Measuring How Corporations Impact Society: The Relationship between ESG Metrics and Securities Litigation

Adam B. Badawi and Frank Partnoy*

Numerical metrics of how corporations impact society have become a crucial part of global law and policy. A wide variety of environmental, social, and governance (ESG) metrics purport to capture the features and efforts of different corporations, with varying degrees of success. These ESG metrics feature prominently in the recent academic, policy, and practitioner literatures. To date, researchers have primarily scrutinized ESG ratings, metrics, and disclosures in order to assess corporate sustainability, with an emphasis on the impact of risk on firm and portfolio performance. Separately, researchers have addressed the risks associated with disclosures about their operations and financial wellbeing, which may give rise to securities lawsuits.

Although both ESG metrics and ESG-related securities litigation have been the subject of extensive commentary from academics and practitioners, there has been almost no examination of the connection between firms that perform poorly on ESG measures and firms that commit the alleged fraud that gives rise to securities litigation. We explore this connection by bridging the gap between these two literatures. We examine the theoretical connections between ESG and securities litigation and we assess these theories through an empirical examination of a novel ESG dataset.

Our empirical analysis generates several interesting results. First, firms with high ESG metrics are less likely to be subjected to securities litigation. Second, more meritorious cases are associated with lower ESG scores. Third, ESG performance declines after a firm is sued, but that decline appears to stop after settlement. We discuss the mechanisms that may account for these findings, along with their implications for law and policy. We explore interpretations that are based on the behavior of firms, plaintiffs' lawyers, and regulators, and we discuss how these interpretations relate to recent changes in both federal and state law.

I. Introduction

The use of environmental, social, and governance (ESG) metrics to classify firms as "good" or "bad" for society[1] has become increasingly important as newer generations of

---

* Badawi and Partnoy are Professors of Law at the University of California, Berkeley School of Law. We thank Truvalue for providing access to their data. We are grateful for comments from Jill Fisch, Sean Griffith, Jim Hawley, Stephen Malinak, Elizabeth Pollman, Max Schanzenbach, and Steven Davidoff Solomon, and for research assistance from Rosie Ward and Graham Wyatt.

[1] See Roy Henriksson, Joshua Livnat, Patrick Pfeifer & Margaret Stumpp, Integrating ESG in Portfolio Construction, 45 J. Portolio Mgt. 67 (2019) (classifying firms as "good" or "bad" based on ESG metrics); see also Mozaffar Khan, George Serafeim & Aaron Yoon, Corporate Sustainability: First Evidence on Materiality, 91 Acc'ting Rev. 1697 (2016) (similarly categorizing good and bad ESG firms to examine

investors have demanded information about how corporate behavior impacts employees, vendors, customers, and society overall.[2] While academics have extensively explored the relationship between these ESG outcomes and firm risk and portfolio performance, there is virtually no work that examines the relationship between firms considered "bad" from an ESG perspective and firms that are considered problematic because they have engaged in the allegedly fraudulent activity that gives rise to securities class actions. Using a novel ESG dataset, we examine the connection between newer conceptions of good and bad corporate behavior (those associated with ESG metrics) with the traditional categorization of appropriate behavior (those implicit in the securities law framework).

The ability to link ESG performance with securities litigation provides answers to some novel questions. Are firms considered bad from an ESG perspective sued more than good firms? Are suits against these bad firms more likely to move succeed? Are firms that appear to do good less likely to commit fraud? Our analysis of comprehensive data on ESG performance and shareholder litigation provides some answers: (1) yes, bad firms are sued more than good firms; (2) yes, suits against bad firms are more likely to move forward; and (3) there is some more limited evidence that good firms are less likely to commit fraud. We argue that these answers should inform how we think about important questions about the role of corporations in society.

The use of ESG metrics reflects the recent literature's strong interest in the topic.[3] Researchers scrutinize ESG ratings, metrics, and disclosures[4] in order to assess corporate sustainability,[5] as well as the impact of ESG-related risks on firm and portfolio performance.[6]

---

stock returns); see also Consultation, Toward Common Metrics and Consistent Reporting of Sustainable Value Creation, World Economic Forum, Jan. 2020 (proposing uniform ESG metrics for consideration by the International Business Council of the World Economic Forum). We use "good" to denote firms with high ESG metrics, and "bad" to denote firms with low metrics.

[2] See Ernst & Young LLP, Sustainable Investing: The Millennial Investor (2017) (documenting the explosive growth in sustainable investing in the last decade).

[3] The ESG literature draws from an extensive earlier literature on corporate social responsibility, and a decades-long debate that we will not rehash here. See Elizabeth Pollman, Corporate Social Responsibility, ESG, and Compliance, in Cambridge Handbook of Compliance (D. Daniel Sokol & Benjamin van Rooij, eds.) (forthcoming 2020) (summarizing the early literature, including the debate over shareholder primacy versus corporate social responsibility); see also See A.A. Berle, Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049, 1049 (1931) (stating that managers should exercise power "only for the ratable benefit of all the shareholders"); E. Merrick Dodd, Jr., For Whom Are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145, 1148 (1932) (stating that the corporation "has a social service as well as a profit-making function"); Milton Friedman, Capitalism and Freedom 133 (1962) (stating that there is "only one social responsibility of business—to use it resources and engage in activities designed to increase its profits").

[4] See Jill E. Fisch, Making Sustainability Disclosure Sustainable, 107 Geo. L.J. 923 (2019) (assessing the limitations of current sustainability disclosure and assessing a new proposal for mandatory disclosure).

[5] See Stavros Gadinis & Amelia Miazad, Corproate Law and Social Risk, Vand. L. Rev. (forthcoming) (describing the recent shift in the emphasis of ESG issues and emphasizing the importance of informing the board about risks).

[6] See Max M. Schanzenbach & Robert H. Sitkoff, Reconciling Fiduciary Duty and Social Conscience: The Law and Economics of ESG Investing by a Trustee, 72 Stan. L. Rev. (forthcoming 2020) (focusing on the relationship between ESG and risk-return strategies for fiduciaries); Virgina Harper Ho, Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk, 41 J. Corp. L. 657, 651 (2016) (discussing a range of non-financial risks that can impact returns, including corporate governance, labor and employment standards, human resource management, and environmental practices").

ESG and sustainability are increasingly important concepts in the markets overall[7]: roughly a quarter of all assets under management globally, more than $30 trillion, are defined as "sustainable."[8]

Meanwhile, shareholder litigation also is a prominent topic among researchers.[9] Securities litigation is a source of voluminous scholarship, including articles questioning the extent to which litigation is socially valuable, or merely circular.[10] Shareholder derivative litigation remains one of the most controversial and puzzling topics in business law.[11] Litigation risk, propensity, and outcomes are important aspects of academic discussions of important topics such as mergers and acquisitions[12] and shareholder activism.[13] The behavior of market participants also suggests that shareholder litigation is important: companies typically purchase insurance covering litigation settlements and expenses for directors and officers, even though payments by individuals in shareholder litigation are uncommon, and corporations typically indemnify individuals against liability.[14]

---

[7] See Elizabeth Lewis et al., Navigating the Sustainable Investment Landscape, World Resources Inst. 21 (2016), https://www.wri.org/sites/default/files/Navigating_the_Sustainable_Investment_Landscape.pdf (providing an overview of strategies investors use to incorporate sustainability concerns into their portfolios)

[8] See Kirsten Ridley & Simon Jessop, Villains or Visionaries?: Hedge Funds Short Companies They Say "Greenwash," Reuters, Dec. 15, 2019, at https://www.reuters.com/article/us-global-hedgefunds-sustainable-analysi/villains-or-visionaries-hedge-funds-short-companies-they-say-greenwash-idUSKBN1YJ097.

[9] See, e.g., Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J. L. Econ. & Org. 55 (1991) (questioning the bases of shareholder litigation). Scholars also have asked whether shareholder litigation and related regulatory changes can influence corporate governance as well, including in litigation settlements. See, e.g., Stephen J. Choi, Do the Merits Matter Less after the Private Securities Litigation Reform Act?, 23 J. L. Econ. & Org. 598 (2007); (analyzing the effects of the 1995 litigation reform legislation); David F. Larcker, Gaizka Ormazabal & Daniel J. Taylor, 101 J. Fin. Econ. 431 (2011) (finding abnormal returns to events related to corporate governance).

[10] See, e.g., Jill E. Fisch, Confronting the Circularity Problem in Private Securities Litigation, 2009 Wisc. L. Rev. 333
(2009) (discussing arguments that securities litigation merely results in restribution and deadweight loss).

[11] See, e.g., See Jessica M. Erickson, Overlitigating Corporate Fraud: An Empirical Examination. 97 Iowa L. Rev. 49 (2011) (assessing derivative suits and finding, among other results, that such suits mainly target individuals, not corporations, consistent with the nature of the derivative action as an equitable suit with the corporation as only a nominal defendant); Research Handbook on Representative Shareholder Litigation (Sean Griffith, Jessica Erickson, Verity Winship & David Webber, eds.) (2018) (collecting research on derivative litigation); Adam B. Badawi & Daniel L. Chen, Shareholder Wealth Effects of Delaware Litigation, 19 Amer. L. and Econ. Rev. 287 (2017) (finding that derivative lawsuit filing has a negative effect on firm value).

[12] See Steven Davidoff Solomon & Randall S. Thomas, The Rise and Fall of Delaware's Takeover Standards, in The Corporate Contract in Changing Times: Is the Law Keeping Up? (Steven Davidoff Solomon & Randall S. Thomas, eds.) (2019).

[13] See C.N.V. Krishnan, Frank Partnoy, and Randall S. Thomas, The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise, 40 J. Corp. Fin. 296 (2016).

[14] See Tom Baker & Sean Griffith, Ensuring Corporate Misconduct: How Liability Insurance Undermines Shareholder Litigation (2010). Managers rarely pay out-of-pocket in litigation settlements, though they often face disciplinary action when litigation is accompanied by regulatory action. See Bernard Black, Brian Cheffins & Michael Klausner, Outside Director Liability, 58 Stan. L. Rev. 1055 (2006) (examining

These two topics, ESG and shareholder litigation, are obviously important to corporate observers and stakeholders. Yet research on ESG factors and shareholder litigation have mostly ignored each other. Scholars writing about ESG have not focused on how shareholders' rights to sue matter to ESG considerations and metrics.[15] Conversely, scholars writing about shareholder litigation have not focused on the implications of ESG-related practices and disclosures for shareholder litigation.[16]

Our contribution is to examine the intersection of ESG and securities litigation comprehensively.[17] Our approach is in in three parts: theoretical, empirical, and normative. First, we examine and critique various theories of how ESG and securities litigation might be related. Second, we empirically explore several propositions about the relationship between ESG and securities litigation. Third, we assess how the relationship between ESG and securities litigation matters to various policy proposals, including the disclosure regime under federal securities law and the treatment of board oversight under state law. We emphasize that our approach is to address securities litigation, not other categories of litigation that implicate ESG concerns, such as toxic tort litigation. Our approach enables us to systematically study an important category of litigation that relates to ESG.

Our goal in each of these three parts is to canvass possible arguments, data, and proposals, and to understand any common threads that run through our discussion of theory, empirics, and normative assessments. To some extent, these three parts are independent, but there also are some overlapping themes, particularly about the role of risk. We emphasize that our results and discussion relate to securities litigation specifically, though they also raise more general questions about the potential relationship between ESG metrics and other categories of litigation more generally. We leave questions about other categories of litigation for future study.

There are several theoretical reasons to believe ESG and securities litigation might be related in important ways, and it is not intuitively obvious whether, on balance, the relationship should be positive or negative, in part because of questions about precisely what is captured by measurements of ESG at firms.[18] ESG ratings might matter to securities litigation propensity and outcomes because ESG ratings are informative, perhaps as a proxy for information that is

frequency of out-of-pocket director civil liability); Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, The Consequences to Managers for Financial Misrepresentation, 88 J. Fin. Econ. 193 (2008) (finding that individual perpetrators of misconduct subject to regulatory enforcement actions face significant disciplinary actions).

[15] For example, Schanzenbach & Sitkoff, supra, refer to questions about firms' litigation risks as part of a trustee's risk-return strategy, but do not examine the relationship between ESG and litigation risk. Pollman, supra, refers to litigation risk as one of several risks that potentially can be quantified.

[16] Litigation data are a prominent feature in legal and finance scholarship and are widely cited in policy discussions by practitioners and regulators. However, these articles typically do not reference ESG at all. See infra Part II.

[17] Sean Griffith and Dorothy Lund have recently examined a broader swath of litigation, including state derivative suits and other fiduciary duty litigation, based on news searches. See Sean J. Griffith & Dorothy S. Lund, A Mission Statement for Mutual Funds in Shareholder Litigation, U. Chi. L. Rev. (forthcoming 2020). As the databases for such cases become more robust and complete, expanding our findings to include a wider range of shareholder litigation might be a promising area of research.

[18] See, infra, Sec.II.A (discussing the potential ways ESG measures and shareholder litigation may be related).

important in securities litigation.[19] If so, one would expect to see a negative relationship between ESG ratings and securities litigation propensity and outcomes, meaning that highly rated ESG firms would incur lower litigation costs. Alternatively, ESG ratings might be capturing other factors, which are only indirectly related to environmental, social, and governance policy, but which nevertheless matter to securities litigation propensity and outcomes, or which show bias with respect to litigation propensity and outcomes. In such a scenario highly-rated ESG firms might incur higher litigation costs.

Conversely, securities litigation might matter to ESG ratings because litigation draws resources away from stakeholders for the benefit of shareholders. In this case, one would expect to see a positive relationship between ESG ratings and litigation propensity and outcomes. But this perspective is also complicated. If firms that face greater shareholder litigation risk are rated lower from an ESG perspective, that association might reflect benefits associated with litigation flowing to shareholders (versus stakeholders), or it might be evidence of other firm characteristics that are negatively associated with ESG factors. Because shareholder litigation is a right held by shareholders, not stakeholders, it is not intuitively obvious from a theoretical perspective what the relationship should be between litigation benefits for shareholders and the stakeholder focus of many aspects of ESG.

There are also are interesting theoretical questions about the extent to which share prices reflect a long-term assessment of ESG-related risks. Are firms that maximize shareholder value engaging in a tradeoff between higher returns and ESG-related future risks that could become monetized through costly litigation and settlement? How is the incidence and settlement of securities litigation related to share prices? To the extent low ESG metrics are correlated with poor performance, and securities litigation also is correlated with poor performance, might a relationship between ESG and securities litigation support the conclusion that efforts to improve ESG metrics merely appear to support stakeholders, but in fact are efforts to support shareholders, particularly in the long-term? One of our goals in this article is to present and analyze these various theoretical questions and their implications.

Whereas our theoretical discussion raises many interesting and unexplored questions but generates ambiguous potential relationships, our analysis of the empirical evidence is relatively straightforward. We ask several versions of a simple empirical question (or at least a question that is relatively simple once we process and match large amounts data): do firms with different ESG ratings have different securities litigation outcomes? Specifically, we investigate three aspects of the association between ESG ratings and shareholder litigation: filing, dismissal, and settlement.

First, we hypothesize that ESG ratings might be associated with the filing of securities litigation, focusing on the question of whether firms with relatively higher ESG metrics are less likely to be sued.[20] Second, we ask whether ESG ratings are associated with the dismissal of securities litigation, relatedly focusing on whether firms with relatively higher ESG metrics are more likely to obtain dismissals.[21] Third, we ask whether ESG ratings are associated with

---

[19] See Virginia Harper Ho, Nonfinancial Risk Disclosure and the Costs of Private Ordering, 55 Amer. Bus. L. J. 407, 435 (2018) ("[I]n the view of many investors, the level of disclosure on sustainability and other nonfinancial risks currently observed in financial reporting, even if limited, is the direct result of investor dialogue that has helped companies identify new risks as material and led them to make more informative disclosures.").

[20] See, infra, Sec.C.1 (analyzing the relationship between filing and ESG metrics).

[21] See, infra, Sec.C.2 (looking at how case quality is associated with a firm's ESG measures).

securities litigation settlement, focusing on whether firms with relatively higher ESG ratings are more likely to obtain settlements of such litigation.[22]

Our empirical investigation shows a strong statistical relationship between ESG ratings and securities litigation propensity and outcomes. Our findings can be simply stated: firms with higher ESG ratings face fewer shareholder lawsuits and are more likely to obtain dismissals of those lawsuits. In other words, empirically, based on our data, ESG ratings and shareholder litigation are negatively related. Good ESG firms are less likely to be sued and more likely to obtain dismissals; the opposite is true for bad ESG firms.

But we also find, surprisingly, that there is a "hangover" effect associated with lawsuits, even if those cases are later dismissed. Getting sued is associated with ESG ratings that are, on average, lower, even if the company pays no damages. There are several nuances in the results related to these findings. Interestingly, ESG ratings are associated with future litigation, even going back as far as two years. In other words, good ESG firms are less likely to be sued in the future.

