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## Corporate Law and Social Risk

Stavros Gadinis

Amelia Miazad

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# Corporate Law and Social Risk

*Stavros Gadinis\**

*Amelia Miazad\*\**

*Over a quarter of total assets under management are now invested in socially responsible companies. This turn to sustainability has gained solid ground over the last few years, earning the commitment of hundreds of CEOs and dominating the global business agenda. This marks an astounding repudiation of Wall Street's get-rich-quick mentality, as well as a direct challenge to corporate law's reigning mantra of profit maximization above all. But corporate law scholars are skeptical about the rise of sustainability. Some scoff at companies' promises to "do the right thing" as empty rhetoric. But companies are revisiting core business practices and adjusting central governance mechanisms, such as executive compensation, to reward improvements in sustainability performance. For other theorists, directors and officers beholden to shareholder primacy can opt for sustainability only as long as it also maximizes profits. While doctrinally straightforward, this approach is highly problematic in practice. The wide range of issues nurtured under the sustainability movement—ranging from environment and climate, to diversity and other workplace concerns, to privacy and supply chain management—do not always lend themselves readily to a profit-maximizing logic and are often costly in the short term.*

*We offer a new solution to this quandary. We argue that, through their sustainability initiatives, companies are looking primarily for safeguards against downside risks, and not simply for opportunities to increase their profits. Social risk has proven highly destructive for corporate value even when the company's key failure is not violating laws, as the recent crises at Facebook*

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\* Stavros Gadinis is Professor of Law, University of California, Berkeley.

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*and Uber demonstrate. Sustainability can help avoid such crises because it provides corporate boards with input from stakeholders such as employees, NGOs, local authorities, and regulatory agencies. These stakeholders are uniquely placed to register the impact of company policies on the ground and can communicate concerns early. Contrasting sustainability with compliance, the only risk monitoring mechanism sanctioned in our laws, we note distinct advantages. While compliance's scope is tethered to legal violations, sustainability encourages intervention even when laws have not caught up. Compliance's emphasis on detection and punishment distorts management's incentives and incites fears of retribution in stakeholders. Rather than dwelling on the past, sustainability builds a new vision for the future hoping to inspire and gain trust.*

*We base our account of sustainability on interviews and roundtable discussions with over three hundred participants, including leading public and private companies, large asset managers, investors and pension funds, shareholder advisory firms, and sustainability standard setters and data providers. Our conversations confirm that it was investors who pushed hard for environmental and social initiatives, putting pressure on more reserved managers and boards. We argue that investors' support for sustainability is precisely because it helps fight risks that are otherwise hard to diversify. Asset managers, in particular, who own significant positions in every U.S. public company, are exposed to industry-wide and market-wide risk and may suffer externalities from a company's reckless behavior.*

*While investors have been early supporters, CEOs and executives are only recently opening up to sustainability, which continues to face some resistance in corporate boardrooms. We argue that directors' and officers' unwillingness to address social risk is a manifestation of agency conflicts. Averting crises is a thankless task, and boards have few incentives to undertake action without external pressure. Moreover, the intractability of many sustainability concerns, combined with management's confidence in the company's success, leads to systematically downplaying social risk. But by failing to establish an appropriate sustainability function, directors and managers are unnecessarily exposing their shareholders to increased risk. Boards should ensure that their company has a well-running sustainability function with proper board oversight that reaches out to stakeholders relevant to the company's business. This governance reform, we conclude, is essential to allow sustainability to reach its full potential.*

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## INTRODUCTION

Socially responsible investing has taken the corporate world by storm. Funds invested according to a company's environmental, social, and governance ("ESG") performance grew to a staggering \$30 trillion at the end of 2018.<sup>1</sup> To put it simply, over a quarter of global assets under management are now invested based on the company's environmental and social profile, not just its earnings.<sup>2</sup> The flow of investor money into ESG funds is growing exponentially.<sup>3</sup> According to a recent survey, eight in ten individual investors in the United States are showing a personal interest in socially responsible investment, and half of them have already invested accordingly.<sup>4</sup> Among S&P 500 companies in the United States, 92% provide disclosures on ESG issues and 78% issue a separate sustainability report.<sup>5</sup>

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1. See Michael Holder, *Global Sustainable Investing Assets Surged to \$30 Trillion in 2018*, GREENBIZ (Apr. 8, 2019), <https://www.greenbiz.com/article/global-sustainable-investing-assets-surged-30-trillion-2018> [<https://perma.cc/3WVJ-6T82>].

2. See generally Deborah Burand & Anne Tucker, *Legal Literature Review of Social Entrepreneurship and Impact Investing (2007-2017): Doing Good by Doing Business*, 11 WM. & MARY BUS. L. REV. 1 (2019) (outlining current approaches to social entrepreneurship and calling for greater exploration of legal issues surrounding it).

3. See Jon Hale, *Sustainable Investing Interest Translating Into Actual Investments*, MORNINGSTAR (Oct. 30, 2019), <https://www.morningstar.com/articles/952254/sustainable-investing-interest-translating-into-actual-investments> [<https://perma.cc/7M5A-CDF7>].

4. See *Sustainable Signals: Individual Investor Interest Driven by Impact, Conviction and Choice*, MORGAN STANLEY 1 (2019), [https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable\\_Signals\\_Individual\\_Investor\\_White\\_Paper\\_Final.pdf](https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf) [<https://perma.cc/VU3E-HKGV>].

5. See Sol Kwon, *State of Sustainability and Integrated Reporting 2018*, INV. RESP. RES. CTR. INST. 27 (Dec. 3, 2018), <https://www.weinberg.udel.edu/IIRCiResearchDocuments/2018/11/2018-SP-500-Integrated-Reporting-FINAL-November-2018-1.pdf> [<https://perma.cc/ST2D-L2U4>].

These developments mark an extraordinary reversal from Wall Street's get-rich-quick mentality and the mantra dominating corporate law theory for the last five decades. Milton Friedman argued that, as agents for shareholders, managers should focus on improving performance; spending shareholder wealth on social projects was wasteful, if not self-aggrandizing.<sup>6</sup> In Friedman's conception, corporations abide by social and moral values as far as these are expressed through legislation and regulation, and they contribute actively to society's well-being through the tax code.<sup>7</sup> Within these boundaries, managers ought to use every available means to pursue profit.<sup>8</sup> Friedman's argument was especially influential in part because it assumed a legal mantle, perched as it were on the theory of agency.<sup>9</sup> Over time, firm value has come to be identified with stock price, utilized as a valid metric by CEO compensation committees and courts alike.<sup>10</sup> For the last half century, interpreting shareholder primacy as a requirement to maximize profits has remained the reigning credo of the corporate world. Prior challenges to this perspective, like the team production theory of corporate law, often failed to gain mainstream following.<sup>11</sup> Similarly, corporate social responsibility projects mostly promoted charitable initiatives, and thus remained peripheral to the running of the company's business.<sup>12</sup>

To understand why this time is different, one need only consider the actors declaring their allegiance. Chief supporters include large asset managers like BlackRock, State Street, and Vanguard, which combine to control on average between 15% and 30% of every publicly

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6. See Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33.

7. See *id.*

8. See *id.*

9. See *id.* As a starting point, Friedman views managers as agents tasked with achieving shareholders' goals. The shareholder's goal is to produce returns from the capital they have contributed—without the expectation of returns, shareholders would not have put their money at the company's disposal. Thus, maximizing returns becomes managers' core mission. See *id.*; see also Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306–07 (1976) (arguing that the only obligation corporations had was to increase profits for their owners, the shareholders).

10. See, e.g., Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247, 264–65 (2017) (pointing out that, in order to measure performance for governance purposes, companies treat shareholder welfare as equivalent to market value, which is based on stock prices, and arguing that this is too narrow an interpretation of shareholder welfare).

11. See generally Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (arguing that corporate law should consider the perspective of other groups involved in corporations' productive models and not focus exclusively on shareholders).

12. See *infra* Section II.A.

traded company in the United States.<sup>13</sup> Larry Fink, the CEO of BlackRock, an investment behemoth with over \$6 trillion under management, averred in 2018 that the companies in which BlackRock invests must “serve a social purpose.”<sup>14</sup> Shareholders, he continued, are just one of the constituencies that stand to benefit from companies, which must also look to their employees, customers, and the communities in which they operate.<sup>15</sup> In 2019, Fink announced that BlackRock will vote against board members in companies that are not adequately managing their climate risk.<sup>16</sup> Even the Business Roundtable, a CEO group with a notoriously anti-regulatory stance that had successfully blocked Securities and Exchange Commission (“SEC”) initiatives on corporate governance, reversed course.<sup>17</sup> In a statement signed by 181 CEOs, including J.P. Morgan’s Jamie Dimon and Apple’s Tim Cook, the CEOs recognized their companies’ commitment to all their stakeholders and pledged to invest in their employees, deal ethically with suppliers, and support their communities. Generating value for shareholders was at the bottom of their commitments.<sup>18</sup> The countless press articles<sup>19</sup> and commentary from major law firms<sup>20</sup> in

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13. See Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 734 (2019); see also Jill E. Fisch, Asaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 62–65 (2019).

14. Larry Fink, *Larry Fink’s 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK (2018), <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter> [<https://perma.cc/S9QA-RMWY>].

15. *Id.*

16. Larry Fink, *A Fundamental Reshaping of Finance*, BLACKROCK (2019), <https://www.blackrock.com/us/individual/larry-fink-ceo-letter> [<https://perma.cc/6LP7-84AQ>].

17. See *Business Roundtable Redefines the Purpose of a Corporation to Promote ‘An Economy That Serves All Americans,’* BUSINESS 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/V4HB-4B67>] (“Since 1978, Business Roundtable has periodically issued Principles of Corporate Governance. Each version of the document issued since 1997 has endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders. With today’s announcement, the new Statement supersedes previous statements and outlines a modern standard for corporate responsibility.”).

18. *Id.*

19. See Andrew Edgecliffe-Johnson, *Companies Under Pressure to Declare ‘Social Purpose,’* FIN. TIMES (Aug. 22, 2019), <https://www.ft.com/content/7ba44ea8-c4f7-11e9-a8e9-296ca66511c9> [<https://perma.cc/QG4M-NSA4>]; Jena McGregor, *Group of Top CEOs Says Maximizing Shareholder Profits No Longer Can Be the Primary Goal of Corporations*, WASH. POST (Aug. 19, 2019), <https://www.washingtonpost.com/business/2019/08/19/lobbying-group-powerful-ceos-is-rethinking-how-it-defines-corporations-purpose/> [<https://perma.cc/8CNY-UARR>]; Alan Murray, *America’s CEOs Seek a New Purpose for the Corporation*, FORTUNE (Aug. 19, 2019), <https://fortune.com/longform/business-roundtable-ceos-corporations-purpose/> [<https://perma.cc/FK3V-8HY9>].

20. See Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Purpose, Stakeholders, ESG and Sustainable Long-Term Investment*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 24, 2019), <https://corpgov.law.harvard.edu/2019/12/24/purpose-stakeholders-esg-and-sustainable-long-term-investment/> [<https://perma.cc/VY46-63VF>]; Rose Ors, *Interview with Susan (Suz) Mac Cormac*,



response to the Business Roundtable's statement confirm the immense attention social issues have attracted. At the 2020 annual meeting of the World Economic Forum in Davos, climate change dominated the agenda.<sup>21</sup> The ESG wave has managed to radically change the public discourse on corporate conduct.

Words are cheap, of course.<sup>22</sup> Some doubt whether investors and companies will show the same dedication in bringing change on the ground, and others worry that allegiance to sustainability's rhetoric will divert public attention from pernicious business practices that will continue unabated.<sup>23</sup> It is tempting to dismiss all this as puffery. In practice, however, boards are adopting reforms that go to the heart of corporate governance. To reorient management incentives towards ESG, companies are introducing ESG improvements as a metric for executive compensation across a range of industries, from consumer giants Pepsi and Walmart, to tech behemoths Microsoft and Verizon, and oil companies Chevron and Shell.<sup>24</sup> Firms are creating sustainability departments to staff initiatives and oversee reforms.<sup>25</sup> ESG is refashioning the composition and operation of the board itself. In a market-wide campaign, State Street announced that if corporate boards do not include at least one woman, it will vote down the entire

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CLIENTSMART: VOICES IN SUSTAINABILITY (Oct. 9, 2019), <http://www.clientsmart.net/blog/voices-in-sustainability-interview-with-susan-suz-mac-cormac> [<https://perma.cc/2RTU-RA8M>]; Neil Whoriskey, Cleary Gottlieb Steen & Hamilton, *Outlaws of the Roundtable? Adopting a Long-term Value Bylaw*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 24, 2019), <https://corpgov.law.harvard.edu/2019/10/24/outlaws-of-the-roundtable-adopting-a-long-term-value-bylaw/> [<https://perma.cc/67BB-4JCK>].

21. See Stephen Fidler & Elena Cherney, *Climate Change—and Ideas for Tackling It—Dominated Davos*, WALL ST. J. (Jan. 24, 2020), <https://www.wsj.com/articles/climate-changeand-ideas-for-tackling-it-dominated-davos-11579896026> [<https://perma.cc/3ZQK-72KD>].

22. See Lucian Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, CORNELL L. REV. (forthcoming Dec. 2020) (manuscript at 46–47), <https://ssrn.com/abstract=3544978> [<https://perma.cc/CXP9-6M9M>] (pointing out that in states with constituency statutes that explicitly allow boards to take into account the interests of stakeholders, boards very rarely do so when negotiating acquisition agreements).

23. See Miriam A. Cherry & Judge F. Snierson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983 (2015) (arguing that companies engage in corporate social responsibility only superficially); William S. Laufer, *Social Accountability and Corporate Greenwashing*, 43 J. BUS. ETHICS 253 (2003) (arguing that the absence of external validation facilitates corporate posturing); David Caleb Mutua, *Green Bonds Get Rubber-Stamped as Investors Question the Label*, BLOOMBERG (Nov. 7, 2019), <https://www.bloomberg.com/news/articles/2019-11-07/green-bonds-get-rubber-stamped-as-investors-question-the-label> [<https://perma.cc/2SXR-4CFF>] (discussing investor skepticism of “green” bonds and third-party investigations into whether funds are in fact used for eco-friendly projects).

24. See *infra* Section I.B (noting that companies have started to pay salary premiums for executives who successfully improve the company's ESG).

25. See Section I.B (discussing the growing trend for companies to hire sustainability experts and even create sustainability committees on their boards).

nominating committee of the board.<sup>26</sup> In annual meetings, ESG shareholder proposals gain support not only from socially minded pension funds, like CalPERS and the New York State Pension Fund,<sup>27</sup> but also from mainstream shareholder advisory firms, like ISS and Glass Lewis.<sup>28</sup> These governance reforms are necessary to oversee the tremendous efforts that companies are devoting to environmental and social causes. From paper straws<sup>29</sup> to greenhouse gas emissions,<sup>30</sup> from privacy<sup>31</sup> to diversity,<sup>32</sup> and from local communities<sup>33</sup> to global supply chains,<sup>34</sup> companies are implementing far-reaching initiatives.

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26. See Andrea Vittorio & Jeff Green, *State Street to Vote Against More Directors at Male-Only Boards*, BLOOMBERG (Sept. 27, 2018), <https://www.bloomberg.com/news/articles/2018-09-27/state-street-to-vote-against-more-directors-at-male-only-boards> [https://perma.cc/56DE-MD2U].

27. See Chris Butera, *New York Comptroller Aims to Double Pension Plan's ESG Funding*, CHIEF INV. OFFICER (June 10, 2019), <https://www.ai-cio.com/news/new-york-comptroller-aims-double-pension-plans-esg-funding/> [https://perma.cc/FKK8-7QQU]; Randy Diamond, *CalPERS Puts 'Laser-Like Focus' on ESG, Board Diversity, and Executive Pay*, CHIEF INV. OFFICER (Apr. 22, 2019), <https://www.ai-cio.com/news/calpers-puts-laser-like-focus-esg-board-diversity-executive-pay/> [https://perma.cc/BM8V-43J8].

28. See David Bixby & Paul Hudson, *Glass Lewis, ISS, and ESG*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 3, 2019), <https://corpgov.law.harvard.edu/2019/07/03/glass-lewis-iss-and-esg/> [https://perma.cc/G8LQ-VADQ].

29. See, e.g., *Starbucks to Eliminate Plastic Straws Globally by 2020*, STARBUCKS (July 9, 2018), <https://stories.starbucks.com/press/2018/starbucks-to-eliminate-plastic-straws-globally-by-2020/> [https://perma.cc/EX4W-B28A] (discussing Starbucks's move to eliminate plastic straws in favor of "recyclable strawless lid[s] and alternative-material straw options").

30. See Fidler & Cherney, *supra* note 21 (noting that climate change "dominated" at the World Economic Forum in January 2020).

31. See Dan Ennis, *Mastercard Seeks Partners on Data Responsibility Standards*, BANKINGDIVE (Oct. 24, 2019), <https://www.bankingdive.com/news/mastercard-seeks-partners-on-data-responsibility-standards/565811/> [https://perma.cc/9JGF-BSTX] (examining Mastercard's initiative to "promote data responsibility" by "recruit[ing] companies, educational institutions and agencies to advance a dialogue on data ownership and protection"); see also *Global Data Responsibility Imperative*, MASTERCARD (Oct. 2019), <https://www.mastercard.us/content/dam/mcom/en-us/documents/global-data-responsibility-whitepaper-customer-10232019.pdf> [https://perma.cc/R8T8-H6LA] ("Innovation is critical to business success, but not at the expense of the ethical use of data.").

32. See Jeff Green, *Goldman to Refuse IPOs If All Directors Are White, Straight Men*, BLOOMBERG (Jan. 23, 2020), <https://www.bloomberg.com/news/articles/2020-01-24/goldman-rule-adds-to-death-knell-of-the-all-white-male-board> [https://perma.cc/S2ZV-EKLB] ("Wall Street's biggest underwriter of initial public offerings in the U.S. will no longer take a company public in the U.S. and Europe if it lacks a director who is either female or diverse.").

33. See Kevin Fagan, *Salesforce, Postmates Agree to Kick In for SF Homeless Services Funding, Regardless of Court Fight*, S.F. CHRON. (Sept. 11, 2019), <https://www.sfchronicle.com/bayarea/article/Salesforce-Postmates-agree-to-kick-in-for-SF-14429554.php> [https://perma.cc/SHV6-3CPP] (discussing Salesforce and Postmates's commitment to let the city of San Francisco keep funds collected from the companies under Proposition C, a ballot initiative to fund services for the homeless, even if it is struck down).

34. See Peter Whoriskey, *Chocolate Companies Ask for a Taste of Government Regulation*, WASH. POST (Dec. 31, 2019, 1:05 PM CST), <https://www.washingtonpost.com/business/2019/12/31/chocolate-companies-ask-taste-government-regulation/> [https://perma.cc/

But as sustainability has grown into a hard-to-ignore reality, so have the challenges it poses for corporate law. The foundational doctrine of shareholder primacy prohibits managers and directors from prioritizing the interests of third parties above their own bottom lines. Traditional carveouts from shareholder primacy, such as for charitable donations,<sup>35</sup> are too limited to accommodate sustainability, which often calls on companies to redesign core business practices. Directors and officers could point to the business judgment rule, which typically grants them wide latitude to opt for the course of action they prefer, as long as they are reasonably informed.<sup>36</sup> Yet, this latitude is available only to directors and officers that believe they are acting in the shareholders' best interests.<sup>37</sup> Hence, we are at a doctrinal impasse. The only remaining option is to confront the challenge head-on and explore whether sustainability falls in line with shareholders' interests.

Corporate law scholars and practitioners, who have long relied on profit maximization as the normative guide for resolving agency conflicts, are wary of widening the aperture in the board's lens. For some, there is only one possible solution to the puzzle: as shareholders' fiduciaries, directors and officers can only undertake sustainability initiatives if they are in line with maximizing profits.<sup>38</sup> ESG proponents have long argued that companies can "do well by doing good,"<sup>39</sup> pointing to factors such as rising consumer demand for sustainable products and innovation around cost-effective sustainable materials and production methods. Yet, there are many ESG initiatives that do not readily fit within the confines of profit maximization, such as large-scale

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8DGC-XLBS] (discussing calls from major chocolate companies for regulations discouraging the use of child labor on cocoa farms).

35. See John A. Pearce II, *The Rights of Shareholders in Authorizing Corporate Philanthropy*, 60 VILL. L. REV. 251, 269–70 (2015).

36. See, e.g., Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 107 (2004) (emphasizing the role of information flow for accountability); but see Yuval Feldman, Adi Libson & Gideon Parchomovsky, *Corporate Law for Good People*, 115 NW. L. REV. (forthcoming 2020), <https://ssrn.com/abstract=3512377> [<https://perma.cc/8UR3-ERF7>] (critiquing the business judgment rule from an ethics perspective).

37. See Bainbridge, *supra* note 36, at 107–08 (discussing the business judgement rule's broad shield from liability for directors and officers who purport to act in furtherance of shareholders' interests).

38. See Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 765–66 (2015) (critiquing the views of "well-meaning commentators . . . [who] ignore certain structural features of corporation law" to argue that officers and directors can put any ends on par with or ahead of "the economic well-being of the corporation's stockholders").

39. See generally Gunnar Friede, Timo Busch & Alexander Bassen, *ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies*, 5 J. SUSTAINABLE FIN. & INV. 210, 226 (2015) (making "the business case for ESG investing" based on a study that indicates a positive correlation between ESG and corporate financial performance).

workplace efforts to eliminate the gender pay gap. Overstretching the logic of profit maximization to fit these initiatives not only threatens its consistency and enforceability, but it also masks the real motivations that directors and officers have for promoting them. In the hopes of avoiding the hard line of profit maximization, another group has defended sustainability as catering to the interests of shareholders in the “long term.”<sup>40</sup> But it is hard to specify how the long term is going to be different from today, how sustainability’s benefits will arise, or why more time is required. Allowing the board to utilize such broad justifications for costly and controversial choices could dismantle the lines of accountability that fiduciary duty case law has so judiciously built.

In this Article, we offer a new resolution to the foundational mismatch between shareholder primacy and ESG, building a novel theoretical framework for boards’ social outreach based on an extensive account of how companies are using ESG on the ground. We argue that ESG serves shareholders’ interests, not because of its upside potential to increase profits, but because it helps companies identify and manage social risks to their business. Social risks arise when a company makes a business choice that exemplifies, epitomizes, or overlooks challenges rattling large societal groups, whole areas of economic activity, or even society as a whole. Core ESG issues such as privacy, climate change, or diversity, though arising out of sweeping technological advances or large-scale societal changes, also implicate individual company decisions. Management’s wrongheaded choices on these issues have sparked corporate crises like those at Facebook<sup>41</sup> and Uber,<sup>42</sup> which have had a profound impact on shareholders. Managers and directors keep falling into such missteps because they are not well-positioned to

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40. See Nadelle Grossman, *Turning a Short-Term Fling into a Long-Term Commitment: Board Duties in a New Era*, 43 U. MICH. J.L. REFORM 905, 906 (2010) (“[B]oard short-termism also seems to be due to some investors with short investment horizons who use activism to influence boards to make decisions that yield short-term returns despite the longer-term impairing effects those decisions might have on the corporate enterprise.”); see also Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 696–97 (2016) (advocating for regulation that accounts for the long-term sustainability of the company).

41. See Matthew Rosenberg, Nicholas Confessore & Carole Cadwalladr, *How Trump Consultants Exploited the Facebook Data of Millions*, N.Y. TIMES (Mar. 17, 2018), <https://www.nytimes.com/2018/03/17/us/politics/cambridge-analytica-trump-campaign.html> [<https://perma.cc/VH8Y-SDLV>] (discussing the Cambridge Analytica data breach and the ensuing scandal and fallout that plagued Facebook as a result).

42. See Mike Isaac, *Uber Embraces Major Reforms as Travis Kalanick, the C.E.O., Steps Away*, N.Y. TIMES (June 13, 2017), <https://www.nytimes.com/2017/06/13/technology/uber-travis-kalanick-holder-report.html> [<https://perma.cc/U88Z-RK3J>] (discussing Uber’s “attempt to repair its reputation over a series of scandals stemming from its bad-boy culture,” which included the resignation of CEO Travis Kalanick and a “sweeping reorganization”).

understand the impact of their choices on third parties, focused as they are on the company's bottom line.

ESG remedies gaps in boards' understanding of social risk by turning directly to potentially impacted third parties in order to source information about the consequences of company practices. Stakeholders such as employees, citizens' groups and NGOs, scientific experts, and government authorities are uniquely sensitive to the implications of board choices on their constituencies and ideally placed to register potential concerns.<sup>43</sup> Although traditionally thought of as managers' adversaries, these stakeholders know the company intimately and can provide the board with specific feedback it would have trouble obtaining through more established information avenues, such as the firm's own hierarchy, as we show below. Understood this way, ESG is not a utopian, quixotic effort to turn altruism into profitmaking, but a business strategy designed to protect shareholders from downside risk, which represents a potential reversal of positive returns and decline in value. Viewed as shielding company assets from negative impact, ESG has little trouble fitting squarely with shareholder primacy.

Our Article is the first to claim that ESG has an informational function that can address deficiencies in board oversight long bemoaned in the industry and the legal literature alike. Most directors in U.S. public companies are themselves very anxious about their boards' inability to grasp disruptive and unanticipated risks.<sup>44</sup> Leading corporate law scholars are recommending radical governance changes to address this deficiency, such as recruiting a separate class of high powered directors with a strengthened oversight role.<sup>45</sup> Others argue for expanding the board's compliance obligations with a forward-looking mandate,<sup>46</sup> or question the distinction between legal and nonlegal risk, which limits compliance's reach under Delaware law.<sup>47</sup>

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43. See *infra* Section III.B (examining the ways in which corporate commitments to sustainability builds trust among key groups of stakeholders and helps eliminate uncertainties).

