors claim to "do well by doing good."[5]

Long dismissed by observers as a fad,[6] the market for SRI funds has ballooned in recent years into a $12 trillion industry that, by one estimate, accounts for one-fourth of assets under professional management in the United States.[7] As the market for SRI

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1. *See* Katia Dmitrieva & Emily Chasan, *Wall Street is More Than Willing to Fund the Green New Deal*, BLOOMBERG BUSINESSWEEK (Feb. 14, 2019), https://www.bloomberg.com/news/articles/2019-02-14/wall-street-is-more-than-willing-to-fund-the-green-new-deal [https://perma.cc/9WMY-5Y87].

2. *Id.*

3. "Socially responsible investing" is also referred to as "responsible investing," "ethical investing," "sustainable investing," "socially conscious investing," or "green investing," among a variety of other designations. *See* Celine Louche & Steven Lydenburg, *Responsible Investing*, *in* FINANCE ETHICS: CRITICAL ISSUES IN THEORY AND PRACTICE 393, 393 (John Boatright ed., 2010). Other socially responsible investment products are offered under an "ESG" label, standing for the environmental, social, and governance factors these products consider. For consistency's sake, this Note will refer to all of these approaches as "SRI."

4. Christopher J. Cowton, *The Development of Ethical Investment Products*, *in* THE ACT GUIDE TO ETHICAL CONFLICTS IN FINANCE 213, 215 (Andres Prindl et al. eds., 1994).

5. Henry Blodget, *The Conscientious Investor*, ATLANTIC (Oct. 2007), https://www.theatlantic.com/magazine/archive/2007/10/the-conscientious-investor/306192 [https://perma.cc/64MQ-29UV].

6. *See* Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#117781f71695 [https://perma.cc/JA9G-6FYL] ("Cynics may argue that responsible investing is just a fad."). *See also* Brad Allen, *Socially Responsible Investing No Longer a Fad*, STAR TRIBUNE (Nov. 17, 2017), http://www.startribune.com/socially-responsible-investing-no-longer-a-fad/458066383 [https://perma.cc/V5FK-2GHQ]; Investment Advisory, *Responsible Investing — A Fad or the Future?*, KPMG (Feb. 2018), https://assets.kpmg/content/dam/kpmg/uk/pdf/2018/03/kpmg_responsible_investment_a_fad_or_the_future.pdf [https://perma.cc/TS9B-CT9E].

7. Press Release, US SIF Foundation, Sustainable Investing Assets Reach $12 Trillion As Reported by the US SIF Foundation's Biennial *Report on US Sustainable, Responsible and Impact Investing Trends* (Oct. 31, 2018) https://www.ussif.org/files/

products has grown, institutional investment managers have rushed to meet this new demand,[8] with investment companies rolling out new SRI mutual funds and exchange-traded funds at a rapid clip.[9] As this market has grown, however, observers have become increasingly concerned over just how socially responsible these new market entrants actually are. Managers with dubious SRI bona fides have been accused of "greenwashing"[10] — a term coined to describe "marketing or PR intended to deceive consumers into believing that a company is practicing environmentally friendly policies."[11]

With the market for SRI funds growing and the risk of greenwashing high, how can investors in SRI mutual funds be assured that their investments are in fact advancing socially responsible causes? For such a large sector of the financial industry, the caselaw addressing SRI fund management is surprisingly thin.[12]

US%20SIF%20Trends%20Report%202018%20Release.pdf [https://perma.cc/M6VJ-6BFY]. *See also* Aaron Levitt, *Why Is Socially Responsible Investing Generating So Much Interest?*, ETFDB.COM (May 16, 2017), https://etfdb.com/etf-education/why-esg-investing-generating-much-interest [https://perma.cc/M6VJ-6BFY] ("While the approach of 'profits with a purpose' has been around for decades, SRI has gained an enormous following in recent years.").

8. *See* Mark Gilbert, *Can Captain Kirk Save the Fund Management World?*, BLOOMBERG OPINION (Feb. 6, 2019), https://www.bloomberg.com/opinion/articles/2019-02-06/star-trek-s-captain-kirk-has-survival-lesson-for-fund-managers [https://perma.cc/KQ9B-LGHC] (referring to a "flood of firms bolting environmental, social and governance considerations onto their existing products.").

9. *See, e.g.*, Press Release, Hartford Funds, Hartford Funds Launches Hartford Global Impact Fund, Expanding Socially Responsible Investing Lineup (Mar. 1, 2017), https://www.hartfordfunds.com/about-us/presscenter/hartford-global-impact-fund.html [https://perma.cc/G6X7-N3QZ]; Press Release, Fidelity Investments, Fidelity Launches Sustainability Bond Index Fund; Only Firm to Offer ESG Index Mutual Funds in Every Major Asset Class (June 26, 2018), https://www.businesswire.com/news/home/20180626005902/en/Fidelity-Launches-Sustainability-Bond-Index-Fund-Firm [https://perma.cc/8WAU-4FRN]; Press Release, The Vanguard Group, Vanguard Expands ESG Fund Offerings With Low-Cost ESG ETFs (Sep. 20, 2018), https://pressroom.vanguard.com/news/Press-Release-VG-Expands-ESG-Fund-Offering-092018.html [https://perma.cc/X588-ARU8]; Press Release, BlackRock Cash Management, BlackRock Intends to Launch Environmentally-Aware Money Market Fund (Jan. 22, 2019), https://www.businesswire.com/news/home/20190122005937/en/BlackRock-Intends-Launch-Environmentally-Aware-Money-Market-Fund [https://perma.cc/G25Y-5BXD].

10. Chase Woodruff & David Sirota, *Is Goldman Sachs' New Fund Really Just Greenwashing Stocks?*, GUARDIAN (Sep. 28, 2018), https://www.theguardian.com/business/2018/sep/28/is-goldman-sachs-new-fund-really-just-greenwashing-stocks [https://perma.cc/ZY79-24Z5] ("For some activists and investors, though, the rapid expansion of the market for SRI-branded financial products has raised concerns about greenwashing[.]").

11. Eric L. Lane, *Greenwashing 2.0*, 38 COLUM. J. ENVTL. L. 279, 280 (2013).

12. In 2008, the Securities and Exchange Commission brought an administrative proceeding against the SRI fund manager Pax World Management Corp., fining the company $500,000 for "fail[ing] to comply with its own internal SRI screening and periodic review policies[.]" Pax World Mgmt. Corp., 2008 SEC LEXIS 1795, at *16 (Sec. & Exch. Comm'n

The SEC has in the past rejected the need to mandate the "disclosure of information describing corporate social practices" under existing securities laws,[13] and has not revisited the issue in the intervening years despite the massive growth of the SRI fund industry in the interval.[14]

Observers have picked up on the risks this regulatory gap creates. One study found essentially "no correlation" between different forms of SRI evaluation, suggesting that the results of such evaluations are arbitrary.[15] This arbitrariness, the *Financial Times* noted, risks creating "a false sense of confidence among [SRI] investors who don't really understand what lies behind the numbers — and therefore don't really understand what they're buying."[16] Similarly, a report in *Bloomberg Businessweek* warned that the rampant greenwashing in the SRI industry has allowed for unscrupulous fund managers to "gaslight[ ] the American public."[17] The report continued, noting that "investors pay on average 15 times more" for SRI funds than similar non-SRI funds, even though those same funds often closely mirror non-SRI funds or invest in ethically-dubious companies.[18] In the face of this growing alarm, officials have taken little action to regulate SRI funds and plug this gap in consumer protection laws.

This Note proposes that existing laws can be interpreted to adequately protect SRI fund investors, without necessarily requiring new legislative or regulatory action. Section 36(b) of the Investment Company Act of 1940, the major federal statute regulating mutual funds, imposes a fiduciary duty on fund directors, enforced by a private right of action for investors, in order to ensure that

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July 30, 2008). In its coverage of the decision, *The New York Times* noted that it was the first time that the Commission had addressed such a problem. *See* Ron Lieber, *Socially Responsible, With Egg on Its Face*, N.Y. TIMES (Aug. 22, 2008), https://www.nytimes.com/2008/08/23/business/yourmoney/23money.html [https://perma.cc/WU57-QZFC].

13. Commission Conclusions and Rule Making Proposals, Exchange Act Release Nos. 33-5627, 34-11733, Fed. Sec. L. Rep. (CCH) ¶ 80,310, at 85,706 (Oct. 14, 1975).

14. *See* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1267–68 (1999).

15. *ESG Ratings — No Quick Fixes*, MORPHIC ASSET MANAGEMENT (Feb. 18, 2019), https://morphicasset.com/esg-ratings-no-quick-fixes [https://perma.cc/R7V3-F3R6].

16. Kate Allen, *Lies, Damned Lies and ESG Rating Methodologies*, FINANCIAL TIMES (Dec. 6, 2018), https://ftalphaville.ft.com/2018/12/06/1544076001000/Lies--damned-lies-and-ESG-rating-methodologies [https://perma.cc/Y7QZ-X96F].

17. Rachel Evans, *How Socially Responsible Investing Lost Its Soul*, BLOOMBERG BUSINESSWEEK (Dec. 18, 2018), https://www.bloomberg.com/news/articles/2018-12-18/exxon-great-marlboros-awesome-how-esg-investing-lost-its-way [https://perma.cc/57K9-H2VN].

18. *Id.*

they appropriately evaluate the qualifications of investment advisers hired to manage a fund.[19] While the fiduciary duty imposed by § 36(b) is undefined in the statute, the landmark cases *Gartenberg v. Merrill Lynch Asset Management, Inc.*[20] and *Jones v. Harris Associates L.P.*[21] have interpreted this duty to require that directors reject management agreements that charge excessively high fees relative to performance. These cases have also created an analytic framework — the *Gartenberg* test — that allows courts to evaluate a fund's performance and determine whether a fund's board has breached its duty under § 36(b). Courts have employed the *Gartenberg* test many times to evaluate funds' financial performance.[22] However, typical SRI investors have additional non-financial concerns regarding the social and ethical impact of their investments that are not fully reflected in the financial performance of a given fund. Protecting these investors' investments will require an expansion of the understanding of "performance" under the *Gartenberg* test that accounts not just for a fund's financial performance, but for its non-financial performance as well.

This Note discusses how the *Gartenberg* test can be employed to ensure that mutual fund directors are meeting their fiduciary duty under § 36(b) to protect SRI fund investors' non-financial interests. Part II of this Note reviews the history of the mutual fund industry and the fiduciary duties placed on directors in selecting a fund's investment adviser. Part III focuses on the history and principles of SRI and the ways in which the interests of SRI investors diverge from those of traditional investors. Part IV examines the factors of the *Gartenberg* test as applied to SRI mutual funds. Part V suggests a new way of viewing SRI fund director responsibilities, drawn from state laws governing public benefit corporations. Part VI applies these findings in the context of the renewal of fund investment advisory contracts, a process during which directors' fiduciary responsibilities are subject to close judicial and shareholder scrutiny.

