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The Emergence of Welfarist Corporate Governance

Law Working Paper N° 683/2023
February 2023

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We would like to thank Jennifer Arlen, Ryan Bubb, Emiliano Catan, Michal Gal, Rob Jackson, Peter Lewisch, Allan Miller, Michael Ohlrogge, Elizabeth Pollman, Eric Zolt and the participants in the NYU Law and Economics Workshop and the Western University Business Law Symposium for helpful comments.

Abstract

Corporate governance may be on the verge of entering a new stage. After the managerialism that dominated the view of the corporation into the 1970s and the shareholderism that supplanted it, we may be witnessing the emergence of a new paradigm: corporate governance welfarism. Welfarism departs from shareholderism in embracing goals that are much broader than shareholder value as a means to promote overall welfare. It departs from managerialism in looking beyond the single firm and in relying on shareholder and stakeholder pressure rather than on managerial discretion to balance the interests of shareholders in firm value maximization and broader objectives. Indicators that welfarism is on the rise include the growing power of highly diversified institutional owners with a multi-firm focus; the increased importance shareholders accord to non-economic interests; the embrace of stakeholderism by top executives, major shareholders, and important politicians at least at the rhetorical level; and the rise of disclosure regulations that serve social goals in addition to investor protection. While there are barriers to the rise of welfarism, there are good reasons to believe that these trends will take hold, grow, and, over time, generate a welfarist turn in corporate governance. Will such a welfarist turn deliver on the promise of enhancing overall welfare by inducing corporations to take the lead when our elected representatives fail? We have too much faith in the power of capital markets to predict that welfarism will succeed economically. But we are more optimistic than those who would argue that welfarism is a dangerous placebo that diverts energy from pursuing more effective political change. Rather, we see the promise of welfarism as playing out in the political realm by potentially changing the political economy of social regulation and thereby facilitating needed regulatory change. While welfarism looks to the corporate sector to substitute for the regulation of externalities blocked by political dysfunction, it may ultimately have a greater impact on improving our politics than on changing private enterprise.

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Abstract

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Indicators that welfarism is on the rise include the growing power of highly diversified institutional owners with a multi-firm focus; the increased importance shareholders accord to non-economic interests; the embrace of stakeholderism by top executives, major shareholders, and important politicians at least at the rhetorical level; and the rise of disclosure regulations that serve social goals in addition to investor protection. While there are barriers to the rise of welfarism, there are good reasons to believe that these trends will take hold, grow, and, over time, generate a welfarist turn in corporate governance.

Will such a welfarist turn deliver on the promise of enhancing overall welfare by inducing corporations to take the lead when our elected representatives fail? We have too much faith in the power of capital markets to predict that welfarism will succeed economically. But we are more optimistic than those who would argue that welfarism is a dangerous placebo that diverts energy from pursuing more effective political change. Rather, we see the promise of welfarism as playing out in the political realm by potentially changing the political economy of social regulation and thereby facilitating needed regulatory change. While welfarism looks to the corporate sector to substitute for the regulation of externalities blocked by political dysfunction, it may ultimately have a greater impact on improving our politics than on changing private enterprise.

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Introduction: A capsule history of corporate governance

The governance of public corporations changes over time. In this Article, we argue that corporate governance of U.S. public corporations may be on the verge of entering a new phase as it increasingly seeks to make corporations internalize the effects of their decisions on broader concepts of welfare. We examine this emerging orientation on its own terms, contrast it with prior phases, consider some of the challenges it may encounter, and evaluate its prospects for success.

A generation ago, Bob Clark argued that the financial side of capitalism has passed through stages.[1] The first stage was the age of the promoter-investor-manager who launched large scale business organizations in corporate form. The iconic figures of that stage were the likes of Andrew Carnegie and John D. Rockefeller, who both owned and managed great enterprises.

The second stage of capitalism arose with the separation of management and ownership. As the professional manager arose, the entrepreneurial function was split between those who ran large enterprises and those who financed them. In the classic account, General Motors was the iconic pioneer. During this stage, public corporations grew in number and size. This necessitated the development of a legal infrastructure to govern the relationship between managers and investors.[2] The corporate governance ideology that emerged during this period was "managerialism," the idea that the best way to run the corporation is to ask, and empower, managers to build great companies by pulling together the efforts of all the participants.[3] In doing so, managers were analogized to trustees, charged with balancing the interests of all participants as they build great companies[4] – an objective that often entailed sacrificing profits to achieve

[1] Robert Charles Clark, The Four Stages of Capitalism: Reflections on Investment Management Treaties, 94 Harv. L. Rev. 561 (1981).

[2] Id. at 563 ("The second stage required the legal system to develop stable relationships between professional managers and public investors, ostensibly aimed at keeping the former accountable to the latter, but also at placing full control of business decisions in the managers' hands.")

[3] We use the term "ideology" primarily in its descriptive sense. As Raymond Geuss summarizes this sense of the term, "[T]he 'ideology' of the group will be more or less extensive, but typically it will include such things as the beliefs the members of the group hold, the concepts they use, the attitudes and psychological dispositions they exhibit, their motives, desires, values, predilections, works of art, religious rituals, gestures, etc." Raymond Geuss, The Idea of a Critical Theory: Habermas and the Frankfurt School (CUP 1981) at 5.

[4] E. Merrick Dodd, Jr., For Whom are Corporate Managers Trustees?, 45 Harv. L. Rev. 1145 (1932) (expressing the view that a corporation "has a social service as well as a profit-making function"); Brian Cheffins The Public Company Transformed (2019) at 37 (noting that managers "took pains to emphasize the good citizenship of the firms they ran."); Dorothy S. Lund & Elizabeth Pollman, The Corporate Governance Machine, 121 Colum. L. Rev. 2563 (2021) ("The vision of corporate managers as socially responsive trustees came to fruition as the economy recovered after World War II."); Jeffrey N. Gordon, The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices, 59 Stan. L. Rev. 1465, 1511 - 14 (2007); Raymond C. Baumhart, How Ethical Are Businessmen?, Harv. Bus. Rev., July-Aug. 1961, at 6, 10 (reporting survey finding of 1700 executives in which Harvard Business Review survey of 1700 executives about 83% of the respondents agreed that "[f]or corporation executives to act in the interests of shareholders alone, and not also in the interests of employees and consumers, is unethical.").

growth.[5] Managerialism dominated the corporate landscape into the 1970s and continues to have vigorous adherents to this day.[6]

For Clark, the third stage of capitalism was marked by the rise of the institutional investor and the portfolio manager.[7] Through the 1980s and into the 1990s, as share ownership kept moving from highly dispersed individual investors to more concentrated control by institutional investors, the dominant ideology shifted from "managerialism" to "shareholderism."[8] This transformation is exemplified by the Business Roundtable 1997 statement proclaiming that:

> the paramount duty of management and of boards of directors is to the corporation's stockholders; the interests of other stakeholders are relevant as a derivative of the duty to stockholders. The notion that the board must somehow balance the interests of stockholders against the interests of other stakeholders fundamentally misconstrues the role of directors. It is, moreover, an unworkable notion because it would leave the board with no criterion for resolving conflicts between interests of stockholders and of other stakeholders or among different groups of stakeholders.[9]

Many commentators saw shareholderism as the final stage, the pinnacle in the evolution of corporate governance in a market economy. Thus, in 2001, Henry Hansmann and Reinier Kraakman, in an article entitled *The End of History for Corporate Law*, proclaimed that "[t]here is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value."[10]

But much has changed since 2001. Though shareholder power has increased as shareholdings have continued to become increasingly concentrated[11] and hedge funds have

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[5] See Victor Brudney, Dividends, Discretion, and Disclosure, 66 Va. L. Rev. 85 (1980); William Baumol, Business Behavior, Value and Growth 15-79 (rev. ed. 1967); Robin Marris, The Economic Theory of "Managerial" Capitalism (1964); R. Joseph Monsen & Anthony Downs, A Theory of Large Managerial Firms, 73 J. Pol. Econ. 221 (1965); Robin Marris & Dennis C. Mueller, The Corporation, Competition, and the Invisible Hand, 18 J. Econ. Literature 32 (1980) (surveying the relevant literature).

[6] For a comprehensive and nuanced recent history of the rise and decline of "managerial capitalism," see Cheffins, supra note 4.

[7] Clark, supra note 1, at 564 ("As the second stage split entrepreneurship into ownership and control, and professionalized the latter, so the third stage split ownership into capital supplying and investment, and professionalized the investment function."). To Clark, writing in 1981, this third stage reached "young adulthood" in the 1960s, yet it has continued to grow in significance.

[8] Cheffins, supra note 4, at Chapters 4-5; Wachtell, Lipton, Rosen & Katz, ESG, Stakeholder Governance, and the Duty of the Corporation, Sep. 16, 2022 ("For several decades, the predominant view among corporate leaders, practitioners, academics, investors, and asset managers was that the role of the corporation was solely to maximize profits for shareholders."); Gordon, supra note 4, at 1514 - 1530.

[9] Business Roundtable, Statement on Corporate Governance (September 1997) at 3-4. (available at http://www.ralphgomory.com/wp-content/uploads/2018/05/Business-Roundtable-1997.pdf)

[10] Henry Hansmann & Reinier Kraakman, The End of History for Corporate Law, 89 Geo. L.J. 439 (2001); for a similar view, see Lund & Pollman, supra note 4.

[11] See infra Section II.A.

emerged as substantial forces in corporate governance,[12] the 2008 financial crisis started to raise fundamental concerns about shareholderism.[13] More recently, climate change and social issues have emerged as pressing challenges. Political paralysis in dealing with these challenges has pushed many to look to the corporate sector for solutions.

This Article argues that we are seeing the emergence of a new conception of corporate governance that differs significantly from both managerialism and shareholderism. Managerialism focuses attention on making individual firms thrive, with managers holding the power to choose both strategy and tactics as well as the discretion to balance the interests of shareholders and other stakeholders. Shareholderism places shareholder interests at the center. With a simpler metric, it grants far less deference to managers on questions of strategy and tactics, and even less on balancing the interests of shareholders and stakeholders. The emerging ideology – an ideology we tentatively dub "welfarism" – focuses on corporate governance as a means of promoting activities that generate positive externalities and controlling those that generate negative ones, going in some respects even beyond managerialism, but trying to achieve these goals through shareholder and stakeholder pressure, rather than through reliance on managers' goodwill.

In Part I, we describe and categorize three varieties of welfarism that have emerged and contrast them with managerialism and shareholderism. In Part II, we analyze the various market and political drivers of the emerging turn to welfarism, including the multi-firm focus of large diversified investors and asset managers, the increased prevalence of pro-social preferences among today's shareholders, the rise of "stakeholderism," and the trend towards "welfarist" regulation of public corporations. In Part III, we evaluate the prospects for welfarism to succeed. In that Part, we assess the forces that counter the rise of welfarism, the argument that welfarism is a dangerous diversion from more effective ways to deal with social problems, and the possibility that welfarism may fail economically but succeed politically. We close with a brief conclusion.

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[12] See, e.g., Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021 (2007); William W. Bratton, Hedge Funds and Governance Targets, 95 GEO. L. J. 1375 (2007); Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. FIN. 1729-31 (2008).

[13] Martin Lipton, The American Corporation in Crisis—Let's Rethink It, Boston Rev. (Oct. 2, 2019), http://bostonreview.net/forum/american-corporation-crisis%E2%80%94lets-rethink-it/martin-lipton-new-paradigm; Joseph Bowers & Lynn Paine, The Error at the Heart of Corporate Leadership, Harv. Bus. Rev., May-June 2017, available at https://hbr.org/2017/05/the-error-at-the-heart-of-corporate-leadership; Lenore Palladino & Kristina Karlsson, Towards Accountable Capitalism: Remaking Corporate Law through Stakeholder Governance (Roosevelt Institute 2018) available at SSRN: https://ssrn.com/abstract=3309431; The Aspen Institute, American Prosperity Project: A Non-Partisan Framework for Long Term Investment, Dec. 2016 https://www.aspeninstitute.org/programs/business-and-society-program/american-prosperity-project/; Steven Pearlstein, Social Capital, Corporate Purpose and the Revival of American Capitalism, Brookings Report (January 10, 2014) https://www.brookings.edu/wp-content/uploads/2016/06/BrookingsPearlsteinv5_Revised-Feb-2014.pdf.

I. "Welfarist" Corporate Governance

The welfarist corporate governance paradigm starts from the notion that the corporate form – with its distinctive characteristics of limited liability, centralized management, transferable shares, indefinite life, and entity status – exists in order to promote some broader notion of general welfare, rather than merely the financial value of a corporation for its shareholders. In this regard, welfarism is consistent with managerialism and shareholderism: all three agree that the ultimate justification of corporate law must be general welfare, but differ on how to achieve that.

For managerialism, welfare is best promoted by giving managers of individual firms broad discretion to run the firm, including choosing business strategy and tactics, making commitments to internal and external stakeholders, and ultimately striking a balance between shareholder and stakeholder interests, all in an effort to produce great firms. From the managerialist perspective, responsible corporate conduct will further both general and private welfare, while minimizing the need for governmental intervention. A corporation that treats its employees well reduces the need for regulation of the labor relationship. A corporation that respects the environment and does not pollute reduces the need for environmental regulation. Though managerialism characterized the second stage of capitalism, it retained support (especially among managers and those allied with managers) and has had a revival since the 2008 financial crisis.[14]

For shareholderism, the link between shareholder value and general welfare is generated by Adam Smith's classical invisible hand.[15] Shareholderism starts with the importance of property rights to promote the efficient use of resources, with shareholders viewed as owners of the corporation (and not just owners of their shares).[16] It then views the relationship between shareholders and managers as a principal/agent relationship, with managers as agents having a duty to promote the interests of their shareholder-principals, an interest typically equated with maximizing the financial payoffs shareholders receive from the corporation (firm value maximization).[17] Shareholderism generally distrusts managers who may try to promote their own interests rather than the shareholders' (or, for that matter, any other stakeholders') interests, thus giving rise to "agency costs,"[18] and who therefore need to be carefully monitored.[19] Moreover, shareholderism views managers as lacking the legitimacy to balance shareholder and

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[14] Id.

[15] Adam Smith, The Wealth of Nations.

[16] Harold Demsetz, Towards a Theory of Property Rights, 57 Am. Econ. Rev. 347-59 (1967); Ronald H. Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960).

[17] Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, agency costs and ownership structure, 3 J.F.E. 305 (1976).

[18] Id.

[19] This is a contingent rather than essential part of shareholderism as the potential divergence of interests of managers can be controlled through institutions (disinterested directors or controlling shareholders) and contracts (incentive compensation). To the extent that managers' interests are tightly yoked to shareholder interests, shareholderism is consistent with greater managerial discretion. The success of private equity is evidence of this.

stakeholder interests. Protecting stakeholder interests, if market forces are insufficient, or dealing with externalities more generally, is the role of government, which can mandate and enforce generally applicable boundary constraints: environmental law, labor law, antitrust law, etc. The goal of corporate law and management then becomes maximizing the value of the firm for the benefit of shareholders subject to these constraints. For shareholderism, individual firms pursuing the private interests of shareholders will thus promote general welfare (through the invisible hand of the market) and protect liberty (through strong property rights).

Welfarism rejects the faith that market forces will promote general welfare and lacks confidence in the government's ability to set proper boundary constraints. In doing so, it also rejects the focus on firm value that lies at the heart of shareholderism. Instead, welfarism looks to corporations to internalize externalities directly. Welfarism comes in three varieties, portfolio welfarism, shareholder welfarism and direct social welfarism, with direct social welfarism representing the starkest departure from shareholderism.

A. Portfolio Welfarism

Portfolio welfarism starts from the observation that shareholders' economic interest is to maximize *portfolio* value not *firm* value.[20] In the current capital market, many of the largest shareholders are "universal owners" (or "universal managers") that own (or manage) portfolios that include all or nearly all public companies. For those highly diversified investors, negative externalities from one company may harm other public companies in their portfolios. When this is the case, the value maximizing strategy, from a portfolio perspective, may be to push companies to refrain from activities that generate negative intra-portfolio externalities even if those activities would raise firm value.[21] As Shareholder Commons asked in its 2022 shareholder proposal at BlackRock,

> that, to the extent practicable, consistent with fiduciary duties, and otherwise legally and contractually permissible, the Company adopt stewardship practices designed to curtail corporate activities that externalize social and environmental costs that are likely to decrease the returns of portfolios that are diversified in accordance with portfolio theory, even if such curtailment could decrease returns at the externalizing company. … [A]

[20] Robert G. Hansen & John R. Lott, Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers, 31 Journal Of Financial and Quantitative Analysis 43 (1996) ("If shareholders own diversified portfolios, and if companies impose externalities on one another, shareholders do not want value maximization to be corporate policy. Instead, shareholders want companies to maximize portfolio values. This occurs when firms internalize between-firm externalities.")

[21] The theoretical arguments were developed by Julio J. Rotemberg, Financial Transaction Costs and Industrial Performance (Mass. Inst. of Tech., Alfred P. Sloan Sch. of Mgmt., Working Paper No. 1554-84, 1984); Ariel Rubinstein & Menahem E. Yaari, The Competitive Stock Market as Cartel Maker: Some Examples (London Sch. of Econ., Suntory and Toyota Int'l Ctrs. for Econ. and Related Disciplines, Theoretical Econ. Paper Series 84, 1983); Timothy F. Bresnahan & Steven C. Salop, Quantifying the Competitive Effects of Production Joint Ventures, 4 Int'l J. Indus. Org. 155 (1986) and Steven C. Salop & Daniel P. O'Brien, Competitive Effects of Partial Ownership: Financial Interest and Corporate Control, 67 Antitrust L.J. 559, 559–614 (2000).

company's externalities harm its diversified shareholders, even if they do not harm the company itself. [22]

For Shareholder Commons, the fact that universal owners own a wide range of companies means that intra-portfolio externalities are typically social externalities as well. When that is true, portfolio welfarism would increase general social welfare at the same time as it increases shareholder economic returns. Indeed, one of the motivating forces for Shareholder Commons is the concern that environmental and social regulations do not sufficiently protect social interests and that, contrary to the postulates of shareholderism, effective governmental regulation is not forthcoming.

But there is also a dark side to portfolio welfarism. Intra-portfolio externalities do not always align with social externalities. Consider, as an example, externalities among competing firms. By raising output, a firm may harm its competitors. While doing so may maximize the value of the firm, it may reduce the value of a portfolio held by an owner with stakes in the firm's competitors.[23] If, as Shareholder Commons argues, Blackrock should try to "curtail corporate activities that externalize … costs that are likely to decrease the returns of portfolios that are diversified in accordance with portfolio theory, even if such curtailment could decrease returns at the externalizing company", why should this be confined to social and environmental externalities, but not externalities among competitors (assuming no laws are broken)? Here, however, if competing companies took account of intra-portfolio externalities by, for example, lowering output and raising prices, portfolio values may increase but social welfare would decline.

Indeed, portfolio welfarism targeted at reducing social and environmental externalities, in practice, is not always be easily distinguished from portfolio welfarism for the purpose of

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[22] According to Shareholder Commons, BlackRock's stewardship strategy, by focusing only on improving individual company performance, does not address "practices of a company that harm the global economy unless those practices also harm that company's financial performance." In its supporting statement, it argued further that

> Given its market position, BlackRock's stewardship activities—engaging with portfolio companies and voting their shares—could significantly improve beta by discouraging corporate practices that externalize costs. This would increase the portfolio value of BlackRock's clients, and also increase the value of the assets it manages, thereby improving the returns of both its clients and shareholders.