44. See NAT'L ASS'N CORP. DIRS., ADAPTIVE GOVERNANCE: BOARD OVERSIGHT FOR DISRUPTIVE RISKS 10–12 (2018), <http://boardleadership.nacdonline.org/rs/815-YTL-682/images/NACD%20BRC%20Adaptive%20Governance%20Board%20Oversight%20of%20Disruptive%20Risks.pdf> [https://perma.cc/T6KE-TDQR].

45. See Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 353–55 (2019) (“Our goal is to frame a board model composed of a workable number of thickly informed, well-resourced, and highly motivated directors who could credibly monitor managerial strategy and operational skill in cases where this would be particularly valuable.”).

46. Under Delaware law, corporate boards have an obligation to monitor their employees' observance of legal obligations. See *infra* Section II.A. See also John Armour, Jeffrey Gordon & Geeyoung Min, *Taking Compliance Seriously*, 37 YALE J. ON REG. 1 (2020) (arguing for strengthening director liability for compliance failures, including compensation clawbacks).

47. See generally Frank Partnoy, *Delaware and Financial Risk*, in THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? 130 (Steven Davidoff Solomon & Randall S. Thomas eds., 2018) (arguing that Delaware laws already cover financial risk); see also Elizabeth

Finally, some are even calling for placing employee representatives on corporate boards, an unprecedented move in American capitalism.<sup>48</sup> We respond to these calls by showing that companies have turned to ESG in order to improve their risk oversight, particularly from a social or ethical standpoint, because ESG offers distinct advantages to other established corporate monitoring mechanisms, such as compliance.<sup>49</sup>

We base our claim that risk management is ESG's primary mission on an extensive account of current ESG practices on the ground, developed after a series of interviews and roundtable discussions with over three hundred participants.<sup>50</sup> These include the largest asset managers, such as BlackRock and State Street; investment banks, such as Goldman Sachs and Wells Fargo; pension funds, such as CalSTRS and CalPERS; proxy advisors, such as ISS and Glass Lewis; hedge funds, such as JANA Partners; leading investors, such as ValueAct; and sustainability advocacy NGOs, such as CERES. We spoke with high-ranking executives from U.S. companies, such as Clorox, Uber, Airbnb, Salesforce, Lyft, and Pepsi Co., and with standard setters, such as the Sustainability Accounting Standards Board ("SASB"). Despite their vastly different industries and roles, participants described the huge efforts that companies undertake in order to canvass a critical mass of stakeholders through extensive surveys, town hall meetings, and face-to-face negotiations. After reaching far and wide, companies utilize this information to determine areas of interest and shape appropriately targeted initiatives. This process-based deduction alleviates fears that companies are arbitrarily promoting whatever values are in vogue at the moment or whatever mission is management's pet peeve.

We develop our argument in five parts below. Part I highlights that introducing social considerations into core business decisions is an extraordinary shift for companies.<sup>51</sup> Prior efforts to reconcile this new direction with the conventional understanding of corporate law's orientation toward profitmaking leave much to be desired. Part II

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Pollman, *Corporate Oversight and Disobedience*, 72 VAND. L. REV. 2013, 2017 (2019) ("[D]rawing a line between business and legal risk is debatable from a social welfare perspective . . .").

48. See Ewan McGaughey, *Democracy in America at Work: The History of Labor's Vote in Corporate Governance*, 42 SEATTLE U. L. REV. 697 (2019) (arguing for co-determination and worker representation on boards); see also Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism* 5 (Univ. Pa. Inst. Law & Econ. Research Paper No. 19-39), <https://ssrn.com/abstract=3461924> [<https://perma.cc/6QAE-FEK5>] (arguing that boards should establish a separate workforce committee).

49. See *infra* Parts III & IV.

50. See *infra* Appendix A. Insights from these conversations are throughout the Article, attributing statements to participants only with their consent.

51. See *infra* Part I.

provides the main evidence that ESG's real function in modern corporations is to manage risk.<sup>52</sup> We illustrate ESG's strengths by comparing it to the only other risk monitoring system law has previously required companies to develop: their compliance operations. We argue that the scope of issues highlighted by sustainability is much wider than the violations that compliance targets. Because of its focus on legal risk, compliance is backwards-looking and remains tethered to statutory and regulatory definitions of appropriate conduct, harm, and liability. In contrast, the stakeholders that populate ESG's information gathering efforts focus on negative developments on the ground, regardless of whether they are punishable by law. For example, many companies who commit to sustainability tend to ratchet up their product or service standards far above the minimum level required by law.<sup>53</sup> Similarly, sustainability pushes companies to think about concerns that might be currently unregulated but invoke values that law often protects.<sup>54</sup>

Part III argues that, in addition to a wider set of issues, ESG also utilizes more effective tools for eliciting information.<sup>55</sup> Compliance puts employees and managers on the spot and threatens sanctions, often leading supervisors to conceal or ignore misconduct. Instead, sustainability offers a new, optimistic vision for the future without lingering on the past, encouraging everyone to enter afresh into new commitments. Thus, the well-documented agency conflicts that often undermine compliance efforts are less pronounced in sustainability's case. Moreover, ESG initiatives, though often costly, manifest the company's credible commitment to stakeholders' concerns, which helps establish trust that can come in handy if risks materialize.

For all the advantages of stakeholder-oriented ESG as risk monitor, one might still wonder why companies have only recently started showing such concern about downside risks. To explain this drastic shift in corporate attention, Part IV points to the rise of asset managers as major shareholders in the United States over the last ten years.<sup>56</sup> Because of their contractual obligation to follow a predetermined investment strategy, such as replicating an index or an industry portfolio, asset managers cannot easily divest of troubled stocks. These hurdles to liquidate, while not generally a cause of concern in a large stock portfolio, make asset managers more

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52. See *infra* Part II.

53. See *infra* Section II.B.

54. See *infra* Section II.C.

55. See *infra* Part III.

56. See *infra* Part IV.

vulnerable to risks that are hard to diversify. The risks targeted by ESG often fall into this category. A crisis in one corporation often heralds a reckoning for the whole industry, which asset managers cannot easily exclude from their portfolios. Moreover, asset managers are particularly concerned about corporate externalities, which typically hurt other companies that large asset managers are very likely to own.

In Part V, we argue that Delaware courts should recognize that, by failing to build up their companies' ESG function, directors and officers are exposing their shareholders to increased risks.<sup>57</sup> If that failure is due to bad faith, it should be treated as a violation of the duty of loyalty. To clear the bad faith hurdle, boards should ensure that the company has a well-established ESG function. This would consist of an internal governance mechanism with adequate staff and resources, a well-defined substantive scope, and, most importantly, a robust effort for outreach to stakeholders. We do not propose a specific governance framework; boards should be free to formulate their framework in a manner that best integrates sustainability with their operations. But we do argue that an internal governance reform is necessary to transform stakeholder input into valuable corporate policy.

## I. SUSTAINABILITY CHALLENGES CONVENTIONAL WISDOM IN CORPORATE LAW

### A. *Shareholder Primacy, For-Profit Character, and ESG*

Despite trillions of dollars poured into ESG investments, a decade of corporate soul searching, and a bevy of standard setters, one would be hard-pressed to come up with a consistent definition for this phenomenon. Environmental concerns are a key area of interest, but they are only a subset of ESG's wide scope.<sup>58</sup> Issues related to workplace relationships, like gender equality and diversity;<sup>59</sup> technology problems, like privacy and cybersecurity;<sup>60</sup> and supply chain challenges, like

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57. See *infra* Part V.

58. See, e.g., PRINCIPLES FOR RESPONSIBLE INV., ANNUAL REPORT 2018, at 15–16 (2018), [https://www.unpri.org/Uploads/g/f/c/priannualreport\\_605237.pdf](https://www.unpri.org/Uploads/g/f/c/priannualreport_605237.pdf) [<https://perma.cc/D4BL-HAUD>] (discussing examples of actions on climate change, water, human rights, and labor in the garment industry).

59. See Terry Morehead Dworkin & Cindy A. Schipani, *The Role of Gender Diversity in Corporate Governance*, 21 U. PA. J. BUS. L. 105 (2018) (exploring rationales for gender diversity in corporate boards).

60. See WORLD ECON. FORUM, GLOBAL RISKS REPORT 2019, at 16–17 (2019), [http://www3.weforum.org/docs/WEF\\_Global\\_Risks\\_Report\\_2019.pdf](http://www3.weforum.org/docs/WEF_Global_Risks_Report_2019.pdf). [<https://perma.cc/H5T8-D9JM>] (discussing technological instability, particularly with respect to data privacy, as one of five areas of perceived major global risk); see also Owen Walker, *Data Privacy: Tech's 'Dark Underbelly'* *Bugs Responsible Investors*, FIN. TIMES (Oct. 14, 2018), <https://www.ft.com/content/707fb606-91a5->



humane work conditions, are now a mainstay of sustainability initiatives.<sup>61</sup> Moreover, ESG's scope expands by the day with new concerns vying for corporate attention, like the use of sugar in packaged foods<sup>62</sup> or children and screen time.<sup>63</sup> This definitional ambiguousness has given rise to a common misconception of ESG as a random and ever-sprawling assortment of objectives, influenced by fads and trends rather than hard business logic. Scoffing at ESG's multiple causes, we argue, is akin to looking at the trees but missing the forest.

Instead, we show that ESG has evolved into a separate corporate function, whose mission is to monitor and manage the risks facing the company due to its environmental and social impact. Conceptualizing ESG as a corporate function, one can easily see why its priorities vary and evolve continuously. ESG's focus adjusts to each company's distinct operations since each company impacts society in different ways. ESG narrows down a company's social risk by subjecting every aspect of its operations to a test of moral rectitude and social equitableness. Rather than frightfully open-ended, this process is, in fact, quite regimented and relies on feedback from the company's stakeholders, as we explore below in Section II.A.<sup>64</sup>

As a corporate function, ESG shares a monitoring mission alongside other departments such as internal controls, accounting, and compliance. But while internal controls and accounting operate under a rules-based framework defined by external actors in mandatory terms, ESG represents an attempt by companies to self-regulate their conduct. Terms like "corporate sustainability," "environmental, social, and governance" issues, and "triple bottom line" have been used widely, and often interchangeably with preexisting concepts like "corporate

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11e8-9609-3d3b945e78cf [https://perma.cc/CZU5-27L4] ("[D]ata privacy has become a crucial metric when assessing the companies in which [many people] invest.").

61. See Miguel Angel Jaimes-Valdez & Carlis Armando Jacobo-Hernandez, *Sustainability and Corporate Governance: Theoretical Development and Perspectives*, 6 J. MGMT. & SUSTAINABILITY 44, 48–50 (2016).

62. See, e.g., S&P GLOBAL, ESG INDUSTRY REPORT CARD: CONSUMER PRODUCTS AND AGRIBUSINESS 2 (2019), [https://www.spglobal.com/\\_media/documents/esg-industry-report-card\\_consumer-products-and-agribusiness.pdf](https://www.spglobal.com/_media/documents/esg-industry-report-card_consumer-products-and-agribusiness.pdf) [https://perma.cc/QL4G-LTFC] ("Consumers are increasingly focused on health and wellness, which has resulted in a loss of market share for some categories of goods such as carbonated nonalcoholic beverages, beer, and cereal. This is partly due to the additives, preservatives, sugar content, and chemicals . . .").

63. See Letter from Barry Rosenstein, Managing Partner, JANA Partners LLC, & Anne Sheehan, Dir. of Corp. Governance, Cal. State Teachers' Ret. Sys., to Bd. of Dirs., Apple Inc. (Jan. 6, 2018), [https://www.calstrs.com/sites/main/files/letter\\_from\\_jana\\_partners\\_and\\_calstrs\\_to\\_apple\\_inc\\_board\\_1.6.18.pdf](https://www.calstrs.com/sites/main/files/letter_from_jana_partners_and_calstrs_to_apple_inc_board_1.6.18.pdf) [https://perma.cc/6GVT-CTSE] (writing that, as shareholders collectively owning \$2 billion in Apple stock, they "believe there is a clear need for Apple to offer parents more choices and tools to help them ensure that young consumers are using your products in an optimal manner").

64. See *infra* Section II.A.

social responsibility.” Broadly speaking, these terms refer to voluntary actions taken by a company to manage its own environmental and social impacts. In this way, they are distinct from actions taken in response to a legal or contractual obligation.

Such an approach to doing business is, at least seemingly, in a collision course with fundamental tenets of corporate law, such as the for-profit character of corporations and the principle of shareholder primacy. The original expression of shareholder primacy is conventionally thought to emanate from the century-old ruling in *Dodge v. Ford Motor Co.*<sup>65</sup> In *Dodge*, the court struck down management’s decision to lower car prices because it was made ostensibly for social purposes—namely, helping customers and creating job opportunities—rather than the benefit of shareholders.<sup>66</sup> Recent cases have continued this thinking. In *eBay Domestic Holdings Inc. v. Newmark*, the court ordered shareholders who saw the company’s intellectual property as a free-for-all social good to either lift their objections to its monetization or change their form of association.<sup>67</sup> Delaware’s antitakeover jurisprudence, the linchpin of its corporate law edifice, seeks to identify the best option for shareholders above all else.<sup>68</sup> Whether doing what is best for shareholders would have grave social implications is not a relevant consideration in this case law.<sup>69</sup>

Shareholder primacy looms large over corporate law not simply as a landmark judicial principle, but also as a normative compass. Conservative theorists, like Milton Friedman and Frank Easterbrook, argue that shareholders hand over their money to a corporation because they want to see their capital grow—not because they want to help build a new community center, subsidize recyclable materials, or help with whatever do-gooding mission the company chooses.<sup>70</sup> If shareholders wanted to achieve any of these socially minded goals, the argument goes, they could directly support the charity or NGO of their preference.<sup>71</sup> Thus, as agents for shareholders, managers and directors ought to respect the shareholders’ wishes, as expressed in their purchase of a share in a for-profit company.<sup>72</sup> Deviation from

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65. 170 N.W. 668, 684–85 (Mich. 1919).

66. *Id.*

67. 16 A.3d 1, 34 (Del. Ch. 2010).

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

69. See Strine, *supra* note 38, at 763.

70. See Friedman, *supra* note 6, at 32; Leo E. Strine, Jr. & Nicholas Walter, *Conservative Collision Course?: The Tension Between Conservative Corporate Law Theory and Citizens United*, 100 CORNELL L. REV. 335, 347 (2015) (“Put simply, conservative corporate theory embraces the notion that seeking profit for the stockholders is the only proper end.”).

71. Strine & Walter, *supra* note 70, at 351.

72. See *id.* at 348, 353.

shareholders' wishes amounts to a violation of the fiduciary duties owed to them. This shareholder-oriented understanding of corporate law has dominated corporate thinking in the last half century, edging out alternatives that prioritized the interests of other stakeholders.<sup>73</sup> CEOs have continuously pledged their allegiance, and press articles have confirmed its hold.<sup>74</sup> Even among academics, generally a quarrelsome bunch, dissident theories have failed to gain traction.<sup>75</sup>

Viewed strictly from the perspective of profit maximization, voluntarily expending corporate resources to achieve sustainable outcomes is a cost to shareholders that might run afoul of boards' and managers' duties. For business decisions that do not implicate self-interest, including those favored by ESG, directors and officers rely on the protection of the business judgment rule, which provides them with wide latitude to make speculative choices.<sup>76</sup> But the business judgment rule comes with two important provisos. First, the board must prove that it made a reasonable effort to be informed about the contours of that decision,<sup>77</sup> and second, the board ought to believe, in good faith, that its choice is in the best interests of the company.<sup>78</sup> Suppose that, in the context of satisfying its duty to be informed, management receives cost estimates confirming that the sustainable option is significantly more expensive than its conventional, but otherwise equivalent, alternative. It might be hard for managers to maintain in good faith that they are acting in the best interests of the company if they choose the expensive option because it is sustainable.<sup>79</sup>

Of course, good faith considerations have not prevented corporations from making charitable donations to universities, local communities, and other nonprofits.<sup>80</sup> It has long been accepted that

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73. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441–42 (2001).

74. See Andrew Edgecliffe-Johnson, *Beyond the Bottom Line: Should Business Put Purpose Before Profit?*, FIN. TIMES (Jan. 3, 2019), <https://www.ft.com/content/a84647f8-0d0b-11e9-a3aa-118c761d2745> [<https://perma.cc/S849-LWEZ>].

75. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. L. REV. 547, 592–99 (2003); Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1926 (2013); Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. PA. L. REV. 2003, 2007 (2013).

76. See *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

77. *Id.*

78. *Id.*; see also Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Garris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 635 (2010).

79. Unless, of course, they are able to explain why the sustainable option is preferable despite its higher price. For possible explanations, see *infra* Section I.C.

80. See *ExxonMobil, Employees and Retirees Donate More than \$50 million to U.S. Colleges and Universities*, EXXONMOBIL (May 14, 2019), [https://corporate.exxonmobil.com/news/newsroom/news-releases/2019/0514\\_exxonmobil-employees-and-retirees-donate-more-than-](https://corporate.exxonmobil.com/news/newsroom/news-releases/2019/0514_exxonmobil-employees-and-retirees-donate-more-than-)

directors and officers do not violate their fiduciary duties by devoting funds to a social cause, as long as the company explicitly states that it expects some benefit to flow back to it, however indirectly.<sup>81</sup> For example, a company can donate to a university because it benefits from an educated workforce. But while such a loose justification may be sufficient for a small payout, it is doubtful whether it would carry the same weight for a large company project that might involve a significant part of its resources. In addition, there is a circular logic to this doctrine since it still requires the company to point to an expected benefit to itself, such as a reputational boost.<sup>82</sup>

Cornered by the limitations of charitable donations' jurisprudence, the doctrinal directive for shareholder primacy, and the normative weight of profit maximization, corporate social responsibility ("CSR") could only remain peripheral. CSR departments developed mostly as an arm of the company's public affairs operations, looking to associate the company's brand with worthy causes.<sup>83</sup> For that reason, top management rarely engaged specifically with the company's CSR activities, and boards did not care to oversee them.<sup>84</sup> Core business strategy was outside of CSR's ambit. In this conceptualization, CSR is simply a more targeted way of conducting corporate philanthropy. These doctrinal boundaries are too constricting for the ambitions of a modern ESG function. Today, ESG aspires to transform key aspects of company operations, from raw materials and energy sourcing to

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50-million—to-us-colleges-and-universities [<https://perma.cc/M9J8-3SYT>]; Donald G. McNeil Jr., *Gilead Will Donate Truvada to U.S. for H.I.V. Prevention*, N.Y. TIMES (May 9, 2019), <https://www.nytimes.com/2019/05/09/health/gilead-truvada-hiv-aids.html> [<https://perma.cc/4NSF-LL9J>].

81. See *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 590 (N.J. 1953) (upholding a modest donation by a corporation to a university as "a lawful exercise of the corporation's implied and incidental powers . . . to insure and strengthen the society which gives them existence and the means of aiding themselves and their fellow citizens"); see also *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991) (affirming the approval of a settlement for a charitable donation and relying on *Theodora's* test of reasonableness and the 5% limitation as "a helpful guide"); *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969) (holding that a corporate donation must be "reasonable" and relying on the federal tax law's deduction limitation of 5% of total income as a test for reasonableness).

82. See *Kahn*, 594 A.2d at 62. The case law has not recognized long term risk mitigation as a potential benefit of corporate philanthropy.

83. See generally Brian Hughes, *Why Corporate Social Responsibility Is Essential for Brand Strategy*, HUFFINGTON POST (Dec. 6, 2017), [https://www.huffpost.com/entry/why-corporate-social-resp\\_b\\_9282246](https://www.huffpost.com/entry/why-corporate-social-resp_b_9282246) [<https://perma.cc/2BLH-MKXX>] (arguing in favor of implementing CSR strategies and providing guidance about how to do so).

84. See Robert B. Hirth, *Think You Know Sustainability? Think Again*, NACD: BOARD TALK (Feb. 27, 2019), [https://blog.nacdonline.org/posts/think-you-know-sustainability?\\_ga=2.132694089.65468589.1565971427-693579900.1564765622](https://blog.nacdonline.org/posts/think-you-know-sustainability?_ga=2.132694089.65468589.1565971427-693579900.1564765622) [<https://perma.cc/6ETC-ALQL>].

packaging and distribution channels,<sup>85</sup> from the company's relationship with its employees to its supply chain and third-party providers.<sup>86</sup> For ESG to enter the corporate mainstream, it has to square with corporations' for-profit character and the concept of shareholder primacy.

### *B. ESG Is Not Just Empty Rhetoric*

ESG is increasingly impacting foundational aspects of corporate governance, from executive compensation to board composition. Notwithstanding, skepticism has dogged the ESG movement from the start. The intractability of problems like climate change makes ESG commitments sound like hollow promises engineered by public relations teams to claim the allure of good citizenship. Public statements of support by key players, like Larry Fink or the Business Roundtable, express vague allegiance to universal values, but do not commit the author to any specific actions, nor do they have any legal implications. It is easy to dismiss these sentiments as marketing ploys or, at most, soft prodding. Contrast their influence with the doctrinal machinery corporate law has built to keep managers responsive to shareholder profit maximization, based on rewarding managers on the basis of earnings. With managerial incentives focused on keeping profits up until the end of the fiscal year, ESG's place among the board's priorities is far from certain. It may gain the support of some well-meaning executives, but it would lack a solid foundation to develop into a market-wide movement. More importantly, it would fail to transform companies on the ground.

For that reason, the strongest indication of ESG's strength as a movement is evidence that companies are changing their incentive structure and governance to incorporate ESG into executive performance. Executive compensation reform looms large. As early as 2012, the Principles of Responsible Investment advocated for introducing ESG-related criteria among the factors determining executive bonuses.<sup>87</sup> By 2018, a growing number of companies began

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85. See Andrew J. Hoffman, *The Next Phase of Business Sustainability*, 16 STAN. SOC. INNOVATION REV. 35 (describing stages for integrating sustainability into business operations).

86. See *id.* at 38 (“[C]ompanies [are] fac[ing] increasing demands for data, for both internal management and external validation, under the watchful eye of activists, investors, suppliers, buyers, employees, and customers. The gathering and dissemination of such information can open up new awareness of supply-chain risks and opportunities.”).

87. Stephan Hostettler, Raphael Lambin & Claudia Wuerstle, *Pay-for-Sustainability: How to Reflect ESG in Modern Compensation Systems*, HCM INT'L 3 (May 2018), [https://www.oebu.ch/admin/data/files/section\\_asset/file\\_de/3314/201805\\_viewpoint\\_-\\_esg%5B1%5D.pdf?lm=1540370871](https://www.oebu.ch/admin/data/files/section_asset/file_de/3314/201805_viewpoint_-_esg%5B1%5D.pdf?lm=1540370871) [<https://perma.cc/ND2F-D53Q>].

offering higher pay to executives who achieve ESG improvements, including technology giants Microsoft<sup>88</sup> and Intel<sup>89</sup> and consumer good companies Pepsi<sup>90</sup> and Walmart.<sup>91</sup> Estimates for the number of companies with ESG-based compensation criteria vary widely from 6% to 32%,<sup>92</sup> mostly because studies disagree on what factors to characterize as ESG-related and, in particular, whether to include compliance reforms among them.

The rapid pace of reform has taken executives by surprise. Just two years ago, Shell was fending off pressure from shareholders to tie executive compensation to carbon emissions reduction goals. Shell's general counsel even went so far as to state that it would be "foolhardy" to expose the company to legal challenges,<sup>93</sup> implying that introducing factors other than stock performance into the compensation calculus may be precluded by the shareholder primacy principle. By December 2018, Shell had become the first major extractive company to incorporate a carbon emissions reduction measure into its executive compensation,<sup>94</sup> prompting similar moves by London-based BP and France's Total. Chevron recently became the first U.S. company to link greenhouse gas emissions targets to compensation. To reduce its methane intensity emissions by 20% to 25% by 2023, Chevron added

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88. MICROSOFT, INC., 2019 PROXY STATEMENT 31–32 (2019), (discussing CEO's performance on culture, diversity, and inclusion as a determinant of their compensation award).

89. INTEL, INC., 2020 PROXY STATEMENT 78 (2020) (discussing specifically how ESG metrics affect compensation decisions).

90. PEPSICO, INC., 2020 PROXY STATEMENT 44 (2020) (grouping sustainability performance in a distinct "people and planet" category under a key determinant of executive compensation).

91. WALMART, INC., 2020 PROXY STATEMENT 51 (discussing the role of ESG criteria in pay determination). See also OPENMIC, BREAKING THE MOLD: INVESTING IN RACIAL DIVERSITY IN TECH 31 (Feb. 2017), [http://breakingthemold.openmic.org/OpenMIC\\_BreakingtheMold\\_Final.pdf](http://breakingthemold.openmic.org/OpenMIC_BreakingtheMold_Final.pdf) [<https://perma.cc/7JN8-QVGC>] (discussing diversity in pay decisions).

92. See, e.g., CERES, SYSTEMS RULE: HOW BOARD GOVERNANCE CAN DRIVE SUSTAINABILITY PERFORMANCE 18–19 (2018), [https://www.niri.org/NIRI/media/NIRI/sampledocs/Systems-Rule\\_Final.pdf](https://www.niri.org/NIRI/media/NIRI/sampledocs/Systems-Rule_Final.pdf) [<https://perma.cc/99A2-Y2VK>] (noting that 32% of companies tie executive compensation to ESG targets but only 6% disclose those targets).

