HERBERT SMITH FREEHILLS

TRUST COMPANIES SURVEY 2022: ESG AND TRUSTS

28 September 2022 | London
Legal Briefings

ESG is one of the most common phrases we hear these days in investing circles and trusts and trustees are not untouched by the increasing focus on Environmental, Social and Governance investment criteria. However, trustees may not feel as free as private individuals to apply ESG screens to their portfolios – concerned that beneficiaries may turn around later and criticise them for not focussing on the maximisation of investment returns, and instead taking into account other (perhaps irrelevant) factors?

Lewin on Trusts outlines eight things trustees must do when considering investment advice:

1. act with a single eye to the benefit of their beneficiaries
2. exclude all ulterior purposes
3. exercise the statutory duty of care in the selection of investments from among those authorised
4. have regard to their suitability,
5. and the need for diversification
6. obtain all necessary consents
7. act fairly and impartially as between beneficiaries with different interests, particularly between those interested in current income and others; and

8. review their investments on the same basis at suitable intervals thereafter.

Lewin records that "the trustees must put aside, not only their personal interests, but also their views about social and political issues. They are in a fiduciary capacity and cannot make moral gestures. The trustees' fiduciary duty is to act in the best interests of the beneficiaries, which requires them to recognise the purpose for which the trust was created, and to promote that purpose. The general rule is that trustees must seek to obtain maximum financial return from their investments, by way of income or capital growth." However, could the very first numbered point above regarding the benefit of their beneficiaries support ESG investing by trustees? Could contributing to a more sustainable world be regarded as being in the interests of present and future beneficiaries? Let's not forget that trust law can be flexible, for example the concept of "benefit" can be a broad one (including making a payment to a non-beneficiary charity to discharge a moral obligation in Re Clore).

The authors of Lewin go on to identify three exceptions which might apply to a pure financial outcome approach:

a. trustees may avoid categories of investments where the trust deed permits them to do so (and, of course, where it prohibits certain investments)

b. trustees need not act so as to bring themselves or the trust into disrepute, but this does not allow them to make personal moral statements

c. they make take into account the views of those who may, on moral grounds, consider an investment to be in conflict with the objects of the charity, but only where such a course would not involve a risk of significant financial detriment

The saving grace here, however, may be found in the pensions case of Cowan v Scargill. The judge in that case stated "If the investment in fact made is equally beneficial to the beneficiaries, then criticism would be difficult to sustain in practice, whatever the position in theory." This leads us to the recent case of Butler-Sloss vs The Charity Commission – albeit in the specific charity context. The case concerned two charities with general charitable purposes (i.e., they have the power to do anything which English law considers to be charitable), which had chosen to focus their efforts on environmental protection and improvement. Consistent with this focus, they decided when identifying the investments that the charities should invest in whether those investments are aligned with the Paris Climate Agreement. The principal goal of the Paris Agreement is to limit global warming to well below 2°C above pre-industrial levels, and pursuing efforts to limit it further to 1.5°C. It aims to do this by reducing greenhouse gas emissions and fostering climate resilience and sustainable development. Taking it further, the trustees used the goals of the Paris Agreement to formulate Investment Guidelines which were implemented by exclusions that have three elements: quantitative screens; qualitative screens; and limits on fund selection. The effect was to exclude over half of publicly traded companies.

Trustees of charities are in a different position to trustees of private trusts because – even though the starting position is maximising financial returns – where trustees are of the reasonable view that particular investments or classes of investments potentially conflict with the charitable purposes, the trustees have a discretion as to whether to exclude such investments. When exercising that discretion, they should reasonably balance all relevant factors including, in particular, the likelihood and seriousness of the potential conflict and the likelihood and seriousness of any potential financial effect from the exclusion of such investments.

The regulator of charities in England, the Charity Commission, and the Attorney General took the position that the trustees did not adequately balance the potential financial detriment that would be suffered by the adoption of the Proposed Investment Policy with the conflict to the charitable purposes. However, it was clear from the Proposed Investment Policy itself that there was a targeted rate of financial return within it, which the Charity Commission's own evidence indicated was in line with the published rates of return of other large charities, such as the Church Commissioners or the Wellcome Trust. In short, you could apply the screens and still achieve acceptable investment returns.

It may be that this last point is the most significant from this case when it comes to private trusts. The idea that you can build an investment portfolio with screens and still expect to obtain a healthy return – or to put in the words of Cowan v Scargill an investment portfolio which is "equally beneficial to the beneficiaries".

That case also sounded a warning though – "But if the investment in fact made is less beneficial, then both in theory and in practice the trustees would normally be open to criticism." However, it may be possible to mitigate that risk if ESG considerations themselves are material to the consideration of the likely financial performance of an investment i.e., it was reasonable to take into account ESG factors not from a moral or ethical standpoint, but from a purely financial one.

For instance, there are scenarios where seeking a means to manage negative ESG impacts could be a legitimate way for trustees to reduce financial risk within their investment portfolio. For instance, by enhancing the focus on “black swan” events, the pandemic has brought into sharper relief the realisation that investing with an eye on ESG risks (such as climate change and other existential threats, including biodiversity loss) can reduce investment risk.

Added to this are the recent examples of reputational (and, consequently, financial) damage suffered by companies that have failed to address concerns over "S" factors, such as human rights and labour conditions, in their own operations and/or their supply chains. A report published by Société Générale found that in two thirds of “high ESG controversy” cases a company’s stock experienced “sustained underperformance,” trailing the global index by an average of 12% over the course of the following 2 years.

On the flip side, ESG may also present new opportunities to enhance or preserve value. For instance, the transition towards a low carbon economy presents significant opportunities for capital growth in the case of investments in sectors and businesses which stand to gain from the transition.

ARTICLES IN THIS SERIES

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

REBECCA PERLMAN
PARTNER, LONDON

+44 207 466 2075
Rebecca.Perlman@hsf.com

RICHARD NORRIDGE
PARTNER, HEAD OF PRIVATE WEALTH AND CHARITIES, LONDON
+44 20 7466 2686
richard.norridge@hsf.com

LEGAL NOTICE

The contents of this publication are for reference purposes only and may not be current as at the date of accessing this publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately before taking any action based on this publication.

© Herbert Smith Freehills 2022

SUBSCRIBE TO STAY UP-TO-DATE WITH INSIGHTS, LEGAL UPDATES, EVENTS, AND MORE
Close

© HERBERT SMITH FREEHILLS LLP 2023