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A Rejoinder to Professor Padfield: Lobbying the States for Anti-ESG Legislation

Dwight Aarons

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INTRODUCTION

Thank you Professor Padfield for your presentation. It is a bit toned down from his article, which he was kind enough to share with me. That article tells us about the environmental, social, and governance factors – ESG for short – which are now being written into corporate management plans and objectives. These corporate directives are the result of the federal government's adoption of these factors through the SEC regulatory process. Some corporations have welcomed the change, and have assimilated the ESG factors into the corporation's corporate social responsibility agenda.

It is clear from his article that Professor Padfield is not a supporter of ESG-based legislation or regulations. In his article, Professor Padfield refers to and relies on information from a website, the Heartland Institute.[1] His point – and Heartland's contention, too, based on its website – is that ESG legislation and other related efforts are antithetical to the United States' values and its economic system. I daresay that they

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[1] *See* THE HEARTLAND INSTITUTE, https://www.heartland.org/ (last visited Apr. 6, 2023).

suggest that the industrialized world, if not capitalism itself, is at risk. Put succinctly, the "ESG movement" – and that has to be put in quotes – must be stopped. Failure to do so will result in the demise of corporations and the end of capitalism as we know it. That is what I drew from his essay.

I will state my thesis upfront: in the U.S., corporations are here to stay. The ESG factors are but the latest means of managing corporations. It is unlikely that state legislation will seriously thwart corporations from adopting ESG-based policies or implementing already adopted ESG policies. However, those who believe that ESG metrics will result in tangible corporate environmental, social, or governance measures are those who will most likely be disappointed in the long run. Stated differently, corporations may adopt ESG policies and metrics, but these programs will be subservient to many other objectives, as defined by each corporation.

THE CURRENT LANDSCAPE

I quibble with whether the modern market system – in either the United States or internationally – is truly capitalistic, and whether ESG factors are that revolutionary. That is because our national and international commercial markets are already heavily regulated. These regulations determine what commercial activity is not only lawful, but how that commerce may be produced and conducted. For example, there are workers' rights laws in most countries, which arguably increase the cost of labor, and do not allow every worker to negotiate his or her own working terms and conditions. Similarly, many nations have enacted and enforce their own anti-corruption and anti-collusion laws; these prohibitions likely inhibit the profit maximization of international corporations.

Capitalism, as I understand its most basic form, is an economic system based on private ownership of the means of production for profit. Traditionally, the owners of the means of production determine which goods and services are available, based on the market or the demand for that good or service. As such, it is the market that determines what is produced and its sale price. However, most nations today do not have purely capitalist economies. Leaders in the most influential national economies nearly every day act to influence or intervene in its domestic economy or the international economy. Though he critiques the ESG movement, it is not quite clear how much unregulated capitalism Professor Padfield wants. The Heartland Institute is somewhat clearer: it believes in free-market solutions to social and economic problems, and believes in personal liberty and limited government.[2] Thus, it seemingly wants as little government regulation and intervention in the marketplace

[2] *About Us,* THE HEARTLAND INSTITUTE, https://heartland.org/about-us/ (last visited April 6, 2023).

as possible.

In any event, to me, the ESG factors are just another form of government regulation. The ESG movement has prompted some corporations to at least articulate – if not also adopt – environmental, social, and self-governance practices and policy statements that satisfy corporate regulators. Now, corporations can proudly proclaim that they are abiding by these standards. That is the smart thing to do in this current regulatory climate.

Yet, one should realize that ESG factors could become a permanent metric of corporate assessment. We will have to wait to see, in the fullness of time – say two or three decades from now – whether the policies adopted today to fulfill the ESG requirements have had the desired impact, and whether they were worth it. By then, the world should have leaders who are from the Gen X, Millennial, or later generations. It is very likely that, in comparison to today's leaders, these next generations are more supportive of ESG principles – corporate environmental awareness, socially conscious corporate policies, and a corporate governance regime that ensures that each corporation has a positive impact on society.

