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The Perils and Questionable Promise of ESG-Based Compensation

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Abstract

With the rising support for stakeholder capitalism and at the urging of its advocates, companies have been increasingly using environmental, social, and governance (ESG) performance metrics for CEO compensation. This Article provides a conceptual and empirical analysis of this trend, and exposes its fundamental flaws and limitations. The use of ESG-based compensation, we show, has at best a questionable promise and poses significant perils. Based partly on an empirical analysis of the use of ESG compensation metrics in S&P 100 companies, we identify two structural problems. First, ESG metrics commonly attempt to tie CEO pay to limited dimensions of the welfare of a limited subset of stakeholders. Therefore, even if these pay arrangements were to provide a meaningful incentive to improve the given dimensions, the economics of multitasking indicates that the use of these metrics could well ultimately hurt, not serve, aggregate stakeholder welfare. Second, the push for ESG metrics overlooks and exacerbates the agency problem of executive pay, which both scholars and corporate governance rules have paid close attention. To ensure that they are designed to provide effective incentives rather than serve the interests of executives, pay arrangements need to be subject to effective scrutiny by outsiders. However, our empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult if not impossible for outside observers to assess whether this use provides valuable incentives or rather merely lines CEO's pockets with performance-insensitive pay. The current use of ESG metrics, we conclude, likely serves the interests of executives, not of stakeholders. Expansion of ESG metrics should not be supported even by those who care deeply about stakeholder welfare.

Keywords: corporate purpose, corporate social responsibility, stakeholders, stakeholder governance, stakeholder capitalism, compensation, corporate governance, ESG

JEL Classifications: D22, G34, G38, K22, M12

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THE PERILS AND QUESTIONABLE PROMISE OF ESG-BASED COMPENSATION

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ABSTRACT

With the rising support for stakeholder capitalism and at the urging of its advocates, companies have been increasingly using environmental, social, and governance (ESG) performance metrics for CEO compensation. This Article provides a conceptual and empirical analysis of this trend and exposes its fundamental flaws and limitations. It shows that the use of ESG-based compensation has, at best, a questionable promise and poses significant perils.

We identify two structural problems with the use of ESG compensation metrics, and provide empirical analysis highlighting their presence in current practices of S&P 100 companies. First, ESG metrics commonly attempt to tie CEO pay to limited dimensions of the welfare of a limited subset of stakeholders. Therefore, even if these pay arrangements were to provide a meaningful incentive to improve the given dimensions, the economics of multitasking indicates that the use of these metrics could well ultimately hurt, not serve, aggregate stakeholder welfare.

Second, and most importantly, the push for ESG metrics overlooks and exacerbates the agency problem of executive pay. To ensure that they are designed to provide effective incentives rather than serve the interests of executives, pay arrangements need to be subject to effective scrutiny by outsider observers. However, our empirical analysis shows that in almost all cases in which S&P 100 companies use ESG metrics, it is difficult, if not impossible, for outside observers to assess whether these metrics provide valuable incentives or merely line CEO's pockets with performance-insensitive pay.

Current practices for using ESG metrics, we conclude, likely serve the interests of executives, not of stakeholders. Expansion of such use should not be supported even by those who care deeply about stakeholder welfare.

Keywords: corporate purpose, corporate social responsibility, stakeholders, stakeholder governance, stakeholder capitalism, compensation, corporate governance, ESG

JEL Classification: D22, G34, G38, K22, M12

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I. INTRODUCTION

A heated debate is taking place on how to create a more inclusive capitalism that serves not only the interests of shareholders but also those of other "stakeholders," including employees, consumers, suppliers, communities, and the environment. According to an increasingly influential view, companies can accomplish this goal by moving away from the traditional shareholder primacy model and shifting toward a new conception of corporate purpose. This stakeholder governance view (in short, "stakeholderism") recommends that corporate leaders be given enhanced discretion to take into account the interests of all stakeholders, not only shareholders.[1]

In response to skepticism about whether corporate leaders have adequate incentives to create value for stakeholders, some supporters of stakeholderism have posited that corporate leaders can be incentivized to improve stakeholder welfare by tying their compensation to environmental, social, and governance (ESG) goals. Based on this view, not only have compensation consultants been busy developing ways to incorporate ESG metrics into executive compensation, but many companies have been using such metrics in their pay arrangements, and supporters of stakeholderism have been urging an expansion of this practice.[2] This trend is based on the idea that ESG-based compensation carries the promise of creating effective incentives for CEOs and top executives to improve the welfare of stakeholders and reduce their companies' negative externalities. Reacting to the increased use of ESG metrics, the SEC recently requested comments on what companies should tell investors about the use of such metrics.[3]

This Article provides a conceptual and empirical analysis of the use of ESG metrics in executive pay. We conduct a detailed investigation of the current use of ESG metrics in S&P 100 companies and examine the extent to which expansion of these practices may or may not be beneficial. Our analysis identifies two structural problems with ESG metrics, which we show to be difficult to solve and which severely limit the benefits of this practice. We conclude that the use of ESG-based compensation has a questionable promise and poses significant perils.

In particular, we warn that using ESG metrics threatens to reverse the progress achieved in the past few decades in making executive pay more

1. *See infra* Part II.A.

2. *See infra* Part II.B.

3. *See* Reopening of Comment Period for Pay versus Performance, 87 Fed. Reg. 5751 (proposed Feb. 2, 2022) (to be codified at 17 C.F.R. pts. 229, 240, 249).

transparent, more sensitive to actual performance, and more open to outside oversight and scrutiny. We explain that encouraging and expanding the use of ESG-based compensation might give self-interested executives a powerful tool to increase their payoffs without creating meaningful value for stakeholders while potentially diluting executives' incentives to deliver value to shareholders.

Our analysis is organized as follows. Part II discusses the recent rise of stakeholderism and the increasing demand for stakeholder-oriented governance arrangements. Many prominent corporate leaders and advisers, as well as influential business interest groups, such as the Business Roundtable and the World Economic Forum, have publicly announced a redefinition of the purpose of the corporation—namely, from shareholder primacy to stakeholder governance—and have pledged to deliver value to all stakeholders.[4]

In particular, Part II discusses the growing trend of including ESG goals in executive compensation packages, presented as an effective tool to incentivize CEOs and top executives to take into account the interests of stakeholders and create value for them.[5] This trend is partly due to well-intentioned (but, as we explain, mistaken) support from investors and business leaders genuinely interested in improving the treatment of stakeholders. However, it might also be driven by corporate leaders who recognize that ESG-based compensation can serve their private interests.

The growing use of ESG-based compensation raises two important questions for corporate governance and the debate on stakeholderism. The first is whether the current practices of ESG-based compensation produce meaningful incentives to increase stakeholder welfare. The second is whether the current limits of ESG-based compensation can be improved and, if so, to what extent.[6]

Part III provides an overview of the companies in our sample and their use of ESG compensation metrics. We chose to focus on the 97 U.S. companies included in the S&P 100 index, as they represent more than half of the entire U.S. stock market and arguably have a significant impact on stakeholders and society at large.[7] We found that slightly more than half (52.6%) of these companies included some ESG metrics in their 2020 CEO compensation packages. These metrics focus chiefly on employee composition and employee treatment, as well as customers and the

4. *See infra* Part II.A.
5. *See infra* Part II.B.
6. *See infra* Part II.C.
7. *See infra* Part III.A.

environment, but also, to a much smaller extent, communities and suppliers.

ESG metrics are mostly used as performance goals for determining annual cash bonuses.[8] However, most companies do not disclose the weight of ESG goals for overall CEO pay, and those that do disclose it (27.4% of the companies with ESG metrics) assign a very modest weight to ESG factors (between less than 1% to 12.5%, with most companies assigning a weight between 1.5% and 3%).

Part IV discusses the first structural limit of ESG-based compensation. ESG metrics inevitably focus on a limited number of welfare dimensions of a limited number of stakeholders. Despite the promise of a new paradigm that delivers value to "all stakeholders," the potential breadth of companies' stakeholders, and the multiple ways their interests are affected by corporate decisions, companies choose a small subset of stakeholder groups and interests on which to focus.[9]

The narrowness of ESG metrics reveals the limits of ESG-based compensation and also raises a well-known problem in the economics of multitasking. By incentivizing CEOs to improve the performance of narrow quantifiable metrics, companies create distorted incentives to neglect other significant but hard-to-quantify dimensions.[10]

Part V examines the second, and fatal, limit of ESG-based compensation. CEOs exert substantial influence on their boards of directors and can therefore extract significant value from their companies through excessive compensation packages. In order to mitigate this agency problem, compensation arrangements should be tied to performance, and companies should disclose enough information to allow an outside observer to review and assess the meaningfulness of the performance.[11]

Yet almost no companies in our sample use ESG metrics that meet this standard. Most companies mention using ESG goals but do not disclose the relevant targets and actual outcomes, or they leave significant discretion to their boards. Among the very few companies that disclose clear and objective

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8. One reason why companies use ESG metrics in the annual incentive plan (bonus) but rarely in the long-term incentive plan (which is typically an equity-based plan) might be that the targets in the long-term incentive plan must be objective in order to benefit from the favorable accounting treatment allowed for equity-based incentives. Michael Bonner & Melissa Burek, *Long-Term Incentive Plans: Payouts and Performance Alignment*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 12, 2022), https://corpgov.law.harvard.edu/2022/05/12/long-term-incentive-plans-payouts-and-performance-alignment [https://perma.cc/NMJ5-AT5X].

9. *See infra* Parts IV.A., IV.B.

10. *See infra* Part IV.C.

11. *See infra* Parts V.A., V.B.

goals and actual outcomes, almost none provide sufficient contextual information allowing outsiders to review and assess the pay arrangements.[12]

Part VI sets forth our conclusions on ESG-based executive compensation and the implications for the broader debate on stakeholderism.[13] Our analysis shows that the ESG compensation trend should not be expected to produce meaningful incentives for the creation of value for stakeholders and that it poses the danger of creating vague, opaque, and easy-to-manipulate compensation components, which self-interested CEOs can exploit to inflate their payoffs, with little or no accountability for actual performance.

II. THE STAKES

In this Part, we discuss the recent spread of stakeholderism and, in particular, the increasing adoption of ESG metrics in executive compensation arrangements as a tool to incentivize corporate leaders to give weight to the interests of stakeholders, not only of shareholders. The study of this phenomenon and its actual efficacy, we argue, is important for assessing the promise of stakeholder governance.

A. The Rise of Stakeholderism

For decades, corporate law scholars have debated whether directors should serve only shareholders or also other constituencies, such as employees, customers, suppliers, or society at large.[14] Recently, however, this longstanding debate on the purpose of the corporation has taken a new form. On the one side, advocates of stakeholderism suggest that corporate leaders be given enhanced discretion to consider the interests of stakeholders, not only of shareholders, when making business decisions.[15] Stakeholderism thus encourages reliance on managerial discretion to produce corporate

12. *See infra* Part V.C.

13. *See infra* Part VI.

14. For a classic example of this debate, see generally A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

15. For recent defenses of the view that corporate purpose includes delivering value to stakeholders and society, see, for example, COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD (2019); ALEX EDMANS, GROW THE PIE: HOW GREAT COMPANIES DELIVER BOTH PURPOSE AND PROFIT (2020); REBECCA HENDERSON, REIMAGINING CAPITALISM IN A WORLD OF FIRE (2020); Leo E. Strine, Jr., *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, 76 BUS. LAW. 397 (2021).

decisions that may increase the welfare of stakeholders.

On the other side, critics of stakeholderism believe that corporate leaders lack the incentives to sacrifice shareholder value in order to benefit stakeholders (the "agency critique" of stakeholderism).[16] Therefore, they worry that relying on managerial discretion and corporate leaders' pledges to serve stakeholders would not produce significant benefits for stakeholders; rather, it would harm stakeholders by worsening the economic performance of the company and by creating illusory and distracting hopes for stakeholder welfare.[17]

This new incarnation of the debate is less about the abstract purpose of the corporation than about the concrete role of managerial power to protect stakeholder interests. Both camps agree that corporate externalities threaten certain social groups, the environment, and society in general, and they both would like to see corporations internalize the cost of those externalities.[18] The disagreement involves whether relying on the discretion of corporate leaders is a promising way to achieve this goal.

