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# The ESG Gap

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*The corporate world is undergoing a transformation: there has been a dramatic influx in demand for companies to promote environmental, social, and governance (ESG) values. Yet these preferences do not necessarily translate into effective corporate actions. In this Article, we underscore the structural problems that prevent such preferences from steering the corporate ship full steam ahead toward ESG goals. We analyze the central actors in the corporate sphere that can potentially bring about such change on the ground: managers, institutional investors, and activist hedge funds. We demonstrate that none of these actors have the two central elements required for promoting ESG goals: motivation and competence. We refer to this problem as the ESG gap. We then suggest bridging the gap by forming a new entity, the Activist ESG Fund (AEF). The AEF would be an exchange-traded, closed-end mutual fund, uniquely designed for targeted activist investment. The closed-end traded fund structure would enable the fund management to focus on the long run by attracting patient money while permitting impatient investors to sell their shares on the highly liquid stock exchange. The establishment of AEFs can be a turning point in corporations' and society's effective promotion of ESG goals.*

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CONTENTS



## INTRODUCTION

The corporate world is undergoing a dramatic transformation. For many decades, the conventional wisdom among judges, practitioners, and most corporate law scholars was that the purpose of corporations is to maximize profits for shareholders.[1] In recent years, the view that firms have a single goal has been challenged. A competing vision, suggesting that corporations must also promote environmental, social, and governance (ESG) values, has become a central theme in corporate law scholarship and policy discussions among business leaders.[2] Total investments in businesses with an

1. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439, 440–41 (2001) ("[T]he managers of the corporation should be charged with the obligation to manage the corporation in the interests of its shareholders . . . ."). The most notable supporters of this view that articulated it early on were Adolf A. Berle, Jr., *see* A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1049 (1931) and Milton Friedman, *see* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 114 (1962). For a more detailed discussion of this view *see infra* notes 41–46 and the accompanying text.

2. *See generally* Martin Lipton, *Stakeholder Capitalism and ESG as Tools for Sustainable Long-Term Value Creation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 11, 2022), https://corpgov.law.harvard.edu/2022/06/11/stakeholder-capitalism-and-esg-as-tools-for-sustainable-long-term-value-creation [https://perma.cc/8ML8-77DH] [hereinafter Lipton, *Stakeholder Capitalism and ESG*]; *see also* Leo E. Strine, Jr., *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, 76 BUS. LAW. 397 (2021); Martin Lipton, Steven A. Rosenblum, Sabastian V. Niles, Sara J. Lewis & Kisho Watanabe, *The New Paradigm*, WORLD ECON. F. (2016),

ESG orientation are estimated to be around $35 trillion and are expected to reach $50 trillion by 2025.[3] In 2021, investments in ESG-oriented mutual funds (green funds) rose globally by 53% to $2.7 trillion, with an annual increase of $596 billion.[4] In 2022, over half of investors invested in ESG products, which is almost double the amount of 2019.[5] And today, the vast majority of investors (88%) in alternative funds, such as private equity funds and hedge funds, inquire with their investment managers about how ESG goals are incorporated into the managers' investment decision-making, indicating that ESG policies are a key factor in the decision whether to invest with a certain investment manager.[6]

There is growing consensus that governments alone cannot promote ESG issues effectively and that commercial companies must take greater responsibility in addressing environmental, social, and governance challenges.[7] Indeed, the rhetoric of the business world suggests that ESG has become the new way of life for corporations.[8] But as multiple leading theorists have noted, there is a wide gap between the rhetoric that calls for the promotion

https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf [https://perma.cc/HN3S-2MFC] [hereinafter Lipton et al., *The New Paradigm*]; Stephen M. Bainbridge, *Why We Should Keep Teaching* Dodge v. Ford Motor Co., 48 J. CORP. L. 77 (2022).

3. Saijel Kishan, *ESG by the Numbers: Sustainable Investing Set Records in 2021*, BLOOMBERG (Feb. 3, 2022, 9:03 AM), bloomberg.com/news/articles/2022-02-03/esg-by-the-numbers-sustainable-investing-set-records-in-2021 [https://perma.cc/QHJ6-6CBJ].

4. *Id.*

5. Ryan Munson, Jessica Bloom, Natalie Deak Jaros & Jun Li, *Does Accelerating Adaptation Present Obstacles—or Increase Opportunities?*, ERNST & YOUNG (Nov. 6, 2020), https://perma.cc/J9QR-L38S.

6. *Id.*

7. Jonathan R. Macey, *ESG Investing: Why Here? Why Now?* 2, (L. & Econ. Ctr. at Geo. Mason Univ. Scalia L. Sch., Working Paper No. 22-013, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3942903 [https://perma.cc/8UF6-PJ2Q].

8. *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 [https://perma.cc/6SRW-9KH4] ("Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country."); *see also* Lipton, *Stakeholder Capitalism and ESG*, *supra* note 2, ("Stakeholder capitalism recognizes that corporations do not exist in a vacuum, but rather each relies on a multitude of stakeholder contributions and interests from employees, customers, suppliers, communities and, more broadly, society and the environment at large in order to operate effectively and create value.").

of ESG goals and the advancement of ESG goals in practice.[9] Simply put, the supply of effective investment vehicles in ESG does not meet the growing demand for such investments.[10] We refer to this problem as "the ESG gap."

In this Article, we analyze the root cause of the ESG gap and offer a novel mechanism to remedy the problem. We argue that the ESG gap results from the fact that, at present, there is neither a market actor nor an institution that can effectively promote ESG goals. The advancement of ESG goals requires *competence* as well as *motivation*.

Competence is necessary because promoting ESG goals is generally more complex than advancing purely profit-maximizing strategies. The advancement of ESG goals requires a long-term vision. Furthermore, ESG goals are multidimensional and uncertain. Weaving them effectively into the culture and operation of firms is a daunting task that only skilled businesspeople can successfully perform.

Motivation is an additional hurdle that stands in the way of the advancement of ESG-friendly policies. As we will show, even those market actors who possess the requisite level of competence will rationally choose to forego the treacherous path of adopting and implementing ESG-oriented policies. This is so either because they wish to maximize their short-term payoffs or because they are

9. Marcel Kahan & Edward B. Rock, *Systemic Stewardship with Tradeoffs* 24, (N.Y.U. L. & Econ. Rsch., Working Paper No. 22-01, 2022), https://ssrn.com/abstract=3974697 [https://perma.cc/CWQ6-K3TL] ("[W]e analyze the extent to which universal owners can and should be expected to induce a firm to sacrifice itself in order to increase a universal owner's overall portfolio value. We are quite pessimistic that universal owners have the ability and inclination to do so."); Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 124–31 (2020) (pointing to the gap between the reformistic rhetoric of the Business Round Table, and the fact that the decision received board approval in only one company represented in the Business Roundtable); Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563, 2609 (2021) (noting that even when corporations are motivated toward increasing ESG awareness by cultural forces, there are other internal forces that do not permit the actual acceptance of ESG goals); Ellen Pei-yi Yu, Bac Van Luu & Catherine Huirong Chen, *Greenwashing in Environmental, Social and Governance Disclosures*, 52 RES. INTL. BUS. & FIN. 101192, 101193 (2020) (underscoring the systematic gap in firms between high level of ESG disclosure and low level of actual ESG performance); *see also* Lucian A. Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?*, 75 VAND. L. REV. 1031 (2022).

10. For discussion, see *infra* Part I and *Table 1*.

under pressure from other market actors to put financial results above ESG goals.

Unfortunately, and as we will discuss below, all existing market actors lack either the competence or the motivation to further ESG goals. These actors are corporate managements, institutional investors, and activist hedge funds.[11] We consider management first. Managers have close familiarity with the ins and outs of their firms' functions,[12] and, at least in principle, can change the business model to accommodate ESG goals. Nonetheless, it is questionable whether managers possess the requisite competence to pursue ESG goals. Although managers are generally sophisticated and skilled, they may suffer from tunnel vision, preventing them from appreciating and accepting new business philosophies.[13] From management's perspective, repurposing the company constitutes an implicit admission that for many years it has chosen an errant path for the company. It is therefore unrealistic to expect management to turn their backs on the strategic vision they have crafted and admit that it was a mistake.

Motivation is an even bigger problem in the case of management. Managers largely lack the motivation to engage with ESG goals due to their short horizons and compensation structures. Managerial compensation is based on short horizons, and the attainment of ESG goals often requires very long horizons. For example, reducing carbon emissions is likely to require years of hard work, as well as massive rethinking of traditional production and operation paradigms. The long-term benefits of these changes will clearly outweigh the short-term losses. But because managerial compensation focuses on short-term performance,[14] management is unlikely to embrace change.

11. For discussion of the central role of these market actors, see Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 974–76, 991 (2019).

12. Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. UNIV. L. REV. 547, 548–49 (2002) (discussing managers' primacy in directing corporate activity).

13. *See generally* Steven S. Posavac, Frank R. Kardes & J. Joško Brakus, *Focus Induced Tunnel Vision in Managerial Judgment and Decision Making: The Peril and the Antidote*, 113 ORG. BEHAV. & HUM. DECISION PROCESSES 102 (2010).

14. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 6–7 (2004); *see also* Kevin J. Murphy & Michal C. Jensen, *CEO Incentives: It's Not How Much You Pay, But How*, 3 HARV. BUS. REV. 1 (1998); Sanjai Bhagat, Brian Bolton & Roberta Romano, *Getting Incentives Right: Is Deferred Bank Executive Compensation Sufficient?*, 31 YALE J. REG. 523 (2014).

Next, consider institutional investors. Institutional investors have been lauded for their potential virtues in reforming the corporate sphere.[15] In contrast to management, institutional investors possess the motivation for incorporating ESG into corporate activity. As Professor Jeffery Gordon notes, because institutional investors hold almost the entire market in their portfolios, they are sensitive to systematic risks. And as "universal owners," they have a strong interest in reducing inter-firm externalities.[16] Gordon therefore argues that because ESG concerns, such as environmental disasters, entail significant externalities and pose systematic risk, institutional investors have the motivation to address those concerns.

Even though we agree that institutional investors may want to see their portfolio companies pursue ESG goals, we argue that they lack the competence for leading such change. It is true that the problem is systematic, but solutions must be tailor made. Properly integrating ESG goals depends on the relevant business model and environment of the firm at hand. Both PepsiCo and Chevron, for example, need to cope with their high carbon-emission profiles, but the business strategies they must implement to do so are almost entirely different. Institutional investors are not involved at the operative level of firms.[17] Their business models prevent them from

15. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); *see* Bernard S. Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); *see also* Marcel Kahan & Edward B. Rock, *Index Funds and Corporate Governance: Let Shareholders Be Shareholders*, 100 B.U. L. REV. 1771 (2020); *see* Kahan & Rock, *supra* note 9, at 3 ("Universal owners are larger than ever . . . [they] collectively hold more than 30% of the shares of even the biggest public companies."). *But cf.* Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019) (criticizing the ability of institutional investors to drive change).

16. Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627, 632 (2022); *see also* Dorothy S. Lund, *Asset Managers as Regulators*, 171 UNIV. PA. L. REV. 77, 83–85 (2022), (emphasizing that the 'Big Three' asset managers have incentives to cater to the wishes of their clients, many of whom have an interest in ESG); John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systemic Risk*, 2021 COLUM. BUS. L. REV. 602 (2021); Frederick H. Alexander, *The Benefit Stance: Responsible Ownership in the Twenty-First Century*, 36 OXFORD REV. ECON. POL'Y 341, 356 (2020); Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020).

17. *See* Kahan & Rock, *supra* note 9, at 1 ("But shareholders, even universal owners, do not manage companies. Rather, the business and affairs of a corporation are managed by full time senior management teams under the general oversight of a board of directors . . . .").

delving into the specifics of the firms in their portfolios. The primary aim of institutional investors is to provide low-cost diversification to their investors. This low-cost business strategy prevents them from spending the significant resources required for their analysts to closely monitor the specifics of their portfolio companies' operations.

In addition, the regulatory framework in which institutional investors operate bars them from getting involved in their portfolio companies to bring such change. And as scholars such as Professors John Morley, Marcel Kahan, and Edward Rock have noted, regulation bars institutional investors from going fully active, and more specifically, institutional investors cannot nominate directors to corporate boards.[18] Under current SEC regulation, active involvement in their portfolio companies would significantly increase their disclosure requirements, entailing prohibitive costs.[19]

The third type of market actor that may be expected to advance ESG goals is activist hedge funds. Activist hedge funds have the competence to form new business plans for companies in which they invest based on their familiarity with the operation modes of the companies they engage.[20] They also have the skills and experience necessary to monitor the execution of new business plans. They often run proxy fights, nominate their own directors to corporate boards, and push for major corporate reforms.[21] Unfortunately, activist hedge funds lack the motivation to incorporate ESG goals into firm objectives. Their business model is ill fitted for the long horizons ESG turnaround requires. Indeed, their business plan is predicated on relatively quick "fixes," such as spin-offs, dividend distribution, and R&D cuts. One of the prime reasons for their short horizons is the fact that they are structured

18. *See* John. D. Morley, *Too Big to Be Activist*, 92 S. CAL. L. REV. 1407, 1422–23 (2019); Kahan & Rock, *supra* note 9, at 24.

