The New Corporate Governance

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Abstract

In the last few years, there has been a dramatic increase in shareholder engagement on environmental and social issues. In some cases shareholders are pushing companies to take actions that may reduce market value. It is hard to understand this behavior using the dominant corporate governance paradigm based on shareholder value maximization. We explain how jurisprudence has sustained this criterion in spite of its economic weaknesses. To overcome these weaknesses we propose the criterion of shareholder welfare maximization and argue that it can better explain observed behavior. Finally, we outline how shareholder welfare maximization can be implemented in practice.

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In the last few years, there has been a dramatic increase in shareholder engagement on environmental and social issues. In some cases shareholders are pushing companies to take actions that may reduce market value. It is hard to understand this behavior using the dominant corporate governance paradigm based on shareholder value maximization. We explain how jurisprudence has sustained this criterion in spite of its economic weaknesses. To overcome these weaknesses we propose the criterion of shareholder welfare maximization and argue that it can better explain observed behavior. Finally, we outline how shareholder welfare maximization can be implemented in practice.

[*] Harvard University and University of Chicago, respectively. We are grateful to Lucian Bebchuk, Ronald Gilson, Bernard Sharfman, Robert Sitkoff, Holger Spamann, David H. Webber, and participants at the University of Chicago Business Law Review Symposium for helpful discussions and feedback. We thank Jack Li for excellent research assistance. Oliver Hart gratefully acknowledges financial support from the Harvard-Radcliffe Institute. Luigi Zingales gratefully acknowledges financial support from the Stigler Center at the University of Chicago.

I. INTRODUCTION

In the last few years, there has been a dramatic increase in shareholder engagement on environmental and social issues. Consider the following activity in 2021. Eighty-one percent of DuPont shareholders approved a proposal requiring the company to disclose how much plastic the company releases into the environment each year and to assess the effectiveness of DuPont's pollution policies.[1] Sixty-four percent of ExxonMobil shareholders approved a proposal requiring the company to describe "if, and how, ExxonMobil's lobbying activities (direct and through trade associations) align with the goal of limiting average global warming to well below 2 degrees Celsius (the Paris Climate Agreement's goal)."[2] Fifty-two percent of Duke Energy shareholders approved a proposal that requests disclosures on contributions to candidates, parties, committees, and 501(c)(4) organizations.[3] Ninety-five percent of Wendy's shareholders approved a proposal requiring the company "to disclose concrete evidence on the effectiveness of its Supplier Code of Conduct in protecting the human rights of workers at its produce and meat suppliers, with respect to COVID-19 in particular."[4]

It is hard to explain this behavior using the dominant corporate governance paradigm in economics, finance, and law. According to the traditional view, shareholders have a single objective: shareholder value maximization (SVM). There is no scope for any other goals, including social ones. But in each of the above examples, shareholders seem to be pushing companies to do things that might reduce value (most of which are opposed by management). Many scholars have criticized the SVM paradigm, arguing that managers should act in the interest of other stakeholders — workers, consumers, the community — or that companies should have a social purpose over and above making money.[5] These criticisms are normative. But a further powerful criticism is a positive one: the paradigm cannot explain what shareholders are actually pressuring companies to do.

1 Kevin Crowley, *DuPont Loses Plastic Pollution Vote With Record 81% Rebellion*, BLOOMBERG (May 3, 2021), https://perma.cc/4HCR-2M5N.

2 ExxonMobil Co., Amended Current Report (Form 8-K/A) (May 26, 2021).

3 Andrew Ramonas & Lydia Beyoud, *Activist Shareholders Score Wins on Election Spending After Riot*, BLOOMBERG L. (July 14, 2021), https://perma.cc/L9LM-WDNA.

4 The Wendy's Co., Current Report (Form 8-K) (May 19, 2021).

5 *See, e.g.*, COLIN MAYER, PROSPERITY: BETTER BUSINESS MAKES THE GREATER GOOD (2018); ALEX EDMANS, GROW THE PIE: HOW GREAT COMPANIES DELIVER BOTH PURPOSE AND PROFIT (2020). *But see* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 105 CORNELL L. REV. 91 (2020).

Corporations are larger, more complex, and more powerful than they were in the 1970s and early 1980s when the traditional paradigm became established. In a more populous and interdependent world, the importance of externalities has also greatly increased, and many feel that governments are not dealing with them. The preferences of investors have changed too.[6] Investors, especially younger ones, are more sensitive to environmental and social issues. As a result, we think that the paradigm needs to change. This is true even if one accepts, as we do, the idea of shareholder primacy, that is, that companies should act on behalf of shareholders.[7] When externalities are important and at least some investors are prosocial, we argue that shareholders will want companies to pursue *shareholder welfare maximization* (SWM) not SVM.

The purpose of this paper is two-fold. First, we reexamine the case for SVM, highlight the weaknesses of the case, and discuss why in spite of these weaknesses SVM has survived as a dominant paradigm. Second, we go into more detail about the meaning of SWM and how it can be implemented.

The paper is structured as follows. We start, in Section II, by reviewing the traditional case for SVM in a "perfect" world. We then turn in Section III to the weaknesses of the case when imperfections, including particularly externalities, are introduced. In Section IV, we discuss how and why SVM became an established norm in spite of its limitations. In Section V, we suggest that SWM better represents the preferences of shareholders, explaining both how it should be interpreted and how it can be implemented. We argue that versions of SWM are actually being developed and used, as we write. Section VI concludes.

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6 For more on this, see Michal Barzuza et al., *The Millennial Corporation: Strong Stakeholders, Weak Managers* (Apr. 12, 2022) (unpublished manuscript), https://perma.cc/T22U-D7NN.