In the last few years, the debate has reached an inflection point. Stakeholderism has been embraced not only by prominent academics but also by influential business interest groups and corporate leaders. In 2019, the Business Roundtable issued a statement in which more than 180 CEOs of leading companies committed to delivering value to all stakeholders, not only to shareholders,[19] and the World Economic Forum issued a manifesto that urged companies to abandon shareholder primacy and embrace stakeholder capitalism.[20] Many leading corporate advisers have defended this "new

16. *See, e.g.*, Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91 (2020); Lucian A. Bebchuk & Roberto Tallarita, *Will Corporations Deliver Value to All Stakeholders?*, 75 VAND. L. REV. 1031 (2022); Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1309 (2021).

17. *See generally* Bebchuk & Tallarita, *Illusory Promise*, *supra* note 16.

18. *Id.* at 96 (noting that the authors' critique of stakeholderism is not driven by the "belief that stakeholder protection does not raise serious policy concerns" but by the conclusion that "corporate law reform[] [cannot be] an effective instrument for addressing such concerns").

19. *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/PPY5-EAG5] [hereinafter *Business Roundtable*].

20. Klaus Schwab, *Davos Manifesto 2020: The Universal Purpose of a Company in the*

paradigm" by advocating for decreased shareholder power and increased managerial discretion to deviate from shareholder value maximization.[21] By contrast, critics of stakeholderism have been raising the alarm about the risk that the acceptance of stakeholderism would bring about a new era of managerialism, low accountability of corporate managers, and corporate waste, with no significant benefits for stakeholders.[22]

This disagreement has important implications for the future of corporate governance. If supporters of stakeholderism are right and corporate leaders can be relied on to protect the interests of stakeholders, those who care about stakeholder welfare should support governance arrangements that increase managerial power and decrease shareholder oversight. If critics of stakeholderism are right, the protection of stakeholders should rely on traditional regulation and government intervention, not on corporate governance reforms.

B. The Demand for ESG Metrics

One important stakeholderist trend we examine in this Article is the growing demand for executive compensation metrics linked to stakeholder welfare. Supporters of stakeholderism and other commentators believe that executive compensation arrangements based in part on stakeholder-oriented

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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/B8ZF-SKXZ]; *see also* Klaus Schwab, *Why We Need the 'Davos Manifesto' for a Better Kind of Capitalism*, WORLD ECON. F. (Dec. 1, 2019), https://www.weforum.org/agenda/2019/12/why-we-need-the-davos-manifesto-for-better-kind-of-capitalism [https://perma.cc/7RWF-DLH9].

21. *See, e.g.*, Martin Lipton, Steven A. Rosenblum & Karessa L. Cain, *Thoughts for Boards of Directors in 2020*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 10, 2019), https://corpgov.law.harvard.edu/2019/12/10/thoughts-for-boards-of-directors-in-2020 [https://perma.cc/ZDJ8-QBWE]; Martin Lipton, *Spotlight on Boards*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 18, 2020), https://corpgov.law.harvard.edu/2020/07/18/spotlight-on-boards-7 [https://perma.cc/SC86-HJHC]; Martin Lipton, Steven A. Rosenblum & William Savitt, *A Framework for Management and Board of Directors Consideration of ESG and Stakeholder Governance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 5, 2020), https://corpgov.law.harvard.edu/2020/06/05/a-framework-for-management-and-board-of-directors-consideration-of-esg-and-stakeholder-governance [https://perma.cc/UR6B-QP2L]; Martin Lipton, *Purpose, Stakeholders, ESG and Sustainable Long-Term Investment*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 24, 2019), https://corpgov.law.harvard.edu/2019/12/24/purpose-stakeholders-esg-and-sustainable-long-term-investment [https://perma.cc/6Z7F-CDAR].

22. *See* sources cited *supra* note 16.

metrics, rather than on traditional financial metrics, would be beneficial to stakeholders and address the incentive problem raised by the agency critique of stakeholderism.[23] If CEOs lack robust incentives to focus on stakeholder

23. *See, e.g.*, EY, STUDY ON DIRECTORS' DUTIES AND SUSTAINABLE CORPORATE GOVERNANCE 109 (Eur. Comm'n 2020), https://op.europa.eu/en/publication-detail/-/publication/e47928a2-d20b-11ea-adf7-01aa75ed71a1/language-en [https://perma.cc/Q4HY-VYDR] ("[T]he integration of ESG metrics into directors' remuneration schemes is a trend that can be expected to continue in the future, as a mean to incentivise directors' to pay attention to (at least some) company's sustainability impacts."); *Id.* at 119–20 ("By addressing the executive remuneration structure, it would be possible to better incentivise directors to focus on environmental aspects, such as reducing GHG emissions (to mitigate risk of climate change), preserving and enhancing the natural capital and ecosystem services, or increasing the company rate of recycling, improving the resource efficiency."); PHILLIPPA O'CONNOR & TOM GOSLING, PWC, PAYING WELL BY PAYING FOR GOOD 7 (2021), https://www.pwc.co.uk/human-resource-services/assets/pdfs/environmental-social-governance-exec-pay-report.pdf [https://perma.cc/52PY-F5GW] ("Where an ESG initiative is aligned to the declared purpose of a company, there is a rationale for this to be embedded in executive pay. Purpose must flow through every facet of an organisation, from day-to-day behaviours in the workforce, interactions with customers and the priorities of the CEO. If ESG is a critical part of purpose, then it may be appropriate to feature it in executive pay."); Shai Ganu, Don Delves & Ryan Resch, *Responsible Executive Compensation During Times of Crisis*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 18, 2020), https://corpgov.law.harvard.edu/2020/05/18/responsible-executive-compensation-during-times-of-crisis/ [https://perma.cc/B93F-GCMD] ("Executive compensation has always (or at least since the 1980s) served to align the interests of management with those of owners. It will be critically important to continue demonstrating this alignment and sharing the pain (and gain) with shareholders. At this critical time, there also is a profound need to make sure that executive compensation is aligned, to some demonstrable degree, with the interests of employees, and other stakeholders."); Patrick Velte, *Sustainable Management Compensation and ESG Performance – The German Case*, 14 PROBS. & PERSPS. MGMT. 17, 22 (2016). (finding that "the degree of sustainable management board compensation has a positive impact on ESG performance in Germany"); Caroline Flammer, Bryan Hong & Dylan Minor, *Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes*, 40 STRATEGIC MGMT. J. 1097, 1099 (2019) (finding that in S&P 500 firms, "[linking executive compensation to social and environmental performance] leads to . . . an increase in social and environmental initiatives . . . especially with respect to less salient stakeholders such as the natural environment and communities"); Sandra Cavaco, Patricia Crifo & Aymeric Guidoux, *Corporate Social Responsibility and Governance: The Role of Executive Compensation*, 59 INDUS. RELS. 240, 266 (2020) ("[F]or firms with a stakeholder-oriented governance model, [corporate social responsibility] contracting seems to have a large

interests, the argument goes, one solution is to include stakeholder-oriented performance goals in their compensation structures.

Reports by prominent compensation consultants show that over the last few years, the demand for ESG compensation metrics—by institutional investors, social and environmental activists, and stakeholder groups—has been growing significantly.[24] Indeed, a recent survey shows that two-thirds of institutional investors want to see executive compensation tied to ESG

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positive impact on all dimensions of extra-financial performance."); James J. Cordeiro & Joseph Sarkis, *Does Explicit Contracting Effectively Link CEO Compensation to Environmental Performance?*, 17 BUS. STRATEGY & ENV'T 304, 307 (2008) (explaining that agency theory would suggest that "an appropriate incentive compensation system should direct management effort towards the pursuit of environmental goals that may be in conflict with financial goals . . . . [When] the outcomes of financial goals . . . and environmental goals . . . conflict with each other, executives who are compensated for the achievement of environmental goals would then be more willing to accept the reduction in compensation that accompanies the simultaneous reduction in financial performance outcomes").

24. *See, e.g.*, Tom Gosling & Phillippa O'Connor, *Executive Pay and ESG Performance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 12, 2021), https://corpgov.law.harvard.edu/2021/04/12/executive-pay-and-esg-performance/ [https://perma.cc/3VTL-A7UB] ("The pressure to include ESG targets in pay is coming not just from special interest groups but from customers, employees, and, increasingly, investors and regulators."); JAMES CHALMERS, EMMA COX & NADJA PICARD, PWC STRATEGY&, THE ECONOMIC REALITIES OF ESG 3 (Oct. 28, 2021), https://www.pwc.com/gx/en/issues/reinventing-the-future/take-on-tomorrow/download/sbpwc-2021-10-28-Economic-realities-ESG.pdf [https://perma.cc/CX6Z-9EKW] ("[I]nvestors are paying more attention to the ESG risks and opportunities facing the companies they invest in, and are poised to take action. . . . [A]lmost 70% [of our respondents] thought ESG factors should figure into executive compensation targets . . . ."); Marc S. Gerber & Simon Toms, *ESG: Many Demands, Few Clear Rules*, SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP (Feb. 3, 2021), https://www.skadden.com/insights/publications/2021/02/the-informed-board/esg-many-demands-few-clear-rules [https://perma.cc/N9YP-E6QV] ("Some investors want executive compensation tied to ESG performance. Many investors subscribe to the view that you get the results that you measure and reward, and we expect some investors to continue to argue for ESG to play a part in setting executive compensation."); Matthew Behrens & Annie Anderson, *ESG Continues to Find Its Way into Incentive Compensation Plans*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 2, 2021), https://corpgov.law.harvard.edu/2021/12/02/esg-continues-to-find-its-way-into-incentive-compensation-plans/ [https://perma.cc/DYD6-KWQ5] ("The move toward ESG metrics is both a response to stakeholder pressures and a growing recognition that these factors are important to long-term shareholder value.").

target performance.[25] Companies are increasingly being asked to prove that their pro-stakeholder rhetoric is not empty talk but is being matched with real action,[26] and many business leaders and advisers believe that integrating ESG factors into executive compensation arrangements is an effective way to offer this proof. Semler Brossy, for example, observes in a recent report that "[l]inking ESG metrics to executive pay is a powerful way to drive change,"[27] and Pay Governance argues that ESG-based metrics are a "sure-fire way to make sure a company's ESG priorities are given the attention required."[28] PricewaterhouseCoopers explains that "[i]ncluding ESG metrics in executive pay packages is a tangible way to close the say-do gap for a skeptical audience,"[29] and, in a recent publication, Deloitte states that "the incorporation of ESG performance measures in executive incentive plans [can be a way for companies to demonstrate their commitment to ESG strategies]."[30]

In a study prepared for the European Commission, Ernst & Young argues that ESG compensation metrics are largely effective in promoting sustainability and even suggests that policymakers consider making their

25. *See* EDELMAN, 2020 EDELMAN TRUST BAROMETER SPECIAL REPORT: INSTITUTIONAL INVESTORS 21 (2020), https://www.edelman.com/sites/g/files/aatuss191/files/2020-11/Edelman%202020%20Institutional%20Investor%20Trust_FINAL.pdf [https://perma.cc/8Z9M-HMUL] (showing that sixty-nine percent of institutional investors say ESG impacts trust in a company a great deal).

26. *See, e.g.*, Peter Reali, Jennifer Grzech & Anthony Garcia, *ESG: Investors Increasingly Seek Accountability and Outcomes*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 25, 2021), https://corpgov.law.harvard.edu/2021/04/25/esg-investors-increasingly-seek-accountability-and-outcomes/ [https://perma.cc/GX25-SNQR].

27. DEBORAH BECKMANN, BLAIR JONES & AVI SHELDON, SEMLER BROSSY, MOVING CAUTIOUSLY ON ESG INCENTIVES IN COMPENSATION 2 (Apr. 2021), https://www.semlerbrossy.com/wp-content/uploads/MovingCautiously_ESGIncentives_Semler-Brossy_2021.pdf [https://perma.cc/XB7G-R8G8].

28. John Ellerman, Mike Kesner & Lane Ringlee, *Inclusion of ESG Metrics in Incentive Plans: Evolution or Revolution?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 30, 2021), https://corpgov.law.harvard.edu/2021/03/30/inclusion-of-esg-metrics-in-incentive-plans-evolution-or-revolution/ [https://perma.cc/3ZPL-8D8Z].