19. Morley, *supra* note 18, at 1422–30.

20. *See, e.g.*, Zohar Goshen & Sharon Hannes, *The Death of Corporate Law*, 94 N.Y.U. L. REV. 263, 283 (2019) ("Activist funds seek to secure value for shareholders (and boost profits for investors in the funds themselves) by nudging, with varying degrees of force, corporations to act in certain ways."); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 UNIV. PA. L. REV. 1021, 1029 (2007); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Funds Activism*, 115 COLUM. L. REV. 1085, 1093 (2015).

21. John Armour & Brian Cheffins, *The Rise and Fall (?) of Shareholder Activism by Hedge Funds*, 14 J. ALT. INVS. 17 (2012).

as partnerships in which capital investment is locked—there is no secondary market on which it can be bought and sold.[22] Hence, hedge funds must cater to the wishes of impatient investors who cannot freely exit and therefore opt for relatively short-term engagements. More so, hedge fund managers are expected to generate immediate returns on their investments. Failure to do so impairs their ability to raise money for future funds.

Our analysis therefore leads to the conclusion that none of the existing actors in the financial market are well suited to lead the incorporation of ESG goals into the agendas of commercial companies. Each actor either lacks the competence or the motivation (or both) necessary to further ESG goals. To address this problem, we propose a new market actor, uniquely designed to promote ESG goals: The Activist ESG Fund (AEF).

The AEF would have the following attributes that would enable it to fill the ESG gap. It would be a closed-end traded mutual fund,[23] designed for targeted activist investment in ESG initiatives. Unlike other institutional investors, including conventional Exchange Traded Funds (ETF) and green funds,[24] it would be a vehicle of undiversified investment. The closed-end traded fund structure would enable the fund management to have long horizons by attracting patient money, while impatient investors could always sell their shares on the highly liquid stock exchange. In addition, the remuneration structure of the AEF's management would be a carried interest à la the hedge fund model: it would provide managers with a significant share of its profits, similar to the hedge

22. *Id*. at 21.

23. A closed-end fund is a mutual fund that raises money from the public and is traded on an exchange in a similar manner to a public corporation. It is also designed to invest in other companies. The difference between closed- and open-end mutual funds is that the former do not allow withdrawal of money from the fund on a continuous basis. A close-end fund may be terminated by its management or by a special majority of its investors. *See* Morningstar, *What Is a Closed-End Fund?* FIDELITY [hereinafter *What Is a Closed-End Fund?*] https://www.fidelity.com/learning-center/investment-products/closed-end-funds/what-are-closed-end-funds [https://perma.cc/99TT-57HQ] (last visited Mar. 6, 2024).

24. A green fund is a mutual fund or any other investment vehicle that limits its investments to environmentally sustainable companies. *See e.g.*, George Serafeim, *Social-Impact Efforts that Create Real Value*, 98 HARV. BUS. REV. 38 (2020), https://hbr.org/2020/09/social-impact-efforts-that-create-real-value [https://perma.cc/F2K6-4N6Q].

fund's conventional twenty-percent cut. At the same time, the AEF would differ from *standard* activist hedge funds in that it would have an unlimited term of organizational structure (no partnership dissolution date). And even more importantly, it would have a secondary liquid market for its securities.

The AEF would have the requisite competence to promote ESG goals. Like other activist hedge funds,[25] it would analyze companies that underperform on the ESG front, create a new business plan for them, and engage their management to ensure that they execute the new vision. As for motivation, the AEF, as we envision it, would be properly incentivized to further ESG goals. In contrast to traditional activist hedge funds that are focused on short-term success, the AEF would have *long*-term horizons because its shares would be publicly traded. Funds' investors in need of liquidity would be able to sell their shares on the market, allowing the AEF to pursue its goals unimpeded.

Notably, our proposal faces an obstacle under current law. The 1940 Investment Company Act imposes heavy regulation on investment companies (including closed-end funds).[26] To discourage fund managers from excessive risk-taking, the Investment Act strongly disfavors success fees.[27] This stance is in tension with our vision of incentivizing the AEF managers via generous success fees that are typical of unregulated hedge funds. Such fees are required to provide the necessary high-powered incentives that are part and parcel of our scheme. The establishment of the AEF would thus require either an exemption from the Investment Company Act or a targeted amendment of the Act's provision concerning success fees.

This Article unfolds in four parts. Part I presents the pressing issue of ESG and the importance of incorporating it into commercial firms. Part II discusses the challenge of incorporating ESG strategies. It focuses specifically on the various players in the financial markets who have the potential to promote ESG objectives and shows why they are ill suited for the challenge. Part III then presents a novel financial vehicle especially designed to fill the ESG gap: the AEF. It also demonstrates how the AEF encompasses and

25. Goshen & Hannes, *supra* note 20, at 283–85.
26. The Investment Company Act of 1940, 15 U.S.C. § 80a-1–64 (2000).
27. Investment Advisory Act of 1940, 15 U.S.C. § 80b-5(a)(1).

combines the advantages of other corporate players and thus represents an ideal vehicle for repurposing firms and transforming the corporate world. A conclusion will follow, reemphasizing the potential contribution of AEFs to advancing ESG goals.

## I. THE CASE FOR ESG

The view that corporations ought to broaden their goals beyond profit maximization for shareholders to include environmental, social, and governance goals is gaining momentum in the corporate world.[28] Proponents of the view advance three principal justifications for their position: long-term value maximization, stakeholderism,[29] and investors' social preferences. We discuss these principles in order.

### *A. Long-Term Value Maximization*

According to the long-term value maximization argument, investment in ESG goals would eventually yield greater returns as it maximizes company value in the long run. Hence, by pursuing ESG goals, shareholders would actually be doing well by doing good.

The long-term value maximization justification therefore does not require one to deviate from the traditional belief that the purpose of corporations is to maximize value for the shareholders, but rather—as its name suggests—emphasizes *long-term* value maximization. Under this view, the pursuit of ESG goals is fully consistent with shareholders' financial interests.[30] Per

28. BUS. ROUNDTABLE, *supra* note 8; *see also* COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD, OXFORD UNIVERSITY PRESS (2019).

29. *See* our discussion, *infra* pp. 1149–50.

30. Max Schanzenbach and Robert Sitkoff have dubbed such motivation for ESG "Risk-Return ESG." For a concise description of this view, see Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 STAN. L. REV. 381, 390 (2020). More recently, scholars such as Virginia Harper Ho, Robert Barlett, and Ryan Bubb have utilized the term "enlightened shareholder value," a term originally coined by Michael Jensen, to describe the maximization of shareholder long-term financial returns motivation for ESG. *See* Robert P. Bartlett & Ryan Bubb, *Corporate Social Responsibility Through Shareholder Governance* (European Corp. Governance Inst., Working Paper No. 682/2023, 2023),

the shareholder-profit-maximization justification for taking into account ESG considerations, corporations have long prioritized short-term profit maximization over long-term value enhancement.[31] The excessive focus on short-term performance, driven in large part by the compensation structures adopted by corporations,[32] has prompted corporations to sacrifice sustainable profitability at the altar of immediate returns. Consequently, corporations have refrained from adopting green technology and making social and governance changes that benefit shareholders in the long haul, instead engaging in a value-destroying "race to the bottom."[33] Incorporating ESG values into firms' strategic plans works to correct the distorted prism adopted by corporations for centuries and endows them with a correct perspective that not only serves society at large, but also their shareholders.

Empirical evidence supports the long-term value maximization brought about by promoting ESG goals. Although it is a complex task to measure the correlation between ESG goals and financial performance,[34] a meta-study of 159 articles concluded that 63% thereof detected a correlation between corporate social and environmental performance and financial performance.[35]

There are many possible explanations for why the pursuit of ESG goals may ultimately enhance shareholders' value and

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4354220; Virginia Harper Ho, *Enlightened Shareholder Value: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59 (2010); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 16 (2001). For a critical view of the concept of enlightened shareholder value, see Lucian Bebchuk, Kobi Kastiel & Roberto Tallarita, *Does Enlightened Shareholder Value Add Value?*, 77 BUS. LAW. 731 (2022) (arguing that the cases in which consideration of stakeholder interests is a win-win for shareholders are rare, and that adoption of enlightened shareholder value may deceive stakeholders that their interests are taken into account when there is no real difference in the conduct of managers between adopting shareholder value and adopting enhanced shareholder value as the corporation's main goal).

31. Lipton, *Stakeholder Capitalism and ESG*, *supra* note 2.

32. Lucian Bebchuk & Jesse Fried, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 60 (2004). *See also* Bhagat et al., *supra* note 14, at 523; Paul Brockman, Xiumin Martin & Emre Unlu, *Executive Compensation and the Maturity Structure of Corporate Debt*, 65 J. FIN. 1123 (2010).

33. Lipton et al., *The New Paradigm*, *supra* note 2, at 18–19.

34. *See* Herman Aguinis & Ante Glavas, *What We Know and Don't Know About Corporate Social Responsibility: A Review and Research Agenda*, 38 J. MGMT. 932, 941 (2012).

35. John Peloza, *The Challenge of Measuring Financial Impacts from Investments in Corporate Social Performance*, 35 J. MGMT. 1518, 1520-21 (2009).

financial performance.[36] First, promoting social objectives improves the relationship between the firm and various stakeholders, such as employees, suppliers, and customers.[37] These improved relationships translate into higher productivity of employees and greater loyalty of customers that generate higher profits.

Second, ESG functions as a form of insurance that protects the company if negative events occur—it serves as a proxy to the company's compliance and creates goodwill.[38] If a company experiences an adverse event, such as an oil spill, the goodwill the company has accrued via its ESG activities will help fend off pressures from prosecutors, shareholders, and the public at large. A firm's ESG record signals that the oil spill did not occur because of indifference or intentional disregard, but rather was an accident or was caused by force majeure. Mitigating nonfinancial risk may even reduce the cost of capital for firms.[39] Investors may be

36. For a full analysis of the various ways ESG may create value, see Witold Henisz, Tim Koller & Robin Nuttall, *Five Ways that ESG Creates Value*, MCKINSEY Q. (Nov. 14, 2019), https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Strategy%20and%20Corporate%20Finance/Our%20Insights/Five%20ways%20that%20ESG%20creates%20value/Five-ways-that-ESG-creates-value.ashx [https://perma.cc/6WBP-MN73]. *See also* Patrick Bolton, Zachery Halem & Marcin Kacpercyk, *The Financial Cost of Carbon*, 34 J. APPLIED CORP. FIN. 17 (2022).

37. *See* Tom J. Brown & Peter A. Dacin, *The Company and the Product: Corporate Associations and Consumer Product Responses*, 61 J. MKTG. 68 (1997) (examining the impact of promotion of social objectives on customers); Daniel B. Turban & Daniel W. Greening, *Corporate Social Performance and Organizational Attractiveness to Prospective Employees*, 40 ACAD. MGMT. J. 658 (1997) (examining the impact of promotion of social objectives on employees).

38. John Armour, Luca Enriques, Ariel Ezrachi & John Vella, *Putting Technology to Good Use for Society: The Role of Corporate, Competition and Tax Law,* 6 J. BRIT. ACAD. 285, 296 (2018). An additional study has found that promotion of social objectives tempers negative judgement and reduces sanctions. *See* Paul C. Godfrey, Craig B. Merrill & Jared M. Hansen, *The Relationship Between Corporate Social Responsibility and Shareholder Value: An Empirical Test of the Risk Management Hypothesis*, 30 STRATEGIC MGMT. J. 425 (2009). An additional study found similar, broader results: ESG practices mitigate downside risks to the firm in situations such as environmental disasters, employee strikes, product recall, boycotts, and criminal or civil liability. *See* Dinah A. Koehler & Eric J. Hespenheide, *Finding the Value in Environmental, Social, and Governance Performance*, 12 DELOITTE REV. 98 (Jan. 31, 2013), https://www2.deloitte.com/us/en/insights/deloitte-review/issue-12/finding-the-value-in-environmental-social-and-governance-performance.html [https://perma.cc/4C9G-BEV6].

39. Sudheer Chava, *Environmental Externalities and Cost of Capital*, 60 MGMT. SCI. 2223, 2225 (2014).

more willing to invest in companies whose exposure to potential liabilities on account of adverse events is mitigated by the goodwill developed through ESG activities.

Third, investment in ESG goals may serve as a signal of the high quality of a company's management and its concern for the corporation's performance in the long run.[40] Given the indirect positive effects of ESG and its contribution to companies' goodwill, managers that invest in such activities demonstrate they are aware of the complex relations between corporate activity and its valuation, and that they care about the corporation's long-term value.

Fourth, and finally, the pursuit of ESG goals protects the company from regulatory measures imposed on it to address the externality problem. For example, when a company decides to abort dirty production processes even at the cost of lowering its profits, it does not necessarily practice altruism. It is highly likely that future regulation would force companies to switch to cleaner production technology and energy sources. Hence, firms may be better off addressing these problems on their own terms at a time that is convenient for them, before the regulator forces them to achieve the same result under less favorable conditions.