The ESG data in our empirical study are from Truvalue Labs, a privately-held technology company that uses natural language processing, cognitive computing, and machine learning to generate ESG metrics.[23] Truvalue Labs approaches ESG in a different way than many other providers of ESG metrics: it essentially surveys the entirety of the internet, using a proprietary content aggregation technology to scan more than 100,000 websites a day, gathering more than one million data points per month. As it scans this data, it uses natural language processing to filter for company names and language that it deems relevant to several ESG categories. The result is a massive volume of unstructured data, including reports by various media, analysts, and other groups that is converted into structured measures, a general score for all public firms, and a set of scores for each firm for a range of subcategories.

We believe the Truvalue Labs ESG metric avoids many of the problems associated with other ESG metrics,[24] even though there are some limitations associated with our data, which we describe below. Because Truvalue Labs is transparent about what, precisely, is being measured by its ESG metric, we are more confident in interpreting our results than we would have been if we had used other metrics, whose flaws we also enumerate below. We also note that several dozen academics who study various aspects of ESG also have used the Truvalue data in their studies (though no one has yet analyzed the relationship between ESG and securities litigation).[25]

Of course, no ESG metric is perfect. Because the Truvalue metric depends on machine learning technology and existing databases of news, it potentially might be vulnerable to algorithmic bias or the "fake news" problem (or at least to potential bias in journalism). It is unclear which way this bias might cut, in favor or against a finding of correlation with a variable

[22] See, infra, Sec.C.3 (showing how ESG measures vary before and after settlement). Settlement is an imperfect measure of the merits of cases, and we recognize such limitations. Nevertheless, overall settlement values should provide some information about the parties perceptions of their expected returns to litigation.

[23] See https://www.truvaluelabs.com ("Truvalue Labs applies AI to uncover opportunities and risks hidden in massive volumes of unstructured data, including real ESG behavior that has a material impact on company value.").

[24] See generally, Kotsantonis & Serafeim, infra note _ (identifying common problems with existing ESG data).

[25] The Truvalue Labs "Academic Research Network," including descriptions of its university partners and various research projects is at https://www.truvaluelabs.com/academic-research-network.

of interest, or whether the distribution of information in the database is skewed in some way that would impact our results. We flag these concerns because they have been expressed by some commentators.

We also want to note upfront that there are a range of potential explanations for our empirical results, and we embrace the variety of possible interpretations. Moreover, the three components of ESG – environment, social, and governance – each are associated with different evidence and arguments, and therefore our analysis with respect to the relationships between each ESG factor and securities litigation varies somewhat.[26] With respect to environmental factors, the obvious focus, both in our data and throughout the literature and in practice, is climate change.[27] With respect to social factors,[28] the questions range from diversity and human capital to consumer protection and other issue-specific concerns.[29] With respect to governance, questions include the rights and responsibilities of directors and officers as to a range of issues, including compensation of executives and employees.[30] In each area, improving ESG factors can be viewed as tool for firms to mitigate risk, and risk arguably could be related to securities litigation propensity and outcomes in various ways.

In addition, the fact that ESG metrics and securities litigation are related has important implications for research that examines just one of these variables. To the extent ESG and securities litigation measures are related, research that captures a relationship between one of the variables and some other variable of interest might instead, at least to some extent, be capturing a relationship between the other the measure and a variable of interest. We recognize that both our analysis and the ESG literature more generally face endogeneity challenges, which in some cases are likely insurmountable; nevertheless, we believe the association among the variables we study is interesting and raises important theoretical and policy questions.

In some cases, it will be obvious that an association involving securities litigation and some other variable is unlikely to be capturing an interaction with ESG, or vice versa. For example, one of us has found, with co-authors, that a U.S. Supreme Court decision on loss causation in the securities law context was associated with a statistically significant change in

---

[26] The "E" of ESG is reasonably well defined as relating to the environment and climate change, but the "S" and "G" are less well defined. Scholars have examined the relationship between various governance aspects of "G" and securities litigation, but have not inquired into the relationship between the aggregated metrics for ESG and such litigation. Sean Griffith has pointed out the importance of disaggregating the three parts of ESG in the context of mutual fund voting. See Sean J. Griffith, Opt-In Stewardship: Toward an Optimal Delegation of Mutual Fund Voting Authority, 98 Tex. L. Rev. 983 (2020).
[27] See Fisch, 107 Geo. L.J. at 937-41.
[28] Some commentators recently have suggested that the "S" in ESG also should include concerns about corporate supply chains, particularly given the sustainability challenges posed by the coronavirus pandemic. See David M. Silk, Sabastian V. Niles & Carmen X. W. Lu, The Other "S" in ESG: Building a Sustainable and Resilient Supply Chain, Harvard Law School Forum on Corporate Governance, Aug. 14, 2020, https://corpgov.law.harvard.edu/2020/08/14/the-other-s-in-esg-building-a-sustainable-and-resilient-supply-chain/#more-132200.
[29] Gadinis & Miazad, at 3-9. Some scholars define social risk as events that impair a company's social capital, and are accordingly focused on reputational harm related to a wide range of conduct. See David F. Larcker & Brian Tayan, Blinded by Social Risk: How Do Companies Survive a Storm of their Own Making?, Stanford Closer Look Series, Jul. 21, 2020 (discussing social capital as goodwill or positive perceptions among stakeholders).
[30] Gadinis & Miazad, at 33-37.

securities litigation filings, dismissals, and settlements;[31] it would be implausible to conclude that this association represented a relationship between litigation outcomes and ESG metrics. However, in other cases the interpretation of a relationship might be much less obvious, and our findings could implicate concerns about endogeneity in those areas. For example, papers that find a relationship between shareholder returns and ESG metrics might be capturing, at least in part, a relationship between shareholder returns and securities litigation risk, suggesting a very different interpretation than the one offered in the ESG literature. We explore these challenges below as well.

Finally, we consider normatively how future researchers, practitioners, and policy makers might interpret and consider the relationship between ESG and securities litigation. We discuss the increasingly important question of required disclosure under federal securities law, including recent cases alleging ESG-related securities fraud. We discuss how courts and legislatures might assess ESG metrics, or factors, in their treatment of shareholder litigation, particularly in the context of alleged board oversight failures, where recent cases arguably have turned on factors related to ESG (including risk to human lives, perhaps the ultimate ESG risk). We also discuss how shareholder litigation might matter for more sweeping proposals related to ESG and corporate purpose. Our overarching message is that the relationship between ESG and securities litigation is important and relevant to many areas of law and finance.

Our article is organized as follows. We begin in Part II by covering some theoretical arguments about the relationship between ESG and securities litigation. Unfortunately, it often is unclear which of several theories are being used in the construction of a particular ESG metrics. Indeed, as we show, the construction and use of ESG metrics has become fractured and problematic, and often is unmoored from any theory about what a particular metric is measuring. We describe the range of available ESG metrics, and the advantages associated with metrics that are based on timely and transparent public reports, as well as advantages associated with tracking categories promulgated by the Sustainability Accounting Standards Board, or SASB, including consistency and comparability.

Part III sets forth our empirical tests and results. We describe in detail both the Truvalue data and the shareholder litigation data from the Stanford Securities Class Action Clearinghouse that we match with the Truvalue ESG metrics. As noted above, we find that ESG metrics are negatively associated with securities litigation, meaning that more highly-rated ESG firms incur lower expected litigation incidence and, presumably, lower costs. As we noted upfront, we can conclude with some confidence that the answer is "yes" to the questions about whether bad ESG firms are sued more than good ones (they are), and whether suits against bad ESG firms are more likely to move forward (they are). Our answer to the question about whether firms that appear to do good are less likely to commit fraud is "maybe," and we describe the various interpretations that may explain any relationship between ESG and fraud. We also describe the various relationships between ESG metrics and settlement.

Part IV analyses the normative implications of our findings. Many scholars have considered ESG as implicating questions about risk; others have separately considered shareholder litigation as implicating questions about risk. We argue that it would be helpful to consider both ESG and shareholder litigation together in thinking about risk.

In normative terms, we attempt to reframe recent policy discussions in two important areas–securities disclosure under federal law and board oversight responsibility under Delaware

---

[31] See Barbara Bliss, Michael Furchtgott & Frank Partnoy, Information Bundling and Securities Litigation, 65 J. Acc'ting & Econ. 61 (2018) (studying the *Dura Pharmaceuticals* decision).

law–as implicating ESG concerns in ways that scholars have not previously recognized. We discuss recent attempts by securities regulators and federal judges adjudicating securities disputes to assess ESG risk. We also examine the role that ESG factors have played implicitly, and might play explicitly, in state cases alleging failures of risk oversight by directors, particularly under Delaware law. We also point to some areas of potential future study.

Given the importance of both ESG and securities litigation, it might seem surprising that scholars have not previously investigated the relationship between these two important areas in detail. Part of the reason stems from the siloing of disciplines, with researchers in accounting or law or finance not noticing findings in other areas. Part of the reason is that reliable data for measuring both ESG and securities litigation previously have not been widely available. We acknowledge that there are still limitations in each of these areas. It will be an ongoing challenge to attract the interdisciplinary interests of researchers in different fields, as well as to improve data sources with respect to ESG and securities litigation. Currently available data, though improving in quality, are far from perfect or comprehensive. Nevertheless, we hope the results reported and assessed in this article will lead researchers to emphasize the relationship between ESG and securities litigation more, in both areas.

II. The Rise of ESG Metrics

In this Part, we describe a range of potential theories about what ESG metrics measure, and how these metrics might relate to litigation. In doing so, we trace the rise of ESG metrics, for better and worse. To some extent, ESG metrics have followed the changes in thinking about ESG more generally. In part, the increasing use of ESG metrics has arisen straightforwardly from attempts to maximize shareholder returns, or at least to raise money from investors who believe ESG metrics will be associated with higher returns. Some corporate law and corporate governance scholars, following the lead of many practitioners, have accordingly focused on the "business" case for ESG.[32] Consistent with this focus, recent survey evidence has shown that an increasing number of institutional investors consider ESG information in their investment allocations.[33]

But ESG metrics also have become important as individuals and institutions have become more focused on corporate sustainability and the interests of stakeholders and corporate purpose. For example, many scholars have emphasized the importance of corporate constituency statutes, which permit managers to take into account ESG concerns.[34] Likewise, prominent practitioners have widely, and controversially, emphasized the importance of ESG from a stakeholder perspective. For example, Blackrock Chairman Larry Fink has supported efforts to "build a

---

[32] See Beate Sjåfjell & Christopher M. Bruner, Corporations and Sustainability, in Cambridge Handbook of Corporate Law, Corporate Governance and Sustainability ((Beate Sjåfjell & Christopher M. Bruner, eds. 2019) (describing the issue as "internalising environmental and social impacts in corporate decision-making, but only to the degree that this has a positive effect on longterm financial performance.")

[33] See Amir Amel-Zadeh, A. & George Serafeim, Why and How Investors Use ESG Information: Evidence from a Global Survey. 1 Fin. Analyst. J. 74 (2018).

[34] See, e.g., Leo E. Strine, Jr., One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term, 66 Bus. Law. 1, 1-2 (2010); Stephen M. Bainbridge, Interpreting Nonshareholder Constituency Statutes, 19 Pepp. L. Rev. 971, 973 (1992) (referring to constituency statutes as "potentially revolutionary").

better framework for serving all [] stakeholders."[35] Likewise, the Business Roundtable, an influential group of corporate leaders, has moved from the pro-shareholder language in its 1997 statement that "the paramount duty of management and of boards of directors is to the corporation's stockholders"[36] to a 2019 articulation of corporate purpose as including the creation of value for all stakeholders, including customers, employees, suppliers, communities, and shareholders.[37]

ESG metrics have evolved along with these references to both the "business case" and "stakeholder" notions of ESG, roughly tracking the Berle-Dodd debate about corporate purpose from decades ago. However, the various approaches to ESG measurement have often become dislodged from these polar theories, creating confusion and generating more questions than answers.[38] Our first objective is to attempt to clarify some of these questions about the use and functionality of ESG metrics. Accordingly, we begin by discussing a few theories of ESG measurement; we set forth some basic principles for what ESG metrics might do. We then turn to a description of the actual types of ESG metrics and their use (and in some cases misuse). Our goal in this Part is to provide both theoretical and empirical clarity, and also to set up our statistical analysis of the relationship between ESG metrics and litigation that follows.

A. ESG Metrics in Theory

First, we consider ESG metrics from a "classical" perspective of the firm. In terms of economic theory, one way of thinking about ESG is centrally focused on externalities, costs imposed on non-shareholder stakeholders, such as employees, customers, the environment, or future generations. Originally, one notion in classical economic theory was that firms should maximize shareholder value and accordingly should internalize the costs of negative externalities (definitionally the costs to society that are not borne by shareholders) only to the extent such costs are imposed on firms by regulation or law, or to the extent they negatively impact firm value by impacting firm reputation.[39] According to this theory, ESG should matter to firms only to the extent ESG factors impact shareholder returns; this shareholder-focused perspective on ESG has been referenced and adopted by many practitioners and policy makers, including the Delaware courts.[40]

---

[35] See, e.g., Larry Fink, Larry Fink's 2019 Letter to CEOs: Purpose & Profit, BlackRock, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter.
[36] See Business Roundtable, Statement on Corporate Governance 3 (1997).
[37] See Business Roundtable, Statement on the Purpose of a Corporation 1 (2019).
[38] See generally, Paul Brest, Ronald J. Gilson & Mark A. Wolfson, How Investors Can (and Can't) Create Social Value, 44 Journal of Corporation Law 205 (2019) (arguing that confusion over ESG metrics can cloud the conclusions that investors draw from them).
[39] See Friedman, Capitalism and Freedom 133. Ronald Coase, Oliver Williamson, and others have emphasized the complexities associated with firm objectives, including the objective to maximize profits. For a discussion of these ideas, see James P. Hawley and Andrew T. Williams, The Rise of Fiduciary Capitalism (2001). Moreover, given the increasing growth of institutional owners, the line between shareholder profits and stakeholder interests is becoming empirically less clear. See, e.g., James P. Hawley, Keith Johnson and Ed Waitzer, Reclaiming Pension Fund Fiduciary Duty, in Tessa Hebb, et al, The Routledge Handbook of Responsible Investment (2016) (discussing fiduciary duty implications for universal owners, who can face different incentive structures than other shareholders).
[40] See eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34-35 (Del.Ch. 2010) ("Directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews

In this classical economics domain, one could theorize two different roles for ESG metrics. One is that they are simply capturing ways in which a focus on ESG is consistent with maximizing shareholder returns. In this role, ESG metrics would be merely another way for managers to focus on their shareholder value objective. Thus, one could think of ESG metrics as capturing a range of risks that matter from a shareholder value perspective. In other words, ESG metrics might measure externalities, but only to the extent that either the regulatory regime has imposed those externalities on firms or firms need to consider such externalities in order to maximize shareholder value, perhaps because of potential negative reputation effects.

Alternatively, still in the classical framework, ESG metrics might measure deviations from shareholder returns that inure to the benefit of stakeholders. In this role, ESG metrics would measure something very different from shareholder-related risks or factors that matter to shareholder value. Instead, they would capture the extent to which managers might be favoring stakeholders over shareholders. Thus, ESG metrics would measure externalities not imposed on firms through regulation, or externalities whose costs firms do not fully internalize due to reputation-related constraints.

One can think of these two roles as being a classical shareholder ESG measure and a classical stakeholder ESG measure. Of course, an ESG metric might also be theorized to play some intermediate role between these two poles, where the metric is designed to capture a blended combination of shareholder and stakeholder factors, both of which relate to ESG. Even in this relatively straightforward theoretical domain there is plenty of room for confusion about ESG metrics. Nevertheless, we think it is important to start by describing this theoretical perspective, where ESG metrics could be designed to measure externalities, and to capture the costs associated with those externalities to varying degrees based on the extent they matter to shareholders. That is one way of thinking about theory. (Of course, whether ESG metrics actually do any of the above is a separate question; as our discussion below illustrates, there is reason to be skeptical about whether ESG metrics actually play either of the two roles described above.)

Another way of thinking about theory is to drill down into the specifics of ESG metrics as being relevant to shareholders vs. stakeholders. We start with shareholders. The theoretical approaches become more capacious, and complicated, when one examines the various ways in which certain aspects of ESG metrics are purportedly associated with higher shareholder returns. For example, a voluminous literature in economics and finance has attempted to assess the extent to which a firm's expenditures of resources on stakeholders might be profit maximizing for shareholders.[41] According to this literature, an ESG metric could play the role of a specific variable or set of variables that are associated with higher shareholder returns. In theory, an ESG metric in this sense could be resemble a risk factor, such as momentum, that is associated with shareholder returns. Thus, from a theoretical perspective ESG metrics potentially could implicate asset pricing theory, and be added to the "factor zoo" literature that attempts to determine periodic shareholder returns.[42]

---

stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law.").