7 The argument for this is standard. Shareholders, as residual income claimants, are the most vulnerable of the constituencies with which a company deals, and so they are allocated votes, and courts have determined that managers have a fiduciary duty to act in their interest. Whereas other groups—consumers, workers, creditors—are protected, at least partially, by contracts and/or have reasonable exit options (consumers or workers can quit), shareholders have weak if any contractual protection and can exit only by selling shares at the market price, which may be low if the company is not being run in their interest. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395 (1983); Eugene Fama, *Contract Costs and Financing Decisions*, 63 J. BUS. S71 (1990); HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE (1996). In some cases other stakeholder groups are not well protected by contracts and company founders may choose to allocate votes to these groups. *See* HANSMANN, *supra*. However, in most companies votes are allocated to the residual income claimants, that is, the founders choose shareholder primacy.

II. THE CASE FOR SVM

We begin by reviewing the basic argument for SVM. Consider a perfectly competitive economy where no agent has an effect on prices. Suppose that there are no externalities and a complete set of (contingent commodity) markets. Each consumer maximizes utility subject to her budget constraint. An increase in the value of one firm increases the wealth of that firm's shareholders without affecting anybody else's wealth or prices. Thus the shareholders are better off—their budget constraints move outwards and they can spend their increased wealth on desirable goods and services—and nobody else is worse off (prices have not changed). It follows that shareholders unanimously favor SVM (even if they care about other people).[8]

A similar logic applies if we think in terms of contracts rather than markets. Suppose that a firm has contracts with customers, workers, suppliers, creditors, etc., that perfectly insulate these groups from any change in the firm's production decision. Then a change in production that increases shareholder value makes the firm's shareholders better off (the pie is bigger) and nobody worse off. Again, such a change is unanimously favored by the firm's shareholders.

It is worth teasing out a further implication. Under the assumptions just described, shareholder value represents *precisely* a firm's contribution to society, in the sense that if it disappeared the shareholders would be worse off by this amount and nobody else would be affected (this is the no-surplus condition[9]).

III. PROBLEMS WITH THE CASE FOR SVM

In reality, competition is not perfect; markets are not complete; and externalities are important. Without giving too much away, we will argue that the issues raised by imperfect competition and incompleteness put a minor dent in the SVM edifice, based on shareholder unanimity, while the issues raised by externalities (and social considerations) bring the whole construction down.

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8 Under these conditions it is also the case that SVM leads to a socially (Pareto) efficient outcome. This is the first theorem of welfare economics. *See, e.g.*, GÉRARD DEBREU, THE THEORY OF VALUE: AN AXIOMATIC ANALYSIS OF ECONOMIC EQUILIBRIUM (1959).

9 *See* Louis Makowski & Joseph M. Ostroy, *Perfect Competition and the Creativity of the Market*, 39 J. ECON. LITERATURE 479 (2001).

A. Imperfect Competition

Suppose that a firm has monopoly power in the goods market (and cannot perfectly price discriminate). Some of the firm's shareholders may purchase and enjoy "consumer surplus" from its product. If their consumption is large enough they may prefer the firm to increase output and lower price even if this reduces profit.[10] Or suppose that the firm has monopsony power in the labor market. Some of the firm's shareholders may be workers who would prefer the firm to employ more workers, thereby raising the wage, even if this is not profit-maximizing. Under these conditions, shareholder unanimity will not generally obtain.[11]

B. Incomplete Markets

When markets are incomplete, a firm's profit is a random variable. Someone who holds shares may then enjoy a "consumption" benefit, to the extent that this random variable has risk-return characteristics that are not already available in the marketplace.[12] As a result, some owners may favor a production plan that provides a particular investment opportunity even if this does not maximize the firm's market value. However, Hart shows that this consumption effect (of a single firm) becomes negligible in a large economy.[13] The reason is that, if one investor enjoys a significant consumption benefit, so will many other similar investors, and competition by them will bid up the share price to the point where the benefit disappears. The consequence is that owners will continue to favor market value maximization.[14]

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10 *See, e.g.*, Joseph Farrell, *Owner-Consumers and Efficiency*, 19 ECON. LETTERS 303 (1985).

11 Of course, under imperfect competition, there is also no reason to think that SVM will lead to a socially efficient outcome.

12 *See, e.g.*, Jacques H. Drèze, *Investment Under Private Ownership: Optimality, Equilibrium and Stability*, *in* ALLOCATION UNDER UNCERTAINTY: EQUILIBRIUM AND OPTIMALITY 129 – 66 (Jacques H. Drèze ed., 1974).

13 Oliver Hart, *On Shareholder Unanimity in Large Stock Market Economies*, 47 ECONOMETRICA 1057 (1979).

14 Even though shareholders may favor SVM, SVM will typically not lead to a (constrained) Pareto optimal outcome in a multi-good/multi-period incomplete markets economy since firms' production decisions affect relative prices, which in turn can affect the degree of market incompleteness. *See, e.g.*, Oliver Hart, *On the Optimality of Equilibrium When the Market Structure Is Incomplete*, 11 J. ECON. THEORY 418 (1975); John D. Geanakoplos & Heraklis M. Polemarchakis, *Existence, Regularity, and Constrained Suboptimality of Competitive Allocations When the Asset Market Is Incomplete*, in UNCERTAINTY, INFORMATION, AND COMMUNICATION: ESSAYS IN HONOR OF KENNETH J. ARROW, VOLUME III (Walter P. Heller et al. eds., 1986).

C. Common Ownership

These days many shareholders hold diversified portfolios, often through indexed funds. Such shareholders will want the total value of their portfolio maximized rather than the value of a single firm. This may lead shareholders to push for firms to be less competitive and at an extreme engage in monopoly pricing since this increases total profit in an industry.[15] Common ownership does not necessarily destroy the unanimity result but does suggest that shareholders may favor something other than SVM.