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19. 15 U.S.C. § 80a–35(b) (2012).
20. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).
21. Jones v. Harris Assocs. L.P., 559 U.S. 335 (2010).
22. *See infra* Part IV (discussing existing caselaw).

II. THE MUTUAL FUND INDUSTRY AND ITS REGULATION

Small investors have been pooling their money together into collective investment funds since the early days of organized stock trading.[23] From the beginning, these pooled investment vehicles have been organized with the goal of providing a way for small investors to diversify their investments.[24] While pooled investments have been organized in various forms in various legal jurisdictions for centuries,[25] the modern open-ended mutual fund first emerged in Massachusetts in 1924.[26] Since then, the market for mutual funds has grown enormously, with mutual funds and other investment companies managing more than $22 trillion in assets by 2017.[27]

Most mutual funds are actively managed, meaning that the fund's investment adviser is expected to continually research and invest in securities in order to meet a particular investment objective, typically with the goal of outperforming a particular market index.[28] Investment through mutual funds provides a number of benefits for investors. While investors lose direct oversight and control of their investments, both investors and investment advisers benefit from the economies of scale available through the mutual fund form. For investment advisers, "harnessing economies of scale through mutual funds allows more efficient delivery of money management services to smaller investors who otherwise could not afford to hire a professional adviser."[29] For the investor, an investment in a mutual fund may offer "the benefits of

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23. *See* K. Geert Rouwenhorst, *The Origins of Mutual Funds*, *in* THE ORIGINS OF VALUE: THE FINANCIAL INNOVATIONS THAT CREATED MODERN CAPITAL MARKETS 249, 249 (William Goetzmann et al. eds., 2005).

24. *Id.* at 249.

25. *See id.* at 250–53 (tracing the emergence of mutual funds to a variety of historical investment practices, including investment trusts organized on the Amsterdam stock market starting in 1774 and life annuities and tontines available in colonial America).

26. *Id.* at 269.

27. INV. CO. INST., 2018 INVESTMENT COMPANY FACT BOOK 34 (2018), https://www.ici.org/pdf/2018_factbook.pdf [https://perma.cc/7X7N-DS57].

28. *Id.* at 280. A discussion of a different investment management strategy — "passive" management, in which the fund's investment adviser invests in securities in order to track certain market indices — is outside the scope of this Note. For a brief overview of the strategy's financial rationale and potential advantages, *see* Burton G. Malkiel, *Efficient Markets and Mutual Fund Investing: The Advantages of Index Funds*, *in* MUTUAL FUNDS: PORTFOLIO STRUCTURES, ANALYSIS, MANAGEMENT AND STEWARDSHIP 119–37 (John A. Haslem ed., 2010).

29. David E. Riggs & Charles C. S. Park, *Mutual Funds: A Banker's Primer*, 112 BANKING L.J. 757, 758 (1995).

professional investment," while allowing the investor to part only with "relatively small sums of money on a periodic basis."[30] Mutual fund investment likewise eliminates the need for an investor to continually monitor their investment, instead allowing the investment adviser to handle day-to-day aspects of their investment like the collection and subsequent reinvestment of dividends.[31]

The way that fiduciary duties apply to mutual fund directors must therefore be considered in light of the idiosyncratic way in which the industry operates. Part II.A of this Note discusses the unique problems of mutual fund director independence, while Part II.B describes how Congressional concerns over those problems motivated the passage of a special statutory fiduciary duty applied to fund directors. Part II.C then explains how subsequent litigation led to the development and widespread adoption of the *Gartenberg* test, a unique reasonableness standard for assessing fund board actions.

A. THE CORPORATE STRUCTURE OF MUTUAL FUNDS AND THE ISSUE OF INDEPENDENCE

Mutual funds have a distinctive corporate structure governed by both state and federal law.[32] Funds are incorporated at the state level, typically as a business trust in Massachusetts or Delaware or as a corporation in Maryland,[33] and are regulated federally by the Investment Company Act of 1940 [hereinafter, the 1940 Act or the Act].[34] A mutual fund company is fully owned by its investors as shareholders and is governed by a board of directors, which those shareholders elect.[35]

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30. Solomon Spiro, *Some Aspects of the Mutual Fund and Investor Protection*, 9 OSGOODE HALL L.J. 601, 601 (1971).

31. *Id.* at 602.

32. A similar pooled investment vehicle, the unit investment trust, is governed under many of the same laws as mutual funds. *See* Jay B. Gould & Gerald T. Lins, *Unit Investment Trusts: Structure and Regulation under the Federal Securities Laws*, 43 BUS. LAW. 1177, 1178 (1987) (Unit investment trusts are "subject to the same general regulatory scheme that governs other investment companies, including mutual funds."). This Note, however, focuses solely on traditional mutual funds.

33. Riggs & Park, *supra* note 29, at 765.

34. Pub. L. No. 76-768, 54 Stat. 789 (1940) (codified as amended at 15 U.S.C. §§ 80a-1–80a-64 (2012)).

35. *Frequently Asked Questions About Mutual Fund Directors*, INV. CO. INST., https://www.ici.org/pubs/faqs/faq_fund_gov_idc [https://perma.cc/Z33E-KNC8] (last visited Jan. 12, 2020).

While a fund may be chartered as an independent company, it has no employees of its own and instead operates entirely through contractual arrangements with third parties.[36] The fund's board is responsible for the negotiation of these contracts, the most important of which is the hiring of an investment advisor to handle the day-to-day portfolio management that actually generates returns for the fund.[37] Although a mutual fund and its investment adviser are in theory operating at an arm's-length distance as separate, independent actors, in practice the two are almost invariably closely intertwined. A fund's investment adviser is often the fund's initial sponsor and its initial shareholder.[38] As former executive adviser to the SEC Nathan Lobell described it:

> [Investment professionals] may already be in the investment management business through the X Management Company, or they may form an X Management Company. They then form the Y Mutual Fund, owning its initial shares, often a minute fraction of those which will eventually be issued. Controlling the X Company and the Y Fund, the founders have both of them enter into a contract under which the X Company undertakes to serve the Y Fund as investment adviser or investment manager at a fee . . . . It is the Y Fund which will offer shares to the public and the business of the Y Fund will be to invest the money entrusted to it by its shareholders. But the actual management of that money will be the work of the X Management Company.[39]

While going through the motions of independence, in reality many mutual funds operate as extensions of the investment adviser that initially sponsored them.[40] The danger created by this dual loyalty to both investors and the adviser is especially acute when a mutual

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36. *Id.*
37. *Id.* Investment advisers are also federally regulated, under the Investment Advisers Act of 1940, Pub. L. No. 76-768, 54 Stat. 847 (1940) (codified as amended at 15 U.S.C. §§ 80b-1–80b-21 (2012)).
38. INV. CO. INST., *supra* note 27, at 285.
39. Nathan D. Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181, 184 (1961).
40. *See* Note, *The Mutual Fund and Its Management Company: An Analysis of Business Incest*, 71 YALE L.J. 137, 142–43 (1961) ("Often the management company is composed of the same individuals who create and dominate the mutual fund. Hence, in the absence of additional safeguards, the interests of prospective mutual fund shareholders may be undermined in the contract between the fund and its adviser.").

fund board goes through the process of setting the fees it will pay to its investment adviser. While a truly independent fund board might be expected to "shop" for different competing advisers, in practice management agreements are continually renewed on the same terms for years on end.[41]

In whose interest, then, is a dually-loyal board actually negotiating? While a truly independent board ought to negotiate a management fee that is solely in the best interests of the fund's investors, there is the risk that a less-independent board will take into account the manager's own profits when negotiating rates. The fees ultimately agreed to by such a "conflicted" board might be significantly higher than those that an arm's-length negotiation between board and adviser might instead produce. This potential for abuse inherent in mutual funds' structure has vexed regulators for decades,[42] which has in turn motivated multiple legislative attempts to systematically regulate the mutual fund industry.

B. PROTECTING SHAREHOLDER INTERESTS THROUGH THE INVESTMENT COMPANY ACT OF 1940

Congress passed the 1940 Act after finding that mutual funds and other investment companies were " affected with a national public interest."[43] The Act provided a comprehensive regulatory scheme[44] for the nascent mutual fund industry in order to protect both the "national public interest and the interest of investors."[45] In the Act's declaration of policy, Congress stated that the public interest is harmed both when mutual funds are sold "without adequate, accurate, and explicit information, fairly presented, concerning [their] character,"[46] and when they are managed "by

41. *See* William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 223 (1971) ("Contract renewal is not a bid-and-ask proposition.").

42. *See* H. Norman Knickle, *The Mutual Fund's Section 15(c) Process:* Jones v. Harris*, the SEC and Fiduciary Duties of Directors*, 31 REV. BANKING & FIN. L. 265, 268 (2011) (noting regulatory concern over the "failure of competitive forces influencing the advisory contract and fee approval process").

43. 15 U.S.C. § 80a-1(a) (2012).

44. The Act covers both the sale and continuing management of an investment company, setting controls on, among other things, the election of a fund's board of directors, 15 U.S.C. § 80a-16(a) (2012), the amount of debt that an investment company can take on, *see id.* § 80a-21 (2012), and how well a fund must be capitalized before it can be offered to the public, *see id*. § 80a-14(a) (2012).

45. *Id.* § 80a-1(b).

46. *Id.* § 80a-1(b)(1).

irresponsible persons"[47] or "in the interest of directors [or] investment advisers" rather than investors.[48] The 1940 Act placed the enforcement of its provisions under the jurisdiction of the SEC[49] and likewise required most classes of investment companies to register with the SEC.[50]

The 1940 Act was initially successful to an extent in regulating the mutual fund industry, but within several years it became clear that the Act was insufficient to curb the "disappointing behavior of fund fiduciaries with respect to [activities] that enriched fund sponsors" at shareholders' expense.[51] Criticism of the industry focused on the poor quality of the management fee negotiations between fund boards and hired investment advisers. To observers, the management fees agreed to by these parties appeared hopelessly conflicted — not at all the products of arm's-length negotiations.[52] Both economists[53] and government regulators[54] raised concerns about the outsized costs these conflicts of interest imposed on investors. Responding to these pressures, Congress amended the 1940 Act in 1970[55] to impose some additional form of oversight on mutual fund fee negotiations.

These amendments added § 36(b) to the 1940 Act, which introduced a private right of action for mutual fund shareholders against a fund's board for the "breach of fiduciary duty in respect of . . . compensation or payments paid by [the] registered investment company or by the security holders thereof to [an] investment adviser."[56] The new statutory fiduciary duty — codified in § 36(b)

47. *Id.* § 80a-1(b)(4).