29. CHALMERS, COX & PICARD, *supra* note 24, at 2.

30. Kristen Sullivan & Maureen Bujno, *Incorporating ESG Measures into Executive Compensation Plans*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 24, 2021), https://corpgov.law.harvard.edu/2021/05/24/incorporating-esg-measures-into-executive-compensation-plans/ [https://perma.cc/Y8JX-5QEH].

adoption mandatory.[31] And prominent corporate governance experts have urged compensation committees to consider the interests of employees as well as environmental and social issues when establishing criteria to determine executive compensation.[32]

As a result of this mounting pressure, a growing number of large companies are including ESG metrics in their executive compensation arrangements.[33] Some experts have called this emerging trend "one of the most significant changes in executive compensation in over a decade."[34]

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31. EY, *supra* note 23, at 118–22.

32. See generally Leo E. Strine Jr. & Kirby M. Smith, Toward Fair Gainsharing and a Quality Workplace for Employees: How a Reconceived Compensation Committee Might Help Make Corporations More Responsible Employers and Restore Faith in American Capitalism, 76 BUS. LAW. 31 (2020).

33. *See, e.g.*, Ira T. Kay, Mike Kesner & Joadi Oglesby, *ESG Incentives and Executives*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 24, 2022), https://corpgov.law.harvard.edu/2022/05/24/esg-incentives-and-executives [https://perma.cc/3NJA-NFAR] ("[T]he inclusion of [ESG] metrics in corporate incentive plans . . . is becoming common . . . ."); Robert Newbury, Don Delves & Ryan Resch, *ESG Issues in the Forefront*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Apr. 15, 2020), https://corpgov.law.harvard.edu/2020/04/15/esg-issues-in-the-forefront/ [https://perma.cc/MHR6-N524] (reporting that "51% of S&P 500 companies use ESG metrics in their incentive plans" and that "these metrics are poised for even greater adoption"); Gosling & O'Connor, *supra* note 24 ("Nearly half of all FTSE 100 companies now have an ESG metric in their bonus or [long-term incentive plan]."); Ellerman, Kesner & Ringlee, *supra* note 28 ("[A]n increasing number of companies are including ESG metrics in their incentive plans in 2021 . . . ."); Andrew Hill, *Executive Pay and Climate: Can Bonuses Be Used to Reduce Emissions?*, FIN. TIMES (Nov. 14, 2021), https://www.ft.com/content/c1d0e4d5-b42f-4287-8bfe-319f31a7acbe [https://perma.cc/DS2V-RRFU] (noting that "[f]or now absolute numbers of companies using climate targets to calculate chief executives' bonuses and long-term incentives remain low" but explaining that "from a low base, the number of companies using climate pay targets more than doubled between 2019 and 2020"); DELOITTE, ROAD TO NET ZERO – INCENTIVISING LEADERSHIP 2–3 (Sept. 2021), https://ukpages.deloitte.com/rs/676-RGI-700/images/Road-to-net-zero-incentivising-leadership-2021.pdf [https://perma.cc/5M26-46DQ] (explaining that "[a]s part of a wider trend towards the use of [ESG] metrics in executive incentive plans, companies are increasingly incorporating the delivery of climate goals under annual and long-term reward frameworks" and finding that "[over one year] we have seen increasing use of ESG metrics linked to climate, in particular under long-term incentive plans (LTIPs)").

34. Ellerman, Kesner & Ringlee, *supra* note 28.

C. The Questions

The increasing use of ESG metrics in executive compensation arrangements raises two important questions for stakeholderism and corporate governance in general. The first set of questions concerns the actual characteristics of this phenomenon and its significance for stakeholder welfare. What kind of ESG-based arrangements are companies adopting, and how effectively do these arrangements incentivize companies to increase stakeholder welfare?

The second set of questions concerns, more generally, the promise of ESG-based compensation for stakeholder welfare. Is ESG-based compensation an effective tool to improve stakeholder welfare? Can it be designed in a way that addresses the concerns raised by the agency critique of stakeholderism?

If ESG compensation metrics prove effective, either in their current form or in some enhanced version, we could expect corporate leaders to make meaningful improvements to the way companies treat their stakeholders, affect the environment, and benefit society at large. By contrast, if ESG compensation metrics prove ineffective in their current form and difficult to improve, the incentive problem underscored by critics of stakeholderism would remain unsolved. Understanding the design and effectiveness of ESG-based compensation is, therefore, a crucial task in assessing the promise of stakeholderism.

III. ESG METRICS IN S&P 100 CEO COMPENSATION

In this Part, we discuss the construction of our dataset and provide an overview of the use of ESG compensation metrics in S&P 100 companies. As our review shows, a very large fraction of CEO pay in S&P 100 companies is contingent on performance goals, and in slightly more than half of the cases, these goals include ESG metrics. However, many companies—including many signatories of the Business Roundtable statement on the purpose of the corporation—continue to link the compensation of their CEOs to purely financial metrics.

A. ESG-Based Compensation in S&P 100 Companies

To examine the use of ESG-based compensation, we conducted a detailed review of the structure and criteria of CEO compensation for all the U.S. companies included in the S&P 100 index, as disclosed in their 2021

proxy statements.[35] The S&P 100 index includes 100 major large-cap companies across many industries.[36] We excluded three companies incorporated in Ireland; therefore, our final sample includes 97 companies.[37]

Together, these companies have an aggregate market capitalization of $26 trillion, equal to more than half of the entire U.S. stock market.[38] Their CEOs typically receive very large compensation packages, with a mean of $25 million and a median of $21 million, contingent largely on performance goals.

Table 1 reports all of the companies included in our sample, their market capitalization, their CEOs, and the compensation paid to their CEOs in 2020. The table also indicates the percentage of total CEO compensation that is contingent on the achievement of performance goals.

35. We manually collected and reviewed the proxy statements filed with the Securities Exchange Commission (as available on its Electronic Data Gathering, Analysis, and Retrieval system (EDGAR)) for all of the companies included in the S&P 100 index as of July 9, 2021.

36. *S&P 100 Overview*, S&P DOW JONES INDICES (Dec. 31, 2021), https://www.spglobal.com/spdji/en/indices/equity/sp-100 [https://perma.cc/ZP9R-VDY2].

37. We excluded Accenture PLC, Linde PLC, and Medtronic PLC, as they are incorporated outside the United States.

38. Market capitalization of sample companies were collected from Compustat on January 4, 2022, and refer to the latest fiscal quarter available (for most companies, September 30, 2021). The total value of market capitalization of listed domestic companies in the United States as of the end of 2020 is $40.7 trillion, according to the World Bank. *Market Capitalization of Listed Domestic Companies (Current US$)*, WORLD BANK, https://data.worldbank.org/indicator/CM.MKT.LCAP.CD [https://perma.cc/W4VL-UX3W].

Table 1. CEO Compensation in S&P 100 Companies

Company	*Market Cap (Billions)*	*CEO*	*CEO Comp. (Millions)*	*Performance-Based Comp.*
3M	$101.1	Michael Roman	$20.7	90.0%
Abbott Laboratories	$208.9	Robert Ford, Miles White	$40.3	91.0%
AbbVie	$190.7	Richard Gonzalez	$24.0	92.0%
Adobe	$318.8	Shantanu Narayen	$45.9	97.2%
AIG	$45.9	Brian Duperreault	$18.8	92.0%
Alphabet	$1,774.4	Sundar Pichai	$7.4	0.0%*
Altria Group	$83.7	William Gifford, Howard Willard	$30.1	88.0%
Amazon.com	$1,665.5	Jeffrey Bezos	$1.7	0.0%*
American Express	$130.3	Stephen Squeri	$24.2	93.0%
American Tower	$120.9	Thomas Bartlett, James Taiclet	$30.4	93.0%
Amgen	$120.1	Robert Bradway	$20.1	91.0%
Apple	$2,324.4	Tim Cook	$14.8	78.2%†
AT&T	$192.9	John Stankey	$21.0	89.0%
Bank of America	$349.8	Brian Moynihan	$25.9	93.9%
Bank of NY Mellon	$42.8	Todd Gibbons	$9.4	91.4%
Berkshire Hathaway	$612.6	Warren Buffett	$0.4	0.0%*
Biogen	$41.6	Michael Vounatsos	$18.7	91%%
BlackRock	$127.5	Laurence Fink	$27.4	95.0%
Boeing	$129.2	David Calhoun	$21.1	85.0%
Booking Holdings	$97.5	Glenn Fogel	$ 7.1	97.7%†
Bristol-Myers Squibb	$131.3	Giovanni Caforio	$20.2	90.0%
Broadcom	$219.6	Hock Tan	$3.7	91.4%
Capital One Financial	$69.7	Richard Fairbank	$20.1	100.0%
Caterpillar	$103.8	James Umpleby	$13.7	90.0%
Charter Communications	$130.4	Thomas Rutledge	$38.8	94.6%†
Chevron	$195.6	Michael Wirth	$29.0	92.0%
Cisco Systems	$236.0	Charles Robbins	$23.2	74.0%
Citigroup	$139.3	Michael Corbat	$23.0	90.0%
Coca-Cola	$226.6	James Quincey	$18.4	90.7%†
Colgate-Palmolive	$63.7	Noel Wallace	$14.4	89.0%
Comcast	$255.5	Brian Roberts	$32.7	89.0%
ConocoPhillips	$89.4	Ryan Lance	$28.1	90.0%
Costco Wholesale	$239.2	W. Craig Jelinek	$8.3	87.6%†
CVS Health	$112.1	Larry Merlo	$23.0	84.0%
Danaher	$217.5	Rainer Blair, Thomas Joyce	$27.2	88.0%

Dow	$42.6	Jim Fitterling	$22.2	91.0%
Duke Energy	$75.0	Lynn Good	$14.5	91.0%
DuPont de Nemours	$35.2	Edward Breen, Marc Doyle	$19.4	92.0%
Eli Lilly	$209.5	David Ricks	$23.7	91.0%
Emerson Electric	$56.1	David Farr	$16.5	91.0%
Exelon	$47.3	Christopher Crane	$15.2	90.9%
Exxon Mobil	$249.0	Darren Woods	$15.6	90.0%
Facebook	$947.9	Mark Zuckerberg	$25.3	0.0%*
FedEx	$61.0	Frederick Smith	$14.3	92.0%
Ford	$56.6	James Farley, James Hackett	$28.5	82.0%
General Dynamics	$54.7	Phebe Novakovic	$19.3	91.0%
General Electric	$113.1	Larry Culp	$73.2	88.0%
General Motors	$79.1	Mary Barra	$23.7	90.0%
Gilead Sciences	$87.7	Daniel O'Day	$19.0	90.0%
Goldman Sachs	$131.4	David Solomon	$23.9	89.0%
Home Depot	$388.8	Craig Menear	$14.0	88.4%
Honeywell International	$146.1	Darius Adamczyk	$19.1	91.0%
IBM	$124.6	Arvind Krishna, Virginia Rometty	$38.1	92.0%
Intel	$216.7	Robert Swan	$22.4	94.0%
Johnson & Johnson	$425.1	Alex Gorsky	$29.6	91.0%
JPMorgan Chase	$483.7	Jamie Dimon	$31.7	95.0%
Kraft Heinz	$45.2	Miguel Patricio	$6.1	66.0%
Lockheed Martin	$94.6	James Taiclet, Marilyn Hewson	$51.9	91.0%
Lowe's Companies	$160.4	Marvin Ellison	$23.1	72.0%
Mastercard	$342.0	Ajay Banga	$27.8	94.0%
McDonald's	$180.2	Christopher Kempczinski	$10.8	90.0%
Merck	$189.7	Kenneth Frazier	$22.1	92.0%
MetLife	$52.1	Michel Khalaf	$15.4	89.0%
Microsoft	$2,117.2	Satya Nadella	$44.3	93.0%
Mondelez International	$81.2	Dirk Van de Put	$16.8	90.0%
Morgan Stanley	$175.1	James Gorman	$29.6	94.6%
Netflix	$270.4	Reed Hastings, Ted Sarandos	$82.5	0.0%*
NextEra Energy	$154.1	James Robo	$23.7	91.0%
Nike	$267.9	John Donahoe	$32.9	92.0%
NVIDIA	$639.7	Jen-Hsun Huang	$19.3	94.0%
Oracle	$242.4	Safra Catz	$10.6	90.2%
PayPal Holdings	$305.5	Daniel Schulman	$23.4	96.0%
PepsiCo	$208.0	Ramon Laguarta	$21.5	91.0%
Pfizer	$241.3	Albert Bourla	$21.0	91.0%