[23] See supra note 21; Jose Azar, Martin Schmalz and Isabel Tecu, Anticompetitive Effects of Common Ownership, 73 J. Fin. 1513 (2018); for other examples of financial intra-portfolio externalities that do not align with social externalities, see, e.g., Joseph Gerakos & Jin Xie, Institutional Horizontal Shareholdings and Generic Entry in the Pharmaceutical Industry 15-16 (Tuck Sch. of Bus., Working Paper No. 3285161, 2019), https://ssrn.com/abstract=3285161 [https:// perma.cc/Q4SA-QEMA], which examines whether common ownership between brand name and generic drug makers increases the likelihood of settlement of patent litigation between the two; Melissa Newham, Jo Seldeslachts & Albert Banal-Estañol, Common Ownership and Market Entry: Evidence from the Pharmaceutical Industry 7-8 (DIW Berlin Discussion Papers, Paper No. 1738, 2018), https://ssrn.com/abstract=3194394 [https://perma.cc/M8KD -2ZHR], which examines whether common ownership decreases the likelihood of generic entry; and Letter from John M. Schroder to Laurence Fink, Oct. 5, 2022, available at https://a4de8bd9-8c02-4b69-8f48-7792cfcaf8fd.usrfiles.com/ugd/a4de8b_38fdc8b7e3c04c9490bf332ce14f8d2f.pdf (letter by Louisiana treasurer to BlackRock claiming that BlackRock's anti-fossil fuel policies damage state economy).

increasing industry profits. In particular, when it comes to goods and services that generate environmental harm – such as fossil fuels or air transportation – curtailing production would at the same time tend to benefit the environment and to increase industry profits and for both of these reasons generate positive intra-portfolio externalities.[24]

Although portfolio welfarism is presented as an incremental shift from maximizing *firm* value to maximizing *shareholder portfolio* value – and hence, like shareholderism, accords primacy to shareholder interests – it represents a fundamental departure from shareholderism. Under shareholderism, corporate law and corporate governance are focused on the individual firm. Within this "single firm focus," directors and managers are to promote the value of their particular corporation which, intermediated by the invisible hand of the market, will promote overall welfare. Corporate governance follows this by seeking to align managers' financial interests with the financial interests of shareholder in their particular firm. For shareholderism, doing so benefits the company's shareholders because shareholders are the residual beneficiaries. In this paradigm, the common injunction that "a corporation should maximize shareholder value" is actually shorthand for a longer, more correct, statement, namely, that when share value is an accurate proxy for firm value (as it generally will be), promoting share value will promote firm value.[25]

By including extra-firm interests of shareholders and privileging portfolio value maximization, portfolio welfarism departs from the single firm focus of shareholderism in favor of a multi-firm focus.[26] But portfolio value, even if a plausible proxy for general welfare, is not a plausible proxy for the value of any individual firm.

Portfolio welfarism marks an even more substantial departure from managerialism. Unlike portfolio welfarism, managerialism, like shareholderism, has a single firm focus. But while both portfolio welfarism and shareholderism accord primacy to shareholder interests, managerialism is comfortable granting managers great discretion in making tradeoffs among shareholders and stakeholders so long as doing so promotes firm value, loosely understood. Thus, while portfolio welfarism embraces tradeoffs between firm interests and other economic interests of *shareholders*, managerialism embraces more fundamental tradeoffs between shareholder and stakeholder interests.

B. Shareholder Welfarism

In a series of recent papers, Oliver Hart and Luigi Zingales have argued that the board of a company should promote the welfare of the company's actual shareholders even when those

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[24] Matt Levine, Anti-ESG Antitrust, Bloomberg Opinion: Money Stuff, Nov. 14, 2022.

[25] Thus, for example, when a firm is insolvent, the beneficiary of management discretion shifts to the creditors. In an insolvent firm, seeking to maximize share value is no longer consistent with seeking to maximize firm value.

[26] Marcel Kahan & Edward Rock, Systemic Stewardship with Tradeoffs, forthcoming __ J. Corp. L. ___ (2023); https://clsbluesky.law.columbia.edu/2020/09/29/the-conflict-between-blackrocks-shareholder-activism-and-erisas-fiduciary-duties/

interests are not homogeneous and not financial, and even when doing so reduces the value of the corporation.[27] Their first paper in this series captures the essence of their claim in its title: "Companies should maximize shareholder welfare not market value."

Shareholder welfarism resembles portfolio welfarism in that both accept the primacy of shareholder interests. But they differ in which shareholder extra-firm interests are taken into account. While portfolio welfarism goes beyond firm value by taking into account shareholders' portfolio financial interests, shareholder welfarism goes beyond firm value by also including shareholders' *non-financial* interests.

As Hart and Zingales put it,

> [If] consumers and owners of private companies take social factors into account and internalize externalities in their own behavior, why would they not want the public companies they invest in to do the same? To put it another way, if a consumer is willing to spend $100 to reduce pollution by $120, why would that consumer not want a company he or she holds shares in to do this too?[28]

The similarities continue in that both portfolio welfarism and shareholder welfarism rely on shareholders' self-interest in promoting social welfare. While portfolio welfarism relies on shareholders' interest in maximizing portfolio value to induce portfolio firms to internalize negative externalities, the Hart and Zingales approach sees shareholders' non-financial interests playing a similar function. Finally, shareholder welfarism, like portfolio welfarism, ignores the injunction to increase firm value by incorporating into the firm objective the secular – and diverging – non-financial interests of shareholders.

As with portfolio welfarism, shareholder welfarism departs significantly from shareholderism, and traditional corporate governance by including in the company's objective function shareholder preferences that are extraneous to their shareholdings. In doing so, it shifts from maximizing shareholder *value* (often a plausible proxy for firm value) to maximizing overall shareholder *welfare* (rarely if ever a plausible proxy for firm value).

Shareholder welfarism departs from managerialism in two significant ways. First, in focusing on shareholder interests, it rejects managerialism's willingness to empower managers

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[27] Oliver Hart & Luigi Zingales, The New Corporate Governance, 1 U. Chi. Bus. L. Rev.195 (2022); Oliver Hart & Luigi Zingales, Companies Should Maximize Shareholder Welfare Not Market Value, 2 J. L. Fin. and Accounting 247 (2017); see also Ann M. Lipton, What We Talk About When We Talk About Shareholder Primacy, 69 Case W. Rsrv. L. Rev. 863 (2019). Their central example arises when activities are not perfectly separable, such as a new product that generates environmental externalities.

[28] One problem with the Hart and Zingales approach is that a large number of shares are held by the ultimate beneficial owners through institutions and the preferences of institutional investors may diverge from those of the beneficial owners. See Jonathon Zytnick, Do Mutual Funds Represent Individual Investors? (October 16, 2022). NYU Law and Economics Research Paper No. 21-04, Available at SSRN: https://ssrn.com/abstract=3803690 or http://dx.doi.org/10.2139/ssrn.3803690. For different ways to address this problem, see https://mailchi.mp/ecgi/summit-2022-4?e=476ee7935e.

to balance shareholder and stakeholder interests. Second, in prioritizing shareholders' overall welfare, including shareholders' non-financial interests that are extrinsic to the firm, it departs from managerialism's focus on using management discretion to promote firm value.

C. Direct Social Welfarism

Direct social welfarism goes beyond portfolio welfarism and shareholder welfarism in that it is not even purportedly tied to shareholder interests, whether in firm value maximization, portfolio value maximization, or shareholder welfare maximization. The goal of direct social welfarism is to align the corporate objective directly with social welfare independent of shareholder preferences.

The British Academy's 2019 Principles for Purposeful Business is a useful illustration of "direct social welfarist" thinking about corporate governance.[29] For the Academy, the goal of aligning "corporate objectives" with social welfare will be achieved in a variety of ways.[30] Corporations are to adopt a "corporate purpose" that explicitly aligns business goals with increasing social welfare and not simply making a profit. "Profit" is to be redefined from the typical accounting measure to a broader notion that both recognizes investments in human capital and requires that the costs of remediating negative externalities be charged to the corporation whether or not the corporation has any legal liability related to those externalities.[31] And owners are to be re-educated to support "corporate purposes as well as . . . [deriving] financial benefit." Shareholders, under this view, should no longer simply seek to maximize the value the firm in which they are invested, but will be expected to engage with firms to make sure those firms are contributing to social welfare. These goals will be implemented through a variety of tools: legal enforcement by shareholders or stakeholders,[32] political persuasion, and normative discourse designed to change the ideology of the boardroom and asset management.

Direct social welfarism departs from shareholderism in its insistence that firms must prioritize general social welfare over shareholders' interests. In doing so, it embraces goals that are much broader than and different from shareholderism's focus on shareholder value. It also departs from managerialism, both in broadening the focus from promotion of firm value to include "the avoidance of harm in not profiting from producing problems for people or planet," thereby effectively extending the concept of stakeholders from anyone who has dealings with

[29] https://www.thebritishacademy.ac.uk/publications/future-of-the-corporation-principles-for-purposeful-business/ .

[30] The two central pillars are: "the positive benefit of producing profitable solutions to the problems of people and planet, and the avoidance of harm in not profiting from producing problems for people or planet."

[31] Id. at 26; Colin Mayer, What is wrong with corporate law.

[32] Id. As with benefit corporations, where only shareholders can enforce the commitments to non-shareholder interests, Delaware General Corporation Law § 367, so too here the expectation is that shareholders with "non-representative" interests will enforce the commitments.

the corporation[33] to everyone alive and yet to be born,[34] and in not according deference to management. Like the other forms of welfarism, direct social welfarism rejects Adam Smith's core claim that a properly regulated market, in which each firm strives to act in its own interest – the invisible hand of the market -- will promote general welfare.

D. A Note on ESG

Over the last years, much has been written about ESG. ESG – the acronym for environmental, social and governance – is an imprecisely defined and poorly understood term.[35] Not only it is unclear what is included, and what is not included, under the broad umbrella of environmental, social and governance, but an ESG orientation can take multiple forms. ESG may refer to a consumer preference for products that have been produced in an ESG-friendly matter; it may refer to companies conducting their operations in an ESG-friendly way; it may refer to asset managers pushing companies towards a more ESG-friendly orientation; it may refer to investors only investing in companies that score high on ESG metrics; or it may refer to governmental officials pursuing ESG policy goals.

Depending of what is included in ESG and what type of ESG is being discussed, ESG may be consistent with portfolio welfarism (as in asset managers trying to push companies not to engage in activities with negative intra-portfolio externalities), shareholder welfarism (as in investors not wanting to invest in companies that discriminate), or direct social welfarism (as an expression of a social objective that companies should, independent of shareholder preferences, be concerned about the environmental and social impact of their actions).

But ESG can also be consistent with shareholderism and managerialism. Thus, companies may cater to ESG constituents because they believe doing so will increase sales or make it easier to hire dedicated employees, and thereby increase firm value. Asset managers or shareholders may believe that companies are not sufficiently attuned to ESG concerns and push companies to

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[33] Adolf A. Berle, For Whom Corporate Managers Are Trustees: A Note, 45 Harv. L. Rev. 1365, 1372 (1932) (viewing "claims by labor, by customers and patrons, by the community and the like" as competing with claims by shareholders).

[34] Colin Mayer, The Role of Corporate Law Reconsidered: A Brief Response to Paul Davies' Blog, The EGCI Blog, July 19, 2022, available at https://ecgi.global/blog/role-corporate-law-reconsidered-brief-response-paul-davies%E2%80%99-blog ("The conventional view would have it that the boundaries of the firm are defined by the property owned by the firm and its contractual claims and liabilities resulting from public and private law in the form of, for example, regulation and contracts. However, the effects of the firm are felt well beyond those boundaries and are determined by the changes that it brings about and the effects that it has on the wellbeing and flourishing of individuals, communities, and the natural world.")

[35] See generally Elizabeth Pollman, The Making and Meaning of ESG (October 31, 2022). U of Penn, Inst for Law & Econ Research Paper No. 22-23, European Corporate Governance Institute - Law Working Paper No. 659/2022, Available at SSRN: https://ssrn.com/abstract=4219857

place greater weight on these concerns expecting that doing so will increase firm value.[36] Shareholders solely concerned with maximizing returns may believe that companies that do better on the ESG front are better prepared to, say, deal with upcoming regulations or meet future consumer demands and will hence see their stock price rise. And managers may believe that building the great company of the future requires addressing environmental, social and governance concerns, for the sake of all constituents.

Thus, the ESG umbrella does not offer a good tool to distinguish between managerialism, shareholderism and welfarism or to distinguish different varieties of welfarism. Later on, we will argue that one particular aspects of ESG – the rise of assets invested in vehicles purporting to consider ESG factors in making investments – is likely a reflection of the increased importance of non-financial concerns of shareholders and thus consistent with shareholder welfarism. Subject to that exception, however, we do not regard ESG as helpful in illuminating the issues we discuss in this article.

II. **Early Signs of a Shift from Shareholderism to Welfarism**

The ideas underlying portfolio welfarism, shareholder welfarism, and direct social welfarism are not new. Thus, for example, the notion that ownership structure has become dominated by large, highly diversified institutional investors who should care about portfolio effects and hence "develop and pursue policies of virtuous efficiency, minimizing negative externalities and encouraging positive outcomes by the firms in their portfolios" was already developed in James Hawley and Andrew Williams' 2000 book THE RISE OF FIDUCIARY CAPITALISM.[37] And the theoretical case that, in firms with diversified shareholders, maximization of shareholder portfolio value will differ from maximization of firm value goes back at least to an 1984 working paper by Julio Rotemberg.[38]

The notion that corporations should have a social responsibility voluntarily to pursue social ends that conflict with profit maximization is even older. In the classic 1932 debate between Adolf Berle and Merrick Dodd, both sides endorsed this vision, though they parted way in other respects.[39] Four decades later, consumer-advocate Ralph Nader emerged as one the

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[36] See Lund & Pollman, supra note 4 ("Today many companies pursue ESG goals, and many investors favor ESG funds, not for moral reasons or a prosocial willingness to sacrifice profits, but because ESG is thought to provide sustainable long-term value or higher risk-adjusted returns for shareholders.")

[37] James P. Hawley & Andrew Williams, The Rise of Fiduciary Capitalism: How Institutional Investors Can Make Corporate America More Democratic (Univ. of Pennsylvania Press, 2000),

[38] Julio J. Rotemberg, Financial transaction costs and industrial performance, WP# 1554-84, April, 1984, available at http://dspace.mit.edu/bitstream/handle/1721.1/47993/financialtransac00rote.pdf?sequence=1 .

[39] See Berle, supra note 33; Dodd, supra note 4. See generally https://en.wikipedia.org/wiki/Berle-Dodd_debate#cite_note-2.

most prominent proponents of this view.[40] Dodd, for that matter, also embraced the view that enlightened business owners would run their companies not to maximize profits, but to serve the public, not due to a legal requirement but because they themselves wanted to do so.[41]

What has changed is that these ideas have moved from the ivory tower and are increasingly becoming part of the mainstream thinking by shareholders, asset managers, regulators, legislators, and corporate decisionmakers. In this Part, we will discuss the reasons why we believe that support for welfarism has grown, will continue to grow, and will have the prospect of changing the focus of corporate actions from maximizing firm value towards broader social goals.

A. Multi-Firm Focus

The ever-increasing concentration of shareholdings in the hands of large, widely-diversified investors, especially index funds, has provided the foundation for the emergence of portfolio welfarism.

The last few decades have witnessed a major shift in the ownership structure of public corporations. At the time Berle and Means wrote their classic work THE MODERN CORPORATION AND PRIVATE PROPERTY,[42] the vast majority of the shares of publicly traded corporations were held by individuals. This remained true until around 1970, when private pension funds started to own an increasing share of corporate equities. By 1985, according to data compiled by the Federal Reserve Board, private pension funds owned 23% of equities, households and nonprofits owned 54%,[43] with the remainder owned by various other investor types. From 1985 onwards, the ownership by mutual funds started to grow rapidly, while the ownership by private pension funds shrank and the ownership by households continued its decline. By 2021, mutual funds and their close cousins, exchange traded funds, had increased their share of holdings from 5% in 1985 to 26% and the share held by households and nonprofits had dropped to 40%. The only other major owner types tracked by the Federal Reserve Board that accounted for more than 5% of holdings are “rest of the world” (16%) and private pension plans (5%). In sum, over this period, ownership of public corporations has shifted from individuals to financial institutions and, within the set of financial institutions, to mutual and exchange traded funds.

Institutional investors, in turn, have dramatically revised their approach to investing. Until 1975, institutions pursued so-called “active” investing strategies – selecting stocks of certain companies usually with the goal of earning superior returns. In 1975, John Bogle, the founder of

[40] Ralph Nader, Mark Green & Joel Seligman, TAMING THE GIANT CORPORATION (1976); see also C. Stone, WHERE THE LAW ENDS (1975); David L. Engel, An Approach to Corporate Social Responsibility, 32 Stan. L. Rev. 1 (1979)
[41] Dodd, supra note 4, at 1153.
[42] A. A. Berle & Gardiner C. Means, The Modern Corporation and Private Property (1932).
[43] Since, Federal Reserve data for households and nonprofits are residuals (in other words, they reflect totals for all sectors less known values for other sectors), the actual shares for households is likely somewhat lower. 1 Bd. Of Governors of tthe Fed. Reserve Sys., Guide to the Flow of Funds Accounts 170 (1993).

the Vanguard Group, started the first index fund, the First Index Investment Trust, which invested its capital in the shares of all S&P 500 companies.[44] Although initially ridiculed as "un-American" and "a sure path to mediocrity,"[45] index investing eventually took off. By 2019, the First Index Investment Trust, now known as the Vanguard 500 Index Fund, had more than $400 billion in assets and had become one of the largest funds in the industry.[46] Overall, as of 2019, funds pursuing index strategies held nearly $7 trillion in assets, compared to $11 trillion in active strategies.[47] In addition, many private and public pension funds pursue internal indexing strategies.[48] The move towards indexing has also resulted in many traditional institutional investors, who once managed their assets directly, shifting asset to outside asset managers.

The shift from picking individual stocks to a portfolio approach has had profound implications. Institutional investors generally, and indexers in particular, hold vast numbers of different securities in their portfolios. This is true both for both pure "asset managers" with no legal ownership of the securities they manage (e.g., mutual fund *advisors* such as Vanguard or Fidelity) and for "asset owners" (e.g., managers with a legal ownership interest such as private or public pension funds). For mutual fund advisors, the degree of diversification is even higher when one looks at portfolios at the level of the fund family rather than at the level of individual funds. The financial interests of institutions,[49] and the financial interest of those who hold beneficial interests through institutional investors (mutual fund shareholders, pension fund beneficiaries), lie not in the fortunes of an individual company, but in the returns earned by a portfolio of their holdings. Thus, for example, what matters to an investor in the Vanguard 500 Index Fund is whether the index goes up, and not how the stock price of a particular stock in the index changes.

Because their holdings are highly diversified, the financial interests of institutional investors (and of their investors) are generally more closely aligned with the interests of the market as a whole than with the interests of any individual portfolio company, including when evaluating a specific action to be undertaken by an individual portfolio company. While this

[44] CNBC, Jack Bogle changed investing forever with index funds, but wasn't always happy about it, Jan. 17, 2019, available at https://www.cnbc.com/2019/01/16/bogle-changed-investing-with-index-funds-but-wasnt-always-happy-about-it.html

[45] Insider, When Vanguard's founder first invented the index fund, it was ridiculed as 'un-American,' but 40 years later it's clear his critics were wrong, Jan. 18, 2019, available at https://www.businessinsider.com/vanguard-jack-bogle-first-index-fund-criticism-2019-1

[46] Id.

