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## Valuing ESG

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## Valuing ESG

*Aneil Kovvali\* & Yair Listokin†*

*Corporate environmental, social, and governance (ESG) commitments promise to make capitalism better. Unfortunately, ESG has become a hotbed of hype and controversy. The core problem is that ESG mixes vague environmental and social goals with a profit maximization goal and does not provide a framework for resolving the conflicts that exist between them. The result is confusion that invites deception and cynicism. This Article proposes a mechanism for resolving conflicts between goals by translating them into the common language of money. Once non-pecuniary environmental or social goals are translated into dollar values, they can provide clear and actionable guidance for firms and investors, enabling ESG to fulfill its promise.*

*To achieve this, corporations and institutional investors that claim to be ESG-friendly should publicly commit to specific valuations for ESG issues. For example, a company or mutual fund concerned with both climate change and profit might commit to valuing a metric ton of carbon emissions at \$100 in its charter. The company would use that valuation as a metric in its assessment of projects, pursuing only those projects that would remain “profitable” after adjusting its forecasted cashflows by subtracting \$100 for every ton of additional carbon emitted. A mutual fund would use the valuation when voting on climate-related governance issues or investment decisions. For example, the fund would back a shareholder resolution supporting lower corporate carbon emissions so long as the resolution would not reduce profits by more than \$100 per ton of carbon saved. Similarly, the fund might pick stocks for investment based on*

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† Deputy Dean and Shibley Family Fund Professor of Law, Yale Law School. We thank Sachin Holdheim for excellent research assistance; Joshua Macey and Roberta Romano for helpful conversations; and participants in the American Law and Economics Association 2023 Conference, hosted by the Boston University Law School, and the Fifth Annual Law and Macroeconomics Conference, hosted by the University of Pennsylvania Wharton Business School, for comments and suggestions.

*potential profitability at a carbon price of \$100. In effect, companies and investors would bid on their valuation of ESG impacts relative to ordinary profit maximization, sending clear and actionable signals on actual and desired behavior. By providing concrete standards and a sorting mechanism for making sense of competing goals, valuation would help realize the potential of ESG investing.*

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## INTRODUCTION

Businesses and investors increasingly support the use of environmental, social, and governance (ESG) factors when making decisions. Trillions of dollars have been committed to ESG styles of investing, in which these environmental, social, and governance considerations are given weight alongside traditional financial metrics.<sup>1</sup> The Department of Labor (DOL) expressly blessed the use of ESG in decision-making by investment managers handling retirement funds.<sup>2</sup> The Securities and Exchange Commission (SEC) appears interested in supporting ESG, with proposed rules targeted at both companies and investors.<sup>3</sup> And business leaders have signaled support for a new ESG paradigm in which companies consider a broad range of stakeholder interests and issues, rather than focusing solely on delivering financial returns to shareholders.<sup>4</sup> By encouraging businesspeople to consider externalities when making decisions, ESG promises to make capitalism better.

Unfortunately, ESG has become “shorthand for hype and controversy.”<sup>5</sup> ESG sets “conflicting goals for firms”, adding “environmental”, “social” and “governance” targets to the goal of

1. *ESG Assets May Hit \$53 Trillion by 2025, a Third of Global AUM*, BLOOMBERG PRO. SERVS. (Feb. 23, 2021), <https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum>.

2. See *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 Fed. Reg. 73822 (Dec. 1, 2022) (codified at 29 C.F.R. pt. 2550).

3. See *Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices*, Exchange Act Release Nos. 33-11068 & 34-94985, 87 Fed. Reg. 36654 (proposed June 17, 2022) (to be codified in scattered sections of 17 C.F.R.) (investors); *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, Exchange Act Release Nos. 33-11042 & 34-94478, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified in scattered sections of 17 C.F.R.) (registrants).

4. See, e.g., *Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy that Serves All Americans’*, BUS. ROUNDTABLE (Aug. 19, 2019), <https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans>; Martin Lipton, *The New Paradigm*, WORLD ECON. F. (Sep. 2, 2016), <https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf>. See also Raghuram Rajan, Pietro Ramella & Luigi Zingales, *What Purpose Do Corporations Purport? Evidence from Letters to Shareholders* (ECGI Working Paper No. 904/2023, 2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4035849](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4035849) (documenting proliferation in statements of purpose other than maximizing shareholder value).

5. *ESG Should Be Boiled Down to One Simple Measure: Emissions*, ECONOMIST (July 21, 2022), <https://www.economist.com/leaders/2022/07/21/esg-should-be-boiled-down-to-one-simple-measure-emissions>.

profit maximization.<sup>6</sup> But ESG does not provide guidelines for resolving the conflicts between these goals. The result is “an unholy mess that needs to be ruthlessly streamlined.” ESG’s current shortcomings also invite derision and accusations of fraud. ESG has been labeled a “complete fraud”; “a lot of sizzle, no steak”;<sup>7</sup> a form of “financial fraud” perpetrated by “corporate cartel elites”;<sup>8</sup> and a “deadly distraction.”<sup>9</sup>

This Article shows that ESG’s problems boil down to a question of valuation. A well-structured mechanism for valuing the effects of corporate decisions on the environment and society would make it possible to translate the conflicting claims of ESG and profit into the common language of money. Firms and investors could then act as if those environmental and social externalities have been addressed through a Pigouvian tax.<sup>10</sup> This approach to ESG provides clear and actionable guidance for firms and investors, enabling ESG to realize its considerable promise.

Valuation offers straight answers to the thorny questions raised by ESG as it is practiced today. Despite the enormous amounts of capital and enthusiasm behind ESG, there is currently no clear guidance on what exactly it means, or how corporate leaders and investors are supposed to comply. What must a company or investor do to warrant an ESG label? Must a company sacrifice financial returns to satisfy environmental or social objectives, and

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6. *Id.*

7. Pippa Stevens, *ESG Investing Is a ‘Complete Fraud,’ Chamath Palihapitiya Says*, CNBC (Feb. 26, 2020), <https://www.cnbc.com/2020/02/26/chamath-palihapitiya-esg-investing-is-a-complete-fraud.html>.

8. Richard Vanderford, *Florida’s DeSantis Takes Aim at ‘Woke Capital’*, WALL ST. J. (July 28, 2022), <https://www.wsj.com/articles/floridas-desantis-takes-aim-at-woke-capital-11659043495>.

9. Cam Simpson, Akshat Rathi & Saijel Kishan, *The ESG Mirage*, BLOOMBERG (Dec. 10, 2021), <https://www.bloomberg.com/graphics/2021-what-is-esg-investing-msci-ratings-focus-on-corporate-bottom-line> (quoting Tariq Fancy, BlackRock’s former chief investment officer for sustainable investing).

10. A “Pigouvian tax” forces the taxed party to internalize a cost that its behavior imposes on others. For example, suppose that a marginal car getting onto a congested road will delay other drivers, and that the total economic value of the delays to other drivers is \$10. Because someone considering getting onto the road will not consider the delays to other drivers (the delay to others represents an “externality”), too many people will get on the road relative to the social optimum. The government can force drivers to internalize the externality by imposing a Pigouvian tax—charging them a \$10 toll for using the road. This would reduce the number of drivers to the socially optimal level. A carbon tax would be a Pigouvian tax intended to cause polluters to internalize the harms associated with climate change. Pigouvian taxes are named for Arthur C. Pigou, who analyzed them in *THE ECONOMICS OF WELFARE* (1920).

if so, how much? Sometimes ESG's aims conflict with each other. For example, a new project might hurt the environment but help workers, or vice versa.<sup>11</sup> How should a company weigh competing ESG interests when they conflict?

At present, there is no clear framework for resolving these questions. Instead, ESG rating agencies apply different proprietary formulas that implicitly answer some of these questions by favoring companies with certain patterns of behavior on a range of ESG issues over companies that behave differently.<sup>12</sup> Their formulas are secret; even if the rater discloses the criteria, they do not disclose the weighting. And none of the raters explain how they balance ESG scores with profits in the event of conflict. The calculus of corporations and institutional investors is even more opaque.

The absence of guidance limits the potential influence of the ESG movement. Because no one knows exactly what ESG means, investors cannot have confidence that their funds are being used in a manner consistent with their values. The uncertainty also limits the potential scope of ESG by preventing its use in contexts where precision is required, such as a takeover or bankruptcy situation.<sup>13</sup> Even worse, the uncertainty emboldens bad actors who are eager to profit by marketing themselves as supporters of ESG while doing little to address environmental or social issues.<sup>14</sup> With so much

11. Cf. Stephen Bainbridge, *The Importance of the Shareholder Wealth Maximization Standard*, PROFESSORBAINBRIDGE.COM (Feb. 7, 2006), <https://www.professorbainbridge.com/professorbainbridge.com/2006/02/the-importance-of-the-shareholder-wealth-maximization-standard.html>. The problem is more than theoretical. For example, electric vehicles require less labor to produce. As a result, the transition away from fossil fuels could be profoundly damaging to worker interests unless it is carefully managed by political, labor, and business leaders. See Timothy Cama, *Auto Union Withholds Support for Biden, Citing Electric Vehicles*, POLITICO (May 3, 2023), <https://www.politico.com/news/2023/05/03/auto-union-withholds-support-for-biden-citing-evs-00095136>.

12. Simpson, Rathi & Kishan, *supra* note 9, ("MSCI and its competitors in ESG rating . . . often disagree with one another, sometimes wildly. That's because each ESG rating provider uses its own proprietary system, algorithms, metrics, definitions, and sources of nonfinancial information, most of which aren't transparent and rely heavily on self-reporting by the companies they rate. No regulator examines the methodology or the results.").

13. See *infra* Part III.

14. This behavior is termed "greenwashing" (in the environmental context), "pinkwashing" or "rainbow-washing" (in the LGBTQ+ rights context), "diversity washing" (in the social justice in hiring context), and more. See, e.g., Amanda Shanor & Sarah E. Light, *Greenwashing and the First Amendment*, 122 COLUM. L. REV. 2033, 2037 (2022) ("Greenwashing generally refers to a set of deceptive marketing practices in which an entity publicly misrepresents or exaggerates the positive environmental impact or attributes of a product or service to create a favorable impression that is not supported by evidence (product-level

uncertainty about what ESG entails, bad actors face relatively little risk of legal accountability.<sup>15</sup>

ESG's lack of clarity also exacerbates corporate governance challenges within firms. Intractable conflicts between a firm's controllers are likely to be expensive for the controllers, distracting for managers, and destructive to the firm's prospects.<sup>16</sup> Vesting control of an enterprise in a heterogeneous group with diverse preferences is a recipe for this type of conflict. Shareholders are often thought to have a homogeneous preference for share price maximization,<sup>17</sup> making them a natural constituency to exercise residual control rights over firms.<sup>18</sup> And even if shareholders are

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claims), or in which an entity misrepresents the entity's overall impact on the environment (firm-level claims)."); Pete Michaels & Alyssa Scruggs, *The Rise of Shareholder Activism and Litigation Related to Environmental, Social, and Governance Investing*, 31 SEC. LITIG. 18, 19 (2021) ("Greenwashing' generally refers to any instance of a company placing more focus on appearing 'green' than actually being 'green.'"); John Towers Rice, *Rainbow-Washing*, NE. U. L. REV. (forthcoming 2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4193059](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4193059); Jeff Green, *CEOs Who Are All Talk and No Action on Inclusion Still Benefit*, BLOOMBERG BUSINESSWEEK (Jan. 19, 2023), <https://www.bloomberg.com/news/articles/2023-01-19/diversity-washing-funds-can-aid-companies-even-if-they-don-t-improve-hiring>.

15. Various enforcers have attempted to act in the space, but the results have been mixed at best. See *People v. Exxon Mobil Corp.*, 119 N.Y.S.3d 829 (N.Y. Sup. Ct. 2019) (finding that the New York Office of the Attorney General did not establish that ExxonMobil misled the investment community in public disclosures related to climate change risk management).

16. See HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 39-44 (1996).

17. E.g. RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 9 (10th ed. 2011) ("Fortunately there is a natural financial objective on which almost all shareholders agree: Maximize the current market value of shareholders' investment in the firm."); ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, *MICROECONOMIC THEORY* 152 (1995) ("[U]nder reasonable assumptions . . . all owners would agree upon . . . the objective of profit maximization."). This idea is subject to serious challenge on both theoretical and practical grounds. For example, when a firm can affect a shareholder in ways that are separate from the increase or decrease of share prices—e.g., when the firm is a monopolist and can increase or decrease the product market prices the shareholder confronts—unanimity may not hold. See MAS-COLELL, WHINSTON & GREEN, *supra* at 153; Oliver D. Hart, *On Shareholder Unanimity in Large Stock Market Economies*, 47 *ECONOMETRICA* 1057 (1979). Various financial market products, strategies, and developments can also undermine the presumption of unanimity. See, e.g., GRANT M. HAYDEN & MATTHEW T. BODIE, *RECONSTRUCTING THE CORPORATION* 68-87 (2020); Theodore N. Mirvis, Paul K. Rowe & William Savitt, *Bebchuk's "Case for Increasing Shareholder Power": An Opposition*, 120 *HARV. L. REV. F.* 43 (2007); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 *UCLA L. REV.* 561 (2006); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 *S. CAL. L. REV.* 811 (2006).

18. See, e.g., HANSMANN, *supra* note 16, at 44 ("[M]aking everybody an owner threatens to increase the costs of collective decision making enormously."); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 70

imperfectly aligned on some financial matters, markets offer mechanisms to resolve potential conflicts between shareholders without affecting corporate governance. For example, a shareholder with an idiosyncratic urgent need for liquidity can simply borrow against their shares instead of using corporate governance mechanisms to agitate for an immediate dividend that other shareholders would oppose. Credit markets and interest rates thus allow shareholders with different liquidity needs to compare priorities and neutralize differences. But these mechanisms are missing in the context of ESG.<sup>19</sup> If one shareholder wants to maximize financial returns, another wants to reduce carbon emissions, and another wants to address social issues, current financial markets do not provide tools the shareholders could use to compare the value of their priorities and come to an agreement. In other words, there is no market mechanism that addresses the heterogeneity of shareholder views on ESG matters, leading to more chaotic governance and potentially to corporate underperformance.<sup>20</sup>

Our solution is simple. Entities claiming to be ESG-friendly should commit to a dollar valuation for each ESG issue they consider. For example, a firm or investment fund might commit to valuing a ton of carbon emissions at \$50. To make this commitment credible, the firm could pass a charter amendment or enter into a binding contract with a third party that would hold the firm to its promise.<sup>21</sup> When making decisions that implicate ESG concerns, the firm should maximize *adjusted* profits, where the adjustment reflects the stated ESG valuations. A binding contract with a third party could adjust corporate profits so that they reflect

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(1991) (“The preferences of one class of participants are likely to be similar if not identical. This is true of shareholders especially, for people buy and sell in the market so that the shareholders of a given firm at a given time are a reasonably homogeneous group with respect to their desires for the firm. So firms with single classes of voters are likely to be firms with single objectives, and single-objective firms are likely to prosper relative to others.”); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 405 (1983); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005).

19. See Anil Kovvali, *ESG and Securities Litigation: A Basic Contradiction*, 73 DUKE L.J. (forthcoming 2024) [hereinafter Kovvali, *Basic Contradiction*].

20. E.g., Eugene F. Fama, *Market Forces Already Address ESG Issues and the Issues Raised by Stakeholder Capitalism*, HARV. L. SCH. F. ON CORP. GOVERNANCE. (Oct. 9, 2020), <https://corpgov.law.harvard.edu/2020/10/09/market-forces-already-address-esg-issues-and-the-issues-raised-by-stakeholder-capitalism/#more-133396>.

21. We propose one such mechanism, a “green swap,” below, *infra* text accompanying notes 151–152.



the commitment, while other commitment strategies require management to behave as if adjusted profits were the key metric. A strategy that would generate an extra \$40 in unadjusted profits but would cause an additional ton of carbon emissions would be viewed as equivalent to a strategy that would cause a \$10 loss.

This model solves several of ESG's biggest problems. First, it clearly defines ESG in precise numeric terms. A purportedly ESG-friendly fund or corporation would put dollar values on stakeholder interests and make decisions based on both the valuations and profits. The more ESG-related issues an entity chooses to value and the higher each valuation is, the higher the level of the entity's ESG commitment. Investors, employees, and other stakeholders could choose their preferred entities based on their specific ESG commitments. And if a fund or firm announces a dollar ESG value but fails to implement it, then the entity would be liable for violation of corporate or securities law with the stated ESG value as the lodestar for damage calculations. No more greenwashing.

Second, our model strikes a workable compromise between shareholder interests and social interests. Firms would not pursue projects where investors' valuation of total social costs exceed benefits, even though some of those projects could generate profits for shareholders. But other projects would be undertaken—even though they may produce new carbon emissions or a different externality—provided that the profit from these projects exceed the externalities as measured by ESG valuations. Importantly, shareholders would keep the full value of any projects pursued without being forced to absorb their social costs in practice. This is more generous to shareholders—and thus, substantially more politically viable—than an actual Pigouvian tax imposed by the government. An actual carbon tax would prevent firms from pursuing projects that are not profitable enough to justify their emission level *and* would reduce the profitability of the remaining projects pursued. A firm's commitment to value carbon emissions at a particular level would only prevent the firm from pursuing projects that are not profitable enough to justify their emission level. Thus, the dollarized ESG values would guide

decision-making rather than reduce profits directly.<sup>22</sup> Investors would also be free to set lower values on carbon than the values that an ideal social planner would select.<sup>23</sup>

Third, ESG valuations would mitigate the shareholder heterogeneity problem, enabling more effective governance. By flattening the ESG preferences of shareholders into a single dollar variable, the proposal would reduce many of the pathologies of collective decision-making in the presence of heterogeneity.<sup>24</sup> If the median shareholder-voter values carbon emissions at \$15 per ton, then shareholders can be treated as a homogenous entity seeking to maximize carbon-adjusted profits, where carbon is valued at \$15 a ton. Shareholder voting will generally produce this outcome, meaning that shareholder governance can integrate ESG values without becoming hopelessly unwieldy and state-contingent.<sup>25</sup>

The Article proceeds as follows. Part I provides a brief introduction to ESG, explaining its promise, but noting that a lack of specificity and clear guidance has limited its potential. Part II lays out the proposal and explains how a valuation mechanism would address many of ESG's salient weaknesses. Part III considers regulatory interventions that enable ESG valuation to realize its potential or that are themselves enabled by ESG valuation.

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22. Of course, corporations or investment funds concerned that this disconnect between the stated bottom line and actual corporate profits is unsustainable could commit to paying a third party (such as an environmental protection non-profit) for externalities, harmonizing the revised ESG goal with profits. In effect, they would be imposing the equivalent of a Pigouvian tax on themselves.

23. Naturally, this is also a weakness of the system. While our proposal seeks to maximize the effectiveness of ESG, it will often be a second-best alternative to optimal (and hypothetical) mandatory regulation by the government.

24. EASTERBROOK & FISCHER, *supra* note 18 at 70; HAYDEN & BODIE, *supra* note 17, at 115.

25. Of course, even slight deviations from the ideal of rational, single-peaked preferences can reintroduce these pathologies. See HAYDEN & BODIE, *supra* note 17. Shareholders may be more likely to behave in seemingly irrational ways with respect to ESG matters. For example, some subset of shareholders may be indifferent between a company pursuing maximum profits (with tolerance for high emissions) or minimum emissions (with tolerance for low profits) and may simply reject compromises they regard as hypocritical. But such shareholders are likely to be relatively rare and to exert little influence over outcomes.