[41] See, e.g., Philipp Krüger, Corporate Goodness and Shareholder Wealth, 115 J. Fin. Econ. 304 (2015) (finding negative stock price reactions to events with negative implications for stakeholders).

[42] The "factor zoo" refers to the extensive analysis in the asset pricing literature of firm variables that may be associated with cross-sectional stock returns. A recent count of the number of factors that scholars have identified as potentially meaningful is over 400. See, Campbell R. Harvey & Yan Liu, A Census of

Alternatively, turning to stakeholders, an ESG metric could be designed to capture more explicitly the gains to one or more stakeholder constituencies at the expense of shareholders. For example, an ESG metric might purport to measure the extent to which a company is damaging the environment beyond an amount that would be reflected in share prices as an expected cost associated with that damage. To the extent the legal or regulatory system does not effectively internalize costs to corporations that damage the environment, or to the extent managers of such corporations inaccurately perceive or discount such costs, an ESG metric might effectively measure the social value that is lost when corporations maximize shareholder returns to the detriment of stakeholders. Put another way, such an ESG metric might seek to capture the extent to which corporations deviate from socially optimal behavior. Such an ESG metric might be geared to measure deviations related to the environment, social, or governance factors individually, or in some combination.

Unfortunately, it is typically unclear for a particular ESG metric which of the above theoretical approaches, if any, might have been considered in constructing the metric. Given the above variety of theoretical approaches, it is difficult to hypothesize about how litigation risk might be related to a particular group of ESG metrics. ESG metrics might or might not capture aspects of litigation risk, depending on what specifically they are designed to do. For example, if an ESG metric is designed to capture the extent to which a company is engaging in ESG-related activities to maximize shareholder returns, any relationship between that ESG metric and shareholder litigation arguably reflects the extent to which litigation results are related to profit-maximizing activities, assuming the relationship between shareholder litigation propensity and outcomes also are related to shareholder returns.

Alternatively, if an ESG metric is capturing the extent to which a corporation is making decisions or engaging in oversight in ways that do not adequately account for externalities and are not reflected in litigation risk, any relationship between the ESG metric and litigation arguably reflects something very different, including the possibility that the firm is profiting from avoiding the internalization of externalities through the litigation system.

Another possibility is that ESG metrics serve as leading indicators of litigation risk. In other words, firms with low ESG metrics might be externalizing harm and, to the degree litigation forces firms to internalize that harm, ESG metrics would indicate that a firm is likely to face litigation in the future. On the flipside, firms that have high ESG metrics might have less litigation risk relative to those with low scores because they have avoided or mitigated much of the harm that they caused. For any particular ESG metric, it might be difficult to disentangle these details, but we mention them as interesting complications for scholars and practitioners to consider.

Our main point in this discussion is that the theory of the role ESG metrics plays is complicated, and it is unclear where the dust should settle based on an asserted relationship between an ESG metric and another measure, such as shareholder returns (as has been widely studied) or litigation (which until now has not).[43] On one hand, a relationship between one type

---

the Factor Zoo, working paper (2019), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3341728.

[43] We are not alone in our concern that ESG metrics are likely to have a complicated relationship with firm performance. See Heli Wang, Cristina Gibson & Udo Zander, Editors' Comments: Is Research on Corproate Social Responsibility Undertheorized?, 45 Acad. Of Mgmt. Rev. 1, 1 (2020) ("CSR is .. rather complex to address theoretically, given that it can be considered both as a firm behavior that potentially

of ESG metric and returns or litigation might reveal something about social utility based on that ESG metric. On the other hand, a relationship between another type of ESG metric and returns or litigation might reveal something about some other underlying variable that is correlated with the ESG metric but unrelated to social utility. The analysis depends on precisely what a particular ESG metric is measuring, and how those factors are related to the variable of interest.

Unfortunately, the literature has not considered these various complications, particularly when the variables of interest might be related to litigation (as opposed to share returns). More than two decades ago, a handful of accounting scholars addressed several important issues that bear on the relationship between ESG and litigation, such as whether voluntary ESG disclosures are deficient,[44] or whether ESG disclosures are made strategically.[45] One interesting study from 2012 showed that voluntarily disclosing ESG information might help reduce the negative reputational effects associated with a company's poor ESG record.[46] However, these papers did not explicitly consider links between ESG and litigation, and did not analyze or theorize about whether ESG metrics were designed to measure the extent to which firms were engaging in shareholder profit maximization related to ESG factors or shareholder profit maximization at the expense of ESG factors, two very different theories with very different implications.

As we describe below, our empirical approach uses a transparent measure of ESG based on public disclosures. Accordingly, we can apply the above theories in two very different ways, with two different interpretations. On one hand, we can assume that the ESG metric reflects firm-level maximization of shareholder returns based on ESG factors, and analyze any relationship between the ESG metric and litigation as related to shareholder value. On the other hand, we can assume that the ESG metric reflects firm-level deviation from maximization of shareholder returns based on ESG factors, and analyze any relationship between the ESG metric and litigation as related to stakeholder value (or, more precisely, the extent to which the expected costs of externalities are not reflect in share prices). As we will show, the two approaches lead to two very different normative conclusions.

B. ESG Metrics in Practice

Given the theoretical complexities underlying the role of ESG metrics, the next question becomes: how are the metrics actually used? We now examine how practitioners and scholars actually have sought to measure ESG and then use those measures. We describe a range of approaches, and discuss the drawbacks to some of the most widely-used and commercially available ESG metrics. Then we describe our dataset based on Truvalue metrics, and some of its potentially advantageous features.

As we indicated in the introduction, if ESG metrics are associated with shareholder litigation, some of the interpretations of correlations found in the literature between ESG metrics

---

affects the bottom line (viewed instrumentally) and as a goal in and of itself that exists simultaneously with financial goals.").

[44] See S. Douglas Beets & Christopher C. Souther, Corporate Environmental Reports: The Need for Standards and an Environmental Assurance Service, 13 Acc'ting Horizons 129 (1999).

[45] See Mary E. Barth, Maureen McNichols & G. Peter Wilson, Factors Influencing Firms' Disclosures about Environmental Liabilities, 2 Rev. of Acc'ting Stud. 35 (1997); Dennis M. Patten, D. 1992. Intra-Industry Environmental Disclosures in Response to the Alaskan Oil Spill: A Note on Legitimacy Theory, 17 Acc'ting Org. & Soc. 471 (1992).

[46] See Cho, Guidry, Hageman & Patten, Do Actions Speak Louder Than Words, supra.

and non-litigation measures (such as returns) should be subject to potential alternative interpretations. In particular, findings of associations between a variable of interest such as shareholder returns and one or more ESG metrics might instead, at least to some extent, be capturing a relationship between the ESG metrics and shareholder litigation, or between the variable of interest and litigation. To the extent such alternative interpretations are possibilities, our suggestion is that research should include one or more shareholder litigation control variables to address endogeneity concerns, and should address litigation risk directly. We also suggest that ESG research be open to the possibility that findings are in fact measuring a relationship that includes litigation in some respects.

There are numerous findings of correlation between various ESG metrics and a range of variables of interest in the literature. Scholars writing in economics, business, and finance have used various ESG metrics to document institutional investors' preferences, strategies, and influence, as well as the relationship between these metrics and corporate performance. ESG metrics have thus become increasingly important in research and among practitioners and policymakers.[47]

For example, researchers found that during the 2008-09 financial crisis, firms with high "social capital," based on ESG ratings, had significantly higher stock returns, profitability, growth, and sales per employee.[48] Greater institutional ownership of public companies also has been associated with superior ESG performance, based on ESG scores, as well as findings that institutions are the driving force behind ESG issues, motivated by both financial and social objectives.[49] The various studies cited in the introduction also include numerous findings of relationships related to ESG metrics.[50]

In our view, the ESG metrics used in many of these studies suffer from several potential problems. First, ESG data are often sourced from disclosures by firms, which have incentives to "game" the metrics by disclosing particular types or amounts of data. Second, ESG metrics often do not capture a firm's current approach to ESG issues, but instead rely on stale data, at least in part. Third, there is an incommensurability problem: because different ESG metrics take into account different or overlapping data and factors, it is difficult to determine how they are or should be related. It is difficult to know, given these problems, what level of correlation one should expect among different ESG metrics, or even which metrics arguably should generate similar scores for similar firms during similar times.

---

[47] See, e.g., Robert G. Eccles & Judith C. Stroehle, Exploring Social Origins in the Construction of ESG Measures, Univ. of Oxford working paper (2018) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3212685.

[48] See Karl V. Lins, Henri Servaes & Ane Tamayo, Social Capital, Trust, and Firm Performance: The Value of Corporate Social Responsibility During the Financial Crisis, 72 J. Fin. 1785 (2017) (concluding that "This evidence suggests that the trust between the firm and both its stakeholders and investors, built through investments in social capital, pays off when the overall level of trust in corporations and markets suffers a negative shock.").

[49] See Alexander Dyck, Karl V. Lins, Lukas Roth & Hannes F. Wagner, Do Institutional Investors Drive Corporate Social Responsibility? International Evidence, 131 J. Fin. Econ. 693 (2019). This study used ESG data based on the Thomson Reuters ASSET4 ESG database, which is derived from information in annual reports, corporate sustainability reports, NGOs, and news sources for large, publicly traded companies from over 45 countries, at annual frequency. The authors note that "Thomson Reuters states that reported data items are chosen to maximize company coverage, timeliness of reporting, data availability, quality, and perceived materiality for investors." Id. at 700.

[50] See, supra, notes 2-7.

Although there are numerous ESG data vendors, they frequently do not agree.[51] One major reason for disagreement is that various ESG metrics are measuring fundamentally different phenomena.[52] Early ESG metrics, from the 1970s, were created by non-profit organizations and driven by controversial issues of that time.[53] During recent decades, the number of companies providing ESG metrics has increased significantly, and there also has been significant consolidation; studies suggest that there are now more than a hundred organizations that collect and analyze ESG metrics.[54]

The very nature of ESG metrics also is highly variable. Some metrics are focused on particular substantive issues, such as climate change or human rights, or the specific agendas of religious institutions or charities.[55] Some organizations use aggregated data to construct rankings or indices, many of which are highly correlated.[56] But other researchers have found that many ESG metrics are not very highly correlated: one study found that the rank correlation of the top five ESG ratings in any particular year likely was in the range of 10 to 15 percent.[57]

Researchers have struggled to determine which ESG metrics are appropriate depending on the inquiry. For example, Bloomberg publishes an ESG score for firms based on the firms' own disclosures.[58] Bloomberg uses a proprietary algorithm to rank every ESG-related datapoint collected by Bloomberg and tailor the rankings by industry. Researchers who use the Bloomberg ESG score recognize its obvious limitations, and some have rejected the Bloomberg index as inappropriate even though it is widely used.[59] For example, Lopez-de-Silanes, McCahery, and Pudschedl rejected Bloomberg ESG scores and instead used data from Sustainalytics, which publishes an ESG ranking assigned to firms relative to their peers and based on a firm's "level of preparedness, disclosure and controversy involvement across all three ESG themes."[60] However, even these researchers, while ultimately opting to use the Sustainalytics ESG metric, also recognized this metric's obvious limitations.[61]

Perhaps not surprisingly, various parties have attempted to "rate the ESG raters," both by surveying market participants and by assessing the nature of various categories of ESG metrics.[62] Researchers at the Massachusetts Institute of Technology have labeled the various operations and

[51] See Eccles & Stroehle, at 2.
[52] Sakis Kotsantonis & George Serafeim, Four Things No One Will Tell You About ESG Data, 31 Applied J. of Corp. Fin. 50, 56 (2019) (noting the lack of agreement among ESG metrics).
[53] See Eccles & Stroehle, at 4 (discussing the early focus on nuclear weapons development and Apartheid South Africa).
[54] See Eccles & Stoehle, at 4 (discussing data from the Global Initiative for Sustainability Ratings, Barb Brown & Mike Wallace, The ESG Ecosystem: Understanding the Dynamics of the Sustainability Ratings & Rankings Landscape, Brown Flynn, Feb. 2018, https://brownflynn.com/resources/white-papers/.
[55] Examples include the Corporate Human Rights Benchmark, Ethisphere, JUST Capital, and the Reputation Institute. See Eccles & Stoehle, at 5.
[56] See Lopez-de-Silanes, et al., at 14 (finding a high degree of correlation among ESG indices)
[57] See Massachusetts Institute of Technology, Sustainability Initiative, Aggregate Confusion https://mitsloan.mit.edu/sustainability/aggregateconfusion
[58] See Lopez-de-Silanes, et al., at 20.
[59] See, e.g., Lopez-de-Silanes, et al., at 21 ("The Bloomberg ESG disclosure score is not a quality measure and measures only the extent of ESG-related data disclosed by a company.").
[60] Lopez-de-Silances, et al., at 21.
[61] See, e.g., Lopez-de-Silanes, et al., at 21 ("the ratings contain significant value judgements as to what constitutes a company's 'good' or 'poor' performance with regard to ESG").
[62] See Eccles & Stoehle, at 5-7.

products that assess ESG factors as "aggregate confusion," concluding that the discrepancies among ESG factors are "making the evaluation of social and environmental impact impossible."[63]

Perhaps most importantly, ESG data may suffer from bias. Firms that have greater capability to provide information, including larger firms, might be more likely to do so. Likewise, ESG disclosures can vary by industry or region. Indeed, one might expect that, to some extent, firms with greater ESG risks might engage in more pro-active ESG disclosures, or "manage" to a particular ESG rating or metric.

Some of the findings in the empirical economics and finance literatures are consistent with the view that ESG metrics might not be accurate, given that they find associations one might not expect, associations that have weak theoretical or intuitive support, or associations that are likely the result of endogenous variables that are driving the results.[64] For example, there is a strong relationship between certain ESG ratings and firms' law of origin, suggesting that firms domiciled in civil law countries have higher ratings than firms from common law countries.[65] Disentangling causation in such a framework is challenging. Such results could be capturing an association between law of origin and litigation, or some other variable. More fundamentally, it is unclear what kind of theory might support such findings. Other results have even less theoretical or intuitive support. Consider the finding, based on ESG metrics, that socially responsible investment funds are more likely to be managed by Democrats than Republicans.[66] It is difficult to know what conclusion to draw from such an association, although there certainly is variance in how politicians frame ESG issues, including in political party platforms.

Scholars also have disagreed about whether different categories of firm ESG ratings share common theoretical drivers or are otherwise commensurable. Chatterji, Durand, Levine, and Touboul found that six ESG ratings lacked such common factors, and concluded that convergence among ESG ratings was unlikely.[67] Eccles and Stoehle have argued that the variance in ESG ratings results from social and contextual origins; they support their arguments with several case studies.[68] Both approaches draw from substantial literatures.

---

[63] See https://mitsloan.mit.edu/sustainability/aggregateconfusion.

[64] See, e.g., Gerhard Halbritter & Gregor Dorfleitner, The Wages of Social Responsibility — Where Are They? A Critical Review of ESG investing, 26 Rev. of Fin Econ 25, 29-34 (2015) (finding that the returns to ESG investing are sensitive to the metrics themselves and the time windows analyzed).

[65] See Hao Liang & Luc Renneboog, On the Foundations of Corporate Social Responsibility, 72 J. Fin. 853 (2017). In addition, these researchers used event studies to conclude that companies from civil law countries were more responsive to changes in ESG ratings related to scandals and disasters than were companies from common law countries. Id.

[66] Harrison Hong & Leonard Kostovetsky, Red and Blue Investing: Values and Finance, 103 J. Fin. Econ. 1 (2012). These researchers used two measures: (1) an index based based on the lines of business or industries that investment funds that are focused on ESG usually screen out (e.g., tobacco, alcohol, gaming, guns, defense, natural resources, nuclear power, adult entertainment, contraceptives, and abortion), and (2) a commercially available score from a private firm, Kinder, Lydenberg, Domini, & Co., based on perceptions of a company's "community activities, diversity, employee relations, and environmental record." Id. at 3.

[67] Aaron K. Chatterji, Rodolphe Durand, David I. Levine, & Samuel Touboul, Do Ratings of Firms Converge? Implications for Managers, Investors and Strategy Researchers, 37 Strateg. Mgt. J. 1597 (2016).

[68] See Eccles & Stoehle, at 7-10 (describing the social construction arguments and situating them within the business-related literature).

Our main point here is to demonstrate that the use of ESG metrics often generates more questions than it answers. We also want to emphasize the importance of questioning ESG metrics before accepting a particular interpretation of an association between an ESG metric and a variable of interest. Along those lines, we describe and defend our ESG metric of choice in the next section, where we turn to our empirical analysis.