D. Externalities and Social Considerations

The deviations from the unanimity result described in Sections III.A and III.B seem "second-order." As evidence, we are not aware of cases where shareholders have pushed firms to reduce prices because the shareholders consume the product, or to choose a production plan with risk-return characteristics that are not already available in the market. There is one important exception. Workers whose pension plans consist of shares have in recent years pushed companies to treat workers better, and this trend may grow.[16]

Concerning Section III.C, the common ownership monopolization effect is hotly debated, and the jury is still out about its empirical significance.[17]

In this section we turn to a set of considerations and departures that we believe are of first-order importance. They are also

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[15] This was pointed out some years ago by Julio J. Rotemberg, *Financial Transactions Costs and Industrial Performance* (Alfred P. Sloan Sch. of Mgmt., Working Paper No. 1554 – 84, 1984), and Roger Gordon, *Do Publicly Traded Corporations Act in the Public Interest?*, ADVANCES ECON. ANALYSIS & POL'Y, June 12, 2003, at 1. It was emphasized recently by José Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018).

[16] For an example of how labor union pension funds use their votes to pursue worker interests, see Ashwini Agrawal, *Corporate Governance Objectives of Labor Union Shareholders: Evidence from Proxy Voting*, 25 REV. FIN. STUD. 187 (2012).

[17] Azar et al., *supra* note 15, find that prices of domestic airline tickets are 3% to 7% higher than they would have been if airlines had no common shareholders. José Azar et al., *Ultimate Ownership and Bank Competition*, 51 FIN. MGMT. 227 (2022), document comparable results in the U.S. banking industry. The first paper has been challenged by Patrick J. Dennis et al., *Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry*, J. FIN. (forthcoming 2022), who document that the positive correlation between common ownership and ticket prices is driven by variation in airline market shares rather than variation in institutional ownership. The second paper has been challenged by Jacob Gramlich & Serafin Grundl, *Estimating the Competitive Effects of Common Ownership* (Bd. of Governors of the Fed. Rsrv. Sys., Finance and Economics Discussion Series Working Paper No. 2017-029, 2017), who document that the effects of common ownership on prices and quantities of deposits are fairly small.

ones that seem to underly the large and rapidly increasing shareholder activity that has occurred in recent years. They involve externalities and, in most cases, the idea that individuals care about others as well as themselves, that is, they are socially responsible.

Externalities do not alter the logic of Section II that shareholders will favor SVM as long as the government has implemented an optimal tax policy. Suppose firms cause environmental harm, e.g., pollution, but that a firm must compensate each affected person by the (marginal) damage incurred. Then the previous arguments go through. An increase in market value net of the tax makes shareholders better off and no one worse off, since everybody is compensated for the harm they experience.

But what happens if the government has not regulated optimally, a particular concern when an externality is global, as with climate change, and coordination by many governments is required for optimal mitigation?[18]

A dominant view over the last fifty years has been that even this does not disturb the SVM prescription. One might call this the Friedman separation theorem.[19] To understand the argument, suppose that, in the absence of an optimal tax policy, the Sierra Club is doing valuable work to preserve the environment. Assume that the shareholders of a firm care about the environment either because environmental harm affects them directly or because they are socially responsible and care about the harm to others. Might the shareholders want their firm to reduce dividend payments and make a charitable contribution to the Sierra Club? The answer, at least according to Friedman, is no. The same outcome—a contribution to the Sierra Club—can be achieved if the firm pays out the higher dividend and each shareholder makes their *own* contribution to the Sierra Club. Given that individual shareholders can do anything the firm can do, it still makes sense for the firm to maximize profit, and for individual shareholders to engage in public welfare activities themselves (we revisit this argument in Section V).

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18 Even if the government does not regulate externalities optimally, an efficient class action system that allows all parties negatively affected by an externality to be compensated appropriately could achieve the same result. In practice, however, class actions are very expensive and cannot easily be organized across legal jurisdictions. In addition, informational asymmetries and limited liability make this system ineffective. *See* Roy Shapira & Luigi Zingales, *Is Pollution Value-Maximizing? The Dupont Case* (Nat'l Bureau of Econ. Rsch., Working Paper No. 23866, 2017), https://perma.cc/6MS5-2R4F.

19 Milton Friedman, *A Friedman Doctrine: The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (Sept. 13, 1970), https://perma.cc/TU2U-FJUE.

Unfortunately, the Friedman separation theorem is not general. Charitable contributions are a very special case. Charitable contributions are separable from a firm's other activities and a firm has no comparative advantage in making them relative to individuals.[20] But in many cases a firm's damage-inducing (or benefit-generating) activities are inseparable from its production activities, and under these conditions the separation theorem no longer holds.[21]

The following examples, two of which have already been mentioned in the introduction, help to illustrate the point.

> (i) DuPont generates large quantities of plastic waste. Reducing the waste would improve the environment but reduce profit.
>
> (ii) Costco uses antibiotics in raising chickens. This is profitable but is a major cause of the development of antibiotic resistance, a problem that costs human lives and billions of dollars in healthcare costs.[22]
>
> (iii) Danco Laboratories LLC is the US distributor of the abortifacent drug Mifeprex (an abortion pill), better known as RU-486A.[23] Danco is privately held, but one can imagine some shareholders, who are anti-abortion, wanting Danco to scale back its activities even though this would reduce profit.
>
> (iv) Duke Energy, like many companies, makes contributions or expenditures on behalf of political candidates and parties. Disclosing these contributions could be good for American democracy but might reduce share value.[24]

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[20] Sometimes even charitable contributions are not easily separable from the business activities of a corporation. Consider for instance impact investment funds run by asset managers who are very knowledgeable about the areas in which gifts are made.

[21] Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L., FIN., & ACCT. 247 (2017).

[22] *Stop Using Antibiotics in Healthy Animals to Prevent the Spread of Antibiotic Resistance*, WORLD HEALTH ORG. (Nov. 7, 2017), https://perma.cc/F76Z-ZZPN.