The process of setting values may also be contentious and difficult, especially if a firm or investor seeks to set values across multiple ESG dimensions. But the value-setting process is likely to have a finite duration, and after it is complete shareholders will sort themselves into firms that align with their values.

## I. ESG'S PROMISE AND PROBLEMS

This Part considers the state of play for ESG. Section I.A provides a capsule summary of the development of ESG and its place in corporate and securities law. It also describes the current state of ESG and the issues that have impeded its further development. Section I.B offers a diagnostic framework for the problems with ESG, with the goal of isolating the issues that reform proposals should address. Section I.C surveys existing proposals for reform.

### A. *Development and Limitations*

ESG challenges the standard theory of corporate and securities law. It is based on a desire to address critical problems, many of which are not being adequately addressed by the political system. The movement appears to be reaching a critical moment in its development that will determine its economic and regulatory influence.<sup>26</sup> This section provides a capsule summary of stakeholderism and ESG, with the goal of introducing the issues driving our valuation proposal.

#### 1. *The Standard Corporate Law Paradigm*

Corporate law is normally understood through the lens of shareholder primacy. This theory suggests that the sole end of a corporation is to advance the interests of its shareholders and is normally treated as a command to maximize their financial returns.<sup>27</sup> Many arguments have been advanced in support of shareholder primacy, but a crucial aspect is its analytic clarity.<sup>28</sup> Shareholder primacy offers a relatively clear instruction. Corporate leaders, courts, and scholars understand exactly what they are striving to accomplish and can evaluate performance against the

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26. See Anil Kovvali, *Stakeholderism Silo Busting*, 90 U. CHI. L. REV. 203, 224 (2023) [hereinafter Kovvali, *Stakeholderism Silo Busting*] (describing this as a “constitutional moment” for economic regulation, due to the increasing salience of stakeholderism).

27. The two concepts are distinct. Even if companies should be run for the benefit of shareholders, the shareholders’ interest may not equate to short run profit maximization. See Ann Lipton, *What We Talk About When We Talk About Shareholder Primacy*, 69 CASE W. L. REV. 863 (2019); Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. CHI. BUS. L. REV. 195 *passim* (2022) (proposing “shareholder welfare maximization” as a replacement for “shareholder value maximization” to account for this distinction).

28. See *infra* Section I.B.1.

financial metric of shareholder returns.<sup>29</sup> Introducing other concerns would only confuse analysis and frustrate efforts to hold decisionmakers accountable.

The problem of clarity is exacerbated by the challenge of finding consensus.<sup>30</sup> Shareholders are a relatively homogenous group: all shareholders have the same kind of interest in the firm and have a pro rata stake in its successes and failures. As a result, shareholders focused on their financial stakes in the firm are likely to agree on the best course of action.<sup>31</sup> By contrast, individual groups like workers have diverse interests,<sup>32</sup> and different groups like creditors and workers are often in direct competition with each other. In the absence of a clear criterion to guide action, it is unlikely that the full range of relevant groups—shareholders, workers, creditors, consumers, environmentalists—could reach consensus. Shareholders alone might.

Backers of shareholder primacy also emphasize that the current architecture of corporate law empowers only shareholders.<sup>33</sup> Only shareholders can vote in corporate elections; only shareholders are owed fiduciary duties;<sup>34</sup> and except in unusual circumstances,<sup>35</sup> only shareholders can bring lawsuits against corporate directors and officers alleging infidelity. Financial market innovations have

29. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 581 (2003) (“Shareholder wealth maximization provides a clear answer to [an] otherwise difficult situation . . . . The alternative to following the shareholder wealth maximization norm would . . . force directors to struggle with indeterminate balancing standards.”).

30. See *infra* Section I.B.1.c.

31. See *supra* note 18.

32. See Suresh Naidu, Eric A. Posner & Glen Weyl, *Antitrust Remedies for Labor Market Power*, 132 HARV. L. REV. 536, 543 (2018).

33. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 136 (2012) (“We act as if entities in which only capital has a vote will somehow be able to deny the stockholders their desires, when a choice has to be made between profit for those who control the board’s reelection prospects and positive outcomes for the employees and communities who do not.”); A.A. Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1367 (1932) (urging that there is no “mechanism now in sight enforcing accomplishment of” the “theoretical function” of having corporate leaders advance community interests).

34. *N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”).

35. When a firm is insolvent, creditors can be empowered to bring derivative claims on the corporation’s behalf. *Id.*

also heightened shareholder power. Instead of being diffused among a large number of small shareholders who lack the capacity and incentive to defend their interests, shares are increasingly held by large institutions that have the power to shape the corporate agenda.<sup>36</sup> And the market for corporate control, fueled by the ease of raising large amounts of capital through debt, allows corporate takeover artists to acquire companies that are not being managed in a way that delivers the highest possible financial returns to shareholders.<sup>37</sup>

According to the traditional account, investors are focused on maximizing financial returns. A standard result in financial economics suggests that shareholders uniformly want the companies that they own to maximize risk-adjusted returns.<sup>38</sup> To the extent that they have outside preferences, shareholders were thought to advance them by channeling their earnings into purchases in consumer markets that reflect those preferences.<sup>39</sup> Until recently, companies and regulators catered to this understanding of investor behavior by emphasizing traditional financial metrics in voluntary and mandatory disclosures.<sup>40</sup>

## 2. ESG in Disclosures and Investing

Various trends have complicated the standard account. Managers have increasingly suggested that environmental and social issues are important to their decisions. This “stakeholderism”

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36. See Serdar Çelik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2013/2 OECD J.: FIN. MKT. TRENDS 93, 96 (2014).

37. See, e.g., William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261 (1992); Kovvali, *Stakeholderism Silo Busting*, *supra* note 26, at 218–19.

38. José Azar, *The Common Ownership Trilemma*, 87 U. CHI. L. REV. 263, 271–72 & n.31 (2020) (describing the literature on the Fisher Separation Theorem, “which shows that, if firms are price takers and markets are complete, all shareholders unanimously agree on the objective of profit maximization”); BREALEY ET AL., *supra* note 17, at 9 (“Shareholders want managers to maximize market value”); Hart & Zingales, *supra* note 27, at 198.

39. For a discussion of this view and some complications, see generally Hart, *supra* note 17.

40. See, e.g., Press Release, Secs. & Exch. Comm’n, SEC Adopts Amendments to Modernize Rule 10b5-1 Insider Trading Plans and Related Disclosures (Dec. 14, 2022), <https://www.sec.gov/news/press-release/2022-222> (describing that new disclosure requirements will “help[] investors decide where to put their money[,] . . . lower[] the cost of capital for businesses seeking to raise capital[,] . . . [and] facilitate[] capital formation”).

can be invoked in either an instrumental or pluralistic fashion.<sup>41</sup> For example, paying workers a higher wage than what market conditions would suggest can increase shareholder profits over the long term by allowing the company to be more selective in hiring, motivating workers, and improving the company's reputation.<sup>42</sup> Thus, concern for workers as a constituency group can be a useful *instrumental* tool for managers to achieve their shareholder-focused goals.<sup>43</sup> But managers might also care about workers and other groups in a way completely disconnected from shareholder value. Under this *pluralistic* conception, managers might actually forego higher shareholder profits to deliver added benefits to other groups. Similarly, institutional investors have suggested that ESG information is important to their decisions—sometimes as an instrumental tool for evaluating risk and opportunity in an effort to maximize financial returns,<sup>44</sup> and sometimes as a strategy for

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41. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 97–98 (2020) [hereinafter Bebchuk & Tallarita, *Illusory Promise*].

42. Cf. M. Todd Henderson, *The Story of Dodge v. Ford Motor Company: Everything Old Is New Again*, in CORPORATE LAW STORIES 37, 50–52 (J. Mark Ramseyer ed., 2009) (discussing profit-oriented reasons for Henry Ford's decision to pay workers \$5 per day).

43. For one famous example, consider Henry Ford's decision to pay workers a \$5 a-day wage. Although the wage was far more than wages paid by competitors, it had the effect of eliminating absenteeism, increasing productivity, pressuring competitors, and discouraging unionization. See Henderson, *supra* note 42, at 37, 50–53. There have also been more recent examples. See, e.g., EDWARD HUMES, FORCE OF NATURE: THE UNLIKELY STORY OF WAL-MART'S GREEN REVOLUTION 3 (2011) (suggesting that Wal-Mart pushed to reduce carbon emissions in its supply chain partly because the “most sustainable business, the cleanest, most energy-efficient, least wasteful company, will have the competitive advantage . . . .”); Zeynep Ton, *Why “Good Jobs” Are Good for Retailers*, HARV. BUS. REV. (Jan.–Feb. 2012), <https://hbr.org/2012/01/why-good-jobs-are-good-for-retailers> (“Highly successful retail chains . . . not only invest heavily in store employees but also have the lowest prices in their industries, solid financial performance, and better customer service than their competitors . . . . [T]hey have proven that the key to breaking” “the presumed trade-off between investment in employees and low prices” “is a combination of investment in the workforce and operational practices that benefit employees, customers, and the company.”).

44. See, e.g., Press Release, World Bank & Gov. Pension Inv. Fund of Japan, *Environmental, Social and Governance Factors Can Be Material Risks for Fixed Income Investors, Finds World Bank Group and GPIF Report* (Apr. 19, 2018), <https://www.worldbank.org/en/news/press-release/2018/04/19/environmental-social-and-governance-factors-can-be-material-risks-for-fixed-income-investors-finds-world-bank-group-and-gpif-report> (“Incorporating environmental, social, and governance (ESG) factors into fixed income investment strategies can strengthen risk management and contribute to more stable financial returns . . . .”).

addressing pressing societal problems that can damage a broader range of societal interests.<sup>45</sup>

Both the instrumental and pluralist conceptions are rooted in a profound sense that markets are failing to capture ESG-related risks and opportunities, and that governments are failing to prevent ESG-related costs imposed on third parties. If share prices captured the environmental and social risks and opportunities that they are currently missing, the instrumental conception would be unnecessary. For example, if stock markets were currently doing their job, any companies that will suffer due to climate change or the transition to a low-carbon economy would have a depressed share price, and investors would not need to separately consider environmental factors to make a sound decision. But markets do not appear to be meeting this challenge.<sup>46</sup> Managers may also have an incentive to downplay the environmental and social risks to their enterprises.<sup>47</sup> This instrumental conception of ESG investing focuses on maximizing risk-adjusted returns and is basically consistent with a traditional account of investor concerns.

Similarly, if the government or other social institutions adequately defended stakeholder interests, the pluralist version would be unnecessary. Companies that aggravate major societal problems would be punished by the government, so that the goal of profit maximization would be aligned with social objectives. Because of a widespread belief that the political process is failing in this function, individuals are increasingly interested in incorporating moral beliefs into the economic decisions they make in their capacity as workers, consumers, and investors.<sup>48</sup> In effect,

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45. See, e.g., Paulina Pielichata, *Norway Sovereign Wealth Fund Manager Launches New Climate Board*, PENSIONS & INV. (Jan. 6, 2023), <https://www.pionline.com/esg/norway-sovereign-wealth-fund-manager-launches-new-climate-board> (describing the GPF's ESG efforts as supporting the push to reduce carbon emissions to zero by 2050).

46. Kovvali, *Basic Contradiction*, *supra* note 19; Madison Condon, *Market Myopia's Climate Bubble*, 2022 UTAH L. REV. 63, 63 (2022). These considerations were highlighted by the Department of Labor in support of a recent rule allowing managers investing retirement funds to consider ESG factors when making decisions. See *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 Fed. Reg. 73822, 73865-66 (Dec. 1, 2022) (codified at 29 C.F.R. pt. 2550).

47. Cf. John Armour, Jeffrey Gordon & Geeyoung Min, *Taking Compliance Seriously*, 37 YALE J. ON REG. 1 (2020).

48. Part of the shift is generational. The rising generation of millennial investors appear to be more interested in expressing moral values in this way than prior generations. See Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CALIF. L. REV. 1243 *passim* (2020).

they are trading away financial returns in the hope of obtaining a non-pecuniary societal benefit. This pluralistic conception of ESG investing focuses on achieving collateral benefits for investors who are sensitive to environmental or social performance, and thus represents a more direct challenge to the traditional account.

As with stakeholderism generally, it is important to distinguish between the two motivations. Under an instrumental approach to ESG, an investor would support sacrificing profits at a company to advance an environmental or social cause if and only if the investor expected to make the money back either in the long run or elsewhere in their portfolio. While such opportunities might be real, it could be difficult for investors to identify or capitalize on them. Under a more pluralistic approach to ESG, an investor may be prepared to sacrifice profits simply to advance an environmental or social cause. But this type of commitment is not likely to be open-ended; investors would only sacrifice some finite amount to achieve altruistic goals. Investors might also struggle to identify instances where altruistic synergies are present. Because of the ambiguity of the ESG label, it can be difficult to determine what approach investors are taking.

*a. Current Debates and State of Play.* An enormous amount of capital has been directed toward ESG in the name of both instrumental and pluralist motivations. Trillions of dollars are now invested through funds that hold themselves out as proponents of ESG.<sup>49</sup>

The growth of the ESG movement brought with it increased pressure from multiple angles. BlackRock and other index fund managers have sought to assure regulators in conservative states that they are only using ESG considerations in an instrumental fashion, to drive financial returns.<sup>50</sup> At the same time, they seem

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49. See *ESG Assets May Hit \$53 Trillion by 2025, a Third of Global AUM*, *supra* note 1.

50. See Dalia Blass, *Letter to Mark Brnovich, Arizona Attorney General, et al.*, BLACKROCK (Aug. 4, 2022), <https://www.blackrock.com/us/individual/literature/press-release/blackrock-response-attorneys-general.pdf> (responding to a letter from nineteen Republican state attorneys general by asserting that its approach to ESG would lead to “better long-term financial outcomes,” and noting that it had avoided setting “unduly prescriptive and constraining” policies at corporations); *cf.* Andrew Ross Sorkin, Ravi Mattu, Bernhard Warner, Sarah Kessler, Stephen Gandel, Michael J. de la Merced, Lauren Hirsch & Ephrat Livni, *An Activist Investor Takes on BlackRock over E.S.G.*, N.Y. TIMES (Dec. 7, 2022), <https://www.nytimes.com/2022/12/07/business/dealbook/blackrock-esg-activist-bluebell.html> (describing limits on BlackRock’s willingness to advance ESG priorities);



eager to suggest to liberal state investors that they are using ESG considerations in a pluralist fashion, to address problems like climate change.<sup>51</sup> The resulting balancing act—and recent maneuvers by institutional investors<sup>52</sup>—has led to increasing cynicism about ESG.

Federal regulators are also active in the ESG space. The DOL regulates employers that offer retirement funds. DOL's guidance to employers who offer ESG-focused investment funds has evolved. During the final days of the Trump Administration, the DOL issued a rule essentially barring the inclusion of ESG considerations in retirement investment.<sup>53</sup> The Biden Administration quickly suspended enforcement of the rule and eventually issued a rule that blessed an essentially instrumentalist approach to ESG.<sup>54</sup>

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Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter> (last visited Oct. 24, 2023) (“We focus on sustainability not because we’re environmentalists, but because we are capitalists and fiduciaries to our clients.”).

51. See Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter> (last visited Oct. 24, 2023) (outlining BlackRock's various commitments to combat climate change, as well as stating that “[g]overnments and the private sector must work together . . . as we pursue the path to a low-carbon world” and “[e]very government, company, and shareholder must confront climate change”); see also Larry Fink, *Larry Fink's 2021 Letter to CEOs*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/2021-larry-fink-ceo-letter> (last visited Oct. 24, 2023) (“I believe that the pandemic has presented such an existential crisis – such a stark reminder of our fragility – that it has driven us to confront the global threat of climate change more forcefully and to consider how, like the pandemic, it will alter our lives. It has reminded us how the biggest crises, whether medical or environmental, demand a global and ambitious response.”). In light of BlackRock's instrumentalist response to red state pressure, New York City Comptroller Brad Lander said, in an open letter to Blackrock, that “[t]he fundamental contradiction between BlackRock's statements and actions is alarming” and that Blackrock must “move its portfolio companies to get their businesses in line with a net zero economy.” Brad Lander, *Letter from Brad Lander, New York City Comptroller, to Laurence D. Fink, CEO of BlackRock, Inc.*, CITY OF NEW YORK, (Sept. 21, 2022), <https://comptroller.nyc.gov/wp-content/uploads/2022/09/Letter-to-BlackRock-CEO-Larry-Fink.pdf>.

52. For example, Vanguard recently exited the Net Zero Asset Managers initiative, which “encourage[d] fund firms to reach net zero emission targets by 2050 and limit the rise in global temperatures.” Ross Kerber & Noor Zainab Hussain, *Vanguard Quits Net Zero Climate Effort, Citing Need for Independence*, REUTERS (Dec. 7, 2022), <https://www.reuters.com/business/sustainable-business/vanguard-quits-net-zero-climate-alliance-2022-12-07>.

53. Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113, 39117 (June 30, 2020) (codified at 29 C.F.R. pt. 2550) (“[F]iduciaries may never subordinate the interests of plan participants and beneficiaries in their retirement income to non-pecuniary goals.”).

54. See Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 87 Fed. Reg. 73822, 73826-27 (Dec. 1, 2022) (codified at 29 C.F.R. pt. 2550);

The SEC has also been active in targeting corporations and institutional investors that have sought to attract capital by falsely presenting themselves as focused on ESG priorities.<sup>55</sup> It has demanded clearer disclosures on certain ESG-related issues, proposing mandatory disclosures by corporations on greenhouse gas emissions<sup>56</sup> and recommending rules that would require institutional investors that hold themselves out as ESG-focused to provide justification for the label.<sup>57</sup>

### *B. Problems with ESG*

This section seeks to trace the root causes of ESG's failure to reach its full potential. First, introducing environmental and social issues into corporate and investment decision-making can result in a lack of clarity. Second, resolving the resulting questions requires consensus amongst investors who may have widely divergent views on environmental and social matters. The resulting conflicts could create chaos and increase decision-making costs. Third, the resulting confusion makes it difficult for capital market participants to send reliable signals, creating space for bad actors. Finally, the lack of clarity increases the costs to capital market participants, who must articulate and advance positions on complex ESG issues.

#### *1. Lack of Clear Definitions and Guidance*

At their best, the ESG and stakeholderism labels create a space for a conversation about environmental and social priorities. But the labels conceal as much as they reveal.

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Daniel Wiessner, *New Biden Rule Allows Socially Conscious Investing by Retirement Plans*, REUTERS (Nov. 22, 2022), <https://www.reuters.com/world/us/new-biden-rule-allows-socially-conscious-investing-by-retirement-plans-2022-11-22>.

55. See, e.g., *Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices*, 87 Fed. Reg. 36654, 36655-56 (June 17, 2022) (to be codified in scattered sections of 17 C.F.R.) (“The lack of specific disclosure requirements tailored to ESG investing creates the risk that funds and advisers . . . may exaggerate their ESG practices . . . . Accordingly, we are proposing various disclosure and reporting requirements to provide shareholders and clients improved information from funds and advisers that consider one or more ESG factors.”).