III. Empirical Analysis of ESG and Shareholder Litigation

As noted in the introduction, there are numerous scholarly articles about ESG as an abstract concept, and there is significant pressure for institutional investors to take into account ESG factors. Nevertheless, researchers and practitioners have struggled to measure ESG and many of the widely used ESG metrics are problematic in various ways. We next describe our analysis of the relationship between ESG and shareholder litigation based on one of the ESG metrics we regard as least problematic.

A. The Truvalue ESG Metric

As noted above, we obtained our data from Truvalue Labs, a privately held technology company that uses natural language processing, cognitive computing, and machine learning to generate ESG metrics. Truvalue Labs approaches ESG in a different way that many other providers of ESG metrics: as noted above, it essentially surveys the entire web, using a proprietary content aggregation technology to scan more than 100,000 websites in numerous languages every day, gathering more than one million data points per month.[69] As it scans, it uses natural language processing to filter for company names and language relevant to several ESG categories.[70] The result is a massive volume of unstructured data, including reports by various media, analysts, and other groups.

The ESG categories reflect 26 topics defined by the Sustainability Accounting Standards Board, or SASB. These topics include Environment, Social Capital, Human Capital, Business Model & Innovation, and Leadership & Governance. The companies surveyed by Truvalue include all public companies in the U.S. as well as large and mid-cap international companies across roughly two dozen "developed markets" and two dozen "emerging markets" countries, covering approximately 85% of the global investable equity opportunity set. It is a large dataset.

Mechanically, Truvalue's software scans every article, and gives each article a score based on linguistic analysis.[71] Essentially, the question is how positive or negative the sentiment in each article is. Each article receives a score from 1 to 100: higher numbers are more positive; 50 is neutral.[72]

Truvalue's use of SASB topic areas is significant and important. The SASB topics are widely considered a standard template for identifying material sustainability issues by industry. There are five sustainability dimensions encompassing the 26 SASB categories, and each category has a set of industry-specific sustainability disclosure topics in SASB standards. SASB also created the Sustainable Industry Classification System™ (SICS™), which includes ten

[69] See Truvalue FAQ, available at https://www.truvaluelabs.com/faq.
[70] Id.
[71] Id.
[72] Id.

"vertical sectors" and at its most granular level encompasses 79 industries.[73] One of the most significant advantages to using SASB is transparency and a degree of analytic rigor in separating various disclosure categories. SASB has been subject to criticism over time, but to the extent there is a "state of the art" in categorizing sustainability and ESG factors, SASB is it.[74]

Truvalue Labs has integrated SICS into the SASB Edition of its data, so that all 8,000 or more companies included in its ESG metrics are covered and have been mapped to a SICS Sector and Industry. In other words, the Truvalue data captures the SASB categorization of both sustainability risks and opportunities. Accordingly, Truvalue Labs describes its data as including information not available through the leading data services, including "information from industry-specific publications, non-company reported regulatory filings, news reports, government agency studies, trade blogs, ESG thought leader-shared Twitter articles and reports from watchdog groups and NGO organizations."[75] Finally, Truvalue has a content and data team of ESG experts, including the former head of research at SASB, who vet the data. All subscribers and researchers (including us) have access to links to every article.

In our analysis we focus on the "Insight" scores provided by Truvalue. This Insight score reflects a firm's long-term performance on a relevant ESG measure. Truvalue derives this score from the daily "Pulse" score, which is a single-day measure of how a firm performs in each ESG category. The Insight score is an "exponentially weighted moving average [of the Pulse score] with a six-month half-life."[76] To put this another way, the Insight score puts more weight on more recent events. While Truvalue seeks to compute an Insight score for every firm for all 26 categories every day, we focus on the composite "All Categories" and "Materiality" Insight scores. We do so for the simple reason that most firms do not get a score in most of the 26 individual categories on most days. The composite nature of the All Categories and Materiality scores means that there is far less missing data.

The All Categories score is straightforward: it aggregates a firm's scores across all 26 SASB categories to provide a single, overall score. The Materiality score requires more explanation. For each industry, SASB defines the categories that are most likely to be material for those industries. SASB claims to use an "investor-centric" approach to the identification of these categories.[77] SASB has constructed a materiality map that shows the categories considered material for each sector.[78] To take some examples, greenhouse gas emissions are considered material for every sector in the "Extractives & Materials Processing" industry.[79] Likewise, SASB designates product quality and safety as a material category for every sector in the "Healthcare" industry. Within each sector, Truvalue aggregates the Insight scores across the categories

---

[73] Id.

[74] See Ruth Jebe, The Convergence of Financial and ESG Materiality, 56 Amer. Bus. Law J. 645, 699 (2019) ("The SASB's drive toward the convergence of financial and ESG disclosure answers much of the dissatisfaction expressed by investors with the existing reporting regime.").

[75] See Truvalue FAQ (citing as examples industry-specific sources such as Automotive News, CleanTechnica, Pharma Live, Solar Industry, Hydrocarbon, and Fierce Telecom), available at https://www.truvaluelabs.com/faq.

[76] Truvalue Labs, Backtesting Data Dictionary, SASB Codified Edition, All Categories, 1.

[77] *Id.*

[78] See https://materiality.sasb.org/.

[79] *Id.*

considered material by SASB to produce a Materiality Insight score for each firm on a daily basis.[80]

The approach used by Truvalue Labs has several advantages over other ESG metrics. First, as indicated in the introduction, the Truvalue metrics are transparently based on public information, and therefore are less susceptible to "gaming" by companies. The Truvalue Labs database is designed to filter out self-reporting, press releases by firms, and similar disclosures made by corporations. To the extent corporations are attempting to "game" disclosures, the database should exclude such responses.

Second, the Truvalue Labs ESG metrics are constantly updated in real time. Accordingly, they do not suffer from the time lag or reliance on stale data that is true for many other metrics. This feature also means that the data are far more comprehensive than other ESG datasets. Truvalue provides daily measures for every firm that it covers. This precision allows us to measure reactions to important litigation events such as lawsuit filing and lawsuit dismissal.

Finally, although the Truvalue metrics might suffer from incommensurability problems because they compare and weigh a wide variety of inputs, including different and overlapping data and factors that are part of other ESG metrics, the extent to which information is used is completely transparent. A researcher who wants to test for bias in a Truvalue metric can do so based on publicly available information. Indeed, based on our sampling of the data, we were able to source (i.e., click through online) to every underlying document that forms the basis of scores in the database. Any researcher seeking to replicate our results using Truvalue metrics would be able to source all of these documents directly.

As noted above, we are not alone in using Truvalue's ESG metrics. An increasingly wide swath of empirical research related to ESG has been based on data generated by Truvalue. The company recently has emphasized its role as an artificial intelligence and alternative data firm that has entered into partnerships with more than three dozen leading global universities to share data for a wide range of projects.[81] Examples of research based on these data include the relationship between ESG measures and credit risk,[82] the effect of ESG changes on the flow of investment,[83] and the association of ESG data with the degree of concentration in the asset management industry.[84]

Truvalue also is transparent about its relationships with universities and researchers, and discloses in a timely manner both the institutions and research by individual professors on its website. Our subscriber agreement with Truvalue did not impose any substantive restrictions on our use of the data. Nor did we receive any compensation either for our empirical study of the data or for work related to this article. We asked Truvalue employees to review a draft of this

[80] Truvalue provided us with daily comma separated value ("csv") files that each compile the Insight and Materiality score as well as scores for each individual SASB category for every company that Truvalue covers. The collective size of these files is over 18 gigabytes, which is too large for most statistical analysis programs to process in a feasible way. To manage the data analysis we read the Truvalue data into a SQLite database that we query to suit our needs.

[81] See Truvalue Labs Academic Network, at https://www.Truvaluelabs.com/academic-research-network.

[82] Witold Henisz & Rachelle Sampson, ESG, Material Credit Events and Credit Risk, 2019 working paper.

[83] Satyajit Bose, Quantification of SDG Impact for Emerging Market Portfolio Flows, 2019 working paper.

[84] Robert Eccles, Concentration in the Asset Management Industry: A Good Thing or a Bad Thing?, 2019 working paper.

article for accuracy, and they provided only minimal comments, none of which were relevant to any of the results presented here.

B. Shareholder Litigation Data

We followed standard empirical approaches to obtain litigation data and then integrated it with the Truvalue ESG data. First, we obtained securities litigation data from the Stanford Class Action Clearinghouse ("SCAC"). This database, which is a collaboration between Stanford Law School and Cornerstone Research, seeks to provide information and documents from every federal securities class action lawsuit filed since the effective date of the Private Securities Litigation Reform Act of 1995 (January 1, 1996).[85] The data are available at no cost and any researcher seeking to replicate our study could obtain the data from the SCAC.

We then use Python to scrape a record for each case in the SCAC from the inception of the database through late 2019. These records include the name of the firm, the filing date of the case, the federal district court where the plaintiffs filed the case, the stock exchange where the firm is listed, and firm industry. We match each case record to the ESG data provided by Truvalue on the basis of stock ticker. For the periods that overlap, the middle of 2007 to late 2019, we are able to match 1,036 cases in the SCAC database to Truvalue's ESG data. The data regarding the individual cases are available by request.

C. Results

Next, we describe the results of our study of the association between the Truvalue ESG metrics and shareholder litigation. The basic question we ask is whether firms with different ESG metrics experience different litigation outcomes. As noted in the introduction, we hypothesize that ESG could matter to defendants in shareholder litigation in three different ways: filing, dismissal, and settlement.

1. Filing

First, we consider the filing of litigation. We ask whether there are differences in ESG metrics for firms that are subject to securities lawsuits as opposed to those that are not. We also inquire into the relationship between ESG metrics and the merits of cases. To assess these differences we compare ESG scores for firms that have meritorious cases filed against them—where we measure merit by the presence of a settlement that results in a payment to the plaintiff class—to those that have meritless cases filed against them (i.e. cases that get dismissed without a settlement).

One methodological challenge in assessing the association between ESG metrics and litigation is the worry that the events that lead to shareholder litigation—allegedly fraudulent statements or omissions of material information—may lead to poor publicity, which would

[85] See http://securities.stanford.edu/about-the-scac.html ("We track securities class actions filed in Federal Court after the Private Securities Litigation Reform Act of 1995 came into effect. Therefore, our population of records consist of securities class action lawsuits filed in federal court on or after January 1, 1996.").

decrease Truvalue scores for the firm, and also produce a shareholder suit.[86] This pattern would make it difficult to determine the association between poor ESG performance that is unrelated to shareholder litigation and the initiation of shareholder lawsuits. To diminish this concern we include lagged values of the ESG metrics well before filing. We do so on the theory that, as we move away from the date of filing, the ESG scores have less of a relationship to the events giving rise to the litigation and the litigation itself and, instead, reflect broader ESG performance by the firm.

Table 1 presents the differences in ESG scores for firms that were sued in a given quarter and firms that were not sued in a given quarter. The table also includes the one-year (four quarter) and two-year (eight quarters) lagged ESG scores before the filing of the case. As Table 1 shows, both the All Categories and Materiality scores are lower for firms that are sued or will be sued relative to those firms that will are not sued and will not be sued. The differences between these two groups are statistically significant at the one-percent level for the quarter when the lawsuit is filed, the year prior to the filing of the lawsuit, and two years prior to the lawsuit.

Table 1: Average ESG Scores for Sued and Never Sued Firms

Quarter of Filing			
	Sued (N=1000)	Not Sued (N=127370)	t-stat
All Scores	49.68	53.56	9.34***
	Sued (N=937)	Not Sued (N=127370)	
Materiality	50.22	54.35	8.27***
Year Before Filing			
	Sued (N=880)	Not Sued (N=116530)	t-stat
All Scores	51.55	53.56	4.35***
	Sued (N=819)	Not Sued (N=116530)	
Materiality	52.32	54.39	3.78***
Two Years Before Filing			
	Sued (N=814)	Not Sued (N=105690)	t-stat
All Scores	51.80	53.57	3.72***
	Sued (N=749)	Not Sued (N=105690)	
Materiality	52.78	54.39	2.89***

Note: This table compares the quarterly average ESG scores for firms that are sued during the relevant time period and the quarterly average for firms that are never sued during the sample period. Statistical significance is denoted by: *p<0.10; **p<0.05; ***p<0.01.

[86] This concern follows from the Truvalue methodology, which scans media coverage for sentiment. If lawsuits produce negative sentiment in news stories, a firm's scores would likely decline. See, supra, notes __-__.

The magnitude of the difference between firms that are sued and those that are not is, naturally, higher during the quarter when the lawsuit gets filed. We expect this result given that lawsuits and the events that give rise to them produce negative publicity and such publicity is an input for the Insight scores. But we also observe substantial difference between firms that are sued and firms that are not sued one year prior to the filing of the lawsuit and two years prior to the filing of the lawsuit. Given that securities suits tend to be filed relatively quickly, these differences are unlikely to reflect only those events that are the basis of securities suits. This evidence strongly suggests poor ESG performance is associated with a higher likelihood of being sued.

To analyze this relationship further we perform regression analysis. We present these results in Table 2. These regressions use the quarterly average for each firm's relevant Insight score as the dependent variable and indicator variables for the timing of lawsuits as independent variables. As with Table 1 we use indicators for whether the firm was sued that quarter, would be sued in a year, or would be sued in two years. We include year and quarter controls to account for yearly and seasonal variation.[87]

Table 2: Regressions of ESG Scores and Lawsuit Timing

	All Categories			Materiality		
Quarter Sued	-3.053^{***}			-3.239^{***}		
	(-.425)			(-.521)		
Year Before Sued		-1.328^{***}			-1.333^{**}	
		(-.461)			(-.568)	
Two Years Before Sued			0.241			-0.992^{*}
			(-.315)			(-.584)
Observations	124,537	110,493	96,816	110,633	97,624	85,044
Adjusted R^2	0.001	0.001	0.525	0.001	0.0004	0.0003
Year and Quarter Fixed Effects	Y	Y	Y	Y	Y	Y

Note: The dependent variable in these OLS regressions is the firm's quarterly average for the relevant ESG score. The independent variables are indicators for whether a lawsuit was filed during the specified time period. All regressions include year and quarter fixed effects and the heteroskedastic-robust standard errors are clustered by firm. Statistical significance is denoted by:*p<.10,**p<.05,***p<0.01.

Like the t-test comparisons in Table 1, this analysis shows that firms that have been or will be sued have lower ESG scores. For the quarter when the firm is sued we see a large difference for both the All Categories and Materiality Insight scores and those differences are significant at the one-percent level. The year prior to the lawsuit we also observe an ESG score

[87] These controls seek to filter out the annual and quarterly trends that may be occurring in order to isolate better the association between ESG scores and litigation.

that is more than two points lower for both measures and, again, both of these coefficients are statistically significant at the one-percent level. Two years before the lawsuit there is still close to a two-point difference with the All Categories score significant at the one-percent level and the Materiality score significant at the five-percent level. This analysis reinforces our findings that lower ESG scores are associated with higher likelihood of being subject to litigation.

The regressions in Table 2 do not include firm-specific controls. For a subset of the firms we are able to obtain financial information through Compustat and governance information through Institutional Shareholder Services (ISS). The financial information includes market capitalization, profitability (return on assets), financial leverage (a measure of debt relative to assets), sales, and firm industry.[88] Using the information from ISS, we construct the Entrenchment-Index (or E-Index), which measures how entrenched managers are.[89] We then run the same regressions from Table 2 with all of these controls. The results appear in Table 3.

We observe largely similar results when including the controls. The coefficients for the lawsuit indicators are all negative. The coefficients are all statistically significant with the exception of the two-year lagged lawsuit indicator for the analysis of materiality scores. These results suggest that, even when we control for firm-level variation, the negative association between ESG performance and securities litigation remains.[90] Though it is not the focus of our study, it is worth noting that we show a negative association between financial leverage and ESG performance. This finding runs counter to other research that finds a positive relationship between leverage and corporate social responsibility.[91] This difference underscores that alternative ESG data sources can lead to results that provide opposite accounts of firm behavior and contributions to social responsibility.

---

[88] These Compustat variables are standard variables used as firm-specific controls.

[89] Although the E-Index has been criticized in the literature, it continues to be used in empirical studies and we use it here for the purpose of showing that results are similar when these particular controls are included. The E-Index is a simple tally of the presence of six features of a firm's governance structure: a staggered board, limits to shareholder amendment of the bylaws, supermajority voting requirements for mergers, supermajority requirements for charter amendments, the presence of a poison pill, and executive golden parachutes. See Lucian Bebchuck, Alma Cohen, and Allen Ferrell, What Matters in Corporate Governance?, 22 Rev. Fin. Stud. 783 (2009).

