Shareholder Primacy versus Shareholder Accountability

Law Working Paper N° 716/2023
June 2023

William W. Bratton
University of Pennsylvania and ECGI

ECGI Working Paper Series in Law

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Abstract

When corporations inflict injuries in the course of business, shareholders wielding ESG principles can, and now sometimes do, intervene to correct the matter. In the emerging fact pattern, corporate social accountability comes out of its historic collectivized frame to become an internal subject matter—a corporate governance topic. As a result, shareholder accountability emerges as a policy question for the first time. The Big Three index fund managers, BlackRock, Vanguard, and State Street, responded to the accountability question with a run of ESG activism. In so doing, they defected against corporate legal theory's central tenet, shareholder primacy. Shareholder primacy builds on a pair of norms. The first is substantive and concerns purpose--the firm should be managed for the shareholders' financial benefit. The second norm is procedural and concerns power--the shareholders should have the power to tell managers how to run the firm. The two norms, once put into operation, are supposed to assure that market control over production, and hence economic efficiency, is maximized. Prior to the Big Three's turn to ESG activism the two norms operated in tandem--power on the ground assured shareholder value maximization in the boardroom toward the generally accepted efficiency goal. But power on the ground now also triggers questions about shareholder accountability and the Big Three, upon switching into activist mode to address those questions, put the two norms out of synch, causing the directive of management for the shareholders' financial benefit to lose focus and compromising shareholder primacy in the performance of its mission. This Article looks closely at this confrontation between shareholder primacy and shareholder accountability, asking three questions: (1) whether investment institutions can legitimately sacrifice their investors' financial returns in connection with the installation of socially responsible business practices at operating companies; (2) whether, assuming ESG concerns take a permanent place at the top of the corporate governance agenda, shareholder primacy can continue to provide a viable cornerstone for corporate legal theory; and (3) whether recent institutional interventions in the name of ESG herald a structural shift toward a welfarist corporation. The Article answers all three questions in the negative. The sequence of questions and answers delivers us at an unsatisfactory destination riven by contradiction and tension.

Keywords: Corporate governance, corporate accountability, social welfare, shareholders, institutional investors, activism, ESG, Big Three, Corporation law, corporate purpose, economic, social & governance, financial welfare

JEL Classifications: D63, G23, G30, I39

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A Joint Research Center of the Law School, the Wharton School,
and the Department of Economics in the School of Arts and Sciences
at the University of Pennsylvania

RESEARCH PAPER NO. 23-19

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UNIVERSITY OF PENNSYLVANIA CAREY LAW SCHOOL

Draft—April 21, 2023

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INTRODUCTION

Shareholders are unaccountable. That's the deal. Their insulation from responsibility for enterprise defalcations is fundamental to the corporate form of business organization, so fundamental that it goes largely undiscussed, at least as regards public companies.[1] This does not go to say that accountability questions are entirely suppressed. We just put them indirectly, focusing not on the equity participants but on the legal entity and subsuming the whole into a category of collective "corporate" accountability. We also break out a separate management accountability problem, which was corporate law's great unsolved problem for the best part of a century. We framed the management problem exclusively in agency terms, as a problem of responsibility to shareholders, who we in turn modelled as powerless victims. We sought in consequence to pile rights onto shareholders; duties did not enter the conversation.

The management accountability problem is now thought to have been solved, or at least brought well under control.[2] The shareholders figured out how to do this themselves, subjecting managers to controls and ending their own history as powerless victims. It was a considerable accomplishment. But it does nothing to ameliorate collective "corporate" accountability problems, in particular those connected to injuries to non-shareholder constituents and to the externalization

[1] The exception is Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008)(arguing that greater shareholder power should be accompanied by greater responsibility).
[2] *See e.g.*, Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Reevaluation of Governance Rights*, 113 COLUM. L. REV. 863, 867 (2013)(declaring the problem of separation of ownership and control to have been solved).

of production costs to the outside world. To see why not, hypothesize a fully accountable manager—an automaton dedicated to the maximization of shareholder wealth. Such an actor has no power to correct corporate accountability problems to the extent that so doing reduces shareholder returns and makes the manager an unfaithful agent. Power to release this accountable manager from its duty and reduce the quantum of injury inflicted by the corporation lies in the shareholders. If the shareholders are unable to organize themselves to exercise that power, as historically has been the case, the matter does indeed end there as a collective, "corporate" problem.

The situation has changed.[3] Shareholders now have outcome-determinative influence on matters they deem important. When corporations inflict injuries in the course of business, shareholders can, and now sometimes do, intervene to correct the matter. In the emerging fact pattern, corporate accountability comes out of the collectivized frame to become an internal subject matter—a corporate governance topic. As a result, shareholder accountability emerges as a policy question for the first time.

The question still would be inconsequential were share ownership so dispersed that no single holder or small group of holders had the power to determine outcomes. Shareholders, thus situated, would be an amorphous group no member of which fairly could be deemed responsible. But here too things have changed. The trend toward institutional, as opposed to individual, shareholding has reached a plateau on which a handful of big players have apparent power to determine many outcomes. Institutional governance practices have come under scrutiny as a result, most notably those of the three largest index fund managers, BlackRock, Vanguard, and State Street (the Big Three). A range of perversities is alleged, from uninformed, self-interested voting to the fomentation of price fixing. The Big Three are said to be, in a word, unaccountable.

Countervailing duties are being mooted.[4] "Stewardship" has made an abrupt appearance as a central concept in corporate governance. Stewardship duties in the first instance concern portfolio management.[5] But they extend[6] to the exercise of governance rights attached to the shares held in institutional portfolios and so can implicate the business plans of investee companies. No clear qualitative line separates the content of stewardship norms from those that guide boardroom business policymaking. With the rise of ESG (environment, societal, governance) investing, stewardship norms have taken on a notably progressive political cast, sweeping in policies and goals long associated with corporate social responsibility (CSR), previously a backwater preserve of leftwing ideologues in a territory driven by capitalist

[3] Not that today's shareholders directly tell managers what to do as principals in an agency relationship; the legal model remains in place and the board manages the business. *See* DEL. CODE ANN. tit. 8, 144(a).
[4] There is a point of contradiction. On the one hand, it is charged that shareholder collective power is being exercised to coordinate prices and suppress market controls, thereby enhancing shareholder value for all. On the other hand, the institutional shareholders fail to assume their fair share of the monitoring burden, sacrificing value for the collective interest of shareholders to benefit themselves.
[5] Given an actively managed fund, stewardship first and foremost concerns portfolio management. Given an index fund, portfolio management is a ministerial task; governance activities accordingly emerge in prominence accordingly.
[6] The directives, which carry much farther than does the prudent person rule of trust law, are technically corporate governance principles as opposed to rules of law.

imperatives. Like the CSR advocates of yore, many in today's governance world take the position that the purpose of the corporation is the enhancement of not shareholder value but social welfare.

Confrontation has resulted.[7] The initial battles were fought during the 2017 and 2018 proxy seasons when the members of the Big Three abruptly shook off a long habit of governance passivity to become active supporters of ESG initiatives against managers. The governance world promptly arrived at an unexpected place: Shareholders were addressing their own accountability problem, and, as a result, CSR, albeit CSR rebranded as ESG, took a front and center position on the governance agenda.

It would not sit there unchallenged. Republican politicians, led by Governors Ron DeSantis of Florida and Rick Perry of Texas, have targeted ESG investing in connection with a wider campaign against woke corporate policies, zeroing in on the Big Three and their pension fund management businesses. Their counterparts in Washington, D.C. are now joining in.

The Big Three, thrown into defensive mode, promptly delivered the governance world to a second unexpected place: Starting in 2022, they instituted programs that cede voting decisions respecting portfolio companies to their investor beneficiaries, thereby getting themselves out of the political crosshairs. It is too early to tell just how many votes the programs implicate and the impact on voting outcomes. Uncertainty reigns as regards the future of each of ESG investing, shareholder voting, institutional investor activism, and, indeed, corporate governance itself.

Meanwhile, a crucial theoretical issue has been joined. The institutions, with their ESG-based activism, defected against corporate legal theory's central tenet, shareholder primacy. Shareholder primacy builds on a pair of norms. The first is substantive and concerns purpose--the firm should be managed for the shareholders' financial benefit. The second norm is procedural and concerns power--the shareholders should have the power to tell managers how to run the firm. Prior to the institutions' turn to ESG activism the two had operated in tandem--power on the ground assured shareholder value maximization in the boardroom. The Big Three put the two out of synch when they switched into activist mode. Power on the ground now also triggers questions about shareholder accountability. The directive of management for the shareholders' benefit loses focus as a result, compromising shareholder primacy in the performance of its mission.

This Article looks closely at this confrontation between shareholder primacy and shareholder accountability. The Article asks three questions, answering each in the negative.

The first question, which has been much mooted, is relational: Can investment institutions legitimately sacrifice their investors' financial returns in connection with the installation of socially responsible business practices at operating companies? Most observers answer in the affirmative. Indeed, a project to revise corporate legal theory to justify the institutions' actions is well under way, a project that modifies the working picture of shareholder incentives. In the new model, the rapacious at-the-margin seeker of cash on the barrelhead of classical shareholder primacy is displaced by a more patient, humane version of the rational economic actor. Positive

[7] Professor Roe refers to "purpose pressure." Mark J. Roe, *Corporate Purpose and Corporate Competition*, ECGI Working Paper No, 601/2021 (2021) available at https://ssrn.com/abstract=3817788.

accounts of institutional motivations complement the new model—fund managers wielding governance power are depicted as at-the-margin actors responding to neutral market diktats. The theoretical goal is to the integrate the institutional turn to social responsibility within the microeconomic framework that long has imported legitimacy to shareholder primacy.

Unfortunately, these efforts to justify the institutions' defection against their investors' interests fall well short of the mark. The actors in question are not market automatons. They exercised agency when they turned to social responsibility, and, indeed, wield power in the economy and in society. The most persuasive explanation for their behavior is self-interest. That is, the institutions turned to social activism in the course of building a ground up case to legitimize their newly acquired governance power, thereby protecting their businesses (and rents) from interference by progressive politicians. That being the case, legitimacy does not follow as a structural proposition. The institutions must process their way to it—soliciting and receiving their investors' consent.

The second question concerns shareholder primacy: Assuming ESG concerns take a permanent place at the top of the governance agenda, can shareholder primacy continue[8] to provide a viable cornerstone for corporate legal theory? The answer again is no.

Shareholder primacy seeks to reduce management agency costs by empowering shareholders, asking no further questions about costs and benefits. If all other things are equal, then agency cost reduction does indeed make a productive contribution. Unfortunately, however, all other things are not equal. The means to the end of value enhancement by agency cost reduction are shifts in business plans, shifts that tend to entail the sale or liquidation of all or part of the companies' assets with a view to the monetization for distribution to the shareholders. Ancillary harms follow these interventions. The breaks in the business plan dissolve commitments to other corporate stakeholders, injuring them and making productive relationships harder to sustain. The constant threat of such events steers risk averse managers away from long term investment in favor of near-term stock market gain. Meanwhile, in the shareholder primacy framework, corporate externalities are not deemed to be a governance problem. They are conveniently, albeit ineffectively, remitted to state regulation.

The ESG agenda modifies shareholder primacy to address all three points of injury—the aversion to long-term investment, the reneging on stakeholder commitments, and the externalization of production costs. The result is shareholder primacy in part—the insistence on shareholder power remains but shareholder value drops out as the end in view. All that remains is a process negative: so long as the marching orders don't come from management, we can live with it. This is not an adequate basis for corporate legal theory going forward. An objective function needs to be articulated, and the process instruction needs to serve it.

The third question applies a progressive perspective to ask the following: Do the recent institutional interventions herald a structural shift toward a welfarist corporation? The answer is

[8] The author concedes the point that shareholder primacy formerly provided a viable cornerstone for corporate legal theory for the sake of simplicity. The author's actual views on that matter are equivocal. *See* William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010).

again negative. The recent policy turns at public companies feature the implementation of items pulled from an ESG grab bag by investment institutions operating pursuant to selective incentives. The incidents certainly point in a welfarist direction. But no commitments have been made by those with the power to determine future outcomes. The achievement of a corporation devoted to pursuit of social welfare requires the destruction and not just the modification of shareholder primacy. Its substantive leg would have to be eliminated and affirmatively replaced by social welfare enhancement as the corporation's purpose. The process leg also would need to be reconstructed. Shareholder power over the business plan would have to be contained, for whatever substantive welfarist instructions we managed to hardwire into the corporate code, shareholders could never be relied upon to follow them.

The sequence of questions and answers delivers us at an unsatisfactory destination, one riven by contradiction and tension. No, as yet there has been no structural shift toward a welfarist corporation. Yet, were that to happen, shareholder primacy could no longer provide a viable cornerstone for corporate legal theory. Meanwhile, the nascent steps recently taken in a welfarist direction already have begun to compromise shareholder primacy. Finally, the investment institutions that took those nascent steps acted illegitimately, even as they exercised shareholder power unprecedented in magnitude.

The tensions stem from an underlying encounter between shareholder primacy and shareholder accountability, two notions, the former old and the latter new, that are natural enemies, like cats and dogs. The big institutions, sensing both the tension (along with their own accountability problem), have been trying to negotiate the conflict, an exercise that at which they are having only limited success.

The case of management accountability offers an instructive historical comparison. Management successfully balanced competing claims for accountability during the decades after the Second World War. But later, as the twentieth century came to a close, management came up against an implacable and persistent unaccountability complaint from its own shareholders. The complaint was eventually resolved against management by means of market-driven disempowerment. The shareholders, wielding power as the beneficiaries of that adjustment, now face accountability demands of their own. If, as seems likely, the accountability demands do not go away, shareholder disempowerment will loom large as a response. The question, for which there is no answer as yet, is how that might be brought about. Structural proposals are starting to find their way to the table. Meanwhile, we are in for a long, difficult period of adjustment.

This Article has five parts.

Part I traces shareholder primacy's origins, both theoretical and historical. Its substantive leg has two theoretical sources. One, derived from Jensen and Meckling's agency model, makes a flimsy efficiency claim, asserting the priority of shareholder interests over those of other corporate stakeholders based on heroic assumptions. The second source is a political economic assertion famously made by Milton Friedman--that shareholder financial gain should trump social welfare in the formulation of the firm's objective function. For Friedman, wealth and freedom could thrive only in a society in which the public and private sectors remain relentlessly separated;

where CSR undermines that separation, shareholder primacy maintains it. Shareholder primacy's procedural leg evolved in history. The claim to shareholder power was first articulated as a strategy for agency cost reduction in response to the failure of the takeover movement of the 1980s. It went on to become the central tenet of corporate legal theory. All of these sources, theoretical and practical, share a powerful normative bottom line: Shareholder primacy is the means to the end of enhanced market control of both corporate production and the wider economy.