[47] CNBC, supra note 44.

[48] See, e.g., CalPERS Beliefs
Our Views Guiding Us into the Future, Agenda Item 7, available at https://www.calpers.ca.gov/docs/board-agendas/201702/pension/item7-01.pdf at 8 ("CalPERS will use index tracking strategies where we lack conviction or demonstrable evidence that we can add value through active management").

[49] See Jonathan Lewellen & Katharina Lewellen, Institutional Investors and Corporate Governance: The Incentive to be Engaged, 77 J. Fin. 213 (2022) (discussing incentives for institutional investors); Marcel Kahan & Edward B. Rock, Index Funds and Corporate Governance: Let Shareholders Be Shareholders, 100 B.U. L. Rev. 1771, 1798 (2020) (discussing how incentives of index fund advisors are tied to portfolio values).

wedge between what may be best for an individual company – a single-firm focus – and what may be best from a portfolio perspective – a multi-firm focus – matters little when the action of an individual company has no effect on the value of the other securities, it can lead to conflicts when an action creates significant positive or negative externalities on other portfolio companies. So much is undisputed.[50]

The notion that institutional investors can, should, or do induce individual portfolio companies to take their broader portfolio interests into account has recently gained significant traction and has become the driver for portfolio welfarism. The Shareholder Commons, the organization that sponsored the BlackRock shareholder proposal mentioned in the Introduction, argues that

> the greatest threat to the long-term returns of diversified investors does not come from the failure of individual companies to optimize their own returns, but rather from the trillions of dollars in social and environmental costs businesses externalize annually. Diversified shareholders do internalize these costs, and the company-first lens of current shareholder engagement cannot adequately address company behavior that undermines long-term, broad economic health.[51]

In a similar vein, Madison Condon has argued that institutional investors could greatly increase the value of their portfolios by pushing oil companies to reduce their output.

> [B]y intervening to reduce 1% of annual industrial emissions [of Chevron and Exxon] each year, BlackRock could avoid damages to its portfolio with a net present value of $9.7 billion. Because this value of mitigated damages outweighs the loss of share value from diminished expected fossil fuel profits by $3.4 billion, it would be in BlackRock's rational economic interest to pursue this intervention and internalize the intra-portfolio climate externalities.[52]

On a more limited scale, Jeff Gordon has argued that institutional investors should support management of systemically important financial firms "in a face-off with activist investors who want the firm to take greater risks to enhance shareholder return" in order to reduce the externalities from a possible financial crisis.[53] A recent commentary in Barron's has urged investors in Covid vaccine manufacturers to push these companies to share their technology, know-how, and intellectual property, reasoning:

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[50] Matthew Backus et al., *Common Ownership in America: 1980–2017*, 13 AM. ECON. J.: MICROECONOMICS 273 (2021).

[51] The Shareholder Commons, Systematic Stewardship, available at https://theshareholdercommons.com/system-stewardship/. See also Trucost, Universal Ownership: Why environmental externalities matter to institutional investors (2011), available at https://www.unepfi.org/fileadmin/documents/universal_ownership_full.pdf. BlackRock, like many institutional investors, tends to vote shares administered by all its funds on a centralized basis rather than leave voting decision to the managers of each fund. See Ryan Bubb & Emiliano Catan, The Party Structure of Mutual Funds, 35 Rev. Fin. Stud. 2839 (2022).

[52] Madison Condon, Externalities and the Common Owner, 95 Wash. L. Rev. 1 (2020)

[53] Jeffrey N. Gordon, Systematic Stewardship, 47 Colum. Bus. L. Rev. 627, 629 (2022).

> [I]t is in their economic self-interest to do so. … For universal owners that ride broad market trends—for instance, passive leaders like BlackRock, State Street, and Vanguard—vaccine inequity increases the risk of generating another Covid-19 variant. That risk is immense, as we have seen with Omicron, for it could indiscriminately cost the global economy trillions of dollars and hundreds of thousands of lost lives.[54]

Going a step further, several recent articles have argued that public companies are in fact run, at least to some extent, to increase the value of the portfolio holdings of their shareholders. Most famously, Jose Azar, Martin C. Schmalz, and Isabel Tecu present empirical evidence suggesting that ownership by diversified institutional investors of U.S. airlines has resulted in higher ticket prices.[55] Their work generated multiple follow-up studies, mostly analyzing whether ownership by institutional investors of competing firms has had anti-competitive effects, with some studies finding supportive evidence and some not.[56] Similarly, Condon attributes climate-change activism by institutional investors to their interest in maximizing portfolio value, rather than the value of the targeted firms.[57]

The conceptual arguments in favor of multi-firm focus are strong. It is obviously correct that many shareholders are highly diversified and equally obviously correct that diversified shareholders care about the value of their portfolio rather than about the value of any particular firm. One study estimates that the net social costs created by public companies account for more than half of their profits.[58] Even if intra-portfolio externalities constitute only a fraction of the overall social costs – as many social costs will be borne by non-public firms or individuals – there is in theory significant scope for raising overall portfolio value by inducing firms to take into account the social costs of their activities, especially firms that generate more than their average share of social costs.[59]

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[54] Peter Singer, Investors Can Change The Course of This Pandemic, Barron's, Jan. 24, 2022, available at https://www.barrons.com/articles/investors-can-change-the-course-of-this-pandemic-51642800068.

[55] Azar et al., supra note 23, at 1521-51.

[56] See, e.g., Andrew Koch, Panayides Marios & Thomas Shawn, Common ownership and competition in product markets, 139 J. Fin. Econ. 109 (2020) (finding no evidence); Mohammad Torshizi & Jennifer Clapp, Price effects of common ownership in the seed sector, 66 Antitrust Bulletin 39–67 (2021) (finding evidence); José Azar et al., Ultimate Ownership and Bank Competition (May 4, 2019) (unpublished manuscript), https://perma.cc/C553-Q2YQ (finding evidence); Patrick Dennis et al., Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry (Fed. Rsrv. Bank of Atl., Working Paper 2019–15, 2019), https://perma.cc/NH2Y-LMEX (finding no evidence). A recent study by Azar and Vives attributes the initial results found by AST to common owners other than the so-called "Big Three," Namely, BlackRock, State Street, and Vanguard. José Azar & Xavier Vives, Revisiting the Anticompetitive Effects of Common Ownership (March 15, 2021). IESE Business School Working Paper, Available at SSRN: https://ssrn.com/abstract=3805047.

[57] Condon, supra note 52, at 5.

[58] Schroders, Foresight, Apr. 2019, at 6, available at https://prod.schroders.com/en/sysglobalassets/digital/insights/2019/pdfs/sustainability/sustainex/sustainex-short.pdf.

[59] See Schroders, supra note 58, at 20, 24 (estimating contribution to social welfare and relation between relation between social value and net profits for companies in different industries).

Institutional investors, however, face significant barriers in inducing firms to pursue a multi-firm focus. Institutional investors are not the beneficial owners of their shares they manage, and thus have only diluted incentives to maximize portfolio values.[60] Institutional investors that run multiple funds, each with different investment portfolios, may run into conflicts of interests, as different actions would maximize portfolio interests for different groups of investors.[61] Institutional investors do not themselves run companies and thus need to find effective mechanisms to induce directors and managers to pursue portfolio value maximization.[62] But fiduciary duties of directors and managers of portfolio companies may conflict with actions that increase the portfolio value of shareholders at the expense of firm value.[63] Depending on the mechanism used, and the issue, institutional investors may face backlash or legal liability if they try to push companies towards a multi-firm focus.[64]

The extent to which institutional investors presently push portfolio companies away from firm value and towards portfolio value maximization is highly disputed.[65] Institutional investors may understandably be reluctant to admit that they adopt a multi-firm focus and induce companies to take actions that reduce their value in order to raise the value of their other portfolio holdings, especially if such actions would have anti-competitive effects.[66] Rather, regardless of their true motivation, they may tend to couch their activities as intended to raise

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[60] See Lewellen & Lewellen, supra note 49; Kahan & Rock, supra note 49.

[61] See, generally, Edward Rock and Daniel Rubinfeld, Antitrust for Institutional Investors, 82 Antitrust L. J. 221 (2018); John Morley, Too Big to Be Activist, 92 S. Cal. L. Rev. 1407 (2019); Max Schanzenbach & Robert Sitkoff, Reconciling Fiduciary Duty and Social Conscience, 72 Stan. L. Rev. 381, 399-425 (2020).

[62] C. Scott Hemphill & Marcel Kahan, The Strategies of Anticompetitive Common Ownership, 129 YALE L.J. 1392, 1395 (2020);

[63] Morley, supra note 61; Kahan & Rock, supra note 26; Brian Ponte, Activist to BlackRock: Prioritize Portfolios Over Holdings, Ignites, Apr. 26, 2022 "BlackRock claims that an activist investor's proposal that the money manager prioritize the value of a fund's portfolio over the returns of an individual portfolio company would cause the firm to violate its fiduciary obligations.")

[64] Hemphill & Kahan, supra note 62; Kahan & Rock, supra note 49 (analyzing incentives of large institutional investors); Lucian Bebchuk & Scott Hirst, Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy, 119 Colum. L. Rev. 2029 (2019) (analyzing incentives of index funds).

[65] In addition to the articles cited in note 56, see Gregor Matvos & Michael Ostrovsky, Cross-Ownership, Returns, and Voting in Mergers, 89 J. Fin. Econ. 391 (2008) (presenting evidence that mutual funds that own a stake in the target firm are more likely to vote for mergers that result in negative returns for the acquirer); Kahan & Rock, supra note 49, (noting that different Vanguard funds voted differently in the CVS-Caremark merger depending on their stakes in the two companies). There are also various anecdotal reports of institutional investors pushing companies to reduce capacity or raise prices. See, e.g., Patti Waldmeir & Pan Kwan Yuk, United Boss Under Fire as Price War Bites, Fin. Times, Oct. 19, 2017, available at https://www.ft.com/content/62d690f4-b4e9-11e7-a398-73d59db9e399 [https://perma.cc/8898-JA2R] (noting that United's CEO had been under pressure from unnamed sources for slashing fares and increasing the supply of flights and seats); Wall Street Tells Frackers to Stop Counting Barrels, Start Making Profits, Wall. St. J., Dec. 13, 2017, available at https://www.wsj.com/articles/wall-streets-fracking-frenzy-runs-dry-as-profits-fail-to-materialize-1512577420 (reporting that twelve major shareholders in U.S. shale-oil-and-gas producers met to discuss how to induce shale producers to reduce capacity). It is, however, unclear, to what extent these investors were motivated to increase the value of the firm at issue or the value of their portfolio at the expense of firm value.

[66] Rock & Rubinfeld, supra note 61; Hemphill & Kahan; supra note 62.

firm value.[67] Furthermore, while there are numerous conceivable mechanisms through which investors may induce a company to take their portfolio interests into account – from direct pressure to do so backed by a threat of a negative vote at the next director election,[68] to a mere failure to pressure companies to take actions that raise firm value but reduce portfolio value,[69] to changes in the managerial compensation scheme,[70] to managers without any prompting, furthering the portfolio interests of their holders[71] – these mechanism often leave no obvious tracks and affect corporate actions in different ways.

But whatever the current extent to which shareholders and public companies adopt a multi-firm focus, it may well rise in the future. For one, if the trends of increased institutional ownership in general, and increased ownership by indexers in particular, continue, both the *influence* of these investors on firm conduct and the *incentives* of institutional investors to use that influence to induce firms to take into account externalities imposed on other firms will rise. Second, as political gridlock impedes the effective regulation of activities that generate externalities – for example, through imposition of a carbon tax – the payoff from a multi-firm focus increases. Third, public calls for institutional investors to pursue a multi-firm focus and justifying such a focus as benefitting society at large – such as those by Alexander, Condon, and Gordon – may make investors both more aware of the potential benefits from doing so and increase its perceived legitimacy. Indeed, even if institutional investors do not themselves change their behavior, managers may follow this clarion call. This could occur because, as Matt Levine has suggested, managers' "understanding of their job is that they are supposed to make shareholders happy" – and if shareholders are highly diversified, a multi-firm focus is what will make them happy. It could also occur if managers hope to earn brownie points with their institutional shareholder base that they could use if, say, they are attacked by hedge funds.[72]

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[67] Kahan & Rock, supra note 26.

[68] Azar et al. supra note 23, at 1554-56

[69] See Hemphill & Kahan, supra note 62, at 1427-1429 (discussing feasibility and plausibility of "selective omission").

[70] See, e.g., Miguel Antón, Florian Ederer, Mireia Giné & Martin Schmalz, Common Ownership, Competition, and Top Management Incentives (European Corp. Governance Inst., Finance Working Paper No. 511/2017, 2022), https://papers.ssrn.com/abstract=2802332 [https://perma.cc/9J7K-CLME]; (presenting an incentive compensation-based mechanism through which common ownership affects product market outcomes).

[71] See Matt Levine, CEOs Learn Something in Business School, Bloomberg Opinion: Money Stuff (Apr. 9, 2019, 11:58 AM EDT), available at https://www.bloomberg.com/opinion/articles/2019-04-09 /ceos-learn-something-in-business-school [https://perma.cc/JPX7-KA8A] ("CEOs want to do a good job, and their understanding of what a good job is changes with intellectual currents. They learned in business school that their job is to maximize shareholder value; they learned in another class in business school that shareholders ought to be, and generally are, broadly diversified. Their understanding of their job is that they are supposed to make shareholders happy; their understanding of shareholders is that they own the market portfolio. Why wouldn't they have internalized those lessons, and make choices that maximize the wealth of diversified shareholders?").

[72] To be sure, as we have recently argued elsewhere, directors and to a lesser degree shareholders face same fiduciary duty constraints if they induce companies to sacrifice firm value to advance their shareholders' portfolio value. But as we have pointed out, when directors themselves do not have a material conflict of interest, the

B. Shareholders' Non-Financial Interests

There are significant indications that a large and growing segment of shareholders have material interests in the activities of companies in which they invest that go beyond the effect of these activities on their financial returns. Market observers regularly note the broadened scope of shareholder interests. For example, according to Deloitte, one of the Big Four accounting firms, "[s]hareholders today are interested in a lot more than just the balance sheet." The S.E.C. claims that "[i]nvestor interest in ESG strategies has rapidly increased"[73] and that funds that use ESG or similar terms in their names "can attract significant interest."[74] Matt Levine, one of the most widely-read financial columnists, agrees:

> "Keep shareholders happy" is a very generic goal. Historically it meant things like having high profits. Later it meant things like doing stock buybacks. Increasingly, it means doing good environmental, social and governance things, as big shareholders become more diversified and more focused on ESG.[75]

Other examples abound.[76]

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business judgment rule affords them substantial discretion – discretion that they can easily use to pursue a multi-firm focus under the guise of pursuing a single firm-focus. Kahan & Rock, supra note 26.

[73] Securities and Exchange Commission, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, available at https://www.sec.gov/rules/proposed/2022/ia-6034.pdf

[74] Securities and Exchange Commission, Investment Company Names, available at https://www.sec.gov/rules/proposed/2022/ic-34593.pdf

[75] See Matt Levine, The SEC Wants to Stop Activism, Bloomberg, Mar. 14, 2022, available at https://www.bloomberg.com/opinion/articles/2022-03-24/the-sec-wants-to-stop-activism

[76] See, e.g., Lisa Fu, ESG Cannot Combat Climate Change: Ex-BlackRock Sustainable CIO, Fundfire (Mar. 18, 2021) https://www.fundfire.com/c/3105474/391684/cannot_combat_climate_change_blackrock_sustainable ("People were interested in ESG, not because they thought … it would help to generate alpha [but] because there was a growing societal anger around the lack of action on social issues." [statement by BlackRock's former chief investment officer for sustainable investing]); Barron's, Activist Shareholders Press Pfizer, J&J, and Other Pharma Companies on Covid Vaccine Price and Access, Dec. 1, 2020, available at https://www.barrons.com/articles/activist-shareholders-press-pfizer-j-j-and-others-on-covid-vaccine-price-access-51606842249 (reporting that "[t]he Interfaith Center on Corporate Responsibility, which represents 300 organizations, many of them with religious affiliations, has filed shareholder proposals at six big pharmaceutical companies urging them to avoid price gouging of medicines that were developed with the help of taxpayer money.") The increase in funds engaging, or purporting to engage, in socially responsible investing has even led to regulatory action. Earlier this year, the S.E.C. proposed a rule prohibiting funds that consider ESG factors, but do not do so to greater extent than other factors, from using ESG or similar terminology in their names. See Securities and Exchange Commission, Fact Sheet: Amendments to the Fund "Names Rule", available at https://www.sec.gov/files/ic-34593-fact-sheet.pdf ("Under the proposal, a fund that considers ESG factors alongside but not more centrally than other, non-ESG factors in its investment decisions would not be permitted to use ESG or similar terminology in its name. Doing so would be defined to be materially deceptive or misleading.") And in 2020, the Department of Labor proposed a rule essentially prohibiting ERISA fiduciaries from using ESG factors to guide investment decisions if doing so was based on social and public policy

The assertions that shareholder preferences have shifted are backed up by several data points. Exhibit 1 is the steep rise in the capital and the number of investment vehicles devoted in some form to socially responsible investing. By some estimates, the amount of assets devoted to sustainable investing has already reached $35 trillion.[77] Within the U.S., that figure is $17.1 trillion – amounting to 1/3 of managed assets – an almost 25-fold increase from its 1995 level.[78] Broadridge Financial, presumably using a different definition of ESG assets, estimates that, as of November 2021, $8 trillion of assets were invested in dedicated environmental, social, and governance mutual funds, ETFs, institutional mandates, and private funds.[79] According to Morningstar, sustainable funds have experienced record inflows in each of the past 5 years.[80] The Forum for Sustainable and Responsible Investment categorizes 1,741 funds as ESG funds as of 2020, a rise from 55 funds in 1995.[81] Unsurprisingly, an increasing number of funds chose names denoting a socially responsible investment strategy – almost 400 according to an S.E.C. estimate.[82]

Public statement and actions by leading investment managers seem to push in the same direction. For example, in his 2022 letter to portfolio CEOs, Larry Fink, the CEO of BlackRock, the world's largest asset managers, admonished them "to set short-, medium-, and long-term targets for greenhouse gas reductions".[83] Letters from prior years urged that "companies must

goal, as opposed to the goal of maximizing risk-adjusted returns. Joseph Lifsics , DOL Proposed Rule Urges Caution Regarding the Use of ESG Factors for ERISA Plans, Benefits and Compensation Blog, June 29, 2020, available at https://www.usbenefits.law/2020/06/dol-proposed-rule-urges-caution-regarding-esg/; Joseph Lifsics & Lennine Occhino, The Department of Labor's ESG-less Final ESG Rule, Harvard Law School Forum on Corporate Governance, Nov. 24, 2020, available at https://corpgov.law.harvard.edu/2020/11/24/the-department-of-labors-esg-less-final-esg-rule/. While the proposed rule permitted use of ESG factors as a tie breaker, it stated that ties "rarely, if ever, occur" and required fiduciaries "to document the basis for concluding that such investment options are indistinguishable." The Final Rule removed explicit references to ESG but retained the opposition to the use of non-pecuniary factors.

