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The Hidden Cost of Contracting for ESG: A New Perspective on Private Ordering

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ABSTRACT

Currently, despite the increasing pressure on corporations to account for Environmental Social Governance (ESG) factors in their disclosures and actions, a lack of clarity on the meaning of ESG persists. ESG might be equivalent to stakeholderism, in which companies can sacrifice firm or shareholder market value to serve non-financial values. A second meaning would permit companies to pursue ESG only if it advanced the firm's financial value. The second meaning poses no new challenges for corporate law.[1]

This Article will address how the lack of clarity on ESG makes it difficult to assess whether a provision in a contract of a firm mandating the pursuit of ESG would violate the mandatory fiduciary duties of managers.[2] That lack of clarity might also render the provision unenforceable under contract law, even if corporate law typically defers to private ordering by firms.

The ambiguity of an ESG-contract term governing management must be considered in conjunction with the central problem: that of

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1. Under the latter view, the pursuit of ESG is a win/win proposition for the company since the pursuit of ESG enhances firm value. The pursuit of ESG and the pursuit of corporate profits do not diverge.

2. *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance,* 97 Nw. U. L. Rev. 547, 548 (2002) [hereinafter Bainbridge, *Director Primacy*].

addressing the ESG class of firm externalities. The relative analytics of deploying the agency contract-like fiduciary performance obligation, when contrasted with other private and interventional alternatives, to deal with firm externalities should be central to the analysis. Evaluating the inclusion of a mandated pursuit of ESG in a contract requires assessing not only whether ESG is a permitted objective of a corporation,[3] but also, if ESG is a permitted objective, whether a contract provision would be enforceable and whether mandating the pursuit of ESG in a contract of a firm would best address the ESG class of firm externalities.[4] Finally, would it impose hidden costs on the governance of firms that should be avoided?

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3. This Article focuses on corporate fiduciaries. As Holger Spamann and Jacob Fischer explain, "[i]nvestment trustees are subject to stricter fiduciary duties." *See* Holger Spamann & Jacob Fischer, *Corporate Purpose*: *Theoretical and Empirical Foundations/Confusions* 10 (Eur. Corp. Governance Inst., Working Paper No. 664, 2022), http://ssrn.com/abstract_id=4269517 [https://perma.cc/A7GW-UF47].

4. A question not addressed in this Article is whether the SEC's increased role in requiring additional climate disclosures exceeds their authority.

Introduction

Evolving investor values have pushed corporations to prioritize not only maximizing shareholder value, but also Environmental Social Governance (ESG) and other stakeholder[5] interests. In doing so, some investors are seeking to codify these ESG-related policies in corporate documents, such as shareholder or subscription agreements. Companies have responded to these pressures by including ESG policies in voluntary sustainability reports or disclosing them more formally in Securities Exchange Commission (SEC) filings.[6] The lack of clarity on the meaning of ESG[7] presents two distinct legal issues when investors seek to contract for ESG policies.

First, such a provision might conflict with a manager's fiduciary duty to maximize firm value as reflected in shareholder market value.[8] Of course, a manager is usually able to conceal, and therefore avoid, sanctions for a possible violation of fiduciary duty due to (1) the broad deference to managers under the business judgment rule[9] as long as

5. Stakeholders affected by actions of corporations include customers, suppliers, employees, and communities. For a discussion of the shift away from shareholder capitalism to stakeholder capitalism, see Kishanthi Parella, *Contractual Stakeholderism*, 102 B.U. L. Rev. 865, 868–69 (2022).

6. *See* Maia Gez, Era Anagnosti & Taylor Pullins, *ESG Disclosure Trends in SEC Filings*, Harv. L. Sch. F. on Corp. Governance (July 16, 2022), https://corpgov.law.harvard.edu/2022/07/16/esg-disclosure-trends-in-sec-filings/ [https://perma.cc/5BU5-NEA3].

7. *See generally* Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure,* 98 Wash. U. L. Rev. 1821 (2021). In reviewing recent proposals on SEC disclosure, Rose notes that "[t]he acronym 'ESG' is used as shorthand for a dizzyingly broad array of 'environmental,' 'social,' and 'governance' topics affecting businesses." *Id.* at 1822. The breadth of meaning for ESG presents a number of problems that may increase costs for companies in a number of ways. *Id.* at 1825.

8. However, for a different and broader view of what value companies should pursue, see Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. Fin. & Acct. 247 (2017).

   Of course, even if there is a potential divergence, "there is not a single case of managers or directors being held personally liable for furthering stakeholder interests over shareholder interests—ever anywhere." *See* Spamann & Fischer, *supra* note 3, at 11.

9. The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good

they can rationalize the decision by positing a potential long-term economic benefit;[10] (2) the ambiguity in the meaning of ESG; and (3) the ambiguity in the precise strategy the manager will pursue to balance the differing interests of various shareholders and stakeholders. Currently, there are several widely accepted meanings of *stakeholderism*, only one of which could allow a manager to pursue ESG *even if* it has a negative impact on firm value "as reflected in the price of stock in an efficient market."[11]

This potential for a manager to sacrifice shareholder value raises the question of whether a company can implement ESG initiatives through private ordering by contract or whether the ESG provision might conflict with the manager's fiduciary duty,[12] even if a conflict might not

faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del 1984). It is "the standard of review that courts apply when evaluating claims for the violation of fiduciary duties to shareholders." Jonathan R. Povilonis, *The Use and Misuse of Fiduciary Duties: Corporate Social Responsibility and the Standard of Review,* 13 Wm. & Mary Bus. L. Rev. 1, 9–11 (2021) [hereinafter Povilonis, *Fiduciary Duties*]. In applying the business judgment rule, "the reviewing court is obligated to 'defer to the board of directors' judgment absent highly unusual exceptions,' and thus the decision will be overturned only in rare circumstances." *Id.* at 9 (quoting Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83, 87–88 (2004)). Stephen M. Bainbridge argues that "the rule is better understood as a doctrine of abstention pursuant to which courts in fact refrain from reviewing board decisions unless exacting preconditions for review are satisfied." Bainbridge, *supra*, at 87.

10. For a discussion of how the business judgment rule shields fiduciaries from lawsuits alleging violations of fiduciary duty even when fiduciaries "appear to do so [act] at the shareholders' expense," see Jonathan R. Povilonis, *Fiduciary Duties, supra* note 13, at 34. Povilonis explains that this results from a narrow view of fiduciary duty. *Id.* at 27. *See also* Jonathan R. Povilonis, *Contracting for ESG: Sustainability-Linked Bonds and a New Investor Paradigm*, 77 Bus. Law. 625, 626–27 (2022) [hereinafter Povilonis, *Contracting for ESG*].

11. Saul Levmore, *Least-Cost Altruists and ESG Firms*, 77 Bus. Law. 713, 714 (2022) (citing Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times, Sept. 13, 1970, at 32).

12. As Leo Strine explains, "there are two fundamental fiduciary duties: loyalty and care." Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L.J. 629, 634 (2010). If fiduciary duty is defined as a duty to maximize shareholder wealth, then the pursuit of ESG or the pursuit of socially responsible goals would be prohibited unless the fiduciaries "reasonably believe[d] such goals will ultimately result in maximized shareholder profits." Povilonis, *Contracting for ESG*, *supra* note 10, at 626.

be detected. To judge whether a conflict with fiduciary duty might arise, we would need to know whether the firm is pursuing ESG and its cost to the firm. Would a provision in a corporate contract encouraging or mandating a manager or director to pursue ESG comport with corporate law norms and statutes? Would shareholder agreements for ESG fall outside any need to conform to corporate statutory mandates?[13]

Two main legal frameworks can be used to answer these questions: contract law and corporate law. Under one view, if the corporation is a "nexus of contracts,"[14] following the contractarian view of the firm,[15] the corporation should be able to contractually agree on ESG provisions, since those contracts would advance their mutual interests.[16] However, an undifferentiated[17] ESG provision likely would not be

In deciding if there is a direct conflict between the pursuit of shareholder value and external stakeholders, see Edward B. Rock, *For Whom Is the Corporation Managed in 2020? The Debate over Corporate Purpose*, 76 Bus. Law. 363, 394 (2021), for a discussion of how "reinterpreting" fiduciary duties to include external social concerns will be ineffective and impose costly burdens on directors.

Of course, if fiduciaries were empowered to embrace the social value of shareholders within shareholder value as well as other potential stakeholders, then the pursuit of ESG would not pose a conflict for the fiduciary.

13. Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 Colum. L. Rev. 1549, 1554 (1989) (exploring whether mandatory norms or rules can be justified and why a combined system of mandatory norms and opt out rules might be optimal).

14. For the origins of the firm consisting of a nexus of contracts, see Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 310–11 (1976).

 Clark, *supra* note 7, at 60–62, finds the nexus of contracts analogy deficient because of the absence of actual consent. If conceived of metaphorically, the analogy to contracts wrongfully suggests that many corporate contracts are optimal, overlooking information asymmetries which may render the contracts non-optimal. *Id.*

15. Lucian Arye Bebchuk, *Foreword: The Debate on Contractual Freedom in Corporate Law,* 89 Colum. L. Rev. 1395, 1408–09 (1989).

16. *See* Gordon, *supra* note 13, at 1550–51 (suggesting a similar rationale for implied terms in corporate law under contractarian principles which select those terms that parties would have agreed on were it not for transaction costs operating as an obstacle to express contracting—that same principle allows parties to opt out of non-optimal rules).

17. This Article defines the term "undifferentiated" by adopting terminology from Bebchuk and Tallarita to mean a pluralistic view of stakeholderism in which concerns about ESG could trump value maximization. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell L. Rev. 91, 97–98 (2020). Such an undifferentiated ESG provision might appear as an addition to a corporation's charter, saying

upheld under contract law due to the fundamental ambiguity in the meaning of ESG and, thus, private ordering should not prevail.[18] Moreover, a mandate requiring managers to pursue ESG might be unenforceable as a kind of contractual illegality.[19] However, if one can demonstrate that the undifferentiated ESG provision can be read as a partial waiver of the fiduciary duty,[20] and that it was adopted knowingly and would solve the problems of firms without generating costs that exceed the gains from adoption, then perhaps the provision could prevail as a waiver.[21]

Because ESG provisions straddle corporate and contract law and there is not unfettered latitude to adopt any private contracts, a new framework should be used to analyze a private order adopting an ESG provision. The lack of express authorization and the ambiguity in the meaning of ESG[22] make it difficult to determine if an ESG provision

that they will pursue ESG interests, but without further specification on what those interests will be and how they plan to pursue them.

18. Some corporate scholars might argue that companies would not adopt such open-ended ESG terms. However, this Article poses the adoption of such an open-ended term in order to squarely address how far companies could go in pursuing ESG within the context of their fiduciary duties and to explore the limits on contractual freedom to alter fundamental corporate rules. *See generally* Case Western Reserve University School of Law, *Corporate Law and Private Ordering–Part 1*, YouTube (Nov. 4, 2022), [hereinafter *Private Ordering*] https://www.youtube.com/watch?v=HeC0EWKjRxc [https://perma.cc/96F7-2ANN] (Jill Fisch, 2022 Leet Symposium keynote speech).

19. *See infra* Part IV.C.

20. Under one meaning of ESG, the fiduciary would be empowered to sacrifice shareholder value for stakeholder values and, thus, the private ordering adopting an undifferentiated ESG provision could be read as a departure from fiduciary duty. One has to compare how the undifferentiated ESG provision would "constrain agency costs when managers are given discretion to run enterprises in which money contributed by others is at risk." Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. Corp. L. 377, 379, 388 (1990).

21. *See infra* Part V.B.

22. A recently proposed SEC rule finds that a fund named to promote ESG may be misleading. *See* Investment Company Names, 87 Fed. Reg. 36594, 36613–14 (June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, 274). The Commission suggests that in order for the fund's name to protect investors against misleading names, they should "invest at least 80% of their assets in accordance with the investment focus that the fund's name suggests." *Id.* at 36642. *See* Jill E. Fisch & Adriana Z. Robertson, *What's in a Name? ESG Mutual Funds and the SEC's Names Rule*, S. Cal. L. Rev. (forthcoming) (concluding "that the SEC's proposal is unlikely to increase investor protection").

This Article finds that ambiguity in the name poses other problems besides misleading investors, although those problems are connected to would violate any mandatory rules of Delaware law for the same reason that enforceability under contract law remains problematic.[23]

This Article suggests the need for a new framework for assessing whether a contract provision mandating an undifferentiated ESG would be efficient or would instead increase the firm's costs of ownership.[24] It concludes that both the resulting heterogeneity of investors and increasing agency costs would be inefficient and, thus, not preferable on a normative basis. The adoption of ESG as a corporate strategy for firms should depend on all the costs of adding an undifferentiated ESG to the performance obligation of managers when contrasted with the costs of other interventional and non-interventional alternatives for addressing firm externalities.[25]

While corporate law has increasingly embraced private ordering, the incorporation of a mandate to pursue ESG—if formulated without any further specification of the meaning of ESG and without any methodology for resolving trade-offs between shareholder or firm value

the lack of clarity about the meaning of ESG. *See infra* Part VI (discussing increased cost of ownership and agency costs).

23. There are some instances in which certain contract provisions can be added to a firm's contracts with its suppliers. The provisions are more specific than an undifferentiated ESG term. The model Contract Clauses to Protect Human Rights comprises one example of contract terms that seek to improve the conditions under which products are made. The relative advantages of such clauses are explored by Jonathan C. Lipson in *Against Corporate Social Responsibility* 3, 12 (Temple U. Beasley Sch. of L., Legal Stud. Rsch. Paper Series, Working Paper No. 2022-24, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4240175 [https://perma.cc/A675-C28W], who sees greater potential for positive change than clauses enacted to force firms to pursue CSR, for example.

24. *See* Charles R. Korsmo, *Woke Capital and the Ownership of Enterprise*, U. Pa. J. Bus. L. (forthcoming 2024) (manuscript at 41–47).

25. Concerns about the high cost of the SEC's recent proposed disclosures raise a similar issue raised by this Article's examination of a firm mandatory pursuit of ESG: that of costs outweighing benefits. *See* Lawrence A. Cunningham, *The Proposed SEC Climate Disclosure Rule: A Comment from Twenty-Two Professors*, Harv. L. Sch. F. on Corp. Governance (July 6, 2022), https://corpgov.law.harvard.edu/2022/07/06/the-proposed-sec-climate-disclosure-rule-a-comment-from-twenty-two-professors-of-law-and-finance/ [https://perma.cc/35Z8-C8DU].

The same lack of clarity affects ESG funds, will result in the same inefficient sorting among investors, and will mislead investors who share different preferences on the weight to be attached to ESG values versus the financial value of the firm. This Article concludes that the proposed SEC rule on name changes and institutional advisors will only partially solve the problem of the heterogeneity and inefficient sorting of investors. The authors will address those issues in a separate article.

and the ESG mandate[26]—should not be incorporated into shareholder agreements or other corporate documents.[27] Even if courts defer to private agreements, that deference should not permit a private agreement on ESG which does not include a mechanism for determining (1) whether stakeholder or shareholder value will be primary; (2) metrics for assessing how accounting for ESG would affect risk and therefore the future income stream to shareholders; and (3) how to manage ESG when one set of claimants disagrees with another set of claimants.[28] Absent such disclosures, the investor population will remain undifferentiated, leading to inefficient sorting and increased costs for corporate ownership. Moreover, the ESG term's ambiguousness may obscure those costs and interfere with investment choices and pricing.

Because of the hidden costs of inserting an ESG provision into a performance obligation, this Article suggests that states in non-constituency jurisdictions should not permit the adoption of contract provisions mandating the pursuit of ESG by managers, including Delaware, if it contains undifferentiated ESG language. To solve this, the Article recommends additional disclosure by companies to clarify the extent to which the pursuit of ESG might sacrifice shareholder value and use models that are transparent and accurate and that reflect any uncertainties in the models.[29]

26. *See* Bebchuk & Tallarita, *supra* note 17, at 119 ("Such an exercise raises very difficult questions regarding conflicts between groups of stakeholders and between stakeholders and shareholders, which stakeholderists have largely avoided by leaving their solution, again, to the discretion of corporate leaders."). The same conflicts can arise between different groups of shareholders committed to ESG, but with differing preferences avoided by leaving their solution, again, to the discretion of corporate leaders. *Id.* at 121.

27. Shareholder agreements constitute a horizontal agreement. Vertical arrangements arise if the shareholders and the corporation enter into an agreement. In some instances, there may be different welfare effects between horizontal and vertical agreements in the context of board control, for example. *See* Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 Yale J. Regul. 1124, 1158–62 (2021). In the case of ESG, the problem of the lack of clarity in meaning would affect charter amendments, shareholder agreements, and vertical and horizontal agreements in the same way.

28. The latter conflict can arise when traditional and activist investors would choose different investment strategies in terms of a willingness to sacrifice profits. That conflict could, if revealed, cause investors to choose different investments.

29. *See* Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* Principals and Agents: The Structure of Business 55, 72 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (discussing the duty of disclosure of corporate managers as an aspect of fiduciary duty).

States should not permit a private agreement or contract on ESG which does not include a mechanism for determining (1) whether stakeholder or shareholder value will be primary; (2) metrics for assessing how accounting for ESG would affect risk and, therefore, the future income stream to shareholders, including the uncertainty of damage calculations such as the present value of future income streams of positive and negative returns (with probabilities) associated with firms addressing climate change and ESG; and (3) how to manage ESG when one set of claimants disagrees with another set of claimants.

The lack of clarity on how ESG provisions should be treated under both contract and corporate law points to the need for a new analytical framework, which takes account of all the benefits and costs of allowing undifferentiated ESG provisions in contract documents, such as shareholder agreements or subscription agreements. This Article suggests that whether ESG in an undifferentiated form should be adopted as a mandate in corporate documents and strategic decision-making requires an analysis of the effects on (1) the sorting of investors according to preferences; (2) the costs and effects of undifferentiated and unsorted investors on ownership structure and corporate decision-making;[30] (3) the effects on agency costs[31] and opportunism;[32] and (4) the costs of addressing firm externalities through an ESG contract provision addressed to management's performance obligation. Without a consideration of those costs, one cannot assess how those costs would compare to other alternatives for addressing ESG externalities.