Part II turns to shareholder accountability, or more accurately, shareholder *un*accountability, describing a separation of ownership benefit from ownership responsibility. The presentation starts with the law, which provides for limited liability and thereby invites externalization of costs. The law also exempts noncontrolling shareholders from fiduciary duty, arming them with rights against other corporate constituents but no correlative duties. The shift from individual to institutional shareholding further embeds the separation. In theory, fund managers could enhance their investors' returns by investing in governance activism toward the end of agency cost reduction. But they do not do that in practice because their investor beneficiaries reject governance engagement as a strategy and seek instead to enhance gain by minimizing carrying costs. As a result, governance passivity has prevailed among shareholding institutions. Corporate governance only got its agency cost corrective when a class of specialized activist hedge funds implemented an agency cost reduction strategy in a structure that remunerated portfolio gains with a twenty percent fee. Significantly, these well-paid hedge funds brought managers to heel, ended the separation of ownership and control, realized the goals of shareholder primacy, and delivered us unto a new era of shareholder empowerment without concomitantly taking legal responsibility. But there was a catch. Power invites scrutiny. Sharp questions were raised about the perverse effects of shareholder maximizing strategies in the wake of the financial crisis of 2008. The questioning continues.

Part III describes the shareholding institutions' shift to social responsibility. It is a partial break in the historic pattern. The institutions are no longer consistently passive and no longer hew absolutely to shareholder value enhancement as a goal. They support a circumscribed agenda of social causes and use their influence as well as their votes to effect results at portfolio companies. The shift just happened to coincide with the coalescence of potentially outcome determinative voting blocks in the hands of the Big Three, whose rise to empowerment has invited scrutiny. But the literature tends towards a benign diagnosis of Big Three incentives, seeking to cabin the turn to social welfare on the private side of Milton Friedman's public/private divide, explaining institutional social voting in market-driven terms. This attempt at a private justification is ultimately unsuccessful. The institutions' social turn relies on economic slack—market failure rather than market control. With slack comes economic, and in this case, political power, along with inevitable demands for its responsible exercise. The fund managers are reenacting the balancing role played by the managers of operating companies during the post-war period, endeavoring to defuse regulatory threats by playing cooperatively with constituent demands. Their commitment to social welfare is contingent, accordingly. Meanwhile, they make their social contributions with other peoples' money. Legitimacy problems inevitably follow.

Part IV takes a new look at shareholder primacy, asking where the institutions leave it in the wake of their questionable emergence as social voters. The answer is that it is diminished. The institutions have compromised its substantive motivation, shareholder financial gain, even as they have wielded its procedural consequence, shareholder power, in new ways. Shareholder primacy emerges as power without purpose, a posture in which it does not make for a plausible anchor for corporate governance going forward. Oliver Hart and Luigi Zingales intervene at this theoretical juncture, proposing that we double down on shareholder power, reconstructing both the legal corporation and our shareholding institutions to let socially minded beneficial owners determine basic business planning questions. The suggestion is analytically sound but disquieting. Shareholder power, originally a means to the end of efficient production has become an end in itself.

Part V turns to the existential threat to shareholder primacy--the movement to substitute social welfare for shareholder value as corporate purpose. The discussion, which centers on the work of Professor Colin Mayer, describes strategies for hardwiring corporate structures to privilege social welfare over shareholder value as the corporation's purpose. With this analysis, accountable shareholders finally make an appearance in corporate legal theory. We simultaneously see that recent developments in corporate governance herald no shift to a welfarist corporation, for taking social welfare seriously as the purpose of the corporation means not just the modification but the destruction of shareholder primacy.[9]

[9] For contrasting treatments of the interplay between shareholder primacy and social welfare, see Robert P. Bartlett & Ryan Bubb, *Corporate Social Responsibility through Shareholder Governance*, working paper (2023) available at http://ssrn.com/abstract=4354220; Marcel Kahan & Edward B. Rock, *The Emergence of Welfarist Corporate Governance*, working paper (2023) available at https://ssrn.com/abstract=4328626.

I. SHAREHOLDER PRIMACY--THE CONCEPTUAL AND HISTORICAL FRAMEWORK

The first fundamental theorem of welfare economics poses that a competitive equilibrium is good for the economy, maximizing wealth.[10] The normative implication is that whatever can be done to make the economy competitive should be done. If improvements can be made to the functioning of the markets, the improvements should be made—for example, information asymmetries should be remedied and barriers to competition should be removed. So doing moves the economy to a production possibility frontier, the set of Pareto optimal points at which there can be no more of A without having less of B. Significantly, the theorem assumes away externalities.[11]

Shareholder primacy amounts to a situation specific application of the theorem. It exalts markets over institutions, seeking to minimize the agency of individual actors and maximize the force of competitive controls. It is, however, stated very differently than is the first fundamental theorem. For one thing, it is not expressed formally. It is more a collection of assertions and assumptions, some stemming from economic theory, others gleaned from practical experience. This Part unpacks this bundle. Section A takes up shareholder primacy's claims respecting the purpose of the corporation, showing how they lead to a claim for shareholder empowerment. Section B traces the concepts through history. First comes a classical phase in which shareholders were seen as victims and primacy served a remedial function. It is followed by a contemporary phase in which shareholders lose their victimhood to emerge as masters of the corporate universe.[12]

A. Corporate Purpose and Shareholder Power in Theory

1. *Primus Inter Pares*.

The first fundamental theorem can be particularized as an efficiency prescription for a corporate governance system. Marco Becht, Patrick Bolton and Ailsa Röell make this extension as follows: a governance system is "ex ante efficient if it generates the highest possible payoff for all the parties involved, shareholders, creditors, employees, clients, tax authorities, and other third parties that may be affected by the corporation's actions."[13] The extension, which embraces all

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[10] *See* Allan M. Feldman, *Welfare Economics* in 8 THE NEW PALGRAVE DICTIONARY OF ECONOMICS 723 (Steven N. Durlauf & Lawrence E. Blume eds., 2d ed. 2008). The theorem follows from a general equilibrium model of the economy. All individuals and firms are price takers, each firm produces so as to maximize its profits subject to a production constraint, and each individual consumes so as to maximize individual utility. *Id*. at 722.

[11] *Id.* at 723.

[12] For a contrasting, but not inconsistent account, see Michael Simkovic, Natural-Person Shareholder Voting 3-8 (March 2022) available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4180982.

[13] Marco Becht et al., Corporate Governance and Control at 8 (October 2002) available at http://ssrn.com/abs=343461.

corporate constituents equally, is uncontroversial and generally accepted in corporate legal theory.[14] Shareholder primacy follows from a further analysis.

Jensen and Meckling took the first step. They posited that if we (1) model the contract between a firm and its shareholders as incomplete (in that the shareholders claim the residual return after all other contractual claims have been met) while (2) modeling the contracts between the firm and its other constituents as complete, then (3) maximization of shareholder value by the firm is tantamount to the economically efficient result.[15] Note that the result is assumption-dependent and depends entirely on the model of constituent contracts. If all contracts other than the shareholders' are indeed complete and embody a maximizing trade for each party, then maximizing the shareholders' residual return does indeed maximize value for all concerned. If, however, the other contracts are incomplete, then the efficiency inquiry has to start *de novo*. The robustness of the shareholder primacy assertion (3) accordingly turns on the robustness of the constituent contracting assumptions ((1) and (2)).

Shareholder primacy proponents make a two-part case in favor of the assumption's robustness. The first part is a claim for shareholder entitlement in a world of incomplete contracts. In fact, no one argues that in the real world all other stakeholders enter into complete contracts. It is argued instead that, relatively speaking, the shareholders' contract holds out less in the way of protection than do the other constituents' contracts. Employees can look to alternative employment at their opportunity wage in competitive labor markets and creditors can take security or shorten their maturities, while shareholders' capital is locked in for an indefinite duration with their only further protection stemming from governance arrangements. A claim to pride of place in corporate governance follows from this diagnosis of relative vulnerability.[16]

The second part of the case assays alternatives to a shareholder maximand and finds them wanting. The argument proceeds in two phases. It is first asserted that decision making costs should be minimized. This in turn implies a limitation on the number of constituents referenced

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[14] See, e.g., Ronald J. Gilson & Reinier Kraakman, *Clark's Treatise on Corporate Law: Filling Manning's Empty Towers*, 31 J. CORP. L. 599, 602 (2006); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637 (2006).

[15] See Becht, et al., *supra* note 13, at 8-9. The principal-agent model tells a corporate creation story in which the only problem confronting the firm is management moral hazard, which causes agency costs. It is a partial equilibrium set up: but for management moral hazard and shareholders' and managers' arrangements in respect thereof, all other things are not only equal but efficient. In the model, agency costs are reduced to the extent that managers find it cost effective to incur bonding costs and investors find it cost effective to incur monitoring costs. See Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323 (1976). A possibility is held open that contracting between managers and investors will yield further cost reductive results, contracting that occurs at the moment a founder-manager conducts an initial public offering (IPO) and creates a public corporation. Id. at 323. The model does not predict that bonding, monitoring, and contracting will reduce agency costs to zero—residual agency costs that cannot be cost effectively eliminated will persist as an intrinsic cost of production. Id. at 327. The persistent residuum is unproblematic because, in the model, the equity trading market allocates these costs to the founder-manager at the moment of creation. *Id*. at 313, 319-19.

[16] See Oliver Williamson, *Corporate Governance*, 93 YALE L. J. 1197, 1210-11 (1984).

in the firm's statement of purpose.[17] Multi-constituent models invite incoherence due to conflict amongst the interests referenced.[18] Incoherence in turn expands the scope of management discretion, potentially increasing management agency costs. Second, the shareholders are the best reference point among the available constituents. Because they hold the residual claim, managing in their interest maximizes returns for the corporation as a whole.[19] Their capital investment[20] in the residual lends them an undiluted, pure financial incentive to maximize the firm's value.[21] From an incentive point of view, they contrast favorably as against managers and employees, whose incentives are comprised by interests in compensation and job retention, and as against all other constituents, whose contractual interests exclude the residual upside.

A conclusion respecting the allocation of authority within the corporation follows ineluctably—because shareholders are the only participants with correct incentives, ultimate decision-making authority should lie with them.[22] The question then becomes whether these pure shareholder incentives can be harnessed by the governance system even though dispersed, diversified shareholders suffer collective action problems, labor under information asymmetries, and lack business expertise. The market, in particular the stock market, comes to shareholder primacy's rescue at this point, facilitating a plausible claim for shareholder power. Shareholder primacy attaches itself to the market price of the stock as the principal measure of the shareholder interest, and thus of incentive compatible instructions for the business plan.[23]

There is a valid point here: if the stock price does in fact hold out an objective and accurate measure of a purely motivated shareholder maximand, it does indeed provide the best source of instructions for governance and business policy.[24] From this it follows that a manager-agent with correct incentives should manage to maximize the market price. But the point is conditional. To the extent that the stock price does not provide an infallible, all-purpose guide to value maximization, the case for shareholder empowerment weakens.[25]

2. *Financial Over Social Welfare*.

The first fundamental theorem looks only to economic efficiency—the creation of aggregate wealth. It makes no assertion concerning the distribution of the wealth thus created.[26]

[17] *See* Becht et al., supra note 13, at 9.
[18] *See* Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 8, 9, 13 (2001).
[19] *See, e.g.*, Henry Hansmann & Reinier Kraakman, *The End of History for Corporate L*aw, 89 GEO.L.J. 439,449 (2001).
[20] Bengt Holmstrom & Steven N. Kaplan, *Corporate Governance and Merger Activity in the United States: Making Sense of the 1980s and 1990s*, J. ECON. PERSP., Spring 2001, at 121, 138.
[21] Hansmann & Kraakman, *supra* note 19, at 449.
[22] *Id*., at 440-41.
[23] *Id*.
[24] *See* Holmstrom & Kaplan, *supra* note 20, at 138 (noting that the price follows from actors putting their money where their mouths are). See also Gorge W. Dent Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOU. L R. 1213, 1226 (2008)("No measure is better.").
[25] Bratton & Wachter, *supra* note 8, at 694-96.
[26] Feldman, *supra* note 10, at 723.

Happily, the follow-on question about distribution is addressed in the second fundamental theorem of welfare economics. This poses an heroic optimum: once the economy has reached the production possibility frontier, optimal social welfare can be achieved through appropriate lump-sum taxes and transfers.[27] The implication is that the government should come on line to effect welfare maximizing distributional adjustments only after competition has done its maximizing work. There is a powerful political economic implication--the private and public spheres should be strictly separated.

This "separation principle" found its way into the bundle of assertions that make up shareholder primacy in writings of Milton Friedman—in his book *Capitalism and Freedom*,[28] first published in 1962, and a follow up piece published in the *New York Times* in 1970.[29] It should be noted that Friedman was not discussing shareholder primacy's productivity advantages. His shareholders took *primus inter pares* status as owners—the holders of a legal entitlement—rather than as economic actors. His objective was the enforcement of public/private separation. To that end, he targeted corporate social responsibility.

Significantly, the topic came up in the book's chapter on monopoly. Friedman observed that the manager of a corporate entity operating as a pure competitor had no room to worry about social responsibility. Companies operating at the margin have no rents with which to finance externality correction[30] or redistributive initiatives. In contrast, the manager of a producer possessing market power has rents of which to dispose and allocative choices to make.[31] In a free economy, said Friedman, the choice was clear: "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."[32] Meanwhile, the diversion of "someone else's money"[33] for a social purpose amounted to the imposition of a tax. The allocator was performing a governmental function inappropriately—civil servants should be appointed through a political process.[34] Bad things

[27] More particularly, given the outcome of the first theorem, almost any Pareto optimal equilibrium can be achieved given imposition of appropriate taxes and transfers. Id. at 724. There's a catch, however, for a tax and transfer regime that impairs productive incentives is suboptimal and arguably "inappropriate." The theory of the second best comes to bear at this point. It is possible that a costly tax and transfer regime can enhance social welfare utility in the context of an economy producing below the production possibility frontier and so be deemed the preferable outcome. *See* Richard G. Lipsey & Kelvin Lancaster, *The General Theory of the Second Best*, 24 REV. ECON. STUD. 11 (1956).
[28] MILTON FRIEDMAN, CAPITALISM AND FREEDOM (4th ed. 2020).
[29] Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business is to Increase Its Profi*ts, available at https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.
[30] The interesting implication is that such a producer is inefficient.
[31] FRIEDMAN, *supra* note 28, at 145.
[32] *Id*. 160. Shareholder rights were implicated--any free cash flow should be distributed to the shareholders by right; they were the owners after all. But the point about surplus distribution was not unique to corporations--a labor union negotiator should not moderate a wage demand in a spirit of cooperation with government policy; the funds at stake belonged to the union members. *Id*.
[33] *Id*.
[34] *Id*.

would happen if private actors persisted in performing public functions—the state would take over their selection and decision-making.[35] In short, the separation principle should be adhered to unremittingly.

Friedman's intervention reads as economics at first inspection--it amounts to a prescriptive application of the second theorem of welfare economics. But Friedman took the matter a step farther, entering political territory. The correction of corporate externalities, he said, should be remitted exclusively to the government, even if the damage was manifest and the government failed to address the corrective task.[36] Those advocating otherwise had simply failed to get their preferred result through the democratic political process and now proceeded undemocratically, subverting the polity.[37] That corporate externalities are by definition inefficient apparently did not matter.[38] It was more important to avoid any traversal of the public/private divide.

Friedman is not rejecting efficiency as a policy goal. He instead makes a two-part cost-benefit judgment: (1) In the long run in an imperfect world an unbreachable wall between public and private fosters an environment conducive to the unimpeded play of competitive forces; and, (2) the benefits yielded in such an environment outweigh the costs of a few unremedied externalities. A clear implication follows for the corporation's purpose—enhancement of financial returns to shareholders should trump enhancement of social welfare. Strict separation admits of no other result.