93. Ron Bousso, *Shell CEO Says 'Foolhardy' to Set Carbon Reduction Targets*, REUTERS (July 5, 2018), <https://www.reuters.com/article/us-shell-carbon/shell-ceo-says-foolhardy-to-set-carbon-reduction-targets-idUSKBN1JV0ZY> [<https://perma.cc/FKK9-9PP6>].

94. See *Joint Statement Between Institutional Investors on Behalf of Climate Action 100+ and Royal Dutch Shell PLC (Shell)*, SHELL (Dec. 3, 2018), <https://www.shell.com/media/news-and-media-releases/2018/joint-statement-between-institutional-investors-on-behalf-of-climate-action-and-shell.html> [<https://perma.cc/FG7C-DJNM>] ("Shell acknowledges and agrees with the importance attached by its investors to the issue of climate change, and also agrees that Shell's future success is contingent on its ability to effectively navigate the risks and the opportunities presented by climate change.").

this goal to the incentive pay formula not only for its executives, but also for forty-five thousand employees.<sup>95</sup>

Executive compensation is also incorporating diversity targets, which are readily quantifiable. Some companies, like Verizon and American Express,<sup>96</sup> are linking executive compensation to specific diversity targets, while others, like Uber,<sup>97</sup> are keeping their proposed formula confidential.<sup>98</sup> These moves often lead to controversial changes, as Google's refusal to link its executives' compensation to diversity metrics has shown. Even after twenty thousand employees around the world dramatically walked out in November 2018, focusing global headlines on Google's practices, the company refused to back down.<sup>99</sup>

Although tying compensation to ESG is a relatively recent phenomenon, social scientists are beginning to explore its effectiveness. According to one large-scale observational study, companies that tie executive compensation to ESG goals tend to show an increase in social and environmental initiatives, a reduction in emissions, and an increase in green innovations.<sup>100</sup> Another study underscores the importance of having specific and quantitative targets, which are more easily set for climate and diversity as opposed to other ESG areas, such as human rights.<sup>101</sup> Anecdotally, the most promising changes seem to come from companies that implement these specific targets and scorecards and make them publicly available. At Pinterest, for example,

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95. *Greenhouse Gas Management: We're Taking Steps to Manage Greenhouse Gases*, CHEVRON, <https://www.chevron.com/sustainability/environment/greenhouse-gas-management> (last visited July 24, 2020) [<https://perma.cc/7M8D-9NWB>].

96. See Andrea Vittorio, *AmEx, Verizon Among Few S&P 500 Firms Tying CEO Pay to Diversity*, BLOOMBERG LAW (Aug. 15 2018, 6:02 AM), <https://news.bloomberglaw.com/bulkprint?includeArticleIds=00000164-f6e1-d8c8-af7e-fee190500002&order=PostedDate&query=AmEx,%20Verizon%20Among%20Few%20S%26P%20500%20Firms%20Tying%20CEO%20Pay%20to%20Diversity> [<https://perma.cc/B22V-6C9N>].

97. See Heather Clancy, *How LinkedIn Embeds Diversity Goals Into Day-to-Day Management*, FORTUNE (Oct. 20, 2015, 7:00 AM CDT), <https://fortune.com/2015/10/20/linkedin-compensation-diversity/> [<https://perma.cc/K5FS-9EAF>]; see also OPENMIC, *supra* note 91, for further reading on companies, including LinkedIn, that tie executive compensation to diversity.

98. Notably, Uber has also not disclosed its current numbers with respect to diversity, so it is unclear where the baseline is. See Shannon Bond, *Uber Ties Executive Bonuses to Diversity Targets*, FIN. TIMES (July 15, 2019), <https://www.ft.com/content/9a6fed76-a6b9-11e9-984c-fac8325aaa04> [<https://perma.cc/2S99-U6JV>].

99. See Vibhuti Sharma & Paresh Dave, *Alphabet Shareholders Reject Diversity Proposal Backed by Employees*, REUTERS (June 6, 2018), <https://www.reuters.com/article/us-alphabet-inc-agm/alphabet-shareholders-reject-diversity-proposal-backed-by-employees-idUSKCN1J22BS> [<https://perma.cc/4SSU-6XD5>].

100. See Caroline Flammer, Bryan Hong & Dylan Minor, *Corporate Governance and the Rise of Integrating Corporate Social Responsibility in Executive Compensation: Effectiveness and Implications for Firm Outcomes*, 40 STRATEGIC MGMT. J. 1097, 1099 (2019).

101. See Karen Maas, *Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?*, 148 J. BUS. ETHICS 573, 579 (2018).

the hiring rates for underrepresented engineers rose by 8% the year after it tied diversity goals to compensation and disclosed those metrics to the public.<sup>102</sup>

These executive pay reforms anchor a broader effort to increase the board's role in overseeing and promoting ESG. An important dimension of this effort is increasing director expertise in ESG issues. Asset managers like BlackRock<sup>103</sup> and State Street<sup>104</sup> and pension funds like CalPERS<sup>105</sup> are pushing for creating "climate-competent boards" by recruiting directors with related backgrounds. In response to such pressures, 17% of all public company boards now count at least one environmental sustainability expert as a director, according to a recent study.<sup>106</sup> Even ExxonMobil capitulated and added atmospheric scientist Susan Avery to its board in 2017.<sup>107</sup> But the most drastic change in board composition concerns gender representation. By 2019, women held 27% of all board seats in the S&P 500, up from 17% in 2012. While this is still a far cry from gender parity, there is significant momentum behind this trend. According to a recent study, 45% of all new board positions among the Russell 3000 were filled by women in 2019, up from

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102. See David Cohen, *Pinterest Updated Its Progress on Its 2017 Diversity Efforts*, ADWEEK (Dec. 20, 2017), <https://www.adweek.com/digital/pinterest-diversity-2017/> [<https://perma.cc/N2RE-E9W5>]; Candice Morgan, *What We Learned from Improving Diversity Rates at Pinterest*, HARV. BUS. REV. (July 11, 2017), <https://hbr.org/2017/07/what-we-learned-from-improving-diversity-rates-at-pinterest> [<https://perma.cc/J7YA-GAL5>]; Queenie Wong, *Pinterest Sets Diversity Goals*, MERCURY NEWS, <https://www.mercurynews.com/2015/07/30/pinterest-sets-diversity-goals-for-2016/> (last modified Dec. 16, 2016, 10:45 AM) [<https://perma.cc/8MBC-ZP9W>].

103. See *Investment Stewardship: Engagement Priorities*, BLACKROCK, <https://www.blackrock.com/corporate/about-us/investment-stewardship/voting-guidelines-reports-position-papers> (last visited Aug. 30, 2020) [<https://perma.cc/7TXK-XZ3Q#engagement-priorities>] ("We expect boards to be fully engaged with management on the development and implementation of the company's strategy.").

104. See *Climate Change Risk Oversight Framework for Directors*, ST. STREET GLOBAL ADVISORS 1 (Mar. 14, 2016), [https://www.ssga.com/investment-topics/environmental-social-governance/2018/06/climate-change-risk-oversight\\_jun%202018.pdf](https://www.ssga.com/investment-topics/environmental-social-governance/2018/06/climate-change-risk-oversight_jun%202018.pdf) [<https://perma.cc/8UY6-587F>] (noting "investor expectations of board members on their responsibilities with regards to climate change related matters at their companies").

105. See Veena Ramani, *Building Board Climate Competence to Drive Corporate Climate Performance*, CERES (June 12, 2018), <https://www.ceres.org/news-center/blog/building-board-climate-competence-drive-corporate-climate-performance> [<https://perma.cc/R2R7-DVPK>]. At the same time, there is still a long way to go: about 39% of all public company boards have recognized sustainability as a priority, suggesting that a good number of them have not gone as far as recruiting an expert director. See CERES, *supra* note 92, at 15.

106. See CERES, *supra* note 92, at 16–17.

107. Randy Showstack, *ExxonMobil Adds Climate Expert to Its Board*, EOS (Jan. 31, 2017), <https://eos.org/articles/exxonmobil-adds-climate-expert-to-its-board> [<https://perma.cc/Q98R-LV27>]; Julie Wokaty, *Shareholders Welcome Appointment of Climate Expert to ExxonMobil Board*, INTERFAITH CTR. ON CORP. RESP. (Jan. 26, 2017), <https://www.iccr.org/shareholders-welcome-appointment-climate-expert-exxonmobil-board> [<https://perma.cc/CF2K-HA3B>].



33% just one year prior in 2018.<sup>108</sup> Very recently, another milestone made headlines—there are no longer any all-male boards in the S&P 500.<sup>109</sup>

Companies are also experimenting with governance structures that keep the board informed about salient ESG issues and strengthen its oversight of ESG. About 10% of U.S. public companies are opting for creating a separate sustainability board committee, which can build channels of communication with sustainability officers, encourage proposals, and communicate concerns to the whole board.<sup>110</sup> Others warn that delegating this crucial function to a separate committee risks creating a silo and prevents ESG risk oversight from being fully embedded into the entire board's strategy.<sup>111</sup> As our interviews revealed, some companies, such as Clorox, have opted to incorporate ESG monitoring among the tasks of their most influential committees, such as the nominating and governance committees, which typically select directors and set the board's agenda.<sup>112</sup>

With such reforms underway, ESG is moving beyond token expressions of allegiance to changing how executives plan their strategy and how boards are monitoring firms' operations. The scale of these reforms, which alter management incentives and expand the scope of the board's obligations, illustrates the level of commitment necessary to achieve a change of direction for companies. Required to recalibrate their internal governance in ESG's image, companies hit upon the

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108. 2019 U.S. Board Diversity Trends, ISS GOVERNANCE (May 31, 2019), <https://www.issgovernance.com/library/2019-us-board-diversity-trends/> [<https://perma.cc/L4LR-HV2J>].

109. Vanessa Fuhrmans, *The Last All-Male Board on the S&P 500 Is No Longer*, WALL ST. J. (July 24, 2019, 5:20 PM ET), <https://www.wsj.com/articles/the-last-all-male-board-on-the-s-p-500-is-no-longer-11564003203> [<https://perma.cc/L6LL-8KA5>].

110. See Lynn S. Paine, *Sustainability in the Boardroom*, HARV. BUS. REV. (Jul.–Aug. 2014), <https://hbr.org/2014/07/sustainability-in-the-boardroom> [<https://perma.cc/47G9-X5X4>] (discussing the benefits of sustainability committees on corporate boards).

111. See Veena Ramani, *View From The Top: How Corporate Boards Can Engage on Sustainability Performance*, CERES 4 (Oct. 2015), [https://www.ceres.org/sites/default/files/reports/2017-03/ceres\\_viewfromthetop.pdf](https://www.ceres.org/sites/default/files/reports/2017-03/ceres_viewfromthetop.pdf) [<https://perma.cc/V48W-KBCP>] (indicating that embedding sustainability in discussions on strategy, risks, and incentives “is essential for ensuring that sustainability is not considered in a silo”).

112. Telephone Interview with Laura Stein, Exec. Vice President & Gen. Counsel, The Clorox Co. (Dec. 18, 2018). At Clorox, the Nominating and Governance Committee changed its name in the last year to the “Nominating, Governance, and Corporate Responsibility Committee” and amended its charter to include oversight of “corporate responsibility and sustainability, including environmental, social and corporate governance matters.” *The Clorox Company Board of Directors Committee Charters*, THE CLOROX CO. (May 20, 2019), <https://www.thecloroxcompany.com/who-we-are/corporate-governance/committee-charters/> [<https://perma.cc/XPV7-UCA9>]. Gap Inc., for example, created a dedicated Governance and Sustainability Committee, which also includes the Chair of the Compensation Committee and a member of the Audit and Finance Committee. *Governance*, GAP INC., <https://www.gapinc.com/content/gapinc/html/investors/governance.html> (last visited Aug. 30, 2020) [<https://perma.cc/XBX3-XHT6>].

normative stumbling block of shareholder primacy, which asks directors and officers to put shareholders' interests first. At first glance, shareholder and stakeholder interests clash. Below, we explore current approaches to reconcile this clash.

### C. Why "Doing Well by Doing Good" Is Not Enough

To find a way out of their doctrinal quagmire, sustainability supporters came up with a new mantra. Companies, they claim, can "do well by doing good."<sup>113</sup> If boards and managers choose the sustainable option because they believe it is also going to lead to higher profits, then there is no clash with shareholder primacy. To start, there is significant consumer demand for sustainably grown or manufactured products.<sup>114</sup> Moreover, the argument goes, companies faced with a significant cost difference between the sustainable and conventional options often choose instead to go back to the drawing board and innovate. If a company finds an innovative and cost-effective way to employ the sustainable option, it can succeed in a marketplace dominated by competitors who employ conventional methods.<sup>115</sup> More broadly, innovation in sustainable production can provide companies with an edge over competitors if one accepts that, in the long term, all competitors will be forced to move toward more sustainable production methods.<sup>116</sup> Conceptualized this way, sustainability is another megatrend of our era, calling for businesses to adapt their production methods just like they did in response to the technology revolution and globalization in the 1980s.<sup>117</sup>

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113. Robert G. Eccles, Ioannis Ioannou & George Serafeim, *The Impact of Corporate Sustainability on Organizational Processes and Performance*, 60 MGMT. SCI. 2835, 2835 (2014) (quoting R. EDWARD FREEMAN, JEFFREY S. HARRISON, ANDREW C. WICKS, BIDHAN L. PARMAR & SIMONE DE COLLE, *STAKEHOLDER THEORY: THE STATE OF THE ART* (2010) and Michael E. Porter & Mark R. Kramer, *Creating Shared Value*, HARV. BUS. REV. 89 (Jan.-Feb. 2011)).

114. See Solitaire Townsend, *88% of Consumers Want You to Help Them Make a Difference*, FORBES (Nov. 21, 2018, 11:43 AM), <https://www.forbes.com/sites/solitairetownsend/2018/11/21/consumers-want-you-to-help-them-make-a-difference> [<https://perma.cc/X3EP-NKX3>] (discussing demand for sustainable brands).

115. Cf. Mike Colias, *GM, Volkswagen Say Goodbye to Hybrid Vehicles*, WALL. ST. J. (Aug. 12, 2019, 10:00 AM), <https://www.wsj.com/articles/gm-volkswagen-say-goodbye-to-hybrid-vehicles-11565602200> [<https://perma.cc/J8EA-DQU4>] (discussing GM's decision to concentrate their investment on fully electric cars in order to beat competitors focused on conventional hybrid cars).

116. See Deniz Gülsöken, *The Future of Plastic Lies in its Reinvention as Bioplastics*, FORBES (Jan. 16, 2019, 12:15 PM), <https://www.forbes.com/sites/denizgulsoken/2019/01/16/the-future-of-plastic-lies-in-its-reinvention-as-bioplastics> [<https://perma.cc/EU49-XNCU>] (explaining how companies are introducing sustainable bioplastics to replace plastic use, a move partly driven by a desire to meet consumer demand for environmentally sustainable materials).

117. See David A. Lubin & Daniel C. Esty, *The Sustainability Imperative*, HARV. BUS. REV. (May 2010), <https://hbr.org/2010/05/the-sustainability-imperative> [<https://perma.cc/Z9HA-KQ5P>].

“Doing well by doing good” helps advance ESG from the corporate philanthropy pigeonhole into a core-business mindset and has shown great momentum, but has also faced significant challenges, both doctrinally and normatively. From a fiduciary duty case law perspective, boards can develop “green” features they believe consumers like or invest in innovating their production without fear of liability. Such decisions are oriented toward profitmaking and, consequently, they neither threaten shareholder primacy nor raise concerns about the good faith of directors and officers. But not all ESG initiatives are directly visible to consumers, and there are many industries that are not consumer-facing.<sup>118</sup> Thus, relying on consumer preferences to justify ESG can only get one so far. In addition, while ESG has been a driver for innovation, it also includes many initiatives where no innovation is involved. For example, many workplace-related ESG goals, such as gender pay equity, strive to change long-established practices.<sup>119</sup> Thus, “doing well by doing good” can plug some doctrinal holes, but does not rise to an all-encompassing justification for ESG. To overcome the doctrinal limitations, policymakers and scholars are exploring alternative business forms that are better suited to pursuing social goals.<sup>120</sup>

The normative front proves even more disappointing for the doing-well-by-doing-gooders. To start, it is easy to recast “doing well by doing good” as a prohibition, demanding companies to engage in ESG only to the extent that there is a solid case for increasing profits. This could prove constricting for boards, which might have to drop ESG initiatives if they cannot justify them adequately. Even if one accepts that ESG can help boost sales to like-minded consumers or cut costs due to innovation, it still represents just one among many means to get to the desired outcome. Directors and officers can opt for any other strategy they choose, even some that are in direct conflict with ESG goals. Due to its optional character, ESG could not develop the normative pull necessary to counterweigh the single-minded pursuit of

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118. For example, chemicals or machinery companies do not interact with consumers. The Global Industry Classification Standard, developed by S&P and MSCI, divides companies into groups, distinguishing chemical and machinery companies from consumer companies. S&P GLOB. & MCSI, GLOBAL INDUSTRY CLASSIFICATION STANDARD 6 (2018), [https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook\\_2018\\_v3\\_letter\\_digitalspreads.pdf](https://www.spglobal.com/marketintelligence/en/documents/112727-gics-mapbook_2018_v3_letter_digitalspreads.pdf) [<https://perma.cc/NW2X-7Y2M>].

119. See CERES, TURNING POINT: CORPORATE PROGRESS ON THE CERES ROADMAP FOR SUSTAINABILITY 33 (2018), <https://www.ceres.org/resources/roadmap-for-sustainability> [<https://perma.cc/9UXD-H64U>] (discussing the trend of investors pushing companies to commit to equal pay for equal work).

<sup>120</sup> See Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937 (2020) (discussing existing hybrid forms, analyzing their strengths and weaknesses, and proposing an alternative form).

profit to which the corporate world had long subscribed. As often reiterated in our interviews with managers and shareholders, ESG proponents who argued for doing-well-by-doing-good did not manage to get a wave of conversions to their cause.

In Part III below, we develop a different business case for the role that ESG plays in modern corporations. Its mission, we claim, is to identify risks that, though emanating from a social or moral core, can lead the company into deep financial trouble, hurting its earnings and stock price performance. Understanding ESG as an exercise in risk mitigation, as we propose, offers an overarching theory that can accommodate different sustainability initiatives across industries without resorting to current trends in consumer preferences, technology, or business operations.

## II. ESG HELPS MITIGATE SOCIAL RISK THROUGH STAKEHOLDER INFORMATION

At first glance, sustainability may strike one as an unexpected choice for protecting a company against downside risk. Most people view sustainability as an effort to ensure that company decisions are in line with certain social or moral values. But, we argue, by operationalizing their commitment to these values, companies are also seeking to avert the reputational uproar, stock price drop, and legal troubles following misconduct. The outcomes visible to employees, shareholders, and the public are simply the end result of an extensive effort to identify areas of concern for the company and improve its performance.

The values that ESG promotes do not originate from an abstract moralistic philosophy of “doing the right thing,” nor are they dictated by a central standard setter, as is common with other industry self-regulatory efforts. Rather, they arise following a wide-ranging consultation with stakeholders, who are better positioned to take notice of potentially catastrophic company operations, as we show below.<sup>121</sup> Through this outward-looking process, ESG introduces new perspectives into the company’s decisionmaking in order to allow management to form a better understanding of the full impact of its decisions. At the same time, this process is iterative, allowing the company to interact and negotiate with stakeholders directly. The broader the circle of stakeholders participating in the company’s ESG outreach, the more representative its outcome will be, communicating the main concerns of the third parties most closely associated with or

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121. See *infra* Section III.B.

affected by company operations. What solidifies ESG is not unity of subject matter, but the common process of consulting stakeholders and operationalizing this feedback into achievable and measurable goals for the company. Thus, sustainability takes two viewpoints traditionally seen as antithetical by corporate law theorists—the shareholder perspective and the stakeholder perspective—and merges them into one coherent approach.

In this Part, as well as Part III below, we develop our argument that ESG gathers information from stakeholders to help companies mitigate risks. We start by situating ESG as an effort by companies to self-regulate their conduct, and compare it to compliance, the only other corporate function enconced by law to rein in corporate misconduct. We first explain why these two functions are comparable, and then explain why ESG is more effective as a tool for risk mitigation compared to compliance. In Section II.A, we argue that ESG has a wider scope than compliance, providing the board with information about problems that might not have otherwise reached it in time. In Section II.B, we show that, even when compliance and ESG target the same value, such as gender in the workforce, ESG's aperture is much wider. In Section II.C, we show how ESG can flag problems with company practices before the law instigates a formal prohibition. In Part III, we argue that ESG encourages stakeholders to share information with management rather than withhold it.

#### *A. Law-Driven Compliance Compared to Stakeholder-Driven Sustainability: An Overview*

Before the arrival of ESG, risk mitigation played a very limited role in corporate governance. Instead of constraining risk-taking, corporate doctrine is designed to encourage it, offering tools like entity partitioning or shielding management under the business judgment rule if investments turn sour.<sup>122</sup> As the conventional saying goes, the higher the risk, the higher the return.<sup>123</sup> Well aware of the need to curb corporate risk-taking, policymakers have enacted various regulations.<sup>124</sup> As companies developed into huge organizations with

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122. See David Rosenberg, *Supplying the Adverb: The Future of Corporate Risk-Taking and the Business Judgment Rule*, 6 BERKELEY BUS. L.J. 216, 217–19 (2009) (discussing corporate risk-taking in the context of the business judgment rule).

123. See *id.* at 221 (“When a corporation embarks on a risky venture, its leaders will likely justify the action on the grounds that, although the likelihood of failure is high, the venture will greatly benefit the corporation and its shareholders if it is successful.”).

124. For examples of regulations, see Occupational Safety and Health Act of 1970, 29 U.S.C. §§ 651-678 (2012), which ensures work environments free of hazards, and Fair Packaging and

hundreds or thousands of employees, however, ascertaining liability for legal violations became increasingly difficult.<sup>125</sup>

Struggling with the dynamics of corporate hierarchies, enforcement authorities like the Department of Justice (“DOJ”) pushed for the development of corporate compliance and an internal corporate department monitoring other employees.<sup>126</sup> Typical compliance methods include a corporate rulebook, monitoring processes, and employee training programs.<sup>127</sup> Over time, compliance became an essential part of laws passed in the wake of severe corporate misconduct, like Sarbanes-Oxley and Dodd-Frank, and national crises, like 9/11. Today, compliance departments in large corporations count hundreds of staff and report to the chief legal counsel or cooperate closely with her.<sup>128</sup>

Since compliance’s chief mission is to ensure that employees abide by the law, its goals, rules, and guidance mirror statutory mandates and agency rules. Heavily regulated areas, like money laundering, corruption, pollution, and intellectual property are primary compliance concerns.<sup>129</sup> Under Delaware law, the board has a duty to ensure that the company has an adequate compliance system and that it responds appropriately to any red flags about ongoing violations by employees.<sup>130</sup> Once red flags reach the board, it must investigate and penalize or fire involved employees.<sup>131</sup> Overall, by deterring employees

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Labeling Act, 15 U.S.C. §§ 1451-1461 (2012), which prevents deceptive packaging or labeling of consumer products.

125. See Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2147 (2019) (noting that a “proliferation of new [federal] rules and regulations” aimed to increase the flow and quality of information to investors by “ensuring adherence to legal and regulatory requirements”).

126. See U.S. DEPT OF JUSTICE CRIMINAL DIV., EVALUATION OF CORPORATE COMPLIANCE PROGRAMS (June 2020), <https://www.justice.gov/criminal-fraud/page/file/937501/download> [<https://perma.cc/RV43-D9TQ>] (indicating that the DOJ examines the effectiveness of a corporation’s compliance program to determine the appropriate form of prosecution or penalty).

127. See Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 939 (2017) (describing the “common structural framework for compliance”).

128. See Sean J. Griffith, *Corporate Governance in an Era of Compliance*, 57 WM. & MARY L. REV. 2075, 2077 (2016) (“[C]ompliance has blossomed into a thriving industry, and the compliance department has emerged, in many firms, as the co-equal of the legal department.”).

129. See generally *Regulatory Compliance*, PRICEWATERHOUSECOOPERS, <https://www.pwc.com/us/en/services/consulting/risk-regulatory/compliance-regulatory-risk-management.html> (last visited July 24, 2020) [<https://perma.cc/TN5Y-UKVZ>] (describing challenges regarding compliance in heavily-regulated areas).

130. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

131. See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 369, 373 (Del. 2006) (affirming *Caremark* and adding a requirement to exercise good faith in dealing with violations, and writing that where no red flags emerge, a board exhibits good faith by ensuring the existence of a “reasonable information and reporting system”).

from violating laws and sanctioning those that do, compliance seeks to limit corporate risk-taking.

In contrast, sustainability summons a very different set of forces. Broadly, the ESG process unfolds in three distinct stages. In the first stage, known as “materiality assessment,” sustainability officers invite internal and external stakeholders to provide input.<sup>132</sup> They typically begin with employees, who are interviewed outside the corporate hierarchy in order to identify concerns that may not reach the executive level. Sustainability leaders then open up the consultation process to external stakeholders, such as NGOs and academics, as well as governmental bodies like local authorities and regulators.<sup>133</sup> The composition of external stakeholders varies by company.<sup>134</sup> Inviting these stakeholders to sit across the table from company officers is a bold move.<sup>135</sup> Most would see themselves as the nemesis of large corporations and would mobilize to fight against business interests. Precisely for this reason, as we argue below, their feedback helps sustainability officers identify concerns whose weight company management might fail to grasp. Sustainability leaders present the most important issues, known in industry parlance as material, in a “materiality matrix” that headlines their report.<sup>136</sup>

Turning these words into deeds is the key task for the second stage of the sustainability process,<sup>137</sup> where sustainability leaders propose initiatives to address stakeholders’ concerns. Hopefully, these will include measurable impact, assessed through key performance indicators (“KPIs”). For example, a technology company responded to a concern about excessive screen time for children by instituting a training program for seventy thousand teachers, seven hundred thousand children and adolescents, and two hundred thousand

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132. KPMG, ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) MATERIALITY ASSESSMENT 3 (2017), <https://assets.kpmg/content/dam/kpmg/nz/pdf/September/esg-materiality-assessment-2017-kpmg-nz.pdf> [<https://perma.cc/V5E7-DDPX>]. For specific examples of various stakeholders providing input, see *infra* Section III.B.

