

# The Millennial Corporation: Strong Stakeholders, Weak Managers

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## Abstract

The most important phenomenon in the corporate world today is the swift and dramatic rise of the Environmental, Social, and Governance (“ESG”) movement. Commentators have tried to fit this development into familiar frameworks of shareholder value or management entrenchment. In contrast, in this Article we develop, for the first time, a theory of ESG as a product of social demand. Our framework shows that increasing demand for socially responsible corporate behavior, originating in but not limited to the millennial generation, has created powerful incentives for corporate managers to promote ESG goals.

We identify and analyze five specific channels of social demand that pressure CEOs to promote ESG. First, markets—consumers, employees, and investors—may reward firms for promoting ESG. Second, and more important, risk averse CEOs may rationally invest corporate money to minimize personal risk from boycotts and walkouts. Third, large index fund managers have responded to social demand by embracing ESG activism to lure investors. Fourth, activist hedge funds target firms with ESG vulnerabilities, to later leverage them in their fight for board seats. Fifth, social demand could facilitate ESG regulation by pressuring firms to reduce lobbying activities that are not aligned with ESG goals and by tilting regulatory cost-benefit analyses in favor of ESG rules. As a result, we argue, CEOs face overwhelming, perhaps excessive, pressure

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to deliver on ESG goals or face career-limiting consequences.

Our framework has important implications for the ESG and stakeholderism debates, for the future and desirability of ESG, and for corporate and securities law.

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“Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.”<sup>1</sup>  
Business Roundtable, Statement on the Purpose of a Corporation (August 19, 2019)

“[T]here was a survey . . . over half of the millennials are disfavoring capitalism . . . that is what the [Business Roundtable] is . . . very sensitive to.”<sup>2</sup>  
John Engler, Business Roundtable President (August 19, 2019)

### Introduction

The most important phenomenon in the corporate world today is the swift and dramatic rise of Environmental, Social, and Governance (“ESG”) issues as a consideration for investors, stakeholders, the public, and—consequently—CEOs and directors. Commentators have tried to fit these changes into familiar frameworks of shareholder value or management entrenchment.<sup>3</sup> Overwhelmingly, however, these views ignore the role that rising demand from employees, customers, shareholders, and the public plays in pushing firms to embrace ESG goals. Recent examples of social demand illustrate its importance. Following the murder of George Floyd and the Black Lives Matter protests that followed, firms increased the proportion of racial minority directors appointed to boards by 120%,<sup>4</sup> and investors “tilt[ed] their holdings toward firms with better workplace equality profiles.”<sup>5</sup> Boycott campaigns, another study reports, have

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1. Bus. Roundtable, Statement on the Purpose of a Corporation (2019), <https://perma.cc/4VSP-GFV6>.
  2. Berkeley Lovelace Jr., CEOs’ Shift Away from Shareholder Value was Aimed at Millennials, says Former Business Roundtable president, CNBC: Markets (Aug. 19, 2019, 6:20 PM) <https://perma.cc/5AZX-QJ87> (John Engler, former president of the Business Round Table, commenting on the organization dramatic announcement to change the purpose of the corporation.).
  3. See, e.g., Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, For Whom Corporate Leaders Bargain, 94 S. Cal. L. Rev. 1467, 1471 (2021) [hereinafter Bebchuk, Kastiel & Tallarita, For Whom] (arguing that “rather than protecting stakeholders, stakeholderism would serve the private interests of corporate leaders by increasing their insulation from shareholder oversight”); Lucian A. Bebchuk & Roberto Tallarita, The Illusory Promise of Stakeholder Governance, 106 Cornell L. Rev. 91, 166, 92 (2020) [hereinafter Bebchuk & Tallarita, Illusory Promise] (arguing that stakeholderism rhetoric is used by managers to defend against activist hedge funds and that stakeholderism “should not be expected to produce material benefits for stakeholders”); Martin Lipton, Wachtell, Lipton, Rosen & Katz, Further on the Purpose of the Corporation, Harv. Law School Forum on Corp. Gov. (July 20, 2021) (stating that “The objective and the purpose of a corporation is to conduct a lawful, ethical, profitable and sustainable business in order to ensure its success and grow its value over the long term.”) <https://perma.cc/M9YG-FPZA>; Cf., Dorothy S. Lund & Elizabeth Pollman, The Corporate Governance Machine, 121 Colum. L. Rev. 2563, 2634 (2021) (arguing that “stakeholderism is unlikely to dethrone shareholder primacy”).
  4. Vicky L. Bogan, Katya Potemkina & Scott E. Yonker, What Drives Racial Diversity on U.S. Corporate Boards? (Nov. 18, 2021) <https://perma.cc/M48R-F3ZE> (finding that “the racial justice movement was the primary cause of the changes in minority director appointment behavior”).
  5. Yanru Han, Do Investors Value Corporate Workplace Equality? (Oct. 18, 2022), <https://perma.cc/LA2H-CYY5>.

led firms to pull out of Russia in response to the invasion of Ukraine.<sup>6</sup> Index fund campaigns, two other studies find, led firms diversify their boards and reduce carbon emissions.<sup>7</sup> Exxon, the oil giant, saw its own shareholders elect three new directors to its board in response to a hedge fund campaign foregrounding concerns about climate change.<sup>8</sup>

In this Article, we develop, for the first time, a theory of ESG as a *product of social demand*. We show that the rise of ESG is linked to a changing social landscape in which key stakeholders—employees, customers and investors—act on their social preferences in their economic lives. This tendency, most pronounced in the millennial generation, but now cutting across all demographics, is magnified by social media and transmitted through financial intermediaries, whether or not they share those views.

Our framework shows that this social demand, through its different manifestations, has created powerful incentives for corporate managers to cater to stakeholders. We identify and analyze five specific channels of social demand that pressure CEOs to promote ESG. These channels include product and labor markets, direct action via walkouts and social media, large index funds, hedge funds, and regulators. For each channel we develop a theoretical analysis of the effect that demand has on the incentives of corporate players and discuss evidence that support this effect. Each of these channels has influence over firms and each responds to social demand and to each other. As a result of their combined effect, we show, CEOs face overwhelming, perhaps excessive, pressure to deliver on ESG goals or face career-limiting consequences.

First, we discuss a significant body of empirical evidence showing that firms face market pressure—from employees, consumers and investors—to demonstrate commitment to social and environmental goals at their firms.<sup>9</sup> Embracing ESG may be necessary to attract and retain talent, attract consumers, and attract investors. Indeed, managers often explicitly make this argument. If some market participants indeed choose to purchase, work for, and invest in socially responsible firms, then ESG may contribute to firms' performance and value. This is the most obvious and broadly discussed source of pressure to embrace ESG. If this was the only channel of influence, pursuing ESG may simply collapse into to maximizing shareholder value, raising no new analytical issues.

But market pressure is not the only force at work. The second channel we identify provides a novel contribution by showing that the demand for ESG has resulted in

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6. See Anete Pajuste & Anna Toniolo, Corporate Response to the War in Ukraine: Stakeholder Governance or Stakeholder Pressure? 2 (Eur. Corp. Governance Initiative Finance Working Paper No. 839, 2022) <https://perma.cc/YVJ6-92LQ> (“the decision to withdraw from Russia is significantly positively associated with boycott campaigns.”).

7. See Todd A. Gormley, Visha K. Gupta, David A. Matsa, Sandra Mortal & Lukai Yang, *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Voice* 149 (2) J. FIN. ECON. 323 (2023); José Azar, Miguel Duro, Igor Kadach & Gaizka Ormazabal, *The Big Three and Corporate Carbon Emissions around the World*, 142 (2) J. FIN. ECON. 674 (2021).

8. Matt Phillips, Exxon's Board Defeat Signals the Rise of Social-Good Activists, N.Y. Times (June 9, 2021), <https://perma.cc/E4XC-8JKW>.

9. See *infra* Section III.A.

strong personal incentives for CEOs to promote ESG, separate from firm value.<sup>10</sup> Cancel culture, employee walkouts, boycotts, and other negative ESG incidents, not only create risks for firms, we argue, but they also threaten the CEO personally. We discuss recent empirical studies that find that negative ESG news, a decline in ESG ratings, or other negative ESG incidents, significantly increase CEOs' risk of termination.<sup>11</sup> Two other factors, we argue, further magnify CEOs' incentives to mitigate their personal risk from ESG failures. First, this personal risk is not diversifiable, while shareholders can spread their risk across thousands of investments, managers have only one career. Second and important, the costs of mitigating this personal risk are not paid out of the CEO's pocket. While the risk of termination is borne by the CEO personally, the costs of ESG investments are borne by the firm and its shareholders. Risk-averse managers may rationally invest (or overinvest) corporate money in ESG even if doing so has no real impact on firm value and even if such investments are not effective ways to pursue social goals, so long as they accrue personal benefits from reduced personal ESG risk.

Third, we show that the social demand for ESG has created strong incentives for index fund managers to promote ESG.<sup>12</sup> The largest shareholders of most large companies are now the "Big Three" index fund managers: BlackRock, State Street, and Vanguard. After years without opportunity to differentiate their products and competing only on price, index fund managers are now using ESG activism to win new investors, millennials in particular.<sup>13</sup> Since index funds offer essentially the same service—a market-tracking portfolio—using their substantial voting power to promote ESG goals is a means of market differentiation, and the competition to attract socially-oriented wealth drives their ESG strategy. Index funds have voted against directors over diversity and climate issues. They also monitor firms' compliance and press for transparency, reducing the likelihood of greenwashing. Thus, index fund activism adds another layer of pressure on managers. Yet, in seeking to be branded as ESG promoters relative to their competitors, index funds might choose to compete aggressively, potentially (though not necessarily) at the expense of firms' performance and

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10. See *infra* Section III.B.

11. Xin Dai, Feng Gao, Ling Lisic & Ivy Zhang, Corporate social performance and the managerial labor market, 28 *Rev. Acct. Stud.* 307, 307 (2021) ("We find that CEOs are more (less) likely to leave office when there is a significant recent decline (improvement) in social performance."); Gonul Colak, Timo P. Korkeamäki & Niclas O. Meyer, ESG & CEO Turnover, 2020 EUROFIDAI-ESSEC Paris Finance Meeting ("We provide evidence that CEOs are significantly more likely to be fired when risk exposure to ESG issues reaches extreme levels."); Richard Walton, What Do the Consequences of Environmental, Social and Governance Failures Tell Us About the Motivations for Corporate Social Responsibility?, 10 *Int'l J. Fin. Stud.* 17 (2022) ("CEO turnover increases when firms are involved in negative ESG events"); Jenna J. Burke, Do Boards Take Environmental, Social, and Governance Issues Seriously? Evidence from Media Coverage and CEO Dismissals, 8 *J. Bus. Ethics* 1 (2021) ("[C]overage of [ESG] issues in prominent media sources is more likely to result in CEO dismissal.").

12. See *infra* Section III.C.

13. We first identified the Millennials effect on index fund and their ESG-activism in a prior paper, Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 *S. CAL. L. REV.* 1243 (2020).

value.

Fourth, we show that social demand has provided activist hedge funds with incentives to target firms with ESG vulnerabilities.<sup>14</sup> Activist hedge funds, which rely on index funds' votes to secure seats on corporate boards, understand that framing their activist campaigns around ESG goals will make their campaigns more successful. As a result, hedge funds are increasingly using ESG goals as a leverage when engaging in activism. Most famously, the small, newly founded Engine No.1 successfully elected three directors to the ExxonMobil board with a climate-focused activist campaign. Other activists are now framing their campaigns with different ESG goals, a strategy that is attractive whether or not the hedge funds in question explicitly share those goals, so long as it tends to attract support from other shareholders. To avoid becoming activist targets, firms must avoid showing exploitable ESG weaknesses. Unsurprisingly, law firm memos now advise managers to search within for ESG weaknesses and fix them to avoid being targeted by activists. Notably, neither index fund managers nor hedge fund managers need to share ESG social goals for these channels to be effective, they are simply responding to social demand.

Fifth, the demand for ESG, we argue, has facilitated ESG regulation, which reinforces the impact of the other channels.<sup>15</sup> While some have argued that embracing ESG and stakeholderism could preempt desirable ESG regulation, we show that the demand for ESG has in fact enabled regulation by weakening long-standing obstacles that regulators have faced. First, firms now face pressure to disclose lobbying activities, and their alignment or misalignment with ESG policies. Second, high shareholder demand for ESG disclosures, and firms' responsiveness to this demand, played a key role in the SEC's Proposed Climate Disclosure Rule by demonstrating a likely-positive regulatory cost-benefit tradeoff.

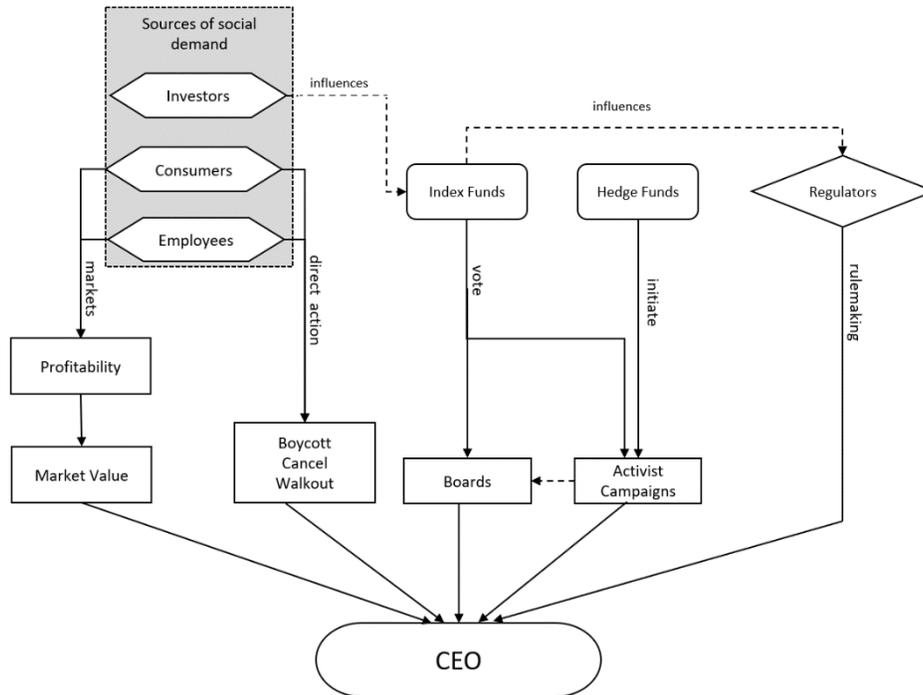
Figure 1 illustrates how multiple channels converge on the CEO to motivate firm response.

### **Figure 1: Channels of ESG Pressure on Management**

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14. *See infra* Section III.D.

15. *See infra* Section III.E.



Our social demand framework, which shows that ESG is a product of external pressure on firms and managers, has important implications for the prospects of ESG, current debates over the desirability of ESG and stakeholderism, and for corporate and securities law and policy.

First, our analysis helps in explaining ESG mixed outcomes. While skeptics regard ESG as smoke and mirrors and greenwashing, proponents suggest that embracing ESG will maximize the value of firms while also promoting the social good. Yet, none of these extremes reflects the reality of ESG. On the one hand, it has become clear that ESG is a force to be reckoned with, with real outcomes, real money at stake, and consequential corporate actions. At the same time, it is also clear that ESG is not always optimal, but rather infused with noise, problematic rating systems, and what sometimes seems to be excessive responses from firms, managers, investment managers, and policy makers.

The set of incentives that we identified indeed leads to both achievements and shortcomings. Since we identify concrete, overlooked incentives for corporate managers, investment managers and activist hedge funds to promote ESG, we expect firms to take real, impactful action to embrace ESG goals. On the other hand, our account shows that incentives are skewed: CEOs incentives are not perfectly aligned with shareholders and the social welfare gains of ESG. Similarly, index fund managers might compete excessively to attract investors at the expense of shareholder value and social welfare.

In addition, our demand-based framework derives several unique predictions, and clarifies a number of perplexing issues related to ESG. First, our analysis predicts that firms are less likely to respond to ESG demand when they possess high market power or when their manager has superstar power. For example, Jeff Bezos at Amazon or Elon Musk at Tesla, have both resisted pushes for ESG enhancements. Second, our analysis suggests that ESG considerations will play a diminished role when negotiating change in control transactions. In the final period of the firm's life the CEOs lose their position in any case, and ESG issues no longer have the same bite. Managers are therefore less likely to look out for employee welfare or social harms post-merger, as in the sale of Twitter.<sup>16</sup> Third, our analysis also explains why ESG is often criticized for lacking coherent conceptual content. Because ESG is a product of social demand, it simply reflects highly salient social concerns of a particular class of consumer and employees. Indeed, diversity and climate, the pillars of current ESG, consistently and repeatedly appeared as a top priority for the vast majority of survey participants.

Second, the forgoing predictions of our framework have normative implications for the desirability of ESG. We see a potential benefit in the results that ESG has promoted so far. The demand for ESG shows some signs that it can cause firms to finally internalize costs that they have historically imposed on society and other parties. The common response of economists, legal scholars, and policy makers has been that environmental concerns, employee rights, and other values should be protected by targeted regulations and are beyond the realm of corporate law. But holding out hope for regulation alone overlooks the influence of money on political and legislative outcomes,<sup>17</sup> not to mention the Supreme Court's recent holding in *West Virginia v. EPA*,<sup>18</sup> which seriously threatens the power of the administrative state to address problems like climate change. Yet, against these benefits, our framework also suggests potential costs of ESG that should be weighed, such as that managers might overreact to the fear of public backlash, that index funds may compete too aggressively, or that ESG may not be promoted if the firm is for sale, if it possesses significant market power, and if the managers are so powerful that they face little risk.