The Article makes four main contributions. First, it identifies an existing and pervasive conflict between corporate law and contract law

30. The traditional view posits that the management of a firm is most efficient when there is "just one master or at least one goal." Levmore, *supra* note 11, at 714. That single goal has been the maximization of the firm. But, as Levmore notes, a firm manager often manages the firm serving both the interests of equity and debt holders. This pursuit of those two interests has the advantage of providing a "good match" mimicking "the debt/equity ratio of outside lenders," which "will encourage managers to take the appropriate risks." *Id.*

31. Jensen and Meckling discuss agency costs and firm managers' incentive to "bond" themselves to the firm's owners by setting up mechanisms (like independent audits) to reduce the costs incurred by the owners in monitoring the managers. They distinguish between "agency costs" and "bonding costs," in contrast to the authors of this Article, who characterize "bonding costs" as a subcategory of "agency costs" and "the costs of monitoring." Jensen & Meckling, *supra* note 14, at 328.

32. Bebchuk and Tallarita emphasized the likely increased managerialism from the reduced accountability afforded by stakeholder governance as well as a reduced overall economic pie. *See* Bebchuk & Tallarita, *supra* note 17, at 164–65, 176. These consequences flow from the reorientation of the purpose of the corporation to include stakeholders in the governance model. *Id.* at 104.

regarding how to deal with private ordering mandates within a firm's contractual documents. Second, it highlights the effects of undifferentiated ESG provisions on the sorting of investors and the effects of that inefficient sorting on the costs of ownership. Third, it embraces a meaningful, understandable, and sensible private ordering solution to clarifying a corporation's commitments to ESG. Fourth, it provides a workable and legally defensible implementation mechanism for this solution that accords with the existing legal mandates and the general theory of market regulation in the United States, which is founded upon disclosure.

By highlighting the effects of undifferentiated ESG provisions on the failure to sort different types of investors—and the effects of that inefficient sorting on the costs of ownership—it adopts a consequentialist[33] analysis of ESG contractual provisions. This Article argues that the undifferentiated ESG provisions which do not specify the impact of ESG on value maximization[34] will lead to an amalgam of investors who put different weights on different aspects of ESG[35] and have different views on whether to pursue ESG if it reduces traditional market value.[36] The lack of homogeneity among investors will add to the costs of ownership in important ways and increase the transaction costs of doing business as a corporation, perhaps leading to a downturn in stockholder-owned companies.[37] The undifferentiated ESG commitment will

33. In the context of contracts, under a guiding principle of instrumentalism, "[t]he guiding principle for legal intervention is thus whether the law can increase gains from trade by overcoming barriers that prevent the parties from devising complete contracts to control opportunism in advance on their own." Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What to Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323, 329 (2006).

    In the different context of whether the law should intervene to force a greater clarity in the meaning of ESG which may appear in a private contractual agreement, the question is whether the legal intervention will increase overall benefits from stock ownership by considering the "consequences, both *ex ante* and *ex post*, legal intervention will produce." *See id.*

34. Saul Levmore argues that ESG currently does not reveal to investors "the cost of the firm's divergence from value maximization." Levmore, *supra* note 11, at 723.

35. Ron Lieber, *The Rush to E.S.G., with or Without Elon Musk*, N.Y. TIMES (June 18, 2022), https://www.nytimes.com/2022/06/18/your-money/esg-investing-stocks-elon-musk.html?smid=em-share [https://perma.cc/QQ7J-2396].

36. This divergence is what means that the pursuit of ESG might raise the need for a "revolution in conventional value-maximizing corporate law." Levmore, *supra* note 11, at 715.

37. *See* Korsmo, *supra* note 24, at 62.

produce a burden, as anything other than firm wealth maximization as measured by stock price will be difficult to ascertain—in turn increasing the cost of ownership.[38] Since companies strive to minimize transaction costs[39] and will structure ownership decisions so that "costs for all patrons are minimized,"[40] presumably companies would want to pursue strategies that minimize transaction costs[41] when responding to ESG concerns from investors and institutional investors. However, companies may, in responding to public pressures on ESG, successfully hide the costs of their actions under the business judgment rule.

This Article will consider what additional types of disclosure the Securities and Exchange Commission (SEC) should require, if any, in order to lower the cost of ownership and promote the efficient sorting of investors. It will assess whether private alternatives, such as pressure by shareholders who are anti-ESG, sustainability-linked bonds, or specialized funds that are geared only to fund value, will solve the sorting problem. All options must be compared in determining the best approach to solving firm externalities.

The SEC could help resolve these issues by promulgating a rule requiring more in-depth disclosures about exactly how a manager would pursue ESG and at what point she would sacrifice shareholder/company value to either stakeholder interest or the social values of the shareholders. That is unlikely to happen as the SEC would argue that anything that is material is already being disclosed[42] and companies would never disclose that they are going to sacrifice shareholder value. Thus, the inefficient sorting of investors may continue. The new SEC rules on the

38. Henry Hansmann, The Ownership of Enterprise 47 (1996) [hereinafter Hansmann, Ownership of Enterprise]. *See also* Henry Hansmann, *Ownership of the Firm*, 4 J.L. Econ. & Org. 267, 273, 281 (1988) [hereinafter Hansmann, *Ownership of Firm*].

39. Oliver E. Williamson, The Economic Institutions of Capitalism 17 (1985) ("[T]he economic institutions of capitalism have the main purpose and effect of economizing on transaction costs.").

40. Hansmann, *Ownership of Firm*, *supra* note 38, at 273. These costs include "the sum of both the costs of market contracting for those patrons who are not owners, and the cost of ownership for the class of patrons who are assigned ownership." *Id.*

41. Williamson, *supra* note 39, at 17.

42. Author's conversation with Robert N. Rapp, Professor, Case W. Rsrv. Univ. Sch. of L., in Cleveland, Ohio (Apr. 6, 2022). The SEC also seems to be taking the approach of targeting specific sub-topics of ESG for more thorough disclosure, as demonstrated by the extensive proposed rules on climate-related disclosure expected to be voted on in the coming year. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Release No. 33–11042, Exchange Act Release No. 34–94478, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022).

duties of investment companies, fund names, and investment advisers[43] may help alleviate the sorting issues of investors by separating out investors who put a high premium on ESG from those who are more conventional investors.[44] However, there is nothing in these rules that would reveal the potential for a sacrifice of firm value and the range of the sacrifice required in the new rules, thus depriving the investor of a critical piece of information.[45] Further disclosure should be required on the lack of certainty associated with current abatement models.[46] All options—private (non-contractual), contractual, and interventionist (disclosure)—should be compared to see which approaches would solve firm externalities at the least cost.

Disclosure of a manager's methodology for pursuing ESG, and how it prioritizes differing investor values, would allow investors to determine how a company would make the trade-offs when stakeholder and shareholder values conflict and sort themselves according to their heterogeneous preferences. These costs of pursuing conflicting priorities are unaccounted for in most treatments of ESG and would be important to investors. However, the nature of disclosure as an assertion upon which investors can rely means that disclosure might subject companies to possible litigation. Thus, companies may not be forthcoming to avoid those litigation risks. Additionally, companies today typically disclose only that which is material and clearly required by the SEC, and the desire to follow peer-disclosure trends tends to dampen the desire to disclose on novel topics.[47]

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43. See *infra* Part VI.

44. One question that Levmore confronts, *supra* note 11, at 714, is why should investors need to know about the ESG policies of firms through greater disclosure on the possible sacrifice of firm value? After all, firms could manage firms according to the single value of firm value maximization. *Id.* Then investors who cared about ESG could directly donate to firms who were committed to ESG issues. Levmore suggests that, in some instances, firms would have a comparative advantage in "pursu[ing] ESG activities within their control." *Id.* at 718. So, instead of leaving ESG to individual shareholders, firms might be better situated to manage ESG, and requiring more disclosure of ESG at the firm level would promote shareholder welfare by (1) allowing investors to gain reputational benefit from associating with an ESG firm and (2) avoiding the transaction costs if ESG were "managing their own socially minded preferences." *Id.* at 718–19.

45. *But see* Levmore, *supra* note 11, at 727–28 (suggesting greater transparency and endorsing a safe harbor that would reveal both the upside of ESG and potential negative impacts of ESG on firm value).

46. Robert S. Pindyck, *Climate Change Policy: What Do the Models Tell Us*?, 51 J. Econ. Literature 860, 860 (2013).

47. A company would be hesitant to be the first to make a disclosure like this absent a mandatory SEC rule or general market movement. *See* Emirhan Ilhan, Philipp Krueger, Zacharias Sautner & Laura T. Starks, *Climate*

This failure to sort, resulting from the failure to disclose how the manager is sorting, will increase the costs of ownership, the burden on the board, and transaction costs as boards will have to navigate a non-homogeneous group of investors without a "salient criterion for balancing those interests."[48] A commitment to maximizing shareholder value has provided that criterion; without clarity on how ESG will be pursued and at what cost to firm value and without a substitute mechanism that can sort investors according to preference,[49] the pursuit of ESG will potentially increase costs of ownership in unintended ways.

This Article also suggests that the Restatement of The Law of Corporate Governance[50] clarifies that an ESG provision in a contract of a firm in a Delaware-type jurisdiction should not be permitted without further clarification on the meaning of ESG. It should include illustrations to make it clear that managers cannot sacrifice shareholder or firm value for ESG or external stakeholders unless the managers can demonstrate with clear data that the pursuit of ESG will maximize the long-term value of the firm. If the data is not clear, then the manager must consider whether the pursuit of ESG by the firm or other options that could comply with corporate governance rules would be a more efficient way of solving the externalities created by the firm. Unless that meaning is clarified, the costs to ownership and governance from an undifferentiated group of investors who rank ESG differently may/will act as drag on gains from stock ownership and may precipitate a move away from public stock ownership.

Part I of this Article will address the difficult question of whether an ESG provision violates fiduciary duties. Part II of this Article will examine whether the inclusion of such contractual provisions would be consistent with or violate mandatory principles of Delaware corporate

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Risk Disclosure, and Institutional Investors, 36 Rev. Fin. Studies 2617, 2618 (2023) (explaining that the SEC has not yet mandated climate risk disclosures and companies might not voluntarily provide climate risk information because "disclosure may also impose unwarranted costs on the firm"). *Id.*

48. Hansmann, Ownership of Enterprise, *supra* note 38, at 42.

49. Greater disclosure of the costs of the pursuit of ESG to firm value as well as information on what aspects of ESG a firm will pursue could promote sorting among investors. Traditional investors, who do not want to pursue ESG if it means that firm value will be sacrificed, will gravitate to other firms who make clear that ESG will not be pursued if it results in a loss of firm value. *See* Vivek Ramaswamy, *Shareholders Stand Up for Profit and Against ESG at Chevron*, Wall St. J. (Sept. 7, 2022, 11:41 AM), https://www.wsj.com/articles/shareholders-stand-up-for-profit-at-chevron-esg-big-three-blackrock-vanguard-state-street-paris-agreement-scope-3-emissions-strive-11662558395 [https://perma.cc/X6S7-USZZ].

50. Restatement (First) of the L. of Corp. Governance (Am. L. Inst. Tentative Draft No. 1, 2022).

law and, if so, whether a waiver should be permitted.[51] The usual precise methods for analyzing whether the statutes would permit novel arrangements, such as an undifferentiated ESG provision, will fail to resolve the issue *so long as the relationship of ESG to shareholder wealth and shareholder values remains opaque*. Such provisions will also lead to a failure to sort different types of investors, leading to hidden inefficiencies and increased costs of ownership.[52]

Part III uses a contractual framework to determine whether an undifferentiated ESG provision mandating or permitting the pursuit of ESG in a corporate document, or a shareholder agreement, would be upheld under contract law, when the trade-offs remain unarticulated. The contractual analysis of these ESG provisions has been under-theorized despite the embrace of corporations as a nexus of contracts.[53]

Since the Delaware statutes do not conclusively resolve whether a private ordering would be allowed because of the lack of clarity on the current meaning of an ESG term, and contract law would be reluctant to enforce a term that lacks clarity on its basic meaning, a new framework should be used. Resolving whether private ordering should be allowed rests on comparing an ESG provision to the current mandatory

51. *See infra* Part II.

52. Differences among preferred and common stockholders present another case where a manager might be presented with a conflict on an investment choice or strategy. When this conflict occurred in *In re Trados Inc. Shareholder Litigation*, the preferred stockholders wanted a judicially supplied rule "to protect [them]." Juliet P. Kostritsky, *One Size Does Not Fit All: A Contextual Approach to Fiduciary Duties Owed to Preferred Stockholders from Venture Capital to Public Preferred to Family Business*, 70 Rutgers L. Rev. 43, 77 (2017). The court declined to do so as it would "divide up the agent's responsibilities and give one class of claimants—the preferred—the ability to restrain any action of the board because it was not in the interest of a single claimant." *Id.* at 78; Charles Korsmo, *Venture Capital and Preferred Stock*, 78 Brook. L. Rev. 1163, 1175–76, 1179 (2013).

53. See Jensen & Meckling, *supra* note 14, at 310–11, for the origins of the nexus of contracts idea. Since Jensen & Meckling, other scholars have questioned whether the nexus of contracts theory can explain fundamental questions such as the boundaries of the firm. Where market contracts are incomplete or lead to lock in and opportunism, firms may vertically integrate and move away from the nexus of contracts. *See* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 Colum. L. Rev. 1757, 1765–66 (1989). Hart suggests that the control of assets is a key factor in minimizing transaction costs and controlling opportunism, and recognizes that "a merger of two firms does not yield unambiguous benefits." *Id.* at 1766.

The nexus of contracts theory of a firm cannot be understood without analyzing how the particular type of contract provisions will operate to achieve the parties' goals and at what cost, including the lack of sorting of investors.

duty of loyalty. The benefits and costs of a mandatory rule of disclosure regarding ESG—with metrics and information on trade-offs among investors putting different weights on ESG and on the degree to which shareholder profits might be sacrificed—must be compared to an undifferentiated ESG provision operating in a corporate context. Although the SEC might argue that all material information is already disclosed, the lack of information on the varying preferences among ESG investors, the lack of a certain standard of wealth maximization for judging board actions when ESG is introduced, and the possible effects on the cost of ownership remain undisclosed costs. Materiality[54] should encompass not only the effects of ESG on financial performance but also other costs that will increase the cost of ownership in various ways if investors remain undifferentiated and non-homogeneous.

Part IV suggests a taxonomy for judging whether the law should allow or intervene against an ESG type of private ordering. The framework will judge how it would achieve the goals of the parties, at what cost, and whether the particular term of ESG in an undifferentiated form would increase *other costs* so that permitting it would lead to *welfare losses*. Other private alternatives, including alternative investments of sustainability-linked bonds[55] or a depoliticized fund,[56] offer investors private alternatives that might allow "investors to sort themselves according to their preferences"[57] and must be considered in the cost/benefit taxonomy. These private alternatives might maximize welfare.[58]

Part V of this Article compares an ESG provision to a corporate opportunity waiver to see if it offers similar advantages and addresses

54. Materiality depends on whether "there is a substantial likelihood that a reasonable investor would consider it important in deciding whether to buy or sell securities." SEC v. Talbot, 530 F.3d 1085, 1097 (9th Cir. 2008).

55. Sustainability-linked bonds (SLBs) are "traditional bond[s] plus a quantifiable ESG commitment by the issuing company." Povilonis, *Contracting for ESG*, *supra* note 10, at 628.

56. *Why Strive*, Strive Asset Mgmt., https://www.strivefunds.com/about-us.php [https://perma.cc/P968-NQP3]. *See also* Ramaswamy, *supra* note 49.

57. Povilonis, *Contracting for ESG*, *supra* note 10, at 628. Povilonis is concerned with the negative effects on shareholders, especially traditional shareholders who will "bear whatever costs such impact ESG actions incur." *Id.* at 626. *See also* Emily Lawrence & Steve Indiveri, *Moving Forward Toward ESG Adoption: Establishing a Process*, Ass'n Governing Bds. (June 21, 2022), https://agb.org/blog-post/moving-forward-toward-esg-adoption-establishing-a-process/ [https://perma.cc/4DLP-4JEY]. This Article highlights other costs which broadly affect firms by increasing the cost of ownership.

58. Povilonis, *Contracting for ESG*, *supra* note 10, at 628 (explaining that the willingness of SLB holders "to accept a lower return" brings down the cost of capital and increases returns).

what standards should be used to judge an ESG provision if it is construed as a permissible waiver of fiduciary duty. Part VI suggests that ESG cannot be deferred completely to private ordering; instead the SEC must mandate additional disclosures to clarify the extent to which the pursuit of ESG might sacrifice shareholder value in order to promote the efficient sorting of investors.

I. Background

ESG is the buzzword of today's corporate America, and Blackrock's CEO, Larry Fink, was ahead of the curve when he brought ESG investing to the forefront by orchestrating a revision of the definition of corporate purpose in 2019.[59] Members of the Business Roundtable (BRT) signed on to the new definition committing them to "lead their companies for the benefit of all stakeholders,"[60] a development that is considered by some a "major milestone"[61] in corporate governance.[62] This new philosophy elevating stakeholders as a permitted object of the firm constitutes a departure from traditional corporate governance.[63]

59. Letter from Larry Fink, BlackRock Chairman & CEO, to CEOs (2019), https://www.blackrock.com/americas-offshore/en/2019-larry-fink-ceo-letter [https://perma.cc/DJ4J-YPR3] ("In a recent survey by Deloitte, millennial workers were asked what the primary purpose of businesses should be—63 percent more of them said 'improving society' than said 'generating profit.'"). Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance,* 93 S. Cal. L. Rev. 1243, 1274, 1285 (2020).

60. *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'*, Bus. Roundtable (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/ED7Z-JZES].

61. Bebchuk & Tallarita, *supra* note 17, at 95. *See also* Johnathan R. Macey, *ESG Investing: Why Here? Why Now?*, Berkeley Bus. L.J. 258, 272 (2022) (depicting the 2019 Business Roundtable statement as "a 180-degree pivot in its perspective").

62. *See* Bebchuk & Tallarita, *supra* note 17, at 95; Sally Susman, *'You're Going to Need a Cleanse': How Pfizer's Sally Susman Was Criticized for Choosing a Corporate Career*, MSNBC (Aug. 25, 2019, 8:59 PM), https://www.nbcnews.com/know-your-value/feature/you-re-going-need-cleanse-how-pfizer-s-sally-susman-ncna1045551 (describing the shift as "something seismic").