### *B. Stakeholderism*

The second justification for furthering ESG goals—stakeholderism—goes one step beyond the long-term value maximization justification. It justifies the pursuit of ESG goals even when it comes at the expense of the financial performance of firms, either in the short or long run. According to the stakeholderist vision, the purpose of the corporation in not to focus solely on the interests of shareholders, but also to account for the interests of other constituencies that have a role in the corporation's success, such as employees, consumers, debtors, the community, and

40. Schanzenbach & Sitkoff, *supra* note 30, at 435 (noting the possibility that it is not only a mere correlation that ESG reflects the broadmindedness of management: the company's ESG activity may attract better managers to the firm).

Benabou and Tirole raise a different possible connection between management quality and ESG: involvement of the company with ESG issues will encourage more stringent environmental, labor, and safety regulation, which will increase the costs for the company's rivals that do not promote such goals as effectively. *See* Roland Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1, 9–10 (2010).

society at large. The stakeholderist view dates back to the classic debate from the 1930s between Professor Merrick Dodd from the Harvard Law School and Professor Adolf Berle from Columbia Law School regarding the purpose of the corporation. Adolf Berle represented the view that managers should act "only for the ratable benefit of all the shareholders."[41] In contrast, Merrick Dodd held the view that a corporation "has a social service as well as a profit-making function."[42] Berle himself admitted in the 1950s that the debate "ha[d] been settled (at least for the time being) squarely in favor of Professor Dodd's contention."[43] But the debate is far from settled.

A 1980s upsurge in the support for stakeholder primacy came in response to a wave of hostile takeovers that swept through the corporate world.[44] In the 1990s, The Dodd-Berle debate experienced a revival and became a popular topic for legal symposia.[45] In 2000, however, Professor Henry Hansmann and Professor Reinier Kraakman published *The End of History for Corporate Law*,[46] proclaiming that shareholder primacy has become the norm around the world. The article seemed to have settled the matter, but not for long. In recent years, the philosophy of stakeholderism is gaining popularity, as demonstrated by the support it enjoys in contemporary corporate law scholarship.[47]

41. Berle, *supra* note 1, at 1049.

42. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

43. ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954).

44. *See* R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, 25 CAL. MGMT. REV. 88 (1983); R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 208 (1984).

45. *See, e.g.*, Jeffrey G. MacIntosh, *Designing an Efficient Fiduciary Law*, 43 UNIV. TORONTO L.J. 425, 426 (1993); David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993).

46. *See* Hansmann & Kraakman, *supra* note 1, at 440–41.

47. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS AND THE PUBLIC (2012); Justin Blount, *Creating a Stakeholder Democracy Under Existing Corporate Law*, 18 UNIV. PA. J. BUS. L. 365 (2016); Iris Chiu, *Operationalising a Stakeholder Conception in Company Law*, 10 L. & FIN. MKTS. REV. 173 (2016).

### *C. Shareholder Social Preferences*

Finally, there is also a third justification for promoting ESG goals that occupies a middle ground between the two other justifications: shareholder social preferences. Proponents of this view maintain that corporations ought to try to maximize shareholders' welfare, a measure that encompasses not only shareholders' financial profits but also their ESG preferences. In contrast to stakeholderism, which broadens the prism of analysis to include groups and constituencies other than shareholders, the shareholder social preferences justification is fully consistent with the shareholder primacy view in that it accepts the premise that corporate decisionmakers should focus exclusively on shareholders. But unlike the "classic" shareholder primacy view that identifies shareholder primacy with maximizing *monetary* profits and share value, the shareholder social preferences justification is directed toward maximizing shareholders' financial and *nonfinancial* interests. Because shareholders may have a preference that the company in which they invest pursues ESG goals, management must respect this preference and manage the company accordingly—even if doing so entails lower profits. Nobel Laureate Professor Oliver Hart and Professor Luigi Zingales have espoused this view.[48] However, another Nobel Prize winner, Professor Milton Friedman, raised a major challenge to this view. Friedman posited that if shareholders have a set of social or environmental preferences, they should promote them in venues outside the market arena—for example, in the charitable or political sphere, while corporations should keep in mind that the "[t]he business of business is business."[49] According to Friedman, bundling together business activity geared toward generating

48. Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCT. 247 (2017).

49. FRIEDMAN, *supra* note 1. Friedman presented his views more sharply in a New York Times article: Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (Sept. 13, 1970) https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html [https://perma.cc/TV7Z-5SLA]. There is evidence that managers still believe in Friedman's view. *See* Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467, 1534 (2021) ("[O]ur findings raise concerns about the extent to which corporate leaders should be expected to give weight to stakeholder interests."); Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *Stakeholder Capitalism in the Time of Covid*, 40 YALE J. REG. 64 (2023).

financial profits with social objectives is suboptimal, as it forces some of the shareholders to contribute to social objectives they are not interested in contributing to.

Hart and Zingales disagree with Friedman. They contend that certain social objectives can be promoted effectively only through the business sector for two reasons: First, commercial companies may have the "technology" to promote social objectives effectively.[50] And second, some ethical activities are inseparable from corporate money-making enterprises.[51] To illustrate these points, they use the example of gun control. Trinity Wall Street, a shareholder of Walmart, has pushed Walmart via shareholder proposals to refrain from selling automatic weapons. A shareholder does not seem to have a cost-effective alternative to promote this goal outside the market sphere. In the legal and political spheres, there are virtually insurmountable hurdles that prevent promoting this objective, ranging from Second Amendment constitutional limits on gun control legislation to the powerful lobby of the NRA and guns manufacturers.[52] The same is true of carbon emissions. Due to pressure from strong interest groups and inability to achieve international consensus, the political process has failed to produce adequate measures to reduce carbon emissions. The public's voice in the political arena has been muffled in recent years. But not all hope is lost because shareholders can use their voices within corporations to effectively promote environmentally friendly policies. [53]

The ESG preferences of shareholders are not a mere theoretical construct. They constitute a pervasive phenomenon that is constantly growing. In 2021, overall investments in ESG-oriented businesses reached \$35 trillion, and this number is expected to rise to \$50 trillion by 2025.[54] Similarly, ESG-oriented mutual funds and ETFs rose by 53% worldwide in 2021 to \$2.7 trillion, and have seen

50. Hart & Zingales, *supra* note 48, at 249.

51. *Id.* at 249–50. For a similar argument, see also Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U L. REV. 733, 740, 796 (2015).

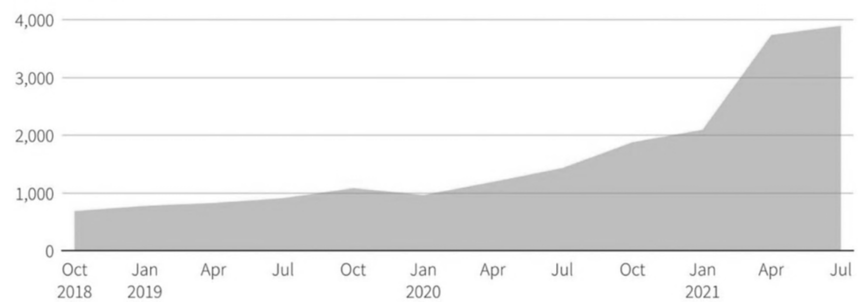
52. Hart & Zingales, *supra* note 48, at 250.

53. *Id.*

54. Kishan, *supra* note 3.

an increase in assets under management (AUM) of $596 billion.[55] It is estimated that in 2022, more than half of all investors invested in ESG products, an increase of more than 100% relative to 2019.[56] Moreover, the lion's share of all investors in alternative funds—88%—requested information from investment managers about the role of ESG in their investment decisions and portfolio building.[57]

*Table 1: Sustainable Funds' Asset Size (in $ billions)*




Source: Patturaja Murugaboopathy & Anurag Maan, *Global Sustainable Fund Assets Hit Record $3.9 Trillion in Q3, Says Morningstar*, REUTERS (Oct. 29, 2021, 9:43 AM), https://www.reuters.com/business/sustainable-business/global-sustainable-fund-assets-hit-record-39-trillion-q3-says-morningstar-2021-10-29 (based on Morningstar data).

ESG preferences are not only reflected on the fund or investment management level, but also on the company level: a large majority of large U.S. company shareholders support shareholders' ESG proposals. For instance, 81% of DuPont shareholders approved a proposal requiring the company to disclose how much plastic it releases into the environment each

55. *Id*. It should be noted that the definition of ESG funds is open ended, which could explain discrepancies between various data sources. For example, Morningstar data, on which *Table 1* below is based, has estimated that ESG funds in the second half of 2021 have reached $3.9 billion, which is significantly higher than the $2.7 billion Bloomberg estimation quotes above. Assets under management, also known as AUM, refers to the combined market value of all investments an individual or entity manages for clients. *See* James Chen, *Assets Under Management (AUM): Definition, Calculation, and Example*, INVESTOPEDIA, https://www.investopedia.com/terms/a/aum.asp (last updated Sept. 29, 2023).

56. Munson et al., *supra* note 5.

57. *Id*.

year, and to assess the effectiveness of its pollution policies.[58] Similarly, 63.9% of ExxonMobil's shareholders supported a proposal requiring the company to describe how its lobbying activities align with the Paris Climate Agreement's goal of limiting global warming to less than two degrees Celsius.[59] And 52% of shareholders of Duke Energy Shareholders support a proposal for the company to disclose contributions to candidates, parties, committees, and 501(c)(4) organizations.[60]

And at least to some extent, corporations respond to shareholders' initiatives and are sensitive to their social preferences. Shareholder demand for promoting ESG has pushed most U.S. companies to publish a corporate social responsibility report—in 2017, 83% of the top 100 U.S. companies did so. This is true also for Europe, where 77% of the top 100 companies publish such reports, and for Asia, where 78% of the top 100 companies have adopted this practice. Of the largest 250 global companies, 93% publish a corporate responsibility report.[61]

It is also important to note that the above-mentioned three justifications directing corporations to pursue ESG goals are not mutually exclusive, and they may be linked in various ways. For instance, the increase in investors' preferences for ESG investments may be driven by their belief that ESG contributes to long-term financial performance.[62] Causation may also run in the opposite

58. Kevin Crowley, *DuPont Loses Plastic Pollution Vote with Record 81% Rebellion*, BLOOMBERG (May 3, 2021, 1:51 PM) https://www.bloomberg.com/news/articles/2021-05-03/dupont-loses-plastic-pollution-vote-with-record-81-rebellion [https://perma.cc/JA8N-TJ44].

59. *Report on Corporate Climate Lobbying in Line with Paris Agreement* (XOM, 2021 Res), CERES, https://engagements.ceres.org/ceres_engagementdetailpage?recID=a0l1H00000CjqZOQAZ [https://perma.cc/G29F-EAFN] (last visited Mar. 10, 2024).

60. Andrew Ramonas & Lydia Beyoud, *Activist Shareholders Score Wins on Election Spending After Riot*, BLOOMBERG (July 14, 2021, 8:32 AM) https://news.bloomberglaw.com/securities-law/activist-shareholders-score-wins-on-election-spending-after-riot [https://perma.cc/GYF5-8U4D].

61. Letter from Cynthia A. Williams, Osla Chair in Business Law, York Univ., & Jill E. Fisch, Saul A. Fox Distinguished Professor Business Law, Univ. Pa. L. Sch. To Brent J. Fields, Sec'y, U.S. SEC. & EXCH. COMM'N 8–10 (Oct. 1, 2018) https://www.sec.gov/rules/petitions/2018/petn4-730.pdf [https://perma.cc/758V-RRTU].

62. Chava, *supra* note 39, at 2223. Numerous scholars are skeptical regarding the ability of ESG activity to affect the cost of capital both for ESG-promoting firms and for those

direction: commitment to ESG goals can attract investors, which lowers the cost of raising capital and improves financial performance. In any case, shareholders' interest in promoting ESG values provides an independent reason for managers to pursue them.

A different question arises in this context: What is causing the growth in demand for ESG? There are a few answers to this question. For one, there are pressing *new* challenges that confront society, such as global warming and social inequality. Although environmental and social problems have accompanied us since time immemorial, they have reached unprecedented levels in recent years. It is the prevailing view among environmental scientists that we are perilously close to the point of no return.[63] Similarly, wealth disparities among and within groups have become so extreme that they threaten to unravel the social fabric that unites us.[64]

A second reason is the growing disbelief in the efficacy of government to confront contemporary challenges.[65] An increasing number of Americans believe that the political process is broken beyond repair. Even if this view is too extreme, the frictions between Republicans and Democrats have rendered the political mechanism currently dysfunctional, and waiting for it to improve is not a realistic option.

