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The Economic (In)significance of Executive Pay ESG Incentives

David I. Walker*

Abstract

The hottest topic in corporate governance circles today involves company commitments to and pursuit of ESG (environmental, social, and governance) initiatives in addition to the traditional pursuit of profits. One facet of this debate has to do with how to motivate executives to pursue ESG goals. Increasingly, companies tie executive pay to ESG performance, although even strong ESG advocates debate the advisability of doing so. This Article joins the fray by closely examining ESG-based CEO pay arrangements at a subset of companies with leadership positions on the Business Roundtable, an industry trade group that embraced ESG in a 2019 statement of corporate purpose. The primary takeaway of this analysis is that in almost all cases, explicit, non-discretionary ESG incentives are economically insignificant relative to executives’ incentives to maximize share value arising from shares owned outright and unvested or unexercised equity-based compensation. These findings suggest that either ESG-based pay arrangements at these firms are window dressing or that the directors making these compensation decisions do not subscribe to conventional thinking on incentive creation.

To be sure, at all but one of these companies, explicit, non-discretionary ESG incentives were incorporated only in annual bonus plans. One sample company – Duke Energy – tied CEO *equity pay* to ESG performance and in so doing created a meaningful link between pay and ESG performance. While this approach could be seen as a roadmap for those seeking meaningful ESG-based pay incentives, this Article concludes by questioning the wisdom of this approach, joining the cautionary camp in the normative debate.

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Introduction

The hottest topic in corporate governance circles today involves company commitments to and pursuit of ESG (environmental, social, and governance) or CSR (corporate social responsibility) initiatives in addition to the traditional pursuit of profits.¹

1. See, e.g., Rusty O’Kelley, Anthony Goodman & Laura Sanderson, 2021 *Global and Regional*

Institutional investors increasingly focus on ESG matters,² and indeed funds devoted to investing in ESG-friendly companies represent one of the most vibrant segments of the industry.³ Companies commit themselves to various ESG goals – such as reduction of their carbon footprints, improvements in the diversity of their managerial ranks, or improved labor standards throughout their supply chains – and commit to report their progress to their stakeholders.⁴

Companies also increasingly tie executive pay to the attainment of ESG goals, either in response to investor pressure or to get ahead of the curve. For example, Meridian Compensation Partners reports that 20% of large companies surveyed in 2020 have adopted ESG-related compensation metrics for their senior management teams.⁵ Presumably, the idea here is that ESG goals run counter to or at least fail to advance share value maximization and that executives need specific ESG-linked incentives to encourage them to pursue initiatives that may not pay off financially for many years, if at all.

Of course, all of this is controversial. Some commentators, such as Lucian Bebchuk and Roberto Tallarita, argue that the entire ESG movement is misguided and likely counterproductive.⁶ But even within the group of commentators and policy makers who embrace the ESG movement, there is disagreement about the advisability of

Trends in Corporate Governance, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 3, 2021) (reporting results of a survey of institutional investors, proxy advisors, and other corporate governance professionals identifying six key trends for 2021, the top four of which fall squarely within ESG: climate change risk; diversity, equity, and inclusion; convergence of sustainability reporting standards; and human capital management). I will refer to ESG/CSR going forward as simply ESG for simplicity. As explained in Part II, my focus will actually be on the E and S elements of ESG.

2. See Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1405–06 (2020) (describing the three largest institutional investors—BlackRock, State Street, and Vanguard—as “[c]hief supporters” of the move towards ESG-focused corporate governance).
3. See *id.* at 1404 (noting that “over a quarter of global assets under management are now invested based on the company’s environmental and social profile, not just its earnings”).
4. Currently, ESG reporting is almost entirely voluntary, but most large public companies do provide voluntary reports. Often these are referred to as sustainability reports. See GOVERNANCE & ACCOUNTABILITY INST., INC., FLASH REPORT: 86% OF S&P 500 INDEX COMPANIES PUBLISH SUSTAINABILITY/RESPONSIBILITY REPORTS IN 2018 (2019) (noting that the rate of reporting was up marginally from 85% in 2017). See also Thomas Lee Hazen, *Social Issues in the Spotlight: The Increasing Need to Improve Publicly-Held Companies’ CSR and ESG Disclosures*, 23 U. PA. J. BUS. L. 740, 748 (2021) (noting the voluntary (and inconsistent) nature of current reporting).
5. MERIDIAN COMP. PARTNERS, LLC, 2020 EXECUTIVE COMPENSATION TRENDS AND DEVELOPMENTS SURVEY 3 (2020).
6. Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 92 (2020) [hereinafter Bebchuk & Tallarita, *Stakeholder Governance*] (arguing that “by raising illusory hopes that corporate leaders would on their own protect stakeholders, acceptance of stakeholderism would impede or delay reforms that could bring real, meaningful protection to stakeholders). In more recent work, these authors argue that tying executive pay to ESG metrics magnifies agency problems and “could well hurt, not serve, aggregate stakeholder welfare.” Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, J. CORP. L. (forthcoming 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4048003 [hereinafter Bebchuk & Tallarita, *ESG-Based Compensation*].

incorporating ESG metrics within executive compensation schemes as a means of achieving ESG goals. In a summer 2021 speech, SEC Commissioner Allison Herren Lee embraced this approach, calling “executive compensation ‘a powerful tool for achieving strategic company goals’ aside from financial ones; lauding companies like Starbucks, McDonald’s and Nike for having recently pledged to link executive pay to diversity metrics[.]” and advocating tying executive pay to achievement of ESG metrics more generally.⁷ By contrast, two days earlier finance professor Alex Edmans argued in the *Wall Street Journal* that while companies should set ESG goals and report on their achievement, tying executive pay to ESG metrics is likely to be ineffective or worse, leading to unintended consequences given the difficulty of designing comprehensive but not overly complex ESG metrics.⁸

So, are executive pay ESG metrics helping to advance ESG goals or are they creating unintended consequences? Thus far, in almost all cases in which companies have incorporated ESG metrics into executive pay schemes, the answer is probably neither. The economic incentives to advance ESG goals created by these plans are simply dwarfed by the incentives to maximize share value.

To be sure, the simple fact that ESG goals are included in pay plans and that executives know that ESG attainments play some role in their compensation may send useful signals to executives, even if the amount of pay tied to ESG is, for them, de minimis. But to the extent that ESG goals run counter to or fail to enhance share value, the size of ESG incentives likely matters, and in almost all cases thus far ESG incentives have been relatively insignificant.

A number of commentators have presented data allowing one to assess the relative economic significance of executive ESG incentives. For example, Caroline Flammer, Bryan Hong, and Dylan Minor, found that among S&P 500 companies that adopted ESG pay between 2004 and 2013, the average ratio of ESG-based pay to total compensation was only 4.2%.⁹ In their 2020 article, Bebchuk and Tallarita reported that ESG metrics accounted for 3% of the CEO’s annual bonus at Marriott in 2019 and for 21% at Duke Energy.¹⁰ More recently, they found that in most cases in which S&P 100 companies disclosed ESG metrics, these metrics represented only 1.5% to 3% of total CEO 2020 compensation.¹¹ But under the standard economic approach used in evaluating executive incentives, these reports actually *overstate* the economic significance of ESG-based pay at these companies.

First, a caveat. Even if we assume, as most commentators seem to do, that ESG incentives and incentives to increase earnings or share prices are independent,

7. Al Barbarino, *SEC Commissioner Says Exec. Comp Should Be Tied to ESG*, LAW360 (June 29, 2021, 8:45 PM EDT), <https://perma.cc/NC9G-ACFV>.

8. See Alex Edmans, *Why Companies Shouldn’t Tie CEO Pay to ESG Metrics*, WALL ST. J. (June 27, 2021, 11:00 AM ET), <https://perma.cc/NDS9-BK2Z>.

9. 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* 28 (Dec. 2018) (working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2831694.

10. See Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 151.

11. Bebchuk & Tallarita, *ESG-Based Compensation*, *supra* note 6, at 15.

eliminating complications from interactions between them, it is impossible to precisely compare the incentives that are created. Suppose, for example, that an executive could earn \$1 million for achieving an ESG-related goal or \$1 million for achieving an earnings goal. Does this mean the incentives are balanced? It does not. One cannot determine the relative power of these incentives by simply comparing dollars at stake without knowing how difficult it is to achieve these goals. These are apples to oranges comparisons.

However, while precise comparisons are impossible, such “dollars at stake” comparisons can give us a ballpark sense of the relative significance of ESG and financial incentives. But under the standard economic framework, the fraction of annual bonus devoted to ESG performance does not tell us this. Annual bonus is a small fraction of annual pay. And even the fraction of total annual compensation devoted to ESG attainments is a poor measure of the significance of ESG-based pay. Under the standard economic approach, an executive has incentives to increase share value arising from stock, options, and bonuses granted in the current year, but these incentives are often dwarfed by the incentives created by stock and option grants from prior years that remain outstanding as well as the shareholdings of these executives.¹² To the extent that incentive dollars matter and that there are tradeoffs between ESG goals and share value maximization, ESG incentives must be compared to the entire raft of share-based incentives in order to get a sense of the relative magnitude of these incentives. Once this is done, it becomes apparent that the relative fraction of incentives devoted to ESG, as matters stand today, are an order of magnitude smaller than reported previously.¹³

Examining the 2020 pay of the CEOs of current and recent former board members of the Business Roundtable, the most recent year for which we have data, at the median, when ESG-based pay could be estimated, ESG-based pay amounted to 0.2% of the value of the CEO’s shares, her outstanding equity awards, and other variable compensation.¹⁴

The logical implication of this data is either that ESG-based pay at these firms is window dressing or that these directors fail to subscribe to the standard economic approach to executive pay incentives. And, indeed, recent survey evidence suggests that many directors and investors downplay portfolio incentives and emphasize annual pay in contradiction of the standard model.¹⁵ For the CEOs of my sample of companies, at the median, ESG pay represented 1.1% of total 2020 annual compensation, still a

12. John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, 9 FRBNY ECON. POL’Y REV. 27, 29 (2003) (explaining that executive incentives arise from three primary mechanisms: annual compensation (termed “flow compensation”), changes in the value of an executive’s stock and options, and changes in the market’s assessment of an executive’s human capital). The latter is difficult to assess and thus most studies focus on flow compensation and the value of stock and unexercised equity pay.)