133. Telephone Interview with Silvia Garrigo, Vice President, Corp. Responsibility & Soc. Inv., Millicom (Mar. 11, 2018).

134. SASB has compiled a map that details financially material sustainability issues by industry. *SASB Materiality Map*, SUSTAINABILITY ACCOUNTING STANDARDS BD., <https://materiality.sasb.org> (last visited Aug. 30, 2020) [<https://perma.cc/6D8S-5AGD>] (defining material issues by industry based on input from stakeholders).

135. See *infra* Section III.B for a discussion of how companies and NGOs often collaborate to address environmental and social risks.

136. *Id.* For an example of a company’s materiality matrix, see THE CLOROX CO., WHAT’S IN A BRAND? 2018 INTEGRATED ANNUAL REPORT 55 (2018), [https://s21.q4cdn.com/507168367/files/doc\\_financials/annuals/2018/Clorox\\_2018\\_Integrated\\_Report\\_Full-FINAL.pdf](https://s21.q4cdn.com/507168367/files/doc_financials/annuals/2018/Clorox_2018_Integrated_Report_Full-FINAL.pdf) [<https://perma.cc/JUD4-TGYR>].

137. Telephone Interview with Silvia Garrigo, *supra* note 133.

families.<sup>138</sup> Other KPIs may institute a timeline for a company to complete a transition, for example reducing its carbon emissions by 20% in two years.<sup>139</sup> After setting targets, the main task left for the third stage of the sustainability process is to monitor their performance. Often, annual sustainability reports offer a structure for this monitoring by providing momentum for gathering information and accountability for performing according to plan.

This brief overview of sustainability as a process illustrates its orientation toward risk mitigation, since its starting point consists in identifying areas of concern for the company. For that reason, comparing sustainability with compliance helps animate their respective strengths and weaknesses. Before we launch into this comparison, we would like to underline that our claim is not that these two functions are at war. In fact, the opposite is often true. In some cases, companies turned to sustainability initiatives at the urging of in-house lawyers.<sup>140</sup> Often, the legal, compliance, and ESG departments work together to advance future policies. In other cases, both departments report to the same officer or board committee. This institutional affinity between sustainability and compliance underscores why comparing them makes sense.

*B. ESG Adopts a Broader View of Harm than Compliance  
Even When Protecting the Same Values*

Compliance and sustainability are often animated by the same core values. Take the example of environmental protection. Our lawmakers have been enacting measures fighting pollution for decades, setting goals ingrained in companies' compliance systems.<sup>141</sup> It is almost tautologous to state that similar concerns about the planet's well-being also led companies to voluntarily undertake environmentally

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138. MILKA PIETIKAINEN & AMAYA GOROSTIAGA, MILLICOM INT'L CELLULAR SA & UNICEF, ASSESSING THE IMPACT OF MOBILE NETWORK OPERATORS ON CHILDREN'S RIGHTS: THE MILLICOM EXPERIENCE 16 (2017), [https://www.unicef.org/csr/css/MILLICOM\\_REPORT\\_26.07.17.pdf](https://www.unicef.org/csr/css/MILLICOM_REPORT_26.07.17.pdf) [<https://perma.cc/C6N5-SYFV>].

139. See Leslie Hook, *Emissions Statement: How Companies Are Getting Serious About Climate Change*, FIN. TIMES (Dec. 9, 2018), <https://www.ft.com/content/9b09c96c-f978-11e8-af46-2022a0b02a6c> [<https://perma.cc/B5X2-B6SM>] (discussing the emissions targets set by various companies such as "[t]o reduce emissions 15 per cent by 2030").

140. See UNITED NATIONS GLOB. COMPACT & LINKLATERS LLP, GUIDE FOR GENERAL COUNSEL ON CORPORATE SUSTAINABILITY 3 (2015), [https://d306pr3pise04h.cloudfront.net/docs/publications%2FGuide\\_for\\_General\\_Counsel.pdf](https://d306pr3pise04h.cloudfront.net/docs/publications%2FGuide_for_General_Counsel.pdf) [<https://perma.cc/6FPA-DHVW>] (explaining the trend of lawyers accelerating issues of corporate sustainability within their companies).

141. See Anthony Heyes, *Implementing Environmental Regulation: Enforcement and Compliance*, 17 J. REG. ECON. 107, 107–08 (2000) (describing past reports on company compliance with pollution regulations).



friendly initiatives. The same substantive dynamic between compliance and sustainability is evident in other areas. In many jurisdictions, laws protect individuals' rights to data privacy,<sup>142</sup> while sustainability initiatives are often geared towards cybersecurity, looking to protect companies' proprietary information more generally.<sup>143</sup> Turning to gender in the workplace, compliance focuses on sexual harassment and discrimination,<sup>144</sup> while sustainability looks at issues such as women's representation in leadership roles.<sup>145</sup> In all these cases, the deeper motives are shared.

But when considering how to best defend and promote these shared values, compliance's focus is much narrower. Delaware's jurisprudence confines compliance to targeting legal risk, rather than business risk.<sup>146</sup> Consequently, compliance officers look to the law in order to fulfill obligations and identify elements of violations, without much leeway for company-by-company variation. This legalistic approach is even more pronounced in specialized compliance regimes, such as anti-money laundering, which not only define substantive rules, but also put in place specific compliance procedures in furtherance of these rules.<sup>147</sup> Bound to legal definitions of misconduct, compliance is, by necessity, backwards-looking, reflecting conceptions of harm as they stood at the time of enactment. Often, new practices develop to take advantage of regulatory loopholes or simply to stay clear of legal boundaries. Although these practices do not violate any laws, they sometimes come to present a challenge to the underlying value that our legal system is trying to serve. Sometimes, the true extent of corporate misconduct may not become publicly known until much later, when the impetus for reform is gone. What rules prohibit depends also on the vicissitudes of our legislative and rulemaking systems.

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142. See generally Paul M. Schwartz & Karl-Nikolaus Peifer, *Transatlantic Data Privacy Law*, 106 GEO. L.J. 115 (2017) (comparing U.S. and E.U. privacy regimes and social norms).

143. See generally Scott J. Shackelford, Timothy L. Fort & Danuvasin Charoen, *Sustainable Cybersecurity: Applying Lessons from the Green Movement to Managing Cyber Attacks*, 2016 U. ILL. L. REV. 1995, 2006–19 (2016) (applying sustainability frameworks, including business ethics and CSR, to cybersecurity).

144. See Dworkin & Schipani, *supra* note 59, at 123 (discussing redress for sexual harassment and sex discrimination under Title VII).

145. See Emma Hinchcliffe, *The Firm Behind 'Fearless Girl' Has a Dubious Record of Backing Gender Diversity as a Shareholder*, FORTUNE (Apr. 1, 2019, 6:00 AM), <https://fortune.com/2019/04/01/state-street-fearless-girl-shareholder-resolutions/> [https://perma.cc/3NLT-FZJG] (describing campaigns to increase women's representation on company boards).

146. See *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 123, 130 (Del. Ch. 2009) (describing a typical failure to monitor claim as involving employee violations of law and holding that the court will not "disregard the presumptions of the business judgment rule and conclude that the directors are liable because they did not properly evaluate business risk").

147. See Stavros Gadinis, *International Compliance Regimes*, in *THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP?*, *supra* note 47, at 319, 327–30.

In contrast, sustainability's mission is not hardwired in statutory mandates or regulations, but instead rooted in voluntary commitments that companies can constantly redefine. This flexibility is particularly valuable because, unlike the policymakers that set compliance's goals, companies have access to far superior information sources that can detect harm and more imaginative solutions for anticipating or remedying it. Unlike policymakers, who obtain information through external sources and in the aggregate, companies can access information from internal and external stakeholders in a way that is tailored to its specific operations. In the context of the materiality assessment described above, sustainability leaders seek to identify issues that are not on the company's radar by turning to external stakeholders, such as customers, civil society groups, NGOs, the media, and academia. Often, external stakeholders include local authorities and other government bodies. Far from being allies of the corporate world, these groups are its traditional adversaries. Their opposition is rooted in their perception of "big business" as a destructive force that often disregards its impact on society.<sup>148</sup> But, because this information often does not implicate legal violations, compliance systems are not designed to register it, much less actively pursue it. Thus, it often goes undetected, unless—or until—it grows into genuine misconduct.

While external stakeholders rarely appear on compliance's radar, ESG sees these groups not only as watchdogs, but also as partners of companies, inviting them to sit across the table and share their concerns. This exchange of information often leads to results. For instance, hundreds of NGOs have cropped up in the past two years alone to amplify the impact of plastic pollution on the planet.<sup>149</sup> In response, some companies are collaborating and dedicating millions of dollars in research and development for plastic alternatives,<sup>150</sup> while others are investing in infrastructure that prevents plastic from

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148. See, e.g., Conor Friedersdorf, *Is Big Government or Big Business the Bigger Threat?*, ATLANTIC (Dec. 14, 2011), <https://www.theatlantic.com/politics/archive/2011/12/is-big-government-or-big-business-the-bigger-threat/249973/> [<https://perma.cc/8AMP-PTZ7>] (presenting the threat posed by big business to American liberalism as an established pillar of public opinion; Gallup has been consistently tracking Americans' perceptions of its force since 1965, comparing it with two other such threats, namely big government and big labor).

149. These NGOs have joined forces in a collective effort called "The Plastic Pollution Coalition." *The Coalition*, PLASTIC POLLUTION COAL., <https://www.plasticpollutioncoalition.org/the-coalition> (last visited July 24, 2020) [<https://perma.cc/7NZX-VSHQ>].

150. See Mark Wilson, *The World's Largest Packaged Food Company Will Ditch Single-use Plastic*, FAST CO. (Jan. 23, 2019), <https://www.fastcompany.com/90294975/the-planets-largest-packaged-food-company-is-ditching-plastic> [<https://perma.cc/UG3F-CBR6>] (explaining that large companies such as Starbucks and McDonald's have contributed millions of dollars to find a more sustainable cup standard and that the design will not be proprietary).

reaching oceans.<sup>151</sup> In another example, palm oil producers have joined forces with the World Wildlife Fund, Greenpeace, and other civil society organizations to develop standards that stem deforestation and human rights abuses.<sup>152</sup> Similarly, Belgian chocolate producers teamed up with civil society organizations and government representatives for an initiative to eliminate child labor, fight deforestation, and provide decent pay and education to the families of cocoa workers.<sup>153</sup> Other examples include the fashion industry<sup>154</sup> and mining.<sup>155</sup> Rather than “keeping their friends close and their enemies closer,” companies are devoting resources to addressing concerns expressed by these groups.

Consumers are another key stakeholder. In addition to routine surveys, sustainability officers also utilize informal mechanisms to capture tidbits of data that could affect the company’s profile and reputation or societal trends that may emerge into risks. At one company we visited, a group of interns worked in an open office with large screens monitoring what the youth in various markets were saying about the company on Facebook, Twitter, and other social media platforms. For the less well-heeled, a seemingly endless number of new technology products are being launched to help companies monitor their reputation on social media. Input from the same stakeholders has a different weight across companies. For a consumer company such as Apple, the views of individual customers matter more than they would for, say, a steel company.

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151. See *Dow Announces New Actions to Support Global Efforts on Plastic Waste*, DOW (Nov. 27, 2018), <https://corporate.dow.com/en-us/news/press-releases/dow-announces-new-actions-to-support-global-efforts-on-plastic-waste> [<https://perma.cc/T5LG-B4YY>]; see also Charlotte Middlehurst, *Waste-to-Energy: Panacea for Asia’s Pollution Problem or a Load of Rubbish?*, FIN. TIMES (July 7, 2019), <https://www.ft.com/content/75312290-7d61-11e9-8b5c-33d0560f039c> [<https://perma.cc/8K2J-P9TY>] (describing the Chinese government’s pursuit of a waste-to-energy policy).

152. *Palm Oil Producers, NGOs Launch Responsible Palm Oil Initiative at RSPO AGM*, FOREST PEOPLES PROGRAMME (Nov. 13, 2013), <http://www.forestpeoples.org/en/topics/palm-oil-rspo/news/2013/11/palm-oil-producers-ngos-launch-responsible-palm-oil-initiative-rsp> [<https://perma.cc/Y4MX-KWBA>].

153. *Belgian Chocolate 100% Sustainable by 2025*, BRUSSELS TIMES (Dec. 6, 2018), <https://www.brusselstimes.com/all-news/belgium-all-news/health/52352/belgian-chocolate-100-sustainable-by-2025/> [<https://perma.cc/J2HC-NDY8>].

154. See, e.g., Amanda Cotler, *Why Sustainable Fashion Matters*, FORBES (Oct. 7, 2019), <https://www.forbes.com/sites/ellevate/2019/10/07/why-sustainable-fashion-matters/> [<https://perma.cc/4J9D-LANZ>] (describing how consumers are pushing fashion companies to develop sustainable fabrics that are better for the environment).

155. See, e.g., ORG. FOR ECON. CO-OP. & DEV., *PRACTICAL ACTIONS FOR COMPANIES TO IDENTIFY AND ADDRESS THE WORST FORMS OF CHILD LABOUR IN MINERAL SUPPLY CHAINS 21–30* (2017), <https://mneguidelines.oecd.org/Practical-actions-for-worst-forms-of-child-labour-mining-sector.pdf> [<https://perma.cc/5Z7N-2XJJ>] (report by the Organisation for Economic Co-operation and Development recommending a due diligence framework to mining companies in order to assess risks for child labor).

A key internal source of information for the ESG function includes employees, a group that compliance also shares. ESG leaders, however, are not interested in how employees perform their mandated obligations, but in problems that the rulebook fails to capture. Employees are often the first ones to observe a major threat to the company's core business because they are in direct contact with any harm potentially caused.<sup>156</sup> It is because of their informational advantage that employees form the most common category of whistleblowers.<sup>157</sup> Sustainability provides them with a platform to express concerns early and without fear of adverse career implications, as it is largely informal.<sup>158</sup> ESG officers interview company employees across the corporate hierarchy. This process allows the sustainability team to identify inconsistencies between commitments made at headquarters and what is happening on the ground, as well as new risks that managers may not have fully comprehended.<sup>159</sup>

The difference between the compliance and ESG approaches can help explain why companies hit by compliance failures turn to ESG in an effort to avoid repeating the same mistakes. Wynn Hotels, whose CEO and founder resigned amidst a widely publicized sexual harassment scandal,<sup>160</sup> recruited new female directors<sup>161</sup> and introduced new communication channels between these directors and employees.<sup>162</sup> Collectively branded the "Women's Leadership Forum," these communication channels include town hall meetings, events, and fireside chats between directors and employees outside the typical corporate reporting hierarchy or the compliance apparatus.<sup>163</sup> But this

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156. See Alexander Dyck, Adair Morse & Luigi Zingales, *Who Blows the Whistle on Corporate Fraud?*, 65 J. FIN. 2213, 2224–26 (2010) (indicating that employees often serve a role in fraud detection).

157. See *id.* at 2214, 2240 (explaining that employees are the most common whistleblowers and that they "clearly have the best access to information").

158. We explain below that, in contrast with compliance, sustainability processes do not necessarily end with liability, so fear of retribution is lower. See *infra* Section III.A.

159. For an example of how employee observations help sustainability officers, see *infra* Section III.B.

160. Alexandra Berzon, Chris Kirkham, Elizabeth Bernstein & Kate O'Keeffe, *Dozens of People Recount Pattern of Sexual Misconduct by Las Vegas Mogul Steve Wynn*, WALL ST. J. (Jan. 27, 2018), <https://www.wsj.com/articles/dozens-of-people-recount-pattern-of-sexual-misconduct-by-las-vegas-mogul-steve-wynn-1516985953> [<https://perma.cc/M5Q2-WHAG>].

161. Aaron Smith, *Wynn Resorts Appoints 3 Women to Board in a 'Turning Point,'* CNN BUS. (Apr. 18, 2018), <https://money.cnn.com/2018/04/18/news/companies/wynn-women-board-of-directors/index.html> [<https://perma.cc/W7HZ-5U2Z>].

162. See Press Release, Wynn Las Vegas, Wynn Resorts Launches Women's Leadership Forum Series with Inaugural Event at Wynn Las Vegas (May 17, 2018), <https://press.wynnlasvegas.com/press-releases/wynn-resorts-launches-women-s-leadership-forum-series-with-inaugural-event-at-wynn-las-vegas/s/97d36392-e135-4bd3-be5b-bb373b772c12> [<https://perma.cc/5GPJ-K2P9>].

163. *Id.*

approach is hardly unique to companies emerging from scandal. LinkedIn's CEO, Jeff Weiner, refers to his own style of leadership as "compassionate management," encouraging employees to speak up and address pain points in town hall meetings.<sup>164</sup> Other companies, such as Salesforce and Amazon, conduct regular surveys among their employees seeking input about employee or sustainability issues.<sup>165</sup>

### C. ESG Addresses Social or Moral Challenges Even When No Laws Are Violated

The informational advantage enjoyed by company ESG officers over policymakers is even starker when business developments generate new social challenges that fall outside the current ambit of the law. We live in an era of huge business disruption, where successful startups can become multibillion-dollar companies in the span of a few years.<sup>166</sup> The explosion of social media has driven millions of users to voluntarily relinquish their private information online and only slowly come to grips with the myriad ways in which this can be exploited.<sup>167</sup> The sharing economy is revolutionizing workforce arrangements,<sup>168</sup> redesigning our urban domains,<sup>169</sup> and dislocating long-term

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164. Bill Snyder, *Jeff Weiner: Manage Compassionately, and Prepare for the Next Worker Revolution*, STAN. GRADUATE SCH. BUS.: INSIGHTS BY STAN. BUS. (Feb. 24, 2017), <https://www.gsb.stanford.edu/insights/jeff-weiner-manage-compassionately-prepare-next-worker-revolution> [<https://perma.cc/9KLB-VSMW>].

165. Adam Robinson, *How Airbnb and Salesforce Are Leading the Way When It Comes to Employee Engagement*, INC.COM (May 1, 2019), <https://www.inc.com/adam-robinson/how-airbnb-salesforce-are-leading-way-when-it-comes-to-employee-engagement.html> [<https://perma.cc/P93Y-C33B>]; Valentina Zarya, *Amazon Wants to Know How Employees Are Feeling—Every Single Day*, FORTUNE (Oct. 9, 2015, 3:04 PM), <https://fortune.com/2015/10/09/amazon-employees-feeling/> [<https://perma.cc/3FC9-8SRG>].

166. See Zoë Bernard, *10 Startups That Became Worth Billions in Less than 3 Years*, BUS. INSIDER (May 1, 2018, 8:25 AM), <https://www.businessinsider.com/fastest-startups-to-become-unicorns-by-crossing-1-billion-valuation-list-2018-4> [<https://perma.cc/9A22-WV3X>] (describing so-called "unicorns": private companies valued at over a billion dollars or more).

167. See Alex Hern, *Why Have We Given Up Our Privacy to Facebook and Other Sites So Willingly?*, GUARDIAN (Mar. 21, 2018), <https://www.theguardian.com/uk-news/2018/mar/21/why-have-we-given-up-our-privacy-to-facebook-and-other-sites-so-willingly> [<https://perma.cc/6UXU-QQVT>] ("We're all losing control of our data, both online and off, and we're starting to kick back. . . . [T]he burgeoning #deletefacebook movement [is] picking up steam.")

168. See M. Keith Chen, Judith A. Chevalier, Peter E. Rossi & Emily Oehlsen, *The Value of Flexible Work: Evidence from Uber Drivers*, 127 J. POL. ECON. 2735, 2736, 2792 (2019) (arguing that flexibility generates value for Uber drivers).

169. See Luke Carroll, *Airbnb, Other Home-Sharing Remove 31,000 Homes from Nation's Rental Market, Study Says*, CHRON. HERALD (June 28, 2019, 7:30 AM), <https://www.thechronicleherald.ca/news/canada/airbnb-other-home-sharing-remove-31000-homes-from-nations-rental-market-study-says-327728/> [<https://perma.cc/JY39-UA9W>] (explaining that Airbnb and other home-sharing services "were responsible for keeping 31,000 homes off Canada's long-term rental market"); Carolyn Said, *Window into Airbnb's Hidden Impact on S.F.*, S.F. CHRON. (June 2014), <https://www.sfchronicle.com/business/item/Window-into-Airbnb->

residents.<sup>170</sup> Artificial intelligence expands the use of computing power into new areas, substituting human judgment with pre-calibrated algorithms.<sup>171</sup> These are only a few examples of imminent challenges facing companies.

Despite these mounting challenges, the policymaking response has so far been underwhelming, when not entirely lacking. To be fair, policymaking is a time-consuming process, which requires generating public support, building political alliances, lobbying, and counter-lobbying. It takes time until the real impact of the problem is fully revealed and touches a broad enough base of voters to spur lawmakers into action.<sup>172</sup> This lengthy process is further compounded by political deadlock and polarization.<sup>173</sup> Some companies, like Uber<sup>174</sup> and Airbnb,<sup>175</sup> have had their run-ins with local authorities, facing bans or permitting requirements. Still, these were mostly localized responses

s-hidden-impact-on-S-F-30110.php [https://perma.cc/LUM7-9CUB] (indicating that almost five thousand San Francisco homes, apartments, and private or shared rooms are offered for rent on Airbnb).

170. See Steven Poole, *Airbnb Can't Go On Unregulated – It Does Too Much Damage to Cities*, GUARDIAN (Oct. 24, 2018, 4:30 AM), <https://www.theguardian.com/commentisfree/2018/oct/24/airbnb-unregulated-damage-cities-barcelona-law-locals> [https://perma.cc/E98P-VG76] (arguing that Airbnb prices out and displaces local residents).

171. See generally Luca Enriques & Dirk A. Zetzsche, *Corporate Technologies and the Tech Nirvana Fallacy* 7, 12–13 (Eur. Corp. Governance Inst., Working Paper No. 457, 2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3392321](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3392321) [https://perma.cc/DSL9-5K4D] (arguing contrary to the “tech nirvana fallacy,” which predicts that technology will replace human judgment and boards).

172. See Drew DeSilver, *A Productivity Scorecard for the 115th Congress: More Laws than Before, but Not More Substance*, PEW RES. CTR.: FACT TANK (Jan. 25, 2019), <https://www.pewresearch.org/fact-tank/2019/01/25/a-productivity-scorecard-for-115th-congress/> [https://perma.cc/2RTG-AHN3] (explaining recent bipartisan legislation, including an overhaul of the criminal justice system, legislation addressing the opioid crisis, and the “first comprehensive NASA authorization bill in more than six years”).

173. See *id.* (describing the inability of Congress and President Trump to agree on temporary funding measures in the 115th Congress).

174. See, e.g., Emma G. Fitzsimmons, *Uber Hit with Cap as New York City Takes Lead in Crackdown*, N.Y. TIMES (Aug. 8, 2018), <https://www.nytimes.com/2018/08/08/nyregion/uber-vote-city-council-cap.html> [https://perma.cc/XBY2-FAAL] (discussing New York City’s decision to halt new vehicle licenses for ride-hail services like Uber); Dirk VanderHart, *Proposal to Regulate Uber, Lyft Spurts Debate in Oregon Capitol*, OR. PUB. BROAD. (Mar. 18, 2019, 2:31 PM), <https://www.opb.org/news/article/uber-lyft-oregon-capitol-debate/> [https://perma.cc/7XF2-3ZXS] (explaining that Oregon lawmakers are considering a bill to allow localities to enforce additional regulations on Uber operations).

175. See, e.g., *New York Deflates Airbnb*, ECONOMIST (Oct. 27, 2016), <https://www.economist.com/business/2016/10/27/new-york-deflates-airbnb> [https://perma.cc/USE7-HVNT] (discussing recent legislation in New York fining individuals for renting properties of whole units in residential blocks for less than 30 days); Joe Williams, *Airbnb Crackdowns in DC, New York Foreshadow Fierce Struggles in 2019*, WASH. EXAM’R (Dec. 4, 2018, 12:00 AM), <https://www.washingtonexaminer.com/business/airbnb-crackdowns-in-dc-new-york-foreshadow-fierce-struggles-in-2019> [https://perma.cc/F43G-HZXC] (describing how Washington, D.C. and New York City have implemented measures to limit the types of property that can be rented through Airbnb).

rather than overarching frameworks. Thus, lawmakers and regulators seem to have had neither the time nor the inclination to understand the challenges posed, let alone respond to them effectively.

But the disruptors themselves—that is, the companies building new businesses on the ground, their suppliers, their creditors, and their investors—are the first ones to come across disconcerting repercussions. Due to their links to affected stakeholders and local communities, sustainability teams are well placed to grasp the impact of company choices on a broader set of constituents and even gauge public reaction. ESG's informational advantage will be particularly valuable when a crisis hits the company. Faced by narratives of unsuspected victims suffering harm they did not bargain for, the company can hardly protect itself by pointing out that it did not actually violate any laws.<sup>176</sup> Thus, the absence of legal obligations, which might have been welcome when business was developing, will turn into a drawback when the true extent of the harm is revealed. To avoid this outcome, the company needs a clear-eyed perspective on the interests of affected constituents, and decisive action to protect the ones most valuable for the company in the long run. The ESG function is well-equipped to serve this role.