Philip Morris International	$147.7	André Calantzopoulos	$21.9	89.0%
Procter & Gamble	$338.3	David Taylor	$23.9	89.0%
Qualcomm	$145.1	Steve Mollenkopf	$25.9	73.0%
Raytheon Technologies	$128.7	Gregory Hayes	$21.0	91.0%
salesforce.com	$294.9	Marc Benioff, Keith Block	$27.0	94.0%
Simon Property Group	$42.7	David Simon	$9.0	85.5%†
Southern	$65.7	Tom Fanning	$22.4	91.0%
Starbucks	$130.2	Kevin Johnson	$14.7	96.0%
Target	$124.9	Brian Cornell	$19.8	91.0%
Tesla	$778.6	Elon Musk	$0.0	100.0%
Texas Instruments	$177.5	Richard Templeton	$19.1	93.0%
Thermo Fisher Scientific	$225.1	Marc Casper	$26.4	91.0%
T-Mobile US	$159.6	Mike Sievert, John Legere	$192.1	92.4%
Union Pacific	$126.3	Lance Fritz	$16.6	91.0%
UnitedHealth Group	$368.1	David Wichmann	$17.9	92.0%
UPS	$158.3	Carol Tomé, David Abney	$9.6	90.0%
U.S. Bancorp	$88.1	Andrew Cecere	$16.8	91.0%
Verizon Communications	$223.6	Hans Vestberg	$19.1	91.9%
Visa	$472.4	Alfred Kelly	$26.4	93.0%
Walgreens Boots Alliance	$43.9	Stefano Pessina	$17.5	100.0%
Walmart	$415.1	Doug McMillan	$22.6	75.3%
Walt Disney	$307.6	Robert Iger, Robert Chapek	$35.2	90.0%
Wells Fargo	$185.5	Charles Scharf	$20.4	89.1%
Mean	$268.6		**$24.2**	**85.5%**
Median	$158.3		**$21.1**	**91.0%**

Total compensation paid to CEOs in 2020 by the companies in our sample. For companies with two co-CEOs or a CEO turnover during the year, compensation is the sum of the compensation received by each CEO. "Performance-Based Comp." reports the potential (*ex ante*) amount of performance-based compensation as a percentage of the total compensation, where disclosed.

* No performance-based compensation.

† Potential (*ex ante*) performance-based compensation not disclosed. This value indicates actually paid (*ex post*) performance-based compensation as a percentage of total compensation received.

B. The Use of ESG Metrics

If S&P 100 companies adopted effective ESG compensation metrics with a real and sizeable impact on CEO incentives, the direct effects on stakeholder welfare would likely be substantial. Furthermore, given their significant size and visibility, these companies would probably influence

compensation practices for smaller companies, thus producing indirect effects across the market. Therefore, the study of ESG-based compensation in S&P 100 companies provides a reliable indication of the general efficacy and reliability of this tool.

To examine the use of ESG compensation metrics in our sample companies, we reviewed the executive compensation section of their 2021 proxy statements, including the compensation discussion and analysis and the compensation tables. We identified all references to ESG criteria, including criteria used by the compensation committee for choosing specific levels of compensation and criteria used as performance goals to determine the amount of variable compensation. By ESG criteria, we mean any criteria connected with the interests of stakeholders, such as employees, customers, suppliers, the environment (including the effect of corporate activities on climate change), and the community or society at large.

Our review found that slightly more than half (52.6%) of S&P 100 companies included some ESG metrics in their 2020 CEO compensation packages. As examined in detail in Part IV, these metrics concern the interests of various stakeholder groups and other societal interests: chiefly, employee treatment (80.4% of the companies with ESG metrics), employee composition (62.7%), customers (49%), and the environment (39.2%), but also the community (19.6%) and suppliers (3.9%).

Almost always, ESG metrics are used to determine the amount of the annual bonus. However, only a minority of companies (27.4% of the companies with ESG metrics) reveal the exact weight of ESG-based pay, while the other companies leave this piece of information undisclosed. Furthermore, in companies that disclose it, the weight of ESG metrics is quite modest. In most cases, ESG metrics account for only 1.5%–3% of the total CEO pay. The rare exceptions, with slightly higher but still limited weights, are Southern Co. (12.5%), American Express (6.6%), and Ford Motor Company (4%).[39]

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39. For a discussion on the limited economic significance of ESG-based compensation for the CEOs sitting on the board of the Business Roundtable, see Bebchuk & Tallarita, *Illusory Promise*, *supra* note 16, at 148–53.

The economic significance of ESG-based compensation is even smaller when we consider the CEO's entire portfolio of incentives, including all shares held by the CEO, all equity compensation paid in previous years and not yet converted into shares, unvested restricted stock and performance shares, and other incentives. *See generally* David I. Walker, *The Economic (In)Significance of Executive Pay ESG Incentives*, 27 STAN. J.L. BUS. & FIN. 318 (2022).

While limited economic significance characterizes the current use of ESG-based

But what if more companies adopted ESG compensation metrics and linked a larger fraction of compensation to them? Would the expansion of this trend be a promising development for the mitigation of corporate externalities and the improvement of stakeholder welfare? In the remainder of the Article, we seek to answer these questions.

IV. NARROW DIMENSIONS AND THE MULTITASKING PROBLEM

In this Part, we discuss the first fundamental limit of ESG-based compensation. ESG metrics inevitably focus on a limited number of dimensions of the welfare of a limited number of stakeholders. This fact raises two problems. First, ESG-based incentives necessarily have a narrow scope, in contrast to the pervasive win-win rhetoric of some stakeholderism advocates. Second, by creating distinct incentives for multiple managerial goals, ESG metrics might incentivize CEOs to favor some goals over others, which might result in counterproductive outcomes for stakeholders.

A. The Breadth of Stakeholder Interests

Corporate activities affect a large number of individuals, groups, and interests. Cognizant of this fact, stakeholderist theories and pledges often refer to various groups of stakeholders and promise to give weight to the interests of all of them. According to some narrow definitions, stakeholders are those who have contributed resources to a company or are "crucial for the achievement of corporate objectives."[40] The 2019 Business Roundtable statement, for example, refers to customers, employees, suppliers, and communities in which the company operates (including the environment) and commits to delivering value to all of these groups, in addition to shareholders.[41]

According to more expansive definitions, a company's relevant stakeholders include all individuals and groups affected by the company, which potentially extends to the entire society, especially for the largest corporations.[42] For example, many U.S. constituency statutes, which authorize corporate directors to consider the interests of non-shareholder constituencies, refer also to society or societal interests, the economy of the

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compensation, this might, of course, change. Our main goal in this Article, which we pursue in the following Parts, is to show that even ESG metrics with increased economic significance would not be desirable.

40. *See, e.g.*, Andrew L. Friedman & Samantha Miles, Stakeholders: Theory and Practice 13–14 (Oxford Univ. Press 2006).

41. Business Roundtable, supra note 19.

42. FRIEDMAN & MILES, *supra* note 40.

state or the nation, or other social purposes.[43] Some scholars (and many shareholder proposals) have also suggested that companies give weight to the interests of future generations, non-human animals, and even past generations (for example, the memory and legacy of founders).[44]

Even if we limit our attention to core stakeholders, such as employees, customers, suppliers, local communities, and the environment, the aspects and facets of the interests at stake are manifold. Unlike shareholders, whose common interests in a company are captured largely by one metric (or a few alternate versions of one metric), stakeholders can be affected by corporate decisions in many different ways and along multiple dimensions.

Consider, for example, a company's employees. Employees care about keeping their job, but also the absolute level of their compensation, the relative level of their compensation compared to others in similar roles (for example, gender pay gap or racial pay gap), the relative level of their compensation compared to the highest-paid managers (for example, CEO pay ratio), health insurance and other benefits; protections in case of unemployment (for example, severance pay or outplacement programs), health and safety, workplace culture and engagement, diversity and inclusion, and so forth. Similarly, the interests of other stakeholders are many and diverse. Customers might care about not only product quality and post-sale assistance, but also health and safety measures in retail spaces (for example, COVID-19 measures), low prices, and flexible payment terms. Local communities might be affected by, and thus concerned about, philanthropic activities, the spillover effects of job creation, pollution, cultural initiatives, and so forth.

Furthermore, within seemingly homogenous groups of stakeholders, different subsets may have, and often have, different or even conflicting interests. Consider, for example, full-time and part-time employees or employees belonging and not belonging to a union. Or, consider large, multi-

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43. *See* Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467, 1485 (2021).

44. For a defense of a broad definition of stakeholders, see, for example, Antonio Argandoña, *The Stakeholder Theory and the Common Good*, 17 J. BUS. ETHICS 1093, 1099 (1998) (arguing that the corporation should serve "the common good," including "the common good of the company itself [and] that of the local community, the country and all humankind, including future generations"). For a particularly extreme definition, see Mark Starik, *The Toronto Conference: Reflections on Stakeholder Theory*, 33 BUS. & SOC'Y 82, 90–94 (1994) (pushing the boundaries of the concept of "stakeholders" by including not only non-living environmental forms but also late founders of the firms (who may be said to have left a legacy that may be affected by company decisions), animals, and "mental images" or "archetypes").

client suppliers and small suppliers dependent on a company's orders.

As recognized in the management literature, mapping stakeholders and their interests, rights, and needs is a complex exercise that involves detailed analytic theorizing.[45] Indeed, according to stakeholder theory, "business exists in society . . . and . . . business managers are responsible . . . for managing claims and lessening harms within an intricate network of societal relationships,"[46] which includes many actors with many different characteristics.

B. The Narrowness of ESG Metrics

Despite the potential richness and intricacy of a company's stakeholders and their interests, ESG metrics used in the real world are inevitably limited and narrow.[47] Table 2 reports, for each company in our sample that uses ESG compensation metrics, the stakeholder groups and interests taken into consideration and specifies whether the metrics used by the company refer to the totality of such stakeholders' welfare (X) or only a subset of interests (○). Most companies use metrics linked to employee composition and employee treatment, and many use metrics connected to consumer welfare and environmental issues (especially carbon emissions and climate change). Very few companies, however, consider their impact on local communities, and only two companies use metrics linked to supplier interests.

45. *See, e.g.*, Ronald K. Mitchell & Jae Hwan Lee, *Stakeholder Identification and Its Importance in the Value Creating System of Stakeholder Work*, *in* THE CAMBRIDGE HANDBOOK OF STAKEHOLDER THEORY (Jeffrey S. Harrison et al. eds., 2019).

46. Donna J. Wood et al., Stakeholder Identification and Salience After 20 Years: Progress, Problems, and Prospects, 60 BUS. & SOC'Y 196, 197 (2018).

47. For a discussion of this conceptual intuition, see Alex Edmans, *Why Companies Shouldn't Tie CEO Pay to ESG Metrics*, WALL ST. J. (June 27, 2021), https://www.wsj.com/articles/why-companies-shouldnt-tie-ceo-pay-to-esg-metrics-11624669882 [https://perma.cc/9S58-HGHL]. In this Section, we examine this issue by providing systematic empirical evidence.

Table 2. Stakeholder Groups and Interests in ESG Metrics

Company	*Empl. composition*	*Empl. treatment*	*Customers*	*Suppliers*	*Community*	*Environment*
Abbott	-	○	○	-	-	○
AbbVie	-	-	-	-	-	○
AIG	○	○	-	-	-	-
Altria Group	○	○	-	-	-	-
American Express	○	○	○	-	-	-
Bank of America	○	○	-	-	○	-
BlackRock	○	○	○	-	-	○
Bristol-Myers Squibb	-	○	-	-	-	-
Capital One	○	○	○	-	○	-
Chevron	-	○	-	-	-	○
Citigroup	○	○	○	-	-	-
Coca-Cola	○	○	-	-	○	○
Colgate-Palmolive	-	○	○	-	○	-
Comcast	○	-	-	-	-	-
ConocoPhillips	-	○	-	-	-	○
CVS Health	-	-	○	-	-	-
Danaher	○	-	-	-	-	-
Dow	○	○	○	-	-	○
Duke Energy	-	○	○	-	-	○
Exelon	-	-	○	-	-	-
Exxon Mobil	-	○	-	-	○	○
Facebook	-	-	○	-	-	-
Ford	-	○	○	-	○	-
General Dynamics	-	○	-	-	○	-
General Motors	○	-	-	-	-	○
Gilead Sciences	○	○	-	-	-	-
Goldman Sachs	○	○	-	-	-	-
Intel	○	○	○	-	-	○
Johnson & Johnson	○	○	-	-	-	-
JPMorgan Chase	-	○	○	-	○	○
Kraft Heinz	○	○	-	-	-	-
Lockheed Martin	○	○	-	-	-	-
Microsoft	○	○	○	-	-	-
Mondelez	○	○	-	-	-	○
Morgan Stanley	○	○	-	-	-	-
NextEra Energy	-	○	○	-	-	○
Nike	○	○	-	-	-	-
PayPal Holdings	-	○	-	-	-	-
PepsiCo	○	○	○	-	-	○
Philip Morris	○	-	○	-	-	-
Southern	○	○	○	○	○	○

Target	-	○	-	-	-	-
Thermo Fisher	○	○	-	-	-	-
Union Pacific	-	○	○	-	-	-
UnitedHealth Group	-	X	○	-	-	-
UPS	○	○	-	-	○	-
Verizon	○	-	-	○	-	○
Visa	○	○	○	-	○	-
Walmart	○	○	-	-	-	-
Walt Disney	○	-	-	-	-	-
Wells Fargo	○	○	-	-	-	-

The table reports, for each sample company using ESG metrics for the determination of CEO compensation, the specific stakeholder groups or interests to which such goals refer. An X indicates that the company uses a general metric encompassing all of the welfare dimensions of that particular group or interest. An ○ indicates that the company uses a metric relating to one or more specific dimensions of that particular group or interest.