3. *Summary and Evaluation*.

Shareholder primacy, thus constituted, yields a two-sided instruction for corporate purpose. Incentives are on one side of the coin: Shareholders should be preferred over other corporate constituents because they see the firm through a pure financial lens and so are the best source of productive instructions. Political economy is on the other side: We can maintain a free and productive society only by maintaining relentless separation between public and private spheres of action; to keep corporations on the private side of the line it is necessary that their managers pursue shareholder financial welfare. Each side leads to the same bottom line: Shareholder value enhancement is the means to the end of maximizing the magnitude of market control over

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[35] *Id*., at 162.
[36] *Id*. ("expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed").
[37] *Id*. ("[T]his argument must be rejected on grounds of principle. What it amounts to is an assertion 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.")
[38] Hart and Zingales offer a more charitable reading of Friedman. *See* Oliver Hart & Luigi Zingales, *The New Corporate Governance*, at 7, Law Working Paper N° 640/2022 April 2022 http://ssrn.com/abstract_id=4087738. They describe a "separation theorem" pursuant to which corporations should avoid actions motivated by social welfare goals when, as with charitable contributions, the shareholders are equally well situated to do the same thing. Where however the firm has a comparative advantage in effecting a result, as with much externality correction, efficiency demands that the firm proceed. Hart and Zingales make a good point, one consistent with the first fundamental theorem. I just do not think Friedman also made the point.

production. Thus do both sides of coin make the same reference back to the first fundamental theorem's norm of market discipline, operationalizing it.

Efficiency gets lost in the shuffle even so. Recall that we started out describing the corporation's efficient frontier as the state that maximizes returns to all constituents and to society as a whole. We found our way to shareholder maximization only by assuming all those other interested actors away. Shareholder primacy's persuasiveness depends on the robustness of that assumption. Any number of real-world complications can weaken the case. Recall that the first fundamental theorem assumes competitive behavior and assumes away externalities. Either of lack of competition amongst producers or chronically unremedied externalization of costs by producers undercuts the assumptions. Nor can we avoid considering the relative completeness of other stakeholder contracts. Given incompleteness and conflicts of interest among different constituent groups, management decisions under a shareholder maximization instruction can be value reductive overall.

In the section that follows, we will see all of these problems arise in history.

B. Historical Context

The foregoing theoretical description lends shareholder primacy the appearance of a timeless force of nature. In fact, shareholder primacy has not always been with us; neither, for that matter, has the concept of corporate governance. Both appeared in history as responses to perceived problems. This section describes that appearance, complementing the theoretical statement with contextual detail.

1. *The Managerialist Era*.

We start with the managerialist era, which began at the end of World War II and ended around 1980. This was the period during which most observers agreed that management power ineluctably flowed from organizational expertise and that structural impediments foreclosed the possibility of putting hierarchical firms under market control.[39] Indeed, based on the experience of the Great Depression, most people thought that market control would be a bad idea anyway, as markets were generally prone to fail. Market constraints accordingly disappeared in the working picture of the corporation. The shareholders disappeared with them, along with any trace of the bundle of concepts that later would comprise shareholder primacy.

Market failure implied management unaccountability. The point, encapsuled as "the separation of ownership and control," had been hammered home during the depths of the Depression by Adolf Berle and Gardiner Means in *The Modern Corporation and Private*

[39] *See* William W. Bratton, *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 413(1989).

Property.[40] Berle and Means's diagnosis would hold sway for the rest of the twentieth century. But the edge of policy concern softened considerably during the quarter century that followed the Second World War, a time when managers enjoyed great prestige as the successful planners of an expanding economy. Berle himself led the chorus of praise. The management incentive problem, he said, was under control, even though managers remained insulated from capital market pressures.[41] A big stick state, armed with New Deal reforms,[42] watched over them instead.[43] To keep the state at bay, managers were forced to keep the public satisfied with jobs and growth.[44] Thus constrained, managers amounted to quasi-civil servants.[45] They took their implicit public duties seriously--corporate social responsibility made its appearance as a topic in management science during this period.[46] Milton Friedman, however, was not pleased. It was this managerial quasi-civil servant against whom he directed his sights in the 1962 book.

Friedman also went against the *zeitgeist* in elevating the interests of shareholder "owners." Berle and Means had demoted them. They no longer played a disciplinary role, if indeed they ever had. Federal bureaucrats wielding the securities laws now patrolled the markets, said Berle after the war.[47] Meanwhile, the shareholders' annual election of directors played only a minimal legitimating role in the wider political framework—it was a ritualized community process pursuant to a hoary legal template.[48] Instead of being chosen by shareholders, managers operated in "tiny, self-perpetuating oligarchies," drawn from and evaluated by the business and financial community,[49] itself an elite group. The shareholders had given up responsibility for corporate property. Therefore, concluded Berle and Means, other constituents should join them as corporate

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[40] ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 1 (Macmillan reissue 1933) (noting that economic power had concentrated in the hands of corporate managers and that the corporate system amounted to a major social institution).

[41] ADOLF A. BERLE, JR., THE 20TH CENTURY CAPITALIST REVOLUTION 36-37 (1954)[hereafter cited as BERLE, 20TH CENTURY].

[42] ADOLPH A. BERLE, THE AMERICAN ECONOMIC REPUBLIC 82, 91 (1963) (describing an "American economic republic" in which the state and the economy were interdependent, with the state taking ultimate responsibility for economic results and exercising the higher level of power) [hereafter cited as BERLE, REPUBLIC].

[43] The state intervened only to stabilize the organizational lines and performance of private producers. *Id*. at 99.

[44] *Id*. at 169; ADOLPH A. BERLE, JR., POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY 122 (1959) [hereafter cited as BERLE, POWER].

[45] BERLE, REPUBLIC, *supra* note 41, at 88. Berle's description had a theoretical counterpart in JOHN KENNETH GALBRAITH, THE NEW INDUSTRIAL STATE (1967). Galbraith's picture leaves the competing groups free to make their own rules, subject to government intervention to assure that excessive power does not accrue to one group. Free competition is allowed to operate on a day-to-day level, but in an administered economy that guards against excessive competition. The need for countervailing power precludes resort to market competition to choose the winners.

[46] *See* Archie B. Carroll, *A History of Corporate Social Responsibility: Concepts and Practices* in THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY 24-26 (Crane, et al., eds. 2008).

[47] Adolf Berle, *Property, Production and Revolution: A Preface to the Revised Edition*, in ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY xxvii, xxxiii (rev'd ed.967) [hereafter Berle, 1967 Introduction].

[48] BERLE, POWER, *supra* note 44, at 104-05. Proxy fights, which had taken the stage in the 1950s, did not imply renewed empowerment for equity capital. Although always a possibility, such upsets would be rare and would tend to involve smaller firms.[48] BERLE, REPUBLIC, supra note 42, at 63. With bigger firms, the shareholder vote was getting ever more dispersed, further diminishing its importance and embedding passivity.[48] Berle, 1967 Introduction, supra note 47, at xxxi.

[49] BERLE, 20TH CENTURY, *supra* note 41, at 180.

beneficiaries; the "rigid enforcement of property rights" of passive shareholders would give way in the face of a "convincing system of community obligations."[50]

Only one role remained for the shareholders.[51] Protection of their interests still might be socially justified because they played a distributive role in society. Shareholders used their wealth to provide for their families, pay taxes, and support charitable institutions.[52] But there was still a catch: *full* justification for special protection of the shareholder interest would follow only when shareholder wealth became so widely distributed as to benefit every American family.[53] Only in a distributive utopia could the shareholder interest serve as a proxy for societal interest and thus hold out political economic salience.[54]

2. *The Appearance of Corporate Governance.*

The managerialist era ended during the 1970s. The first blow came with the collapse of the once great Penn Central railroad in 1970. The company's passive and inattentive board of directors figured prominently in the causal post-mortem.[55] The bad news compounded when the economic bill for the Vietnam War came due in 1972 and 1973. The economy went into a severe recession aggravated by the mid-east oil crisis even as inflation increased.[56] The stock market collapsed along with the economy. It spent a long time in recovery--there would be no money to be made investing long term in equities for a decade. The appearance of international competition

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[50] BERLE & MEANS, *supra* note 40, at 356.

[51] BERLE, REPUBLIC, *supra* note 42, at 51-52 ("Why have stockholders? What contribution do they make, entitling them to heirship of half the profits of the industrial system . . .? Stockholders toil not, neither do they spin, to earn that reward. They are beneficiaries by position only. Justification for their inheritance must be sought outside of classic economic reasoning.").

In Berle's view, the capital markets on which shares were sold and traded followed the shareholders into policy irrelevance. The capital allocation function had passed from the securities markets to the internal capital markets at individual corporations. Berle pointed out in 1954 that during the preceding six years 64 percent of invested capital had been financed by retained earnings and only 6 percent from new equity. BERLE, 20TH CENTURY, *supra* note 41, at 36-37 (acknowledging exceptions for utilities and new industries). See also BERLE, POWER, *supra* note 44, at 45 (noting that 10-15 percent of new capital came from pension funds and insurance companies and 20 percent from bank borrowing). The markets were left to provide liquidity for the original owners' wealthy heirs, a minor function in the overall scheme of social welfare. It followed that the stock exchanges no longer served primarily as places for new investment and capital allocation, traditional functions only implicated in the rare instance of a new issue of common stock. The markets instead served as mechanisms for investor liquidity, a service provided for the benefit of the original owners' passive grandchildren or the transferees of their transferees. Berle, 1967 Introduction, *supra* note 47, at xxvii, xxxiii-iv.

[52] BERLE, REPUBLIC, *supra* note 42 , at 51-52

[53] Berle, 1967 Introduction, *supra* note 47, at xxxv. See also Adolf A. Berle, *The Impact of the Corporation on Classical Economic Theory*, 79 Q.J. ECON. 25, 39 (1965).

[54] Others saw things similarly. If shareholdings were not widely distributed across the population, maybe returns to large company shareholders should be limited to fixed interest plus a small risk premium. Alternatively, the tax system should target shareholder returns redistribution. Edward S. Mason, *The Apologetics of "Managerialism"*, 31 J. BUS. 1, 4 (1958) (reporting on the thinking of the British Labour Party and making an extension).

[55] *See* JOSEPH R. DAUGHEN & PETER BINZEN, THE WRECK OF THE PENN CENTRAL 290, 303 336 (1971).

[56] GERALD F. DAVIS, THE VANISHING AMERICAN CORPORATION: NAVIGATING THE HAZARDS OF A NEW ECONOMY 47 (2016).

in manufactured goods added to the stock of chronic problems.[57] The malaise undermined the economic assumptions of the managerialist era.[58]

The public service gloss also faded. The New Deal political coalition that created and maintained the strong regulatory state fell apart. Managers, formerly co-operative in the face of overwhelming state power, defected. No longer afraid of non-compliance, they played a hostile game against regulatory initiatives. Accountability concerns resurfaced. They crystallized when corporate "questionable payments" were uncovered in the Watergate investigation. At company after company secret slush funds had been channeled into domestic political contributions and bribes of foreign officials,[59] even as CEOs and board members consistently denied any knowledge. Legal compliance suddenly came to be seen as a part of management's job, right up there with business planning. And the job was not being done.[60]

The conceptual framework surrounding large corporations underwent a substantial change. The happy story of managers as capable technocrats who enhanced social welfare under the watchful eye of the big stick state no longer resonated. It had become difficult to associate management power with either productive efficiency or responsiveness to constituent needs. Empowered managers were no longer the engine pulling the social welfare train. Indeed, their empowerment had led to economic and social dysfunction. The separation of ownership and control came back to the forefront as a problem in need of solution, but with a twist. Now no one looked to the government to rectify the situation.

Corporate governance was invented to tackle the job instead. The role of the board of directors, long seen as a moribund institution,[61] was reconsidered. We should, it was thought, give the board a more focused job description, assigning it the task of monitoring management performance. If boards could be induced to monitor successfully, corporate performance would improve.[62] The monitoring function in turn required independent directors and a committee structure keyed to monitoring functions.[63] The approach, fully developed in Melvin Eisenberg's *The Structure of the Corporation*,[64] which appeared in 1976, caught on quickly.

The burning question concerned implementation. Progressives wanted one thing while the management interest wanted another, with neither side looking to the shareholders to play a leading role. The progressives had become frustrated—they were dissatisfied with the level of new regulation and outraged by corporate non-co-operation. Yet they also despaired of marshalling political backing for new initiatives.[65] They turned to this new corporate governance thing instead,

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57 *Id*. at 55–56.

58 *Id*. at 55.

59 Joel Seligman*, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Projec*t, 55 GEO. WASH. L. REV. 325, 333-35 (1987).

60 Bayless Manning, *Principles of Corporate Governance: One Viewer's Perspective on the ALI Project*, 48 BUS. LAW. 1319, 1319-20 (1992).

61 MILES MACE, DIRECTORS: MYTH AND REALITY 2-3, 41, 43 (1971).

62 MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 156-57 (1976).

63 *Id.*

64 *Id*.

65 Elliott J. Weiss, *Social Regulation of Business Activity, Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 347-48 (1981).

envisioning governance institutions as reform platforms. For them, director "independence" meant putting like-minded types onto corporate boards with socially responsible results.[66] They looked to federal incorporation initiatives as a wedge to open up this possibility.[67]

The management interest at first felt threatened by these progressive initiatives. It turned to the same potential remedy—the new corporate governance thing—and tried to capture it. The Business Roundtable, seeking to stave off more intrusive initiatives, publicly embraced the independent director majority.[68] As management saw it, no harm need come from the concession--so long as incumbent CEOs could use their influence to secure appointment of cooperative types on boards of directors, any threat was minimal.[69]

3. *Shareholder Primacy Takes Hold—The Takeover Wars of the 1980s.*

Management's cooperative engagement with corporate governance did not last long. Once the political climate changed and the progressive threat receded, management reverted to opposition, fighting tooth and nail when the American Law Institute geared up to recommend governance mandates in the 1980s.[70] It turned out to be a long defensive campaign, for there would be no letup in the governance-based assaults on management prerogatives. But the source of pressure changed during the 1980s. The shareholders themselves finally emerged to take a place at the new corporate governance table. Shareholder primacy came with them, but as a function of market activities rather than as the message of a policy movement.

The market control scenario unfolded for real during the takeover wars of the 1980s.[71] The markets, suppressed in the New Deal settlement, came back to retake the forward role in corporate governance, a position that has been steadily solidifying ever since.[72] Numerous factors combined

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[66] *Id*. at 426-32 (suggesting that corporations be required to nominate directors from a centrally qualified list). *See also* Victor Brudney, *The Independent Director-Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 603-04 (1982).

[67] They backed a preemptive federal incorporation scheme variously suggesting: (1) Minimum standards of conduct and stepped-up liability, *see* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 700-03 (1974); Harvey Goldschmid, *Symposium, The Greening of the Board Room: Reflections on corporate Responsibility*, 10 COLUM. J. L. & SOC. PROBS. 15, 17-28 (1973); (2) a universal and mandatory director independence requirement; and (3) an expanded shareholder franchise. See RALPH NADER, MARK GREEN & JOEL SELIGMAN, TAMING THE GIANT CORPORATION 118-31 (1976). Bills were introduced in Congress and hearings held. See Joel Seligman*, A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Projec*t, 55 GEO. WASH. L. REV. 325, 337-38 (1987). But no legislation was forthcoming.