56. See *The Enhancement and Standardization of Climate-Related Disclosures for Investors*, 87 Fed. Reg. 21334 (Apr. 11, 2022) (to be codified in scattered sections of 17 C.F.R.).

57. See Gary Gensler, *Statement by Chair Gensler on ESG Disclosure Proposal*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 26, 2022), <https://corpgov.law.harvard.edu/2022/05/26/statement-by-chair-gensler-on-esg-disclosures-proposal>.

To make progress, corporate and investment managers must be given clear guidance on how to make decisions. There needs to be a clear account of when ESG considerations are relevant, which ESG goals should be prioritized, and how to trade off ESG considerations against profits.

*a. Scope of ESG.* Almost any business decision can be characterized as having an ESG dimension, and the importance and direction of those ESG considerations can change over time. For example, until recently, a decision about whether to site a facility in Texas as opposed to California would not have been taken as a corporate statement about the importance of abortion rights. With the Supreme Court's decision in *Dobbs* and the fragmentation of abortion rights regimes across the United States, such siting decisions have very clear implications along a social dimension.

Similarly, decisions about cooperation with foreign regimes carry new significance. Until recently, relatively few people would have identified business operations in Russia as an indication of poor ESG performance. Indeed, such investments might have been taken as supporting Russia's integration into the world economy and thus supporting geopolitical stability. But Russia's invasion of Ukraine changed that calculus. Corporations have come under serious pressure to withdraw, even where withdrawal was not required by government sanctions.<sup>58</sup>

*b. Defining Progress.* Once an ESG issue is identified, it is necessary to define what progress on that issue looks like. Put differently, it would be difficult to make better corporate decisions unless it was possible to describe preferences in an ordinal fashion. If it is impossible to confidently state that one outcome is better than another, it will not be possible to shape corporate decisions in a coherent way.

On an instrumental conception of ESG, this is relatively straightforward. A company does better on ESG issues if it maximizes risk-adjusted shareholder returns by addressing risks and taking advantage of opportunities. Essentially, the core ordinal preference at work is that more money is better than less money.

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58. See *Over 1,000 Companies Have Curtailed Operations in Russia – But Some Remain*, YALE SCH. MGMT. (Oct. 23, 2023), <https://som.yale.edu/story/2022/over-1000-companies-have-curtailed-operations-russia-some-remain>.

This understanding of ESG plays an important role for rating agencies like MSCI.<sup>59</sup>

But even within this narrow understanding of ESG there are complications. For example, along the “governance” dimension, most academics would describe good corporate governance as ensuring that managers are required to advance shareholder preferences and interests. Measures that prevent shareholders from easily replacing directors and officers, such as a classified board in which only a third of the directors are up for election each year, are often considered “bad” corporate governance. Indeed, because of a sustained effort led by Professor Lucian Bebchuk and the Harvard Law School Shareholder Rights Project, major corporations have largely dismantled classified boards.<sup>60</sup> But the claim is controversial. Many accept the premise that shareholder value should be the exclusive corporate focus but reject the idea that dismantling classified boards helps advance that objective.<sup>61</sup> Even when applying a narrow and instrumental understanding of ESG to a single technical dimension of ESG, it remains difficult to determine whether a certain decision is good or bad.

On a pluralistic conception of ESG, the task becomes dramatically harder. If the goal is to improve environmental or social outcomes, as opposed to merely maximizing shareholder returns, it becomes necessary to navigate serious factual and moral complexities.

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59. See David F. Larcker, Lukasz Pomorski, Brian Tayan & Edward M. Watts, *ESG Ratings: A Compass Without Direction*, ROCK CTR. FOR CORP. GOVERNANCE AT STANFORD UNIV. 2 (Aug. 2022), [https://www.gsb.stanford.edu/sites/default/files/publication/pdfs/cgri-closer-look-97-esg-ratings\\_0.pdf](https://www.gsb.stanford.edu/sites/default/files/publication/pdfs/cgri-closer-look-97-esg-ratings_0.pdf); Simpson et al., *supra* note 9.

60. See K.J. Martijn Cremers & Simone M. Sepe, *Board Declassification Activism: The Financial Value of the Shareholder Rights Project 2* (June 21, 2017) (unpublished manuscript) (manuscript at 2), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2962162](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2962162) (“In practice, the SRP’s work resulted in board declassification at ‘about 100 S&P 500 and Fortune 500 companies.’”); see also Yakov Amihud, Markus Schmid & Steven Davidoff Solomon, *Settling the Staggered Board Debate*, 166 U. PENN. L. REV. 1475, 1482 (2018) (“The primary set of studies on the effect of the staggered board have examined staggered board adoptions or rejections over time. The most prominent and important study in this group is by Professors Bebchuk and Cohen.” (footnote omitted)).

61. See, e.g., K.J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, *Staggered Boards and Long-Term Firm Value, Revisited*, 126 J. FIN. ECON. 422, 424 (2017) (“[S]taggered boards could contribute to firm value by preventing inefficient takeovers and/or serving to bond a firm’s commitment to the firm’s long-term stakeholders.”); Amihud et al., *supra* note 60, at 1475 (suggesting “caution about legal solutions that advocate wholesale adoption or repeal of the staggered board and instead point to an individualized firm approach”).

A pluralist conception creates important controversies, even about relatively technical governance questions. Many commentators believe that managers should enjoy some protection from shareholders, thus freeing them to pursue objectives that cost shareholders money but help stakeholders.<sup>62</sup> Others have insisted that these measures are unhelpful to stakeholders,<sup>63</sup> or potentially destructive to society.<sup>64</sup> For example, requiring managers to focus on delivering immediate profits to shareholders might benefit consumers and competitors by precluding long-term strategies aimed at achieving market dominance.<sup>65</sup> Thus, it is not clear whether governance mechanisms that shield managers from accountability to shareholders are “good” or “bad.”

This problem is even more pronounced when it comes to social questions. For example, most commentators once suggested that weapons manufacturing is antisocial.<sup>66</sup> But with Russia’s invasion

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62. See, e.g., Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, HARV. BUS. REV. (May–June 2017), <https://hbr.org/2017/05/the-error-at-the-heart-of-corporate-leadership> (arguing that because of shareholder primacy, “managers are under increasing pressure to deliver ever faster and more predictable returns and to curtail riskier investments aimed at meeting future needs and finding creative solutions to the problems facing people around the world”); see also Martin Lipton, *It’s Time to Adopt the New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 11, 2019), <https://corpgov.law.harvard.edu/2019/02/11/its-time-to-adopt-the-new-paradigm> (describing opposition to shareholder-driven short-termism and advocating for a stakeholder approach).

63. See, e.g., Bebchuk & Tallarita, *Illusory Promise*, *supra* note 41, at 101 (The “increased insulation from shareholders” promoted by stakeholderism “would serve the private interests of corporate leaders, but not those of others. Increased insulation and reduced accountability would increase managerial slack and agency costs, thus undermining economic performance and thereby damaging both shareholders and stakeholders. The danger is that, by cloaking it in stakeholder clothing, stakeholderism would advance a managerialist agenda, thus facilitating a new managerial era.”).

64. See, e.g., Virginia Postrel, *Stakeholder Capitalism Isn’t Working as Planned*, BLOOMBERG (June 22, 2022), <https://www.bloomberg.com/opinion/articles/2022-06-22/disney-s-stakeholder-capitalism-vs-netflix-s-shareholder-capitalism> (“Stakeholder capitalism . . . [is] a prescription for culture wars, political backlash, managerial paralysis and human-resources nightmares.”).

65. Cf. James J. Park, *From Managers to Markets: Valuation and Shareholder Wealth Maximization*, 47 J. CORP. L. 435, 440 (2022) (suggesting that investors are more patient in demanding profits from firms that have a strategy for achieving market dominance); Amelia Miazad, *Prosocial Antitrust*, 73 HASTINGS L.J. 1637 (2022) (considering the concern that ESG initiatives may amount to antitrust conspiracies where firms could agree to constrain production on conservation or environmental grounds).

66. See Jason Halper, Timbre Shriver & Jayshree Balakrishnan, *“Defense Stocks” Highlight Challenges in Navigating Sustainability Taxonomies*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 6, 2022) <https://corpgov.law.harvard.edu/2022/06/06/defense-stocks->

of Ukraine, analysts began suggesting that this view should be reconsidered.<sup>67</sup> Western defense contractors suddenly began playing an essential role in protecting Ukrainian democracy. Allowing defense contractors to access cheap capital to expand production of arms suddenly appeared socially beneficial.

If each dimension of ESG is poorly defined, it becomes very hard to decide which dimension to prioritize. Suppose that a manager has an opportunity to replace an older plant that pollutes heavily and employs hundreds of workers with a new plant that has far lower emissions but employs far fewer workers.<sup>68</sup> The improvement in emissions would clearly represent better environmental performance, but the reduction in employment might represent a dip in social performance. Does this represent a net ESG win or loss?

These conflicts are more than just hypothetical. Many credit electric vehicle manufacturer Tesla with having a profoundly helpful impact on climate change. By replacing fossil-fuel-burning cars with electric vehicles, the company might play a helpful role in reducing overall carbon emissions and combatting climate change. As discussed below, Tesla's direct impact is ambiguous because of its practice of selling carbon credits.<sup>69</sup> But Tesla clearly seems to have kick-started a transition to electric vehicles that is likely to have profound implications across the automotive industry: perhaps envious of Tesla's share price, GM's managers have committed to selling only zero-emissions vehicles by 2035, and Ford has promised a similar transition.<sup>70</sup> Despite this arguable environmental impact, Tesla recently suffered an ESG ratings

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highlight-challenges-in-navigating-sustainability-taxonomies (noting that the rapporteur of the EU Social Taxonomy "maintains that weapons could not qualify as social goods because they do not promote human rights").

67. *See id.*

68. *See* Stephen Bainbridge, *Kindly Help Popularize the Bainbridge Hypothetical*, PROFESSORBAINBRIDGE.COM (Aug. 19, 2019), <https://www.professorbainbridge.com/professorbainbridge.com/2019/08/kindly-help-popularize-the-bainbridge-hypothetical.html>.

69. *See infra* note 110.

70. Aneil Kovvali, *Stark Choices for Corporate Reform*, 123 COLUM. L. REV. 693, 748 (2023) [hereinafter Kovvali, *Stark Choices*]; Neal E. Boudette & Coral Davenport, *G.M. Will Sell Only Zero-Emission Vehicles by 2035*, N.Y. TIMES (Oct. 1, 2021), <https://www.nytimes.com/2021/01/28/business/gm-zero-emission-vehicles.html>.

downgrade due in part to shocking allegations of racial discrimination and mistreatment of workers.<sup>71</sup>

Investors face the same definitional challenges as corporate managers. Just as with corporations, the term ESG does not have a clear definition that could guide investors.<sup>72</sup> In practice, ESG funds often implicitly make tradeoffs through their choice of ESG scores. These scores aggregate different ESG goals according to proprietary weighting mechanisms. The ad hoc and secretive nature of many ESG scoring mechanisms leaves them ripe for abuse. If a fund manager using a proprietary ESG index doesn't like one ranking of corporations, then the manager can adjust the ESG scoring mechanism to produce a different ranking more to the fund manager's liking.

Because of this lack of transparency, ESG-oriented shareholders cannot provide concrete guidance to management about how to integrate ESG goals with profit maximization. Instead, ESG-oriented shareholders communicate their values to a corporation "holistically." If a company has only one shareholder, then this approach can be effective, but it is nearly impossible for management to aggregate differing holistic ESG approaches into a concrete ESG strategy or to interpret the result of a corporate vote with ESG implications effectively. Alternatively, a corporation can improve its value according to the many ESG indexes by hiring index compilers as consultants and taking steps to improve performance under different components of each index. Different indexes, however, may be difficult to aggregate into a single ESG strategy. Even worse, the index strategy provides no guidance for how the company should balance ESG considerations with profits.

What's more, ESG scores provide little governance guidance. Ranking companies may be helpful for investors choosing which companies to buy or sell, but it provides no guidance for the governance of the companies that an investment fund has already chosen. Should an ESG fund always vote in favor of shareholder initiatives that raise ESG scores? That would be the best strategy for ESG funds seeking to maximize their ESG scores, but it might not be the best strategy for a fund balancing ESG with profit.

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71. See Lora Kolodny, *Why Tesla Was Kicked Out of the S&P 500's ESG Index*, CNBC (May 19, 2022), <https://www.cnbc.com/2022/05/18/why-tesla-was-kicked-out-of-the-sp-500s-esg-index.html>.

72. See *supra* Section I.B.1

*c. Trading Off Against Profits.* Instructions to corporate managers require more than an ordinal ESG ranking. It is also necessary to define how ESG and profit maximization will interact. Perhaps everyone would agree that it would be better to reduce carbon emissions by one ton. But at the cost of a billion dollars in profit, few would suggest that it actually represents progress. There are clearly more sensible ways to achieve such a reduction in emissions. Because they currently lack clear instructions, corporate managers do not know how to weigh the pursuit of profits against ESG priorities.

Investors face similar problems. They might exclude a company from their portfolio if the company falls short on ESG criteria, even when the company is extremely profitable. They might prefer to invest on a preferential basis in companies that perform better on ESG criteria, essentially trading financial performance for ESG performance in their investment decisions. Or they might invest on a financially focused basis and then use governance strategies to encourage better performance on ESG matters.

The choice between the basic strategies of exclusion, subsidy, and governance is not obvious. Exclusion may be the cleanest choice, and it avoids accusations that an investor purports to be ESG-friendly but profits from dirty or antisocial activities. But using ESG scores as exclusion criteria might lead to inefficiencies. It might be cheaper to make a very “dirty” company somewhat cleaner than to improve upon the performance of a clean company. As a result, simply excluding “dirty” companies from an ESG portfolio may be an inefficient way to drive improvements for the environment. Moreover, exclusions could drive dirty companies out of the public markets, taking them out of the reach of investors and levers that might encourage them to do better.

Even after settling on a basic strategy, the investor would still need to make specific choices to flesh the strategy out. Ad hoc ESG scores tell fund managers nothing about how to balance ESG with profits. In practice, ESG funds often invest exclusively in corporations with high ESG scores, whether within a given sector (e.g., investing in only the most environmentally friendly companies in each industry) or between sectors (e.g., favoring tech companies over fossil fuel companies because tech companies produce more output per unit of carbon emissions). But this is not a satisfying resolution to the problem of balancing profits with ESG.



If a company is extraordinarily profitable but scores slightly below a peer company that loses money, the first company's superior profitability may make it a better fit, even to an investor who cares about ESG. A blunderbuss exclusion method does not permit profits to outweigh ESG motives when picking companies.

## 2. *Difficulty of Finding Consensus*

Today's ESG undermines a signal benefit of shareholder primacy: homogeneity. A result from social choice theory known as Arrow's Theorem teaches that it is impossible to design a system that aggregates the preferences of individuals into decisions that are both responsive to individual concerns and rational.<sup>73</sup> For example, within a single group of individuals, a majority might prefer option A to option B, a different majority from the same group might prefer option B to option C, and a different majority from the same group might prefer option C to option A.<sup>74</sup> This means that the person setting the order of the votes can manipulate the outcome, and that the outcome could be unstable as small changes in the electorate or the surrounding circumstances lead to radically different results.

This suggests that corporate democracy may struggle to handle divergent preferences. At a minimum, where preferences are divergent, managers could have outsized power to manipulate outcomes. Professor Hansmann<sup>75</sup> and then-Professors Easterbrook and Fischel<sup>76</sup> offered this as a reason for limiting the corporate

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73. See, e.g., Amartya Sen, *Arrow and the Impossibility Theorem*, in *THE ARROW IMPOSSIBILITY THEOREM* at 33–41 (Eric Maskin & Amartya Sen eds., 2014); MAS-COLELL, WHINSTON & GREEN, *supra* note 17, at 792–99; Michael Morreau, *Arrow's Theorem*, *STAN. ENCYC. PHIL.* (Nov. 26, 2019), <https://plato.stanford.edu/entries/arrows-theorem>.

74. This hypothetical is commonly known as Condorcet's Paradox, discovered by the Marquis de Condorcet in 1785. Sen, *supra* note 73, at 33–34; Morreau, *supra* note 73.

75. HANSMANN, *supra* note 16, at 42 (“[T]he instability that underlies [vote] cycling can give extraordinary power to those in control of the voting agenda to obtain the outcomes they desire, no matter how inefficient those outcomes may be.”).

76. As they wrote:

It is well known . . . that when voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices. If a firm makes inconsistent choices, it is likely to self-destruct. Consistency is possible, however, when voters commonly hold the same ranking of choices (or when the rankings are at least single-peaked). The preferences of one class of participants are likely to be similar if not identical. This is true of shareholders especially, for people buy and sell in the market so that the shareholders of a given firm at a given time are

franchise to shareholders. Unlike workers, creditors, customers, environmentalists, and members of the surrounding community, shareholders at least have the same type of direct financial interest in the firm. If the firm is not overly large and financial markets are reasonably complete, shareholders should have similar preferences – or at least should be able to enter market transactions that neutralize any differences they might have.<sup>77</sup> Contracts can then be written based on the presumption that shareholders unanimously prefer that managers maximize shareholder profits.

It is important not to overstate the argument. Where markets are incomplete or a corporation's conduct creates meaningful externalities, shareholders may not be united even if they are acting in their personal financial interest.<sup>78</sup> But that interest is still a powerful motive across a range of situations.

While it is frequently offered as a reason for limiting the franchise to shareholders, the challenge of dealing with divergent preferences is also a reason for limiting potential objectives. Shareholders can be expected to agree on ordinary business and financial matters because they can neutralize any disagreements on those topics through other transactions. A shareholder with an idiosyncratic preference for cash now can borrow against their holdings, while a shareholder with an idiosyncratic aversion to risk can diversify their holdings with risk-free treasury bonds. But shareholders cannot be expected to agree on the environmental and social topics that are implicated by ESG. Shareholders plainly have divergent political preferences,<sup>79</sup> and there are currently no market mechanisms that allow them to sort out those disagreements.<sup>80</sup>

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a reasonably homogenous group with respect to their desires for the firm. So firms with single classes of voters are likely to be firms with single objectives, and single-objective firms are likely to prosper relative to others.

EASTERBROOK & FISCHER, *supra* note 18, at 69–70.

77. For example, if a shareholder has an idiosyncratic need for cash now, that shareholder can borrow against the value of their shares. As a result, they will agree with other shareholders on the goal of maximizing current share price and should not adopt an idiosyncratic position demanding that the firm return capital immediately.

78. *E.g.* Hart & Zingales, *supra* note 27, at 198–204; Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN. & ACCT. 247 (2017); Hart, *supra* note 17; HAYDEN & BODIE, *supra* note 17, at 110.

79. *Cf.* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 90 (2010) (“[S]hareholders generally do not sort themselves among companies according to their political preferences . . .”).

80. Kovvali, *Basic Contradiction*, *supra* note 19.

This is a powerful reason for limiting the role of ESG in decision-making. As Nobel laureate Eugene Fama put it:

Pulling the curtains aside, the ESG movement argues that the resulting decision rule should be max shareholder welfare, not max shareholder wealth. But that puts us in the quagmire of satisfying the divergent tastes and interests of different shareholders—a multiple dimension problem that implies high contracting costs. The max shareholder wealth rule is a single dimension alternative with low contract costs relative to max shareholder welfare.<sup>81</sup>

Instead of telling managers to maximize profits, ESG shareholders tell them to balance profits with other goals. As a result, shareholders disagree about how to evaluate management. While some continue to focus on profits exclusively, others prefer that ESG considerations dictate an alternative path. Managers of a heterogeneous group of shareholders can justify almost any decision or investment, claiming that ESG benefits outweigh lost profits, or vice versa. Without any framework for resolving this conflict, ESG renders shareholder governance ineffective.