63. For an excellent article exploring the history of corporate governance (both old and new), see Jill E. Fisch, *The New Governance and the Challenge of Litigation Bylaws*, 81 Brook. L. Rev. 1637, 1638–39, 1644–52 (2016) [hereinafter Fisch, *New Governance*]. Fisch delineates the old governance which relied on the market for control to discipline managers with the new governance aimed at altering the structure of governance between shareholders and the board through private ordering through

The 1997 BRT's Principles of Corporate Governance explicitly embraced shareholder primacy in the statement of corporate purpose.[64] This movement for ESG (whose predecessor movement was entitled Socially Responsible Investing (SRI))[65] has "taken the corporate world by storm."[66]

Interest in ESG, and its predecessor movement in SRI,[67] originated with social movements aimed at persuading buyers to avoid "investment in firms that made antisocial products."[68] The eighteenth century witnessed social movements originating with religious leaders who opposed slavery and other morally objectionable practices.[69] Successor

innovative bylaws. *Id.* The new governance Fisch delineates can also occur through shareholder agreements. *See also* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 Wash. U. L. Rev. 913, 945 (2021) [hereinafter Fisch, *Stealth Governance*].

64. *See* Rock, *supra* note 12, at 364. The BRT's Statement of Purpose from 2018 notably "omits any statement on the relative importance or primacy of any of the various stakeholders." *Id.* at 365.

    Other institutions have acted in the wake of the BRT adoption; the World Economic Forum's 2020 manifesto mirrored the expansion of corporate purpose to include other stakeholders beyond shareholders. *Davos Manifesto 2020: The Universal Purpose of a Company in the Fourth Industrial Revolution*, World Econ. F. (Dec. 2, 2019), https://www.weforum.org/agenda/2019/12/davos-manifesto-2020-the-universal-purpose-of-a-company-in-the-fourth-industrial-revolution/ [https://perma.cc/4UNF-T9Z3]. For an article discussing the toxic effects of shareholder primacy, see Lynn A. Stout, *The Toxic Side Effects of Shareholder Primacy*, 161 U. Pa. L. Rev. 2003, 2012 (2013). For a discussion of the origins of shareholder primacy as a way of deterring managers from pursuing self-interest at the expense of the firm, see Ann M. Lipton, *ESG Investing, or If You Can't Beat 'Em, Join 'Em*, *in* Research Handbook on Corporate Purpose and Personhood, 130, 130–47 (Elizabeth Pollman & Robert B. Thompson eds., 2021).

65. SRI is an investment strategy that considers investing in green or ethical investments to promote positive change in the community as well as financial returns during portfolio selection and management. Alice Martini, *Socially Responsible Investing: From the Ethical Origins to the Sustainable Development Framework of the European Union*, 23 Env't Dev. & Sustainability 16874, 16874–75 (2021).

66. Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 Vand. L. Rev. 1401, 1404 (2020). *See also* Jonathan R. Macey, *Corporate Social Responsibility: A Law & Economics Perspective*, 17 Chap. L. Rev. 331, 332, 335–36 (2014) (discussing the rapid way in which ESG has achieved prevalence in corporate law).

67. Max M. Schanzenbach & Robert H. Sitkoff, *Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee*, 72 Stan. L. Rev. 382, 388, 392 (2020).

68. *Id.* at 392.

69. *Id.*

movements adopted divestment strategies aimed at particular industries, such as fossil fuels[70] or firms with ties to the then-apartheid country of South Africa.[71]

Populist sentiment for external stakeholders has contributed to an anti-shareholder primacy movement.[72] Because of this pressure, investors and companies have been addressing ESG in many different ways: a cascade of investment in funds that pursue a sustainability and social

70. Julie Ayling, *A Contest for Legitimacy: The Divestment Movement and the Fossil Fuel Industry*, 39 L. & Pol'y 349, 349 (2017).

71. Schanzenbach & Sitkoff, *supra* note 67, at 393.

72. *See* Bebchuk & Tallarita, s*upra* note 17, at 93–94 (addressing the pressure by supporters of stakeholder governance which "encourages corporate leaders to make choices that would on their own protect stakeholders" who are "non-shareholder constituencies"). Some scholars argue that taking account of these social problems caused by firms will not necessarily solve the problems, *see, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 110 Geo. L.J. 387, 441–42, 448, 454 (2001), and may even offer a false assurance that firms taking account of ESG will ameliorate those problems when in fact it might, by rendering managers less accountable, "increase slack," thus reducing the overall economic pie. *See, e.g.*, Bebchuk & Tallarita, *supra* note 17, at 167. Bebchuk and Tallarita have identified one consequence of ESG as a lack of managerial accountability. *Id.* at 164. This Article focuses on another consequence of undifferentiated investors adding to the cost of ownership, as another outcome of ambiguous ESG terminology. Regulatory pressure has increased as well, with investors lobbying the SEC for greater disclosure on ESG. *See* Allison Herren Lee, *Statement on the Review of Climate Related Disclosure*, SEC (Feb. 24, 2021), https://www.sec.gov/news/public-statement/lee-statement-review-climate-related-disclosure/ [https://perma.cc/ER39-2HZD]. The SEC has responded by proposing rules for companies to make greater disclosure regarding ESG in companies' annual reports and registration statements. *See infra* Appendix; Gadinis & Miazad, *supra* note 66, at 1404 (describing the exponential growth of "investor money into ESG funds"). *See also* Rock, *supra* note 12, at 365–67 (discussing various legislative proposals that aim to require firms to consider "the interests of all stakeholders"). For a good discussion of the anti-shareholder primacy tenets, see Stout, *supra* note 64, at 2012–13, 2015, 2017–19.

responsibility-based investment strategy;[73] activist proposals;[74] new positions on corporate boards for environmental experts have opened up and sustainability committees established;[75] and the SEC's working to provide clarity on required ESG disclosure.[76]

While companies are under more pressure than ever to adopt ESG initiatives, their general response has been to make non-binding statements or reports. Companies have resisted the inclusion of ESG goals

73. Gadinis & Miazad, *supra* note 66, at 1404. Funds that consider ESG in investment decisions have "captured $51.1 billion of net new money from investors [in 2020], a record, and more than double the 2019 figure of $21 billion." Macey, *supra* note 61, at 261 (citing Gret Iacurci, *Money Invested in ESG Funds More Than Doubles in a Year*, CNBC (Feb. 11, 2021), https://www.cnbc.com/2021/02/11/sustainable-investment-funds-more-than-doubled-in-2020-.html [https://perma.cc/7D2N-9HUY]). Indeed, this market share has been predicted to continue increasing. "In the coming decades, somewhere between $12 trillion and $30 trillion will be transferred to millennials." Barzuza, et al., *supra* note 59, at 1286. "US Trust found 75 percent of wealthy millennials 'consider the social and environmental impact of the companies they invest in to be an important part of investment decision-making.' Two-thirds 'view their investment decisions as a way to express their social, political, or environmental values.'" *Id.* at 1291 (quoting Gillian Tett, *Millennial Heirs to Change Investment Landscape*, FIN. TIMES (Sept. 20, 2018), https://www.ft.com/content/59f6562a-786d-11e8-af48-190d103e32a4 [https://perma.cc/83SD-4G3T]).

74. There were 169 ESG shareholder proposals in the 2021 annual general meeting season. HANNAH OROWITZ, GEORGESON, AN EARLY LOOK AT THE 2021 PROXY SEASON 4 (2021) https://content-assets.computershare.com/eh96rkuu9740/86dc295b74b247a595ed58da9917867e/391d43630f7f37da64b3e9fd1e27524b/Georgeson-Early-Proxy-Season-Review.pdf [https://perma.cc/LM35-3U62]. This number was an interim figure reflecting companies with annual meeting dates between July 1, 2020, and June 2, 2021. According to Morningstar proxy-voting database, there were 449 ESG shareholder resolutions in 2021. This figure increased to 522 in 2022, and 616 as of August 28, 2023. Lindsey Stewart, *Are There Too Many ESG Shareholder Proposals?*, MORNINGSTAR (Sept. 13, 2023), https://www.morningstar.com/sustainable-investing/are-there-too-many-esg-shareholder-proposals [https://perma.cc/8RTG-DZRK].

    However, as recently noted, "few such proposals are made, being limited to a minority of public companies; most lose; and many are not made by traditional investors but by political activists taking advantage of the shareholder proposal process." Cunningham, *supra* note 25. To demonstrate this, of the 337 Environmental and Social shareholder resolutions that were voted on as of August 28, 2023, only 20 percent were supported by a majority of shareholders. Stewart, *supra*.

75. Gadinis & Miazad, *supra* note 66, at 1422 (noting the trend of pension funds "pushing for creating 'climate competent boards'").

76. John Coates, *ESG Disclosure—Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets*, SEC (Mar. 11, 2021), https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121 [https://perma.cc/VRT5-4XGM].

in their 10-Ks or other documents that would subject them to liability if the goals were unmet.[77] Currently, these statements look at the *policy* behind ESG, rather than attempting to clarify any issues of vagueness or potential conflicts a fiduciary faces when making decisions surrounding ESG, especially when there are investors who hold competing views on how ESG should be weighed and balanced against the goal of maximizing shareholder value. The most common example of this plays out in published and SEC-filed (but non-binding)[78] sustainability reports that describe various ESG initiatives. An example of a non-binding statement contained in one of these reports is the following: "We plan to reach this goal by reducing our emissions by 75 percent

77. *See* Comments for The Enhancement and Standardization of Climate-Related Disclosures for Investors, Securities Act Release No. 33–11042, Exchange Act Release No. 34–94478, 87 Fed. Reg. 21334, 21339, 21407–08 (proposed Apr. 11, 2022).

"We encourage the Commission to amend the draft rules to require reporting of measured emissions rather than estimated emissions from incorrect inventories and emission factors." LongPath Techs. Inc., Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 13, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20128696-293943.pdf [https://perma.cc/4EK4-D28G].

To avoid the costs of increased disclosure from being borne by the company's investors, "the Commission should require disclosure of specific climate change information *only* if a company has determined that climate change may have a material impact on its business." Dimensional Fund Advisors LP, Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 13, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20128689-293923.pdf [https://perma.cc/7PZ9-Z5VU].

Smaller and independent businesses cannot afford to keep up with increasing, complex government disclosure requirements. Nat'l Fed'n Indep. Bus., Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 11, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20129129-295014.pdf [https://perma.cc/26Z3-NZCB].

"[American Wood Council] takes the position that its members who are registrants should not be required to include such speculative analysis in their SEC periodic reports. AWC prefers a principles-based, flexible approach to disclosures regarding these tools." Am. Wood Council, Comment Letter on The Enhancement and Standardization of Climate-Related Disclosures for Investors (May 16, 2022), https://www.sec.gov/comments/s7-10-22/s71022-20128786-294514.pdf [https://perma.cc/U2RE-KNKG].

78. *See* Coco Zhang, *What to Expect from the US SEC's Proposed Climate Disclosure Requirements*, ING (Oct. 15, 2021), https://think.ing.com/articles/what-to-expect-from-the-us-secs-proposed-climate-disclosure-requirements [https://perma.cc/MY6N-S74U].

compared to 2015."[79] However, some companies have incorporated ESG provisions into shareholder agreements, investor's rights agreements, and subscription agreements.[80] While adoption of ESG in official documents may seem like a step forward, often the terms remain overly vague and do not bind the company to any specific actions. Instead, the language is mere puffery that provides significant deference to the board. One relevant provision reads that the company "shall use its best endeavors to comply with the ESG guidelines";[81] "shall use commercially reasonable efforts to comply with applicable [ESG] laws and regulations";[82] and "shall . . . ensure that it adheres to . . . [ESG] disclosure requirements and best practice."[83] We ask: is there a way to move beyond puffery containing vague, non-binding statements through ESG adoption in contracts or even in corporate documents that indicate the specific operating commitments the company is making and how they will be measured or evaluated? This type of clarity is needed to put investors on notice of company priorities at the time of investment. The consequences of failing to do so, including the lack of differentiation among different types of investors and increased heterogeneity of investors, increasing the burden of trading off preferences without a fixed and certain standard of wealth maximization, will increase the cost of ownership. Are these increased costs of ownership being revealed to investors? What can be done to decrease these costs?

An ESG provision that goes beyond these non-binding statements and mandates the pursuit of ESG adopted through private ordering raises many questions that straddle both corporate and contract law.[84] Many different methods exist to grapple with these questions, but each approach fails because it conceals the hidden economic costs of a commitment to an undifferentiated ESG. This Article argues that, although contract and corporate law frameworks are useful lenses, they do not by themselves offer a useful way of resolving whether an ESG

79. Apple, Inc., Environmental Social Governance Report 7 (2021), https://s2.q4cdn.com/470004039/files/doc_downloads/2021/08/2021_Apple_ESG_Report.pdf [https://perma.cc/8C8R-BETS].

80. Aptorum Grp. Ltd., Subscription Agreement Between the Company and Peace Range Limited Dated April 6, 2018 (Form F-1) (Sept. 5, 2018); Galecto, Inc., Amended and Restated Investors' Rights Agreement (Form S-1/A) (Oct. 22, 2020).

81. Aptorum Grp. Ltd., *supra* note 80.

82. Galecto, Inc., *supra* note 80.

83. Lava Therapeutics NV, Amended and Restated Shareholders Agreement (Form F-1/A) (Mar. 18, 2021).

84. Although the adoption of such a clause would be unlikely, a hypothetical consideration of such a clause illuminates the myriad challenges for firms posed by the pressure to pursue ESG.

provision, if undifferentiated as to the trade-offs,[85] would be allowed or enforced under contract or corporate common law or statutory law[86] and what the costs would be.

II. Corporate Law Principles: Fiduciary Duty and ESG Investing

This Part considers the preliminary question of whether an undifferentiated ESG provision violates fiduciary duties. We consider first the traditional view of the director as a fiduciary and the difficulties of fiduciary duty analysis in the ESG context.

Under a traditional view, in a non-constituency Delaware jurisdiction, stakeholders' interests or ESG considerations should enter only as an instrumental means of advancing shareholder wealth and firm value; morals or other personal shareholder beliefs would not constitute legitimate considerations for directors.[87] Moreover, there are sound reasons, under a law and economics lens, for why the exclusive beneficiaries of fiduciary duty should remain with the shareholders since sharing the assets of the firm with non-owners, such as stakeholders, would cause a decline in value of the firm[88] for which shareholders should be

85. This ESG term affords discretion to corporate managers and leaves them without "a method to aggregate or balance the interests of different constituencies." Bebchuk & Tallarita, *supra* note 17, at 98.

86. Armand Picou & Michael J. Rubach, *Does Good Governance Matter to Institutional Investors? Evidence from the Enactment of Corporate Governance Guidelines*, 65 J. Bus. Ethics 55, 60 (2006) (explaining that "for those firms which announced the enactment of corporate governance guidelines, and which disclosed the substance of the guidelines, the results support the notion that good governance has a positive effective on stock performance"); *but see* Fisch, *New Governance*, *supra* note 63, at 1639–40.

87. *See* Bainbridge, *Director Primacy*, *supra* note 2, at 582–83.

88. *See* Bebchuk & Tallarita, *supra* note 17, at 167 (suggesting that promoting stakeholderism will lead to a lack of accountability, foster managerialism, and potentially reduce the "economic pie").

compensated,[89] if the effect of doing so would be to sacrifice financial gains.[90]

The development of stakeholder-influenced investing poses a critical question for corporate law: "[f]or [w]hom [i]s the [c]orporation [m]anaged"[91] under traditional corporate law, and how does the pressure to account for ESG affect the legal duties of and practical burdens on corporate fiduciaries?[92] The fiduciary duty of loyalty, a "cornerstone of

89. Macey, *supra* note 66, at 331–32. Macey's argument for fiduciary duties being owed exclusively to shareholders is based on the idea that shareholders "as suppliers of equity capital . . . bring to the firm their special ability at risk-bearing, which creditors, managers, and employees tend to lack." *Id.* at 337 (quoting Jesse H. Choper, John C. Coffee, Jr. & C. Robert Morris Jr., Cases and Materials on Corporations 28 (3d ed. 1989)). According to Robert Miller, expanding the beneficiaries to include stakeholders would also harm shareholders as it "permits (indeed encourages) boards to transfer wealth from shareholders to other constituencies." Robert T. Miller, *How Would Directors Make Business Decisions Under a Stakeholder Model*, 77 Bus. L. 773, 776, 778 (2022). This is a different question than one posed by fiduciaries considering shareholders' own values or interests. Some scholarship focuses on to whom the duty is owed, such as Rock, *supra* note 12, at 363. Other scholarship such as Bebchuk & Tallarita, *supra* note 21, Macey, *supra* note 66, and Miller, *supra* note 89, focuses on the instrumental effects of expanding the duty. This Article specifically addresses those instrumental effects that are generated by the undifferentiated ESG term.

90. *See* Povilonis, *Contracting for ESG*, *supra* note 10, at 642 ("Delaware courts have not held that directors violate their fiduciary duties if they sacrifice shareholder wealth in service of broader shareholder values."). However, "recent Delaware decisions have made the connection between directors' fiduciary duties and maximized *economic* value explicit." *Id.* at 638. *See also infra* Part II.A.

91. Rock, *supra* note 12, at 363. There is a plethora of other laws which interfere with shareholders' profit maximization, but since these are passed by the government, and corporate law requires adherence to laws, fiduciaries must follow these restrictions even if they interfere with shareholder profit maximization.

92. Rock explores the burdens on firms of having to engage in trade-offs between shareholders and stakeholders questioning, "[b]y what metric will shareholder interests be traded off against employee interests? How much profit may a board sacrifice in order to reduce its carbon footprint?" Rock, *supra* note 12, at 394.

