ESG and Private Ordering

Michal Barzuza, Quinn Curtis† & David H. Webber‡*

Easterbrook and Fischel's seminal book The Economic Structure of Corporate Law *has taught us the crucial role of markets in shaping the corporate contract. With the rise of ESG, the nature of that contract is changing, but the importance of markets (and of their limitations) is not. In this piece, building on our previous work that traces the remarkable growth of ESG to a shift in demand, primarily, but not solely, among millennials, we discuss the role of markets in shaping ESG, as well as their limitations. The rise of social values, and the increasing willingness of millennials to act on them as market participants and corporate stakeholders, has forced managers to respond in ways that multiply the effect of those values. Critically, these preferences ultimately act as a constraint on firms' behavior, and the emergence of ESG is best understood as a product of strong, though sometimes excessive, incentives to respond to social demand. Thus, conducting a context specific incentives' analysis, rather than assuming that markets are always efficient or inefficient, should be preserved in the ESG era.*

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* Professor of Law, University of Virginia School of Law. For useful comments and suggestions we are grateful to Elizabeth Pollman and participants at the University of Chicago Business Law review, inaugural symposium.
† Albert Clark Tate, Jr., Professor of Law, University of Virginia School of Law.
‡ Professor of Law and Paul M. Siskind Research Scholar, Boston University School of Law

I. INTRODUCTION

Easterbrook and Fischel's seminal book *The Economic Structure of Corporate Law* has taught us the crucial role of markets in shaping the corporate contract. Markets—the market for corporate control, the labor market, capital markets, and product markets—all discipline managers to perform at their best and offer the best package, including firm governance package, to shareholders. This insight has had crucial implications for corporate law. Corporate law should be enabling, providing flexibility to shareholders and managers to optimize the corporate contract. This flexibility is nothing to fear because markets will incentivize managers and founders to offer the governance terms that maximize firm value.[1]

Firms that offer inefficient terms or lose focus on shareholder value will have a lower share price. Low share prices will attract hostile bidders that can profit from buying control, replacing poor management, reforming poor governance, and capturing the resulting increase in stock price. Thus, market forces inexorably push firms toward a disciplined focus on creating value for shareholders.

Easterbrook and Fischel's insights about the power of markets in shaping optimal corporate law remain important and influential views. American corporate law is mostly enabling, and, three decades after its publication, *The Economic Structure of Corporate Law* outlines the analytical approach to corporate law, based on contractual freedom and the centrality of shareholders, that remains at the heart of contemporary debates. A corollary of this important insight is that mandatory corporate law is generally not desirable as it applies one-size-fits-all to firms that would otherwise operationalize legal flexibility in the interests of

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1 FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4 (1996) ("Managers may do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.").

shareholders.[2] Firms differ in their needs and structures, and a one-size-fits-all rule is likely to do more harm than good. Instead of offering mandatory corporate law, the role of corporate law should be limited to offering a menu of different governance terms that reduce the cost of contracting.

While Easterbrook and Fischel's insight remains valid and influential, the extent to which markets are effective in that role has been challenged. In particular, market forces work in tension with the agency problem, which may sometimes prevail. First, managers' wealth is only remotely tied to stock value.[3] Second, managers have the power to diminish market discipline with defensive tactics such as poison pills and staggered boards.[4] With respect to stakeholders, managers have especially weak incentives to maximize their value, and might use stakeholder interests to further insulate themselves from market forces.[5]

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In recent years we have seen an emergence of private ordering of ESG. Most famously, the Business Roundtable issued a statement in 2019 that affirmed that companies have a "fundamental commitment to *all* of our stakeholders"[6] (emphasis in original). This public embrace of stakeholders by an influential group of large-company CEOs was a marked shift in at least the *rhetoric* around shareholder centrality. The Business Roundtable statement did not happen in a vacuum. The public embrace of stakeholders coincided with rapidly increasing emphasis on ESG issues among investors, consumers, and business leaders. In the Easterbrook and Fischel framework the corporate contract was not limited to managers and shareholders. Rather, a nexus of contracts, between managers, shareholders, employees, and other relevant constituencies will evolve as an efficient corporate contract. Is the recent rise of ESG an optimal contract that maximizes

2 *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) [hereinafter Easterbrook & Fischel, *Corporate Contract*] ("No one set of terms will be best for all; hence the 'enabling' structure of corporate law."); *see also* EASTERBROOK & FISCHEL, *supra* note 1, at 2.

3 *See, e.g.*, Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1841–43 (1989).

4 *Id.* at 1843–44.

5 *See* Lucian A. Bebchuk et al., *For Whom Corporate Leaders Bargain*, 94 S. CALIF. L. REV. 1467 (2021).

6 *Our Commitment*, BUS. ROUNDTABLE (emphasis added), https://perma.cc/3YD6-XQZC (last visited Feb. 8, 2022).

shareholder value? Or are managers seizing on ESG to shirk their accountability, as some have argued?[7]

We think the answer to both questions is "no." In this piece, we argue that the striking rise of ESG, the most significant development in corporate law and finance in recent years, is a demand-driven phenomenon. Thus, unlike in the past when managers promoted semi-ESG initiations to further insulate themselves, now they mostly respond to outside pressures. Yet, the bottom up pressure on managers, as we showed, while sometimes directed at maximizing value, and other times at genuine environmental or social goals, can also lead to excessive, misdirected, or defensive ESG in the self-interest of CEOs and fund managers.

In particular, building on our prior work on the importance of millennials to index fund ESG incentives (*Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*), and CEOs' ESG incentives (*The Millennial Corporation: Strong Stakeholders, Weak Managers*), we show that the rise of ESG is a market response to shifting demand from investors, consumers, and employees driven by, but not limited to the millennial generation.[8]

The "millennials markets"—their consumption, employment, and investment choices—combined with their use of social media, and their willingness to boycott, walkout and cancel, create powerful incentives for CEOs to promote ESG. As in the Easterbrook and Fischel framework, CEOs may promote ESG to maximize profits from consumption, employment, and investment. However, CEOs also respond to the personal magnified risk from cancel culture, boycotts and walkouts, and to changing notions of what constitutes firm value. Furthermore, millennial preferences also affect investment funds' managers, whose incentives are skewed toward attracting assets, rather than maximizing their value, and who in turn pressure management to promote ESG.

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7 *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020); Bebchuk et al., *supra* note 5.