48. *Id.* § 80a-1(b)(2).

49. *See* 15 U.S.C. § 80a-37(a) (2012).

50. *See generally id.* § 80a-8.

51. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1017 (2005).

52. *See* John Baumann, Note, *Isn't This Where We Came In?: An Examination of the Turbulent History and Divergent Economics Underlying Section 36(b) of the Investment Company Act of 1940 and A Proposal to Finally Put the Law to Use*, 85 S. CAL. L. REV. 917, 924 (2012).

53. A study performed by the University of Pennsylvania's Wharton School of Business at the behest of the SEC, for example, found "potential conflicts of interest between fund management and share-owners" and "the possible absence of arm's-length bargaining between fund management and investment advisers[.]" *See* H.R. REP. NO. 87-2274, at 3 (1962).

54. The SEC, in particular, produced a market study noting that the "unique structure" of mutual funds was easily subject to abuse. *See* H.R. REP. NO. 89-2337, at 1 (1966).

55. Pub. L. No. 91-547 § 20, 84 Stat. 1413, 1429 (codified as amended at 15 U.S.C. § 80a-35(b) (2012)).

56. 15 U.S.C. § 80a-35(b) (2012).

of the 1940 Act — replaced fund directors' existing duty to act only reasonably in negotiations.[57] It would take at least a decade of litigation, however, for courts to determine the full scope of this new duty.

C. FIDUCIARY DUTIES UNDER § 36(B) FOLLOWING GARTENBERG AND JONES

Enforcement under § 36(b) of the 1940 Act has been limited.[58] Section 36(b) does not define what it means by fiduciary duty,[59] and neither the SEC nor fund industry lobbyists suggested a common definition while the 1970 amendments were being considered.[60] Initial judicial attempts to apply existing common law definitions of fiduciary duty to § 36(b) had decidedly inconsistent results,[61] with little further clarity forthcoming from either Congress or the SEC. Various circuit courts weighed in on the fiduciary duty confusion in the years following the 1970 amendments,[62] but the Supreme Court initially held only that federal courts should apply

57. Langevoort, *supra* note 51, at 1021.

58. Writing in 2008, Professor Lyman Johnson commented that "[t]he most remarkable statistic under section 36(b) is that, thirty-seven years after its enactment . . . no investor has obtained a verdict against an investment adviser." Lyman Johnson, *A Fresh Look at Director Independence: Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 VAND. L. REV. 497, 519 (2008).

59. *See* Green v. Nuveen Advisory Corp., 295 F.3d 738, 742 (7th Cir. 2002) ("[Section] 36(b) does not explain the term 'fiduciary duty'[.]").

60. *See* William P. Rogers & James N. Benedict, *Money Market Fund Management Fees: How Much Is Too Much?*, 57 N.Y.U. L. REV. 1059, 1084 (1982) ("[T]he Commission and the industry never did concur on what the term "fiduciary duty" meant[.]"). According to Rogers and Benedict, opponents of the amendments in the mutual fund industry feared that the enhanced fiduciary standard would obligate courts to determine de novo the reasonableness of a mutual fund's management fee, rather than deferring to the board's business judgment. *Id.* at 1085.

61. Two cases are illustrative of the confusion. In litigation arising under the pre-1970 form of § 36, a district court found that there was "no indication in the legislative history of [the 1940 Act] that Congress meant to incorporate common law principles [of fiduciary relationships]." Schlusselberg v. Colonial Mgmt. Assocs., Inc., 389 F. Supp. 733, 739 (D. Mass. 1974). A separate district court decision just five years later found that "the [fiduciary] standards under the [1940 Act] are at least as stringent as those of common law." Herzog v. Russell, 483 F. Supp. 1346, 1349 n.1 (E.D.N.Y. 1979) (citing Tannenbaum v. Zeller, 552 F.2d 402, 416 n.20 (2d Cir. 1977)).

62. *See, e.g.*, SEC v. Advance Growth Capital Corp., 470 F.2d 40, 55 n.21 (7th Cir. 1972) ("[T]he provisions of the [1940 Act] impose fiduciary obligations of the highest order upon persons who control investment companies.").

state law regarding the duties of independent directors for issues that fall outside of the explicit regulations of the 1940 Act.[63]

Twelve years after its passage, the Court of Appeals for the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management* articulated what is now the dominant interpretation of § 36(b)'s fiduciary duty.[64] The court in *Gartenberg* held that Congress' replacement of the 1940 Act's preexisting "reasonableness" language with § 36(b)'s "fiduciary duty" language was a "more semantical than substantive compromise."[65] The court then set forth a new standard stating that, in order for a breach of fiduciary duty under § 36(b) to occur, a mutual fund's "adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[66] To evaluate a breach of *Gartenberg*'s standard, courts have since used a six-part test to judge a fee's reasonableness, considering:

> (1) the nature and quality of the services provided by the adviser; (2) the profitability of the mutual fund to the adviser; (3) the extent to which "fall-out" benefits inured to the adviser; (4) economies of scale realized by the adviser; (5) fee structures of comparable funds; and (6) the independence and conscientiousness of the board of directors.[67]

Congress intended to move away from the lenient common law corporate waste standard with the passage of § 36(b),[68] but the final level of judicial oversight *Gartenberg* imposed on fund boards

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63. Burks v. Lasker, 441 U.S. 471, 486 (1979). Following this decision, "[b]ecause no federal common law existed for mutual funds, the Supreme Court essentially created a fresh slate for mutual fund litigation." Amy Y. Yeung & Kristen J. Freeman, Gartenberg, Jones, *and the Meaning of Fiduciary: A Legislative Investigation of Section 36(b)*, 35 DEL. J. CORP. L. 483, 488 n.29 (2010).

64. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923 (2d Cir. 1982).

65. *Id.* at 928.

66. *Id.*

67. Gallus v. Ameriprise Fin., Inc., 675 F.3d 1173, 1177 n.2 (8th Cir. 2012) (quoting *Gartenberg*, 694 F.2d at 928–32).

68. *See* S. REP. NO. 91-184, at 15 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4910 ("Thus, upon a challenge in court to compensation or payments, the ultimate test, even if the compensation or payments are approved by the directors and stockholders, will not be whether it involves a 'waste' of corporate assets but will be whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee.").

is decidedly unclear.[69] While the *Gartenberg* court initially compared § 36(b)'s fiduciary duty to a reasonableness test, they ultimately ruled in favor of the defendant mutual fund board on the ground that the fee they charged was not so "unfair" as to constitute a breach of § 36(b)'s fiduciary duty.[70] Judicial review of corporate action under a fairness standard is typically "even more exacting" than reasonableness review,[71] and thus the exact degree of judicial scrutiny *Gartenberg* calls for remains somewhat vague. Nevertheless, the *Gartenberg* framework was soon adopted by other courts.[72] After several decades of growing circuit-by-circuit acceptance, in the 2010 decision *Jones v. Harris Associates L.P.*, the Supreme Court adopted the *Gartenberg* standard as the national controlling interpretation of "fiduciary duty" under § 36(b).[73]

Mutual fund boards today also generally follow the *Gartenberg* test closely when reviewing their investment advisory agreements, which is reflected in the corporate disclosures addressing the board's consideration of each *Gartenberg* factor in shareholder communications.[74] The contract renewal process, known as the "15(c) process" after the section of the 1940 Act mandating it,[75]

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69. Professor Johnson generously suggests that the court in *Gartenberg* "spoke clumsily" in articulating its standard. Johnson, *supra* note 58, at 518.

70. *Gartenberg*, 694 F.2d at 930.

71. *See* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994).

72. For example, both the Third and Fourth Circuits have adopted and followed the *Gartenberg* test. *See* Green v. Fund Asset Mgmt., L.P., 286 F.3d 682, 685 (3d Cir. 2002); *see also* Migdal v. Rowe Price-Fleming Int'l, Inc., 248 F.3d 321, 326 (4th Cir. 2001).

73. Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010) ("The *Gartenberg* standard, which the panel rejected, may lack sharp analytical clarity, but we believe that it accurately reflects the compromise that is embodied in § 36(b), and it has provided a workable standard for nearly three decades."). The Seventh Circuit decision which the petitioners appealed from in *Jones* featured a vigorous disagreement about the continuing relevance of the *Gartenberg* standard between Judges Easterbrook (writing for the majority) and Posner (dissenting). *See* Jones v. Harris Assocs. L.P., 527 F.3d 627 (7th Cir. 2008) (Easterbrook, J.) and 537 F.3d 728, 729 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc). The Supreme Court ultimately sided with Judge Posner's view, but for a deeper discussion of the alternate theory of liability advanced by Judge Easterbrook, *see* M. Todd Henderson, *Justifying* Jones, 77 U. CHI. L. REV. 1027 (2010).

74. For a typical example of such a disclosure, *see* the Annual Shareholder Report for the Dreyfus Appreciation Fund for the period ended December 31, 2017, which discusses that fund board's consideration of "all factors that it believed to be relevant" in choosing to renew the fund's existing investment advisory agreement, including that "the nature, extent and quality of the services provided by [the investment adviser] are adequate and appropriate[,]" and that "the economies of scale which may accrue to [the investment adviser] in connection with the management of the fund had been adequately considered . . . in connection with the fee rate charged to the fund pursuant to the Agreement[.]" Dreyfus Appreciation Fund, Inc., Annual Report 29–32 (Form N-CSR) (Dec. 31, 2017).

75. 15 U.S.C. § 80a-15(c) (2012).

requires directors to request from their investment adviser all information necessary to evaluate the terms of a proposed management contract pursuant to the *Gartenberg* factors.[76] The interplay between § 36(b)'s fiduciary standard and the *Gartenberg* test is highlighted by the 15(c) process: "[b]y requiring certain factors to be analyzed by fund directors, *Gartenberg* and its progeny link Section 15(c) directly to the fiduciary duties contained in Section 36(b)."[77]

The *Gartenberg* standard has its critics. A 2001 study indicated that, while the growth of a fund manager's assets under management produced significant economies of scale, the savings of those economies were not passed along to shareholders through a reduction in management fees.[78] Beyond its failure to provide "effective means to restrain advisory fees,"[79] *Gartenberg* signaled a retreat from the "tone of high investor expectations of care and loyalty" that are implied by the words "fiduciary duty."[80] Indeed, *Gartenberg*'s acceptance of reasonable "arm's-length bargaining"[81] is quite distinct from the historical understanding of fiduciary duties as "something stricter than the morals of the market place."[82] The *Gartenberg* test has nevertheless endured and, with the Supreme Court's blessing in *Jones*, it now applies to every mutual fund fee dispute in the country. SRI funds operate in the legal environment created by the 1940 Act as well. The private right of action created by § 36(b) and shaped by *Gartenberg* therefore provides the most immediate way for investors to ensure that SRI fund directors are meeting their fiduciary obligations.