The most recent Facebook/Cambridge Analytica debacle exemplifies a profound corporate crisis, unabated by the absence of any primary legal violations, that a robust sustainability function could have helped to avoid. Even though Facebook could claim to have obtained the contractual consent of its users for exploiting their data, it faced accusations that its practices violated users' privacy.<sup>177</sup> Mark Zuckerberg found himself the unwilling protagonist of a ritualistic congressional hearing,<sup>178</sup> culminating in a humbling apology to stem the slide of the company's share price.<sup>179</sup> He repeated time and again that

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176. See Rosenberg et al., *supra* note 41 (discussing Facebook's response to the leak of private user data to Cambridge Analytica, a voter-profiling company, and suggesting possible violations of election laws by Cambridge Analytica).

177. See *id.*

178. See Kevin Roose & Cecilia Kang, *Mark Zuckerberg Testifies on Facebook Before Skeptical Lawmakers*, N.Y. TIMES (Apr. 10, 2018), <https://www.nytimes.com/2018/04/10/us/politics/zuckerberg-facebook-senate-hearing.html> [<https://perma.cc/4WTJ-NGCB>] (describing Zuckerberg's congressional appearance as a "pointed gripe session").

179. See Sheena McKenzie, *Facebook's Mark Zuckerberg Says Sorry in Full-Page Newspaper Ads*, CNN (Mar. 25, 2018, 2:17 PM), <https://www.cnn.com/2018/03/25/europe/facebook-zuckerberg-cambridge-analytica-sorry-ads-newspapers-intl/index.html> [<https://perma.cc/8YW2-8U6L>] (explaining that Facebook took out full-page advertisements in British and American newspapers to apologize for its role in the Cambridge Analytica scandal after the company's value plunged almost \$50 billion); Danielle Wiener-Bronner, *Mark Zuckerberg Has Regrets: 'I'm Really Sorry that This Happened'*, CNN BUS. (Mar. 21, 2018, 10:17 PM), <https://money.cnn.com/2018/03/21/technology/mark-zuckerberg-apology/index.html> [<https://perma.cc/SSP7-LYLT>]; see also Sheera Frenkel, *Facebook Starts Paying a Price for Scandals*, N.Y. TIMES (July 25, 2018),

no laws were violated,<sup>180</sup> but shareholders could not have been happy with how the crisis unfolded within the company.<sup>181</sup> In the end, Zuckerberg stated that regulation was “inevitable,” recognizing the need for a stricter framework.<sup>182</sup>

Yet, details of the problem were well-known among employees, who were concerned about the company’s treatment of its users. Alex Stamos, the company’s chief security officer, had spotted potential gaps months before the scandal broke and rang the alarm bells.<sup>183</sup> But Cheryl Sandberg, Facebook’s chief operating officer, chose not to heed warnings, misjudging how users would react if the problem was revealed.<sup>184</sup> As Facebook’s former vice president for global communications, marketing, and public policy recently conceded, “We failed to look and try to imagine what was hiding behind corners.”<sup>185</sup>

<https://www.nytimes.com/2018/07/25/technology/facebook-revenue-scandals.html> [<https://perma.cc/B82X-52JU>] (detailing Facebook’s business losses following the Cambridge Analytica scandal).

180. Mark Zuckerberg stated that he did not believe Facebook had violated its consent decree with the FTC, nor any other obligation under then-current law, but that it ought to have in place stricter protections than law demands. *Transcript of Mark Zuckerberg’s Senate Hearing*, WASH. POST (April 10, 2018, 9:25 PM CDT), <https://www.washingtonpost.com/news/the-switch/wp/2018/04/10/transcript-of-mark-zuckerbergs-senate-hearing/> [<https://perma.cc/6WZH-SQSB>] (“But as I’ve said a number of times today, I think we need to take a broader view of our responsibility around privacy than just what is mandated in the current law.”)

181. Indeed, a derivative suit followed soon after. See Hamza Shaban, *Shareholder Sues Facebook After Stock Plunges*, WASH. POST (July 30, 2018, 10:30 AM), <https://www.washingtonpost.com/technology/2018/07/30/shareholder-sues-facebook-after-stock-plunges/> [<https://perma.cc/4MSK-5PL9>] (discussing an investor lawsuit accusing the company of misleading shareholders over the data privacy scandal involving Cambridge Analytica); Julia Carrie Wong, *Angry Facebook Shareholders Challenge Zuckerberg over ‘Corporate Dictatorship,’* GUARDIAN (May 31, 2018, 18:27 PM EDT), <https://www.theguardian.com/technology/2018/may/31/facebook-shareholder-meeting-mark-zuckerberg> [<https://perma.cc/XD2Z-FLFB>] (describing anger towards Zuckerberg at Facebook’s shareholder meeting).

182. *Facebook: Transparency and Use of Consumer Data: Hearing Before the H. Comm. on Energy & Commerce*, 115th Cong. 33 (2018) (statement of Mark Zuckerberg, Cofounder, Chairman and CEO, Facebook, Inc.).

183. Nicole Perloth, Sheera Frenkel & Scott Shane, *Facebook Exit Hints at Dissent on Handling of Russian Trolls*, N.Y. TIMES (Mar. 19, 2018), <https://www.nytimes.com/2018/03/19/technology/facebook-alex-stamos.html> [<https://perma.cc/XW4V-XWPH>] (“Mr. Stamos . . . had advocated more disclosure around Russian interference of the platform and some restructuring to better address the issues, but was met with resistance by colleagues.”); Matthew Rosenberg, Nicholas Confessore & Carole Cadwalladr, *How Trump Consultants Exploited the Facebook Data of Millions*, N.Y. TIMES (Mar. 17, 2018), <https://www.nytimes.com/2018/03/17/us/politics/cambridge-analytica-trump-campaign.html> [<https://perma.cc/D9T8-CUZT>] (explaining how data collected by Cambridge Analytica played an essential role in Russian interference with the 2016 U.S. presidential election).

184. See *id.*

185. Sheera Frenkel, Nicholas Confessore, Cecilia Kang, Matthew Rosenberg & Jack Nicas, *Delay, Deny and Deflect: How Facebook’s Leaders Fought Through Crisis*, N.Y. TIMES (Nov. 14, 2018), <https://www.nytimes.com/2018/11/14/technology/facebook-data-russia-election-racism.html> [<https://perma.cc/V5YD-5BN7>].



Facebook's blind spot is hardly surprising given that it is a clear laggard in sustainability, at least from the outside. Facebook does not release a sustainability report, now published by about 78% of S&P 500 companies.<sup>186</sup> These reports often follow rigorous templates such as the Global Reporting Initiative ("GRI"), whose Standard 418<sup>187</sup> sets out reporting requirements for customer privacy. While sustainability reports are informative for investors and consumers, their value also lies in the exercise of self-reflection and self-discipline they require companies to undertake. As Tim Mohin, the GRI president, recently noted, "[R]eporting can be more of a mirror than a window . . ."<sup>188</sup> Facebook just had not looked in that mirror yet. After the scandal, Zuckerberg acknowledged that Facebook needs "to take a broader view of our responsibility around privacy than just what is mandated in the current law."<sup>189</sup>

In contrast with Facebook's casual apathy on privacy, ESG proposes voluntary self-regulation, developed through ongoing engagement with stakeholders, including regulators and other government authorities. Leading Silicon Valley in-house lawyers advocate for this strategy as a risk mitigation tool, arguing that it will prove beneficial when government knocks on their door.<sup>190</sup> For example, when Lyft and Uber were founded, there was no regulation of ridesharing and there were no mandatory laws regarding liability insurance for their drivers.<sup>191</sup> Lyft's response to this regulatory vacuum was to create its own safety protocols, including instituting background checks for drivers, mandating periodic vehicle inspections, and requiring drivers to carry \$1 million in liability insurance.<sup>192</sup> To

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186. Kwon, *supra* note 5, at 3.

187. GLOB. REPORTING INITIATIVE, GRI 418: CUSTOMER PRIVACY 2016, at 2 (2018), <https://www.globalreporting.org/standards/gri-standards-download-center/gri-418-customer-privacy-2016/> [<https://perma.cc/5A3Y-SFER>] (click "download standard" and fill out form to view report).

188. Bob Eccles, *Twenty Years of the Global Reporting Initiative: Interview with CEO Tim Mohin*, FORBES (Aug. 15, 2017, 9:35 AM), <https://www.forbes.com/sites/bobeccles/2017/08/15/twenty-years-of-the-global-reporting-initiative-interview-with-ceo-tim-mohin/> [<https://perma.cc/8HJB-D3CV>].

189. Elizabeth Weise, *Will the FTC Come Down Hard on Facebook? It's Only Happened Twice in 20 Years*, USA TODAY, <https://www.usatoday.com/story/tech/2018/04/17/ftc-come-down-hard-facebook-its-only-happened-twice-20-years/508067002/> (last updated Apr. 19, 2018, 3:22 PM ET) [<https://perma.cc/3B6C-SNEM>].

190. Irene Liu, *Knocking on Government Doors: How Do You Respond to the Government Knocking on Your Door?*, THOMSON REUTERS LEGAL EXEC. INST. (Apr. 15, 2019), <https://www.legalexecutiveinstitute.com/knocking-on-government-doors-government-knocking/> [<https://perma.cc/Y4GF-TTFP>].

191. Interview with Kristin Sverchek, Gen. Counsel, Lyft (Aug. 28, 2019).

192. See *id.*; Rose Ors, *Conversation with Kristin Sverchek*, CLIENTSMART: VOICES IN SUSTAINABILITY (Jan. 23, 2020), <https://www.clientsmart.net/blog/voices-in-sustainability->

implement this framework, Lyft hired an in-house insurance broker and developed a tailored product.<sup>193</sup> Throughout this process, Lyft's general counsel kept in close contact with regulators at California's Public Utilities Commission.<sup>194</sup> When California became the first state to regulate rideshare companies in 2013, the enacted provisions echoed Lyft's regime.<sup>195</sup> Poles apart from Lyft's considerate approach was Uber's Travis Kalanick, who saw the regulatory vacuum into which rideshare companies were founded as an opportunity.<sup>196</sup> Uber went so far as to develop software to thwart the sting operations of undercover police officers fining drivers and impounding cars.<sup>197</sup> This literal game of "cat and mouse" that Uber aggressively played exploited grey areas in the law.<sup>198</sup>

### III. ESG AS A SUPERIOR STRATEGY FOR ELICITING INFORMATION

We have shown that ESG turns to stakeholders in order to elicit information, but ESG is far from being the only avenue through which these stakeholders interact with the company. Employees, for example, interact with the company's hierarchy daily and are also subject to its compliance oversight. Other stakeholders, like local authorities, may cross the company's path less regularly, but nevertheless quite frequently. Still others, like NGOs or regulatory agencies, often find themselves opposing company actions. Thus, to understand ESG's strength as an information collection tool, we need to explore why these disparate actors are willing to abandon deep-rooted fears and long-held biases and share information with ESG freely, or at least more willingly as compared to other forums.

Below, we argue that information flows openly from stakeholders to management through ESG for two reasons. First, ESG's

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conversation-with-kristin-sverchek [<https://perma.cc/4LJ4-CMR3>] (an interview with Lyft's General Counsel during which she explains that on her first day on the job, she went to the California Public Utilities Commission "to assure them we are aligned with what they care about. Being open to sitting down and talking with regulators is how we conduct business").

193. Interview with Kristin Sverchek, *supra* note 191.

194. Ors, *supra* note 192.

195. *Decision Adopting Rules and Regulations to Protect Public Safety While Allowing New Entrants to Transportation Industry*, CAL. PUB. UTILS. COMM'N 23 (Sept. 19, 2013), <https://docs.cpuc.ca.gov/PublishedDocs/Published/G000/M077/K112/77112285.PDF>

[<https://perma.cc/K2Y7-VEPM>] ("Additionally, Lyft has been the only TNC that has acknowledged that safety is not only a priority, but there should also be some overarching rules and regulations. We applaud Lyft for its leadership in this area and we certainly agree with Lyft in this area.").

196. See MIKE ISAAC, *SUPERPUMPED: THE BATTLE FOR UBER* 245 (2019) ("The term 'gray area' was music to Travis Kalanick's ears.").

197. *Id.*

198. See *id.* (describing Uber's efforts to evade regulatory oversight).

forward-looking perspective and inclusivity help stakeholders overcome the threats of liability and retaliation that often undermine compliance. Where compliance seeks to sanction and deter, ESG seeks to reconcile and inspire. Second, ESG helps establish trust between the company and its stakeholders. Throughout the ESG process, information flows in both directions. By showing interest and undertaking initiatives, the company also communicates to stakeholders its commitment to shared values, to be proven in practice through its initiatives. Thus, stakeholders are more likely to trust a company with a more successful ESG function.

*A. Sustainability Helps Overcome the Threat of Liability and Retaliation that Undermines Compliance*

For any company employee caught misbehaving, and for any manager found to have turned a blind eye or simply let her guard down, an internal compliance investigation is a stressful process. Often, the risk of legal liability looms large, forcing the main culprits behind a wall of self-protection.<sup>199</sup> Regardless of legal sanctions, targets may lose their job or suffer a career setback.<sup>200</sup> Even without being directly targeted, those participating in the process may come to perceive it as strict and bureaucratic.<sup>201</sup> Compliance produces a written record often synthesized in a report, which can be unearthed in inopportune moments.<sup>202</sup> Under such circumstances, blowing the whistle on coworkers may not be the easiest choice, countermanded by feelings of loyalty and sympathy.<sup>203</sup> It is not surprising that employee cooperation with compliance staff has never been entirely smooth.

Even from the board itself, compliance often elicits a mix of eagerness and trepidation. Corporate boards have authorized and overseen a huge expansion of compliance departments in an effort to

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199. See Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 859–60 (1994) (indicating that corporations may conceal evidence of their agents' crimes to minimize expected liability).

200. *Cf. id.* at 860 (suggesting that corporations may shift criminal liability on to the responsible agents).

201. See Gadinis & Miazad, *supra* note 125, at 2154–55 (describing in-house compliance officers as part of the “professional class” who share characteristics of outside gatekeepers such as accountants, bankers, and attorneys); see also Langevoort, *supra* note 127, at 941 (discussing the “check-the-box mentality” surrounding compliance).

202. See Gadinis & Miazad, *supra* note 125, at 2170 (indicating that plaintiffs often seek compliance reports in derivative suits).

203. See *id.* at 2149 (explaining that compliance staff may suppress corporate failures due to peer pressure); see also Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559, 590 (2008) (discussing the legal concept of good faith in Delaware and its effect on director accountability).

rein in corporate misconduct and satisfy their fiduciary duties.<sup>204</sup> But, as we have discussed elsewhere, compliance reports that raise red flags informing the board about violations are an essential link in establishing bad faith if the board then subsequently fails to address these violations adequately.<sup>205</sup> Practically, the board may wish to never have known about illegal activity, because then it risks seeing its reactions challenged in court.<sup>206</sup> Under such threat, boards may choose to stay aloof and limit their exposure to challenging reports, rather than step up and fix the problem.<sup>207</sup> Ultimately, compliance is a mechanism intended to deter violations through monitoring and to impose sanctions in a quasi-disciplinary setting when violations are caught. Deterrence and sanctioning have an important role to play in fighting corporate wrongdoing. But clearly, they are intended to be feared and not celebrated.<sup>208</sup>

This conundrum of risk monitoring and liability eases considerably under the umbrella of sustainability. Although sustainability evolves around issues of key legal interest, it employs a non-confrontational approach. Sustainability does not point the finger toward specific problematic individuals, but instead deals in broader terms, emphasizing culture, values, and relationships.<sup>209</sup> It does not get triggered by a mandate to penalize a violation, but by a desire to uphold a value.<sup>210</sup> It does not scrutinize the past, seeking to sanction mistakes,

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204. See Gadinis & Miazad, *supra* note 125, at 2139, 2146, 2152 (describing the explosion of corporate compliance departments in the last ten years as a result of changes in Delaware law and corporate misconduct scandals).

205. See *id.* at 2190–94 (explaining that compliance reports establishing the board’s bad faith are often key to cementing liability in legal cases against boards and management).

206. See Arlen, *supra* note 199, at 859 (indicating that internal corporate reports of misconduct may lead to additional liability for corporations).

207. See *id.* (explaining the possible liability that can result from internal corporate reports); see also Gadinis & Miazad, *supra* note 125, at 2175–79 (describing board responses to “red flags” from internal reports).

208. See Veronica Root, *The Compliance Process*, 94 IND. L.J. 203, 205 (2019) (explaining that organizations have initiated compliance programs “out of fear of sanction, harm, retribution, or ridicule”).

209. See Tara J. Radin, *Stakeholders and Sustainability: An Argument for Responsible Corporate Decision-Making*, 31 WM. & MARY ENVTL. L. & POL’Y REV. 363, 385–87, 399 (2007) (“[S]takeholder theory has evolved . . . into a more developed inquiry into the nature of stakeholder relationships . . . . The relationships between workers, firms, and the environment are both distinct and interrelational . . . . Sustainability . . . [builds] upon existing relationships, interconnectedness, and synergies.”).

210. See, e.g., THE COCA-COLA CO., 2018 BUSINESS & SUSTAINABILITY REPORT 25–32 (2018), <https://www.coca-colacompany.com/content/dam/journey/us/en/private/fileassets/pdf/2019/Coca-Cola-Business-and-Sustainability-Report.pdf> [<https://perma.cc/49A9-Y6ZM>] (indicating that Coca-Cola’s values encouraged the company to take part in initiatives aimed at reducing packaging waste, replenishing water and preventing droughts, and sourcing sustainably).

but looks to the future, helping the company evolve.<sup>211</sup> The outcome of a sustainability initiative is not severance or lawsuit, but a transformed product, process, or corporate culture.<sup>212</sup> In our meetings and roundtables, participants repeatedly emphasized that employees participating in sustainability discussions are more forthcoming about issues that threaten the company.<sup>213</sup>

For the individuals participating in attaining a KPI, the experience is markedly different than the bureaucratic, quasi-disciplinary compliance exercise. Sustainability may replace previous practices, but it does not directly criticize the employees who followed and tolerated them, making it easier for all to adopt and adapt. Of course, not all may be amenable to change, and sometimes changing established patterns of behavior may prove an uphill battle. But the mere fact that sustainability focuses on company-wide initiatives rather than individuals' own failures removes a point of contention and helps push reforms forward. Sustainability brings with it a promise for self-improvement in the form of a recognition that, regardless of how we did business in the past, we can do better from now on.

To insulate participants from fear of retaliation or other legal entanglements and invite uninhibited information flow, Airbnb redesigned its approach. Its general counsel, Rob Chesnut, invested in developing direct communication with employees that emphasizes proactive conversations and risk prevention, as opposed to only reactive investigations and sanctions.<sup>214</sup> In an unusual commitment for such a high-ranking executive, he personally led an orientation session for new Airbnb employees each week to champion the company's values and

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211. See Radin, *supra* note 209, at 398 (“[Sustainability] emphasizes investments in the future rather than one-time actions.”).

212. See Jeff Civins & Mary Mendoza, *Corporate Sustainability and Social Responsibility: A Legal Perspective*, 71 TEX. B.J. 368, 369 (2008) (“[A] distinguishing feature of a corporate social responsibility program is the notion that long-term environmental and social aspects, as well as economic aspects, be integrated into a corporation’s business strategy . . .”).

213. Our interviews provided individual as well as aggregate level examples of these effects. At the individual level, employees in energy companies were more willing to share concerns with sustainability officers about potential environmental violations, rather than alerting compliance officers to these problems. Representatives of companies participating in our November 2018 Roundtable emphasized that employees are more willing to share information with sustainability officers because their comments can have a broader scope and do not trigger a formal investigation into their colleagues. At the aggregate level, many companies responded to #MeToo by creating forums where employees, particularly female ones, can discuss experiences and share information so that they effect a broader change in culture.

214. Interview with Rob Chesnut, Gen. Counsel, Airbnb (Oct. 11, 2019). Chesnut recently published a book about how fostering a culture of integrity is vital to corporate success, premised on his work at Airbnb. See ROBERT CHESNUT, *INTENTIONAL INTEGRITY: HOW SMART COMPANIES CAN LEAD AN ETHICAL REVOLUTION* (2020).

strengthen connections.<sup>215</sup> He based his sweeping and nonhierarchical approach not on the concept of law, which he believed would alienate people, but on the concept of practical integrity, which resonated with employees.<sup>216</sup> Rob Chesnut now focuses all his time into this work as the company's "Chief Ethics Officer."<sup>217</sup>

*B. Sustainability Addresses Uncertainties Through  
Commitment to Values and Trust*

Uncertainty is endemic in many arrangements that companies enter into, from contracts with employees to government permits. Because predicting and writing clauses about all contingencies is impossible, a robust ESG function signals a commitment to the values that will guide the company in addressing existing or future problems. The stronger this commitment, the greater its importance for employees and stakeholders. Organized communities have long addressed such uncertainties by relying on the concept of social capital. People in a society adhere to unwritten norms voluntarily—even though it is costly to them and beneficial to a third party—because they expect that, if they are the ones standing to benefit at a future moment, others will also adhere to society's norms.<sup>218</sup> Particularly when norm violations would result in externalities, adherence is meaningful both for the party itself, which internalizes the cost on the expectation that future would-be violators will do the same, but also for society, which averts these externalities. In his seminal work, Robert Putnam describes social capital as valuable connections among individuals based on "reciprocity and trustworthiness,"<sup>219</sup> while La Porta et al. underline the "propensity of people in a society to cooperate to produce socially efficient outcomes."<sup>220</sup> According to a leading study of company

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215. Caroline Spiezio, *Airbnb's General Counsel Shows Up and Gets Creative to Promote Employee Ethics*, LAW.COM: CORP. COUNS. (Jun. 13, 2019, 6:51 PM), <https://www.law.com/corpcounsel/2019/06/13/airbnbs-general-counsel-shows-up-and-gets-creative-to-promote-employee-ethics/> [<https://perma.cc/2AEG-LX5F>].

216. *See id.* ("Chesnut said that [a system of ethics advisers] allows employees who may be nervous about going to legal to speak with someone they know about their issue.").

217. *Id.*; *see also* Phillip Bantz, *Airbnb Chief Ethics Officer, Ex-General Counsel Rob Chesnut Steps Down*, LAW.COM (May 29, 2020), <https://www-law-com.proxy.library.vanderbilt.edu/corpcounsel/2020/05/29/airbnb-chief-ethics-officer-ex-general-counsel-rob-chesnut-steps-down/> [<https://perma.cc/3CJK-TSBS>].

218. Henri Servaes & Ane Tamayo, *The Role of Social Capital in Corporations: A Review*, 33 OXFORD REV. ECON. POL'Y 201, 203 (2017).

219. ROBERT D. PUTNAM, *BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY* 19 (2001).

220. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W Vishny, *Trust in Large Organizations*, 87 AM. ECON. REV. 333, 333 (1997).

performance during the 2008 financial crisis, companies with robust corporate social responsibility programs prior to 2008 were better able to weather the crisis.<sup>221</sup> Their successful performance, the study claims, was due to the trust they were able to inspire in consumers and regulators.<sup>222</sup>

### 1. Sustainability Helps Companies Inspire Employees

To illustrate how sustainability can help reduce uncertainty by fostering norms and building trust, let us consider an employment contract that may last for years. There are many aspects of company life, hierarchy, and culture that are hard to stipulate contractually. For example, a female employee considering whether to join the company may be uncertain about the company's commitment to gender equity. Clearly, monitoring alone cannot fully resolve this problem, since not every employee interaction can be monitored. Imagine now that our company shows its commitment to gender equality through its sustainability initiatives, such as releasing equal pay data. The employee can be more confident that the company will not tolerate practices that disadvantage women. In addition, by adhering to this norm herself, she can help establish a more inclusive workplace for her other female colleagues. By becoming personally invested in promoting company values, employees also grow more loyal to their company and more committed to its success beyond the confines of their job description.<sup>223</sup> Their job is not simply a means of securing the necessities of life, but a personal contribution to a greater mission.

But employees can also play an important role in enforcing norms and ensuring that companies' commitments to values do not become empty words, as Google's recent travails show. Since the early 2000s, its famous "don't be evil" motto allowed Google to hire thousands of highly talented employees who felt committed to its mission of

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221. Karl V. Lins, Henri Servaes & Ane Tamayo, *Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility During the Financial Crisis*, 72 J. FIN. 1785, 1819–20 (2017).