Although pension trustees face analogous pressures to take ESG and outside interests into account, the standards which govern a pension trustee in making a number of decisions is subject to the ERISA rule mandating that any actions taken be "*solely* in the interest of the participants and beneficiaries" and for the "'*exclusive* purpose' of providing benefits to them." Schanzenbach & Sitkoff, *supra* note 67, at 403. Because the standard for ERISA trustees is focused solely on financial benefits for the beneficiaries, Schanzenbach and Sitkoff propose allowing consideration of ESG only "if those factors are purely used to enhance the manager's evaluation of the risk and/or return of the investment." Bernard Sharfman, *ESG Investing Under ERISA*, Anglo-American corporate law,"[93] ordinarily requires the fiduciary to not be self-serving, to "avoid acting for personal financial advantage" in the context of a firm,[94] and to act "in a manner the director *reasonably believes to be in the best interests of the corporation.*"[95]

A. The Difficulty of ESG/Fiduciary Duty Analysis

When ESG goals are presented and expressed, determining whether there is a conflict between fiduciary duty and a contract provision mandating the pursuit of ESG is challenging for two reasons. First, because fiduciaries are given wide discretion under the business judgment rule, fiduciaries may be able to hide their actions from investors.[96] Some may pursue ESG even if it sacrifices profits, and others may refrain from pursuing ESG actions because of fear of potential liability for violating fiduciary duties if they prioritize shareholder values over shareholder profits.[97] Second, given the lack of a prescriptive definition of ESG, does ESG mean that the managers, as fiduciaries, can take into account ESG but only so long as it promotes the long-term economic value of the firm?[98] Under this latter approach, the fiduciary could

38 Yale J. Regul. Bull. 112, 119 (2020). Since a benefit for ERISA trustees is defined exclusively in financial terms, a trustee acting in a way "other than to benefit the beneficiaries financially" would constitute a breach of the duty of loyalty. *See* Schanzenbach & Sitkoff, *supra* note 67, at 403–04. A different standard applies if the duty is waived; it is a "best interest" standard. *Id.* at 401–02.

This Article will concentrate on the corporate governance issues associated with ESG outside the pension fund context but will explore the analogous problem faced by companies and index funds when the term *ESG* remains insufficiently calibrated, making it hard to determine if actions taken under the ESG umbrella would or would not advance shareholder value or advance the best interest of the firm when there are conflicts with stakeholders or conflicts among shareholders. *See* Rock, *supra* note 12, at 364–65.

93. Gabriel Rauterberg & Eric Talley, *Contracting Out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117 Colum. L. Rev. 1075, 1076 (2017).

94. Strine Jr., et al., *supra* note 12, at 629, 689.

95. Model Bus. Corp. Act § 8.30(a)(ii) (Am. Bar Ass'n, 2016) (amended 2021) (emphasis added).

96. Povilonis, *Fiduciary Duty*, *supra* note 10, at 59 (deference to corporate decision-makers via the business judgment rule insulates directors even when they "favor nonshareholder constituencies" because "the heightened standards of review in Delaware are triggered only by violations of disinterestedness and infrequent ownership control issues").

97. Povilonis, *Contracting for ESG*, *supra* note 10, at 637–44 (discussing the disadvantages for both the ESG activist investor and the traditional investor).

98. Schanzenbach and Sitkoff, *supra* note 67, at 407, have suggested a way in which trustees could comply with their fiduciary duty while taking into

sacrifice some monetizable value that would adversely affect shareholders but only when that is in the best long-term interest of the firm.[99] Arguably, these meanings of ESG fall within the definition of traditional shareholder or firm value. Under one meaning of ESG, fiduciaries could take account of external stakeholders and would not need to place primacy on shareholder or firm value.[100] Fiduciaries, however, might "forego impact ESG actions"[101] out of a concern that their actions might violate their duty to further the best interest of the corporation and follow their fiduciary duty, even if it were rational for some shareholders or individuals to sacrifice the present value of future residual returns.[102]

Without greater clarity on the meaning of ESG, the difficult fiduciary duty issues that are lurking in the rush to promote ESG in a contract provision will remain hidden. The SEC has taken a strong

account ESG. See *id.* at 389–90, for a discussion of their bifurcated approach for clarifying ESG. They find the lack of clear parameters for taking ESG into account when the ESG term is undifferentiated for pension trustees problematic. *Id.* at 405. This Article argues that a similar lack of clarity on ESG will make it difficult for managers to know whether following ESG will cause them to violate their fiduciary duties. However, pension trustees operate by clearly defined standards that require an exclusive focus on financial benefit to the beneficiaries. *See also* Sharfman, *supra* note 92, at 113–14 (citing Schanzenbach & Sitkoff, *supra* note 67, at 382; Financial Factors in Selecting Plan Investments, 85 Fed. Reg. 39113 (June 30, 2020) (to be codified at 29 C.F.R. pt. 2550); Fiduciary Duties Regarding Proxy Voting and Shareholder Rights, 85 Fed. Reg. 55219 (Sept. 4, 2020) (to be codified at 29 C.F.R pts. 2509, 2550)). However, if the term *ESG* is interpreted to include collateral benefits ESG, such as screening for non-financial reasons, it could result in "lower expected risk-adjusted returns relative to a well-constructed benchmark index." *Id.* at 121.

99. The 1997 BRT statement sees no conflict because stakeholder interests would only be pursued to advance stockholder value. *See* Bus. Roundtable, Statement on Corporate Governance 3 (1997).

100. This is the approach taken by a constituency jurisdiction but not in Delaware. Gadinis & Miazad, *supra* note 66, at 1428–29.

101. Povilonis, *Contracting for ESG*, *supra* note 10, at 626.

102. If investors could be differentiated, the fiduciary could capture benefits for the company in terms of a lower cost of capital as the ESG investor would be willing to accept lower returns in return for lower carbon footprints, etc. Although fiduciaries can deal with multiple claimants, such as preferred stock and common stockholders, each with competing interests, ultimately the duty must be to the "firm and to the pool of assets," not to individual claimants. Kostritsky, *supra* note 52, at 64–65. If the commitment remains to promote the pool of assets of the firm, then the fiduciary could reject ESG actions even if some "shareholders would ultimately prefer they be carried out." Povilonis, *Contracting for ESG*, *supra* note 10, at 626. But without the overriding duty to promote the assets of the firm, fiduciaries would have trouble resolving conflicts among different types of shareholders.

stance in favor of more climate-related disclosure,[103] hiring a Senior Policy Advisor for Climate and ESG and enhancing its focus on public-company climate disclosures.[104] In fact, "[b]road requirements for ESG reporting could be viewed as an attempt to shoehorn disclosures that may be relevant to society and stakeholders, but are financially immaterial to investors."[105] Unfortunately, even with the push for more disclosure of climate and other ESG risks, investors may still be left without crucial information needed to judge whether to invest in a company since they won't know whether fiduciaries would sacrifice profits for either ESG and external stakeholders or for shareholders' own values; nor will they know what the pursuit of ESG might mean for firm value. Even if companies must disclose strategies for managing or prioritizing climate-related risks,[106] financially minded investors would only care about such risks if the failure to act impacted the financial value of the firm, and that information may not be available. Disclosing a climate risk without also disclosing the financial impact on the firm's value might make it harder to assess whether the prioritization or accounting for risk *makes financial sense*. Nor will investors know how conflicts among investors will be resolved and at what cost.[107] Finally, even if the pursuit of ESG could be pursued as a permitted objective at the cost of shareholder wealth, one would still need to analyze how the method of the use of managerial discretion to pursue ESG would solve externalities created by the firm and how those costs compare with other alternatives, such as governmental action and

103. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249). *See also* Jay Clayton, *Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure,* SEC (Jan. 30, 2020), https://www.sec.gov/news/public-statement/clayton-mda-2020-01-30 [https://perma.cc/PJ7D-3GWM]; Press Release, SEC, SEC Announces Annual Regulatory Agenda (June 11, 2021), https://www.sec.gov/news/press-release/2021-99 [https://perma.cc/2NLT-5QRS].

104. Press Release, SEC, Satyam Khanna Named Senior Policy Advisor for Climate and ESG (Feb. 1, 2021), https://www.sec.gov/news/press-release/2021-20 [https://perma.cc/47J2-CULB].

105. David A. Katz & Laura A. McIntosh, *SEC Regulation of ESG Disclosures*, Harv. L. Sch. F. on Corp. Governance (May 28, 2021), https://corpgov.law.harvard.edu/2021/05/28/sec-regulation-of-esg-disclosures [https://perma.cc/VRR6-CTQ9].

106. *See infra* Part VI.

107. Under one view, the SEC's rule on disclosing material items would be sufficient without further disclosure on the strategies regarding trade-offs amongst different types of investors since everything of material interest to an investor is already disclosed.

private solutions. So, although fiduciaries may not be liable for breach of fiduciary duty due to their ability to escape scrutiny through the lenient business judgment rule and their discretion, the lack of clarity may nonetheless lead to inefficiencies and distorted investments by investors unable to know the trade-offs that fiduciaries are making.[108] Investors may be unable to sort themselves according to their preferences because they lack reliable information on how the commitment to ESG will be weighed and balanced among disparate investors.

If managers factor ESG into corporate decisions following adoption of a contract provision for ESG, they should also provide a detailed accounting of how environmental investments affect the financial projections of the firm.[109] As part of that accounting, corporations should be required to disclose how managing a company for a group of investors with non-homogeneous preferences would increase the costs of ownership and what uncertainties there are in existing data about the effects of pursuing or not pursuing ESG policies. Without that data, one cannot assess all hidden costs and so cannot resolve whether a commitment to ESG would result in a loss of financial value to the firm or present uncertainties that would make valuation difficult for investors. Threading the difficult fiduciary duty issue would require a fiduciary to resolve to what extent she could take into account the preferences for investor's non-economic values, how the fiduciary could ascertain such preferences, and how the fiduciary might juggle the possible conflicts among investors.[110] In addition, the fiduciary should

108. *See* Bebchuk & Tallarita, *supra* note 17, at 115, 120 (explaining that the "potential trade-offs between shareholders and stakeholders are ubiquitous" and "often difficult to measure" when balancing these trade-offs with stakeholder interests). The importance of these trade-offs is magnified when some investors may be willing to sacrifice shareholder value.

109. *See* Avis Devine & Erkan Yönder, *Impact of Environmental Investments on Corporate Financial Performance: Decomposing Valuation and Cash Flow Effects*, 66 J. Real Est. Fin. & Econ. 778, 802 (2023) ("Findings suggest that a higher share of environmentally-sustainable investment supports firm value . . . ."). *See also* Schanzenbach & Sitkoff, *supra* note 67, at 390–91 (suggesting that empirical evidence on the benefits of ESG investing "could improve risk and return" but noting caution, since "support is far from uniform").

110. The recognition that conflicts could exist among common stockholders is addressed in Shachar Nir, *One Duty to All: The Fiduciary Duty of Impartiality and Stockholders' Conflict of Interest*, 16 Hastings Bus. L.J. 1, 38–41 (2020) (suggesting a duty of impartiality to navigate conflicts among common stockholders). This Article seeks to shed light on the inefficient sorting of investors who may have conflicts on how aggressively to pursue ESG and at what cost. Whether a duty of impartiality to solve conflicts among stockholders subscribing to an undifferentiated ESG could be implemented without increasing the overall costs of ownership should be studied in further research. This same debate of potential horizontal conflicts, not involving conflicts among common stockholders, plays out

consider whether the pursuit of an undifferentiated ESG goal and the negative effects on efficient sorting among investors would increase the associated costs on ownership and governance and whether the potential long-term benefits to companies from accounting for ESG would outweigh those costs.

B. Directorial Fiduciary Duties and ESG Prioritizing

Traditionally, a director's goal was to maximize firm value or shareholder value.[111] But today, directors are finding shelter under the umbrella of ESG, including the social *values* held by shareholders under the definition of shareholder value. Because this consciousness typically subverts the traditional notion of firm value or shareholder value, the question becomes whether such actions are consistent with fiduciary duties. To determine this, we must ask whether the notion of shareholder value includes the social values of shareholders.[112] Without answering this, it is unclear whether a fiduciary can take into account the values held by shareholders without compromising her duty to maximize economic benefits for shareholders and the firm. Even if a fiduciary were permitted to take into account the social values of shareholders,[113] how would a fiduciary weigh the different preferences of shareholders when some may be willing to sacrifice significant monetary returns for non-monetary satisfactions and others may not? Normally, a fiduciary can make trade-offs between classes of claimants; they can hurt one class *as long as there is a benefit to another class* of claimants, long-term shareholders, or the firm.[114] However, if a fiduciary can impair the firm's pool of assets with no enhancement to long-term value when considering

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when fiduciaries have to weigh how to act and what actions to take when there are conflicts among common stock and preferred stockholders. *See* Korsmo, *supra* note 52, at 1175–79; Kostritsky, *supra* note 52, at 61–98.

111. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985)). Although some academics deny the fundamental meaning of *Revlon*'s principle constraining the ability to take into account non-shareholder values, Robert Miller emphasizes that under one of the two alternative holdings of *Revlon*, "the board may consider the interests of other constituencies to the extent doing so benefits shareholders," thus signaling a commitment to the principle that directors can consider stakeholders' interests only when "there are rationally related benefits" to shareholders. Miller, *supra* note 89, at 774, 774 n.1 (quoting *Revlon*, 506 A.2d at 182). *See also* Bainbridge, *Director Primacy*, *supra* note 2, at 547–48.

112. *See* Barzuza, et al., *supra* note 59, at 1250, 1272–75, 1303–06.

113. That would be true if the ESG investor were willing to accept a lower return in exchange for a non-monetizable stream of ESG values' promotion. *See generally* Hart & Zingales, *supra* note 8, at 247–55, 263–66, 270–71 (proposing that a corporation should enact policies that further its investors' welfare instead of policies designed to maximize profits).

114. Miller, *supra* note 89, at 774.

the social values of shareholders, would this be allowed and is it in the best interest of the corporation? Jonathan R. Povilonis argues such actions might be permissible as a contractual arrangement if shareholders all agreed to such a strategy.[115] Without that strategy, however, shareholders committed to welfare maximization might not be able to ascertain which fiduciaries would adhere to a welfare maximization strategy.[116]

The Restatement of the Law of Corporate Governance embraces a broad notion of corporate purpose to include all stakeholders.[117] Although a commitment to all stakeholders may conflict with shareholder primacy, the goals *may be* consistent when the pursuit of ESG (or Corporate Social Responsibility (CSR))[118] *may not be a* "*zero sum game*"[119] since "they can benefit shareholders by creating value through . . . brand differentiation, operational efficiency, access to market capital, and risk mitigation."[120] It is also possible, however, that the pursuit of ESG *may* actually "serve[] shareholders' interests, not because of its upside potential to increase profits, but because it helps companies identify and manage social risks to their business."[121] The identification of risk factors posed by environmental and social issues *may mean* that affected firms are subject to "greater political, regulatory, and litigation risks."[122] ESG may also be a proxy for identifying "managerial quality."[123]

115. Povilonis, *Contracting for ESG*, *supra* note 10, at 629.

116. *Id.* at 643–44.

117. Restatement (First) of the L. of Corp. Governance § 2.01 (Am. L. Inst. Tentative Draft No. 1, 2022).

118. CSR is the philosophy that business should act in a way that positively impacts or enhances society whether it be through better ESG initiatives, philanthropic initiatives, or even being activists. Arielle Sigel, *CSR Statements: Incentives and Enforcement in the Wake of the Business Roundtable's Statement on Corporate Purpose*, 101 B.U. L. Rev. 803, 808 (2021).

119. *Id.* at 806 (emphasis added).

120. *Id.*

121. Gadinis & Miazad, *supra* note 66, at 1410. These authors see these risks as particularly acute when asset managers follow a "predetermined investment strategy, such as replicating an index" that will make them more "vulnerable to risks that are hard to diversify" given the difficulty of divestment from such funds. *Id.* at 1413–14.

122. Schanzenbach & Sitkoff, *supra* note 67, at 435.

123. *Id.* at 435 n.295 (citing CFA Inst., Environmental, Social and Governance (ESG) Survey 11 (2017)) (reporting that of those who used ESG factors in 2017, 41% reported one reason for doing so was as a proxy for management quality).

Shareholders value the pursuit of ESG differently—one may be willing to sacrifice significant value for the pursuit of any ESG while others may only wish to sacrifice little or no value. When there is a lack of clarity on the meaning of ESG and a lack of methodology for determining trade-offs between claimants, it is not clear whether a director would be acting consistently with their fiduciary duty when considering stakeholder interests.

In some ways ESG, although not strictly defined, would seem to fall into a type of stakeholderism in which the corporate purpose is defined to include effects on other constituencies, such as employees, communities, and creditors.[124] Two versions of stakeholderism exist: instrumental stakeholderism and stakeholderism as an independent end (pluralistic).[125] This pressure by shareholders amounts to what Schanzenbach and Sitkoff called "*active shareholding*," in which shareholders participate through a shareholder vote or a voluntary agreement.[126]

In the first version of stakeholderism, the director or other fiduciary is permitted to consider stakeholder interests only when it advances shareholder primacy. This comports with traditional corporate law principles of enhancing firm value or shareholder wealth.[127] However, the second version of stakeholderism differs by placing shareholder value and other stakeholder interests on an equal plane and disavowing the need to give primacy to shareholder value. This Article will use these different concepts of stakeholderism in its analysis of what contractual provisions would be permitted or constrained under relevant statutory law and contract law to illustrate the different meanings that could be embodied in the term *ESG*.

III. The Statutory Validity of ESG Provisions in Non-Constituency Jurisdictions

If the term *ESG* remains open to different meanings, public companies could respond to pressure from activists by revising their charters or bylaws to give the board discretion to pursue ESG or mandate that the board pursue ESG in a Delaware jurisdiction.[128] Additionally, there

124. *See* Sigel, *supra* note 118, at 810. In fact, CSR is implicitly connected to stakeholderism. *Id.* at 806.

125. Bebchuk & Tallarita, supra note 17, at 108–09, 114.

126. Schanzenbach & Sitkoff, *supra* note 67, at 398.

127. Bainbridge, *Director Primacy*, *supra* note 2, at 574–78.

128. The relevance of situating the issue in a Delaware jurisdiction is that, in such a jurisdiction, the values of stakeholders could be pursued if doing so "entails a short-run cost to achieve an appropriately greater long-run profit." Restatement (First) of the L. of Corp. Governance § 2.01 cmt. e (Am. L. Inst. Tentative Draft No. 1, 2022). Under these

could be a shareholder agreement between the company and the investors in which the company agrees to or states that it will pursue ESG.

If investors are going to achieve influence on funds or companies that are not specifically and exclusively devoted to ESG, they can try to persuade the fund or company to adopt language to reflect a commitment to pursuing ESG in a corporate document. This could play out in charter provisions, bylaws, shareholder agreements, proxy proposals, or a board resolution either signed among shareholders or signed between the company and the shareholders.