Third, our framework has implications for ongoing debates, and the different views of ESG, stakeholderism and the purpose of the corporation. Our analysis rejects the view that ESG is all smoke and mirrors, or worse, that it is yet again a tool developed by management to justify entrenching mechanisms such as the poison pill.<sup>19</sup> Under this latter managerial entrenchment view, not only does ESG not provide any

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16. See Lucian A. Bebchuk, Kobi Kastiel & Anna Toniolo, *How Twitter Pushed Stakeholders Under the Bus*, *STANFORD J. OF LAW, BUS. & FIN.*, (forthcoming 2023).

17. See generally MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (Princeton Univ. Press 1994); Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 *ECONOMICA*, no. 305, 2010, at 2 (suggesting that governments might fail in protecting stakeholders due to lobbying); LAWRENCE LESSIG, *REPUBLIC, LOST: HOW MONEY CORRUPTS CONGRESS—AND A PLAN TO STOP IT* (Twelve 2011).

18. *West Virginia v. EPA*, No. 20-1530, 2022 WL 2347278, (U.S. June 30, 2022).

19. See, e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3; Bebchuk, Kastiel & Tallarita, *For Whom*, *supra* note 3.

value to stakeholders, but it is likely to entrench management at the expense of shareholders and stakeholders,<sup>20</sup> and to preempt desirable ESG regulation.<sup>21</sup> Proponents of this influential view urge that we learn from history, and argue that managers have no incentives to cater to stakeholders.<sup>22</sup> We do not disagree that in the past managers had no incentives to cater to stakeholders, and accordingly have adopted the rhetoric of social responsibility to fend off accountability. But this time, we argue, since the rise of ESG is driven by external pressures that result in newly created powerful incentives, it is likely to produce real value to stakeholders. Indeed, the progress on board diversity and climate commitments (even if imperfect) illustrates the distinction between past and present.

We also discuss the evidence offered by proponents of the managerialist view and explain why it does not support their conclusion that ESG is just cheap talk. To begin with, most of the evidence relied upon by proponents of the managerial entrenchment view comes from M&A transactions. In particular, they present evidence that when selling their firms managers did not negotiate value for their firms' employees.<sup>23</sup> Yet, as explained above, firm sales create a final period problem, where managers are no longer exposed to the risks of being fired or having their compensation reduced in response to poor ESG performance.

Second, ESG critics also point to a lack of effective commitment mechanisms for promoting ESG as an indication that ESG is all smoke and mirrors. For example, they analyze the proliferation of ESG-based compensation and argue that they are not designed to provide sufficiently strong incentives for managers to promote ESG goals.<sup>24</sup> Similarly, they show that firms that committed to the BRT announcement did not update their governance guidelines or their bylaws to reflect this commitment.<sup>25</sup> They conclude from this that ESG is all talk. Yet, we believe that these examples have limited explanatory power. Since under our analysis there is already strong external pressure, there is no need for these mechanisms to further incentivize managers and boards. Strong incentives (perhaps too strong) are already in place to promote ESG without accompanying compensation or corporate reform.

Proponents of the managerial entrenchment view also argue that ESG will

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20. Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 108 (arguing that the support of stakeholderism is driven by the interest of managers and their advisors "to use stakeholderism "strategically" to insulate corporate leaders from shareholder oversight").
  21. *Id.*, at 168 ("by raising illusory expectations about its ability to remedy corporate externalities, stakeholderism would impede, limit, or delay policy reforms that could offer effective protection to stakeholders.").
  22. *Id.*, at 99 ("corporate leaders have significant incentives *not* to benefit stakeholders beyond what would serve shareholder value"); Bebchuk, Kastiel & Tallarita, *For Whom*, *supra* note 3.
  23. *See, e.g.*, Bebchuk, Kastiel & Tallarita, *For Whom*, *supra* note 3.
  24. *See* Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, 48 J. CORP. L. 37 (2022) [hereinafter Bebchuk & Tallarita, *ESG-Based Compensation*].
  25. *See* Lucian A. Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?*, 75 VAND. L. REV. 1031 (2022) [hereinafter Bebchuk & Tallarita, *Will Corporations*].

preempt desirable regulation. According to this argument, opponents of ESG regulation may utilize ESG practices and policies to argue that regulation is redundant. Our analysis suggests the opposite, the rising demand for ESG has facilitated ESG regulation, as evidenced by the rise of diversity audits and the SEC's proposed disclosure mandate. That these practices were adopted by some firms was utilized by the financial regulators to support their cost-benefit analysis. The obstacles these rules face now are primarily constitutional.

Our analysis has implications also for the view of ESG proponents that ESG maximizes long-term firm value.<sup>26</sup> For these commentators, attention to ESG issues is simply the right way to run the firm. We agree that some aspects of ESG will contribute to firm value and to social welfare. Firms that perform poorly on ESG could suffer backlash from the three markets we describe, harming profits and performance. At the same time our analysis suggests that while the incentives created by social demand are forceful, they are also skewed, and could sometimes be excessive. Thus, ESG could reduce shareholder value, and sometimes social welfare.

Finally, our analysis has important policy implications for corporate and securities law. Currently, securities regulators are responding to ESG by increasing disclosure requirements, and skeptics argue that disclosures related to issues like carbon emissions are about "naming and shaming" bad actors. Yet, when a litany of socially sensitive issues can suddenly become very real problems for a consumer brand or for firms recruiting employees, even the most hard-nosed investors must take notice. Information that would not have been considered material a decade ago may suddenly become material in the new ESG environment. Securities laws should reflect this change.

Our analysis has implications for corporate law policy as well. Commentators have suggested different mechanisms to incentivize CEOs and boards to promote ESG goals. Chief Justice Leo Strine argued that ESG should be in the realm of board risk oversight.<sup>27</sup> Following Delaware court line-of-oversight decisions holding that boards should monitor mission-critical risks, we think that it is more than likely that some parts of ESG will fall within this realm. Oliver Hart and Luigi Zingales argued that managers and fund managers should maximize shareholder welfare rather than returns, and they propose different mechanisms to achieve that goal.<sup>28</sup> We do not have a strong position on these proposals, but we believe that social demand will continue to drive change even without reforms to existing law. Even within current legal frameworks ESG can continue to rise, since strong incentives are already in place, and

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26. See e.g., Lipton, *supra* note 3. But see Mark J. Roe, Holger Spamann, Jesse Fried & Charles Wang, *The Sustainable Corporate Governance Initiative in Europe*, 38 YALE J. ON REG. BULL. 133 (2021) (arguing that externalities and distributional concerns should not be conflated with time-horizon problems).

27. See Leo E. Strine, Jr., Kirby M. Smith & Reilly 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 (2021).

28. See Oliver D. Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACC. 247 (2017); Oliver D. Hart & Luigi Zingales, *The New Corporate Governance*, 1 CHI. BUS. L. REV. 195 (2022).

everyone is on the same page—managers, board members, index fund managers, activist hedge funds, and regulators.

This paper proceeds as follows. Part I provides an overview of the current ESG literature and attempts to square the rise of ESG with traditional views of the corporation. It then turns to a discussion of why existing accounts of ESG do not fully capture current dynamics. Part II gives an overview of the classical theory of the firm, and Part III develops the five channels by which social forces travel directly into the c-suite. In Part IV, we discuss implications for the ESG and stakeholderism debates, for the future and desirability of ESG, and for corporate and securities law. Part V concludes.

### I. Traditional Corporate Law Theories Miss an Important Piece of the Puzzle

This section briefly describes the rise of the ESG movement and its current, central importance to the business world. We then review existing academic accounts of ESG and explain why—in our view—they overlook an important piece of the puzzle.

#### A. The Rise of ESG

Both critics and advocates agree that once relatively marginal phenomena like socially responsible investing and stakeholderism have taken center stage in the corporate world.<sup>29</sup> ESG has become the corporate governance watchword and CEOs, directors, corporate counsel, investors, consumers, and employees are paying attention as the business landscape rapidly shifts.

The modern ESG movement began with pressure on firms to address a lack of gender diversity on corporate boards. These efforts have produced real results. Mutual fund giant State Street's launch of the SHE fund led to a "one upswomanship" rivalry with Blackrock over who could more aggressively support the election of women to corporate boards.<sup>30</sup> These efforts resulted in a dramatic increase in women directors and the adoption of diversity criteria by NASDAQ and Goldman Sachs for companies that list on the former or go public via the latter.<sup>31</sup> The protests following the murder of George Floyd have helped fuel an unprecedented increase in representation of racial minorities on US boards.<sup>32</sup> In 2021, diverse candidates filled more than 70% of new board appointments.<sup>33</sup> Yet, progress is still far from satisfactory due to the low pace of turnover on US boards.<sup>34</sup>

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29. See e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 106 ("In the past decade, however, stakeholderism has been on the rise, especially in terms of its acceptance by corporate executives, management advisors, and policy thought leaders.").

30. See *infra* Section III.C.

31. See *id.*

32. See Maksims Dzabarovs, Romans Madesovs & Anete Pajuste, *Boardroom Racial (In)Equality and Stock Returns: Evidence from the Black Lives Matter Protests* (Eur. Corp. Governance Inst., Working Paper No. 789, 2021), <https://perma.cc/WB2W-8HMJ>.

33. See SpencerStuart, 2022 S&P 500 Board Diversity Snapshot (June 2022). <https://perma.cc/D653-Z8SG>.

34. *Id.*

There has also been notable progress on climate issues. Blackrock CEO Larry Fink recently stated that the environment and global warming were at the center of everything Blackrock does.<sup>35</sup> Shareholder proposals requesting that companies set carbon-neutrality goals consistent with the Paris Climate Accords enjoy broad support and regularly pass. These campaigns have brought measurable results both in emissions level and in relevant disclosure.<sup>36</sup> The 2021 proxy season brought the most recent shock in favor of environmentally-friendly investors as dissident shareholders elected three new directors to the board of Exxon on a campaign aimed at reducing emissions related to Exxon oil and gas production.<sup>37</sup> Other activist hedge funds jumped on the new opportunity to leverage ESG.

In the asset management sphere, money is pouring into funds that specialize in ESG investing. Indeed, it is the fastest growing section of the industry. In 2020, flows into sustainable funds exceeded \$50 billion, a nearly tenfold increase over 2010, and almost a fourth of total flows into U.S. stocks and bonds.<sup>38</sup> Total assets in U.S. sustainable funds exceed \$200 billion, a more than 70 percent increase from their value in 2019.<sup>39</sup> These funds seek out firms with strong ESG records or invest in poor-ESG firms and engage with management to generate improvements.

An entire ecosystem has developed to help businesses manage ESG issues, itself a big business. Lawyers, accountants, consultants, rating agencies, data providers like Standard and Poors, ISS, and MSCI<sup>40</sup> all have pivoted to provide insight into ESG issues and help managers and investors navigate the shifting ESG terrain. Firms' investor relations websites now almost universally include an ESG section, often with hundreds of pages of disclosures going far beyond what securities laws require. These disclosures are shaped by an alphabet soup of third-party standards-setters like the Sustainability Accounting Standards Board and GRI which provide detailed specifications for how companies should disclose emissions and workforce diversity and are taken seriously by investors who frequently press for more information.<sup>41</sup>

As if to punctuate the rise of ESG, on August 19, 2019, the Business Roundtable, a group of CEOs of major corporations, announced that they "share a fundamental commitment to all of our stakeholders," including customers, employees, and

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35. See e.g., Larry Fink's 2021 Letter to CEOs, BlackRock (Jan. 2021), <https://perma.cc/P4CT-G3U5> ("There is no company whose business model won't be profoundly affected by the transition to a net zero economy"); Andrew Ross Sorkin, BlackRock C.E.O. Larry Fink: Climate Crisis Will Reshape Finance, N.Y. Times (Jan. 14, 2020), <https://perma.cc/K5J7-R4C3>.

36. See *infra* Section III.F.

37. See *infra* Section III.D.

38. Jon Hale, A Broken Record: Flows for U.S. Sustainable Funds Again Reach New Heights, MorningStar (Jan. 28, 2021), <https://perma.cc/YAX5-QSZD>.

39. *Id.*

40. Quinn Curtis, Jill Fisch & Adriana Z. Robertson, Do ESG Funds Deliver on Their Promises?, 120 Mich. L. Rev. 393 (2021).

41. See, e.g., SASB Standards, Value Reporting Foundation, <https://perma.cc/F7BP-ZCQH> (last visited July 23, 2022); Global Reporting Initiative, <https://perma.cc/8YEH-T59Y> (last visited July 23, 2022).

communities.<sup>42</sup> The statement was in sharp contrast to past commitments to run companies solely in the interest of shareholders. And while the Business Roundtable statement was mostly aspirational, ESG is having real, measurable effects on the ways businesses operate, talk to shareholders, and plan their strategies.

ESG has taken center stage with remarkable swiftness and—as we will detail below—dramatic effects. The question is why? Legal scholarship has provided no shortage of potential answers.

### B. Current Approaches to the Rise of ESG and their Limitations

Corporate law scholars have tried to explain the recent rise of ESG and stakeholderism and to make predictions on where it will lead us. Will ESG and stakeholderism grow or disappear? Are managers truly committed to following their announcements or is it all just cheap talk? For example, while the Business Roundtable announcement attracted significant attention and publicity, and was described by some as radical,<sup>43</sup> numerous commentators believed that it did not indicate a significant shift in the corporate form and purpose.<sup>44</sup> These different views can be subdivided into familiar camps, including the shareholder primacy camp, the long-term value camp, the managerial entrenchment camp, the political dysfunction camp, and the concentrated economic power camp.

The shareholder primacy camp represents general skepticism that ESG represents a real departure from shareholder primacy. Lund and Pollman argue that the immense apparatus of corporate governance has bent ESG's stakeholder ambitions back toward shareholder interests, hence the fixation of ESG investors on long-term shareholder value.<sup>45</sup>

Others have argued that promoting ESG is essential to maximize firms' long-term value. Martin Lipton, a prominent supporter of this view, argued that management duties extend to promoting stakeholderism "in order to ensure its [firms'] success and grow its value over the long term."<sup>46</sup> Many asset managers also foreground shareholder value. State Street says:

"As supported by an abundance of research, we believe that companies that are managed responsibly and adhere to high environmental, social and governance standards deliver better financial results over the long-term and are well-positioned to withstand emerging risks and capitalize on new opportunities. As such, we believe we have a responsibility as an asset manager to integrate sustainability risk and opportunities

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42. *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'* (Aug. 19, 2019), <https://perma.cc/6YRD-ZAEC>.

43. See e.g., Lipton, *supra* note 3.

44. See e.g., Bebhuk & Tallarita, *Illusory Promise*, *supra* note 3, at 98 ("[W]e show that the BRT statement was mostly for show, largely representing a rhetorical public relations move, rather than the harbinger of meaningful change."); Lucian Bebhuk & Roberto Tallarita, *Stakeholder Capitalism Seems Mostly for Show*, WALL ST. J. (Aug. 7, 2020), <https://perma.cc/BWU7-N995>.

45. Lund & Pollman, *supra* note 3.

46. See Lipton, *supra* note 3.

into investment decision-making alongside traditional investment analysis.”<sup>47</sup>

The suggestion from investors is that ESG and stakeholderism are simply the right way to invest, and that social values will rarely, if ever, conflict with long-term shareholder value.

Other commentators are convinced that stakeholderism is just managerialism in sheep’s clothing. They not only argue that managers will not promote stakeholder welfare, but that they will use stakeholderism as an excuse to self-serve and to further insulate themselves from shareholders.<sup>48</sup> A prominent pioneer of this managerial entrenchment view, Lucian Bebchuk, has argued that managers in fact have no incentives to promote stakeholder interests, and can cleverly use stakeholderism to insulate themselves from shareholder pressures. Bebchuk is not alone in this view. For example, Larry Summers, who served as Harvard University president and U.S. Treasury Secretary, opined that “without enforcement tools the [Business Roundtable] statement lacked teeth,” and speculated about its ulterior motives.<sup>49</sup>

This managerial entrenchment view has several important implications. First, it argues that stakeholders will not benefit at all from the rise of ESG/stakeholderism.<sup>50</sup> In another paper, Bebchuk, Kastiel & Tallarita use the example of Other Constituency Statutes, which allowed managers to take into account the interests of other constituencies in change-of-control situations, as support for their argument that stakeholderism is a trojan horse.<sup>51</sup> These statutes, which were adopted in many states in response to the hostile takeover wave of the 1980s, arguably, were intended to protect employees and other constituencies that were hurt by hostile takeovers.<sup>52</sup> Yet, in reality, Bebchuk, Kastiel & Tallarita show employees and other constituencies did not benefit from having them in place.<sup>53</sup> Rather, managers relied on them primarily to benefit themselves.<sup>54</sup> This experience, the authors argue, suggests that stakeholderism should be regarded with suspicion.<sup>55</sup>

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47. State Street Global Advisors, ESG Investment Statement, State Street Global Advisors (Oct. 2021), <https://perma.cc/UUE4-4CX4>.

48. *See, e.g.*, Bebchuk & Tallarita, Illusory Promise, *supra* note 3; Bebchuk, Kastiel & Tallarita, For Whom. *supra* note 3.

49. *See* Richard Henderson & Patrick Temple-West, Group of US Corporate Leaders Ditches Shareholder-First Mantra, *Fin. T.* (Aug. 19, 2019), <https://perma.cc/23QZ-DSTX>.

50. Bebchuk & Tallarita, Illusory Promise, *supra* note 3, at 107 (“We...show that recent commitments to stakeholderism were mostly for show rather than a reflection of plans to improve the treatment of stakeholders.”).

