

## ESG Investing: Why Here? Why Now?

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### ABSTRACT

This article seeks to shed light on the nature, purpose, and prospects of ESG investing. Along the way, it develops an explanation for why so-called “ESG” or Environmental, Social, and Governance principles suddenly have emerged to dominate the corporate governance and investing landscape. Clearly, the real and existential threat of climate change has galvanized the investing public into taking some sort of action. As such, I argue that the ESG movement reflects a significant libertarian turn in the history of American politics. This is because one naturally would think that government, rather than the private sector, would be the place to look for solutions to broad societal problems like social injustice and protecting the environment. The emergence of ESG investing and governance demonstrates a consensus that government lacks credibility and is not viewed by rational citizens as a likely source of solutions to these broad problems. In simple terms, government unresponsiveness and ineptitude have created a vacuum, and the ESG movement reflects a broad shift from primary reliance on government to primary reliance on the private sector as the source of solutions to broad social problems.

Thus, ESG investing and governance can be explained, at least in part, as a response to the failure of government. People are turning to corporations for solutions to problems that are typically in the government’s domain because government has failed. This explains the “E” and the “S” in ESG, but it does not explain the “G,” the governance component. Besides lack of faith in government, the emergence of ESG is attributable to the fact that the ESG movement focuses intensely on allowing management to govern for the “long term.” Focusing long term serves the private interests of important political groups such as organized labor and corporate management because it takes pressure off management to

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focus on profit maximization or on objective criteria such as share prices for evaluating managerial performance. In addition, ESG governance is a new form of an anti-takeover device and a convenient tool for enabling ineffective management to escape accountability. Thus, the recent success of the ESG movement is attributable to the confluence of the private interests of management with the public's loss of confidence in the ability of government to address, much less to solve, the important environmental and social problems of the day. This loss of confidence has played conveniently into the hands of corporate managers who wish to avoid accountability.

While the ESG movement has found success in attracting investors, I argue that it will not be successful in ameliorating the fundamental problems of global warming and income inequality that it purports to address. In fact, much, if not most of ESG investing is "cheap talk" in light of three fundamental realities: (a) corporate managers are overwhelmingly compensated by bonuses, stock, and stock options, all of which are forms of compensation that reward strong shareholder performance rather than the achievement of ESG objectives; (b) activist investors, particularly activist hedge funds and other elements of the market for corporate control, pose an existential threat to managers who ignore the shareholder wealth maximization paradigm; and (c) corporations are run by or under the direction of their boards of directors, who are elected exclusively by shareholders.

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INTRODUCTION

Few concepts have come to dominate an academic discipline as quickly as the concept of Environmental, Social, and Governance (ESG) has come to dominate the field of corporate law. While certain forms of ESG investing and governance have been around since the 19<sup>th</sup> century and achieved a certain prominence during the anti-apartheid movement,<sup>1</sup> the term first appeared in 2004 when the former UN Secretary General challenged various financial institutions “to develop guidelines and recommendations on how to better integrate environmental, social and corporate governance issues in asset management, securities brokerage services and associated research functions.”<sup>2</sup>

The last couple of years have seen the ESG investing and governance paradigm make a decisive move from the wings to center stage in discussions of how corporations should be governed. As of this writing, almost half of investors are currently investing in ESG products, which is almost double the number of investors including ESG products in their portfolios as recently as 2019.<sup>3</sup> Investors are also placing a significant emphasis on managers’ ESG policies when deciding whether to invest with a manager, as evidenced by the fact that nearly all investors (88%) ask managers how ESG is incorporated into their investment decision-making.<sup>4</sup> A recent Morgan Stanley Bank survey found that almost 90 percent of millennials would prefer to have investments that suit their values.<sup>5</sup>

In fact, it is fair to say that 2020 was the year of ESG investing as ESG funds captured \$51.1 billion of net new money from investors, a record, and more than double the 2019 figure of \$21 billion.<sup>6</sup> ESG investing is estimated to represent a remarkable \$20 trillion in assets under management (AUM) or around one-

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1. See Robert G. Eccles, Linda-Eling Lee & Judith C. Strohle, *The Social Origins of ESG: An Analysis of Innovest and KLD*, 33 *ORG. & ENV'T* 575, 576–77 (2019).

2. United Nations Global Compact, *WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD* (2004).

3. See Ryan Munson, Jessica Bloom, Natalie Deak Jaros & Jun Li, *Does Accelerating Adaption Present Obstacles or Increase Opportunities?*, ERNST & YOUNG (Nov. 6, 2020), [https://www.ey.com/en\\_us/wealth-asset-management/does-accelerating-adaptation-present-obstacles-or-increase-opportunities?WT.mc\\_id=10814266&AA.tsrc=paidsearch&gclid=CjwKCAjw7diEBhB-EiwAskVi13wVUICtzt\\_cj\\_K0oYrupByfFPgmolVp123DiUHdfjmg\\_pLlwqiRoCrMsQAvD\\_BwE](https://www.ey.com/en_us/wealth-asset-management/does-accelerating-adaptation-present-obstacles-or-increase-opportunities?WT.mc_id=10814266&AA.tsrc=paidsearch&gclid=CjwKCAjw7diEBhB-EiwAskVi13wVUICtzt_cj_K0oYrupByfFPgmolVp123DiUHdfjmg_pLlwqiRoCrMsQAvD_BwE).

4. See *id.*

5. See Press Release, Morgan Stanley, *Morgan Stanley Survey Finds Investor Enthusiasm for Sustainable Investing at an All-Time High* (Sept. 12, 2019), <https://www.morganstanley.com/press-releases/morgan-stanley-survey-finds-investor-enthusiasm-for-sustainable-#:~:text=Investors%20want%20products%20that%20match,report%2C%2090%25%20among%20millennials>.

6. See Gret Iacurci, *Money Invested in ESG Funds More Than Doubles in a Year*, CNBC (Feb. 11, 2021), <https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020.html#:~:text=ESG%20funds%20captured%20%2451.1%20billion,change%20and%20inequality%2C%20for%20example>.

quarter of all professionally managed assets around the world.<sup>7</sup> By 2017, 83 percent of the top 100 companies in the Americas published a corporate responsibility report, as do 77 percent of top 100 companies in Europe and 78 percent in Asia. Of the largest 250 companies globally, reporting rates are 93 percent.<sup>8</sup>

This article addresses the question of why ESG investing and governance have exploded on the legal and social landscape so suddenly and argues that its arrival was prompted by the confluence of three factors: the public's loss of confidence in the government's ability to solve problems, management's self-interest in avoiding attention to share prices, and rational ignorance on the part of shareholders.

I posit that the emergence of ESG investing and governance demonstrates a consensus that government no longer has credibility as an engine of social change. Ordinarily, one would expect problems like environmental degradation and social justice to be the responsibility of the government. But government has failed to produce results, and, worse, government has failed to even offer hope of achieving meaningful and effective policies. ESG investing and governance can be explained, at least in part, as a response to the failure of government. People are turning to corporations for solutions to problems that are in the proper domain of government because government has failed.

Finally, and perhaps most importantly, I argue that the emergence of ESG is attributable to the fact that such investing and governance serves the private interests of important political groups such as organized labor and corporate management. ESG investing and governance, to some extent, is a new form of antitakeover device and a convenient tool for enabling ineffective management to escape accountability.

Following this introduction, Part I of this article explains that, contrary to popular belief, the traditional approach to corporate law and corporate governance in the United States was not to ignore environmental and social problems, but rather to compartmentalize them. In the U.S., unlike most of world, the relevant field of study was corporate law in the narrow sense of the word. Corporate law was the law pertaining to the organization of business. It was,

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7. 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> [<https://perma.cc/J7DW-ARPX>].

8. See Cynthia A. Williams & Jill E. Fisch, *Request For Rulemaking On Environmental, Social, and Governance (ESG) Disclosure*, U.S. SEC. & EXCH. COMM'N 9 (Oct. 1, 2018), <https://www.sec.gov/rules/petitions/2018/petn4-730.pdf> [<https://perma.cc/TW4J-YFEG>] (citing KPMG, THE KPMG SURVEY OF CR REPORTING 2017, at 11, [https://home.kpmg.com/content/dam/kpmg/campaigns/csr/pdf/CSR\\_Reporting\\_2017.pdf](https://home.kpmg.com/content/dam/kpmg/campaigns/csr/pdf/CSR_Reporting_2017.pdf)).

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essentially, a course in advanced contracts, with the twin concepts of agency costs and Ronald Coase's paradigm of the corporation as a nexus of contracts serving as the intellectual core of the discipline. Social problems were addressed in other areas of the law, especially labor law, environmental law, and constitutional law. The corporation's role was to obey these other laws and to maximize profits.