If the language used in these provisions is to be more than an "illusory promise"[129] or puffery,[130] the ESG component must be incorporated into some corporate document constituting a contract. The question becomes whether that document would be legally enforceable and, secondarily, whether it would normatively be beneficial, i.e., whether it would produce more benefits than costs if it remained undifferentiated and would, therefore, be efficient. In Part IV, we will explore whether recent SEC proposals would adequately address the lack of clarity on the meaning of ESG and whether their proposals would promote efficiency by promoting self-selection among investors.[131]

The ESG provision could be incorporated into an environmental resolution that shareholders could vote on at a meeting.[132] The resolution might take the form of a shareholder proposal pursuant to Rule 14a-8 of the Securities Exchange Act.[133] It might have a "recommendation or requirement that the company and/or its board of directors take action."[134] The effect of that resolution would depend on the outcome at the board level. If a shareholder proposal reaches a majority vote, a company could do several things: (1) implement the

circumstances, the strategy "is therefore not a departure from the economic objective." *Id.* at cmt. e, illus. 5, 8. *See also* Rock, *supra* note 12, at 374 (explaining the Delaware rule of shareholder primacy: when "forced to choose between shareholders and other participants in the enterprise, the Delaware courts make clear that the primary beneficiary of directors' duties are the shareholders").

129. Bebchuk & Tallarita, *supra* note 17, at 176.

130. Many of the provisions incorporating ESG have precatory or aspirational statements, but there is increasing pressure on boards to *implement* ESG. Boards may then run a risk if actions fail to match their aspirational statements. Thomas Lee Hazen, *Social Issues in the Spotlight: The Increasing Need to Improve Publicly-Held Companies' CSR and ESG Disclosures*, 23 U. Pa. J. Bus. L. 740, 755, 758–59 (2021).

131. *See infra* Part IV.

132. *See* Scott Hirst, *Social Responsibility Resolutions*, 43 J. Corp. L. 217, 218 (2018).

133. 17 C.F.R. § 240.14a-8 (2022).

134. *Id.*

proposal; (2) reach settlements with the majority voters; or (3) reject the implementation of the proposal.[135] Corporate law[136] requires that board directors exercise their independent judgment when considering whether to implement a majority vote resolution.[137] Directors can choose not to implement the majority-vote resolution according to their best business judgment in exercising their fiduciary duties.[138] Additionally, a shareholder proposal cannot be binding because under traditional state law, shareholders do not have the power to require the board to take any action.[139] If such action were required, it would interfere with the board's ability to govern the affairs of the corporation.[140] Thus, a shareholder resolution would become binding only if the company decides to implement the shareholder proposal.[141] Even then, the meaning of an ESG provision[142] and its effect on the discretion of the board might be ambiguous and—if clarified to mean the pursuit of stakeholder values even if it degrades shareholder value—might be a violation of the board's fiduciary duty and, thus, unenforceable.[143]

However, freedom of contract does not necessarily mean freedom to eliminate legal duties. Thus, because many of the ways that an ESG provision could be implemented are through a contractual provision or a policy, it is important to resolve whether one can enter into a contract or adopt a policy that would give the board the discretion to pursue or mandate the pursuit of ESG, and whether the effect of the contract would differ depending on what context the contract arises in.[144]

135. Hirst, *supra* note 132, at 218.

136. Corporate law requires the board to exercise independent judgment as part of their managerial duties. Thus, even if shareholders adopt a provision, the board might reject it if, in its independent judgment, it was not beneficial to the corporation. *Id.* at 231, 233.

137. *See id.* at 231.

138. *Id.* at 233.

139. *Id.* at 234.

140. Stephen M. Bainbridge, The New Corporate Governance in Theory and Practice 108, 113 (2008).

141. *Id.* at 112, 124.

142. The definition of ESG has been particularly hard to define. It includes environmental issues, "workplace relationships, like gender equality and diversity; technology problems, like privacy and cybersecurity; and supply chain challenges." Gadinis & Miazad, *supra* note 66, at 414–15.

143. *See* Rock, *supra* note 12, at 375; Stephen M. Bainbridge, The Profit Motive 74 (2023).

144. Mary Siegel, *Fiduciary Duty Myths in Close Corporate Law*, 29 Del. J. Corp. L. 377, 400–01 (2004) (discussing how fiduciary duties are affected by the context in which they arise; Siegel argues that "the context of most

Further issues include whether a contract that alters a fundamental policy or immutable rule would be enforceable and how to decide whether the contract or obligation is enforceable using contractual doctrinal analysis. Finally, would such a contractual provision be normatively desirable? Would it enhance efficiency, promote the maximization of wealth/shareholder wealth, and increase the value of the firm? What costs might caution against adopting undifferentiated ESG provisions?

To analyze the legal issues here, this Article will limit its consideration to jurisdictions such as Delaware that have not adopted a constituency statute.[145] In a constituency jurisdiction, the statute permits or mandates that the board consider stakeholder interests and not accord primacy to shareholder interests,[146] validating the propriety of giving effect to ESG as an independent end that may trump shareholder value.[147] Absent a constituency statute, it is incumbent on legal decision-makers to decide whether an agreement that allowed or mandated the board to pursue ESG would be legally valid and, as a secondary matter, whether it would be beneficial and welfare enhancing.

Analyzing ESG documents that permit or mandate the pursuit of ESG under contract law principles would be consistent with the trend to treat corporations as a nexus of contracts[148] and the increased trend to private ordering in the governance sphere.[149] The first question for contract analysis is whether the corporate contracts can and should be

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cases require[s] courts to impose an enhanced fiduciary duty on the controlling shareholder," especially within the context of a close corporation).

145. David P. Porter, *Institutional Investors and Their Role in Corporate Governance: Reflections by a 'Recovering' Corporate Lawyer*, 59 Case W. Rsrv. L. Rev. 627, 639–41, 641 n.50 (2009) (discussing constituency statutes which provide "that directors, in fulfilling their duties to the corporation, may (and in Connecticut's case, must) consider interests other than those of the shareholder in making their decisions").

146. *Id.* at 645.

147. Bebchuk & Tallarita, *supra* note 17, at 112–13.

148. *See* Bainbridge, *Director Primacy*, *supra* note 2, at 552 n.31. *See also* Eli Bukspan, *The Notion of Trust as a Comprehensive Theory of Contract and Corporate Law: A New Approach to the Conception that the Corporation is a Nexus of Contract*, 2 Hastings Bus. L. J. 229, 232 (2006) (arguing that if the corporation is a "nexus of contracts and . . . a voluntary organization based on cooperation and consent, trust can . . . function as a (universal) axis that best fits corporate law, and also serves to justify it"); Jensen & Meckling, *supra* note 14, at 310–11 (discussing the origins of the firm consisting of a nexus of contracts).

149. Fisch, *New Governance*, *supra* note 63, at 1639 (suggesting the custom fit advantage to private ordering but highlighting defects such as reduced accountability of managers and the pursuit of personal rather than firm value).

examined in isolation when applying contract law principles exclusively. That is a complicated issue, as the private ordering may sometimes conflict with the "fundamental values of the corporate form."[150] If the private ordering conflicts with corporate law, then contract law may not provide a basis for resolving that conflict. However, for this Part of the Article, we will analyze whether it is appropriate to use contract principles. It may seem obvious that contract law should apply, but because these agreements arise in connection with shareholders and corporations, the issue of the propriety of contract should be analyzed under the Delaware statutes to determine if there is explicit authorization for private ordering.[151] Additionally, even if there is *not explicit authorization* for private ordering, is there room in the Delaware statute for private ordering that accounts for ESG?[152] Then, if there is authority for private contracting, this Article will address how contract law would treat these ESG provisions. Finally, it will suggest that the ultimate normative determination of the propriety of undifferentiated ESG provisions should rest on whether they would enhance the economic pie or decrease that pie by increasing the costs of ownership and agency costs.

A. The Embrace of Private Ordering in Delaware

Leaving aside the question of whether a conflict with Delaware law exists, including the common law of fiduciary duty and the duty of loyalty, there is a broad embrace of "the contractual theory of the corporation."[153] The Delaware court emphasized this in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation*,[154] when it said: "[T]he bylaws of a Delaware corporation constitute part of a binding broader contract among the directors, officers, and stockholders formed within the statutory framework of the [Delaware General Corporation Law]."[155]

The embrace of private ordering is reflected in the broadly enabling approach of Delaware corporate law, which regularly adopts a provision but then expressly allows parties to provide otherwise.[156] In other instances, Delaware's statutory scheme provides a mandatory rule but

150. Fisch, *Stealth Governance*, *supra* note 63, at 918.

151. *Id.* at 920.

152. *Id.* at 935.

153. *Id.* at 921.

154. 73 A.3d 934 (Del. Ch. 2013).

155. *Id.* at 939.

156. *See* Fisch, *Stealth Governance*, *supra* note 63, at 920.

then includes another statute which includes a menu of terms that are authorized deviations from the normal mandatory rule.[157]

In addition to enhancing freedom of contract values, the embrace of private ordering offers advantages of customization, which allows firms to tailor rules to their needs and permits innovation and experimentation.[158] ESG is still an emerging and evolving trend, and although the SEC has made sweeping statements regarding its focus on disclosure and proposed rules on climate change disclosure, there are currently no climate-related disclosure requirements for public companies.[159] In the gap left by this lack of government regulation, companies have developed novel ways of assuring investors of their sustainable commitments through private ordering, such as sustainability-linked bonds, which are essentially "traditional bond[s] plus a quantifiable ESG commitment by the issuing company."[160] This innovation allows companies to tie investment perks and returns to sustainability metrics, and "allow[s] companies to meet investor demand for ESG goals without sacrificing shareholder wealth and allow[s] investors to 'pay' for only the ESG products that suit their preferences." [161]

B. When Does Delaware Law Allow or Constrain Contractual ESG Provisions?

Several different approaches can help determine whether Delaware statutes limit a company's ability to contractually adopt an ESG provision. Since these contracts involve corporate entities in a non-constituency jurisdiction, one should look to the statutory text for guidance.[162]

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157. *Id.* at 920–21.

158. *See id.* at 922 (citing D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws,* 80 Fordham L. Rev. 125, 174 (2011). *See also* Fisch, *New Governance*, *supra* note 63, at 1639 (describing the advantages of private ordering).

159. *See* Investment Company Names, 87 Fed. Reg. 36594 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, 274); Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279); The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed April 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249). If the SEC-proposed rule is adopted, that may change. Additionally, if a company's climate-related activities are considered material under the Securities and Exchange Acts, they may be required to disclose this activity in various reports.

160. Povilonis, *Contracting for ESG*, supra note 1412, at 628.

161. *Id.* at 625.

162. *See* Fisch, *Stealth Governance*, *supra* note 63, at 923.

Because an ESG provision—either in a shareholder resolution, a corporate charter, a bylaw, or a shareholder agreement—arises in a corporate context, and because this Article focuses on a non-constituency jurisdictions, we must first decide if there is room in the Delaware statutes for private ordering through bylaws or charters, either granted explicitly by statute or freely afforded in the charter and bylaws. As Professor Jill Fisch rightly points out, "[s]tate statutes [like Delaware's] afford corporate participants broad authority to use the charter and bylaws to adopt firm-specific governance terms."[163] Under Delaware General Corporation Law (DGCL) section 102(b)(1), the charter may contain "any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders" so long as the "provisions are not contrary to the laws of this State."[164] DGCL section 109(b) affords similar authorization to adopt bylaws but rules out bylaws that are inconsistent with the charter or with the public policy of Delaware.[165]

C. Delaware Statutory Analysis

Statutory analysis of a private contract would ordinarily begin with DGCL sections 141, 102(b)(1), and 109(b).[166] Section 141 addresses the parameters of private ordering in general and directs that certain deviations must occur via bylaw or charter. Specifically, section 141 contemplates private ordering by the inclusion of language "may be otherwise provided."[167] Section 102(b) allows charter provisions if they "are not contrary to the laws of this state."[168] Section 109(b) widely permits any bylaw provision that does not violate the charter and is "*not inconsistent with the law* or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees."[169]

For example, section 211 provides a provision for the annual election of a board,[170] but a different provision provides for a staggered

163. *Id.* at 920.

164. DEL. CODE ANN. tit. 8, § 102(b)(1) (2023).

165. Fisch, *New Governance*, *supra* note 63, at 1640, 1653–54, 1662 (analyzing the relevant statutory provisions in an expert manner).

166. *See* DEL. CODE ANN. tit. 8, §§ 141, 102(b)(1), 109(b) (2023).

167. *Id.* § 141(a).

168. *Id.* § 102(b).

169. *Id.* § 109(b) (emphasis added).

170. *Id.* § 211(b) ("[A]n annual meeting of stockholders shall be held for the election of directors on a date and at a time designated by or in the manner provided in the bylaws.").

board—section 141(d). Section 141(d) gives the board the power to adopt a staggered board either in the charter, initial bylaw, or a bylaw adopted by the stockholders despite the provision that the board annually elects all directors.[171] Other statutes which facilitate private ordering are worded so that the corporation can opt into a menu of terms as a way of customizing the contracts with the corporation.[172] Section 102(b)(7) is an example of this.[173] There is no comparable provision allowing for a menu in Delaware law that includes an ESG provision that would permit directors to pursue it on a mandatory or permissive basis, so the question of its permissibility remains unresolved under that analysis.

If you posit that the shareholders might succeed in adopting a bylaw by voting on ESG and including a provision that mandated the directors to follow ESG, would it comport with Delaware law?

To decide whether the ESG provision would be permitted if adopted in a charter provision, a bylaw provision, or a shareholder agreement, one would first resolve whether this provision could be interpreted as a pluralistic version of stakeholderism, in which the board can choose to pursue stakeholder interests even if it reduces long-term shareholder value. If ESG is conceived of in that way, it may violate the duty of loyalty.

Because there is no direct statutory authorization for an ESG provision,[174] one must confront whether an undifferentiated ESG provision would violate the laws of Delaware or is otherwise inconsistent with the charter or bylaw. One cannot resolve whether an undifferentiated ESG provision violates Delaware law, including the Delaware common law of fiduciary duty, so long as the provision remains unclarified as to the trade-off between stakeholders and shareholders.

The statutory provision of section 102(b)(7) disallows any abolition or limitation "for any breach of the director's or officer's duty of loyalty to the corporation or its stockholders."[175] Because an undifferentiated ESG provision would, under one interpretation, mean that the director could consider stakeholder interests but only if it promoted shareholder

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171. *Id.* § 141(d).

172. *See id.* § 102(b).

173. *Id.* § 102(b)(7) ("In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters . . . ."). *See also* Fisch, *Stealth Governance*, *supra* note 63, at 921–922.

174. Note that the new SEC rule specifically does not define ESG. *See* Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279).

175. § 102(b)(7).

value, the inclusion of an ESG provision would not necessarily amount to a provision breaching or abolishing the duty of loyalty.

Another provision of section 102(b)(1) would prohibit charter or bylaw amendments if "contrary to the laws of this State."[176] Because case law suggests a violation would include statutes, common law, and Delaware public policy implicit in the statutes,[177] an ESG provision would have to be evaluated to determine if it violated the common law of fiduciary duty law or the public policy in the statutes. As Jill Fisch explains, these are "implicit"[178] limits on contractual freedom to engage in private ordering. Without further clarification on whether stakeholder interests could trump shareholder value in a contract provision mandating the pursuit of ESG, there would be no way to determine if a violation exists. If the ESG provision explicitly gave the board discretion to abandon shareholder primacy, and to pursue stakeholder interests even if they reduced shareholder value, it would presumably be a violation of a director's fiduciary duties to agree to it because the director's duty of loyal fiduciary is to take steps in good faith that are "in the best interests of the corporation and its shareholders."[179] At the end of the day, that must remain primary.[180]

A predicate for making decisions about ESG must include consideration of enough information about the positive and negative returns with associated probabilities of pursuing an ESG strategy for the firm. Without that information, it is possible that the director might violate the duty of care. In addition, if the director acquired information suggesting that the decision would cause social detriment and detriment to the firm, then a decision to pursue ESG might be deemed to violate the common law duty of good faith.

The Delaware case law suggests "that directors 'cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the

176. *Id.*

177. Fisch, *Stealth Governance*, *supra* note 63, at 924 (explaining that "'contrary to the laws of this State' means charter provisions that 'transgress a statutory enactment or a public policy settled by the common law or implicit in the General Corporation [Law] itself'") (quoting Jones Apparel Grp. v. Maxwell Shoe Co., 883 A.2d 837, 843 (Del. Ch. 2004)).

178. *Id.*

179. Stephen M. Bainbridge, Star Lopez & Benjamin Oklan, *The Convergence of Good Faith and Oversight*, 55 UCLA L. Rev. 559, 564 (2008).

180. Strine Jr., et al., *supra* note 12, at 633. *But see* Robert P. Bartlett, III, *Shareholder Wealth Maximization as Means to an End*, 38 Seattle U. L. Rev. 255, 256, 280 (2015) (discussing the need to take account of shareholder maximization as a "means").

directors' fiduciary dut[ies] under Delaware law.'"[181] Under this formulation of directors' fiduciary duties, it would not be permissible to subordinate stockholder welfare to other constituencies, such as employees.[182] This means that, if an ESG provision was adopted that allowed the director to sacrifice shareholder welfare at any cost, it would likely violate Delaware common law, which would lead the provision to be a violation of section 102(b)(1).[183]

Even if Delaware law could redefine stockholder welfare to include non-market returns,[184] two further questions remain: (1) how would that reconceptualization of stockholder welfare to include non-market returns comport with the pursuit of the best interest of the firm, including the protection of the asset pool; and (2) how would managers and directors make decisions when the stockholders themselves may assign different weights to the stream of market and non-market returns? Further, it is difficult to see how managing that burden of assigning weights and trading off the different values assigned to market and non-market returns would result in a benefit to the firm or to the stockholders themselves. The uncertainty and lack of a methodology for making the trade-offs would potentially threaten a loss in value to wealth maximization and stockholder value, even if stockholder welfare is defined to include non-monetary returns. However, if some subset of investors values non-monetary returns at a high level, they might be willing to give up certain benefits (such as a higher interest rate) in exchange for those non-monetary benefits, and that could benefit a firm.[185] But in order to make these decisions, firms would have to assess

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181. Stephen M. Bainbridge, *Making Sense of the Business Roundtable's Reversal on Corporate Purpose*, 46 J. CORP. L. 285, 300 (2021) (quoting eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 35 (Del. Ch. 2010)). *See also* Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 135 (2012).

182. Bainbridge, *supra* note 181, at 300 (citing 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, 764 (2015)).

183. Of course, if Delaware courts were to adopt a constituency statute or embrace a broader version of corporate purpose to include shareholder value comprised of the "ethical and social concerns" of shareholders, then the pursuit of stakeholder or shareholder values by directors could sacrifice market value since the pursuit of shareholder welfare, not market value, would be the dominant objective of corporations. Hart & Zingales, *supra* note 8, at 248, 270–71.