[68] *See* Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2085, 2089, 2093 (1978) (proposing reforms to encourage more independent directors).

[69] *See* Brudney, *supra* note 66, at 610–12 (describing the pattern of cooperation and management control of appointments).

[70] *See* Victor Brudney, *The Role of the Board of Directors: The ALI and Its Critics*, 37 U. MIAMI L. REV. 223, 228 (1983) (opposing increased government regulation of board structure).

[71] *See* Scheherazade S. Rehman, *Can Financial Institutional Investors Legally Safeguard American Stockholders?*, 2 N.Y.U. J.L. & BUS. 683, 701 (2006) ("In the 1980s, takeovers (friendly and hostile) radically changed the landscape of the U.S. economy.").

[72] *See* Bratton & Wachter, *supra* note 8, at 676 ("[M]anagers emerged from the 1980s sensitized to the benefits of shareholder-value maximization even as the board of directors emerged as a more robust monitoring institution.

to effect the change. Reagan came in and the left was marginalized.[73] Antitrust policies that inhibited same industry mergers were abandoned.[74] Labor unions markedly declined in influence.[75] Competition from abroad intensified. Ideas about acceptable levels of leverage changed markedly so that high leverage (effected with the new junk bonds) became a means to facilitate corporate control transfers.[76] The prime targets were a signature product of post-war managerialism, conglomerate structures. They came to be seen as dysfunctional, for the stock market systematically undervalued their businesses.[77]

Leveraged restructuring roared through the economy. There were many stakeholder victims, even as shareholders as a group vastly benefited from premium payouts. But they too had a claim to victim status. In the prevailing account, managers (and by implication employees) had been exploiting the shareholders for years, retaining and suboptimally reinvesting free cash flows.[78] Leveraged restructuring's redeployment of capital from suboptimal projects to shareholder pockets amounted to the market equivalent of compensatory damages. Meanwhile, the national economy was being reshaped as a fit competitor in the new global economy.

4. *Primacy without Power*.

The takeovers abruptly stopped at the end of the 1980s, ostensibly[79] as the result of collaboration between managers and state lawmakers to erect costly legal deterrents.[80] Shareholder primacy survived, more as a theoretical aspiration than as a practical reality. Thinking about corporations had shifted fundamentally. Berle and Means were displaced by a new primacy-centered conceptual framework grounded in agency cost analysis.[81] The problem, it was thought, lay in the practice, where agency costs remained stubbornly excessive.

Hostile takeovers lost their place at the cutting edge of corporate governance as a result.").

[73] *See* Terry Carter, *Should This Toy be Saved?,* A.B.A. J., May 2013, at 52 (2013) ("Then Ronald Reagan became president in 1981 with a mission to shrink government and lighten the regulatory load on business.").

[74] DAVIS, *supra* note 56, at 53–54.

[75] *Id*. at 65–66.

[76] *See* Gilson & Gordon, *supra* note 2, at 870–71 ("By the mid-to late 1980s, more than half of all junk bond issuances were related to acquisitions.").

[77] DAVIS, *supra* note 56, at 54–59.

[78] Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,* 76 AMER. ECON. REV. 323 (1986).

[79] In the author's view, takeovers disappeared because asset prices caught up with asset values, causing the hostile mode of acquisition to lose its cost advantage.

[80] *See* Edward F. Greene, *Regulatory and Legislative Responses to Takeover Activity in the 1980s: The United States and Europe*, 69 TEX. L. REV. 1539, 1542 (1991) ("The desire by both management and state legislators to curb hostile takeovers placed the courts in a difficult dilemma.").

[81] Easterbrook and Fischel had turned what is implicit in the principal-agent model into a sequence of normative assertions for legal contexts. *See, e.g.,* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs,* 38 STAN. L. REV. 271 (1986); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract,* 89 COLUM L. REV. 1416 (1989); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation,* 52 U. CHI. L. REV. 89 (1985); Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. 611 (1985). They relax the model's limiting assumptions and expand the set of market controls of agency costs. In addition to stock market pricing, the accuracy of which was deemed assured by the efficient market hypothesis of financial economics, they rely on three additional sources of market control—hostile takeovers (called the "market for corporate control"), the market for the firm's products, and the executive labor market. The four markets operate

Jensen and Meckling had predicted that market forces would keep agency costs in check. In the mid-1980s, takeovers had seemed to be doing just that. Now, with takeovers gone, billions of dollars of shareholder value were going up in smoke and separated ownership and control was as much of a problem as ever. The microeconomic account of corporate governance needed adjustment accordingly. The new formulation retained the principal-agent model's focus on management moral hazard. But now, instead of a contracting field conducive to efficient self-correction, we had a field riven with collective action problems, path dependencies, and other failures.[82] Regulation came back into the policy picture as a result, but for the limited purpose of adjusting the process framework so that market control could work in fact. The problem was power, not purpose: corporate governance needed positive law reforms directed to shareholder empowerment so as finally to get us to the market control equilibrium posited by Jensen and Meckling.[83]

Shareholders, now depicted as a permanently aggrieved class with an unmet regulatory entitlement,[84] retained their status as victims, the victims of unaccountable managers. Social welfare disappeared completely from the screen of corporate legal theory. Shareholder welfare was the only welfare that mattered. It accordingly was reflexively accepted as social welfare's proxy.[85]

5. *Power in Fact*.

A second practice shock occurred after the turn of this century—the advent of the empowered shareholder. With this, for the first time in the history of production by large, publicly-held companies, the market--that is, dispersed investors—had the power to determine production decisions. The facilitating factors were a massive re-concentration of corporate ownership in the hands of institutional investors and the rise of a subset of shareholding institutions, namely the activist hedge funds.

The activist hedge funds changed the governance game. They targeted companies susceptible to quick, cash producing business plan adjustments. They made their financial

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together to assure agency cost minimization on a multi-period basis. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 4, 18-21, 91, 93, 96-97 (1991).

[82] See, e.g., Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 644-45 (1996). *See also* Lucian A. Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

[83] *See, e.g.*, Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 865-70 (2005) (recommending expansion of the zone shareholder legislative access to the corporate charter and the state of incorporation decision); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. Rev. 675, 699-702 (2007) (recommending a right to replace all incumbents every two or three years).

[84] *See id.* at 665–73 ("Shareholder empowerment emerged from the takeover era as the leading issue in corporate law, with a consistent consensus in its favor.").

[85] See Hansmann & Kraakman, *supra* note 19, at 441-42.

demands publicly, backing them with credible threats of proxy contest intervention.[86] A back and forth would follow. Rational managers tended to accede to the demands; indeed, they often modified their business plans in anticipation of activist intervention.

A different Jensen and Meckling prediction was now being acted out in real time: "If the costs of reducing the dispersion of ownership are lower than the benefits to be obtained from reducing the agency costs," they said, "it will pay some individual or group of individuals to buy shares in the market to reduce the dispersion of ownership."[87] Restating, agency cost deficits would induce the appearance of shareholders holding large blocks, who would take arbitrage profits from disciplinary interventions. Shareholder proponents had long bemoaned the relative absence of such blockholders in U.S. equity capital structures, speculating that they might, if we had them, make up the disciplinary deficit under the prevailing governance model.[88]

Now we finally did have them. Their strategy not only generated a lot of shareholder value,[89] it also precipitated a fundamental shift in the balance of power. Shareholders, when prompted, now had the ability to influence business planning and so shared power with the management team and the board of directors. Clearly, they were no longer victims.

But were they victimizers, and inefficient ones at that? As with hostile takeovers, activist intervention caused a lot of collateral damage to other constituents. But that was assumed to wash out in an overall cost-benefit balance—the ideology of the time made light of injuries incurred in the service of agency cost reduction. It took the financial crisis of 2008 to give rise to the suggestion that shareholder empowerment might be long-run inefficient. The crisis followed from investment risk-taking at the banks that had been calculated to enhance near term returns on shareholders' equity.[90] It was obvious that pandering to the shareholder interest had figured into the toxic causal mix.

Serious questions started to be asked about shareholder primacy. Maybe management agency costs were not corporate governance's only salient concerns.[91] Maybe the stock price was not the perfect performance metric. Maybe information asymmetries between those inside of companies and price-setting market traders on the outside could cause disempowered managers to pass on good but complex new projects.[92] Maybe disrespect for implicit commitments to other

[86] For empirical studies of incidence, tactics, and success, see Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 188 (2009); Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610 (2013).
[87] *See* Jensen & Meckling, *supra* note 15, at 352.
[88] *See* MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 223-24 (1994); Ronald J. Gilson & Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate,* 45 STAN. L. REV. 985, 1006-09 (1993).
[89] *See, e.g.*, Brav et al., *supra* note 86, 1739-45.
[90] Bratton & Wachter, *supra* note 8, at 717-23.
[91] Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767 (2017).
[92] Bratton & Wachter, *supra* note 8, at 697-704.

stakeholders to benefit the shareholders could be discouraging new investment. Maybe corporations were losing their capacity to make credible commitments to their relational counterparties.[93] Suddenly a governance landscape ruled by shareholder primacy was cluttered with difficult trade-offs and ugly results.

C. Conclusion

Let us pose a question. Suppose the shareholders stay in charge but stop maximizing for themselves, responsibly seeking to remedy externalities and to respect constituent commitments. Can this be done consistently with shareholder primacy as we have known it?

Let us go back to shareholder primacy's theoretical roots in our search for an answer. We start by drawing on Friedman's analysis. It provides a negative answer, but also sends inconsistent signals. The shareholder social responsibility hypothesized in the above question entails no expenditure of other people's money. The shareholders are the "owners" in Friedman's vision and presumably can do what they want with their property. At the same time, shareholder beneficence traverses his private side closure to cross the line to the public side. Friedman predicts that destructive entanglements will follow--the welfare state looks the gift horse in the mouth and turns this owners' beneficence into duty, socializing the business corporation. The reply to this objection is that the predicted scenario is low probability. The creeping socialism problem Friedman identifies has lost salience in the intervening, deregulatory decades. What today's shareholders give they can take away. Presumably, they would not hesitate so to do in given a credible threat of welfare state intervention.

Now let us make reference to the alternative basis for shareholder primacy articulated in agency theory. In the agency picture, shareholder primacy is not an end in itself but a means to the end of production efficiency in a world with moral hazard. To the extent that shareholder beneficence disrupts this incentive picture, it implies a productive sacrifice and accordingly is inconsistent with shareholder primacy. The objection prompts the same reply given to the Friedmanite objection—so long as the shareholders make no commitment, and unaccountable shareholders don't make commitments, they can be expected to contain and channel their largesse to avoid perverse effects. There is also another possibility: Maybe there are countervailing gains and shareholders are not in fact sacrificing value at the bottom line.

The question posed above sits at the cutting edge of corporate legal theory. Real world shareholders are stepping back from maximization, necessitating a new look at shareholder primacy, a look taken in the remaining Parts of this Article.

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[93] See COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT (2013).

II. SHAREHOLDER UNACCOUNTABILITY

During the long decades in which shareholder primacy was unrealized in practice, its adherents identified management accountability as corporate law's great unsolved problem. There was, as we have seen,[94] a diagnosis of market and institutional failure: If the markets by themselves did not discipline substandard managers, then institutional reform was needed. But, as we also have seen, the markets finally managed to correct the situation, bringing forth disciplinarian shareholders. We as a result entered a world in which shareholders share power with managers.

Let's go back to the financial crisis of 2008 and put a question. The nation railed against bank managers who had taken on excessive risk, demanding accountability. Should that demand also have extended to their newly empowered shareholders? After all, the risk-taking that led to the disaster and massive externalities had been undertaken for their benefit. But the extension runs into an obvious problem. Identifying the CEO in charge is easy. But how does one go about corralling the banks' dispersed shareholders to hold them accountable?

One doesn't. Given that, why bother to pose the question in the first place? The reason is that the prevailing paradigm in corporate law states shareholder value as the corporation's purpose and recommends shareholder power as a process touchstone on the assumption that shareholders have correct incentives. If that assumption is robust, there is indeed no accountability problem. This Part explores the contrary possibility, asking whether the shareholder interest is incentive incompatible. The inquiry is two-sided. Section A looks at one side, modelling "the shareholders" on the assumption that all shareholders hold their shares outright and ownership is dispersed. Incentive incompatibility shows up in the picture despite the fact that, as residual risk holders, the shareholders take the first loss. The residual risk position also lends them a keen interest in externalization, an interest unmitigated by portfolio diversification. Section B looks at the other side, relaxing the direct-holding assumption to look through to the institutions that hold and vote most of the shares. This compounds the incentive problem by separating the vote from the financial interest in the company. In the final analysis, corporate managers, the malign actors from whom all bad things flow in corporate legal theory, emerge looking at least as well incented as their shareholders.

The same question is posed on both sides of the coin: Whether the justifications that underlie shareholder primacy remain sufficiently robust to negate recognition of a shareholder accountability problem. This Part's analysis results in a negative answer. As we poke bigger and bigger holes into shareholder primacy, the accountability problem looms ever larger.

A. The Human Beneficiaries

Let us assume that all shares are held outright by multitudinous dispersed owners. There are no institutional intermediaries. Most holders are human beings, the exceptions being trusts,

[94] *See supra* text accompanying notes 79-85.

endowments, and corporate beneficial owners. Assume also that this dispersed human majority somehow collectively wields power over business planning. Should we slap down a diagnosis of power without accountability?

We should. We develop the case below, working past the argument that residual risk bearing assures incentive compatibility to the problem of externalization. The problem, given dispersed holdings, is that once the diagnosis attaches there is no one against whom to seek a remedy.

Many, perhaps most, observers will resist even the posing of a problem. Citing the incentive compatibility argument at the core of shareholder primacy, they will argue that shareholders are in fact accountable because they hold the residual interest in the corporation. If there is financial pain to be felt, they feel it first, whether the pain stems from operating losses or a socially-motivated initiative. And they feel it where other stakeholders do not. When a manager's bad business plan and incompetent execution wrecks the company, the shareholders are wiped out. The manager may lose his or her job, but lives to fight another day with his or her remaining human capital. Meanwhile, the injured shareholders have no recourse to corrective justice. Furthermore, there's a reason why, given dispersion, there is no individual shareholder on whom to pin responsibility. No shareholder has in fact done anything. That is the reason why the law makes control power the tipping point of fiduciary responsibility. If dispersed shareholders are in any sense "responsible" for injuries inflicted by the corporation, it is on a group basis and in a moral, not a legal framework.

This defensive case, while powerful, has a limit. The incentive compatibility argument works only with respect to management agency costs and the related question about the allocation of power between managers and shareholders. If we widen the lens to pick up corporate externalities,[95] the case collapses. Unremedied externalization of costs imports manifest inefficiency into the corporate production process, and the shareholders, as residual interest holders, take the associated gain. No rational, self-interested shareholder will turn down an investment that externalizes costs, whatever the shareholder's more particular characteristics. That the corporate form encourages just this when it provides for shareholder limited liability,[96] does not correct the incentive skew.