51. Bebchuk, Kastiel & Tallarita, For Whom. *supra* note 3.

52. *Id.*; *see also* Michal Barzuza, The State of State Antitakeover Law, 95 *Va. L. Rev.* 1973 (2009).

53. Bebchuk, Kastiel & Tallarita, For Whom. *supra* note 3.

54. *Id.*; *see also* Bebchuk & Tallarita, Illusory Promise, *supra* note 3.

55. Bebchuk, Kastiel & Tallarita, For Whom. *supra* note 3, at 1468 (“[T]hese findings also provide important lessons for the ongoing debate on stakeholderism.”). In a recent work, Bebchuk, Kastiel & Tallarita find that also in current acquisition, during the pandemic, managers did not protect employees and other constituencies. *See* Bebchuk, Kastiel & Tallarita, Stakeholder Capitalism in the Time of Covid, 40 *Y. J. on Reg.* 60 (2023) [hereinafter Bebchuk, Kastiel & Tallarita, Covid].

Second, the managerial entrenchment view asserts that stakeholderism will be harmful as it will lead to further management entrenchment.<sup>56</sup> In particular, in a recent paper, Bebchuk & Tallarita argue that the current motivation of the stakeholderism movement is to empower managers to use stakeholderism as a defense against activist hedge funds.<sup>57</sup> Recently, activist hedge funds' common strategy has been to run director nominees to the board. Whether they succeed depends, to a large extent, on whether they get the large index funds to vote in support for their candidates. The stakeholderism rhetoric, Bebchuk and Tallarita argue, will be used by managers to "urge institutional investors to avoid cooperating with hedge fund activists and to side with and support corporate leaders."<sup>58</sup>

Furthermore, managers can also use this rhetoric, they argue, to preempt legislative or regulatory reforms that would truly aid stakeholders while constraining managerial power.<sup>59</sup> As a result, not only will stakeholderism not provide meaningful benefits to stakeholders, but accepting it "would be substantially detrimental to shareholders, stakeholders, and society."<sup>60</sup> Bebchuk and Tallarita advocate protecting stakeholders through governmental and not corporate action, that is, with rules and regulations outside the realm of corporate law and governance.<sup>61</sup>

Both the shareholder value camp and the managerial entrenchment camp share one underlying feature: they do not fully account for the rising social pressure on firms to act responsibly. Both views fail to address the question "Why now?" If ESG is merely maximizing shareholder value or entrenching managers, then why has it come to the fore so suddenly? We think that incorporating social demand for corporate responsibility into the explanation for ESG is essential to understanding the dynamics of the ESG ecosystem and hence the modern corporation.

Another common limitation of the shareholder value and the managerial camps is that they do not explain the relatively sudden shift in index fund activism with respect to ESG. Why have traditionally passive index funds turned aggressively active on the ESG front? Proponents of the shareholder primacy view argue that index funds engage to maximize shareholder value.<sup>62</sup> Yet, index funds, as passive investors selling

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56. Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 92 ("[W]e show that acceptance of stakeholderism could well impose major costs.").

57. *Id.* at 167 ("It might not be a coincidence that support for stakeholderism among some management advisors and corporate leaders has been growing in recent years in which hedge fund activism has intensified.").

58. *Id.* at 166.

59. *Id.*, at 108 ("A second driver is the interest among some corporate leaders and their advisors to use stakeholderism 'strategically' to insulate corporate leaders from shareholder oversight and to impede or delay stakeholder-protecting reforms that would constrain companies' choices.").

60. *Id.*, at 100.

61. *Id.*, at 94 ("In our view, the most effective way to do so [to protect stakeholders] is by adopting laws, regulations and government policies—such as labor-protecting laws, consumer-protecting regulations, and carbon-reducing taxes—aimed at protecting stakeholder groups.").

62. *See* Lund & Pollman, *supra* note 3. Yet, investment managers are likely to frame their

only market exposure, are indifferent to how individual companies perform.<sup>63</sup> Indeed, to this day they have remained utterly passive with respect to inefficient traditional corporate governance practices, while being confrontational and voting against boards with poor diversity and environmental records.

Two other accounts attempt to explain the rise of ESG. One attributes the rise of ESG to public frustration with political dysfunction in Washington.<sup>64</sup> Political polarization, under this account, has brought regulatory deadlock. The fear that regulators won't act, or act irrationally, with respect to pressing issues like climate change have led investors to decide that protection of other constituencies cannot be left to regulation. While in the past, the protection of the environment,<sup>65</sup> employee rights,<sup>66</sup> and social values, was left to Congress or administrative agencies, if Congress is not functioning, or if administrative power is constrained, then corporate law cannot remain idle.

It is true that the acceleration of ESG coincided with the start of the Trump administration. Yet, this account does not explain why ESG has remained robust to the change in administration and has only accelerated with the shift in Washington. Put differently, political forces were once against ESG and are now supportive. But ESG's growth has persisted into the Biden administration, even as the regulatory environment has grown more favorable to those with ESG concerns. Finally, this view also does not explain index funds' ESG activism, which persisted even as it drew negative regulatory attention from the Trump administration.

Another view explains the rise of ESG as a result of increased concentration in the product markets.<sup>67</sup> Under this view, ESG is a luxury that monopolists can invest in

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actions as maximizing shareholder value to avoid potential challenges based on their fiduciary duties. Cf. Madison Condon, *Externalities and the Common Owner*, 95 Wash. L. Rev. 1 (2020) (arguing that universal owners have incentives to internalize intra-portfolio externalities, creating an incentive to push for reduced greenhouse gas emissions and therefore explaining at least the environmental activism of institutional investors.); Jeffrey N. Gordon, *Systematic Stewardship* (Colum. L. & Econ., Working Paper No. 640, 2021), <https://perma.cc/BFV3-74V7> (arguing that index funds should promote ESG to decrease systemic risks); Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 Vand. L. Rev. 1401 (2020) (explaining the rise of ESG as an Index funds attempt to reduce investors downside risk). These theories build on index funds' incentives to increase the share value of their portfolio firms, which are relatively weak.

63. See generally Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Colum. L. Rev. 2029 (2019).

64. See Edward B. Rock, *For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose*, 76 Bus. Law. 363 (2021).

65. *Id.* at 368 ("If the legislature will not enact reasonable environmental regulation to control carbon, and we face imminent and irreversible environmental degradation, perhaps corporate law and governance should do more to control climate change, either by treating it as an additional risk factor that boards should consider, or as a direct object").

66. *Id.* ("If labor law does not provide employees with adequate bargaining power to secure a fair share of productivity gains, and the resulting populist upsurge threatens damaging mandatory regulation, perhaps corporate law and governance should do more for employees").

67. See Mark J. Roe, *Corporate Purpose and Corporate Competition*, 99 Wash. L. Rev. 223

with their monopolist profits.<sup>68</sup> Firms in competitive industries who sell at marginal costs of production have no resources for ESG.<sup>69</sup> In contrast, monopolists or quasi-monopolists can abuse their market power to offer the luxury of spending on ESG.<sup>70</sup> Social pressure, under this account, is the trigger. What enables firms to respond to the growing social pressure, however, is primarily their growing market power and monopolist slack over the last decade.<sup>71</sup>

While firm concentration has been associated with ESG in the past,<sup>72</sup> the current reality is different.<sup>73</sup> Firms find it difficult to survive competition if they are ignorant of ESG issues.<sup>74</sup> ESG has become a competitive dimension. Firms that invest in ESG attract customers, employees, and investors. It's not that monopolists and quasi-monopolists can offer ESG as a luxury good. Quite the contrary, they are the only ones that can resist ESG pressures.

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Many of these accounts have explanatory power, but none of these accounts capture all of the facets of the growth of ESG, because they overlook the important role that bottom-up social pressure has played in shifting economic incentives. On close inspection, each of these competing accounts can be understood within the long-standing, manager-vs.-shareholder account of corporate structure. But, as the following parts will show, managers are not driving ESG, they are responding to fierce bottom-up demand. This demand has spread throughout the market and constrains managers from all sides: via consumption, employment and investment, index funds, hedge funds, and pension funds.

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(2021).

68. *Id.*

69. *Id.*

70. *Id.*

71. *Id.* at 246 (“Unions in the United States were historically less effective “in establishments facing competitive product market conditions [than] in establishments with . . . product market power as a result of facing limited competition”).

72. *Id.* at 244-249 (surveying evidence on ESG and market power).

73. See Brian Bell, Paweł Bukowski & Stephen Machin, Rent Sharing and Inclusive Growth 2-4 (LSE Int'l Inequalities Inst., Working Paper No. 29, 2019) (“The decline in rent sharing is coincident with the rise of product market power that has occurred as worker bargaining power has dropped. Although firms with more market power previously shared more of their profits, they experienced a stronger fall in rent sharing after 2000”); Cf. Roe, *supra* note 65, at 261-63 (discussing potential changes in the new politicized environment).

74. See e.g., Rui Dai, Hao Liang & Lilian Ng, Socially Responsible Corporate Customers, 142(2) J. Fin. Econ. 598, 619 (2021) (finding that “when the supplier is in a highly competitive industry, it tends to align its CSR practices with that of its customer.”); Philippe Aghion, Roland Bénabou, Ralf Martin & Alexandra Roulet, Environmental Preferences and Technological Choices: Is Market Competition Clean or Dirty?, 5(1) Am. Econ. Rev. Insights 1, 2 (2023) (“We find a significant positive effect of proenvironment attitudes on the probability of a firm to innovate relatively more in the clean direction, and this effect is stronger the higher competition is”).

## II. The Classic Corporation: Strong CEOs, Weak Shareholders & Weaker Stakeholders

In the classic corporation, prior to the recent rise of ESG and the social pressure to promote it, managers had weak incentives to promote shareholder wealth and even weaker incentives to promote stakeholder wealth. Since ownership was dispersed, shareholders suffered a severe collective action problem. Small shareholders who maximized returns had no incentive to be active, as they could rarely influence firms, and had little potential gain from such influence because of the free-rider problem: any benefits to activism had to be shared with those who remained passive. Consequently, there was little that shareholders could do to discipline managers.

To be sure, markets provided some incentives to managers to cater to shareholder interests. To begin with, the market for corporate control could provide accountability. If managers extract perks or poorly manage, the price of stock should decline as a result and an intrepid investor could buy control of the firm, replace management, and reap the rewards. The leveraged buyouts of the 1980s demonstrated the feasibility of this approach and provided some support for the “greed is good” mantra of raw shareholder value. But the poison pill, staggered boards, and other takeover defenses blunted this constraint. Similarly, Judge Frank Easterbrook and Daniel Fischel have argued low stock value results in higher costs of capital, difficulties competing in the product market and lower compensation.<sup>75</sup> Yet, as Lucian Bebchuk and Jesse Fried have argued forcefully, managerial exposure to share value is limited.<sup>76</sup> Private benefits may outweigh their small share in the harm to the firm. The managerial labor market is also limited in its influence since firm performance is noisy, and as a result, unobservable management efforts and performance are hard to evaluate with precision.

The entry of large institutional shareholders held some potential to solve the collective action problem of shareholders. If retail investors pool money and invest through mutual funds, then perhaps the mutual funds can monitor managers more effectively. But even large and powerful index funds like the Big Three—State Street, Blackrock, and Vanguard—have weak incentives to exercise their power to check and discipline managers.<sup>77</sup> While the Big Three index managers have plenty of voting power to influence firms, their managers reap no rewards from being active. Fund managers’ compensation is designed to reward assets under management, not changes to the portfolio’s value.<sup>78</sup> Furthermore, if the value of the firms in BlackRock’s portfolio increases, so does that of rivals State Street and Vanguard, as (being index investors)

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75. Frank Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law 2* (1996) [hereinafter Easterbrook & Fischel, *Economic Structure*], at 4 (“Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors’ interests at heart. It is almost as if there were an invisible hand.”).

76. Lucian Bebchuk and Jesse Fried, *Pay without Performance: The Unfulfilled Promise of Executive Compensation* (2004)

77. *See, e.g.*, Bebchuk & Hirst, *supra* note 63.

78. *Id.*; *see also* Marcel Kahan & Edward Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 *B.U. L. Rev.* 1771 (2020).

they all owned the same assets in the same proportions.<sup>79</sup> Thus, activism would confer identical benefits on their competitors, creating a classic free-rider problem.<sup>80</sup> Furthermore, being confrontational with managers could lead to management retaliation by diverting valuable employees 401(k) assets from one of the Big Three to another. Indeed, as Bebchuk and Hirst demonstrated, index funds have historically remained overwhelmingly passive despite their enormous economic and voting power. They did not submit shareholder proposals and tended to side with management in annual elections to the board, say on pay votes and votes on shareholder proposals.<sup>81</sup>

If managers' incentives to protect shareholders were weak, their incentives to protect stakeholders such as employees, customers and the environment were close to non-existent. While these stakeholders are entitled to whatever contractual bargain they are able to strike, managers' welfare was tied primarily to shareholder value and to their private benefits. Furthermore, managers owe non-shareholders no obligations and would sacrifice their welfare to serve shareholder interests (or their own) whenever possible.

Under this classic account of the corporation, in which managers had only weak incentives to improve shareholder value and no incentives to improve stakeholder value, it does not come as a surprise that stakeholderism was invoked primarily as a tool to further insulate managers from shareholder pressure. Indeed the passage of "other constituency statutes" that Bebchuk, Kastiel & Tallarita have identified as an ineffective foray into stakeholderism, was one of the very few cases in which stakeholders were ever brought into corporate law and managers duties.<sup>82</sup> These statutes, which allowed managers to consider the interests of other constituencies (like employees and suppliers), were lobbied for by management themselves and from the outset had a clear personal advantage for them: equipping them with power to block hostile bidders.

### III. The Millennial Corporation: Social Demand Channeled into Firms

This Part develops a theory of the rise of ESG in a setting of social demand and resulting incentives. It analyzes how, over the recent decade, CEO incentives to promote stakeholderism have significantly strengthened. It shows that the bottom-up demand for ESG has created pressures on CEOs through at least five distinct channels. Channel I operates via the direct demand for jobs, goods, and investments that comport with social values. Channel II focuses on the personal incentives that the CEO has to promote ESG goals, in order to protect his or her own reputation and career. Channel III addresses the effects of social demand in incentivizing the large index funds to exert ESG stewardship. Channel IV has emerged recently through hedge fund

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79. Bebchuk & Hirst, *supra* note 63.

80. *Id.*; see also, Jill Fisch, Asaf Hamdani & Steven D. Solomon, The New Titans of Wall Street: A Theoretical Framework for Passive Investors, 168 U. Pa. L. Rev. 17 (2019) (arguing that index funds face competition from other funds).

81. *Id.*

82. Bebchuk, Kastiel & Tallarita, *supra* note 3.

activism. Finally, Channel V emerges from regulators, who respond to investors' demand for transparency and accountability around ESG issues.

Importantly, each of these channels separately exerts pressure on managers to promote ESG. None of them is crucial for our proposed thesis. It is their cumulative effect that determines to what extent firms will promote ESG.

#### A. Channel I: Millennials, Markets and Social Demand for ESG

This part will describe the rising demand of employees, consumers, investors and the public in general that creates pressure for firms to promote ESG goals. It analyzes studies on the relationship of ESG to consumption, employment, investment, and firm performance, often with specific focus on millennial-driven changes. The social demand for ESG is not limited to the millennial generation, but millennials, as the largest generation ever, one that will soon dominate employment, consumption, and investment, are a powerful source of social demand and their preferences are a key driver of ESG. Equally important, millennials have gained a reputation as living out their social values via economic conduct—through investment, consumption, and employment. We emphasize both academic and industry evidence because CEOs are likely to respond to both. Overall, the evidence is consistent with ESG having at least some economic value. Not less important, the evidence is sufficient for managers and index fund managers to rationalize potentially excessive or defensive ESG investments and policies rooted in greenwashing or virtue signaling.

##### 1. Millennial Demographics

First and foremost, the millennial generation is massive. It was born between 1981-1996 and has a population of 72 million. Generation Z, born between 1997-2012, has a population of 67 million. The millennials constitute the largest generation in U.S. history, larger than the Baby Boomers, born 1946-1964, with a population of 69.5 million, and larger also than Generation X, born 1965-1980 with a population of 65 million, the smallest living generation.<sup>83</sup>

Millennials and Generation Z combined already comprise most of the U.S. population.<sup>84</sup> In 2021 millennials comprised 35% of the US total labor force, almost half of it

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83. Resident Population in the United States in 2020, by Generation (in millions), Statista (June 2021), <https://perma.cc/SEZ3-AR7M/>; see also, Millennials Coming of Age, Goldman Sachs Global Investment Research, <https://perma.cc/FA3Z-R4FS> (last visited July 24, 2022) (“[T]he Millennial generation is the biggest in U.S. history.”).

84. William H. Frey, Now, More Than Half of Americans are Millennials or Younger, The Brookings Institute: The Avenue (July 30, 2020), <https://perma.cc/AB93-CWKL>. Studies have shown that millennials are not more likely to become conservative as they age, breaking from the traditional trend of voters to become more conservative as they age. A possible explanation for this is the unique experience of millennials, such as reaching political maturity after a global financial crisis, which shaped the collectives' values. John Burn-Murdoch, Millennials are shattering the oldest rule in politics, Financial Times (Dec. 30, 2022), <https://perma.cc/G9RF-J2KK>.

when combined with Gen Z.<sup>85</sup> In 2020, millennial spending power was estimated at \$2.5 trillion.<sup>86</sup> And, as described in our prior work, the millennials stand to inherit roughly \$24 trillion in assets, described by BlackRock CEO Larry Fink as, “the largest asset transfer in history.”<sup>87</sup> In short, millennials are rapidly becoming the most dominant generation, and their priorities matter to corporations.