III. SOCIALLY RESPONSIBLE INVESTMENT FUNDS: THEIR FINANCIAL AND ETHICAL RATIONALES

In order to understand how § 36(b) can be adapted to suit the needs of SRI fund investors, it is important to first understand the unique ethical and non-financial priorities those investors may

76. *See* Knickle, *supra* note 42, at 274.

77. *Id.* at 275.

78. John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 627 (2001).

79. Rogers & Benedict, *supra* note 60, at 1079. *See generally* Daniel S. Alterbaum, *To "Make Full Disclosure and Play No Tricks": A Proposal to Enhance Fee Transparency After* Jones v. Harris Associates, 120 YALE L.J. 1579, 1580 (2011).

80. Langevoort, *supra* note 51, at 1017.

81. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 928 (2d Cir. 1982).

82. Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

have. SRI is a diverse movement which seeks to influence the investment decisions of a variety of institutional investors, from pension plans to university endowments. Likewise, many mutual funds are advertised to private investors as SRI mutual funds.[83] Unlike many traditional investors, however, most SRI investors are not morally neutral as to the nature of the securities they purchase. Instead, SRI investors seek a "double bottom line" from their investments, consisting of both reasonable financial performance and a "social dividend."[84] An ethical investment under SRI should not only generate financial value but also societal value, which can be measured based on environmental, religious, ethical or moral considerations. SRI mutual funds are therefore challenged to produce financial returns despite the restraints of these ethical and moral considerations.[85] SRI mutual funds, while not legally distinct from traditional mutual funds, specifically highlight their ethical considerations to prospective investors.[86] According to proponents of SRI, because corporations rely on capital markets in order to operate, motivated investors can influence corporate behavior by tying receipt of capital to environmental and social considerations.[87]

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83. Not surprisingly, mutual funds dedicated to the opposite of SRI, so-called "sin" funds, have also attracted investors. For example, the USA Mutuals Vice Fund invests in "companies that derive a significant portion of their revenues from a group of vice industries that includes the alcoholic beverages, defense/aerospace, gaming and tobacco industries." USA Mutuals, Registration Statement (Form N-1A) (July 26, 2018). "Sin" mutual funds, however, have not had a fraction of the success of SRI mutual funds, perhaps because these funds "border a very thin line between insult and profit." Shauna Carther Heyford, *Socially (Ir)responsible Mutual Funds*, INVESTOPEDIA (Apr. 26, 2017), https://www.investopedia.com/articles/mutualfund/03/031903.asp [https://perma.cc/S2YS-9SVF].

84. Joan Shapiro, *The Movement since 1970*, *in* THE SOCIAL INVESTMENT ALMANAC: A COMPREHENSIVE GUIDE TO SOCIALLY RESPONSIBLE INVESTING 8, 10–11 (Peter Kinder et al. eds., 1992).

85. *See* Louche & Lydenburg, *supra* note 3, at 393–94.

86. Promotional materials for the Ave Maria Bond Fund, for example, advertise both the fund's multiple positive calendar-year-end returns and the fund's investment commitment to the "core values and teachings of the Roman Catholic Church." *Bond Fund*, AVE MARIA MUTUAL FUNDS, https://avemariafunds.com/fund-family/avefx.html [https://perma.cc/DDM9-L8BZ] (last visited Jan. 27, 2020). For a more secular example, the John Hancock ESG Large Cap Core Fund is advertised as investing in "high-quality stocks" giving investors "diversified exposure to the U.S. market" while also adhering to "a very high level of environmental, social, and governance criteria." *John Hancock ESG Large Cap Core Fund Overview*, JOHN HANCOCK INVESTMENTS (Nov. 2018), https://www.jhinvestments.com/john-hancock-esg-large-cap-core-fund-overview [https://perma.cc/N2AR-UDWN].

87. *See* Benjamin Richardson, *Financial Markets and Socially Responsible Investing*, *in* COMPANY LAW AND SUSTAINABILITY: LEGAL BARRIERS AND OPPORTUNITIES 226, 234 (Beate Sjåfjell et al. eds., 2015).

This Note suggests that it is necessary for observers to understand the non-financial expectations that SRI investors attach to their investment (what this Note terms as a "consumption value") in order to effectuate meaningful investor protection under § 36(b). The history of SRI as a movement and the methods through which it is practiced provide an important backdrop to these expectations. Part III.A of this Note therefore lays out the strategies an SRI mutual fund might pursue in order to achieve its ethical goal. Part III.B discusses the conflicting studies on the objective benefits, both financial and non-financial, of SRI. Part III.C then explains that, despite these unclear objective outcomes, the subjective expectations of SRI investors (conceptualized as the consumption value of investing) provide a sufficiently clear investor interest that SRI fund directors are obliged to protect.

A. THE SRI MUTUAL FUND INDUSTRY IN PRACTICE

Among the most popular SRI financial products available to the investing public are SRI mutual funds. The SRI mutual fund industry has grown exponentially in the U.S. in the decade following the financial crisis.[88] Between 1995 and 2018, assets under management in the industry increased eighteen-fold,[89] and the total number of SRI mutual funds increased by fifty percent from 2016 to 2018 alone.[90]

SRI mutual funds generally attempt to ethically invest through at least one of two strategies. The first approach is through portfolio screening, an investment strategy wherein a fund's portfolio manager avoids (in a negative screen) or favors (in a positive screen) certain companies and industries that are either ethically questionable or laudable. The second approach is corporate engagement, wherein the fund, as a shareholder of other companies, engages with management either informally or through shareholder resolutions to change corporate behavior.[91] Of the two

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88. Tim Gray, *Follow Your Conscience Without Losing Your Shirt*, N.Y. TIMES (Jan. 17, 2016), https://www.nytimes.com/2016/01/17/business/mutfund/follow-your-conscience-without-losing-your-shirt.html [https://perma.cc/27NW-RTKH].

89. US SIF FOUND., 2018 REPORT ON US SUSTAINABLE, RESPONSIBLE AND IMPACT INVESTING TRENDS 1 (2018), https://www.ussif.org/files/Trends/Trends%202018%20executive%20summary%20FINAL.pdf [https://perma.cc/N9EV-P6VV].

90. *SRI Basics*, US SIF FOUND., https://www.ussif.org/sribasics [https://perma.cc/MLF6-9JEU] (last visited Jan. 27, 2020).

91. Richardson, *supra* note 87, at 233.

approaches, screening strategies are most common. According to a 2018 survey of 182 SRI mutual funds, 124 of those funds (i.e., sixty-eight percent) had adopted some form of a corporate engagement strategy, whether through shareholder resolutions or through informal dialogue with corporate management, while every fund surveyed adopted a variety of different positive and negative screens based on varied criteria.[92]

SRI screening strategies generally consider four categories of interest: religious or ethical concerns, environmental performance, social considerations (like a company's labor or human rights record), and corporate governance (a category which focuses on "those companies that are open towards shareholder resolutions and active engagement by investors with the board of directors").[93] The latter three categories are often referred to as a company's "Environmental, Social, and Governance" (or ESG) factors. Satisfactory investments "pass through" a fund's screen, based either on the fund manager's own criteria (stated in the fund's prospectus)[94] or on a security's inclusion on one of several "pre-selected" SRI benchmark indices, which are in turn composed of companies that meet that index's ESG criteria.[95]

Screening strategies, though generally straightforward, present complications for SRI fund managers. Managers using a negative screening strategy, for example, may find it difficult to evaluate conglomerates with multiple lines of business, some of which might pass the fund's screen while others may fail. Meanwhile, managers using a positive screen must accept that some ESG criteria are non-quantifiable or difficult to judge, leaving portfolio inclusion decisions to the manager's own professional judgment.[96]

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92. *See Sustainable, Responsible and Impact Mutual Fund and ETF Chart*, US SIF FOUND. (Dec. 31 2018), https://charts.ussif.org/mfpc [https://perma.cc/2ZA2-TWUN].

93. HUNG-GAY FUNG ET AL., SOCIALLY RESPONSIBLE INVESTMENT IN A GLOBAL ENVIRONMENT 26 (2010).

94. The prospectus for the Parnassus Endeavor Fund, for example, states that the fund will invest in the common stock of companies based on a judgment from the portfolio manager "as to which companies have good workplaces based on factors such as respectful and fair treatment of employees, good two-way communication, equitable pay and benefits, family-friendly policies and support for volunteerism and charitable contributions to the community." Parnassus Funds, Registration Statement (Form N-1A) (Apr. 30, 2018).

95. *See, e.g.*, Index Family Overview, ROBECOSAM AG, https://www.sustainability-indices.com [https://perma.cc/Z3YH-CADX] (last visited Jan. 27, 2020). *See also S&P 500 Environmental & Socially Responsible Index*, S&P DOW JONES INDICES, https://us.spindices.com/indices/equity/sp-500-environmental-socially-responsible-index [https://perma.cc/44KR-HUU6] (last visited Jan. 27, 2020).

96. FUNG ET AL., *supra* note 93, at 28.

Corporate engagement via shareholder activism by SRI mutual funds is another potential investment strategy. More than two hundred institutional investors filed ESG-related shareholder resolutions between 2016 and 2018.[97] Investors in these actively-engaged SRI funds are aided by a 2003 SEC rule requiring mutual funds to disclose their policies and procedures for proxy voting with regard to securities in their portfolios.[98] Prior to the SEC rule, most portfolio managers followed the "Wall Street Rule,"[99] and supported management in voting decisions as a default — simply selling the stock in question if major disagreements ever arose between the portfolio manager and the company.[100] As such, before the SEC rule was enacted, "a majority of the nation's one hundred largest mutual funds opposed all social issue shareholder resolutions" on the grounds that their financial impact would be too uncertain.[101] Now, however, activist investors can more easily select funds that pledge to vote on social issues in certain ways.

Of these strategies, it is perhaps positive screens that present the highest risk of greenwashing. The ESG standards adopted by positive-screened SRI funds can be vague, and their application to portfolio companies unclear.[102] These factors together combine to create a heightened risk that consumers can be misled or underserved when investing in positive-screened funds.[103]

B. EVALUATING THE PURPORTED FINANCIAL BENEFITS OF SRI

The appeal of SRI to investors lies in its promise of an ethical and financial double bottom line — SRI mutual funds promise to let investors "do well by doing good."[104] Indeed, proponents of the SRI movement and SRI fund managers have both framed the movement's appeal in terms of its "ability to build both natural and

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97. *See SRI Basics*, *supra* note 90.

98. 17 C.F.R. § 275.206(4)-6 (2018).

99. *See* JOHN C. COFFEE ET AL., SECURITIES REGULATION: CASES AND MATERIALS 46 (13th ed. 2015) ("[M]utual funds . . . have remained relatively passive, content largely to follow the traditional 'Wall Street rule' of selling stocks when they disapproved of their managements, but seldom challenging them openly.").