[95] See Simkovic, supra note 12, at 8-9 ("The most famous examples are environmental pollution and imposition of undercompensated risk of illness or injury, but there are many others. Additional examples of corporate actions that transfer value to shareholders without apparently creating value for society include: financial restructuring to reduce corporate taxes; leveraging transactions that benefit shareholders at the expense of creditors and employees; restraints on compensation (assuming monopsony power or collusion) that shift income from employees to shareholders; and monopolistic or oligopolistic pricing that increases profits but may generate deadweight loss.")

[96] For most of the 19th and 20th centuries shareholder limited liability was the corporate form's most distinctive feature. It has lost this defining aspect due to the proliferation of other modes of organization offering the feature, limited partnerships and limited liability most prominently. Expended availability reflects a policy judgment—limited liability is good for the economy and ought to readily available. The policy judgment became entrenched in the teeth of basic microeconomic analysis. Recall our base efficient condition for efficient corporate production—all participants are made better-off and none made worse off. See supra text accompanying note 13. Shareholder limited liability traverses this. Liability imposes responsibility for corporate externalities, whether in contract or in tort. Limited liability caps shareholder responsibility at the amount of equity capital contributed, encouraging the

The comparison with managers is instructive once again. The shareholders risk their capital investment, but subject to a liability cap and with the option of easy exit on the way down. They also get to diversify their portfolios, wringing out unsystematic risk. The managers, in contrast, suffer losses to their undiversified human capital investments in the corporation and otherwise incur reputational costs if it firm performs badly. They also can be sued in respect of some of the actions they take. It follows, in the classic profile of management incentives, that there will be a tendency toward suboptimal risk aversion.[97]

Noncontrolling public shareholders with well-diversified portfolios experience risk differently. According to the basic precepts of portfolio theory, company-specific risk can be reduced in the context of portfolio investment and systemic, economy-wide risk ameliorated through investment of a portion of the portfolio in safe debt securities.[98] The resulting profile is one of "risk neutrality." The investor is shriven of risk averse emotional pollution and ready to project risk and return rationally: if a good project is a good project, take it however risky. This is the investor model to which shareholder primacy looks when it singles shareholders out for their superior incentives. Meanwhile, the reduction of company specific risk through diversification does not somehow wash out the incentive to externalize. Risk free rents increase returns, period, even if the projects that generate them are socially suboptimal.[99]

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externalization of costs. While contract counterparties can negotiate around a limited liability default, tort claimants cannot.

In the first wave of economic analysis limited liability was thought to be superior on a cost benefit basis. The liability regime applied to equity permits any one participant to be held for the entire amount and left to seek pro rata contribution from the rest of the group. Cite to partnership rules. As such it is singularly unsuited to capital raising from passive holders of small equity stakes. Paul Halpern Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L.J. 117 (1980); EASTERBROOK & FISCHEL, supra note 81, at 40-44. But a simple fix, the adjustment of the liability regime to a pro rata approach, would cure the problem. The resulting inefficiency signal is strong. Shareholders running a pro rata risk of liability for corporate externalities would end up with a strong monitoring incentive, pushing the corporation toward risk-return calculations weighted against externalization of costs. Henry Hansmann & Reinier Kraaakman, *Toward Unlimited Liability for Corporate Torts*, 100 YALE L.J. 1879, 1882-83 (1991); David Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991). Rejoinders to this analysis address not its broad outlines but the numerous sticking points in the way of implementation. Janet Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 382 (1992).

[97] *See* Bratton & Wachter, *supra* note 7, at 666 ("From an incentive point of view, shareholders contrast favorably with managers and independent directors, whose incentives are comprised by interests in compensation and job retention."). Opportunities to externalize costs will have a beneficial corrective effect, at least from the point of view of the welfare of the corporation taken in isolation. An undiversified shareholder—a principal in a close corporation or the founder of a startup--might have a similar profile. Such an actor's combined financial and human capital investment in the firm is impacted similarly to the human capital investment of the manager.

[98] RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 181-88 (8th ed. 2006).

[99] There is an exception to this case. When a company externalizes on other companies in its industry, a shareholder holding the industry portfolio may be less well off net of the externalities. *See infra* text accompanying notes 174-175.

This account of misaligned shareholder incentives can be extended to decisions that enhance shareholder value but negatively impact the welfare of other corporate stakeholders, albeit with significant modifications.[100] Here outright production inefficiency isn't necessarily implied. Corporate restructuring can implicate cost efficiencies that outweigh negative constituent impacts, leaving us with a wealth transfer to the shareholders rather than an overall negative result. But lens widening once again can change the outcome. Restructuring means reductions of staff, pay, and benefits. These net out as a corporate positive, enhancing shareholder value. But, over time and across the economy as more companies restructure (or otherwise modify their business plans) so as to enhance shareholder returns, income inequality emerges as a social issue. Questions about inefficiency follow.

These questions are being asked in the public square. Climate change, now a leading issue in both politics and finance, fairly can be characterized a consequence of corporate externalization. At the same time, the shareholders' most prominent stakeholder victims, the employees, have not been doing so well.[101] Quality of life has diminished; income inequality has returned to the level of the 1920s.[102]

As these problems gain in salience, some of shareholder primacy's longstanding sources of justification lose resonance. As we have seen,[103] shareholder primacy seeks to enhance welfare by enhancing market control of corporate management. And, as the theory would predict, the real world accomplishment of shareholder power did follow from market ministrations. Now, with externalities piling up, market control of management agency costs no longer legitimates.

A follow up question arises: if shareholder primacy's market control strategy no longer carries sufficient justificatory weight, can we shift to a political perspective for a justificatory strategy? Let us try a theory. We argue that shareholder-based decision-making imports democratic legitimacy unobtainable when the CEO calls all the shots. Proponents of this approach like to point out that shareholding's demographic has been widened, sweeping in much of the populace as a whole.[104] Even if shareholders are unaccountable, they are us. So let us waive the unaccountability objection.

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[100] *See* Leo E. Strine Jr., *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, 76 BUS. LAW. 397, 410 (2021) ("Importantly, because corporate power has been used to undermine the regulatory protections for stakeholders, the probability that corporate wrongdoing will be punished in a way that makes overreaching more harmful to stockholders than beneficial to them has diminished. In sum, equity value prices this lack of stakeholder protection as a positive, not a negative.").

[101] For a structural account of the deterioration in the positions of corporate employees tied to shareholder primacy and institutional ownership, see Zohar Goshen & Doron Levit, Agents of Inequality: Common Ownership and the Decline of the American Worker, 72 DUKE L.J. 1 (2022).

[102] Chad Stone, Danilo Trisi, Arloc Sherman & Jennifer Beltrán, *A Guide to Statistics on Historical Trends in Income Inequality* 12-13 (2020) available at https://www.cbpp.org/sites/default/files/atoms/files/11-28-11pov_0.pdf.

[103] *See supra* text accompanying notes 10-11.

[104] The Investment Company Institute in 2005 noted that around half of American households owned stock, up from one-fifth in 1983. See Inv. Co. Inst. & Sec. Indus. Ass'n, *Equity Ownership in America*, 2005 (2005), available at http://www.ici.org/pdf/rpt_05_equity_owners.pdf. We were still at around one-half in 2022. *See* Lydia Saad & Jeffrey M. Jones, *What Percentage of Americans Own Stock?* (2022) available at https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx.

The theory might have some purchase if shareholdings were distributed evenly across the population. That was Berle's point.[105] But they are not so distributed. We can still sweep in around half of the households by conducting a per capita count, enough to stake a democratic claim. But once we reference the numbers of shares held per household the claim becomes risible. The modal shareholder is rich, old, white,[106] and, we can add, irresponsible and unaccountable.

The fact that responsibility cannot be pinned on a particular individual or group does not make the accountability problem go away. It just means that it is hard to do anything about it. To see why, compare Berle and Means's treatment of early twentieth century managers. They framed the management accountability problem with a property analogy. The shareholders were the owners, but unlike a human owner of a house or a car, the shareholders exercised no control over their property. Control lay in non-owning managers, resulting in management empowerment and an accountability gap. The managers accordingly needed to be monitored and held in check by the state, which rose to the regulatory occasion during the New Deal, achieving some of its objectives with direct regulation and others by relational influence backed by implicit regulatory threats.[107] Now, nine decades later, the empowerment picture has changed. The shareholders are still the owners but now share control of the assets. Were the regulatory state to try to extend its regulatory reach to bring them to account, it would not be a simple matter of reapplying the template devised for management during the twentieth century. Given the shareholders' small stakes and dispersion, there is no ready lever for government influence. You cannot lean on them or nudge them, as you can the CEO and the board. A structural law reform discussion is similarly pointless. To intervene to disempower the shareholders structurally is to disenfranchise them in whole or in part.[108] So doing would only return us to the twentieth century's management accountability problem.

B. Institutional Voters

This Section relaxes the direct-holding assumption to look through to the incentives of the institutions that hold and vote most of the shares. The results fit awkwardly with the assertions bound up in shareholder primacy.

1. *The Standard Account of Institutional Investor Incentives*.

Recall that shareholder primacy draws on two conceptual sources, one in Friedmanite political economy and the other in agency theory. The Friedmanite source exalts shareholders as "owners." But, in the real world, ownership is split between institutional investors and beneficial owners.

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[105] *See supra* note 53and accompanying text.

[106] William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489, 515-21 (2013). And even if we waive the numbers point, a look at the transmission mechanisms of shareholder power does not reveal much in the way of democratic process. Points of contention in corporate governance rarely result in votes. Activists deal in threats and defensive responses. When there is a vote, most votes are cast by institutions. For a more recent, but largely unchanged, statistical abstract, see Simkovic, *supra* note 12, table 1A.

[107] *See supra* notes 49-50 and accompanying text.

[108] *See* Dorothy S. Lund, *The Case Against Passive Shareholder Voting*, 43 J. CORP. L. 101 (2018.)

Mutual funds, pension funds, and other investment vehicles hold the title to most of the shares outstanding for the benefit of their investors. The vote, and thus the power to determine corporate outcomes, goes to the titleholders, who, unfortunately, do not have the economic incentives of a 100 percent owner, problematizing the Friedmanite case for primacy.

Now let us switch over to shareholder primacy's source in agency theory. This exalts productive efficiency, emphasizing the at-the-margin position that devolves on the shareholders in their role as residual interest holders. But, in the real world of split ownership the institutional titleholders with outcome determinative voting power do not operate at that economic margin. Although certainly subject to market constraints, the constraints do not put them at the risk of loss to their own bottom lines when they vote the shares they hold. The case for primacy is compromised once again.

Thus does the real-world robustness of shareholder primacy depend on the incentives of the shareholding institutions. What kind of shareholders are they?

They are disposed to be passive. Accounts of institutional shareholder incentives explain why, making four points. First, the institutions make their money from the management fees they charge investors and the fees are set competitively, allowing little room for administrative slack at the institutions. Second, an institution that makes a cognizable investment in governance activism must share the fruits with its competitors—a successful engagement with a badly run company that causes its stock to go up benefits not only the intervening institution but all institutional investors with positions in the stock, which happen to be its competitors. Third, if a given fund is heavily diversified, then the yield to its manager from engagement with a portfolio company, which is a function of the increase in its asset fees due to an increase in the value of the stock, is likely to be small in relation to the out-of-pocket cost of the campaign. Fourth, the institutions' client lists include listed companies. They are accordingly unlikely to spearhead attacks on the quality of such companies' managers for fear of disrupting client relations.[109] The four points support a prediction: institutions cannot be expected to make significant investments in governance or performance improvement at portfolio companies.

The practice has borne out the prediction. Although the institutions are not reflexively pro-management, they do not spearhead engagements and interventions with underperforming managers.[110] It took the appearance of a new class of institution—the activist hedge fund—to

[109] For the seminal account of this problem, *see* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 19 GEO. L.J. 445 (1991).
[110] Prior to the mid-1980s, institutions followed the Wall Street Rule—when long in a stock they supported management; when dissatisfied with management they sold the stock. Thus postured, they were "rationally apathetic" as regarded issues at particular companies: Since they were going to support management in any event there was no reason to expend resources getting up to speed on particular issues. The pattern shifted during the takeover wars, when the institutions, which appreciated enhanced returns from takeover premiums, objected to legal barriers to hostile bids. They stopped supporting management's defensive proposals and started paying attention to governance issues. See William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L.REV. 1861, 1906-08 (1995).

produce an institutional investor incented to play hardball with corporate managers. Significantly, these funds' compensation schemes work very differently than those of the managers at the big mutual and index funds. The arrangements at hedge funds resemble those of private equity funds, adding a "carry" to the standard percentage fee based on assets under management. The carry, a percentage of gains yielded in the stock of portfolio companies, imports a high-powered incentive to intervene. The activist funds' portfolios reflect this. Where the big mutual and index funds hold the market or other broadly diversified portfolios, the activist hedge funds do research and pick targets, taking significant stakes—5 percent of shares outstanding and upward.[111] The managers of big funds with diversified market portfolios tend to support their interventions, following the leader without ever taking leadership roles.

2. *The Special Case of Index Funds.*

At this point one would have thought the matter closed: No, the big asset managers have no incentive to play the governance game; but, yes, activist hedge funds now pick up the slack. Out-of-control management agency costs no longer pose a capitalist emergency,[112] if indeed they ever did. The institutional shareholder incentive problem has returned to center stage nevertheless. The reason is the rise of index funds.

Index funds buy and hold market indices such as the S&P 500. Their expenses and fees are lower than those of their mutual fund competitors. They accordingly offer the cheapest means to hold a fully diversified stock portfolio.[113] Unsurprisingly, investors have been stampeding into them, particularly funds sponsored by the "Big Three"—BlackRock, State Street, and Vanguard. The Big Three's stock portfolios have ballooned as a result. Their voting power has grown in tandem--it has been estimated that they could be casting 34 percent of the votes at S&P 500 companies by the end of this decade and 41 percent by the end of the next.[114] Commentators have made much of this—some attributed unprecedented power to the Big Three, while others speak of a slightly higher numbers of large asset managers, ranging from four to twelve.[115] Whatever the

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But "awake" did not mean "active." Developments on the ground bore out the prediction of passivity. While the institutions were ready to vote against management on certain issues, engagements were occasional and discrete and directed to specific issues. They were spearheaded not by the big asset managers but by actors from state-level public pension funds. The incentive contrast was sharp. Actors from the pension funds, who tended to manage indexed portfolios, looked more like civil servants than Wall Street portfolio managers. Their payoffs came not from portfolio gains but from resume lines qualifying them as corporate governance professionals. Limited resources limited their room for maneuver. So they employed cheap strategies, like "just vote no" announcements designed to cast a negative spotlight on managers of whose performance they disapproved. The private fund managers followed their lead. *Id*. at 1914-15. The engagements, while sporadic and underfunded, tended to be successful, with risk averse managers coming to the table to make concessions. *Id*. at 1909.

[111] See William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1426-28 (2007).

[112] Gilson & Gordon, *supra* note 2, at 867.

[113] William W. Bratton, CORPORATE FINANCE: CASE AND MATERIALS 129 (9th ed. 2020).

[114] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 724 (2019).