Millennials, it is widely believed, are inclined to bring their values to work, to the shop, and to their portfolio. Numerous surveys repeatedly and consistently demonstrate these stated preferences. Their visible confrontational ESG activism, using walk-outs, boycotts and cancel culture, and utilizing social media for influence, has further contributed to this reputation. Moreover, millennials—unlike prior generations—are not trending to the political right as they age, portending a seismic shift in the social landscape.<sup>88</sup> The following parts discuss studies that assess the potential economic effects of ESG on these markets and on firms.

## 2. Employment & ESG

### a. Employees’ Demand for ESG in Choosing Where to Work

Social demand has made executing on ESG issues essential to attracting and retaining talent.<sup>89</sup> Anecdotal evidence suggests, for example, that, despite its profitability, the fossil fuel industry increasingly struggles to attract workers, who prefer to work on projects related to renewables.<sup>90</sup> Facebook recruiters report that the firm struggled to attract talent in the fiercely competitive tech hiring space after the Cambridge Analytica scandal.<sup>91</sup>

Several academic studies have attempted to assess whether there is rising employee demand for ESG.<sup>92</sup> For example, Philipp Krueger, Daniel Metzger, and Jiaxin

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85. Ed O’Boyle, *Workplace*, Gallup (Mar. 30, 2021), <https://perma.cc/U83D-8M4E>. By 2025 they are expected to comprise half of the U.S. workforce and 75% of the global workforce. *Id.*

86. *Millennials & Gen Z Teens’ Combined Spending Power Is Nearly \$3 Trillion in 2020*, YPULSE (Jan. 9, 2020), <https://perma.cc/K2JM-P6YM>.

87. Larry Fink, *Profit and Purpose: Larry Fink’s 2019 Letter to CEOs*, BlackRock (2019), <https://perma.cc/6GEH-J26T>.

88. John Burn-Murdoch, *Opinion, Millennials are Shattering the Oldest Rule in Politics*, Financial Times (London), Dec. 29, 2022.

89. *See e.g.*, Jennifer Miller, *For Younger Job Seekers, Diversity and Inclusion in the Workplace Aren’t a Preference. They’re a Requirement*, Wash. Post, Feb. 18, 2021, <https://perma.cc/PW3J-DVCJ>; Arne Gast et al., *Purpose: Shifting from Why to How*, McKinsey Quarterly (Apr. 22, 2020), <https://perma.cc/H9TF-GN4V>.

90. Ron Bousso, *Oil and Gas Industry Faces Workforce Crunch as Renewables Beckon: Survey*, The Globe and Mail, Nov. 30, 2021, <https://perma.cc/U4GR-WKRN>.

91. Salvador Rodriguez, *Facebook Has Struggled to Hire Talent Since the Cambridge Analytica Scandal, According to Recruiters Who Worked There*, CNBC (May 16, 2019, 2:58 PM), <https://perma.cc/7XGZ-8C2Y>.

92. *See e.g.*, Philipp Krueger, Daniel Metzger, & Jiaxin Wu, *The Sustainability Wage Gap* (Eur. Corp. Governance Inst., Finance Working Paper No 718/2020, Apr. 2022) (“There is

Wu analyzed a comprehensive and novel data set on employment and wages of Swedish firms.<sup>93</sup> Their results suggest that firms in sustainable sectors were better able to attract and retain high skilled workers, and were paid lower wages than firms in unsustainable industries.<sup>94</sup> Consistent with the view that the preferences for sustainability are stronger among young workers they find the sustainability wage gap they identified increases over time.<sup>95</sup> The findings are consistent with employees increasingly valuing sustainability, but whether firms can profit more by changing their ESG strategies remains an open question.

Two recent experimental studies provide evidence for potential causal effects of ESG on employee attraction and retention. In one recent field experiment, Hedblom, Hickman & List find both that “[Corporate Social Responsibility] increases the number of applicants by 25 percent,” and that “when a firm advertises work as socially oriented, it attracts employees who are more productive, produce higher quality work, and have more highly valued leisure time.”<sup>96</sup> Another study, by Vanessa Burbano, finds that introducing ESG employer-related information to online job applicants lowered the wage the workers were willing to accept.<sup>97</sup> Yet, while these studies provide some causal evidence, their interpretation should be limited to short-term employment.

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mounting evidence that individuals increasingly care about the environment.”); In a study of 14,808 gen Z’s and 8,412 millennials across 46 countries, nearly half the participants who hold senior positions in their job say that they would reject a job and/or assignment based on their personal ethics. In the same survey, less than half of the participants found business to have a positive impact on society, the fifth consecutive year the percentage has dropped. The Deloitte Global 2022 Gen Z and Millennial Survey (2022), <https://perma.cc/RYQ6-VEZH>.

93. *Id.*

94. *Id.* (“[We] provide evidence that workers earn about 9% lower wages in firms that operate in more sustainable sectors. We hypothesize that this Sustainability Wage Gap arises because workers, especially those with higher skills and from younger cohorts, value environmental sustainability and accept lower wages to work in more environmentally sustainable firms and sectors. Accordingly, we find that the Sustainability Wage Gap is larger for high-skilled workers and increasing over time. . .”)

95. *Id.* at 15. (“While we would like to test the prediction that environmental preferences vary across birth cohorts in the Prolific survey data, we do not have enough variation in terms of birth cohorts: the median age of our respondents is 24 years (see Table B.1) and the 95 percentile is 45 years”).

96. See Daniel Hedblom, Brent R. Hickman & John A. List, *Toward an Understanding of Corporate Social Responsibility: Theory and Field Experimental Evidence* (Nat’l Bureau of Econ. Rsch., Working Paper No. 26222, 2019); see also Vanessa C. Burbano, *Getting Gig Workers to Do More by Doing Good: Field Experimental Evidence from Online Platform Labor Marketplaces*, 34(3) *Org. & Env’t* 387 (2019) (conducting two field experiments and finding that providing gig workers with information about employer charity contribution increases their willingness to do extra work).

97. See Vanessa C. Burbano, *Social Responsibility Messages and Worker Wage Requirements: Field Experimental Evidence from Online Labor Marketplaces*, 27(4) *Org. Sci.* 1010 (2016) (preferences for social performance were especially strong among high-skilled employees).

### b. Employees' ESG Activism: Walkouts, Boycotts & Use of Social Media

Employee demand for ESG extends beyond hiring, remaining active in the workplace. Employee walkouts and boycotts at Disney, Starbucks, and other organizations attracted significant media attention. These examples of employee ESG activism may also have economic effects. RepRisk, a data analysis firm that follows negative ESG incidents as reported in the media, constructs a ranking of ESG risk based on the different aspects of the media coverage, including its severity and reach. As several recent studies report, an increase in firms' risk on RepRisk RRI ranking system has a negative impact on firms' market value.<sup>98</sup> Furthermore, analysts respond to increases in a firm's RepRisk ranking by lowering sales forecast and returns.<sup>99</sup>

### 3. Consumers & ESG

As with employment, consumers—and particularly millennial consumers—state that they place a high premium on the social responsibility of the firms they purchase from.<sup>100</sup> In a recent experimental study Hirst, Kastiel, and Kricheli-Katz found that approximately 70% of consumers were willing to sacrifice money for their preferred social cause.<sup>101</sup> On average, consumers were willing to sacrifice more than 30% of their purchase value for environmental causes.<sup>102</sup> The results were directionally consistent with millennials having the largest willingness to sacrifice.<sup>103</sup>

Recent studies also inquire into whether firms respond to consumers preferences for ESG. Studying the effect of changes to consumers' social preferences on firm

98. *See e.g.*, Francois Derrien et al., ESG News, Future Cash Flows, and Firm Value (Swiss Fin. Inst., Working Paper No. 21-84, 2021).

99. *Id.*

100. *See e.g.*, How Can Consumer-Facing Companies Weave Social Justice into their DNA?, PWC (2021), <https://perma.cc/2X9N-REB5> (“Younger consumers (17-38 years) are almost twice as likely to consider ESG issues when making purchasing decisions than consumers over 38 years old”); 66% of Consumers Willing to Pay More for Sustainable Goods, Nielsen Report Reveals, Ashton Mfg. (2015), <https://perma.cc/4NJC-9JSU> (“Despite the fact that Millennials are coming of age in one of the most difficult economic climates in the past 100 years, they continue to be most willing to pay extra for sustainable offerings—almost three-out-of-four respondents (73%)”); *see also* Two-Thirds of Consumers Worldwide Now Buy on Beliefs, Edelman (Oct. 2, 2018), <https://perma.cc/M8Z3-MXQV> (“Nearly two-thirds (64 percent) of consumers around the world will buy or boycott a brand solely because of its position on a social or political issue, according to the 2018 Edelman Earned Brand study, a staggering increase of 13 points from last year.”).

101. Scott Hirst, Kobi Kastiel & Tamar Kricheli-Katz, How Much Do Investors Care About Social Responsibility? (Eur. Corp. Governance Inst., Law Working Paper No 674/2023, Jan. 2023).

102. *Id.* at 35.

103. *Id.* at Figure A2. Willingness to Sacrifice by Age (reporting that largest amounts were sacrificed by age cohort 35-44). In a regression the age effect was directionally consistent but not statically significant potentially due to the small size of the sample and the correlation of age with other controls. *Id.* at Table 4 and accompanying text.

innovation, Aghion, Benabou, Martin & Roulet find that an increase in consumers' pro-environmental attitudes has led to an increase in clean innovations by relevant firms.<sup>104</sup> Further supporting the notion of economic demand for ESG, the study finds that this effect increases with competition.<sup>105</sup> Importantly, relying on consumers' to assess their pro-environmental attitudes, the study assessed consumers' stated, rather than observed, preferences.

Another recent study by Dai, Liang & Ng documents a causal connection between consumers' ESG preferences and supplier behavior.<sup>106</sup> Further investigating the mechanism through which consumers affect suppliers' social responsibility, the study finds evidence of influence via stakeholder proposals, networks, and bargaining. The authors, however, found that firms' responses to their consumers' demand haven't increased their sales. Thus, while there is evidence for consumers' stated preferences for ESG, and for firms' responsiveness to these preferences, there is little to no evidence supporting the hypothesis that consumers reduce their consumption due to ESG failures.<sup>107</sup> Past studies similarly found a gap between consumer' intended ethical purchasing and their actual behavior.<sup>108</sup>

Nevertheless, Derrien, Krüger, Landier & Yao find that in response to negative ESG news, sell-side analysts downgrade earnings forecasts significantly to reflect expectations of lower future sales.<sup>109</sup> Finally, providing further supporting evidence that consumers drive ESG, Chen, Dechow & Tan find that firms in the consumer sector were more likely to pronounce support for BLM after the murder of George Floyd.<sup>110</sup>

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104. Aghion et al., *supra* note 74, at 2 (“We find a significant positive effect of proenvironment attitudes on the probability for a firm to innovate relatively more in the clean direction, and this effect is stronger the higher competition is”).

105. *Id.*

106. See Dai, Liang & Ng, *supra* note 74, at 3-4 (finding “strong correlations between customer CSR and subsequent improvement in supplier CSR” & stronger customers' influence on suppliers' CSR after “unexpected product safety scandals that have created global shocks to consumerism”).

107. *But see* Walton, *supra* note 11. (Sales growth declines when firms are involved in negative ESG events).

108. See Michal J. Carrington, Benjamin A. Neville & Gregory J. Whitwell, Why Ethical Consumers Don't Walk Their Talk: Towards a Framework for Understanding the Gap Between the Ethical Purchase Intentions and Actual Buying Behaviour of Ethically Minded Consumers, 97(1) J. Bus. Eth. 139 (2010) (“Despite their ethical intentions, ethically minded consumers rarely purchase ethical products”); Marylyn Carrigan & Ahmad Attalla, The Myth of the Ethical Consumer—Do Ethics Matter in Purchase Behaviour?, 18(7) J. Consumer Mktg. 560 (2001).

109. See e.g., Boon Wong Jin & Qin Zhang, Stock Market Reactions to Adverse ESG Disclosure via Media Channels, 54(1) Brit. Acct. Rev. 101045 (2022); Derrien et al., *supra* note 98.

110. See A.J. Chen, Patricia M. Dechow & Samuel T. Tan, Corporate Response to the Black Lives Matter Movement: Determinant of Speaking Out in Support of Social Causes 5 (Dec. 2021, on file with Research Collection School of Accountancy), (“We also find that support for BLM varies by industry, with firms in the consumer sector being the most likely to support BLM, underscoring that the opinion of a firm's individual customers is likely to influence firms' decisions to speak out”).

#### 4. Investors & ESG

ESG investments are booming. Investors contributed over \$50 billion to sustainable investment funds in 2020, ten times what they had contributed just five years earlier.<sup>111</sup> According to a 2021 survey by Morgan Stanley, 99% of millennials are interested in sustainable investing (relative to 79% in the general population).<sup>112</sup> While the general population's interest dipped in 2019 (85%), millennial interest actually rose (95%).<sup>113</sup>

Several recent experimental studies confirm investors' stated willingness to pay for social responsibility. Bonnefon, Landier, Sastry & Thesmar find that investors are willing to pay \$0.70 more per share of a firm that donates \$1 per share to charities.<sup>114</sup> This large and statistically significant effect was present even if the charitable giving would occur independently of the investor decision.<sup>115</sup> Another study found that the willingness to forgo returns for social responsibility does not increase with the potential impact of their choices on firms.<sup>116</sup> This suggestive evidence of unconditional commitment to values could explain why investors frequently respond to ESG problems by divesting instead of voicing dissatisfaction by voting their shares.<sup>117</sup>

Returning to the Hirst, Kastiel, and Kricheli-Katz experiment, the authors found that a majority of investors were willing to sacrifice returns for their preferred social cause.<sup>118</sup> On average, those investors were willing to sacrifice 10%-20% of their returns for social goals.<sup>119</sup> The results were directionally consistent with millennials having the

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111. Passive Sustainable Funds: The Global Landscape 2020, Morningstar (September 4, 2020), <https://perma.cc/3R96-H2DU>.

112. Sustainable Signals, Morgan Stanley 1 (2021), <https://perma.cc/ZTU7-7ALU>.

113. *Id.* at 4. See also Karen Demasters, Millennials' ESG Investing Will Transform Markets, DeVere Group Says, Financial Adviser (January 2, 2020), <https://perma.cc/2SQN-6ZPJ> ("Millennials are more than twice as likely as Generation Xers to say that they often or always use investment vehicles that take ESG into account (33% of Millennials versus 16% of Generation X and just 2% of Baby Boomers)").

114. See Jean-Francois Bonnefon, Augustin Landier, Parinitha Sastry & David Thesmar, The Moral Preferences of Investors: Experimental Evidence 1-43 (HEC Paris, Working Paper No. FIN-2019-1350, 2022).

115. *Id.* (finding that conditioning donations on an actual purchase of an auctioned stock did not affect the results, and concluding that there is "no evidence of impact-seeking motives.").

116. See Florian Heeb, Julian F. Kolbel, Falko Paetzold & Stefan Zeisberger, Do Investors Care About Impact?, *Rev. Fin. Stud.* (forthcoming 2022), <https://perma.cc/6R3N-NRSF> (finding investors high willingness to pay for social policies does not vary with the size of the impact).

117. Eleonora Broccardo, Oliver Hart & Luigi Zingales, Exit vs. Voice (Eur. Corp. Governance Inst., Working Paper No. 694, 2020), <https://perma.cc/7T5Y-SXAC> (when individuals benefit from consequential positive effects on others "if the majority of investors are socially responsible, voice achieves the socially desirable outcome, while exit does not").

118. Hirst, Kastiel & Kricheli-Katz, *supra* note 97 (finding that 32% of participants were not willing to sacrifice more than 1% of their returns for any social cause).

119. *Id.* (Finding that out of potential returns of \$1000 (on a \$10,000 portfolio), investors were willing to sacrifice between \$100-\$200 for social goals).

largest willingness to sacrifice, and with other age groups having significant willingness to sacrifice.<sup>120</sup>

Retail investing is also affected by ESG. Analyzing data from Robinhood, a trading platform that is populated by younger investors, found that firms that publicly supported Black Lives Matter (“BLM”) saw an increase of 2% in the number of retail investors holding their shares on the platform, with some potential effect on firm valuation.<sup>121</sup>

Rob Bauer, Tobias Ruof, and Paul Smeets conducted a field experiment in which they gave investors the option to change their ESG investments in their pension funds savings. Two thirds of participants opted for more ESG investments, even at the expense of financial performance. Importantly, younger people were more likely to favor more sustainable investing.<sup>122</sup>

ESG, evidence suggests, could also affect fund flows. Hartzmark and Sussman find that the first introduction of funds ESG ranking by Morningstar in 2016 had a significant effect on funds flow in favor of funds with high ESG rankings.<sup>123</sup> Furthermore, a high ESG ranking was not associated with better performance, and participants who in a survey considered themselves as valuing ESG invested more money in the top sustainability performers.<sup>124</sup> The authors concluded that the evidence is consistent with non-monetary motives in impact investment.<sup>125</sup>

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The evidence suggests that the demand for ESG may have real economic effects on firms’ performance and value. The assertion that poor ESG performers would have difficulties in employing, selling to, and attracting investors has some evidentiary support. To the extent that the demand for ESG has economic effects on firms, managers’ incentives to promote ESG align with shareholder value. However, as the following

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120. *Id.* at Figure A2. (reporting that largest amounts were sacrificed by age cohort 35-44). In a regression the age effect was directionally consistent but not statically significant potentially due to the small size of the sample and the correlation of age with other controls. *Id.* at Table 4 and accompanying text.