[23] Sharon Bernstein, *Persistence Brought Abortion Pill to U.S.*, L.A. TIMES (Nov. 5, 2000), https://perma.cc/629W-MKRX.

[24] *See* Saumya Prabhat & David M. Primo, *Risky Business: Do Disclosure and Shareholder Approval of Corporate Political Contributions Affect Firm Performance?*, 21 BUS. & POL. 205 (2019); Christopher Poliquin & Young Hou, *The Value of Corporate Political Donations: Evidence from the Capitol Riot* (Jan. 11, 2022) (unpublished manuscript), https://perma.cc/3CZ3-CH3G.

The first thing to notice about these examples is that separability does not hold: shareholders cannot easily replicate (or undo) the firm's decision. It would be very costly for individual shareholders to clean up the plastic waste produced by DuPont, and it is unclear how they can offset Costco's antibiotic usage, Duke Energy's political contributions, or Danco's distribution of RU-486A. In principle, a coalition of shareholders or other citizens could negotiate a desirable outcome with one of the firms, e.g., a coalition could bribe DuPont to choose a technology that reduces plastic waste. But assembling such a coalition runs into serious free-rider problems: each person would prefer others to be in the coalition. In contrast, if Dupont itself chooses a less-polluting technology, all shareholders are forced to pay their pro-rata share of the cost and the free-rider problem is eliminated.[25]

Second, in these examples, there is no reason to suppose that SVM is unanimously favored by shareholders. In (i), some shareholders may favor a less-polluting technology because plastic waste affects them directly or because they care about the effect of the waste on others; other shareholders may not be personally affected or may care less about the welfare of others, and so would like to stick to the current technology. In (ii), some shareholders may want to reduce the use of antibiotics because of the public health threat to them or others or because antimicrobial resistance reduces the profits of other companies in their portfolio;[26] others, being less concerned by the personal threat, putting less weight on others, and not having a diversified portfolio, may support the current strategy. In (iii), some shareholders may not care about the abortion issue, or may favor greater access to abortion, and will therefore support the wide distribution of RU-486A; others may be anti-abortion and regard the distribution of the pill as a sin. In (iv), some shareholders may care a lot about the threat to American democracy, while others may be more concerned about financial return.

There is also no reason to think that SVM achieves a socially efficient outcome among the group of shareholders as a whole (or for society). If the disutility environmentally-sensitive

[25] For more on this, see Eleonora Broccardo et al., *Exit vs. Voice*, J. POL. ECON. (forthcoming 2022).

[26] The idea that the shareholders of one firm may be concerned about the impact of that firm's externalities on the profitability of other firms the shareholders own is at the center of the growing literature on universal ownership. *See, e.g.*, Jeffrey N. Gordon, *Systematic Stewardship*, J. CORP. L. (forthcoming 2022); Ellen Quigley, *Universal Ownership in the Anthropocene* (Feb. 20, 2020) (unpublished manuscript), https://perma.cc/K43K-4UAC.

shareholders experience from Dupont's plastic waste exceeds the profit the waste generates, SVM leads to the production of the plastic waste even though it would be efficient for the shareholders as a group to eliminate the waste.[27]

It is very important to note that there is *no* neutral outcome in these examples. Friedman and others have suggested that a deviation from profit or value maximization imposes a tax on (some) shareholders.[28] For instance, in (i), if socially responsible shareholders persuade management to reduce the plastic waste this imposes a tax on those who favor profit maximization. This may be true but it is equally true that, if less socially responsible shareholders persuade management not to reduce the waste, this imposes a tax on the socially responsible shareholders.

It is also worth noting that deviations from profit maximization are neither "left-wing" nor "right-wing". In (i), (ii) and (iv), the deviation may be regarded as left-wing, while in (iii) it may be thought of as right-wing. In the same way, profit maximization is neither right-wing nor left-wing. In (i), (ii) and (iv), it may be thought of as right-wing, while in (iii) it may be regarded as left-wing. Profit maximization is amoral, not immoral.

Our conclusion is this. To the extent that examples like these are widespread, and we believe that they are, there is nothing special about SVM: there is no reason to think that it will be unanimously favored or will deliver the right outcome among a firm's shareholders as a whole. What to put in its place? We believe that companies should pursue shareholder *welfare* maximization (SWM) not SVM, and that a shareholder vote on issues like those in examples (i)-(iv) is one way to implement this.[29] We consider this further in Section V. But first we turn to why SVM, in spite of its defects, has become the norm.

IV. Why Did Shareholder Value Maximization Become the Norm?

Consider a firm whose stock is 100% owned by an individual. Even if the firm is set up as a corporation with a board of directors, the firm will pursue the goal the only shareholder would want it to pursue. This goal is not necessarily the maximization of shareholder value or profit. In fact, Scott Morton and Podolny show that privately-held wine producers maximize the utility of

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27 And Coasian bargaining is unlikely to resolve the issue given free-rider problems.

28 *See, e.g.*, Friedman, *supra* note 19.

29 *See* Hart & Zingales, *supra* note 21; Broccardo et al., *supra* note 25.

their major shareholders, not profits.[30] Similarly, Shive and Forester show that privately-held companies curb pollution more than publicly traded ones, consistent with the idea that they are maximizing a different objective function.[31]

When the number of shareholders is more than one, however, there are two layers of agency problems that make it difficult for shareholders to get managers to maximize their welfare. The first agency problem is between managers and shareholders. Corporate law delegates the business of running the corporation to directors. Directors have a fiduciary duty toward shareholders, but they also have enormous discretion provided by the business judgment rule. This discretion makes it easy for directors to pursue their own objectives. In contrast, there are two reasons why shareholders cannot force managers to pursue their own agenda. First, until very recently the SEC's "ordinary business" exception made it easy for the board to exclude from the proxy ballot any resolution that requires managers to run the business in a particular way. Second, even if such a resolution were put on the ballot and received majority approval, it would not be binding. A large individual shareholder can easily force management to pursue her own agenda by threatening to replace the board. It is much harder for dispersed shareholders to do this.