13. See *infra* Part III.

14. See *infra* Part III.

15. See *infra* Part III. The proffered explanation, in short, is that reputation, recognition, and notions of fairness play outsized roles in creating executive incentives and that these factors are more tightly associated with annual pay than an executive’s stock portfolio. *Id.*

very small fraction, but not as trivial as the fraction of total incentive dollars.¹⁶

In any event, while company proxy statements reveal that dollars tied to ESG attainments generally are relatively small, discussion of ESG efforts, goals, and attainments make up a robust portion of these statements. On average, the companies referred to above devoted 30% of their letters to shareholders¹⁷ and 10% of total proxy statement pages¹⁸ to ESG matters. Thus far, ESG talk far outweighs ESG walk, at least as far as executive incentives go, and ESG-based pay seems more like window dressing than a serious attempt to incentivize executive behavior.

What would it take for ESG incentives to become economically meaningful? ESG-based pay would have to change. Today, almost all companies that explicitly tie executive pay to ESG performance do so as part of their annual bonus determinations and not as an element of long-term equity compensation.¹⁹ But equity-based pay accounts for about two-thirds of the present value of senior executive pay at large U.S. companies²⁰ and contributes a large share of executive incentives that last beyond the present year. ESG metrics could easily be incorporated in equity pay. A company need only reduce or eliminate equity compensation elements that are linked solely to share price, like conventional stock options or restricted stock, and replace these with equity instruments that award executives a variable number of shares based on their achievement of certain goals. Historically those goals have focused on shareholder return and accounting-based results, but ESG goals could easily be added. One company in my sample – Duke Energy – has done so, and the difference in the economic significance of ESG incentives is remarkable.²¹ If and when this becomes common, ESG advocates will know that firms are now walking the ESG talk and that ESG-based pay metrics are not simply window dressing.

The remainder of this Article is organized as follow: Part I briefly recounts the rise of ESG as a corporate objective and the rise of ESG-based pay. Part II investigates how companies incorporate ESG metrics into executive pay arrangements and why some approaches lend themselves to quantification while others do not. Part III attempts to get at the economic significance of quantifiable ESG pay metrics arguing that 1) the best feasible approach is to compare ESG pay linked dollars to the whole panoply of share-based incentive dollars and 2) having done so, ESG pay today is revealed as being even less economically significant than previous studies may have suggested. Part IV switches gears and offers a brief impressionistic appraisal of “ESG talk” in

16. See *infra* Part III.

17. See *infra* Part IV. Many proxy statements include a letter from the board chair, CEO, and/or lead outside director to the company's shareholders.

18. See *infra* Part IV. Pages devoted to shareholder resolutions and appendices are excluded from these calculations.

19. See *infra* Part III.

20. See, e.g., LAWRENCE MISHEL & JORI KANDRA, CEO COMPENSATION SURGED 14% IN 2019 TO \$21.3 MILLION 7 (2020) (projecting that 69% of the total 2019 grant date value of compensation for the average CEO of the 350 largest US companies would consist of stock and options).

21. See *infra* Part III (demonstrating that CEO ESG incentives at Duke Energy are an order of magnitude greater than those at the sample firm with the largest CEO ESG incentives based solely on non-equity pay).

proxy statements that companies might employ to deflect attention away from a lack of significant ESG pay incentives. Part V looks ahead and describes how executive pay practices could evolve to produce meaningful ESG incentives. The key would be to incorporate ESG metrics in equity pay and to minimize non-performance-based equity pay elements like traditional options and restricted stock. While it would be fair to conclude that Part V offers a roadmap for ESG pay enthusiasts, I want to be clear that nothing in this Part reflects normative values. Personally, I am skeptical of basing compensation on ESG in any meaningful way. These normative arguments are briefly recounted in Part VI. Part VII concludes.

I. The Rise of ESG and ESG-Based Pay

While social responsibility has existed as a corporate governance undercurrent since the 1950s or before,²² it has only recently risen to prominence under the ESG banner.²³ One significant difference in recent years has been that large institutional investors like BlackRock, Vanguard, and State Street have embraced the ESG movement.²⁴ And when the Business Roundtable, an association of the CEOs of some of America's largest companies, issued a statement of corporate purpose in 2019 that recognized a commitment to stakeholders beyond shareholders and specifically committed the signatories to investing in employees, supporting communities, and protecting the environment,²⁵ many observers concluded that this was a watershed event.²⁶ To some extent, however, the Roundtable statement was a lagging, not a leading indicator. In 2018 the Governance and Accountability Institute had reported that 86% of S&P 500 companies had published sustainability reports that year, up from about 20% in 2011.²⁷

Another indicator of the rising importance of ESG is the appearance of ESG rating agencies, such as MSCI, Sustainalytics, Bloomberg ESG, and ISS, that advise investors with respect to the ESG efforts and attainments of various companies.²⁸ Finally, if one had any doubt that the ESG movement is real, one need only look at the 2021 proxy contest at Exxon in which investors displeased with Exxon's pace or commitment to

22. See HAROLD R. BOWEN, *SOCIAL RESPONSIBILITIES OF THE BUSINESSMAN* (1953).

23. The ESG term dates back to at least 2006. See Betsy Atkins, *Demystifying ESG: Its History & Current Status*, FORBES (June 8, 2020, 4:49 PM EDT), <https://perma.cc/9D7M-L73H>.

24. See Gadinis & Miazad, *supra* note 2, at 1405-06 (describing these firms as being "chief supporters" of the ESG movement). BlackRock, State Street, and Vanguard are not just any large institutional investors. Often characterized as the Big Three index funds, these fund families collectively owned more than 20% of the shares of the S&P 500 in 2017 and their collective ownership and influence is growing rapidly. See generally Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019).

25. *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE (Aug. 19, 2019), <https://perma.cc/XUT6-HRYL>.

26. See Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 124-26 (describing media reaction to the Business Roundtable statement).

27. See Governance & Accountability Inst., Inc., *supra* note 4.

28. See generally Betty Moy Huber & Michael Comstock, *ESG Reports and Ratings: What They Are, Why They Matter*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 27, 2017) (discussing the methodology of the major ESG data providers).

dealing with climate change replaced three of Exxon's proposed directors with "greener" alternatives."

As the preceding paragraphs suggests, closely related to ESG is the concept of stakeholderism – the idea that companies should be managed in the interest of all corporate stakeholders, not just shareholders. Of course, CSR, ESG, and stakeholderism have been and remain hugely controversial despite seemingly widespread embrace of ESG by institutional investors and even major corporations. In 1970, Milton Friedman famously opined that "there is one and only one social responsibility of business – . . . to increase its profits so long as it stays within the rules of the game[.]"²⁹

Much more recently, Lucian Bebchuk and Roberto Tallarita have decried "the illusory promise of stakeholder governance," arguing that stakeholderism as put forward by advocates would be inadequate and counterproductive.³⁰ In their view, external regulation is a better way of protecting stakeholder interests than re-orienting the internal governance of companies to attempt to protect non-shareholder interests.³¹ Why? Because stakeholderism tends to increase managerial discretion (away from a sole focus on share value maximization), and there are no guarantees that such discretion will be used to advance stakeholder interests.³² They also fear that widespread acceptance of stakeholderism will reduce the pressure for regulation, which will ultimately harm stakeholders.³³ Finally, they suspect that some advocates of stakeholderism are less interested in advancing stakeholder interests than in limiting shareholder power vis-à-vis management.³⁴

Colin Mayer has critiqued Bebchuk and Tallarita's assessment of stakeholderism arguing that the pair overstate the difficulty of balancing competing stakeholder interests and that, given the risk of regulatory capture, external regulation is no panacea.³⁵ To the latter observation, one could add that, in the U.S., at least, legislative disfunction

29. Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021), <https://perma.cc/4VJJ-Y4MU>.

30. Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), <https://perma.cc/R9Y3-L8FZ> (describing corporate executives as agents of their shareholders with, executives of eleemosynary institutions aside, a duty to maximize shareholder value while complying with law and ethical constraints).

31. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 94.

32. *Id.*

33. *Id.* at 98-100. With Kobi Kastiel, Bebchuk and Tallarita have argued in related work that history suggests that executives will not use discretion to benefit stakeholders at the expense of shareholders. See Lucian A. Bebchuk, Kobi Kastiel & Roberto Tallarita, *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467 (2021) (analyzing transactions governed by state "constituency statutes" and finding that executives used the discretion afforded by these statutes to benefit themselves, shareholders, and directors, but not other stakeholders, in any meaningful way).

34. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 101.

35. *Id.* at 97.

36. Colin Mayer, *Shareholderism Versus Stakeholderism—A Misconceived Contradiction*. A Comment on "The Illusory Promise of Stakeholder Governance" by Lucian Bebchuk and Roberto Tallarita (Eur. Corp. Governance Institute—L. Working Paper, Paper No. 522/2020, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3617847.

likely places even plainly sensible social and environmental regulation out of reach at present.

In this Article, however, I do not intend to engage in the broader ESG or stakeholderism debate. My focus is on the role that executive pay can and does play in shaping ESG incentives. Unsurprisingly, as pressure to adopt ESG goals has intensified, companies have begun tying executive pay to ESG performance. Statistics on the adoption of ESG metrics within executive pay plans vary widely, however, likely due to differences in determinations of what counts as ESG or CSR.³⁷ Bebchuk and Tallarita investigated CEO pay at the 20 companies represented on the Roundtable board in 2019 and found that only three (15%) linked bonuses to quantifiable stakeholder metrics.³⁸ But in their analysis of 2020 CEO pay at S&P 100 companies, Bebchuk and Tallarita found that 53% included some ESG metrics.³⁹ In its 2020 survey of over 100 major companies, compensation consultant Meridian, found that 20% of respondents included ESG metrics in their incentive programs.⁴⁰ By contrast, in a 2021 report, another consultant, Semler Brossy, reported that 62% of Fortune 200 companies disclosed the use of ESG metrics in senior executive pay contracts, although only 23% of these companies disclosed a standalone metric.⁴¹

Information on the economic significance of ESG incentives is even more sparse. In their earlier analysis of 2019 CEO pay at Roundtable companies, Bebchuk and Tallarita could only assess significance at two of these companies, finding that stakeholder concerns contributed to only 3% of the CEO's annual bonus at Marriott and about 21% at Duke Energy.⁴² In their more recent analysis of 2020 compensation at S&P 100 companies, Bebchuk and Tallarita found that in "most cases" in which ESG metrics were disclosed, these metrics represented only 1.5% to 3% of total CEO 2020 compensation.⁴³ In a 2018 publication, Matt Turner of Pearl Meyer, yet another compensation consultant, noted that ESG metrics typically account for "10-20% of the total" "incentive funding formula," presumably referring to the annual bonus calculation.⁴⁴ In their study of the S&P 500 between 2004 and 2013, Flammer, Hong, and Minor calculated that CSR-based compensation represented 4.2% of total annual compensation, on

37. This Article's approach to defining ESG metrics, and specifically E&S metrics, is detailed below in Part II.B.2, and a list of E&S metrics is provided in Appendix B.

38. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 149-51. Bebchuk and Tallarita also cite a 2019 Conference Board report indicating that only 2.6% of the Russell 3000 companies include nonfinancial metrics, like ESG, in awarding bonuses. *Id.* at 148. It would not be surprising, however, if larger companies which attract greater investor scrutiny adopted ESG pay incentives more quickly than smaller firms.

39. Bebchuk & Tallarita, *ESG-Based Compensation*, *supra* note 6, at 15.

40. See Meridian Compensation Partners, LLC, *supra* note 5, at 3.

41. DEBORAH BECKMANN, BLAIR JONES & AVI SHELDON, SEMLER BROSSY, *MOVING CAUTIOUSLY ON ESG INCENTIVES IN COMPENSATION 4* (2021). The use of a standalone metric is as opposed to including ESG in discretionary evaluation or as one element on a "scorecard" approach to performance evaluation.

42. See Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 151.

43. Bebchuk & Tallarita, *ESG-Based Compensation*, *supra* note 6, at 15.

44. Matt Turner, Pearl Meyer Ask the Expert, *The ESG Impact on Executive Compensation 1* (2018).

average.⁴⁵

From a normative perspective, the idea of using executive pay to drive ESG efforts is also quite controversial. Bebchuk and Tallarita consider whether executive pay practices could be modified to advance stakeholder interests. They are skeptical, noting the difficulty of finding appropriate metrics for the myriad of stakeholder interests and “aggregating and balancing the interests of the various constituencies.”⁴⁶ Alex Edmans’ shares this concern and notes the potential unintended consequences that can arise from incorporating ESG targets in executive pay packages. One example: “Rewarding CEOs according to average employee pay may encourage them to outsource or automate low-paid jobs”⁴⁷ He also focuses on the difficulty of measuring performance with regard to diversity, for example, where, unlike, say, earnings per share, no consensus on measurement exists.⁴⁸ Finally, Edmans worries that ESG pay targets will be adopted that represent the flavor of the day rather than being based on their materiality to a particular company.⁴⁹ To be sure, Edmans notes that ESG-based pay targets might be appropriate in particular circumstances where particular ESG concerns are “much more important than any other stakeholder issue.”⁵⁰ In general, however, he would decline.

II. How Companies Create ESG-Based Executive Pay Incentives

This Part takes a deep dive into how companies that have adopted executive pay ESG incentives incorporate these incentives into their pay schemes. It begins with a brief overview of modern executive pay practices more generally to provide context.

A. Modern Executive Pay Arrangements

At a 30,000-foot level, public company executive pay practices are quite homogeneous.⁵¹ CEOs and other top executives receive base salary, annual bonuses paid in cash or shares, and “long-term” incentive pay that typically consists of equity-based pay. I initially place “long-term” in quotes because the most popular equity pay instruments today are performance shares that pay out in three years based on performance over a three-year period.⁵² In addition, senior executives receive various perks

45. Flammer et al., *supra* note 9, at 28.

46. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 160. In their more recent work, Bebchuk and Tallarita stress the enhanced agency problems arising from poorly disclosed ESG-based pay. Bebchuk & Tallarita, *ESG-Based Compensation*, *supra* note 6.

47. Edmans, *supra* note 8.

48. *Id.*

49. *Id.*

50. *Id.*

51. David I. Walker, *The Law and Economics of Executive Compensation: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 232, 236-37 (Claire Hill & Brett McDonnell, eds., 2012).

52. David I. Walker, *The Way We Pay Now: Understanding and Evaluating Performance-Based Executive Pay*, 1 J.L. FIN. & ACCT. 395, 405-06 (2016) (documenting the large-scale replacement of compensatory stock options with three-year vesting performance shares).

that are reported as compensation, such as personal use of corporate aircraft, and in some cases receive above market returns on pension plans that are reported as income, although these latter categories are typically small relative to the primary pay elements. For example, for 2020, GM's CEO Mary Barra received total pay of \$23.7 million, consisting of \$2 million salary, \$3.8 million annual bonus, \$16.8 million equity pay, and \$1 million other.⁵³

When one drills deeper, differences in pay practices appear. Top executive annual bonuses, for example, are typically based on some combination of firm and individual performance, either of which may be based upon financial and non-financial targets (such as ESG performance). Boards often have discretion in determining ultimate bonus amounts. Because ESG-based pay is almost always incorporated in annual bonus determinations, more detail on annual bonus design will be provided in the following section.

Equity pay elements have evolved over the years. In the late 1990's, stock options dominated equity-based pay, accounting for up to 85% of equity-based pay,⁵⁴ but option use has waned more recently.⁵⁵ Executive stock options are uniformly granted at the money (that is, with exercise or strike price set equal to the market price of the stock on the grant date), vest or become exercisable over a period of years following grant and expire 10 years after the grant date.⁵⁶ Restricted stock or restricted stock units (RSUs) comprise a second category of equity-based pay. As the term suggests, restricted stock consists of stock grants to executives, typically at zero cost, that vest or become owned outright several years following grant.⁵⁷ For more than 30 years, restricted stock has accounted for a significant minority of equity grants by U.S. public companies in aggregate.⁵⁸ As briefly noted above, today the dominant equity instrument is the performance share or performance share unit (PSU).⁵⁹ Unlike options and restricted stock that pay off based on share price but not other company performance metrics, PSU plans specifically incorporate other performance criteria. A typical PSU delivers a variable number of shares at the end of a three-year performance period. The number of shares can be based on any number of criteria and in some case multiple criteria. Typically, these metrics are share price based, such as total shareholder return, or accounting based, such as return on equity. Often performance is measured

53. See General Motors, Proxy Statement (Form DEF 14A), at 69 (Apr. 30, 2021). Note that these figures represent total pay as defined by the SEC. It is a mix of realized compensation and the expected value of some compensation elements.

54. See David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting*, 64 VAND. L. REV. 611, 633 (2011).

55. Compensation consultant FW Cook reports that stock options accounted for 18% of total equity compensation for the CEOs of the largest 250 U.S. public companies for 2020. FW COOK, 2020 TOP 250 REPORT 6 (2020).

56. Walker, *supra* note 51, at 237.

57. *Id.*

58. FW Cook reports that restricted stock accounted for 22% of top 250 CEO equity pay in 2020. FW COOK, *supra* note 55, at 6. In the 1990s, restricted stock accounted for about 10% of senior executive equity pay at large companies. See Walker, *supra* note 54, at 633.

59. Performance awards accounted for 59% of equity pay for the top 250 CEOs in 2020. FW COOK, *supra* note 55, at 6.

relative to that of a group of peer companies. At the end of the day, because PSUs pay off in shares, the value of the instrument is a function of both the specific performance criteria and the company's share price.⁶⁰

B. How Companies Incorporate ESG Into Executive Pay Schemes

1. Sample Companies

In their 2020 article, Bebchuk and Tallarita looked for ESG-based pay at the twenty companies whose CEOs served on the board of the Business Roundtable in 2019 when the Roundtable issued its statement of corporate purpose embracing ESG.⁶¹ Presumably, the authors chose to investigate these companies in expectation that they would be leaders in the ESG movement and ESG implementation. Curious as to how ESG pay practices have evolved at these companies, I included in my analysis the nineteen companies from this set that remained public during the 2021 proxy season.⁶² I also investigated executive pay at the twelve public companies whose CEOs joined the Roundtable board between 2019 and 2021.⁶³ In total, I investigated executive pay at thirty-one companies whose CEOs currently or recently served on the Roundtable's board.⁶⁴

2. What Are ESG Metrics?

As an initial matter, before analyzing the incidence or strength of ESG-based pay incentives, one must define what counts as an ESG or CSR metric. As I believe is conventional, I have chosen to focus on environmental and social metrics and not corporate governance. Of course, good corporate governance is important, but it makes little sense to think about paying executives for adopting governance best practices such as adopting excess pay clawback mechanisms.

But even within the world of E&S, there can be disagreement on what "counts." Some initiatives, such as those focused on diversity and sustainability, should obviously be included, but other calls are closer. Assuming for the moment that E&S metrics aren't just window dressing, I take as a given that compensation would be tied to E&S performance because the board and/or the executives believe that insufficient attention would otherwise be paid to these matters because they either conflict with shareholder value maximization (e.g., oil companies committing to leave exploitable resources in the ground) or because the equity markets may not immediately recognize the value proposition and fail to reward such efforts through an increase in share

60. Walker, *supra* note 52, at 410-16.

61. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 149.

62. One company represented on the 2019 Roundtable board, United Technologies, was acquired in 2020. Raytheon Press Release, *United Technologies and Raytheon Complete Merger of Equals Transaction*, RAYTHEON TECH. (Apr. 3, 2020), <https://perma.cc/5AFV-KYMZ>.

63. The CEOs of five non-public companies sat on the Roundtable board in May 2021. See Appendix A.

64. See Appendix A for a list of companies making up the sample.

price. If directors, executives, and the market all agreed that sustainability efforts, for example, were the most efficient way to boost share price, share-based pay would be sufficient and targeted incentives unnecessary.⁶⁵

Using this lens and drawing on E&S metrics employed elsewhere, I developed the list of E&S categories detailed in Appendix B. The list of environmental categories should not be considered exhaustive, but environmental metrics are relatively easy to identify and include. Within the realm of “social” categories, some will uncontroversially count, such as diversity, employee and product safety, sexual harassment, and human rights. But I have also chosen to include as ESG metrics some categories where there may be no misalignment vis-à-vis share value maximization, such as employee satisfaction and privacy policies.