[77] Saijel Kishan, There's $35 Trillion Invested in Sustainability, but $25 Trillion of That Isn't Doing Much, Bloomberg (August 18, 2021).

[78] US SIF, Report on US sustainable and impact investing trends 2020, available at: https://www.ussif.org/files/trends%20report%202020%20executive%20summary.pdf.

[79] Broadridge, ESG Investments Poised to Reach $30 Trillion by 2030, available at https://www.broadridge.com/intl/press-release/2021/esg-investments-poised-to-reach-30-trillion-dollar-by-2030.

[80] Sustainable Funds U.S. Landscape Report – More funds, more flows, and impressive returns in 2020, Morningstar Manager Research (Feb. 19, 2021), available at https://www.sec.gov/comments/climate-disclosure/cll12-8899329-241650.pdf.

[81] US SIF, Report on U.S. Sustainable, Responsible and Impact Investing Trends, 2016, available at https://www.ussif.org/files/SIF_Trends_16_Executive_Summary(1).pdf and US SIF, Sustainable Investing Basics (2020), available at https://www.ussif.org/sribasics.

[82] Securities and Exchange Commission, Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices, available at https://www.sec.gov/rules/proposed/2022/ia-6034.pdf at 185 (33 open end funds, 21 closed end funds and 35 UITs).

[83] BlackRock, Larry Fink's 2022 Letter To CEOs: The Power of Capitalism, available at https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter?cid=ppc:CEOLetter:PMS:US:NA&gclid=EAIaIQobChMIpqKuxOCK-AIV18izCh2c_QuWEAAYASAAEgJ6ovD_BwE&gclsrc=aw.ds.

demonstrate their commitment to the countries, regions, and communities where they operate, particularly on issues central to the world's future prosperity",[84] advised that "[t]o prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society,"[85] or warned that "[t]he world is moving to net zero, and BlackRock believes that [its] clients are best served by being at the forefront of that transition."[86] Though Fink's letters are short on specifics and may reflect portfolio welfarism or conceivably even shareholderism,[87] his highlighting of commitments to countries, regions and communities where firms operate and the need to make a positive contribution to society also supports shareholder welfarism. Consistent with Fink's letter, BlackRock announced that climate change would become a central part of its own investment approach and that it would divest its actively managed portfolios from coal stocks.[88] New York's state pension fund, as well, announced that it was divesting from fossil fuels and various other funds divested from, or declared they intend to divest from, firearms manufacturers, operators of private prisons, and companies from countries that do not meet specified labor standards, among others.[89]

State Street – like BlackRock one of the Big Three investment advisors – similarly claims that "sustainability has been at the center of [its] asset stewardship program for a number of years."[90] Climate Action 100+ counts 700 investors, with over $68 trillion in assets under management, as its supporters.[91] Overall, Deloitte reports that "more than 70 asset managers, including BlackRock and Vanguard, have also recently signed a pledge with the Net Zero Investors Initiative, which has been formed to help achieve net-zero greenhouse gas emissions by 2050."[92]

This change in shareholder attitudes, according to academic commentators, is backed up by actions. Professors Julia Mahoney and Paul Mahoney have argued that non-financial

[84] BlackRock, Larry Fink's 2019 Letter To CEOs: Purpose & Profit, available at https://www.blackrock.com/corporate/investor-relations/2019-larry-fink-ceo-letter.

[85] BlackRock, Larry Fink's 2018 Letter To CEOs: A Sense of Purpose, available at https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter.

[86] BlackRock, Larry Fink's 2021 Letter To CEOs, available at https://www.blackrock.com/corporate/investor-relations/2021-larry-fink-ceo-letter.

[87] See Lund & Pollman, supra note 4, at 2591 ("Rather than indicate a sharp turn toward stakeholder capitalism, Fink's statements may instead reflect an enlightened approach to shareholderism that views consideration of stakeholder welfare as a means of sustainably achieving value for shareholders.")

[88] See Michal Barzuza, Quinn Curtis & David H. Webber, Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance, 93 S. Cal. L. Rev. 1243, 1274 (2020).

[89] Paul G. Mahoney & Julia D. Mahoney, The New Separation of Ownership and Control: Institutional Investors and ESG, 2021 Colum. Bus. L. Rev. 840, at TAN 91 (2021).

[90] State Street Global Advisors, Incorporating Sustainability Into Long-Term Strategy, Feb. 2019, available at https://www.ssga.com/investment-topics/environmental-social-governance/2019/02/incorporating-sustainability-into-long-term-strategy.pdf

[91] Climate Action 100+, "About ," available at https://www.climateaction100.org/about/.

[92] Ross Kerber, Investors BlackRock, Vanguard join net zero effort , Reuters, March 29, 2021, cited in Deloitte, Tectonic shifts: How ESG is changing business, moving markets, and driving regulation, Oct. 29, 2021, available at https://www2.deloitte.com/us/en/insights/topics/strategy/esg-disclosure-regulation.html/#endnote-12.

motivations account for the push by institutional investors to reduce greenhouse gases.[93] Professors Barzuza, Curtis and Webber see similar dynamics accounting for index fund advisors pushing for gender diversity on corporate boards.[94] Retail investors as well, they claim, pursue values, not just value. As evidence, they cite to data from Robinhood that firms that publicly supported Black Lives Matter saw an increase in the number of retail investors holding their shares on its platform and to experimental studies indicating that many investors are willing to accept lower returns in exchange for firms acting in a more socially responsible fashion.[95] They conclude that socially responsible investing, a "once relatively marginal" phenomenon, has "taken center stage in the corporate world."[96] Economists, in turn, have taken to modelling the effect of social preferences on shareholding structure,[97] share prices,[98] expected shareholder returns,[99] and the scope of shareholder voting rights.[100]

Another indication of shareholders' willingness to act in accordance with their non-economic preferences is the increased number of, and the increased support for, social issue shareholder proposals. Last year's proxy season saw support for "an unprecedented number of ESG proposals, on issues ranging from climate change to human capital management to diversity, equity and inclusion."[101] According to an analysis by ISS, environmental and social issue proposals have earned in recent years "record levels of support" – with the percentage of proposals gaining more than 30% support rising from 0% in 2000 to 36% in 2018.[102] Moreover,

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[93] Mahoney & Mahoney, supra note 89 ("[W]e hypothesize that institutional investors seek to impose a capital cost on greenhouse gasses. … The capital cost will prod companies to operate in ways more closely aligned with the investors' view of social welfare.")

[94] See Barzuza et al., supra note 88, at 1277 ("though index fund operators appeal to the academic literature in making the case for increased diversity, the academic record is more ambiguous than these arguments would suggest. An extensive literature has examined the effect of board gender diversity on firm value. The results of this literature are mixed ...") and at 1301 ("By aggressively and publicly staking out a progressive position on board diversity, index funds credibly signal that they are in tune with millennial values and differentiate themselves from less aggressive competitors.")

[95] See Barzuza et al., supra note 88.

[96] Id.

[97] Henry L. Friedman & Mirko S. Heinle, Taste, Information, and Asset Prices: Implications for the Valuation of CSR, 21 Rev. Accounting Stud. 740 (2016).

[98] Eugene F. Fama & Kenneth R. French, Disagreement, Tastes, and Asset Prices, 83 J. Fin. Econ. 66 (2007).

[99] Friedman & Heinle, supra note 97; Lubos Pastor, Robert F. Stambaugh & Lucian A. Taylor, Sustainable Investing in Equilibrium, 142 J. Fin. Econ. 550 (2021)

[100] Oliver Hart & Luigi Zingales. 2017. Companies should maximize shareholder welfare not market value. *Journal of Law, Finance, and Accounting* 2 (2): 247–275.

[101] Wachtell, Lipton Rosen & Katz, Board Oversight of ESG: Preparing for the 2022 Proxy Season and Beyond Mar. 25, 2022. See also Jody Grewal, George Serafeim & Aaron Yoon, Shareholder activism on sustainability issues (2017), Working paper, available at: https://ssrn.com/abstract=2805512 (reporting that the number of shareholder proposals on sustainability doubled from 1999 to 2013).

[102] See Kosmas Papadopoulos, The Long View: US Proxy Voting Trends on E&S Issues from 2000 to 2018, Harv. L. Sch. F. on Corp. Governance, https://corpgov.law.harvard.edu/2019/01/31/the-long-viewus-proxy-voting-trends-on-es-issues-from-2000-to-2018/.

a record percentage of such proposals are withdrawn as companies reach pre-vote settlements with the proponents.[103]

To be sure, socially responsible investing, and support for social issue shareholder proposals, do not necessarily indicate that shareholders are motivated by non-financial preferences. Arguably, individual shareholders are purely driven by financial returns and believe that socially responsible investing will generate such returns – believing, in effect, that companies that are socially responsible are undervalued.[104] If so, there would be no correlation between shareholders' views on issues like climate change or diversity and shareholders' investment decisions.

While we cannot exclude this possibility, at least for some investors, we believe it is unlikely that purely returns-driven investors account for a large segment of socially responsible investing. For one, at least some socially responsible investors admit that financial returns are not their sole motivations.[105] Moreover, if so many investors thought that that companies that are socially responsible are undervalued, the market price for the shares of these companies would already have adjusted[106] – unless, that is, a similarly large number of investors believed that these companies are *over*valued. But unlike in other areas where shareholders who believe that certain types of companies are misvalued have a choice of different investment vehicles – like growth funds and value funds, small stock funds and large stock funds, or sector funds devoted to different industries – we find only funds who specialize in socially responsible investing, but no funds that specialize in companies that score low on ESG metrics.[107] Similarly, if ESG investing were purely returns driven, a proposed 2020 Department of Labor rule to prohibit ERISA fiduciaries from taking ESG factors into account unless they are meant to increase returns

[103] Id.

[104] This belief is highly disputed. See Cornell, Brad & Damodaran, Aswath, Valuing ESG: Doing Good or Sounding Good?, 1 The Journal of Impact and ESG Investing, 76 (2020); Terrence R. Keely, ESG Does Neither Much Good nor Very Well, Wall St. J., Sep. 13, 2022 ("Over the past five years, global ESG funds have underperformed the broader market by more than 250 basis points per year, an average 6.3% return compared with a 8.9% return."). Moreover, what type of stocks are overvalued or overvalued can change with time and even if companies that are socially responsible were undervalued 10 years ago, this would not imply that they remain undervalued today or will continue to be undervalued in 10 years.

[105] For other investors, circumstances strongly indicate that they are not purely returns drive. Thus, the comptroller of the New York State pension funds reportedly divested from fossil fuels only after pressure from state legislators and activists, after having initially resisted such a move on the grounds that divestment would make it harder to achieve the required long-term returns. See Mahoney & Mahoney, supra note 89. Similarly, Idaho politicians asked the state pension fund to divest from social media companies that they argued were engaged in censorship. Id.

[106] There is indeed some evidence that sustainable stocks have become overvalued. See Nickolay Gantchev, Mariassunta Giannetti & Rachel Li, Sustainability or Performance? Ratings and Fund Managers' Incentives, ECGI Working Paper No. 747/2021 (2021),

[107] Strive Asset Management, which uses shareholder engagement and proxy voting to impress a non-ESG policy on companies (see https://www.investmentnews.com/anti-esg-movement-spawns-new-fund-in-battle-against-blackrock-vanguard-and-state-street-225185), is no counterexample. Strive's strategy is not based on the notion that firms that follow ESG are overvalued (given that strategy they follow), but that they would have a higher value if they changed their strategy.

would not have been heavily criticized by ESG proponents.[108] And while some are skeptical about how much investors in ESG funds are willing to sacrifice returns to pursue their non-financial interests,[109] investors at a minimum seem willing to incur the higher fees charged by ESG funds.[110]

Even if ultimate investors in socially responsible investment vehicles are motivated by non-financial concerns, it could be that asset managers such as BlackRock and State Street that incorporate ESG in their engagement are purely returns driven.[111] This is more plausible. In particular, asset managers may push for social responsibility in their portfolio companies as part of a multi-firm focus strategy[112] or to fend off regulation.[113] But while these motivations may well also account for the decisions by asset managers, that fact that asset managers openly and vocally publicize their ESG orientation[114] – and, according to some, exaggerate their ESG activities[115] – suggests that they are trying to appeal to their investor clients. Indeed, BlackRock

[108] Amanda Rose, A Response To Calls For S.E.C. Mandated ESG Disclosure, 98 Wash. U. L. Rev. 1821 (2021)..

[109] Jennifer Arlen & Lewis A. Kornhauser, Battle for Our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct (July 3, 2022). Available at SSRN: https://ssrn.com/abstract=4152960 or http://dx.doi.org/10.2139/ssrn.4152960 (finding support for proposition that people want to be moral but are primarily driven by self-interest and will pursue self-interest if they can without feeling immoral).

[110] For example, the Vanguard ESG U.S. Stock ETF and the Vanguard FTSE Social Index Fund Admiral Shares charge annual fees of 0.09% and 0.14%, respectively, compared to 0.04% for both the Vanguard Large Cap ETF and the Vanguard 500 Index Fund Admiral. See Vanguard, Discover Vanguard Mutual funds & ETF, available at https://investor.vanguard.com/investment-products/list/all?managementstyle=index&assetclass=equity-region-us,equity-market_cap-large-cap,equity

[111] Asset managers generally claims that they are returns driven. See, e.g., BlackRock, Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance (2020) https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceoletter (stating that BlackRock's "investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors"); see also Gordon, supra note 53 (arguing that index funds' approach to ESG matters can serve the interests of their investors by reducing systematic risk).

[112] See supra note Section II.A. Asset managers may conceivably also pursue certain forms socially responsible investing as part of a multi-firm focus strategy, though it is not clear if a multi-firm focus translates into socially responsible investing (as opposed to engagement).

[113] But see Barzuza et al., supra note 88, at 1280 (noting that pursuit of ESG may increase regulatory pressure, as it did when the Department of Labor issued its proposed ERISA regulations on the use of ESG in investing).

[114] Larry Fink's letters to CEOs, for example, are prominently posted on the firm's website (see https://www.blackrock.com/us/individual?cid=ppc:BlackRock_USWA:google:BlackRockBrandNew&gclid=EAIaIQobChMIhYGwtMGM-AIVCuOzCh1PFwc1EAAYASAAEgKAGfD_BwE&gclsrc=aw.ds) and State Street accompanied its campaign for greater gender diversity on boards with a high profile placement of the "Fearless Girl" statue opposite the Charging Bull statue in Manhattan's Financial District. Barzuza et al., supra note 88, at 1243.

[115] See, e.g., Press Release, SEC Charges BNY Mellon Investment Adviser for Misstatements and Omissions Concerning ESG Considerations, May 23, 2022, available at https://www.sec.gov/news/press-release/2022-86 (reporting that the S.E.C charged BNY Mellon with overstating the degree to which ESG considerations affected investment decisions); Eshe Nelson, Sustainable investing risks becoming a victim of its own success, Dec. 13, 2018, available at https://qz.com/1490365/esg-investing-risks-becoming-a-victim-of-its-own-success/ (quoting Harvard Business School professor George Serafeim as stating that there are "now stronger incentives for asset managers to greenwash," and "ESG cannot be just a marketing tool to attract capital."); Sadok E. Ghoul, and Aymen Karoui, What's in a (Green) Name? The Consequences of Greening Fund Names on Fund Flows, Turnover, And Performance, 39 Finance Research Letters 101620 (2021) (not finding a statistically significant change in fund exposure to socially responsible investment following a fund name change suggesting socially responsible investment); Bertrand Candelon, Jean-Baptise Hasse & Qunetin Lajaunie, ESG-Washing in the Mutual Funds Industry? From Information

issued a report *Understanding Millennial Investors* that explains that to earn brand loyalty from millennial investors, it is crucial to do "things the 'right' way."[116] Put differently, asset managers act as if they believe that talking the ESG talk, and walking the ESG walk, will appeal to a substantial segment of their investors.

The amount devoted to ESG investments is likely to continue to grow. In 2020, a record $51.1 billion in additional funds was invested in ESG funds, approximately 10 times as much as during 2018. Even if fund inflows stabilize at that level, the percentage of the assets under management devoted to sustainable investing would be bound to rise. But many commentators foresee even greater growth. Bloomberg predicts that global ESG assets will exceed $53 billion by 2025.[117] Broadridge Financial projects that ESG investments will grow to between $20 and $30 trillion by 2030.[118] Professors Barzuza, Curtis and Webber have identified millennials as an important constituency for investment driven by values, in addition to value. Millennials, they argue, care more, and more deeply, about non-financial considerations that prior generations.[119] And millennials are set for a huge increase in investable assets[120] – "the largest transfer of wealth in history."[121] Larry Fink in his 2021 letter to CEOs predicted that the recent large increases in investments in sustainable assets was "the beginning of a long but rapidly accelerating transition – one that will unfold over many years and reshape asset prices of every type."[122]

How investor preferences in general, and the growth in ESG investing in particular, affect company actions is a different issue. In principle, there are two mechanisms: "exit" and voice.[123] "Exit" – not investing in and divesting from companies whose actions do not accord with one's preferences – can influence corporate actions through two channels. First, if the pool of investors who refuse to fund certain objectionable investments is very large, there may not be enough capital left to fund these investments. Second, if certain investors refuse to fund certain objectionable investments, other investors (who care purely about financial returns) have to hold an unbalanced portfolio that entails some diversifiable risk – thereby raising the cost of capital

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Asymmetry to Regulation, Risks, 9, 199 (2021) (providing empirical evidence that some asset managers incorrectly portray themselves as socially responsible).

[116] Barzuza et al., supra note 88, at 1289-90.

[117] Bloomberg, ESG assets may hit $53 trillion by 2025, a third of global AUM, Feb. 23, 2021, available at https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/. These various sources do not specify what assets are regarded as invested in ESG and their estimates may differ because their definition of ESG assets differs.

[118] Broadridge, ESG Investment, supra note 79.

[119] Barzuza et al., supra note 88, at 1284 – 85, 1291 – 1303.

[120] Id. at 1286.

[121] BlackRock, Larry Fink's 2019 Letter to CEOs, supra note 84 ("In the years to come, the sentiments of these generations will drive not only their decisions as employees but also as investors, with the world undergoing the largest transfer of wealth in history: $24 trillion from baby boomers to millennials.").

[122] BlackRock, Larry Fink's 2021 Letter to CEOs, supra note 86; see also Practus Comment Letter to S.E.C. (noting that "some observers predict that the style could command half of all assets under management in 2025").

[123] See generally Albert O. Hirschman, Exit, Voice, And Loyalty: Responses To Decline In Firms, Organizations, And States (1970).

for these investments.[124] However, a recent study estimates that the latter effect, at current levels, is unlikely to be significant,[125] casting some doubt at the effectiveness of the exit approach.

Voice may hold comparatively greater promise, at least in the short term. Indeed, there is some evidence that investors' expressing their concerns has already started to affect corporate actions. Following the push for greater gender diversity, for example, gender diversity on boards has in fact increased.[126] And a large number of companies now make climate-related disclosures, a move that seems at least partly driven by investor demands.[127]

Whether these company actions have, on the whole, come at the expense of corporate value is less clear.[128] For example, a comprehensive review of the literature concludes that "empirical studies examining the relation between corporate social responsibility and firm value find mixed results."[129]

But the issue is not the general relationship between acting in a socially responsible way and profitability. Even the most devoted shareholderist hardly believes that the best way for a company to make money is to mistreat its employees, customers and suppliers or to violate environmental laws.[130] Up to some point, being a responsible corporate citizen is surely likely to enhance a company's financial performance. The issue rather is whether investor concern about

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[124] Jonathan Berk & Jules H. Van Binsbergen, The Impact of Impact Investing (June 10, 2022), available at https://papers.ssrn.com/abstract_id=3909166.