121. See Ruby Brownen-Trinh & Ayan Orujov, *Corporate Support for Black Lives Matter: Determinants and Effects on Retail Investors*, SSRN (December 1, 2020), <https://perma.cc/BC6L-ZK3U> (“We also find some evidence that speaking up is associated with an increase in firm value.”); see also Sergio A.G. Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51 (2021).

122. Rob Bauer, Tobias Ruof & Paul Smeets, *Get Real! Individuals Prefer More Sustainable Investments*, 34(8) REV. FIN. STUD., 3976, 3976–4043 (2021) (“Older people are less likely to choose four SDGs. Each 10 years of age decreases the likelihood of choosing four SDGs by 15.5%.”).

123. Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. Fin. 2789 (2019).

124. *Id.* (“We do not find evidence that high-sustainability funds outperform low-sustainability funds.”)

125. *Id.* (“The evidence is consistent with positive affect influencing expectations of sustainable fund performance and nonpecuniary motives influencing investment decisions.”)

parts will argue, managers have additional incentives to promote ESG that are not tied to shareholder value.

### B. Channel II: CEO Careerism Versus Shareholder Value

Whether and to what extent ESG affects traditional firm value is still far from clear. Yet, the social demand effect on CEOs is not limited to the extent to which it affects firms' profitability. Rather, pressure from millennials and socially-motivated investors more generally creates personal, undiversifiable career risks for CEOs. Managers, this Part argues, might invest in ESG in order to mitigate this personal risk to their job, their reputation, and their career trajectory.

#### 1. CEO's Personal Risk from Cancel, Walkouts, Boycotts and Negative ESG Incidents

Cancel culture, employee walkouts, and boycotts, create significant risk for CEOs' career and wealth prospects. Across industries, CEOs have lost their jobs at Nike, Uber, Papa Johns, Crossfit and Disney due to ESG failures. These visible examples, standing alone, could have significant influence on management assessment of the potential costs from ESG failures.<sup>126</sup> Furthermore, several studies now report evidence that poor performance on ESG is associated with higher CEO turnover<sup>127</sup> and with less success in finding new jobs.<sup>128</sup> Even good firm performance will not necessarily protect CEOs against ESG problems. In 2020, the correlation between total shareholder returns and CEO replacement declined, according to a recent report by the conference board, Heidrick & Struggles, and ESG analytics firm ESGAUCE.<sup>129</sup> In particular, the gap between the average CEO turnover rate of top performers and bottom performers has narrowed almost by half.<sup>130</sup> Social media increases the risk of ESG failures for CEOs.

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126. See Daniel Kahneman, & Amos Tversky, *On the Psychology of Prediction*, 80 PSYCH. REV. 237 (1973) (finding that individuals may overestimate the probability of visible examples).

127. Dai, Gao, Lisic & Zhang, *supra* note 11 ("We find that CEOs are more (less) likely to leave office when there is a significant recent decline (improvement) in social performance."); Colak, Korkeamäki & Meyera, *supra* note 11 ("We provide evidence that CEOs are significantly more likely to be fired when risk exposure to ESG issues reaches extreme levels."); Walton, *supra* note 11 ("CEO turnover increases when firms are involved in negative ESG events"); Burke, *supra* note 11 ("Coverage of issues in prominent media sources is more likely to result in CEO dismissal.").

128. Dai, Gao, Lisic & Zhang, *supra* note 11 (finding that CEOs with strong social performance at their previous employer "are more likely to find a new executive position, move up to a larger public firm, and receive higher compensation from the new public firm"). The authors also find that "strong social performance of the previous employer helps CEOs find their next executive positions sooner." *Id.*

129. *CEO Succession practices*, THE CONFERENCE BOARD (2021), <https://perma.cc/GS53-8GVW>; see also Allan Murray & David Meyer, *CEO Turnover Has Picked Up Again*, FORTUNE (June 22, 2021, 5:51 AM), <https://perma.cc/5P5Q-JG5U>.

130. *Id.* ("What was a 10-percentage point gap in 2019 narrowed quite drastically to 5.3 percent last year.").

ESG data provider RepRisk uses data analysis<sup>131</sup> of different media channels including social media sources, to construct an ESG risk measure (RRI).<sup>132</sup> High RRI is associated with a high likelihood of CEO turnover the following year.<sup>133</sup>

Social media also makes cheap talk easier to detect and challenge. The resurgence of the Black Lives Matter movement in response to the killing of George Floyd swept through the corporate world as it did through the rest of society. IBM, Microsoft and Amazon quickly announced bans or moratoriums on selling facial recognition technology to police departments.<sup>134</sup> Google, Estée Lauder, and PepsiCo announced programs to increase minority hiring.<sup>135</sup> Apple, Target and Comcast announced significant donations to advance social justice initiatives.<sup>136</sup> While many of these initiatives were welcomed, they were not accepted at face value or uncritically. Young consumers fact-check claims and use social media to call out empty gestures.

For example, Sharon Cuter, the 33-year-old founder of Uoma Beauty, a cosmetics company targeting Black women consumers, created the #pulluporshutup hashtag which quickly went viral on Instagram. Cuter accused companies of cheap talk in support of Black lives, demanding that they disclose the racial makeup of their executives and workforce. Cuter's targets weren't alone. Despite its history of working with high-profile Black designers and athletes, and its social media posts on racism, Adidas's workforce was revealed to be fewer than 4.5 percent Black. When employees raised issues of racism at a company meeting, Karen Parkin, the company's global head of

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131. *RepRisk in a Nutshell*, REPRISK, <https://perma.cc/3HXS-4M2H> ("We combine AI and advanced machine learning with human intelligence to identify material ESG risks on companies, real assets, and countries") (last visited July 24, 2022); see also Florian Berg, Kornelia Fabisik, & Zacharias Sautner, *Is History Repeating Itself? The (Un)Predictable Past of ESG Ratings* (Eur. Corp. Governance Inst., Working Paper No. 708, 2021), <https://perma.cc/22MG-KSGB> (stating that "RepRisk offers the key database for [negative ESG] events").
132. RepRisk, *Methodology Overview*, REPRISK, <https://perma.cc/7HRU-86C4> ("RepRisk screens, on a daily basis, over 100,000 public sources and stakeholders in 23 languages. These include print media, online media, social media including Twitter and blogs, government bodies, regulators, think tanks, newsletters, and other online sources. These sources range from the international to the regional, national, and local level.").
133. Colaka, Korkeamäkib & Meyera, *supra* note 11 ("We provide evidence that CEOs are significantly more likely to be fired when risk exposure to ESG issues reaches extreme levels."); Walton, *supra* note 103 ("CEO turnover increases when firms are involved in negative ESG events"); Burke, *supra* note 11 ("Coverage of issues in prominent media sources is more likely to result in CEO dismissal."). Negative ESG media reports also lead to CEOs losing seats on other firms' boards. Xiangshang Cai, Ning Gao, Ian Garrett & Yan Xu, *Are CEOs Judged on Their Companies' Social Reputation?*, 64 J. CORP. FIN. 101621 (2020).
134. Larry Magid, *IBM, Microsoft And Amazon Not Letting Police Use Their Facial Recognition Technology*, FORBES (June 12, 2020, 9:26 PM), <https://perma.cc/UFL6-EARQ>.
135. Rob Copeland, *Google Sets Hiring Goal to Advance Black Executives*, WALL ST. J. (June 17, 2020, 7:11 PM), <https://perma.cc/MQ7A-KWNF>; Bowdeya Tweh, Patrick Thomas & Sebastian Herrera, *Apple, Google Join Roster of Companies Pledging to Donate, Change Practices on Race*, WALL ST. J. (June 12, 2020, 9:25 AM), <https://perma.cc/MAV9-FE42>.
136. Jean E. Palmieiri, *Target Chief Promises to Improve Diversity, Reopen Damaged Stores*, WWD (June 10, 2020), <https://perma.cc/4CNS-BH7S>; Tweh, Thomas & Herrera, *supra* note 139.

human resources, characterized such talk as “noise” only raised in the United States. She rapidly resigned as employees successfully demanded that the company increase hiring of Blacks and Latinos. Indeed, while firms survived the backlash, the personal price for managers was high.

Similarly, Yael Alflalo was the founder of Reformation, a highly successful, sustainable fashion brand with hundreds of millions of dollars in annual sales. Reformation was described by New York Magazine’s *The Cut* as “arguably the most successful sustainable fashion brand of all time.” But after the company announced on social media that it would be donating to organizations affiliated with Black Lives Matter, the company, and its CEO in particular, were called out on Instagram by a former manager of Reformation’s flagship store for racial discrimination. Elle Santiago described being repeatedly passed over for promotion in favor of white women and called out the CEO for repeated instances of demeaning behavior. In addition to pointing out racism, Santiago also lamented the fact that the company, despite positioning itself as feminist and pro-woman, offered “a lack of options when it comes to sizing and fit (many of Reformation’s It-dresses stop at a size 12, when the average US woman is now between a size 16-18).” Alflalo—the CEO—was fired. Similar stories led to the swift departure of women’s co-working space *The Wing*’s Audrey Gelman, founder and editor-in-chief of *Refinery29*’s Christene Barberich, and *CrossFit* founder and CEO Greg Glassman.

These are clearcut examples of strong stakeholders and weak CEOs. A generation earlier, the workers in the above scenarios might have been readily dismissed by the “disgruntled former employee” narrative, particularly in a conflict with a corporation with much greater public relations capabilities. Social media and cultural change have combined to place new pressure on once comparatively immune CEOs. Such CEOs might pursue ESG strategies to preemptively insulate themselves from similar attacks.

## 2. CEOs’ Incentives to Promote ESG as Means to Reduce Personal Risk

For several reasons the risk from cancel culture, walkouts, boycotts, and other negative ESG news creates strong incentives for managers to promote ESG. Cancel culture, walkouts, and boycotts tend to be dismissed in the literature as not having a significant effect. Indeed, in the context of an investment portfolio they are immaterial, many firms bounce back from them, and their risk is partially diversifiable. But for the CEOs of the targeted companies, the impact is utterly different. As shown above, CEOs have lost their jobs due to ESG failures and negative news, faced more difficulties in finding new jobs, and if they were lucky enough to find one, they were forced to accept lower compensation. The effect is not limited to CEOs. A recent study found that board members lose board seats following negative ESG news, and the loss spreads to other boards they sit on.

Furthermore, importantly, this significant personal risk is non-diversifiable. This again stands in contrast to investors who hold diversified portfolios, in which the loss from firms that turn into ESG lemons could be balanced with gains from firms that turn into ESG stars. Thus, the expected damage for the CEO from a potential ESG failure is magnified by his or her inability to diversify the risk, and his or her risk aversion

with respect to losing his job and income. As a result, CEOs envision a significant potential risk from ESG failures, which results in forceful incentives for them to invest in ESG and promote it.

On top of that, the costs of mitigating these risks are not paid out of the CEO's pocket. While the risk is borne by the CEO personally, the investment in ESG to reduce the risk is taken from firm resources. Thus, the CEOs internalize only a very small fraction of the costs of ESG investments, with the rest externalized on shareholders. Put together, with respect to negative ESG events, relative to investors, the CEO faces a risk of higher personal harm, that is not diversifiable, and that risk can be mitigated using investors' money. This significant misalignment of incentives could lead to excessive ESG investments at the expense of shareholder value and perhaps also at the expense of social welfare.

Finally, our analysis suggests that the extent to which CEOs are likely to invest in ESG depends on several factors that affect their risk from ESG performance. CEOs that possess more power would be less vulnerable to these pressures. Thus, our analysis suggests that CEOs with superstar status, or CEOs of firms that possess significant market power might be less pressured to invest in ESG and to cater to stakeholders.<sup>137</sup> Firms with significant power, be it their market power, or the CEO's personal power, might be able to get away with poor ESG practices. Firms that face fierce competition will find it harder to survive if they ignore ESG goals. Similarly, managers who do not possess superstar power will find it harder to protect their job if their firm performs poorly on ESG. Indeed, recent examples—Jeff Bezos at Amazon and Elon Musk at Twitter—support these predictions. Second, our analysis also suggests that ESG will be weak with respect to decisions to sell or merge the firm. In the last period of the firm's life, CEOs are likely to lose their position in any case, and ESG issues no longer have the same bite. Managers are therefore less likely to look out for employee welfare or social harms post-merger.

### C. Channel III: Index Fund ESG Activism

The demand for ESG is also operating indirectly through a separate channel, by incentivizing the Big Three index funds—Blackrock, State Street and Vanguard—to exert ESG activism. Index fund competition to win socially-motivated investors channels investors' preferences to firms resulting in immense influence on corporate governance.

Index funds in the classic model had weak incentives to engage in activism. Index funds all own the same investments, so they cannot compete on performance.<sup>138</sup> Fierce competition has whittled fees down to nearly zero.<sup>139</sup> Engaging in corporate governance oversight only adds costs for the fund and creates benefits shared by their

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137. See Assaf Hamdani & Kobi Kastiel, *Superstar CEOs* (Eur. Corp. Governance Inst. Working Paper No 695/2023 2022).

138. Bebchuk & Hirst, *supra* note 63.

139. *Id.*

competitors who all have identical exposure to the same firms.<sup>140</sup> There has been real concern that the largest index funds, which hold more than 20% of the stock of many of the largest companies,<sup>141</sup> would be asleep at the corporate governance wheel. Indeed, as Bebchuk and Hirst have shown, index funds have been utterly passive regarding portfolio firms' governance. They have not submitted shareholder proposals and have sided with management on most votes, including for directors in annual meetings, say on pay votes, and shareholder and management proposals.<sup>142</sup>

While index funds have minimal incentives to expend resources on activism that could increase shareholder financial returns, these funds care very much about their assets under management (AUM).<sup>143</sup> Increasing the number of their investors results in high financial rewards. In the past, however, when investors maximized returns exclusively, since the three of them are invested in the same portfolio and offer the same returns, there was no real strategy that could help them to attract investors. Yet, we argue, the rise of ESG demand, where at least some investors do not focus exclusively on maximizing returns, created an opportunity (and risk) for index funds to compete on dimensions of stewardship that cater to these different values. This competition is driven not by the impact on returns (which might in turn drive flows), but by the direct impact on fund flows of investors seeking to align their investments with their values.

Bebchuk and Hirst carefully acknowledge this option in their analysis of index funds' passivity:

[T]he above analysis has implicitly assumed that index fund investors care exclusively about the financial return from their investment, some index fund investors might well have a preference for investing with an index fund manager whose stewardship activities they view favorably, or at least not unfavorably, and may expect index fund managers with which they invest to be good stewards. The more widely held these preferences are, the stronger the index fund managers' incentives to be perceived as good stewards. But incentives to be perceived as good stewards are quite different from incentives to make desirable stewardship decisions.<sup>144</sup>

Importantly, recent studies found clear evidence that investors with ESG preferences move their money to funds that better meet those preferences. In short, ESG could have significant effects on fund flows. In 2016 Morningstar introduced its sustainability ranking with a particular ranking for each fund. In a recent study, Hartzmark and Sussman found that investors with ESG preferences quickly responded to this ranking by moving their money from funds with low ESG scores to funds with

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140. *Id.*

141. *Id.* at 2033.

142. *See e.g.*, Bebchuk & Hirst, *supra* note 63.

143. *Id.*

144. *Id.* at 2057-2058.

high ESG scores.<sup>145</sup> Within 11 months from the day the ranking was published, funds that were ranked in the bottom 10% of sustainability lost more than \$12 billion (4% of fund size) in outflows. Funds that were categorized in the top 10% of sustainability gained more than \$24 billion (6% of funds size) in inflows.<sup>146</sup> The authors conclude that the evidence is consistent with non-monetary motives impacting investments.<sup>147</sup>

The Big Three clearly see an opportunity (and a risk) in foregrounding ESG stewardship initiatives. We have previously shown that index funds have competed vigorously to be branded as ESG promoters in order to attract and retain millennials as investors.<sup>148</sup> Index funds worry about the coming generational shift in wealth to millennials and about the unique preferences of this generation to prioritize values in their investments.<sup>149</sup> BlackRock CEO Larry Fink has been explicit in his response: “The sentiments of [the millennial generation] will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: \$24 trillion from baby boomers to millennials.”<sup>150</sup>

Indeed, when it comes to ESG issues, the Big Three—and State Street and BlackRock in particular—have been leaders in pressing for reform.<sup>151</sup> Importantly, these stewardship interventions have demonstrated a pattern of competitive escalation, consistent with these funds attempting to signal ESG commitment to their investors. When SSGA started its Fearless Girl campaign in 2017, it voted against nomination committee chairs at more than 500 out of 910 Russell 3000 portfolio firms that had no female directors on their boards.<sup>152</sup> By 2018, 400 of those firms added a female director to their board.<sup>153</sup> During 2018, SSGA voted against 428 directors from the remaining 510 all-male boards.<sup>154</sup> By 2020, the number of firms that responded increased to 612 and State Street voted against directors in an additional 156 firms.<sup>155</sup> In 2020, Blackrock voted

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145. Hartzmark & Sussman, *supra* note 123.

146. Hartzmark & Sussman, *supra* note 123, at 2790 (“Moderate ratings of two, three, or four globes do not significantly affect fund flows.”).

Low sustainable funds experienced outflows of more than \$12 billion while high sustainable funds experienced inflows of more than \$24 billion. Hartzmark & Sussman, *supra* note 122, at 2831-32

147. Hartzmark & Sussman, *supra* note 123, at 2789 (“The evidence is consistent with positive affect influencing expectations of sustainable fund performance and nonpecuniary motives influencing investment decisions.”).