For the moment, these problems are muted. ESG policies are normally framed in vague and aspirational terms, reducing the potential for conflict at the cost of reducing the policies' impact. But even this weak compromise is breaking down. As ESG becomes more well-known, its controversies multiply. The officials responsible for government pension funds in liberal jurisdictions are demanding one set of actions, while officials in conservative jurisdictions are demanding the opposite.<sup>82</sup> A new class of governance entrepreneurs is now looking to advance conservative objectives, largely out of a perception that other market participants are sacrificing profit to advance liberal aims.<sup>83</sup> The potential for conflict and confusion is high and getting higher.

### *3. Lack of Reliable Signals and Greenwashing*

At its best, ESG creates space for a conversation among firm managers, fund managers, and underlying savers about goals

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81. Fama, *supra* note 20.

82. See *supra* notes 50–52 and accompanying text.

83. See Allison Prang, *An Anti-ESG Activist Investor Presses for Changes at Apple and Disney*, WALL ST. J. (Sept. 20, 2022), <https://www.wsj.com/articles/anti-esg-activist-investor-vivek-ramaswamy-presses-for-changes-at-apple-and-disney-11663684474>.

and preferences. But the conversation is not structured in a way that is likely to lead to better results. For example, there is no way for an investment fund or corporation to signal the strength of its commitment to ESG. If one fund says a company's effect on the climate is a very important investment criterion, while another says climate is merely an investment consideration, is the first fund more committed to the climate than the second? Perhaps, but without a precise definition of "very important" or "consideration" it is hard to know.

In the current environment, ESG claims are difficult to police. If it is impossible to determine the *meaning* of ESG-related statements, it is impossible to bring claims against companies and investors that make unsubstantiated ESG statements: such statements will be treated as non-actionable puffery.<sup>84</sup> It is hard to determine the truth of such statements, let alone bring claims against alleged bad actors. With so much money chasing ESG, this state of affairs can encourage bad actors to engage in "greenwashing," making popular declarations on hot-button topics but failing to take meaningful action.<sup>85</sup> This is a particular problem for institutional investors pursuing passive strategies because they are eager to use ESG labels to differentiate and market themselves.<sup>86</sup> While ESG funds may offer a differentiated offering,<sup>87</sup> it is not clear that they are making real financial sacrifices to pursue their prosocial objectives.<sup>88</sup>

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84. See Aisha I. Saad & Diane Strauss, *The New "Reasonable Investor" and Changing Frontiers of Materiality: Increasing Investor Reliance on ESG Disclosures and Implications for Securities Litigation*, 17:2 BERKELEY BUS. L.J. 391, 395 (2020).

85. See Shanor & Light, *supra* note 14.

86. Barzuza et al., *supra* note 48.

87. Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2021) (finding that ESG funds do represent a differentiated offering).

88. See, e.g., *id.* at 399 ("[W]e find no evidence that ESG funds cost more than comparable non-ESG funds or that they offer inferior performance during our sample period (either raw or risk adjusted)."); Michael Iachini, *How Well Has Environmental, Social, and Governance Investing Performed?*, CHARLES SCHWAB (Sept. 9, 2021), <https://www.schwab.com/learn/story/how-well-has-environmental-social-and-governance-investing-performed> ("ESG has tended to perform very similarly and with very similar levels of risk to non-ESG approaches."); *Sustainable Funds Outperform Peers in 2020 During Coronavirus*, MORGAN STANLEY (Feb. 24, 2021), <https://www.morganstanley.com/ideas/esg-funds-outperform-peers-coronavirus> ("U.S. sustainable equity funds outperformed their traditional peer funds by a median total return of 4.3 percentage points [in 2020]."). For a more equivocal summary of available research, see

This makes trust difficult: corporations cannot reliably benchmark (or reliably be benchmarked by others) on ESG efforts because other corporations may be taking advantage of ESG ambiguity.<sup>89</sup> For the same reason, institutional and individual investors cannot safely allocate funds or make governance decisions based on ESG matters because the corporations they invest in may be lying, and individuals cannot place money with ESG funds because the funds may be lying. Without reliable metrics and accountability, ESG cannot work. No one will be willing to sacrifice monetary objectives in the name of non-monetary objectives if no one can trust that the non-monetary objectives will actually be advanced.

New laws and rules can help, but they will not solve ESG's problems. For example, the SEC recently proposed an update to its Names Rule that would require funds that call themselves "ESG" to disclose how they consider ESG information.<sup>90</sup> But without strong and clear market mechanisms, these rules may also invite puffery and evasion.<sup>91</sup> They also force individual savers to comb through complex fund prospectuses to try to figure out whether a fund's proposed behavior matches the savers' preferences.

#### 4. Costs and Inefficiency

ESG also creates costs for capital market participants. First, investors must find a way to apply their position on ESG to a diverse array of companies in a variety of circumstances. It is not enough for an investor to decide that it has a particular view on environmental and social matters. The investor must translate that view into decisions about which companies to invest in and how to cast votes at the companies the investor holds. That translation is costly. Every investor with an ESG focus must spend

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David F. Larcker & Brian Tayan, *ESG Research Spotlight*, STAN. GRADUATE SCH. OF BUS. (2023), <https://www.gsb.stanford.edu/sites/default/files/publication/pdfs/cgri-research-spotlight-12-esg-activities.pdf>.

89. Cf. EASTERBROOK & FISCHER, *supra* note 18, at 290-91 (noting that mandatory disclosure solves for the problem that a company cannot capture all the value generated by its disclosures, including the value of benchmarking).

90. See *Fact Sheet: Amendments to the Fund "Names Rule"*, SECS. & EXCH. COMM'N, <https://www.sec.gov/files/ic-34593-fact-sheet.pdf> (last visited Oct. 24, 2023).

91. As commentator Tyler Gellasch has observed, the proposed rule could lead to unintended liability unless funds used vague or generic descriptions of their decision-making process. Tyler Gellasch (@TylerGellasch), TWITTER (Aug. 25, 2022, 11:31 AM), <https://twitter.com/TylerGellasch/status/1562825102684667906>.

time and money analyzing information, training personnel, and making decisions.

Some effort duplication is avoidable through outsourcing, but only at the cost of transparency and granularity. As noted above, an ESG fund can effectively outsource investment decisions to ratings agencies like MSCI and can effectively outsource governance decisions to proxy advisory services like ISS. But these services have serious drawbacks because they fail to capture the individual preferences of the investors. Ratings are not transparent and may not reflect the particular ESG positions of a particular investor. Indeed, some ratings appear to focus on whether ESG matters create risks to a company's profitability as opposed to the company's impact on environmental and social matters.<sup>92</sup> Various proxy advisory services offer multiple strategies to choose from. For example, the proxy advisory service ISS offers six flavors of ESG recommendations, including Catholic Faith-Based, Sustainability, and Climate.<sup>93</sup> But even this menu of options is unlikely to capture the full range of possible ESG positions.

More fundamentally, outsourcing ESG matters to a small group of ratings agencies and proxy advisory services undermines the core advantages of markets. Instead of drawing upon the insights and information of a broad range of market participants, this type of outsourcing would simply accord legislative powers to an opaque oligopoly of service providers. A similar approach was applied to ordinary corporate governance, as ISS and Glass Lewis effectively promulgated a "new civil code" mandating particular arrangements.<sup>94</sup> The result has been near-uniformity on matters like classified boards, even though it remains unclear whether the mandated arrangements are really optimal across firms.<sup>95</sup> Given the breadth of topics and views embraced by ESG, this type of convergence on a single answer is unlikely to be the best outcome.

Beyond active investment and governance decisions, investors must also engage in monitoring. Investors must find out whether

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92. *What Is an MSCI ESG Rating?*, MSCI (last visited Oct. 24, 2023), <https://www.msci.com/our-solutions/esg-investing/esg-ratings>.

93. Hart & Zingales, *New Corporate Governance*, *supra* note 27, at 213.

94. Neil Whoriskey, *The New Civil Code: ISS and Glass Lewis as Lawmakers*, CLS BLUE SKY BLOG (July 28, 2020), <https://clsbluesky.law.columbia.edu/2020/07/28/cleary-gottlieb-discusses-the-new-civil-code-of-iss-and-glass-lewis>.

95. Amihud et al., *supra* note 60, at 1475 (presenting empirical study suggesting "caution about legal solutions that advocate wholesale adoption or repeal of the staggered board").

companies are following through on their commitments, and they must devote resources to holding companies accountable if they fail. Monitoring could be expensive if disclosures are not made regularly or if disclosures are not in a standardized format that allows for easy verification of commitments. Accountability is also costly. An accountability mechanism that imposes real costs on corporations and managers who are untrue to ESG commitments is likely to entail costs for the investor. Selling off a stake in the company would only hurt the company if it depressed the price, and lawsuits are expensive and uncertain in their payoff.

### C. Proposals

While there have been other proposals to address ESG's problems, most fall short. First, several accounting concepts have been proposed with the goal of helping firms produce accurate, intelligible, and comparable figures on environmental and social matters. These include standards issued by the Sustainability Accounting Standards Board<sup>96</sup> and climate change disclosure rules proposed by the SEC.<sup>97</sup> While these concepts can do important work in shaping thinking and reducing the costs to shareholders of absorbing and acting on ESG information, they have important limits. Our goal here is not merely to *quantify* the problems, but to make them *commensurable* with the type of financial issues that normally preoccupy companies and investors.

Second, commentators have also proposed using ESG concepts for governance decisions as opposed to investment decisions. ESG priorities may be advanced more effectively if their adherents hold stock in dirty companies and vote to achieve their goals than if their adherents boycott dirty companies entirely.<sup>98</sup> But investors pursuing that strategy still must reconcile their competing financial, environmental, and social priorities. And they could

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96. See Nina Trentmann, *SASB Launches Sustainability Accounting Standards*, WALL ST. J. (Nov. 7, 2018, 10:06 AM), <https://www.wsj.com/articles/sasb-launches-sustainability-accounting-standards-1541603218>.

97. Press Release, Secs. & Exch. Comm'n, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), <https://www.sec.gov/news/press-release/2022-46>.

98. Alex Edmans, Doron Levit & Jan Schneemeier, *Socially Responsible Divestment* (Eur. Corp. Governance Inst., Finance Working Paper No. 823/2022, 2023), [https://ssrn.com/abstract\\_id=4093518](https://ssrn.com/abstract_id=4093518).

benefit from an efficient mechanism that allows companies and investors to announce their positions and act on them.

Third, commentators have suggested a variety of contractual mechanisms that would either require or incentivize firms or projects to meet particular ESG performance criteria. For example, Professors John Armour, Luca Enriques, and Thom Wetzer have suggested “green pill” mechanisms in which firms would contractually commit to either hit a specific emissions target or make a payment to a third party.<sup>99</sup> Similarly, Professor Dorothy S. Lund’s “Corporate Social Responsibility Bonds” proposal would have investors forgive debts if firms met specified ESG performance criteria.<sup>100</sup> But while it is debatable to cap quantities at the aggregate level<sup>101</sup> it is likely silly to cap a specific firm. What if a firm finds a great investment opportunity that requires them to exceed their carbon cap? What if they can meet their carbon cap easily while another firm cannot? Our framework has no trouble with this, while a hard constraint formula does.

Finally, in a brief digression in a recent paper, Professors Oliver Hart and Luigi Zingales offered a suggestion that parallels our own:

Vanguard could offer an S&P500 light green fund, ready to vote in favor of all shareholder resolutions that promote a greener economy, as long as their cost of reducing CO<sub>2</sub> emission does not exceed \$100 per ton. Vanguard could also offer an S&P500 dark green fund that votes in favor of all shareholder resolutions that promote a greener economy, as long as their cost of reducing CO<sub>2</sub> emission does not exceed \$200 per ton.<sup>102</sup>

The discussion here begins with Hart and Zingales’s carbon insight and develops a framework for valuing any ESG commitment within corporations or by investment managers.

99. John Armour, Luca Enriques & Thom Wetzer, *Green Pills: Making Corporate Climate Commitments Credible* (Eur. Corp. Governance Inst., Law Working Paper No. 657/2022, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4190268](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4190268); see also Emilie Aguirre, *Beyond Profit*, 54 U.C. DAVIS L. REV. 2077, 2135 (2021) (describing “poison put” mechanism that would commit organizations to prosocial objectives); cf. Robert Cooter & Ariel Porat, *Anti-insurance*, 31 J. LEGAL STUDS. 203 (2002).

100. See Dorothy Lund, *Corporate Finance for Social Good*, 121 COLUM. L. REV. 1617, 1636–37 (2021); see also Aguirre, *supra* note 99, at 2134–38 (describing corporate finance solutions committing companies to social goals).

101. Martin L. Weitzman, *Prices vs. Quantities*, 41 REV. OF ECON. STUD. 477 (1974).

102. Hart & Zingales, *supra* note 27, at 213–14.



Without the ESG valuation infrastructure we propose here, it is unlikely that investors will have opportunities to directly influence a company's valuation of carbon or any other ESG valuation matter as Hart and Zingales presume.

## II. VALUATION AS A SOLUTION

This Part lays out the ESG valuation mechanism. Section A explains how it could be implemented by corporations. Section B explains how it could be implemented by institutional investors that hold themselves out as committed to ESG criteria.

### *A. Corporations*

We propose a reorientation of corporate ESG activity in which companies adopt dollar valuations for all their ESG priorities. For example, a hypothetical ABC Corp. (ABC) might declare that it values the externalities of each ton of carbon emissions at \$50 and that ABC decides to value each dollar of salary divergence between its average male and female employee as 3 times the number of employees, and so on for each ESG matter ABC wishes to recognize. The company could then adjust its traditional profit metrics by deducting these calculated amounts and seek to maximize this adjusted profit metric.

Applying this approach, ABC might choose to pass on an investment that would generate \$40 in additional profit but cause one ton of carbon emissions—the ESG cost (\$50) exceeds the additional profit (\$40). Or perhaps ABC has 1,000 employees. It then should be willing to spend \$2,000 on an HR campaign expected to reduce the average pay gap by \$1 because the campaign would cut ESG costs by \$3,000 (3 x \$1 reduction in gender pay gap x 1,000 employees = \$3,000).

The valuations give ABC's ESG commitments concrete meaning and provide the company with reliable direction. ABC now knows that it should pursue a project that would generate \$200 in profit at the cost of one ton of carbon emissions and should forego an HR campaign that costs \$4,000 to bring the average gender pay gap down by \$1.

### 1. Using Valuation

To implement ESG with dollar values, a corporation commits to a dollarized value for any ESG factor. The corporation then adjusts the estimated profits associated with any proposed project using the ESG impact and decides accordingly. Put differently, the company commits to acting *as if* a regulator had imposed a Pigouvian tax equal to the dollarized value.

Although valuing carbon emissions would be a natural starting point, ABC can add dollar values for other ESG concerns. For example, ABC may attribute a social cost to laying off workers of \$5 per worker.<sup>103</sup> If an investment entails the emission of a ton of carbon, earns ABC \$49, and enables ABC to avoid a single layoff, then it has an adjusted value of  $\$4 = \$49$  (profits)  $- \$50$  (emissions cost)  $- (-\$5)$  (1 avoided layoff). Since the investment now has a positive value on ABC's ESG adjusted objective function, ABC should invest. And with appropriate commitment and enforcement mechanisms, ABC would.

The same approach could be used in a variety of corporate decision-making contexts. For example, suppose that an acquirer seeks to obtain control over ABC by offering shareholders a premium over the market price, with the plan of boosting profits by pursuing projects that will increase emissions or by engaging in extensive layoffs. In evaluating the proposed transaction, ABC's board of directors would examine a socially adjusted valuation of the acquirer's bid. If the acquirer is offering a \$50 premium but plans to emit an additional ton of carbon and to fire one employee, the board would reject the proposal and deploy takeover defenses like a poison pill to fend off the attack.<sup>104</sup> If ABC's directors were

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103. The social costs of layoffs are far higher. See, e.g., Robert H. Haveman & David L. Weimer, *Public Policy Induced Changes in Employment: Valuation Issues for Benefit-Cost Analysis*, 6 J. BENEFIT-COST ANALYSIS 112, 148 (2015) (“[W]e estimate a substantial opportunity cost of \$29,200 associated with the firing of an employee during a period of high unemployment . . . .”); Jonathan S. Masur & Eric A. Posner, *Regulation, Unemployment, and Cost-Benefit Analysis*, 98 VA. L. REV. 579, 583 (2012) (“A senior worker who is laid off will on average experience a long-term reduction in income of as much as twenty percent . . . .”); cf. YAIR LISTOKIN, *LAW AND MACROECONOMICS: LEGAL REMEDIES TO RECESSIONS* 70–73 (2019) (describing some of the consequences of prolonged periods of high unemployment).

104. Cf. Aguirre, *supra* note 99, at 2135–36. For a discussion of the corporate law implications of allowing directors to cite ESG valuations to support takeover defenses, see *infra* Section III.A.

accused of violating their fiduciary duties by mounting a defense against a premium offer, they would cite their analysis.<sup>105</sup>

ESG valuation would have some key advantages. By offering a well-defined measure of non-pecuniary goals instead of poorly defined and aspirational language, valuation would curtail greenwashing. Companies would send credible signals and could be ranked according to their commitment to avoiding climate change by comparing their dollarized carbon valuations. This would be true for balancing differing ESG commitments. A manager who wants to avoid layoffs but also protect the environment could consult valuations when making decisions that affect both objectives. And it would be true for balancing ESG commitments against shareholder value, as managers could balance ESG against profits.

ESG valuations would also help solve agency problems, like the communication of instructions to employees. Currently, middle managers understand an instruction like “maximize sales” or “minimize costs”, but struggle with an instruction like “balance profits with moral considerations.” ESG valuations provide much more specific guidance.<sup>106</sup>

Valuation can also be used to tie pay packages to performance. By identifying relevant metrics of ESG performance and providing an exchange rate into dollars, the system would solve many of the current problems associated with tying executive compensation to ESG.<sup>107</sup> Tying executive compensation to ESG-adjusted metrics would encourage executives to internalize the shareholders’ ESG valuations, rather than treating them as a nuisance that distracts from the real work of maximizing share price (and thus the value of stock option and stock grant compensation). And if ABC enters into the swap contracts just described, then ordinary executive

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105. By contrast, the directors might be vulnerable to a suit if they violated a promise to value carbon or employment at a certain amount by approving an inappropriate deal.

106. Admittedly, low-level employees do not always receive direction through price signals. See Weitzman, *supra* note 101, at 479 (“[T]he allocation of resources within private companies (not to mention governmental or non-profit organizations) is almost never controlled by setting administered transfer prices on commodities and letting self-interested profit maximization do the rest. The price system as an allocator of internal resources does not itself pass the market test.”). But many midlevel managers are responsible for a profit and loss statement (P&L) that could be adjusted using ESG valuations.

107. Cf. Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, 48 J. CORP. L. 37 (2022).

incentive compensation ties ESG performance to compensation without requiring any modification.