I suspect that these next generations will insist that corporate actors adopt environmental, social, and governance norms that are more sensitive to the impact that a corporate actor can have on the world. If so, then this is just the beginning. Instead of resisting the change, it might be more constructive to work within the change that is coming. That could mean ensuring that corporations adopt reasonable, practical, and achievable goals. If a state does otherwise, that is, oppose ESG corporate policies and distance itself from corporations that have adopted such policies, it may become an outlier.

But when it comes to corporations, I am skeptical. I seriously doubt that the ESG movement will meaningfully change most corporations from being primarily a profit maximizing entity. However, I do not mean to suggest that some ESG policies do not or will not make financial sense for a corporation, or achieve an environmental, social, or governance goal, at least temporarily. For example, a company that uses lumber in its manufacturing process may decide to plant or purchase thousands of acres of woodlands as part of its ESG goals. The company would likely tout that its purchase benefits the environment by replenishing acres of a forest. Years later, the corporation might one day use the wood to manufacture products to sell. Indeed, there may be some social and governance policies that make good financial sense, too. In turn, adopting social and governance policies that current or future customers may welcome is a good way to create a loyal and robust consumer base.

However, over time, I suspect that it will be those who currently advocate for ESG governance who will become dismayed by how little corporations change, and the marginal impact of the ESG factors.

Corporations act in their best interest. They are designed that way. They are risk averse entities, and typically adopt long-term strategies brimming in moderation. Accordingly, those who support the ESG movement, expecting a marked change in corporate behavior, may soon find themselves exploring other paths to bring about changes in society once thought forthcoming through a corporation's adoption of ESG-based policies.

ANTI-ESG STATE LEGISLATION

Some state legislatures have enacted anti-ESG legislation. This legislation, according to Professor Padfield, has taken two forms: divestment bills or ESG bans. Divestment bills are state laws that authorize or require state actors to end their current business activities with entities that have adopted ESG policies. Bills that ban ESG prohibit the government from doing business with entities that have adopted ESG principles.

A. The Tennessee Example

In 2022, Tennessee enacted a divestment ban. The Heartland Institute can take some credit for that, as one of its members testified before Tennessee's House and Senate on that bill.

As is often appropriate in the financial services industry, Tennessee's law is anticipatory legislation.[3] It provides before-the-fact authority to state treasury officials. The bill added two subsections to Tennessee Code Annotated Section 9-4-107,[4] which deals with public financing and in which banks the state can deposit its monies.

The new provisions read:

> ( )(1) On or after July 1, 2022, the state treasurer shall not enter into a contract or amendment with a state depository for the state's primary cash management banking services if the state depository has a policy that prohibits financing to companies in the fossil fuel industry; provided, however, that the state treasurer may award or enter into a contract or amendment with a state depository that has such a policy upon a determination that the services sought are necessary for the department of treasury or the state to perform its functions, and that absent such an exemption, the department of treasury or the state would be unable to obtain the services sought from another contractor.
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> (2) For purposes of this subsection ( ), the term "companies in the fossil fuel industry" means entities with at least fifty percent (50%) of its annual revenue obtained from business operations involving natural gas, oil, kerosene, petroleum, coal, hydrocarbon product, or any form of solid, liquid, or gaseous fuel derived from such material to produce heat for the generation of electricity.

The statute now ostensibly prohibits Tennessee's treasurer from depositing state funds in financial institutions that have a policy against

[3] *See, e.g.*, Karen Harris, *Anticipatory Regulation for the Management of Banking Crises*, 38 COLUM. J.L. & SOC. PROBS. 251, 253–54 (2005).