222. *Id.*

223. See WILLIAM D. EGGERS, NATE WONG & KATE COONEY, DELOITTE UNIV. PRESS, *THE PURPOSE-DRIVEN PROFESSIONAL* 4–6 (2015), [https://www2.deloitte.com/content/dam/insights/us/articles/harnessing-impact-of-corporate-social-responsibility-on-talent/DUP\\_1286\\_Purpose-driven-talent\\_MASTER.pdf](https://www2.deloitte.com/content/dam/insights/us/articles/harnessing-impact-of-corporate-social-responsibility-on-talent/DUP_1286_Purpose-driven-talent_MASTER.pdf) [<https://perma.cc/7XJP-GJ3A>]; PRICEWATERHOUSECOOPERS, *THE KEYS TO CORPORATE RESPONSIBILITY EMPLOYEE ENGAGEMENT* (2014), <https://www.pwc.com/us/en/about-us/corporate-responsibility/assets/pwc-employee-engagement.pdf> [<https://perma.cc/64RZ-S5RR>]; Robert E. Quinn & Anjan V. Thakor, *Creating a Purpose-Driven Organization*, HARV. BUS. REV. (July-Aug. 2018), <https://hbr.org/2018/07/creating-a-purpose-driven-organization> [<https://perma.cc/N2HY-Z4WN>].

making information available to all.<sup>224</sup> Since its founding, Google has nurtured a culture of employee feedback through face-to-face town hall meetings with founders and large-scale surveys, inviting employees' comments on everything from management and strategy to diversity and inclusion, and even President Trump's position on immigration.<sup>225</sup>

So, when management considered projects viewed as antithetical to Google's values, employees were ready to fight back. They convinced management to drop Project Maven, which would have developed artificial intelligence technology to help the U.S. military enhance its drones, estimated to bring almost \$70 million to Google in the first year alone.<sup>226</sup> They also convinced Google to withdraw from Project Dragonfly, its censored search engine in China, thus reaffirming its commitment to openness.<sup>227</sup>

Of course, open dialogue can also bring to light differences of opinion that might not always reach happy resolution. After revelations that Google had offered multimillion-dollar severance packages to high-ranking executives accused of sexual harassment, employees around the world staged dramatic walkouts.<sup>228</sup> Their demands included an end to mandatory arbitration for harassment claims, public data on the gender pay gap and sexual harassment reports, elevating the role of the chief diversity officer, and putting an employee representative on the board.<sup>229</sup> Google has acquiesced to some demands, such as providing

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224. See Steve Lohr, *Don't Be Evil*, N.Y. TIMES (Dec. 26, 2004), <https://www.nytimes.com/2004/12/26/weekinreview/dont-be-evil.html> [https://perma.cc/UN8P-RL9C] (discussing Google's announcement of the motto "don't be evil").

225. See, e.g., Steffen Maier, *How Google Uses People Analytics to Create a Great Workplace*, ENTREPRENEUR (Nov. 28, 2016), <https://www.entrepreneur.com/article/284550> [https://perma.cc/CW7V-Y76Y] (providing an example of Google's efforts to incorporate the feedback of low-level employees into management's strategy).

226. Scott Shane & Daisuke Wakabayashi, *The Business of War: Google Employees Protest Work for the Pentagon*, N.Y. TIMES (Apr. 4, 2018), <https://www.nytimes.com/2018/04/04/technology/google-letter-ceo-pentagon-project.html> [https://perma.cc/3UBN-G7XX]; Daisuke Wakabayashi & Scott Shane, *Google Will Not Renew Pentagon Contract that Upset Employees*, N.Y. TIMES (June 1, 2018), <https://www.nytimes.com/2018/06/01/technology/google-pentagon-project-maven.html> [https://perma.cc/PSY9-MKBT].

227. See John Carlo A. Villaruel, *Google Employees Resign in Protest of Project Dragonfly, A Censored Search Engine for China*, TECHTIMES (Sept. 16, 2018), <https://www.techtimes.com/articles/234346/20180916/google-employees-resign-in-protest-of-project-dragonfly-a-censored-search-engine-for-china.htm> [https://perma.cc/TY72-2AVC] (describing how one employee resigned in protest of the Dragonfly project).

228. Daisuke Wakabayashi, Erin Griffith, Amie Tsang & Kate Conger, *Google Walkout: Employees Stage Protest over Handling of Sexual Harassment*, N.Y. TIMES (Nov. 1, 2018), <https://www.nytimes.com/2018/11/01/technology/google-walkout-sexual-harassment.html> [https://perma.cc/TY72-2AVC].

229. Claire Stapleton, Tanuja Gupta, Meredith Whittaker, Celie O'Neil-Hart, Stephanie Parker, Erica Anderson & Amr Gaber, *We're the Organizers of the Google Walkout. Here Are Our Demands*, CUT (Nov. 1, 2018), <https://www.thecut.com/2018/11/google-walkout-organizers-explain-demands.html> [https://perma.cc/K9XA-MNAH].



information about sexual harassment reports and ending mandatory arbitration, but has rejected the governance reforms concerning the chief diversity officer and the board.<sup>230</sup> While Google's reaction to the walkouts dampened employee spirits at the company, it demonstrates how ESG can provide a vehicle for exchange of information and bargaining. Some of the reforms headlined at the walkouts, like ending mandatory arbitration, became templates for other companies amidst the ensuing #MeToo crisis.<sup>231</sup>

## 2. Sustainability Helps Companies Gain Government Entities' Trust and Inform Future Regulation

Sustainability can also help companies address information asymmetries in their relationships with government entities, such as regulators or local authorities. Regulators have a hard time predicting the diverse negative repercussions of various business practices because they do not understand the businesses as well as the companies do.<sup>232</sup> By committing to sustainability goals, companies undertake to constrain their discretion in ways that align their interests more closely with government objectives. By inviting governments to provide input during materiality assessments, sustainability officers can reassure their fears and satisfy their needs. Moreover, commitments to sustainability go beyond the initial stage of requesting government permits and obtaining approvals to last throughout the ongoing operation of the venture.<sup>233</sup> This is particularly important for government, whose ability to influence the venture diminishes once permits are issued, since monitoring is costly and not always straightforward.

Since this process involves repeated interactions and thorough negotiations, businesses can establish channels of communication with government entities that can be useful throughout the venture's operation. Besides familiarity, these negotiations help the company

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230. See Sundar Pichai, *A Note to Our Employees*, GOOGLE: THE KEYWORD (Nov. 8, 2018), <https://www.blog.google/inside-google/company-announcements/note-our-employees/> [<https://perma.cc/5UPT-F5FE>].

231. See Jean R. Sternlight, *Mandatory Arbitration Stymies Progress Towards Justice in Employment Law: Where to, #MeToo?*, 54 HARV. C.R.-C.L. L. REV. 156, 204 (2019) (naming other companies and law firms that followed Google's lead on ending mandatory arbitration).

232. See Kenneth R. Bamberger, *Technologies of Compliance: Risk and Regulation in a Digital Age*, 88 TEX. L. REV. 669, 734 (2010) (stating that institutional structures in businesses may prevent meaningful independent analysis).

233. See generally Luigi Guiso, Paola Sapienza & Luigi Zingales, *Corporate Culture, Societal Culture, and Institutions*, 105 AM. ECON. REV.: PAPERS & PROC. 336, 336 (2015) (discussing the importance of trust even in the presence of strong formal institutions such as governmental authorities).

gain the government's trust because it can point to its many efforts to voluntarily pursue socially desirable goals.<sup>234</sup> In a moment of crisis, this trust can help the company set aside suspicions about malice and build a genuine rapport with authorities, which can help cooperation and minimize fallout.

As disruptive technologies are opening up previously unregulated terrains, a strategy of approaching regulators proactively is not necessarily intuitive, as it prevents a company from taking advantage of the latitude that comes with the lack of regulation. Yet, many disruptors opt for that strategy in an effort to build a solid foundation for expansion. We have discussed above Lyft's success in clearing its driver insurance template with regulators and contrasted it with Uber.<sup>235</sup> Another disruptor who opted to build relationships with regulators is Airbnb. While Airbnb's founders were gearing up for war with authorities wary about its impact on their cities, its chief operating officer, Belinda Johnson, opted for another approach.<sup>236</sup> She noticed that, as Airbnb's hometown of San Francisco was considering how to tax the practice, dozens of passionate Airbnb hosts appeared to defend the company as a social movement helping people to belong anywhere.<sup>237</sup> Capitalizing on this goodwill, she suggested that Airbnb communicate with authorities in cities around the world years before entering these new markets.<sup>238</sup> This message resonated with local authorities in cities like London and Paris and allowed Airbnb to build relationships with them before problems arose. Operating in over 190,000 cities around the world, Airbnb has managed to stay away from crippling legal problems often arising around disruptive technology.

#### IV. ASSET MANAGERS, DOWNSIDE RISK, AND SUSTAINABILITY

By sourcing information from stakeholders, directors and managers can get valuable insights into the risks facing their companies, as we have argued above. But while ESG's informational advantages help justify its popularity, they do not explain why corporate governance started shifting in that direction only in the last decade or so. This shift is even more surprising considering that

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234. *See id.*

235. *See supra* text accompanying notes 190–198.

236. *See* Jessi Hempel, "Airbnb's Sheryl Sandberg" Is the Valley's Quiet Superpower, WIRED (Jul. 13, 2016, 12:00 AM), <https://www.wired.com/2016/07/airbnbs-sheryl-sandberg-is-the-valleys-quiet-superpower/> [<https://perma.cc/FA4X-H2LZ>] (discussing Belinda Johnson's career and approach to her work at Airbnb).

237. *Id.*

238. *Id.*

it has to overcome the ideological roadblock of shareholder primacy's prevailing interpretations, which are averse to stakeholder perspectives.

In this Part, we examine why this shift is happening now and what conditions make it possible. We argue that the drive behind ESG results from the transformation of public firms' shareholding structures, which are now dominated by institutional investors, and large asset managers in particular. These investors are more sensitive to risk than dispersed shareholders because they cannot liquidate their holdings as readily and are thus exposed to risks that are harder to diversify. Seeking to mitigate these risks, large asset managers are increasingly turning to sustainability, which offers a tool for assessing risk and a mechanism for responding. We first link the rise of ESG reforms within corporations to the support these reforms are receiving from large asset managers. While socially oriented proposals have been a mainstay of annual meetings for decades without managing to pass, they started gaining ground when large asset managers threw their weight behind them. We then examine their business model and argue that it makes them more sensitive to certain risks.

#### *A. Asset Managers as ESG Supporters*

For decades, efforts for socially oriented reforms in companies had failed to gain much traction. Social activists and religious organizations were bringing shareholder proposals in annual meetings with little success. Public pension funds were more likely than other asset managers to join socially oriented coalitions for passing shareholder proposals.<sup>239</sup> But in recent years, the tide has been turning. Large asset managers like BlackRock, State Street, and Vanguard have started to join these coalitions. Each of these asset managers controls, on average, 5% to 8% of every publicly traded U.S. company, often qualifying as the biggest shareholder.<sup>240</sup>

These large asset managers have embraced sustainability in a very public manner, fueling public debate. In 2019, Larry Fink, BlackRock's CEO, declared in his annual letter to CEOs that "[s]ociety is increasingly looking to companies, both public and private, to address pressing social and economic issues. . . . [C]ompan[ies] [must] serve all of its stakeholders over time – not only shareholders, but also

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239. See Patrick Bolton, Tao Li, Enrichetta Ravina & Howard Rosenthal, *Investor Ideology* 22–24 (Eur. Corp. Governance Inst., Finance Working Paper No. 557, 2019), <https://ssrn.com/abstract=3119935> [<https://perma.cc/8CZL-A4YW>].

240. Bebchuk & Hirst, *supra* note 13, at 735.

employees, customers, and communities.”<sup>241</sup> The business community underlined the importance of the letter as a paradigm shift for corporate strategy.<sup>242</sup> Board advisors emphasized that, to give shape and meaning to Fink’s broad directive, companies ought to think through their ESG initiatives and adherence to responsible investment values.<sup>243</sup> BlackRock’s proclamation is highly visible, but it is hardly alone. State Street has actively campaigned to increase diversity on boards, putting pressure on over six hundred companies to elect more women, and did not hesitate to vote against the reelection of directors in some cases.<sup>244</sup>

Wondering whether these expressions of support will materialize into a wider push for ESG reform, a growing empirical literature explores how much impact institutional investors have had on the ground. Overall, firms with higher institutional ownership are more likely to also demonstrate higher performance in their environmental and social profiles.<sup>245</sup> To gauge asset managers’ influence, some studies examine their role in shareholder proposals. While the number of environmental and social proposals brought has not changed significantly throughout the 2000s, these proposals are increasingly more likely to gain support from mutual funds and asset managers, as well as attract a positive recommendation from

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241. See Fink, *supra* note 16.

242. See Leslie P. Norton, *BlackRock’s Larry Fink: The New Conscience of Wall Street?*, BARRON’S (June 23, 2018), <https://www.barrons.com/articles/in-defense-of-social-purpose-1529716548> [<https://perma.cc/QSJ2-6ULUJ>]; Andrew Winston, *Does Wall Street Finally Care About Sustainability?*, HARV. BUS. REV. (Jan. 19, 2018), <https://hbr.org/2018/01/does-wall-street-finally-care-about-sustainability> [<https://perma.cc/Y8QW-4VSPJ>].

243. See Ed Batts, *BlackRock Talks ... and U.S. Companies Must Listen*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 13, 2018), <https://corpgov.law.harvard.edu/2018/02/13/blackrock-talks-and-u-s-companies-must-listen/> [<https://perma.cc/RFF5-YBNB>]; Martin Lipton, *Corporate Purpose: ESG, CSR, PRI and Sustainable Long-Term Investment*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 4, 2018), <https://corpgov.law.harvard.edu/2018/05/04/corporate-purpose-esg-csr-pri-and-sustainable-long-term-investment/> [<https://perma.cc/E27P-UFDWJ>]; Shaun Mathew & Sarah Fortt, *Takeaways From BlackRock’s 2018 CEO Letter*, LAW360 (Jan. 26, 2018, 11:01 AM EST), <https://www.law360.com/articles/1005956/takeaways-from-blackrock-s-2018-ceo-letter> [<https://perma.cc/LQ6Q-UAR8>].

244. See Press Release, State St. Glob. Advisors, State Street Global Advisors Reports Fearless Girl’s Impact: More than 300 Companies Have Added Female Directors (Sept. 27, 2018, 9:16 AM EDT), <https://newsroom.statestreet.com/press-release/corporate/state-street-global-advisors-reports-fearless-girls-impact-more-300-companie> [<https://perma.cc/5V35-7TVBJ>]; see also Simon Jessop, *Investor State Street Uses Financial Clout to Get More Women to the Top*, REUTERS (Mar. 8, 2018, 6:28 AM), <https://www.reuters.com/article/us-womens-day-state-street-uses-financial-clout-to-get-more-women-to-the-top-idUSKCN1GK1MF> [<https://perma.cc/5LKY-5XCJ>].

245. See Alexander Dyck, Karl V. Lins, Lukas Roth & Hannes F. Wagner, *Do Institutional Investors Drive Corporate Social Responsibility? International Evidence*, 131 J. FIN. ECON. 693, 694 (2019).

shareholder advisory firms like ISS.<sup>246</sup> Moreover, firms with a higher percentage of institutional investors known for their commitment to ESG are more likely to receive more ESG shareholder proposals in the first place.<sup>247</sup> Besides shareholder proposals, asset managers and other institutional investors communicate their priorities to management through private engagement meetings, where ESG features prominently on the agenda.<sup>248</sup>

The staggering growth of ESG-minded investors in recent years is a confluence of multiple factors. Consumer demand for products developed sustainably or ethically, or even for companies whose stances on social issues are in line with their own priors, is undeniable.<sup>249</sup> The sustainability movement, however, has reached companies beyond the consumer or retail sectors, suggesting that other forces are also at play. Similarly, retail investors, particularly millennials, are increasingly choosing to place their money with companies committed to ESG.<sup>250</sup> In 2018 alone, new ESG funds were put together by Vanguard,<sup>251</sup> Goldman Sachs,<sup>252</sup> Morgan Stanley,<sup>253</sup> Fidelity Investments,<sup>254</sup> and many others.

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246. See Yazhou Ellen He, Bige Kahraman & Michelle Lowry, *ES Risks and Shareholder Voice* 3 (June 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3284683](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3284683) [<https://perma.cc/ZL4X-L5JJ>].

247. See Erwin Eding & Bert Scholtens, *Corporate Social Responsibility and Shareholder Proposals*, 24 CORP. SOC. RESP. ENVTL. MGMT. 648, 658 (2017) (finding that “[t]he responsibility of institutional owners of the firm positively affects the probability of receiving an environmental shareholder proposal”).

248. See generally Elroy Dimson, Oguzhan Karakas & Xi Li, *Active Ownership*, 28 REV. FIN. STUD. 3225, 3257 (2015) (finding that successful engagements in social and environmental topics induce positive returns and improvements in operating performance and corporate governance); Andreas G. F. Hoepner, Ioannis Oikonomou, Zacharias Sautner, Laura T. Starks & Xiao Y. Zhou, *ESG Shareholder Engagement and Downside Risk* (Eur. Corp. Governance Inst., Working Paper No. 671, 2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2874252](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874252) [<https://perma.cc/YF63-ZNU3>] (finding that engagement on ESG issues reduces risk).

249. See Suzanne Vranica, *Consumers Believe Brands Can Help Solve Societal Ills*, WALL ST. J. (Oct. 2, 2018, 7:00 AM ET), <https://www.wsj.com/articles/consumers-believe-brands-can-help-solve-societal-ills-1538478000> [<https://perma.cc/LC62-WJ7W>].

250. See ERNST & YOUNG, *SUSTAINABLE INVESTING: THE MILLENNIAL INVESTOR* (2017), [https://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/\\$FILE/ey-sustainable-investing-the-millennial-investor.pdf](https://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/$FILE/ey-sustainable-investing-the-millennial-investor.pdf) [<https://perma.cc/GMG9-L4FZ>].

251. Crystal Kim, *Vanguard Group Goes Greener With Two ESG ETFs*, BARRON'S (June 27, 2018, 12:10 PM ET), [https://www.barrons.com/articles/vanguard-group-goes-greener-with-two-esg-etfs-1530115846?mod=article\\_inline](https://www.barrons.com/articles/vanguard-group-goes-greener-with-two-esg-etfs-1530115846?mod=article_inline) [<https://perma.cc/Z7T4-46G4>].

252. In July 2018, Goldman Sachs partnered with Just Capital to launch its own ESG ETF, the Goldman Sachs JUST U.S. Large Cap Equity ETF (“JUST”), which has gathered more than \$135 million in assets as of July 2020. See *Historical Performance for JUST*, NASDAQ, <https://www.nasdaq.com/symbol/just/etf-detail> (last visited July 25, 2020).

253. See Steve Garmhausen, *Morgan Stanley: The Case for Sustainable Investing*, BARRON'S (July 19, 2018, 4:17 PM ET), <https://www.barrons.com/articles/morgan-stanley-the-case-for-sustainable-investing-1531167431> [<https://perma.cc/YX42-2KVN>].

254. See Tim Gray, *Aiming to Do Good, Not Just Well*, N.Y. TIMES (July 14, 2017), <https://www.nytimes.com/2017/07/14/business/mutfund/aiming-to-do-good-not-just-well.html>

According to estimates, the total amount of assets invested in line with ESG principles had reached, by 2018, about \$22 trillion, or a quarter of all assets under management in the world.<sup>255</sup> But slow-changing demographics alone cannot justify a sudden surge in interest in the last few years. Moreover, it is not only retail investors who have turned to ESG, but also institutional investors, such as university endowments.<sup>256</sup>

We argue that large asset managers support sustainability because they understand its potential as a risk management tool and its promise as a complement to compliance. The paragraphs below develop our argument in further detail. We first discuss why asset managers' own business model, which prevents them from selling underperforming stocks until losses deepen significantly, turns the focus on downside risk. Even though risk is present in every investment, we identify three types of risk that disproportionately affect asset managers compared to retail investors: corporate crises, hard-to-diversify risks, and externalities.

### *B. Why Asset Managers Are Particularly Worried About Risk*

To explain why large asset managers are particularly worried about stock price downturns, we need to briefly describe their business model. Large asset managers control the vast majority of their holdings through passive funds, that is, pools of assets purchased with investors' money in order to implement a predetermined investment strategy, such as replicating an index or following a specific industry.<sup>257</sup> Since the fund's goals are set upon its foundation, asset managers have little flexibility in deciding, say, what stocks the fund will buy; it will buy whatever stocks make up the index it has promised to track.<sup>258</sup> Take the Dow Jones Industrial Average ("DJIA") index, which is composed of thirty large publicly owned companies in the United States. Whereas an active large cap fund would seek to select, say, the ten best companies out of the DJIA thirty, a passive fund would own shares in

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[<https://perma.cc/NCS9-DRXW>] (noting that Fidelity Investments introduced its International Sustainability Index Fund in 2016).

255. See Amy Whyte, *McKinsey: ESG No Longer Niche as Assets Soar Globally*, INSTITUTIONAL INV. (Oct. 27, 2017), <https://www.institutionalinvestor.com/article/b15cc1dxds8k97/mckinsey-esg-no-longer-niche-as-assets-soar-globally> [<https://perma.cc/R5DK-GKBZ>].

256. See Samuel M. Hartzmark & Abigail B. Sussman, *Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows*, 74 J. FIN. 2789 (2019) (finding no difference in the choices of retail and institutional investors).

257. See Fisch et al., *supra* note 13, at 27.

258. See *id.* at 37 ("Passive funds, by their very nature, must hold both the good and bad companies in their index.").

all thirty companies. The two different strategies have apparent trade-offs. The active fund's stock pickers would have to work harder so as to identify the top tier of the DJIA stocks, poring over their disclosures and conducting their own research. Their success would lie in overperforming the DJIA thirty, but they would charge higher fees to investors. Passive funds, in contrast, would simply buy the thirty stocks that form the index and would even replicate the price weighing that goes into forming it. This is a far more straightforward task, so the fees charged are much lower.

Of course, by eschewing active stock picking, investors expose themselves to the risk of underperforming stocks, which an active fund might avoid, supposing that its research revealed the risks. Financially, upside gains and downside losses are two sides of the same coin. Passive funds, however, have a structural limitation that renders them particularly exposed to downside risk. Their contractual commitment to replicate an index, follow an industry, or implement a specific strategy determines also whether they can sell a stock. Even when a stock is underperforming the market by a significant margin, passive funds cannot sell it as long as it remains central to their contractual commitment.<sup>259</sup> Thus, passive funds can remain tethered to underperforming stocks for much longer than active funds. Of course, accepting that some companies will underperform others is part and parcel of investing in an index-tracking fund. After all, not all companies can make sound business choices all the time. But there are certain types of risks that have a significantly more profound impact on passive funds compared to other investors, as we argue below.

### *C. Asset Managers Are Exposed to Risks that Are Hard to Diversify Away*

We noted above that passive funds are particularly exposed to serious downturns in a company's stock price because they cannot be as nimble as other investors. To some extent, passive funds offer protection against this risk through diversification, since they invest in a portfolio. Yet, it is hard to diversify against risks that involve a broader set of companies or the whole industry, and practically impossible to diversify against market-wide, systemic risks.<sup>260</sup> As we argue below, recent years have witnessed an extraordinary upsurge in

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259. See *id.* at 21 (“[Passive funds] cannot exploit mispricing or other informational advantages through trading, nor can they follow the Wall Street Rule and exit from underperforming companies the way traditional shareholders, particularly active funds, can.”).

260. See W. H. Wagner & S. C. Lau, *The Effect of Diversification on Risk*, 27 FIN. ANALYSTS J. 48, 48–53 (1971).

these risks, due to developments in technology, science, and politics. Because some of these risks are at the core of sustainability concerns, companies and investors have increasingly turned to this corporate function.

Industry-wide risks arise when a new set of developments affects all companies in that industry to a significant level, though not necessarily equally. We live in an age of unprecedented industry disruption, so examples of industry-wide reversals abound. Data privacy and cybersecurity are risks affecting Silicon Valley companies.<sup>261</sup> The use of clean water resources affects all beverage manufacturers.<sup>262</sup> The role of fossil fuel-powered cars plagues the automotive industry.<sup>263</sup> Sometimes, specific corporate crises like the ones we discussed in Section III.B above morph into industry-wide risks, exercising pressure on all companies operating under a similar business model. The repercussions of these crises suggest that the industry has reached a critical juncture, at which its ability to function in the same manner as before is in serious doubt. Arguably, the Cambridge Analytica debacle in Facebook, with its wide reach and political undertones, shattered any illusions the public had about data security. Critics attacked not only Facebook, but the tech industry as a whole.<sup>264</sup> The Equifax data breach brought to light similar issues in the financial industry.<sup>265</sup> While only one company found itself at the eye of the storm, the tidal wave hit other companies perceived to be in the same industry and viewed as following a similar approach.<sup>266</sup>

Some crises are so potent that they engulf the whole market, rendering diversification through alternative investment strategies

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261. Tim Seymour & Ryan Dodd, *Tech Stocks May Stay Under Pressure as Investors Weigh the Data Privacy and Cybersecurity Risks*, CNBC (Nov. 27, 2018, 12:42 PM EST), <https://www.cnbc.com/2018/11/27/tech-stocks-may-suffer-as-investors-weigh-the-data-privacy-risks.html> [<https://perma.cc/U2JJ-KCND>].

262. Barbara Grady, *Institutional Investors to Big Food: Come Clean on Water Risks*, GREENBIZ (Sept. 2, 2016), <https://www.greenbiz.com/article/institutional-investors-big-food-come-clean-water-risks> [<https://perma.cc/RA98-QZ8P>].

263. See LUKE FLETCHER, KANE MARCELL & TOM CROCKER, CDP, DRIVING DISRUPTION 3 (Jan. 18, 2018), <https://b8f65cb373b1b7b15feb-c70d8ead6ced550b4d987d7c03fcd1d.ssl.cf3.rackcdn.com/cms/reports/documents/000/002/953/original/CDP-autos-exec-summary-2018.pdf?1516266755> [<https://perma.cc/YN8Y-MUQD>] (discussing risks to automobile manufacturers from emissions regulations).

264. See Walker, *supra* note 60 (“Data has been dubbed the ‘new oil’ by many market commentators, . . . [b]ut, as investors are finding, scandals caused by data leaks can be just as damaging to tech behemoths as oil spills are to supermajors.”).