Ideally, every corporate decision would be considered through the lens of the ESG valuations: managers would consider the marginal impact of every decision, apply the valuation, and determine whether it remained profitable. Tying employee compensation to adjusted profits would give employees incentives to do exactly this. But it is unrealistic to expect a formal analysis of most decisions. Managers do not conduct a full financial analysis of every decision—a manager might consider whether a better brand of coffee in a break room would be an unwarranted expense, but they are unlikely to formally model its impact on employee retention or productivity. Expecting that type of analysis, plus an estimation of the marginal impact of the decision on problems like climate change or social justice based on unfamiliar methodologies, is not realistic. While an “ordinary business matters” exemption may be too expansive,<sup>108</sup> a materiality threshold may be appropriate. For example, a decision might be exempted from consideration if it involves less than \$5 million in new expenditures or revenues, unless it has patent relevance to an ESG issue.

There would be some important complications to work through in designing the system. First, it would be helpful to provide sensible rules or guidance on the scope of a relevant corporate decision. For example, suppose that ABC has committed to a \$50 valuation for a ton of carbon emissions. A manager at ABC is considering two projects: expanding facility A, and building a new neighboring facility B. The payoffs and performance of the two prospective projects are independent:

	Profits	Emissions	Adjusted Profits
Project A	\$150	1.5 tons	\$75
Project B	\$100	3 tons	-\$50

108. See 17 C.F.R. § 240.14a-8(i)(7) (providing that corporations do not need to include a shareholder proposal on the ballot “[i]f the proposal deals with a matter relating to the company’s ordinary business operations”). Among other things, the ordinary business rule has been used to exclude a shareholder proposal that would have caused Wal-Mart to develop a policy on stocking products that threaten public safety, such as the AR-15. *Trinity Wall Street v. Wal-Mart Stores, Inc.*, 792 F.3d 323 (3d Cir. 2015).

If the manager considers the projects separately, they will pursue project A and reject project B. Project A would generate profits even if a \$50 per ton Pigouvian tax was in place. Although project B would generate financial profits in the real world, it would generate a loss if a Pigouvian tax were in place. Because it would pursue project A and reject project B, ABC would generate \$150 in profits (and \$75 in ESG-adjusted profits).

But if the manager resented the result, they might simply recharacterize project A and project B to be a single large project C:

	Profits	Emissions	Adjusted Profits
Project C (A + B)	\$250	4.5 tons	\$25

Through this sleight-of-hand, the manager would appear to comply with ABC's commitment to value carbon at \$50 per ton but would be able to boost profits from \$150 to \$250.

There are several responses to this and other problems with using ESG valuations in a corporate setting. First, companies that commit to using a valuation should commit to adopting compatible incentives for managers, using ESG adjusted profits as the criterion for bonuses. A manager who is incentivized to maximize adjusted profits instead of gross profits would have no reason to gerrymander projects to sneak dirty projects in.

Second, the system should address trading of credits and offsets. Some companies have created internal markets for carbon emissions: if one part of a firm emits less than the company's target, it can "sell" credits to another part of the company and allow that part to emit more.<sup>109</sup> Companies also participate in external markets, buying or selling carbon offsets. These activities can raise questions that are similar to gerrymandering projects. An internal market effectively allows the firm to combine all of its activities into one project, even though each project should be evaluated in relation to the stated ESG valuations. In deciding how credits and offsets are handled, policymakers should keep a few principles in mind: all firms should be clear and transparent about what they are doing; a firm that sells an offset should be "charged" for the

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109. See Sarah E. Light, *The New Insider Trading: Environmental Markets Within the Firm*, 34 STAN. ENV'T. L.J. 3, 30-41 (2015).

emissions it facilitates;<sup>110</sup> and firms should generally be encouraged to improve their own operations instead of buying their way into compliance by purchasing offsets.<sup>111</sup> Indeed, we argue in Part III that the costs of genuine mitigation of social ills should serve as an upper bound on a firm's valuations.

Third, the system should provide some guidance on forecasting and discounting. A manager evaluating a project that will last many years should not simply add up the forecasted cashflows. Under conventional finance principles, the manager should calculate the expected cashflows for each future year, then discount those cashflows at a rate that reflects the time value of money and the risk to the investor associated with the project.<sup>112</sup> Every aspect of this analysis would be open to serious question in the context of an ESG valuation system.<sup>113</sup> While these issues could be resolved in many reasonable ways, our central suggestion is that firms should be clear about their methodology so that investors and savers can understand what exactly they are paying for.

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110. For example, if a firm sells a carbon offset, it is enabling another firm to emit more carbon. The seller should take responsibility for the additional emissions. This may be a consequential caveat; for much of its development, Tesla's business was highly dependent on the sale of carbon credits. Dharendra Tripathi, *Tesla Gains as Results Show Dependence on Carbon Credits Falling*, YAHOO (July 27, 2021), <https://www.yahoo.com/now/tesla-gains-results-show-dependence-053528438.html>.

111. This follows from the observation that corporate efforts on ESG are more likely to create value if there are relevant operational synergies. M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 590-603 (2009); Hart & Zingales, *supra* note 27, at 210-12.

112. This is the "Net Present Value" or "NPV" criterion for evaluating an investment. Other investment criteria are in common use, but NPV ties directly to the value created by a project. See, e.g., WILLIAM W. BRATTON, *CORPORATE FINANCE: CASES AND MATERIALS* 40-41 (9th ed. 2021).

113. For example, in a conventional context managers would normally discount cashflows at the firm's cost of capital. That analysis may not be appropriate when valuing the benefits of a future reduction in carbon emissions or other externality reduction. Importantly, intuitions about the appropriate discount rate in this context may not align with intuitions about the appropriate discount rate for related contexts. Advocates for action on climate change often insist on a low or zero-discount rate when evaluating the future costs of climate disasters. See *Stern Review: The Economics of Climate Change*, HM TREASURY 31-32 (2006), [https://webarchive.nationalarchives.gov.uk/ukgwa/20100407172811/http://www.hm-treasury.gov.uk/stern\\_review\\_report.htm](https://webarchive.nationalarchives.gov.uk/ukgwa/20100407172811/http://www.hm-treasury.gov.uk/stern_review_report.htm). A zero-discount rate in this context would allow a firm to treat forecasted future reductions in carbon emissions as equivalent to current reductions.

## 2. Finding an ESG Valuation

Before a company can put their valuation of an ESG issue to use, it will need to arrive at that valuation. This section presents options for how the system might work. First, it will be necessary to define the relevant issues and to identify the metrics that will be valued (e.g., climate change can be valued with a carbon price). Second, companies will need some process for setting those values. For example, ABC might use shareholder voting to set its valuation. Third, any participants in the process will need approaches for developing substantively reasonable positions. For example, ABC's managers and shareholders will need to figure out what values they should use.

*a. Defining the issue:* First, ESG issues must be defined through questions that isolate dollar values. To create an effective system, questions should be kept simple and consistent across companies. They should also address the underlying issues in a meaningful and understandable way.

Climate change presents a good example. The fundamental question is, "What should a company do to address the threat of climate change?" Naturally, that question is complex: it could be presented by asking how the company should behave with respect to each operational decision; or it could be presented by asking for technical modeling assumptions like discount rates or the likelihood of extreme weather events. A complex set of interrelated questions would exacerbate voting pathologies, force shareholders to inform themselves on tailored questions across every company in their portfolio, and likely produce results that have little meaningful relationship to the underlying issues.

But a broad literature has conceptualized the climate problem in terms of a "cost of carbon" that captures the externalities generated when emitters release an additional ton of carbon dioxide.<sup>114</sup> The fundamental question—what should a company do to address the threat of climate change?—may be intractable. But it

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114. See, e.g., Jason Scott Johnston, *The Social Cost of Carbon*, 39 REGULATION 36 (2016); David V. Wright & Meinhard Doelle, *Social Cost of Carbon in Environmental Impact Assessment*, 52 U.B.C. L. REV. 1007 (2019); Peter Howard & Jason Schwartz, *Think Global: International Reciprocity as Justification for a Global Social Cost of Carbon*, 42 COLUM. J. ENV'T L. 203 (2017). The basic move of using prices to control quantities of pollution has a broader foundation. See Weitzman, *supra* note 97, at 480 (suggesting that price mechanisms can be superior where the ideal outcome is uncertain).

can be collapsed into a more tractable question – what dollar value should the company put on each marginal ton of carbon? The question is simple and can be presented as a choice of a single number. Because individual shareholders are likely to have single-peaked preferences on that narrow issue, the normal voting pathologies are less likely to come into play.<sup>115</sup> And it should be easier for the question to remain standard across companies, and for shareholders to make informed decisions.

Because there is pre-existing literature on the cost of carbon, that formulation of the question may be relatively uncontroversial. But even with respect to the cost of carbon, there may be consequential and controversial details. For example, companies emit greenhouse gases through their direct operations at their facilities and through company vehicles (Scope 1 emissions); by buying electricity, steam, heat, cooling, goods, and services from emitters (Scope 2 emissions); and by selling products to consumers who proceed to use them (Scope 3 emissions).<sup>116</sup> An oil company's Scope 1 and 2 emissions might be quite small relative to the Scope 3 emissions from customers burning the company's oil. Should all these emissions be added up and subjected to the same cost of carbon, or should they be subject to different valuations? It may be more efficient for companies to focus on their Scope 1 and 2 emissions, allowing consumers who care about climate change to reduce their own consumption.<sup>117</sup> Under that logic, it might be sensible for the company to set a lower or zero value on its Scope 3 emissions.

Other topics could prove even more complicated. For example, the problem of gender inequity might be reduced to the difference between the average earnings of men and women within an

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115. See *supra* notes 76–77 and accompanying text; see also Peter J. Coughlin, *Single-Peaked Preferences and Median Voter Theorems*, in *THE ENCYCLOPEDIA OF PUBLIC CHOICE* 524, 524 (C.K. Rowley & F. Schneider, eds., 2004) (describing the theory of single-peaked voting preferences).

116. See, e.g., Madison Condon, *What's Scope 3 Good For?*, 56 U.C. DAVIS L. REV. 1921 (2023) (describing "Scope 1," "Scope 2," and "Scope 3" emissions in the context of defending a proposal that public companies be required to report Scope 3 emissions as well as narrower measures); *Scope 1 and Scope 2 Inventory Guidance*, ENV'T PROT. AGENCY (Sept. 9, 2022), <https://www.epa.gov/climateleadership/scope-1-and-scope-2-inventory-guidance>.

117. Cf. Henderson & Malani, *supra* note 111, at 576 ("[A] corporation should only engage in philanthropy . . . when it has a comparative advantage over other corporations and, importantly, nonprofit organizations and the government."); Hart & Zingales, *supra* note 27, at 210 ("[I]t seems reasonable to limit shareholder engagement on social issues" to cases where "a company has a comparative advantage in achieving a social goal.").



organization. But that would omit many of the issues that are often thought to be important in conversations about gender equity, including the availability of family leave policies and robust checks on sexual harassment. It could also create perverse incentives, in which companies seek to have a few senior female employees while reducing the number of female employees overall.

Ideally, the metric would facilitate a Pigouvian mechanism that causes companies to internalize the costs associated with their behavior. That suggests that the metric should map onto the structure of the externalities associated with their behavior. If the externality is driven by the difference in average earnings, it would be sensible to use the difference in average earnings as the key metric. But there may be many externalities present—for example, a firm’s family leave policies may influence the policies of other firms. Collapsing the issues into a single metric will not be straightforward and will undoubtedly create some perverse incentives.

Such details are likely to be controversial, and different companies and investors would likely resolve them in different (likely self-serving) ways. That would cause a dramatic increase in cost and inefficiency. Instead of taking a position on the proper cost of carbon or gender equity and applying it across their portfolio, investors would have to take a tailored stance at each company they own.<sup>118</sup>

In Part III below, we argue that these costs could be mitigated by standardization efforts led by the SEC or industry bodies such as stock market exchanges.

*b. Corporate process:* Companies could set their valuations in a variety of ways, many of which would have analogues in existing corporate law mechanisms. The board of directors might simply decide what the company’s valuation should be and announce it publicly. Many companies allow for this type of unilateral process in amending their bylaws.<sup>119</sup> The board of directors might propose a valuation, which would then be subject to approval by a shareholder vote. Corporations use a similar process when

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118. See Hart & Zingales, *supra* note 27, at 213 (identifying this problem and suggesting that it might be mitigated by proxy advisory services).

119. See *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934, 939 (Del. Ch. 2013); DEL. CODE ANN. tit. 8 § 109(a) (West 2023) (“[A]ny corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors . . .”).

amending their articles of incorporation.<sup>120</sup> Shareholders might also set valuations more directly by offering proposals subject to yes or no votes by the full group of shareholders. Indeed, shareholder proposals on ESG topics are already common, though current law limits their specificity and effectiveness.<sup>121</sup> Shareholders could also vote by submitting their individual valuations, which would then be aggregated: selecting the mean, median, or 33rd percentile of the submitted valuations might all be reasonable approaches.<sup>122</sup> Hybrid approaches might also be sensible.<sup>123</sup>

In selecting a process, decisionmakers should be sensitive to the potential for voting pathologies. It would also be sensible to select a process that encourages substantively reasonable results,<sup>124</sup> and is consistent with a meaningful corporate commitment to the valuation.<sup>125</sup>

Many criticisms of the proposal are likely to be based on the potential for voting pathologies. As noted above, shareholders are likely to have diverse preferences on ESG matters.<sup>126</sup> Indeed, it is impossible to design a system that is guaranteed to aggregate their preferences in a rational way while preserving voice.<sup>127</sup> This can create two problems. First, there is the potential for *manipulation*, because managers could drive shareholder votes toward managers' preferred outcomes by shaping the manner in which questions are presented to shareholders.<sup>128</sup> Second, it could make outcomes

120. DEL CODE ANN. tit. 8 § 241(b) (2023).

121. *See, e.g.*, 17 C.F.R. § 240.14a-8(i) (2023) (setting out numerous exceptions to mandatory shareholder proposal inclusion).

122. Adopting the median valuation would be similar to using a majority vote process, while using the thirty-third percentile would be similar to requiring a two-thirds supermajority to impose a public objective on a firm. Delaware's current public benefit corporation statute allows for conversion from a for-profit corporation to a public benefit corporation upon a vote of a simple majority of shareholders, while the former version of the statute called for a two-thirds supermajority. AN ACT TO AMEND TITLE 8 OF THE DELAWARE CODE RELATING TO THE GENERAL CORPORATION LAW, ch. 256 Formerly House Bill No. 341 (approved July 16, 2020). Taking the mean would incorporate more information from individual votes but may invite strategic and insincere voting absent appropriate adjustments and incentives. An investor might select an extraordinarily high or low number simply to move the mean up or down.

123. For example, the initial valuation might be set unilaterally by the board.

124. *See infra* Section II.A.2.c.

125. *See infra* Section II.A.3.

126. *See supra* Section I.B.1.

127. *See supra* text accompanying notes 76–77.

128. HAYDEN & BODIE, *supra* note 17, at 118–19 (describing this as a “synchronic consistency” problem).

*unstable*, because subtle and frequently shifting features of the process or electorate could reshape corporate policy.<sup>129</sup>

One solution could be to empower managers, who could achieve rational and stable results by setting valuations in a relatively dictatorial fashion. This could be implemented by allowing the board to set the valuation unilaterally, or by giving them power to propose valuations subject to shareholder ratification or to set the order in which issues are presented to the shareholders. But giving managers too much power could stifle useful conversation. When the scheme is fully operational, institutional shareholders will devote substantial resources to formulating positions.<sup>130</sup> Ideally the process would pull out and widely disseminate their insights, enriching the ESG conversation and leading to more sensible results.

Another option could be to maintain direct shareholder involvement, but to directly tackle any manipulation or instability pathologies caused by voting. Economists have proposed a variety of sophisticated mechanisms for addressing voting pathologies, including ranked choice voting.<sup>131</sup> More prosaically, if manipulation by managers is a concern, regulations could limit their ability to set the agenda by framing standardized questions and specifying timing. If stability is a concern, shareholders might only be allowed to revisit the valuations every five years as opposed to every year.<sup>132</sup> Alternatively, shareholders might be permitted to revise valuations only in set increments – perhaps no less than 5% in either direction, to avoid trivial amendments, but no more than 20% in either direction, to avoid wild swings in corporate policy. Shareholders might also be required to hold shares for a set period before becoming eligible to vote on a company's ESG valuations.

A final option might be to worry less.<sup>133</sup> Voting pathologies are not a concern when voters have single-peaked preferences.<sup>134</sup>

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129. *Id.* at 119 (describing this as a “diachronic inconsistency” problem).

130. *See infra* Section II.B.

131. Hart & Zingales, *supra* note 27, at 214.

132. *Cf.* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

133. *See* Hart & Zingales, *supra* note 27, at 209–10 (“[A] vote will lead to a socially efficient outcome as long as a majority of shareholders are socially responsible and have a small holding in the company.”).

134. *See supra* note 76 and accompanying text.

Shareholders might have messy preferences on a complicated topic like climate change. But after the topic has been flattened into a one-dimensional numerical issue like setting a value on each ton of carbon emissions, it is reasonable to think that shareholders do have single-peaked preferences. As a result, once the complex ESG issue has been reformulated as a one-dimensional valuation question, it probably will not raise the same concerns about voting pathologies.<sup>135</sup>

Admittedly, preferences might be more complicated when multiple issues are in play. A shareholder with a finite “budget” for ESG issues might want a strong approach to climate change if and only if the company adopts a weak approach to social justice issues. But such possibilities seem remote and are likely to be weeded out over time: it would be difficult for an important institutional investor like BlackRock to justify supporting a weak position on climate change at a company by citing its strong position on social justice. If it attempted to do so, it would likely draw public criticism that would prompt changes.

Various forces are also likely to lead to relative homogeneity. Within particular firms, shareholders are likely to sort themselves. If a firm has a materially higher or lower valuation than a shareholder, the shareholder will sell their stock and purchase shares in a firm that is a better match.<sup>136</sup> Across the investing universe, asset managers and companies engaged in transparent conversations on ESG matters are likely to coalesce around a set of best practices and valuations.

*c. Substance:* Valuations do not need to be anchored in any real theory or rationale. A company could propose any valuation on any issue; it would simply be disciplined by the preferences and activity of other market participants. This is not a new idea in financial markets. It can often be difficult to justify stratospheric share prices using a sensible discounted cash flow model. Prices emerge from

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135. See Easterbrook & Fischel, *supra* note 18, at 405 (“[W]hen voters hold dissimilar preferences it is not possible to aggregate their preferences into a consistent system of choices . . . . Consistency is possible, however, when voters commonly hold the same ranking of choices (or when the rankings are at least single peaked).”).

136. Better matching between investor preferences and corporate policies would be inherently valuable, even if there are no changes to corporate behavior. For example, investors pay a psychic cost when the organizations they are affiliated with engage in conduct they find morally abhorrent. See Bebchuk & Jackson, *supra* note 79, at 95–97. Better matching would reduce these costs.

the views and interactions of market participants rather than from abstract theory.

As a result, any limitations on the institutional competence of corporations will have limited effects. A company does not need to figure out the “right” price of carbon or social inequality. It just needs to propose figures that other market participants can act on, and that other companies can compete with by proposing higher or lower figures.