184. *See id.*

185. Povilonis, *Contracting for ESG*, *supra* note 10, at 648 (quoting Matt Levine, *Money Stuff: BlackRock Borrows Against Diversity*, BLOOMBERG LAW (Apr. 7, 2021 12:37 PM), https://news.bloomberglaw.com/banking-law/matt-levines-money-stuff-blackrock-borrows-against-diversity [https://

the positive and negative returns and probabilities associated with each ESG action as well as how well those actions achieved a reduction in the firm-generated externalities.

Whether the adoption of an ESG provision in a contract would violate the common law fiduciary duty *should* depend on whether the pursuit of ESG helps limit the discretion of managers in their rendering of services and the operation of the firm's assets. Without further differentiation of the meaning of ESG—including the probabilities of a negative and positive return from the pursuit of ESG, together with a resolution of what the permitted objective of the corporation is and a recognition of how uncertainty affects these calculations—it will be difficult to assess whether there is a violation of the fiduciary duty affecting managers.

The uncertainty surrounding the pursuit of ESG as a permitted objective might be resolved in another way. Even if it is determined that the pursuit of an undifferentiated ESG strategy would violate fiduciary duty, it might be upheld as a waiver of the duty of loyalty that might be permitted. If waivers of appraisal rights—a fundamental right—can be upheld, could a provision for ESG also be upheld? The difficulty with analogizing to a waiver of appraisal rights is that in cases where the court has upheld the waiver, the court found that the waiving party should be held to the contractual bargain because there was no contract of adhesion, the party "enjoyed the benefit of their bargain,"[186] and the bargain was unambiguously expressed in clear terms. In the case of an undifferentiated ESG provision, it is difficult to make the argument that a party agreeing to an ESG provision could negotiate a bargain that compensated them for the provision when they might be giving up rights that would need to be compensated for in a reciprocal bargain due to the ambiguity of the meaning of ESG. If a court weighing the waiver of a fundamental appraisal right emphasizes (1) the knowledge and sophistication of the waiving party; (2) the absence of a contract of adhesion; and (3) the clearly negotiated benefit of the waiver, then the undifferentiated ESG might not survive because of the bargaining difficulty associated with giving up uncertain rights and the

perma.cc/W4Q4-5NHT]) (explaining that "socially responsible investors provide *cheaper capital* to companies in exchange for those companies promising to do socially responsible things"). Povilonis discusses SLBs, which are "traditional bond[s] plus a quantifiable ESG commitment by the issuing company." *Id.* at 628. There is a willingness to pay a premium for ESG funds that in turn reduces the cost of capital because "SLBs give companies the opportunity to meet market demand for ESG goals while nonetheless maximizing shareholder wealth, since the holders of SLBs are typically willing to accept a lower return and the issuer thereby has a reduced cost of capital." *Id.*

186. Manti Holdings, LLC v. Authentix Acquisition Co., Inc., No. 2017-0887-SG, 2019 WL 3814453, at *2–4 (Del. Ch. Aug. 14, 2019).

difficulty of assessing whether a benefit was received in return for the waiver.[187]

IV. An Understudied Aspect of Private Ordering: Contractual Analysis of ESG Provisions

Because true determination of whether an undifferentiated ESG provision would be permissible under the Delaware statutes remains opaque, another analytical approach to assess private ordering through ESG provisions might be relevant: the theory of the firm as a nexus of contracts.[188] Could the issue of ESG provisions be resolved by the increasing deference afforded to private agreements entered into by firms?[189] Can these agreements be enforced solely by reference to contract principles?

Scholars generally agree that private ordering should be encouraged and that corporations should have broad discretion to alter default statutory rules. Analyzing private ordering, scholars have focused on the theoretical justifications for treating corporations as a nexus of contracts. They have also examined how contracts may or may not solve the meta problems of agency costs, looked at the firm as a solution to contracting difficulties, and have broadly endorsed the idea that "corporate law is private" and not public law.[190] They have focused on

187. If the undifferentiated contract provision mandating the pursuit of ESG were adopted, it might be considered as an implicit waiver of the duty of loyalty. Because Delaware adopted a statute that permitted parties to partially waive the duty of loyalty for corporate opportunities, the question arises whether that would permit parties to contract for ESG if it violated the duty of loyalty. Del Code Ann. § 122(17) (2023). However, since the carve-out in section 122(17) is narrow, there is nothing in the statute that suggests such a carve-out would be permitted for the remaining affirmative duty of loyalty to advance the best interests of the corporation. Presumably, that affirmative duty would include the duty to maximize shareholder value in the long-term. Moreover, unlike the case of the corporate opportunity waiver statute, which can be justified on efficiency grounds, *see* Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 Yale J. on Reg. 1124, 1151–52 (2021), allowing or mandating an undifferentiated ESG provision would not produce efficiency advantages. *See infra* Part IV.B.

188. *See supra* notes 14 & 53 and accompanying text.

189. *See* Fisch, *Stealth Governance*, *supra* note 63, at 938–39.

190. Asaf Raz, *Why Corporate Law is Private Law*, 25 U. Pa. J. Bus. L. 981, 986, 1016–18 (2023). *See also* Jill E. Fisch, *Governance by Contract: The Implications for Corporate Bylaws*, 106 Calif. L. Rev. 373, 375 (2018) (citing D. Gordon Smith, Matthew Wright & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 Fordham L. Rev. 125 (2011)) (discussing the increasing use of private ordering in a corporate context to customize their corporate governance).

what latitude there is under Delaware statutes for contractual departures from the default rules of corporate law. Scholars have sanctioned a broad latitude to design customized rules to replace the largely enabling default rules of corporate law.[191] However, such scholars have not focused on how particular contracts—such as resolutions or provisions mandating the pursuit of ESG—should be treated and whether, why, and in what circumstances a system that gives priority to private ordering might instead limit such deference to instances in which the agreement represents an optimal, least-cost solution to parties' problems and control of firm externalities. This Part asks how an ESG provision would be treated under contract law principles and later suggests a comparative institutional taxonomy for deciding whether ESG provisions should be permitted.

Additionally, although a generally favorable consensus exists in the academic community that private ordering should prevail, there are significant problems with deferring to the particular private ordering of a provision permitting or mandating the pursuit of ESG or constraining the discretion of firm managers under both contract law and theory. Even if corporate law, in theory, generally defers to private ordering and sees firms as engaged in a nexus of contracts, the nature of ESG provisions is different than, say, a contract requiring that a corporation send notice of its annual meeting via certified mail. First, because of the uncertain meaning of the term *ESG*, the parties may not be able to validly consent to the provision. Further, because of concerns about the ability of parties to bargain over such a term (bargaining process concerns), the law should withhold its enforcement of such terms. Finally, the law should remain skeptical about construing an ESG contract provision in a shareholder resolution as trumping shareholder welfare because it may be difficult to solve the underlying opportunism or shirking problem by contract, and because other private counter-strategies may be difficult or costly in the context of an undifferentiated ESG provision and may increase the costs of ownership or promote opportunism by managers without proof of a solution to a firm's externalities.

Moreover—if opportunism is an underlying meta problem[192] for corporate contracts, if the ESG provision, at least in its undifferentiated

191. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 782–83 (2006).

192. *See* E. ALLAN FARNSWORTH, CONTRACTS 201–03 (4th ed. 2004). *See also* Varney v. Ditmars, 111 N.E. 822, 823 (N.Y. 1916) (finding the agreement regarding compensation in the amount of a "fair share of [the] profits" to be unenforceable because it is "indefinite, and uncertain"); RESTATEMENT (SECOND) OF CONTRACTS § 33 (AM. L. INST. 1981).

See WILLIAMSON, *supra* note 39, at 30–32. *See also* Richard A. Epstein, *Agency Costs, Employment Contracts, and Labor Unions*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 127, 128–29 (John W. Pratt format, does not solve that problem because it fails to restrain the agent's discretion and reduces accountability of the agent,[193] and if other alternative strategies, such as pricing, are ineffective due to the uncertainty and lack of transparency surrounding the ESG term[194]—the law should be reluctant to construe the term as one that allows the agent unlimited discretion to pursue stakeholder and shareholder value or to pursue shareholder values but without being fully accountable.[195] Alternatively, a decision-maker should be reluctant to defer to such a provision under private ordering principles where there is no mechanism for trading off the values of shareholders and other stakeholder values since that would increase the cost of ownership.[196]

So, despite an embrace of contractarian principles,[197] the question remains: whether particular contracts, such as ESG shareholder agreements, would and should survive scrutiny as contracts under contract principles even if the Delaware courts broadly accept the idea of the corporation being able to enter contracts to arrange its affairs.[198] Ordinarily, contract law theory of the corporation would counsel deference,[199] but lack of clarity on the meaning of ESG suggests that decision-makers should not defer for these reasons because (1) there is

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& Richard J. Zeckhauser eds., 1985); Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, 48 J. Corp. L. 37, 42–44 (2022).

193. *See* Bebchuk & Tallarita, *supra* note 17, at 164–65.

194. Jill Fisch raises similar objections to the growing prevalence of private shareholder agreements to address governance issues, arguing that they constitute "stealth governance" that should be rejected because it insulates them from "the transparency and price discipline of the public capital markets." Fisch, *Stealth Governance*, *supra* note 63, at 913–14. She cites shareholder agreements on appraisal rights and fiduciary duties as examples of provisions that should only be permissible in a corporate charter or bylaw since they offer greater "transparency, predictability, and standardization." *Id.* at 916. *See also* Bebchuk & Tallarita, *supra* note 21, at 101, 176 (arguing that "reduced accountability would increase managerial slack and agency costs, thus undermining economic performance and thereby damaging both shareholders and stakeholders").

195. *See* Bebchuk & Tallarita, *supra* note 17, at 164.

196. Directors routinely trade off the differing preferences when they trade off common stockholders and preferred stockholders. However, in that context, they have a clear metric for maximizing shareholder value. *See* Hansmann, Ownership of Enterprise, *supra* note 38, at 62.

197. *See* Bebchuk, *supra* note 15, at 1395–96 (exploring "Contractual Freedom in Corporate Law").

198. *See* Fisch, *Stealth Governance*, *supra* note 63, at 938–39.

199. Fisch, *supra* note 190, at 376–77 (discussing "the contemporary understanding that the contractual nature of the corporate form warrants the high level of judicial deference to private ordering").

no true consent; (2) there can be no accurate pricing of the term; (3) it is too indefinite to be enforceable and thus not fully transparent; and (4) there are bargaining problems when parties consent to an ESG term.

Thus, there are two parts to the analysis: (1) how would contract law regard the term; and (2) whether the term should be enforced in an undifferentiated form using a comparative institutional analysis to determine whether parties would adopt an undifferentiated term given the costs and benefits of an uncertain term that does not contain a trade-off mechanism. Further, even if parties might agree to such a shareholder resolution, should the board agree to adopt such a resolution given the uncertainties that surround the term? Perhaps the SEC could promulgate a rule that requires greater transparency on the meaning of ESG by requiring the board to assess the positive and negative impacts of accounting for ESG in company actions.[200] Given that parties act in a discriminating manner to adopt governance mechanisms that are most cost-effective to solve durable problems in contracting,[201] would the parties' adoption of an ESG term in a particular instance be entitled to deference, or would there be a need for additional scrutiny to determine whether the ESG term should be analyzed to see if it is *consistent* with a mandatory duty of loyalty term? In cases where there is doubt about whether there is a direct conflict with a duty of loyalty, one should resort to a consideration of how the ESG provision, if considered a private ordering, compares with other constraints on managerial abuses. Where the other private ordering strategies for curbing managerial misconduct would be less efficacious because of the uncertainty of how the term "ESG" is meant to constrain managers, the possible undermining effect that an ESG term in its undifferentiated form has on a mandatory term of loyalty, and the possible contribution it might make to a "market for lemons,"[202] whether the principle of

200. *See* Levmore, *supra* note 11, at 727–29; *see also* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334, 21366 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249) (proposing that "within each category (*i.e.*, climate-related events or transition activities), impacts would, at a minimum, be required to be disclosed on an aggregated, line-by-line basis for all negative impacts"). So, the negative financial impacts of the transition would be captured in the new rule.

201. WILLIAMSON, *supra* note 39, at 18 (discussing the manner in which firms economize "by assigning transactions (which differ in their attributes) to governance structures (the adaptative capacities and associated costs of which differ) in a discriminating way").

202. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 488–89, 495 (1970). The undifferentiated ESG term may make it difficult for companies to alert investors that they will achieve high earnings, since investors may assume that the company will sacrifice earnings in the pursuit of social values under ESG. This informational asymmetry may result in profitable companies

private ordering should prevail or whether another approach should be implemented demands analysis. The determination of whether to defer to the private ordering of ESG must depend on an assessment of whether and how the undifferentiated ESG provision would affect market and pricing constraints. Would the market be able to judge whether a manager was "mak[ing] appropriate use of corporate assets"?[203] Or would it be judged on a variety of other benchmarks when the standard of ESG is uncertain and its effect on the duty of loyalty remains unclarified?

A. Ambiguity in the Meaning of ESG

Contract analysis requires the application of the consent principle. Consent in the corporate context is different from consent as it is conceptualized in a contract. Consent in contract law depends on the explicit consent of the parties.[204] In corporate law, consent is a more attenuated concept. Corporate law views the shareholder as having consented to the contract terms in the charter and the certificate of incorporation through their choice to invest in the corporation.[205] Consent to the terms such as the charter also rests on the ability of the shareholder to exit the market and to remove directors through a shareholder vote.[206] If shareholders do not exit the market, or do not remove the directors who have implemented the relevant terms, they have impliedly consented to the terms to govern the corporation.[207]

Implied consent generally makes sense in the corporate context, where the wide dispersion of shareholders in the public corporation context makes individual bargaining too difficult to achieve. However, the uncertain meaning of a term permitting or mandating the directors to consider ESG—without resolving whether ESG exists as a term that

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being unable to distinguish themselves, thereby leading to a market of lemons. *See id.* at 495.

203. Thompson, *supra* note 20, at 381.

204. FARNSWORTH, *supra* note 192, at 108, 140–45.

205. *See* Fisch, *Stealth Governance*, *supra* note 63, at 921 (citing Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 940, 958 (Del. Ch. 2013), *judgment entered sub nom.* Boilermakers Local 154 Ret. Fund & Key West Police & Fire Pension Fund v. Chevron Corp., 2013 WL 3810127 (Del. Ch. 2013)).

206. *Id.* at 921–22, 931.

207. *See id.* at 918 (contrasting the explicit consent of contract law with the implicit assent to corporate documents); *see also* Boilermakers Local 154 Ret. Fund v. Chevron Corp., 73 A.3d 934, 939 (Del. Ch. 2013), *judgment entered sub nom.* Boilermakers Local 154 Ret. Fund & Key West Police & Fire Pension Fund v. Chevron Corp., 2013 WL 3810127 (Del. Ch. 2013) (noting that "the bylaws of a Delaware corporation constitute part of a binding broader contract").

can trump shareholder value or whether ESG can only be pursued if it advances shareholder value—renders the idea of implied consent for an ESG provision less convincing. How can shareholders impliedly consent to a term, which they may even have suggested, if they do not know what meaning the directors are ascribing to it? In addition, consent seems flawed in this context since the addition of an ESG provision in a contract with the firm may seem like a benign addition to a contract and may not signal to the shareholder that a mandatory ESG provision may deprive them of what would otherwise be an exclusive duty to them to maximize shareholder/market value.[208] Without a clearer specification of the trade-offs that might be required under the ESG provision, and how they would impact the shareholder and shareholder wealth, it is hard to see how a shareholder could meaningfully consent to the provision, even on an implied basis. Parties should be forced to articulate which version of stakeholderism is being adopted before deciding that a court should defer to the ESG provision as a form of private ordering. The SEC could step in by promulgating a rule that requires companies to disclose to investors which form of stakeholderism they are pursuing regarding ESG provisions.

The uncertainty of the meaning of the term "ESG" may mean that even if implied consent principles apply, the term is too indefinite to be enforceable. Traditionally, contract law has refused to enforce contracts in which a term such as the subject matter or the quantity of goods sold is omitted.[209] There are possibly three distinct meanings that might be ascribed to an ESG provision: (1) where the directors are mandated to pursue ESG even if it trumps shareholder value; (2) where the directors can pursue ESG only to the extent it advances shareholder value; or (3) where the managers defer to shareholder values. Certain mitigating doctrines[210] allow a court to resolve the uncertainty by using external sources such as trade usages to interpret the term so as to avoid the indefiniteness that would otherwise render the agreement unenforceable. However, since there is no trade usage or common practice that might allow the court to resolve the ESG's interpretation

208. Milton Friedman, *A Friedman Doctrine–The Social Responsibility of Business Is to Increase Its Profits*, N.Y. Times., Sept. 13, 1970, at 32 (cited by Levmore, *supra* note 11, at 714).

209. U.C.C § 2-201(1) (Am. L. Inst. & Unif. L. Comm'n 1977). *See also* Levine v. Blumenthal, 186 A. 457, 457–58 (N.J. 1936), *aff'd*, 189 A. 54 (N.J. 1937).

210. Courts might seek to resolve indefiniteness by resorting to interpretation and contextual evidence including trade usages. *See* Farnsworth, *supra* note 192, at 201–03. For a discussion of contextualism, see Peter M. Gerhart and Juliet P. Kostritsky, *Efficient Contextualism*, 76 U. Pitt. L. Rev. 509 (2015).

issue, indefiniteness would and should remain a substantial barrier to enforcement.

The third component of a contract analysis must consider the bargaining process surrounding the insertion of an ESG provision into a contract. There are reasons to be skeptical of such a provision since it might be construed as a broad fiduciary duty waiver (if the non-instrumental view of ESG prevails). The ambiguity of an ESG provision means investors may have agreed to a provision that allows a director to pursue ESG to the detriment of shareholder value. A court might see this as the parties' agreeing to waive fiduciary duty since this bargain goes against the traditional notion of this duty. The ability of the shareholders to conceive of all the possible violations of the fiduciary duty is limited and constrained by the limits on rationality.[211] Moreover, when shareholders are dispersed, private solutions face impediments. Together, this means that, at least in the context of private ordering in such corporations, the ESG provision should be questioned.