148. See Barzuza, Curtis & Webber, *supra* note 13.

149. *Id.*

150. Fink, *supra* note 87.

151. See Barzuza, Curtis & Webber, *supra* note 13 (arguing and bringing evidence that the big three have been active in pressing managements to improve board diversity and environmental practices).

152. See *State Street Stewardship*, STATE STREET 42 (2017), <https://perma.cc/HYM7-4W5G>; see also Justin Baer, *State Street Votes Against 400 Companies Citing Gender Diversity*, WALL ST. J. (July 25, 2017, 8:38 PM), <https://perma.cc/669X-9365>.

153. See *State Street Stewardship 2018-19*, STATE STREET 36 (2018), <https://perma.cc/QZE9-RLSJ>.

154. *Id.*

155. See *State Street Stewardship 2020*, STATE STREET 32 (2020), <https://perma.cc/M6HA-6Y5U>.

against 1,367 board members in America based on insufficient progress on board diversity.<sup>156</sup> With only an additional 448 votes against US directors in 2020, “insufficient progress on board diversity [w]as the predominant reason for [Blackrock] votes against directors.”<sup>157</sup> In 2021, Blackrock voted globally against 1,862 board members in 975 firms based on lack of diversity.<sup>158</sup>

Recently, State Street announced it will vote against chairs of nomination committees in boards that do not have at least one member from underrepresented communities by the end of the year.<sup>159</sup> And it has already voted against nomination committees chairs based on lack of disclosure of the ethnic and racial composition of their boards.<sup>160</sup> BlackRock has also turned to pressuring firms to improve board racial and ethnic diversity.<sup>161</sup> These initiatives, alongside engagement on issues of climate change, often receive top billing on asset managers’ websites. Notably, outside the ESG sphere, the Big Three continue their historical pattern of passivity, including with respect to issues that could improve governance and shareholder value.

Index funds’ ESG activism creates significant pressure on managers. Most firms now have majority voting rules which require that board members running unopposed who receive more votes against than in favor submit their resignation to the board.<sup>162</sup> While the board may choose to renominate the director who did not receive support from a majority of the votes,<sup>163</sup> the board is also required to address the source of shareholder dissatisfaction, or else it may face a negative ISS recommendation in the next annual election.<sup>164</sup> Index funds are often the largest shareholders, so their threats

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156. See BlackRock, *Investment Stewardship Annual Report*, BLACKROCK 13 (September 2020), <https://perma.cc/2NW8-P9WH>.

157. *Id.* (reporting that in the US for 2020 Blackrock voted against 246 directors for lack of independence and 202 directors for overcommitment).

158. BlackRock, *supra* note 156.

159. *Racial Diversity Stagnated On Corporate Boards, Study Finds*, CNBC (June 10, 2021, 1:52 PM), <https://perma.cc/9RF4-BSU9>.

160. *Id.*

161. BlackRock, *Pursuing Long-Term Value for Our Clients, A look into the 2020-21 Proxy Voting Year*, BLACKROCK 9 (2021), <https://perma.cc/MZ6K-LME7>.

162. Marc S. Gerber, *US Corporate Governance: Boards of Directors Face Increased Scrutiny*, Sub-section in *2014 Insights*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP 157 (2014), <https://perma.cc/SKC3-HXCE> (“Approximately 90 percent of S&P 500 companies (and approximately 46 percent of Russell 3000 companies) have a majority voting standard in director elections and/or a policy requiring resignation if a director fails to get majority support . . .”).

163. Stephen J. Choi et al., *Does Majority Voting Improve Board Accountability?*, 83 U. CHI. L. REV. 1119, 1126 (2016) (“As a legal matter, nothing prevents the board from appointing the very person who failed to receive a majority of ‘for’ votes to fill the vacancy.”).

164. *Voting On Director Nominees in Uncontested Elections*, Sub-section in *ISS Proxy Voting Guidelines Benchmark Policy Recommendations*, ISS 12 (2021), <https://perma.cc/Q2UY-L4P6> (stating that ISS may recommend voting against directors if “At the previous board election, any director received more than 50 percent withhold/against votes of the shares cast and the company has failed to address the issue(s) that caused the high withhold/against vote”).

have real teeth.

The incentives of the fund managers, however, are also not necessarily aligned with shareholder value nor with social welfare. These funds have incentives to attract investors, compete to brand themselves as ESG leaders, and offer genuine commitments to promote current and future ESG goals. Since their interest in attracting investors is stronger than their interest in maximizing firm value, they might compete aggressively and excessively for their brand, potentially at the expense of shareholder value and social welfare.

#### D. Channel IV: Hedge Fund ESG Activism

Socially-motivated investor pressure on management is felt through another major channel—hedge fund activism. For well over a decade, activist hedge funds have become the main threat to managers. Recently, their dominant strategy has been to push director nominees to the board.<sup>165</sup> Whether they succeed depends, to a large extent, on the support of the large index funds.<sup>166</sup> Because hedge funds rely on index funds' votes, and because index funds are competing to promote ESG values, hedge funds are seeking activism opportunities where ESG goals can be centered in order to win campaigns and increase the share price of target companies.

Opponents of stakeholderism have argued that management will use the stakeholderism rhetoric to garner the support of institutions in their fight against activist hedge funds<sup>167</sup> to “urge institutional investors to avoid cooperating with hedge fund activists and to side with and support corporate leaders.”<sup>168</sup> In reality, however, hedge funds have been quick to realize that they can use ESG in the opposite direction. Foregrounding ESG problems at target firms is now standard practice in hedge fund activist events.

And firms will respond. If ESG weaknesses draw activist attention, then managers who don't want to be targets have to respond by proactively identifying and fixing potential ESG problems. Board diversity, decarbonization, workforce welfare, and human rights in the supply chain—all of these might have been viewed as “soft” issues in the old corporate framework. But for ESG CEOs, addressing them may be a matter of keeping their jobs.

That was clearly the case in the most high-profile fight of the 2021 proxy season, when a small startup fund, Engine No. 1, gained three seats on ExxonMobil's board after a proxy campaign focused on climate change.<sup>169</sup> To be sure, Exxon was a

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165. Bebchuk & Tallarita, *supra* note 3.

166. *Id.*

167. *Id.* (“Stakeholderism has been used to urge institutional investors to be more deferential to corporate leaders and more willing to side with them in any engagement with hedge fund activists”).

168. *Id.* at 158.

169. *The Little Engine that Could, ExxonMobil Loses a Proxy Fight with Green Investors*, THE ECONOMIST (May 29, 2021), <https://perma.cc/XC7H-PWDV> (“An activist hedge fund succeeds in nominating at least two climate-friendly directors to the energy giant's board”).

candidate for a traditional activist attack after suffering its first annual loss in decades following the pandemic and the fall of oil and gas prices globally.<sup>170</sup> Yet, Engine No. 1's success shocked markets.<sup>171</sup> It won because of its focus on ESG.<sup>172</sup> A small, relatively new fund, Engine No. 1 held only a tiny fraction of Exxon—a \$40M stake,<sup>173</sup> hardly a fifth of one percent of Exxon's outstanding stock.<sup>174</sup> Furthermore, the campaign that placed three out of the fund's four nominees on Exxon's board cost \$12.5M—a strikingly low number for a proxy fight of this magnitude,<sup>175</sup> especially compared to Exxon's expenditures.<sup>176</sup> Accordingly, the victory was described as not less than "shocking,"<sup>177</sup> "David against Goliath,"<sup>178</sup> "the Little Engine that Could,"<sup>179</sup> and "the most groundbreaking development this proxy season."<sup>180</sup>

Industry players explained Engine No. 1's win as a result of its unique strategy to use ESG as leverage.<sup>181</sup> A Wachtell Lipton memo explains:<sup>182</sup>

While there were various factors at play in the ExxonMobil scenario, the bottom line is this: A newly launched and virtually unknown hedge fund with a tiny stake in a massive global enterprise managed

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170. *Exxon Plunges to First Loss in Decades As Pandemic Chokes off Demand*, BBC (Feb. 2, 2021), <https://perma.cc/8TGU-4M6K>.

171. David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, *EESG Activism After ExxonMobil*, HARV. L. SCH. F. CORP. GOVERNANCE (July 23, 2021), <https://perma.cc/6UKJ-QB65> ("The high-profile ExxonMobil shareholder vote in May sent shock waves through many of corporate America's boardrooms.").

172. *Id.* ("A newly launched and virtually unknown hedge fund with a tiny stake in a massive global enterprise managed to leverage environmental and governance issues into winning three board seats at the annual meeting, displacing three incumbent directors, and is now in a position to influence the strategic direction of the company.")

173. Robert G. Eccles & Colin Mayer, *Can a Tiny Hedge Fund Push ExxonMobil Towards Sustainability?*, HARV. BUS. REV. (Jan. 20, 2021), <https://perma.cc/A7PT-AXCA>.

174. Thomas Ball, James Miller & Shirley Westcott, Alliance Advisors, *Was the Exxon Fight a Bellwether?*, HARV. L. SCH. F. CORP. GOVERNANCE (July 24, 2021), <https://perma.cc/7BRM-KQTV> ("Engine No. 1 launched in December with approximately \$250 million in assets, and owned 0.02% of Exxon's outstanding shares.").

175. Svea Herbst-bayliss, *Little Engine No. 1 Beat Exxon with Just \$12.5 Mln*, REUTERS (June 30, 2021), <https://perma.cc/8DGT-R8JE> ("Investors said the fund's small budget could become a template for low-cost proxy contests.").

176. *Id.* ("Industry experts speculated that Exxon's costs could have topped \$100 million.").

177. Herbst-bayliss, *supra* note 175.

178. *See, e.g.*, Peter Georgescu & JUST Capital, *EN1 Versus Exxon: This David Wants To Strengthen His Goliath*, FORBES (April 30, 2021), <https://perma.cc/Z7DF-BEZC>.

179. The Economist, *supra* note 169.

180. Ball, Miller, Westcott & Alliance Advisors, *supra* note 178.

181. *See e.g.*, Lindsay Frost, *Activist Hedge Funds Increasingly EESG Converts*, AGENDA (July 26, 2021), <https://perma.cc/L5T8-X5QP> ("Whereas before an activist investor had to reflect more ownership, Engine No. 1 has shown that a smaller position, coupled with a compelling EESG issue, could be sufficient to win a campaign for a board seat (or four). Boards cannot afford to ignore the issues raised by activists, even little-known funds.").

182. Katz & McIntosh, *supra* note 171.

to leverage environmental and governance issues into winning three board seats at the annual meeting, displacing three incumbent directors, and is now in a position to influence the strategic direction of the company.<sup>183</sup>

Indeed, ESG vulnerabilities tilted the votes in favor of Engine 1 candidates. BlackRock for example, explained that it voted for three out of Engine's four candidates since "... we believe more needs to be done in Exxon's long-term strategy and short-term actions in relation to the energy transition in order to mitigate the impact of climate risk on long-term shareholder value."<sup>184</sup>

A clear result of the Engine No. 1 success is that managers now have even more incentives to invest in ESG. Following Engine No. 1's win, a growing number of activist campaigns are centered around a variety of ESG goals, including diversity and climate. Accordingly, law firm memos repeatedly advise managers to search within for ESG weaknesses and fix them in order to avoid being targeted by an activist. For example, in its 2022 memo to clients, Skadden Arps explains:

In the coming proxy season, companies should be wary of so-called 'Trojan horse' campaigns, where activists combine ESG initiatives with traditional activism campaigns, e.g., a breakup or sale of a company or the nomination of a slate of directors. By pressing both sets of issues, an activist can appeal to the growing concern over ESG factors by institutional investors and, consequently, garner support for their more traditional, non-ESG proposals.

Similarly, a Fortune magazine article advises "Warning: diversify your board or activist investors may 'weaponize' the issue."<sup>185</sup>

Thus, as an immediate result, managers must take ESG seriously and constantly invest in it and improve it. Activist hedge funds' business model is based on searching for firms' weaknesses, and now they will use this model to look for ESG weaknesses. Thus, managers have to up their game with respect to their ESG practices, for the sake of their firms, but also defensively, to protect their careers.

Finally, it is also important to emphasize that the Engine No. 1 campaign did not stop at ESG. Rather, the campaign included other non-ESG demands of the type that are common to activists' campaigns.<sup>186</sup> Activist hedge funds typically target firms

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183. Katz & McIntosh, *supra* note 171.

184. BlackRock, *Vote Bulletin: ExxonMobil Corporation*, BLACKROCK (May 26, 2021), <https://perma.cc/3PXP-9LSD> ("Exxon and its Board need to further assess the company's strategy and board expertise against the possibility that demand for fossil fuels may decline rapidly in the coming decades, as was recently discussed in the International Energy Agency's (IEA) Net Zero 2050 scenario. The company's current reluctance to do so presents a corporate governance issue that has the potential to undermine the company's long-term financial sustainability.").

185. Phill Whaba, *Warning: Diversify Your Board Or Activist Investors May 'Weaponize' the Issue*, FORTUNE (December 1, 2021), <https://perma.cc/3DMB-69TD>.

186. *See, e.g.*, Georgescu, *supra* note 178 ("But James is suggesting immediate changes in the way Exxon handles money and his ideas will bring smiles to those who care about little more than dividends and earnings per share.").

which they believe invest excessively and pressure management to cut investments and instead distribute some money to shareholders. Accordingly, in its letter to management, Engine No. 1 argued that management should cut some non-profitable investments.<sup>187</sup> Furthermore, in its letter to management, Engine No. 1 promoted a classic hedge fund intervention in CEO pay, tying it to shareholder value and cutting it based on Exxon's recent performance.<sup>188</sup>

Thus, Engine No. 1's activism showed that activists can use ESG as leverage to discipline management, even for issues beyond the realm of stakeholderism, such as firms' capital investment and even executive compensation. This further provides managers with incentives to fix any ESG vulnerability within their firm.

#### E. Channel V: ESG Regulation

This part argues that the social demand for ESG is complementary to regulatory efforts, in sharp contrast to those who have argued that it would undermine or substitute for regulation.<sup>189</sup> There are several reasons why the pressures that we described could facilitate regulation aimed at ESG issues. To begin with, managers might be less inclined to invest corporate resources in lobbying for deregulation. Second, the investor demand will tilt the regulators' cost-benefit calculus in favor of regulation. On the benefits side, investor demand for regulation serves as an indication of its potential benefits. On the costs side, if many firms have already done so voluntarily, the costs of implementation are less likely to outweigh the benefits.<sup>190</sup>

##### 1. Pressure to disclose lobbying activities' potential misalignment with ESG goals

Public pressure on ESG has turned its focus to firms' lobbying. Managers feel that pressure via several of the channels we described. Firms that have invested significant resources in lobbying against climate protective regulations are now facing pressures from different angles to disclose these contributions and explain how they are aligned with their stance on, e.g., climate. BlackRock, for example, has updated its 2021 voting

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187. Georgescu, *supra* note 178 ("He has a specific request to fund only projects that can break even on the assumption of conservative oil and gas prices.").

188. Georgescu, *supra* note 178 ("EN1 would like to change executive compensation to align it more closely with shareholder value. That's a nice way of saying the CEO has been grossly overpaid.").

189. In a contemporary paper, Aneil Kovvali makes similar arguments in arguing against the assumption that ESG regulation is mutually exclusive with ESG corporate reform. See Aneil Kovvali, *Stark Choices for Corporate Reform*, 123 COLUM. L. REV. 693 (2023).

190. See Kovvali, *supra* note 189, at 729 ("The stark choice hypothesis also neglects the potential for dynamic interaction between reforms. A more stakeholder-focused model for corporate decision-making can make external reforms more likely by reducing corporate opposition to external reform and causing some corporations to actively support external reform . . . . And stakeholder-focused models of corporate decision-making can make external regulations more valuable while reducing their costs, increasing the likelihood of their adoption.").

guidelines to that end.<sup>191</sup> Accordingly, shareholder proposals for disclosure of lobbying activities and their alignment with ESG policies have recently gained significant support at United Airlines, Exxon, Eli Lilly, Caterpillar, Chevron, and others.<sup>192</sup> Finally, lobbying activities could also make firms more vulnerable to activist hedge fund attacks. At the ExxonMobil proxy fight with Engine No. 1, an important consideration that weighed in favor of the activist candidate was related to the company's lobbying activities. Both Blackrock and Vanguard pronounced their concerns that Exxon did not explain how its lobbying activities are consistent with its commitment to the Paris climate agreement and the potential reputation risk from this misalignment.<sup>193</sup>

## 2. Demand, Voluntary Disclosure & Cost Benefit Analysis

The current demand for ESG could facilitate regulation by tilting the cost-benefit analyses toward a net positive, as exemplified by two recent important ESG regulations: Nasdaq's Board Diversity Rule and the SEC's proposed Climate Disclosure mandate.

On August 6, 2021, the SEC approved Nasdaq's board diversity listing standards. These standards require boards to publicly disclose board-level diversity statistics and to have at least two diverse members or explain why they do not.<sup>194</sup> During the comment period, the SEC received 200 submissions, out of which 85% supported the rules (Comments submitted to the SEC become public immediately).<sup>195</sup> Not surprisingly, firms that cater to millennials publicized their support. For example, Robin Hood CEO Wes Moore wrote in his comment, in support of the Nasdaq Rule,<sup>196</sup> "Corporations that lead on equity and inclusion become more durable, have greater resonance with America's diverse consumer markets, and are more creative and competitive in the global marketplace."<sup>197</sup>

As noted, the rule requires firms to disclose information on their board diversity. As stated by SEC chair Gary Gensler, the rules "reflect calls from investors for greater transparency."<sup>198</sup> The proposed rule refers to demand from institutional investors for

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191. *Global Principles and Market-level Voting Guidelines*, BLACKROCK (2021), <https://perma.cc/6TMB-78MS>.