A third, and final, explanation focuses on millennials. Professor Michal Barzuza has powerfully argued that millennial investors have brought with them a new set of tastes and preferences. Millennials attribute much more weight to social and other real

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not promoting ESG. *See* Schanzenbach & Sitkoff, *supra* note 30, at 398–99 (claiming that such effect "is unlikely given the depth and liquidity of modern financial markets"); Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *Essay: How Investors Can (and Can't) Create Social Value*, 44 J. CORP. L. 205, 210 (2018); Eleonora Broccardo, Oliver Hart & Luigi Zingales, *Exit v. Voice*, 130 J. POL. ECON. 3101, 3121–26 (2022) (arguing that the strategy of divesting companies of stocks when companies do not promote ESG often fails to have any impact due to the many investors who do not care about ESG in their investment decisions).

63. *See* Vivan Sorab, *Too Little, Too Late? Carbon Emissions and the Point of No Return*, YALE ENV'T REV. (March 26, 2019), https://environment-review.yale.edu/too-little-too-late-carbon-emissions-and-point-no-return [https://perma.cc/C7GQ-MJA7].

64. Ana Monteiro, *IMF Warns of Social Unrest, Trust Erosion as Inequality Worsens*, BLOOMBERG (Apr. 1, 2021, 7:00 AM), https://www.bloomberg.com/news/articles/2021-04-01/imf-warns-of-social-unrest-trust-erosion-as-inequality-worsens [https://perma.cc/6TM4-8T83].

65. Macey, *supra* note 7, at 11.

world effects of their investments, and do not focus solely on financial returns.[66] They are much more sensitive to the impact of their investments on the environment.[67] The preferences of millennial investors have been noted by financial giants, such as BlackRock, Deloitte, PricewaterhouseCoopers, Morgan Stanley, and Wells Fargo, who have started catering to them.[68] BlackRock and Wells Fargo were the first financial firms to form ESG retirement saving plans targeting millennials as early as 2018.[69] The prominence of millennials in driving the shift toward ESG-oriented investing has been emphasized in various prominent media outlets, such as the Financial Times, The Economist, and CNN.[70]

In this case, too, the causes may be interconnected. The preferences of millennials may have been shaped by the significant environmental and social challenges into which they were born. It is likewise possible that the disillusionment of millennials with the political system prompted them to search for a different arena in which they could express their preferences and have a stronger voice. One can also argue that the mounting environmental and social problems are the result of our political system's malfunctioning. Or vice versa: that the social and environmental challenges have exposed the limits of our political system and brought about a paralysis. Regardless, the demand for ESG is not a fleeting phenomenon. Nor is it a fad that can be dismissed or brushed aside. The demand for an ESG-oriented corporate world is real. Investors expect companies to promote ESG goals and fashion their investment decisions accordingly. Yet a key problem remains. As we will show in the next Part, existing market actors are ill

66. Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243, 1284–85 (2020).

67. FIDELITY CHARITABLE, IMPACT INVESTING: AT A TIPPING POINT? 3 (2018), https://www.fidelitycharitable.org/content/dam/fc-public/docs/insights/impact-investing-at-a-tipping-point.pdf [https://perma.cc/GS52-TXM5] (reporting findings that 77% of affluent millennials indicated that they have made some form of impact investment, in contrast to 30% among baby boomers and older generations).

68. Barzuza et al., *supra* note 66, at 1289.

69. *Id*. at 1300. *See also* Giovanni Strampelli, *Can BlackRock Save the Planet? The Institutional Investors' Role in Stakeholder Capitalism*, 11 HARV. BUS. L. REV. ONLINE 1 (2020).

70. Barzuza et al., *supra* note 66, at 1290 n.147.

suited for the task of promoting ESG goals. They lack either the competence or the motivation necessary for this mission. Therefore, at present, the demand for incorporating ESG goals into corporate governance structures and business plans cannot be adequately addressed.[71] We refer to this problem as the ESG gap.

## II. The Root Causes of the ESG Gap

As the previous Part established, promoting ESG values is widely perceived as a laudable goal. But it is not easily attainable. Even though investors are interested in promoting ESG targets, institutional factors stand in the way of effectively promoting ESG goals.

In this Part, we will analyze the effectiveness of each of the major market actors—namely, managers, institutional investors, and activist hedge funds—in promoting ESG goals. We will analyze each of these relevant market actors along two dimensions: motivation and competence.

Motivation refers to the willingness or desire of the relevant agent to engage in promoting ESG. Motivation may be internal or external. It may stem from the agent's ideology or beliefs, or it may arise from the agent's compensation or reward system.

Competence denotes the ability of the relevant agent to pursue ESG goals. It refers to the agent's position within (or outside) the corporation, degree of sophistication, familiarity with the corporation, and ability to affect the corporation's path.

Both competence and motivation are required to effectively promote ESG. An actor who has strong motivation to further ESG goals but lacks the requisite competence will fail to effectively advance ESG. Similarly, an agent who possesses the necessary skillset to promote ESG but lacks the motivation to do so cannot be trusted to promote ESG values. This is because ESG goals are, by nature, oriented toward the long term.[72] They involve wide-scale

71. Interestingly, Mark Roe argues that only firms in oligopolistic industries that enjoy supercompetitive rents currently engage extensively in ESG initiatives. *See* Mark J. Roe, *Corporate Purpose and Corporate Competition*, (European Corp. Governance Inst., Law Working Paper No. 601, 2021) 2–3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3817788.

72. Henisz et al., *supra* note 36, at 3, 9 ("[A] strong ESG proposition can safeguard a company's long-term success . . . . [B]eing thoughtful and transparent about ESG risk enhances long-term value—even if doing so can feel uncomfortable and engender some short-term pain."); Ilze Zumente & Julija Bistrova, *ESG Importance for Long-Term Shareholder*

changes that cannot take place overnight; they are highly complex and multidimensional.[73] Their pursuit entails a high degree of uncertainty. Successful implementation of ESG policies in the corporate context requires weaving them effectively into the operation of the corporation, while utilizing the comparative advantage of the corporation in furthering such goals. Market actors geared toward short-term success are, therefore, unlikely to have the requisite patience for pursuing ESG goals. Similarly, market actors who are unwilling to sacrifice short-term personal financial rewards in exchange for remote or societal ones are ill suited for the mission of advancing ESG goals.

Competence sets an equally high bar. Integrating ESG values into corporations requires intimate familiarity with the business of the corporation, and an understanding of the exact way in which ESG goals could be woven into its existing business model and functioning. Hence, from a competence standpoint, only actors who possess firm-specific acumen can succeed in advancing ESG interests. As we will show in the following paragraphs, none of the existing market actors possesses both the requisite motivation and the necessary competence to advance ESG goals.

### *A. Management*

The first category of actors who come up in scholarly discussions about the future path of corporations is management. At first glance, management seems to possess the required competence to integrate ESG goals into the business model of corporations. Management is intimately familiar with firm activity,

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*Value Creation: Literature vs. Practice,* 7 J. OPEN INNOVATION: TECH. MKT. COMPLEXITY 1, 10 (2021) ("[T]o ensure its place in the economy in the long term[,] . . . ESG performance translates into sustainable shareholder value via the value drivers.").

73. Marc J. Epstein, Adriana Rejc Buhovac & Kristi Yuthas, *Managing Social, Environmental and Financial Performance Simultaneously*, 48 LONG RANGE PLAN. 35, 43 (2015) ("In fact, sustainability decision-making is marked by considerable uncertainty because of changing expectations, the complexity of the problem, and the difficulty of its resolution (Bansal, 2005). Companies will try to reduce the level of uncertainty in their organizational environment by imitating the structures, systems and activities of successful similar companies."); Pratima Bansal, *Evolving Sustainably: A Longitudinal Study of Corporate Sustainable Development*, 26 STRATEGIC MGMT. J. 197, 202 (2005) ("Sustainable development is marked by considerable uncertainty because of changing expectations, the complexity of the problem, and the difficulty of its resolution.").

including its strengths and weaknesses.[74] It understands the firm's governance structure and the various levers that may be used to pass resolutions within the firm. Moreover, it has firsthand knowledge of the various business possibilities and strategies that are open to the corporation.[75] Management is therefore well positioned to design a business strategy and select business opportunities that are necessary to advance ESG goals.

A closer examination, however, raises questions about the management's competence. A *sine qua non* for promoting ESG goals is acceptance of the ESG vision. Management, however, often suffers from tunnel vision, as managers are mostly trained to pursue routine financial goals.[76] They may likewise be captured by the existing business paradigm, which prevents them from appreciating—let alone attempting—alternative pathways for businesses. This may irrationally prevent them from even searching for the right fix. As we noted, managers have a high level of familiarity with their company, which provides them with an edge in incorporating ESG goals, but their capture by the traditional function of management—which by and large disregards ESG values—undermines their fitness to serve as agents of change. Moreover, for many seasoned managers, acknowledging the importance of ESG goals is tantamount to admitting failure. The endorsement of ESG philosophy requires management to acknowledge that the philosophy of profit maximization that served as their lodestar for years is either incorrect or incomplete. Managers may be unable to accept this change, or at the very least, unwilling to admit it. Given the unconscious aspect of this effect, we view it as a problem of competence and not one of ill motivation.

74. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 252 (1999).

75. *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) ("A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation."); Grant Hayden & Matthew T. Bodie, *Shareholder Democracy and the Curious Turn toward Board Primacy*, 51 WM. & MARY L. REV. 2071, 2076 (2010).

76. Posavac, *supra* note 13, at 102; Elizabeth Pollman, *Corporate Social Responsibility, ESG, and Compliance, in* THE CAMBRIDGE HANDBOOK OF COMPLIANCE 662 (Benjamin van Rooij & D. Daniel Sokol eds., 2021); Ki-Hoon Lee & Robert Ball, *Achieving Sustainable Corporate Competitiveness: Strategic Link Between Top Management's (Green) Commitment and Corporate Environmental Strategy,* 44 GREENER MGMT. INT'L J. 89, 101 ("[T]op executives do not consider green issues as new opportunities. Rather, they think of these issues as extra costs.").

This takes us to the managerial motivation problem. Indeed, the main problem that impedes management's ability to promote ESG goals is lack of motivation. To begin, management's compensation is tied to short-term returns.[77] A large fraction of the management's compensation package is based on annual and even quarterly benchmarks, such as sales, revenues, and returns per share.[78] And while equity-based compensation (such as restricted shares and stock options) is common,[79] it is sub-optimally designed to vest over a few years.[80] Overall, the design of management's pay package makes managers especially sensitive to the performance of the firm in the short run.[81]

There are some propositions to remold managerial compensation to include financial payoffs for ESG activity,[82] as well as proposals

77. Bebchuk & Fried, *supra* note 14, at 6–7; Kevin J. Murphy, *Executive Compensation, in* 3B HANDBOOK OF LABOR ECONOMICS 2485, 2499 (Orley Ashenfelter & David Card eds., 1999) ("[A]ccounting profits are inherently backward-looking and short-run, and managers focused only on accounting profits may avoid actions that reduce current profitability but increase future profitability, such as cutting R&D."); Patrick Bolton, Jose Scheinkman & Wei Xiong, *Executive Compensation and Short-Termist Behaviour in Speculative Markets,* 73 REV. ECON. STUD. 577, 579 (2006); Patrick Bolton, Jose Scheinkman & Wei Xiong, *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 101, 113 (2005); Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. REG. 359, 363 (2009).

78. *See generally* Luann J. Lyncha & Susan E. Perry, *An Overview of Management Compensation*, 21 J. ACCT. ED. 43, 51 (2003); Stephen Bryan, LeeSeok Hwang & Steven Lilien, *CEO Stock-Based Compensation: An Empirical Analysis of Incentive-Intensity, Relative Mix, and Economic Determinants*, 73 J. BUS. 661, 664–65 (2000); Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCT. ECON. 3, 35–36 (2002).

79. *See* Partha Mohanram, Brian White & Wuyang Zhao, *Stock-Based Compensation, Financial Analysts, and Equity Overvaluation,* 25 REV. ACCT. STUD. 1040, 1041 (2020).

80. BEBCHUK & FRIED, *supra* note 14, at 189–90 ("Well-designed executive compensation can provide executives with cost-effective incentives to generate value for shareholders. Unfortunately, the promise of such arrangements has not yet been fully realized.").

81. Wilbur Lewellen, Claudio Loderer & Kenneth Martin, *Executive Compensation and Executive Incentive Problems: An Empirical Analysis,* 9 J. ACCT. & ECON 287, 289–90 (1987); Alex Edmans, Vivian W. Fang & Allen H. Huang, *The Long-Term Consequences of Short-Term Incentives*, 60(3) J. ACCT. RSCH. 1007, 1012 (2021).

82. *See*, *e.g.*, Tom Gosling & Philippa O'Connor, *Executive Pay and ESG Performance*, HARV. L. SCH. F. ON CORP. GOV. 1 (Apr. 12, 2021) ("The pressure to include ESG targets in pay is coming not just from special interest groups but from customers, employees, and, increasingly, investors and regulators."). *See also* Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation,* 48 J. CORP. L. 37, 44–45, 45 n.24(2002).

to improve the long-term focus of executive pay.[83] But these attempts have not been highly successful thus far,[84] primarily because it is much harder to quantify and assess ESG benchmarks. The markers of ESG success are murkier than those of financial success. Even among ESG supporters, there exists no consensus regarding which activities should count as ESG.