B. Agency Costs of ESG: Do ESG Provisions Achieve the Parties' Goals at the Lowest Cost?

The final part of any contract analysis should include an assessment of what durable problems parties in this context face and an assessment of what private strategies or public law would best achieve the parties' goals at the lowest cost. Thus, when conducting a contract analysis of the mandatory (or permissive) ESG provisions that could amount to a waiver of or a bargaining around fiduciary duty, one should begin with the risk that shareholders face: that of unconstrained management shirking. Under a private ordering contractual analysis, one could suggest that parties might have other means of constraining that shirking or opportunism by private means. One such means might be pricing of the shares. However, the uncertainty surrounding the meaning of ESG might make the pricing of the risk to shareholders difficult. It would be unclear whether shareholders were taking the risk that the manager would be unconstrained to pursue any interest and whether the manager could use ESG to trump the pursuit of shareholder value. The uncertainty surrounding ESG makes the use of a private strategy to constrain the risk of managerial abuse unattainable. Other private strategies to contain managerial abuse, such as monitoring, would also become more difficult. Even if there were independent board members to monitor, the lack of clarity on the meaning of ESG would make it difficult for monitors to know whether the agent-director was violating the terms of the agreement or not.

Because private mechanisms for constraining managerial discretion would be impaired by the uncertainty of the ESG provisions, and because derivative suits would be hampered by the potential waiver of

211. Thompson, *supra* note 20, at 388, 396.

fiduciary duty implied by an ESG term, the need for a mechanism to constrain the discretion of managers remains. On a comparative institutional analysis,[212] one would argue that because other strategies for constraining managerial shirking, such as a contract, pricing, or monitoring, are too costly or likely to fail, the contract provisions for ESG should not be construed to permit a broad and unconstrained waiver of the duty of loyalty. It would be particularly hard to price the ESG provision without a further specification of the meaning and without a methodology for determining how the manager would trade off decisions involving shareholder value and ESG concerns. There should, therefore, be less deference to the private ordering to pursue ESG. Further, the contractual approach to corporate law depends on an analysis of how parties would structure their transactions to minimize the costs of constraining opportunism under conditions of uncertainty and sunk costs. Those conditions might affect the decision to integrate provisions to constrain opportunism where contractual alternatives were too costly. The lesson from this literature is that parties weigh the risks of opportunism, face difficulties in constructing contracts to control those risks, and make decisions about property rights or ownership to constrain those costs.

When shareholders urge corporations to adopt mandatory provisions for ESG, because the other constraining mechanisms are unlikely to be effective, "the legal protection provided by fiduciary duty or other legal rule is a logical trade-off of the law's constraint for a more effective alternative."[213] Even if the shareholders embrace ESG, that does not warrant an interpretation that the shareholders want to waive the fiduciary duty to maximize shareholder value; the need to constrain managerial abuse remains. If the ESG provision is going to promote a freedom to pursue any goal at the expense of the shareholder, and if other strategies for containing that managerial abuse are lacking, then it is unlikely that the parties would all consent to such a provision and it should be rejected. It would not be the most efficacious means, under a discriminating alignment theory, of structuring transactions to maximize value by minimizing transaction costs, including the friction of managerial abuse. Why would shareholders consent to an ESG provision if it cannot constrain managerial opportunism and the other strategies they might use to constrain opportunism, such as pricing, would be too difficult given the uncertainty surrounding the meaning of ESG?

212. *See generally* Neil K. Komesar, Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy (1994).

213. Thompson, *supra* note 20, at 390.

C. Pluralistic Versus Instrumental ESG: How Should a Court Interpret Between the Two?

The final contractual issue ripe for debate is one of interpretation: should the contract provision in a corporate document be interpreted so that the ESG provision mandates the sacrifice of shareholder value to other stakeholders' needs and interests? Or should the contract provision be interpreted to mean that the board can consider other stakeholder interests, but when they conflict, shareholder value would trump other stakeholders' interests or shareholders' social concerns? More importantly, what method should the court use for making that interpretive decision? This Article suggests the following analytical approach, which might apply when it is not clear when an ESG provision in an undifferentiated form should be permitted under the private ordering principle.

The analysis starts with the assumption that there is an "organizational imperative"[214] for firms to control opportunism in the most cost-effective ways, aligning their contracts and governance structures to achieve those goals. Under those assumptions, a court should prefer an interpretation that the ESG provision will curb managerial opportunism.[215] Under that approach, the ESG provision should not be interpreted to permit the manager to pursue ESG at the expense of shareholder value.[216] Giving the manager free rein under an ESG provision to pursue stakeholderism or shareholder social values would lessen accountability of the manager,[217] and interpreting the provision in that manner would lead to a drag on gains from trade as it would leave managerial abuse unchecked. A court would not prefer that interpretation.

Contractual interpretation techniques of an ESG provision would also strive to avoid a direct conflict with a relevant statutory provision. If the ESG provision is interpreted to mandate the pursuit of ESG in a way that would operate as an independent value and trump shareholder value, that might run afoul of DGCL section 102(b)(7), which prohibits duty of loyalty waivers, if the duty of loyalty includes the affirmative

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214. Williamson, *supra* note 39, at 32.

215. Matthew Jennejohn, *Do Networks Govern Contracts?*, 47 J. Corp. L. 333, 342 (2022).

216. Of course, in many instances, "no conflict exists between the interests of other constituencies [stakeholders] and those of shareholders." Macey, *supra* note 66, at 345.

217. *See id.* at 343. Macey discusses other constituency statutes that allow "managers . . . [to] justify virtually any decision they make on the grounds that it benefits some constituency of the firm." *Id.* The same latitude or discretion allowing managers to pursue an ill-defined ESG provision would lead to a similar lack of accountability because of the difficulty of monitoring.

duty to pursue the best interests of the firm.[218] Although the ESG provision itself does not directly mandate that the manager pursue ESG in such a way that the manager would violate the duty of loyalty, which includes under case law, the duty to maximize shareholder value, one possible interpretation of the ESG provision would lead to such a violation.[219]

When confronted with a contract provision, courts will strive to assign the interpretation that will avoid a conflict with a statutory mandate on the assumption that the drafting parties would not want to take the risk that a contract provision would be struck down. As Professor Farnsworth explains,[220] "[g]iven a choice between two reasonable interpretations of an agreement, a court will prefer the one under which the agreement involves no contravention of public policy."[221] Using this interpretative technique, a court confronted with interpreting an ESG provision would prefer the interpretation that a board may pursue ESG only when doing so advances the long-term shareholder value.

V. Taxonomy for Judging Legal Intervention: When Should Law Yield to or Intervene Against Private Ordering?

A. Cost Benefit Analysis

Deciding whether to allow ESG provisions in contracts—which include bylaws, charters, and shareholder agreements that would permit or mandate the pursuit of ESG—cannot be considered in isolation without a cost-benefit analysis when measured against achievement of goals. Should the law yield to such ESG provisions as a kind of private ordering? If it does not yield to ESG provisions in private investor contracts, and specifically outlaws undifferentiated ESG provisions in case law or by statute (a kind of anti-constituency statute), what would be the justificative framework it would use to reach that conclusion?

The question under any taxonomy for judging legal intervention is whether the legal intervention or legal rule should be adopted because it would be the "preferred alternative"[222] to either allowing a deviation

218. Del. Code Ann. tit. 8, § 102(b)(7) (2023).

219. *See* Farnsworth, *supra* note 192, at 317. *See also* Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation,* 96 Ky. L.J. 43, 89 (2007) (explaining that courts will select an interpretative method to curb opportunism).

220. Farnsworth, *supra* note 192, at 313–18.

221. *Id.* at 317.

222. Thompson, *supra* note 20, at 379.

from the legal rule or adopting other private strategies that the parties can use to mitigate the durable problems in the corporate contexts involving shareholders and firms. In this context, the legal rule could take the form of a judicial decision or a statute permitting the use of undifferentiated ESG provisions in a contractual document governing the discretion of the firm's managers or in a vote by fund managers to pursue ESG at the behest of investors in a fund. Alternatively, it could outlaw undifferentiated ESG provisions in contracts unless they are further defined. Finally, would the SEC proposals[223] be specific enough to avoid a lack of accountability by managers and permit an appropriate sorting of investors to avoid the increased cost of ownership that comes with a heterogeneous group of investors?

In the context of shareholders pressing for firms to include ESG provisions to govern managerial discretion or to mandate ESG policies, the shareholders still face the endemic problem of managerial opportunism or shirking. The question is whether and how the generic ESG provision, if adopted, would impact the normal corporate law provisions that shareholders might use to control such opportunistic behavior. The taxonomy for legal intervention should examine whether the benefits from the legal rule, either current or prospective, would achieve more benefits in terms of controlling divergence than can be achieved with other private strategies the parties might adopt without introducing greater offsetting costs. Robert Thompson, in a keenly insightful article, has explored many of these alternative strategies that parties can utilize to manage the agency costs that otherwise burden the relationship.[224]

If those strategies can contain the problems at less cost than the legal rule (mandatory or otherwise) regarding ESG, and the legal rule does introduce new costs, then there would be a compelling case for deferring to the private arrangements, but not otherwise.[225]

Some alternative private arrangements are market based and do not involve private contracts mandating the pursuit of ESG by managers. The market for corporate control and the capital market are two such private checks that the market uses to discipline ineffective

223. *See generally* Investment Company Names, 87 Fed. Reg. 36594 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, 274); Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279); The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).

224. *See generally* Thompson, *supra* note 20.

225. *See* R.J. Coffey, The Birth of an Interventional Choice—A Justificational Analysis (Summer 2005) (unpublished manuscript) (on file with the Case Western Reserve Law Review).

managers. If managers are not behaving to further corporate value, then the firm will have difficulty accessing capital for its needs. Similarly, if the managers are not performing well for the firm, takeover bidders may enter the market on the assumption that they can perform better and raise the value of the firm.[226] These private market checks, if effective, may obviate the need for a legal rule to constrain manager opportunism.

However, an undifferentiated contractual provision for a manager to pursue ESG might interfere with these market checks on managers. It would be difficult for the market to judge whether the manager had acted improperly when the managers are directed to pursue ESG. The public lacks the inside information necessary to make this judgment call, and the lack of clarity on the managers' duties created by the ESG mandate would make it difficult to judge whether there was mismanagement or not. Thus, the market control devices might not be available to constrain opportunism by managers.

The lack of clarity on the meaning of ESG would also hamper other private devices which might be used to curb opportunism. As noted above, the lack of clarity about the meaning of ESG could significantly hamper the ability of the market to price the shares to reflect the risk of opportunism. If the effect of the ESG provision is unclear, the buyer of the stock does not know whether or not shareholder value will be sacrificed to satisfy the desires of external stakeholders or shareholder values at the expense of shareholder/market value. That lack of clarity might insulate managers from oversight and increase opportunism. Other private strategies that would look for management deficiencies would also be difficult to implement when there is a lack of clarity on how the manager is supposed to trade off the interests of the shareholders when those shareholders' interests' conflict and when they are adverse to other stakeholders. That would increase the burden on the manager and introduce new costs of ownership.

Because ESG provisions pose particular challenges for how a variety of private constraints on managerial opportunism would operate, the next question is whether a generic ESG provision should be recognized as a private strategy that courts should defer to or whether it should be rejected because it does not, in an undifferentiated form, adequately constrain duty of loyalty violations.

226. Antitakeover legislation was often motivated by concerns for stakeholders, like communities who might be adversely affected by takeovers. However, as Bebchuk and Tallarita point out, antitakeover legislation had a more nefarious motive of protecting ill-performing managers. Bebchuk & Tallarita, *supra* note 17, at 105 (citing Mark J. Roe, *Takeover Politics*, *in* The Deal Decade 321, 338–52 (Margaret M. Blair ed., 1993); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cinn. L. Rev. 457, 458 (1988)).

First, although an undifferentiated ESG provision would not expressly constitute, by its terms, a reversal of the duty of loyalty under one iteration of meaning, it would be construed as a limitation on the duty of loyalty and, thus, should be rejected since the duty of loyalty is considered immutable and un-waivable.[227]

Second, there is a probability that one possible meaning of the ESG provision would allow a corporation to sacrifice shareholder wealth for external stakeholders, which would result in an imminent loss to firm value, at least for traditional investors.[228] Since shareholders bought the shares with the expectation of the pursuit of shareholder maximization as the sole end of managerial discretion, any change in the terms of that contract would result in a hit to the value. In that situation, the ability of the shareholder to exit would be hampered by difficulties in pricing the shares once they are encumbered by an amorphous duty to follow ESG without further delineation.

Third, if the inclusion of a generic ESG provision is considered in the larger context of the need to control agency costs in a shareholder-manager relationship, the ESG provision, in an undifferentiated format, would not work to curb opportunism by managers. Because it would give managers unlimited discretion to consider ESG without having to account for the consequences or articulate any trade-offs, courts and Restatement scholars should be hesitant to allow for ESG provisions in a non-constituency jurisdiction.

Although courts may have expertise and a comparative advantage in responding to duty of loyalty concerns, the undifferentiated ESG provisions in a charter or bylaw would impair the ability of courts to supervise duty of loyalty cases. Although "the fiduciary duty of loyalty may be the most effective way to deter subtle forms of management self-dealing,"[229] the power of courts would be a virtual nullity if the ESG provision remains undifferentiated since the court would be unable to determine if a violation had occurred. The power to regulate abuses remains with the retention of a fiduciary duty for matters which could not be anticipated. For that to occur, the ESG provision in an undifferentiated form cannot be permitted to enter contractual agreements via charter, bylaw, or shareholder agreement.

The other cost, not fully accounted for in an undifferentiated ESG provision, would be the increased costs of ownership that would necessarily accompany a heterogeneous group of shareholders with different commitments to ESG. The costs of trading off those interests without a shareholder maximization lodestar would increase the costs of ownership. That cost should be factored into a decision about whether to

227. *See* Gordon, *supra* note 13, at 1597.

228. Povilonis, *Contracting for ESG*, *supra* note 10, at 633. *See also* Miller, *supra* note 89, at 778–79.

229. Thompson, *supra* note 20, at 408.

embrace undifferentiated ESG provisions in whatever private ordering context occurs.

B. Do Contractual ESG Provisions Offer Efficiency Advantages Similar to a Corporate Opportunity Waiver?

In determining whether an ESG provision in a contract should be enforced, and whether doing so would be in the best interests of the firm and the shareholders, one could scrutinize the provision to see if it might offer the same efficiency advantages that a waiver of a corporate opportunity ex ante might offer a firm. In the Corporate Opportunity Waiver (COW) context,[230] in exchange for credibly giving up the right to pursue selected corporate opportunities, the firm would be allowed to exchange that right for "cheaper financing" or other benefits to the firm.[231] Normally, to comply with the duty of loyalty, an agent of the firm presented with a corporate opportunity must first offer the opportunity to the firm. Only if the firm declines to pursue the opportunity can the agent proceed with the opportunity that would ordinarily belong to the firm, not the agent. In recent legislation, Delaware has eliminated the need for the agent to seek prior approval from the firm through legislation that authorizes waivers of the need to seek such approval.[232] The difficulty with assessing whether companies should be allowed to insert ESG provisions in investor contracts is that it is not clear that the company would be signaling anything by adopting an ESG provision given its lack of clear meaning. Thus, it is hard to argue that there would be efficiency gains from adopting ESG provisions that would be comparable to the corporate opportunity waivers. Further, the adoption of an ESG provision in an undifferentiated form would put a significant burden on courts to decide the meaning of the provision and to resolve whether the ESG provision was intended to waive the duty of loyalty. That uncertainty about the meaning would act as a drag on firm value as firms struggle with how ESG provisions would affect managerial discretion and how value could be assigned given the uncertainty of whether managers would be able to place stakeholders above shareholders. In addition, there is uncertainty regarding what metrics would be used to determine the overall effect of an ESG provision on firm performance.

The statutory waiver of the corporate opportunity doctrine initiated by the 2000 Delaware amendments seeks to avoid some of the

230. The corporate opportunity doctrine precludes officers and directors from benefiting from the opportunities that belong to the corporation. Rauterberg & Talley, *supra* note 93, at 1077–78. For further explanation and discussion of COWs, see Rauterberg & Talley, *supra* note 93.

231. *Id.* at 1115.

232. *Id.* at 1078.

uncertainty and "unpredictability"[233] endemic to the traditional "nebulous *standard* of the common law with a *rule* crafted by the parties themselves."[234] There is at least a requirement in the statute that the opportunities be carefully delineated since it covers waivers of "specified business opportunities or specified classes or categories of business opportunities."[235] The statute "does not invite corporations to invert or 'flip' the default."[236] In other words, it does not sanction a vague waiver of all corporate opportunities.

It is hard to see how an ESG provision, if undifferentiated, would reach the level of specificity that would be required for a corporate opportunity waiver in the statute. That specificity is important because it allows for an exchange between a firm and a fiduciary, with an investor investing in a firm in exchange for an ex ante waiver of a corporate opportunity. This could be welfare enhancing if the fiduciary and not the firm would have the comparative advantage for exploiting a particular opportunity.[237]

In assessing whether a case can be made for allowing an ESG provision to function as a waiver of the duty of loyalty, though not specifically covered by the statutory provision when the ESG provision is undifferentiated, one would need to ask whether the court would accept an ESG provision without the level of clarity normally required for the waiver of a fundamental right.[238]

Even leaving aside the level of specificity required for a waiver of a fundamental right, one should ask whether there are efficiency reasons for allowing an undifferentiated ESG standard to attach to a duty of loyalty. Because the duty of loyalty would remain unclarified and murky, parties who were willing to invest in a company which would sacrifice shareholder wealth for stakeholder value would not know where to allocate their resources. This is the sorting problem. A similar

233. *Id.* at 1104.

234. *Id.* at 1117.

235. *Id.* at 1095.

236. *Id.* at 1097.

237. Firms may want to sacrifice some income to pursue ESG because they are "'least-cost altruists,' with a comparative advantage in offering 'socially desirable things.'" Levmore, *supra* note 11, at 713.