Today most dispersed shareholders own their shares through intermediaries such as BlackRock, Fidelity, and Vanguard. This is where the second agency problem comes in. Both the ERISA law regulating private pensions and standard practice have contributed to enshrining the idea that asset managers must support only shareholder resolutions that increase the long-run financial return of their clients.

Start with ERISA. To prevent abuses, the 1974 ERISA Law required that a fiduciary should discharge his duties "for the exclusive purpose of: (i) providing benefits to participants and their beneficiaries."[32] The law did not specify whether these benefits can also be non-pecuniary. Yet, in 2014 the Supreme Court stated that, "[r]ead in the context of ERISA as a whole, the term 'benefits' in the provision just quoted must be understood to refer to the sort of *financial* benefits (such as retirement income) that

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30 Fiona M. Scott Morton & Joel M. Podolny, *Love or Money? The Effects of Owner Motivation in the California Wine Industry*, 50 J. INDUS. ECON. 431 (2002).

31 Sophie A. Shive & Margaret M. Forster, *Corporate Governance and Pollution Externalities of Public and Private Firms*, 33 REV. FIN. STUD. 1296 (2020).

32 Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1104(a)(1)(A).

trustees who manage investments typically seek to secure for the trust's beneficiaries."[33]

The ERISA Law applies to the pension managers of 401k plans, e.g., Harvard University, not to the fund managers themselves. Nevertheless, there is an indirect effect on fund managers. The fear of potential liability makes 401k plan managers reluctant to include in the investment options available to plan participants a fund that explicitly states that it will pursue goals other than financial ones. Thus, any fund manager who wants to achieve economies of scale would have little incentive to offer a fund with a broader purpose since this runs the risk of being excluded from 401k plans.

In marketing themselves to investors, mutual funds face some of the same concerns ERISA law tried to address: how to commit credibly not to waste the investors' money. Given the lack of awareness of any possible interaction between a business purpose and a "philanthropic" one, mutual funds found it natural to commit themselves to the "long-term economic interests" of their clients, as the promotional material of BlackRock states.[34] BlackRock is not alone. We looked at the governance guidelines adopted by all the top 5 mutual fund families. Vanguard promises "to serve as a voice for our investors and to promote long-term value creation at the companies in which our funds invest."[35] State Street declares that it will "promote the long-term economic value of client investments."[36] JPMorgan asserts that its guidelines have been developed "with the objective of encouraging corporate action that enhances shareholder value."[37] It is only Fidelity that states that the corporate board must focus "on protecting the interests of shareholders" (without any qualification that the interest must be only economic).[38] When money has been raised

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33 Fifth Third Bancorp v. Dudenhoeffer, 573 U.S. 409, 420–21 (2014). Some legal scholars argue that SWM can be partially accommodated under current ERISA law. *See, e.g.,* David H. Webber, *The Use And Abuse Of Labor's Capital*, 89 N.Y.U. L. REV. 2106 (2014). For example, the Eleventh Circuit blessed a pension plan that offered below-market rate home loans to plan participants. Brock v. Walton, 794 F.2d 586 (11th Cir. 1986).

34 *BlackRock Investment Stewardship*, BLACKROCK, https://perma.cc/UZ86-65DQ (last visited Apr. 22, 2022).

35 VANGUARD, GLOBAL INVESTMENT STEWARDSHIP PRINCIPLES (Nov. 2021), https://perma.cc/UZ4L-3PVK.

36 STATE ST. GLOB. ADVISORS, PROXY VOTING AND ENGAGEMENT GUIDELINES (Mar. 2022), https://perma.cc/MN77-D8DS.

37 J. P. MORGAN, GLOBAL PROXY VOTING GUIDELINES (Apr. 2022), https://perma.cc/6HAX-YH4M.

38 *Stewardship Principles and Proxy Voting*, FIDELITY, https://perma.cc/U2E4-RLS9 (last visited Apr. 22, 2022).

under these premises, it is very difficult for an institutional investor to change course.

Besides the law and any existing contracts, a major role in enforcing SVM is played by business norms. Directors are routinely confronted with complex business decisions. Unless they are purely self-interested, they need some principle to guide them. Decades of academic thinking, both in the law and in finance, have enshrined the idea that the fiduciary duty owed to shareholders means the pursuit of shareholder value maximization. In other words, SVM has become the business norm.

As an example of how legal rules about SVM have affected practice even outside the realm of their strict applicability, consider what Larry Fink, the CEO of BlackRock, declared in 2016:

> We live in a world where the Department of Labor gave us this guidance about what is our fiduciary responsibility as investors. We only have one responsibility as investors: to maximize return. That's it. So basically we can tell a company to fire five thousand employees tomorrow, and if that maximizes return for the company we did something well. We can tell that company to do something that maybe is bad for the environment. There is nothing right now that guides, other than a maximization of return behavior."[39]

V. SHAREHOLDER WELFARE MAXIMIZATION

In this section we describe the objective of shareholder welfare maximization (SWM), and discuss how it can be implemented.

A. The Meaning of SWM

To explore SWM, we follow Hart and Zingales and Broccardo et al. in the way we model socially responsible shareholders.[40] We suppose that, when making a decision, a shareholder puts weight $\lambda \epsilon [0,1]$ on the welfare of others affected by the decision, where λ reflects her degree of social responsibility. Different shareholders may have different λ's, with some perhaps having λ=0 (they are purely self-interested).

To see the implications of this, consider the Costco example of Section III, where the issue is whether to stop the use of

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[39] *Unusual Debate at Davos: Lobbying, Maximizing Shareholder Value and the Duty of CEO's*, PROMARKET (April 1, 2016), https://perma.cc/2HEV-3QGW.