[90] Including these controls accounts for much more variation than the simpler analysis in Table 2. This is evident from the adjusted r-squared numbers in Table 3, which range from .106 to .203 as compared to the equivalent figures from Table 2, which range from [ADD].

[91] *See* Allen Ferrell, Liang Hao, and Luc Renneboog, Socially Responsible Firms, 122 J. Fin. Econ. 585, 585 (2016) (finding that higher leverage is associated with better ESG performance).

Table 3: Regressions of ESG Scores and Lawsuit Timing with Controls

	All Categories			Materiality		
Quarter Sued	-3.519***			-1.879*		
	(-0.759)			(-1.02)		
Year Before Sued		-2.635***			-2.409**	
		(-0.761)			(-0.964)	
Two Years Before Sued			-1.570*			-1.123
			(-0.921)			(-1.061)
E-Index	0.329	0.341*	0.326	0.151	0.133	0.083
	(0.205)	(0.206)	(0.214)	(0.255)	(0.256)	(0.264)
Log(Market Cap)	-0.045	-0.041	0.099	-0.268	-0.269	-0.167
	(-0.24)	(-0.241)	(0.257)	(-0.293)	(-0.292)	(-0.307)
Return on Assets	-10.467	-9.324	-7.838	-6.866	-6.361	-4.084
	(-6.677)	(-6.736)	(-7.209)	(-7.454)	(-7.484)	(-8.219)
Leverage	-3.533**	-3.448**	-3.171**	-3.692*	-3.833**	-4.389**
	(-1.385)	(-1.376)	(-1.402)	(-1.895)	(-1.918)	(-2.051)
Log(Sales)	0.256	0.249	0.193	0.299	0.295	0.27
	(0.158)	(0.157)	(0.166)	(0.187)	(0.184)	(0.195)
Observations	23,568	22,807	19,082	22,229	21,488	17,885
Adjusted R^2	0.106	0.107	0.113	0.190	0.191	0.203
Year, Quarter, and Industry Fixed Effects	Y	Y	Y	Y	Y	Y

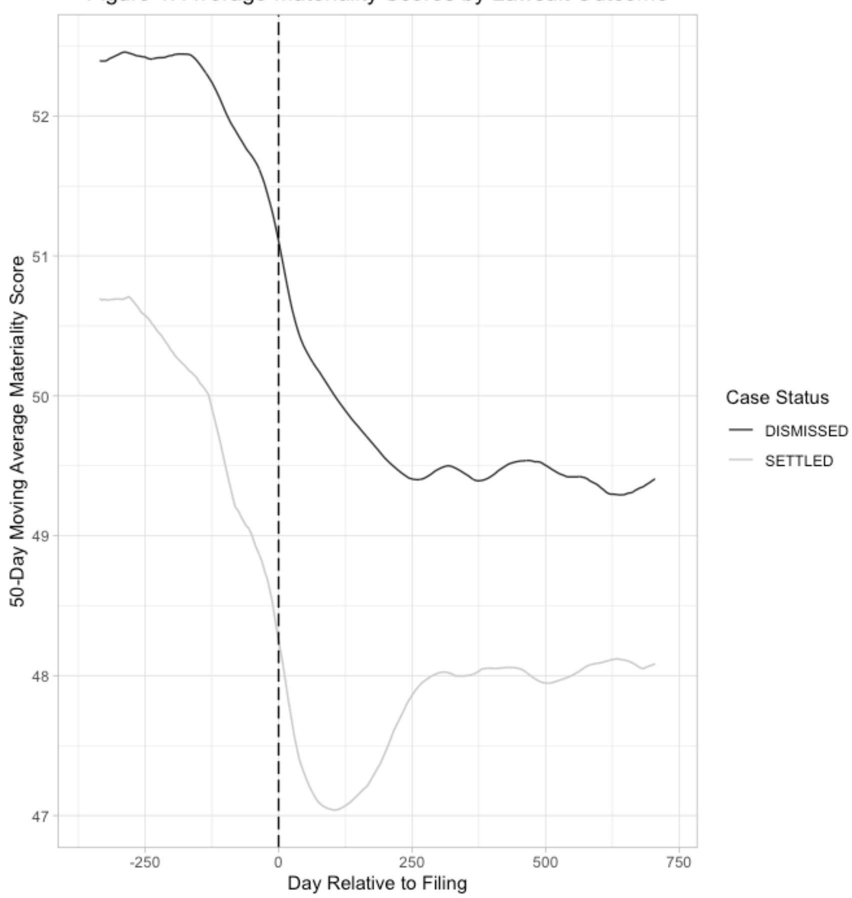
Note: The dependent variable in these OLS regressions is the firm's quarterly average for the relevant ESG score. The independent variables of interest are the indicators for whether a lawsuit was filed during the specified time period. All regressions include year and quarter fixed effects and the heteroskedastic-robust standard errors are clustered by firm. Statistical significance is denoted by:*p<.10,**p<.05,***p<0.01.

2. Lawsuit Quality

We are also interested in the relationship between ESG metrics and the merits of a case, which we measure by whether a case is dismissed or results in a monetary settlement for the plaintiff class. The SCAC database provides information about whether each case is dismissed, settled, or is still ongoing. In the analysis that follows we focus only on firms that were sued at some point during the sample and that have resolved that litigation through a dismissal or settlement.

Figure 1 shows the 50-day moving average of the daily average Materiality Insight score the 335 days prior to the filing of a lawsuit and the 700 days after lawsuit filing.[92] There are a number of interesting trends shown in the figure. First, the Materiality scores are demonstrably lower for firms that are subject to more meritorious cases both before and after the filing of the case. The difference at the outset is a little over a point and a half. The drop from the highest score to the lowest score is precipitous for the more meritorious cases and totals to over three and a half points. The drop is also quite severe for those firms that will have their cases dismissed—those firms drop about three total points. Scores level out for both groups about 250 days after filing and the difference between them is about a point and half.

Figure 1: Average Materiality Scores by Lawsuit Outcome



One stark difference is that there is a bounce back for the settled cases, but not for the dismissed cases. Indeed, a little after 250 days after the filing of a more meritorious lawsuit, the average Materiality score for these firms has returned to nearly the same level as at the time of filing. This bounce back is consistent with firms trying to counter the negative publicity spurred by the events that give rise to a securities suit with a public relations campaign or other media or reputation-related efforts. The firms that are subject to less meritorious cases and, thus do not

[92] The moving average is centered, meaning that it aims to take an equal number of observations from before and after the relevant date.

have as dire a problem with ESG issues, do not appear to be investing in improving ESG metrics post filing, or at least are not doing so effectively.

The fact of settlement alone does not address the value of settlements. To conduct a more robust analysis of lawsuit quality we incorporate the settlement amounts from the cases. We next describe that analysis.

3. Settlements

Our final set of results examines what happens to ESG scores when a lawsuit settles. As we conduct this analysis it is important to note that it can be difficult to pin down the exact date when a case settles. Parties will sometimes announce that a preliminary settlement has been reached and they will often file motions with the court that indicate this development. But, in many cases, the settlement will not become final until far later. Determining what the settlement date is requires some subjective judgment and capable analysts may differ in deciding what the appropriate date of settlement should be. For our analysis, we rely on the settlement data entered into the SCAC database for the 355 cases where we can confirm a match to the Truvalue data.

Figure 2: Average Materiality Scores Around Lawsuit Settlement

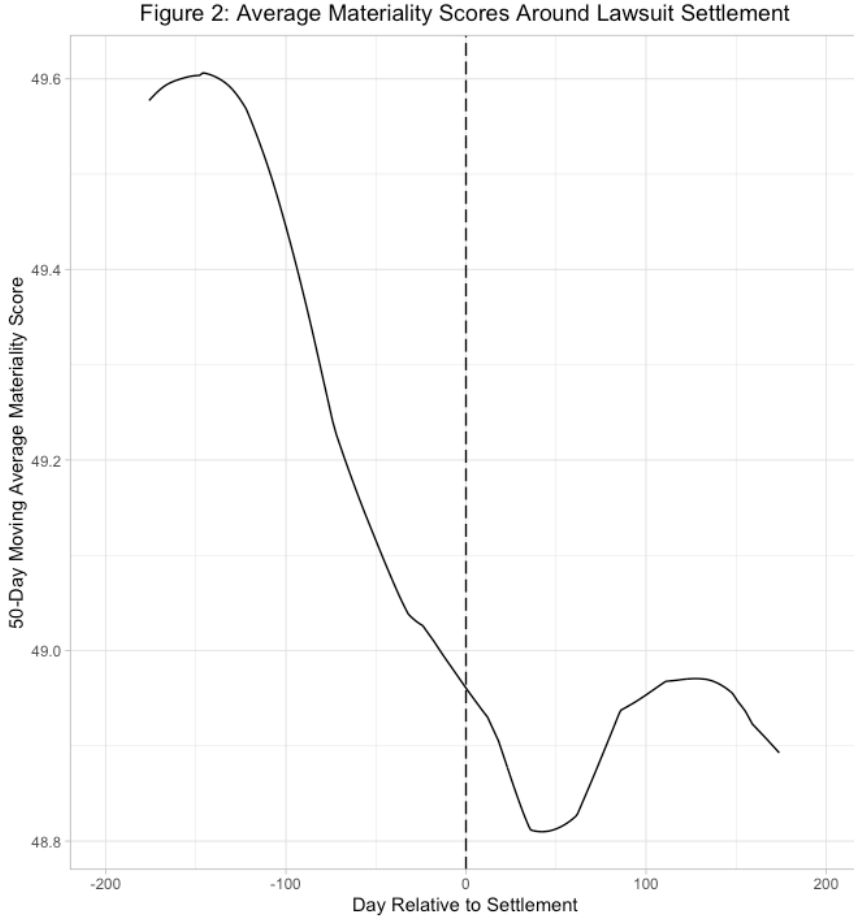


Figure 2 presents the 50-day moving average of the mean Materiality score for the 200 days prior to settlement and the 200 days following settlement. The first thing to note is that these results are more muted than those surrounding filing. The drop from the highest average score to the lowest average score around the time of settlement ranges from about 49.6 to 48.8, while the drop around the time of filing is several points. Second, there is a substantial drop prior to settlement. This drop may be due to news of a preliminary settlement being announced prior to the formal settlement being approved. Nevertheless, it appears that the drop levels off around the settlement date, with a brief dip and subsequent increase in the 100 days after settlement.

D. Interpretations of the Results

There are a number of different ways that we can interpret our findings about the relationship between ESG performance and shareholder lawsuits. Before doing so, we summarize our headline results, which are: (1) firms that are not subject to lawsuits have higher Truvalue ESG metrics than those that are later sued and this is true even well before the lawsuits materialize; (2) ESG scores are lower for firms that have more meritorious cases filed against them both before and after the filing of the lawsuit; and (3) the period before settlement is associated with a mild decrease in ESG scores and that decrease appears to stop post-settlement. We explore interpretations that are firm-centric, plaintiffs' firm-centric, and regulator-centric.

1. Firm-Centric Interpretations

Our finding that firms that are subject to shareholder lawsuits have lower ESG performance suggests that firms that engage less with stakeholders, or at least are perceived to be less focused on ESG concerns based on Truvalue's ESG metrics, may be more likely to act in the fraudulent and problematic ways that attract shareholder lawsuits. Or, to put it more bluntly, firms that are "bad" in some ways (that are related to ESG) are more likely to be "bad" in other ways (that lead to litigation). There are a number of potential channels for this interpretation and we should be clear that we cannot differentiate these channels in our data. Nevertheless, it is useful to discuss how this outcome may come about.

One potential reason why firms might be bad across multiple dimensions is management and broader firm culture. If the people in charge of firms act in less socially responsible ways, as reflected by poor ESG performance, that behavior may be correlated with a propensity to engage in misreporting and other types of securities fraud. This channel would be consistent with research showing that executives that engage in anti-social or unethical behavior are more likely to engage in corporate fraud.[93] Scholars have also shown that broader firm measures of ethical

[93] See Robert Davidson, Aiyesha Dey & Abbie Smith, Executives "Off-the-Job" Behavior, Corporate Culture, and Financial reporting risk, 117 J. Fin. Econ. 5 (2015) (finding that firms with executives that have traffic and criminal convictions are more likely to engage in financial fraud); Brandon Cline, Ralph Walkling, and Adam Yore, 2017, The Agency Costs of Managerial Indiscretions: Sex, Lies, and Firm value, 127 J. Fin. Econ. 389 (2015) (showing that announcements of personal dishonesty, drug abuse, and other indiscretions correlates with poor firm performance and increased likelihood of being subject to government investigation); John M. Griffin, Samuel Kruger & Gonzalo Maturana, Do Personal Ethics Influence Corporate Ethics?," available at SSRN 2745062 (2017) (demonstrating that an executives appearance in the Ashley Madison database is associated with a much higher likelihood of a firm engaging in securities fraud).

behavior are associated with financial fraud[94] as well regional measures of upstanding behavior.[95]

An alternative, but not mutually exclusive, account of the relationship between ESG performance and shareholder litigation is as a product of poor financial performance. If a firm is not performing well, it may be subject to pressure from shareholders and creditors to improve that performance. This influence can be effective because shareholders may be able to agitate for change[96] and creditors may have the leverage that comes when poor financial performance leads to tripping a covenant in a loan agreement.[97] This distress may lead to directing resources away from ESG activities and may also lead an increased risk of being subject to securities litigation. This risk could also be a product of poor stock price performance—which can draw scrutiny from investors and attorneys[98]—or, more nefariously, the pressure to improve performance may lead to aggressive financial reporting and the other sorts of behaviors that can tip into the suspected fraud that underlies a securities lawsuit.

Firms may also be strategic in the ways they engage with ESG issues. Commentators have identified the phenomenon of "astroturfing," which is the practice of creating positive publicity through means that are difficult to trace to the firm.[99] Alternatively, when firms are the subject of meritorious lawsuits, they may make legitimate investments in ESG activities in order to counter the negative effect associated with the events that underlie the lawsuit.[100] As noted above, this may be what is happening in Figure 1, where there is a post-filing bounce back in Materiality scores for the firms that are subject to lawsuits that will eventually settle.

2. Plaintiffs'-Firm Centric Interpretations

Another potential channel may be the way plaintiffs' firms—who are the primary initiators of securities lawsuits—find cases. Researching and filing a securities case against a

---

[94] See William David Grieser, Nishad Kapadia, Rachel Li & Andrei Simonov, Fifty Shades of Corporate Culture, Working paper (2016) (finding that firms with more Ashley Madison users are more likely to engage in unethical behavior).

[95] See Christopher A. Parsons, Johan Sulaeman & Sheridan Titman, The geography of Financial Misconduct, working paper (2015) (showing that regional measures of ethical behavior correlate with financial misconduct).

[96] There is voluminous evidence that shareholder influence can lead managers to change their behavior. See Matthew R. Denes, Jonathan M. Karpoff & Victoria B. McWilliams, Thirty Years of Shareholder Activism: A Survey of Empirical Research, 44 J. of Corp. Fin. 405 (2017) (compiling the result of 73 studies to show that shareholder activism has a substantial effect on firm behavior).

[97] See Greg Nini, David C. Smith & Amir Sufi, Creditor Control Rights and Firm Investment Policy, 92 J. Fin. Econ. 400 (2009) (finding tripping a financial covenant results in a number of actions that favor creditors over stockholders, such as decreased shareholder payouts and decreased risk taking).

[98] See generally, Irene Kim & Douglas J. Skinner, Measuring Securities Litigation Risk, 52 J. of Acct. and Econ. 290 (showing that stock price volatility increases litigation risk for firms).

[99] Ben Elgin & Zachary Mider, Who's That Hiding Under the Astroturf?, Bloomberg Businessweek, Nov. 20, 2017, at 43, 43-44 (detailing that firms will surreptitiously create positive public relations to "provide an appearance of public support that doesn't exist").

[100] Some have suggested that strong ESG performance can act as insurance against risk. See Ping-Sheng Koh, Cuili Qian & Heli Wang, Firm Litigation Risk and the Insurance Value of Corporate Social Performance, 35 Strat. Mgmt. J. 1464, 1478-80 (2013) (finding that strong social performance may be more valuable for firms that are in industries with high litigation risk).

firm requires significant investment of time and resources.[101] A successful case will often require scouring a firm's public disclosures and it often takes financial and accounting expertise to spot irregularities.[102] While some commentators are skeptical of this process, one can hypothesize that picking firms that are worth investigating receives careful consideration. To the degree that bad behavior in other domains correlates with financial wrongdoing, poor performance on ESG metrics may bring added scrutiny from plaintiffs' attorneys.