In recent years, however, the government has abdicated its regulatory duty and private actors have filled the void. The current privately driven ESG movement is thus highly libertarian—it assumes that the government's current failings will continue and proposes a path forward that doesn't rely too much on future contributions from the government.

Traditional approaches to ethical investing and governance presumed that “only government can legitimately deal with the prevention and correction of social and moral problems.”<sup>9</sup> The shift to ESG investing and governance as the principal paradigm in corporate law is existentially important because it reflects a new, broad societal perspective that corporations, not government, are the main source of solutions to the grave social and moral problems that plague the nation. In simple terms, the ESG movement presents the corporation as a substitute for government. In this context, it is particularly important to note that ESG does not involve a public/private partnership. There is no role for government in providing solutions to social and moral problems in ESG investing and governance; corporations must go it alone. As such, ESG investing and governance is both a reflection and manifestation of abject government failure. We have moved from thinking that only government can solve social and moral problems to a world in which only corporations can solve these problems.

Part II explains how difficult it is to measure how well or how poorly a company is performing from an ESG perspective, particularly in light of the fact that there is no consensus on how to measure a company's performance. In contrast, no measurability problem exists for firms that pursue the traditional corporate governance norm of profit maximization because measuring profit maximization, which looks at returns to shareholders as reflected in return on equity, is both transparent and simple. ESG's measurability problem has profound implications for corporate governance.

Part III describes how ESG investing and governance serve the interests of powerful political groups—especially corporate management. ESG investing and governance ostensibly puts new constraints on corporate management. Under a regime of ESG investing and governance, managers are supposed to abandon their historical exclusive focus on profit maximization and instead

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9. JOHN G. SIMON, CHARLES W. POWERS & JON P. GUNNERMAN, *THE ETHICAL INVESTOR: UNIVERSITIES AND CORPORATE RESPONSIBILITY* 28 (1972).

pursue simultaneously both profit maximization and ESG goals. Paradoxically, instead of further constraining managers, focus on ESG investing expands managerial discretion in two ways. First, ESG investing is so complex and multifaceted that almost any action short of theft or outright destruction of corporate property can be defended on some ground or another. Second, poor corporate performance as measured by returns to investors can be justified on the grounds that the company was not supposed to maximize profits in the first place, but rather maximize ESG impact, which, of course, is impossible to measure.

Part IV shifts from a focus on the implications of ESG investing and governance from a political science perspective to a consideration of ESG investing and governance from a corporate governance perspective. Here ESG investing and governance presents a paradox. Firms claim to be abandoning—or at least modifying—the profit maximization paradigm, but three key incentive structures remain unchanged: incentive-based compensation for managers, the threat of activist hedge funds and takeovers, and the election of corporate directors. I argue that those three incentive systems will prevent companies from meaningfully abandoning their profit-maximizing tradition. A conclusion follows.

#### 1. ESG GOVERNANCE: THE END OF COMPARTMENTALIZATION

While the traditional profit maximizing paradigm in corporate law ignored ESG, it simply is not the case that corporate law was indifferent to issues of environmental and social justice. Rather, these issues were addressed more circuitously. Thus, while it is easy to assume that corporate law did not pay attention to ESG issues, the facts are otherwise.

Three points are necessary to understanding the traditional corporate law approaches to ESG investing. First, U.S. law is highly compartmentalized. There is a field of law or statute for every possible ESG concern. Significantly, when these laws are passed, corporate law does not ignore them. Rather corporate law coalesces around these laws and internalizes them. In particular, the fiduciary duties of officers and directors literally transform with every new law and court ruling for the simple reason that officers and directors are obligated, as part of their portfolio of fiduciary duties, to obey the law.

Second, a strong, clearly articulated and mandatory government response to ESG concerns is vastly superior to corporation-by-corporation approaches to ESG investing and governance. The individualized approach suffers from a number of flaws, including the fact that such investing and governance is discretionary, vaguely articulated, and uncoordinated. To overcome the

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significant collective action problems ESG investing aims to solve, a coordinated government response is necessary.

Third, and most importantly, ESG investing and governance is a substitute for, not a complement to, a broad governmental response to environmental problems and problems of social justice. As such, the move to ESG investing is nothing shy of a remarkable libertarian turn in the history of American law.

### *A. Compartmentalization: Corporate Law and ESG Investing*

The law interacts with ESG issues in two main ways. First, through the business judgment rule, corporate law gives officers discretion to pursue profits and ESG goals as they see fit while still honoring their fiduciary duties. Second, a host of discrete laws cabin officers' discretion, often requiring them to pursue certain environmental or social goals even when doing so is not profit maximizing. Traditionally, the two channels have combined to create a compartmentalized approach to ESG issues. Officers use their discretion to pursue profits and general laws check that discretion, creating a level playing field where all corporations must adhere to the same ESG limitations. Although corporations remain free to pursue additional ESG goals beyond what the law requires, the government carries the burden of ESG regulation, rather than letting it fall to individual actors.

While it is true that officers and directors owe fiduciary duties exclusively to shareholders, the notion that law requires such officers and directors to maximize profits is a myth.<sup>10</sup> This is because corporate law gives directors deference in fulfilling those duties. That deference effectively gives corporations broad, indeed virtually unfettered, discretion to take actions that they believe further ESG goals and objectives.<sup>11</sup> As Leo Strine observed, “a corporation can also embrace a culture that gives primacy to ethical practices, even when such practices might not generate the most profit.”<sup>12</sup>

Corporations are run by or under the authority of their boards of directors.<sup>13</sup> The directors' actions and the corporate management decisions are governed by

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10. See Jonathan Macey, *Corporate Law as Myth*, 93 S. CAL. L. REV. 923, 943–51 (2020).

11. See Jonathan Macey, *Sublime Myths: An Essay in Honor of the Shareholder Value Myth and the Tooth Fairy*, 91 TEX. L. REV. 911, 911 (2013) (“[S]hareholder primacy is not bad law because it is not law at all[.]”). See also LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS AND THE PUBLIC* (2012).

12. Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steel, *Caremark and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective Caremark and EESG Strategy*, 106 IOWA L. REV. 1885, 1895 (2001).

13. See, e.g., 8 Del. C. § 141(a) (“[T]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors[.]”); MODEL BUS. CORP. ACT § 8.01(b) (AM. BAR ASS’N, amended 2016) (“[A]ll corporate powers shall be exercised by or under the authority of the board of directors, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors.”).

the fiduciary duties of care and loyalty that directors owe to their corporations' shareholders.<sup>14</sup>

Although those fiduciary duties may result in direct liability when breached, they can only be fully understood in the context of the business judgment rule.<sup>15</sup> The business judgment rule is a legal principle in the form of a rebuttable presumption. The rule makes directors immune from liability to the corporation for loss incurred in corporate transactions that are within their authority and power to make and made in good faith.<sup>16</sup>

The business judgment rule is the central organizing principle that has allowed ESG principles to take center stage in U.S. corporate governance.<sup>17</sup> As Frank Easterbrook and Daniel Fischel observe, the business judgment rule mitigates the impact of the liability rules of care and loyalty because it “reflects limits” on the efficacy of these liability rules. In other words, the business judgment rule gives directors broad discretion to use their “business judgment” to decide what is best for the corporation. High wages, radical transformation of the company to respond to ESG concerns, and charitable contributions might seem inconsistent with a shareholder wealth maximization paradigm. Yet, they are all easy to defend because the business judgment rule requires that courts give corporate decisions a strong, even radical, form of judicial deference. Other than egregious situations involving either abject failures of corporate oversight<sup>18</sup> or transactions or corporate maneuvers that benefit directors personally at the corporation's expense,<sup>19</sup> as a practical matter, directors have unfettered discretion to enact ESG objectives.<sup>20</sup>

The second critical component of the corporate governance landscape is the relationship between fiduciary duty law and the norm of profit maximization and other, more general law. Corporate law requires adherence to all other applicable

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14. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“[A]lthough [the fiduciary duty of] good faith may be described colloquially as part of a triad of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties [breaches of care and breaches of loyalty] where violated, may directly result in liability[.]”).

15. See *id.*

16. See *Business Judgment Rule*, in WEST'S ENCYCLOPEDIA OF AMERICAN LAW 190–92 (2d ed. 2005).

17. See FRANK EASTERBROOK & DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 94 (1991).

18. See *Marchand v. Barnhill*, 212 A.3d 805, 821 (Del. 2019) (applying the duty of care's requirement that directors provide oversight to reinstate claims against a board based on allegations that the directors failed to implement reasonable monitoring and reporting systems on “mission critical” issues).

19. See *Zapata v. Maldonado*, 430 A.2d 779 (Del. 1981) (finding directors personally benefited from accelerating the exercise date of certain options by receiving tax benefits, where such acceleration was costly to the corporation from a tax perspective).