I have chosen to exclude from my primary analyses two categories that are sometimes included as E&S – customer satisfaction and product quality.⁶⁶ While these are hard lines to draw, satisfying customers and providing high quality products is what customer-facing and product-producing businesses do and is the source of their profits and share value. There is no conflict between shareholders and other stakeholders when it comes to satisfying customers and making high quality products. However, out of an abundance of caution I have noted in the Appendix cases in which firms tie executive pay to customer or client satisfaction.⁶⁷

3. Increasing Incidence of ESG-Based Pay at Roundtable Board Companies

While the focus of this paper is on *how* firms link pay to ESG performance and the resulting economic significance, the growing use of ESG-based pay is also noteworthy. My research assistant and I closely read the proxy statements of the thirty-one sample companies in order to assess what these firms disclosed about the linkage between ESG performance and pay.⁶⁸ We were able to roughly estimate the amount of compensation tied to ESG at thirteen of these thirty-one companies. The remaining eighteen companies in the sample either claimed to take ESG into account but provided too little information for any credible estimate, failed to make any disclosure with respect to ESG pay, or clearly did not include ESG in making compensation decisions. Consistent with the idea of rapid change in this space, however, five of these eighteen companies noted in their proxy statements that they were adding ESG metrics for their

65. This is the position of Alex Edmans who argues that in most cases executive pay should be tied exclusively to share prices over the long term and not to ESG metrics. Edmans, *supra* note 8.

66. See, e.g., Karen Maas, *Do Corporate Social Performance Targets in Executive Compensation Contribute to Corporate Social Performance?*, 148 J. BUS. ETHICS 573, 577 (2018) (including product quality as an ESG metric in analyzing the relationship between ESG-based compensation and ESG performance).

67. At Marriott, for example, 15% of senior executive annual bonuses is tied to guest satisfaction measurements. It is difficult to imagine anything more central to a hotelier's business model than guest satisfaction. In my view, this is not what is typically meant by ESG. See Marriott International, Proxy Statement (Form DEF 14A), at 35 (May 7, 2021).

68. In the large majority of cases, this was calendar year 2020 pay reported in 2021 proxy statements. A few companies hold annual meetings in the fall. For these companies the most recent data was for pay in the 2019 calendar year.

2021 pay period.⁶⁹

Focusing in on the Bebchuk and Tallarita sub-sample, we found that nine of the nineteen companies that remained public linked 2020 pay to ESG performance in a quantifiable way, up from three companies two years ago, while three of the remaining ten announced plans to add ESG metrics for 2021 pay.⁷⁰ While the Roundtable board represents a small sample and likely a group of firms subject to particular scrutiny given the public position of the Roundtable on ESG, this rapid increase in adoption of ESG-based pay remains striking.

4. How is Executive Pay Tied to ESG?

I now turn to the question of how sample companies linked executive pay to ESG performance. At the thirteen firms for which we were able to roughly estimate the amount of compensation tied to ESG, equity-based pay was tied to ESG at only one company – Duke Energy. In the other twelve cases, only annual bonuses were tied to ESG performance in a way that could be roughly estimated. This section examines how these quantifiable linkages were accomplished and why in some other cases the link between pay and ESG performance could not be quantified with any confidence.

a. Tying Annual Bonuses to ESG

Let us begin by examining how firms tied annual bonuses to ESG performance. Exactly how this was accomplished varied. In most cases bonuses were based on qualitative as well as quantitative measures and boards or compensation committees had significant discretion in determining ultimate bonus payouts. This subsection briefly outlines how ESG was tied to annual bonuses at four companies – GM and Dow, where the link could be quantified, if only roughly, and Eastman Chemical and IBM, where one can only speculate as to the economic significance of the link.

As is true for many companies, GM sets annual bonus target payouts for its senior executives, and actual bonuses may range from 0 to 200% of these targets.⁷¹ 2020 senior executive bonuses at GM were based 75% on financial measures and 25% on strategic goals.⁷² Financial performance was determined at the firm level, and so financial results were the same for all executives. Performance relative to strategic goals was determined at the individual level.⁷³ With respect to the latter, GM employs a point system, sometimes referred to as a scorecard, that the reviewing body – the board or compensation committee – uses to assess performance against pre-set goals.⁷⁴ GM did not disclose the specific scorecard results, but strategic objectives were divided into three categories, two of which – culture and people, and transformation – were heavily focused on ESG attainments, such as joining a Business Roundtable initiative on equity and

69. These companies are Apple, Boeing, CVS, IBM and Raytheon.

70. See Appendix A.

71. General Motors, Proxy Statement (Form DEF 14A), at 46 (Apr. 30, 2021).

72. *Id.* at 51.

73. *Id.* at 52.

74. *Id.* at 51.

diversity and increasing investment in electric vehicles to \$27 billion by 2025.⁷⁵ The third strategic goal category – core operations – was not chiefly focused on ESG. Thus, I was able to roughly estimate that two-thirds of 25% of 2020 annual bonuses at GM were related to ESG performance.

Dow employed an approach similar to GM's in determining top executive bonuses for 2020, but unusually among sampled companies, Dow provided specific quantitative targets and attainments for its ESG metrics.⁷⁶ Similar to GM, Dow first specified that 80% of annual bonuses was to be based on financial measures and 20% on ESG performance.⁷⁷ ESG performance was divided into three categories—customer satisfaction, measured against a customer experience index; sustainability, also based on an index; and inclusion, based on three measures: participation in employee led groups fostering inclusion at Dow, global representation of women, and U.S. ethnic minority representation.⁷⁸ Given my decision to exclude customer satisfaction from quantitative ESG analysis, I determined the ESG portion of the Dow annual bonuses to be two-thirds of 20% or 13.3%.

The common feature of the GM and Dow annual bonus plans is the clear division of the bonus opportunity between a financial or firm-wide portion, which does not include ESG performance, and a non-financial or individual portion, which does include ESG. Indeed, this is a feature shared by the bonus plans at all thirteen firms at which the link between annual pay and ESG performance could be roughly estimated.

Eastman Chemical employed a slightly different approach in determining top executive bonuses for 2020, an approach that effectively precludes quantification of the link between pay and ESG performance. Eastman first assesses company financial performance relative to pre-determined targets to determine an overall, company-wide bonus “pool.”⁷⁹ Then, individual bonuses are adjusted for individual performance which is assessed relative to pre-determined financial and non-financial performance “commitments.”⁸⁰ This adjustment is often referred to as an individual performance “multiplier.” Two of the four commitments assessed for Eastman CEO Mark Costa for 2020 involved financial and business performance and company growth and innovation, not closely related to ESG, but the other two addressed employee wellness and safety and inclusion and diversity efforts, which are ESG related.⁸¹ Although the proxy statement indicates that individual commitments carried no specific weighting,⁸² one might consider treating 50% of the individual portion of Eastman's annual bonus as ESG-based pay. However, Eastman also does not disclose how individual performance affects bonus payouts, i.e., how the multiplier works. We only know that there

75. *Id.* at 57.

76. Dow Inc., 2021 Proxy Statement (Form DEF 14A), at 52-53 (Mar. 5, 2021).

77. *Id.* at 52. At Dow, none of these performance measures is individualized. An executive's final bonus amount also reflects individual performance, but the proxy statement provides little information on the determination of individual multipliers.

78. *Id.* at 53.

79. Eastman Chem. Co., 2021 Proxy Statement (Form DEF 14A), at 47-48 (Mar. 25, 2021).

80. *Id.* at 48-49.

81. *Id.* at 49.

82. *Id.*

are two elements – a purely financial company-wide element and an individual element – but we have no indication as to how they are weighted. Moreover, given the fact that firms that explicitly divide bonus opportunities into financial/non-financial portions or firm-wide/individual portions routinely assign greater weight to the former,⁸³ it does not seem reasonable to assume, say, a fifty-fifty weighting of firm-wide and individual performance at Eastman. Ultimately, I concluded that while it is clear that ESG plays a role in executive bonuses at Eastman, the link could not be quantified with any degree of confidence and Eastman was excluded from the quantitative analysis in Part III.

The link between ESG performance and executive bonuses at IBM was even more uncertain. As an initial matter, financial performance determines bonus payouts at IBM, but the board's compensation committee has discretion to adjust payouts "based on factors beyond IBM's financial performance [including improvements in the] diversity and inclusion of IBM's workforce."⁸⁴ There were no such adjustments for 2020.⁸⁵ Moreover, base payouts can be adjusted for individual performance (a multiplier). For 2020, the IBM compensation committee recognized its CEO's accomplishments with respect to societal impact, talent development, and leadership, all of which implicate ESG, in addition to business results in deciding *not* to adjust the CEO's bonus from the base payout amount.⁸⁶ ESG apparently plays some role in annual bonus determinations at IBM, but the size of the contribution is anyone's guess.

b. Tying Equity Pay to ESG

As noted, Duke Energy was the only company within the thirteen-company subsample to tie equity pay to ESG attainment. Duke actually tied both annual bonus and equity-based pay to ESG performance for 2020. Safety and environmental performance together accounted for 5% of 2020 top executive bonuses.⁸⁷ But much more significantly, Duke issued performance shares to its top executives that vest after three years based on three factors—cumulative earnings per share (50%), total shareholder return relative to peer companies (25%), and safety (25%).⁸⁸ Safety performance is assessed based on workplace injury rates as compared to peer companies.⁸⁹ Each Duke executive was assigned a target number of shares based on his or her salary.⁹⁰ The ultimate

83. See, e.g., *supra* notes 72, 77 and accompanying text (discussing the weighting of financial and non-financial inputs into bonus calculations at GM and Dow).

84. Int'l Bus. Machs. Corp., 2021 Proxy Statement (Form DEF 14A), at 37 (Mar. 8, 2021).

85. *Id.* (reporting a 2020 pool funding score of 85% of target before and after qualitative adjustments).

86. *Id.* at 44 (reporting that the CEO received a 2020 bonus at 85% of target, unadjusted from the company's overall bonus funding score).