100. James E. Heard, *Fiduciary Duty and Institutional Shareholder Activism*, *in* THE SOCIAL INVESTMENT ALMANAC: A COMPREHENSIVE GUIDE TO SOCIALLY RESPONSIBLE INVESTING 100, 102 (Peter Kinder et al. eds., 1992).

101. BENJAMIN RICHARDSON, SOCIALLY RESPONSIBLE INVESTMENT LAW: REGULATING THE UNSEEN POLLUTERS 314–15 (2008).

102. *See* Morphic Asset Management, *supra* note 15.

103. *See supra* Part I (discussing public concerns over unregulated SRI funds).

104. Blodget, *supra* note 5.

financial capital."[105] While the purported financial benefits of SRI have been heavily contested by economists, the ethical and psychological effects of SRI, while not always economically measurable or rational, constitute a non-financial value that SRI investors derive from their investment.

For some modern SRI investors, there is no underlying activist motivation guiding their investment decisions. Instead, for many investors, SRI is primarily a morally neutral form of long-term financial risk management. The ESG factors discussed above are often of interest to investors not for ethical reasons, but because corporate decisions which impact a company's ESG factors could also easily impact its financial return.[106] A company with a poor human rights record or one that mistreats its workers, for example, is not only ethically compromised but also suffers from real reputational and regulatory risks should the public choose to boycott it or regulators choose to impose sanctions over its policies. As such, this "SRI-as-risk-hedging" approach serves to protect investors from future risk of loss.[107] Over a long enough span, SRI proponents argue, "firms behaving in a manner that is not environmentally sound [or that] have poor management of social issues . . . will eventually crumble, and succumb to the firms that conduct themselves in a sustainable manner," enhancing the value of SRI portfolios in the long term.[108]

Ethicist Russell Sparkes, an early champion of SRI, has suggested that there are factors inherent to SRI that make it not only probable, but inevitable that SRI funds will outperform similar

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105. RICHARDSON, *supra* note 101, at 159.

106. *See* Richardson, *supra* note 87, at 240.

107. As an illustration, activist movements like the Extinction Rebellion have called on institutional endowments to divest from publicly-traded oil and gas companies — citing not just the moral laxity of profiting from companies contributing to the ongoing climate crisis, but also because of the as-of-yet unrealized "stranded asset risk" such investments pose to the endowments. *See, e.g.*, Extinction Rebellion, *An Antidote to Toxic Risk: The Case for Total Divestment from Fossil Fuels*, COLUM. DAILY SPECTATOR (Feb. 13, 2020), https://www.columbiaspectator.com/opinion/2020/02/14/an-antidote-to-toxic-risk-the-case-for-total-divestment-from-fossil-fuels/ [https://perma.cc/DCU6-WFJQ] (calling on Columbia University's endowment to divest from oil and gas companies, as "[f]ossil fuels are rapidly becoming stranded assets, creating a carbon bubble that threatens to burst if left unchecked"). Stranded asset risk is the risk that future changes in the regulation and consumption of fossil fuels will adversely impact the value of untapped fuel reserves, which would in turn devalue the stock of any companies holding significant assets in these reserves — suggesting that investors in those stocks should sell them while the risk is not yet realized. *See* Alan S. Miller & Stacy A. Swann, *Climate Change and the Financial Sector: A Time of Risk and Opportunity*, 29 GEO. INT'L ENVTL. L. REV. 69, 92–93 (2016).

108. FUNG ET AL., *supra* note 93, at 49.

non-SRI portfolios.[109] SRI funds can benefit from an "anticipation effect" wherein, by excluding certain morally-repugnant firms, SRI portfolios avoid the sorts of reputational and legal risks to its portfolio discussed above.[110] Sparkes credits most of SRI's inherent financial benefit, however, to its "information effect."[111] For SRI funds to meet their ethical mandate, whether by screening companies on ESG factors or by actively participating in corporate engagement, SRI portfolio managers must be highly knowledgeable at all times about the companies they invest in and the SRI strategies they are employing. This encourages portfolio managers to be engaged and active analysts and stock-pickers, which, when averaged out over the whole of the mutual fund industry, can give SRI portfolio managers an informational advantage over other non-SRI mutual fund managers.

Other economists, however, have been more critical of the financial argument for SRI. For instance, in a survey of SRI portfolios, economist Jeffrey Teper found that there was a consistent cost to SRI which, while varying with specific portfolio goals and strategies, amounted roughly to a one percent reduction in annualized return for SRI equity portfolios compared to equivalent non-restricted investments.[112] Teper speculates that this could be the result of several different factors inherent to SRI. For one, SRI portfolios that actively respond to changing ESG factors may incur higher transaction costs than a portfolio that has no need to respond to non-economic company developments.[113] An SRI fund, for example, may be required to liquidate its shares in a company that has recently announced a new environmentally-unfriendly policy, incurring both transaction costs and potential losses on the sale, while a similarly-positioned non-SRI fund could continue to hold that stock and incur no such costs. Additionally, SRI funds suffer serious diversification costs from the possibility that an SRI fund might need to exclude entire asset classes from its holdings — for

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109. RUSSELL SPARKES, SOCIALLY RESPONSIBLE INVESTMENT: A GLOBAL REVOLUTION 272 (2002).

110. *Id.*

111. *Id.* at 273.

112. Jeffrey A. Teper, *Evaluating the Cost of Socially Responsible Investing*, *in* THE SOCIAL INVESTMENT ALMANAC: A COMPREHENSIVE GUIDE TO SOCIALLY RESPONSIBLE INVESTING 340, 349 (Peter Kinder et al. eds., 1992).

113. *Id.* at 343.

example, "not investing in international equities because it may be too difficult to monitor social responsibility."[114]

Professor Michael Knoll, while also critical of SRI strategies, has reached a different conclusion. Professor Knoll agrees with proponents of SRI in concluding that screening strategies do not impose any significant costs on SRI portfolio returns.[115] However, for Professor Knoll, this is attributable to SRI's inability to influence companies' actual business practices. Per Professor Knoll, "the available evidence suggests that long-run demand curves for the securities of individual firms are not so steep that screening will have a substantial long-run impact on targeted firms' stock prices[,]" meaning that screening has no real substantial impact on targeted firms' stock price and, as a result, cannot influence those firms' activities.[116]

C. THE CONSUMPTION VALUE AS A WAY OF CONCEPTUALIZING SRI'S NON-FINANCIAL BENEFITS

Despite the decidedly ambiguous financial outcome that an SRI strategy creates for a mutual fund portfolio, it would be a mistake to discuss SRI funds solely in terms of the financial returns that their investors expect. As discussed, SRI is, at its core, predicated on values that, while tied to potential financial gain, go beyond pure profit. SRI investors are also concerned about the *ethics* of their investment — both from a deontological or process-oriented perspective (focusing on the inherent rightness or wrongness of the investment) and from a teleological or outcome-oriented perspective (focusing on the consequences of a particular investment's effect).[117] The benefits that investors derive from following these ethical precepts are not quantifiable in the way that a financial return would be. Nevertheless, the benefits are, for ideological SRI investors, just as real, even if only amounting to the "feel good satisfaction" of "doing the 'right thing.'"[118]

This non-financial benefit, which can be thought of as a sort of ethical dividend, is a significant component of the return on

114. *Id.* at 342–43.
115. Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681, 726 (2002).
116. *Id.*
117. RICHARDSON, *supra* note 101, at 84–85.
118. FUNG ET AL., *supra* note 93, at 48.

investment that SRI generates.[119] A survey of investors in SRI mutual funds found that they viewed their investments in two ways: referring, on the one hand, "to their desired level of return[,] and [on] the other [to] their expectation of corporate social responsibility in terms of 'affirmative' and 'avoidance' behaviors."[120] This expectation of non-financial benefit can be fulfilled by any number of different aspects of the socially responsible investment. One study referred to this benefit as a gain in "utility from the social outcomes" of ethical investments.[121] The same study characterized SRI investors as "consumption-investors" and attributed the motivations for their investments to "fashion" or the need to "feel good because they are engaging in an activity that is viewed as desirable by their peer group."[122] Another study found that many investors buying into SRI mutual funds did so with only a portion of their total invested funds, suggesting that those investors were utilizing SRI to "assuage their guilty consciences" and legitimize their concurrent holdings of non-restricted investments.[123]

For other investors, this ethical dividend derives from a different, new definition of "wealth creation," distinct from profit maximization, which includes such factors as "increased productivity, product innovation, and having less impact on the environment."[124] Professor John Langbein and Judge Richard Posner have characterized the collective non-financial values that SRI investments generate as a "consumption value" and theorize that the desire for this benefit drives SRI mutual fund investors.[125]

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119. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 784 (2005) ("An increasing number of investors now put their money in funds committed to avoid investments in corporations that create environmental harms, make tobacco, alcohol, or weapons, or engage in some other activity that conflicts with various conceptions of the public interest. . . . For such shareholders, their welfare reflects a combination of their financial returns and their social or moral satisfaction with corporate activities.").

120. Barry N. Rosen et al., *Social Issues and Socially Responsible Investment Behavior: A Preliminary Empirical Investigation*, 25 J. CONSUMER AFF. 221, 231 (1991).

121. Diana Beal et al., *Why Do We Invest Ethically?*, 14 J. INVESTING 66, 70 (2005).

122. *Id.* at 73.

123. Craig Mackenzie & Alan Lewis, *Morals and Markets: The Case of Ethical Investing*, 9 BUS. ETHICS Q. 432, 450 (1999).

124. FUNG ET AL., *supra* note 93, at 49.

125. John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72, 94 (1980) ("It is not only possible, it is strongly implied by economic theory, that people who choose to invest in mutual funds dedicated to social investing derive a consumption value from their investment, since the pure investment value is, at least on an expected basis, inferior to that of alternative investment vehicles.").

Considering the ambiguity surrounding the financial benefits that SRI strategies may or may not generate for investors, this consumption value should be treated as a major reason why investors buy into SRI products to begin with, or else their investment decisions would appear to be irrational. Even though the impact that SRI has on corporate behavior is exceedingly difficult to demonstrate,[126] consumption value is as much psychological for SRI investors as it is outcome-oriented. Given that the SRI mutual fund industry has continued to grow quite significantly in recent years despite the well-publicized concerns over its financial outcomes,[127] it stands to reason that the benefit of consumption value has motivated many of these investors to purchase shares in SRI mutual funds, no matter those funds' potential financial returns. Far from being a frivolous concern of unserious and unsophisticated investors, SRI investors are serious and educated consumers.[128] As such, the pursuit of consumption value should be treated seriously by SRI fund directors and managers as well, insofar as it is a significant component of the value of a given shareholder's investment. By recognizing the expectation of this value as a legitimate investor interest, § 36(b) actions can be used as an avenue to ensure that SRI funds pursue SRI goals, without needing to raise the question of those funds' financial performance.