[125] Id.

[126] Barzuza et al., supra note 88, at 1265 ("Calls for public companies to increase the gender diversity of their boards of directors are not new, but in recent years, calls for diversification have come not just from social activists, but from investors as well, and companies have responded.").

[127] See Securities and Exchange Commission, The Enhancement and Standardization of Climate-Related Disclosures for Investors, available at https://www.sec.gov/rules/proposed/2022/33-11042.pdf, note 76 ("over 3,000 companies have provided climate-related disclosures through the CDP's platform by responding to the CDP's questionnaires that are aligned with the TCFD's disclosure recommendations"); Grewal at al., supra note 101 (reporting that filing shareholder proposals are related to subsequent improvements in the performance of the company on the focal environmental or social issue, even though such proposals nearly never received majority support); but see Why ESG is fatally flawed, available at http://www.chrisleithner.com/why-esg-is-fatally-flawed/, (quoting former senior BlackRock executive as stating "Despite tens of trillions of ESG investments, investors haven't done very well nor generated much good. ESG advocates need to do better or stop claiming they can.").

[128] Hans Bonde Christensen, Luzi Hail & Christian Leuz, , Mandatory CSR and Sustainability Reporting: Economic Analysis and Literature Review (May 17, 2021). European Corporate Governance Institute - Finance Working Paper No. 623/2019, Available at SSRN: https://ssrn.com/abstract=3427748; see also Ananth Madhavan, Aleksander Sobczyk & Andrew Ang, Toward ESG Alpha: Analyzing ESG Exposures through a Factor Lens, 77 Fin. Anal. J. 69–88 (2021) (surveying the literature which finds mixed performance); Gerhard Halbritter & Gregor Dorfleitner, The Wages of Social Responsibility—Where Are They? A Critical Review of ESG Investing, 26 Rev. Fin. Econ. 25, 35 (2015) (finding no link between ESG ratings and returns).

[129] Mandatory CSR, supra note 128; see also id. ("A different way to examine the potentially value-enhancing effects of CSR is to study its association with financial performance (e.g., return on assets), essentially testing whether companies "do well by doing good." There is a large number of studies broadly examining this relation and their results are again mixed."). Though many studies show a positive association between corporate social responsibility and firm performance, it could be that companies with better performance are more likely to be socially responsible. Id.

[130] Bartlett & Bubb Working Paper.

non-financial metrics has driven companies to go beyond that point – an issue that is much more difficult to investigate empirically.

Even more relevant is whether, going forward, companies will be driven to sacrifice financial returns for other values. The push towards social responsibility is still relatively new. In our estimate, it is likely to get stronger as the percentage of assets under management devoted to values-based investment grows, as values-based investors get more expertise in dealing with portfolio companies, and as corporate resistance to investor demands breaks down. Furthermore, the anticipation of further growth and influence in the values-based investment sector may induce companies to change their behavior to preempt any pressure they may face in the future. Aiding these trends and enhancing the ability of shareholders to pressure companies, the S.E.C. limited companies' ability to exclude social issue shareholder proposals.[131] As shareholder pressure to pursue non-economic goals increases, the trade-off between profits and pursuit of such goals will become starker.

C. Stakeholderism

As stakeholderism broadens the corporate objective from benefitting shareholders to promoting the interests of all corporate "stakeholders" – current and retired employees, customers, suppliers, creditors, and community in which a firm operates – it represents a step in the direction of direct social welfarism. And stakeholderism is on the rise. On August 19, 2019, the Business Roundtable, an organization of chief executives of major U.S. corporations, released its new statement on the purpose of the corporation:

> [W]e share a fundamental commitment to all of our stakeholders. We commit to:
>
> - Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
> - Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
> - Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
> - Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.

[131] Wachtell, Lipton, Rosen & Katz, SEC Staff Limits Exclusion of "Social Policy" Shareholder Proposals, Nov. 4, 2021, available at https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.27894.21.pdf.

- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.[132]

As the accompanying press release notes, the 2019 statement "moves away from shareholder primacy" – a principle that had been endorsed by every prior statement – to "include[] a commitment to all stakeholders."[133] The 2019 statement shows how far the Business Roundtable has moved since 1997, when it had declared that "[the paramount duty of management and of boards of directors is to the corporation's stockholders. … The interests of other stakeholders are relevant as a derivative of the duty to stockholders."[134]

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132 Statement on the Purpose of a Corporation, available at https://opportunity.businessroundtable.org/ourcommitment/

133 Business Roundtable, Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans', Aug. 19, 2019, available at https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans. Stakeholders are not entirely new to the debate. In the late-1980, many states adopted constituency statutes that permitted the board to consider the interests of groups other than shareholders, such as employees and customers, in particular in deciding how to respond to a hostile takeover. See generally American Bar Association Committee on Corporate Laws, Other Constituencies Statutes: Potential for Confusion, 45 BUS. LAW. 2253 (1990). But these laws were about enabling managers to obstruct a bid that managers opposed but shareholders favored. See Marcel Kahan, Delaware's Peril, 80 U. Maryland L. Rev. 59, 70 ("The notion that constituency statutes would induce a board—technically elected by shareholders but in practice often deferential to top management—to take an action opposed by managers and shareholders because it benefitted other constituents, such as employees, or not to take an action favored by managers and shareholders because it would hurt employees, seems farfetched.")

134 Fortune, America's CEOs Seek a New Purpose for the Corporation, Aug. 19, 2019, available at https://fortune.com/longform/business-roundtable-ceos-corporations-purpose/

Many applauded or opposed the statement.[135] Others regarded it as a meaningless "public relations move" that was "mostly for show"[136] and "largely rhetorical."[137]

We agree that the 2019 statement should not be read as a whole-hearted embrace of stakeholderism by corporate America. But we think the skepticism misses an important point. Even if the signatories of the 2019 statement did not truly mean what they said, the fact that they nevertheless issued the 2019 statement reflects an erosion of the norm of shareholder primacy. [138]

There is plenty of evidence for such erosion and for increasing support of the position outlined by the British Academy's Future of the Corporation project. According to a Fortune poll conducted in 2019, 41% of Fortune 500 CEOs agreed that "solving social problems should be 'part of [their] core business strategy.'"[139] Only seven percent thought that their main focus should be

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[135] Id. (noting support from CEO of Vanguard, President and CEO of Progressive Corporation, and President of the Ford Foundation); https://corpgov.law.harvard.edu/2019/08/22/so-long-to-shareholder-primacy/ (noting that seven CEOs declined to sign the statement and that the Council of Institutional Investors expressed concern that it gave "CEOs cover to dodge shareholder oversight."); Carmen Lu, Martin Lipton & William Savitt, Further on the Purpose of the Corporation, Harvard Law School Forum on Corporate Governance, available at https://corpgov.law.harvard.edu/2021/07/20/further-on-the-purpose-of-the-corporation/ (praising statement as embracing the "imperative of a society-facing purpose beyond a singular pursuit of profit"); Editorial, The 'Stakeholder' CEOs, Wall St. J. (Aug. 19, 2019, 5:09 PM), https://www.wsj.com/articles/the-stakeholderceos-11566248641 ("[a]n illdefined stakeholder model can quickly become a license for CEOs to waste capital on projects that might make them local or political heroes but ill-serve those same stakeholders if the business falters"); Karl Smith Corporations Can Shun Shareholders, But Not Profits, Bloomberg Opinion (August 27, 2019) ("it's a blueprint for ineffective and counterproductive public policy on the one hand, and blame-shifting and lack of accountability on the other").

[136] Lucian A. Bebchuk & Roberto Tallarita, The Illusory Promise of Stakeholder Governance, 106 Cornell L. Rev. 91, 98 (2020); see also Jay Coen-Gilbert, Andrew Kassoy & Bart Houlihan, Don't Believe the Business Roundtable Until It's CEO's Actions Match Their Words, Fast Company (August 22, 2019).

[137] Michael Hiltzik, Big Business buries the shareholder value myth, L.A. Times, available at https://enewspaper.latimes.com/infinity/article_share.aspx?guid=49054bfa-305d-484e-92a9-e70c6faf5ab7; see also Andrew Winston, Is the Business Roundtable Statement Just Empty Rhetoric? Harvard Business Review (August 30, 2019).

[138] By norm, we mean a nonlegally enforceable rule or standard. Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation 149 U. Pa. L. Rev. 1619 (2001). Though directors generally owe fiduciary duties to the corporation and its shareholders, the business judgment rule confers significant discretion on directors who have no personal conflict of interest. As such, in most context, shareholder primacy is not legally enforceable.

[139] Cydney Posner, So Long to Shareholder Primacy, Aug. 22, 2019, Harvard Law School Forum on Corporate Governance, available at https://corpgov.law.harvard.edu/2019/08/22/so-long-to-shareholder-primacy/

on making profits. New terms like "inclusive capitalism"[140] and "compassionate capitalism"[141] abound. Larry Fink's favorite term is stakeholder capitalism – "capitalism, driven by mutually beneficial relationships between you and the employees, customers, suppliers, and communities your company relies on to prosper."[142] Even Wachtell, Lipton, Rosen and Katz, a leading proponent of managerialism, pays homage to the normative appeal of stakeholderism in declaring that the purpose of the corporation should be "to conduct a lawful, ethical, profitable and sustainable business in order to create value over the long-term, which requires consideration of the stakeholders that are critical to its success (shareholders, employees, customers, suppliers, creditors and communities)." Shareholders are merely "essential partners in supporting the corporation's pursuit of this mission."[143]

Some commentators argue that stakeholderism is consistent with, or even required for, corporate value maximization. Thus, a Deloitte report claims that

> companies that hold themselves accountable to their stakeholders by increasing transparency will be more viable—and valuable—in the long term. ... Today, people from around the globe, including employees, suppliers, business partners, members of the community, activists, and society at large, are equal participants—stakeholders—in a direct dialogue with your company about what they expect from your business. ... As consumers, people increasingly want to purchase products they view as sustainable across the entire value chain, including matters of equity and equality. ... As employees,

[140] See, e.g., Council for Inclusive Capitalism website, https://www.inclusivecapitalism.com/ (website of Council for Inclusive Capitalism, a movement of CEO leaders doing business in ways that lead to a more inclusive and sustainable economy); The Rockefeller Foundation, A Framework for Inclusive Capitalism, https://www.rockefellerfoundation.org/rfbreakthrough/a-framework-for-inclusive-capitalism/; University of Oxford, The State and Direction of Inclusive Capitalism, https://www.sbs.ox.ac.uk/sites/default/files/2020-01/in-pursuit-of-inclusive-capitalism-V2.pdf. In a Westlaw search of the News file on November 21, 2022, the term was found in 1068 documents dated from 2017 to 2022.

[141] What is Compassionate Capitalism and Why We Need it in These Times of Planetary Crisis? https://www.managementstudyguide.com/compassionate-capitalism.htm; Carrie Sheffield, Compassionate Capitalism Is The Best Solution To Global Poverty, Forbes, Oct. 5, 2015, available at https://www.forbes.com/sites/carriesheffield/2015/10/05/compassionate-capitalism-is-the-best-solution-to-global-poverty/?sh=2e424706658d; Compassionate Capitalism: Journey To The Soul of Business (Book Title). In a Westlaw search of the News file on November 21, 2022, the term was found in 293 documents dated from 2017 to 2022.

[142] BlackRock, Larry Fink's 2022 Letter to CEOs, supra note 83; see also Frederick Alexander, Holly Ensign-Barstow, Lenore Palladino, & Andrew Kassoy, From Shareholder Primacy to Stakeholder Capitalism: A Policy Agenda for Systems Change (arguing that fiduciary duties should incorporate external costs of individual companies that harm portfolios); Tom Gosling, Can Shareholders Save Capitalism?, available at https://mailchi.mp/ecgi/summit-2022-4?e=476ee7935e ("The idea that untrammelled Friedmanite pursuit of shareholder value has led to environmental destruction, climate change, inequality, and all manner of other ills is widely held. The emergence of the idea of stakeholder capitalism has at its core the idea that shareholder interests need to be prioritized in favour of other goals.")

[143] Wachtell, Lipton, Rosen & Katz, On the Purpose of the Corporation, May 26, 2020 , available at https://www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.26961.20.pdf.

people are increasingly concerned with the ESG activities of their employers across all geographies.[144]

It is surely correct that catering to one's customers, employees and supplies, and embracing wider concerns of equity and equality, can, up to some point, make a company more profitable. But it is equally correct that, in some contexts, the interests of shareholders and the interests of other stakeholders will conflict. Picking the optimal point, from the perspective of firm value maximization (or, for that matter, portfolio value maximization or shareholder welfare maximization), is not easy. Our guess is that companies that try to do so err or both sides, with some not going far enough and some going too far in taking into account stakeholder interests. But statements like those by Deloitte and Larry Fink imply that most companies should show more concern about their non-shareholder stakeholders. Despite the rhetoric that doing so is merely meant to increase the long-term value of the company, these statements therefore suggest that stakeholder interests should be taken into account even if they conflict with shareholder interests.

Political developments present further evidence of the erosion of the shareholder primacy norm. In the 2020 Presidential election, two leading contenders for the Democratic nomination proposed corporate governance reforms that would confer substantial power to non-shareholder constituents. Under Senator Bernie Sanders's proposal, employees at publicly traded companies would be entitled to elect 45% of the board members.[145] Under Senator Elizabeth Warren's, they would have the right to elect 40% of the board.[146] Both proposals contained further provisions designed to make boards less responsive to shareholder interests.[147] In the end, neither Sanders nor Warren became the Democratic nominee – though many believe that one of them would have been nominated and gone on to win the election had the other withdrawn earlier.[148] But even Joe Biden, the eventual nominee and president of the United States, called for an end to shareholder capitalism.[149]

On one hand, the corporate governance proposals by Sanders and Warren may seem radical and perhaps would have stood a slim chance of enactment even had Sanders or Warren

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144 Deloitte, Tectonic Shifts, supra note 92. Similarly, Wachtell, Lipton bemoans what it claims to be "the confusion sewn by critics of stakeholder governance who pit shareholders against other stakeholders through the misleading allure of an existential conflict that requires directors to choose between value for one versus the other." See Wachtell Lipton, supra note 8.

145 Corporate Accountability and Democracy, Berniesanders.Com, https://berniesanders.com/issues/corporate-accountability-and-democracy/

146 S. 3348, Accountable Capitalism Act, 115th Cong. (2018).

147 See Kahan, Delaware's Peril, supra note 133, at 70-71.

148 FSU News, We only like female politicians when they don't challenge men for power, Mar. 8, 2020 https://www.fsunews.com/story/opinion/2020/03/08/warren-drops-out-support-flows/4993977002/ ("Leading up to Super Tuesday, many supporters of Senator Bernie Sander's candidacy made repeated calls for Warren to drop out, insisting that, by staying in the race she was selfishly "stealing" votes from Sanders.")

149 CNBC, Biden says investors 'don't need me,' calls for end of 'era of shareholder capitalism,' (July 9, 2020), available at https://www.cnbc.com/2020/07/09/biden-says-investors-dont-need-me-calls-for-end-of-era-of-shareholder-capitalism.html.

been elected. On the other hand, from the perspective of stakeholderism, their proposals seem modest in letting only employees, but no other stakeholders, into the "room where it happens."[150] Either way, we doubt that 30 years ago a Presidential candidate making similar proposals would have had much traction.

Ideology matters, especially in the absence of high-powered financial incentives. In the corporate power structure, there is one important group that lacks such incentives: outside directors. Most outside directors own trivial stakes in the corporations on the boards of which they sit and do not receive much incentive-based compensation.[151] While they presumably want to retain their positions, involuntary departures – by failing to get re-nominated or failing to get re-elected if re-nominated – tend to be rare. In other words, outside directors have no strong financial reasons not to advance the interest of stakeholders at the expense of the interests of shareholders, at least if they are moderate about doing so and can plausibly claim that, viewed properly and over the long term, these interests do not really conflict. If they repeatedly read in the press and hear from their peers and investors that a corporation needs to pursue mutually beneficial relationships with employees, customers, suppliers, and communities, that companies must demonstrate their commitment to the communities where they operate, and that they should consider all the stakeholders – including, but with no special regard to, shareholders – they will start acting accordingly.[152]

Unlike outside directors, managers have high-powered financial incentives.[153] At present, a substantial portion of their compensation is to shareholder returns. Moreover, managers rather than outside directors make most day-to-day managerial decisions and, on most matters, outside directors tend to defer to management recommendations. As long as their financial incentives do not change, is it perhaps warranted to write off their endorsement of stakeholderism as cheap talk?

Even the answer to that question is not clear cut. For one, norms may affect the attitudes of stakeholders such as employees or customers. Thus, in an experimental study, Hajin Kim showed that Amazon Mechanical Turk workers taught an exclusive profit maximization norm were less likely to sign a real petition against Amazon than those taught that firms can and should care about society.[154] Changed attitudes by stakeholders would in turn affect the actions of corporations, even if corporate managers do not themselves subscribe to the norms. For

[150] https://en.wikipedia.org/wiki/The_Room_Where_It_Happens

[151] Matthew Friestedt, Marc Treviño, and Melissa Sawyer, Trends in U.S. Director Compensation, Harv. L. School Forum on Corp. Gov., Aug. 16, 2020, available at https://corpgov.law.harvard.edu/2020/08/16/trends-in-u-s-director-compensation/ (average compensation of S&P 500 outside directors in 2019 was about $300,000 of which 57% was in form of stock awards and 3% in form of option grants).

[152] Edward Rock, For Whom is the Corporation Managed in 2020, 76 Bus. Law. 363, 386-87 (2021).

[153] See Marcel Kahan, The Limited Significance of Norms for Corporate Governance, 149 U. Pa. L. Rev. 1869, 1896-97 (2001)

[154] Hajin Kim, Expecting Corporate Prosociality.

example, in 2019, Amazon improved its climate commitments in response to a walk-out by a few hundred of its employees[155] – presumably in order to maintain amicable employee relations.

More fundamentally, however, managerial incentives themselves are not written in stone, but are themselves endogenous. The present structure of high-powered incentives provided via stock-based compensation reflects the rise of shareholderism[156] and supplanted a compensation structure that relied much more on fixed salaries and accounting-based bonuses that prevailed under managerialism.[157] Ultimately, it is the board that structures managerial compensation. While managers must of course agree to these packages, there is no inherent reason to believe that managers would resist a change in structure, as long as the overall expected compensation levels do not decline and the riskiness of the compensation does not increase. Managers, indeed, did not seem to object to the rise of stock-based compensation in the 1980s and 1990s. Thus, in principle, nothing stands in the way of reorienting managerial incentives away from maximizing shareholder value and towards a broader set of goals.