Importantly, even if companies settle on values that are “too low” and thus generate socially destructive externalities, the approach still represents an improvement over the current approach, which values negative externalities at zero. Even small changes can drive major effects. Deadweight losses are proportional to the square of the externality, so a small change in externality valuation can have major efficiency effects as it eliminates the most socially wasteful externalities. One company’s decisions can also be multiplied by competition, as a “green firm” may be more attractive to consumers, driving increased profits. And a company’s decisions can be amplified by the political process, as regulators react by setting more stringent standards.<sup>137</sup> As a result, the exercise would be worthwhile even if market valuations of externalities failed to converge on the “true” value.

But ideally, market participants would try to anchor their valuations in a sensible methodology that earnestly seeks to capture the true impact of carbon emissions and other problems. A consensus on appropriate valuations would help reduce the potential for chaotic governance, and convergence on the true valuation would help create good incentives for market participants to engage in efficient behavior.

There are many sensible potential approaches. Market participants could simply borrow valuations reached by government regulators. For example, during the Obama Administration, the Interagency Working Group on the Social Cost of Greenhouse Gases developed estimates of the cost per metric ton of carbon dioxide.<sup>138</sup> Although the working group was disbanded

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137. Cf. Kovvali, *Stark Choices*, *supra* note 70, at 720.

138. See *Technical Support Document – Technical Update of the Social Cost of Carbon for Regulatory Impact Analysis – Under Executive Order 12866*, INTERAGENCY WORKING GRP. ON SOC. COST OF GREENHOUSE GASES, U.S. GOV. (Aug. 2016), [https://obamawhitehouse.archives.gov/sites/default/files/omb/inforeg/scc\\_tsd\\_final\\_clean\\_8\\_26\\_16.pdf](https://obamawhitehouse.archives.gov/sites/default/files/omb/inforeg/scc_tsd_final_clean_8_26_16.pdf).

during the Trump Administration,<sup>139</sup> it was reestablished during the Biden Administration and continues to publish findings.<sup>140</sup> As long as such estimates are the result of a credible process, there is no need for market participants to spend the money to do the work over again. Similarly, market participants could look to academic literature or look abroad for analysis.

Market participants could also develop their own estimates. This approach is not completely fanciful. Fossil fuel companies devote meaningful resources to understanding climate change and public policies intended to address it. For example, in response to pressure from shareholders,<sup>141</sup> ExxonMobil issued reports indicating that it expected rich countries to develop regulations that would impose costs of \$80 per ton of carbon dioxide by 2040.<sup>142</sup>

Another approach would be to look to the market. When corporate managers set or propose valuations, they can examine commitments by the relevant investors. This might entail searching for consensus among the investors, which admittedly may not exist, or finding the valuation that minimizes the company's overall cost of capital. Of course, allowing shareholders to play a more direct role in setting values would have similar effects. Participants could look to other markets, such as markets for carbon offsets or carbon sequestration, for other guidance.

It is important to acknowledge that absent changes to surrounding law, the company's approach could have significant consequences. A company that commits to valuing carbon emissions at \$80 per ton because it anticipates a regulatory environment that will impose that level of cost would be acting in a manner that is clearly consistent with a financial conception of shareholder primacy. The action would also have little negative

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139. Exec. Order No. 13783, 82 Fed. Reg. 16093 (Mar. 31, 2017).

140. OFF. OF MGMT. & BUDGET, EXEC. OFF. OF THE PRESIDENT, TECHNICAL SUPPORT DOCUMENT: SOCIAL COST OF CARBON, METHANE, AND NITROUS OXIDE: INTERIM ESTIMATES UNDER EXECUTIVE ORDER 13990, INTERAGENCY WORKING GRP. ON SOC. COST OF GREENHOUSE GASES, (Feb. 2021), [https://www.whitehouse.gov/wp-content/uploads/2021/02/TechnicalSupportDocument\\_SocialCostofCarbonMethaneNitrousOxide.pdf](https://www.whitehouse.gov/wp-content/uploads/2021/02/TechnicalSupportDocument_SocialCostofCarbonMethaneNitrousOxide.pdf)

141. Jennifer Hijazi, *Exxon Goes to Trial Next Week Over Secret Carbon Costs*, E&E NEWS (Oct. 18, 2019), <https://www.eenews.net/articles/exxon-goes-to-trial-next-week-over-secret-carbon-costs>.

142. *The Outlook for Energy: A View to 2040*, EXXONMOBIL (2013), [https://legacy-assets.eenews.net/open\\_files/assets/2019/10/18/document\\_cw\\_02.pdf](https://legacy-assets.eenews.net/open_files/assets/2019/10/18/document_cw_02.pdf). The New York Attorney General later alleged that Exxon had misstated the proxy values it used in its internal business planning, though the case was later dismissed. *People v. Exxon Mobil Corp.*, 119 N.Y.S.3d 829, 829 (N.Y. Sup. Ct. 2019).

impact on its suitability as an investment for a pension fund with a fiduciary duty to focus exclusively on delivering financial returns to beneficiaries. But a company that set an aggressive \$800 per ton valuation because it believes that the full social cost will not be captured in regulations may raise awkward questions.<sup>143</sup> The valuation would fit awkwardly with Delaware corporate law, at least if the company retains its for-profit form, and it could complicate its suitability as an investment for pension funds.

### 3. *Committing to a Valuation*

The valuation approach to ESG does not require corporations to use a particular mechanism to commit to a valuation. However, an ideal mechanism would have several characteristics. It would allow for meaningful enforcement by shareholders if the corporation failed to follow through.<sup>144</sup> It would allow commitments to be durable enough that shareholders can reasonably count on them to remain consistent over time. And it would be flexible enough to respond to changes in shareholder views.

Corporations could use a number of mechanisms to commit to their stated valuation, although each would present challenges absent reform. First, corporations might issue securities disclosures that would be actionable if they were false. For example, if a company promised in its disclosures that it was using a particular

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143. As of this writing, the EPA has proposed raising the government's central estimate of the social cost of carbon dioxide to \$190 per ton, an almost fourfold increase from the previously applicable estimate of \$51 per ton. EPA, SUPPLEMENTARY MATERIAL FOR THE REGULATORY IMPACT ANALYSIS FOR THE SUPPLEMENTAL PROPOSED RULEMAKING, "STANDARDS OF PERFORMANCE FOR NEW, RECONSTRUCTED, AND MODIFIED SOURCES AND EMISSIONS GUIDELINES FOR EXISTING SOURCES: OIL AND NATURAL GAS SECTOR CLIMATE REVIEW" (2022), [https://www.epa.gov/system/files/documents/2022-11/epa\\_scghg\\_report\\_draft\\_0.pdf](https://www.epa.gov/system/files/documents/2022-11/epa_scghg_report_draft_0.pdf).

144. While a strong commitment would be valuable, it might also be sensible to expect different levels of commitment in different contexts. If managers want to use adjusted metrics but are subject to discipline from the market for corporate control, the risk of abuse might be small. But if they can use a poison pill to defend their policy against shareholder activism it may have greater risks, particularly if they are able to adopt the policy after collecting investments. Of course, there may also be a connection between risks and reward: a weak mechanism may not create many risks, but it is unlikely to meaningfully shape incentives or behavior. Cf. Bebchuk & Tallarita, *Illusory Promise*, *supra* note 41 (constituency statutes do not do much to shape incentives and do not affect behavior). To balance these concerns, a court reviewing a problematic corporate decision, such as the use of a poison pill to defend an ESG policy, might take a harder look at whether the company has lived up to that policy. For example, it might consider evidence like the use of executive and director compensation tied to the ESG metric.

investment criterion when making decisions but failed to do so, disgruntled shareholders or regulators might bring suit.<sup>145</sup> This valuation approach would help give the promises specificity, avoiding arguments that they were mere puffery. But it might be difficult for shareholders to establish reliance or establish damages.<sup>146</sup> More importantly, a mere statement in a disclosure may not be durable. If management unilaterally wished to change its valuation going forward, it would be free to do so simply by issuing a new disclosure.

Second, corporations might adopt more fundamental changes. They might adopt a charter amendment committing to the valuation with the approval of the board and shareholders,<sup>147</sup> or reincorporate as a public benefit corporation and specify the valuation as part of its statement of public purpose.<sup>148</sup> The valuation framework would help give promises specificity. Although public benefit corporations today are expected to articulate a social purpose that they will balance against shareholder profits,<sup>149</sup> their statements are generally too vague to be actionable.<sup>150</sup> The valuation approach would solve that problem.

Third, corporations could contractually commit to a valuation criterion in green swaps or other ESG swaps, bond covenants, or project-based financing.<sup>151</sup> The valuation approach would assist by providing a clear numerical criterion that could be used to evaluate corporate performance.

For example, a “green swap” could transform ABC’s carbon-emitting calculus so that ESG considerations affect ABC’s bottom line according to its ESG valuations—without affecting average

145. See *Exxon Mobil*, 119 N.Y.S.3d at 829 (rejecting New York Attorney General’s attempt to hold ExxonMobil liable for allegedly failing to follow through on disclosures promising to apply a proxy cost of carbon when evaluating investments).

146. Kovvali, *Basic Contradiction*, *supra* note 19.

147. For a discussion of the use of corporate chartering as a method to set corporate purpose, see generally Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 99 TEX. L. REV. 1423 (2021), and Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1309 (2021).

148. See David A. Katz & Laura McIntosh, *The Corporate Form for Social Good*, HARV. L. SCH. F. ON CORP. GOV. (May 24, 2019), <https://corpgov.law.harvard.edu/2019/05/24/the-corporate-form-for-social-good>.

149. See *id.*

150. See Jill E. Fisch & Steven Davidoff Solomon, *The “Value” of a Public Benefit Corporation*, in RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD 68, 69 (Elizabeth Pollman & Robert B. Thompson eds., 2021).

151. Cf. Lund, *supra* note 100.



profits. In a green swap transaction, ABC enters into a contract with a financial institution named FIN. This contract could be a long-term arrangement, or it could be renewed annually like an insurance contract. Suppose that ABC expects to emit 10 tons of carbon and has committed to a \$50 per ton valuation. Under a green swap, FIN would first pay ABC an amount that reflected ABC's expected emissions, minus a commission. In exchange, ABC would pay FIN \$50 for every ton of carbon it emits during the relevant period. The expected total payment would be zero (excluding FIN's commission) but ABC's profits would decrease \$50 for each ton of carbon it emits as ABC pays FIN. As a result, the profit motive incentivizes ABC to treat carbon emissions as a \$50 per ton cost. And the lump sum upfront payment from FIN to ABC means that ABC's overall profits should not take a big hit because the lump sum reflects the expected value of ABC's emissions. The green swap affects ABC marginal emission incentives without imposing undue harm to ABC's average profits.

Indeed, the green swap contract gives the financial counterparty economic incentive to enforce the ESG valuation because its payments under the contract are a function of the level of carbon emissions or other ESG measures subject to the swap.

The simplicity of the ESG swap enforcement mechanism makes it our preferred mechanism for corporations to commit to an ESG valuation. But we acknowledge that the approach might be difficult to implement, as it requires the evolution of a new type of financial contract.

#### *4. Impacts on Corporate Behavior*

ESG values expressed in dollars would affect corporate conduct in two ways. First, shareholders would vote their shares and support employee compensation packages linked to ESG valuations, inducing managers and corporations to adopt the ESG preferences of their median shareholders. Second, ESG valuations expressed in dollars would lower the cost of capital for ESG-friendly corporations. We cover shareholder pressure in this section and defer our examination of the cost of capital to the investment funds section below.

ESG valuation clarifies the ESG signals shareholders send to corporations via shareholder communication and voting. When a

shareholder commits to ESG valuations,<sup>152</sup> the valuations communicate how that shareholder hopes to contribute to ESG goals, as well as how that shareholder wishes to balance ESG goals with profits. By looking at the range of shareholders' ESG valuations, management can meaningfully aggregate the shareholders' preferences into actionable guidance by taking a midpoint or weighted average of the valuations.

Shareholder or management sponsored proposals for corporations to formally adopt specific ESG valuations allow shareholders to provide immediate guidance to management and employees. Suppose a shareholder puts forward a resolution that the corporation should adopt a shadow CO2 emissions price of \$50 per ton. If the median shareholder maintains a CO2 valuation of \$50 or more, then the proposal will pass.<sup>153</sup> Otherwise, the proposal will fail. The result is a generalizable instruction to the firm about ESG matters and their relation to profits that does not intervene in specific firm decisions. Management should forego projects if the present discounted value of the project (discounted at the firm's hurdle rate) minus \$50 per ton of CO2 emissions (appropriately discounted) yields a negative value.

Shareholder guidance can also be valuable to fellow shareholders. Not all shareholders who are committed to ESG goals have the means or inclination to invest resources in voting campaigns to shift corporate policy. For example, BlackRock might be willing to vote shares in favor of a climate friendly corporate agenda but unwilling to incur expenses to sponsor shareholder resolutions or candidates for board seats. "Sustainability activists" are an emerging class of investor that could address this problem.<sup>154</sup> They identify problems at particular companies, buy shares, run campaigns designed to drive change, and recruit support from fellow shareholders. For example, Engine No. 1 identified Exxon as a target for change, nominated its own candidates for the board of directors, and successfully recruited support from investors like

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152. See *infra* Section II.B.

153. For the moment, we assume that each shareholder votes their shares in accordance with their ESG valuation.

154. See Anna Christie, *The Agency Costs of Sustainable Capitalism*, 55 U.C. DAVIS L. REV. 875 (2021).

BlackRock.<sup>155</sup> The valuation system would help activists like Engine No. 1 identify targets like Exxon by exposing the firms that set low ESG valuations or fail to live up to their commitments and by identifying firms at which likeminded shareholders are likely to be found.

Like many ESG initiatives, the aggregate effect of ESG valuations depends not only on the behavior of firms and funds adopting ESG valuation but also of other firms and funds. If each firm or fund eschewing ESG valuation begins to emphasize investments that have high profit but entail significant new externalities because these now earn high returns (due to the retreat by other investors and firms), then the aggregate improvement to social welfare from adoption of ESG valuation by some firms may be offset by the increased negative externalities associated with non-ESG entities.

This may already be happening. In “brown-spinning” transactions, firms that are subject to pressure from ESG activists sell off polluting assets to operators that are not under the same constraints.<sup>156</sup> The company selling off the dirty assets can show an improvement in its numbers, even as overall emissions increase. While this is a real concern, it arguably affects any effort to improve performance on ESG matters that falls short of a universally and uniformly applicable regulation. If firms are given any incentive to run cleaner operations, they will have an incentive to sell off dirty assets to operators that are not subject to the same constraints.

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155. Matt Phillips, *Exxon’s Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021), <https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html>.

156. See Alperen Gozlugol & Wolf-Georg Ringe, *Private Companies: The Missing Link on the Path to Net Zero* (European Corp. Governance Inst., Law Working Paper No. 635/2022, July 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4065115](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4065115); Ran Duchin, Janet Gao & Qiping Xu, *Sustainability or Greenwashing: Evidence from the Asset Market for Industrial Pollution*, SOC. SCI. RSCH. NETWORK (May 18, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4095885](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4095885); Hiroko Tabuchi, *Oil Giants Sell Dirty Wells to Buyers With Looser Climate Goals, Study Finds*, N.Y. TIMES (May 10, 2022), <https://www.nytimes.com/2022/05/10/climate/oilfield-sales-pollution.html>; Shadia Nasralla, *Deals Shifting Oil, Gas Assets Away from Climate Committed Firms on the Rise, Report Says*, REUTERS (May 10, 2022), <https://www.reuters.com/business/energy/deals-shifting-oil-gas-assets-away-climate-committed-firms-rise-report-2022-05-10>; Sam Meredith, *An Energy Transition Loophole is Allowing Big Oil to Offload High-Polluting Assets to Private Buyers*, CNBC (May 19, 2022), <https://www.cnbc.com/2022/05/19/climate-how-big-oil-sells-off-polluting-assets-in-a-bid-to-look-green.html>.

The valuation mechanism would at least clarify incentives and make the behavior more transparent.

### *B. Institutional Investors*

Just as corporations friendly to ESG would benefit from adopting ESG valuation, so too would ESG-oriented investment funds and institutional investors. Although a system allowing institutional investors to declare valuations of ESG issues would largely parallel the system for corporations, there are some important distinctions. This section works through the mechanism for institutions.

#### *1. Using a Valuation*

*a. For governance:* Investment fund sponsors interested in forming new ESG funds (or soliciting further investments in existing funds) should include and publicize ESG valuations in their prospectuses. For example, DEF Fund, an S&P 500 index fund, might announce that it will exercise its governance powers based on a carbon price of \$75 a ton. Assume ABC is in the index. In communicating with ABC management about its preferences, DEF would emphasize that it wants the corporation to treat carbon emissions as if they have a price \$75 per ton above the prevailing price of carbon. Indeed, DEF can “communicate” its ESG preferences to the management of any corporation it owns without any formal interaction at all. Corporate management simply needs to see DEF’s prospectus or marketing material to understand how DEF wishes ABC (or any other company DEF owns) to balance concern for the environment with profit.

DEF would also evaluate any measures up for a shareholder vote according to this carbon valuation.<sup>157</sup> It would support climate-related shareholder resolutions that cost the company up to \$75 per ton of reduced carbon emissions.<sup>158</sup> If, for example, ABC shareholders vote on a shareholder resolution to adopt an ESG valuation of \$50 a ton (see above), then DEF will support the

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157. See Hart & Zingales, *New Corporate Governance*, *supra* note 27.

158. Carbon valuations that exceed \$75 per ton may also receive the investment fund’s voting support, depending on the alternatives available to the corporation. Faced with a choice between a valuation of \$80 and a valuation of \$0 per ton of carbon, for example, the investment fund might well choose to support the \$80 valuation, even though \$80 exceeds the fund’s ideal carbon valuation.

resolution. A carbon valuation of \$50 per ton for ABC is closer to DEF's target valuation of \$75 than ABC's current implicit valuation of \$0. And if a disputed proxy contest offers two alternative visions for a firm, then the investment fund will vote for the slate that maximizes carbon-adjusted profits, where the carbon emissions are valued at \$75 per ton.

Any investment fund can apply ESG valuation to its governance decisions. Index funds that delegate control over their investment strategy to index makers, for example, retain the ability to use ESG valuations as described above to govern the firms they are bound to own.

Investment funds can apply ESG valuation for governance without any legal or regulatory reforms. ESG funds already vote their shares differently than other mutual funds.<sup>159</sup> An ESG valuation mechanism merely provides more transparent criteria for integrating ESG and profit than existing ESG methods. As a result, the governance improvements associated with fund adoption of ESG valuation need no legal or regulatory reform.<sup>160</sup>

*b. For investment decisions:* For investment funds with discretion over their stock portfolios, such as a hypothetical GHI fund, ESG valuation could also be used to allocate investments. For example, ESG valuations could be used to exclude firms from GHI's portfolio. If GHI values carbon at \$10 per ton, then it might only be willing to invest in companies that say they value carbon at \$10 per ton or higher.<sup>161</sup> If ABC adopts a \$50 per ton carbon valuation, then GHI would consider investing in ABC. If, however, ABC ignores

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159. Curtis, Fisch & Robertson, *supra* note 7, at 399 (“[W]e document clear differences between the voting behavior of ESG and non-ESG funds. ESG funds do not automatically support every shareholder proposal related to ESG, but they do vote more independently of management compared to other funds when it comes to environmental and social issues.” (internal citation omitted)). That said, an ESG fund committed to sacrificing returns to achieve social goals may not be a suitable investment for an institutional investor managing pension funds or trust assets.