[40] Hart & Zingales, *supra* note 21; Broccardo et al., *supra* note 25.

antibiotics in raising chickens in order to reduce the risk of antibiotic resistance in the human population. For expositional purposes start with a very simple scenario. Suppose that Costco has three shareholders, each of whom owns a third of the company, with social responsibility parameters λ_1, λ_2, λ_3, respectively. Assume that the additional cost of not using antibiotics is 120 and the monetary benefit attached to the reduced risk in humans is 180. Now imagine that these shareholders have the opportunity to vote on whether Costco should stop using antibiotics. Each shareholder votes her preference, with the majority determining the outcome. Then, according to our formulation shareholder i (i=1,2,3) votes to stop if

$$-40+\lambda_i(180-80)>0, \tag{5.1}$$

where the first term represents the capital loss the shareholder experiences herself if the extra cost of 120 is incurred, and the second term represents the impact on others—the environmental gain minus the capital loss incurred by her fellow shareholders—multiplied by her social responsibility parameter λ_i. We can rewrite (5.1) as

$$\lambda_i>2/5. \tag{5.2}$$

Thus, if at least two of the shareholders have λ's above 2/5, the outcome of the vote will be to stop antibiotics, while if at least two of the shareholders have λ's below 2/5 the outcome will be to maintain the status quo.

In principle, shareholder welfare maximization can mean more than just majority rule. A natural approach is to follow Kaldor[41] and Hicks[42] and ask whether the winners could bribe the losers to support stopping antibiotic use. Suppose that shareholder *i* receives a monetary transfer t_i. Then (5.1) is replaced by

$$-40+ t_i + \lambda_i(180-80)>0. \tag{5.3}$$

Given that the t_i's sum to zero, it is easy to see that (5.3) can be satisfied for all shareholders if and only if

$$\lambda_1+\lambda_2+\lambda_3>6/5, \tag{5.4}$$

[41] Nicholas Kaldor, *Welfare Propositions of Economics and Inter-Personal Comparisons of Utility*, 49 ECON. J. 549 (1939).

[42] J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939).

which is just the sum of (5.2).

For future reference, it is useful to generalize the analysis. Suppose Costco has n shareholders, where shareholder i has a shareholding s_i. Let δ be the cost of dropping antibiotics and h be the value of the reduced risk to humans. Then, absent transfers, shareholder i will vote to stop if

$$-s_i\delta + \lambda_i(h-(1-s_i)\delta) > 0, \tag{5.5}$$

where, as before, the first term represents the capital loss the shareholder experiences herself, and the second term represents the impact on others. (5.5) can be rewritten as

$$-s_i\delta(1-\lambda_i) + \lambda_i(h-\delta) > 0. \tag{5.6}$$

Since the first term is negative, (5.6) can only be satisfied if $(h-\delta) > 0$, i.e. shareholders will only vote for something that is socially efficient.

In this general formulation the Kaldor-Hicks criterion becomes

$$\textstyle\sum_{i=1}^{n}[-s_i\delta + \lambda_i(h-(1-s_i)\delta)] > 0, \tag{5.7}$$

which, by the same logic, can only be satisfied if $h > \delta$.

Returning to the numerical example, it is interesting to observe what happens to voting decisions when the number of shareholders increases. Suppose that there are 100 shareholders, each of whom owns 1%. Then (5.1) becomes

$$-1.2 + \lambda_i(180-118.8)) > 0, \tag{5.8}$$

since each shareholder's personal capital loss is now only 1.2. As there are more and more shareholders, with each holding a smaller fraction of Costco—a situation that describes the world of diversified investors that we see today—the first term converges to zero and eventually all shareholders with a positive λ_i will vote to stop the antibiotics.[43] In other words a vote will lead to a socially efficient outcome as long as a majority of shareholders are socially responsible and have a small holding in the company.

43 More generally, it follows from the results of Broccardo et al., *supra* note 25, that, as shareholdings converge to zero, each shareholder with a positive λ_i will vote to stop the antibiotics if and only if $h > \delta$, that is, doing so is socially efficient.

The Costco situation may be one where, possibly with the help of management, fairly reliable estimates of the cost δ and the benefit h can be presented to shareholders. In other cases there may be more disagreement about the facts, and in politicized contexts disagreements about what should enter h. For example, in the case of Mifeprex, pro-choice shareholders might assign a very high positive value to h, the benefit of making the pill widely available, whereas anti-abortion shareholders may think that h is large and negative. Under these conditions, voting may not lead to a shareholder welfare maximizing outcome in the Kaldor-Hicks sense. Yet achieving the Kaldor-Hicks outcome would require shareholders to report truthfully their λ_i's and their views about h, something that they may not be willing to do. Whether incentive compatible mechanisms can be devised to elicit preferences is an interesting topic for future research. In the meantime, voting may be a reasonable second-best alternative, and we will focus on this in what follows.[44]

B. Which Topics/Decisions?

One concern with SWM is that the set of controversies corporations may be pushed to be involved in potentially explodes. Should corporations fight for animal rights, voting rights, gun rights, diversity, etc.?

As the discussion and examples in Section III make clear, SWM diverges from SVM when a company has a comparative advantage in achieving a social goal. Thus it seems reasonable to limit shareholder engagement on social issues to such cases. Here we provide the beginnings of a taxonomy concerning when comparative advantage is likely to exist and when it is not.