192. Ciara Torres-Spelliscy, *More Shareholders Seek Transparency on Corporate Political Spending and Climate Change*, BRENNAN CTR. (June 16, 2021), <https://perma.cc/4RSN-X5WQ>.

193. *Vanguard Investment Stewardship Insights Voting insights: A proxy contest and shareholder proposals related to material risk oversight at ExxonMobil*, VANGUARD (May 26, 2021), <https://perma.cc/2GGC-236U>; see also Kovvali, *supra* note 189, at 36.

194. *Nasdaq's Board Diversity Rule What Nasdaq-Listed Companies Should Know*, NASDAQ, <https://perma.cc/9RJR-HRV2> (last updated Aug. 6, 2021).

195. Comments on NASDAQ Rulemaking, SEC (2020), <https://perma.cc/9H77-WSG8>.

196. Katherine Doherty & Jeff Green, *Nasdaq Wins SEC Support for Plan to Diversify Company Boards*, BLOOMBERG NEWS (Aug. 6, 2021), <https://perma.cc/3CMD-PFTJ>.

197. Wes Moore, *Support for File No. SR-NASDAQ-2020-081, Related to Board Diversity*, U.S. Sec. and Exch. Comm'n (Jan. 8, 2021), <https://perma.cc/GKN4-BVL6>.

198. Gary Gensler, *Statement on the Commission's Approval of Nasdaq's Proposal for Disclosure about Board Diversity and Proposal for Board Recruiting Service*, U.S. Sec. and Exch. Comm'n

board diversity as an important component of its desirability, and as an indication of its potential benefits. For example, the Exchange stated that “the wave of investors increasingly calling for companies to disclose diversity metrics and diversify their boards, and basing their voting decisions on whether companies do or do not, demonstrates that investors consider diversity disclosures material to their voting and investment decisions.”<sup>199</sup>

Similarly, the SEC Proposed Climate Disclosure rules repeatedly point to the growing demand from investors for climate disclosure as an indication of potential benefits from the proposed rule. Furthermore, the proposed rules explain how the wide practice of voluntary climate disclosure reduces its potential costs. As the proposed rule states “the incremental costs would be lower to the extent that registrants already provide the required disclosures.”<sup>200</sup>

That public pressure could promote ESG regulation via the channels that this Article identified could have important implications. A main argument against stakeholderism has been that the interests of other constituencies would be more appropriately protected by specific rules, such as labor or environmental regulations, rather than by corporate law. Furthermore, it has been argued that corporate stakeholderism could even preempt ESG regulation or weaken its justification and thus its likelihood.<sup>201</sup> Yet prior to the rise of ESG public demand, not surprisingly, regulation has not protected the interests of other stakeholders. Managers, who have significant political clout, have lobbied constantly against regulations that protect the environment, employees, and consumers. Placing such hope in regulation overlooks the documented influence that money, and management money in particular, have had on our political process and legislative outcomes.<sup>202</sup>

The rising demand to promote ESG has facilitated ESG regulation by incentivizing firms to decrease their anti-ESG lobbying activities, and by improving the likelihood that a cost-benefit analysis would cut in favor of ESG rules. Investor demand serves as an indication of potential benefits and the costs of a mandated disclosure are probably

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(Aug. 6, 2021), <https://perma.cc/8MBR-ZXS7>.

199. See US. Sec. and Exch. Comm’n, Order Approving Proposed Rule Changes, as Modified by Amendments No. 1, to Adopt Listing Rules Related to Board Diversity and to Offer Certain Listed Companies Access to a Complimentary Board Recruiting Service, at 20 (Aug. 6, 2021), <https://perma.cc/FLF9-LHUZ>; see also Alexandra Olson, *SEC Approves Nasdaq’s Plan to require board diversity*, AP NEWS (Aug. 6, 2021), <https://perma.cc/G9K9-M23P> (“Lorraine Hariton, CEO of the women’s workplace advocacy group Catalyst, said Nasdaq’s plan was a reasonable response to a desire from the consumers, investors and many company leaders for greater transparency on corporate diversity.”)

200. U.S. Sec. and Exch. Comm’n, *supra* note 199, at 48.

201. See Bebchuk, Kastiel & Tallirata, *For Whom supra* note 3.

202. See Roe, *supra* note 67; see also Bénabou & Tirole, *supra* note 16 (suggesting that governance might fail in protecting stakeholders due to lobbying); Lessig, *supra* note 16; Lucian Bebchuk & Mark Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127-170 (1999); Lucian Bebchuk & Zvika Neeman, *A Political Economy Model of Investor Protection* (Harvard L. Sch. Working Paper Paper, 2005), <https://perma.cc/2W44-NWWN>.

lower where many firms already do so voluntarily.<sup>203</sup>

#### F. Social Demand Has Had Real Effects

The social demand for ESG is having real effects on firm operations. The five channels we document above are pushing CEOs to take concrete steps to respond to social demand.

##### 1. Board Diversity

In 2017, the Big Three index funds began actively pushing for more women to be placed on corporate boards. The results have been immediate and dramatic, which is hardly surprising, given that the Big Three hold ~20% of the market. According to one recent study, the Big Three's campaign in favor of board gender diversity prompted firms to add more female directors<sup>204</sup> and to promote female directors to key positions on the board.<sup>205</sup>

The fight for racial diversity has also started showing results.<sup>206</sup> The share of new directors in S&P 500 firms who are Black has tripled from 11% in 2020 to 33% in 2021,<sup>207</sup> an unprecedented jump in the data, according to Julie Daum, the North American board practice leader for Spencer Stuart.<sup>208</sup> Daum, ISS and other commentators all attribute this jump in the data to the murder of George Floyd and the Black Lives Matter protests in the summer of 2020.<sup>209</sup>

That's not to say that diversity on U.S. corporate boards has been achieved. Far from it.<sup>210</sup> But these changes are significant. Overall, 456 directors were nominated in

203. See Condon, *supra* note 62 (making the case for a mandatory disclosure rule).

204. See Gormley *et al.*, *supra* note 8 (estimating that the Big Three "campaigns led American corporations to add at least 2.5 times as many female directors in 2019 as they had in 2016." and finding that "one standard deviation greater 2016 Big Three ownership is associated with a 76% increase in the net flow of new female board members and an 11% increase in the overall proportion of female directors." and that "the timing of the increase corresponds to the timing of each asset manager's campaign").

205. See Gormley *et al.*, *supra* note 8.

206. Catherine Thorbecke, *Boardroom diversity is on the rise after racial reckoning hits private sector, study finds*, ABC NEWS (June 16, 2021, 2:04 PM), <https://perma.cc/BB7P-WJ8N>.

207. SPENCER STUART, *2021 S&P 500 Board Diversity Snapshot 2* (2021), <https://perma.cc/DE8H-FFBN>; *Number of Black Director Appointments Grows Exponentially at Large U.S. Companies*, ISS Press Release, ISS INSIGHTS (May 25, 2021), <https://perma.cc/4YSQ-GJUB>.

208. See Thorbecke, *supra* note 206 (citing Daum telling of ABC News: "We've been collecting this data for a long time and we've never seen a jump like that.").

209. See Thorbecke, *supra* note 206 ("Daum said most companies tend to start looking for new directors in September, noting that Floyd's murder and last summer's Black Lives Matter protests likely loomed large over that decision-making process."); see also ISS Insights, *supra* note 207 ("The spike follows widespread racial justice protests last summer that, in turn, prompted many U.S. corporate leaders to pledge to increase the number of Black directors and executives within corporate ranks.").

210. See STUART, *supra* note 207, at 2 ("Just 21% of all S&P 500 directors in 2021 are

2021, the largest number of new nominations since 2004.<sup>211</sup> Almost three quarters (72%) of the new directors that were nominated in 2021 are women or belong to a racial or ethnic minority; the share of new directors who are Latino or Hispanic has more than doubled, rising from 3% in 2020 to 7% in 2021; and the total share of new directors from racial or ethnic minorities has almost doubled from 21% in 2020 to 47% in 2021.<sup>212</sup> Overall, 2021 saw the most diverse incoming class of directors in history.<sup>213</sup>

Finally, a recent article provides evidence to assess the relative effectiveness of the social pressure to diversify boards. Vicky L. Bogan, Katya Potemkina, and Scott E. Yonker studied nominations of black directors following BLM protests, the California mandate, and the Nasdaq listing standards.<sup>214</sup> They found that all measures had a significant effect on firms, with the BLM protests having the largest and most significant effect.<sup>215</sup>

The changes to board diversity are significant, as they cut against traditional measures of CEO self-interest. Diverse board members exert more monitoring on issues that are at the heart of CEO self-interest: executive compensation and CEO turnover.<sup>216</sup> Diversity is associated with higher sensitivity of both executive compensation and of CEO's turnover to firm performance.<sup>217</sup> Thus, entrenched CEOs will find it more difficult to make their compensation committees award them large packages when their firms perform poorly. Similarly, they will face a higher risk that their board will fire them. Indeed, many firms still resist adding diverse board members to their boards. Indeed, many firms resist adding even one diverse director to their boards.

## 2. Environmental Practices

The demand for ESG has achieved progress on climate as well, though this progress is less mature than the progress on diversity.

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Black/African American, Hispanic/Latino/a, Asian, American Indian/Native Alaskan or multiracial . . . And women now represent 30% of all S&P 500 directors.”). Furthermore, there are fewer achievements in small firms. *See generally* Kobi Kastiel & Yaron Nilli, *The Corporate Governance Gap*, 131 YALE L. J. 782 (2022), <https://perma.cc/7YJ4-HWQ3>.

211. STUART, *supra* note 207, at 4. As low turnover continued to be an impediment to changes to U.S. boards, some of these nominations led to an increase in board size. Theo Francis & Jennifer Maloney, *Big Companies Boost Share of Black and Latino Directors*, WALL ST. J. (June 16, 2021, 6:02 AM), <https://perma.cc/NGP8-6TQ7> (“A number of boards—including Square and Ralph Lauren—added seats, in many cases increasing diversity without waiting for openings from retirement.”).
212. Spencer Stuart, *supra* note 207, at 2.
213. *Id.* at 4 (“Driven by the increase in Black/African American directors, the incoming class of directors is the most diverse we have seen”).
214. Vicky L. Bogan, Katya Potemkina & Scott E. Yonker, *What Drives Racial Diversity on U.S. Corporate Boards?* (Working Paper, 2021), <https://perma.cc/DG9D-A5AG>.
215. *See id.*
216. *See Renee Adams & Daniel Ferreira, Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291 (2009), <https://perma.cc/8945-VZTD>.
217. *See id.*

A recent study found that the climate campaigns by the Big Three achieved meaningful environmental results.<sup>218</sup> The study used novel data on engagements of the Big Three with individual firms in their portfolio and found that the funds targeted large firms with high CO2 emissions and in which they held large stakes.<sup>219</sup> The study also found evidence consistent with the hypothesis that the funds' efforts were effective. In particular, the study found a strong and statistically significant negative association between ownership by the Big Three and subsequent carbon emissions.<sup>220</sup> Importantly, consistent with causal connection, this effect became stronger in recent years after the funds launched their public climate campaigns.<sup>221</sup>

### 3. Disclosure

Social demand is also affecting disclosure practice. Even investors indifferent to the social goals of ESG understand that being labeled a bad corporate citizen when it comes to climate or diversity can have effects on firm value if it becomes difficult to recruit young investors or consumers or employees. Investors need information to manage that risk. Indeed, many of the largest firms have already begun to make voluntary ESG disclosures. A recent study by Atinuke O. Adediran finds that firms' disclosure of diversity statistics has increased significantly between 2017-2021.<sup>222</sup> In particular, board diversity "saw a 319 percent increase in statistical disclosures between 2017 and 2021."<sup>223</sup>

Firms also disclose more information about carbon emissions. BlackRock reported that 65% of the 224 firms it targeted for climate change issues have "made progress on integrating climate risk into business strategy and disclosures." A significant number of large public companies have agreed to begin disclosing detailed EEO-1 data, in part reflecting pressure from the New York City Comptroller's office; yet another example of pension-initiated activism given new life in the era of the ESG CEO.<sup>224</sup> Companies are required to submit these reports to the U.S. Equal Opportunity Employment Commission. While firms have long been required to assemble these detailed reports, which include breakdowns of rank-and-file employees by race and gender across different job types, these companies are not agreeing to disclose this information to investors. These reports therefore provide a concrete numerical backdrop to Larry Fink's

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218. See Azar *et al.*, *supra* note 8.

219. *Id.*

220. *Id.*

221. *Id.*

222. See Atinuke O. Adediran, *Disclosing Corporate Diversity*, 109 VA. L. REV. (forthcoming 2023), <https://perma.cc/V5G8-6D4B>.

223. *Id.*

224. Jena McGregor, *Urged to Back Up Pledges for Racial Justice, 34 Major Firms Commit to Disclose Government Workforce Data*, WASH. POST (Sept. 29, 2020, 11:09 AM), <https://perma.cc/GB5J-MSGG>. See generally, DAVID WEBBER, *THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON* (Harv. Univ. Press 2018) (describing pension fund shareholder activism).

request, noted above, for companies to discuss long-term plans to increase diversity, and the SEC's principles-based disclosure on human capital.

#### IV. Implications

In this Part, we lay out the implications of our account. We begin by discussing the implications of our analysis for current debates on ESG and stakeholderism. We then discuss normative implications for the desirability of ESG. We argue that, while growing investment in ESG has obvious benefits in reducing externalities, it also has notable risks, in that there is no reason to think that the level of ESG investment will be socially optimal in all cases. We then consider the implications of our account for the concept of materiality in securities law and for corporate law and policy.

##### A. Implications for the ongoing Debates on ESG and Stakeholderism

Our analysis has implications for ongoing important debates on the future and desirability of ESG and stakeholderism. Current views on ESG are polarized with respect to its consequences and desirability. On the one end, strong proponents equate ESG with long-term value maximization, and advocate that firms and managers should abandon their focus on shareholder value in favor of total welfare maximization. On the other end of the spectrum, fierce opponents assert that ESG is all smoke and mirrors, or even a global scam to take over America with foreign ideologies. Along this spectrum, in between fans and condemners, others have suggested that ESG is no more than the same old shareholder value maximization, or worse, that it is yet again a tool developed by management to justify entrenching mechanisms such as the poison pill. The following sections will discuss our implications for each view.

##### 1. Implications for the Managerial Entrenchment View

Under the managerial entrenchment view, not only will ESG not provide any value to stakeholders, but it will likely entrench management at the expense of shareholders and stakeholders,<sup>225</sup> while increasing the risk that it will preempt desirable ESG regulation. The managerial agency view relies on two important assumptions.<sup>226</sup> First, it relies heavily on the assumption that managers have no incentives to cater to stakeholders.<sup>227</sup> Second, it assumes that managers can use ESG as a means to entrench themselves, mostly in defense against activist hedge funds.<sup>228</sup>

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225. See, e.g., Bebchuk, Kastiel & Tallarita, *For Whom*, *supra* note 3.

226. See e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 168 (“[B]y raising illusory expectations about its ability to remedy corporate externalities, stakeholderism would impede, limit, or delay policy reforms that could offer effective protection to stakeholders.”)

227. See e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 139-164.

228. See e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 166 (“Stakeholderism could be used and is being used by corporate leaders and management advisors to urge institutional investors to avoid cooperating with hedge fund activists and to side with and

Our analysis challenges both assumptions, and as a result also the predictions of the managerialist view. We do not disagree that in the past managers had no incentives to cater to stakeholders. Indeed, decades ago, the adoption of other constituency statutes was one of the rare occasions in which stakeholders were brought to the table. And managers initiated the demand for these statutes and lobbied for them in response to the hostile takeover wave of the 1980s with the clear goal of using them to protect themselves against hostile bidders. The managerialist entrenchment view, however, assumes that managers' incentives have not changed despite the rise in the social demand for ESG.

Advocates of this view use the historical example of other constituency statutes to derive implications for modern ESG.<sup>229</sup> Applying the same analysis to the current rise of ESG, however, ignores the rising demand for ESG and the pressure it exerts on managers. Indeed, the managerial entrenchment school does not take into account the potential effect that boycotts and walkouts have on managers. Nor do they take into account the pressure from index funds and activist hedge funds. Considering the risks that managers face from ESG failures, the inability to diversify this risk, and their option to mitigate with firm resources, it is simply incorrect to assert that managers have no incentives to promote ESG. In addition, the risk doesn't need to be high to create strong incentives for managers to respond given their lack of diversification and ability to use firm resources to address the risk.

Second, managerialists argue that managers promote ESG in order to use it against activist hedge funds.<sup>230</sup> Under the managerial entrenchment view, managers could, for example, use a poison pill with a low threshold to defend against activist hedge funds, justifying it with ESG and stakeholderism arguments. Yet, they do not explain why activists cannot similarly use ESG to their advantage. In contrast, our analysis has shown that activist hedge funds outsmarted managers by utilizing ESG to their benefit. Activist hedge funds now have incorporated ESG into their campaigns successfully. It is not clear that managers have any advantage over activists in promoting ESG goals.

Finally, while the proponents of the managerial entrenchment approach portray ESG as if it has no genuine achievements, they ignore evidence that ESG has genuinely advanced the interests of stakeholders, as we demonstrated above in Section III.F. It is not just that the managerial entrenchment school ignores the evidence of ESG's genuine accomplishments. It is that the evidence they rely upon in support of entrenchment does not respond to what we actually claim. First, most of the examples that Bebchuk, Kastiel and Tallarita use to support their arguments are from M&A transactions, where they find that managers neither protected their employees nor negotiated on their

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support corporate leaders.”)