Indeed, basing managerial compensation on the realization of goals beyond shareholder profits is already increasing. A recent article by Lucian Bebchuk and Roberto Tallarita found that over half of S&P 100 companies in the U.S. included stakeholder-interest based metrics in their 2020 compensation package for their respective CEOs.[158] Bebchuk and Tallarita are skeptical that these current arrangements actually generate benefits to stakeholders, as opposed to serve the interests of executives – and perhaps they are right. But these packages are consistent with the rhetorical move away from shareholder primacy and, as Bebchuk and Tallarita acknowledge, even in their present form, make executive pay less sensitive to firm performance. More to the point, the present structure may evolve to provide meaningful incentives to managers to promote wider stakeholder interests.

D. Welfarist Regulation of Public Corporations

[155] James F. Peltz, Jeff Bezos Expanded Amazon's Climate Change Pledge. His Workers Wanted More , L.A. Times (Sept. 20, 2019), https://www.latimes.com/business/story/2019-09-19/amazon-climate-change.

[156] It is important to recognize in this regard that the shareholder primacy norm is itself of recent vintage. Up to the late 1970s, major U.S. corporations often retained earnings and reinvested them, providing workers with higher incomes and greater job security. William Lazonick, Profits Without Prosperity, Harv. Bus. Rev., Sep. 2014, available at https://hbr.org/2014/09/profits-without-prosperity Shareholder primacy as a norm came to the fore as a result of the works of Milton Friedman and of Michael Jensen and William Meckling, who coined the phrase agency costs to denote the fact than managers (the agents) should but fail to act in the interest of shareholders (the principals). See So Long Shareholder Primacy, supra note 139. The increased acceptance of that norm is presumably one of the reasons why traditional agency costs have declined.

[157] Marcel Kahan & Edward B. Rock, How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. Chi. L. Rev. 871, 884 (2002); Gordon, supra note 4, at 1530 – 31.

[158] Bebchuk & Tallarita, supra note 136.

Publicly-traded corporations have long been subject to special rules and regulations that are designed to protect their investors. The most common form of these regulations are requirements to disclose information that is financially material to investors to eliminate information asymmetries and enable them to value the stock of these firms accurately.[159]

But increasingly, regulatory initiatives are more plausibly driven, at least in part, by corporate governance welfarist goals. What makes these initiatives distinct, and different from boundary constraints that are fully compatible with shareholderism (and, to a lesser extent, managerialism), is that these initiatives apply *only* to public corporations, and are typically adopted by the S.E.C. or other regulators of public companies under the rationale of being in the interest of shareholders.[160] Welfarist regulations, as we use the term, thus do not include regular environmental, employment, and consumer protection laws that apply broadly and openly pursue goals other than investor protection.

One well-known instance of welfarist regulation is the mandate, imposed by the Dodd-Frank Act of 2010, that the S.E.C. require companies to disclose their use of conflict minerals.[161] Congress was clear that it was motivated by concerns beyond investor protection:

> the exploitation and trade of conflict minerals . . . is helping to finance conflict characterized by extreme levels of violence in the eastern Democratic Republic of the Congo, particularly sexual- and gender-based violence, and contributing to an emergency humanitarian situation therein.[162]

The Dodd-Frank Act also required the S.E.C. to mandate disclosures by public companies on mine safety.[163] While mine safety is presumably also a significant concern of investors, these

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159 Joel Seligman, The Changing Nature of Federal Regulation, 6 Wash. U. J.L. & Pol'y 205 (2001).

160 In this section, we primarily focus on U.S. regulation. European regulators are much farther down the road to welfarist regulation of public corporations. For large U.S. based publicly traded multi-national corporations, European regulations increasing set the standards. Luca Enriques and Matteo Gatti, The Extraterritorial Impact of the Proposed EU Directive on Corporate Sustainability Due Diligence, available at https://www.law.ox.ac.uk/business-law-blog/blog/2022/04/extraterritorial-impact-proposed-eu-directive-corporate. The EU has also provided criteria for determining whether an economic activity qualifies as environmentally sustainable. See Regulation (EU) 2020/852 Of The European Parliament And Of The Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088. For a list of applicable EU regulations, see European Commission, Corporate sustainability reporting, at https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en. For the CSDD text, see European Commission Proposal for a Directive on Corporate Sustainability Due Diligence 2022/0051 (COD)(23.2.3033) at https://eur-lex.europa.eu/resource.html?uri=cellar:bc4dcea4-9584-11ec-b4e4-01aa75ed71a1.0001.02/DOC_1&format=PDF

161 Dodd-Frank Act, § 1502. The disclosure rules were struck down as violating the First Amendment in Nat'l Ass'n of Mfrs. v. Sec. & Exch. Comm'n, 800 F.3d 518, 530 (D.C. Cir. 2015).

162 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111- 203, § 1502, 124 Stat. 1376, 2213 (2010).

163 Dodd-Frank Act, § 1503(a).

rules are generally viewed as also reflecting social goals beyond investor protection.[164] More specifically, one of the rationales for these types of disclosure requirements appears to be to create public pressure on corporations to reshape their supply chains or to improve their mine safety.[165] Empirical evidence indicates that such pressure can be effective in changing corporate behavior.[166]

Another salvo in favor of welfarist regulation of public companies was fired by the Human Capital Management Coalition (HCMC). In 2017, the HCMC asked the S.E.C. to enhance human capital management disclosure.[167] THE HCMC sought, among others, data, from each company, on:

> (1) Workforce demographics (number of full-time and part-time workers, number of contingent workers, policies on and use of subcontracting and outsourcing); (2) Workforce stability (turnover (voluntary and involuntary), internal hire rate); (3) Workforce composition (diversity, pay equity policies/audits/ratios); (4) Workforce skills and capabilities (training, alignment with business strategy, skills gaps); (5) Workforce culture and empowerment (employee engagement, union representation, work-life initiatives); ... (9) Workforce compensation and incentives (bonus metrics used for employees below the named executive officer level, measures to counterbalance risks created by incentives).[168]

In response, the S.E.C. proposed amendments to the disclosure rules to require "[a] description of the registrant's human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business" if such information is material.[169] The S.E.C. proposal stopped far short of the HCMC request, which would have required the disclosure of voluminous data regardless of their materiality, and was

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[164] Donald C. Langevoort & Robert B. Thompson, "Publicness" in Contemporary Securities Regulation after the JOBS Act, 2013 Geo. L.J. 337-386 (2013).

[165] Mahoney & Mahoney, supra note 89 (Conflict mineral disclosure rules were "designed to shame companies into reshaping their supply chains to avoid possibly introducing conflict minerals into their operations. Given the difficulty of tracing minerals back to their original sources, the statute had the predictable, if unintended, consequence of inducing companies to avoid sourcing any products from Congolese manufacturers, with 'devastating' consequences for its intended beneficiaries."); Christensen et al., supra note 128 ("The underlying idea is that reporting and the resulting transparency are change agents, incentivizing desirable behaviors and discouraging undesirables ones.")

[166] Christian Leuz, & Peter D. Wysocki, The economics of disclosure and financial reporting regulation: Evidence and suggestions for future research, 54 J. Accounting Research 525 (2016); Sugata Roychowdhury, Nemit Shroff & Rodrigo S. Verdi, The effects of financial reporting and disclosure on corporate investment: A review. 68 J. Accounting & Econ. 101246 (2019); Chandra Kanodia & Haresh Sapra, A real effects perspective to accounting measurement and disclosure: Implications and insights for future research, 54 J. Accounting Research 623 (2016) (finding that disclosure rules have a significant impact on the real decisions that firms make); Hans B. Christensen, Eric Floyd, Lisa Y. Liu & Mark Maffett, The real effects of mandated information on social responsibility in financial reports: Evidence from mine-safety records. 64 J. Accounting & Econ 284 (2017).

[167] Rose, supra note 108.

[168] Letter from Hum. Cap. Mgmt. Coal., to William Hinman, Dir., Div. of Corp. Fin., S.E.C (July 6, 2017), https://www.sec.gov/rules/petitions/2017/petn4-711.pdf, at 26–27.

[169] Id.

adopted in August 2020 over the objections of the two Democratic commissioners.[170] While the adopted S.E.C. rule can be justified as being principally designed for investor protection, the broader rule favored by the HCMC was more plausibly designed to promote social goals such as inducing companies to: hire more full-time workers; limit outsourcing; , and increase pay equity and training.

The S.E.C. is not the only party imposing welfarist regulations. The State of California enacted legislation requiring public companies headquartered in California to have a minimum number of directors (varying depending on board size) from underrepresented communities,[171] and who are female.[172] Both laws were held unconstitutional under California's equal protection clause by the Los Angeles County Superior Court, with an appeal pending.[173] In 2021, NASDAQ imposed rule which requires that boards of most NASDAQ listed companies disclose board diversity data and either meet diversity objectives or explain why have not.[174] NASDAQ justified its rule on the ground that diverse boards are associated with better performance,[175] but also noted that it consulted with a "broad spectrum of market participants and other stakeholders" including civil rights leaders, to obtain their views on how the proposed rule would "promote the public interest" and their assessment of the "inherent value of board diversity."[176] Again, it seems that NASDAQ's goals extended beyond enhancing firm performance.[177]

The latest example of disclosure rules with an arguable social purpose are the recently proposed S.E.C. rules on greenhouse gas emissions. Under the proposed rules, all companies

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[170] Rose, supra note 108; Joint Statement of Commissioners Robert J. Jackson, Jr. and Allison Herren Lee on Proposed Changes to Regulation S-K, Apr. 27, 2019, at https://www.sec.gov/news/public-statement/statement-jackson-lee-082719 (Robert Jackson and Allison Lee statement on initial release); Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information, Nov. 19, 2020, at https://www.sec.gov/news/public-statement/lee-crenshaw-statement-amendments-regulation-s-k (Allison Lee and Caroline Crenshaw statement dissenting from final rule).

[171] Assembly Bill 979. Directors from underrepresented communities include directors who identify as "Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual or transgender."

[172] Senate Bill 826, available at https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826&search_keywords=corporations+code

[173] See Arnold & Porter, Double Trouble: California Set to Challenge Two Decisions Rejecting Diversification of Corporate Boards, Aug. 5 2022 (reporting on California superior court decisions Crest v. Padilla I and II that held the board diversity requirements were unconstitutional), available at https://www.arnoldporter.com/en/perspectives/advisories/2022/08/california-set-to-challenge-two-decisions.

[174] Sandra Feldman, Nasdaq's new board diversity rule, Aug. 30, 2021, available at https://www.wolterskluwer.com/en/expert-insights/nasdaqs-new-board-diversity-rule. This rule was currently under direct review in the 5th Circuit. See WilmerHale, Fifth Circuit Hears Argument on Nasdaq Board Diversity Rule, Sep. 7, 2022, available at https://www.wilmerhale.com/en/insights/blogs/ESG-Epicenter/20220907-fifth-circuit-hears-argument-on-nasdaq-board-diversity-rule.

[175] Securities and Exchange Commission, Release No. 34-90574; File No. SR-NASDAQ-2020-081, Dec. 4, 2020, https://www.sec.gov/rules/sro/nasdaq/2020/34-90574.pdf ("There is a significant body of research suggesting a positive association between diversity and shareholder value.")

[176] Id.

[177] See also Mahoney & Mahoney, supra note 89, at fn. 24.

would have to disclose their scope 1 emissions ("direct GHG emissions that occur from sources owned or controlled by the company") and their Scope 2 emissions ("emissions primarily resulting from the generation of electricity purchased and consumed by the company"). In addition, companies would have to disclose their Scope 3 emissions — "all indirect GHG emissions not otherwise included in a registrant's Scope 2 emissions, which occur in the upstream and downstream activities of a registrant's value chain") — if material or if the company has set a target that includes Scope 3 emissions.[178] As in the case of the conflict minerals and mining rules, many commentators have predicted that disclosure will serve not only to provide information, but to pressure companies to change their behavior.[179]

A lot of ink has been spilled on the basis for the GHG emissions proposal. Some argue that GHG data are material in a strictly financial sense as they help market participants assess the value of securities.[180] Others argue that they are designed to give shareholders information that shareholders want, whether they want it for financial or non-economic reasons.[181] Yet others do not see them as related to shareholder interests at all.[182]

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[178] Wachtell Lipton Rosen & Katz, SEC Proposes New Climate-Related Disclosures, Mar. 22, 2022.

[179] See, e.g., Mahoney & Mahoney, supra note 89 ("political activists ... want to use the information to prod companies to change policies in socially-motivated directions); Langevoort & Thompson, supra note 164 ("environmental disclosure can be designed to produce societal benefits, and we strongly suspect that the motivation for action in this area cannot be explained by investor needs alone"); see generally Barzuza at al., supra note 88, at 1311 (2020) (describing pressures applied by social activists).

[180] Rose, supra note 108 (proponents on increased disclosure "include financially motivated investors and traditional asset managers who believe companies' approach to (at least certain) ESG topics will bear on the companies' long-term performance, or the long-term performance of the investors' or asset managers' broader investment portfolios."); Barzuza et al., supra note 88 ("Some investors doubtless believe that reducing greenhouse gas emissions and increasing workforce diversity are simply the best way to run a profitable company. ...[But] even investors indifferent to these as first order issues of business success understand that being labelled a bad corporate citizen when it comes to climate or diversity can have effects on firm value if it becomes difficult to recruit young investors or employees."); Jill E. Fisch & Cynthia A. Williams, Petition to the U.S. Securities and Exchange Commission for a rulemaking on environmental, social and governance (ESG) Disclosure (Oct. 1, 2018) at 6.

[181] Rose, supra note 108 (proponents on increased disclosure ""also include values-based investors who care about whether, and how, corporations address (at least certain) ESG topics due to religious or sociopolitical commitments."); Matt Levine, Securities and Environment Commission, Bloomberg Opinion: Money Stuff, Mar. 22, 2022, ("If it's material to an institutional investor that its portfolio be carbon-neutral, then it needs to know the carbon emissions of each portfolio company, even if those emissions are not actually material to that company."); Barzuza et al., supra note 88 ("While it is true that some ESG investors argue that ESG maximizes returns, we believe a significant cohort of investors care about their social goals at least as much, if not more than, returns."); Fisch & Williams, supra note 180, at 8.

[182] Rose, supra note 108 (""The ESG umbrella also shelters various non-investor corporate stakeholders and third parties who care about whether, and how, corporations address (at least certain) ESG topics because they are personally affected (e.g., employees vis-à-vis labor practices) or due to religious or sociopolitical commitments (e.g., environmentalists vis-à-vis environmental impact).") Statement by Commissioner Hester M. Peirce, We are Not the Securities and Environment Commission - At Least Not Yet, Mar. 21, 2022, available at https://www.sec.gov/news/statement/peirce-climate-disclosure-20220321; Jay Clayton & Patrick McHenry, The SEC's Climate-Change Overreach, Wall St. J., Mar. 20, 2022; Mahoney & Mahoney, supra note 89 ("Supporters of mandatory ESG disclosures deny that their purpose is to pursue policy goals outside the S.E.C.'s ambit. Institutional investors who have joined environmental and social activists in supporting mandatory ESG disclosures argue that

We believe that it is likely that some of the disclosures required under the proposal are financially material. But we also believe that it is likely that other disclosures are not financially material. Unlike the human capital regulation, the GHG proposal is detailed and "prescriptive" – it contains a detailed and specific list of required disclosure items – rather than "principles-based" – imposing a general requirement to disclose material information in a topic.[183] Even the Scope 3 disclosure requirements, which is generally subject to a materiality threshold, would require disclosure regardless of materiality for companies that have set an emissions target. Importantly, proponents of increased disclosure do not base their argument solely on the financial materiality of the information.[184] And a House Bill on climate disclosure that preceded the S.E.C. proposal was "clear about its willingness to have the S.E.C. adopt an ESG disclosure framework that extends beyond traditional notions of financial materiality."[185]

For information that is not financially material, the line between information that shareholders want for non-economic reasons and information that serves goals beyond investor protection is blurry. Any social goals to be advanced by a regulation will overlap with information that some shareholders may want – for the simple reason that some shareholders will share the social goal.

This being said, there are strong indications that the S.E.C. shared, rather than merely took account of, the non-economic preferences of shareholders favoring GHG disclosures. First, the House Bill preceding the proposal expressly encouraged the S.E.C. to "incorporate any internationally recognized, independent, multi-stakeholder environmental, social, and governance disclosure standards" into its ESG metrics.[186]

Second, European climate disclosure regulations (which also apply to non-public companies) are expressly based on sustainability goals, rather than mere investor protection

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the disclosures will help them generate superior returns—that ESG investing is about "value, not values." The S.E.C should recognize, however, that institutional asset managers could not make a social value argument even if they wished to, for they are fiduciaries for their shareholders or beneficiaries."); Barzuza et al., supra note 88 (quoting comment letter by Heritage Foundation as arguing that ""[R]hetorical obfuscation notwithstanding, the goal of proponents of ESG, CSR, SRI, sustainability requirements, diversity requirements or stakeholder theory is not to increase corporate profits but to instead alter corporate behavior by legislative, regulatory or other means in furtherance of some (or many) social or political objectives … [N]owhere in the mission of the Commission is found a reference to furthering any social, environmental or other factor.")

[183] Christensen et al., supra note 128. For the distinction between these rules, see Jay Knight, Recent SEC Comment Letter Reveals the Difference Between Prescriptive-Based and Principles-Based Rules, Nov. 5, 2020, available at https://www.bassberrysecuritieslawexchange.com/prescriptive-based-principles-based-rules-securites-exchange-commission-sec-comment-letter/.

[184] See, e.g., Fisch & Williams, supra note 180; John Armour, Luca Enriques, & Thom Wetzer, Mandatory Corporate Climate Disclosures: Now, but How? (November 1, 2021). European Corporate Governance Institute - Law Working Paper No. 614/2021, Columbia Business Law Review, Forthcoming, Available at SSRN: https://ssrn.com/abstract=3958819 (favoring disclosure regulation as second-best to mitigate climate change since direct regulation is politically in feasible); see also Ann M. Lipton, Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure, 37 Yale J. on Regul. 499 (2020).

[185] Rose, supra note 108.

[186] See ESG Disclosure Simplification Act of 2019, H.R. 4329, 116th Cong. § 2(b)(3)–(4) (2019).

goals.[187] Thus, the EU's own website prominently states: "EU rules require large companies to publish regular reports *on the social and environmental impacts of their activities*."[188]

Third, the S.E.C. indicated that it may start imposing employee, environmental, social and governance disclosures on large private companies – companies for which the investor protection rationale is far less plausible.[189] As put by S.E.C. Commissioner Allison Lee, a proponent of such change: "When they're big firms, they can have a huge impact on thousands of people's lives with absolutely no visibility for investors, employees and their unions, regulators, or the public."[190] Though investors appear in her statement, many investors in private companies do in fact have access to (nonpublic) information – but employees, unions and the public would generally lack such access.

Fourth, many commentators regard the fact that the proposed rules are prescriptive, rather than principles-based, is an indication that they are not just meant to inform shareholders but to make it easier to pressure companies to change their behavior:[191] Standardized disclosures facilitate comparisons and permit ranking of corporations – thereby enabling shaming campaigns against the worst performers.[192] Commentators take a similar view on the requirement to disclose Scope 3 emission. As one commentator remarked: "The disclosure regime effectively deputizes public companies to be climate enforcers: If their suppliers don't start measuring and reducing their emissions, the companies won't be able to do the required disclosure."[193]

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[187] Rose, supra note 108 (citing call by European parliament to "take account of the multidimensional nature of corporate social responsibility (CSR) ... as well as the need to provide consumers with easy access to information on the impact of businesses on society"); Christensen et al., supra note 128 ("The European Union (EU) is further along. Its Non-Financial Reporting Directive (NFRD 2014/95/EU) requires large companies and groups with more than 500 employees to provide "non-financial and diversity information" in the management report, starting in 2017. The NFRD adopts a double materiality perspective, stipulating that companies not only disclose how sustainability issues affect them, but also how their activities affect society and the environment.")