160. While investment funds can influence corporate decisions without significant legal or regulatory reform, some SEC voting reforms may be necessary for ESG valuations to realize their full potential, as we discuss in Part III below.

161. Until a critical mass of firms formally adopt ESG valuations, this approach will have to rely on implicit corporate ESG commitments inferred from the corporation's behavior.

externalities associated with carbon then GHI might exclude ABC from its portfolio.<sup>162</sup>

While it has the advantage of clarity, an exclusion strategy for portfolio selection would become nigh impossible if GHI adopted multiple ESG valuations. Few firms would be likely to meet or exceed GHI's valuations along every dimension of ESG, meaning that GHI would exclude most firms from its portfolio. The resulting portfolio would likely be poorly diversified and unduly risky.<sup>163</sup> As a result, exclusion may not be the right strategy for incorporating ESG valuations into investment decisions.

A more nuanced approach would involve GHI adjusting its private evaluations of companies based on the relevant ESG valuations. GHI analysts might adjust stock price targets and investment decisions based on an assessment of ABC's current and expected future effects on social welfare as measured by ESG valuations as well as ABC's expected future profits. GHI would purchase the stocks that offer the best value in terms of ESG-adjusted future profits relative to current stock price. This procedure closely resembles the stock purchasing perspective of a profit-maximizing, actively managed fund, with the difference being that funds with ESG valuations adjust expected future profits with the appropriate ESG values.

For investors to choose firms based on ESG-adjusted profits or even excluding firms on ESG valuations, companies must supply adequate ESG disclosure.<sup>164</sup> Mandatory, standardized reporting of firm data regarding important ESG components makes feasible the use of ESG valuations to compare firm ESG performance and select investments accordingly. Since there are so many possible dimensions of ESG, regulators will need to focus required disclosures in the ESG areas most likely to be emphasized via a valuation.

*c. Advantages and disadvantages:* ESG valuation offers important advantages over existing investment fund ESG commitments.

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162. At least in principle, one might imagine a fund making investments so that its overall portfolio is consistent with its stated valuation, as opposed to ensuring that every individual investment is consistent with its stated valuation. The issue is akin to gerrymandering projects, as discussed above. See *supra* Section II.A.1. If fund managers are compensated appropriately, they should not have an incentive to manipulate outcomes.

163. See Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840, 864–65.

164. See *infra* Section III.B.

Some of these advantages are comparable to the benefits of applying ESG valuation at companies. For example, ESG valuation would reduce the vagueness and ambiguity of various funds' marketing, enable penalties for greenwashing, and provide guidance on how to balance multiple objectives.

Apart from these benefits, ESG valuations would enable investment funds to be more effective shareholders. The valuations would facilitate communication with management about ESG—all firms would need to do to understand their investors' ESG preferences is look at their valuations—a much easier task than engaging with diverse shareholders on a multidimensional topic such as ESG. Furthermore, ESG valuation comprises a restriction on preferences that helps shareholders incorporate ESG without unduly undermining shareholder homogeneity. Because diverse ESG valuations could be aggregated relatively simply (for example, by using the median or mean shareholder valuation for each ESG issue), investment funds with contrasting ESG preferences could own the same shares without forcing the company to make arbitrary ESG tradeoffs, enabling the firm to run more efficiently.

For all these virtues, neither people nor investment funds ordinarily translate their preferences into dollars. ESG valuation requires this conversion. The reluctance to convert values into dollars can be attributed both to discomfort with putting a number on core commitments such as the environment or equity<sup>165</sup> and to the imprecise alignment between any dollar figure and people's underlying preferences (recall the difficulty of converting gender equity goals into a single metric described in section II.A.2.a above). If a number cannot encapsulate preferences on any given issue, why should ESG be oriented around precisely such a number?

One response to these concerns would be to embrace a *laissez faire* approach to ESG valuation. If the advantages of ESG valuation outweigh the disadvantages, then investment funds and firms will adopt it. Otherwise, they won't. In this scenario, little regulatory

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165. There is a large literature discussing this discomfort and either seeking to bolster or reject it. *See generally, e.g.*, GUIDO CALABRESI & PHILIP BOBBITT, TRAGIC CHOICES (1978) (discussing discomfort with using market mechanisms to make choices with life or death consequences); MARGARET JANE RADIN, CONTESTED COMMODITIES (1996) (discussing unwillingness to commodify babies or organs and permit them to be sold); CASS R. SUNSTEIN, THE COST-BENEFIT REVOLUTION (2019) (arguing that decisions should be made by quantifying benefits and costs of regulations in dollar amounts).

intervention is necessary, even if ESG valuation would resolve a series of ongoing problems with ESG. However, the full advantages of ESG valuation cannot be realized without some degree of standardization and regulatory intervention, which is described in Part III below.

## 2. Finding an ESG Valuation

Much like corporations, institutional investors participating in an ESG valuation scheme will have to set their own valuations of ESG metrics. New and existing funds should adopt different processes to handle this task.

*a. New funds:* There is little need to impose requirements for new investment funds selecting an ESG valuation. New investment funds could choose any ESG valuation for any issue. The market for fund managers and strategies, rather than any centralized decisionmaker, would ensure that funds choose valuations in accord with the preferences of investors.

Funds would not be required to support their ESG valuations with data. Indeed, there is good reason to expect that ESG valuations would systematically be below estimates of social costs. Unlike Pigouvian taxation or optimal regulation, ESG is not a first-best instrument for controlling externalities. The corporate sector makes up only part of the economy and the longstanding goal of corporate profit maximization may well continue to predominate. Instead of thinking of ESG as a primary mechanism for achieving social goals, the industry may regard it as a stop-gap redundancy measure, designed to prevent the most egregious ESG harms if governments are not able to do better by taxation or regulation. With this background, investors and fund managers may well adopt ESG valuations below estimated social costs, even if the ESG valuations are ad hoc.

Ultimately, ESG valuations would be determined by the market for investment funds. Funds that offer compelling ESG valuations would attract ESG-oriented investors, who would be drawn to the funds' transparent ESG commitments and congruent ESG goals.<sup>166</sup>

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166. We imagine that many investors in new funds would prefer ESG valuations based on systematic evaluation to ad hoc numbers. As a result, funds would likely scour the social science literatures on the social costs of externalities to support their ESG valuations. A new fund adopting a carbon valuation, for example, might use the U.S. government figure for the social cost of carbon as the starting point for its valuation.



Funds with ESG valuations out-of-step with investors would struggle to attract money and would be more likely to fail. Though this may be a weakness of a valuation system, in that investors may demand lower ESG valuations than would be socially optimal, it is ultimately a weakness of any system relying on voluntary action by private persons.

*b. Existing funds:* Unlike a new fund, an existing fund would already have investors' capital committed. While this should not necessitate substantive limits on the positions that existing funds can take, it does suggest the need to impose procedural requirements. If a fund adopts ESG valuations that frustrate its investors, then the investors would be likely to withdraw their capital. But because of the costs of switching funds, the market for investment funds would exercise a weaker disciplining role on ESG valuation by existing funds than it does with new funds. Even if an existing fund adopted ESG valuations out-of-step with its investors' preferences, some investors would retain their money in the fund because the costs of switching funds would exceed the benefits.<sup>167</sup>

Existing funds should, therefore, pay heed to the preferences of their current investors when announcing ESG valuations. If a fund adopted the median ESG valuation for each item derived from a survey of its investors, for example, then it would have a principled basis for its ESG valuations. Investors with alternative preferences could then liquidate their fund shares and invest elsewhere.<sup>168</sup>

### 3. *Committing to a Valuation*

Investment funds should document their ESG valuations in their prospectuses. If ESG valuation becomes standardized, then

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167. Note that this is a problem for any new ESG commitment by an existing fund. Indeed, it is a problem for a lack of ESG commitments as well. Underlying savers may prefer that their capital be deployed in an environmentally and socially responsible way but be largely unable to act on that preference. See Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 *YALE L.J.* 1870, 1878-90 (2017). Current regulations may bias exits in this direction. Individuals have less freedom to exit the funds in their retirement accounts, both because their choices may be constrained by their employer's 401(k) provider and because of the heavy tax penalties from withdrawals. Current Department of Labor regulations limit the objectives that retirement funds can pursue.

168. Regulations might strengthen the ability of investors to exit. Funds that change their ESG valuations might be required to offer redemptions to investors, or simply required to provide enough advance notice to allow investors to make trading decisions.

funds can report their valuation along each standard dimension, reporting a zero valuation for any ESG factor that an investment fund has chosen not to consider.

ESG valuations must be credible to be effective. This means that some enforcement mechanism is necessary. Class action securities fraud lawsuits are one likely mechanism. If an investment fund claims to use ESG valuations in its prospectus but fails to use those valuations as described, then the fund's investors should be able to sue the fund's management for fraud.

SEC rules or enforcement actions could give ESG valuation further teeth. At present, the SEC can only realistically pursue actions against funds that claim to care about ESG but transparently do not.<sup>169</sup> Once an ESG investment fund considers ESG, however cursorily, the fund is effectively immune from SEC enforcement. Investors thus have weak protection against firms that claim to care about ESG solely to attract investment. ESG valuation makes investor protection more robust. If a fund claims to use ESG valuations, then it is not enough for the fund to say it considered ESG when making investment or governance decisions. Instead, the fund must show that it used ESG valuations in a structured manner, balancing expected profits against ESG values as prescribed in its ESG valuations. And if ESG valuation can deliver a structured and consistent balancing of profits and ESG considerations, then it will have achieved a significant advance over today's ESG morass.

Unfortunately, the green swap mechanism described with respect to corporations is unlikely to work effectively for institutional investors due to an extreme moral hazard problem. While it is hard for companies to reduce emissions, it is easy for funds to buy portfolio companies with lower emissions. If DEF Fund signs a green swap with FIN to pay \$75 for each ton of carbon emitted by DEF portfolio companies, for example, DEF can easily change its investment portfolio so that it pays FIN much less than FIN expects. Knowing this, FIN is unlikely to offer a substantial

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169. Absent this type of clear contradiction, the SEC would struggle to show that the fund's conduct was contrary to its claims to consider ESG information. As a result, SEC actions to date have focused on egregious failures to consider ESG information at all, or to follow stated policies on ESG. *E.g.*, Press Release, Secs. & Exch. Comm'n, SEC Charges Goldman Sachs Asset Management for Failing to Follow its Policies and Procedures Involving ESG Investments (Nov. 22, 2022), <https://www.sec.gov/news/press-release/2022-209>.

lump sum payment to DEF, making a green swap unattractive to DEF and all other investment companies.

#### 4. *Impacts on Capital Markets*

In addition to directly encouraging the corporations they own to adopt ESG valuations and change their behavior via corporate governance, ESG valuation for investment decisions by investment funds could contribute to ESG goals by affecting the cost of capital. A large amount of capital is invested in ESG funds; that capital is exclusively available to firms that meet ESG criteria.<sup>170</sup> In principle, this should make capital cheaper for ESG-friendly firms, enabling these firms to expand and reducing harmful externalities. In addition, the availability of lower-cost capital would provide an incentive for non-ESG friendly corporations to adjust their behavior and generate fewer harmful externalities themselves.

Although affecting the cost of capital is an aspiration of many pluralist ESG investment strategies,<sup>171</sup> ESG valuation could improve the effectiveness of this mechanism for reducing harmful externalities. ESG valuation applied to fund investment decisions would clarify the extent to which different corporate strategies affect the cost of capital, making this avenue more effective. Suppose Fund DEF, with discretion over its investments, invests in ABC because ABC's carbon valuation (\$50 per ton) sits near DEF's (\$75 a ton). Because ABC attracts investment from funds with similar carbon valuations as well as funds that ignore carbon but simply appreciate ABC's profit opportunities, ABC enjoys preferential access to capital. With access to cheaper capital, ABC grows larger than similar corporations without a carbon valuation. And since ABC strives to minimize carbon emissions, its growth will be associated with lower total emissions.

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170. Cf. Edmans, Levit & Schneemeier, *supra* note 98 (identifying divestment as a potential mechanism for driving improvements but suggesting that others may be more effective).

171. If the cost of capital is not affected, it is unlikely that the strategies will actually drive improved outcomes. For example, unless investors can affect the actual economic characteristics of a profitable but dirty project, that project will be pursued by *someone*, meaning that the pollution will be emitted.

The availability of lower cost capital could also induce formerly ESG-indifferent firms to consider reform.<sup>172</sup> If many ESG funds value CO2 emissions at \$50 per ton, then a corporation that uses a lower threshold (or no carbon valuation) will find that these ESG funds withhold or reduce their investment. If, however, the firm adopts a CO2 valuation of \$50, then these investment funds will no longer discount the firm's performance, and the firm's cost of capital will go down accordingly. As a result, firms may adopt ESG valuations to appeal to more investors.

While affecting the cost of capital is an important mechanism for ESG to make the world a better place, it is not clear that existing ESG fund investing has practically driven a reduction in the cost of capital at ESG-friendly firms. ESG funds have similar returns to other funds, suggesting that they are not currently offering capital on materially better terms.<sup>173</sup>

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172. Cf. Hajin Kim, *Expecting Corporate Prosociality* 6 (Univ. of Chi. Coase-Sandor Inst. For L. & Econs., Research Paper No. 978, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4282358](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4282358) ("Stronger rewards for prosociality and penalties for antisocial acts are tangible incentives that encourage firms to internalize more externalities . . . . In other words, even a purely profit-maximizing firm would consider societal impacts, because doing so would be more profitable.").

173. Curtis, Fisch & Robertson, *supra* note 87, at 399. The yields on green bonds – debt instruments issued specifically to finance climate-friendly projects – are only modestly lower than other corporate bonds, with relatively little variation based on the green credentials of the issuer or project. John Caramichael & Andreas C. Rapp, *The Green Corporate Bond Issuance Premium*, Federal Reserve International Finance Discussion Papers No. 1346 (June 2022), <https://www.federalreserve.gov/econres/ifdp/files/ifdp1346.pdf> (finding that green bonds have a yield spread that is eight basis points relative to conventional bonds); Zach Tokura, *Have Corporate Green Bonds Offered Lower Yields?*, MSCI (Mar. 10, 2020), <https://www.msci.com/www/blog-posts/have-corporate-green-bonds/01738309960> (summarizing recent findings suggesting that yields are up to 2 basis points lower on green bonds); cf. Quinn Curtis, Mark C. Weidemaier & Mitu Gulati, *Green Bonds, Empty Promises*, VA. PUB. L. & LEGAL THEORY RSCH. PAPER NO. 2023-14, 41 (2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4350209](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4350209) ("There is a debate in the finance literature over the existence of a 'greenium' associated with green bonds. That is, green bonds are thought, under some circumstances, to be priced at a modest premium to conventional bonds. The existence of a greenium is disputed . . . ."). It is possible that there are offsetting effects present. ESG criteria might boost the financial performance of part of the fund's portfolio by helping the fund sense risks and opportunities. And the fund may plow all additional earnings and avoided losses into firms that are helpful to society.

But it is also possible that the similarity in returns is driven by clientele effects, in which non-ESG funds devote all their investments to non-ESG friendly corporations, thereby offsetting the loss of ESG investments. Given the importance of investment diversification, such complete "clientele effects" are unlikely, meaning that ESG-friendly corporations likely enjoy cheaper access to capital, while ESG equity funds likely earn a slightly lower return. See Lasse Heje Pedersen, Shaun Fitzgibbons & Lukasz Pomorski, *Responsible Investing: The*

The muddle surrounding ESG investing may be preventing the cost of capital mechanism from operating effectively. If ESG funds cannot identify corporations genuinely committed to ESG, then it is hard for socially conscious corporations to benefit from the relatively cheap capital ESG funds have to offer. Conversely, if corporations cannot determine how they need to reform to appeal to ESG funds, then the corporations may not bother. By clarifying ESG behavior, ESG valuation may enable this hypothetical mechanism for changing behavior to become more of a reality.

Even if ESG does not meaningfully change the cost of capital for corporations, investors benefit from owning investments in harmony with their values. ESG valuation would enable capital markets to sort ESG preferences more effectively, increasing the benefits associated with better matching between investors and their investments. This increases investor welfare, even if ESG does not affect the cost of capital.

In essence, ESG converts some aspects of financial markets into something akin to the markets for jobs or residential real estate, in which participants are motivated both by the potential for income and by some set of personal subjective preferences. People buy houses not only because they believe they will eventually be resold at good prices but because they believe they will enjoy living there. At least under certain assumptions, this quality should not compromise the market's ability to match buyers and sellers in a sensible way.<sup>174</sup> But mixing consumption with investment in this way could potentially increase friction and search costs. By standardizing the market and collapsing complex issues into simple, actionable variables, ESG valuation helps reduce those problems.

### III. COURTS AND REGULATORS

This Part considers how courts and regulators could use and build on an ESG valuation mechanism.

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*ESG-Efficient Frontier*, 142 J. FIN. ECON. 572 (2021), <https://www.sciencedirect.com/science/article/pii/S0304405X20302853>.

174. See PAUL MILGROM, DISCOVERING PRICES: AUCTION DESIGN IN MARKETS WITH COMPLEX CONSTRAINTS 64–72 (2017) (setting out theorems demonstrating the existence of an efficient equilibrium under certain assumptions).

*A. Courts Hearing Corporate Law Disputes*

Specificity in ESG targets would be helpful in a broad range of corporate law disputes. This section suggests three examples. First, corporate managers can use a variety of mechanisms to fend off takeover bids from hostile acquirers. Managers deploying such tactics must show that a bid creates a threat to corporate policy and that their response is reasonable in relation to the threat.<sup>175</sup> If a company and its shareholders had precisely quantified the value of its ESG commitments, this task would be substantially easier. Suppose that a company and its shareholders had committed to value carbon dioxide emissions at \$80 per ton, and a hostile bidder had offered a \$100 million premium, with plans to increase profitability by dropping costly environmental policies. If the change in environmental policies would cause the company to emit 1 million extra tons of carbon, the board might be expected to let the takeover bid go through. The value of the extra emissions ( $\$80 \times 1 \text{ million} = \$80 \text{ million}$ ) would be less than the premium (\$100 million). If the change would cause the company to emit 2 million extra tons of carbon, the board might be expected to fight. The value of the extra emissions ( $\$80 \times 2 \text{ million} = \$160 \text{ million}$ ) would exceed the premium.

Similarly, a board might favor acquisition bids from cleaner acquirers. When a company is “up for sale,” its managers are normally expected to behave as auctioneers, maximizing the price received by shareholders to the exclusion of all other goals and values.<sup>176</sup> But if a company and its shareholders have committed to valuing ESG objectives at a particular level, it would offer a clean and verifiable basis for drawing other distinctions. If a bidder offers \$80 million less but credibly commits to keep emissions at least one million tons lower, the board would have a credible basis for preferring that bid. By contrast, if a company had not made any binding commitments in advance, the board would lack a credible good faith basis for preferring one bidder over another on non-pecuniary grounds.<sup>177</sup>

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175. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

176. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

177. Cf. *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1148–49 (Del. 1989) (Time's board had demonstrated a real interest in corporate identity and culture through its extended course of investigation and negotiation, supporting the conclusion that it was

Second, many states have adopted constituency statutes that authorize corporate boards to consider a range of stakeholder interests. These statutes are generally framed in vague terms that limit their effectiveness: even if a board is told that it may consider stakeholder interests, it has no legal encouragement to do so<sup>178</sup> and may face liability if it tries.<sup>179</sup> Widespread adoption of a valuation approach might help give constituency statutes more meaning.