20. See generally STOUT, *supra* note 11.

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laws and the compartmentalized, issue-specific laws that check officers' discretion to pursue profits have been the traditional, government-led way of pursuing ESG goals.<sup>21</sup>

On environmental issues, for example, the Clean Air Act, the Clean Water Act, and the Paris Climate Change Accords all force corporations to pursue ESG goals they might not have otherwise.<sup>22</sup> On the social side of ESG, the Foreign Corrupt Practices Act (FCPA)<sup>23</sup> and a host of domestic anti-bribery statutes address political corruption. Similarly, progressive income taxation, public schooling, Social Security, Aid to Families with Dependent Children, and Supplemental Security Income<sup>24</sup> all further the ESG objective of promoting social justice.

In *Gall v. Exxon*, Exxon paid approximately \$59 million in bribes and political payments to Italian political parties and corporate officials in the Italian state oil company, ENI SpA. This was done in the pursuit of business, political favors, and other “illegal commitments” from the largely state-controlled Italian oil sector.<sup>25</sup> The core assumption in the plaintiffs' case was that paying bribes, even when not illegal in the country where the bribes were paid, can constitute a breach of fiduciary duties.

The seminal case of *Gall v. Exxon*<sup>26</sup> and the subsequent enactment of the Foreign Corrupt Practices Act illustrate the government-led process. In some countries, corruption is endemic. Whether called baksheesh or bribes, sometimes the only way to maximize profits or even to do business at all, in light of government corruption, is to expend corporate resources to pay bribes or make “contributions” to the political parties that determine which companies in the private sector can enter into contracts or otherwise do business with the government.

To clarify any remaining ambiguities after the case, Congress passed the Foreign Corrupt Practices Act, making it unlawful for corporate actors to pay bribes in pursuit of shareholder wealth maximization.<sup>27</sup> Now all individuals and entities, including certain foreign issuers of securities, are prohibited from paying

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21. See Strine, Smith & Steel, *supra* note 12, at 1893–94.

22. See generally THOMSON REUTERS, FEDERAL ENVIRONMENTAL LAWS (2021); see generally Douglas Kysar, *The Public Life of Private Law: Tort Law as a Risk Regulation Mechanism*, 9 EUR. J. RISK REG. 48 (Mar. 22, 2018), <https://www.cambridge.org/core/journals/european-journal-of-risk-regulation/article/abs/public-life-of-private-law-tort-law-as-a-risk-regulation-mechanism/19B48E8F15A5BBA4A24443146BE069CF>.

23. 15 U.S.C. §§ 78dd-1, et seq.

24. See *Welfare*, LEGAL INFO. INST. (last visited May 10, 2021), <https://www.law.cornell.edu/wex/welfare>.

25. *Id.*

26. *Gall v. Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976).

27. 15 U.S.C. §§ 78dd-1, et seq.

foreign government officials or their associates for business purposes.<sup>28</sup> The statute is vigorously enforced by the Securities and Exchange Commission and Department of Justice.<sup>29</sup>

Similarly, while it clearly would be a profit-maximizing strategy for corporations to meet and agree to fix prices or reduce output, the antitrust laws should make such conduct illegal, as even the most free-market antitrust experts acknowledge.<sup>30</sup> The fact that a corporation is pursuing the sacred goal of shareholder wealth maximization is, of course, no defense at all to a claim that a corporation or its officers or directors engaged in price fixing or in a conspiracy to restrain trade.

Insider trading provides yet another example of the way in which corporate law is subservient to other law. Insider trading is illegal.<sup>31</sup> And yet there is little doubt that insider trading can, at least under certain highly constrained assumptions and conditions, be defended on the grounds that it is an efficient form of executive compensation that provides high-powered incentives to corporate insiders.<sup>32</sup> But regardless of insider trading's merits, the practice is generally illegal, and no shareholder wealth maximization model can save insider traders from doing the requisite prison stint if they are caught and convicted.

The paradigm of contract dominates the field of corporate law and also explains how shareholders can ultimately demand corporations to pursue ESG goals not required by law.<sup>33</sup> A useful way of conceptualizing the corporation is as a nexus of contracts that are reified by a statutory framework that allows a properly incorporated business to be treated as a separate, independent, and distinct legal entity.<sup>34</sup> An important foundational contract in this nexus is the corporate charter. Corporate charters establish a default rule of profit maximization, but corporations can be organized to serve “any lawful business

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28. See RICHARD CARNELL, JONATHAN MACEY, GEOFFREY MILLER & PETER CONTI-BROWN, *THE LAW OF FINANCIAL INSTITUTIONS* 563 (7th ed. 2021).

29. See *id.* at 563–64 n.3.

30. See generally ROBERT BORK, *THE ANTITRUST PARADOX* (2021).

31. See generally Jonathan Macey, *Martoma and Newman: Valid Corporate Purpose and the Personal Benefit Test*, 71 SMU L. REV. 869 (2018); see also Jonathan Macey, *The Genius of the Personal Benefit Test*, 69 STAN. L. REV. ONLINE (2016) <https://www.stanfordlawreview.org/online/the-genius-of-the-personal-benefit-test/>.

32. See generally HENRY G. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1967); David Haddock & Jonathan Macey, *A Coasian Model of Insider Trading*, 80 NW. U.L. REV. 1449 (1987).

33. See EASTERBROOK & FISCHEL, *supra* note 17, at 163.

34. See generally Jonathan Macey & Leo Strine Jr., *Citizens United as Bad Corporate Law*, 2019 WISC. L. REV. 451 (2019).

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or purposes.”<sup>35</sup> As such, shareholders are fully within their rights to require that their companies pursue ESG goals, even ahead of profit maximization.

In sum, discrete laws have forced corporations to adopt some ESG priorities, placing a legal check on the methods they may otherwise use to pursue profits. The discretion given to corporations’ directors and officers through the business judgment rule, however, also allows corporations to pursue other ESG goals beyond the legal floor.

### *B. The Superiority of a Governmental Response*

Corporations can legally pursue ESG goals. But the fact that companies *can* pursue ESG goals does not mean that corporations should be the unique provenance of solutions to the deep environmental, social, and governance problems that afflict the United States. Government traditionally has been, and should remain, the most prominent actor in any struggle for environmental and social justice.

There are many reasons for government and not corporations to play the key role in the ESG campaign. For one, environmental and social injuries often are not attributable to the actions of any particular company in isolation. Rather, they are attributable to the collective actions taken by all participants in an industry. In such cases, isolated action by one company to address the problem will likely be futile and could even exacerbate the social injury. A particular concern is that socially conscious and responsible investors will coalesce around particularly socially conscious and responsible companies. Less responsible investors will coalesce around rival firms. Absent legal rules that make socially responsible conduct mandatory for all firms, less responsible companies will have a competitive advantage since socially responsible investing is costly.

The above-referenced scenario, in which the actions of individual companies to do the right thing may actually exacerbate the problem at hand, describes the collective action problem faced by individual businesses that cause social or environmental harm. A collective action problem exists here because, absent regulation, any single company that ceases production or otherwise takes socially conscious actions inevitably internalizes all costs associated with such desirable behavior without achieving any useful objective. This is because the producer’s competitors can increase their own production (and profits) to make up for the shortfall caused by the exit or higher costs of the single, more socially and environmentally conscious, producer.

For example, it would be perfectly legal, as well as commendable, for an individual company unilaterally to raise wages above the going rate in a particular industry and region. From a competitive perspective, however, such

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35. 8 Del. C. §101(b).

unilateral action would only reduce profits of the socially responsible company relative to its less “woke” competitors. As such, any meaningful response to problems like global warming or income inequality must include a collective response that encompasses all firms.

Generally, government action (or sometimes actions by an industry group in the form of best practices) is the only effective means for addressing significant collective action problems. For example, government regulations that impose a price on carbon, such as carbon taxes or cap-and-trade programs, provide a promising pathway to making those who benefit from carbon emissions internalize the costs of those emissions. This observation applies with particular force to the costs associated with the damage caused by the emission of greenhouse gases into the environment. Government support for low-carbon innovation, including support for developing new and nascent technologies for carbon capture and sequestration is also of paramount importance. The transition to a net-zero carbon economy may require innovation in many areas, and we still do not fully know what a carbon-free economy is going to look like in the future. However, it is clear that greater incentives are needed to generate such large-scale innovation.

Thus, the response to climate change involves a paradigmatic case in which government action is the appropriate channel for redressing grave social injury because the injury involves an industry-wide practice. Lone action or cessation by a single firm would not achieve the desired result of mitigating the grave social injury. In such cases, ethical investing principles recognize that divestment from individual companies should not necessarily be required.<sup>36</sup>

On the other hand, the fact that a collective action problem exists does not mean that individual companies are “off the hook” and relieved of responsibility for their actions. Fossil fuel companies, like all other economic actors, have personal responsibility for their own actions. Thus, actions taken by individual fossil fuel companies to impede government responses to climate change through lobbying or climate change denial raise significant ethical concerns. In addition, where there are industry best practices that companies can follow to reduce or eliminate their carbon footprint or otherwise ameliorate social effects, companies are strongly motivated to follow those practices.