[4] *Id.*

financing companies in the fossil fuel industry. Yet, that restriction can be waived if the sought "services are necessary" and the state is "unable to obtain the services sought from another contractor." In other words, the state can use an otherwise prohibited bank if that bank is too important to ignore.[5]

This is a faint-hearted prohibition. If state leaders believe that conducting state business with companies with pro-ESG-based policies harms the state or other important interests, that resolve should not weaken simply because a corporation that would otherwise be excluded delivers top-notch goods and services. Concomitantly, if state leaders adopted a more intractable stance against ESG policies, that might lead to some corporations modifying their pro-ESG stance; it might even result in the emergence of corporations with anti-ESG policies, who then seek engagement with the state. Yet, instead of standing on the principle that it will not become part of the ESG movement, Tennessee has indicated that it will be anti-ESG only so long as that is convenient.

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[5] This brings to mind the "too-big-to-fail" claim made by government regulators and some financial companies in 2008, which was that due to the size, complexity, interconnection within the economy, and the function of certain financial firms, it was necessary for the federal government to provide financial support to those entities. *See generally* ANDREW ROSS SORKIN, TOO BIG TO FAIL: INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009). It subsequently seemed as if the people involved in bringing about the crisis were "too big-to-go-to-jail" as very few served time in prison. *See generally* Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, NY TIMES MAG., May 4, 2014, at 34, https://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html.

Though the amendment aims to nullify antipathy against the fossil fuel industry, for years Tennessee has been turning away from carbon-based fuels. As a state, Tennessee produces hydro-electric power, and has a major oil refinery in Memphis. The Tennessee Valley Authority, a federal entity that is one of the main sources of power in the state, has moved away from traditional coal-based production and towards cleaner forms of power generation; carbon emissions in the power TVA generates have been reduced by 57% since 2005.

B. *Other State Anti-ESG Legislation*

According to its website, Heartland Institute analysts testified before eleven state legislatures in spring 2022,[6] warning of anticipated harms arising out of the federal government's embrace of the ESG factors in corporate management. Typically, the analyst's testimony focused on individual rights, liberties and freedoms, and the likely negative impact of adopting or acquiescing in ESG-based measures.

Apparently, Kentucky is the only other state among those lobbied by the Heartland Institute that passed anti-ESG legislation. That law was enacted in 2022 and it requires that Kentucky's state treasurer identify and

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[66] *See Environmental, Social, and Governance (ESG) Scores*, *supra* note 2.2 (other states were: Arizona, Hawaii, Indiana, Missouri, New Hampshire, New Mexico, Vermont, Virginia, and Wyoming).

list all financial companies that have engaged in "energy company boycotts."[7] That list will be made publicly available to all state governmental entities.[8] Within 90 days of the financial company receiving notice that it is on that list, it must end the energy company boycott.[9] If it does not, the state usually has one year within which to sell, redeem, divest, or withdraw all publicly traded securities of the financial company.[10] Notwithstanding the divestment mandate, the state must continue to act as a prudent investor and asset manager.[11] Kentucky thus appears a bit more serious than Tennessee in not using financial institutions that exclude fossil fuel companies from their customer base.

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[7] Ky. Rev. Stat. § 41.474(1)(a).. An "energy company boycott" is defined as: without an ordinary business purpose, refusing to deal with, terminating business activities with, or otherwise taking any action that is intended to penalize, inflict economic harm on, or limit commercial relations with a company because the company: 1. Engages in the exploration, production, utilization, transportation, sale, or manufacturing of fossil fuel-based energy and does not commit or pledge to meet environmental standards beyond applicable federal and state law; or 2. Does business with a company described in subparagraph 1 of this paragraph. Ky. Rev. Stat. § 41.472(1)(c) (2023).

[8] *Id.* § 41.474(1)(a).

[9] *Id.* § 41.474(3)(b).

[10] *Id.* § 41.474(3)(d).

[11] Kentucky's law does not require the government to divest any indirect holdings in investment funds or private equity funds of financial companies that are boycotting energy companies. It also gives the state the choice of either: requesting each investment fund manager to remove the listed financial companies from the fund or creating a similar managed fund with indirect holdings devoid of the listed financial companies. If a fund manager creates a similar fund with substantially the same management fees, level of investment risk, and anticipated return, then the state may replace all impacted investments with investments in the similar fund in a time period consistent with prudent fiduciary standards, but within 450 days of the creation of the fund. See Ky. Rev. Stat. § 41.474(5).