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126. *See* William Sanders, *Resolving the Conflict Between Fiduciary Duties and Socially Responsible Investing*, 35 PACE L. REV. 535, 543 (2014) ("[I]t is impossible for nonfinancial screening to change corporate behavior while remaining costless to the investor."). For some, fundamental financial theories suggest that SRI should struggle to actually have an effect on a given firm's behaviors through its stock price, whether that firm's stock is excluded or preferred based on its ESG factors. Because, pursuant to the efficient capital markets theory, a firm's stock price incorporates all publicly-available information about that firm, that price also reflects investors' overall expectations as to the firm's value and potential earnings. *See* COFFEE ET AL., *supra* note 99, at 214–18. Should any given investor act on a given stock in such a way that the stock's price may deviate from its underlying economic fundamentals, other investors will immediately react such that the imbalance is corrected. Therefore, if SRI investors' demand for a given ethical firm's stock is enough to increase that stock's price above its "market" value, other non-SRI investors will sell their shares of that firm, thereby increasing the supply of that firm's stock on the open market and eventually returning the stock's price to where it started. *See e.g.*, Knoll, *supra* note 115, at 702–10 (discussing whether SRI can change corporate behavior).

127. *See supra* Part I.

128. *See* Rosen et al., *supra* note 120, at 226 ("Socially responsible investors are better educated than [general mutual fund investors] with 60 percent of SRIs having graduate degrees.").

IV. ENSURING THAT SECTION 36(B)'S FIDUCIARY STANDARD IS PROPERLY APPLIED TO SRI FUNDS

Keeping in mind the consumption value that SRI investors hope to obtain, the directors of SRI mutual funds should also be expected to evaluate SRI mutual fund managers' ability to deliver on investors' expectation of consumption value if they are to fulfill the fiduciary standard set out by § 36(b). This is achievable under the test established by *Gartenberg* and *Jones* but requires that courts take a more holistic view of some of the factors set out in that framework.

Under the *Gartenberg* test, SRI fund directors must consider "the nature and quality of the [manager's] service" and the "expertise of the independent trustees of a fund," including "whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties."[129] A claim under § 36(b) suggesting, for example, that a board has failed to properly choose a well-equipped SRI manager, though novel,[130] would be consistent with § 36(b)'s goal in confirming "the duty of the directors to evaluate such information [necessary to evaluate the management contract] in accordance with the best interests of the fund and its shareholders."[131]

Section 36(b) lawsuits provide a template as to how that right of action can be applied to SRI funds. Part IV.A discusses ways in which the *Gartenberg* factor requiring consideration of the nature and quality of a fund manager's services can be applied properly to SRI funds, while Part IV.B likewise explains how the *Gartenberg* factor requiring directors be informed of their duties can be applied to SRI funds.

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129. Gartenberg v. Merrill Lynch Asset Mgmt., 694 F.2d 923, 930 (2d Cir. 1982).

130. Issues over the performance of SRI investments have rarely been litigated, and, to the author's knowledge, no claims have yet been raised by SRI fund investors regarding the selection of and fees charged by SRI mutual fund managers. George Djurasovic does identify one similar dispute which the SEC ultimately chose not to prosecute, in which an investor in the Freedom Environmental Fund sued after learning that the fund had holdings in companies that had been cited by the U.S. Environmental Protection Agency (EPA) for dumping toxic waste into rivers. *See* George Djurasovic, *The Regulation of Socially Responsible Mutual Funds*, 22 J. CORP. L. 257, 276 (1997).

131. S. REP. NO. 91-184, at 15 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4910.

A. THE NATURE AND QUALITY OF SRI PORTFOLIO MANAGER SERVICES

The first *Gartenberg* factor that should be treated differently for SRI funds is the requirement that mutual fund directors consider the "the nature and quality of the [manager's] service" when choosing to renew an investment advisory contract.[132] This is in essence a test of performance, meant to ensure that directors evaluate whether fund managers are generating adequate returns on investment in exchange for the fee the fund is paying them. In most § 36(b) excessive fee litigation, directors' compliance with this factor is met by examining a fund's overall performance "us[ing] mutual funds pursuing similar investment strategies as comparators."[133] Directors generally compare mutual funds with similar strategies on the basis of their returns (often in reference to a shared index) and the fees charged by their manager.[134] This comparison approach is useful for courts because it helps ensure that fund managers are charging a reasonable fee for the value they are generating for investors, based on what fees are generally available in the mutual fund marketplace. In *Chill v. Calamos Advisors LLC*, for example, the district court, in applying the *Gartenberg* test, found that evidence that the defendant fund charged higher fees than its peers and underperformed those same peers created a triable issue of fact whether the defendant fund's directors had properly considered the nature and quality of services that the fund was receiving from that underperforming manager.[135]

Though most excessive fee litigation considers the *financial* quality of services that fund managers provide, this factor can be easily transposed into the SRI context. As the Seventh Circuit noted in *Jones* on remand, the question of the quality of services that fund managers deliver is ultimately a question of whether the

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132. *Gartenberg*, 694 F.2d at 929–30.

133. *Turner ex rel. Davis N.Y. Venture Fund v. Davis Selected Advisers, LP*, 626 F. App'x 713, 717 (9th Cir. 2015).

134. *See, e.g.*, Zehrer v. Harbor Capital Advisors, Inc., No. 14 C 00789, 2018 WL 1293230, at *11 (N.D. Ill. Mar. 13, 2018) ("[The defendant board of directors] argues that the Funds have performed at least as well as comparable funds. Specifically, [defendant] points out that [the fund] has exceeded its benchmark over the last 10-year and 25-year periods, by 4.43% and 5.34% net of fees, respectively[.]") (citations omitted).

135. No. 15 CIV. 1014 (ER), 2018 WL 4778912, at *20 (S.D.N.Y. Oct. 3, 2018) ("Calamos charged more than most other investment advisers; the Fund performed worse than most comparable mutual funds[.]").

managers "delivered value for money."[136] For SRI funds, investors still expect value for money; however, a portion of this value will be non-financial.[137] This non-financial portion — the consumption value — though not quantifiable in the way normal investment performance is, remains an integral part of the value proposition that SRI fund investors seek in exchange for the management fee they pay. As such, fidelity to the *Gartenberg* test requires that directors evaluate whether managers properly generate consumption value at a similar level to peer funds. How to best ensure that directors properly evaluate a manager's non-financial performance, however, remains an open issue.[138]

B. ENSURING THE CONSCIENTIOUSNESS OF SRI FUND DIRECTORS

Gartenberg also requires directors to consider "the expertise of the independent trustees of a fund" and "the extent of care and conscientiousness with which they perform their duties," including whether they are "fully informed about all facts bearing on the adviser-manager's service and fee."[139] This attention to fund director procedure is a reflection of congressional intent in passing § 36(b), which was to "rely largely upon independent director 'watchdogs' to protect shareholders' interest."[140] The Supreme Court elaborated on the extent of this obligation on fund boards in *Jones*, noting that boards are expected to exercise "a host of special responsibilities"[141] and "scrutin[ize] investment adviser compensation[.]"[142]

The conscientiousness factor is a reflection of congressional intent that § 36(b) guarantee that the "responsibility for managing an investment company in the best interest of its shareholders" is left to the directors of that company.[143] Ensuring that fund directors are conscientious of the best interests of shareholders is especially important for investors in SRI funds. While most managers

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136. Jones v. Harris Assocs. L.P., 611 F. App'x 359, 361 (7th Cir. 2015).

137. *See supra* Part III.C.

138. For a discussion of this issue, *see infra* Part VI.

139. Gartenberg v. Merrill Lynch Asset Mgmt., Inc., 694 F.2d 923, 930 (2d Cir. 1982).

140. Jones v. Harris Assocs. L.P., 559 U.S. 335, 353 (2010) (alteration in original) (quoting Burks v. Lasker, 441 U.S. 471, 485 (1979)).

141. *Id.* at 340 (quoting *Burks*, 441 U.S. at 482–83).

142. *Id.* at 348.

143. S. REP. NO. 91-184, at 7 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

and other people employed in the mutual fund industry are presumably aware of the expectations of traditional investors (namely, to deliver risk-adjusted financial returns), multiple studies have suggested that "internal investment institutions' conventions and culture do not encourage analysts and investors to consider EGS [*sic*] information."[144] Fund boards must be capable of understanding and pursuing the development of SRI fund shareholders' consumption value.

Expanding the *Gartenberg* test for SRI funds to explicitly take into account the consumption value that their investors hope to obtain would be, in many ways, a step into uncharted territory for fund directors. It is, in some respects, a step into uncharted territory for securities laws generally — the Supreme Court has traditionally drawn a sharp distinction between commodities purchased for their consumptive use and securities purchased for their promise of investment return.[145] There are no real existing standards to evaluate mutual fund directors' consideration of the quality of non-financial performance or their expertise in socially responsible business decisions. Rather than trying to fashion an entirely new standard, however, SRI fund directors can find guidance in the legal treatment of public benefit corporations.

V. THE PUBLIC BENEFIT CORPORATION AS A MODEL FOR PROTECTING THE NON-FINANCIAL INTERESTS OF SHAREHOLDERS

Public benefit corporations (also referred to as benefit corporations) are a recent innovation in state corporate law. They are corporations which "have an expanded purpose beyond maximizing share value to explicitly include general and specific public benefit" and "are required to consider/balance the impact of their decisions not only on shareholders but also on their stakeholders[.]"[146]

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144. Hager Jemel-Fornetty et al., *Changing the Dominant Convention: The Role of Emerging Initiatives in ESG*, *in* FINANCE AND SUSTAINABILITY: TOWARDS A NEW PARADIGM? A POST-CRISIS AGENDA 85, 89–90 (William Sun et al. eds., 2011).

145. *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 852–53 (1975) ("[W]hen a purchaser is motivated by a desire to use or consume the item purchased . . . the securities laws do not apply."). As the Court observed in that same opinion, however, certain transactions may offer investors both "a commodity . . . for use and an expectation of profits" in such an entwined way that application of securities laws to these transactions would "raise difficult questions" that the Court declined to address in that instance. *Id.* at 853 n.17.

146. *Benefit Corporations FAQ*, B LAB, https://benefitcorp.net/faq [https://perma.cc/4JWJ-ABY5] (last visited Jan. 12, 2020).