A natural case of comparative advantage occurs when a company controls a unique technology of production that cannot easily be reversed. We already described examples of this in Section III: a company that produces plastic waste as a by-product of e-commerce, or a company that uses antibiotics in raising chickens. As another, in 1984 DuPont faced a choice between polluting the Ohio river with a toxic substance known as PFOA and investing

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[44] For a different justification of the desirability of voting, see Adi Libson, *Taking Shareholders' Social Preferences Seriously: Confronting a New Agency Problem*, 9 U.C. IRVINE L. REV. 699 (2019). Libson argues that social decisions should be delegated to shareholders given that managers' human capital is nondiversified and as a result managers will not be inclined to promote social initiatives.

in incineration. Dupont decided not to incinerate, an action that shareholders could not easily undo.[45]

A second case of comparative advantage occurs when a company has some market power. Along the lines of the Danco example in Section III, consider a producer of a day-after abortion pill. Unless the market for these pills is perfectly competitive, a change in supply can have an effect on the price of the pill and thus on the number of people using it. It would be difficult, for free-rider reasons, to assemble a group to offset what the firm is doing by buying back pills in the marketplace (if the group wants to reduce abortions) or by subsidizing them (if the group wants to increase access to abortion). In this sense, the producer has a comparative advantage in determining supply and influencing the price.

As another example in this category, consider a pharmaceutical company that produces a scarce vaccine. Profit maximation might lead to a very high price for the vaccine, but socially responsible shareholders may prefer that the company make the vaccine widely available at a lower price.

A third case of comparative advantage involves political pressure. In 2015 Indianapolis-based Angie's List announced it was canceling a $40 million headquarters expansion in protest against the passage of the Religious Freedom Restoration Act (RFRA), which opponents claim was targeted against LGBT people.[46] The protest led to an amendment of the RFRA that provided protections for LGBT customers, employees, and tenants. Individuals do not have the same power. Unless they can perfectly coordinate their actions, the threat of many small firms is not as powerful as the threat of a firm employing many people. Note that a large business can often exercise this threat at no cost since they get what they want and they do not have to move, something that a collection of small firms would find it very hard to achieve.

As a final example, let us return to corporate charitable donations. As noted in Section III, this is often regarded as a slam-dunk case for Friedman's argument that companies should leave social matters to shareholders. In fact, the conclusion is not so obvious. Under classical economic assumptions, when an individual gives to charity—a contribution that, say, will save the life of a starving child—the individual trades off the marginal cost of giving against the marginal benefit she receives from saving the

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45 *See* Shapira & Zingales supra note 18.

46 Tim Evans, *Angie's List Canceling Eastside Expansion Over RFRA*, INDYSTAR (Mar. 28, 2015, 11:47 AM ET), https://perma.cc/RBH2-8EBG.

child, ignoring the marginal benefit others receive from there being one less starving child. But this leads to the undersupply of charity from a social perspective. In contrast, if a majority of shareholders vote for a company to give to charity, all shareholders are forced to make contributions. This amplification effect can push charitable contributions closer to the social optimum.

However, there is a countervailing force. Consider the founder(s) of the company at the IPO stage. Rather than setting up the company in such a way that it can make future charitable contributions, the founder can create two companies: one that does business but is prohibited from giving to charity and the other that is a charitable foundation. The charitable foundation would be funded by some fraction of the extra amount that investors are willing to pay for the shares of the first company given that there will be no outflows to charity (the fraction depends on how prosocial the founder herself is; if she is selfish she will pocket all of the extra amount). Under reasonable assumptions, one can show that the two-company alternative is at least as good as and sometimes strictly better than the one-company alternative for the founder. For this reason, preventing shareholders from voting on purely charitable activities can be justified.

While we have provided examples where a shareholder vote seems legitimate, we do not want to suggest that our views are sacrosanct. A company should be free to limit by charter which social issues are allowed on (or which ones are excluded from) the proxy ballot. Also, firms with political power or large market power are relatively rare. Thus, the vast majority of issues that would need to be voted on pertain to situations where there is a technological interaction between the prosocial and business activities of a corporation. We will discuss further possible restrictions in Section V.D.

C. Voting in Practice

Most investors own stock via a financial intermediary, generally a mutual fund. Currently, these institutions vote on behalf of their investors, almost universally taking the view that they have a fiduciary duty to vote for the value-maximizing outcome. But shareholders can become more involved in the voting process, and that seems to be happening.

At least three approaches are possible. The first one is to push down the voting decision to the level of individual investors. This is a strategy that BlackRock is trying to implement now with its major investors. Thus, if the New York State Common

Retirement Fund invests in BlackRock S&P500 ETF, it will have the right to vote pro-rata the shares it indirectly owns in all the S&P500 companies.

This strategy might work well for major pension funds and endowments, but it is unreasonable for individual shareholders. We cannot expect shareholders to express an opinion on all ballots of all the companies they own. This was hard to imagine in a world where investors owned just a few stocks. It is inconceivable today when most investors buy indexed mutual funds, which own hundreds if not thousands of stocks. Proxy ballot advisors employ an army of analysts to provide guidelines on how mutual funds should cast their votes in corporate ballots. It would be enormously inefficient to expect every single investor to duplicate that effort.

Fortunately, there is a solution. Today many institutional investors buy proxy advising services customized to specific needs. For example, Institutional Shareholder Services (ISS) has six sets of "specialty" proxy voting guidelines—each geared toward a specific special interest group: Taft-Hartley Advisory Services, Public Fund, Socially Responsible Investment (SRI), Catholic Faith-Based, Sustainability, Climate. Each set of guidelines is 70-80 pages long and describes in excruciating detail how the vote would be cast in different contingencies. In this sense, it is a much more detailed version of a party electoral platform. Thus, it would be relatively simple for each investor to choose one type of guideline and ask that her shares be voted accordingly. The main objection to this approach is that it limits investors' choice to the pre-determined specialty policies available in the market. Yet, in the long run, if proxy advisors are paid on the basis of the number of clients who choose to follow their advice, competition is likely to lead to a broad range of "political platforms."