8 Michal Barzuza et al., *The Millennial Corporation: Strong Stakeholders, Weak Managers* (Sept. 6, 2021), https://perma.cc/GLP6-B4VV (unpublished manuscript); *see also* Michal Barzuza et al., *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CALIF. L. REV. 1243 (2020) (arguing and bringing evidence to show that Index Funds compete on ESG branding to attract and retain millennials); Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN., & ACCT. 247 (2017); Sergio Alberto Gramitto Ricci & Christina M. Sautter, *Corporate Governance Gaming: The Collective Power of Retail Investors*, 22 NEV. L.J. 51 (2022) (arguing that younger retail investors use technology to promote social and environmental goals).

Activist hedge funds leverage ESG goals to gain funds' support for their activism, as in the recent Engine No. 1 campaign at Exxon.[9] ESG funds attract other investors that wish to benefit from the premium millennials pay for high-ESG stock (the "millennial premium"), who further bolster the price of ESG stock and the volume of investments in it.

In unpacking ESG as a market phenomenon, we illustrate the enduring importance of Easterbrook and Fischel in centering markets and flexibility in corporate law. The same framework that explains the leveraged buyouts of the 80's and the fixation on share price of the 90's can accommodate the emphasis on environmental, social, and stakeholder goals that dominates the corporate law conversation today. At the same time, we also highlight the limits of their theory, and mostly of their assumption that the corporate contract results in shareholder- maximizing outcomes.

The fact that ESG is driven by demand has important implications for corporate law and finance. First, unlike previous instances when ESG was driven exclusively by managers who utilized it primarily to insulate themselves, the current ESG movement actually tends to produce results for stakeholders: for example, board diversity has increased significantly in recent years, and firms have significantly increased disclosures related to ESG goals.

Second, the effects of markets and demand, however, are not necessarily efficient. CEOs' incentives to mitigate personal risks may result in excessive or misdirected ESG, having net negative social value, harming shareholder value with little or no social payoff. Similarly, Big Three managerial incentives to attract assets regardless of, and even at the expense of, share value may lead to further pressure on managers to promote excessive or defensive ESG. Third, the ESG movement has a more complicated relationship with firm value than its most ardent adherents have suggested. On the one hand, market demand for ESG helps mitigate the long-standing distinction between values and returns. Firms that are not responsive to the demand for ESG have difficulties selling their products, recruiting talent, and attracting investments. They will sell at lower prices and pay higher salaries. Their profits will decline, and their stock will be traded at a discount. On the other hand, because ESG commitments are rooted

[9] *The Little Engine that Could: ExxonMobil Loses a Proxy Fight with Green Investors*, ECONOMIST (May 29, 2021) ("An activist hedge fund succeeds in nominating at least two climate-friendly directors to the energy giant's board."), https://perma.cc/QFW3-X9U5.

in social preferences that operate as constraints on firms, there is no ex-ante reason to believe that the effect of these preferences will be to increase share price relative to a world in which different (perhaps more selfish) preferences prevail. Investment management in an ESG world is an exercise in constrained optimization.

This paper proceeds as follows. Part I gives an overview of the relevant contributions of Easterbrook and Fischel in understanding corporate law. Part II describes the transition of ESG from the margins to the center of corporate law. Part III argues that the rise of ESG is best understood as a market response to shifting demand. We conclude by arguing that conducting a context specific incentives' analysis, rather than assuming that markets are always efficient or inefficient, should be preserved in the ESG era.

II. Markets, Corporate Governance, and ESG

A. Easterbrook & Fischel's Seminal Contribution–Markets and Corporate Governance

The market for capital is just that–a market. On one side of the exchange is the capital needed for a business to grow, and on the other is a share of the business itself, structured in such a way as to make it maximally attractive to its potential purchasers. While every firm is subject to a variety of agency problems, the capital markets will put inexorable pressure on managers to find credible ways to reduce them. As Easterbrook and Fischel elegantly and succinctly put it in their seminal book:

> Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities the customers in capital markets want. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure.[10]

And this set of incentives promotes socially optimal investment.

> The firms and managers that make the choices investors prefer will prosper relative to others. Because the choices do not impose costs on strangers to the contracts, what is optimal for the firms and investors is optimal for society. We can

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10 Easterbrook & Fischel, *supra* note 1, at 4–5.

> learn a great deal just by observing which devices are widely used and which are not.[11]

While Easterbrook and Fischel's insight that markets incentivize managers to offer value-enhancing governance remains valid and influential, the extent to which markets are effective in that role has been challenged. Most notably, Lucian Bebchuk has argued that the market discipline thesis is limited by several factors.[12] To begin with, managers diminish the power of the market for corporate control with defensive tactics such as poison pills and staggered boards.[13] Second, managers' wealth is only remotely tied to stock value.[14] Third, many firms do not operate in competitive markets, but rather possess monopoly power, and accordingly enjoy monopolistic slack—with leeway to perform in less than optimal efficiency.[15] Lax corporate governance allows managers to extract private benefits that may exceed their share in the harm to their firm and its stock value. [16]

Indeed, we argue, markets work differently in the ESG framework than in the Easterbrook and Fischel framework. In their framework, markets respond only to profitability and thus care about governance *indirectly*. In our framework, consumers, employees, and investors care about ESG *directly*, as part of their utility function. Accordingly, firms respond to it directly and firmly. In Easterbrook and Fischel, market discipline hinges on firm value. If firms offer poor governance, their stock value will decline and thus also their ability to raise capital and to be profitable. Yet, as the critique suggests, the extent to which managers care about market price is limited.

The product market didn't care about governance and neither did the capital market. Millennials, on the other hand, care about ESG beyond just its effect on profitability and returns. Thus, managers face direct discipline to promote ESG, which power is not contingent on managers responsiveness to their firms' stock value.

This magnified discipline, however, does not necessarily lead to shareholder maximizing outcomes. As a context-specific incentives analysis shows, while it may produce value to stakeholders,

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11 *Id.* at 6–7.
12 *See, e.g.*, Bebchuk, *supra* note 3, at 1840–46.
13 *Id.* at 1843–44.
14 *Id.* at 1841–43.
15 *Id.* at 1845–46.
16 *Id.* at 1840–41.

it could also lead to excessive or defensive ESG, overinvestment, or greenwashing.

III. EXPLAINING THE RISE OF ESG

A. ESG Takes Center Stage

The focus on environmental, social, and governance issues is an unmissable characteristic of the modern corporate landscape. While corporate obligations to stakeholders other than shareholders have always been a point of emphasis among environmental advocates, union and public pension funds,[17] and corporate reformers, it is striking that the new wave of ESG has swept in large, conventional asset managers like BlackRock and State Street, as well as a smattering of hedge funds, venture capital funds, and others.