[188] European Commission, Corporate Sustainability Reporting, supra note 160 (emphasis added).

[189] See David A. Katz & Laura A. McIntosh, The SEC Takes Aim at the Public-Private Distinction, Harv. L. School Forum on Corp. Gov., Jan. 28, 2022, available at https://corpgov.law.harvard.edu/2022/01/28/the-sec-takes-aim-at-the-public-private-disclosure-gap/; see also Lipton, supra note 184 (arguing that generalized disclosure system designed for stakeholders is superior to shareholder-oriented system

[190] Paul Kiernan, SEC Pushes for More Transparency From Private Companies, Wall St. J., Jan. 10, 2022.

[191] Christensen et al., supra note 128 (a descriptive approach divorced from financial materiality "is likely to attract external pressures from various (and potentially unforeseen) parties and also requires that standard setters apply political and moral judgments about the underlying CSR activities").

[192] Mahoney & Mahoney, supra note 89; Lipton, supra note 184, at 513–17.
(discussing conditions for "shaming campaigns"); Christensen et al., supra note 128 (a descriptive approach divorced from financial materiality "is likely to attract external pressures from various (and potentially unforeseen) parties and also requires that standard setters apply political and moral judgments about the underlying CSR activities"); id. ("CSR standards could make it easier to benchmark firms' CSR performance over time and across firms. However, ranking firms produces winners and losers, as not all firms can be at the top.")

[193] Matt Levine, Securities and Environment Commission, Bloomberg Opinion: Money Stuff, Mar. 22, 2022.

Finally, the breakdown in the S.E.C. support for the proposal – with Democratic commissioners favoring it and Republican ones dissenting – indicates that there is a political element to the proposed rules.

On top of these rules are numerous requests for disclosure rulemaking that the S.E.C. has not heeded – at least not yet. In the 29 months between January 1, 2020 and May 30, 2022, requests on six topics with, in our assessment, a material social regulation component were submitted: business dealings with China (2022); business dealings with Russia and Belarus (2022); COVID mandated terminations (2021); Black Lives Matter pledge fulfillment (2021); equal opportunity practices (2021); and exposure of physical assets to climate change (2020). For comparison, in the five years from 2011 to 2015, there were only two such requests, both on the use of corporate resources for political purposes (2014) and (2011).[194] The steep rise in requests for social regulation is a further indication that the differential burden placed to public corporations through the disclosure regime is likely to keep rising.

Corporate governance welfarist regulation can succeed in changing public company behavior even if managers still try to run the company to maximize firm value because welfarist regulation can affect what actions are firm-value maximizing. For example, the proposed regulations imposing GHG disclosure requirements could expose companies to pressure from investors who have objectives other than firm-value maximization, to pressure from consumers who buy fewer company products and pressure from employees who are less willing to work for it. Still, such regulations could be "corporate governance welfarist" in several ways: they are imposed by the S.E.C., an agency charged with the protection of investors, and the mandate of which does not include supplying product information to consumer or work-related information to employees; they are imposed with the stated objective to enhancing investor protection or supplying information to investors that investors find significant for making investment decisions; and they are supported by at least a subgroup of investors that find the information at issue relevant to pursue a multi-firm focus or their non-financial interests.

III. Will the turn to Corporate Governance Welfarism Succeed?

As with any change, there are forces aligned against the turn to welfarism. In this Part, we first survey two counterforces that may hinder the turn to welfarism: the private company alternative and political opposition. We then address the arguments that welfarism is counter-productive because it will fail to induce meaningful change while sapping the energy for legislative reform or that, on the contrary, welfarism, though failing to have a substantial economic impact, will increase political support for change.

[194] Securities and Exchange Commission, Petitions for Rulemaking Submitted to the SEC, available at https://www.sec.gov/rules/petitions.htm.

A. The Private Company Alternative

A competitive private capital market poses the most significant barrier to welfarist corporate governance. To the extent that welfarism involves tradeoffs between individual firm value and outside benefits, it creates a market opportunity for investors in firms that focus on single firm value. Indeed, each of the four drivers of welfarism that we have discussed before – multi-firm focus, non-economic preferences of shareholders, stakeholderism, and welfarist regulation – affects public companies differently from private ones. As a result, private companies are largely insulated from a turn to welfarism and may even profit from a pursuit of welfarism by public companies. For these purposes, "private" companies include closely held U.S. corporations as well as other companies with a plausible single firm focus, such as foreign state-owned energy companies or public companies with an individual controlling shareholder.[195] The private company alternative means that a success of welfarism is, to some extent, self-limiting. The more public companies embrace welfarism, the more attractive it will become to invest instead in private companies that pursue firm-value maximization.

1. Private Companies' Single Firm Focus

In contrast to public companies, privately held companies are neither likely to be pressed to adopt a multi-firm focus nor to do so on their own accord. For one, many private companies are owned by individual investors who have a major portion of their wealth tied up in the enterprise and are much more concerned about maximizing company value than about externalities that would affect their other portfolio holdings.

To be sure, institutional investors also often hold significant stakes in privately held companies. But the institutions that hold stakes in privately held companies are typically of a different type than those that hold stakes in public companies. Specifically, institutional shareholders of privately held companies are often private equity funds and venture capital funds, but rarely mutual funds. Venture capital funds and private equity funds are much less diversified than mutual funds both overall and with regard to specific limited partnerships (in which they owe fiduciary duties to the investors in the particular fund). As a result, their incentives are much more closely aligned with the maximization of individual portfolio holdings and they are therefore unlikely to induce firms to adopt a broad multi-firm focus. And although private equity and venture capital funds may ultimately want to take their portfolio companies public, and at that point may want to make the company appealing to diversified institutional

[195] See Kahan & Rock, supra note 26.

investors, the percent of such companies that go public is declining[196] and the possibility of a future IPO will not directly affect their incentives as long as the company is still privately held.[197]

While the pursuit of a multi-firm focus may be rational from the perspective of highly diversified investors, it places public companies at a disadvantage relative to privately held companies that are insulated from such pressure. A characteristic of a firm pursuing a multi-firm focus is that the firm forgoes profitable opportunities that, if pursued, would impose negative externalities on other portfolio firms. This, in turn, generates profit opportunities for firms with a single firm focus. The more other firms pursue a multi-firm focus, the greater the opportunities for firms with a single firm focus.

Consider as a simple example an industry with five firms, each of which can chose a “high” or a “low” output level. Producing a “high” output maximizes firm value, regardless of the output level chosen by the other firms (assuming no collusion). By contrast, producing “low” output results in a higher aggregate value of all firms in the industry. Table 1 below presents illustrative values for “high” and “low” output firms, as well as industry value, depending on firms’ production choices. Assume, for example, that four firms produce “low” output. If one of the low output firms instead produced a high output, its value would rise from 80 to 120, while industry value would fall from 460 to 420. If instead the “high” output firm decided to reduce its output, its value would fall from 140 to 100, while industry value would rise from 460 to 500.

Table 1: Output, Firm Value and Industry Value

	0	1	2	3	4	5
Value of “high” output firm	60	80	100	120	140	N.A.
Value of “low” output firm	N.A.	20	40	60	80	100
Industry value	300	340	380	420	460	500

[196] See Michelle B. Lowry, The Blurring Lines between Private and Public Ownership (August 25, 2022). European Corporate Governance Institute – Finance Working Paper No. 844/2022, Available at SSRN: https://ssrn.com/abstract=4200794, at Figure 7 (showing that of VC companies that that have raised $100 million or more (in real 2020 dollars) in financing, percent that went public declined from 10 – 20% in the 1990s to less than 5% since 2010).

[197] The hope of taking a company public could affect investment by private equity and venture capital firms in industries, such as fossil fuel, but generate such high intra-portfolio externalities for diversified investors that diversified investors would not want to invest in any company in that industry.

In this example, assume that four firms are publicly owned. The fifth firm is privately held. If the publicly owned firms try to maximize firm value, all firms will produce a "high" output and have a value of 60 each. But if the four publicly-held firms try to maximize their joint value, under the rationale that doing so would increase the portfolio value of diversified investors in public companies, they would all produce a "low" output, giving them a total value of 320, while the privately held firm would produce a "high" output for a value of 140. As this example illustrates, the more (multi-firm focus) firms there are that produce a "low" output, the greater will be the value of (single-firm focus) firms that produce a "high" output. Accordingly, the greater will be also the incentive for new private firms to enter the industry or for existing public firms to go private.

Indeed, and peculiarly, even institutional investors with highly diversified portfolios may want to become "silent" investors in these "maverick" private firms. Thus, for example, public pensions funds who mostly hold highly diversified portfolios of publicly traded companies may want to invest a portion of their assets in private equity funds *even if their funds are invested in firms that generate negative intra-portfolio externalities that make the net returns on their investment negative*. Mutual funds and hedge funds also increasingly invest in private firms.[198] While the number of IPOs has declined, investment in private companies is booming and private companies are increasingly able to raise capital at levels previously available only to publicly traded firms.[199]

To see why, take a private equity fund that plans to make an investment that generates an attractive stand-alone return (say 1% above the market rate) but generates negative externalities for diversified holders to the tune of -1.5%. To be sure, diversified holders would be best off it if the fund did not make the investment at all. But, if the fund makes the investment regardless, diversified holders would prefer to participate in it, and at least benefit somewhat from the investment's higher returns. Thus, as long as a diversified holder believes that there are other sufficient investors – perhaps undiversified holders or perhaps other diversified holders afraid to get preempted – ready to invest in the private equity fund, it would make sense for that diversified holder to do so as well.[200] More generally, this is an example of the value of non-commonly owned firms in a world of high levels of common ownership.[201] Such firms will tend

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[198] See Lowry, supra note 196, Figures 3 and 4 (showing that percent capital provided by mutual funds, among VC rounds with mutual fund participation rose from slightly more than 20% during 1995 – 2006 to almost 40% during 2011 – 2016).

[199] Michael Ewens & John Farre-Mensa, The deregulation of the private equity markets and the decline in IPOs, 33 Rev. Fin. Stud. 5463, 5466 (2020).

[200] As investors in the fund, diversified holders would try to use their influence to stop the fund from funding projects that generate negative intra-portfolio externalities. But most funds are set up in a way to give their investors no say in how the portfolio companies held by these funds are run and private equity fund managers have strong incentives to maximize fund returns without regard to the portfolio interests of their investors.

[201] Edward Rock & Daniel Rubinfeld, Common Ownership and Coordinated Effects, 83 Antitrust L. J. 201, 247-50 (2020).

to be pro-competitive from an antitrust perspective and profitable from an investors' perspective.

Moreover, many shareholders will want companies to pursue a single-firm focus even if they want to hold a diversified portfolio. To be sure, a shareholder would want each firm in which she invests to take into account intra-portfolio externalities. But the benefits of diversification are not linear. At the margin, each additional investment generally reduces risk by less than each prior investment. Some studies suggest that holding stock in as little as 32 different companies can generate a well-diversified portfolio[202] – a far cry from the thousands of companies held by so-called universal owners or other highly diversified investors who would benefit the most from a multi-firm focus. The extent to which shareholders would want a firm to deviate from profit maximization depends substantially on whether a shareholder has a disproportionate ownership stake in that firm. Rather than investing in several thousand firms as universal owners or several hundred as many mutual funds do, shareholders could both hold a balanced portfolio and want firms to adopt largely a single firm focus by investing in several dozens of firms.

2. Private Companies and Stakeholderism

Similarly, "stakeholderism" plays out differently in the private company context. The board of private companies will often include individuals who have a significant direct ownership stake in the company. Even directors who do not themselves have economic stakes in the company are often appointed by shareholders who do. Boards of privately held companies thus have much stronger incentives to further the interests of shareholders than outside directors of publicly traded corporations. Managers of private corporations, as well, are more likely to either be major shareholders themselves or to be closely monitored by major shareholders. To that extent, their interest in shareholder value thus does not derive merely from the compensation structure – which is to some extent endogenous – but from the ownership structure. For these reasons, an erosion of the norm of shareholder primacy is likely to have much less effect on privately held corporations than on public traded ones.

While many corporate welfarists point to private companies that treat their employees and other stakeholders well as exemplars, the ownership structure of such companies makes it likely that those companies have found a link between treating stakeholders well and long-term corporate value. Indeed, while they are often held up as examples of how treating stakeholders well is consistent with promoting firm value, they are much more likely to be examples of "enlightened" shareholderism than any sort of welfarism.

3. Private Companies' Exemption from Welfarist Disclosure Requirements

[202] Lawrence Fisher & James H. Lorie, Some Studies of Variability of Returns on Investments in Common Stocks, 43 J. Bus. 99 (1970); Malika Mitra, Here's How Many Stocks You Should Have in Your Portfolio, Money, June 16, 2017, available at https://money.com/diversification-how-many-stocks/ (quoting finance professor for proposition that "between 20 and 25 stocks are needed for a diversified portfolio" and that "[a]nything above 25 will only offer marginal benefits.")

To the extent that many new disclosure requirements are or will be welfarist, the limits on the ability of the S.E.C and of regulators like NASDAQ to impose similar requirements on private companies provides another advantage to private capital markets. This advantage has two aspects: first, to the extent that such regulations are costly or push firms to sacrifice firm value to promote pro-social goals, private companies will be more profitable than public ones; second, the ability to avoid those costs may lead public firms to go private, thereby further strengthening private capital markets.

Climate disclosure provides a case in point.[203] An S.E.C mandate to disclose GHG emissions may, from the perspective of the investors in publicly traded corporations, be enough to determine how vulnerable their firm is to changes in regulation, such as the imposition of a carbon tax. But from a wider "social" perspective, the incomplete coverage of the climate disclosure rules is problematic because the largest carbon emitters are not all public companies. Indeed, the worst polluters are likely small, non-public oil and gas drilling companies. Moreover, in many cases, the small exploration and production companies have bought dirty assets from the large publicly traded companies. This reallocation is a "win-win proposition for the firms, if not for the public."[204] Put differently, the public-private divide in securities law constrains the S.E.C.'s ability to change conduct through disclosure mandates that do not increase firm value.

Indeed, the S.E.C seems to be acutely aware that the strength of private capital markets poses a threat to the new regulations that are being proposed for public companies. Increasingly, the S.E.C has argued that their rule-making authority should be expanded so that they can impose similar requirements on private companies and thereby "level the playing field" and promote "transparency." Allison Lee, as Acting Chair of the S.E.C, raised these issues in an important speech.[205] She noted the incredible growth of private capital markets, the ability of very large companies to remain private, and the resulting lack of transparency:

> These private businesses are not just big, but also consequential, making significant positive contributions to innovation. They shift paradigms, create jobs, stimulate the need for new services and supply chains. They've even changed the infrastructure of the nation's labor force, ushering in the so-called "gig" worker. In other words, they have a dramatic and lasting impact on our economy, at the local, state, and even national level.

[203] George Georgiev, The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms, 18 NYU J. Law & Bus. 221, 284-85 (2021).
[204] Id. at 285.
[205] Allison Lee, Going Dark: The Growth of Private Markets and the Impact on Investors and the Economy (Oct. 12, 2021) available at https://www.sec.gov/news/speech/lee-sec-speaks-2021-10-12; Georgiev, supra note 203 at 297. Current chair Gary Gensler has signaled many of the same concerns. See, e.g., Thomas Franck, Gensler says S.E.C. weighing new rules, greater disclosure from private equity funds, CNBC, available at https://www.cnbc.com/2022/01/10/gensler-says-sec-weighs-new-rules-more-disclosure-from-private-capital-funds.html ("Gensler, who spoke on CNBC's 'Squawk Box,' said he wants to ensure large private companies and private equity firms are disclosing enough information.").

But investors, policymakers, and the public know relatively little about them compared to their public counterparts.[206]

Could the S.E.C extend the reach of its new regulations to private companies? Commissioner Lee proposed revisiting the interpretation of Section 12(g) of the Securities Exchange Act that imposes the mandatory reporting obligations on any company with "assets exceeding $10,000,000 and a class of equity security . . . held of record by either (i) 2,000 persons, or (ii) 500 persons who are not accredited investors."[207] Because hardly anyone holds shares in record name, even the largest of the "unicorns" currently do not fall under the S.E.C.'s jurisdiction.

The attraction of revising Section 12(g) is that the S.E.C. could do so without any additional congressional authorization. The difficulty is that any change would be both over- and under-inclusive. It would also substantially increase the regulatory costs for any firm caught by the expanded definition, which would have to comply not just with welfarist regulations but with the whole slew of other rules applicable to public companies. As a result, firms would have strong incentives to limit ownership to very large investors and/or buy out smaller investors to reduce the number of their beneficial owners to below 2,000.[208]

Beyond revising its interpretation of Section 12(g), the S.E.C would likely need legislative authorization in order to impose additional disclosure obligations on private companies, and passing such legislation may be difficult. Any such attempts would immediately pose the questions whether the broader regulatory authority is justified under an investor protection rationale or a social rationale. To the extent that the rationale is "social" – as in the climate disclosure example discussed above – a question would be raised why mandates should be imposed as part of "securities regulation" rather than as a law of general application. So long as the S.E.C can present changes in disclosure regulation as necessary for investor protection, it can claim traditional authority. But when it becomes too obvious that the goal goes beyond investor protection, its claims to authority quickly decline. As Commissioner Hester Peirce pointed out in her statement dissenting from the climate disclosure proposal, "We are Not the Securities and Environment Commission - At Least Not Yet."[209]

4. Private Companies are Better Equipped to Address Shareholders' Non-Economic Preferences

Finally, private companies are better equipped to address non-economic preferences of their shareholders than public companies are. In general, if all shareholders hold identical non-

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[206] Lee, supra note 205 (footnotes omitted).
[207] 15 U.S.C. Section 781(g).
[208] Employee-shareholders are excluded from the definition of "shareholders of record" by the JOBS Act. Georgiev at n. 77. § 12(g)(1)(A), 15 U.S.C. § 781(g)(1)(A)(2012).
[209] Peirce, supra note 182.

economic preferences, no one will challenge a corporate decision to pursue objectives that reduce corporate financial value.[210]

The issue, however, is more complex when shareholders disagree – as shareholders of public corporations are bound to do. When shareholders disagree, many shareholders will be dissatisfied with the degree to which a corporation takes into account their personal non-financial interests and the diverging interests of other shareholders. Further complicating this picture, shareholders not only have non-financial interests on multiple dimensions,[211] but their non-financial interests may conflict. Thus, recently, oil producers were pressured both to increase drilling, even if unprofitable, to do "'whatever it takes' to increase supply and tame oil prices that have soared following Vladimir Putin's invasion of Ukraine" and to reduce drilling, even if profitable, to reduce emissions.[212] As a result, taking into account shareholders' non-economic preferences can not only significantly increase decision costs in public corporations,[213] but will also leave some of shareholders of public corporations worse off.

To the extent that public companies accommodate the non-economic preferences of some shareholder segments and pursue policies that fail to maximize corporate value, investing in companies that try to maximize financial returns becomes relatively more attractive for purely returns-driven investors. And if public companies ignore the non-economic preferences of some investors, these investors may find it more desirable to invest in non-public companies that commit to take those preferences into account.