229. See, e.g., Bebchuk, Kastiel & Tallarita, *For Whom. supra* note 3, at 1471 (arguing that “rather than protecting stakeholders, stakeholderism would serve the private interests of corporate leaders by increasing their insulation from shareholder oversight”).

230. See e.g., Bebchuk & Tallarita, *Illusory Promise, supra* note 3, at 166 (“Stakeholderism could be used and is being used by corporate leaders and management advisors to urge institutional investors to avoid cooperating with hedge fund activists and to side with and support corporate leaders.”)

behalf when they sold their firms.<sup>231</sup> Yet, these transactions, as discussed extensively in the literature, involve a unique set of weak incentives, the well-known “Final Period” problem, where managers face no long-term repercussions for their decisions. The authors address the “Final Period Decision” problem in their examples, and acknowledge that “it would be desirable to supplement our analysis with empirical investigation of ongoing-concern decisions.”<sup>232</sup> They argue, however, that if corporate leaders really cared about stakeholders, they are even freer to take their interests into account in the final period, when they are free from shareholder pressure to maximize share value.<sup>233</sup>

Yet, our analysis does not rely on an assumption that managers have internal or ethical preferences to cater to stakeholders, but rather, regardless of whether they have such preferences, we show that they have strong incentives resulting from their personal cost-benefit calculation. For the incentives we identified, the last period is significantly different, since managers will not have to be accountable to the firm stakeholders after they sell the firm. The risk that the board will fire them or reduce their compensation due to stakeholders’ frustration is not relevant. The risk that an activist hedge fund will leverage on ESG goals to gain board seats is also not relevant. The risk that index funds will vote against board members is also not relevant. As a result, under our demand-based analysis managers are expected to cater significantly less to stakeholders when the firm is for sale. Thus, whether or not firms adopt ESG-based compensation, and how efficient and well-designed it is, will not determine the future of ESG, and should be relied upon to indicate whether ESG will achieve results.

Second, proponents of this view point to the absence of any effective mechanism forcing managers to commit to promoting ESG. For example, they analyze the proliferation of ESG-based compensations and argue that they are not designed to provide sufficiently strong incentives for managers to promote ESG goals.<sup>234</sup> Similarly, they argue that firms that committed to the Business Roundtable announcement did not update their governance guidelines or their bylaws to reflect this commitment.<sup>235</sup> They therefore conclude that ESG is all talk. Yet, we believe that these examples have limited explanatory power. Under our analysis, there is already strong external pressure on managers to promote ESG. There is no need for these commitment or compensation mechanisms to further incentivize managers and boards.

Finally, proponents of this view also argue that managers can also use this rhetoric to preempt legislative or regulatory reforms that would truly aid stakeholders while

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231. See, e.g., Bebchuk, Kastiel & Tallarita, *For Whom. supra* note 3; Bebchuk, Kastiel & Tallarita, *Covid, supra* note 54.

232. Bebchuk, Kastiel & Tallarita, *For Whom. supra* note 3, at 1534.

233. *Id.* (“[I]f corporate leaders view stakeholder interests as part of the corporate purpose they are supposed to pursue, they might be relatively freer to do so in a final period than in ongoing-concern decisions where they are dependent on the continued support of shareholders.”)

234. See Bebchuk & Tallarita, *ESG-Based Compensation, supra* note 24.

235. See Bebchuk & Tallarita, *Will Corporations, supra* note 25.

constraining managerial power.<sup>236</sup> As a result, not only will stakeholderism not provide meaningful benefits to stakeholders, but accepting it “would be substantially detrimental to shareholders, stakeholders, and society.”<sup>237</sup> Bebchuk and Tallarita advocate protecting stakeholders through governmental and not corporate action, that is, with rules and regulations outside the realm of corporate law and governance.<sup>238</sup>

We do not disagree that it would be valuable, for example, to adopt environmental rules to protect the environment from externalities imposed by firms’ activities. Externalities cause inefficiencies. Yet, environmental regulations have faced significant impediments from the firms they are supposed to constrain. Firms spend significant lobbying money to oppose these types of rules. The rising demand for ESG, as we argue in Channel V, has in fact facilitated regulation. Shareholders have pressured firms to disclose lobbying expenses, and in particular, the extent to which these expenses are aligned with their public commitment to support the Paris Climate Agreement. BlackRock and Vanguard supported Engine No. 1 directors since Exxon was not sufficiently transparent about its lobbying expenses and whether they are consistent with its declared commitment to the Paris Agreement.

In addition, the demand for ESG, as we explained in Channel V, has made it easier for the financial regulator to justify ESG regulations based on cost-benefit analysis. Indeed, as part of the rising social demand we also saw a rise in ESG regulation. While it might not be sufficient, and still faces significant obstacles, it is an increase rather than a decrease, clashing with what the managerial entrenchment view predicted. Second, the main obstacles to these rules now are constitutional ones, not arguments that ESG has reduced the need for such rules. Quite the contrary, most examples demonstrate that social demand for ESG helped make the case for adoption of the rules. Take, for example, the SEC’s proposed Disclosure Mandate and Nasdaq’s diversity listing standards. In both cases, the proposed rules referred to the index funds’ activism as evidence of the demand for diversity or climate disclosure. Similarly, in both proposed rules, the regulator pointed to the practice to disclose or to diversify by some firms as evidence that the costs of compliance will be relatively low.

## 2. Implications for the view that ESG Maximizes Long-Term Value

Our analysis also has implications for the view that ESG maximizes long-term shareholder value. This view relies partially on the first channel we discussed—the perception that ESG is needed to attract and retain talent, attract consumers, and

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236. See e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 3, at 168 (“[B]y raising illusory expectations about its ability to remedy corporate externalities, stakeholderism would impede, limit, or delay policy reforms that could offer effective protection to stakeholders.”)

237. *Id.* at 100.

238. *Id.* at 94. (“In our view, the most effective way to do so [to protect stakeholders] is by adopting laws, regulations and government policies—such as labor-protecting laws, consumer-protecting regulations, and carbon-reducing taxes—aimed at protecting stakeholder groups.”)

attract investors—to argue that ESG will promote a firm’s long-term success.<sup>239</sup>

While part of ESG indeed could contribute to firms’ long-term value and to social welfare, the incentives we identified caution that at times it could be value-reducing for shareholders, and even for total social welfare. Our analysis demonstrates that managers’ incentives to promote ESG are not perfectly aligned with those of shareholders. Rather, managers have incentives to promote ESG defensively and to protect their own career prospects, in order to mitigate a risk that is personal and non-diversifiable. Also, other players that promote ESG are not aligned with the interest in maximizing long-term shareholder value, like customers and employees. In addition, our analysis suggests that ESG may not be promoted if the firm is for sale, if it possesses significant market power, and if the managers are so powerful that they face fewer risks.

#### B. Normative Implications—ESG Benefits and Perils

The main salutary effect of the social demand for ESG is the pressure it puts on firms to internalize costs that they have previously imposed on society. That externalities can be inefficient is not debated. Firms that pollute might cause more harm than good, as seems likely with firms’ carbon emissions. The common answer of economists, legal scholars, and policymakers has been that environmental concerns, employee rights, and other values should be protected by targeted regulations and are beyond the realm of corporate law. But holding out hope for regulation alone overlooks the influence of money on political and legislative outcomes, not to mention the Supreme Court’s recent holding in *West Virginia v. EPA*,<sup>240</sup> which seriously threatens the power of the administrative state to address problems like climate change. As Mark Roe has shown, managers have significant political clout in Washington.<sup>241</sup>

But as a result of social pressure from consumer and employment markets, from direct action, from index funds, hedge funds, and regulators, to move toward net zero or control water pollution at manufacturing facilities, firms and their CEOs are likely to respond. Even if the effect is simply to reduce firms’ lobbying in opposition to climate regulations, that could be sufficient to remove a major obstacle to such regulation.

On the other hand, while it is too early to predict how the complex system of ESG incentives will play out, we can already identify one key risk of ESG CEOs: overinvestment in ESG. It is not surprising that the pressure on firms to respond to social demand could also lead to inefficient results. Each of the key players—managers, index funds, and activist hedge funds—have incentives to respond to social demand in ways that

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239. See e.g., Lipton, *Further on the Purpose of the Corporation*, *supra* note 3.

240. *West Virginia v. EPA*, No. 20-1530, 2022 WL 2347278, (U.S. June 30, 2022).

241. See MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (Princeton Univ. Press 1994); Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, *Economica* Jan. 2010, at 1 (suggesting that governance might fail in protecting stakeholders due to lobbying); LAWRENCE LESSIG, *REPUBLIC, LOST: HOW MONEY CORRUPTS CONGRESS—AND A PLAN TO STOP IT* (Twelve 2011).

may differ from the social optimum.

Several of the channels constraining managers may exacerbate managerial agency problems in ways that reduce efficiency by inducing overinvestment in ESG. Index funds<sup>242</sup> have only weak incentives to maximize firm value. Rather than considering the effect of ESG on portfolio value, an index fund is motivated by the risk of losing investors to another fund. Equally important, if a fund is branded as a poor ESG performer it might lose a significant number of investors. Thus, the social demand for ESG creates branding competition between index funds, in which funds internalize the risk of being perceived as poor ESG players, but not the costs they impose on firms. As a result, index funds might rationally choose to be active on ESG even if it reduces firms' value. Similarly, activist hedge funds have strong incentives to search for firms' ESG vulnerabilities, and to be innovative and creative in identifying new ESG weaknesses. Since they make profits on their typical activism, their incentives are not necessary to push for efficient ESG policies, ones that maximize shareholder value, or to be efficient overall, but simply to identify ESG weaknesses that can gain support from index funds. Index funds themselves, as explained above, have incentives to push for potentially excessive ESG policies. Each of these pressures may reduce shareholder value without any corresponding environmental or equity payoff.

Finally, managers themselves may overreact to direct pressure on ESG issues. The fear of public backlash, personal criticism, and attendant career consequences is not diversifiable, nor is it shared with shareholders. The introduction of personal interest and career concerns leads to potential distortion in ESG investments, because the manager is in a position to use firm resources to decrease his or her own personal risk, which could rationally lead to ESG overinvestment.<sup>243</sup> Managers' interest diverges from shareholders' interest due to differences in the risk they are exposed to. A diversified investor might not consider boycotts as a significant potential cost since the risk for them is low and at least partially diversifiable. For the manager, however, the personal risk to his or her reputation and career is not diversifiable. Supportive of the risk aversion hypothesis, overconfident CEOs are less inclined to invest in ESG.<sup>244</sup>

### C. Implications for Securities Law

Many investors prioritize social objectives for the purpose of attaining those social objectives, while others prioritize the same because they believe it maximizes returns. It is exceedingly difficult to regulate disclosure by trying to discern when the information is wanted for profit maximization versus some overlapping or alternative purpose. Regardless, in a world in which consumers and employees are sensitive to the social implications of corporate behavior and in which sensitivity can result in dramatic effects on brand value, employee retention, and ultimately profit, investors must

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242. Bebchuk & Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, *supra* note 63.

243. See discussion of board diversity *supra* note 207.

244. See Scott McCarthy, Barry Oliver & Sizhe Song, *Corporate Social Responsibility and CEO Confidence*, 75 J. BANKING & FIN. 280 (2017).

worry about a dramatically expanded universe of risks, and the information firms provide investors should change accordingly.

It is important to recognize the convergence in interests across stakeholder groups. Diversity also matters because prospective employees increasingly value diversity in the workforce and want to work for diverse companies. Those employees, of course, are themselves the retirement savers whose money BlackRock seeks. Moreover, a lack of workforce diversity has the potential to become an issue for consumers and employees, as the Adidas case vividly illustrates.<sup>245</sup> The point is that these investors, consumers, and employees are not distinct groups of individuals. They are the same individuals interacting with companies in various ways, but with a willingness to foreground their values in these various roles.

The idea that financially material disclosures can be clearly distinguished from politically motivated disclosure requirements is less tenable when firms find themselves financially affected by perceptions of their social and environmental responsibility. Stakeholder power is leading to a convergence of the political and the financial, and one of the main consequences is that social issues can become financial problems in short order. Drawing distinctions between financial and social motivations is becoming increasingly pointless and untenable. Instead, regulators should be asking whether the demanded disclosures are actually something most investors want. Put differently, the information that would assume “actual significance in the mind of a reasonable investor” has changed.

Materiality is a core concept in securities regulation. In the presence of a duty to disclose, companies must share material information with the market that would assume actual significance in the mind of a reasonable investor.<sup>246</sup> Millennial and socially-motivated investor preferences should force a re-reckoning with traditional notions of materiality, as these preferences are altering what kind of information so-called reasonable investors would deem to be important. Courts should not be too quick to dismiss disclosures about social or environmental issues merely because such disclosures would not have ordinarily been understood to relate to a company’s financials. If courts lag behind investors in understanding the connection between stakeholder preferences and firm performance, or—worse—if such disclosures are dismissed as puffery, then investors risk being left in the dark. Instead, courts should follow investors’ lead, and adopt a flexible notion of materiality that is responsive to investors’ changing needs for information.

#### D. Implications for Corporate Law Policy

The ideology of shareholder primacy long associated with Milton Friedman has also held sway in corporate law for decades. Many have argued over the years that

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245. Shelley E. Kohan, *Adidas Lags Behind Nike And Puma In Terms of Diversity And Inclusion*, FORBES (June 12, 2020, 8:10 AM), <https://perma.cc/P2K6-P2X6>; Jaelyn Jaeger, *Adidas Vows More ‘Diverse and Inclusive’ Workplace After Key Exec Departs*, COMPLIANCE WEEK (July 6, 2020, 5:56 PM), <https://perma.cc/J28T-N4EB>.

246. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Delaware law requires companies to maximize shareholder value (at least without breaking the law). More recently, as shareholder primacy has come under increasing attack, so has the view that the law requires it.<sup>247</sup> Strine has recently argued in two articles that ESG is consistent with Delaware fiduciary duties along several dimensions. One article conceptualizes ESG as “an extension of the board’s duty to implement and monitor a compliance program under Caremark.”<sup>248</sup> That is, ESG should be situated within the compliance function of corporations as part of a larger effort by which companies seek to abide by legal and ethical requirements in the conduct of their businesses. “[A]s a matter of practical business strategy, if a company strives to be an above-average corporate citizen, then it will also be much more likely to simultaneously meet its minimum legal and regulatory duties.” A second piece, co-authored by Strine and Chris Brummer, argues that corporate fiduciary duties are consistent with efforts aimed at diversity, equity, and inclusion as a means to comply with civil rights and anti-discrimination laws and norms.<sup>249</sup> And as further proof of the changing legal and intellectual climate on these issues, economists Oliver Hart and Luigi Zingales have argued for maintaining shareholder primacy but with a goal of shareholder welfare maximization rather than maximizing returns, to incorporate shareholder preference for environmental and social goals, and offer different mechanisms to that end.<sup>250</sup> Other commentators have argued that CEOs and boards should abandon the shareholder primacy paradigm.<sup>251</sup>

We have no strong position on these accounts and proposals. Poor ESG performance poses a real risk to firms and shareholders. In addition, we agree with Hart & Zingales analysis that the firm is a better ESG promoter than the shareholder with respect to ESG goals that are not separable from its operations. But in our view, the social demand for ESG is already driving corporate efforts past what is strictly required by corporate law. Our analysis suggests that strong incentives are already in place, with or without legal mechanisms to support them.<sup>252</sup>

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247. See, e.g., Martin Lipton, *Stakeholder Governance—Some Legal Points*, Harv. L. Sch. F. on Corp. Governance (Sept. 20, 2019), <https://perma.cc/78DT-CGL7>.

248. Leo E. Strine, Jr., Kirby M. Smith & Reilly 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 (2021).

249. Chris Brummer & Leo Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1 (2022).

250. See Oliver D. Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACC. 247 (2017); Oliver D. Hart & Luigi Zingales, *The New Corporate Governance*, 1 CHI. BUS. L. REV. 195 (2022).

251. See, e.g., Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005).

252. Cf., Holger Spamann & Jacob Fisher, *Corporate Purpose: Theoretical & Empirical Foundations/Confusions* (Eur. Corp. Governance Inst., Working Paper No. 664, 2022) (arguing that proposed governance changes will have little effect, due to different reasons, such as limits of enforceability, lack of precise measures, and lack of evidence for potential effect of stakeholderism on firm performance), <https://perma.cc/F8XG-GLDY>.

### Conclusion

Corporate law scholars have attempted to shoehorn the rise of ESG, and of the CEOs who enact it, into preexisting corporate law frameworks. But these frameworks fail to capture the complex reality of ESG's rise. At bottom, our view of the rise of ESG is that it is about values, likely beginning with millennial generational values and spreading to the market overall. We do not think that CEOs who enact ESG are chasing returns alone through an enlightened framework, or are using ESG as cover to self-serve their own bottom lines. The story is much more complicated. ESG is a bottom-up demand from socially-motivated investors, workers, and consumers who genuinely care about the environment, diversity, and economic inequality. That demand has driven ESG and stakeholderism—ideas that have been around for decades and have been championed by many constituencies—to the center of economic life. Yes, ESG might well improve long-term shareholder value, but at bottom that is not the movement's motivating principle. The reality of ESG is simple: ESG is important because corporate America is facing pressure from young people seeking to live their economic lives consistent with a set of social values. The ESG CEO is operating in a new kind of business environment, subject to multiple channels of social influence, and responding to a genuine social demand that is more complicated and multifaceted than demand for maximizing returns.