Securities litigation in particular is complicated, and can be driven more by entrepreneurial attorneys than shareholders (or stakeholders), particularly for event-driven litigation that is file when bad news is correlated with a stock drop. To the extent lawyers have a propensity to file disclosure litigation when they have a plausible claim that a material disclosure was omitted or misrepresented, their causes of action might correlate with negative press coverage, which in turn might correlate with low ESG metrics. One important perspective is that the correlation of ESG scores with news might also reflect the correlation of plaintiffs' attorneys behavior with news.

Regardless of whether poor ESG performance leads to a higher propensity to engage in financial fraud, the additional scrutiny from plaintiffs' attorneys may lead them to find stronger cases against these firms. That pattern would account for the observation that firms with lower ESG scores tend to get sued more often. And, assuming closer scrutiny makes it more likely that fraudulent activity will be discovered, this pattern would also be consistent with our finding that firms that will have more meritorious cases filed against them have lower ESG scores than those who will be subject to less meritorious cases.

Of course, there may be multiple explanations for the patterns we observe. It is possible that firms that score poorly on ESG metrics are more likely to engage in fraud and that plaintiffs' firms scrutinize firms with low ESG performance more closely. Both of these phenomena could reinforce each other in ways that are consistent with the results that we find above.

3. Regulator-Centric Explanations

Another central player in securities litigation is the Securities and Exchange Commission. It is quite common for private plaintiffs to file a lawsuit after the SEC has completed an investigation into securities fraud at a firm.[103] Just as poor ESG performance may draw increased scrutiny from plaintiffs' firms, that same activity may cause the SEC to take a closer look at these firms. These examinations may reveal securities fraud, or at least enough problematic behavior that a firm, if investigated, believes it prudent to enter into a settlement with the SEC. To the degree that these settlements draw scrutiny from plaintiffs' firms, this regulator channel is yet another way that poor ESG performance can lead to an increased likelihood of being subject to a securities lawsuit.[104]

---

[101] See generally, Stephen J. Choi, Do the Merits Matter Less After the Private Securities Litigation Reform Act?, 23 J. of Law Econ. and Org., Volume 598 (2007) (showing that the merit of a lawsuit likely mattered to the likelihood of being sued both before and after the passage of the Private Securities Litigation Reform Act).
[102] Id.
[103] See Stephen J. Choi, Karen K. Nelson & Adam C. Pritchard, The Screening Effect of the Private Securities Litigation Reform Act, 6 J. of Emp. Leg. Stud. 35, 43 ("The existence of an SEC investigation … does suggest a substantial likelihood of fraud.").
[104] Id.

Regulators may also believe that they have increased leverage over firms with poor ESG performance.[105] If a firm already suffers from a poor reputation, it might fear that a successful prosecution would be especially harmful to its standing. In that case, a firm might settle with the SEC even though the underlying claims have relatively little merit. A firm with a stronger public standing might not face as much public relations risk from such a suit and might be willing to defend itself more forcefully when claims have scant factual basis. Insofar as settlements are more likely to attract securities litigation, this mechanism could drive a negative relationship between ESG performance and the likelihood of being subject to securities lawsuits.

Judicial behavior also might explain the variance in treatment of firms that face litigation. If judges are more sympathetic to firms with better ESG performance, and accordingly higher ESG scores, they might be less likely to dismiss those cases, or more likely to indicate that the such cases are more likely to succeed. Similarly, judicial views might also influence settlement behavior.

We are not able to observe which of these interpretations dominates. Nor can we measure the relative strength of each interpretation. However, we can show that the various interpretations matter to a range of policy questions, and we can point to areas where our robust findings of a relationship between ESG metrics and litigation are important to understanding optimal policy. Ultimately, the above interpretations all relate in varying ways to a central question facing all firms: risk.

IV. Normative Implications of the Relationship between ESG and Securities Litigation: A Story about Risk

How should the relationship between ESG metrics and shareholder litigation matter from a policy perspective? We argue here that the normative assessment of this relationship depends on risk, and we focus here on various aspects of risk, particularly litigation risk. We do so in part because investors and practitioners focus on risk, and we want our interpretation to be useful to those groups, so we begin below by setting forth some of that discussion. Then we turn to risk interpretations that might matter to policymakers: first, in securities disclosure and regulation, and then in various interpretations of Delaware law. We close this Part with a few thoughts about other potential future policy proposals that relate to ESG and risk.

Our central point here is that our empirical findings about the association between ESG metrics and securities litigation have significant implications for numerous areas of law and practice. Investors, regulators, and policymakers might think they are making decisions and conducting oversight based on ESG factors, when in reality what they are doing, at least in part, relates to litigation risk. Conversely, securities regulators and judges in particular might consider whether various aspects of their decisions related to litigation risk might be framed as in fact addressing ESG issues. Our central point is that ESG and litigation risk should be considered together.

A. The Investor and Practitioner Perspective

[105] See Christopher McKenna & Rowena Olegario, Corporate Reputation and Regulation in Historical Perspective, in The Oxford Handbook of Corporate Reputation (eds. Michael L. Barnett & Timothy G. Pollack) 260 (2012).

First, as noted above, investors and practitioners are highly focused on ESG factors, and often their discussions are framed in terms of risk. Our new observation here, consistent with our our empirical findings, is that when investors and practitioners address ESG and risk, they are, at least in part, addressing securities litigation risk.[106] We note some recent evidence of explicit references to litigation in recent discussions of ESG, and we suggest that investors and practitioners should think more explicitly about the extent to which their discussion of ESG in fact relates to securities litigation risk.

For example, discussions of climate change are often framed abstractly in terms of ESG risk, without delineating the source of that risk. With respect to climate change, the first large-scale empirical survey of institutional investors' attitudes about the financial materiality of ESG risk, a 2019 study published by Amir Amel-Zadeh of Oxford University, found that 22% of the respondents considered climate change to be very important to investment decisions in the past 5 years, while 46% considered it somewhat important.[107] Obviously, climate change is widely regarded as a significant ESG risk.

But what kind of risk? Importing here the ideas from our earlier theoretical discussion, the interpretation of risk might be the risk associated with future externalities, risks to stakeholders, or shareholder litigation risks. We note that the answers from investors in the recent Amel-Zadeh climate survey included some specific, granular questions about risk that help to illuminate this question. For example, when asked why climate change poses a material risk to companies in their investment portfolio, the most common answer among institutional investors was "Regulatory and litigation risk" (at 63%), ahead of "Risk to operational reliability/ business continuity/ supply chain" (59.3%), "Risk to customer demand (37.3%), "Risk of stranded assets" (36.9%), and "Risk to employee safety" (14.9%).[108] In other words, it appears that not only do a majority of investors consider climate risk to be financially material, they emphasize that these risks arise in significant part from the risk of litigation. Not surprisingly, large institutions rank regulatory and litigation risk more highly than small institutions.[109]

The results of this survey also are consistent with our finding of a relationship between ESG metrics and securities litigation risk. In other words, a significant part of investor attitudes toward ESG are apparently concerns about securities litigation.

---

[106] See, supra, Sec. III.C.

[107] See Amir Amel-Zadeh, Materiality of Climate Risk, Said Business School, University of Oxford working paper, Mar. 2019, at 21; Stefano Giglio, Matteo Maggiori, Krishna Rao, Johannes Stroebel & Andreas Weber. 2018. Climate Change and Long-Run Discount Rates: Evidence from Real Estate, Yale University Working Paper (2018).

[108] Amel-Zadeh, Materiality of Climate Risk, at 42. When company officials were asked the same question, the concerns were weighted differently: just 42.9% put regulation and litigation in their top categories; operations and customer demand were of greater concern. Id. at 44. Other recent studies find that climate risks are financially material to companies. See Asaf Bernstein, Matthew Gustafson & Ryan Lewis, Disaster on the Horizon: The Price Effect of Sea Level Rise, University of Colorado working paper.

[109] See Amel-Zadeh, Materiality of Climate Risk, at 22, 24. Concerns about climate change are industry-specific as well. In terms of materiality, energy sector are ranked first with 68% of investors responding they believe the impact of climate change to be material for companies in this sector. This is followed by companies in basic materials (62%), utilities (60%), transportation (56%) and industrials (56%). Amel-Zadeh, Materiality at 26. Climate change concerns are less in knowledge-intensive sectors and financial services. Id. at 26-27.

The connection between ESG and securities litigation also is reflected in discussions among practitioners. Increasingly, lawyers have begun warning clients about the relationship between ESG and litigation risk. For example, in a November 2019 memorandum, fifteen partners from Wachtell, Lipton, Rosen & Katz emphasized the importance of "Special Considerations Regarding ESG and Sustainability-Related Risks," and included numerous litigation-related risks in its discussion.[110] A recent memorandum from Ceres also mentions litigation in the context of enterprise risks and climate change impact, specifically citing "ESG-based litigation."[111]

Why might investors and lawyers be so focused on ESG-related litigation risk? We see two main reasons, one related to federal securities law and one related to Delaware law. We address each of those reasons next.

B. Federal Securities Disclosure

One way ESG risk and securities litigation risk are related is securities disclosure. Indeed, our empirical findings that ESG metrics and securities litigation are related are consistent with recent changes in how plaintiffs (and to some extent judges) view federal securities disclosure requirements. The number of securities cases involving allegations related to ESG has increased in recent years, though the numbers are still relatively small.[112] These cases include claims of false or misleading statements or omissions involving sustainability or corporate social responsibility reports, human rights documents, employer codes of conduct, or ethics/integrity statements.[113] Such complaints face barriers including those related to materiality and reliance, and, consistent with securities litigation jurisprudence generally, appear to have been more successful to the extent they are based on statements that are concrete as opposed to merely aspirational.[114] To the extent the perceived risk associated with such cases is increasing, securities disclosure increasingly appears to be implicating ESG risk.

As recent examples, consider two securities complaints filed against executives of PG&E Corporation and the Chemours Company during October 2019. The PG&E shareholder claimed

---

[110] See Wachtell, Lipton, Rosen & Katz, Risk Management and the Board of Directors. Nov. 2019, at 16. Specifically, the memorandum noted: "ESG risks represent a specific subset of general risks that a company should manage, where relevant, by identifying and mitigating company-specific risks, such as environmental liabilities, labor standards, consumer and product safety and leadership succession, and contingency planning for macro-level risks, including by identifying supply chain and energy alternatives and developing backup recovery plans for climate change and other natural disaster scenarios." Id.

[111] See Veena Ramani and Hannah Saltman, Running the Risks: How Corporate Boards Can Oversee Environmental, Social And Governance Issues, Ceres, Nov. 25, 2019, https://corpgov.law.harvard.edu/2019/11/25/running-the-risks-how-corporate-boards-can-oversee-environmental-social-and-governance-issues/.

[112] See Caitlin M. Ajax & Diane Strauss, Corporate Sustainability Disclosures in American Case Law: Purposeful or Mere "Puffery"?, Ecol. L.Q. 101,103 (2019) ("Recent years have shown an uptick in lawsuits involving sustainability disclosures, or lack thereof, by companies.").

[113] See Ajax & Strauss, Sustainability Disclosures, at 103. To some extent such litigation might represent attempts to connect a significant economic loss to a disclosure issue, and questions about whether there were real substantive disclosure violations in these cases are murky. See Donald Langevoort, Vand. L. Rev. (citing British Petroleum as an example).

[114] See Ajax & Strauss, Sustainability Disclosures, at 115-20 (discussing securities litigation involving sustainability disclosures).

the company made misleading statements and failed to disclose that "PG&E's purportedly enhanced wildfire prevention and safety protocols and procedures were inadequate to meet the challenges for which they were ostensibly designed, and as a result, PG&E was unprepared for the rolling power cuts the Company implemented to minimize wildfire risk."[115] The Chemours shareholder claimed that, when Chemours was spun off from DuPont, environmental liabilities regarding were shifted to and concealed by Chemours.[116] Our conversations with practitioners suggest that more similar cases are likely to be filed during the upcoming years, and that the risk of such litigation is increasing.

The relationship between ESG disclosures and securities litigation warrants a rethinking of many findings about ESG in the now-significant literature on the financial impact of environmental risks and how companies disclose such risks.[117] How should we interpret findings of a negative stock market reaction to news about environmentally harmful behavior,[118] or findings of no such relationship?[119] It would be helpful to disentangle the extent to which returns are responding to changes in expected litigation costs, or at least to consider litigation risk as a potential factor.

Numerous findings related to ESG and securities disclosure arguably depend on litigation risk, including findings of a positive or at least neutral relationship between sustainability efforts and financial returns (and perhaps the minority of studies that find a negative relationship).[120] Professor Virginia Harper Ho has referred to ESG risk management as contributing to "future financial performance by reducing the cost of liabilities due to … legal claims" among other factors.[121] Reduced capital costs associated high-quality disclosures[122] or strong environmental risk management practices also could be viewed as related to litigation risk.[123] Similar interpretations apply to the relationship between bond yields and strong governance programs, including findings that good governance reduces credit costs,[124] or the relationship between

---

[115] Christopher Vataj, et al. v. William D. Johnson, et al., 19-CV-06996, at 3-4 (N.D. Cal. Oct. 25, 2019).
[116] Electrical Workers Pension Fund, Local 103, I.B.E.W., et al. v. The Chemours Company, et al., 19-CV-01911, at 2 (D. Del. Oct. 8, 2019).
[117] See Bernstein, Gustafson and Lewis; Charles H. Cho, Robin Roberts & Dennis Patten, The Language of US Corporate Environmental Disclosure, 35 Acc't Org. & Soc. 431 (2010); Charles H. Cho, Ronald P. Guidry, Amy M. Hageman & Dennis Patten, Do Actions Speak Louder Than Words? An Empirical Investigation of Corporate Environmental Reputation, 35 Acc't Org. & Soc. 14 (2012)
[118] See Caroline Flammer, Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors, 56 Acad. of Mgt. J. 758 (2013).
[119] See, e.g., Florencio Lopez-de-Silanes, Joseph A. McCahery & Paul C. Pudschedl, ESG Performance and Disclosure: A Cross-Country Analysis, ECGI Law Working Paper N° 481/2019 (finding that ESG scores have little or no impact on risk-adjusted performance).
[120] See generally Virginia Harper Ho, Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk, 41 J. Corp. L. 647, 662-676 (2016).
[121] See id. at 633-665.
[122] See generally Dan. S. Dhaliwal et al., Voluntary Nonfinancial Disclosure & the Cost of Equity Capital: The Initiation of Corporate Social Responsibility Reporting, 86 Acc'ting Rev. 59 (2011).
[123] See generally Mark Sharfman & Chitru S. Fernando, Environmental Risk Management and the Cost of Capital, 29 Strategic Mgmt. J. 569 (2008); Sadok El Ghoul et al., Does Corporate Social Responsibility Affect the Cost of Capital?, 35 J. Banking & Fin. 2388 (2011).
[124] See generally Sanjeev Bhojraj & Partha Sengupta, Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors, 76 J. BUS. 455 (2003).

positive ESG indicators and capital costs.[125] Findings that lower ESG risk is associated with lower idiosyncratic risk,[126] lower financial risk overall,[127] lower future volatility,[128] (including for particular ESG factors[129]), or that ESG risk is associated with increased arbitrage opportunities[130] could be reframed as related at least in part to litigation. To the extent ESG investment is "insurance" against future liability, that reduced risk arguably is significantly related to litigation risk.[131]

One central concept in the federal securities regulation regime is materiality. The duty to disclose social and environmental information that is perceived as material falls within the existing disclosure framework,[132] and accordingly the materiality of ESG disclosures can vary by industry.[133] Although there is not yet legislation specifically imposing requirements that firms disclose ESG metrics or risks, and firms do not have an affirmative duty to disclose all information, there is increasing pressure on firms to disclose material non-financial information, including many aspects of ESG-related information.[134] For example, Regulation S-K, Item 101 of the Securities Act of 1933 requires firms to disclose any material effects on the financial position of the firm stemming from a failure to comply with environmental regulations. Firms also must disclose any material effects of their non-compliance with the law, as well as pending legal proceedings.[135] Regulation S-K, Item 303 requires narrative disclosures of risks in firm's Management Discussion & Analysis (MD&A) section of filings. Moreover, firms must disclose risks under environmental statutes, including litigation risk. For example, Regulation S-K effectively requires the disclosure of material "Superfund" risks under CERCLA,[136] although there is some evidence that such risks are not adequately disclosed.[137]

---

[125] See generally Allen Goss & Gordon S. Roberts, The Impact of Corporate Social Responsibility on the Cost of Bank Loans, 35 J. Banking & Fin. 1794 (2011).

[126] See generally Darren D. Lee & Robert W. Faff, Corporate Sustainability Performance and Idiosyncratic Risk: A Global Perspective, 44 Fin. Rev. 213 (2009); see also Bouslah et al., infra note 25.

[127] See Harper Ho, supra note 14 (citing Marc Orlitzky & John D. Benjamin, Corporate Social Performance and Firm Risk: A Meta-Analytic Review, 40 Bus. & Soc'y 369, 370 (2001)).