Furthermore, with respect to each of these groups or interests, ESG metrics focus on a narrow subset of dimensions that are relevant for stakeholders. Table 3 reports our findings.

As the table shows, for each stakeholder group or interest, companies choose to give weight to specific dimensions that represent only part of what stakeholders care about. With respect to employees, for example, most companies choose goals related to inclusion or diversity and many focus on work accidents and illness, but none incentivizes its CEO to increase salaries or benefits or to improve job security. With respect to community, many companies focus on trust and reputation, but almost none chooses incentives linked to reducing local unemployment or to distributing free products or services to disadvantaged residents.

Table 3. Dimensions of Stakeholder Welfare in ESG Metrics

Company	*Dimensions of Stakeholder Welfare*
PANEL A: EMPLOYEE COMPOSITION	
AIG	- Diversity
Altria Group	- Diversity
American Express	- Gender and race diversity in management
Bank of America	- Diversity
BlackRock	- Diversity - Attracting and inspiring talent
Capital One Financial	- Diversity - Recruitment
Citigroup	- Diversity
Coca-Cola	- Diversity
Comcast	- Diversity
Danaher	- Diversity
Dow	- Global representation of women - U.S. ethnic minority representation
General Motors	- Workforce diversity
Gilead Sciences	- Employee diversity
Goldman Sachs	- Attraction of key talent - Diversity
Intel	- Inclusive hiring practices
Johnson & Johnson	- Employee diversity
Kraft Heinz	- Hiring of key talent
Lockheed Martin	- Diversity
Microsoft	- Diversity
Mondelez International	- Diversity
Morgan Stanley	- Diversity progress
Nike	- Diversity
PepsiCo	- Managing and developing a diverse workforce
Philip Morris International	- Attraction of top talent - Representation of women in senior roles
Southern Co.	- Representation of minorities and women in leadership
Thermo Fisher Scientific	- Diversity
UPS	- Diversity in management - Equal opportunity employment
Verizon Communications	- Workforce diversity
Visa	- Diversity
Walmart	- Diversity
Walt Disney	- Race and gender diversity in management
Wells Fargo	- Diversity
PANEL B: EMPLOYEE TREATMENT	
Abbott Laboratories	- Inclusive culture - Fair and balanced treatment
AIG	- Inclusion and equity - Talent development - Employee engagement

	- Employee well-being - Workplace culture
Altria Group	- Inclusion and equity
American Express	- Talent retention - Collegiality and team spirit
Bank of America	- Inclusion - "Human capital metrics"
BlackRock	- Inclusion - Purpose and culture
Bristol-Myers Squibb	- Human capital management quality
Capital One Financial	- Inclusion - Retention
Chevron	- Recordable incident rate Serious injuries number
Citigroup	- "Human capital goals"
Coca-Cola	- Inclusion and equity - Talent retention and development
Colgate-Palmolive	- Employee health and safety
Comcast	- Inclusion
ConocoPhillips	- Recordable injury rate
Danaher	- Inclusion
Dow	- Participation in employee groups - Fatalities, severe injuries, and illness incidents - Motor vehicle accident fatalities
Duke Energy	- Work injuries and illnesses
Exxon Mobil	- Health and safety of employees
Ford	- Employee engagement and morale
General Dynamics	- Human capital management - Employee health and safety
Gilead Sciences	- Employee engagement
Goldman Sachs	- Retention of key talent - Culture
Intel	- Employee engagement
Johnson & Johnson	- Employee engagement - Employee health and safety
JPMorgan Chase	- Workplace culture - Employee well-being
Kraft Heinz	- Retention and engagement of key talent
Lockheed Martin	- Talent management - Inclusion
Microsoft	- Culture - Inclusion
Mondelez International	- Employee engagement
Morgan Stanley	- Talent development
NextEra Energy	- Reportable employee injuries and illnesses
Nike	- Inclusion and equity
PayPal Holdings	- Collaboration, inclusion, innovation, and wellness - Human capital management
PepsiCo	- Managing and developing a talented workforce
Philip Morris International	- Retention of top talent
Southern Co.	- Serious injuries reduction
Target	- Employee engagement
Thermo Fisher Scientific	- Culture

Union Pacific	- Employee engagement
UnitedHealth Group	- Employee welfare
UPS	- Promotion of ethical behavior
Visa	- Inclusion - Employee development - Employee health, safety, productivity, and engagement
Walmart	- Inclusion and equity
Wells Fargo	- Inclusion - Investment in employees - Enhancements to culture

PANEL C: CUSTOMERS

Abbott Laboratories	- Quality products provided at competitive prices
American Express	- Customer satisfaction - Attrition rates - Financial relief for customers impacted by COVID-19
BlackRock	- Client engagement
Capital One Financial	- Customer advocacy - Customer satisfaction
Citigroup	- Growth in client relationship
Colgate-Palmolive	- Continuity of supply and services
CVS Health	- Customer service - Client satisfaction
Dow	- Customer satisfaction index
Duke Energy	- Outage events and service interruptions - Customer satisfaction surveys
Exelon	- Outage frequency and duration
Facebook	- Privacy, safety, and security
Ford	- Quality survey - Customer satisfaction survey - Warranty spend
Intel	- Customer experience
JPMorgan Chase	- Cybersecurity - Customer experience
Microsoft	- Customer engagement and outreach - Customer satisfaction
NextEra Energy	- Customer interruptions - Customer satisfaction survey
PepsiCo	- Customer satisfaction
Philip Morris International	- Consumer-centric organization
Southern Co.	- Customer satisfaction - Outage frequency and duration
Union Pacific	- Customer safety - Customer experience
UnitedHealth Group	- Customer satisfaction
Visa	- Cybersecurity and data privacy - Access to unbanked customers

PANEL D: ENVIRONMENT

Abbott Laboratories	- Sustainable infrastructure
AbbVie	- Sustainability
BlackRock	- Sustainability

Chevron	- Process safety incidents - Greenhouse gas intensity reduction
Coca-Cola	- Sustainability initiatives
ConocoPhillips	- Unintentional releases of hazardous material - Other process safety incidents - Emissions reduction
Dow	- Process safety events - Freshwater intake - Waste intensity footprint - Emissions offsetting - Renewable sources
Duke Energy	- Reportable environmental events
Exxon Mobil	- Investment in lower-emissions technologies - Reduction of methane emissions and flaring - Finding solutions on climate change
General Motors	- Emissions reduction - Renewable energy
Intel	- Use of renewable energy - Water conservation
JPMorgan Chase	- Environmental impact
Mondelez International	- Sustainability initiatives - Recyclability goals
NextEra Energy	- Significant environmental violations
PepsiCo	- Environmental sustainability
Philip Morris International	- Carbon footprint reduction - CDP rating - Recycling of reduced-risk products
Southern Co.	- Reduction of greenhouse gas emissions
Verizon Communications	- Reduction of carbon emissions

PANEL E: COMMUNITY

Bank of America	- Trust and credibility in the community
Capital One Financial	- Corporate reputation and community engagement
Coca-Cola	- Philanthropic initiatives
Colgate-Palmolive	- Fulfillment of community initiatives and commitments
Exxon Mobil	- Health and safety of the community - COVID-19 response efforts
Ford	- Production of COVID-19 medical equipment
General Dynamics	- Community health and safety
JPMorgan Chase	- Investing in communities
Southern Co.	- Pipeline safety and leakages
UPS	- Well-being of local communities
Visa	- Support to governments for public fund disbursements

PANEL F: SUPPLIERS

Southern Co.	- Diverse suppliers
Verizon Communications	- Diverse suppliers

The table reports, for each sample company using ESG metrics for the determination of CEO compensation, the specific dimensions of stakeholder welfare that the relevant metrics address. Each panel reports our findings with respect to a specific stakeholder group or interest.

The narrowness of ESG metrics is an empirical fact and also a theoretical necessity. No compensation package could exhaustively identify and incentivize goals that address all of the interests and needs of all individuals and groups affected by a company's activities. The very act of identifying a measurable goal and designing a metric to assess the achievement of that goal requires the choice of some specific dimension and measure and, therefore, the rejection of other potential dimensions and measures. Business leaders have embraced stakeholderism by promising win-win scenarios in which companies deliver value to shareholders and all stakeholders.[48] The reality, however, is that companies choose only a few groups of core stakeholders and focus on a limited number of aspects of their welfare.

C. The Multitasking Problem

Could companies correct this "narrowness" problem by expanding the number of goals and metrics in order to capture as many stakeholders as possible and as many dimensions of their welfare as practicable? The answer is likely negative. Although the narrowness of ESG metrics reveals the inability of compensation arrangements to recognize the needs and interests of all those affected by corporate activities, the mere multiplication of goals might make ESG metrics even less effective.

To begin with, the identification of a measurable goal incentivizes managers to allocate attention and effort to that particular task, thereby diverting attention and effort away from other tasks. To the extent that the welfare of a shareholder group consists of several dimensions, some of which are hard or impossible to measure, the creation of incentives to achieve narrow measurable goals will disincentivize managers from focusing on the hard-to-measure tasks, which might result in problematic outcomes.[49]

As discussed in Part IV.A, stakeholder welfare is multi-dimensional. However, some of these dimensions are easier to pin down and measure, while others, equally important, are difficult to measure. Consider, for

48. For example, the Business Roundtable's statement notes that "[e]ach of our stakeholders is essential" and pledges "to deliver value to all of them." *Business Roundtable*, *supra* note 19.

49. For the formalization of this problem, see Bengt Holmström & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991). *See also* BENGT HOLMSTRÖM, PAY FOR PERFORMANCE AND BEYOND 413, 427–31 (Mass. Inst. Tech. 2016). Moving from Holmström's theoretical framework, Hong *et al.* conducted a field experiment in a natural setting with factory workers in China and found results in line with the predictions of the multitasking theory. *See generally* Fuhai Hong et al., *Testing the Theory of Multitasking: Evidence from a Natural Field Experiment in Chinese Factories*, 59 INT'L ECON. REV. 511 (2018).

example, the welfare of employees. Employees are interested in receiving a good salary, avoiding accidents and illnesses, and keeping their job: these goals are relatively easier to measure and assess. However, employees are also interested in being treated fairly, developing good professional relationships with supervisors and peers, growing professionally, and other factors that are very hard to measure.