Benefit corporations are distinct from SRI funds in a number of critical ways: a benefit corporation is specifically chartered as such, and specific provisions of state business codes regulate benefit corporations, while SRI funds are governed by the general rules of the 1940 Act. Nonetheless, the principles behind the laws regulating benefit corporations can apply coherently to the fiduciary issues facing SRI funds.[147]

Benefit corporations are a new corporate form available in thirty-six states[148] (including the three states in which mutual funds are usually incorporated:[149] Delaware,[150] Maryland,[151] and Massachusetts[152]) and are regulated in each state by broadly similar benefit corporation statutes. In each state, benefit corporations are for-profit businesses which have the "duty to secure profits for the shareholders while considering the socially beneficial purposes of the corporation."[153] Using Maryland's code as an example, benefit corporations must "have the purpose of creating a general public benefit,"[154] meaning "a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits."[155] Though there has been hardly any litigation concerning directors' fiduciary duties in benefit corporations,[156] this

147. This is not to suggest that public benefit corporate codes are actually binding on SRI mutual funds, or indeed any other corporate form. Such codes make clear that the rules governing public benefit corporations do not extend to or modify existing regulations on other corporations. *See, e.g.*, DEL. CODE ANN. tit. 8, § 368 (West 2013) ("This subchapter shall not affect a statute or rule of law that is applicable to a corporation that is not a public benefit corporation[.]"). Rather, this Note seeks to suggest that there is a sufficient identity of interest between SRI investors and public benefit corporation investors that the rules governing the investor relations for the latter provide a useful roadmap for the former.

148. *State by State Status of Legislation*, B LAB, https://benefitcorp.net/policymakers/state-by-state-status [https://perma.cc/LN9L-462X] (last visited Jan. 12, 2020).

149. *See supra* Part II.A.

150. DEL. CODE ANN. tit. 8, §§ 361–368 (West 2013).

151. MD. CODE ANN., CORPS. & ASS'NS §§ 5-6c-01 to 5-6c-08 (West 2012). Public benefit corporations are simply called "benefit corporations" under Maryland law. *Id.*

152. MASS. GEN. LAWS ANN. ch. 156E, §§ 1–16 (West 2012). Public benefit corporations are also called "benefit corporations" under Massachusetts law. *Id.*

153. Marc J. Lane, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 128 (2011).

154. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06(a)(1) (West 2012).

155. *Id.* § 5-6C-01(c).

156. *See* Alicia E. Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In*, 14 U.C. DAVIS BUS. L.J. 247, 249 (2013) ("The public benefit corporation and other corporate forms with similar grounding . . . are untested, and characterized by ambiguity and uncertainty."); *see also* Lane, *supra* note 153, at 128 ("The body of law governing fiduciary duties in the benefit corporate setting is scant."). Since the publications of these

requirement translates into an additional responsibility for benefit corporation directors to take into account the interests of parties other than corporate shareholders and to provide shareholders information on how well the corporation has created a general public benefit.

This Part of the Note argues that the concerns that shaped the development of public benefit corporate codes are sufficiently similar to the concerns highlighted above regarding SRI funds. As such, the fiduciary duties laid out in these codes can provide guidance to SRI fund directors seeking to meet their obligations under § 36(b). Part V.A begins by explaining that both benefit corporation investors and SRI investors attach unique non-financial expectations to their investment, and that these shared expectations shape the obligations of all parties involved in those corporations. The next two subparts elaborate on the special duties required of benefit corporation directors: Part V.B describes how public benefit fiduciary duties differ from traditional corporations, while Part V.C discusses the requirement that benefit corporation directors regularly report on whether the corporation is meeting its beneficial goal.

A. SIMILARITIES BETWEEN SRI FUND INVESTORS AND BENEFIT CORPORATION INVESTORS

As different as the legal structures of SRI funds and benefit corporations may be, they share a key commonality: investors in both corporate forms seek a consumption value payout alongside financial performance. Benefit corporations attract "social investors" alongside traditional wealth-maximization-oriented investors.[157] While social investors in benefit corporations do not treat benefit corporations as charities — they expect financial returns — social investors are also motivated by broad non-financial considerations

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articles, there has not been, to the author's knowledge, any significant litigation on this subject.

157. Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TRANSACTIONS: TENN. J. BUS. L. 221, 252 (2012) (a benefit corporation is "likely to attract . . . impact investors and social investors"); *see also* Sean W. Brownridge, *Canning Plum Organics: The Avant-Garde Campbell Soup Company Acquisition and Delaware Public Benefit Corporations Wandering* Revlon-*Land*, 39 DEL. J. CORP. L. 703, 725 (2015) ("[B]enefit corporations likely attract social investors concerned with more than wealth maximization[.]").

in pursuing consumption value.[158] These two groups of investors are not just overlapping sets but are also often the very same entities. Indeed, in many cases the social investors in benefit corporations *are* SRI funds.[159] Benefit corporations are structured to ensure that social investors' consumption value expectations are met. The unique fiduciary duties imposed on benefit corporation directors obligate those directors to pursue public benefits,[160] with potential legal consequences if they fail to do so.[161]

Additionally, though benefit corporations (and, by extension, SRI funds) must be uniquely attuned to investors' non-financial expectations, it would be unwise to treat these new fiduciary standards as wholly unprecedented in the law. The idea that a corporation operates "primarily for the profit of [its] stockholders" has long been ascendant in in U.S. corporate law, dating back at least to the 1919 decision in *Dodge v. Ford Motor Co.*[162] This conception of shareholder primacy holds true for benefit corporations and for SRI funds, even though a portion of their profit will be non-financial in the form of consumption value.

Professor Alicia Plerhoples characterizes the distinct set of expectations between social investors and directors as a "modified contract" that shapes the norms that ought to govern benefit corporations.[163] Professor Plerhoples' argument flows from the "nexus of contracts" theory of corporations, which imagines the corporation as a legal entity composed of the contractual relations between

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158. Plerhoples, *supra* note 157, at 253–54 (Social investors are "investors who make investment decisions based wholly or in part on non-financial considerations. This is not to say that impact or social investors wholly subordinate their profit-making preferences to the achievement of social and environmental results; many impact and social investors expect to realize financial returns equal to those of traditional investments, although many also expect to make less.").

159. *See id.* at 252 ("[T]he [benefit] corporation is likely to attract impact and social investors, including sustainable and responsible investing funds[.]").

160. *See* Brett H. McDonnell, *Committing to Doing Good and Doing Well: Fiduciary Duty in Benefit Corporations*, 20 FORDHAM J. CORP. & FIN. L. 19, 34 (2014).

161. *See* Brett H. McDonnell, *Benefit Corporations and Public Markets: First Experiments and Next Steps*, 40 SEATTLE U. L. REV. 717, 719 (2017) ("The revised fiduciary duty of benefit corporations may also help ensure that they pursue their dual missions, with a greater chance of suits being brought . . . if the corporation fails to pursue their dual mission.").

162. *See* 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.").

163. Plerhoples, *supra* note 157, at 254.

investors, directors, and officers, in which the obligations of each party are shaped by the contractual expectations of the others.[164] Social investors buy into benefit corporations fully aware of the fact that they are investing in a company "fundamentally different than a traditional profit-maximizing corporation."[165] They want consumption value from their investments, and the expectation that the corporation will pursue that benefit is an implicit part of the bargain struck between the investor and the corporation.

Benefit corporation codes, in fact, take pains to ensure investors are aware of exactly what they are buying into. Delaware, for example, requires that benefit corporations "shall, prior to issuing unissued shares of stock or disposing of treasury shares, provide notice to any person to whom such stock is issued . . . that it is a public benefit corporation."[166] Benefit corporation investors are thus on notice that their investments are in a non-traditional corporation which will have, as part of its payout, a heightened consumption value. Some commenters have expressed surprise that benefit corporation codes would mandate this sort of notice for investors, but not for other potential parties contracting with a benefit corporation.[167] If benefit corporations are meant to look out for the interests of stakeholders other than their investors, why should the codes extend the protections of disclosure and director fiduciary duties only to investors?[168]

However, these limited notice requirements cohere to Professor Plerhoples' modified contract model. Rather than formally

164. *See* Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) ("The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships. . . . While this definition of the firm has little substantive content, emphasizing the essential contractual nature of firms and other organizations focuses attention on a crucial set of questions — why particular sets of contractual relations arise for various types of organizations, what the consequences of these contractual relations are, and how they are affected by changes exogenous to the organization.") (emphasis removed).

165. Plerhoples, *supra* note 157, at 254.

166. DEL. CODE ANN. tit. 8, § 362(c) (West 2015).

167. *See, e.g.*, David G. Yosifon, *Opting Out of Shareholder Primacy: Is the Public Benefit Corporation Trivial?*, 41 DEL. J. CORP. L. 461, 482 n.96 (2017) ("These stakeholders are apparently assumed to either have no interest in the public benefit status of the firm, or else to acquiesce in the cost of the public benefit by that cost being impounded into reduced wages for workers or increased prices.").

168. Professor Brett McDonnell argues that the right to sue to enforce benefit corporations' directors' fiduciary duties ought to extend beyond investors to other stakeholders. Noting that "the range of stakeholder interests is vast, and some of the stakeholder groups are quite large and ill-defined," Professor McDonnell nonetheless asks "[i]f benefit corporations are to be run for the benefit of a range of stakeholders, why not give them the right to enforce what is owed to them?" McDonnell, *supra* note 160, at 35 n.63.

expanding the groups of stakeholders benefit corporations are responsible to, benefit corporations are ultimately still responsible only to their shareholders. The need to disclose benefit status to investors, however, ensures that all investors are aware of the corporation's pursuit of increased consumption value. Benefit corporations, therefore, can comfortably pursue non-financial performance while remaining true to the doctrine of shareholder primacy.

This analysis maps onto investors in SRI mutual funds as well. Though SRI funds do not operate under statutory rules distinct from those governing traditional mutual funds in the way that benefit corporations do, the 1940 Act requires that all mutual funds disclose their investment policy in their prospectus,[169] and prohibits deviations from that policy without shareholder approval.[170] Investors in an SRI mutual fund, thus informed of the fund's investment policy in its prospectus, can also reasonably be assumed to expect and have bargained for the pursuit of a consumption value through their investment. The non-financial fiduciary duties that benefit corporation investors have implicitly bargained for, and that are guaranteed by statute, are, in this way, the same non-financial duties that SRI fund investors have bargained for with SRI mutual funds and should be likewise protected by § 36(b).

B. STATUTORY FIDUCIARY RESPONSIBILITIES OF BENEFIT CORPORATION DIRECTORS

What exactly, then, are the fiduciary duties that benefit corporation laws guarantee? The key characteristic of benefit corporation codes is their creation of a duty for directors to consider factors other than shareholder value maximization in performing their responsibilities. Maryland's code, for example, requires directors to consider the effects of corporate action on not only the "stockholders of the benefit corporation" but also "[t]he employees and

169. 15 U.S.C. § 80a-8(b)(2) (2012) ("Every registered investment company shall file . . . a registration statement . . . containing . . . a recital of all investment policies of the registrant[.]").