[128] See generally Orlitzky & Benjamin, supra note 20.

[129] See generally Kais Bouslah et al., The Impact of Dimensions of Social Performance on Firm Risk, 37 J. Banking & Fin. 1258, 1259 (2013).

[130] See Harper Ho, supra note 14, at 672.

[131] See generally Ping-Sheng Koh et al., Firm Litigation Risk and the Insurance Value of Corporate Social Performance, 35 Strategic Mgmt. J. 1464 (2013).

[132] See, e.g., Monsuma and Olson 2007; Williams 1999. See also Hanock (2005) (discussing the possibility of legal action against polluting firms accused of causing coastal flooding, draughts and the adverse effects on human health that are attributed to global warming).

[133] See Mozaffar Khan et al., Corporate Sustainability: First Evidence on Materiality, 91 Acct'ing Rev. 1697, 1698-1703 (2016).

[134] See, e.g., Reg. S-K, 1998, Item 101, 17 C.F.R § 229.101; Item 103, 17 C.F.R § 229.103; and Item 303, 17 C.F.R § 229.303. Developments in other jurisdictions, particular in Europe, will change the regulatory mandate and likely will impact U.S. firms that do business in those jurisdictions, with likely spillover effects, although it is difficult to tell at this stage how comprehensive those changes will be.

[135] See Levine v. NL Industries, Inc, 926 F.2d 199, 203 (2d Cir. 1991).

[136] See Palmiter, Partnoy, and Pollman, Business Organizations (discussing environmental liability under The Comprehensive Environmental Response, Compensation and Liability Act of 1980 in the context of business law).

[137] See Repetto and Austin (2000).

Some investors have expressed frustration with the SEC's current materiality reporting regime, and the lack of clarity has led to a secondary web of voluntary disclosure regimes.[138] Indeed, as mainstream investors now incorporating ESG into investment decision-making,[139] they increasingly recognize the importance of ESG issues for considering financial performance,[140] and some demand that public companies provide ESG information that can be incorporated into their models.[141] Many investors rely of the SASB framework as an approach to materiality,[142] in part because it reflects a convergence of financial and ESG concerns.[143] Some scholars have predicted SASB will "set off a chain reaction," leading all public companies to disclose environmental practices.[144] Others favor a "comply or explain" standard that would allow companies to elect to comply with a code set by regulators or explain why they have chosen to deviate.[145] The current materiality standard arguably does not capture ESG concerns that are large in absolute terms yet immaterial, and thus undisclosed, at major corporations simply due to their size.[146]

Reforming materiality has been controversial at the SEC. In 2010, the SEC recognized in its guidance that material ESG risks were not being disclosed under the existing framework.[147] It also sought public comment in 2016 on incorporating ESG into its reporting requirements.[148] Most recently, several SEC Commissioners have disagreed with respect to proposed amendments to disclosure requirements. Commenting in an individual capacity, SEC Chair Jay Clayton acknowledged in Febuary 2020 that the proposed amendments did not address ESG, but stated that he was "pleased" with the SEC's ongoing commitment to the materiality standard.[149] He noted as a "threshold" matter that the current regime is built around "verifiable and largely historic issuer-specific information," and environmental capital allocation determinations are forward-looking estimates that "in many cases" fall within safe-harbor protection.[150] Commissioner Hester Peirce agreed with Clayton, speaking separately to express her skepticism

---

[138] See Ruth Jebe, The Convergence of ESG and Materiality: Taking Sustainability Mainstream, 56 Am. Bus. L. J. 645, 647 (2019).
[139] Id. at 647-48.
[140] See Virginia Harper Ho, "Comply or Explain" and the Future of Nonfinancial Reporting, 21 Lewis & Clark L. Rev. 317, 318-319 (2017).
[141] Id. at 320.
[142] Jebe, supra note 30, at 649.
[143] Id. at 687.
[144] See Paul Rissman & Diana Kearney, Rise of the Shadow ESG Regulators: Investment Advisers, Sustainability Accounting, and their Effects on Corporate Social Responsibility, 49 Envtl. L. Rep. News & Analysis 10155, 10157 (2019).
[145] Harper Ho, supra note 32, at 321.
[146] See George S. Georgiev, Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation, 64 UCLA L. Rev. 602, 605-606 (2017).
[147] See Commission Guidance Regarding Disclosure Related to Climate Change, Exchange Act Release Nos. 33-9106; 34-61469; FR-82, 75 Fed. Reg. 6292 (Feb. 8, 2010).
[148] Business and Financial Disclosure Required by Regulation S-K: Concept Release, 81 Fed. Reg. 23,916 (Apr. 22, 2016).
[149] See Jay Clayton, Statement by Chairman Jay Clayton on Proposed Amendments to Modernize and Enhance Financial Disclosures, Harvard Law School Forum on Corporate Governance (Feb. 1, 2020), https://corpgov.law.harvard.edu/2020/02/01/statement-by-chairman-jay-clayton-on-proposed-amendments-to-modernize-and-enhance-financial-disclosures/#more-126478.
[150] Id.

of ESG's materiality.[151] She suggested requiring ESG disclosures regardless of their materiality would "degrade[]" the standard.[152] She cautioned that mandatory ESG disclosures lead to "information overload" and "misallocation of capital."[153]

But Commissioner Allison Lee disagreed. She pointed out that investors "overwhelmingly" tell the SEC they need "consistent, reliable, and comparable disclosures of the risks and opportunities related to sustainability measures, particularly climate risk."[154] Lee commented that the materiality standard has "not produced sufficient disclosure to ensure investors are getting the information they need," noting that the resulting voluntary frameworks are also creating difficulties.[155] She urged the SEC to "show[] leadership" by modernizing the provisions relating to climate change disclosure, bringing consistency and reliability back into the market.[156]

This debate raises numerous issues, many of which are beyond the scope of this article. But our main point here is that the relationship between ESG and securities litigation matters to the securities regulation debate. Securities disclosure reform proposals should take into account and reference securities litigation risk. Regulators should address the impact of the association we find between ESG and securities litigation in their discussion of reform proposals. For example, what are the expected costs and benefits of increased disclosures about climate risk if such disclosures will lead to "bad" ESG firms being sued relatively more frequently (and less frequent dismissals)? Will increased required disclosure of ESG risks lead to an even stronger relationship between ESG and securities litigation than the results reported in Part III? We believe that a robust discussion of the relationship between ESG and securities litigation would help focus the proposals on specific disclosure requirements.

More generally, in our view, securities regulation implicitly creates an association between ESG factors and securities litigation risk by focusing on disclosure of material risks related to ESG. When researchers study the relationship between ESG factors and some variable of interest, they potentially are importing the relationship between securities disclosure requirements and ESG factors. In particular, to the extent there is a relationship between ESG factors and returns, that relationship might be due, at least in part, to the litigation risk associated with securities disclosures about ESG, instead of some other economic risk related to externalities or stakeholders.

People disagree, strongly, about the extent to which ESG disclosure is material and, if so, what ESG information is material. Our results do not necessarily dictate a particular stance as to the scope of ESG disclosure that is, or should be, required by the SEC. Instead, our main normative point to emphasize based on our empirical results that increased disclosure of ESG

---

[151] See Hester Pierce, Statement by Commissioner Pierce on Proposed Amendments to Modernize and Enhance Financial Disclosures, Harvard Law School Forum on Corporate Governance (Feb. 1, 2020), https://corpgov.law.harvard.edu/2020/02/01/statement-by-commissioner-peirce-on-proposed-amendments-to-modernize-and-enhance-financial-disclosures/#more-126449.
[152] Id.
[153] Id.
[154] Allison Herren Lee, Statement by Commissioner Lee on Proposed Amendments to Modernize and Enhance Financial Disclosures, Harvard Law School Forum on Corporate Governance (Feb. 1, 2020), https://corpgov.law.harvard.edu/2020/02/01/statement-by-commissioner-lee-on-modernizing-regulation-s-k-ignoring-the-elephant-in-the-room/#more-126455.
[155] Id.
[156] Id.

risks under federal securities law (to the extent it occurs) arguably strengthens the association between ESG and securities litigation, and makes it more likely that what is being captured by ESG metrics includes securities litigation risk.

C. Corporate Law

Although our empirical study in Part III is focused on federal securities litigation, we also want to address the potential relationship between corporate law and ESG factors. Recent cases in Delaware suggest that there might be an increased focus on the oversight responsibility of directors, and we see one way of framing these new cases is that they at least implicitly involve ESG-related risks. Environmental and social concerns include risks to human life, and governance concerns include the relationship between the board and stakeholders when there are risks to human life. Moreover, the central, or "mission critical," aspects of a firm's business often relate to ESG issues, including sustainability. We want to raise the question here whether our findings are potentially consistent with the broader notion that corporate law and corporate governance should be and are related to ESG.[157]

We focus here on Delaware law, but our analysis could apply to any state corporate law. It also could apply to a new federal law framework to the extent it implicates traditionally-state notions of corporate law and corporate governance. Delaware's approach to risk oversight has set a national standard in the area, so it makes sense for us to emphasize Delaware and its recent cases.

The key case under Delaware law is *Caremark*, which established national legal standards for directors' duties in risk management.[158] *Caremark* held that directors can be liable for a failure of board oversight where there is "sustained or systemic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists."[159] It is widely recognized that the *Caremark* test is a demanding one, and until recently it was difficult for oversight allegations to survive a motion to dismiss.

However, a few recent cases suggest that the tide might be shifting. Consider the litigation that followed the announcement that Wells Fargo employees had created millions of customer accounts without their knowledge or consent. In *In re Wells Fargo & Company Shareholder Derivative Litigation*, the court, applying Delaware law, denied a motion to dismiss based on a "red flags" rationale resembling the one pled by the plaintiffs in *In re Citigroup Inc. Shareholder Derivative Litigation*, a case arising in the aftermath of the financial crisis.[160] The defendants, as in *Citigroup*, argued that any one of the alleged red flags was insignificant in the larger context, particularly for a large financial institution. The court rejected this argument, and found that the red flags collectively supported an inference that a majority of the board consciously disregarded their oversight duties.[161]

---

[157] See Bruner at 9 ("Bringing 'planetary boundaries' to bear upon corporate law and corporate governance accordingly connects with and better operationalises the environmental precautionary principle and the polluter pays principle.").
[158] In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996).
[159] Id. at 971.
[160] In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106 (Del. Ch. 2009).
[161] For a discussion of the *Citigroup* litigation and related cases addressing financial risk, see Frank Partnoy, Delaware and Financial Risk, in The Corporate Contract in Change Times: Is the Law Keeping Up? (University of Chicago Press 2018) (Steven Davidoff Solomon and Randall Thomas, eds.).

More recently, two Delaware cases have suggested a potential expansion of director responsibility in the *Caremark* context, though the implications for future case law remains unclear. First, in June 2019, the Delaware Supreme Court, in *Marchand v. Barnhill*, reversed the dismissal of a *Caremark* suit based on the directors' oversight of risks related to the contamination of ice cream distributed by Blue Bell Creameries.[162] The facts of that case were arguably extreme: Blue Bell Creameries's ice cream had been contaminated with listeria, and the company had recalled its products and suspended operations after news emerged that its ice cream had killed three people.[163] The case matters from an ESG perspective: killing customers obviously implicates ESG concerns.

As the court described in *Marchand*, Blue Bell Creameries's safety concerns stretched back for years.[164] The complaint alleged that from 2009 to 2013 inspectors in Alabama, Texas, and Oklahoma found "troubling" compliance failures, including condensation dripping into food products and facilities in "disrepair."[165] Management received multiple positive tests for listeria in 2013 and 2014.[166] But those reports did not make it to the board.[167] Board minutes during that time included no discussions about listeria specifically, or food safety generally.[168] Indeed, it was not until the board's September 2014 meeting that it first discussed sanitation—after management already had received fifteen positive listeria test results.[169] At that meeting, the Vice President of Operations informed the board only that a recent food safety audit "went well."[170] The complaint alleged that this meeting was the only board-level discussion about food safety until the customer outbreak.[171]

Marchand was notable for allowing the complaint to proceed under *Caremark*. The Supreme Court substantively critiqued the company's food safety programs – which only "nominally complied with FDA regulations" – because there was no board committee or full board level process to address food safety, and no protocol for how the board would become informed of food safety reports and developments.[172] Key to the Supreme Court's holding was that Blue Bell Creameries was a "monoline business," making food safety "essential and mission critical" to the company's success."[173] The court held that "directors must make a good faith effort to implement an oversight system and then monitor it."[174] Given that "no system of board-level compliance monitoring and reporting" in place to ensure management would alert the board about sanitation issues, the court refused to dismiss the complaint's *Caremark* claim.[175]

Although *Marchand* was not explicitly framed in terms of ESG issues, the key language in the Delaware Supreme Court's opinion can be viewed as implicating ESG concerns. Food safety concerns are fundamentally about externalities, whether or not the firm ultimately bears

[162] Marchand v. Barnhill, 212 A.3d 805 (Del. 2019).
[163] Id. at 814-15.
[164] Id. at 811-12.
[165] Id.
[166] Id.
[167] Id. at 812.
[168] Id. at 812-13.
[169] Id.
[170] Id.
[171] Id.
[172] See id. at 822.
[173] See id. at 809, 824
[174] Id. at 821.
[175] Id. at 822.

the costs due to regulation or litigation. The language "essential and mission critical" can be interpreted as related to serious social concerns that warrant oversight. Perhaps most importantly, the underlying facts in *Marchand* involved risk to human life, perhaps the ultimately externalized ESG risk.[176]

More generally, *Marchand* can be seen as related to protecting social welfare, which is often a significant purpose of legal compliance. One way of thinking about the "mission critical" aspects of the case is that if the allegations are related to the main part of the business, a court can more easily infer conscious disregard, or lack of good faith, with respect to directors' failure to monitor. This approach does not necessarily implicate ESG directly, but nevertheless relates to ESG because such "mission critical" cases generally relate to legal compliance, which is usually about protecting social welfare in some way.

Second, in October 2019, the Delaware Court of Chancery, in *In re Clovis Oncology, Inc. Derivative Litigation*, upheld claims against the directors of a biotechnology firm for oversight failures related to the reporting of drug trial results.[177] Unlike in *Marchand*, the board had compliance and monitoring programs in place, including two subcommittees dedicated to audit and regulatory functions.[178] But under *Caremark*'s second prong, the court found that the plaintiffs adequately had alleged that oversight was inadequate with respect to Clovis's experimental cancer drug.[179] Clovis's drug needed FDA approval before it could be introduced to the market, which required proving its "efficacy and safety" in clinical trials.[180] The FDA requires companies to specify clinical trial standards before they proceed, including chiefly how success will be measured.[181] Clovis committed to following an industry-leading methodology, calculating success using an objective response rate ("ORR") that measured the percentage of patients upon whom the drug worked.[182] The complaint alleged that during 2014-15, Clovis failed to follow the prescribed methodology and therefore inflated its ORR in public disclosures.[183] The board received numerous reports that management was improperly calculating Clovis's ORR, but it still relied on the public's focus on the inflated number to "make its case" for additional financing.[184] Additionally, "with hands on their ears to muffle the alarms," the board was aware that Clovis's 2014 annual report included the incorrect, inflated ORR.[185] When the FDA began an inquiry and the public finally learned of Clovis's true ORR, Clovis's stock price immediately fell by 70%, destroying more than $1 billion in market capitalization.[186] (One obvious difference between *Clovis* and *Marchand* is that Clovis shares were publicly traded, whereas Blue Bell Creameries was privately held.)

The decision in *Clovis* could be characterized as primarily focused on shareholders, particularly given that Clovis's share price declined significantly when the company disclosed its

---

176 See Frank Partnoy, Corporations and Human Life, 40 Seattle U.L.R. 399 (2017) (assessing firm behavior that results in increasing risk to human life).
177 In re Clovis Oncology, Inc. Derivative Litigation, C.A. No. 2017-0222-JRS (Del. Ch. Oct. 1, 2019).
178 See id. at *2.
179 Id. at *15.
180 Id. at *4.
181 Id.
182 Id. at *4-5.
183 Id. at *5-6.
184 Id. at *6.
185 Id. at *7.
186 Id. at *7-8.

poor clinical results (and that there was ensuing securities litigation as well as an SEC investigation).[187] However, the Delaware court also emphasized questions about the drug's efficacy and the fact that the industry was highly regulated.[188]

As with *Marchand*, one interpretation of *Clovis* is that the courts are more likely to deny motions to dismiss, and therefore litigation risks are higher, when the plaintiff shareholders are alleging concerns related to ESG. Indeed, the court in *Clovis* nodded to *Marchand*, noting that a "careful observer" under *Caremark*'s second prong is one whose "gaze is fixed on the company's mission critical regulatory issues."[189] In both cases, the mission critical regulatory issues involved risks to human life. Although the Delaware courts did not explicitly reference ESG, or risks to human life, one way to distinguish these cases is that they are based on serious ESG-related concerns about externality risks to humans.