While it is challenging to pinpoint the start of the modern ESG movement, one might point to State Street and BlackRock's efforts to address a lack of gender diversity on public company boards as a seminal moment.[18] While not first-movers in the push for greater diversity, the entry of these asset managers signaled an important shift for several reasons. First, it signaled that conventional asset managers were taking an interest in social issues. Second, the funds framed the issue in terms of shareholder value, aligning social goals with shareholder welfare. Finally, the fund families didn't just pay lip service to the goal of board diversity, but put real teeth behind their demands with numerical thresholds and a demonstrated willingness to back up their demands with withhold votes.

Index funds are a somewhat surprising source for change of any kind. While index funds might, through exercising shareholder stewardship, improve the companies in which they hold significant stakes, such improvement would increase the value of all funds tracking the index, while the costs would be borne by the fund or subset of funds tackling the activist pressure. As such, one might expect index funds to be relatively passive

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17 DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON 162 (2018) (describing public pension fund and labor fund shareholder activism).

18 State Street Fearless Girl campaign was launched on Women's International Day in March 2017.

shareholders.[19] Nevertheless, the immense asset base of index funds put substantial shareholder power behind ESG goals.

If index funds' activism around ESG issues had been limited to board diversity, it is doubtful that ESG would play as significant a role in the corporate governance discussion. But they followed the board diversity push with pressure on firms to address issues related to climate change, suggesting that their interest in socially responsible investing was not idiosyncratic but a new fixture in markets.

What followed was an explosion of interest in ESG. Data providers like Standard and Poor's, ISS, and MSCI delivered detailed metrics aimed at various components of ESG risk. Index providers built specialized ESG indices. Specialized ESG mutual funds became the fastest-growing segment of the industry.[20] And, as outlined above, regulators took notice. Law firms, accounting firms, and management consultants rushed to advise firms on how to respond.

And other asset managers entered the fray. In the highest-profile case of ESG activism, the small hedge fund Engine No. 1 won a proxy fight against Exxon, replacing multiple directors, with an activist pitch heavy on ESG arguments related to climate change. This successful fight, backed by ISS, Glass Lewis, and the big index funds, may serve as a template for shareholder activism going forward.

B. Explanations for the Rise of ESG

Unsurprisingly, academics and others have offered a number of explanations for the rise of ESG. ESG-oriented asset managers have advocated ESG as a means of promoting long-term value, suggesting that there is no conflict in the long-term between environmental stewardship, employee welfare, and shareholder value. State Street writes of its investing philosophy:

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

[19] Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029 (2019).

[20] Quinn Curtis et al., *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2021).

> an asset manager to integrate sustainability risk and opportunities into investment decision-making alongside traditional investment analysis.[21]

This language is typical of the host of asset managers—as well as data providers and other denizens of the ESG space—who advocate ESG-focused approaches as simply the correct way to generate returns. The idea that ESG, or at least some versions of it, are a subspecies of shareholder primacy is present in the academic literature as well. Professors Bebchuk and Tallarita characterize common approaches to ESG as "instrumental stakeholderism," or "enlightened shareholder value."[22] Professors Lund and Pollman describe how the shareholder-focused corporate governance ecosystem converts ESG's would-be-stakeholder focus to a fixation on shareholder value.[23]

Other accounts identify more concerning forces at work in the rise of ESG. One argument is that ESG provides cover to reduce managerial accountability to shareholders—benefiting managers, not stakeholders.[24] Professor Roe has suggested that accommodating ESG goals reflects competitive slack due to market concentration.[25] In another account, ESG rose as backlash to political disfunction following the financial crisis politics.[26] And of course, there is the ever-present possibility that corporate commitments to ESG goals are nothing more than cheap-talk greenwashing by companies that seek to stave off public censure or regulation without actually changing practices. Finally, on another account, ESG merely maximizes shareholder value.

Indeed, the rise of ESG can be squared with Easterbrook and Fischel's account of the corporate contract and managers' fiduciary duties. As Easterbrook and Fischel pointed out, there is nothing inconsistent about the idea that running the firm in the interest of shareholders requires carefully considering the interests of

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21 *ESG Investment Statement*, STATE ST. (Oct. 2021), https://perma.cc/QVP7-3MTR.

22 Bebchuk & Tallarita, *supra* note 7, at 108.

23 Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021).

24 *See, e.g.*, Bebchuk & Tallarita, *supra* note 7; Bebchuk et al., *supra* note 5.

25 Mark J. Roe, *Corporate Purpose and Corporate Competition* (Eur. Corp. Governance Inst., Law Working Paper No. 601/2021, 2021).

26 Edward B. Rock, *For Whom Is the Corporation Managed in 2020?: The Debate over Corporate Purpose* 5 (Eur. Corp. Governance Inst., Law Working Paper No. 515/2020, 2020) ("The various efforts to bring greater attention to 'ESG' or 'Environmental Social and Governance' matters in the boardroom, including a board level focus on climate change, diversity and human capital, are of a piece with the effort to converge on a more sustainable system.").

other stakeholders to the extent they are key contributors to firm value.

On the other hand, the more skeptical views, too, apply in the context of ESG. Managerial self-interest, the classic corporate law agency problem, and one that plays no small role in the critique of *The Economic Structure of Corporate Law*, also arises in the ESG context.

C. Challenges to Existing Accounts

To summarize, we observe a widespread focus on ESG among corporate managers, passive institutional shareholders, and at least some hedge fund activists. Explanations for the prevalence of ESG include the notion that ESG is simply shareholder primacy by another name or that it arises as a tool to insulate managers from the influence of markets.

In our view, the evidence is inconsistent with a managerialist account of the rise of ESG. While there may be instances in which managers benefit from ESG's attention to multiple stakeholders, recent events suggest that ESG does not expand managerial discretion as it did in the past. In many ways it even constrains it. When proxy contests regularly cite ESG failures and when ESG shareholder proposals pass with broad support over the objection of management, it seems clear that ESG commitments are being embraced by shareholders. To be sure, there may be some instances in which managers will use ESG to insulate themselves. Yet, there is also clearly an opposite effect, as ESG has been utilized by activist hedge funds to leverage their power and influence.

The idea that ESG is merely greenwashing or politically correct window-dressing also seems in tension with the evidence. To be sure, there will always be some cheap talk around social and environmental commitments, but what is notable about the current ESG movement is its fixation on transparency, measurement, and progress. As noted above, the campaign to diversify boards focused on specific numerical goals. More broadly, an entire industry has sprung up scoring firms' ESG status on hundreds of dimensions, and firms that fall short or fail to disclose have faced shareholder backlash.