Furthermore, in order to establish an ESG benchmark that would enable creating an ordinal ranking of ESG goals for managers, ESG activities must be converted to a scale that attributes a certain weight to each activity. This requires making value judgements about various ESG activities. Even when there is agreement regarding the "ESGness" of certain types of activities, it is much harder to reach consensus regarding the relative weight that should be assigned to various types of activities. Should board diversity count more than equalizing employee pay between genders or among ethnic groups? If yes, to what extent? On the environmental front, should a small reduction in pollution count more heavily than a charitable contribution to environmental purposes offsetting the pollution of the company? If yes, by how much?

It is true that there are many indexes that attempt to provide firms with ESG rankings, but there is great variation among them due to the inherent difficulty in determining the relative significance of various ESG goals.[85] Such variation does not exist in the measurement of financial performance, for which there are clear and broadly agreed-upon indicators. The variation and uncertainty regarding ESG assessments make utilizing such indicators for evaluating managerial performance highly contestable.

There are other reasons for managers' unwillingness to get on the ESG bandwagon. While shareholders may be willing to trade financial profits for ESG promotion, managers will likely be

83. Sanjai Bhagat & Roberta Romano, *Reforming Executive Compensation: Focusing and Committing to the Long-Term*, 26 YALE J. L. ECON. 359, 374 (2009); Bebchuk & Fried, *supra* note 14, at 189–200.

84. Bebchuk & Tallarita, *supra* note 82, at 37. ("[T]he use of ESG-based compensation has, at best, a questionable promise and poses significant perils.").

85. Agnes Sipiczki, *A Critical Look at the ESG Market*, CEPS POLICY INSIGHTS 1, 4 (2022), https://www.ceps.eu/wp-content/uploads/2022/04/PI2022-15_A-critical-look-at-the-ESG-market.pdf; Sakis Kotsantonis & George Serafeim, *Four Things No One Will Tell You About ESG Data*, 32 J. APPLIED CORP. FIN. 50, 54 (2019).

reluctant to do so.[86] Shareholders are diversified. Hence, a lower return on one of their portfolio companies does not ordinarily have a substantial impact on their financial well-being. In contrast, management is not diversified: all of management's human capital is invested in the company for which they work. Lower financial returns for the company have a significant impact on the wealth of management.[87] Furthermore, managers' future market value is largely affected by their firms' financial performance.[88] Even though some corporations would want to hire managers that promote ESG, managerial track record is largely determined by financial performance at previous companies.[89]

Finally, as we already noted when we discussed the competence of managers, the current generation of managers is the one that created many of the challenges that ESG awareness aims to overcome. For instance, in many industries, the incumbent management is often the one that promoted a high emission strategy, which is now a threat. Hence, advancing ESG goals poses the risk of reputational costs, and in some cases, even legal liability to managers.

For these reasons, one cannot count on managers to serve as effective promoters of ESG goals and must search for other candidates to perform this task.

### *B. Institutional Investors*

The academic interest in institutional investors has risen exponentially in recent years. Professor Bernard Black was the first to point out that institutional investors may assist in overcoming the rational apathy problem of individual shareholders, engage in effective monitoring of management, and promote the interests of

86. Rodrigo Zeidan, *Why Don't Asset Managers Accelerate ESG Investing? A Sentiment Analysis Based on 13,000 Messages from Finance Professionals*, BUS. STRATEGY & ENV'T 1, 2 (2022), https://onlinelibrary.wiley.com/doi/full/10.1002/bse.3062 [https://perma.cc/HD2K-L8L8] ("Sentiment analysis indicates that asset managers mostly hold a negative view of ESG investing.").

87. Adi Libson, *Taking Shareholders' Social Preferences Seriously: Confronting a New Agency Problem*, 9 U.C. IRVINE L. REV. 699, 708 (2019).

88. Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88(2) J. POL. ECON. 288, 293 (1980).

89. *Id.*

all shareholders. Other scholars have followed suit.[90] This view has gained traction from the amazing growth in the holdings of institutional investors, and especially the Big Three—BlackRock, Vanguard, and State Street, which currently hold more than 18 trillion dollars in AUM.[91]

Building on these ideas, in a 2022 article,[92] Professor Jeffery Gordon argued that institutional investors may also constitute the most effective agent for promoting ESG policies.[93] He suggested that because institutional shareholders hold in their portfolios large segments of the whole market, their interest is to minimize systematic risks.[94] They are hardly concerned about idiosyncratic risks pertaining to each of their portfolio companies because the materialization of such risks will not have a significant impact on their portfolios. In contrast, market-wide systematic risks can devalue their entire portfolios. Thus, it is worthwhile for them to invest in mitigating market-wide risks.[95] Accordingly, they will support company actions aimed at reducing systemic risks, even if the expected gain to the mitigating company is actually smaller than the cost. For instance, if decreased drilling can help avert an environmental disaster that will affect all, or many, of institutional shareholders' portfolio companies, it makes sense for those shareholders to vote their oil company shares in favor of a proposal to decrease drilling, even though there may be a net

90. *See, e.g.*, Edward B. Rock, *Institutional Investors in Corporate Governance*, *in* OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 363–73 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) ("As shareholding becomes more concentrated, and the costs of coordination among shareholders drops, both of which have occurred in the last 20 years, shareholders can capture more of the gains, allowing them to move beyond rational apathy."). *But see* Lucian A. Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 107 (2017).

91. Shaun Bisman & Felipe Cambeiro, *Big Three Institutional Investor Updates,* CAP (March 25, 2022), https://www.capartners.com/cap-thinking/big-three-institutional-investor-updates.

92. Gordon, *supra* note 16, at 631.

93. For a similar argument, that institutional investors function as "universal owners" that can act as effective agents for the change in corporate conduct, see Frederick H. Alexander, *The Benefit Stance: Responsible Ownership in the Twenty-First Century*, 36 OXFORD REV. ECON. POL'Y 341, 356 (2020); *see also* Luca Enriques, *ESG and Shareholder Primacy: Why They Can Go Together, in* THE PALGRAVE HANDBOOK OF ESG AND CORPORATE GOVERNANCE, 131, 131–35 (Paulo Câmara & Filipe Morais, eds. 2022) ("[F]or investors of that kind, portfolio value maximization may well mean pushing for Environment, Social and Governance.").

94. Gordon, *supra* note 16, at 672, and accompanying text.

95. *Id.*

decrease in oil company profitability. This strategy is known as "portfolio primacy."[96]

Gordon argues that almost all ESG policies mitigate systematic risk. He uses policies for addressing global warming as an example.[97] Extreme weather fluctuations not only lead to increased sea levels and agricultural losses from arability, but they can also cause displacement of large population groups and trigger a global economic slump. Even a local climate shock could produce a "rising tide of debtor defaults" that would affect the global economy.[98]

Promoting the well-being of employees is another example. Corporate employees cannot diversify their human capital and do not benefit from the upside of risk-taking strategies to the same extent as shareholders.[99] Corporate strategy that serves shareholders' interests but endangers employment may therefore trigger social instability, leading employees to see the economic system as their foe. Such potential backlash entails a systematic risk: it may impose losses on the entire portfolio.[100] Employees may be the most significant cause of social unrest, but there may be many other causes, such as gender inequality, businesses that harm communities by polluting or otherwise, and even potential consumer backlash. These systemic risks can be ameliorated by institutional investors who protect the interests of stakeholders by fighting against layoffs (even when they may improve financial performance), pressing for equal gender representation on the board, and calling on corporations to give back to surrounding communities.

96. Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. 511, 514 (2023). ("This theory is based on the view that the goal of index funds is not to maximize the value of individual companies (shareholder primacy), but rather to maximize the value of their entire investment portfolio (portfolio primacy).")

97. Gordon, *supra* note 16, at 659.

98. *See* Peter Conti-Brown & David Wishnick, *Technocratic Pragmatism, Bureaucratic Expertise, and the Federal Reserve,* 130 YALE L. REV. 636, 689 (2021).

99. *See* Alex Raskolnikov, *Distributional Arguments, in Reverse*, 105 MINN L. REV. 1583, 1619 (2021) ("'[L]abor-market adjustment to trade shocks is stunningly slow.' Even more disturbing is growing evidence that 'less-skilled workers [are] less mobile and more sensitive to local shocks.' The U.S. labor market turned out to be not that efficient after all.").

100. Gordon, *supra* note 16, at 629.

Governance improvements, too, may mitigate systematic risk. The collapse of a large public corporation may cause a financial crisis which will adversely affect the entire portfolio of an institutional investor. Accordingly, adopting a governance mechanism that ensures the financial stability of large public firms mitigates systematic risk.

Though Gordon's argument regarding the strong motivation of institutional investors to promote ESG policies is appealing, scholars have noted it suffers from several limitations. It is true that ESG policies *can* mitigate systematic risk, and given institutional investors' sensitivity to systematic risk, they ought to divert most of their energy to mitigating such risk when possible. But as Professors Robert Bartlett and Ryan Bubb have noted, not all ESG policies mitigate the systematic risks to institutional investors' portfolios. Many of the externalities addressed by ESG do not fall in the category of interests that affect the market portfolio.[101] For instance, externalities that affect the health or well-being of individuals are not necessarily internalized through the market portfolio because the harm is born directly by individuals and not by public corporations. In addition, Professor Roberto Tallarita has pointed out that institutional investors are not really "universal owners" as Professor Gordon assumes.[102] A significant share of the institutional investor's assets is invested in funds that are designed to track specific industries or specific indices.[103] For those funds, it is impossible to offset the losses to certain companies with gains to firms in other business sectors.[104] For example, Tallarita uses the concrete example of an energy fund for whom the systematic benefits of reduced drilling are unlikely to make up for losses in sales.[105]

101. Bartlett & Bubb, *supra* note 30, at 46.

102. Tallarita, *supra* note 96, at 517; *see also* Kahan & Rock, *supra* note 9, at 6–7.

103. Tallarita, *supra* note 96, at 555–56. For a study that looks at the various types of funds, focuses on numerous parameters, and comprises the large institutional investors, see Adriana Z. Robertson, *Passive in Name Only: Delegated Management and "Index" Investing*, 36 YALE J. REG. 795, 815 (2019).

104. Tallarita, *supra* note 96, at 555–56.

105. *Id.* at 557. The variance in the weight of energy companies is exemplified in the comparison between two pervasive types of funds: growth funds and value funds. Energy companies comprise 5% of the iShares Russell 1000 Value ETF, which tracks value companies (companies with low market value relative to book value) in comparison to 0.25% in the

The preceding analysis shows that the picture of institutional investors portrayed by Gordon only partially tracks their complex web of motivations. A complete analysis of the motives of institutional investors reveals that, at best, they have partial incentives to promote ESG goals. This brings us, however, to the critical weakness of institutional investors in the ESG context: competence.

As noted above, effectively integrating ESG into a firm is a highly intricate matter. While some of the problems ESG addresses are systematic, the solutions must be tailor-made. Successfully integrating ESG requires close knowledge regarding the specific business affairs of the firm and the various business strategies it could employ. Institutional investors do not have the information and capabilities for repurposing business. They are not involved in the operative level of the firm and have no experience in that sphere. Just like in the financial performance sphere, where maxims like "buy low and sell high" are not very useful for improving the firm's financial performance, maxims ring hollow in the realm of the ESG sphere, which is at least as complex as the financial sphere. The prescription to "emit less $CO_2$" does little to advance the effective reduction of greenhouse gasses.

To achieve such significant pollution reduction, one must delve into a firm's production processes and analyze whether there are viable alternatives that will not unduly undermine the firm's financial performance. For instance, an institutional investor should not adopt a general guideline opposing downsizing. Downsizing may be essential to ensure the financial stability of corporations or as a precondition for switching to green production technologies. Fighting downsizing plans makes sense only after close analysis of productivity patterns, potential employment plans, and potential technology upgrades. Generally, insofar as ESG promotion is concerned, the policy must be tailored to the company after a close analysis of that company's

iShares Russel 1000 Growth ETF, which focusses on growth companies (companies with relatively high market value compared to book value). One would expect a large disparity between these two fund types with respect to reduced drilling ESG policies, even given the systematic effect of such policies. *See id*. at n.88.

competitive advantages. Institutional investors do not work at this high-resolution.

An interesting indication of institutional investors' lack of ESG competence is Bluebell's ongoing campaign against BlackRock. Bluebell, an activist hedge fund, invested $10 million in BlackRock's shares and then proceeded to call for the resignation of BlackRock's legendary CEO, Larry Fink, on account of his failure to promote ESG goals.[106] Tellingly, according to the statements issued by Bluebell, BlackRock's ESG performance is so poor that it must halt its ESG-related activities and exit the ESG scene, leaving it to others who are better qualified to promote ESG goals.[107]

Aside from the lack of competence, there is an additional barrier preventing institutional investors from being active in designing firm ESG strategy. As Professor John Morley discusses at length,[108] securities laws practically prevent large institutional investors from playing a highly active role in firm governance and corporate strategy. For instance, they are barred from nominating candidates to corporate boards.[109] But while regulatory restrictions can be lifted—and, indeed, overseas institutional investors sometimes have the ability to nominate directors—[110] the inherent competence problem is more pervasive.