265. Brian Fung, *Equifax’s Massive 2017 Data Breach Keeps Getting Worse*, WASH. POST (Mar. 1, 2018, 9:51 AM CST), [https://www.washingtonpost.com/news/the-switch/wp/2018/03/01/equifax-keeps-finding-millions-more-people-who-were-affected-by-its-massive-data-breach/?noredirect=on&utm\\_term=.155fca5c1526](https://www.washingtonpost.com/news/the-switch/wp/2018/03/01/equifax-keeps-finding-millions-more-people-who-were-affected-by-its-massive-data-breach/?noredirect=on&utm_term=.155fca5c1526) [<https://perma.cc/3T5T-643U>].

266. *Id.*



much harder. The paradigmatic example is the spread of the #MeToo movement, which overturned many a powerful executive. By now, #MeToo has grown into a market-wide reckoning, having overturned the careers of over four hundred executives and high-profile employees, according to some counts.<sup>267</sup> Companies such as CBS, Intel, Wynn Resorts, and Guess are only some of the household names that saw top officers leave as a result of sexual misconduct allegations.<sup>268</sup>

But large-scale problems, one might retort, have upended business practices since time immemorial. The turn to sustainability, on the other hand, counts less than a decade of life. To understand why companies have only recently started focusing on such risks through the sustainability lens, we need to take into account the profound change in the incentives of corporate managers and boards due to the increasing presence of passive funds. Traditional corporate governance mechanisms, like quarterly disclosures or annual executive compensation, are tied to a set period, and in particular to the net profit number at the end of that period. With few built-in incentives to consider the long run,<sup>269</sup> directors and officers need only focus on what happens during their time at the helm. In large companies, the median CEO tenure stands at five years.<sup>270</sup> This looks like an awfully short time to solve the problems of humanity, particularly without any extra pay. And since all competitors are bound to be exposed to the same risk, any failure to address it will not stand out.

In contrast, the impact of such problems on businesses has become a salient question for asset managers who have committed to holding significant blocks of stock on behalf of their clients. As our interviews and roundtables with asset managers and investors have confirmed, when a whole industry faces a major downturn, asset managers understand very well that the inescapable implications will reverberate through their client base.<sup>271</sup> For some, it will be a direct hit to their savings, but for others, it may mean prolonging their retirement or cutting back on essentials. When the whole market is headed for a

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267. See Jeff Green, *#MeToo Has Implicated 414 High-Profile Executives and Employees in 18 Months*, TIME (June 25, 2018, 11:49 AM EDT), <http://time.com/5321130/414-executives-metoo/> [<https://perma.cc/HK2F-JE74>].

268. See Riley Griffin, Hannah Recht & Jeff Green, *#MeToo: One Year Later*, BLOOMBERG (Oct. 5, 2018), <https://www.bloomberg.com/graphics/2018-me-too-anniversary/> [<https://perma.cc/N9ET-J528>] (reflecting on one year of #MeToo and providing a list of individuals implicated in scandals, as well as headlines of stories covering the movement).

269. See *infra* Section V.A.

270. Dan Marcec, *CEO Tenure Rates*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 12, 2018), <https://corpgov.law.harvard.edu/2018/02/12/ceo-tenure-rates/> [<https://perma.cc/PHA3-YSAC>].

271. Representatives from CalPERS, CalSTRS, BlackRock, and State Street reiterated the unique inability for them, as passive investors, to escape systemic risks such as climate change at the Berkeley Law CEO Letter Roundtable on November 19, 2018.

reckoning, these consequences are even more severe. Asset managers do not have the luxury of hoping that disaster will hit only after they depart, as their clients' horizons are decades-long. They need to maintain client trust to ensure that capital continues to flow into their products. In their effort to mobilize boards and managers, sustainability is one of the most useful levers.

*D. Corporate Externalities Can Hit Asset  
Managers' Other Shareholdings*

Corporate law scholars have long discussed the impact of externalities on the decisionmaking of corporate boards.<sup>272</sup> When a business choice benefits the corporation but harms other constituencies, managers have strong incentives to take it nevertheless, since they are being rewarded for increasing shareholder profits.<sup>273</sup> Of course, tort doctrine seeks to force companies to internalize some harmful consequences *ex post*, while legislatures and regulators have often imposed *ex ante* restrictions over potentially harmful corporate activity. Yet, as long as the probability of detection remains low, managers can still bet strongly on misbehaving.

The core of this problem lies in the sharp distinction drawn by corporate law between the corporate entity and its internal operation, on the one hand, and the external world, on the other. In the conventional understanding of the corporation, shareholders and managers occupy a different sphere from the corporation's other constituencies, and problems affecting other constituencies will have only a negligible impact on shareholders and managers, respectively.<sup>274</sup> For example, when a company suffers an oil spill just off the coast, very few, if any, of its shareholders are expected to reside by that coast. Similarly, when a retail company experiences a cybersecurity breach, few of its shareholders are likely to actually have their banking information stolen and suffer losses due to identity fraud. With shareholders unlikely to suffer any of the harm directed at other constituencies, managers are motivated to benefit the former and disregard any adverse impact to the latter.

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272. See, e.g., Anthony Biglan, *Corporate Externalities: A Challenge to the Further Success of Prevention Science*, 12 *J. PREVENTION SCI.* 1 (2011).

273. See Anthony Biglan, *The Role of Advocacy Organizations in Reducing Negative Externalities*, 29 *J. ORG. BEHAV. MGMT.* 215, 215–30 (2009) (“[C]ompanies have no incentive to reduce externalities, since they receive no negative consequences for producing them but likely will experience negative ones by reducing or eliminating them.”).

274. See, e.g., John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 *MICH. L. REV.* 1, 15–16 (1987).

This distinction between shareholders and other constituencies collapses, at least in part, with large institutional shareholding. As discussed above, three or four large asset managers collectively control significant percentages, ranging between 15% and 30% on average, of virtually every public company in the country.<sup>275</sup> With such widespread presence, a company's harmful conduct is much more likely to impact its institutional investors compared to its retail ones because it can affect one of their other investments. To go back to our examples above, the off-the-coast oil spill can seriously affect that state's fisheries and tourism industries, and the cybersecurity breach will impact retail banks and credit card companies. In both cases, shareholders in the affected industries will most likely include large asset managers, who will also have a significant representation in the misbehaving companies. For these shareholders, the losses in the harmed industries will counterbalance the gains of corporate misconduct. It makes sense, then, that these shareholders are supporting a shift toward sustainability, which gives voice to constituencies previously neglected in corporate decisionmaking. Some of these constituencies represent other business interests of these institutional shareholders.

There is another inroad into the stark dividing line between the company's internal and external spheres, which goes far deeper into the institutional shareholding business model. Asset managers' continued existence depends on the ongoing influx of cash flow from their clients to their funds. Some of these clients are retail investors, while others are specialized institutional investors, like pension funds.<sup>276</sup> Even though these investors have long horizons, positions get liquidated daily. To replenish their resources and attract new funds, asset managers need to gain new clients of at least comparable means and convince existing clients to maintain and hopefully increase their current level of contributions. Both these propositions would be at risk if worsening market conditions disrupted clients' ability to contribute. Disruptions occur when market participants fail to grasp the full impact of ongoing developments and the need to address them. The 2008 financial crisis was a wake-up call because it showed how Wall Street's short-term approach could endanger the whole financial system and set off a worldwide recession.<sup>277</sup> Failures of similar scale could severely

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275. See Bebhuk & Hirst, *supra* note 13, at 735.

276. PRICEWATERHOUSECOOPERS, ASSET MANAGEMENT 2020: A BRAVE NEW WORLD 13 (2020), <https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf> [<https://perma.cc/SYN6-AQH6>].

277. See, e.g., RIMS, THE 2008 FINANCIAL CRISIS: A WAKE-UP CALL FOR ENTERPRISE RISK MANAGEMENT 4 (2009), <https://community.rims.org/HigherLogic/System/DownloadDocumentFile.aspx?DocumentFileKey=f26b1c64-8123-4c96-9c59-83fc43bc99cb&forceDialog=0>

diminish investors' savings, thus raising serious threats for the asset management industry.

## V. WHY ESG SHOULD BE PART OF THE BOARD'S FIDUCIARY DUTIES

We have argued that ESG helps managers address diverse risks relating to the company's business by obtaining information from stakeholders that are ideally placed to understand such risks.<sup>278</sup> While conventional corporate governance tools like compliance tend to antagonize internal stakeholders and exclude external ones, ESG encourages an iterative process of negotiation that helps boards solidify their response and build ties.<sup>279</sup> Our portrayal of ESG helps explain its widespread acceptance among so many different companies in such a short amount of time.

Yet, it is still unclear how ESG fits within the board's mandate to monitor management. On the one hand, if the board completely eschews any ESG considerations, it may be exposing its shareholders to unnecessary risks that other companies have reasonably addressed, perhaps placing its good faith in doubt. If courts agreed with this logic, then they would recognize ESG as part of the board's fiduciary duties. But on the other hand, as companies are embracing ESG at a quickening pace, it is less clear why we need the muscle of fiduciary duties to compel boards in that direction. Even when management happens to stall, shareholders take it upon themselves to prod, either privately through engagement or publicly through shareholder proposals.

Courts invoke fiduciary duties to resolve agency conflicts between shareholders and managers.<sup>280</sup> Below, we claim that managers' and directors' incentives are not necessarily in line with shareholders' interests as far as ESG is concerned.<sup>281</sup> ESG's key outcome, preventing a crisis, is hard to measure because it lacks a manifestation. Thus, it does not work well with governance mechanisms designed to reward net earnings increases and encourage risk-taking. This fundamental problem is compounded by two additional complications. First, managers and directors may not be aware of an ESG challenge, even

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[<https://perma.cc/RNH3-KZCF>] (noting that, leading up to the 2008 financial crisis, "individuals on the front line who were taking—and trading in—these risks ostensibly were rewarded for short-term profit alone").

278. See *supra* Part II.

279. See *supra* Part III.

280. See generally Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045 (1991) (connecting fiduciary duties to failures in principal/agent models).

281. See *infra* Section V.A.

though they need to expend resources to spot problems they may not be incentivized to solve. Second, some of the issues that ESG addresses, like climate change or diversity, are complex societal challenges in which a single company's contributions may feel like a drop in the bucket. Thus, measuring results is not straightforward without first operationalizing specific commitments, which requires effort and resources.

Based on this analysis, we argue that courts should recognize ESG as an essential part of boards' monitoring mission.<sup>282</sup> We first explore the misalignment of incentives between managers and shareholders with regard to ESG in order to identify the failures that can arise. Because these are mostly information-gathering failures, we propose a mechanism which would furnish this information to the board, allowing it to fulfill its monitoring mission more effectively. Once obtaining this information, we propose that boards should be free to fashion the most appropriate response according to their business judgment.

### *A. ESG at the Core of Agency Conflicts Between Shareholders and Managers*

#### 1. Averting a Crisis Is a Thankless Job: Misaligned Incentives Due to the Nature of ESG Problems

When ESG operates as a crisis prevention tool, its success lies in helping the company avoid turbulence. From the shareholders' vantage point, the company simply looks like it is operating smoothly, undisturbed by ESG challenges. This might be because the company runs an effective ESG program that successfully identifies and neutralizes problems, or simply because no problem has arisen yet by happenstance. For shareholders, distinguishing between the two hypotheses is impossible until a real crisis occurs to put the company's readiness to the test. Due to the nature of risk prevention, it is hard for shareholders to monitor companies effectively.

This opacity raises many challenges for managers in either scenario. If managers choose to invest in ESG, they will have difficulty convincing shareholders that it was a worthwhile effort. They may try to present to shareholders the implications of an impending crisis had

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282. For example, in the aftermath of the Wells Fargo accounting fraud scandal, regulators were concerned about similar practices in other banks, which scrambled to review their processes. See Matt Egan, *Wells Fargo Isn't the Only Bank with Fake Accounts, Regulators Say*, CNN MONEY (June 6, 2018, 1:53 PM ET), <https://money.cnn.com/2018/06/06/news/companies/wells-fargo-fake-accounts-banks-occ/index.html> [<https://perma.cc/WUA3-PRNW>].

they not acted earlier, though hypothesizing about counterfactuals is hardly persuasive. Perhaps they can take advantage of a crisis hitting another company and explain how they were better able to avoid it. But these opportunities are rare and require a certain degree of imagination. None of these arguments sound like a winning strategy for managers that want to get a pay raise. Managers would have to find comfort in the thought that, had the crisis not been averted, getting said pay raise would be even harder.

Imagine now that managers make the opposite choice, that is, not to invest in ESG. Let's assume that they understand that, as a result, their company is more vulnerable to a crisis. Still, it is hard to predict when this crisis is going to hit their company. With respect to some ESG issues, the crisis might hit immediately, such as in the #MeToo context. But the chances that a company will face a #MeToo problem in a given year are lower than the chances that it will face such a problem in, say, the next three years, or five, or ten. In contrast, executive compensation is calculated on an annual basis.<sup>283</sup> Managers may simply decide to take their chances, redirecting resources away from ESG and towards efforts that help raise their company's profitability immediately or with higher certainty. After all, the median CEO tenure is only five years or so.<sup>284</sup>

This misalignment of incentives between managers and shareholders is further compounded when the problem at hand is multifaceted and calls for coordinated actions by companies and governments on many fronts. Climate change is the paradigmatic example of such a huge challenge. A single company's actions, while necessary to produce an effective outcome, are only an infinitesimal aspect of the problem.<sup>285</sup> Addressing such problems cannot start without breaking them down into smaller issues, exploring different solutions, and negotiating with various stakeholders. All these steps increase the cost of undertaking action against climate change for each company, all while the impact of climate change remains decades away.

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283. See generally LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* 25–29 (2004) (explaining how annual incentives around compensation and director reelection affect boards' review).

284. See Dan Marcec, *CEO Tenure Drops to Just 5 Years*, EQUILAR (Jan. 19, 2018), <https://www.equilar.com/blogs/351-ceo-tenure-drops-to-five-years.html> [<https://perma.cc/2MYG-9FV8>].

285. See Michael P. Vandenbergh & Jonathan M. Gilligan, *BEYOND POLITICS: THE PRIVATE GOVERNANCE RESPONSE TO CLIMATE CHANGE* 179 (2017) ("Private corporate initiatives will often not be complete solutions, but seeking a panacea, as we have seen, can often lead to worse results than seeking multiple partial solutions.").

## 2. Insularity and Blind Spots: Imperfect Monitoring

In addition to features inherent in ESG risks, characteristics of CEOs and directors also hinder efforts to gather information and develop a response. More specifically, CEOs overconfident about their abilities and dedicated to their vision about the company tend to underestimate risks associated with failure.

Overconfidence is one of the key traits analyzed in a growing literature in corporate finance, which relies on insights from social and experimental psychology to identify and understand managerial biases. The starting point for this research is the extraordinary position that CEOs have attained in American culture. Figures such as Elon Musk, Mark Zuckerberg, Jeff Bezos, and Jamie Dimon often appear on popular media and make headlines with their statements and actions.<sup>286</sup> In the last decade, CEOs like Steve Jobs, Larry Page, Sergei Brin, and Larry Ellison occupied a similar high mark.<sup>287</sup> The archetypal portrait of a CEO emerging from these examples is that of a widely admired genius acutely aware of her own achievements, and often accused of overconfidence when flawed decisions emerge.

Journalists, investors, and academic researchers have been alternately fascinated and disillusioned with overconfident CEOs. Some draw a link between overconfidence and the out-of-the-box thinking that drives innovation and competitiveness.<sup>288</sup> Yet, seminal studies in this field have linked CEO overconfidence to practices that destroy value for shareholders, such as a higher tendency to undertake mergers, paying out smaller dividends, overestimating future earnings, and practicing less conservative accounting.<sup>289</sup> But there is little

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286. See, e.g., Niraj Choksi & Eric A. Taub, *Elon Musk Is Cleared in Lawsuit over His 'Pedo Guy' Tweet*, N.Y. TIMES (Dec. 6, 2019), <https://www.nytimes.com/2019/12/06/business/elon-musk-defamation-verdict.html> [<https://perma.cc/79WH-Y2L7>]; Ben Hubbard & Michael Schwartz, *Bezos Phone Hack Tied to Saudi Crown Prince Puts New Pressure on Kingdom*, N.Y. TIMES (Jan. 28, 2020), <https://www.nytimes.com/2020/01/22/world/middleeast/bezos-phone-hacked.html> [<https://perma.cc/2QQ4-LB7R>]; Aimee Ortiz, *JPMorgan Chase C.E.O. Says It Needs to Do More to Tackle Racism*, N.Y. TIMES (Dec. 13, 2019), <https://www.nytimes.com/2019/12/13/business/Jamie-Dimon-racism-chase.html> [<https://perma.cc/95WV-UDRY>]; Aaron Sorkin, *An Open Letter to Mark Zuckerberg*, N.Y. TIMES (Oct. 31, 2019), <https://www.nytimes.com/2019/10/31/opinion/aaron-sorkin-mark-zuckerberg-facebook.html> [<https://perma.cc/9G2C-DYSW>].

287. See generally Matthew L.A. Hayward, Violina P. Rindova & Timothy G. Pollock, *Believing One's Own Press: The Causes and Consequences of CEO Celebrity*, 25 STRATEGIC MGMT. J. 637 (2004) (exploring how CEOs became media favorites); Ulrike Malmendier & Geoffrey Tate, *Superstar CEOs*, 124 Q.J. ECON. 1593 (2009) (arguing that superstardom leads to bad decisions).

288. See Alberto Galasso & Timothy S. Simcoe, *CEO Overconfidence and Innovation*, 57 MGMT. SCI. 1469 (2011) (linking overconfidence to devoting efforts to innovation).

289. See generally Ulrike Malmendier & Geoffrey S. Tate, *Behavioral CEOs: The Role of Managerial Overconfidence*, 29 J. ECON. PERSP. 37 (2015) (providing an overview of the literature in corporate finance spurred by their seminal article on CEO overconfidence).

disagreement that overconfidence is pronounced among CEOs, as evidence from their stock options suggests that they fail to diversify and maintain their investment within their companies for much longer than rationally expected.<sup>290</sup> To understand why managerial overconfidence is so widespread, some researchers have pointed to the CEO selection process, arguing that CEOs got their jobs due to their superior performance compared to peers, which they would not have achieved without increased risk aversion.<sup>291</sup>

Since managerial overconfidence leads to a willingness to tolerate increased risks, it can affect how CEOs react to ESG-related concerns in many ways. To start, overconfident CEOs tend to underestimate the force with which ESG challenges can hit their company. They believe deeply in the positive transformations that their companies are bringing to society and do not want to see their achievements marred by negative associations. Overconfident CEOs are dedicated to their vision and are not concerned about information specific to projects which might interfere with this vision.<sup>292</sup> Due to this preoccupation, managers' perspective can become insular and self-absorbed, discounting outside signals.<sup>293</sup>

But even if they can understand the importance of ESG considerations, overconfident CEOs will tend to overestimate their company's and their own ability to withstand a crisis.<sup>294</sup> In essence, they believe that their company's achievements come with so much goodwill that they can overcome negative events virtually unscathed. Other companies may have been humbled by similar crises, but not theirs. When managers start believing their own press, hubris quickly sets in.<sup>295</sup> They believe that they can rewrite the rulebook,<sup>296</sup> coming up with innovative responses that will help them succeed where other companies have failed.

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290. *See id.* at 40–42.

291. *See* Anand M. Goel & Anjan V. Thakor, *Overconfidence, CEO Selection, and Corporate Governance*, 63 J. FIN. 2737 (2008) (arguing that overconfidence increases the likelihood of making high-risk and high-return business choices).

292. *See id.* at 2739 (arguing that the overconfident CEO “invests in a project even when her positive information about the project is such that she would not invest if she were rational”).

293. *See* Arijit Chatterjee & Donald C. Hambrick, *It's All About Me: Narcissistic Chief Executive Officers and Their Effects on Company Strategy and Performance*, 52 ADMIN. SCI. Q. 351, 357–58 (2007).

294. *See* MIKE WILSON, *THE DIFFERENCE BETWEEN GOD AND LARRY ELLISON* (1997) (exploring the effect of Ellison's outsize personality on Oracle).

295. *See* Hayward et al., *supra* note 287, at 649.

296. *See, e.g.,* Peter Elkind, *The Trouble with Steve*, CNN MONEY (Mar. 5, 2008, 1:03 PM EST), [https://money.cnn.com/2008/03/02/news/companies/elkind\\_jobs.fortune/index.htm](https://money.cnn.com/2008/03/02/news/companies/elkind_jobs.fortune/index.htm) [<https://perma.cc/Z4AS-97RG>] (“Jobs likes to make his own rules, whether the topic is computers, stock options, or even pancreatic cancer.”).



These dynamics may inhibit managers from understanding the breadth of ESG factors that can affect their companies, either in full or in part. Because ESG concerns are vastly different from each other, a company that is particularly alert to one issue may be blindsided by another. For example, Facebook scored high on environmental issues, while disregarding privacy issues.<sup>297</sup> Even companies for whom sustainability has been a central motivation can find themselves embroiled in ESG crises on a different issue.<sup>298</sup>

Although the literature on overconfidence highlights CEOs' decisionmaking propensities, corporate law has established boards of directors as a check to counterbalance CEOs. One can imagine that some directors are more attune to social developments than vision-driven executives, perhaps due to individual circumstances. In aggregate, however, most directors' qualifications are unlikely to have much to do with ESG, rendering them ill-prepared to pick up early signals of discontent across a broad array of topics. In the next Section, we discuss how this systematic bias hampers successful handling of social risk.

### 3. Ill-Equipped for ESG: Personal Background and Ideology

For many decades, corporate boards were provided with a clear-cut mandate to maximize profits for shareholders, widely interpreted as leaving no space for considering other stakeholders' interests. Regardless of whether these interpretations were excessively prohibitive from a doctrinal perspective, in practice boards avoided seeking other stakeholders' perspectives.

This normative orientation affected not only the decisions board members took once appointed, but also the selection process for their appointment. Directors were picked on the basis of skills that would assist them in monitoring whether managers maximized returns for shareholders. Some academics connect the rise of independent directors with a desire to induce market-oriented discipline over management.<sup>299</sup> Many directors in U.S. public companies are or have been CEOs in other companies, have an industry or finance background, or have training in law or accounting. These qualifications do not necessarily prepare them

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297. See VANDENBERGH & GILLIGAN, *supra* note 285, at 211–12; *supra* text accompanying notes 177–185.

298. See Sheelah Kolhatkar, *The Disrupters*, NEW YORKER (Nov. 13, 2017), <https://www.newyorker.com/magazine/2017/11/20/the-tech-industrys-gender-discrimination-problem> [<https://perma.cc/PR83-LRL3>] (discussing Tesla's gender problems).

299. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (arguing that independent directors are more sensitive to stock price information).

for grasping the full extent of certain ESG risks. Some ESG concerns and strategies, like those related to climate change, are clearer to those with a scientific background in this area. Other ESG concerns, like diversity, are linked to personal experiences. Generalist board members will find it harder to master the nuances and sensitivities associated with many ESG issues. The company would benefit from board members that are able to break down problems convincingly and steer management toward a proper response.

The need for improving boards' ESG competence has become a priority for investors pushing for sustainability. In 2018, BlackRock made clear that it "expects the whole board to have demonstrable fluency in how climate risk affects the business and management's approach to adapting the long-term strategy and mitigating the risk."<sup>300</sup> Similarly, in 2016, State Street issued a Climate Change Risk Oversight Framework for Directors, which sets out its expectations for board members to evaluate climate risk and preparedness.<sup>301</sup> Pension funds like CalPERS and CalSTRS are sounding a similar rallying cry for climate competency on boards.<sup>302</sup>

In addition to building up skills and qualifications, managers and directors have to contend with the radical shift in thinking that ESG represents. Reversing course after decades of established conventional wisdom is not easy, and skepticism toward ESG is widespread in corporate America. Early ESG proponents witnessed firsthand the obstinate reluctance of U.S. directors and officers to take ESG considerations into account, believing them to be contrary to their fiduciary duties.<sup>303</sup> Board advisors such as law firms and consultancies have penned extensive memos to convince their clients that they can adopt ESG measures without risking a shareholder challenge.<sup>304</sup>

The roadblocks discussed above help explain why, even as the public discourse over sustainability is gaining salience and shareholders are lending their support, directors and managers may

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300. See BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: ENGAGEMENT PRIORITIES FOR 2018 (2018).

301. See ST. STREET GLOBAL ADVISORS, *supra* note 104, at 1 ("State Street Global Advisors (SSGA) believes that boards should regard climate change as they would any other significant risk to the business and ensure that a company's assets and its long-term business strategy are resilient to the impacts of climate change.").

302. See CERES, *supra* note 92, at 7, 15 (arguing that "[c]limate competent boards" and "[s]ustainability strategies" is "the language of investors today," including "California's biggest public pension funds").

303. Interview with Tim Youmans, Hermes Inv. Mgmt. (Dec. 13, 2018).

304. Martin Lipton of Wachtell, Lipton, Rosen & Katz has argued for companies to embrace ESG in what he calls "The New Paradigm." See MARTIN LIPTON, WORLD ECON. FORUM, THE NEW PARADIGM (2016), <https://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.25960.16.pdf> [<https://perma.cc/BDC3-HAW2>].

still be disinclined to back ESG. Below, we present our proposal for overcoming these hurdles.

*B. A Duty to Set Up an ESG Process: Standard of Conduct*

Our goal is to ensure that the board identifies and understands the ESG risks threatening its business and gathers appropriate information through a functioning ESG process. We envisage boards' main obligation as establishing an operational ESG mechanism that would evolve around two key pillars: internal governance and outreach to stakeholders.