Nor has investors' approach been characterized by cheap talk. While interest in ESG surged during the Trump administration, investors and financial firms faced significant regulatory pushback and nevertheless remained committed to advising ESG goals. In 2018, the DOL reminded retirement plan fiduciaries that they "are not permitted to sacrifice investment return or take on additional investment risk as a means of using plan investments to promote collateral social policy goals."[27] In 2020, the DOL released a proposed rule that would have sharply curtailed the ability of asset managers serving retirement accounts, including many mutual funds, to explicitly consider ESG factors.[28] While the final Trump Administration rule[29] took a more neutral approach, it was nevertheless framed as a response to the rise of ESG investing. (The Trump rule was never actually implemented, as the Biden Administration announced that it would not enforce it and is still in the process of rewriting it.)[30]

The pushback to ESG was not limited to investment funds. Banks, which had increasingly been pressed to address their role in financing carbon-intensive activities, found themselves in the crosshairs as well. The Trump OCC "Fair Access to Financial Services" rule,[31] aimed to pressure banks to continue extending credit to industries that had been attracting ESG criticism, including energy and firearms.[32] The rule was viewed as a direct response to the ESG movement and was widely opposed by banks and investment firms.[33]

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27 John J. Canary, *Field Assistance Bulletin No. 2018–01*, U.S. DEP'T OF LABOR (Apr. 23, 2018), https://perma.cc/5ZB8-TY9J.

28 Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113 (proposed June 30, 2020) (to be codified at 29 C.F.R. pt. 2550).

29 29 C.F.R. §§ 2509, 2550 (2022).

30 Tara Siegel Bernard, *The Labor Department Will Not Enforce Two Trump-Era Rules Regulating Retirement Plans*, N.Y. TIMES (Mar. 11, 2021), https://perma.cc/7YUW-5JKC.

31 OFF. OF THE COMPTROLLER OF THE CURRENCY, FAIR ACCESS TO FINANCIAL SERVICES (Jan. 13, 2021) (rule finalized but never published or codified), https://perma.cc/39AD-7GQD. While this rule did become final, the Office of the Comptroller of the Currency paused publication of the rule before it became effective.

32 Eric Rosenbaum, *Trump Bank Regulator's New Rule Incurs Wall Street and Climate Investor Ire on His Way Out the Door*, CNBC (Jan. 14, 2021, 12:47 PM), https://perma.cc/ZT8X-Z8LR.

33 *Id.*

The Biden administration, by contrast, has been aggressive in advancing ESG goals, including in a new DOL rule strongly backing ESG[34] and numerous ESG initiatives at the SEC.[35]

These examples of regulatory push and pull are telling for three reasons. First, they are inconsistent with the idea of ESG as harmless greenwashing or management window dressing. If ESG were simply marketing spin, there would be little reason for even skeptical regulators to engage it. If anything, allowing such "thin" ESG to continue might lower the demand for other regulatory interventions aimed at climate and other issues. Second, the anti-ESG regulations were aimed at investors and banks—financial intermediaries—suggesting that regulators saw ESG pressure as external to most firms. This, again, is inconsistent with the concept of ESG as primarily embraced by management, whether because of managerial agency problems or firm market power, as opposed to other stakeholders. Third, it seems clear that both pro- and anti-ESG initiatives from two administrations have done little or nothing to slow the adoption of ESG, suggesting that the commitments to ESG goals are at least sincere enough to thrive amid regulatory scrutiny and are not merely a response to the Trump administration.

If ESG is neither managerial power run amok nor window dressing, then should we embrace the argument of ESG investor-advocates that ESG is simply the smart way to manage money in the long term? We think it is unduly reductive to treat all ESG interventions as oriented to improving enterprise value. While the diversification of boards of directors is surely an important social movement, the finance literature linking such reforms to firm value is ambiguous at best.[36] Given the relatively attenuated incentives of index funds to intervene in corporate governance at all,[37] their choice to focus on board diversity as an initial foray into

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34 Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (proposed Oct. 14, 2021) (to be codified at 29 C.F.R. pt. 2550). For a comment by one of us encouraging the DOL to do more to protect consideration of workers in plan investment decisions, see David H. Webber, *New Department of Labor Investment Rules Could Be Big Win for Everyone but Labor*, CLS BLUE SKY BLOG (Mar. 28, 2022) (citing Letter from David H. Webber, Professor of L., Bos. Univ., to Off. of Regul. & Interpretations, U.S. Dep't of Lab. (Dec. 13, 2021), https://perma.cc/6LKT-NDJ7), https://perma.cc/4HDR-XT84.

35 *SEC Responses to Climate and ESG Risks and Opportunities*, U.S. SEC. & EXCH. COMM'N (Oct. 26, 2021), https://perma.cc/YM3R-8SV2.

36 Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?* (Eur. Corp. Governance Inst., Law Working Paper No. 579/2021, 2021); Barzuza et al., *supra* note 8.

37 Bebchuk & Hirst, *supra* note 19.

activism is hard to square *solely* with a commitment to increasing returns.

At the firm level, engagement with salient social issues also raises questions about the impact on stock price of, for example, corporate responses to the Black Lives Matter movement,[38] or red-state voting restrictions[39] that risked (and in the case of voting restrictions resulted in) backlash. While certainly cognizable under the "S" in "ESG," these instances of corporate political engagement are best understood as managers responding to significant immediate pressure, often from employees, rather than arising out of a long-term strategy to create shareholder value in the abstract. It appears that stakeholder social concerns are functioning as a constraint on management in such cases.

Indeed, as we show, managers may invest firms' resources in ESG to promote stakeholder interests but also to mitigate personal risk to their reputation and career concerns.

IV. MILLENNIAL MARKETS–THE DEMAND FOR ESG

We argue that the rise of ESG is traceable, not to managerial attempts to insulate themselves from market forces, nor to maximizing firms' long term shareholder value. Instead, we argue that the rise of ESG is traceable to an important shift in demand, and in turn, in incentives. In particular, corporate stakeholders, and the millennial generation in particular (though not exclusively), are increasingly willing to act on preferences regarding social, environmental, and worker-welfare consequences of corporate actions. This tendency, with an assist from social media, has given non-shareholder stakeholders leverage over firm behaviors and essentially forced managers to be attentive to ESG issues as a matter of preserving traditional firm value, altering traditional notions of firm value—and, equally important, their safeguarding and advancing their own careers. And the demand for ESG has created incentives to index funds managers to promote ESG as means to preserve or increase their assets under management, regardless of, and sometimes at the expense of, shareholder value.