In a related vein, Professors Marcel Kahan and Edward Rock have noted that entrusting institutional investors to promote ESG goals runs into another hurdle.[111] Institutional investors are shareholders. They are not directors and do not make decisions in firms. To affect or redirect decision-making in firms, they need cooperation from the directors in their portfolio firms. Kahan and

106. Michael Hytha & Nishant Kumar, *Activist Bluebell Urges BlackRock to Oust Fink as CEO Over ESG*, BLOOMBERG, (Dec. 6, 2022, 9:04 PM), https://www.bloomberg.com/news/articles/2022-12-06/activist-bluebell-urges-blackrock-to-oust-fink-as-chief-over-esg?leadSource=uverify%20wall [https://perma.cc/2FVS-45T3].

107. 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 [https://perma.cc/B2EZ-NQ8C].

108. Morley, *supra* note 18, at 1422–23.

109. *Id.* at 1446.

110. Assaf Hamdani & Sharon Hannes, *Institutional Investors, Activist Funds and Ownership Structure*, in COMPARATIVE CORPORATE GOVERNANCE 368–80 (Afra Afsharipour & Martin Getler eds., 2021).

111. Kahan & Rock, *supra* note 9, at 3.

Rock point out, however, that corporate law's fiduciary duty does not permit corporate directors to "tradeoff" the interests of their own companies for the interests of other portfolio companies.[112] This means that even if institutional investors wanted to adopt portfolio wide ESG policies, they would find it difficult to achieve this goal. It should be noted that Gordon is aware of at least some of the inherent limitations of institutional investors and admits that, in many cases, due to their regulatory constraints and business models, they will not lead ESG campaigns. Gordon specifically acknowledges that institutional investors do not design new business strategies, which prevents them from delving into the firm's business model and from making appropriate suggestions.[113] Gordon also recognizes that, in many cases, the institutional investor would first need an activist to make a proposal, which the institutional investor would then support—a strategy Gordon calls "leading from behind."[114] This admission raises the question: Who could be the activist that leads the way for the institutional investors? Ordinarily, institutional investors follow the lead of activist hedge funds. For the reasons we detail in the next section, however, activist hedge funds cannot be expected to spearhead ESG campaigns.

### *C. Activist Hedge Funds*

Activist hedge funds seem to possess the competence to promote adopting and implementing ESG goals within firms. The activist hedge fund business model is predicated on active engagements with public companies.[115] To this end, activist hedge funds carefully study individual companies to identify weaknesses in their business plans, management, or governance systems.[116]

112. *Id*. In addition to corporate law's fiduciary duty, Kahan and Rock argue that fund managers' fiduciary duties may also prevent them from advancing policies that would promote the interests of other funds. They also note that a fund may incur the loss for its company without obtaining the systematic benefit because the company's competitors will fill in and may generate the harmful but beneficial externality instead. *Id*. at 8.

113. Gordon, *supra* note 16, at 637.

114. *Id*.

115. Rock & Kahan, *supra* note 20, at 1046.

116. Armour & Cheffins, *supra* note 21, at 11.

They then propose and implement corrective measures to enable companies to reach their full potential.[117] Activist hedge funds' experience in forming alternative business models for companies and their close familiarity with companies equip them with the necessary capabilities for designing optimal firm-specific ESG policies. Activist hedge funds have the requisite competence not only to form alternative business plans for the company, but also to execute them. Their business model relies on their ability to form coalitions to promote their plans, convince institutional investors to back them,[118] and pressure the management and board, which monitor the implementation of the changes they advocate.

The problem with activist hedge funds, however, is that they lack the motivation to integrate ESG policies into the business model of public companies. As some scholars have noted, activist hedge funds are focused on short-term performance.[119] Common corporate fixes they promote include large dividend distributions or other capital restructuring, the sale of the company, a divestiture of business units or a breakup of the entire company, and expenditure (including research and development) cuts, which do not require lengthy execution.[120] Though scholars continue to debate the value of hedge fund activism,[121] it is quite clear that the business model of activist hedge funds is ill fitted for changes that take years to craft and execute. Hedge fund activism campaigns normally happen in a timeframe of several months, and only in rare

117. *Id.* ("[Hedge funds] typically will be looking for are companies that are not merely 'underpriced' but also are 'underperforming', in the sense that they anticipate a change in financial policy or strategic direction will increase shareholder returns (i.e. bi > 0.) Offensive activists therefore seek out firms where shareholder returns can be improved significantly through a feasible intervention.").

118. Sharon Hannes, *Super Hedge Fund*, 40 DEL. J. CORP. L. 163, 199 (2015).

119. Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 12 (2010) ("Indeed, it is increasingly the case that the agenda setters in corporate policy discussions are highly leveraged hedge funds, with no long-term commitment to the corporations in which they invest."); *see also* Adam Harmes, *The Trouble with Hedge Funds*, 19 REV. POL'Y RSCH. 156, 161 (2002) ("[I]nvestment funds have a number of characteristics that lead to trend-chasing behavior and the quest for short-term profits.").

120. K.J. Martijn Cremers, Erasmo Giambona, Simone M. Sepe & Ye Wang, *Hedge Fund Activism and Long-Term Firm Value*, 3–4, https://ssrn.com/abstract=2693231 (last updated May 29, 2020).

121. Bebchuk et al., *supra* note 20, at 1154.

cases do they span a period of two to three years.[122] Such engagements are too short lived to work in the ESG context because promoting ESG policies generates no payoff in the short run. It requires patience and persistent effort.

There are at least two causes for activist hedge funds' focus on quick "fixes." The first is that such quick fixes enable them to provide their investors with high returns on investment (ROI) because the increase in value occurs over a very short period of time. Furthermore, quick fixes allow activist hedge funds to provide "alphas" to their investors—returns that are independent of the fluctuating market ("beta"). Corporate reforms that require more time increase the exposure of investors to market fluctuations and to the "beta" of the market.

The second reason activist hedge funds concentrate on short-term policies is that they are structured as partnerships, with no secondary markets. Hedge funds cannot be traded on secondary markets due to regulations restricting investment in hedge funds to accredited investors. Consequently, the capital invested in activist hedge funds is locked up. And because the capital is locked up, the managers of an activist hedge fund must show returns to fend off pressure from their investors, who do not have the option of liquidating their investments.

Thus, although activist hedge funds have the capability to promote ESG policies effectively, they do not have the motivation to do so.[123] It should be noted that commentators use the recent successful campaign of activist hedge fund Engine No. 1 in ExxonMobil as an example of activist hedge funds' ability to effectively promote ESG goals.[124] In an engagement that received close media attention, Engine No. 1 managed to nominate three

122. Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 30 (2020).

123. This may explain the growing phenomenon of activist hedge funds that have both a financial purpose (R&D reductions, etc.) and an ESG purpose: their primary motivation is the financial purpose, and the ESG reform is designed to gain the automatic support of institutional investors, but they have no real interest in the effectiveness of the ESG reform.

124. Jennifer Hiller & Svea Herbst-Bayliss, *Exxon Loses Board Seats to Activist Hedge Fund in Landmark Climate Vote,* REUTERS (May 26, 2021, 7:38 PM), https://www.reuters.com/business/sustainable-business/shareholder-activism-reaches-milestone-exxon-board-vote-nears-end-2021-05-26 [https://perma.cc/A4Z3-P3B4].

directors to ExxonMobil's board. The campaign was motivated by Engine No. 1's goal to reduce the company's carbon footprint and thus serves as "Exhibit A" for views that activist hedge funds can promote ESG goals. In theory, Engine No. 1's environmental campaign seems to undermine our argument that activist hedge funds are ill fitted to promote ESG goals. In reality, however, the Engine No. 1 case is the exception that proves the rule.

The popular media has described the Engine No. 1 campaign as a historic and "unprecedented" moment.[125] Sadly, however, it would be a mistake to interpret Engine No. 1's engagement with ExxonMobil as a sign of things to come. Engine No. 1's engagement may well be an event that will never be repeated. No similar engagement has taken place before or after Engine No. 1 because such engagements are not a viable strategy for hedge funds. As Matt Levine has explained, Engine No. 1 incurred a loss from its engagement with ExxonMobil despite its success.[126] It is estimated that the campaign cost Engine No. 1 approximately $30 million, and its 2% stake in ExxonMobil shares cost it $53 million. Even though ExxonMobil shares have gone up by 20% since Engine No. 1 purchased the shares, it is still a losing deal for Engine No. 1: its gains of more than $10 million from the increased share price cover only about a third of its costs. Even if ExxonMobil's shares appreciate by an additional 40%, it would still be a losing deal for Engine No. 1. Indeed, commentators speculate that the main purpose of Engine No. 1's engagement with ExxonMobil was not to make a profit, but to make a name for itself. In a similar vein, Professor Bernard Sharfman has noted that the purpose of the Engine No. 1 engagement with ExxonMobil was to promote the new Environmental ETF Engine No. 1 was issuing.[127]

Furthermore, Engine No. 1's eighty-two-page letter to its investors reveals that many of its plans for ExxonMobil were classic activist hedge fund maneuvers, which were only cloaked under an

125. 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 [https://perma.cc/7P3C-3U6C].

126. Matt Levine, *Money Stuff: Exxon Has a Tough Green Activist*, BLOOMBERG (May 26, 2021, 11:04 AM), https://www.bloomberg.com/news/newsletters/2021-05-26/money-stuff-exxon-has-a-tough-green-activist [https://perma.cc/XMY8-FJHB].

127. Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1's Proxy Fight at ExxonMobil*, 12 HARV. BUS. L. REV. ONLINE 1, 3 (2021).

environmental dressing.[128] In the letter, Engine No. 1 justified targeting ExxonMobil in light of its poor performance relative to its peers—trailing by 57.2% the average returns of its peers over the previous ten years.[129] This has caused ExxonMobil's arch-rival, Chevron, to close the historical market cap gap between the two companies. In 2010, the market cap of ExxonMobil was more than twice that of Chevron, but since 2020, the two companies have had almost the same market cap.[130] Like typical activist hedge funds' critique of companies in which they engage, Engine No. 1 highlighted ExxonMobil's inefficient capital expenditures, which failed to produce the equivalent amount of value in undiscounted dollars.[131] The critique of the capital expenditures on drilling is not based on long-term projections of potential liabilities and decrease in demand, but rather on the prices of oil and gas in the short term that do not justify such investments. This critique is very similar to activist hedge funds' typical critique of R&D investments. In addition, in its presentation to investors, Engine No. 1 emphasized the misaligned incentives in management's compensation packages. In the period between 2017 and 2019 in which ExxonMobil's returns declined by 12%, its CEO compensation had grown by 35%.[132] This issue is completely disconnected from the advancement of environmental goals and is a classic activist hedge fund fix.[133]

Careful analysis of the details behind Engine No. 1's engagement of ExxonMobil brings us full circle: Activist hedge funds are not the right actors to promote ESG goals. While they

128. *Reenergize ExxonMobil // Investor Presentation*, ENGINE NO. 1, https://web.archive.org/web/20210623025030/https://reenergizexom.com/wp-content/uploads/2021/05/Investor-Presentation-May-2021-v2.pdf [https://perma.cc/S9YT-LDTM] (last visited Mar. 6, 2024) [hereinafter *Reenergize ExxonMobil*].

129. *Id.* at 7.

130. *Id.* at 13. *See also* Christopher M. Matthews, *Exxon Used to Be America's Most Valuable Company. What Happened?*, WALL ST. J. (Sep. 13, 2020, 4:50 PM), https://www.wsj.com/articles/exxon-used-to-be-americas-most-valuable-company-what-happened-oil-gas-11600037243 [https://perma.cc/BV4L-4494] ("It has been a stunning fall from grace for Exxon Mobil Corp.").

131. *Reenergize ExxonMobil*, *supra* note 128, at 12.

132. *Id.* at 64.

133. *Id.* at 65.

have the competence for planning strategic reforms in a company's functioning, they lack the motivation to advance ESG goals. Their structure causes them to maintain a tight focus both on the short term and on financial performance. The reason why Engine No. 1 decided to embark on its unique campaign despite the losses it knew it would incur was the company's desire to attract media attention and brand itself as a player. At present, at least, promoting ESG goals is not a viable strategy for activist hedge funds. Indeed, our discussion of the case of Engine No. 1 reveals that its primary objectives were standard activist hedge fund objectives.[134] In conclusion, our analysis reveals that none of the central candidates for promoting ESG in the existing financial market seem to be suited to this purpose.

We summarize the findings of our discussion in this Part in *Table 2*, below.