Finally, many states have adopted statutes authorizing “public benefit corporations” (PBCs). These hybrid organizational forms allow a company to balance profit maximization with a public purpose spelled out in its charter.<sup>180</sup> While many companies have adopted the PBC form, the effectiveness of the mechanism is limited. As Professors Jill E. Fisch and Steven Davidoff Solomon have found, “independent of structural limitations on accountability, . . . purpose statements are, in most cases, too vague and aspirational to be legally significant, or even to serve as a reliable tool for evaluating whether corporate decisionmakers are adhering to the PBC’s social mission.”<sup>181</sup> The valuation approach would allow for more meaningful commitments, which could, in turn, be enforced by shareholders.<sup>182</sup>

### B. SEC

As we described above, ESG valuations will only be credible if failure to adhere to a valuation is actionable under securities law. This form of SEC support is a bare necessity for ESG valuation’s

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empowered to prefer and defend a transaction that preserved those values.); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33–34 (Del. Ch. 2010) (rejecting claim that company had real culture or moral commitments because those arguments had only been invoked “talismantically for purposes of this trial in order to find deference”).

178. Bebchuk & Tallarita, *Illusory Promise*, *supra* note 41 at 140–55; Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 768 (2015).

179. William Savitt & Aneil Kovvali, *On the Promise of Stakeholder Governance: A Response to Bebchuk and Tallarita*, 106 CORNELL L. REV. 1881, 1891 (2021); Hilton Hotels Corp. v. IIT Corp., 978 F. Supp. 1342, 1346–47 (D. Nev. 1997) (applying Delaware law principles to a Nevada corporation’s takeover defense, even though Nevada has a constituency statute).

180. DEL. CODE ANN. tit. 8, § 362(a) (2023) (effective August 1, 2015) (“[A] public benefit corporation shall be managed in a manner that balances the stockholders’ pecuniary interests, the best interests of those materially affected by the corporation’s conduct, and the public benefit or public benefits identified in its certificate of incorporation.”).

181. Fisch & Solomon, *supra* note 150, at 69.

182. DEL. CODE ANN. tit. 8, §§ 365(a), 367 (2023) (effective July 16, 2020).

success, but more robust SEC engagement would help ESG valuation to more fully realize its promise.

### *1. Not Enforcing Rule 14a-8 Limitations on Shareholder ESG Valuation Proposals*

The most effective way to aggregate disparate shareholder preferences for ESG would be for shareholders to vote on resolutions concerning valuations for important ESG criteria, such as carbon emissions, employee satisfaction, and pay equity. Such votes would enable the shareholders to fix a coherent aggregate valuation for important externalities. If brought forward by shareholders, however, the votes would be novel and might be fought by management under SEC Rule 14a-8 as excludable from a corporate proxy because they would involve what is generally considered a “management function.”<sup>183</sup> If these votes were considered by the SEC to infringe on management’s role in the corporation, then the proposals would be rejected.

This would be an unhelpful interpretation of the SEC’s rules. Shareholder votes about ESG valuations would not compel management to make any particular decision. Rather, they would provide guidance about how shareholders want their company to be governed, leaving the execution of this guidance to management. As a result, such shareholder proposals would align with current law regarding the division of authority between shareholders and management. But the novelty and precision of these shareholder proposals might provide an opening for management wishing to follow its own ESG preferences to reject such proposals as violating corporate law. Courts interpreting corporate law and the SEC interpreting 14a-8 should reject such arguments.

### *2. Standardization*

ESG valuation would be most effective with standardization of ESG measures. If every climate-oriented ESG fund adopts a different climate measure, then many of the benefits of ESG valuation will be undermined. It is impossible to tell which of two investment funds is more climate friendly if one fund announces a

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183. 17 C.F.R. § 240.14a-8 Note to Paragraph (l)(2)(7).



valuation per ton of carbon emission while another announces a valuation of some other metric. A surfeit of ESG valuation standards would also impair a corporation's ability to use valuations to infer its shareholders' ESG preferences.

Standardized measures for each category of ESG valuation would mitigate these concerns. If every investment fund reported its climate valuation in terms of dollars per ton of carbon, then funds could be compared by their commitment to climate change on a common scale. And corporate managers could estimate their shareholders' climate preferences without being forced to haphazardly convert different ESG valuations into a common scale.

Standardization would also mitigate the data burdens on corporations seeking to inform investment funds about their ESG conduct. If investment funds announced thousands of different ESG metrics, then corporations would feel pressure to release thousands of data points to inform these metrics at potentially great expense. Standardization of ESG valuations, by contrast, would reduce this cost, enabling corporations to focus their data releases on standardized measures.

The SEC (or, alternatively, private industry groups such as the Financial Accounting Standards Board or nonprofits such as the Sustainability Accounting Standards Board) should develop standards for measuring the most important ESG considerations. While the climate change category has already converged on a standard (dollars per ton of carbon or carbon equivalent),<sup>184</sup> other ESG factors, such as diversity, equity, and inclusion, do not have similar benchmarks.<sup>185</sup> Effective standards would be tightly linked to ESG values, easily calculated, and have relatively little overlap with other ESG considerations. Standards would enable ESG

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184. Of course, there are important methodological issues where substantial disputes remain. For example, there is substantial controversy over the inclusion of "Scope 3" emissions in carbon disclosures. See Condon, *supra* note 116. Discounting could also be a concern. See *supra* note 116 and accompanying text. But the topic has largely been flattened into a single number.

185. This is not to suggest that no one has identified relevant metrics. For example, partly in response to the SEC's emphasis on human capital disclosures in 2020 updates to Regulation S-K, many firms have begun to share statistics on gender and racial diversity. See Meghan Sherley & Mike Titera, *Evolving Human Capital Disclosures*, GIBSON DUNN (Jan. 9, 2023), <https://www.gibsondunn.com/wp-content/uploads/2023/01/evolving-human-capital-disclosures.pdf>. However, there is no single number or score that is generally thought to capture a firm's performance on these issues.

valuation's potential to be realized without imposing excessive costs on corporations or fund managers.

Limiting ESG to a few standardized dimensions would also enable the SEC to mandate disclosure of corporate data regarding performance on these dimensions, as the SEC is currently doing with carbon emissions. Mandatory disclosures are much harder to justify, by contrast, when ESG funds are using a hodgepodge of bespoke metrics.

Of course, just as no accounting measure perfectly captures firm performance, so too will ESG standards be imperfect proxies for the values that investors really care about. But without such standards, ESG valuations will have a hard time getting off the ground. The SEC should set ESG standards by choosing a few metrics correlated with the most important dimensions of ESG and revise these standards periodically as investors grow concerned about other aspects of corporate externalities.

### *3. Upper Bounds on Valuation*

While the market for investment funds ensures that ESG valuations cannot differ from investor preferences too dramatically, the SEC may want to impose limitations on such valuations to prevent ESG valuations from turning corporations or investment funds into de-facto charitable organizations.

ESG valuations should be below the cost of mitigation.<sup>186</sup> For example, if carbon capture costs \$100 a ton, then a corporation or investment fund's ESG valuation should be below \$100 a ton. Otherwise, the entity should "invest" entirely in mitigation. At that point, the entity ceases to be a corporation or investment fund and transforms into a pool of money devoted to climate change, even though investors can make the same mitigation efforts via their charitable giving. Instead of fixing society, ESG-oriented corporations and investment funds want to improve ESG outcomes when corporations can do so at costs below the generalized costs of mitigation. If a corporation modifies its investments and reduces

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186. Since it is unclear whether today's carbon offsets in fact reduce the amount of carbon in the atmosphere, this restriction should not apply to current carbon offset prices. Maggie Astor, *Do Airline Climate Offsets Really Work? Here's the Good News, and the Bad*, N.Y. TIMES (May 18, 2022), <https://www.nytimes.com/2022/05/18/climate/offset-carbon-footprint-air-travel.html>. If the offset market becomes more credible, however, then a restriction imposed by external costs of mitigation should be followed.

carbon emissions at a cost of \$50 a ton, then ESG valuation has improved the world. But there is no need for corporations or investment funds to buy carbon offsets at \$100 a ton when investors can buy offsets at the same price on the open market.

By capping ESG valuations at the social cost of mitigation, funds guarantee that they remain investment funds focused on corporate investment. The ESG valuation governs the portfolio corporation's behavior rather than encouraging corporations to become generalized social improvement entities.

Even stronger limitations on valuations may be necessary for investment funds with stricter fiduciary duty rules. For example, retirement plan sponsors (regulated by the DOL) might be forbidden from offering funds using ESG valuations for pluralist reasons since ESG valuation makes the tradeoffs between ESG considerations and profit maximization more explicit than other ESG orientations.<sup>187</sup>

#### 4. *Benefits to the SEC of Widespread Adoption*

The valuation mechanism would allow for more precise quantification of the benefits of disclosure rules. This could have two positive impacts. First, it would allow the SEC to show quantitatively that an ESG disclosure requirement was relevant to investors' decisions. This can be an important point of contention when ESG disclosure mandates are considered: commentators frequently urge that environmental or social matters are immaterial to investors and thus are not proper subjects for SEC rules.<sup>188</sup>

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187. Put differently, the opacity of current ESG mechanisms and deference extended to managers allows companies and investors to transfer value to environmental or social goals, even if there is a legal duty to do otherwise. Cf. Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 772 (2005) (“[E]ven if profit-maximization were the nominal standard, business judgment review would still sustain any public-spirited activity without any inquiry into actual profitability or managers’ actual purposes as long as it has some conceivable relationship, however tenuous, to long run profitability.”); LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* 29–31 (2012).

188. For example, Professor Sean J. Griffith has suggested that this limitation has constitutional dimension, and that an SEC mandate to disclose information immaterial to investors would raise First Amendment concerns. Sean J. Griffith, *What’s ‘Controversial’ About ESG? A Theory of Compelled Commercial Speech under the First Amendment*, 101 NEB. L. REV. 876 (2023). *But see* Jill E. Fisch, George S. Georgiev, Donna M. Nagy & Cynthia A. Willaims, *Comment Letter of Securities Law Scholars on the SEC’s Authority to Pursue Climate-Related Disclosure, Re: Enhancement and Standardization of Climate-Related*

Showing that investors have actually made consequential commitments on these issues, so that a disclosure could reshape their investment or governance decisions would be consequential in these debates.

Second, the information revealed by the system would allow for better estimates of the ultimate effects of disclosure on corporate conduct. This, in turn, would allow the SEC to recognize a broader range of benefits from new disclosure requirements, which could help more rules survive legal challenges.<sup>189</sup>

### C. Bankruptcy Courts

In recent years, bankruptcy courts have increasingly been confronted with difficult challenges involving the valuation of ESG policies. This can involve a pre-bankruptcy commitment. A diverse array of non-profit organizations with important values-based commitments have entered bankruptcy.<sup>190</sup> Courts must then wrestle with the question of whether that mission should be preserved and at what cost. It can also involve a proposal for a commitment post-bankruptcy. Scandal-plagued enterprises entering bankruptcy have proposed to reorganize themselves into organizations that have a social mission.<sup>191</sup> Courts must then find ways to determine how much value those commitments generate and must allocate that value appropriately.

A robust ESG valuation market would help. If a firm makes a binding ESG commitment before entering bankruptcy, any subsequent lender would be on notice that they should not expect a bankruptcy reorganization to focus exclusively on maximizing

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Disclosures for Investors (S7-10-22) at 13 (June 6, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4129614](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4129614) (“[N]othing in the federal securities statutes or in judicial precedent, including Supreme Court precedent, imposes a materiality constraint on [SEC] rulemaking, or requires the [SEC] to incorporate materiality qualifiers in the language of specific disclosure rules.”).

189. John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015); *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011) (rejecting SEC’s proposed Rule 14a-11 on ground that agency had failed to adequately weigh costs and benefits).

190. See, e.g., Pamela Foohey, *Bankrupting the Faith*, 78 MO. L. REV. 719 (2013) (presenting study of bankruptcy reorganizations of faith-based institutions like churches, synagogues, and religious schools); cf. Vincent S.J. Buccola, *The Logic and Limits of Municipal Bankruptcy Law*, 86 U. CHI. L. REV. 817 (2019) (discussing the increasing importance of municipal bankruptcies).

191. Samir D. Parikh, *Scarlet-Lettered Bankruptcy: A Public Benefit Proposal for Mass Tort Villains*, 117 NW. U. L. REV. 425 (2022).

their returns. The binding ESG commitment would also give the bankruptcy court precise instructions on how to trade off values in a reorganization. Instead of having to work through vague and economically indeterminate ideas about fairness or morality, the court would have a clear numerical formula to apply.

If a reorganization plan suggests that the reorganized firm will have a commitment upon exiting bankruptcy, the market would provide a ready means of valuing that commitment. Litigants and the court could look to the experiences of firms with comparable commitments and could set the commitment to the level that creates the most overall value.

#### *D. Mandates, Standards, or Laissez Faire*

To this point, we have outlined a relatively minimal regulatory regime for ESG valuation. The SEC, or even a private party, should standardize ESG valuation categories, mandate a bit of disclosure, and penalize fraud. That's it. It is up to investors, funds, and corporations to decide if ESG valuation is worth the candle. If they decide not, they don't need to change a thing or will at most have to disclose a bit of new data.

If following ESG was simply an individual choice, then this regime would clearly be appropriate. But there are two features of ESG investing that suggest that this regime is too laissez faire.

First, the fiduciary nature of corporations and investment funds strengthens the case for further ESG restrictions. Shareholders entrust their capital to the management of corporate executives. And investment fund investors entrust their savings to fund managers, who choose corporate investments on behalf of the investors. The separation of ownership from control (and ownership from ownership<sup>192</sup>) raises a host of principal agent problems. Corporate law, which imposes a fiduciary duty on executives and directors to maximize shareholder value, and investment fund law, which imposes a fiduciary duty on fund managers to pursue the interests of their investors, seek to

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192. See Strine, *supra* note 167 (noting that fund managers may have different incentives from the underlying human beings whose capital they deploy, and suggesting that managers should be encouraged to attend to the environmental and social issues that affect human savers); Mahoney & Mahoney, *supra* note 163 (noting that fund managers may have different incentives from underlying savers, and suggesting that fund managers should be forced to focus exclusively on financial returns).

moderate these principal agent problems with a presumption that managers seek the best returns for a given risk profile. This standard simplifies the evaluation of possibly self-interested decisions by corporate executives or investment fund managers. But ESG threatens to exacerbate principal agent problems. If fund managers are maximizing along both risk/return and ESG dimensions, it can become difficult to identify violations of their fiduciary duties. Even if an investment flunks a risk/return test, the manager can claim that its ESG properties made it a desirable investment.

ESG valuation mitigates this threat. As described above, ESG valuation facilitates the identification of investment decisions that differ from stated objectives, even if those investment decisions are multi-dimensional. The necessity of working with relatively simple rules when evaluating fiduciary relationships may justify restricting ESG to commitments that give verifiable values to purported ESG interests. Indeed, enabling ESG but requiring ESG valuation is less restrictive than the current fiduciary structure, which is often interpreted to require profit maximization by the agent even if the principal does not demand profit maximization.<sup>193</sup>

The collective nature of investment further strengthens the case for restrictions on the forms ESG can take. A shareholder or investment fund's ESG commitments do not affect themselves alone but also other co-venturers. A majority of ESG oriented shareholders can induce a company to decline profitable investment opportunities, harming shareholders interested exclusively in profit maximization.

These externalities and conflicts are an inevitable conflict of enterprises with multiple owners. Indeed, corporate and securities law permits non-controlling shareholders to vote their shares however they please, even if they stand to profit from a decline in a corporation's value.<sup>194</sup> Shareholders interested in ESG are doing nothing illegal or even unusual by mixing the pursuit of profit with other interests.

Even if the pursuit of ESG goals by shareholders is legal, its effects on other investors in a joint enterprise remain real.

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193. The DOL's new rules for retirement plan sponsors allow them to include ESG funds, but only on instrumental grounds. See *Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights*, 87 Fed. Reg. 73822 (Dec. 1, 2022) (codified at 29 C.F.R. pt. 2550).

194. See Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006).

A company with a majority of ESG oriented shareholders may be worth less to a profit maximizing investor than the value of the same company co-owned with fellow profit-maximizers. And it is currently very difficult to learn about the preferences of other shareholders. Even if some funds claim to follow ESG principles, it is almost impossible to ascertain how intensive or even genuine the commitment is.

ESG valuation greatly expands an investor's ability to ascertain the ESG commitments of their fellow investors. A few valuation numbers explain how ESG investors trade social values off against each other and against profit goals. Valuations enable non-ESG investors to know what they are getting into and to be confident that ESG will not wreck a company's existing governance mechanisms.

The external effects of ESG on other investors and on corporate governance more generally therefore justify some restrictions on how ESG is implemented. But this is a small price to pay for enabling ESG to realize some of its potential benefits without unduly impairing corporate governance more generally. In short, we think ESG investing should be permitted and indeed encouraged, but that if a company or investment fund wants to hold itself out as pursuing ESG, then they should be required to list their preferred valuations on at least some of the standardized dimensions proposed by the SEC. (The default valuation for any ESG dimension is zero.) While no specific ESG value would be required, firms and funds that want to pursue ESG should be required to turn to ESG valuation as the expression of their ESG interests.

While the use of ESG valuation along a standardized set of ESG dimensions should be mandated for entities wishing to pursue ESG, we think government imposition of specific mandatory ESG values on all entities would be unwise. This would entail a substantial expansion of some regulator's authority. Choosing a carbon valuation is Congress's job, or perhaps the EPA's—it is not obviously a matter for regulators focused on corporate investment. The same holds true for other ESG considerations, such as social equity or the interests of employees. These are decisions for shareholders, Congress, or expert regulators.

But even if ESG valuations were imposed by statute, we think they would be ineffective relative to alternatives. Pigouvian taxes

transform externalities into direct costs, forcing firms and individuals to internalize their externalities. ESG valuations, by contrast, require firms to treat externalities “as if” they were direct costs. This may be workable if the firm’s principals – its investors – want the firm to behave this way. It will be unworkable, however, if the valuation is imposed on the shareholders by an outside entity. Corporate decision-making is so complex and multifaceted that even a massive and intrusive enforcement mechanism would struggle to make firms adhere to mandatory valuations. Put differently, the valuation proposal is a corporate governance mechanism—to be effective, it will require buy-in from shareholders and managers. Without that buy-in, it is unlikely to be effective.

Mandatory ESG valuations would also be inequitable relative to Pigouvian taxation for externality control. While Pigouvian taxation applies regardless of status, ESG valuation would apply only to public companies and institutional investors. As a result, mandatory specific ESG valuations should be avoided even if mandatory use and disclosure of ESG valuations were adopted.

#### CONCLUSION

We have argued that to realize its promise, the ESG movement should be channeled into a form we call ESG valuation. Any corporation or investment fund purporting to pursue ESG should be required to announce and use its own valuations of standardized ESG metrics. Failure to pursue these stated valuations would then be actionable under the securities laws.

By translating nebulous ESG considerations into the standardized dollar metrics, ESG valuation would make it possible for stakeholderism and shareholder primacy to peacefully co-exist.