We have previously identified index funds' market incentives as the cause of their embrace of ESG goals. Subsequent events

38 Heather Haddon, *Starbucks, in Reversal, to Distribute 'Black Lives Matter' Shirts to Baristas*, WALL ST. J. (June 12, 2020, 5:25 PM), https://perma.cc/5UNC-B353.

39 *See* Thomas Pallini, *Delta Spent the Pandemic Earning Goodwill from Passengers and Workers. It Might Be About to Vanish*, BUS. INSIDER (Apr. 3, 2021, 6:38 AM), https://perma.cc/CL58-DJP2.

have borne out that theory, but it is clear now that index funds are not the sole, or even the most important, channel through which firms have been forced to respond to the governance preferences of the millennial generation. CEOs must now grapple with millennials as employees and consumers as well as index investors. Moreover, the investment community at large has taken notice of the potential financial impact of millennial preferences, meaning that even investors without a direct commitment to ESG goals nevertheless must account for the reality of ESG risks, unless they are for some reason immune to social preferences through any channel. Moreover, now that the market has begun to respond to millennial preferences, others have shown a willingness to press corporations on social goals, increasing the scope and degree of pressure on firms.

Put simply, our view is that the current focus on ESG among investors is a private ordering phenomenon driven by shifting demand, transmitted through a number of increasingly effective channels, ultimately acting as a constraint on corporate behavior. Yet, as we have shown, these effects go far and beyond incentives to maximize share value. They may directly cater to the interests of powerful stakeholders. They also create personal incentives for managers to mitigate personal risks to their reputation and career prospects.

A. Millennial Preferences and Markets

Millennials are different. Born between 1981 and 1996, Millennials represent the largest generation in US history.[40] Combined with their ideological compatriots in Gen Z, they already represent a majority of the US population.[41] Millennials numerosity is matched by economic might that has not escaped the attention of asset managers. While Millennials wield considerable wealth already, they also stand to inherit from their Baby Boom parents in what will be "the largest transfer of wealth in history,"[42] in the words of Blackrock CEO Larry Fink.

But what truly sets the Millennials, and now Gen Z, apart is their willingness to act on their political and social values in making economic decisions as consumers, employees, and investors,

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40 *Millennials Coming of Age*, GOLDMAN SACHS ("The Millennial generation is the biggest in US history . . . ."), https://perma.cc/G8XQ-UX3T (last visited Feb. 8, 2022).

41 William H. Frey, *Now, More than Half of Americans Are Millennials or Younger*, BROOKINGS INST. (July 30, 2020), https://perma.cc/CMB8-GPQK.

42 *Profit & Purpose: Larry Fink's 2019 Letter to CEOs*, BLACKROCK [hereinafter *Profit & Purpose*], https://perma.cc/T5ZV-BM2X (last visited Feb. 8, 2022).

in boycotting and canceling, and in their extensive use of social media to promote their goals.

Thus, there is basis to the argument that to a certain level ESG is now a component of a shareholder value maximization strategy. On the employment front, millennials are perceived to seek out workplaces that share their values.[43] For technology and other firms that heavily rely on a Millennial workforce, managers argue, aligning with their social values is a matter of economic survival. Facebook, for example, has arguably struggled mightily to recruit talent in the fallout of the Cambridge Analytica scandal.[44] Facing fierce competition with other technology giants for talent, "struggling to recruit" could translate into higher salaries for the same set of skills. Conversely, companies that manage to align themselves with Millennial values may be able to pay less. Philipp Krueger, Daniel Metzger, and Jiaxin Wu find that companies in sustainable industries are able to attract talent while offering lower salaries.[45] Recent field experiments suggest similar dynamics.[46]

Millennials might behave similarly in product markets. Numerous industry reports, the types of research likely to form the basis of corporate strategies, point to young consumers' appetite for brands they associate with their social values.[47] While some

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43 Afdhel Aziz, *The Power of Purpose: The Business Case for Purpose (All the Data You Were Looking For Pt 2)*, FORBES (Mar. 7, 2020, 12:04 PM), https://perma.cc/5WYT-D973.

44 Salvador Rodriguez, *Facebook Has Struggled to Hire Talent Since the Cambridge Analytica Scandal, According to Recruiters Who Worked There*, CNBC (May 16, 2019, 2:58 PM), https://perma.cc/N27M-Y6SQ.

45 Philipp Krueger et al., *The Sustainability Wage Gap* (Eur. Corp. Governance Inst., Finance Working Paper No. 718/2020, 2020) ("We hypothesize that this Sustainability Wage Gap arises because workers, especially those with higher skills and from younger cohorts, value environmental sustainability and accept lower wages to work in more environmentally sustainable firms and sectors. Accordingly, we find that the Sustainability Wage Gap is larger for high-skilled workers and increasing over time.").

46 *See* Daniel Hedblom et al., *Toward an Understanding of Corporate Social Responsibility: Theory and Field Experimental Evidence* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26222, 2021); *see also* Vanessa Burbano, *Getting Gig Workers to Do More by Doing Good: Field Experimental Evidence from Online Platform Labor Marketplaces*, 34 ORG. & ENV'T 387 (2021) (conducting two field experiments and finding that providing gig workers with information about employer charity contribution increases their willingness to do extra work).

47 *See, e.g.*, *66% of Consumers Willing to Pay More for Sustainable Goods, Nielsen Report Reveals*, ASHTON MFG., https://perma.cc/BTD5-JUPD (last visited Feb. 9, 2022); *Two-Thirds of Consumers Worldwide Now Buy on Beliefs*, EDELMAN (Oct. 2, 2018), https://perma.cc/WVG3-X2KQ; PORTER NOVELLI, 2021 BUSINESS OF CANCEL CULTURE STUDY 8–9 (Jan. 25, 2021), https://perma.cc/A2MC-JA7J; Afdhel Aziz, *The Power of Purpose: The Business Case for Purpose (All The Data You Were Looking For Pt 1)*, FORBES

social commitments take the form of relatively thin marketing, there are numerous examples of companies who fail to deliver on social commitments being called out with serious corporate consequences.