The second strategy would be for mutual funds to elicit investors' preferences and then cast their votes based on an aggregation of these preferences. As we have noted, this may be challenging since shareholders may not report their preferences truthfully. While it may be possible to develop incentive-compatible mechanisms to deal with this, a shortcut would be for mutual funds to ask their investors how they would vote and then aggregate these votes.

The third strategy is for mutual funds companies to offer investors funds with a very clear and predetermined voting strategy and let investors choose among them. For example, Vanguard could offer an S&P500 light green fund, ready to vote in favor of all shareholder resolutions that promote a greener economy, as long as their cost of reducing CO_2 emission does not exceed $100 per ton. Vanguard could also offer an S&P500 dark green fund that votes in favor of all shareholder resolutions that promote a greener economy, as long as their cost of reducing CO_2 emission does not exceed $200 per ton.

Voting strategies become more complex when one moves beyond simple Yes/No decisions. Consider Costco's use of antibiotics. Perhaps the issue is whether to eliminate them; moderate their use; or do nothing. We know from Arrow that preference aggregation runs into difficulties when there are more than two alternatives,[47] but political elections take place in spite of Arrow's result. Certainly, the current electoral system can be improved and many scholars have proposed valid alternatives, like ranked-choice voting, or methods to select the Condorcet winner.[48] These methods could also be applied in the corporate context.

D. Opening the Floodgates

One possible objection to SWM is that it would open the floodgates to thousands of shareholder resolutions that will dominate shareholder meetings and distract management from creating value. Before we address this concern it is important to review where we stand today. Tallarita analyzes all shareholder proposals on social and environmental issues for the period from 2010 to 2019 at companies included in the S&P 500 index.[49] He finds 2,410 proposals.[50] Thus, on average S&P500 companies receive less than half a proposal a year. 19% of the proposals are successfully excluded by the company, and so the average company in the S&P500 will have to vote on a shareholder proposal every three years.[51]

The distribution of proposals per company is not uniform. During the sample period, Exxon received on average 7.5 proposals a year, while companies in the bottom quartile of the distribution of proposals receive less than one proposal in 10 years.[52] Companies outside the S&P500 index are likely to receive fewer

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47 *See generally* KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (Yale Univ. Press, 3d ed. 2012).

48 *See, e.g.*, Eric Maskin, *Arrow's Theorem, May's Axioms, and Borda's Rule* (Mar. 2021) (unpublished manuscript), https://perma.cc/GZV4-LBR8.

49 Roberto Tallarita, *Stockholder Politics*, 73 HASTINGS L.J. (forthcoming 2022).

50 *Id.*

51 *Id.*

52 *Id.*

proposals than the bottom quartile of the S&P500 index.[53] Thus, for the vast majority of companies shareholder propositions are not an issue. Consistent with Section V.A, the issue is concentrated in a few companies that have disproportionate political or market power.

Filters for shareholder resolutions can also be employed. Currently, there are three. The first is the amount of stock required to file a proposal. Under Rule 14a–8 any shareholder who held at least $25,000 worth of the company's stock continuously for at least one year before the date the proposal is submitted (or $2,000 for three years) can file a proposal. If shareholder activism leads to too many proposals this requirement could be strengthened.

The second filter is that companies can request from the SEC a no-action letter if they exclude the proposal from the ballot. In Tallarita's sample, management tried to exclude the proposal from the proxy statement in 39% of the cases and it succeeded approximately half the time (49.6%).[54] Thus, the SEC does represent an important filter. The question is what it is filtering on. In the past the principle has been that a proposal that involves "ordinary business" matters is inappropriate. Thus, a proposal advanced at Walmart to reconsider the sale of automatic weapons was blocked because it concerned the ordinary business decision: what to sell.[55] As we have seen, the most relevant proposals are precisely those that pertain to the business of a company and thus they risk being filtered out. But the SEC could adopt a different rule: allow only proposals that pertain to a company's comparative advantage.[56]

The third filter is represented by the fact that all these proposals are precatory. Thus, there is no legal obligation for companies to follow them.[57] In fact, one can think about these ballots as a way to elicit shareholders' preferences, leaving to management the final decision about what to do given those preferences. Our view is that it would be better to make shareholder resolutions

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53 *Id.*

54 *Id.*

55 Clare O'Connor, *Walmart Beats Out Church in Court Fight over Gun Sales*, FORBES (Apr. 15, 2015, 1:35 PM EDT), https://perma.cc/F4YU-PCMF.

56 On November 3, 2021, the SEC issued Staff Legal Bulletin No. 14L, providing a more nuanced interpretation of the ordinary business exception, which is likely to result in the exclusion of fewer shareholder proposals. We are grateful to Jill Fisch for alerting us to this change.

57 As we stated above, shareholders could threaten to replace directors who do not implement their precatory proposals. Yet, this is much more easily done by large institutional investors than by individual investors.

binding since this would make it easier for shareholders to get managers to do what they want. However, if the main reason to oppose the SWM approach is the fear of making corporations ungovernable, having a transitory period where proposals remain precatory may make sense.

In sum, we believe that there are sufficient mechanisms available to prevent a dangerous floodgate of shareholder proposals in the future.

VI. CONCLUSIONS

Corporations are larger, more complex, and more powerful than they were in 1970. In a more populous world, the importance of externalities has also greatly increased. Finally, the preferences of investors have changed. Investors, especially younger ones, are more sensitive to social issues. In spite of all these changes, the view on the proper objective of a business enterprise does not seem to have adapted.

In this paper, we have suggested that it should. We have argued that, when externalities are important and investors are at least somewhat prosocial, shareholder welfare maximization not value maximization is an appropriate goal. The standard defenses of SVM are untenable. SWM is what shareholders want and it is implementable. We outline several ways to achieve this. Interestingly, some of these are being adopted as we write. This is an area where practice is ahead of theory. In this paper, we have tried to fill the gap.

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