Our empirical analysis of employee-related metrics reveals that companies focus on only a small number of these goals. However, the economics of multitasking tells us that even if companies expanded their lists, the fact that many important dimensions of employee welfare are hard to measure means that CEOs might be pushed to focus on some factors and ignore others based on criteria that depend not on the importance of these factors but their measurability.[50]

This problem is especially relevant for ESG metrics since many stakeholder welfare dimensions are indeed hard to define. As Part V will show, ESG-based incentives often use vague metrics with no specific, assessable objectives. This is probably partly due to the insistence of corporate leaders in retaining discretion over determining the final amount of compensation, but also to the intrinsic nature of stakeholder interests, which are diverse, complex, and difficult to narrow down with a sufficient level of accuracy. As the literature on ESG has shown, even the most prominent ESG rating agencies disagree substantially on companies' performance on environmental and social goals.[51]

The multitasking problem can also lead to a waste of corporate resources by compensating CEOs for worthless performance or by incentivizing CEOs to "manipulate" outcomes in ways that do not create real value for

50. *See, e.g.*, Ann P. Bartel, Brianna Cardiff-Hicks & Kathryn Shaw, *Incentives for Lawyers: Moving Away from "Eat What You Kill"*, 70 INDUS. & LAB. RELS. REV. 336, 338 (2017) ("The compensation function needs to precisely mirror the firm's profit function. For example, if employees are paid a piece rate for the amount they produce, they will not be incentivized to pay attention to the quality of their output, unless the firm also measures and pays for quality."); *see also* Michael Waldman, *Theory and Evidence in Internal Labor Markets*, *in* THE HANDBOOK OF ORGANIZATIONAL ECONOMICS 520, 547 (Robert S. Gibbons & John Roberts eds., 2012) (reporting the argument of Holmström & Milgrom¸ *supra* note 9, and explaining that "[a] standard problem in the theory of multitasking is that incentive pay that is based on measurable output inefficiently distorts effort away from important tasks whose value to the firm is not measurable").

51. *See, e.g.*, Aaron K. Chatterji et al., *Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers*, 37 STRATEGIC MGMT. J. 1597, 1600–01 (2016); Florian Berg, Julian F. Kölbel & Roberto Rigobon, *Aggregate Confusion: The Divergence of ESG Rating*, 33 REV. FINANCE 1, 2 (2022).

stakeholders.[52] For example, CEOs can meet carbon emission goals by selling carbon-intensive assets to private buyers that commit to continue to supply the company with products and services, or they can meet average employee pay goals by outsourcing low-paying jobs. These actions would impose direct expenses on the company, would create no benefit at all for the environment or employees, and would divert managerial attention away from more worthwhile objectives.

V. OUTSIDE REVIEWABILITY AND THE AGENCY PROBLEM

In this Part, we discuss the other fundamental limit of ESG-based compensation. In order to mitigate the risk of manipulation and self-interested use of ESG metrics by CEOs, outside observers should be able to review and assess the relevant goals. Yet almost no company in our sample uses ESG metrics that meet this standard. Hence, the practice of ESG-based compensation can create opportunities for CEOs to increase their pay without delivering concrete benefits to shareholders or stakeholders.

A. Agency Problem and the Importance of Outside Reviewability

A central problem in corporate governance is how to create good incentives for CEOs and other top executives to create value for shareholders. In the typical U.S. public company in which ownership is dispersed and shareholders do not have enough incentives to monitor and discipline managerial behavior, the CEO exerts substantial influence over the board of directors and can therefore extract significant value from the company through excessive compensation packages.[53]

Over the past few decades, the high levels of CEO compensation have attracted much public scrutiny and inspired a trove of academic research.[54] In particular, an influential strain of the literature has shown that, contrary to what traditional economic models say, the relationship between CEOs and boards is not at arm's length; in fact, CEOs often wield substantial power over directors and use such power to get overly generous compensation packages.[55]

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52. HOLMSTRÖM, *supra* note 49, at 428–29.

53. For an early overview of this problem, see Lucian Bebchuk & Jesse Fried, Pay without Performance: The Unfulfilled Promise of Executive Compensation (2004).

54. For a recent survey of the economic literature on executive compensation, see Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence*, *in* 1 THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 383, 383–505 (Benjamin Hermalin & Michael Weisbach eds., 2017).

55. *See generally* BEBCHUK & FRIED, *supra* note 53.

Even in the presence of apathetic shareholders, market forces are expected to limit the extent to which CEOs can abuse their influence and obtain bloated pay. For example, the managerial labor market, the market for corporate control, the market for additional capital, and the product market provide CEOs with incentives not to deviate too much from shareholder value maximization. However, the constraints created by these market forces on excessive CEO pay are quite limited, and while they may perhaps avoid extreme forms of rent extraction, they still allow CEOs to extract considerable value from their companies.

One factor that strengthens the disciplinary force of the market is transparency. When detailed information about the design of the compensation package is disclosed, market actors can perform their monitoring role more easily and effectively. Furthermore, transparency concerning the levels of the compensation and the criteria used to determine them can deter CEOs from seeking arrangements that would be perceived as abusive or outrageous by outsiders.

With this in mind, over the last three decades, institutional investors and their advisers have been pressuring companies into disclosing and justifying the design of their executive compensation arrangements, and policymakers have facilitated investor oversight by mandating disclosure and strengthening shareholder rights. Three important developments, in particular, have contributed to increasing the transparency of compensation arrangements and, indirectly, their design.

First, a series of legislative and regulatory interventions have imposed increasing disclosure obligations with respect to executive pay.[56] As a result, public companies today must discuss and analyze in their proxy statements the objectives of their executive compensation programs, the elements of compensation, the criteria used to determine the amount of each element, the benchmarks used for any elements of the compensation, and so forth.[57] Companies must also disclose performance targets and the actual achievement levels against each target if they are a material element of the compensation decision and do not result in competitive harm for the

56. *See generally* Kevin J. Murphy, *The Politics of Pay: A Legislative History of Executive Compensation*, *in* RESEARCH HANDBOOK ON EXECUTIVE PAY (Randall S. Thomas & Jennifer G. Hill eds., 2012). Some important regulatory changes were introduced by the Securities and Exchange Commission in 1992 and then again in 2006. For an analysis of current executive compensation disclosure rules, see ELIZABETH A. ISING ET AL., EXECUTIVE COMPENSATION DISCLOSURE HANDBOOK (2010).

57. *See* 17 C.F.R. § 229.402 (2022) (stating that "[t]he discussion shall describe the following" under (b)(1)).

company.[58] However, if performance goals are qualitative or subjective, the company does not have to disclose quantitative targets.[59]

Second, compensation for top executives has become the object of a mandatory advisory vote by shareholders (the "say-on-pay"), which companies must hold at least every three years (but most companies choose to have it annually).[60] The introduction of say-on-pay was supported by the idea that it would result in tighter shareholder monitoring of directors' compensation packages.[61] Companies whose compensation packages received low support would then be induced to change them[62] by reducing pay levels and linking executive pay more tightly to firm performance.[63] Indeed, even if the vote is merely advisory, it is used by shareholders to signal disapproval and warn management that more drastic steps might be taken. This has prompted companies to improve compensation practices and communicate them to shareholders in ways that increase the chance of a favorable say-on-pay vote.[64] Among other things, companies have made their

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58. *See Id.* (stating that "the discussion shall explain all material elements of the registrant's compensation" and "[r]egistrants are not required to disclose target levels . . . [if] the disclosure of which would result in competitive harm for the registrant").

59. *See Id.* (stating that "[r]egistrants are not required to disclose target levels with respect to specific quantitative or qualitative performance-related factors").

60. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951, 124 Stat. 1376, 1899 (2010).

61. *See, e.g.*, *Compensation Structure and Systemic Risk: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 38 (2009) (statement of Gene Sperling, Counselor to the Secretary of Treasury, U.S. Department of Treasury) ("I truly think the say-on-pay is a situation of all upside, no downside. You are empowering shareholders with the ability to have stronger oversight. You are forcing the company to think more seriously about what they do, how it will be perceived and not just to go on automatic pilot doing practices that are not defensible simply because of their peer group is doing it.").

62. *See, e.g.*, David F. Larcker, Allan L. McCall & Gaizka Ormazabal, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, 58 J.L. & ECON. 173, 175 (2015) (discussing the influence of proxy advisory firms on executive compensation).

63. *See, e.g.*, Jill Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 HARV. BUS. L. REV. 101, 102 (2018) (explaining that giving shareholders a say on pay would both reduce overall pay levels and incentivize boards to tie executive pay to firm performance).

64. Larcker, McCall & Ormazabal, *supra* note 62, at 203 (finding that "many boards of directors change their compensation programs before formal shareholder votes in a manner that better aligns the programs with the recommendation policies of proxy advisory firms" and that "[t]hese changes appear to be an attempt to avoid a negative [say-on-pay] recommendation by proxy advisory firms and thereby increase the likelihood that the firm

compensation disclosures more readable and informative[65] and have started engaging with shareholders in advance of the vote in order to understand which issues are most relevant for them.[66]

Third, proxy advisors—which advise institutional investors on how to vote their shares, including on say-on-pay votes—have become increasingly influential and have developed guidelines and principles on what good compensation arrangements should look like.[67] In assessing compensation arrangements, proxy advisors conduct quantitative analyses aimed at measuring how much compensation is sensitive to performance as well as qualitative analyses based on several criteria, including transparency and clarity of disclosure, objective and transparent metrics, and the rigor of performance goals.[68]

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will not fail the vote"); *see also* Marinilka B. Kimbro & Danielle Xu, *Shareholders Have a Say in Executive Compensation: Evidence from Say-on-Pay in the United States*, 35 J. ACCT. & PUB. POL'Y 19, 37 (2016) (looking at the effects of the first two years of say-on-pay and finding that "shareholders effectively identify firms with excessive and abnormal levels of CEO pay and expressed their dissatisfaction through [say-on-pay]" and that "shareholders vote down excessive CEO compensation, and boards respond to this advisory message by reducing the growth of executive pay"); Steven Balsam et al., *The Impact of Say-on-Pay on Executive Compensation*, 35 J. ACCT. & PUB. POL'Y 162, 164 (2016) (analyzing the effects of say-on-pay in 2010 and finding evidence that "firms reduce their compensation prior to the first say-on-pay vote, with the decrease being greater for firms that overpaid their CEOs in prior periods" and that "[those same companies] increase the use of performance-based compensation").

65. *See, e.g.*, Sean C. Feller, *Say-on-Pay Requirements and Considerations*, *in* PRACTICAL GUIDE TO SEC PROXY AND COMPENSATION RULES § 4, § 4.01[C] (Amy L. Goodman, John F. Olson & Lisa A. Fontenot eds., 6th ed. 2018) (noting that "[a] common response of many companies to the say-on-pay vote requirement has been an enhanced disclosure of their named executive officer compensation programs").

66. *See, e.g.*, Matt Orsagh, *"Say on Pay": How Voting on Executive Pay is Evolving Globally – And is it Working?*, CFA INST. (Dec. 26, 2013), https://www.cfainstitute.org/en/advocacy/market-integrity-insights/2013/12/say-on-pay-how-voting-on-executive [https://perma.cc/PB2U-5N9P] ("Overall, it seems that say-on-pay votes have spurred engagement between investors and issuers . . . .").

67. *See, e.g.*, Yonca Ertimur, Fabrizio Ferri & David Oesch, *Shareholder Votes and Proxy Advisors: Evidence from Say on Pay*, 51 J. ACCT. RSCH. 951, 952 (2013) (finding that proxy advisors' voting recommendations are a "key determinant of voting outcomes" on executive compensation).

68. INSTITUTIONAL S'HOLDER SERVS., UNITED STATES COMPENSATION POLICIES 8–17 (2021), https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf [https://perma.cc/6YLT-Z8AM]; GLASS LEWIS, 2021 PROXY PAPER

All of these trends are based on the recognition that an essential tool to mitigate the agency problems of the CEO pay-setting process is to make the compensation arrangements transparent and to allow outsiders (investors, investor advisers, and the general public) to review and assess the structure, goals, and metrics used in these arrangements.[69] Although these analyses and the consequent innovations relate to traditional financial metrics, which link CEO compensation to shareholder value, the underlying rationale applies to ESG metrics as well. In fact, the risk of managerial abuse is even higher with ESG metrics since the main supposed beneficiaries of ESG-based incentives—a company's stakeholders—do not have the same powers and rights that shareholders have to monitor and discipline management. Thus, the possibility of an effective review and assessment by an outsider (which we will refer to as "outside reviewability") is a crucial prerequisite for well-designed ESG metrics.

B. Three Key Requisites for Effective Outside Reviewability

CEO compensation typically consists of three main components: a base cash salary, an annual bonus linked to performance goals, and a long-term equity incentive in the form of stock options, stock grants, or other equity

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GUIDELINES 34–47 (2020), https://www.glasslewis.com/wp-content/uploads/2020/11/US-Voting-Guidelines-GL.pdf?hsCtaTracking=7c712e31-24fb-4a3a-b396-9e8568fa0685%7C86255695-f1f4-47cb-8dc0-e919a9a5cf5b [https://perma.cc/SEN6-E3WQ]; SEMLER BROSSY, RIGHTING THE SAY ON PAY SHIP AFTER A "NO" VOTE 1 (Sept. 2013), http://www.semlerbrossy.com/wp-content/uploads/ATD-Shareholder-Engagement.pdf [https://perma.cc/3S3S-83GY] (explaining that "[o]ne of the positive outcomes of the Say on Pay provision in the Dodd-Frank legislation has been more regular dialogue between companies and shareholders").