Importantly, these social preferences not only act to create brand affinity, but also to destroy it—often irrevocably.[48] The "cancel culture" social media dynamic that has been observed repeatedly in non-economics contexts, operates in the world of consumer brands as well. For example, Oatly, a vegan milk brand with ESG-forward marketing, faced withering consumer criticism and a boycott after selling a stake to the private equity group Blackstone, which activists argued (incorrectly, as it turned out) was involved in the destruction of the Amazon rainforest.[49]

More important, these visible examples pose personal risk to CEOs' reputation and career prospects. Risk averse managers are aware of the potential consequences of being on the wrong side of a social media campaign. To mitigate their personal, non-diversifiable risk, CEOs may rationally use corporate resources to promote, sometimes appropriately, sometimes excessively, ESG goals

B. Millennial Preferences and Indirect Channels

CEOs also feel indirect pressures to promote ESG, which pressures do not necessarily align with maximizing value. Increasingly, asset managers are internalizing Millennial values because they believe in them, or because they seek to attract Millennial assets, or because they are sensitive to the risks posed by ESG problems at portfolio firms, and partially because they are sensitive to the risk/opportunity to lose/gain assets under management.

As we have previously argued,[50] a key channel through which Millennial preferences impact firms is the immense shareholder power of index funds. Because funds tracking the same index are more or less commodities that compete only on costs, and because costs are already quite low, index-oriented asset managers have strong incentives to seek differentiation. Index fund ESG engagement can be understood as an attractive source of differentiation,

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(Mar. 7, 2020, 12:06 PM), https://perma.cc/TJ3J-2XWM (citing CONE/PORTER NOVELLI, 2018 PURPOSE STUDY, https://perma.cc/U3L6-S729 (last visited Feb. 8, 2022)).

48 Kian Bakhtiari, *Why Brands Need to Pay Attention to Cancel Culture*, FORBES (Sept. 29, 2020, 6:32 PM), https://perma.cc/FX82-7S54.

49 *Id.*

50 Barzuza et al., *supra* note 8.

as these funds must vote proxies in any case, and engaging on socially salient issues popular with young current and future investors may provide a competitive edge. Indeed, commentators in the asset management industry have identified Millennials as a driving force behind the rapid growth of ESG, both in the indexed and non-indexed sectors.[51]

But index funds are not the only financial powerhouses putting pressure on firms to address ESG issues. Activist hedge funds have long been the most direct threat to management's preferred policies and have not hesitated to run campaigns aimed at improving corporate performance. Now, an increasing number of hedge funds are speaking the language of ESG. There is no more striking example of this than the Engine No. 1 campaign at Exxon.

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In the highest-profile activism event to date, Engine No 1., a small hedge fund with a tiny stake, successfully unseated three Exxon directors in a proxy fight that focused largely on climate change.[52] Wachtell Lipton observed in a firm memo:

> The bottom line is this: A newly launched and virtually unknown hedge fund with a tiny stake in a massive global enterprise managed to leverage environmental and governance issues into winning three board seats at the annual meeting, displacing three incumbent directors, and is now in a position to influence the strategic direction of the company.[53]

Engine No. 1's small position, coupled with its strong ESG message, proved persuasive to major shareholders, and may provide a template for future activism, putting additional ESG pressure on managers. "Engine No. 1 has shown that a smaller position, coupled with a compelling ESG issue, could be sufficient to win a campaign . . . . Boards cannot afford to ignore the issues raised by activists, even little-known funds."[54]

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51 *Millennials Are a Driving Factor in the Growth Behind ESG Investments*, NASDAQ (May 25, 2021, 11:39 AM), https://perma.cc/WDF5-5FVD.

52 *The Little Engine that Could*, *supra* note 9 ("An activist hedge fund succeeds in nominating at least two climate-friendly directors to the energy giant's board.").

53 David A. Katz & Laura A. McIntosh, *EESG Activism After ExxonMobil*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 23, 2021), https://perma.cc/3RKG-YRXN.

54 Lindsay Frost, *Activist Hedge Funds Increasingly ESG Converts*, AGENDA (July 26, 2021), https://perma.cc/UUC4-DK82.

Even in more conventional cases of activism, we see activists cite ESG issues as part of the reason for a needed change. For example, Peloton, now trading below its IPO price, drew fire from Blackwells Capital, which, among a litany of complaints, noted that the company "received the worst possible score for environmental disclosure and governance risk, and nearly the worst possible score for social and human rights disclosure, from a respected proxy advisory and governance firm."[55] This fusion of ESG and conventional firm performance complaints is portentous for managers of struggling firms. Companies with lagging stock prices that also fail on board diversity, ESG disclosure, or related issues are increasingly likely to become activist targets.

The rise of hedge funds as ESG activists is perhaps even more surprising than index funds. Hedge funds have frequently been critiqued as short-term biased, and empirical evidence has suggested that some hedge fund interventions have come at the expense of employees. Hedge funds, with their supercharged compensation incentives are among the sharper practitioners of capitalism in the economy and so the embrace of ESG among a subset of them is notable. Of course, that index funds and hedge funds are both turning to ESG is unlikely to be a coincidence. While index funds are the largest pools of assets in the capital markets, hedge funds play a critical role in shareholder activism by leading proxy contests and pressing firms for changes. Of course, there is an interaction between hedge funds and index funds, because hedge fund activism relies on the support of passive asset managers in order to succeed. It is therefore not surprising that hedge funds have begun to embrace ESG.

But even if hedge funds are foregrounding ESG in campaigns mainly in an effort to draw the support of mutual fund investors, who are in turn attempting to woo Millennial assets, the fact remains that managers are receiving pressure from all sides: the labor market, the product market, and the capital markets. Market forces have coalesced around ESG, putting overwhelming pressure on managers to respond. Indeed, the engagement of hedge funds with ESG is a remarkable convergence between the conventional mechanics of corporate control as outlined by Easterbrook and Fischel, and longstanding concerns about stakeholder welfare.

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55 *Blackwells Sends Letter to Peloton Board of Directors, Calling for New Leadership and Initiation of Strategic Alternatives*, BUS. WIRE (Jan. 24, 2022, 7:00 AM), https://perma.cc/8MTY-7YYX.

C. The Market for ESG

Many institutional investors would argue that there is no tension between their ESG agenda and the long-term financial performance of target companies. For example, State Street wrote in their Corporate Responsibility Report: "[O]ur singular focus is on long-term value creation. . . . That is why our asset management business has been stressing ESG issues . . . ."[56] Others, including regulators,[57] have viewed such claims skeptically. Does it make sense for a company like Exxon to commit to decarbonization? Can it really be the case that there is no tension between the social and environmental goals of ESG investors and the stock price of individual companies?