87. Duke Energy Corp., 2021 Proxy Statement (Form DEF 14A), at 44 (Mar. 23, 2021). The safety metric was a measure of workplace injuries and illnesses. The environmental metric was a measure of reportable events, i.e., spills or other reportable releases. *Id.* at 45.

88. *Id.* at 46-48.

89. *Id.* at 48.

90. *Id.* at 46.

number of shares received falls along a sliding scale based on company performance in these three categories.⁹¹ As noted above, the ultimate value provided by performance shares is a function of the number of shares received and their value. As a result, although 25% of the shares issued under this plan are a function of ESG performance (safety), it arguably overstates the case to say that 25% of performance share value at Duke is tied to ESG.⁹² Nonetheless, that is what I have done, because 1) it is impossible to tease out the share price incentive from the ESG incentive and 2) doing so, if anything, tends to overstate ESG incentives. I would prefer to overstate ESG incentives than to understate them.

Although the linkage between equity pay and ESG performance could be estimated only at Duke Energy, several other firms claim that ESG performance affects equity-based pay as well as other pay elements. Walmart, for example, had the following to say about the impact of non-financial performance on executive compensation:

[W]hile non-financial metrics are not directly included in our incentive plans, non-financial performance can impact [executive] pay in two key ways. First, [executive] annual performance evaluations include non-financial metrics such as sustainability and culture, diversity, equity and inclusion. . . . [The compensation committee] considers performance evaluations, along with other factors, when making pay decisions.⁹³

For example, while performance-based equity instruments issued to Walmart executives ultimately pay off based on financial performance, ESG performance could factor into the target number of shares issued to individual executives. However, while such a linkage is suggested at Walmart, Procter & Gamble,⁹⁴ PayPal⁹⁵ and Cummins,⁹⁶ the proxy statements of these companies disclose nothing to indicate that this has occurred or how large a role ESG performance played.

III. How Economically Significant Are ESG-Based Executive Pay Incentives?

This Part evaluates the economic significance of ESG-based executive pay incentives at firms that have adopted such incentives and disclosed sufficient information for at least rough estimation. I begin with the standard economic model of executive incentives, which holds that executive motivations are a function of an executive's entire portfolio of incentives—those arising from shares held outright, from equity pay grants from prior years that remain unvested or unexercised, and from current year

91. *Id.* at 46-48. For example, Duke reported that under the 2018-2020 performance share plan, which incorporated the same metrics, executives received 114% of target shares. *Id.* at 48.

92. Compare, for example, a *cash* bonus tied 75% to financial performance and 25% to ESG. In this case, 25% of the bonus is clearly tied to ESG and ESG alone. Designing the plan to pay off in company shares rather than cash complicates the incentive picture somewhat.

93. Walmart Inc., 2021 Proxy Statement (Form DEF 14A), at 52 (Apr. 22, 2021).

94. Procter & Gamble Co., 2020 Proxy Statement (Form DEF 14A), at 34, 38 (Aug. 28, 2020).

95. PayPal Holdings, Inc., 2021 Proxy Statement (Form DEF 14A), at 47 (Apr. 13, 2021).

96. Cummins Inc., 2021 Proxy Statement (Form DEF 14A), at 42-43 (Mar. 29, 2021).

equity grants and bonuses.⁹⁷ By this reckoning, ESG incentives embedded in annual bonus calculations appear much too small to be economically significant, and ESG metrics would likely be significant only in the rare cases in which ESG factors into equity compensation payouts. From this I conclude that incorporation of ESG metrics in annual bonus determinations is either window dressing or that the directors of these companies don't accept the standard model.

I am not aware of any previous work that has attempted to contextualize ESG incentives in this fashion. In previous work, ESG incentives have been compared to annual bonuses⁹⁸ or to total annual compensation,⁹⁹ and some commentators have remarked on the relative paltriness of ESG incentives.¹⁰⁰ But both of these approaches are inconsistent with the standard economic approach and actually *over-state* the significance of ESG incentives relative to that approach.

To be sure, recent evidence indicates that some directors believe that executives are motivated less by their portfolio of incentives and more by recognition of and reputation for strong performance.¹⁰¹ Under this view, annual "flow" pay and ESG-based bonuses take on heightened importance. While still relatively small, ESG metrics embedded in annual bonuses typically do represent a larger fraction of annual pay than of aggregate portfolio incentives.

A. Economic Significance of ESG-Based Pay Under the Standard Economic Model of Executive Incentives

1. Applying the Model in the Context of ESG-Based Pay

The standard economic model begins with the assumption that corporate executives seek to maximize their wealth.¹⁰² Of course, that is an over-simplification. Executives care about their personal reputations as well as, to a greater or lesser degree, social and environmental issues like the rest of us. But the standard model assumes executives are wealth maximizers. As noted, under this model the source of gains is immaterial. Incentives from shares held outright, outstanding equity grants, and current year incentives are fungible.¹⁰³

In this context, we may also take as a given that companies tie compensation to ESG performance because the board and/or the executives believe that insufficient attention would otherwise be paid to these matters. Attention to ESG might be

97. See also Core et al., *supra* note 12, at 29 (recognizing that incentives also arise from reputational effects).

98. Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 150-51.

99. Flammer et al., *supra* note 9, at 28; Bebchuk & Tallarita, *ESG-Based Compensation*, *supra* note 6, at 15.

100. See, e.g., Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 151 (characterizing the weights of ESG metrics at Marriott, for example, as "negligible").

101. See *infra* Part III.B.

102. See Core et al., *supra* note 12, at 29 (defining incentives as variation in wealth related to stock price).

103. See *id.*

insufficient because ESG efforts conflict with shareholder value maximization or because the markets fail to immediately recognize the value proposition of ESG efforts and thus fail to reward such efforts through an increase in share price. If directors, executives, and the market all agreed that ESG efforts were the most efficient way to boost share price, share-based incentives would be sufficient and targeted ESG incentives unnecessary.

In economics-speak, the assumption here is that ESG and financial/share-based goals are substitutes for one another and so advancing one does not advance the other. As Bengt Holmstrom has explained, under the standard model when agents are charged with multiple tasks that are substitutes, time or other resources dedicated towards one effort reduces the time or other resources available for other efforts.¹⁰⁴ In such a situation, the principal seeking to advance secondary tasks can provide incentives for these tasks in addition to those aimed at the primary task, or the principal can reduce incentives for the primary task thereby reducing the agent's opportunity costs of advancing secondary tasks.¹⁰⁵ If one assumes that companies are unlikely to reduce executive incentives to maximize share value, they are left with the alternative of implementing incentives to advance ESG goals.

2. Fundamental Incomparability of Incentives

Even given the abovementioned assumptions, it is impossible to precisely compare ESG and share-based incentives. Suppose, for example, that an executive has only two elements of compensation—some number of performance shares tied to the company's three year total shareholder return and a bonus opportunity that is a function of achieving various ESG targets. Suppose the two incentives have the same expected value as reflected in the proxy statement. Does this mean that the two incentives exert the same influence on the executive? It does not. We would have to evaluate the degree to which the executive can influence the share price and the achievement of the ESG target and the effort required to move one needle or the other. There is no way to do this systematically.¹⁰⁶

104. Bengt Holmström, *Pay for Performance and Beyond*, Nobel Prize Lecture (Dec. 8, 2016), in *THE NOBEL PRIZES*, 413, 428 (2016). More precisely, Holmstrom explains that when tasks are substitutes, more time spent on task A increases the marginal cost of time spent on task B. *Id.*

105. *Id.* at 428-30. See also Edmans, *supra* note 8 (arguing that firms should eliminate all executive incentives not based on long-term share price).

106. Contrast this situation with the project of comparing or aggregating various equity-based incentives—e.g., stock owned outright, restricted stock, and options. Economists have developed a common language based on the sensitivity of an instrument's value to changes in the underlying stock price (delta) and the sensitivity of an instrument's value to the volatility of the share price (vega), which facilitate comparison and aggregation. The seminal work on the sensitivity of executive pay to stock price performance is Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). For a succinct explanation of delta and vega, see Walker, *supra* note 51, at 237-38. But this common language does not extend even to all financial incentives, such as accounting-based bonuses, let alone to ESG-based incentives.

Alex Edman, Xavier Gabaix, and Dirk Jenter note that accounting-based incentives could

However, as a rough proxy for incentive strength, we can (when sufficient information is provided in proxy statements) determine the value of incentives that are tied to ESG performance (ESG-linked Dollars) and compare this to the total value of shares held, outstanding equity awards, and bonus opportunities that make up the totality of an executive's incentives (Total Incentive Dollars) to get an idea of the relative economic significance of ESG compensation metrics under the standard model.

I cannot over-emphasize how rough an approximation this is. In addition to the problem of incomparable incentives, we saw above that given board discretion, the use of scoresheets, and other limitations in evaluating qualitative goals, it is generally difficult to precisely determine even the fraction of compensation dollars that is tied to ESG. However, even this rough approximation of economic significance requires the analyst to make some choices. These choices are described in the next section.

3. What is Included in Total Incentive Dollars?

In order to compare ESG-linked compensation dollars to Total Incentive Dollars, we must define the latter. Total Incentive Dollars first includes shares held by executives outright or in various savings or retirement vehicles.¹⁰⁷ Obviously, these shareholdings create an incentive to maximize share value. Next, and for the same reason, I include all outstanding equity compensation that is issued during the current year or during previous years if that compensation has not yet been converted into shares.

Unvested restricted stock is included at its current market value as of the end of the calendar year. I estimate and include the value of unexercised stock options as of the end of the calendar year. Unvested performance shares are included at the year-end value reported in the proxy statement. In all cases, these outstanding equity awards create incentives to maximize share value.

Finally, I add the target annual bonus reported in the proxy statement for the year just ended. As described above, these bonuses typically reward both financial and non-financial, firm-wide and often individual performance. Clearly, these bonuses create incentives to improve performance along all of the relevant metrics. I use target bonus levels rather than actual bonuses paid for two reasons. First, under the standard economic model, incentives are related to bonus opportunities, not to ex post bonus realizations. Second, bonus realizations are volatile, particularly for 2020 performance which was so heavily affected by COVID-19.