238. *See* Manti Holdings, LLC v. Authentix Acquisition Co., No. 2017-0887-SG, 2018 WL 4698255, at *2 (Del. Ch. Oct. 1, 2018) (holding that "a waiver of the statutory right to appraisal requires language evincing the clear intent to waive," thus ambiguous language is insufficient for a court to find the waiver of a fundamental right under the stockholders' agreement). The effect of this court's decision is to require unambiguousness in the language of the waiver. *Id. See also* Manti Holdings, LLC v. Carlyle Grp. Inc., No. 2020-0657-SG, 2022 WL 444272, at *2 (Del. Ch. Feb. 14, 2022) ("A waiver of fiduciary duties, to the extent allowed by Delaware law, must be clear and unambiguous.").

dilemma confronts an investor who wishes to pressure companies to pursue ESG but not at the expense of shareholder wealth. With only an undifferentiated meaning of how ESG would affect the duty of loyalty, shareholders might erroneously invest in companies who were willing to subordinate shareholder value to stakeholder value. As long as the ESG provision remains unclarified, both sets of investors may misallocate resources due to a misperception about how the company would trade off shareholder and stakeholder interests.

There are other investors who would want to know more details about how the trade-offs between shareholder value would be made. Absent such information, some investors might be unwilling to invest, representing a potential loss in gains from trade. A failure to differentiate among investors would lead to an inefficient sorting of investors as well as the need to make trade-offs amongst different types of investors who have fundamental disagreement on the key issue of whether stakeholder or shareholder values should trump shareholder value and to what degree.

In the context of the recently enacted Delaware COW statute,[239] there are plausible arguments for why—in certain contexts where there is heterogeneity of corporate opportunities, with some fiduciaries better able to capitalize on corporate opportunities than the firm—there are efficiency arguments for an ex ante waiver. There are no plausible arguments for comparable efficiencies from an undifferentiated ESG standard. Investors cannot allocate resources appropriately. Judges will not know how to scrutinize managers' actions, thus increasing the burden on courts. It would remain unclear if the firm adopted an ESG provision authorizing a departure from shareholder primacy. If so, would that departure represent an impermissible action violative of section 102(b)(7)? If firms adopt ESG provisions in board resolutions, can the directors continue to pursue shareholder primacy as the sole end, or will the adoption of a board resolution muddy their fiduciary responsibilities to shareholders?

VI. What Solutions Have Been Offered So Far on ESG and Do They Solve the Hidden Cost Problem?

The SEC has recently proposed several rules which will increase disclosure regarding ESG both at the company and investment fund levels. It has proposed increased quantitative disclosure around greenhouse gas emissions and strategies for addressing ESG risks.[240] While these quantitative disclosures provide insight on how greenhouse gas emissions and other ESG risks may affect the financial performance of

239. *See* Del. Code Ann. tit. 8, § 122(17) (2023).

240. Press Release, SEC, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/MYP5-JW8N].

a company, the disclosure obligations of greenhouse gases are not restricted to those affecting company value; thus, the disclosure regarding greenhouse gases will not shed light on how a company will trade off ESG against shareholder value maximization. It implicitly assumes that the pursuit of ESG will result in a win/win situation. Additionally, it only addresses one aspect of ESG—the environmental harm related to climate risk and emissions—while leaving the discussion of the broader concept and its definition to other bodies or regulations.[241] Thus, while the proposed rule would improve investor access to climate-risk-related information about the companies they engage with, it has limited impact on the information investors have about how managers weigh the differing preferences of the individual investors when it comes to the pursuit of ESG over non-ESG objectives. The new SEC rule does little to clarify that issue, and so the potential for a disparate non-heterogeneous group of investors could increase the cost of ownership for any company. A contract provision mandating the pursuit of ESG, if undifferentiated and without any metric for trading off the weights that different investors attach to ESG, would increase burdens on company managers and lead to a failure to sort investors according to preference and risk profile.

Professor Saul Levmore proposes one solution: a safe harbor that might solve the problem of an undifferentiated term of ESG attracting different types of investors, some of whom might only prefer value maximization and others of whom would place a premium on "socially desirable" values.[242] He argues that firms currently have no incentive to disclose more precise information on the costs and benefits of ESG because they can attract both types of investors, more conventional investors and those drawn to the pursuit of ESG.[243] If the company chooses to disclose additional information about their ESG goals, it could cause either group of investors to choose other investments.[244] Additionally, disclosing more information leaves the company open to additional liability.[245] Levmore proposes a safe harbor for companies that disclose information about "costs and allocations of their present and planned ESG deviations from value-maximization."[246] That safe harbor for estimates verified by an accounting firm, or a third party, would begin to achieve the sorting of investors according to their ESG

241. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).

242. Levmore, *supra* note 11, at 713.

243. *Id.* at 726.

244. *See id.* at 716–17.

245. *Id.* at 727.

246. *Id.* at 726.

preferences and risk profile.[247] Those unwilling to accept the sacrifice of profits that might result from a particular company's pursuit of ESG would not invest in that firm.[248] Thus, it would help to sort investors according to type.[249] Levmore's proposal would help address the problem with an undifferentiated ESG provision in a contract provision, sort investors according to type, and lower the cost of ownership by reducing the heterogeneity of investors.

The SEC in its recently proposed rules has implicitly recognized a number of flaws with the current undifferentiated use of the term *ESG* in the context of investment funds managed by investment advisors. The agency has highlighted the possibility that a fund with the term *ESG* in its name may mislead investors by exaggerating the commitment of the fund to ESG.[250] Currently, outside of themed ESG funds (like clean energy or water), general ESG funds have the same general top holdings as non-ESG fund peers.[251] Including *ESG* in the fund name is currently a marketing signal instead of meaning a clear investment strategy.[252]

The SEC's proposed rule changes concerning the naming of funds and regulating investment funds and advisors would do a better job at sorting investors and, therefore, would be useful tools to promote efficiency in investments by helping to sort investors according to their various ESG goals (i.e., board diversity, executive compensation, or climate change). Currently, inefficiencies can occur in the context of funds managed by investment advisors. In some instances, the fund might be denoted as an ESG fund, but that name might connote different meanings to different investors. That could lead to the fund being misleading to investors and, thus, a violation of the investment advisor's duty not to create misleading statements. Another inefficiency could occur with distortions in the investors who are attracted to invest

247. *Id.* at 727–28, 727 n.26.

248. *Id.* at 715.

249. His proposal might pose a problem for jurisdictions in which the company must adhere to value maximization as the single goal for the company. His proposal, which would allow investors to sacrifice profits for socially minded values, would work in a constituency jurisdiction or in a jurisdiction which adopted shareholder-value maximization rather than market value. *Id.* at 716–17. *See also* Hart & Zingales, *supra* note 8, at 270–71.

250. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36668 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279).

251. Dana Brakman Reiser & Anne Tucker, *Buyer Beware: Variation and Opacity in ESG and ESG Index Funds*, 41 CARDOZO L. REV. 1921, 1956 (2020).

252. *Id.* at 1927, 1945.

in a fund. If the claims of a commitment to ESG are exaggerated, then investors who place a premium on ESG will be drawn to a fund when they would have invested in a different fund had they been aware of the true facts. They will also pay a premium for doing so. A similar inefficiency could occur with investment advisers and investment companies when they provide incomplete information regarding their ESG practices. The SEC proposes that funds that are designated as pursuing a specific type of ESG, like wind or solar for example, must devote 80 percent of their investments into wind and solar assets, although there might be some discretion as to how the investments are allocated between these two options.[253]

This requirement would prevent some exaggeration by funds as the investor would know that at least 80 percent of the assets in the fund are put toward whatever ESG type is designated in the name. However, it would not mitigate the problem of investors with different preferences for or willingness to sacrifice profits for the pursuit of ESG. Therefore, the SEC proposal might fail to achieve the kind of sorting that the Levmore proposal would since it fails to require a disclosure on what type of profits could be sacrificed to achieve socially desirable goals and does not alert investors to the fact that the pursuit of ESG might not be a win/win proposition.[254]

The SEC has, however, proposed that funds should be subject to additional minimum disclosure requirements. Currently, there is no disclosure regime when it comes to ESG funds, but the SEC has proposed new Climate Disclosure rules. The current disclosure by companies uses vague generic statements that provide no real substance to the investor.[255] Alternatively, under the new SEC rule, funds that market themselves as ESG-focused would have to "summarize how [the fund] incorporates ESG factors into its process for evaluating, selecting, or excluding investments."[256] These "ESG-Focused Funds" are ones where the consideration of ESG is the main factor in investment selection.[257] Other funds known as "Integration Funds" would have to

253. Investment Company Names, 87 Fed. Reg. 36594, 36600 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 230, 232, 239, 270, 274).

254. Levmore, *supra* note 11, at 721.

255. Reiser & Tucker, *supra* note 251, at 1940–42, 1974.

256. Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices, 87 Fed. Reg. 36654, 36665 (proposed June 17, 2022) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 249, 274, 279).

257. *Id.* at 36657. This proposed rule would delineate and define three categories of funds: Integration, ESG-Focused, and Impact Funds (which is a subset of ESG-Focused Funds that seeks to achieve a specific ESG impact). *Id.* Generally, Integration Funds are "funds that consider one or more ESG factors as part of a broader investment process that also

disclose how they consider ESG and non-ESG factors in investment selection. However, unlike ESG-Focused Funds, in Integration Funds, "ESG factors may be considered in the investment selection process but are generally not dispositive compared to other factors when selecting or excluding a particular investment."[258] These Integration Funds would provide that "ESG factors are generally no more significant than other factors in the investment selection process."[259] The advantage of the SEC approach is that it would require investment advisors to distinguish between ESG-Focused Funds, in which ESG factors are "a significant or main consideration in selecting investments or in engaging with portfolio companies."[260] Requiring such differentiation would help to promote self-selection among investors and promote efficiency in that way.

With these increased disclosures, investors would be able to select the funds that best match their preferences, which would create more efficient investments by preventing the mismatching of investors with funds that do not match their preferences. By distinguishing funds that weigh ESG factors differently and signaling those differences to investors, the SEC can promote efficient investments. Eventually, investors would gain data on the effect that the respective investment strategies of ESG-Focused Funds and Integration Funds had on financial performance of various companies or industries.

The Integration Fund would appeal to the traditional investor since it proposes a layered disclosure approach. By requiring only certain ESG disclosures in Integration Funds, the SEC's goal is to discourage any overemphasis on ESG, which "impede[s] informed investment decisions."[261] So, in Integration Funds, "the need for investors to have access to [ESG] information . . . [is balanced with the need to] mitigat[e] the risk of overemphasis of ESG factors."[262]

By contrast, ESG-Focused Funds and its subset of ESG Impact strategies would appeal to investors who place higher emphasis on ESG, since these funds require much more detailed disclosures "to provide investors a clear, comparable, and succinct summary of the salient

incorporates non-ESG factors," while ESG-Focused Funds "include funds that employ several different ESG investment strategies as a significant or main consideration in selecting investments." *Id.* at 36708. Under this proposed rule, the requirements for Integration Funds to disclose information regarding ESG factors are more limited relative to the requirements for ESG-Focused Funds. *Id.*

258. *Id.* at 36657.

259. *Id.* at 36660.

260. *Id.* at 36657.

261. *Id.* at 36660.

262. *Id.* at 36661.

features of a fund's implementation of ESG factors. This information would help an investor determine if a given ESG-Focused Fund's approach aligns with the investor's [ESG] goals."[263]

The proposed disclosures regarding ESG would act as a signal to investors that ESG considerations are extremely important to the investment strategy of the firm. Thus, by delineating the funds, the SEC is helping to resolve the sorting issue of investors, specifically aiding the issue of increased ownership costs that stem from heterogenous preferences. However, the proposed SEC rule is not a complete resolution, as it does not provide clarity to the investors about how much value is at risk as a result of the company's focus on ESG. In order to achieve greater sorting of investors, the SEC should incorporate Professor Levmore's safe harbor rule into the description of the strategy for ESG funds to alert the investor as to the type of profit that might be sacrificed or at risk to pursue ESG goals. Whether the decision of the fund manager to sacrifice profit in pursuit of ESG would violate the fiduciary duty of the investment adviser to the fund is an issue that still needs to be resolved.

Moreover, the SEC's new Proposed Climate Disclosure[264] rules threaten to promote more confusion among investors. The SEC plans to require disclosure of the financial impacts of transition activities to take account of "increased costs attributable to climate-related changes in law or policy, reduced market demand for carbon-intensive products leading to decreased sales, prices or profits for such products," as well as any strategies it is taking to "manage climate-related risks."[265] The difficulty with this approach is that because companies are already required to disclose material matters in their financial statements, these new requirements suggest that the SEC is requiring the disclosure of risks that may or may not directly affect the company's performance. Although the SEC often couches the disclosure requirement in terms of a materiality requirement, some of the requested information may not affect the financial performance of the company and there is great uncertainty about the likely financial effects of climate change on the financial performance of companies; the SEC will require companies to disclose information that may not be related to the company's financial performance.[266] Requiring disclosure of such matters where there is no evidence of causation or certainty of the effects on firm value will allow companies to continue to mask what the financial trade-off would be of

263. *Id.* at 36663.

264. *See* The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (proposed Apr. 11, 2022) (to be codified at 17 C.F.R. pts. 210, 229, 232, 239, 249).

265. *Id.* at 21350, 21356.

266. *Id.* at 21344–45 (discussing disclosure of greenhouse gas emission data in addition to material climate-related business information).

trying to mitigate a risk when that risk may not actually be costly for the company. Investors should have the information needed to determine the trade-offs companies make when they invest in a risk that may have no material financial impact in order to decide whether the company is making financial sacrifices that are not justified. The emphasis on mandating climate-change disclosure—when the evidence of financial impact is lacking—will further exacerbate the failure to sort investors according to disparate preference by suggesting that taking account of climate risks means that failure to act will necessarily have a negative financial impact when that may not be the case. Further, it increases the risks and liability for the board of directors, which is being asked to disclose information and to take actions to account for risk when the data does not provide evidence on the financial benefits of such steps.

Conclusion

Although corporate law typically defers to private ordering by firms, ESG should not be left entirely to private ordering. The lack of clarity on ESG will render the provision in a contract of a firm unenforceable under contract law. The same lack of clarity will lead to inefficient sorting among investors and will mislead investors with different preferences on the weight to be attached to ESG values versus the financial value of the firm.

This Article suggests that the persisting ambiguity surrounding the unenforceability of ESG highlights the need for a new taxonomy for analyzing whether a contract provision mandating ESG is efficient or instead increases the costs of ownership for firms due to heterogeneity of investors, increasing agency costs, and opportunism.

Lastly, the current SEC rule on name changes and institutional advisors will only partially solve the problem of the heterogeneity and inefficient sorting of investors. Both companies and funds must clarify the extent to which a company or fund would be willing to sacrifice shareholder value to pursue ESG values. The SEC must force this disclosure to lower the cost of ownership and promote the efficient sorting of investors.

Our recommended disclosure, combined with the other recently proposed disclosure rules by the SEC on naming of funds and differentiation of investors under the Investment Advisors Act, means that ESG would become an unambiguous term that solves many of the efficiency problems investors face when pursuing their ESG goals. This unambiguity would allow a court or any decision-maker to uphold private ordering that includes an ESG term and would at the same time help solve the costs of ownership that would come with a large heterogeneity of investors. We would urge the adoption of Levmore's safe harbor rule.

Appendix

SEC Public Statements on Climate-Related Disclosure

Date	SEC Public Statement	Source
Varies—last updated 10/26/2021	SEC Response to Climate and ESG Risks and Opportunities (with Public Input Welcome), https://www.sec.gov/sec-response-climate-and-esg-risks-and-opportunities	SEC Webpage
Spring 2021	Proposed Rule: Climate Change Disclosure—Spring 2021 Agenda, https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202104&RIN=3235-AM87	RIN: 3235-AM87
9/22/2021	Sample Letter to Companies Regarding Climate Change Disclosures, https://www.sec.gov/corpfin/sample-letter-climate-change-disclosures	SEC Webpage
7/28/2021	Chair Gensler's "Prepared Remarks Before the Principles for Responsible Investment 'Climate and Global Financial Markets' Webinar," https://www.sec.gov/news/speech/gensler-pri-2021-07-28	SEC Webpage
5/24/2021	Speech: "Living in a Material World: Myths and Misconceptions about 'Materiality'," https://www.sec.gov/news/speech/lee-living-material-world-052421	SEC Webpage
6/28/2021	Speech: "Climate, ESG, and the Board of Directors: 'You Cannot Direct the Wind, But You Can Adjust Your Sails'," https://www.sec.gov/news/speech/lee-climate-esg-board-of-directors	SEC Webpage
3/11/2021	Statement ESG Disclosure: "Keeping Pace with Developments Affecting Investors, Public Companies and the Capital Markets" (33rd Annual Tulane Corporate Law Institute),	SEC Webpage

	https://www.sec.gov/news/public-statement/coates-esg-disclosure-keeping-pace-031121	
3/23/2021	Press Release: "SEC Responds to Investor Demand by Bringing Together Agency Information About Climate and ESG Issues," https://www.sec.gov/news/press-release/2021-52	SEC Press Release 2021-52
3/4/2021	Press Release: "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," https://www.sec.gov/news/press-release/2021-42	SEC Press Release 2021-42
2/1/2021	Press Release: "Satyam Khanna Named Senior Policy Advisor for Climate and ESG," https://www.sec.gov/news/press-release/2021-20	SEC Press Release 2021-20
5/9/2022	Press Release: "SEC Extends Comment Period for Proposed Rules on Climate-Related Disclosures, Reopens Comment Periods for Proposed Rules Regarding Private Fund Advisers and Regulation ATS," https://www.sec.gov/news/press-release/2022-82	SEC Press Release 2022-82
5/25/2022	Press Release: "SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices," https://www.sec.gov/news/press-release/2022-92	SEC Press Release 2022-92
6/6/2022	Press Release: "SEC Investors Advisory Committee to Discuss Non-Traditional Accounting and Climate Disclosure on June 9," https://www.sec.gov/news/press-release/2022-100	SEC Press Release 2022-100

1/30/2020	"Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures; Other Ongoing Disclosure Modernization Initiatives; Impact of the Coronavirus; Environmental and Climate-Related Disclosure," https://www.sec.gov/news/public-statement/clayton-mda-2020-01-30	SEC Webpage
Real Time	Public Comments on Climate Change Disclosures, https://www.sec.gov/comments /climate-disclosure/cll12.htm	SEC Webpage
7/28/2021	"Office Hours with Gary Gensler: The SEC & Climate Risk Disclosure," https://www.youtube.com /watch?v=xjSk7wWJG6o	YouTube
Real Time	A search of the SEC's website yielding 5,545 results concerning "climate disclosure": https://secsearch.sec.gov /search?utf8=%3F&affiliate =secsearch&query=Climate +Disclosure	SEC Webpage