### *C. The Failure of Government*

While government is and should be the entity primarily responsible for addressing social justice and environmental concerns, it has abdicated its proper

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36. See generally SIMON, POWERS & GUNNERMAN, *supra* note 9.

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role, particularly during the Trump administration. Accordingly, it is no surprise that the ESG movement reached its apogee under the former President.

Because of the critical role played by government in solving social and environmental problems and the remarkable ability of corporations to generate returns for shareholders, the optimal organizational structure for societal governance is compartmentalization. Under this approach, companies would focus on profit maximization subject to the traditional constraint that corporations and the individuals who act on behalf of corporations must obey the law. Laws that move society further on the path to social and environmental justice must be in place for the system to function as intended.

What is remarkable about the current shift in favor of ESG investing is that it is a movement that purports to act on a company-by-company basis. This is remarkable for two reasons. First, individual companies must act individually because the antitrust laws prohibit them from acting in concert to set wages or to reduce pollution in coordinated ways.<sup>37</sup> Second, the ESG movement is not a movement to inspire, incentivize, or compel the government to act. It is, in other words, a movement directed at publicly held corporations on a case-by-case basis.

Put simply, the ESG movement is radically libertarian. It is an attempt to achieve social and environmental goals in a world in which government is assumed either not to exist or to be completely non-responsive to ESG concerns. From this perspective, the ESG movement, which posits no government, is a natural response by a society that has given up on government as a responsible actor.

In an essay that garnered significant attention, Tariq Fancy, the former head of sustainability investing for the world's largest investment firm, describes sustainable investing as a "dangerous placebo that harms the public interest."<sup>38</sup> This experienced investor observed that:

If the COVID-19 pandemic has taught us one key lesson, it's that we must listen to the scientific experts and address a systemic crisis with systemic solutions. Reacting instead with denial, loose half-measures, or overly rosy forecasts lulls us into a false sense of security, eventually prolonging and worsening the crisis. And yet Wall Street is doing just that to us today with the far more dangerous threat posed by climate change, craftily greenwashing the economic system and delaying overdue systemic solutions, including those intended to combat rising inequality and the insidious political risks it creates. It's clear to

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37. See generally PHILLIP AREEDA & HERBERT HOVENKAMP, ANITRUST LAW (2021).

38. Tariq Fancy, *The Secret Diary of a 'Sustainable Investor' – Part 1*, MEDIUM (Aug. 20, 2021), <https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139>.

me now that my work at BlackRock only made matters worse by leading the world into a dangerous mirage, an oasis in the middle of the desert that is burning valuable time. We will eventually come to regret this illusion.<sup>39</sup>

## II. THE MEASURABILITY PROBLEM

A political organization called the Business Roundtable has issued one of the more compelling views of the new world of ESG investing. The Business Roundtable describes itself as “an association of chief executive officers of America’s leading companies working to promote a thriving U.S. economy and expanded opportunity for all Americans through sound public policy.”<sup>40</sup> To qualify for membership in the Business Roundtable, one must be the Chief Executive Officer (CEO) of a major American corporation. The CEOs on the Business Roundtable lead companies with 20 million employees, more than \$9 trillion in annual revenues,<sup>41</sup> and collectively engage in “research and advocacy” through the organization.<sup>42</sup>

To understand ESG investing and governance, one must understand the Business Roundtable’s position on the issue. On August 19, 2019—after years of maintaining that corporations’ purpose was to maximize profits—the Business Roundtable announced a 180-degree pivot in its perspective.

The Business Roundtable’s statement began by announcing how radical it was. It claimed to be usurping the role of the government in a sort of rhetorical coup d’état, by asserting that its statement “Redefines Purpose of a Corporation to Promote ‘An Economy that Serves All Americans.’”<sup>43</sup> It went on to pronounce that:

Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance. Each version of the document issued since 1997 has endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders. With today’s announcement, the new Statement supersedes previous statements and outlines a modern standard for corporate responsibility.<sup>44</sup>

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39. *Id.*

40. *See About Us*, BUS. ROUNDTABLE, <https://www.businessroundtable.org/about-us>.

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

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Arguably, the Statement aimed to fill a void left by government inaction and ineptitude. No longer was the government the place to look for succor in the pursuit of life, liberty, and happiness. Instead, Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. and Chairman of Business Roundtable stated that “[t]he American dream is alive, but fraying.”<sup>45</sup> The implicit message, of course, was that government had abdicated its responsibility to revive the American dream, and that the CEOs of America’s largest public companies had decided to fill the breach. Furthermore, the CEOs were not just moving into the government’s turf in matters of microeconomic policy, they were moving in on macroeconomic issues as well, committing “to continue to push for an economy that serves all Americans.”<sup>46</sup>

The CEOs promised nothing less than to deliver on a promise to provide “an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity.”<sup>47</sup> Happily, the CEOs indicated no interest in upsetting the basic capitalist fabric of American life, stating that “[w]e believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all.”<sup>48</sup> This was not just a statement about how to approach corporate governance, but rather a political manifesto. It was a transparent effort to replace the government of elected officials and their appointed bureaucrats with a new order led by CEOs appointed by directors who were elected not by citizens, but by the global community of shareholders.

Continuing in this vein, the Statement could be read to indicate that the CEOs believed that business, not government, was responsible for “creating jobs, fostering innovation and providing essential goods and services.”<sup>49</sup> No facet of government was to be left to the government, as it was business that provided the support for national defense, food production, health care, the generation and delivery of energy, and other services including the finance and communications infrastructure that underpins economic growth.<sup>50</sup>

Furthermore, the Statement announced a new governance hierarchy. Moving far beyond the traditional corporate purpose of maximizing value for shareholders, the new paradigm attempts to serve all Americans by serving every imaginable corporate constituency. The pecking order starts with customers and

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45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.*

50. See *Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy That Serves All Americans,’* BUS. ROUNDTABLE (Aug. 19, 2019), <https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans>.

is followed by employees, then suppliers. After that, the CEOs said their priority was “[s]upporting the communities in which we work.”<sup>51</sup> The CEOs also announced, reassuringly, that “[w]e respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.”<sup>52</sup>

Last, and apparently least, the CEOs announced that they were also concerned about their shareholders. Here, the language is critical. Ignoring the teachings of modern finance, the CEOs perpetuated the greatest myth in corporate governance: that the prices of financial assets in today’s capital markets do not understand the basic concept of present value. Specifically, the CEOs signaled that they see a distinction between “short-term” and “long-term” value. They then proceeded to ignore short-term value and focus exclusively on the long-term. The Business Roundtable outlined its concern with “[g]enerating long-term value for shareholders, who provide the capital that allows companies to invest, grow, and innovate.”<sup>53</sup>

The Business Roundtable Statement made its critical maneuver and revealed its true purpose by tying ESG investing to a corporate governance system that ignores the short term and focuses only on long-term shareholder value. This move is important because, in creating this false dichotomy between current share prices and long-term results, the CEOs revealed that the entire Statement is, at its core, a move from a corporate governance system in which their performance was highly measurable to a system in which it is not measurable at all.

Critical to this analysis is the well-known fact that, just as there is no way to measure a company’s long term performance other than current share prices, it simply is not possible to objectively measure a company’s performance using ESG ratings.<sup>54</sup> There is no standard, accepted metric for evaluating a company’s ESG performance.<sup>55</sup> Unlike financial ratings which are broadly similar, companies with a high score from one ESG rater often receive a middling or low score from another rater.<sup>56</sup> For example, credit ratings match across ratings agencies 99% of the time, while ESG ratings from different sources vary across ratings firms such that ratings from different sources align in only 6 out of 10

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51. *Id.*

52. *Id.*

53. *Id.*

54. See generally Elroy Dimson, Paul Marsh & Mike Staunton, *Divergent ESG Rankings*, 47(1) J. PORTFOLIO MGMT. 75 (2020).