Our understanding of the ESG movement as a market-oriented phenomenon arising out of the social and environmental preferences of stakeholders helps resolve this tension. For ESG to be a successful investment strategy, it needn't be the case that, in a vacuum, the optimum approach (in the long-term shareholder value sense) to running the firm is to perform well along various ESG dimensions. Rather, investors are pressing ESG because they believe an ESG-forward approach is the optimal solution to the *constrained* optimization problem where the preferences of stakeholders with genuine—and growing—leverage must be, to some degree, accommodated.

Put another way, if firms were a black box where the environmental impact of their operations and conditions of their workers deep in the supply chain were invisible to investors, consumers, and professional employees, it may well be in the long-term interest of shareholders to cast-aside ESG considerations.[58] But firms have never been less of a black box, and their ESG failures *do* have consequences for employment and consumption choices. Taking these market realities as given, capital markets are merely responding in a way that they expect will maximize shareholder and even stakeholder welfare, broadly understood.[59]

This market-oriented approach also helps address any lingering skepticism that much of ESG is simply greenwashing and cheap talk. ESG-preferences are functioning as a constraint on

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56 STATE ST., 2018 CORPORATE RESPONSIBILITY REPORT 4 (2019), https://perma.cc/GZ5H-3HVC.

57 *See* Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113 (proposed June 30, 2020) (to be codified at 29 C.F.R. pt. 2550).

58 This is a claim we suspect many of the investors pressing ESG would not concede, as many of their arguments suggest that ESG is a first-best approach to firm governance.

59 Hart & Zingales, *supra* note 8, at 15.

managers in much the same way that Easterbrook and Fischel identified the market for corporate control as a constraint. Managers in the ESG era are not relieved of obligations to shareholders, but the relative power—and desire—of shareholders to have the firm run solely in their interest has declined. Moreover, other stakeholders' interests are being pressed by sophisticated investors wielding conventional shareholder power and armed with an ever-increasing panopticon of firm-specific information about ESG practices. Market-discipline around ESG is complex, but real. If we may paraphrase Easterbrook and Fischel, "[m]anagers may do their best to take advantage of their [stakeholders], but they find that the dynamics of the market drive them to act as if they had [stakeholders'] interests at heart. It is almost as if there were an invisible hand."[60]

However, while managers now have incentives to promote stakeholder interests, these incentives are not necessarily optimal under traditional notions of firm value, though they may be becoming increasingly acceptable under evolving notions of firm value. As we showed in a previous work, the demand for ESG gives rise to a new manifestation of the agency problem: excessive or defensive ESG.

V. IMPLICATIONS

Thus, our analysis that ESG is driven by markets starts by observing that shifting preferences are creating new market incentives, which interact in novel and important ways. ESG preferences are transmitted to managers through a variety of channels, including not just the employment market and product market, but also through the capital markets. The latter includes both investors with preferences other than maximizing returns, and investors who seek only to maximize returns but recognize that the shift in preferences we document represents a significant source of business risk. As a result, managers face demands for ESG performance on all fronts, creating very strong incentives.

A. Measurable Achievements

The most important implication of this analysis is that we expect ESG pressure to deliver concrete, meaningful results. As already noted, managers face pressure not just from consumers, but from investors (both passive and activist), and employees.

60 EASTERBROOK & FISCHEL, *supra* note 1, at 4.

These constituencies have vocally demanded the incorporation of ESG considerations into corporate decision-making.

Firms are in the process of diversifying their boards. Index funds pressure was associated with an accelerated pace of board diversification. In response to the BLM protests following the murder of George Floyd, many firms added directors from racial minorities to their board, and in some cases even increased their size of the board to facilitate nominations. In 2021, 72% of newly nominated directors were female or unrepresented minorities. And firms subjected to ESG pressure have also made progress on climate disclosure. One study even found that fund campaigns on the environment were associated with declines in carbon emissions of firms they held.[61]

B. ESG for the Long Haul?

Will these incentives prove durable? An implication of our analysis is that the market for ESG will only last as long as the preferences that underlie it. Nevertheless, it seems plausible that the current ESG movement will prove be more sustainable than past instances in which corporations embraced social goals. As outlined above, Millennials appear distinctly different from their generational forebears when it comes to market behavior. Moreover, the claim that their leftward tilt will inevitably dissipate as they age may be more folktale than social science.[62]

Nevertheless, the future is hard to predict, and intervening events could shift preferences in unpredictable ways. Understanding ESG as a product of market phenomena, though, suggests at least that the ESG movement is more than window-dressing, cheap talk, or management slack.

Importantly, the future of preferences for ESG among stakeholders is as uncertain to managers as it is to us. Much of the evidence we marshal for shifting Millennial preferences is similar to the market research that drives corporate decision-making. Indeed, BlackRock CEO Larry Fink has been explicit about the role Millennials play in their stewardship strategy.[63] While other

61 José Azar et al., *The Big Three and Corporate Carbon Emissions Around the World*, 142 J. FIN. ECON. 674, 674 (2021) ("[W]e observe a strong and robust negative association between Big Three ownership and subsequent carbon emissions among MSCI index constituents, a pattern that becomes stronger in the later years of the sample period as the three institutions publicly commit to tackle Environmental, Social, and Governance (ESG) issues.").

62 Jonathan C. Peterson et al., *Do People Really Become More Conservative as They Age?*, 82 J. POL. 600, 600–11 (2020).

63 *Profit & Purpose*, *supra* note 43.

firms have not been as vocal, the evidence is clear that they perceive and respond to the same trends that we document. These trends may shift and predictions about the future may be incorrect, but the fact is that investors and managers are acting on their best guesses about where things are headed, and that appears to be a future in which ESG continues to play an important role.

The comparison between the market for ESG and the market for corporate control is important in another way. Arguably, the market for ESG may discipline managers more effectively in our framework than in the conventional market for corporate control as analyzed. For Easterbrook and Fischel, market discipline hinged on firm value. Product markets didn't care about the quality of firm governance, and shareholders cared about governance practices only to the extent it led to a difference in stock price. If firms offer poor governance, their stock value will decline, limiting their ability to raise capital and to be profitable. Thus, in the traditional market-discipline framework of Easterbrook and Fischel, the market for corporate control responds to firms' prospects for long-term profitability and impounds information about governance only *instrumentally*.

In our framework, consumers, employees, and investors care about ESG *directly*, as part of their utility function, and accordingly respond to ESG information. Other market participants care about ESG *indirectly* due to its potential impact on them, sometimes regardless of or even despite firm value.