BEYOND STATE ANTI-ESG LEGISLATION

State anti-ESG legislation is, at best, signaling legislation (also known as virtue signaling) – that is, legislation that is more symbolic than substantive.[12] As of now, Tennessee and Kentucky state officials can insist that they have erected a wall against infiltration of the ESG movement into their respective state governments. They really haven't. But they can claim otherwise, and get political credit for impeding corporations flying the ESG flag. These approaches will be short-lived, if more corporations adopt ESG policies and become more aggressive in implementing an ESG agenda.

We have to realize the possibility that ESG-type policies might be here to stay. Anti-ESG state legislation runs the serious risk of being ineffectual and signaling a state's hostility to an emerging national or international consensus. In that regard, Professor Padfield and the Heartland Institute are misguided. They focus on whether ESG has resulted in corporations transitioning from capitalism to some other economic system. They miss the more important transmutation that ESG policies may portend: the end of representative democracy as we know it.

Indeed, that is the warning of Professors Carl Rhodes and Peter

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[12] *See* Daniel Gibbs, Jesse M. Crosson, Charles M. Cameron, Message Legislation and the Politics of Virtue Signaling 28-30 (Apr. 2, 2021) at https://scholar.princeton.edu/sites/default/files/ccameron/files/virtue_signalling_gibbs_crosson_cameron.pdf

Fleming.[13] They posit that multi-national corporations, under the guise of their corporate social responsibility work, might begin to address some of modern society's most pressing and persistent problems.[14] If the public becomes used to corporations addressing and solving problems – or at least managing aspects of the problem – society may come to "hold them up as a saviour against society's woes."[15] Corporate actors may then move in to "'fill the governance gap left by declining power, capacity, or willingness of states to engage with global governance issues.'"[16]

In light of these possibilities, a more meaningful inquiry for state legislatures would be whether the corporations with which it interacts have social duties, and, if so, who gets to define those duties. This seems like an area of law that state law should address. If so, the natural source for such answers would be the state legislature.

CONCLUSION

Though no one has asked, here's my advice to those quite concerned about the ESG movement. Don't box yourself in. Taking an absolute

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13 Carl Rhodes and Peter Fleming, *Forget Political Corporate Social Responsibility*, 27 Organization 943 (2020).

14 *Id.* at 944-45.

15 *Id.* at 945.

16 *Id.* (quoting Jeroen Veldman, Responsibility and the Modern Corporation 77 in GLOBALISATION OF CORPORATE SOCIAL RESPONSIBILITY AND ITS IMPACT ON CORPORATE GOVERNANCE (JEAN J. DU PLESSIS, UMAKANTH VAROTTIL AND JEROEN VELDMAN EDS. 2018)).

stand against a corporation that has adopted ESG provisions may well be the mark of a fierce gladiator, but it may also reflect an inability to pick a fight worth winning, and it might show an inability to know when you are fighting a losing cause.[17]

Tennessee's and Kentucky's approaches reflect that ideal. They've changed the law – declaring that some financial institutions are now ineligible to provide banking services for the state. Yet, both have exceptions that allow government officials to continue to do its business.

The debate over the propriety and effectiveness of ESG legislation is far from over. Indeed, not much meaningful state anti-ESG legislation has been enacted. And of those provisions that have been enacted or have become operative, they haven't had a chance to succeed or fail. The larger question we should all begin to consider – and address – is what role should corporations play in our government and in society.

[17] We can all fall subject to these criticisms.

Justice Cardozo once cast the dissenter as: Athe gladiator making a last stand against the lions.@ BENJAMIN N. CARDOZO, LAW AND LITERATURE AND OTHER ESSAYS AND ADDRESSES 34 (1931). Sometimes it may be properly said of the dissenter that it Ais certainly the work of a gladiator, but he thrusts at lions of his own imagining.@ *Board of Educ. of Kiryas Joel Village School District v. Grumet*, 512 U.S. 687, 708 (1994).