Practitioners have viewed these oversight cases as potentially implementing ESG concerns. After the Delaware rulings in *Marchand* and *Clovis*, several law firms directly linked the success of *Caremark* claims to ESG issues. Gibson, Dunn & Crutcher predicted that *Marchand* would lead the plaintiffs' bar to focus on *Caremark*'s first prong (whether a board failed to implement any reporting or monitoring systems),[190] under which the firm reasoned that plaintiffs are "bound to focus on the full array of corporate risks," including "broader environmental, social, and governance" factors.[191] Similarly, Mayer Brown advised clients on what "central issues" should be prioritized for board monitoring, suggesting that companies conduct "periodic and regular reassessments" of "risks relating to cybersecurity, violations of laws, consumer safety, employee safety, environmental damage, natural disasters and a variety of other risks."[192] In Weil, Gotshal & Manges's 2020 Governance Outlook, the firm noted that the Delaware rulings in *Marchand* and *Clovis* implore boards to identify their "mission critical" risks and ensure they have board-level reporting mechanisms—especially "against the backdrop of growing investor demand for board oversight of [ESG] related risks and a widening vision of 'corporate purpose.'"[193]

Commentary about the Delaware rulings similarly highlighted the relationship between *Caremark* claims and ESG. For example, Bloomberg reported that the Delaware rulings "signal that boards in regulated industries may have a tougher time evading claims of lax oversight, particularly in cases where human lives are at stake."[194] Similarly, in an opinion article published

---

[187] See id.
[188] Id. at *13-14.
[189] See id. at *13.
[190] See Gibson, Dunn, & Crutcher LLP, Delaware Supreme Court Revisits Oversight Liability (July 29, 2019), https://www.gibsondunn.com/wp-content/uploads/2019/07/delaware-supreme-court-revisits-oversight-liability.pdf.
[191] Id.
[192] See Mayer Brown, Delaware Decision Breathes New Life Into Bad Faith Claims Against Directors: Practical Advice After Marchand v. Barnhill Allows Bad Faith Claim Based on Failure to Monitor Central Compliance Risks (July 1, 2019), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2019/07/delaware-decisionnew.pdf.
[193] Adé Heyliger et. al., 2020 Governance Outlook: Projections on Emerging Board Matters, Weil, Gotshal & Manges LLP (2019), https://www.weil.com/~/media/files/pdfs/2019/nacd-2020-governance-outlook--weil-contribution.pdf.
[194] Andrea Vittorio, Corporate Boards May Face Higher Legal Hurdle in Risk Oversight, Bloomberg L. (Nov. 21, 2019, 2:46 AM), https://news.bloomberglaw.com/corporate-law/corporate-boards-may-face-higher-legal-hurdle-in-risk-oversight.

by Yahoo! Finance, two lawyers wrote that the Delaware rulings “provide clarifying contours” to the “spirited debate around the duties of directors in relation to [ESG] risks.”[195] The authors thought the cases “help lay the foundation for claims against directors for oversight failures related to ESG.”[196] They noted both *Marchand* and *Clovis* “implicate ‘G’ issues [and] ‘S’ risks related to public health,” and suggested that many of the ESG issues identified by SASB “arguably are, or will soon become, mission critical in the same food safety was to Blue Bell and testing protocols were to Clovis.”[197] Like the law firm publications cited above, these authors advised boards to understand their “mission critical ESG and compliance risks,” commenting that “additional board-level attention to critical ESG risks is going to be time well spent.”[198]

In addition, some recent advice from practitioners has emphasized the importance of advising boards that the Delaware rulings’ focus on “mission critical” operations could disproportionately impact companies in heavily regulated industries. Although this advice does not explicitly reference ESG risks, heavily regulated industries arguably are more likely to raise ESG concerns, which suggests that this advice is implicitly related to ESG.

For example, WilmerHale characterized *Marchand* as unique because of the “associated health risks that even a layman could appreciate.”[199] The firm noted there is “no one-size-fits all approach” to governance,[200] and that boards must “have discretion to implement context- and industry-specific approaches to risk oversight,”[201] particularly where “a compliance issue is intrinsically critical to the company’s business operation.”[202] This response suggests that industries particularly sensitive to ESG concerns, such as ice cream and other food products, are at an elevated risk of *Caremark* litigation.[203] Similarly, Skadden, Arps, Slate, Meagher & Flom advised clients that “although *Marchand* does not signal any change in Delaware law, … the recent decisions highlight the importance of director oversight when a company operates in an environment subject to external regulations that govern its ‘mission critical’ obligations.”[204] Skadden concluded that courts “might be inclined to more aggressively monitor directors’ *Caremark* efforts at the pleading stage in those circumstances.”[205] Likewise, Sullivan & Cromwell stressed that the Delaware rulings “confirm the need for boards of directors to review carefully their board processes … particularly with respect to important or otherwise highly

---

[195] Jonathan Drimmer & Yousuf Aftab, ESG and Mission-Critical Issues for Director & Officer Liability, Yahoo! Fin. (Dec. 6, 2019), https://finance.yahoo.com/news/esg-mission-critical-issues-director-184102077.html.
[196] Id.
[197] Id.
[198] Id.
[199] Wilmer Cutler Pickering Hale and Dorr LLP, Sounding the Bell for Proactive Risk Oversight (Aug. 15, 2019), https://www.wilmerhale.com/en/insights/blogs/Focus-on-Audit-Committees-Accounting-and-the-Law/20190815-sounding-the-bell-for-proactive-risk-oversight.
[200] Id.
[201] Id.
[202] Id. (quoting Marchand, 212 A.3d at *33).
[203] See id.
[204] Paul J. Lockwood & Veronica B. Bartholomew, Delaware Supreme Court Reinforces Director Oversight Obligation, Skadden, Arps, Slate, Meagher & Flom LLP and Affiliates (Nov. 19, 2019), https://www.skadden.com/insights/publications/2019/11/insights-the-delaware-edition/delaware-supreme-court-reinforces.
[205] Id.

regulated aspects of the business."[206] Paul, Weiss, Rifkind, Wharton & Garrison linked heavily regulated industries to "mission critical" operations, noting that "this type of key regulatory risk requiring compliance with positive law can be distinguishable from the overall package of business risks that boards oversee and that may be more or less critical to varying degrees."[207]

Prior to *Marchand* and *Clovis*, some commentators thought *Caremark* would lead to "overcompliance," [208] and others were justifiably dismissive of the *Caremark* doctrine's ability to influence corporate decision-making with respect to ESG. For example, Professor Virginia Harper Ho has argued for an "enlightened shareholder value" view of corporate purpose, emphasizing "the benefits to shareholders that can result from focusing corporate management on areas of shared shareholder and stakeholder concern while recognizing the very real challenges posted by the diversity of shareholder and stakeholder interests."[209] She noted that investors are "able and willing" to advance ESG interests due to "the prospect of higher long-term returns and more comprehensive information on investment risks."[210] With respect to the mechanism by which investors might seek to support those interests, she found that "litigation is not likely to be a significant means of promoting an enlightened shareholder value rule," pointing to *Citigroup*'s reaffirmation of the business judgment rule.[211] That skeptical view made some sense before 2019.

However, it now appears that skeptical attitudes towards the potential of *Caremark* to impact ESG might be less justified, and scholarly voices advocating for expanding boards' oversight responsibilities might gain some support. For example, in the context of systemic risk and the sustainability of large financial institutions, Professors John Armour and Jeffrey Gordon have concluded that *Caremark* has been "understood solely in terms of the monitoring of activities that might lead to a breach of applicable statutory or regulatory standards," and that by "cabining" it to regulatory compliance, "[*Caremark*] seeks to preserve the traditional business judgment rule."[212] They have argued that this framing incorrectly assumes that the current regulatory construct appropriately internalizes the social externalities from corporations' actions.[213] Accordingly they wrote that "it is desirable for a duty to monitor to be applied in wider circumstances and to a higher standard."[214] The recent Delaware jurisprudence implicitly lends support to their position, not only with respect to large financial institutions, but in the broader context of business overall.

---

[206] Sullivan & Cromwell LLP, Delaware Court Again Finds Bad Faith Adequately Pled Against Directors (Oct. 4, 2019), https://www.sullcrom.com/files/upload/SC-Publication-Delaware-Court-Again-Finds-Bad-Faith-Adequately-Pled-Against-Directors.pdf.
[207] Frances F. Mi et. al., Recent Delaware Decisions Signal Renewed Focus on Board-Level Compliance Oversight, Paul, Weiss Rifkind, Wharton & Garrison LLP (Nov. 13, 2019), https://www.paulweiss.com/media/3979130/13nov19-caremark.pdf.
[208] See Robert C. Bird & Stephen Kim Park, Turning Compliance into Competitive Advantage, 19 U. Pa. J. Bus. L. 285, 310 (2017).
[209] See Virginia Harper Ho, "Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide, 36 J. Corp. L. 59, 62 (2010).
[210] Id. at 80.
[211] Id. at 92-93.
[212] See John Armour & Jeffrey N. Gordon, Systemic Harms and Shareholder Value, 6 J. Legal Analysis 35, 67-68 (2014).
[213] Id. at 68.
[214] Id.

Indeed, the "mission critical" standard could support a conclusion that oversight standards are related to ESG and sustainability. Consistent with this notion, Professors Armour and Gordon have advocated business strategies in the context of large financial corporations that go beyond the regulatory landscape, to nudge corporations to "identify those risks which are of a magnitude and kind as to threaten the firm's stability."[215] *Caremark* might be reinterpreted to be sympathetic to this proposed nudge. More broadly, scholars have argued that reforming oversight at the board level is the "most likely way for proponents of CSR to achieve their goals," suggesting that corporate management looking to the long-term interests of a corporation could fulfill some ESG aspirations.[216]

Even before *Marchand* and *Clovis*, some scholars argued that boards should incorporate ESG into compliance in order to adequately manage legal risk. One notion has been that "evolving standards" place ESG considerations "well within" the board's mandate to manage legal risks.[217] ESG potentially matters to boards for "uncover[ing] and address[ing] governance gaps, "fraud prevention," and "improv[ing] business decision-making and risk management."[218] Most fundamentally, boards need to have adequate information, including about ESG risks, in order to satisfy the business judgment rule.[219] Similarly, Professor Narine Weldon has argued that compliance officers "must help develop and assess [their] portfolio of risks … particularly in light of the board's *Caremark* obligations."[220] She recommended that counsel work cross-functionally with "IT, human resources, internal audit, health and safety, and marketing departments" to meet these oversight requirements.[221] And she encouraged gatekeepers become "risk intelligent by re-evaluating their company's vulnerability," necessitating an ESG discussion with their board.[222]

One interpretation of *Marchand* and *Clovis* is that courts are more likely to deny motions to dismiss, and therefore litigation risks are higher, when the plaintiff shareholders are alleging concerns related to ESG. Another interpretation is that these cases are simply narrow exceptions to the general protection afforded directors in the oversight context, and are based on the unique factual setting without regard to ESG. We favor the first interpretation, and we see this approach as a potential way for courts to take into account corporate purpose without necessarily abandoning their views of the role of shareholders. Either way, we suggest that the courts should be explicit in addressing whether or not their jurisprudence depends on ESG.

Marchand and *Clovis* suggest a relationship between what are arguably ESG considerations and litigation risk. They therefore support an argument that even though our empirics here focus on securities fraud litigation, one can at least posit a correlation with a broader scope of litigation risk. They also suggest a mechanism for that relationship. Both cases

[215] Id. at 68-69.
[216] See Lawrence E. Mitchell, The board as a path to corporate social responsibility, in The New Corporate Accountability: Corporate Social Responsibility and the Law 279, 283 (Doreen McBarnet et. al. eds. 2007).
[217] See Ben Haddock et. al., Why Corporate Attorneys and Other Gatekeepers Should Consider ESG and Sustainability Principles, 30 Fordham Env't L. Rev. 1, 1 (2018).
[218] Id. at 2-9.
[219] Id. at 9 n.10.
[220] See Marcia Narine Weldon, Corporate Governance, Compliance, Social Responsibility, and Enterprise Risk Management in the Trump/Pence Era, 19 Transactions: Tenn. J. Bus. L. 275, 305 (2017).
[221] Id.
[222] Id.

are about board oversight, and failures in board oversight can, but need not necessarily, impact financial performance. To the extent ESG metrics measure not just risk management, but also how well the board is exercising its oversight function, they might be useful in assessing liability for fiduciary duty breaches. Failures in oversight might be expected to matter not only to overall disclosure quality and related securities litigation), but also other types of liability such as *Caremark* liability.

In sum, although Delaware case law and efforts at enforcing legal compliance and good faith actions by the board have not explicitly focused on ESG concerns, the cases fundamentally seek to maintain corporate law's legitimacy. Such legitimacy requires sustainability. Accordingly, corporate law can provide a kind of fail-safe mechanism for egregious fact patterns that threaten the sustainability of firms. In other words, Delaware law can and should be seen as dovetailing with many ESG concerns.

D. Other Regulatory Proposals

We close with a brief discussion of how the relationship between ESG and securities litigation potentially matters to other regulatory proposals. In a broad sense, the relationship suggests that when policy makers seek to encourage firms to take into account ESG factors, what they effectively might be doing is either encouraging firms to take into account litigation exposure or encouraging firms to behave in ways that change their litigation exposure.

As examples, consider Senator Elizabeth Warren's proposal to require that large public corporations consider the interests of stakeholders,[223] or Martin Lipton's similar proposal from a private ordering perspective, The New Paradigm, which would provide a framework for companies to be managed in the public interest.[224] These proposals are part of new and wide-ranging discussions about the purpose of the corporation. The subject of litigation is often missing from discussions of corporate purpose, and our findings here suggest that proposals to change corporate purpose should take into account the relationship between purpose and litigation.

The same is true of proposals related to disclosure. Several organizations have advocated enhanced ESG disclosures beyond traditional financial metrics.[225] But it is unclear how much the disclosures actually result in improved ESG policies, and how much they simply increase litigation risk. Relatedly, SEC Commissioner Hester Peirce has questioned the utility of ESG-related disclosures, noting that many ESG factors rely on unsettled research (Commissioner Peirce quipped that the discussion about ESG should including trying to figure out the extent to which ESG might stand for "enabling stakeholder graft").[226] The Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce has developed a framework for best

---

[223] See Accountable Capitalism Act, S. 3348, 115th Cong. (2018).
[224] See Martin Lipton, The New Paradigm: A Better Way Than Federalization, Wachtell, Lipton, Rosen & Katz,, Aug. 17, 2018, at 7-8.
[225] See Amir Amel-Zadeh, The Materiality of Climate Risk, Said Business School Working Paper, at 1 (discussing examples, including the Carbon Disclosure Project, the Global Reporting Initiative, the International Integrated Reporting Council, and SASB).
[226] See Hester Peirce, Remarks to SEC Investor Advisory Committee; see also Hester Pierce, Remarks to California State University Fullerton's Center for Corporate Reporting and Governance.

practices surrounding voluntary disclosures of ESG-related information.[227] The framework is worded in terms of risk and financial performance: "ESG disclosure should focus on a company's risks and opportunities with sufficient potential to impact the company's long-term operational and financial performance in light of its business and should discuss the company's approach to risk management."[228] The Chamber of Commerce framework emphasizes clear terminology, utility, comparability, availability, and reliability of disclosures. From our perspective, this debate about disclosure also should explicitly take into account litigation risk.

Our main point here is that policy makers should not assume that proposals related to ESG, including ESG disclosure, are always simply ESG proposals. Instead, there is a complex relationship between ESG and litigation; to at least some extent, ESG and litigation are related. Policy makers should at least consider this relationship.

V. Conclusion

We show in the article that ESG metrics and securities litigation are related: firms with higher ESG ratings are less likely to be sued in securities cases and they have more favorable litigation outcomes. We demonstrate this fact empirically, and we discuss some of its implications. Our analysis is consistent with a conclusion that firms with higher ESG ratings are less likely to commit fraud, although we cannot completely rule out other explanations.

While there has been some discussion of the relationship between ESG and litigation risk among practitioners, this relationship has attracted scant attention from researchers. We argue that scholars who are investigating ESG-related issues need to ask whether they are also investigating litigation risk. We provide a theoretical, empirical, and normative framework for doing so.

[227] See Tom Quaadman & Erik Rust, ESG Reporting Best Practices, U.S. Chamber of Commerce, Dec. 2, 2019, https://corpgov.law.harvard.edu/2019/12/02/esg-reporting-best-practices/.
[228] Quaadman & Rust, ESG Reporting Best Practices.