[115] Some just look at the Big Three. See *id*., at 725 (arguing that "recognition of the Giant Three scenario increases the importance of the agency problems afflicting Big Three incentives"). Compare John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve*, at 2 (Sept. 2018), available at https://ssrn.com/abstract=3247337 (speaking of twelve asset managers and opining that "the prospect of twelve

precise number, the asset managers in this magic power circle occupy a fulcrum position at hundreds of companies, with enough votes to determine outcomes. For convenience, we will refer to the Big Three.

The incentive profile of the managers of index funds differs very little from that drawn above.[116] The *sturm und drang* concerning their incentives goes to a matter of degree: Take everything that was wrong with fund managers' incentives before and now further embed the imperfections and possibly even exacerbate them. The reason: these are the most diversified funds and at the same time have the lowest fee yield in the market, a combination that makes it even less likely that their managers will have an incentive to invest in governance improvements at portfolio companies. An opportunity cost is thought to be incurred: If there was ever any hope of waking the sleeping giants of asset management to agency cost activism, now all hope is lost.

There is also alleged to be dark side to the incentives of index fund managers—the phenomenon of "horizontal shareholding."[117] The Big Three own large stakes of multiple firms in the same industry. Competition among the firms within the industry reduces the returns to those thus positioned. It is thought to follow that industry-wide shareholders will take an industry wide perspective that favors diminished competition. The allegation has empirical support based on statistical analyses.[118] But the support is inferential--there is no smoking gun evidence of collusion. Nor, given the rest of the incentive picture and the institutions' lack of boardroom presence, is there a persuasive projection of some other means of accomplishment.[119] Even so, proponents of

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people even potentially controlling most of the economy poses a legitimacy and accountability issue of the first order - one might even call it a small "c" constitutional challenge"); Leo E. Strine Jr., *Fiduciary Blind Spot: The Failure of Institutional Investors to Prevent the Illegitimate Use of Working Americans' Savings for Corporate Political Spending*, 97 WASH. U. L. REV. 1007, 1017 (2020)(adding fidelity to the Big Three).

[116] See, e.g., 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, 1246-47 (2020)(describing index fund incentives). For the minority view that that the Big Three invest cognizable assets in governance, see Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 49-50 (2019). Compare Jeff Schwartz, *Stewardship Theater*, 100 WASH. U. L. REV. ___, ___ (forthcoming 2022)(comparing the small size of the Big Three's governance teams to the large numbers of issues on which they cast votes).

There is one positive wrinkle--because these funds indexed their investments in particular companies are for the most part locked in. It follows that their time perspective is long-term and that their growing salience could ameliorate the short-term bias built into hedge fund activism. Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2035-36 (2019).

[117] See Einer Elhauge, *Horizontal Shareholding*, 129 HARV. L. REV. 1267 (2016); Eric A. Posner et al., *A Proposal to Limit the Anti-Competitive Power of Institutional Investors*, 83 ANTITRUST L.J. 669 (2017); Jose Azar et al., *Anticompetitive Effects of Common Ownership*, 73 J. FIN. 1513 (2018) (identifying anticompetitive effects in the airline industry).

[118] Id., Melissa Newham et al., *Common Ownership and Market Entry: Evidence from Pharmaceutical Industry* 38 (DIW Berlin Discussion Paper No. 1738, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3194394 (pharmaceutical industry); Jose Azar et al., *Ultimate Ownership and Bank Competition* (May 4, 2019) https://ssrn.com /abstract=2710252 (banking industry).

[119] Goshen & Levitt, *supra* note 101, at 6-7, attribute shareholder power and "strong corporate governance" to institutional holding; it in turn discourages new investment in favor of stepped up payouts. The structural losers are the workers, id. at 7-8:

regulatory intervention in respect of horizontal shareholding have a response to this objection: executives of the companies in the industry, being aware of the preferences of these large shareholders, will pull back from price competition without having to be pushed.[120] It is a bit of a stretch. Unsurprisingly, the jury is still out on the question whether horizontal shareholding presents a cognizable problem.

3. *Questions*.

Shareholder primacy proponents conclude, based on the above, that the institutions disserve their investors. The investors, it is asserted, would want the institutions to expend resources going after bad managers and reducing agency costs. Yet the institutions stubbornly remain passive.[121] As a result a big rock candy mountain of shareholder value goes up in smoke!

The critique gives rise to some questions. First, why, given the continuing presence of hedge fund activists, is institutional passivity still viewed as a serious problem? It seems we now have plenty of appropriately incented equity investors. Second, given that the incentive problems stem from competitive pricing, why is it that shareholders should expect asset managers to incur the costs of active engagement? Consider a numerical example offered by Professor Schwartz:

> . . . [A]sset managers' gains are the fees associated with the activist-driven increase on this holding. In 2020, Vanguard's average fee was .09%, State Street's was .16%, and BlackRock's was .25%. Say an activist increases the value of a firm by $100 million in the first year, Vanguard's share, assuming a 10% holding and its average fee, would be $9,000. Vanguard would earn this additional fee each year for as long as the increase in value remained. A $100 million improvement may be worth it for an activist hedge fund with a concentrated ownership position, but the resulting gain is a pittance for a large asset manager.[122]

Given the trivial nature of the payoff projected, it would seem that rational clients would "expect" returns from Big Three activism only to the extent that the the clients themselves actually paid for

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> As investment falls, so too will hiring, as companies no longer require the labor force to operate new factories or staff new divisions. This hiring shortfall artificially depresses wages, allowing firms to enjoy a wage discount and moving wealth from workers to shareholders. By switching firms *en masse* to strong governance, institutional investors reduce the total investment in the economy and the demand for labor. In other words, they create the anticompetitive twin of a *monopoly*, known as a *monopsony*. While a monopoly is a powerful seller that reduces supply and raises prices of *products*, a monopsony is a powerful buyer that reduces demand and lowers prices of *resources* (in this case, labor). They create a labor market monopsony without resorting to collusion, and indeed, likely without intending to create one. Common owners' labor monopsony is driven by *shareholders'* market power over *managers* of numerous firms, each separately pursuing its economic interest. This concentration of ownership results in lower demand, and consequently a lower equilibrium price, for labor, causing wages to stagnate rather than rise with productivity increases.

[120] Einer Elhauge, *The Causal Mechanisms of Horizontal Shareholding*, 82 OHIO ST. L.J. 1, 22-23 (2021). One wonders why they would not do this in any event.
[121] *Id.*
[122] Schwartz, *supra* note 116, at __.

them. Yet none of the incentive accounts claims that the clients in fact pay a penny. Indeed, the rise of index funds signals that the clients want just the opposite—the cheapest possible fee without regard to any agency opportunity costs.

C. Observations

We began this Part by inflicting a blow on shareholder primacy with the point that shareholders benefit when their corporations inflict injuries not only on other corporate stakeholders but on the world at large. When, during the twentieth century, there wasn't a lot shareholders could do to stop the actions in question, this embedded unaccountability raised no policy issues. Now, in the twenty first century, when shareholders can intervene, questions arise. Shareholder primacy does nothing to answer the questions in the shareholders' favor. It ties shareholders to production efficiency and accords them privileges as owners, but there's nothing efficient about externalized costs and owners are not privileged to injure their neighbors. Not that liability is an issue. More salient is the robustness of the group's continuing claim to status as a protected class.

Shareholder primacy, which is a theory of incentive alignment, took a second blow when this Part turned to the incompatible incentive profile of the institutions that hold and vote most of the shares. Shareholder primacy proponents seek to correct for this by blaming the institutions for falling down on the job, excoriating them for failing to join the activist hedge funds as shock troops for agency cost reduction. But the criticism is unfair. The fund managers perform the tasks for which they are paid. The problem lies instead with shareholder primacy itself, which claims that shareholder power assures certain efficient outcomes and then goes into denial when it turns out that real world shareholders do not have the incentive profile needed to bring those outcomes about.

Thus does the move to institutional holding baffle shareholder primacy. It simultaneously transforms the accountability problem. With the emergence of the Big Three we for the first time have poster children against whom to press a case for accountability. They make excellent targets for a state actor looking for empowered shareholders to nudge or punish.

But punish for what? Since they are not the beneficial owners, they do not enjoy the financial rewards of injuries inflicted by their portfolio corporations. Nor, based on their fee income, do they have an economic incentive to intervene in those companies' internal affairs. Part III takes up this question.

III. THE TURN TO SOCIAL SHAREHOLDING

Shareholder primacy recently entered a new phase of history when corporate social responsibility, long a subordinated topic within corporate governance, returned to the front line for the first time since the 1970s. All of a sudden, the governance world redirected its attention from agency costs and shareholder financial returns to question the purpose of corporations. BlackRock's CEO, Mr. Larry Fink, in a 2018 statement, publicly instructed portfolio companies to consider "the societal impact of your business as well as the ways that broad, structural trends [including] climate change" affect growth potential.[123] More generally, wrote Fink:

> Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.[124]

The portfolio companies' managers themselves seconded Fink's motion a year later, when the Business Roundtable negated its 1997 statement favoring economic returns to shareholders and announced a "fundamental commitment to all of our stakeholders."[125]

The new formulations of corporate purpose, however more particularly phrased, all import social welfare into the governance frame as a priority concern. Critically, the Big Three have come out in support, engaging with managers and voting for selected ESG proposals. This is a development of historic proportions: for the first time, public company shareholders with the wherewithal to affect results are taking responsibility for corporate externalities. They traverse shareholder primacy's purposive leg as they do so, for shareholder primacy defines corporate purpose exclusively in terms of shareholder financial welfare. Should the new behavior pattern persist and generalize, shareholder primacy will undergo a transformation on the ground. By hypothesis, it will survive only on its procedural side to stand for the following proposition: So long as the shareholders and not the managers are giving the instructions, a corporation legitimately may shift its emphasis from shareholder returns to social welfare enhancement.

That proposition has in turn triggered opposition from politicians in red states whose platforms deny climate change. This came as a jolt to the Big Three, which took up ESG looking for political credit with progressives only to find themselves targeted by the other side. They responded by redirecting themselves to a reform of the terms of their shareholding. The presently are implementing schemes for passing voting decisions to their clients. In this they manifestly seek to get out of the political crosshairs.

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[123] Larry Fink, Larry Fink's 2018 Letter to CEOs: A Sense of Purpose, BLACKROCK (2018), available at https://www.blackrock.com/corporate/investorrelations/2018-larry-fink-ceo-letter [https://perma.cc/W7QK-NDBC].
[124] *Id*.
[125] Business Roundtable, Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans' (2019), available at https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

This Article draws two points from this sequence of events. First, shareholder primacy and shareholder accountability are natural enemies, like dogs and cats. As a result, crossings of the public/private divide by empowered shareholders acting accountably turn out to be intrinsically disruptive. We accordingly are likely to see fewer of them in the future. Second, institutional shareholder power is contingent and vulnerable. It looms largest when it remains unexercised. There is less there than has met the eye.

Section A recounts events on the ground. It observes that the recent ESG-fueled shift in the shareholder agenda, while novel as regards the subject matter endorsed, otherwise entails no break with the pre-existing pattern of engagement and activism. It goes on to note that the tilt toward social responsibility puts the institutions on a path long trodden by corporate managers. Such are the demands of a political culture in which business empowerment breeds concerns about accountability. But there are also contextual differences. The Big Three, thrust onto the political stage in their capacity as shareholders, potentially have more room for maneuver than do the managers of operating companies. When they impose courses of action that sacrifice financial value, they go where managers acting *sua sponte* cannot. At the same time, the institutions' political salience has a contingent aspect. Managers of operating companies are in charge of the economy's productive core, as suppliers, customers, and employers. There is no avoiding the spotlight. Institutional shareholders occupy a more marginal position. While shareholder empowerment in corporate governance, itself a relatively recent development, facilitated their emergence as critical actors, it did not require it. The institutions might have continued to lay low, as passive holders, letting the political winds blow above them. Alternatively, as is now happening, they can diffuse their power by passing the franchise to their investors.

This Part's remaining sections turn to explanations and justifications for the change in the institutional behavior pattern, assaying a long list of possibilities. Section B starts off with three preconditions—background factors conducive to a shift in approach: (1) the prevalence of shareholder primacy, which provides a weak ideological justification; (2) the presence of a corps of corporate governance intermediaries, which generates a steady supply of new issues and proposals along with justificatory duties newly imposed on institutional shareholders; and (3) the benefit of a period of economic expansion, which yielded rents for distribution. Section C looks at two possible explanations, both of which imply justifications: (1) that the institutions sought to gain financially for themselves and their clients; and (2) that the institutions responded to competitive demands in the market for investment services. Both explanations highlight economic, as opposed to social, motivations and accordingly anchor the institutions' social shareholding on the private side of the Friedmanite divide, which is a considerable justificatory advantage in a world in which Friedman's precepts continue to hold ideological sway. Section D turns to a contrasting account, suggesting that the Big Three took up social shareholding not for financial or competitive reasons but to improve their profiles with regulators in Washington and stave off new regulatory initiatives. The shift in perspective enhances descriptive persuasiveness even as it carries reduced justificatory implications. Section E concludes that the cumulated justifications fall short, leaving behind legitimacy questions. It still matters that the money is other people's.

A. The Institutional Awakening

Corporate social responsibility (CSR) has a long history as a management topic. Managers first started to think of themselves as stakeholder trustees back in the 1920s. CSR has remained a management concern ever since.[126] Indeed, it is well-institutionalized at many companies as a focus for both strategic management and governance.[127] Shareholders, in contrast, have dealt with CSR only peripherally, at least until recently. A shareholder level CSR movement waxed and quickly waned during the 1970s.[128] CSR topics remained on the corporate governance screen only at the urging of proponents of shareholder proposals,[129] whose initiatives until recently were dismissed as idle gestures of idiosyncratic interests that never passed.[130] Lately, as CSR has evolved into a more business-friendly mode as ESG, the reception has been warmer.

1. *The Social Agenda*.

Levels of support for social shareholder proposals have increased markedly in recent years, even as the passage rate remains low. A study of all social proposals put for a vote from 2010 to 2019 shows that only 1.1 percent garnered a majority.[131] But average support stood at 27.6 percent by 2019,[132] and with 40 percent of submissions pulling more than 30 percent.[133] There also has been a change in the framing. In the ESG era, financial justifications have become prominent.

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[126] See Archie B. Carroll & Jill A. Brown, A. (2018) C*orporate Social Responsibility: A Review of Current Concepts, Research and Issues* in James Weber, J. & David M. Wasleleski, D. (eds.) CORPORATE SOCIAL RESPONSIBILITY 39-69 (2018)(summarizing the history of theories about and descriptions of corporate social responsibility).

[127] Carroll, supra note 46, at 20.

[128] See William W. Bratton, *The Separation of Corporate Law and Social Welfare*, 74 WASH. & LEE L. REV. 767, 776 (2017). Nor has there ever been much of an interface with the production of corporate law. The classic case, Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), excludes it, remitting management to devote itself to shareholder returns. Even so, the received legal framework still leaves management extensive room within the business judgment tent to attend to stakeholder interests. Charitable contributions are the only area in which a subsequent caselaw developed to address the address limits on boardroom altruism, leaving us a thin literature applying a reasonableness rubric. See, e.g., A.P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, appeal dismissed, 346 U.S. 861, 74 S.Ct. 107, 98 L.Ed. 373 (N.J. 1953).

[129] Shareholder proposals must be included in public company proxy statements pursuant to an SEC mandate. *See* Shareholder Proposals, 17 C.F. R. §240.14a-8.