134. A similar case in which an activist hedge fund presumably focused on effective promotion of ESG is Bluebell Capital's engagement with BlackRock and its campaign to oust BlackRock's CEO Larry Fink. Bluebell's activism was cloaked as a response to Blackrock's failures in the realm of ESG. *See* Hytha & Kumar, *supra* note 106. This campaign is part of Bluebell's efforts to mold itself as an ESG-minded activist hedge fund. *See* BLUEBELL CAPITAL PARTNERS, https://www.bluebellcp.com [https://perma.cc/N27X-XBMR] (last visited Mar. 11, 2024) ("Unique ESG Approach . . . Environmental, Social and Governance considerations can represent a core pillar of the value creation story . . . ."). A careful examination reveals, however, that promotion of ESG was not Bluebell's core concern. Rather, it used ESG as a public relations device. The underlying objective of "ousting" Fink was not to enhance BlackRock's investment in ESG but rather to eliminate it altogether. Bluebell stated in its letter to BlackRock's board that "it is not BlackRock's role to direct the public debate on climate and energy policies or to impose ideological beliefs on the corporate world." *See* Ross Sorkin et al., *supra* note 107. Bluebell summarized its position as follows: "BlackRock's E.S.G. push had become politicized and a distraction, as several Republican state officials have moved to withdraw funds from BlackRock in protest." *Id.* It seems that Bluebell's main objective was to increase BlackRock's value, which had in the previous year fallen by almost thirty percent, over twice as much as the S&P 500. The utilization of ESG for public relations purposes without it actually being a part of Bluebell's core investment strategy is also reflected in Bluebell's celebrated strategy of "one share ESG campaign[s.]" *See* George Casey, Scott Petepiece & Lara Aryani, *Recent Activism Trends*, HARV. CORP. GOVERNANCE BLOG (Nov. 29, 2021), https://corpgov.law.harvard.edu/2021/11/29/recent-shareholder-activism-trends. In many of Bluebell's high-profile ESG engagements, including its engagement with Solvay that prompted the letter to BlackRock's board, Bluebell only buys one share in the company in which it engages (*ESG Activism – 2021*, INSIGHTIA 1, 8 (2021), https://www.activistinsight.com/wp-content/uploads/dlm_uploads/2021/06/Insightia ESGActivism-1.pdf?ut [https://perma.cc/C4FY-9ZGA]) which means that the outcome of the campaign has no impact on its profits.

*Table 2: Corporate Actors Matrix – The ESG Gap*

| | Competence | Motivation | Regulation |
|---|---|---|---|
| Management | (X) | | X |
| Institutional Investors | | X | |
| Activist Hedge Funds | X | | X |

## III. INTRODUCING THE ACTIVIST ESG FUND

To bridge the ESG gap, we call for the introduction of a new market institution: the Activist ESG Fund (AEF). The AEF would be uniquely designed to promote ESG goals. It would be an exchange-traded, undiversified, closed-end fund[135] that shares many of the defining characteristics of hedge funds, though not all of them. And, most importantly, AEFs would possess the necessary competence and motivation to achieve ESG objectives.

AEFs would follow the business strategy of activist hedge funds. They would search and analyze public companies to identify suitable candidates for ESG engagements. The search would target public companies that can effectively integrate ESG values into their business models. In keeping with the modus operandi of activist hedge funds, AEFs would acquire a significant block of shares in the target, which would enable them to push the incumbent management to adopt ESG-friendly policies. If necessary, the AEF would recruit other investors to put pressure on management to amend the target company's business plan and even run a proxy fight to change the board's composition.

By and large, we expect the AEF would do whatever an activist hedge fund can do to achieve its goals, with the exception that the

135. A closed-end fund is a unique type of fund governed under the Investment Company Act (1940). Closed-end funds make public offerings for a fixed number of shares in exchange for cash to fund their investments. Following such public offering, the funds' shares are traded on the stock exchange, and there are no inflows or outflows from the fund on a daily basis. Unlike open-ended funds, such as most mutual funds and exchange-traded funds (ETFs), there is no redemption of shares by the issuer on demand. *See Investor Bulletin: Publicly Traded Closed-End Funds*, U.S. SEC. & EXCH. COMM'N. (Sept. 25, 2020), https://www.sec.gov/oiea/investor-alerts-and-bulletins/investor-bulletin-publicly-traded-closed-end-funds [https://perma.cc/2AVN-TR2W].

AEF would have *long*-term horizons of investment and activism. This means that, following the search phase, the AEF would zero in on a target that requires an ESG overhaul. It would then tailor a business strategy for the target and purchase a significant stake in it—which, in the case of hedge funds, is typically five to ten percent of the target's stock.[136] The AEF would articulate its plan in an elaborated document, similar to the white papers issued by activist hedge funds.[137] The plan would set out the reasons for the proposed strategy shift and outline the new strategy's tenets.

The AEF would then begin engaging with the target's management and other major stockholders to explain its aims and seek cooperation. Part of the AEF's role would be to convince the target's institutional investors of the importance and viability of the AEF's plan. Green funds that hold shares in the target would be an especially welcoming audience for the AEF because of their interest in ESG initiatives.[138] Still, we expect other institutional investors would follow suit. More often than not, the AEF would have to replace at least some of the directors on the target's board to monitor and execute its business plan. Monitoring would be necessary even if the incumbent management does not resist the AEF and decides to go along with the ESG plan. Given the long and uncertain nature of many ESG initiatives, the business plan of the AEF would have to be refined along the way. Trustworthy board members would be essential to ensure the free flow of information. However, unlike routine activist hedge fund campaigns, we expect AEF campaigns to last a decade or even longer when necessary. Reshaping the carbon emission business profile of a company, as

136. Given the AEF's access to public funds, it is possible that it would form even large stakes of above ten percent.

137. A white paper is an informational document, often issued by activist hedge funds, proposing a solution or approach to a specific and complex problem. Relying on research and statistics-based insights, a white paper aims to convince readers of its merits and build support for its implementation. *See* Adams Hayes, *What Is a White Paper? Types, Purpose, and How to Write One*, INVESTOPEDIA (Dec. 22, 2023), https://www.investopedia.com/terms/w/whitepaper.asp.

138. *See* Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Mutual Funds Deliver on their Promises?*, 120 MICH. L. REV. 393, 434–35 (2021) (finding empirically that ESG funds have a much greater tendency to vote against management's recommendation when the recommendation conflicts with ESG principles). Even though their study found that ESG funds vote differently on shareholder proposals and other topics, ESG funds do not advise the company on how it should promote ESG—this is why the AEF is needed.

well as making other ESG-related changes, may require such prolonged engagements.

What induces activist hedge funds' general partners to expend time, effort, and skill on a target company is the carried-interest compensation structure that is the norm for hedge funds. The classic carried-interest compensation structure of hedge funds is a "success fee" consisting of twenty percent of the appreciation of their investment beyond some hurdle rate of return.[139] This aspect of activist hedge funds' operations distinguishes them from traded closed-end funds (CEFs), exchange-traded funds (ETFs), regular (open-end) mutual funds, and other open-to-the-public investment vehicles that are legally barred from charging an asymmetric success fee.[140]

Just like the activist hedge fund, the AEF would be able to use its high-powered success-fee compensation structure to recruit highly skilled businesspeople and offer them adequate compensation. Importantly, however, since we expect that a considerable number of the AEF's managers will be champions of ESG goals, or at least sympathetic to such goals,[141] they would also receive ideological rents from successful engagements that promote ESG values. It is entirely possible that AEFs would be able to recruit accomplished and wealthy businesspeople who wish to use their business acumen to promote ESG turnarounds as a second career. This, in turn, suggests that some AEF managers may settle for lower success fees than managers of traditional activist hedge funds. Nevertheless, one cannot expect all AEF managers to have the same inner drive, and therefore we envision that the AEF would normally have to use incentive pay of high magnitude. If AEFs

139. *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 82–84 (2005). In addition to the success fee, hedge fund managers receive a fixed compensation fee that is typically between 1.5%–3%. As Fleischer points out, in many funds there is a return rate that is also dubbed a "hurdle rate: the success fee is paid only after the fund reaches a minimum return threshold, which is usually around eight percent. *Id.*

140. Investment Advisory Act, *supra* note 27, § 80b-5(a)(1) ("No investment adviser registered or required to be registered with the Commission shall enter into, extend, or renew any investment advisory contract, or in any way perform any investment advisory contract entered into, extended, or renewed on or after November 1, 1940, if such contract . . . (1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client . . . .").

141. *See* Hart & Zingales, *supra* note 48, at 263 (adopting a similar normative assumption).

succeeded in raising very large amounts of money, it would be possible to lower the success-fee portion of management remuneration because the combination of the fixed percentage (that would be derived from a very large AUM)[142] and the ideological satisfaction may prove sufficiently attractive to lure talented managers.[143]

The number of engagements of AEFs would depend on their resources[144] as well as their specific expertise. While some AEFs would concentrate on a specific business sector—say, energy—and designate it in their charter and prospectus before they raise money, other AEFs would be free to look at the entire stock market. In contrast to the special purpose acquisition company (SPAC), which is an exchange-traded financial vehicle aimed at purchasing a closely held target and then merging into it, there would be no need for prior approval by the AEF's shareholders before executing planned engagements.[145] An AEF investor who objected to a specific engagement could exit from the AEF swiftly and easily by selling her shares in the AEF on the public market. Additionally, to be successful, AEFs would have to fly under the radar until they engaged their targets. Otherwise, the share price of the target would increase after the disclosure of the engagement plan, impeding the engagement's profitability.[146]

Most importantly, because AEFs would be traded on an exchange, they would be able to attract "patient money" necessary for investments with long horizons. This attribute would distinguish AEFs from standard activist hedge funds. Because standard activist hedge funds are *not* traded on an exchange, investors' capital is locked for a period of a few years. As a result,

142. *See* Chen, *supra* note 55 (defining AUM).

143. It should be noted that the activism itself requires many more resources than do conventional funds. A certain percentage of the funds of the AEF would be at the disposal of the AEF's manager to cover the costs of activism.

144. Similar to other closely held funds, the AEF could borrow money and leverage its resources. *See Investor Bulletin Publicly Traded Closed-Funds*, U.S. SEC. & EXCH. COMM'N. (Sept. 25, 2020), https://www.sec.gov/oiea/investor-alerts-and-bulletins/investor-bulletin-publicly-traded-closed-end-funds. Such leverage would enable the AEF to purchase a stake in the company that is much larger than the original equity raised by the AEF.

145. Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. REG. 228, 235 (2022).

146. Given the long duration and uncertain outcomes of many ESG campaigns, however, the disclosure of AEFs' engagements might not automatically trigger a significant uptick in the stock price of the target.

hedge fund investors may pressure management to demonstrate short-term results, which drives management of the hedge fund to relatively short campaigns and fast exits.[147] If the hedge fund manager contemplates a prolonged engagement campaign, some of its investors with locked-in capital may become impatient and lose faith in the manager's business strategy. And even if the hedge fund strategy is viable, the lack of a fluid secondary market prevents impatient investors from selling their stake to other investors who believe in the business plan. Hence, to cater to all its investors, the hedge fund manager is driven to show results as early as possible and neglect longer-term plans. In addition, hedge funds are organized as partnerships with predetermined dissolution dates, which also limits their investment and activism time horizons.

The fact that AEFs would be traded on an exchange open to the public and organized as corporations without a specified time horizon will enable AEF management to have longer time horizons. Furthermore, because the fund would be traded on the market, there would be essentially no minimum investment required for investing in the AEF. The AEF would therefore provide a solution to a long-felt desire on the public's part to participate in activism—an arena from which the public has thus far been excluded. Allowing the public to invest in AEFs would not only work to the benefit of those members of the public who harbor a strong preference for ESG goals, but it would also help AEFs raise significant amounts of money. Allowing retail investors to participate in ESG activism would likely channel significant funds to AEFs. Empirical evidence indicates that ESG values hold a place

147. *Review and Analysis of 2020 U.S. Shareholder Activism and Activist Settlement Agreements*, SULLIVAN & CROMWELL LLP 1, 27–28 (Dec. 2. 2020), https://www.sullcrom.com/shareholder-activism-review-us-2020 [https://perma.cc/5G3V-PHGF] (finding that only approximately 10% of activist campaigns that were initiated and settled in 2020 took six months or longer to settle); Fredrick Cedergren & Mangus Noack, *Hedge Fund Activism in Europe: Are Activist Hedge Funds Guardians of Shareholder Value?* MASTER'S THESIS, COPENHAGEN BUS. SCH. 1, 45 (2020), https://research.cbs.dk/en/studentProjects/2b3e157d-12d0-4830-ad7a-10232076dcc9 (finding that the median period of time for engagements of activist hedge funds in Europe between 2010–2019 was 4.2 months, and the average was 9.2 months). *But see* Bebchuk et al., *supra* note 122, at 30 (2020) (finding that the average length of activist campaigns initiated between 2000–2013 was approximately 2.5 years). It should be noted that the data on which the Bebchuk et al. study is based is at least a decade old.

of pride among retail investors. This means that investors would receive both financial and ideological returns from investing in AEFs.[148]

The AEF, as already mentioned, would be designed as a publicly traded, closed-end fund. Currently, there are more than 450 publicly traded, closed-end funds in U.S. markets. Prominent examples include BlackRock Innovation and Growth Trust CEF, Eaton Vance Tax-Managed Global Diversified Equity Income Fund, CEF, and DNP Select Income Fund Inc.[149] The largest closed-end funds have a market cap of a few billion dollars. However, the difference between all these funds and our AEF is that current closed-end funds are diversified investment vehicles. The AEF, in contrast, would be undiversified, and its added value would be its activist ESG orientation.