This problem would be ameliorated if shareholders could sort.[214] In publicly traded companies, such sorting is unlikely to take place. For one, the shareholder base in such companies

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[210] eBay Domestic Holdings v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010) ("If Jim and Craig were the only stockholders affected by their decisions, then there would be no one to object."); See Fama & French, supra note 98; Friedman & Heinle, supra note 97.

[211] See, e.g., Stavros Gadinis & Amelia Miazad, Corporate Law & Social Risk, 73 Vand. L. Rev. 1401, 1414–15 (2020) (noting that ESG includes issues related to privacy, climate change, diversity, workplace relationships, including gender equality and diversity, technology problems like privacy and cybersecurity, and humane work conditions).

[212] Matt Levine, ESG, Bloomberg Opinion: Money Stuff, Mar. 9, 2022.; see also Alicia McElhaney, West Virginia Treasury Drops BlackRock Over Stance on Climate Risk, Institutional Investor (Jan. 18, 2022) (West Virginia's Board of Treasury Investments divested $8 billion from BlackRock funds, arguing that its "'net zero' investment strategies that would harm the coal, oil, and natural gas industries"); Matt Levine, Opposite ESG, Bloomberg Opinion: Money Stuff, Sep. 21, 2022 (reporting on Inspire, an investment company that "views supporting LGBTQ rights, covering travel for reproductive health, stem cell research and in vitro fertilization as big negatives.")

[213] Bengt Holmstrom, Session III: Corporate Purpose and the Theory of the Firm, 33 J. Applied Corporate Finance 60, 62-63 (Spring 2021).

[214] Daniel Loeb's suggestion that Shell break up into a "clean" and a "dirty" Shell was presumably designed to permit such sorting. See Matt Levine, Dan Loeb Wants a Clean Shell and a Dirty Shell, Bloomberg, Oct.. 28, 2021, available at https://www.bloomberg.com/opinion/articles/2021-10-28/dan-loeb-wants-a-clean-shell-and-a-dirty-shell?cmpid=BBD032422_MONEYSTUFF&utm_medium=email&utm_source=newsletter&utm_term=220324&utm_campaign=moneystuff. Sorting would ameliorate the problem if shareholders cared particularly if a company in which they invest acts in accordance with their non-economic preferences. If shareholders are purely result oriented in these preferences, sorting may not lead to any improvements for shareholders with non-economic preferences.

is just too large and too fluid to make sorting practicable. Moreover, a growing percentage of shares are held by index funds, and index-based investing inhibits sorting.[215]

By contrast, sorting is much easier for non-public companies that have fewer investors and can be set up more easily to insulate their policies from the potentially shifting preferences of their ultimate owners. For example, these companies could be held by private equity funds marketed to certain investor segments. Non-public companies can thus more easily commit to pursue either policies designed to maximize financial returns or policies designed to maximize some blend of financial returns and specific non-economic preferences. Such sorting not only results in investor preferences and company policies being more closely matched. It also simplifies the task for managers of ascertaining what these non-economic preferences are and what weight to accord to them and avoids potentially costly battles among different investor groups and management over which policies a company should pursue.

More generally, the more heterogeneous investor preferences are, the more investors can benefit from sorting into companies with like-minded investors, and the more attractive it becomes to invest in non-public companies with a smaller and more stable investor base. The move from relatively homogeneous preferences for financial returns to more, and diverse, non-economic preferences thus presents another challenge to public corporations that does not apply with equal force to private ones.

B. Lack of Political Support

The animating concern for welfarism is that the political system has proven unable to deal with the problems facing society in an effective way. But the problem with that argument is that welfarism, in particular direct social welfarism, potentially lacks democratic legitimacy. Thus, as Milton Friedman argued in his classic attack on "corporate social responsibility," a manager who sacrifices firm value in order to increase social welfare by, e.g., reducing pollution below the legal permitted level or hiring long-term unemployed instead of better qualified available workers to reduce poverty, "would be spending someone else's money for a general social interest."[216] According to Friedman, this is illegitimate in two ways. First, it does not follow any of the procedures that taxation in a democratic society must pass through. Second, the manager lacks democratic credentials to make such important decisions. While portfolio and shareholder

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Sorting, however, could benefit shareholders with only financial preferences if companies with mixed groups of shareholders try to some extent to accommodate the non-economic preferences of some shareholders.

[215] Thus, while BlackRock divested from coal company stocks in its active portfolios, it retained them in its index portfolios. See Barzuza at al., supra note 88. Index-based investing is consistent with sorting if the index itself is constructing, say, of firms engaging is CRS activities. But most assets are invested in funds that follow broad-based indexes like the &P 500.

[216] Milton Friedman, A Friedman doctrine-- The Social Responsibility Of Business Is to Increase Its Profits, New York Times, Sep. 13, 1970.

welfarists may retort that the money is spent to benefit shareholders, direct social welfarism has no easy way out.

In a recent article, Professor Ron Gilson makes a similar but more general argument:

> Putting distributive decisions in the hands of public company boards of directors who, however diverse their social or political views, are still made up predominately of aging white males seems an odd, and hardly progressive, group to whom to delegate the making of social policy. As of 2019, males held 73% of the board seats of S&P 500 companies, and 81% of the seats of Russell 3000 companies. Eighty percent of S&P 500 directors were white. The average board age of an S&P 500 board director in 2019 was 63.5 years.[217]

The lack of democratic legitimacy generates a political vulnerability for direct social welfarism. Anticipating the arguments in favor of welfarism, Friedman noted that many supporters of corporate social responsibility believe that "the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems." But, as he points out, this reasoning amounts to an acknowledgement that "those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures."

Phil Gramm, formerly a long serving senator from Texas (and, before that, a professor of economics at Texas A & M) has repeatedly made this point as he has attacked large asset managers who push portfolio companies to take ESG into account. Thus, for example, he noted that:

> Arguments for imposing political and social objectives on business often are little more than rationalizations for forcing businesses to abide by values that have been rejected in Congress and the courts. Activists increasingly attempt to disguise their values with the cloak of fiduciary responsibility.[218]

Moreover, he goes on,

> Since funds are voting their investors' shares and not their own, they may be inclined to vote in a way that prioritizes their public image and fundraising above the performance of the company on which they're voting. When BlackRock, Vanguard or State Street supports political resolutions, are they acting in the interest of their investors or themselves?

[217] Ronald Gilson, Corporate Governance versus Real Governance, 34 J. Applied Corporate Finance 8, 11 (footnotes omitted) (Spring 2022).
[218] Phil Gramm & Mike Solon, Keep Politics out of the Boardroom, July 19, 2018 Wall St. J. at A17.

This is an interesting pivot around one of the core drivers behind the push for corporate governance welfarism, namely "political dysfunction." While supporters of welfarism point to the government's inability to adopt essential environmental regulations like a carbon tax as evidence of political dysfunction, opponents like Phil Gramm view that failure as the outcome of a functioning democratic process and accuses activists and funds of furthering their personal ideological or PR goals at investors' expense. Rather than helping to internalize externalities, critics view some forms of welfarism as "woke capitalism" and "as a way for sanctimonious CEOs to smuggle in progressive ideas that many dislike."[219]

The lack of political support for governmental action that, for the supporters of welfarism, creates the need for companies to step in may accordingly also make it harder for welfarism to succeed. This is most evident with regard to direct social welfarism. The proposals by Senators Sanders and Warren to give board representation to employees were not enacted, the human capital management disclosure rules sought by activists were watered down by a Republican-majority S.E.C, and the proposed rules on climate disclosure were opposed by the two Republican S.E.C commissioners and, if adopted, have to withstand the inevitable appeal to the D.C. Circuit.

But even other forms of welfarism can be subject to political interference. Thus, a recent op-ed in the Wall Street Journal argued that Big Three investment advisors be broken up because they engaged in a coordinated pursuit of ESG objectives in violation of the antitrust laws.[220] In a letter to Larry Fink, nineteen Republican state attorneys general accused BlackRock of sacrificing pensioners' retirements for BlackRock climate agenda.[221] Florida's State Board of Administration prohibited the state's pension fund from considering social, political, and ideological interests in making investment decisions[222] and the state pulled $2 billion from BlackRock due to its focus on ESG.[223] Republican Senators sent a letter warning that firms that support ESG goals could face investigations for engaging in ESG collusion and participating in climate cartels.[224] And in the last

[219] Special Report ESG Investing, The Economist, Jul. 23, 2022, at 4.

[220] See Dan Morenoff, Break Up the ESG Investing Giants, Wall. St. J., Aug 31, 2022.

[221] Press Release, AG Pax-ton Demands Black-Rock Account for its Under-per-form-ing, Potentially Illegal 'ESG' State Pension Fund Investments, Aug. 8, 2022, available at https://www.texasattorneygeneral.gov/news/releases/ag-paxton-demands-blackrock-account-its-underperforming-potentially-illegal-esg-state-pension-fund

[222] Andrew Ross Sorkin, DealBook, N.Y. Times, August 24, 2022

[223] Danielle Moran & Saijel Kishan, Florida Will Pull $2 Billion of Assets From BlackRock Over ESGBloomberg, Dec. 1, 2022, available at https://www.bloomberg.com/news/articles/2022-12-01/florida-will-pull-2-billion-of-assets-from-blackrock-over-esg?cmpid=BBD120122_MONEYSTUFF&utm_medium=email&utm_source=newsletter&utm_term=221201&utm_campaign=moneystuff#xj4y7vzkg

[224] Letter from Senators to Kennth Markowitz, Nov. 3, 2022, available at https://www.grassley.senate.gov/imo/media/doc/cotton_grassley_et_altolawfirmsesgcollusion.pdf; https://www.bloomberg.com/news/articles/2022-11-11/wall-street-hit-by-mad-reality-as-legal-risk-of-co2-pact-grows?cmpid=BBD111422_MONEYSTUFF&utm_medium=email&utm_source=newsletter&utm_term=221114&utm_campaign=moneystuff&leadSource=uverify%20wall; see also Saijel Kishan & Jeff Green, Onetime Trump Appointee Helps Spark Sweeping ESG Backlash, Bloomberg Law, Nov. 21, 2022 (detailing Republican anti-ESG efforts).

year of the Trump administration, the Department of Labor proposed a rule to prohibit ERISA fiduciaries from taking ESG factors into account unless they are meant to increase returns.

Then again, under the Biden administration, the Department of Labor adopted a rule clarifying that ERISA fiduciaries may consider the economic impacts of climate-related risks and other environmental, social and governance factors in assessing the risk and return of investments and that they may take participants non-economic preferences into account in constructing investment options in defined contribution plans.[225] The comptroller for New York City warned BlackRock that it would be reassessing its business ties with the company due to BlackRock's "backtracking on its climate commitments."[226] And in 2021, Maine passed a law requiring its pension fund to divest from the 200 largest publicly traded fossil fuel companies.[227] Finally, Democratic state Attorneys General responded with their own letter arguing that fund managers' use of ESG factors are relevant to evaluating the risk and reward of a potential investment and attacking efforts to chill the use of these factors where relevant to "value."[228]

Consistent with political paralysis, there is neither a consistent political majority in favor of the welfarist goals nor one opposed to it. Rather, different branches of the political system hold different views on the various issues, with the views shifting depending on who controls the respective branch. The same political deadlock that makes it difficult to adopt effective boundary constraints may also make it harder to impose political barriers to welfarism. These political dynamics may slow the emergence of welfarism down and force it to proceed in fits and starts, with two steps forward when the government is under Democratic control and one step back when it is under Republican control.

C. Welfarism as dangerous placebo or valuable catalyst?

Friedman's attacks on corporate governance welfarism assume that corporate social commitments are actually meaningful. A different attack on welfarism comes from the opposite direction, namely, that welfarism will be ineffective and that its pursuit diverts attention from the hard work of enacting legislation to address serious environmental and social problems.

As noted above, one powerful contemporary argument for managerialism is that, unless boards are empowered to seriously consider the interests of stakeholders (and do so), intrusive—

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[225] Federal Register, Prudence and Loyalty in Selecting Plan Investments and Exercising Shareholder Rights, at https://www.federalregister.gov/documents/2022/12/01/2022-25783/prudence-and-loyalty-in-selecting-plan-investments-and-exercising-shareholder-rights

[226] Letter from Brad Lander to Laurence Fink, Sep. 21, 2022, available at https://comptroller.nyc.gov/wp-content/uploads/2022/09/Letter-to-BlackRock-CEO-Larry-Fink.pdf

[227] Andrew Ross Sorkin, DealBook, N.Y. Times, August 24, 2022

[228] November 21, 2022 letter from 17 Attorneys General to Senators Sherrod Brown, Patrick Toomey, Maxine Waters and Patrick McHenry, available at https://oag.dc.gov/sites/default/files/2022-11/ESG%20Letter_Final_11.18.22.pdf.

and undesirable – regulation will be unavoidable. But, while these managerialists view the regulatory alternative as something to be avoided as damaging to firms, what if some set of regulations – e.g., a climate tax – are socially beneficial or even essential? Does the reverse of the managerialist argument apply: should boards *not* be encouraged to seriously consider the effect on climate precisely in order to increase the likelihood of enacting, say, a carbon tax?

A version of this argument is made by Tariq Fancy, formerly BlackRock's head of sustainable investing.[229] In his widely read "The Secret Diary of a 'Sustainable' Investor," Fancy maintains that the push towards sustainable investing is not only ineffective in mitigating climate change but affirmatively harmful in draining support for the painful but necessary regulatory changes demanded by climate change. Sustainable investing, on his view, has become a dangerous distraction.

Even worse than a distraction, Fancy argues, shareholder driven corporate climate initiatives may actually lead people to conclude that business rather than government will lead the way in building a more sustainable economy.[230] After leaving BlackRock, Fancy concluded that "we weren't just selling the public a wheatgrass placebo as a solution to the onset of cancer. Worse, our lofty and misleading marketing messages were also delaying the patient from undergoing chemotherapy."

This argument has some experimental support. A set of experiments, published in the 2019 volume of *Nature Climate Change* (a sub-journal of *Nature*) showed that introducing a green energy default nudge – such as defaulting residential consumers into a renewable energy plan – diminished support for a carbon tax. The authors conclude that the perceived existence of a low-cost solution (a nudge) "decrease[s] support for substantive policies by providing false hope that problems can be tackled without imposing considerable costs."[231] Even closer to home, another experiment published in the American Political Science Review indicated that broad industry participation in voluntary environmental programs, in which firms go beyond the requirements of current environmental law, had a substantial impact on the support by voters, activists, as well as government officials for more draconian government regulations.[232] Importantly, support by

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[229] Tariq Tancy, The Secret Diary of a 'Sustainable Investor' — Part 1, Aug. 21, 2021, available at https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139; see also Bebchuk & Tallarita, supra note 136, at 171-173; Special Report ESG Investing, supra note 219, at 4 ("The most salient criticism is that by promoting a second-best solution such as ESG, the private sector may be giving policymakers an excuse to avoid imposing what many see as the best way to respond to climate change: coordinated carbon taxes.")
[230] Id. at 27.
[231] David Hagmann, Emily H. Ho & George Loewenstein, Nudging out support for a carbon tax, Nat. Clim. Chang. 9, 484–489 (2019). Troublingly, this seems to be a general phenomenon across ESG policy issues: a retirement savings nudge reduces support for expanding the social security tax to the same degree that a green energy nudge reduces support for a carbon tax. Id.
[232] Neil Malhotra, Benoît Monin & Michael Tomz, Does Private Regulation Preempt Public Regulation?, Am. Pol. Science Rev. (Nov. 12, 2018).

voters and governmental officials declined substantially even if the voluntary program involved only modest steps beyond compliance with existing regulations.

On this view, welfarism, by providing a facially plausible (but ineffective) way to address climate change, lets everyone off the hook too easily, furthers the myth that the private sector can address all significant challenges, and damages the political efforts to enact an effective response.

But there is also the opposite argument. While largely failing to induce companies to incorporate interests outside the maximization of firm value into their objective function, welfarism could nevertheless increase political support for effective governmental interventions. If this occurred, it could ameliorate the dysfunction that prevents the political system from addressing the underlying social problems.

Welfarism could have such a political impact in two ways. First, it heightens both the awareness of the social problems and the failure of the political system to address them effectively. This argument is basically the flip side of argument that welfarism is a dangerous placebo. Rather than fooling people into believing that companies can solve problems like climate change, welfarism highlights the fact that the political system has not been able to solve these problems and helps rally the population in support of not just welfarist corporate actions but also effective governmental policies.

Second, if welfarism succeeds in changing corporate behavior at least to some extent, or even if it merely makes management believe that their companies ultimately will have to change their behavior, it could affect the political economy of direct governmental intervention. Consider, for example, a public company that, due to pressure from shareholders and other stakeholders, announced that it will reduce its carbon emissions.[233] This company may now be at a competitive disadvantage with a private company that is not subject to similar pressures.

Under normal circumstances, the company could be expected to oppose, say, climate regulation requiring companies to reduce their carbon emissions. Regulation increases compliance costs and makes the company's business less profitable. But for a public company that will reduce its carbon emissions anyway because of welfarist pressures, the situation has changed in two ways. First, the costs of complying with regulations mandating reduced emissions is lower, as the company is already planning to be in partial or full compliance with the regulation. Second, the regulation would impose higher costs on private company competitors that have taken no steps to reduce their carbon emissions, thereby improving the company's competitive position.[234] Rather than lobbying against climate regulation, the company may therefore stay neutral or even lobby in favor of such regulation.

[233] See Kahan & Rock, supra note 26.

[234] Steven C. Salop & David T. Scheffman, Raising Rivals' Costs, 73 Am. Econ. Rev. 267 (1983).

Conclusion

Corporate governance may be on the verge of entering a new stage. After the managerialism that dominated the view of the corporation into the 1970s and the shareholderism that supplanted it, we may be witnessing the emergence of a new paradigm: corporate governance welfarism. Welfarism comes in three versions: portfolio welfarism, shareholder welfarism, and direct social welfarism. All three depart from shareholderism in embracing goals that are much broader than shareholder value as a means to promote overall welfare. They depart from managerialism in looking beyond the single firm and in relying on shareholder and stakeholder pressure to induce companies to internalize otherwise legal externalities rather than on managerial discretion to balance the interests of shareholders and other stakeholders.

Indicators that welfarism is on the rise include the growing power of highly diversified institutional investors with a multi-firm focus; the increased importance that shareholders accord to non-economic interests; the embrace of stakeholderism by top executives, major shareholders, and important politicians at least at the rhetorical level; and the rise of disclosure regulations that serve social goals in addition to investor protection. While there are barriers to the rise of welfarism – the private company alternative may make welfarism self-limiting and political opposition may mean that the move to welfarism proceeds in fits and starts, rather than linearly – there are good reasons to believe that these trends will take hold, grow, and, over time, generate a welfarist turn in corporate governance.

Will such a welfarist turn deliver on the promise of enhancing overall welfare by inducing corporations to take the lead when our elected representatives fail? We are too impressed with the power of capital markets to predict that welfarism will succeed economically, but we are more optimistic than those who would argue that welfarism is a dangerous placebo that diverts energy from pursuing more effective political change. Rather, we see the promise of welfarism as playing out in the political realm by potentially changing the political economy of social regulation and thereby facilitating needed regulatory change. While welfarism looks to the corporate sector to make up for the regulation of externalities that political dysfunction blocks, it may, somewhat ironically, ultimately have a greater impact on improving our politics than on changing private enterprise.

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