[130] See Roberto Tallarita, *Stockholder Politics*, at 3 working paper available at https://ssrn.com/abstract=3798101 (Sept. 2021). Shareholder proposals come in two flavors, governance related and social. Governance-related proposals--for example, a request to repeal a poison pill or adopt majority voting—address shareholder primacy's core process concerns. They played a strategic role when shareholder-centric governance first emerged in the 1980s and 1990s: If a proposal seemed likely to garner a significant favorable vote, managers averse to political instability proved willing to negotiate for its withdrawal. *See supra* note 110. Historically, social proposals did not have the same potency.

[131] Tallarita, *supra* note 130, at 22.

[132] *Id.* at 28.

[133] *Id.* at 29.

They often are plausible--some social proposals are seen as "good for business."[134] Political traction results, with interactions following a familiar pattern. As with governance proposals, the submission or threated submission of a plausible social proposal triggers negotiations with, and possibly concessions from, managers afraid of an embarrassing loss at the polls.[135]

This embodies a significant expansion of the territory on which shareholders exercise directive power over the conduct of the business. It also bespeaks changes of position on the part of the big institutions. The first concrete sign of this came in 2017 and 2018, when social activists benefitting from Big Three support successfully sponsored climate change proposals at a group of energy companies. Dozens of other target companies had made concessions in exchange for the withdrawal of similar proposals.[136] The Big Three also started to pressure companies for more gender diversity in the boardroom—the target companies added 2.5 times as many female directors in 2019 than they did in 2016.[137] There were also public statements and occasional no votes on compensation plans and board candidates.[138] A climax of sorts occurred in 2021, when a tiny ESG-motivated activist hedge fund, Engine No. 1, secured the election of a short slate of directors at Exxon on a platform of reduced oil and gas investment.[139] Engine No.1 had been backed by the Big Three, along with the proxy advisors and the big state pension funds.[140]

The foregoing may not sound like much. But the results were unprecedented: Never before had institutional shareholders forced social change on business plans.

2. *Legal Posture*.

It was their privilege so to do. As a matter of corporate law, the shareholders, unburdened by fiduciary duty and legal accountability, may instruct the company to make financial sacrifices in the name of social responsibility.[141] Perhaps fittingly, the same unaccountability that lets

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[134] *Id.* at 3.
[135] Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1, 4 (2020).
[136] *Id*. It is safe to assume that these public incidents had been accompanied by background jockeying between target managers and Big Three representatives expressing concern and applying pressure, and that similar background maneuvering at the other targeted companies had succeeded in assuring that no public incident occurred at all.
[137] Todd A. Gormley, et al., *The Big Three and Board Gender Diversity: The Effectiveness of Shareholder Value*, Eur. Corp. Gov. Inst. 1, 3 (Aug. 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3724653..
[138] Condon, *supra* note 135, at 50-56. But the Big Three continued to vote no on the overwhelming majority of social proposals. That changed in 2021 when BlackRock supported 64 percent of all environmental proposals and 43 percent of all social proposals, with Vanguard voting yes on 46 percent and 29.6 percent, respectively, and State Street voting yes on 56.8 percent and 35.6 percent. *See* Schwartz, *supra* note 116, at 32.
[139] Matt Phillips, Exxon's Board Defeat Signals the Rise of Social-Good Activists, N.Y. Times, Jun. 9, 2021 available at https://www.nytimes.com/2021/06/09/business/exxon-mobil-engine-no1-activist.html.
[140] Thomas Ball, James Miller & Shirley Westcott, *Was the Exxon Fight a Bellwether?*, HARV. L. SCHL. FORUM ON CORP. GOV., July 24, 2021 available at https://corpgov.law.harvard.edu/2021/07/24/was-the-exxon-fight-a-bellwether/.
[141] Provided the outcome did not fall into the category of "waste," which requires unanimous shareholder consent. An action in pursuit of a social goal, while not profitable, does not implicate the concept, which is directed to bad deals. *See* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1999)("consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade").

shareholders benefit financially from stakeholder injuries and externalized costs makes possible shareholder-generated corrective action.

A board of directors and CEO, constrained by shareholder primacy's purposive leg, would have to process their way to the same result.[142] Corporate law is nominally prohibitive of board and management level social initiatives but permissive in operation. Social motivations are taboo taken by themselves, but can be masked by statements of business exigency and thereby placed within the board's zone of discretionary decision making. The bundle of financial assertions collected under the ESG rubric opens up the permissive space. ESG began as a CSR movement but rapidly took on a financial coloration due to inputs from technicians, both scientific and financial. A mixed bag of evaluative metrics emerged, metrics used by asset managers and

[142] The legal position of managers is problematic even when they are acting under shareholder instruction. Assume that Company X, which operates in a primary industry, is pressured by Large Institutions A, B, and C to initiate a climate protection program. X management knows that this will reduce returns to shareholders; financial benefits, if any, will redound in the far, financially insignificant future. Despite this, X management, fearing negative and withheld votes at the next board election, knuckles under. Does management run any legal risks, in a particular the risk of suit for breach of the duty of loyalty by a dissenting shareholder plaintiff?

There is a risk. See Edward Rock, For Whom is the Corporation Managed in 2020: The Debate Over Corporate Purpose 15, ECGI Law Working paper 55/2020 available at http:// ssrn.com/abstract _id=3589951(2020) ("If [Martin Lipton and I] disagree in our legal analysis, it is over whether directors can pursue the interests of society and people when they believe that doing so does not benefit shareholders over any time frame or even injures the interests of shareholders. In the sale of company context, we agree that they may not in a 'traditional'" jurisdiction like Delaware, but may in a 'constituency' jurisdiction like Pennsylvania.") Since management knows that the environmental improvement comes at the cost of reduced shareholder returns, this arguably is a bad faith violation of the duty—an action taken not in the "best interests" of the corporation. Management's defense will reference the discretionary envelope for "reasonable" actions taken to benefit society recognized in the American Law Institute's Principles of Corporate Governance. [2] Publication would take a further two years. See 1 American law Institute, Principles of Corporate Governance: Analysis and Recommendations (1994). Unfortunately, the legal line between permitted social benefits and bad faith is undefined. Rock, *supra*, at 14. Meanwhile, the fact that Company X's action resulted from shareholder pressure is not outcome determinative by itself. In legal contemplation, the shareholders do not have the authority to dictate the business plan and the managers' duty runs to the entity. *See* DEL. CODE ANN. tit. 8, 144(a).

Let us change the facts to strengthen management's case. This time the first mover is an environmental NGO submitting a formal shareholder proposal. Management opposes the proposal. But Large Institutions A, B, and C loudly support it and the proposal garners a bare majority vote. Management has a decision to make at this point. Shareholder proposals are precatory. *See* Shareholder Proposals, 17 C.F. R. §240.14a-8(i)(1)(providing that the proposal must be a proper subject for action under state law). Management is free to disregard them. Management knuckles under anyway and implements the successful proposal. The same lawsuit follows. The formal shareholder recommendation certainly improves the defensive atmospherics. But it does not import a complete defense. As a corporate law proposition, this is still management's decision. It bears noting that Large Institutions A, B, and C have no legal responsibility whatsoever, even though they are directly responsible for the change. As they are noncontrolling, they are not fiduciaries operating in a zone of legal accountability.

In the real world, management will win both cases, not because there is no basis for complaint but because counsel will have intervened to shore up the defensive case before any action is taken in the boardroom. A report will be prepared in apparent good faith that characterizes the action as risk management, describing in detail the risks addressed and minimized. See Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1410 (2020)(justifying ESG investment as management of social risk). Projections of future positive cash flows will not be required, but such projections could be ginned up easily enough. The report creates a foundation for application of the business judgment rule. End of story.

financial analysts.[143] Reference to ESG factors in profit-seeking investment and finance is now an ordinary course proposition.[144] It is also a business factor in mergers and acquisitions.[145]

Thus did ESG emerge as a robust corporate governance vehicle where CSR did not. Its environmental and governance bookends are particularly susceptible to being rendered consistent with profitmaking. The Big Three follow this template in their stewardship policies, according long term shareholder value either first priority status or concomitant status with social welfare.[146] As between senior and concomitant status, there is no discernable difference in legal contemplation. Meanwhile, comparative quantification is not required; so long as shareholder value is on the table it operates as a business justification.

3. Political Posture.

The Big Three's turn to ESG, while unprecedented in its impact, is notably circumscribed as regards subject matter. There are two favored topics—climate change and boardroom diversity.[147] Despite Larry Fink's reference to a broader substantive reach--"employees, customers, and the communities in which they operate"[148]--the pattern of engagement does not show much in the way of broader follow through. Climate, biodiversity, and gender equality get votes, where employee issues and questions about political contributions lag.[149]

The chosen topics reflect the agendas of self-interested members of society's economic elite. Climate change directly threatens their individual welfare. Boardroom diversity implicates their interest in effecting the widest opportunity set for their daughters. Other social matters, such as employee interests and corporate political spending and influence[150] register differently in these precincts. As to these the Friedmanite public/private divide might as well have been left in place. On the broad political scale of things, this is at best a moderate intervention.

Nor, significantly, does it implicate any credible commitment to social welfare enhancement. Actors at the Big Three must have understood the risks of climate change long before they lurched out of passivity. Yet years passed and they did nothing. Nothing in the fact pattern prevents them

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[143] *See Historical Time Line of ESG* available at https://www.preqin.com/preqin-academy/lesson-5-esg/history-of-esg (showing origins in NGO and United Nations initiatives in the 1990s and 2000s followed by widespread use in the capital markets in the 2010s).
[144] It is also a factor in mergers and acquisitions. See Wachtell, Lipton, Rosen & Katz, *Mergers and Acquisitions—2023*, at 11 (Jan. 24, 2023) available at: https://corpgov.law.harvard.edu/2023/02/08/mergers-and-acquisitions-2023/.
[145] *Id*. at 11.
[146] *See* Strine, *supra* note 115, at 1015 (summarizing the policies).
[147] *See* Barzuza et al., supra note 116, at 39-42.
[148] *See supra* text accompanying note 124.
[149] Lindsey Stewart, Proxy Voting: Managers Focus on Environmental and Social Themes, Harv. L. School Forum on Corp. Governance, Aug. 18, 2022 available at https://corpgov.law.harvard.edu/2022/08/18/proxy-voting-managers-focus-on-environmental-and-social-themes/; Strine *supra* note 115, at 1019-20.
[150] *Id*.

from returning to sleep if their companies' interests so dictate,[151] a possibility that will loom ever larger when we work the regulatory environment and preemptive political strategies into the explanatory mix in Section D.[152] The economic environment also may matter. Given a severe recession, or, worse, long enduring economic malaise, the flow of rents decreases and priorities are reordered, not just those of the Big Three but those of their clients. On the economic downside, shareholder value can be expected to trump ESG, benefitting from a sort of financial priority. That is how corporate capitalism works. Even assuming prosperity, profitability always operates as a constraint.[153]

The posture of moderation is as unlikely to satisfy the political right as it is the political left. Recall that Friedman condemned management CSR as a tax on other people's money. Things are different with shareholder-initiated CSR—shareholders who are beneficial owners can spend their money as they please. Unfortunately, institutions like the Big Three are not beneficial owners. This accordingly remains a case of other people's money to the extent they act without the affirmative backing of client consent. Friedman's warning of impending socialism also retains some resonance. When institutions use their voting power to cross the divide to effect public results, there is a risk, if not of socialized equity investment, then of unintended and destabilizing political consequences.[154] As we will see, that risk has already come to fruition.

B. Facilitative Conditions

Why did the Big Three suddenly wake from governance somnolence to start pushing social issues? Our explanations come in three tranches. The first, in this Section B, highlights facilitative conditions—factors that laid the groundwork for change. We identify three of these: (1) the legitimacy attached to exercises of shareholder power, (2) the interest of corporate governance professionals both in generating a steady stream of new issues to push against managers and in imposing their governance agenda on institutional shareholders, and (3) the availability of rents. Sections C and D, which follow, project more particular motivations and in so doing look into the case for (and against) legitimacy.

1. *Shareholder Primacy*.

The big institutions, cautious by nature, took a risk in shaking off their lethargy and using their voting power to effect social results at investee corporations. Action can excite regulatory

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[151] This may already be happening. BlackRock has cut back on its votes in favor of ESG proposals, finding them too prescriptive. See Simon Jessup, Drop in BlackRock's Support for Environmental, Social Resolutions, Reuters, July 26, 2022) available at https://www.reuters.com/business/sustainable-business/drop-blackrocks-support-environmental-social-resolutions-2022-07-26/.
[152] *See infra* text accompanying notes 187-213.
[153] *See* Roe, *supra* note 7, at 6 ("Many analysts indicate that most ESG/CSR is ultimately just cheap talk; executives and boards will only do CSR if it is profitable. I agree that much purpose pressure in the end must be profitable to succeed widely.")
[154] *Id*. at 6 ("[I]f corporate profit becomes a major distributional battlefield inside the corporation, that conflict would contribute to the increasing instability and tension in the polity.")

responses as much as can inaction, as we will see in the Section D. But at least one background factor held out a promise of legitimacy—shareholder primacy itself. One suspects that the institutions assumed that their interventions would be accepted as legitimate precisely because they acted in the capacity of shareholders. They assumed reasonably.

Within the confined frame of corporate governance, which historically has been obsessed with management agency costs to the exclusion of almost everything else, shareholder initiatives—even social shareholder initiatives--do not raise legitimacy problems. To see why not, take a single company perspective and ask whether any agency costs are involved here. The answer is "no" because it is the principals who are giving the orders.[155]

The problem, of course, is that the moment we widen the lens and take the institutions out of the single company governance frame, exercises of power by institutional holders raise all sorts of serious questions. We accordingly classify this point as a "facilitative condition" rather than as a "justification." Shareholder primacy provides cover, albeit of a limited sort.

2. *Structural Bias*.

A corps of governance professionals shape and channel exercises of shareholder power—regulators, lawyers, actors at socially- and governance-oriented NGOs, analysts at asset managers and producing companies, and information intermediaries. Their job is to tell management what to do (or to advise management not to do it).[156] To keep busy, they need a constant supply of new instructions to lay down (or oppose). A generation ago, the corps focused on basic governance topics like majority voting and board declassification.[157] Those matters are now done and dusted. New issues need to be created to justify the flow of rents into the profession. ESG metrics and goals fill this bill admirably. Indeed, they came along at just the right time. Now that shareholders are no longer victims and are in fact the governance arena's winners, the governance machine[158] has plenty of space within which to broaden its agenda.[159]

The governance profession also likes to lay duties on institutional shareholders. It has produced a whole literature describing, under the rubric "stewardship," how an institution appropriately includes social concerns in the appropriate performance of its governance role. The notions animating Larry Fink's high profile 2018 announcement are iterated in stewardship

[155] We do not of course exclude the possibility that there are agency costs as between the institution and its clients.
[156] Cf. Tallarita, *supra* note 130, at 5 (describing a two-sided job performed by "shareholder politics specialists").
[157] Bratton & McCahery *supra* note 110, at 1907-09.
[158] See generally Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021).
[159] The corps of professionals generates new inputs all over the world. Ideas and initiatives ebb and flow across national lines. CSR took a strong hold in Europe a decade or so ago, Carroll, supra note 46, at 20, influencing the national stewardship codes. See infra text accompanying note 161. European asset managers are significantly more likely to support ESG initiatives than are US managers. Transmission back to the US occurs in the ordinary course. It also bears noting that there were no homegrown centers working to the same end. See Strine, *supra* note 100, at 414-15 (describing the Aspen Business and Society Program).