In closed-end funds, investors cannot redeem their investments from the fund itself.[150] In contrast, open-end funds, or exchange-traded funds (ETFs), allow investors to redeem their investments daily.[151] Open-end funds are much more common on public markets due to their greater flexibility; the amount of capital in the fund matches the investment demand for the fund.[152]

148. The existence of "ideological rents" is especially prevalent among millennial investors. The Nuveen Third Annual Responsible Investor Survey has found that among millennials, ninety-two percent care more about having a positive impact on society than about doing well financially. *See Third Annual Responsible Investing Survey: Investor Interest in Responsible Investing Soars,* NUVEEN, https://www.tiaa.org/public/pdf/investor_interest_in_responsible_investing_soars.pdf (last visited Mar. 11, 2024).

As Barzuza, Curtis, and Webber point out, this is not mere cheap talk, but seems to be the driving force behind the surge in ESG investments, which is primarily fueled by Millennials' demands for ESG investments. *See* Barzuza et al., *supra* note 66.

149. *The Authority on Closed-End Funds, Fund Screener*, CEF CONNECT, https://www.cefconnect.com/closed-end-funds-screener [https://perma.cc/7XEF-ABYQ] (last visited Mar. 11, 2024).

150. *Investor Bulletin: Publicly Traded Closed-End Funds*, S.E.C. INVESTOR.GOV., (Sept. 25, 2020), https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-bulletins-90 [https://perma.cc/C8FY-XSF2].

151. *Id.* In the case of ETFs there is also a secondary market on the stock exchange.

152. For this reason, common investment vehicles such as Exchange Traded Funds that are mostly pegged to an index are comprised of an open-end fund. *See Investor Bulletin: Publicly Traded Closed-End Funds*, *supra* note 150. In theory, investors in an S&P 500 ETF could approach the fund itself to redeem their investment, instead of selling their shares in the market. Some investors actually utilize this option and redeem their shares in the ETF in exchange for shares of companies the ETF holds for tax reasons. Such exchange does not

Nevertheless, we propose that the AEF be designed as a closed-end fund so that its managers would not have to worry about redeeming investments in planning the fund's strategy. In many cases, closed-end funds are utilized for investments in relatively illiquid assets, for which redemption poses a problem.[153] This is not true, however, of the AEF: it would be designed to invest solely in public companies whose shares are highly liquid. The reason for limiting the redemption option in the case of AEFs is different: to enable the AEF managers to plan for the long run, without having to fear early redemption. Impatient investors, however, would be able to sell the AEF shares on the stock exchange without directly interfering with the AEF managers' activity, a feature that is much needed for successful ESG engagements.

An additional advantage of closed-end funds is that they have a greater ability to leverage their investments or take debt if their charter permits them to do so.[154] The fact that their resources are not redeemable by investors provides greater certainty to potential creditors. Such leverage would enable the AEF to gain greater power and voice in the companies it engages. Of course, the AEF could also limit its ability to obtain credit in order to lower its exposure to the risks involved with debt.

The closed-end fund design may give rise to the following concern: since closed-end funds do not enable redemption, managers may have unchecked power over the money invested in the fund for an infinite period. This, in turn, would enable them to shirk on the job or even abuse their power. To address this concern, we suggest that the AEF could be designed as a *convertible* closed-end fund that, after a predetermined period of years, transforms into an open-end fund, enabling investors to redeem their investments. This combination would allow the fund managers to focus their attention on the long run, providing them a sufficient period in which they need not be concerned with redemption. At the same time, they would not leave investors without an exit

constitute a realization event for the ETF and enables it to lower the tax cost of making the required changes in its portfolio.

153. *What Is a Closed-End Fund?*, *supra* note 23.

154. *Id.*

option, as investors would be able to cash out their investments once the fund becomes open-ended.

The establishment of AEFs, however, necessitates overcoming a regulatory challenge. Currently, both the Investment Advisory Act[155] and the Investment Company Act prohibit asymmetric success-based compensation. One way to overcome this hurdle is to pass a legislative amendment that would exclude AEFs from the prohibition, thereby allowing them to use asymmetric success-based prohibition. The problem with this solution is that it might make it possible for other funds to circumvent the asymmetric success-based-fee prohibition, thereby undermining the Act's protections to common fund investors. The rationale behind this prohibition is to prevent money managers from taking excessive risks on behalf of the funds' investors. However, to fulfill the unique goals of the AEF, it is necessary and worthwhile to deviate from the prohibition.

Still, there does not seem to be a simple way to distinguish AEFs from conventional mutual funds. Though AEFs would actively engage with the companies in which they invest, other funds could feign active engagements by sending a letter to the management, suggesting a reform in the company's business plan, or nominating alternative directors to those proposed by management. These actions are not necessarily extremely costly; the main cost element they implicate is the strategic planning behind them, which is much harder to discern.[156]

The second possibility is to exempt AEFs from the fee limitations in the Investment Advisory Act, similar to the debated exclusion of SPACs,[157] while limiting AEFs to investment in only one company. There are two advantages to this solution. First, it would be practically impossible for conventional mutual funds to benefit from the asymmetric success fee as it would require them to invest in only one company, which stands in diametric opposition to their business model of diversified investment.

155. Investment Advisory Act, *supra* note 27, § 80b-5(a)(1); The Investment Company Act, *supra* note 26.

156. Even proposing and pushing for the nomination of alternative directors to those that have been endorsed by management is not necessarily costly if the company permits proxy access. Regarding proxy access as a device that enables shareholders to suggest and nominate directors at a lower cost, see Lucian A. Bebchuk & Scott Hirst, *Private Ordering and the Proxy Access Debate*, 65 BUS. LAW. 329, 335–36 (2010).

157. John C. Coates, *SPAC Law and Myths*, 78 BUS. LAW. 371 (2023).

Second, this solution may not require amending the Investment Advisory Act or the Investment Company Act, as the SEC can use its rulemaking power to clarify the limited exclusion and craft a proper safe harbor.[158]

The problem with this solution is that it limits AEFs to investing in one company, reducing their flexibility and potential impact. Imposing such a limitation on AEFs might make them less attractive to investors for the simple reason that their investment in an AEF would not be diversified. This problem is more illusory than real, however. In a world with multiple AEFs, investors would be able to get the benefits of diversification by splitting their investments among many AEFs (as well as other public investments). We expect that, over time, institutional investors would make diversification even easier by offering retail investors opportunities to invest in packages or indexes of AEFs.

Before concluding, we would like to note that shareholders are teetering on the verge of disaster. The current equilibrium—where companies can continue to cause harm to the environment and disregard social causes with impunity—is not sustainable. Private lawsuits are already being brought against polluting companies for past wrongs. What is now a trickle may soon become a flood.[159] Academics, too, are laboring on new models of liability for carbon emission–related harms.[160] Finally, the public pressure

158. The Investment Company Act of 1940 § 80a-3(a)(1) defines an "investment company" as any company that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." The SEC can craft a safe harbor that clarifies that an AEF that invests most of its funds in active investment in a single public target does not fall under the definition of "investment company" under the Act (while excess funds may be invested in government securities).

159. *See e.g.*, BP P.L.C. v. Mayor of Baltimore, 141 U.S. 1532 (2021) (Baltimore's mayor and city council sued energy companies for promoting and concealing the environmental impact of fossil fuels); Native Vill. of Kivalina v. ExxonMobil Corp., 696 F.3d 849, 853 (9th Cir. 2012) (The Alaskan City of Kivalina sued multiple oil, energy, and utility companies for contributing substantially to global warming, which harms and severely threatens the native village's lands).

160. *See, e.g.*, Yael R. Lifshitz, Maytal Gilboa & Yotam Kaplan, *The Future of Property*, 44 CARDOZO L. REV. 1443 (2023) (arguing that a reform of property law address climate change by engendering a greater sensitivity to intemporal conflicts of interests and imposing corresponding duties on property holders); Maytal Gilboa, Yotam Kaplan & Roee Sarel,

on regulators to take action against corporations will also bear fruit at some point. The precedents of the tobacco and opioid industries are telling. For decades, these industries too felt immune from liability.[161] Evidently, the traditional profit model of firms is unsustainable. We believe that the arguments that ESG is a losing proposition from a profit-making perspective are incorrect. In fact, the opposite is true. In the long term, companies that endorse ESG values will not only do good but will also do well—or at least much better than companies that believe that ESG is a mere fad. If we are

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*Global Warming as Unjust Enrichment*, GEO. L.J. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4502750 (suggestion to address global warming by imposing liability via unjust enrichment doctrines, in addition to tort doctrines). The European Research Council has decided to fund Yotam Kaplan's project of addressing global warming through the doctrine of unjust enrichment. *See ERC Starting Grants 2022: List of Principal Investigators Selected for Funding Social Science and Humanities Domain*, https://erc.europa.eu/sites/default/files/2022-11/erc_2022_stg_results_sh.pdf [https://perma.cc/NL6G-ZM84].

161. Tort litigation in the tobacco industry started in the early fifties, but by the nineties the "forty years of hard-fought litigation had effectively come to naught[.]" Nora Freeman & Robert Rabin, *Pursuing Public Health Through Litigation*, 73 STAN. L. REV. 285, 299 (2021). The litigation's paradigm shifted in the nineties with the case *Castano v. American Tobacco*, which focused on the harm of addiction rather than wrongful deaths. This shift in the litigation's allowed for a break from the litigation failures of the prior forty years. Claims could now aggregate and amass more resources, thereby passing evidentiary barriers that the wrongful death claims faced. *Id.* at 300–01. Similarly, the opioid litigation has consisted of two waves of litigation—tens of failures in the first wave, succeeded by a myriad of successes in the second wave. *Id.* at 313–17. The first wave of litigation was aimed specifically at Purdue Pharma, the manufacturer of OxyContin. It started in 2001 with *Burton v. Purdue Pharma*, a case responding to the death of a twenty-eight-year-old mother as a result of OxyContin overdose. Hundreds of suits followed. Yet by 2004, Purdue "had secured the dismissal of more than seventy suits" and not a single one has made it to trial. *Id.* at 313. By May 2007, the New York Times reported that Purdue had defeated hundreds of plaintiffs. *Id.* Purdue has suffered from two losses in public litigation. First, a $10 million settlement with West Virginia for Purdue's limited disclosure of risks led to copycat litigation by other states and another settlement of $19.5 million. In addition, the DOJ charged Purdue for violating the Federal Food, Drug & Cosmetic Act by introducing a misbranded drug into interstate commerce. Purdue paid the DOJ a fine of $600 million. *Id.* at 314–15. Despite Purdue's losses in public litigation, the opioid market was barely affected. The change came with the second wave of litigation that started in 2014. This wave targeted a significantly broader web of opioid manufactures, as well as distributors and retailers, including Walmart, Walgreens, and CVS. The first successful suit was initiated by the state of Oklahoma against Purdue, Teva, and Johnson & Johnson. In that case, the courts ruled against the latter defendant (J&J) in a $465 judgment. The two other defendants settled—Purdue for $270 million and Teva for $85 million. *Id.* at 320 n.191. This second wave recently culminated in a settlement involving the three largest pharmacy chains—Walmart, Walgreen, and CVS—for $13 billion. Janice Hopkins Tanne, *US Pharmacy Chains Settle Opioid Lawsuits for $13 Billion*, THE BMJ (Nov. 8, 2022), https://www.bmj.com/content/379/bmj.o2688.full [https://perma.cc/TE2W-7J2U].

right, the tradeoff that critics of ESG keep invoking between maximizing profits and promoting ESG values will disappear. Changes take time, but they are coming. Introducing AEFs would enhance the process.

## CONCLUSION

Corporations have a profound impact on our lives. Their actions and omissions shape our society. The power of certain large corporations surpasses that of some national governments. Over the last few decades, they have grown in sophistication and have accumulated unique knowledge that puts them in a position to ensure a better future for humanity.

Given their might and capabilities, it is no wonder that corporations are expected to promote ESG goals. Many social and environmental problems arise from corporate activity. And more importantly, corporations are best positioned to respond to many of the mounting ESG demands. But, as demonstrated in this Article, there is a critical gap between the ESG-related expectations we have of corporations and corporations' ability to fulfill these expectations. The gap stems from the fact that none of the existing actors in the corporate sphere possesses the requisite motivation and competence to effectively promote ESG goals. To overcome this problem, we proposed a new corporate structure—the AEF—whose point and purpose would be to further ESG goals. The AEF would be a publicly traded closed-end fund. It would possess powerful long-term incentives and enjoy the backing of patient capital. The funding of activist ESG funds would come from the public, and because the shares of AEFs would be traded on a stock exchange, investors would be able to liquidate their investments at any time if they are dissatisfied with the performance of an AEF. The AEF could thus bring to fruition the desire of investors to see corporations make a real change for the better on ESG fronts.