69. In a similar direction also goes the recent reopening by the Securities and Exchange Commission of the comment period for the pay-versus-performance rule, originally proposed in 2015. *See* Pay Versus Performance, Exchange Act Release No. 74,835 (Apr. 29, 2015). If finalized, the rule would implement Section14(i) of the Securities Exchange Act of 1934 to require companies to disclose, through both tabular and narrative disclosure, how the executive compensation paid by the company relates to the company's financial performance. SEC. EXCH. COMM'N, PAY VERSUS PERFORMANCE: COMMENT PERIOD REOPENING 1 (2022), https://www.sec.gov/files/34-94074-fact-sheet.pdf [https://perma.cc/6BHB-PJV4]; *see also* Gary Gensler, *Statement by Chair Gensler on Reopening of Comment Period for Pay Versus Performance*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 29, 2022), https://corpgov.law.harvard.edu/2022/01/29/statement-by-chair-gensler-on-reopening-of-comment-period-for-pay-versus-performance/ [https://perma.cc/GDD6-RQJG].

instruments.[70] Historically, the largest component of CEO pay was cash (base salary and bonus); since the 1980s, however, the equity component has been growing significantly and now represents the largest element of CEO pay in large companies.[71]

This evolution was probably driven in part by legislative changes (in particular, tax laws)[72] and in part by an attempt to address the agency concerns discussed in Part V.A. Indeed, stock options and stock grants increase the sensitivity of CEO pay to a company's performance and therefore create high-powered incentives for CEOs to increase shareholder value. Cash compensation, however, and in particular annual bonuses, remains a significant fraction of CEO pay to this day. In 2020, 21.5% of CEO pay in Russell 3000 companies was in the form of annual bonuses.[73] Bonuses are especially vulnerable to agency problems because their determination may be purely discretionary, may be based on subjective or qualitative goals that still leave much room for discretion, or may be based on objective or quantitative goals that cannot be meaningfully reviewed or assessed by shareholders and other outside observers.

To ensure the outside reviewability of performance goals and therefore limit the aforementioned concerns, companies should meet the following requisites when setting and disclosing performance goals:[74]

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70. *See, e.g.*, Matteo Tonello & Olivia Tay, *CEO and Executive Compensation Practices in the Russell 3000 and S&P 500*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 7, 2021), https://corpgov.law.harvard.edu/2021/10/07/ceo-and-executive-compensation-practices-in-the-russell-3000-and-sp-500/ [https://perma.cc/J3T2-QUHA] (discussing CEO compensation as affected by the Covid-19 panedemic).

71. Alex Edmans, Xavier Gabai & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* 13 (Nat'l Bureau of Econ. Rsch., Working Paper No. 23596, 2017).

72. *See generally* Tod Perry & Marc Zenner, *Pay for Performance? Government Regulation and the Structure of Compensation Contracts*, 62 J. FIN. ECON. 453 (2001) (finding large effects of a 1993 tax code reform on the composition of executive pay).

73. Tonello & Tay, *supra* note 70.

74. The outside reviewability framework proposed in this Article is consistent with the approach recommended by major asset managers. Vanguard, for example, recommends "the use of quantitative metrics, but in cases where qualitative ones are used . . . [there should be] disclosure about how the metrics will be assessed."; it stresses that "[i]nvestors need to be able to evaluate whether incentives tied to metrics can actually drive company performance"; and it urges companies to thoroughly explain any discretionary adjustments and to use metrics that are "measurable, reportable, and clearly linked to a company's strategy and risk mitigation efforts." John Galloway, *Policy Insights on Executive Compensation*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 15, 2022), https://corpgov.law.harvard.edu/2022/06/15/policy-insights-on-executive-compensation/ [https://perma.cc/YCH2-9CVE].

a) Have clear and objective goals. To limit manipulation and self-serving structures, companies should adopt clearly defined goals, not subject to discretionary determination or interpretation, and disclose them in their proxy statements. Clear and objective goals are, for example, those with an explicitly quantified target against which performance can be measured. Examples of quantitative financial metrics widely used to determine annual bonuses and equity grants are total shareholder return, return on assets, and earnings per share. In these cases, companies set target values that can be used to assess whether the actual performance was below or above the expected goal. By contrast, bonuses that are given on the basis of vague and underspecified goals, such as "outstanding leadership," escape the possibility of an outside assessment.

With respect to ESG metrics, examples of clear and objective goals used by S&P 100 companies are the following: number of work accidents, carbon emissions, reportable environmental accidents, amount of energy from renewable sources, predetermined targets in customer satisfaction surveys, predetermined targets in third-party rankings of workplace quality, and so forth. By contrast, vague and underspecified goals, such as increasing sustainability, diversity, inclusion, or employee well-being, without any specific targets or additional information, cannot be meaningfully assessed by outside observers.

b) Disclose outcome. In order for an outsider to be able to address a company's performance, the identification of clear and objective goals is necessary, but not sufficient. Companies must also disclose the actual outcome and compare it to the assigned target. If a company discloses a specific goal but does not report the actual performance, an outsider cannot observe what the performance was relative to the goal.

c) Provide meaningful context. Finally, companies should provide enough contextual information to allow an outside observer to tell whether the goalpost was sufficiently ambitious (and not too low) and to assess the disclosed performance. Performance-based compensation does not automatically translate into effective incentives. In fact, performance goals, even quantitative objective goals, can be used by CEOs to simulate a rigorous incentive structure when the effort required to achieve the goal is modest or minimal.

Suppose, for example, that a company discloses the goal of equal representation of men and women on the board of directors and announces that the goal has been met. Outsiders do not know whether the incentive was meaningful as long as they do not know, for example, how many men and women were serving on the board at the beginning and the end of the fiscal year. Indeed, the following two scenarios are equally consistent with the

aforesaid disclosure but represent very different performances with respect to progress in gender diversity: (i) there were initially five men and four women, and then one man resigned; (ii) there were initially eight men and one woman, and then two men were replaced by two women, and three additional women were appointed.

Or consider a company setting, as a performance goal, the achievement of a certain ranking in a proprietary employee satisfaction index, without any explanation of how the index is constructed or what the various rankings mean in practice. In this case, even if the company discloses clear and objective goals and discloses the relevant outcome, a meaningful assessment of the performance is not possible.

The proliferation of ESG metrics in the absence of outside reviewability would not only be of dubious efficacy for stakeholders but could undermine decades of progress in making executive compensation more transparent and sensitive to actual, verifiable performance.

The evolution of compensation practices discussed in Part V.A—from the centrality of discretionary cash payments to the spread of pay-for-performance packages—might be reversed through the massive use of ESG metrics that are hard or impossible to review and verify. In fact, such a prospect might be particularly appealing to many CEOs, as it gives them the opportunity to get rid of painful incentives and increase their pay while at the same time pretending to steer the company toward social responsibility and stakeholder welfare. To assess the quality of ESG-based performance, it is therefore essential to review in detail the metrics used by companies and the additional information disclosed in order to establish whether the disclosed information allows an outside observer to review and verify the stakeholder-oriented performance of the CEO.

C. Outside Reviewability of ESG Metrics

To empirically test the outside reviewability of the ESG metrics used by the companies in our sample, we examined the presence of the three requisites discussed in Part V.B: (i) whether the company discloses clear and objective ESG goals; (ii) whether the company discloses the actual outcome of the performance with respect to the ESG goals; and (iii) whether the information disclosed to the public provides sufficient meaningful context. Table 4 reports our findings for each company in the sample.

As the table shows, most of the companies that disclose the use of ESG performance goals do not specify what those goals are or else use vague and underspecified concepts to indicate them. For example, Bank of America states that its compensation committee, in reviewing the CEO's performance, considers various "financial and non-financial measures," including

"shareholder return, ESG and human capital metrics, including diversity and inclusion . . . [h]ow we build trust and credibility in the communities we serve, and represent a company that people want to work for, invest in, and do business with."[75] However, the proxy statement does not disclose the specific goals or how they are assessed.

Other examples concern the companies disclosing employee diversity as one of their performance goals. Of the 31 sample companies that mention a diversity criterion in their disclosure, only five identify a specific goal; all of the other companies include only vague references to the concept or leave full discretion to the compensation committee. For example, Citigroup states that one of the pillars of performance evaluation concerns "leadership goals" that "focus on: leadership values, including diversity and other human capital management goals," with no additional information.[76] Microsoft lists a number of strategic goals that "may have [been] included" among the CEO performance goals, and the list contains such concepts as "culture" and "diversity and inclusion" with no additional information.[77]

[75] Bank of Am. Corp., 2021 Proxy Statement (Form 14A), 56 (Mar. 8, 2021).

[76] Citigroup, Inc., 2021 Notice of Annual Meeting and Proxy Statement (Form 14A), 83 (Mar. 17, 2021).

[77] Microsoft Corp., 2021 Proxy Statement (Form 14A), 42 (Oct. 14, 2021).

Table 4. Outside Reviewability of ESG Metrics

Company	*Criterion 1: Clear and Objective Goals?*	*Criterion 2: Outcome Disclosed?*	*Criterion 3: Meaningful Context?*	*Outside Reviewability?*
Abbott Laboratories	-	-	-	-
AbbVie	-	-	-	-
AIG	-	-	-	-
Altria Group	-	-	-	-
American Express	Yes	-	-	-
Bank of America	-	-	-	-
BlackRock	-	-	-	-
Bristol-Myers Squibb	Yes	-	-	-
Capital One Financial	-	-	-	-
Chevron	Yes	-	-	-
Citigroup	-	-	-	-
Coca-Cola	-	-	-	-
Colgate-Palmolive	Yes	-	-	-
Comcast	Yes	-	-	-
ConocoPhillips	Yes	Yes	-	-
CVS Health	Yes	-	-	-
Danaher	-	-	-	-
Dow	Yes	Yes	-	-
Duke Energy	Yes	Yes	-	-
Exelon	Yes	Yes	Yes	Yes
Exxon Mobil	-	-	-	-
Facebook	-	-	-	-
Ford	Yes	Yes	-	-
General Dynamics	-	-	-	-
General Motors	-	-	-	-
Gilead Sciences	-	-	-	-
Goldman Sachs	-	-	-	-
Intel	-	-	-	-
Johnson & Johnson	-	-	-	-
JPMorgan Chase	-	-	-	-
Kraft Heinz	-	-	-	-
Lockheed Martin	-	-	-	-
MetLife	-	-	-	-
Microsoft	-	-	-	-
Mondelez International	-	-	-	-
Morgan Stanley	-	-	-	-
NextEra Energy	Yes	Yes	-	-
Nike	-	Yes	-	-
PayPal Holdings	-	-	-	-
PepsiCo	-	-	-	-
Philip Morris International	Yes	-	-	-

Southern Co.	Yes	Yes	-	-
Target	Yes	-	-	-
Thermo Fisher Scientific	-	-	-	-
Union Pacific	-	-	-	-
UnitedHealth Group	Yes	-	-	-
UPS	-	-	-	-
Verizon Communications	Yes	Yes	-	-
Visa	-	-	-	-
Walmart	-	-	-	-
Walt Disney	Yes	-	-	-
Wells Fargo	-	-	-	-

The table reports, for each company in the sample using ESG metrics for the determination of CEO compensation, whether the company's performance can be effectively assessed by an outsider based on the information disclosed in the proxy statement. The last column reports a synthetic indication of whether the company's performance can be effectively reviewed and assessed by an outside observer. It reports a positive value only if the second, third, and fourth columns all contain a positive value.