I do not include salaries and other non-variable compensation in the total incentive dollar denominator. Of course, it would be naïve to think that multi-million-dollar salaries and perk packages do not influence executive behavior. Presumably, executives are motivated to continue the flow of these benefits. But what this means for the economic significance of ESG-based pay is unclear. My intuition is that, as things stand

be stronger than share price-based incentives, all else being equal, because of a clearer link between executive action and accounting results than executive action and share price. Alex Edmans, Xavier Gabaix & Dirk Jenter, *Executive Compensation: A Survey of Theory and Evidence* 24 (Nat'l Bureau of Econ. Rsch., Working Paper No. 23596, 2017). ESG metrics may be similar to accounting-based metrics in this regard.

107. All of the data discussed in the subsection is provided for the top five executives of public companies in annual proxy statements. See *infra* notes 111-14.

currently, increasing the firm's share price is the surest way of ensuring continued employment. In at least one case, the CEO of a company that made ESG a top priority and saw its share price suffer was replaced.¹⁰⁸ However, as the recent director election at Exxon demonstrates, investors also care about ESG.¹⁰⁹ Given the uncertainty, I have elected to compare ESG pay to share-based and other variable incentives, ignoring salary and perks. In most cases, salary and perks are relatively insignificant relative to share-based incentives and so their omission makes little practical difference.¹¹⁰

4. A Discrete Example of ESG-Based Pay Incentives at GM

GM's 2021 proxy statement reported a 2020 annual bonus target for CEO Mary Barra of \$4.2 million.¹¹¹ As discussed above, I estimated that 16.67% (2/3 of 25%) of that bonus (\$0.7 million) was tied to ESG. As of the date of the proxy statement, Barra also held 1.1 million shares of GM stock worth \$46.9 million.¹¹² She held unexercised stock options worth \$21.3 million as of year-end 2020.¹¹³ And she held unvested performance share units worth \$24.5 million as of year-end 2020.¹¹⁴ Combining the entire target 2020 bonus, stock, options, and PSUs, yields Total Incentive Dollars for Barra of \$97 million. The standard economic approach suggests comparing Barra's \$0.7 million of ESG-linked bonus dollars to her entire portfolio of incentives, estimated as \$97 million. Under this view, the portion of her bonus that was tied to ESG represented only 0.7% of her Total Incentive Dollars.

How should one contextualize this data? Assuming that CEO Barra only cares about her wealth, she would choose to expend GM resources and/or have the firm bear opportunity costs to achieve her entire ESG bonus only if the resulting detriment to GM's share price was less than about 0.7%.¹¹⁵ And in some ways, this calculation overstates ESG incentives. First, most ESG efforts will produce only marginal improvements and only marginal impacts on executive bonuses. Second, most ESG bonus plans incorporate several ESG metrics, reducing the significance of any particular incentive.

108. See Beckmann et al., *supra* note 41, at 4 (discussing replacement of CEO at Danone S.A.).

109. See Phillips, *supra* note 29 (discussing successful proxy contest by hedge fund Engine No. 1 that resulted in the replacement of three Exxon directors).

110. Core et al., *supra* note 12, at 30 (noting that executive incentives are largely driven by equity holdings and ignoring changes in the flow of annual compensation).

111. Gen. Motors Co., 2021 Proxy Statement (Form DEF 14A), at 50 (Apr. 30, 2021).

112. *Id.* at 36-37, 74 (2.75 million shares beneficially owned less 1.63 million shares underlying options multiplied by GM's 12/31/20 closing stock price of \$41.64).

113. Author's calculation based on data provided in the proxy statement. See *id.* at 74.

114. Author's calculation based on data provided in the proxy statement. See *id.*

115. This is a rough approximation. More accurately, one would need to compare the \$0.7 million ESG-based bonus opportunity to total equity held plus the adverse impact of pursuing ESG goals on non-ESG annual bonus dollars. In this particular case, if one (conservatively) ignores impacts on non-ESG bonus dollars, the breakeven share price detriment still rounds to 0.7%.

5. ESG Pay Significance at the Roundtable Board Member Companies

As noted above, I was able to estimate ESG-based pay at thirteen of the thirty-one public companies that supplied Roundtable board members between 2019 and 2021. The following chart displays ESG-linked Dollars divided by Total Incentive Dollars for the CEOs of each company. At the mean (median), ESG-linked Dollars represent 1.1% (0.2%) of Total Incentive Dollars. The difference between the mean and median values is basically Duke Energy, which, by including an ESG metric in its equity compensation grants, is an outlier within this group.¹¹⁶

Although it is impossible to say how large an ESG-based bonus opportunity would have to be to reach economic significance when pitted against all of the incentives an executive has to maximize share value, my intuition is that none of the annual bonus designs reaches that threshold, while the equity-based ESG incentives at Duke Energy likely does. Indeed, at four companies, Stryker, PayPal, Union Pacific, and Johnson & Johnson, the CEO’s ESG-based bonuses represent less than 0.1% of total incentives, and the fraction is 0.2% or less at three other companies, S&P Global, Cisco, and Marriott. And these low-powered incentives are not unique to CEOs. Although not reported here, the ESG fraction of Total Incentive Dollars for other senior executives whose pay is disclosed in proxy statements is very similar to that of their CEOs.¹¹⁷

116. Excluding Duke Energy, mean CEO ESG-linked Dollars/Total Incentive Dollars was 0.4%.

117. Top executives other than the CEO generally receive pay packages with the same elements

For either group of executives, however, to the extent that the standard economic model accurately describes how executive incentives work, the most commonly employed ESG incentives—those incorporated in annual bonuses—seem to serve more as window dressing than motivators of performance.

Does this analysis also suggest that other incentives, such as earnings or sales targets, embedded in annual bonuses generally lack economic significance under the standard model as well? We should not jump to this conclusion for two reasons. First, the non-ESG portion of annual bonuses is generally much larger than the ESG portion. In this sample, the ESG portion of annual bonuses ranged from 5% to 33% with a mean of just over 10%. Larger fractions of annual bonuses aimed at financial targets would naturally be more significant. Second, non-ESG incentives generally are aimed at financial or operating goals that, unlike at least some ESG incentives, are unlikely to run counter to, or to be viewed as orthogonal to, share value maximization, leading to less competition between incentives and more cooperation, if you will.

B. Executive Incentives Based on Fairness, Recognition, and Reputation

One possible interpretation of the evidence presented above is that most of the ESG-based pay incentives at this sample of companies are window dressing. Another is that the directors of the companies that have adopted these incentives don't subscribe to the orthodox view regarding incentives. And indeed, although the standard economic model dominates sophisticated analysis of executive compensation, there is some evidence that boards do not follow its dictates. In a recent paper, Alex Edmans, Tom Gosling, and Dirk Jenter present evidence from a survey of non-executive directors and major investors in UK public companies suggesting that fairness, recognition of superior performance, and reputational effects are more important than a strict consumption-based account of executive pay would suggest.¹¹⁸ Both directors and investors reported that intrinsic motivation and personal reputation were more important motivators for CEOs than compensation incentives.¹¹⁹ And only a small majority of both groups agreed that variable pay was used "to motivate the CEO to improve outcomes other than long-term shareholder value."¹²⁰

One consequence of this view is to elevate the importance of what are known as "flow" incentives—annual pay, bonuses, and current year equity compensation grants—and to downgrade to some extent the importance of portfolio incentives in thinking about executive pay. Why? Annual compensation is easily compared firm to firm, and boards can only adjust current year compensation to recognize superior performance. Thus, current year pay, particularly as compared to one's peers, more

– salary, annual bonus, equity compensation – just scaled down from the CEO levels. See Walker, *supra* note 54, at 657-60. These executives are also subject to scaled down share ownership guidelines, which are discussed in Part V.A below. Thus, it is no surprise that the ratio of ESG-based bonus dollars to Total Incentive Dollars would be similar between the CEO and other senior executives of a particular company.

118. Alex Edmans, Tom Gosling & Dirk Jenter, *CEO Compensation: Evidence from the Field* (European Corp. Governance Inst. Working Paper No. 771/2021, 2021).

119. *Id.* at 62.

120. *Id.* at 38, 62.

directly affects executive reputations. Company shares held outright and previous year equity grants don't figure into these comparisons, at least not directly.

Taken to an extreme, in evaluating ESG-based pay incentives under this view, we would simply ignore shares held outright and outstanding grants of equity compensation from previous years and instead focus solely on current year pay. As reputation is key and reputational effects rely on transparent and comparable data, the "denominator" for ESG incentive analysis under this view would be total reported compensation as presented in the SEC-dictated "summary compensation table" included in all public company proxy statements (Total 2020 Compensation).

The following chart adds the ratio of ESG-linked Dollars to Total 2020 Compensation for the CEOs of the thirteen companies to the data already presented. At the mean (median), ESG-linked Dollars represent 2.5% (1.1%) of Total 2020 Compensation. Again, the difference between means and medians is largely Duke Energy.

Clearly, shifting focus from portfolio incentives to flow incentives as the denominator heightens the relative significance of ESG-based compensation, but whether such incentives are sufficient to motivate executives with respect to ESG matters, even assuming executives discount portfolio incentives, is difficult to say. CEO ESG incentives still represent just over 1% of total flow pay at the median. In their work, Flammer, Hong, and Minor did find an economically and statistically significant relationship between CSR performance and the fraction of annual pay tied to CSR.¹²¹ Of course,

121. Flammer et al., *supra* note 9, at 29.

that is only one data point, but it is a result consistent with this currently unorthodox view of executive incentives.

IV. ESG Talk

While the ESG incentives that could be estimated from proxy disclosures turn out to be largely insignificant relative to executive incentives to maximize share value, one might not guess that from the amount of ESG discussion in those proxy statements. But perhaps this is not surprising. Firms feeling pressure to deliver on ESG might rationally decide that ESG talk is a possible substitute for ESG action in the form of pay incentives. This Part provides an impressionistic analysis of ESG talk in the proxy statements of the Roundtable board member companies.

A. Methodology

We evaluated the extent of ESG talk in proxy statements in two ways. First, we combed through the most recent proxy statements of each of the Roundtable board member companies for discussion of the E&S concepts or issues listed in Appendix B. This analysis was performed page by page, and we roughly estimated the fraction of a page devoted to ESG talk when less than a full page was devoted to these topics. We then summed up the number of pages of a proxy focused on ESG talk and divided by total proxy statement pages, excluding from the analysis shareholder resolutions and appendices. While shareholder resolutions frequently target ESG matters, these are initiated by shareholders, not management, and fall outside of the volitional management discussion of ESG that we sought to capture.