C. Transparency and Markets for Information

Information is the lifeblood of markets of all kinds, and the market for ESG is no exception. Corporate disclosure has long generated reams of information about the financial state of public firms, the sort of information traditionally used to price securities. The accuracy of stock prices is critical to the market for corporate control and extensive mandatory disclosure ensures comparability and standardization of financial disclosures across firms.

In the ESG space, the market has far exceeded regulatory requirements when it comes to disclosure. Competing disclosure frameworks from SASB, GRI, and others, backed by disclosure ratings, have created strong market incentives for transparency. Given that many of the demands for disclosure come from shareholders rather than other stakeholders, firms have found it difficult to decline requests for information that can be reasonably made available.

The growth in ESG disclosures has naturally raised questions about what disclosures should be mandatory. The robust growth in ESG disclosures without regulation lowers the stakes of the debate, but our markets approach to ESG is helpful in contemplating the potential role of regulation in the ESG disclosure space.

A comparison to earlier disclosure mandates related to ESG is helpful. Consider the conflict mineral disclosures enacted as part of the Dodd-Frank Act. These disclosures were not a product of investor demand. They were enacted by legislative fiat and aimed not at improving the occurrence of stock prices, but at embarrassing companies into addressing social problems related to raw materials production. By forcing firms to disclose, the conflict minerals requirements would make it easier for activists to bring pressure to bear on problematic firms who were forced to be open about their supply chain. This type of name-and-shame disclosure, of which the CEO pay ratio disclosure is also an example, is not a product of market forces despite being related to ESG issues—at least, not at the time Dodd-Frank passed.

It is important to distinguish these earlier types of disclosure requirements from the current state of play. Consider the new ESG-relevant disclosure requirements related to human capital. As of 2020, firms are required to make disclosures related to their employee relations under Item 101(c)(1)(xiii) of Regulation S-K[64] including:

> A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the *development, attraction and retention of personnel*).[65]

The ESG valence of such a disclosure is fairly clear, but the origin of this new disclosure mandate is not only labor groups, but investors as well.[66]

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[64] 17 C.F.R. §§ 229, 239, 240 (2020).

[65] 17 C.F.R. § 229 (2020) (emphasis added).

[66] *See Members*, HUMAN CAP. MGMT. COAL., https://perma.cc/8A38-LRA2 (last visited Feb. 8, 2022).

There are two reasons investors might want this information. First, businesses increasingly rely on human capital for their success. It is reasonable for investors to want to better understand how companies manage risks related to human capital. But there is another reason as well: Companies' relations with their workforce are a source of ESG risk. Low pay, mistreatment, or sexual misconduct by management can all result in high-profile scandals that damage consumer demand or lead to investor backlash. This can be true even at firms that don't rely on high-skill, highly paid workers. Thus, investors need human capital information because it is a business risk in itself, but also because it is a source of ESG risk that could have business consequences arising out of other stakeholders as well.

While critics of the new disclosure complain that the SEC is attempting to illicitly promote environmental and social goals through disclosure,[67] the truth is that investors need socially-relevant information to manage the risk of genuine economic harm arising out of firms being insufficiently attentive to social issues that matter to other stakeholders. What is true of human capital, is true of a host of other salient risks: what matters to stakeholders will increasingly matter to investors, even those not seeking to promote ESG goals themselves.

D. Concerns

Our account of ESG predicts that managers may engage in excessive, misallocated, or defensive ESG. First, managers may use firms' resources to mitigate personal risk to their reputation and career prospects. Second, index fund managers may compete aggressively to attract and retain assets under management, by increasing the level of their ESG activism, regardless of, and even at the expense of, its effects on shareholder value.

Second, CEOs may respond to ESG pressure by engaging in "greenwashing," that is, exaggerating or fabricating claims that a company's products are environmentally friendly.[68]

Third, the issues that draw the most attention will be the ones salient to relatively young, wealthy, highly skilled professionals active on social media. These are disproportionately individuals with money to invest, leverage as employees, and

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67 David R. Burton, Comment Letter on Proposed Rule Regarding the Modernization of Regulation S-K Items 101, 103, and 105 (Oct. 22, 2019), https://perma.cc/9HDZ-6F5E.

68 *See, e.g.*, Will Kenton, *Greenwashing*, INVESTOPEDIA (Mar. 22, 2022), https://perma.cc/S7LP-RBMM; *Greenwashing*, WIKIPEDIA, https://perma.cc/XR5D-KDEW (last visited Apr. 10, 2022).

flexibility to be choosy in consumer markets. A casual survey of the ESG landscape suggests that the prediction that ESG is oriented toward this population survives at least a brush with reality.

But, if ESG is based on social values and aggregated individual preferences, then it operates as a largely[69] exogenous constraint, and not itself as a product of market forces. Other-regarding preferences are complicated and fraught. How well do individuals actually do at identifying important social issues to address? How effective can they be in operationalizing concerns for stakeholders whose interests they may not fully understand? Will pressure on managers to, say, improve working conditions lead to better outcomes for put-upon workers, or will it lead fewer employees altogether, or—worse—a shift in production to offshore facilities away from prying eyes.

Moreover, the issues that attract Millennial attention may or may not be the ones with the largest social impact or most human welfare at stake, much less the ones connected to long-term firm profitability, or even returns at a portfolio level. Asset managers will engage on ESG issues when those issues are salient to powerful stakeholders, because failing to satisfy stakeholder preferences can have serious consequences for firm value, but it doesn't follow that the salient set of concerns is optimal in any robust sense. Some of the old concerns about managers having too much discretion in a stakeholder model may reappear in the form of managers beholden to stakeholders with ill-advised ESG goals.

A long-term risk is that preferences push managers in the direction of "the wrong kind" of ESG to address pressing social issues, and there is no obvious market corrective to this dynamic.

VI. Conclusions

Markets shape firms, and managers respond to market incentives. When demand changes, firms adjust. We are witnessing a dramatic shift in demand of a sort that has no clear analog in corporate law. The result is managers facing strong incentives, through multiple channels, to address stakeholder interests. Our argument is that these forces are best conceptualized as a constraint, just as the market for corporate control is a constraint. The ESG ecosystem consists of investors, managers, and other

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[69] It may be possible for institutional actors to actively shift or direct these preferences under some circumstances through awareness campaigns and other types of marketing activity.

stakeholders attempting to satisfy their preferences subject to these new constraints.

Some of these forces may produce ESG that maximizes shareholder value. Some may attain socially-valuable goals even at the expense of shareholder value. And some may lead to production of ESG to mitigate managers' personal risk, and maximize index funds flows, regardless of both shareholder and stakeholder value.