55. *Id.*

56. *Id.*

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cases.<sup>57</sup> Additionally, the weightings given to each pillar and the pillars themselves of an ESG rating also vary across ratings firms.<sup>58</sup> Each rating agency has its own “customized scoring method which evaluates different non-financial metrics and frequently disagree about the components of ESG. . . . Core ESG metrics vary from as few as 12 performance indicators to as many as 1,000 for other agencies.”<sup>59</sup>

There are problems with determining with anything approaching rigor or precision precisely how a firm is performing from an ESG perspective.<sup>60</sup> ESG factors cover a wide range of issues, including how corporations respond to climate change, how well they manage their water use, whether their supply chains fall short of international human rights standards, how they treat their labor force, and whether they have a corporate culture that fosters innovation, among many other factors.<sup>61</sup> In addition, “ESG rating agencies do not fully disclose their methodologies or the material impact of selected indicators, likely as a result of overprotectiveness of their proprietary methodologies. This, in turn, leads to an overall lack of transparency over ratings and the inexistence of . . . agreements on best practices.”<sup>62</sup>

Over the last 25 years, in addition to the four dominant market rating firms (MSCI ESG, Sustainalytics, RepRisk, and ISS), over 100 ESG standard-setting initiatives have emerged, causing “option overload” for companies. These include the Sustainability Accounting Standards Board (SASB) and the Climate Disclosure Standards Board (CDSB), the Global Reporting Initiative (GRI) and the Carbon Disclosure Project (CDP), among many others. As a recent article noted, “[t]hese initiatives, while well-intentioned, contribute to poor market-wide communication and lack of transparency.”<sup>63</sup>

Worse, ESG ratings appear to be biased, with larger companies and European firms receiving higher ratings than similarly ESG-oriented U.S. firms. For example, scandal-ridden Volkswagen has a higher ESG rating than Tesla.<sup>64</sup> In

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57. See Billy Nauman, *Credit Rating Agencies Join Battle for ESG Supremacy*, FIN. TIMES (Sept. 16, 2019), <https://www.ft.com/content/59f60306-d671-11e9-8367-807cbd53ab77> [<https://perma.cc/42FU-X8JZ>].

58. Dimson, Marsh & Staunton, *supra* note 54. There are four market-leading companies that compete among themselves to provide ESG metrics: MSCI ESG, Sustainalytics, RepRisk, and ISS. See Timothy Doyle, *Ratings that Don't Rate: The Subjective World of ESG Ratings Agencies*, AM. COUNS. FOR CAP. FORMATION (2018).

59. *Id.* at 8.

60. See Javier El-Hage, *Fixing ESG: Are Mandatory ESG Disclosures the Solution to Misleading Ratings?*, 26 FORDHAM J. CORP. & FIN. L. 359, 361–62 (2021).

61. *See id.* at 363.

62. *Id.* at 365.

63. *Id.* at 367.

64. “In September 2015, the Environmental Protection Agency (EPA) found that Volkswagen was guilty of intentionally using a ‘defeat device’ to circumvent official emissions-testing software, effectively causing 11 million vehicles worldwide produced from 2009 to 2015 to pollute at a much higher rate than advertised. The company was sanctioned with more than \$25 billion in fines and penalties to account for

fact, the Volkswagen example is so egregious that one commentator noted “a complete failure by the ratings agencies to accurately capture ESG risk, even after a blatant attempt at bypassing environmental regulations.”<sup>65</sup> As Michael Bloomberg has observed, “for the most part, the sustainability information that is disclosed by corporations today is not useful for investors or other decision-makers.”<sup>66</sup>

The problem here is not a mere technological problem that can be solved by regulations that require standardization. The problem is that reasonable people can disagree about how, and even whether, various factors should be weighted in evaluating a company’s ESG performance. For example, some people believe that issues like employment and income and wealth inequality trump environmental issues. Some believe that companies should be rewarded for placing women and traditionally under-represented groups on a company’s board. Others do not. Because there is no consensus about what counts as ESG investing, managers have ample discretion to define it for themselves.<sup>67</sup>

Thus, in the world that the Business Roundtable imagines, CEOs are essentially absolved of any responsibility for their company’s short-term stock prices. That proposal has two main flaws. First, the proposed world would trend towards even more unfettered managerial discretion than investors currently endure. Second, the proposal clashes with established Supreme Court precedent that investors have a right to rely on current stock prices.

Solid evidence supports this assertion:

[R]elative to their peers, publicly-listed [Business Roundtable] signatories report higher rates of environmental and labor-related compliance violations, pay more penalties as a result, and spend more on lobbying policymakers. [Business Roundtable] signatories have been lobbying actively in recent years against a price on carbon, the elimination of tax loopholes, and a number of other initiatives designed to fight climate change and rising inequality. And a ... report last September [2000] confirmed that since the global pandemic began,

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one of the worst violations of the Clean Air Act by a corporation ever.” Despite this, Volkswagen continued to have an “ESG rating higher than its peer average.” *Id.* at 374.

65. Doyle, *supra* note 58.

66. BLOOMBERG, IMPACT REPORT UPDATE 2015, at 2 (2015).

67. Mandatory ESG disclosure will not solve this problem. To be effective there would have to be mandatory standardization of ESG metrics, but mandatory metrics inevitably will frustrate those whose favored metrics do not receive sufficient weight in a particular regime: “[a]ll private sector initiatives to date, including those by both rating agencies and market-leading wealth management funds, have failed to come up with standardized metrics, [and therefore] it may not be realistic to expect the SEC to be able to ‘define ESG factors’ effectively because of the complexity this task entails.” See El-Hage, *supra* note 60, at 388.

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[Business Roundtable] signatories have proven no better than anyone else in protecting jobs, workplace safety, and labor rights, or doing anything to redress racial inequalities.<sup>68</sup>

These results should come as a surprise to no one. Large American companies have “developed into complex bureaucratic machines that are designed primarily to extract maximum profits for shareholders within the rules of the game.”<sup>69</sup> People are able to become CEOs of U.S. companies because of their ability to earn profits. The modern multinational corporation is “a profit-making machine that’s built to do one thing [generate profits] really well [and it] operates exactly as we should expect it to.”<sup>70</sup>

With specific reference to “climate change, inequality and a host of other important issues, the experts [e.g., William Nordhaus on the environment and Thomas Piketty on income inequality] are not advising us to leave it to individual, voluntary action. They know that it won’t work.”<sup>71</sup> Rather, government action, from carbon taxes to negative income taxes, are the only real solutions to the existential problems facing society.

### *A. The Shift Towards Unfettered Managerial Discretion*

Share price performance is the best measure of a CEO’s performance. Nonetheless, the Business Roundtable CEOs aim to eliminate share price performance from the corporate governance tool kit. By justifying the elimination as a shift to focusing on “long-term value,” they rely on a diabolically false premise. In fact, the only valid distinction between short-term share price performance and long-term share price performance is that short-term share price performance is observable and measurable, while long-term share prices are neither observable nor measurable. Thus, by ignoring short-term share prices, the CEOs are making the shocking claim that their performance cannot readily be measured because the most valid and reliable measure of their performance simply does not matter.

The point is made clear by a quick review of the science of present value. The current share price of a company’s stock is the present value of the future income stream associated with those shares. Because money can be invested at a positive rate of return, and because the future is risky and uncertain, a payment of \$100,000 to be received in the future is worth less than \$100,000 that is available immediately. Present value is the simple calculation used to determine

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68. Tariq Fancy, *The Secret Diary of a ‘Sustainable Investor’ – Part 2*, MEDIUM, Aug. 20, 2021 <https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-2-831a25cb642d>.

69. *Id.*

70. *Id.*

71. *Id.*

the current value of a payment or stream of payments that will be received in the future.

The crucial point here is that a company that entirely ignores the short-term to focus exclusively on the long-term can have a healthy and robust share price as long as the market is optimistic about the company's future prices. After all, the current share prices reflect nothing more or less than the market's consensus estimate of the present value of the cash flows that a share of stock is expected to receive in the future.<sup>72</sup> Because traders can make money both when share prices move down as well as when they move up, market prices are unbiased.

Thus, what the basic concept of present value teaches is that the current share price of a company's stock is the best window into how a company will perform in the future because it reflects the market's unbiased assessment of future cash flows. Many companies with no earnings, and therefore no profits, trade at positive share prices for the simple reason that market participants—including many highly sophisticated professional investors—study companies and invest both on the short side and the long side and this rivalrous competition among market participants drives share prices to their correct levels.

The Business Roundtable CEOs and, indeed, the entire ESG movement embraces the false dichotomy between current share prices and long-term results. In reality, current share prices are still the best prediction of long-term results. Nonetheless, the CEOs are essentially claiming that market prices should be ignored and replaced with their own predictions about long-term results.

#### *B. Share Prices and Market Efficiency*

Business Roundtable's approach to corporate governance—asserting that market prices should be disregarded—is also inconsistent with the Supreme Court's view of how markets work. Specifically, it goes against the Court's iconic decision, *Basic v. Levinson*,<sup>73</sup> which explicitly endorsed modern financial theory and stands for the proposition that shareholders have a right to rely on current share prices when trading.

Basic Incorporated ("Basic") was a publicly traded company that made chemical refractories for the steel industry. Another company, Combustion Engineering, Inc., which made alumina-based refractories, had long expressed an interest in buying Basic, but had been deterred by antitrust concerns. Over time the regulatory environment loosened and, in 1976, Combustion Engineering

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72. The standard present value formula is  $[\text{Present Value} = \text{FV}/(1+r)^n + \text{FV}/(1+r)^n \dots]$  where FV=Future Value, r=Rate of return, and n= the number of time periods over which payments will be made.

73. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

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became intensely focused on acquiring Basic, developing a general strategic plan that gave acquiring Basic a central role.

Unsurprisingly, in light of Combustion Engineering's longstanding interest in acquiring Basic, rumors about a possible takeover had been floating around the markets for some time. These rumors posed a significant problem for Basic's management team because, as is often the case in mergers, it was vitally important to the acquirer to maintain the confidentiality of the merger negotiations. If word got out about a proposed merger, shares of Basic would likely skyrocket. This, in turn, would put the deal itself in jeopardy by raising, perhaps dramatically, the cost of the acquisition. As Geoff Miller and I previously have observed:

Combustion Engineering had been involved in discussions with Basic for over ten years prior to the consummation of the merger on December 19, 1978. The protracted nature of these negotiations suggests that both firms had invested a considerable amount of managerial time, money, and other resources exploring a possible merger. These circumstances make clear why Combustion had a strong desire to keep its negotiations with Basic confidential. News that merger negotiations were in progress would signal to other investors that Basic was an attractive merger prospect, allowing them to "free ride" on Combustion's investment in information about Basic. The simple *identity* of valuable takeover targets is information that lends itself to free riding. This is because the identification of a firm such as Basic as a likely takeover target signals to other investors that undervalued assets have been located. Because the subsequent bidders have incurred no costs to acquire information, they can offer more to target-firm shareholders, forcing the initial bidder to increase her offer or lose the opportunity to acquire the target firm.<sup>74</sup>

Put simply, the fiduciary duties that Basic's management owed to their shareholders required that they keep the information about the company's negotiations with Combustion Engineering secret at almost all costs.

Basic had a simple strategy for maintaining the confidentiality of its merger negotiations with Combustion Engineering despite the rumors swirling in the months preceding the merger's announcement: to lie. On three occasions Basic made public statements denying that it was engaged in merger negotiations during the months that preceded the December merger announcement.

Plaintiffs in the suit were Basic shareholders who sold their shares during the period between Basic's first false denial that merger negotiations were taking

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74. Jonathan Macey & Geoffrey Miller, *Good Finance, Bad Economics: An Analysis of the Fraud-on-the-Market Theory*, 42 STAN. L. REV. 1059, 1069 (1990).

place on October 21 and the December 18 trading halt in Basic stock that preceded the formal merger announcement.

The plaintiffs' main tactical problems were based in their need to satisfy the legal requirement of reliance. The plaintiffs had to show that they relied on Basic's statements denying the merger negotiations in making their investment decisions. Moreover, even if individual plaintiffs could demonstrate reliance, class certification would be jeopardized because each and every plaintiff would have to show that they specifically had heard and relied upon one of the false statements.

The Supreme Court's decision ultimately endorsed a trend among lower courts and accepted the "fraud on the market" theory, which makes it much easier for plaintiffs to show reliance. Rather than showing that they relied on a particular misstatement, plaintiffs can satisfy the reliance requirement by just showing that they relied on the market price of the security they traded and that the securities in question traded in an efficient market.

The Court's approach to satisfying the reliance requirement raised the question of what, precisely, the Court meant when it said that securities markets were efficient. Simply put, the Court punted on the details of what it meant when it said that securities markets were efficient. While accepting the fraud-on-the-market theory and its rebuttable presumption of reliance on securities prices, the Court, for whatever reason, pronounced in a footnote that "we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price."<sup>75</sup> Lawyers unschooled in corporate finance were left to struggle a bit about this. For corporate finance mavens, however, there was no doubt that the Court, whether it realized it or not, was adopting the semi-strong version of the efficient capital markets hypothesis (ECMH).

By way of background, the ECMH is actually three competing hypotheses about market efficiency: weak form efficiency, semi-strong form efficiency, and strong form efficiency.<sup>76</sup> The weak form of the ECMH posits that a stock's price is independent of past price performance; whatever information is inherent in the historic progression of a stock's price is reflected in the current price. Thus, "an

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75. *Basic Inc. v. Levinson*, 485 U.S. 224, 248 n.28 (1988).

76. Eugene Fama's famous 1970 review article introduced this important taxonomy. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970). See also ROBERT C. CLARK, *CORPORATE LAW* 281 n.2 (1986); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555-56 (1984).

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investor cannot enhance his/her ability to select stocks by knowing the history of successive prices and the results of analyzing them in all possible ways.”<sup>77</sup>

The all-important semi-strong form of the ECMH is a bit more ambitious. This form of the ECMH claims “that current prices fully reflect public knowledge . . . and that efforts to acquire and analyze this knowledge cannot be expected to produce superior investment results.”<sup>78</sup>

Finally:

. . . the strong form takes the market idea to its limit and asserts that both public and private information are fully reflected in the price of a stock. Thus, no investor should be able to outperform the market systematically because the market incorporates all possible information into the stock price. Under this theory, even inside traders cannot outperform investors as a group.<sup>79</sup>

As Geoff Miller and I have previously observed:

It is clear that the Supreme Court implicitly applied the semi-strong form of the ECMH in *Basic*. Plaintiff shareholders claimed in *Basic* that three misleading public statements about potential merger prospects depressed the value of their stock relative to its “true” value. In holding for the plaintiffs, the Court unambiguously rejected the strong form of the ECMH: If the market were strong-form efficient, *Basic*’s share price would have adjusted to reflect all relevant information, including the fact that the statements issued by *Basic* were false. In other words, the strong form of the ECMH and the fraud-on-the-market theory are fundamentally incompatible. Critical to the strong form of the ECMH is the assumption that the stock market cannot be fooled because it always accurately reflects all corporate information relevant to the pricing of a security.<sup>80</sup>

Thus, *Basic v. Levinson* and its progeny stand for the proposition that as long as securities prices reflect all publicly available information, investors are presumed to be relying on market prices, and not on public disclosures, their own research into securities prices, or advice from stockbrokers or investment advisers. Furthermore, investors are certainly not presumed to rely on unmeasurable, unverifiable views of corporate CEOs about the future performance of the company untethered from share prices. Nonetheless, the

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77. JAMES H. LORIE ET AL., *THE STOCK MARKET: THEORIES AND EVIDENCE* 56 (2d ed. 1985). The weak form of the ECMH is also known as the “random walk” theory because it implies that successive price movements of a security are independent of each other, and therefore security prices follow a random walk. *Id.* at 56–57.

78. *Id.*

79. Macey & Miller, *supra* note 74, at 1077–78.

80. *Id.* at 1078.

Business Roundtable's vision calls for precisely that: the trade of stock prices for CEOs' predictions about "long-term value."

### III. PRIVATE INTERESTS AND ESG INVESTING

The ESG movement in general, and the CEOs who populate the Business Roundtable in particular, reject the traditional view that the regulation of the corporation "is a governmental function which companies cannot undertake without being oppressive or incompetent or competitively self-destructive."<sup>81</sup> They instead propose a corporate governance regime in which they choose their priorities and set their own agenda, free from any mechanism to objectively evaluate their performance.

From a political science perspective, this approach is entirely unsurprising. Corporate executives are a special interest group. They have galvanized into an effective political coalition to lobby and proselytize for positions that advance their own private interests.

To the extent that embracing ESG investing effects any change in firm behavior or existing law, it complicates corporate governance immeasurably. Specifically, embracing corporate social responsibility or ESG governance along the lines of the Business Roundtable requires directors to attempt the impossible: pleasing a multitude of masters with competing and conflicting interests. As the Committee on Corporate Laws of the American Bar Association's Section on Business Law has argued in its position paper on state statutes that purport to expand directors' duties to constituents other than shareholders:

The confusion of directors in trying to comply with such statutes, if interpreted to require directors to balance the interests of various constituencies without according primacy to shareholder interests, would be profoundly troubling. Even under existing law, particularly where directors must act quickly, it is often difficult for directors acting in good faith to divine what is in the best interests of shareholders and the corporation. If directors are required to consider other interests as well, the decision-making process will become a balancing act or search for compromise. When directors must not only decide what their duty of loyalty mandates, but also to whom their duty of loyalty runs (and in what proportions), poorer decisions can be expected.<sup>82</sup>

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81. SIMON, POWERS & GUNNERMAN, *supra* note 9, at 6-7.

82. Am. Bar Ass'n Comm. on Corp. L., *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2269 (1990).

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In one view, the “too many masters” argument is that other constituency statutes make life more difficult for corporate managers and boards of directors by making them responsible to too many masters. In fact, the better view is that such statutes make life easier rather than harder for incumbent management of the large, public corporation. After all, these statutes enable management to justify virtually *any* decision on the grounds that it benefits *some* constituency of the corporation.