Second, most proxy statements (two-thirds of our sample) include an introductory letter to shareholders from the company's CEO, board chair, or lead outside director. These letters typically run one to two pages and allow management to highlight key issues and accomplishments. We roughly estimated the fraction of each shareholder letter devoted to ESG matters.

B. Results

For the entire sample of 31 Roundtable board member companies, on average 8% of the pages of their most recent proxy statements and 20% of shareholder letters were devoted to ESG topics. While there were exceptions, ESG proxy talk was more extensive at companies that explicitly tied executive pay to ESG results than at companies that failed to do so. On average, 10% of proxy pages at ESG compensating companies was devoted to ESG, versus 6% at firms that did not explicitly tie pay to ESG performance.¹²² On average, 30% of shareholder letters at ESG compensating companies was focused on ESG, versus 13% at the other companies.¹²³

None of this is terribly surprising. Whatever management's take on ESG and on compensating executives based on ESG, ESG matters are front and center for investors,

122. Difference in means statistically significant at the 5% level.

123. Difference in means statistically significant at the 5% level.

and companies would be foolhardy to ignore them in their presentations to shareholders. It is also not surprising that companies that have decided to explicitly tie executive pay to ESG, even if the magnitude is small, would be more focused on ESG and that focus would manifest in ESG discussion in proxy statements and shareholder letters. Finally, there may be some instances of management attempting to deflect attention away from a failure to tie pay to ESG by emphasizing their ESG efforts and accomplishments in their proxies. At J.P. Morgan, for example, executive pay does not appear to be tied to ESG in any meaningful way, but 10% of proxy pages and 25% of its shareholder letter are devoted to ESG discussion.¹²⁴ But based on this small sample, this sort of substitution does not appear to be prevalent.

V. ESG Pay Going Forward

Critics of ESG efforts generally, or of linking executive pay to ESG performance specifically, likely will not be disappointed by evidence and analysis suggesting that ESG-based executive pay incentives may be even weaker than commonly understood, but proponents of paying for ESG performance will want to know how to create more meaningful ESG-based incentives. This Part explores the possibilities. In doing so I return to Holmstrom and the implications of his work on incentives in a multitask setting. In a nutshell, incentives to advance ESG goals can be improved by incentivizing ESG performance directly in a more economically significant way or by reducing the strength of competing incentives to maximize share value. Although less realistic and promising, I will begin with the latter. Before doing so, however, let me repeat that these are not normative arguments. I recognize that I am offering a roadmap for ESG-based pay proponents, but I do so in order that all may recognize what are and are not meaningful incentives and to focus the debate on the merits. Part VI, which follows, will briefly highlight the normative arguments related to adoption of ESG-based pay.

A. Reducing Non-ESG Executive Incentives

Imagine a world in which executives received only large cash salaries and owned no stock in the companies they managed. Boards set goals for their companies—financial and ESG—and executives were rewarded for their performance by retaining their positions and receiving raises. Absent incentives tied to particular goals, the executives would maximize their financial returns, and reputations for effective management, by advancing board priorities as closely as possible. In this world, if boards took ESG goals seriously, presumably executives would as well.

Of course, this is not a plausible state of affairs. Because boards cannot perfectly monitor executives and outcomes are a result of luck as well as effort and effectiveness, agency costs in this hypothetical world would be extreme.¹²⁵ Equity compensation

124. Author's calculation based on JPMorgan Chase & Co., Proxy Statement (Form DEF 14A) (Apr. 7, 2021).

125. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) (discussing the incurrence of

exists to reduce those agency costs and better align executive incentives with those of shareholders. Of course, the alignment is imperfect,¹²⁶ but the alternative is much worse. While institutional investors are pushing public companies to advance ESG goals, they remain committed to paying executives for financial performance and for increasing share value. We should not and are not going to jettison equity-based compensation.

That said, one can certainly ask whether share-based incentives arising from outright share ownership and outstanding equity pay awards have gotten out of hand, resulting in executives focusing too much of their attention on maximizing share prices to the exclusion of advancing ESG or other non-financial goals. As noted above, at year end 2020, GM's Mary Barra held stock and equity pay instruments worth about \$93 million, and her case is not extreme.¹²⁷ At year end 2020, JPMorgan Chase head Jamie Dimon held stock and equity compensation in the company worth \$1.2 billion.¹²⁸

One can also ask whether the sources of share-based incentives are suboptimal if we want executives to take ESG goals seriously. While just over half of Mary Barra's share-based incentives arise from shares owned outright, for Jamie Dimon the fraction is about 85%.¹²⁹ As we will see below,¹³⁰ it is quite easy to incorporate ESG incentives into equity pay awards, but those incentives last only so long as the equity awards are unvested or unexercised. Once equity-based pay is converted into shares, any ESG incentives disappear. Thus, while ESG pay proponents might not want to discourage executives from holding equity interests in their companies, they might not want to encourage outright ownership as the mechanism.

One way that boards have encouraged outright ownership of company shares is through adoption of executive shareholding guidelines. Typically, companies require their CEOs and other senior executives to hold stock in their companies worth some specified multiple of their annual salaries. Today, executive shareholding guidelines are considered a key element of executive pay best practices and are strongly encouraged by proxy advisors ISS and Glass Lewis and by major institutional investors.¹³¹ Importantly, however, many companies exclude some or all outstanding equity awards in determining whether these guidelines are satisfied.¹³²

monitoring and bonding costs by principals to reduce residual losses arising from the use of agents).

126. *Id.* at 326 (explaining that expenditures on monitoring and bonding should be made as long as marginal benefits exceed marginal costs; in other words, the divergence between manager and shareholder interests will never be totally eliminated).

127. *See supra* notes 111-113 and accompanying text.

128. Proxy Statement of JPMorgan Chase & Co., *supra* note 124, at 75-76, 82.

129. Author's calculation based on data from JPMorgan Chase & Co., Proxy Statement (Form DEF 14A), at 75-76, 82 (Apr. 7, 2021).

130. *See infra* Part V.B.

131. *See, e.g.*, INSTITUTIONAL SHAREHOLDER SERVICES, ISS ESG GOVERNANCE QUALITYSCORE: METHODOLOGY GUIDE, at 57 (June 30, 2021) (noting that "[b]est practice suggests that executives attain substantive share ownership by a certain time after appointment to better align their interests with those of shareholders" and that ownership multiples of less than three times base salaries raise governance concerns for U.S. companies).

132. According to a 2020 survey, "a third of companies that grant performance awards count

One obvious change that would better support ESG pay incentives would be to count all outstanding equity awards towards share ownership guidelines. The idea behind share ownership guidelines is to ensure that incentives are aligned. Alignment is as effectively accomplished with PSU awards as with outright share ownership, and as noted, PSUs can be tied to ESG performance while outright share ownership cannot. Thus, this change would eliminate a bias in favor of executives holding shares outright in a form that does nothing to incentivize ESG performance.

B. Enhancing ESG Incentives Within Equity Pay Awards

Realistically, in order to create economically meaningful ESG incentives, these incentives must be incorporated in equity compensation awards. Why? Because that's where the money is.¹³³ But, as with all questions involving equity pay, the details are critical.

As discussed above, the three primary categories of equity pay instruments currently in use are stock options, restricted stock or restricted stock units (RSUs) (interchangeable for present purposes), and performance-based equity pay, of which performance share units (PSUs) are the most popular variety. Vesting of options and RSUs could be made contingent on achievement of particular targets, but this is very rarely done. Options and RSUs almost always vest with the simple passage of time. Time-vesting is basically a standard feature of RSUs and options.¹³⁴ Thus, rather than attempting to swim against the tide and add ESG vesting criteria to RSUs and options, the better path for ESG pay advocates would be to minimize the use of these instruments and focus on PSUs instead. PSUs can be designed to mimic the economics of options, and PSUs have already largely replaced options as the equity instrument of choice in executive compensation plans.¹³⁵ The key is to begin incorporating ESG metrics in PSUs in a meaningful way.

As described above, PSU plans typically deliver a number of shares to an executive after three years based on some performance criteria.¹³⁶ Boards or compensation

the unearned awards towards [share] ownership levels" and "over a quarter of companies that grant stock options count at least a portion of unexercised options towards ownership levels." NASPP Blog, *ISS Updates Policy on Stock Ownership Guidelines* (May 18, 2021), <https://perma.cc/2KMM-K9R7>.

133. See Mishel & Kandra, *supra* note 20, at 7 (projecting that 69% of the total 2019 grant date value of compensation for the average CEO of the 350 largest US companies would consist of stock and options).
134. See, e.g., FW COOK, *supra* note 55, at 4 (defining restricted stock as "shares or share units that are earned for continued employment").
135. One set of researchers has found that option compensation is associated with greater ESG investments. See Atif Ikram, Zhichuan Li & Travis MacDonald, *CEO Pay Sensitivity (Delta and Vega) and Corporate Social Responsibility*, 12 SUSTAINABILITY 1, 11 (2020). The idea is that ESG investment is risky because it may not pay off or may not be recognized as valuable by the equity markets. With their non-linear payoffs, options encourage risk taking. Thus, it might be argued that reducing the use of options in executive portfolios might discourage ESG. But that is not the case since the risk inducing properties of options can be easily replicated with PSUs. See Walker, *supra* note 52, at 413.
136. Walker, *supra* note 52, at 410-16.

committees set threshold, target, and maximum numbers of shares that are associated with threshold, target, and maximum performance. Performance below the threshold level results in no shares being delivered. Performance above the maximum level results in no additional shares beyond the specified maximum. Across the range from threshold to maximum, the number of shares delivered is a continuous function of performance.

Consider the following stylized example of a CEO's PSU plan. The performance measure is relative earnings per share (EPS). That is, at the end of three years, EPS will be determined for the company issuing PSUs as well as for, say, 20 peer companies and then the companies will be ranked. Threshold performance is defined as being at the 25th percentile, target at the mean, and maximum at the 75th percentile. Performance below the threshold results in no shares being issued. Threshold performance delivers 100,000 share, target performance delivers 200,000 shares, and maximum performance delivers 400,000 shares. This example is described graphically in the figure below.