Even the five companies that identify more specific diversity goals do not always disclose quantitative targets. Dow, Southern, and Verizon do indicate quantitative targets,[78] but the other companies do not. American Express indicates that its performance goal was "to globally increase minority and women representation at management levels," but it is unclear whether there was a quantitative target or whether any increase (even of only one woman) would suffice.[79] Walt Disney Co. states that one performance factor taken into account by the compensation committee is to "[m]eaningfully increase the diverse representation of management and executives, with a focus on women and people of color, through a variety of engagement efforts," with no specific quantitative goal.[80]

We found the above pattern—most companies use discretionary or underspecified goals, and many others use only qualitative goals—not only with respect to diversity goals but also with many other ESG goals, such as sustainability, equity, inclusion, employee engagement, hiring and retention

78. Dow Inc., Proxy Statement (Form 14A), 53 (Mar. 5, 2021) (reporting the goals of global representation of women of 28.4% and U.S. ethnic minority representation of 25%); Southern Co., Proxy Statement (Form 14A), 58 (Apr. 4, 2021) ("[A]chieve top quartile performance on Diversity Inc. Ranking . . . ."); Verizon, Inc., Proxy Statement (Form 14A), 34 (Mar. 29, 2021) (reporting a target of 59.3% of U.S.-based workforce that is composed of women and minorities).

79. Am. Express Co., Proxy Statement (Form 14A), 53 (Mar. 19, 2021). The company indicates that the diversity goals were "quantitative," but it does not disclose them.

80. The Walt Disney Co., Proxy Statement (Form 14A), 37 (Jan. 19, 2021).

of top talent, trust or reputation in the community, use of renewable energy, and so forth. For an outside observer, it is virtually impossible, in most cases, to understand what the CEO is incentivized to achieve.

Furthermore, Table 4 shows that most companies do not disclose the actual outcome of the performance. In order for an outsider to be able to observe the relevant ESG performance, companies must disclose both the target and the actual outcome. Only nine companies do so for at least some of their ESG metrics.

Finally, the table shows that even in these nine cases, only Exelon discloses enough contextual information to enable an outside observer to assess the meaningfulness of the performance. Exelon uses two ESG metrics to measure continuity of service to customers: outage duration and outage frequency. For each of these two metrics, the company explains how the metrics are calculated, and it discloses quantitative targets, actual outcomes, and targets and outcomes for the previous two years. Furthermore, the company explains that the 2020 targets represent top-quartile performance among industry peers.[81] To be sure, the quality of this disclosure (at par with traditional disclosure on financial metrics) is probably due to the fact that the metrics used by Exelon are closer to traditional operational metrics than to what most people think when they refer to ESG metrics. Nonetheless, they represent a good but isolated example of outside reviewability.

The other companies' disclosure falls short of this standard. To better understand the limits of ESG metrics, let us analyze in detail the use of ESG metrics by some of these other companies.

ConocoPhillips discloses the use of ESG goals with respect to employee safety, environmental accidents, and greenhouse gas emissions. It includes clear and objective goals for employee safety and environmental accidents (top-quartile performance and industry leader for employee incident rates and continuous improvements on process safety), and it also reports the actual outcomes on these two metrics (lowest rate of employee incidents on record; ranked "Best-in-Class" and recognized as health and safety leader; flat number of environmental and process incidents).[82] However, the company does not disclose the starting point or the actual absolute progress on these metrics, nor does it explain what the recognitions as "Best-in-Class" and "industry leader" concretely mean.

Dow reports multiple ESG metrics on different dimensions, namely a "Customer Experience Index" on customer satisfaction and loyalty, a "World-Leading Operations" index on sustainability, rate of participation in

81. Exelon, Proxy Statement (Form 14A), 46–48 (Mar. 17, 2021).

82. ConocoPhillips, Inc., Proxy Statement (Form 14A), 82 (Mar. 29, 2021).

employee groups, and global representation of women and U.S. ethnic minorities. It discloses quantitative targets and actual outcomes.[83] It does not, however, explain how those indices are constructed or how to interpret the relevant scores (either in absolute terms or relative to other companies or to Dow's performance in previous years). For example, was the "Customer Experience Index" target of 76 (which was diligently met) an ambitious target? What does it mean in practice? Does it represent significant progress compared to 2019? Without this background information, we cannot really tell whether these metrics worked as meaningful incentives for the CEO.

Even with respect to the global representation of women and minorities, Dow discloses clearly defined quantitative targets (28.4% of women, 25% of U.S. ethnic minorities) and outcomes (28.1% of women, 25.1% of U.S. ethnic minorities), but it does not disclose the relevant starting points at the beginning of the year. Therefore, we cannot tell whether the goal was difficult to achieve. For all we know, reaching these targets might have been so easy that linking a fraction of compensation to such a goal had little or no incentive value.

Ford uses ESG discretionary metrics relating to employee morale and engagement, as well as the production of COVID-19 masks and equipment to support the community during the pandemic. It also uses objective, quantitative metrics on customer interests: "Things Gone Wrong," customer satisfaction survey, and warranty spending.[84] However, it provides no information to make sense of these metrics and the company's performance.

In some cases, reasonable people might disagree on whether the requisites of outside reviewability are met. For example, on employee safety, Duke discloses a clear and objective target (0.37 injuries for 100 employees) and the actual outcome (0.33 injuries for 100 employees); it also informs us that the target corresponds to the 90th percentile of comparable peer companies (thus allowing an outside observer, unlike Dow's case discussed above, to make sense of the significance of the performance compared to peer companies).[85] However, even in this case (which is certainly among the closest to outside reviewability), we are not told the starting point and, therefore, cannot assess whether the target represented a significant incentive for the CEO or a low goalpost.

NextEra Energy and Southern Co. disclose several ESG goals, some of which are clearly and objectively identified and compared with the actual

83. Dow Inc., Proxy Statement (Form 14A) (Mar. 5, 2021).

84. Ford Motor Co., Proxy Statement (Form 14A), at 65–67 (Apr. 1, 2021).

85. Duke Energy Corp., Proxy Statement (Form 14A), at 44–45 (Mar. 23, 2021).

performance.[86] However, the companies do not disclose the starting point and do not provide additional context to help us understand how significant the performance was. Similarly, Verizon discloses quantitative goals and outcomes on supplier diversity, employee diversity, and reduction of carbon intensity, but it does not explain how significant the goal and performance were (for example, by comparing it to industry peers or other benchmarks).[87]

The lack of, or serious limitations to, outside reviewability is a concern for all of the companies in our sample. Although, in some cases, the disclosure is more meaningful than in others, in no case do they provide sufficient context to evaluate the effectiveness of the incentive.[88]

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86. NextEra Energy Inc., Proxy Statement (Form 14A), at 59–60 (Mar. 31, 2021); Southern Co., Proxy Statement (Form 14A), 59–60 (Apr. 12, 2021).

87. Verizon Commc'ns, Inc., Proxy Statement (Form 14A), at 34 (Mar. 29, 2021).

88. In response to an earlier draft of this Article, a prominent compensation consultancy firm has issued a report suggesting that the use of ESG does not exacerbate the agency and opportunism problems involved in executive pay. *See* Ira T. Kay, Mike Kesner, & Joadi Oglesby, *ESG Incentives and Executives*, HARV. L. SCH. F. ON CORP. GOVERNANCE (May 24, 2022), https://corpgov.law.harvard.edu/2022/05/24/esg-incentives-and-executives/. Consistent with the view that bonus compensation goal posts are not high, the report finds that executives are rather successful in meeting both financial metrics and ESG metrics used by bonus arrangements. However, the report finds that executives are somewhat less successful in reaching the latter than the former, and therefore suggests that, taking as fixed the total amount of the maximum target bonus, adding ESG metrics could reduce the total amount of bonus granted. However, because the expansion of metrics to include ESG metrics might make a higher maximum amount of target bonuses seem more acceptable, inclusion of such metrics could still raise executive payoffs by facilitating an increase in the amount of the maximum total bonus.

We also note that two empirical studies using pre-2014 data reported that companies with better corporate governance are more likely to adopt ESG compensation metrics. *See* Bryan Hong, Zhichuan Li, & Dylan Minor, *Corporate Governance and Executive Compensation for Corporate Social Responsibility*, 136 J. BUS. ETHICS 199 (2016) (finding that the use of ESG metrics is statistically associated with more independent directors (hired before the CEO), more institutional blockholders, shorter CEO tenure, and higher executive share ownership); Atif Ikram, Zhichuan (Frank) Li, & Dylan Minor, *CSR-Contingent Executive Compensation Contracts*, J. BANKING & FIN. (forthcoming) (finding that "more independent boards, larger boards, and more industry competition predict [the use of ESG metrics], while firms with classified boards, co-opted boards, CEO duality are less likely to [use ESG metrics]"). These findings, however, raise the concern that corporate leaders who are more concerned about how compensation decisions are viewed by shareholders might tend to make more use of ESG metrics to "camouflage" arrangements favorable to executives.

VI. THE PERILS OF ESG-BASED COMPENSATION

The demand for ESG-based compensation is, explicitly or implicitly, based on the recognition that corporate executives do not have, on their own, sufficiently strong incentives to give weight to the welfare of stakeholders. We agree with this recognition; in fact, we believe it is the fundamental weakness at the core of stakeholderism. When framed in this way, the campaign to promote and expand the use of ESG compensation metrics can be interpreted as a good-faith attempt to address this key problem.

However, our conceptual and empirical analysis has shown that the current use of ESG metrics is crucially flawed. Furthermore, as we have shown, such use is afflicted by certain structural problems that are difficult to address and that both significantly limit potential benefits and introduce considerable perils. Thus, we warn that the expansion in the use of ESG metrics, which stakeholderists support and corporate leaders have incentives to embrace, would likely be counterproductive. It likely would deliver little value to stakeholders and operate to increase executive payoffs without improving their incentives. [89]

We have identified two main structural problems with ESG-based compensation. First, despite the wide array of stakeholder groups and the myriad ways in which they are affected by corporate activities, ESG metrics currently tend to focus on narrow dimensions of a subset of relevant stakeholders. The economics of multi-tasking indicates that, by incentivizing executives to improve performance on narrow and very partial measures, the current practice disincentivizes corporate leaders from focusing on many other important aspects of stakeholder welfare and thus likely fails to improve overall incentives.

Second, and importantly, the current use of ESG metrics exacerbates

89. A recent empirical study reports some evidence that, in companies adopting ESG compensation metrics, a decrease in CO_2 emissions is associated with higher variable pay for executives, consistent with the hypothesis that ESG metrics reward executives for ESG performance. *See* Shira Cohen et al., *Executive Compensation Tied to ESG Performance: International Evidence* 26 (Eur. Corp. Governance Inst. Fin. Working Paper No. 825, 2022), https://ssrn.com/abstract=4097202. However, the association is statistically significant only for European companies, not for U.S. companies, and the direction of causality is unclear (companies that have decided to reduce their carbon emissions might adopt ESG metrics with the aim of increasing executive payoffs). *See id.* at 25–29. The same study reports some evidence that the adoption of ESG metrics is associated with improvements in ESG performance. *Id.* at 30. However, the findings are statistically significant only in some specifications and only for European companies, not for U.S. companies; furthermore, the association does not indicate a causal relationship. *See id.* at 25–29.

agency problems with respect to executive pay. Our empirical analysis has shown that shareholders commonly are unable to assess effectively whether the use of ESG metrics provides beneficial incentives or largely operates to provide executives with additional performance-insensitive payoffs. As a result, the current practice weakens shareholder oversight, which is widely viewed as an important constraint on insider-favoring design of executive pay. Current practices regarding the use of ESG metrics, and the trend towards increasing their use, thus represent a serious setback in the attempt to address and mitigate the agency problems of executive compensation.

Could one envision a different form of ESG-based compensation that would address these structural problems and create effective stakeholder-oriented incentives for corporate leaders? Our analysis has identified the considerable problems that this project would have to overcome. It would be necessary to design clear and objective measures of stakeholder impact that are comprehensive (i.e., taking into account a sufficiently large set of the stakeholders of a given company), reviewable by outsiders, and standardized in order to prevent executives from strategically cherry-picking. In our view, this would require significant initiative and pressure from shareholders, as the compensation industry does not have clear incentives to make the substantial effort to push for effective constraints on executive pay, and corporate leaders, without shareholder pressure, do not have incentives to introduce hard-to-achieve, non-discretionary goals that might reduce their payoffs.

In any event, our work provides a framework for assessing the use of ESG compensation metrics and examining the challenges that would have to be overcome for such use to be beneficial and not counterproductive. In the meantime, shareholders and those who care about stakeholder welfare should not support maintaining or expanding current practices for using ESG metrics. Existing practices and their expansion should not be regarded as a positive development for those concerned about stakeholder protection. They serve the interests of executives but not those of shareholders or stakeholders.

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