To illustrate the point that other constituency statutes increase rather than decrease the degree of freedom enjoyed by incumbent managers, one has only to imagine virtually any decision or transaction contemplated by a corporation. Take, for example, the issue of whether a firm should relocate its headquarters from the large metropolis that has served as its base for several years to a small town with better schools, lower labor costs, and lower taxes. While shareholders might benefit by this move, the community in which the firm is currently located would clearly suffer. Some employees might benefit by the move, while others might suffer. The firm could justify virtually any decision as serving the interests of one or more of the firm’s constituencies. Imagine now that the proposal to relocate the company comes not from incumbent management, but from an outside bidder who is launching a hostile tender offer for the company at a substantial premium over the current market price of the firm’s shares. Now the other constituency statute can be used to justify resisting an outside offer that may be in the best interests of the firm’s stakeholders. This is an additional reason why other constituency statutes diminish in value when they are shared by more than one group of stakeholders; the more constituencies a corporation has, the more readily its managers can justify their decisions.

Thus, the primary beneficiaries of other constituency statutes are incumbent managers who can justify virtually any decision they make on the grounds that it benefits some constituency of the firm. Strong support for this assertion lies in the fact that not only are these statutes (with a single exception) permissive, they also do not afford standing to sue to any of the other constituencies that they purportedly are designed to benefit.<sup>83</sup> A similar sentiment was expressed by Dean Robert Clark, who has observed that it is socially optimal for corporate law to promote the interests of shareholders in profit maximization in a rather single-minded fashion:

A single objective goal like profit maximization is more easily monitored than a multiple, vaguely defined goal like the fair and reasonable accommodation of all . . . interests. Assuming shareholders have some control mechanisms, better monitoring means that corporate managers will be kept more accountable.

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<sup>83</sup>. See Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 *STETSON L. REV.* 163, 165 (1991).

They are more likely to do what they are supposed to do and do it efficiently.<sup>84</sup>

Like the argument that other constituency statutes are ill-advised because they ignore the special status of shareholders as residual claimants, the “too many masters” argument is not without merit. Indeed, this argument provides a logical explanation of state legislatures’ eagerness to enact these statutes. Other constituency statutes originated as a response by state legislatures to the perceived problem of hostile takeovers by outsiders for control of in-state corporations. Of course, the winners of the takeover battles of the 1980s were corporate shareholders, while the losers were incumbent managers. Other constituency statutes give such managers the ability to obtain politically what they were unable to obtain in the marketplace—meaningful job security regardless of the quality of their performance.

The problem with the “too many masters” argument is that it is overstated. Corporations traditionally have been able to issue multiple classes of common and preferred stock, and corporate managers and directors have owed fiduciary duties to all of these various classes of claimants simultaneously. Moreover, just as the interests of common shareholders can conflict with the interests of non-shareholder constituencies, so too can the interests of one class of equity claimant conflict with the interests of another class of equity claimant. In particular, certain preferred shareholders may have interests that more closely resemble the interests of fixed claimants than the interests of common shareholders. Such preferred shareholders may seek to discourage the firm from engaging in certain risky projects while the other shareholders would support the firm’s decision to undertake such projects.

With respect to corporate law jurisprudence, as the Committee on Corporate Law has observed, in no case has the all-important Delaware Supreme Court held that directors will be permitted to prefer the interests of other constituencies over shareholders or that they ought, as a normative matter, to take such interests into account.<sup>85</sup> The Committee has reformulated the position of the Delaware Supreme Court to be that:

[D]irectors have fiduciary responsibilities to shareholders which, while allowing directors to give consideration to the interests of others, compel them to find some reasonable relationship to the long-term interests of shareholders when so doing. In Delaware, this principle is modified when the decision

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84. CLARK, *supra* note 76, at 20.

85. See Am. Bar Ass’n Comm. on Corp. L., *supra* note 82, at 2260.

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is made to sell the company, at which time the directors may consider only the interests of shareholders.<sup>86</sup>

From a political science perspective, Delaware's approach recognizes the Hayekian argument that it generally is not possible to identify precisely which actions are in shareholders' interests and which are not.<sup>87</sup> Experimentation and ex-post observation is required. As such, managers require plenty of latitude for experimentation. In addition, many technological or managerial improvements to a firm's operations may well result from pure happenstance and fortuity, rather than careful strategic planning. Consequently, judicial efforts to hold managers to a strict profit maximization standard through the palliative of ex-post judicial review of corporate decisions and operations is not likely to benefit anyone other than the legal community. The obvious exception to this general rule occurs in the case where there is a palpable conflict of interest between the actions of managers and the interests of shareholders. Where this is the case, there is, of course, an important role played by judicial enforcement of corporate law norms.

Thus, the problem with ESG proposals is not that they require managers and directors to serve too many masters. Even under current law and traditional approaches to ESG investing, corporate officials must serve a shifting and highly variegated set of masters. Rather, the problem is that ESG allows managers and directors to serve nobody but themselves—and that is why the Business Roundtable supports it so enthusiastically.

#### IV. THE ESG PARADOX

Another question is whether ESG-investing and governance can be successful from either a managerial or societal perspective.

To start, there is no dispute that companies must generate some level of profit in order to pursue ESG goals. As such, ESG investing and governance are complements and not substitutes because a company must reach a certain level of profitability to fund its ESG work. And, of course, the more money a company makes, the more ESG initiatives it will be able to support.

In addition, the push towards ESG investing has not eliminated the desire of investors to obtain some level of returns. Even the most altruistic investors have an expectation of earning some sort of economic return on their investments. An enduring and unanswered question is what will happen to the shareholder wealth

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86. *Id.* at 2261.

87. A basic tenet of Austrian economic thought, as exemplified by the work of Friedrich A. Hayek, is that "there is an unpredictability and indeterminacy with regard to human preferences, expectations and knowledge." Israel M. Kirzner, *On The Method of Austrian Economics*, in *THE FOUNDATIONS OF MODERN AUSTRIAN ECONOMICS* 48 (Edwin G. Dolan ed., 1st ed. 1976). See also FRIEDRICH A. HAYEK, *INDIVIDUALISM AND ECONOMIC ORDER* 46 (1st ed. 1948).

maximization paradigm if the basic norm of corporate governance shifts from a wealth maximization model to an ESG model.

For the reasons set forth here, I believe that nothing will change. As Lucian Bebchuk and Roberto Tallarita have trenchantly observed:

In assessing the extent to which the [Business Roundtable] statement is expected to bring about major changes, it is useful to examine whether the decision to join the statement was approved by each company's board of directors. The most important corporate decisions (such as approving a major transaction, amending bylaws, or making a major change in corporate strategy) require or at least commonly receive approval by a vote at a meeting of the board of directors. Thus, if the commitment expressed by joining the [Business Roundtable] statement had been expected to bring about major changes in a company's choices and practices, it would have been expected to be approved by the board of directors.

Therefore, to examine this issue, we contacted the public relations offices of 173 companies whose CEOs signed the [Business Roundtable] statement. We asked each company to indicate who was the highest-level decision maker who approved the decision to join the [Business Roundtable] statement, either the CEO, the board of directors, or an executive below the CEO. Forty-eight companies responded to our inquiry. Of the responding companies, 47 companies indicated that the decision was approved by the CEO and not by the board of directors. Only one responding company indicated that the decision was approved by the board of directors. Thus, among responding companies, about 98% had no approval by the board of directors.<sup>88</sup>

I believe firms will continue to focus on profits rather than ESG goals because of three core incentives that are tied directly to share prices rather than ESG objectives: incentive-based compensation for managers, the threat of activist hedge funds and takeovers, and the election of corporate directors.

#### *A. Incentive-Based Compensation*

Executive compensation provides powerful incentives to executives. As Bebchuk and Tallarita have observed:

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<sup>88</sup> Lucian Bebchuk & Robert Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 130-31 (2020).

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An important source of incentives for corporate directors is their compensation. Historically, the largest fraction of compensation for non-employee directors was represented by a fixed-cash payment. In recent times, however, companies have increasingly compensated directors with equity-based compensation to align their interests with those of shareholders. Under current compensation practices, 99% of S&P 500 companies give directors substantial equity compensation, mainly in the form of restricted or deferred stock. Furthermore, equity pay represents more than half of total director compensation in S&P 500 companies.<sup>89</sup>

Stock-driven executive compensation incentivizes executives to focus on shareholder welfare. It does not, in any way, incentivize attention to ESG investing or non-shareholder constituencies. This strongly suggests that the commitment to ESG investing articulated by CEOs is a form of “greenwashing.”<sup>90</sup> After all, their personal incentives remain tied to short-term stock prices, not the amorphous “long-term value” they ask others to grade them on.