There are two ways in which ESG performance can factor into PSU incentives like those described in the figure. First, ESG performance can be a factor used in determining the overall size of PSU awards, which is reflected in the target number of shares assigned to a particular executive—in my example, 200,000 shares. Target share levels are set by the board or compensation committee and typically reflect a number of factors including the size of compensation packages granted to executives at the same level at peer companies, the size of the company and scope of responsibility, and

performance along any number of dimensions.¹³⁷ As noted above, four of the thirty-one companies in my sample claimed that ESG performance was a factor or could be a factor in determining the number of shares associated with PSU or similar equity awards, but without any further elaboration.¹³⁸

In my view, this is a relatively weak way of incorporating ESG incentives into equity-based pay. First, conditioning the size of future equity awards on ESG and other performance, just like conditioning salary increases on such performance, strikes me as a remote and weak incentive, at least under the standard economic approach, which highlights an executive's portfolio of incentives. Second, determinations of the size of equity awards—the number of target PSU shares, for example—are almost always discretionary and based on multiple factors, further devaluing the incentives created. For example, the PayPal proxy statement lists seven factors (in addition to size and complexity of the position) that the compensation committee uses to determine the size of equity awards including leadership, financial and strategic performance, fostering innovation, as well as championing core values (including inclusion) and human capital development, but goes on to state that “[i]ndividual performance was evaluated based on a holistic and subjective assessment of . . . performance against these factors.”¹³⁹ To be sure, conditioning the size of equity awards on ESG performance fares somewhat better under the fairness-recognition-reputation model of executive pay as this approach highlights disclosed flow pay and larger equity awards would increase total reported compensation.

By contrast, Duke Energy's PSU design likely creates stronger ESG incentives under the standard economic approach. Recall that under Duke Energy's PSU plan the number of shares that *actually* vest after three years across the range running from minimum to maximum is a function of financial performance (75%) and safety performance (25%).¹⁴⁰ This approach creates a very discrete and immediate incentive with little role for compensation committee discretion. To be sure, the Duke Energy approach requires quantifiable metrics, like workplace injuries at Duke.

VI. Turning Normative—Should ESG Proponents Champion Meaningful ESG-Based Compensation?

This article is primarily descriptive. Its primary goals have been to describe how a small sample of firms incorporate ESG metrics in executive pay and to show that in almost all cases the incentives created appear to be economically insignificant when contrasted with the whole panoply of incentives that executives have to maximize share value. At the very least, the incentives implied by this standard economic approach are shown to be much smaller than those suggested by previous work that has considered ESG incentives relative to executive bonuses in isolation or to total annual

137. Brian D. Cadman, Mary Ellen Carter & Xiaoxia Peng, *The Participation Constraint and CEO Equity Grants*, 96 ACCT. REV. 67 (exploring determinants of CEO equity compensation grants at ExecuComp firms between 2006 and 2016).

138. See *supra* notes 93-96 and accompanying text.

139. PayPal, Proxy Statement (Form DEF 14A), at 47 (Apr. 13, 2021).

140. Duke Energy Proxy Statement, *supra* note 88.

compensation. Secondly, I have described how ESG-based incentives could be incorporated into equity pay awards in order to make them more economically significant vis-à-vis incentives to maximize share value. This Part briefly considers whether ESG proponents *should* advocate in favor of the sorts of meaningful ESG-based pay plans described in Part V. In a nutshell, I believe the answer is no. If economically significant, ESG incentives would, almost by definition, result in action by executives. But creating economically significant incentives does nothing to dispel the concerns raised by Bebchuk and Tallarita and by Edmans.¹⁴¹ If anything, it heightens them.

Relocating ESG metrics from annual bonus plans to equity compensation plans does not resolve the problems of multiple and perhaps competing ESG interests; the difficulty of measuring ESG performance in some instances, if not all; the complexity and reduced efficacy of compensation instruments with multiple metrics; and the pressure to include metrics related to the ESG “flavor of the day.”¹⁴²

At first blush, an attractive answer to these problems might be thought to lie in the use of comprehensive ESG ratings generated by one of several commercial ESG rating agencies, such as Bloomberg or MSCI. These organizations typically collect data from public sources, including company disclosures, and rate firms on a broad number of ESG indicators.¹⁴³ What could be easier than to condition equity compensation payouts on a company’s absolute aggregate ESG rating or aggregate ESG rating relative to a peer set of companies? Nothing easier, but the folly of so doing should be readily apparent to any law professor or any other academic whose school lies at the mercy of such ratings and rankings. It takes little imagination to picture companies investing in efforts that would boost their aggregate ESG ratings but provide little social value. Of course, to the extent that investors take such ratings seriously, those incentives exist today. But they would be magnified many times over if executive pay depended on such ratings in a meaningful way.¹⁴⁴

In addition to the general concerns about ESG-based pay that have been raised in the literature, I would add the problem of ESG-based pay metrics leading to increased board discretion over executive pay. Many of the eighteen companies in our sample for which we were unable to estimate ESG-based pay purported to base pay, in part, on ESG. In many cases, a principal reason for our inability to estimate the relationship was that boards had substantial discretion with respect to evaluating and weighting ESG and other outcomes in determining bonus targets and payouts.¹⁴⁵ If there is one thing we have learned about executive pay over the years, it is that enhanced

141. See *supra* notes 46-50 and accompanying text.

142. *Id.*

143. See generally Huber & Comstock, *supra* note 28 (noting, for example, that Bloomberg ESG covers 120 ESG indicators while MSCI ESG focuses on 37 key ESG issues).

144. The only good news on this front is that thus far no provider has a monopoly on ESG ratings. Competition could theoretically yield superior rating methodologies, but one would still question their general applicability.

145. See, e.g., Union Pacific, Proxy Statement (Form DEF 14A), at 64 (Mar. 31, 2021) (discussing the non-formulaic, i.e., discretionary portion of the company’s annual incentive plan which included several ESG elements).

discretion generally works in favor of the executives.¹⁴⁶ Extending the use of ESG metrics into equity-based pay would likely exacerbate this problem.

So perhaps upping the ante and incorporating ESG incentives into equity pay might not be all that desirable. Perhaps the optimal solution for most companies is the currently common one of incorporating ESG metrics into annual bonuses only. Even if economically insignificant, these ESG metrics send *some* signal to executives that ESG matters.

As Alex Edmans suggests, despite all these concerns, meaningful ESG-based pay incentives might make sense for some companies if a single or very small number of ESG issues are of over-riding importance.¹⁴⁷ Perhaps this could be the case for some large energy producers or consumers, but for firms with a myriad of ESG concerns, such as diversity, sustainability, and privacy, the obstacles to creating non-counter-productive ESG-based pay incentives are formidable.

In sum, while companies have the tools to create meaningful ESG-based pay incentives under any view of how incentives are generated, in most cases doing so is unlikely to be in the interest of shareholders or of other stakeholders.

VII. Conclusion

Economists have long been concerned about executive incentives. In the 1990s and early 2000s, the burning issue was whether executives held sufficient equity to align their incentives with shareholders and minimize consumption of perks and resistance to hostile takeovers.¹⁴⁸ In 1990, Jensen and Murphy famously claimed that CEOs were paid like bureaucrats.¹⁴⁹ That is no longer much of a concern. The concern today is whether equity incentives are so large that they swamp and render ineffective the modest incentives that have been adopted to encourage executives to pursue ESG goals. This article suggests that most ESG incentives are trivial in this context and that ESG incentives are meaningful only in rare cases in which equity-based pay is tied to ESG. From a normative perspective, however, the current state of affairs may actually be in the best interest of stakeholders and beefing up ESG incentives undesirable. Even advocates of pursuing ESG goals, in general, may agree that executive incentives are a poor way of getting the job done.

146. See, e.g., Lucian A. Bebchuk, Jesse Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 834-37 (2002) (discussing the dangers of boards making gratuitous acquisition-related payments to CEOs).

147. Edmans, *supra* note 8.

148. Jensen & Murphy, *supra* note 106, at 242 (finding that between 1974 and 1986 the median CEO of 1300 companies included in a *Forbes* survey experienced a change in wealth of only \$3.25 for each \$1,000 change in shareholder value and concluding that this was an insufficient incentive to deter executives from consuming excessive perks). See generally Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653 (1998) (documenting an increase in pay for performance sensitivity arising from increasing use of stock options and offering a broader perspective on the relationship between pay and performance).

149. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, 68 HARV. BUS. REV. 138, 138 (1990).

Appendix A – Business Roundtable Board Membership

2019

AECOM
AT&T
Boeing
Cisco Systems
Cummins
CVS
Duke Energy
Eastman
General Motors
IBM
Int'l Paper
Johnson & Johnson
JPMorgan Chase
Lockheed Martin
Marriott
Oracle
S&P Global
Stryker
~~United Technologies~~
Walmart

Added by 2021

Accenture
Apple
~~Beehtel~~
Best Buy
~~Boston Consulting~~
Dow
Eaton
Johnson Controls
~~Kaiser Permanente~~
~~Land O Lakes~~
PayPal
Proctor & Gamble
Progressive
Raytheon
Steelcase
Union Pacific
~~Vista Equity Partners~~

Bold = 2020 ESG pay could be estimated.

Italic = Has announced plans to add an ESG-based pay metric for 2021.

~~Strikethrough~~ = Not a public company in 2021.

Source: See Bebchuk & Tallarita, *Stakeholder Governance*, *supra* note 6, at 143 (2019 column); Business Roundtable, *Board of Directors* (May 26, 2021) (on file with author) (2021 column)

Appendix B – E&S Metrics Included/Excluded in Analysis

Unclassified	Committees covering ESG CSR or citizenship generally
Environmental	Climate change Greenhouse Gas (GHG) Emissions Carbon footprint Natural resource management Waste Pollution Clean/green technology Renewable resources Sustainability Energy efficiency Environmental compliance
Social	Human capital development Employee health and safety Employee satisfaction/retention/engagement Supply chain labor standards Diversity, equity & inclusion Board diversity Business ethics/culture Lobbying Political spending Shareholder/stakeholder engagement Product safety Privacy and data security Public access to health care Public access to finance Sexual harassment Human rights Community development
Excluded	Customer satisfaction Product quality