The internal governance framework is necessary in order to manage the information-gathering process and present results to the board. Many companies have voluntarily set up internal ESG governance frameworks, providing a blueprint for this effort. Typically, the first step consists of identifying the officer(s) responsible for leading it. This might entail hiring an entirely new ESG head or having multiple officers with different expertise working under the supervision of an existing top executive, such as the chief financial officer or the chief legal officer. The main task for the internal governance framework is to identify key ESG concerns for the company and put together a proposal for how to monitor these areas and contact relevant stakeholders. Once it completes its information gathering, the ESG function will present the results to the board and propose action where appropriate.

Outreach to stakeholders is an essential step of the ESG information-gathering process. We do not envisage that the company ought to respond to all comments it receives or that it ought to take steps addressing all issues brought to its attention. Its ESG function can prioritize concerns, identify areas in need of immediate intervention, and propose responses to the board. It may decide to investigate certain issues further or simply express why it has decided to put a certain issue at the bottom of its priorities. The goal of the proposed duty is to open channels of communication between the company and a hitherto unexplored group of actors that are closely following its trajectory. Responding to information that reaches the board through this channel will come to be assessed under the board's duty of care, as explained below.

*C. Failing to Set Up an ESG Process: Standard of Review*

For our proposal to have bite, it is essential that directors and officers are subject to liability for failing to develop their ESG function.

This failure, we argue, can sit squarely within Delaware's current jurisprudence on fiduciary duties, particularly as it relates to the concept of good faith. In Delaware fiduciary duty law, directors' and officers' good faith is a key criterion for the dividing line between the duty of care and the duty of loyalty.<sup>305</sup> As long as the board is acting in good faith—that is, it believes that it is acting in the best interests of the shareholders—it is not at fault for pursuing the course of action of its choice, however catastrophic the outcome;<sup>306</sup> it need only prove that it took good care in considering the options before it.<sup>307</sup> In contrast, if the board knowingly or recklessly disregards the interests of the shareholders, then it does not show the loyalty required by its relationship to them.<sup>308</sup> Our proposal is grounded in this understanding of good faith, which permeates Delaware case law on fiduciary duties. Below, we articulate a test that companies must satisfy in order to fulfill this duty and explain why, despite its radical implications, this test mirrors approaches Delaware courts have been using continuously for decades.

We argue that, given what we know about the role of ESG in limiting risk, a board that completely fails to operationalize sustainability is simply exposing its shareholders to much greater risk than they would otherwise have faced. When a company's management declines to inquire how female employees are treated in the workplace, it allows pernicious behaviors to flourish. When a company's environmental efforts simply try to meet legal limits long decried as inadequate by environmentalists, the company may find itself exposed when these environmentalists are proven right and catastrophe hits. Completely disregarding these concerns should not be a viable option for boards of publicly traded companies, since overcoming any resulting crisis will be extremely costly for their shareholders. Thus, developing an ESG function and providing the company with a mechanism for early risk discovery and prevention is an imperative for directors and officers, who should find themselves in bad faith if they fail to act.

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305. See Leo E. Strine et al., *supra* note 78, at 633 (“[G]ood faith has long been used as the key element in defining the state of mind that must motivate a loyal fiduciary.”).

306. See *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807, 812 (N.Y. Sup. Ct. 1976), *aff'd*, 387 N.Y.S.2d 933 (N.Y. App. Div. 1976) (holding that corporate directors are afforded protection of the business judgment rule even where their business choices may be negligent).

307. See *Smith v. Van Gorkom*, 488 A.2d 858, 872–73 (Del. 1985) (“Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.”).

308. See *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 62 (Del. 2006) (affirming the Court of Chancery's application of a bad faith standard that required a showing of “intentional dereliction of duty [and] a conscious disregard for one's responsibilities”).

How the board treats the information that reaches it through the sustainability function should remain its prerogative, provided it shows due care in considering the information. Our proposal does not seek to force the board to act in a particular way or to respond to every concern that the company receives from aggrieved parties through the stakeholder grapevine. The board should remain free to reach its own judgment, provided it receives adequate information about these concerns. After all, the board can decide the resources it chooses to invest in sustainability, depending on the severity of the risks it hopes to mitigate.

One might worry that, barring an affirmative obligation to respond, boards can simply go through the ESG process performatively without making any essential change on the ground. While these concerns are valid, we believe they are also premature. By broadening the board's horizons, ESG also removes any constraints imposed by profit maximization and embraces courses of action previously thought as precluded. Moreover, by highlighting the risks arising out of the social implications of company actions, our proposal would make a business case for ESG, aligning it squarely with boards' core competencies. Just as with other business opportunities, boards remain accountable to shareholders for missing them. Our proposal further enhances this accountability because it creates a written record of the board's information and deliberations, available to public scrutiny in case of a trial.

Even though our proposal opens up the boardroom to considerations outside the current mainstay of corporate law, it adopts a process already familiar to practitioners and thoroughly monitored by courts. Corporate law scholars will recognize in our proposal some similarities with the *In re Caremark International Inc. Derivative Litigation* ("Caremark") framework that governs corporate compliance, discussed above,<sup>309</sup> as well as some distinct differences. Similar to Caremark's first prong, which requires boards to set up a process for monitoring employees' legal violations, our proposal requires boards to set up a process for overseeing social risks arising out of companies' operations. Delaware courts have a long track record of assessing boards' compliance with Caremark's first prong. Traditionally, courts examined indicators such as rulebooks, staffing, and training, and more recently have delved deeper into how companies are integrating compliance in their operations. Moreover, courts have explored how information about legal violations reaches boards. Thus, the framework we envisage for ESG borrows many ideas from compliance, which it

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309. See *supra* Section II.A.

applies to issues outside compliance's ambit. Delaware courts should have little difficulty operationalizing it.

Where our proposal deviates from *Caremark* is with regard to the response we expect from boards when addressing ESG concerns. Under *Caremark*'s second prong, once the company's compliance system informs the board of employee misconduct, the board ought to respond appropriately to the red flag based on the information before it.<sup>310</sup> We do not envisage any similar requirements for directors and officers who are considering whether to support a sustainability initiative or whether to take ESG into account as one of the factors determining their ultimate choice on a business quandary before them. It is impossible to separate ESG as a factor in this decision from all the other factors going into it and then to request distinct action.

#### *D. How Our Proposal Compares to Alternatives*

##### 1. Why Not Simply Expand the *Caremark* Framework?

A new wave of thinking on compliance centers around corporate culture as the defining element of effectiveness.<sup>311</sup> Responding to criticisms of compliance reviews and investigations as highly legalistic tools that fail to identify serious misconduct, this new wave of compliance efforts seeks to broaden its reach beyond a sterile enforcement and deterrence mechanism.<sup>312</sup> It aspires to reconceptualize compliance as a collective commitment to ethical values that will steer individual employee behavior away from illegality. In its reliance on peer pressure and socialization, the emphasis on corporate culture borrows a lot from behavioral and social sciences.<sup>313</sup> It brings ethics and compliance closer together conceptually.<sup>314</sup> Regulators and companies alike are embracing this new direction. The DOJ has been emphasizing "tone at the top"—that is, mission statements by top executives in favor

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310. For a discussion of *Caremark*'s second prong, see Gadinis & Miazad, *supra* note 125, at 2168–80.

311. See Langevoort, *supra* note 127, at 936, 954–55 (arguing that "[c]ulture is crucial to compliance").

312. See Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 952–54 (2009) ("Given the expanding scholarly interest in New Governance regimes, it is useful to consider how a 'true' New Governance compliance regime might alter the firm's relationship with government actors, as well as the internal relationships between the firm's compliance personnel and its managers and employees.").

313. See Langevoort, *supra* note 127, at 947 (arguing that the "case for optimism about the possibility of corporate cultural change has a solid academic pedigree" arising from "behavioral ethics and other contemporary social sciences research").

314. See Steven A. Ramirez, *Diversity and Ethics: Toward an Objective Business Compliance Function*, 49 LOY. U. CHI. L.J. 581 (2018).

of complying with the law—for quite some time.<sup>315</sup> Its guidelines now officially refer to “compliance and ethics” programs. Companies are responding by creating distinct chief ethics officers whose mandate extends beyond simply illegal conduct. According to recent commentary, the Delaware Supreme Court’s ruling in *Marchand v. Barnhill*,<sup>316</sup> which emphasizes the board’s good faith in addition to illegality, also draws heavily on how the board perceives its core mission in connection to core values in the company’s products, such as food safety for ice cream makers.<sup>317</sup>

Perhaps heartened by this shift, some academics propose to take this a step further. Some would like to expand compliance’s scope to include socially harmful conduct more broadly.<sup>318</sup> They argue that the short-term perspectives clouding managers’ and directors’ judgment, as we have discussed above, also affect their compliance choices. Viewing the current *Caremark* framework as too lax for meaningful review, they call for a more stringent fiduciary standard. Other proposals emphasize the role of criminal enforcement in strengthening compliance and would elevate compliance culture into a key consideration in corporate crime sanctions, asking judges to balance it against the need to punish.<sup>319</sup>

The increasing importance of corporate culture in regulatory policy and companies’ growing engagement with ethics are definitely moving in the direction that we are proposing and have reinforced interest in sustainability. ESG and ethics represent companies’ efforts to self-regulate in the wake of the realization that a simple divide between legal and illegal activity is failing to serve shareholders’ interests. Both moves respond by placing values front and center, hoping to inspire individuals rather than deter them.

Where ESG has an edge over a broader appeal to culture or ethics is in its bottom-up, grassroots approach. Neither compliance

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315. U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a)-(b) (U.S. SENTENCING COMM’N 2004) (“To have an effective compliance and ethics program . . . an organization shall . . . promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”).

316. 212 A.3d 805 (Del. 2019).

317. See Pollman, *supra* note 47, at 2024–25 (“As the ice cream manufacturer makes only a single product, the court noted that food safety is a central compliance issue for the company and the complaint therefore created a reasonable inference that the ‘dearth of any board-level effort at monitoring’ was a conscious failure.”).

318. See Armour et al., *supra* note 46, at 47, 51–52 (arguing that because “the bar for monitoring obligations is so low”—i.e., plaintiffs must prove that the company had no compliance system whatsoever—courts “restrict themselves to defining egregious malpractice, as opposed to providing any guidance on good practice”).

319. See Mihailis E. Diamantis, *Clockwork Corporations: A Character Theory of Corporate Punishment*, 103 IOWA L. REV. 507 (2018) (arguing that corporate character should play a more important part in judicial considerations).

culture nor corporate ethics come with any specific proposal for how managers and directors are going to identify the values that ought to be guiding their choices. In comparison, ESG's defining feature is a turn to stakeholders as a way of mapping unwanted implications of the company's choices. By looking to stakeholders, ESG has managed to transform the abstract concept of ethical conduct into an operational framework where impact can be charted, measured, and improved. At the same time, ESG's approach helps corporations boost their legitimacy with the public, ensuring that companies' actions track broader societal concerns. Through the ESG channel, companies are not left to decide for themselves what is ethical, but can draw on feedback from affected parties, as well as benefit from input from other companies, the academic community, or even global developments.

## 2. Why Is Disclosure Not Enough?

Most companies already engaging in sustainability choose to make some form of disclosure about their efforts.<sup>320</sup> Some of them issue a comprehensive corporate responsibility or sustainability report, while others prefer to issue stand-alone reports about specific initiatives.<sup>321</sup> Typically, these documents are not part of the official reports submitted to the SEC in accordance with federal securities laws' requirements. In an effort to organize this information in a manner immediately approachable to investors, standard setters have set rules for assessing each company's effort and have proposed metrics for ESG engagement.<sup>322</sup> In addition, asset managers are coming up with their own ways of appraising each company's ESG credentials in order to create investment products that encompass only the most committed companies.<sup>323</sup>

Fostering this dynamic has been a key goal of recent legislative actions by policymakers around the world. The European Union already has in place a mandatory sustainability-disclosure directive.<sup>324</sup> In the

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320. See Kwon, *supra* note 5.

321. See *id.* at 27–33 (examining sustainability reporting practices across companies in the S&P 500).

322. See Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923, 944 (2019) (noting that because sustainability disclosure is currently happening on a voluntary basis, there have been efforts by “global standard setters seeking to promulgate disclosure standards or guidelines”).

323. There are various ESG data providers, including well-known financial news firms such as Bloomberg, MSCI, and the Dow Jones Co. For a discussion of the resulting confusion for investors, see Kristin Broughton, *Which Are the Most Ethical Companies? Good Luck Figuring that Out*, WALL ST. J. (June 24, 2019, 8:32 AM ET), <https://www.wsj.com/articles/which-are-the-most-ethical-companies-good-luck-figuring-that-out-11561379528> [<https://perma.cc/9QYE-XXN6>].

324. Kwon, *supra* note 5, at 11.



United States, the SEC is considering whether to demand sustainability disclosure from companies,<sup>325</sup> as market and scholarly proposals are advocating.<sup>326</sup> Even the Delaware legislature, in a rare foray into disclosure, passed the Certification of Adoption of Transparency and Sustainability Standards Act in October 2018.<sup>327</sup> Under this Act, companies can receive a certification from Delaware provided they formulate and adopt a set of standards by which they commit to abide and make those standards public.<sup>328</sup>

Yet, we argue, disclosure is unlikely to accomplish, on its own, the transformation that sustainability's proponents yearn for. Disclosure focuses on facts, typically of the recent past. In sustainability's case, examples would include priorities that the company has set and actions that the company is currently undertaking. Yet, these disclosed priorities and actions say nothing about what the company is not acting upon. It provides us with no insight into what stakeholders' real concerns are, whether they were communicated to the board, and why the board rejected them. Disclosure provides us with only the board's reading of its sustainability needs and its current response, without any basis on which to assess their adequacy. Disclosure is geared towards deterring the board from lying, but it puts no pressure on the board to get it right by expanding efforts to eliminate blind spots.

Disclosure does not have a particularly good track record in holding companies accountable for failing to address risks, because future calamities are innately imprecise. Companies have been disclosing risks to their financial condition for decades.<sup>329</sup> These risk disclosures operate as a means to limit company liability for plans or projections that do not pan out because they explain to investors factors that may set the company off its course. Their function is to introduce uncertainty to the company's other disclosures, thus making the claim of a misstatement much harder to prove.<sup>330</sup> Sometimes, companies also disclose measures to mitigate these risks, and they may be found liable if these measures' effectiveness proves lower than described. But, in

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325. Fisch, *supra* note 322, at 939–40.

326. See *id.* at 952 (proposing that “the SEC implement a new disclosure requirement of sustainability discussion and analysis as part of Regulation S—K”).

327. DEL. CODE ANN. tit. 6, §§ 5000E-5008E (effective Oct. 1, 2018).

328. *Id.*

329. For a discussion of the usefulness of these disclosures, see John L. Campbell, Hsinchun Chen, Dan S. Dhaliwal, Hsin-min Lu & Logan B. Steele, *The Information Content of Mandatory Risk Factor Disclosures in Corporate Filings*, 19 REV. ACCT. STUD. 396 (2014) (finding that companies facing greater risks include more extensive disclosures).

330. See Donald C. Langevoort, *Disclosures that “Bespeak Caution,”* 49 BUS. LAW. 481, 482–84 (1994).

sustainability's case, no such yardstick is likely to be available to litigants because no promises about the effectiveness of sustainability can be made.

### CONCLUSION

Corporate vilification is undoubtedly in vogue. Attacks on “big corporations” are dominating the political debate.<sup>331</sup> From Senator Warren’s Stop Wall Street Looting Act,<sup>332</sup> which targets private equity, to Senator Harris’s EMPOWER Act,<sup>333</sup> which mandates gender pay equity, we are in the midst of a regulatory arms race to rein in corporate power. It is not just the Democrats either. President Trump, who blatantly favors his base over “Corporate America,” has made a habit out of hurling Twitter attacks at American darlings from GM to Harley Davidson.<sup>334</sup> He followed up by drafting an executive order against “Tech Giants” who are, according to him, biased against conservatives.<sup>335</sup> Crucially, these messages are resonating with voters, with each attack drawing crescendoing cheers and millions of “likes” from Americans across the political spectrum.<sup>336</sup> Millennials and GenXers, who feel the burden of climate change as an existential crisis, are also demanding that businesses act responsibly.<sup>337</sup> And major asset

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331. See Ursula Perano, *Big Business Becomes Boogeyman at 1st Democratic Debate*, AXIOS, <https://www.axios.com/first-democratic-debates-big-business-elizabeth-warren-02fcb7f7-7b61-4e19-9e5b-7d98936578d2.html> (last updated Jun. 27, 2019) [<https://perma.cc/3MNF-GN4T>].

332. Stop Wall Street Looting Act, S. 2155, 116th Cong. (2019).

333. EMPOWER Act, S. 2988, 115th Cong. (2018).

334. See Krishnadev Calamur, *Uneasy Riders: Trump’s War on Harley*, ATLANTIC (June 26, 2018), <https://www.theatlantic.com/international/archive/2018/06/trump-harley-davidson/563729/> [<https://perma.cc/AT9Q-B7GF>].

335. See Margaret Harding McGill & Daniel Lippman, *White House Drafting Executive Order to Tackle Silicon Valley’s Alleged Anti-conservative Bias*, POLITICO (Aug. 7, 2019, 3:07 PM EDT), <https://www.politico.com/story/2019/08/07/white-house-tech-censorship-1639051> [<https://perma.cc/X5PV-HAJQ>].

336. See Bernie Sanders (@SenSanders), TWITTER, <https://twitter.com/sensanders> (last visited July 25, 2020) [<https://perma.cc/UC69-JXL9>]; Donald J. Trump (@realDonaldTrump), TWITTER, <https://twitter.com/realdonaldtrump/> (last visited July 25, 2020) [<https://perma.cc/LTD5-TP5V>]; Elizabeth Warren (@SenWarren), TWITTER, <https://twitter.com/SenWarren> (last visited July 25, 2020) [<https://perma.cc/74M2-RPDB>].

337. See Matthew Ballew, Jennifer Marlon, Seth Rosenthal, Abel Gustafson, John Kotcher, Edward Maibach & Anthony Leiserowitz, *Do Younger Generations Care More About Global Warming?*, YALE PROGRAM ON CLIMATE CHANGE COMM. (June 11, 2019), <https://climatecommunication.yale.edu/publications/do-younger-generations-care-more-about-global-warming/> [<https://perma.cc/38DW-833Y>].

managers and investors are asking companies to articulate a social purpose that goes beyond profit.<sup>338</sup>

It would be a mistake—and a lost opportunity—for corporate law to dismiss this distrust of corporations as political jockeying, mere whims of a generation that will outgrow its idealism, or hollow demands of asset managers who are confused about their fiduciary responsibilities. The focus on short-term profits has produced externalities that are becoming harder and harder to dismiss. In moments like this, academics have historically stepped up to reimagine corporate purpose. In the 1930s, it was Adolf Berle and Gardiner Means who argued for a socially conscious articulation of corporate purpose, triggering the sweeping regulation of the Roosevelt Era.<sup>339</sup> And Milton Friedman entered the stage during a slump in the economy in the 1970s, an ideal moment for him to influence the deregulation of the Reagan Era.<sup>340</sup> Today, we find ourselves at another inflection point. Mounting global challenges—from climate change and shifting energy sources, to disruptive technologies and social media, and even changing demographics—call for us to reimagine both the marketplace and the demos.

It is tempting to cast corporations as the villains in this future, locked in a perennial game of cat and mouse with legislatures, regulators, and law enforcement authorities. In this scenario, corporations are constantly seeking to evade current laws, exploit unregulated terrains for their own benefit, or force unequal bargains to struggling communities and disadvantaged groups. The law has no option but to chase after the corporate perpetrator in as many ways as it can and with as many resources as it can muster.

While this portrayal may still be accurate for many corporations, our research shows that a good number of companies are moving away from it because management, directors, and shareholders are realizing that it does not make business sense. Instead, ESG envisages corporations not simply as efficient production mechanisms, but as mini-social laboratories where relationships between stakeholders are constantly evolving in the face of newly mounting challenges. From an aggregate social perspective, these laboratories are essential because

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338. See Fink, *supra* note 14 (call from BlackRock CEO Larry Fink for other CEOs to consider “[a] new model for corporate governance”).

339. See, e.g., Andrew Smith, Kevin D. Tennent & Jason Russell, *Berle and Means’s The Modern Corporation and Private Property: The Military Roots of a Stakeholder Model of Corporate Governance*, 42 SEATTLE U. L. REV. 535, 548 (2019).

340. See Peter S. Goodman, *A Fresh Look at the Apostle of Free Markets*, N.Y. TIMES (Apr. 13, 2008), <https://www.nytimes.com/2008/04/13/weekinreview/13goodman.html> [<https://perma.cc/8QQC-CU3X>].

they are the first line of defense against major societal issues. They propose solutions that thrive in the microcosm of the workplace in a way that would be hard to imagine for policymakers looking at the world from the heights of their legislative chambers. They mobilize resources and utilize dynamics that are simply hard to engage in the broad-brush approach of statutes and regulations. They are nimbler in aligning with social trends, altering the enforcement landscape with minor changes in the legal one, as is the case with the #MeToo movement.<sup>341</sup>

Ten years ago, this second scenario might have sounded overly optimistic, but today many companies are moving in this direction, as we have shown above. This shift is due to the combined forces of a rapidly evolving marketplace that constantly generates new relationships and new challenges, a change in shareholding structure that emphasizes risks, and a favorable social climate that rewards good corporate behavior. Of course, corporations alone cannot address society's most pressing problems. Yet, it is hard to imagine any solution to these problems that does not entail a change in corporate behavior. Such a change, cynics believe, can only come through the force of external regulation.

We disagree. We show that companies have many incentives to bring about this change on their own, and we illustrate how corporate governance can reinforce these incentives even further. We argue that corporate law's age-old ideological fights, or neat divisions between public and private spheres and between legal risk and business risk, do not need to stand in the way. ESG has honed a novel approach to inform boards about risks arising from the impact of their operations on third parties, which companies had previously failed to fully understand. Obtaining and assessing this information should be among all directors' and officers' duties. But corporate law should free boards' hands to decide how best to address the implications.

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341. See Catharine A. MacKinnon, *#MeToo Has Done What the Law Could Not*, N.Y. TIMES (Feb. 4, 2018), <https://www.nytimes.com/2018/02/04/opinion/metoo-law-legal-system.html> [<https://perma.cc/39WR-8LAK>]; Catharine A. MacKinnon, *Where #MeToo Came From, and Where It's Going*, ATLANTIC (Mar. 24, 2019), <https://www.theatlantic.com/ideas/archive/2019/03/catharine-mackinnon-what-metoo-has-changed/585313/> [<https://perma.cc/FUQ9-8JT5>].

## APPENDIX

TABLE 1: INTERVIEWS

Participant Name & Title	Date
Allison Bennington, Chief Legal Officer, <i>ValueAct Capital</i>	September 20, 2018
Verity Chegar, Vice President, ESG Strategist, <i>BlackRock</i>	October 11, 2019
Rob Chesnut, Chief Ethics Officer, <i>Airbnb</i>	October 11, 2019
Brenden Corbett, Associate, Global Investment Research, <i>Goldman Sachs</i>	December 6, 2019
Silvia Garrigo, Vice President, Corporate Responsibility and Social Investment, <i>Millicom</i>	March 11, 2018
Jim Hawley, Head of ESG Research, <i>TruValue Labs</i>	December 6, 2019
Bob Hirth, Sr. Managing Director, <i>Protiviti</i> , Vice Chair, <i>Sustainability Accounting Standards Board (SASB)</i> , Chairman Emeritus, <i>COSO</i>	December 6, 2019
Courteney Keatinge, Senior Director, ESG Research, <i>Glass Lewis</i>	April 22, 2018
Nashat Moin, Senior ESG Analyst, <i>Wells Fargo</i>	December 6, 2019
Chris Power, Senior Manager, Technical Accounting & SEC Reporting, <i>Salesforce</i>	December 6, 2019
Laura Stein, Executive Vice President & General Counsel, <i>Clorox Corporation</i>	December 18, 2018
Tim Youmans, Engagement Director, <i>Hermes Investment Management</i>	December 13, 2018

TABLE 2: ROUNDTABLES

<b>Type</b>	<b>Firm/Entity Name</b>
Investor/Asset Manager/ Proxy Advisory	State Street Global Advisors SASB BlackRock, Inc. JANA Partners Glass Lewis & Co. Goldman Sachs
Corporate Executive	Clorox Goodyear Levi Strauss & Co. Lyft Salesforce Snap Uber Nestle Global PepsiCo Wells Fargo
Law Firm	Wachtell, Lipton, Rosen & Katz LLP Morrison & Foerster LLP Linklaters LLP
Standard Setting & Rating Agency	SASB TruValue Labs
NGO/Nonprofit	The UN Global Compact

Sources: Blackrock CEO Letter Roundtable on November 8, 2019 and the SASB-Berkeley Roundtable on Sustainability as Risk Prevention in Corporate Law on December 6, 2019.

TABLE 3: ADDITIONAL PARTICIPANTS IN SYMPOSIA

<b>Type</b>	<b>Firm/Entity Name</b>
Investor/Asset Manager/Proxy Advisor	Boston Common Asset Management Generation Investment Capital JANA Partners Soros Fund Management The Boston Company Asset Management Parnassus Investments PJT Camberview Newton Investment Management Charles Schwab Investment Management Generation Investment Management Hermes EOS Voleon Capital Management
Corporate Executive	BNY Mellon Cisco Checkr Chevron Corporation First Republic Bank Levi Strauss & Co. Nevro PepsiCo Wells Fargo Social Impact Investing
Standard Setting & Rating Agency	IdealRatings
NGO/Nonprofit	Amnesty International Association of Corporate Counsel Bay Area Impact Investing Initiative CECP Strategic Investor Initiative Ceres Kapor Center for Social Impact Society for Corporate Governance SustainAbility

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