Performance-based compensation also affects the incentives of portfolio managers of mutual funds and other investment professionals. As the former head of sustainable investing at Blackrock observed, “[p]ortfolio managers ... wanted to pass the ‘ESG test’ and be left alone. . . . The portfolio manager’s view was that they’re already focused on performance since it usually determines their compensation. . . .”<sup>91</sup>

### *B. Activist Hedge Funds and Takeovers*

Takeovers are a powerful tool for disciplining managers who do not maximize value for shareholders. If managers fail to maximize value for shareholders, then share prices will fall. These lower share prices are a very attractive target for rival management teams who can make arbitrage profits by taking over the company then restructuring or reorganizing it to generate returns on the shares they originally purchased.

Takeovers are such a powerful mechanism for aligning managers’ interests with profit maximization that those in favor of ESG investing have lobbied hard to weaken the market for corporate control by lobbying for statutes that empower directors to reject takeover bids and other shareholder-wealth maximizing

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89. *Id.* at 140–41.

90. Greenwashing is the process of conveying a false impression or providing misleading information indicating that a company’s products are more environmentally sound. Greenwashing is considered an unsubstantiated claim to deceive consumers into believing that a company’s products are environmentally friendly.

91. Fancy, *supra* note 68.

corporate actions on the grounds that they harm the interests of non-shareholder constituencies.<sup>92</sup> Not surprisingly, the Business Roundtable has been a big supporter of anti-takeover statutes.<sup>93</sup>

Activist shareholders, particularly hedge funds have, in recent years, come to play an important role in the market for corporate control. As Lucian Bebchuk has observed:

[L]ow shareholder value increases the chances of intervention by a hedge fund activist and, if the company is targeted, the likelihood that the hedge fund will obtain a settlement. There is considerable empirical evidence that the odds of activist engagement and the threat it poses are higher when stock returns have been lagging and metrics of shareholder value ... are low relative to industry peers.<sup>94</sup>

There is no question that the market for corporate control provides high powered incentives for corporate managers to maximize profits for shareholders. The recent firing of Emmanuel Faber, the former Chair and CEO of Danone, is a case study illustrating this point.<sup>95</sup> Faber was a strong advocate of moving Danone to focus less on profit and more on environmental concerns, particularly by moving Danone towards more sustainable ways of doing business.<sup>96</sup> It appears that Faber was ousted due to pressure from activist investors, particularly the hedge fund Bluebell Capital and the U.S. investor Artisan Partners. It also appears that the activist investors' bet paid off, as shares in the French food group "jumped" on the announcement and were immediately up by 4.2% on news of Faber's departure.<sup>97</sup>

Danone adopted a French legal framework known as *Entreprise à Mission*, which allows companies to take greater consideration of social and environmental issues in their business model.<sup>98</sup> The new legal framework was

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92. See MARK J. ROE, *Takeover Politics*, in *THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE* 338–52 (Margaret M. Blair ed. 1993). For a broader analysis of politics and lobbying regarding anti-takeover statutes, see generally Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CINN. L. REV. 457 (1988).

93. See Bebchuk & Tallarita, *supra* note 88, at 105 n.37.

94. *Id.* at 48–49. See also Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1752 (2008).

95. I am grateful to Sam Peltzman for bringing the Danone case to my attention.

96. See Sarah White & Gwénaëlle Barzic, *Danone Board Ousts Boss Faber After Activist Pressure*, REUTERS, Mar. 14, 2021, <https://www.reuters.com/article/us-danone-management/danone-board-ousts-boss-faber-after-activist-pressure-idUSKBN2B60PN>.

97. See *id.*

98. See Lauren Hirsch, *A Boardroom Shake-up at the Food Giant Danone Sets Off Shareholder Infighting*, N.Y. TIMES (March 16, 2021), <https://www.nytimes.com/2021/03/16/business/Danone->

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approved by 99 percent of Danone's shareholders.<sup>99</sup> Upon its announcement, then CEO Faber declared that Danone had "toppled the statute of [renowned University of Chicago free market economist] Milton Friedman,"<sup>100</sup> a pronouncement that this paper argues was premature.

### *C. The Election of Corporate Directors*

It is important to remember that, even now, at the height of the ESG tsunami, corporations remain democracies, with shareholders as their only citizens. Boards of directors are elected for specific terms, rarely more than three years, and often only one year. Moreover, "[v]oters may call elections on short notice and oust directors for any reason or none."<sup>101</sup>

Corporations are managed by or under the authority of their boards of directors, but, as Easterbrook and Fischel have observed:

[R]ules denying tenure to the board put the voters firmly in control – should they choose to exercise it at any time and ensure that the residual claimants (shareholders) have the final say. Managers may be given a quick boot if agency costs (the divergence between the interests of shareholders and the interests of the directors and managers of the corporation) become unacceptable.<sup>102</sup>

And regarding managers:

"Because the consequences of their acts are reflected in stock prices and in their own future salaries, they strive to maximize firms' discounted future earnings even if they have insecure tenure. There is no similar monitoring and reward system for political office-holders . . . ."<sup>103</sup>

The point here is that no matter what CEOs say in statements like the one made by the Business Roundtable in 2019, the structural features of corporate governance discussed here, which include executive compensation, the market for corporate control, and shareholder democracy, indicate that shareholder value maximization will remain the priority of corporate managers and their corporations for the foreseeable future. In other words, ESG investing is likely to be little more than a minor distraction from the shareholder wealth maximization juggernaut as long as corporate managers are motivated to focus

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Emmanuel-Faber.html. See also DANONE, 'Raison D'Être' Danone, <https://www.danone.com/about-danone/sustainable-value-creation/danone-entreprise-a-mission.html#Framework>.

99. See DANONE, *supra* note 98.

100. Leila Abboud & Billy Nauman, *Former Danone Chief Says Power Struggle Was Behind His Ousting*, FIN. TIMES (May 6, 2021), <https://www.ft.com/content/9e4c84e5-d2d7-4fd4-a925-43aa25d4d2e0>.

101. EASTERBROOK & FISCHEL, *supra* note 17, at 76.

102. *Id.*

103. See *id.* at 77.

on profit maximization by executive compensation, the market for corporate control, and shareholder democracy.

In fact, the notion that it is possible to shift from a profit maximization paradigm to an ESG paradigm while the structural components of corporate governance remain focused on profits with laser-like intensity is highly illogical. Worse, the assumption that ESG investing will change corporate behavior in any significant way is dangerous. The further ESG oriented shareholders indulge themselves in the fanciful notion that private sector actors can replace the government in dealing with the acute social and environmental problems of the day, the slimmer the chances of actually addressing these issues in a meaningful way.

Thus, ESG is likely to be of only limited success to executives. Executives will continue to maximize profits and run companies for the benefit of shareholders and use ESG as a shield to fend off takeovers and criticism of below-par performance. However, to the extent that companies are successful in getting ESG advocates on boards and in getting vague ESG considerations as part of their compensation, they will be successful in placing a buffer between themselves and the capital market forces that see to discipline them.

#### CONCLUSION

ESG investing is a paradox because it purports to constrain managers but actually gives them more latitude. The profit maximization infrastructure (compensation tied to share price performance, election of directors by shareholders, hedge fund activism, few staggered boards, etc.) has a lot of problems, but it “constrains” managers by channeling their behavior towards profit maximization. I am in favor of a new “G” that channels managerial behavior towards ESG goals. I am not in favor of a new “G” that just expands directors’ and officers’ freedom to act without repercussions and hopes for the best. Even the most casual student of agency costs recognizes that this conception of corporate governance poses grave problems.

I worry that, after the rhetorical fog surrounding this proposal has lifted, what we are left with is just anti-takeover protection for management in disguise. On the issue of metrics, I do not think that it is reasonable or appropriate to tell managers to go out and pursue ESG goals or risk being fired without providing them with some clarity about what counts as successful management towards ESG objectives. Managers know when they are meeting performance goals in a shareholder wealth-maximization world. We should strive for the same certainty in an ESG world.

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In the meantime, it is difficult to take ESG investing seriously when: (a) directors are elected only by the shareholders without input from stakeholders; and (b) executive compensation is tied to equity values, without consideration of ESG values. Basic features of corporate governance (shareholders having exclusive voting rights and executive compensation being tied to share price performance above all else) seem to be antithetical to the pursuit of meaningful ESG objectives.

The biggest challenge in this area is not a lack of support for stakeholder governance. Rather, I think that the root problem is measurability. It is very easy to measure returns to shareholders, both in terms of capital appreciation and in terms of actual share price performance. In the past I have argued that the disparity between the ease of measuring shareholder returns and the difficulty of measuring risk creates a challenge for good corporate governance. I think that the same is true about the disparity between the ease of measuring shareholder returns and the difficulty of measuring benefits generated by corporations to non-shareholder constituencies, including workers, local communities, and the environment. That is why requiring corporations to consider stakeholders and to take into account externalities in their pursuit of profit is so challenging. The problem is not that accounting for externalities is the wrong thing to do. The problem is measuring that accounting. Identifying when it is being done or done well is very hard.