170. *Id.* § 80a-13(a)(3) ("No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities . . . deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement[.]").

workforce of the benefit corporation[,]" "[t]he interests of customers[,]" "[c]ommunity and societal considerations[,]" and "[t]he local and global environment[.]"[171]

Massachusetts' code requires benefit corporation directors to take these same considerations into account, along with "the effects of any action upon . . . the short-term and long-term interests of the benefit corporation, including benefits that may accrue to the benefit corporation from its long-term plans[.]"[172] Massachusetts' code also imposes an explicit duty of care on benefit corporation directors, requiring that directors consider these factors "using sound and reasonable judgment[.]"[173] Shareholders of a benefit corporation are given a corresponding cause of action against the breach of these corporate duties. In Massachusetts, benefit corporation investors can bring a "benefit enforcement proceeding" to enforce the "the general public benefit purpose and any specific public benefit purpose of a benefit corporation" in the event of a board's "failure to pursue or create general or specific public benefits set forth in its articles" or a "violation of a duty or standard of conduct" created by the benefit corporation statute.[174]

Although benefit corporation directors are required to consider the interests of non-shareholders, this duty is ultimately meant to benefit shareholders, not general beneficiaries of a benefit corporation's public purpose. Indeed, non-shareholder beneficiaries have no way to enforce a board's public benefit duties to non-shareholder constituents.[175] Likewise, decisions by a board of directors as part of their public benefit duties are entitled to deference under the business judgment rule, just as the financial decisions of a traditional corporation's board would be owed deference.[176] The business judgment rule grants directors deference when they act "based on a rational belief that their business judgment is in the best interests of the company."[177] In the case of benefit corporations, however, such interests include the creation of a public benefit. In the same way that benefit corporation directors must take into account the generation of a public benefit for their shareholders, SRI fund directors should be afforded deference under the

171. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a) (West 2015).
172. MASS. GEN. LAWS ANN. ch. 156E, § 10(a) (West 2012).
173. *Id.* § 10(b).
174. *Id.* § 14(a).
175. William H. Clark et al., BENEFIT CORPORATIONS, at A-23 (2014).
176. *Id.*
177. *Id.*

Gartenberg standard only when they are acting rationally to generate consumption value on behalf of investors.

C. REPORTING REQUIREMENTS FOR BENEFIT CORPORATIONS

Benefit corporation statutes also impose unique reporting requirements on corporate boards. The information intended for disclosure under these requirements can provide a useful analogue for courts and boards looking for information comparing different SRI fund managers' quality of service. Maryland's disclosure requirement, which is broadly similar to the ones in Delaware and Massachusetts, obligates benefit corporations to produce annually a "benefit report" that provides a description of "[t]he ways in which the benefit corporation pursued a general public benefit during the year and the extent to which the general public benefit was created" and "[a]ny circumstances that have hindered the creation by the benefit corporation of the public benefit[,]" along with "[a]n assessment of the societal and environmental performance of the benefit corporation prepared in accordance with a third-party standard[.]"[178]

This benefit report is basically a financial statement for a corporation's social and environmental performance. The requirement that the report be produced and compared against a third-party standard is meant to facilitate comparisons with other benefit corporations along standard measures.[179] Though the third-party standard which benefit corporations should use is not outlined in any statute, generally these standards "assess the effect of the benefit corporation on the interests of a variety of parties including the company's employees, workforce, subsidiaries, suppliers, customers, the general community, and the local and global environment."[180] In facilitating comparisons between benefit corporations, these reports serve the same purpose that information about peer funds serve fund directors in evaluating investment advisory agreements. The criteria which these standards apply could be easily translated into criteria for the evaluation of SRI funds' non-financial performance.

178. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-08(a) (West 2010).
179. Clark et al., *supra* note 175, at A-29.
180. *Id.* at A-31.

VI. PRACTICAL APPLICATIONS: A ROLE FOR BENEFIT CORPORATION PRINCIPLES IN THE 15(C) PROCESS FOR SRI FUNDS

With the importance of consumption value for SRI investors established and the basic principles of benefit corporation governance laid out, what practical application can these insights have for the directors of SRI funds seeking to meet their fiduciary duty? Section 36(b)'s standard bears most heavily on fund directors during the 15(c) process when their fund renews its management agreement.[181] The 15(c) process is a thorough review of fund performance and activity that can involve months of preparation on the part of the board and the adviser.[182] The *Jones* Court placed particular emphasis on the importance of the 15(c) process to the performance of directors' fiduciary duty, holding that "where the board's process [is] deficient or the adviser with[holds] important information, the court must take a more rigorous look at the outcome" of the renewal, since "the withheld information might have hampered the board's ability to function as an independent check upon the management."[183]

Typically, with an eye to the *Gartenberg* test, fund directors must request "all information as may reasonably be necessary to evaluate the terms of an advisory contract" from the adviser.[184] The scope of the 15(c) request is broad, touching on "all aspects of the advisory contract, not simply the advisory fee."[185] The Mutual Fund Directors Forum (Forum), in its collection of best practices for fund directors during the 15(c) process, provides a suggested list of what directors should request from the adviser which hints at the range of factors directors must consider.[186] Among other materials, the Forum recommends that directors request:

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181. *See supra* Part II.C (discussing the 15(c) process).

182. *Frequently Asked Questions About Mutual Fund Directors*, INDEP. DIRECTORS COUNCIL, https://www.idc.org/idc/issues/governance/composition/faqs/faq_fund_gov_idc [https://perma.cc/YYQ6-788P] (last visited Jan. 12, 2020) ("[T]he process of preparing for [the contract renewal] meeting is rigorous and takes several months, if not the entire year.").

183. Jones v. Harris Assocs. L.P., 559 U.S. 335, 351–52 (2010) (citation omitted).

184. Knickle, *supra* note 42, at 278.

185. *Id.* at 275–76.

186. MUTUAL FUND DIRECTORS F., BEST PRACTICES AND PRACTICAL GUIDANCE FOR MUTUAL FUND DIRECTORS 44 (2004) [https://perma.cc/FB8G-GEQA].

> a description of the services it provides to the fund, including services under the advisory contract[;] a discussion of its philosophy for setting fees of a fund, its profitability goals, and its rationale for setting the fund's advisory fees[;] a discussion of the criteria for the selection of all comparative information presented, including comparative information regarding fees, costs and performance[;] a discussion . . . of the appropriateness of the fees charged, supported in part by comparisons of the adviser's cost and expense structure with the cost and expense structure of other firms where meaningful comparative information is available; [and] information on the fund's performance for specified time periods, compared with performance of an appropriate peer group, with explanations of any material differences in performance relative to the fund's peers[.][187]

Along with this list of materials to consider, directors of SRI funds should request one more item: discussion of the fund's social performance in a report mirroring the benefit report that benefit corporations must annually produce.[188] Such a report, designed to compare social performance against other benefit corporations, would fall in easily with the other 15(c) materials boards currently receive. As suggested by the above list, mutual fund directors already receive comparative data about fund performance, typically prepared for the 15(c) process by third-party researchers.[189] A fund benefit report, perhaps capable of being prepared by one of the many research companies that currently produce benefit reports,[190] should neither be completely foreign to fund directors nor unduly expensive to commission. Because the key element of the 15(c) process is that fund directors "consider whether each fund's investment performance on a long-term basis has satisfied investor expectations,"[191] adoption of the benefit corporation model of benefit report consideration and disclosure can best ensure that

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187. *Id.* at 44–47.
188. *See supra* Part V.C.
189. *See, e.g.*, *15(c) Board Reporting*, BROADRIDGE FIN. SOLUTIONS, https://www.broadridge.com/financial-services/asset-management/mutual-funds-etf/simplify-financial-and-regulatory-reporting/15c-board-reporting [https://perma.cc/VM2C-D826] (last visited Jan. 12, 2020).
190. *See How Do I Pick a Third Party Standard?*, B LAB, https://benefitcorp.net/how-do-i-pick-third-party-standard [https://perma.cc/3ZM3-MWP9] (last visited Jan. 12, 2020).
191. MUTUAL FUND DIRECTORS F., *supra* note 186, at 45 n.92.

investors' consumption value expectations are being adequately met by the SRI fund manager.

VII. CONCLUSION

This Note is primarily concerned with the abuse of positive screening strategies. Investors can more easily detect when SRI funds fail to follow the negative screens or proxy voting strategies to which they have pledged, and existing securities fraud laws provide a straightforward remedy in these instances. Positive screens, however, can be vague and difficult to track, and failures to follow them may not necessarily meet the intent requirements typically required for fraud. By requiring SRI directors to take reasonable care to protect investors' ethical interests, however, § 36(b)'s right of action provides a check for investors to ensure that fund directors adequately consider an SRI fund's ethical goals.

In recommending that fund directors evaluate and disclose SRI funds' comparative social performance, this proposal does not call for more rigorous judicial oversight of SRI fund performance or suggest that fund directors be responsible for social change. Beyond the difficulties of causing corporate social change through SRI, requesting only consideration and disclosure of social performance is more in line with "the central strategy of U.S. securities law and the leading way in which we regulate public companies."[192] Most benefit corporation statutes themselves require board members to only *consider* the impact of corporate action on non-investor stakeholders.[193] As Professor Brett McDonnell notes, "[*p*]*ursuing* and *creating* are different from *considering*."[194] A breach of fiduciary duty for benefit corporation directors occurs not when they fail to have a positive impact, but when they fail to think about what social impact may occur from corporate action.[195] Likewise, even

192. McDonnell, *supra* note 161, at 731.

193. *See* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1) (West 2015) ("A director of a benefit corporation, . . . [i]n determining what the director reasonably believes to be in the best interests of the benefit corporation, *shall consider* the effects of any action[.]") (emphasis added); *see also* MASS. GEN. LAWS ANN. ch. 156E, § 10(a)(1) (West 2012) ("In discharging the duties of their respective positions and in considering the best interests of the benefit corporation, the board of directors, committees of the board and individual directors of a benefit corporation . . . *shall consider* the effects of any action[.]") (emphasis added).

194. McDonnell, *supra* note 160, at 41.

195. *Id.* ("But what if plaintiffs can show that the management never even *thought* about the impact a decision would have on some stakeholder they were required to consider? . . . That may give rise to a claim under [benefit corporation legislation].").

if SRI fund directors are expected to consider their funds' social impact as part of their fiduciary duty, such an expectation does not entail that those directors could be held liable if that fund has no social impact. A rule to the contrary would be the equivalent of exposing directors to liability if a fund loses money over a given period.

Instead, if § 36(b)'s fiduciary duty includes a duty to consider an SRI fund's non-financial and social performance, then directors' evaluation of comparative social measurements should satisfy *Gartenberg*'s mandate that directors approve only reasonable advisory contracts. Even if the final outcome of this additional oversight is only to protect SRI investors' consumption value — and even if it only helps investors to feel good about the impact of their investment — then shareholder value has nonetheless been protected.