"codes" which proliferate worldwide.[160] The UK code, promulgated by a government agency, leads off with social purpose: Stewardship, it says, should create "long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."[161] Such pronouncements provide a source of built-in justification for the social initiatives of institutional shareholders.

3. *Economic Environment*.

As Friedman observed, managers of corporations operating as pure competitors have no room to worry about social responsibility.[162] Contrariwise, competitive slack produces rents. Rents need to be distributed, opening the boardroom door to consideration of concerns other than business exigency, including social concerns.[163] Professor Mark Roe recently repeated Friedman's point about rents, inquiring into the impact of ESG notions on companies with market power and tying the recent turn to social shareholding to a long-term trend toward diminished competition.[164] Roe suggests, *inter alia*, that shareholder primacy works best in competitive industries and that justification for it weakens (without disappearing entirely) as the level of competition declines.[165]

Roe's points are well taken. Even if prosperity looms larger than declining competition in explaining recent events, there were facilitative rents on the table when the institutions switched into active mode and competitive slack played a role in their generation.

C. Economic Motivations and Justifications

Shareholders are unaccountable unless they are in control. Yet now we have a new and identifiable class of noncontrolling institutional shareholders (1) who exercise influence behind the scenes through "engagement" with operating companies, and (2) who often have the fulcrum position when votes are taken, yet (3) who are not the economic beneficiaries of the shares they hold. When these shareholding institutions abruptly awakened from passivity and started to effect public-regarding results, acting largely without transparency or oversight, questions about

[160] *See* Dionysia Katelouzou & Mathias Siems, *The Global Diffusion of Stewardship Codes* in Dionysia Katelouzou & Dan W. Puchniak (eds.) GLOBAL SHAREHOLDER STEWARDSHIP 631-662 (2022) available at https://www.cambridge.org/core/books/global-shareholder-stewardship/global-diffusion-of-stewardship-codes/E4C0C926266ECF1149640DB8E82A87F2 (describing the global diffusion of stewardship codes from 1991 to 2019). For an exhaustive report on interventions respecting climate change and boardroom diversity, *see* Barzuza, et al., *supra* note 116, at 1265-75.

[161] Financial Reporting Council, The UK Stewardship Code 2020, principle 1 (2020) available at https://www.frc.org.uk/getattachment/5aae591d-d9d3-4cf4-814a-d14e156a1d87/Stewardship-Code_Dec-19-Final-Corrected.pdf. Interestingly, the US equivalent, which comes from an NGO, is more compatible with shareholder primacy, it stresses diligence and transparency but contains no comparable social welfare goal. *See* INVESTOR STEWARDSHIP GROUP, THE STEWARDSHIP PRINCIPLES (2022) available at https://isgframework.org/stewardship-principles/.

[162] *See supra* text accompanying notes 30-31 .

[163] *Id.*

[164] See generally, Roe, *supra* note 7.

[165] *Id.*at 5.

democratic accountability and legitimacy inevitably followed,[166] questions which have attracted a great deal of attention in recent years (even as there remains absolutely no movement to make shareholders accountable as a whole).

The accountability problem is more or less acute depending how we explain the institutions' shift out of passivity. To the extent we can account for their actions by reference to economic fundamentals, the case in their favor strengthens considerably: If an asset manager is just trying to maintain or expand its business, it remains in its proper place on the private side of the Friedmanite divide even if the action taken has a public aspect. Commentators make two contrasting cases for applying this gloss, variously looking to client and institutional financial gain and competition in the market for asset management services. There is a shared goal: the commentators seek to cabin institutional behavior within the theoretical framework of shareholder primacy and thereby deliver it safely on the private side of the divide with the institutions' legitimacy confirmed.

To see better how this strategy works, recall that shareholder primacy justifies shareholder value and shareholder power in exclusively economic terms, wringing out any public politics and pursuing the most private of goals--market discipline of corporate production. The commentators seek to push institutional social shareholding into this framework. The first case for this, described in Subsection 1, looks to investment portfolio gain for diversified shareholders as a motivation and models shareholder social intervention in purely financial terms. We get a fully private pursuit of financial welfare, but not one that erases the prevailing account of selective institutional incentives. A contrasting case, described in Subsection 2 focuses on Big Three incentives, doing its best to strip away any taint of public spiritedness. Instead of private actors performing a public function we get striving competitors responding to market pressures.

We turn now to the two cases. The stakes are high, because substantive justification (and thus legitimization) of the institutions' conduct is more or less difficult depending on the descriptive account.

1. *Financial Returns*.

The institutions' legitimacy problem lessens to the extent we can depict them as actors reacting to competitive pressures. Market competition conduces incentive compatible behavior, depriving the actor of agency. In this account, competitively-driven institutions intervene in the corporate governance of portfolio companies not to satisfy the preferences of their own agents or of their customers, but because failure so to do means a loss of market share. Investor preferences matter only indirectly and then only to the extent that the market pressures reflect them. At the same time, any departure from Friedmanite separation is minimized, for there is no longer a resemblance to Friedman's picture of discretionary management-initiated CSR funded by other people's money.

[166] Dorothy S. Lund, *Asset Managers as Regulators*, 171 U PA L REV. __, [6] (forthcoming 2022).

There are two versions of this story. The first, told in this Subsection 1, is that the Big Three react to pressure to increase their clients' (and thus their own) financial returns. The second version, told in Subsection 2, is that the Big Three react to market pressures to satisfy shareholder social preferences.

a. *Financial Returns through Performance Improvement.* ESG proponents claim that their policies are profit-enhancing. The connection is intuitive as regards climate change. Staggering costs are projected,[167] making it plausible to suggest that making money will be so much harder in a drastically degraded environment as to justify the incurrence of present costs.[168] A justification for the Big Three's social turn follows: They intervened on climate to enhance their clients' returns.

Professors Jill Fisch, Assaf Hamdani, and Steven Solomon present this picture. They assert that the Big Three look for capital appreciation through operational improvement at portfolio companies. This is a hard point to carry, for it turns the standard account of the institutional incentives on its head. Here is the reasoning: Index funds worry about competition from managed funds because managed funds can adjust their portfolios to discard underperforming companies and thereby outperform the index funds, which are stuck with the underperformers.[169] "To stay competitive," they say, "passive investors can engage in broad-based efforts to improve the overall performance of the market and address cross-cutting issues such as corporate governance, risk management, sustainability, and cybersecurity."[170] They even have a cost advantage in so doing, because portfolio management costs them next to nothing.[171]

Once we put aside the pleasing topsy turvy aspect of this argument, we are left with two problems. First, it poses a counter-story to the prevailing account of institutional incentives without displacing it. Yes, portfolio management costs index fund managers next to nothing, but they as a result are paid next to nothing for portfolio management. It is a story of market exigency without a source of market demand. Second, market movements over the past couple of decades denude the competitive margin depicted of market salience. Investors have moved in droves to index funds precisely because they lost confidence in managed funds and the Big Three are the market's competitive successes precisely because they don't charge clients for active monitoring.

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[167] Deloitte estimates that inaction on climate change could cost the global economy $178 trillion by 2070. Deloitte, *The Turning Point*, June 20, 2022 available at https://www.deloitte.com/global/en/issues/climate/global-turning-point.html.

[168] Concrete empirical backing is lacking, however. Studies looking for ties between CSR and financial performance yield mixed results. See Anjan Thakor, *Higher Purpose, the Greater Good and Finance* 6-7, Finance Working Paper N° 824/2022 April 2022 http://ssrn.com/abstract_id=4097198 (reporting that on the positive side there are showings of long-term orientation, employee satisfaction, and improved outcomes and on the negative side they show output declines and a failure to reach stated goals); Tallarita, supra note 130, at 34 (summarizing eth results of 128 papers and showing that 59 percent show a positive relationship, 27 percent a missed relationship, and 14 percent a negative relationship).

[169] Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. PA. L. REV. 17, 25 (2019).

[170] *Id.*

[171] *Id.* at 26.

The problems, unfortunately, are insurmountable. The account does not succeed.

b. *Financial Returns through Systemic Stewardship*. A contrasting, more focused, account of Big Three social shareholding builds on a connection between diversification, risk management, and sustainability. The account centers on the "universal owner"--a fully diversified shareholder, or, more particularly, an index fund investor—an investor with a distinct perspectives on risk and return. Where an undiversified, single firm investor factors in risk by looking at the volatility of the firm's returns, a fully diversified shareholder looks at risk and return through the lens of the portfolio as a whole. Diversification cancels unsystematic or idiosyncratic risks, reducing the level of volatility. Only systematic risks, which are defined as risks that cannot be diversified out, remain to affect the valuation.[172]

Such is the basic lesson of portfolio theory.[173] The teaching has been redirected to cast a different light on the economics of corporate externalities. Externalities benefit the owner of a single firm by shifting costs onto others. A universal owner will not be similarly benefitted to the extent that the costs befall other firms in her portfolio. If the costs to the victims are greater than the return enhancement to the externalizing firm, the portfolio is better off if the externality is eliminated.[174] Running this point back through portfolio theory, Professor Jeffrey Gordon suggests that the managers of broadly diversified portfolios should look at risk systematically, directing their allocations of resources for governance engagement to the reduction of systemic risk—a systemic approach to their stewardship duties.[175] The E in ESG makes for an appropriate point of application. If climate change threatens to wreck the economy, an index fund investor has a financial interest in emissions reduction at the companies most responsible[176] despite any concomitant earnings reductions at those firms.[177]

There follows a strictly financial justification for social shareholding directed to climate change. Simply, the portfolio manager is seeking to maximize risk adjusted returns by reducing the portfolio's systemic risk. This carries considerable justificatory weight: If the underlying value theory is sound, then a responsible portfolio manager would have no choice to do otherwise. While Friedman would still fulminate about incipient socialism, the intervention

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[172] WILLIAM W. BRATTON, CORPORATE FINANCE: CASES AND MATERIALS 82-83 (9th ed. 2020). It follows that diversified investors are risk neutral as regards any single firm where an undiversified investor in the same single firm is risk averse. If the firm takes on more risk, the diversified investors require only that the projected returns compensate for the risk taken where the same risk, even with the added returns, could be excessive from a single firm investor's perspective. *Id*. at 116-17. The diversified investors deal with their subjective levels of risk aversion at the portfolio level, allocating a portion of the portfolio to risk free debt securities to the extent the investor deems excessive the risk of the market basket of stocks. *Id*. at 86-89.
[173] *Id*. at 83-89.
[174] Condon, *supra* note 135, at 5-6, 9.
[175] Jeffrey N. Gordon, *Systematic Stewardship*, at 47 J. CORP. L. 627, 629-32 (2022). The most salient point of application for this approach is banking and finance. The holder of a stock in a bank or of a portfolio of banks might favor risky lending, where an index fund investor would worry about negative effects of systemic financial risk on the economy as a while and favor conversative banking regulations anathema within the industry. *Id.* at 631.
[176] *Id.*
[177] It is not at all clear that the S and the G get similar uplift from a systemic risk perspective. *Id*.

entails only the most minimal crossing of the public/private divide. Strictly speaking, public regarding preferences are not in play.

But there are some notable limits on systemic stewardship's zone of application. It kicks in only given full diversification and covers only externalities that increase systemic risk. Not all do. A given externalized risk could be idiosyncratic and disappear in diversification.[178] It follows that systemic stewardship justifies some but not all recent shareholder activity. It certainly picks up the high-profile intervention against energy companies.[179] The asset managers' other chosen subject matter, gender diversity, fills that bill less well.

Interestingly, the institutions' accountability to their investors and the single firm shareholder's unaccountability to the company work in tandem here. As agents, institutional fund managers are not only responsible for the welfare of their beneficiary clients, they are accountable to them. Systemic stewardship gives them a client-based justification for making the switch from passivity to climate activism, even if the result is diminished earnings at single energy companies. Happily, shareholder unaccountability at the single firm level provides cover for these negative effects. As we have seen,[180] noncontrolling shareholders have no duty to attend to the firm's best interests in voting or exercising whatever interest they have. They are free to take a systemic perspective even if injury results for a given company.

A question remains. Systemic stewardship's justificatory power is clear enough. But how well does it do as an explanation? Staggering cost projections respecting climate change were on the table long before the big institutions woke up. Financial returns accordingly are less than satisfying as a standalone explanation for their turn to ESG activism. They still have a place in a thickly-textured account, for they would weigh as an important positive in the mind of an asset manager contemplating a change of approach.

2. *Client Demand*.

Professors Michal Barzuza, Quinn Curtis, and David Webber offer a contrasting economic account. In this picture, the Big Three compete not with managed funds but among themselves for new clients. Capital gains at portfolio companies are not the focus, for gain through engagement with portfolio companies cannot make cost-benefit sense for the Big Three so long as the gain is shared with competitors.[181] The only way they can enhance their bottom lines is to

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[178] Moreover, not all institutional (or for that matter individual) investors include systemic risk in their analyses. A stock-picking fund takes a single firm perspective. *Id*. at 633-34. An industry specific fund will worry about sectoral but not systemic risk.

[179] Although there is empirical evidence supporting the proposition that financial rewards follow, there is countervailing evidence to the contrary. See Schwartz, supra note 116, at 24 (summarizing the literature); Barzuza, et al., *supra* note 116, at 1277.

[180] *See supra* text accompanying notes 94-96.

[181] Barzuza, et al., *supra* note 116, at 1259. As to Fisch, Hamdani and Solomon, they comment, "[t]his important argument surely captures a competitive dynamic that is true as far as it goes, but how far it goes is quite unclear." *Id.* at 1261.

attract new clients. The Big Three accordingly concentrate on their client-competitive profiles.[182] Most of the client capital is in the accounts of aging baby boomers, of course. But there will soon be a generational transfer of that capital to millennials,[183] making them the competitive target group. Millennials "are less interested in investment returns and more interested in their investments reflecting their social values," say the authors.[184] The big asset managers accordingly seek to be social first movers,[185] trading off the risk of alienating corporate clients and triggering political retaliation as they do so.[186]

This account, like that based on financial returns, has the justificatory advantage of leaving the Big Three's motivations on the private side of the public/private divide and relegating accompanying traversals of the divide to "incidental" status. Unlike the financial explanations, it has the descriptive advantage of consonance with the prevailing account of institutional incentives. Its depiction of a tradeoff—between satisfying one group of clients over another and putting client preferences ahead of regulatory risk—is intuitive. But it also raises a follow-on question: How, more particularly, have regulatory relations figured into to the institutions' conduct of business? We now turn to that question.

D. Political Preemption

Could the Big Three, when intervening in the governance of portfolio companies, be attempting to diffuse regulatory pressures by catering to politicians? There are more than a few regulatory threats rumbling in the background. They come in two varieties. The first concern shareholders as a class and the second concern the institutional holders.

1. *Threats to the Shareholder Interest*.

As we have seen, the shareholders continue to enjoy a group exemption from legal accountability even though they now wield power in corporate affairs. Indirect challenges to their unaccountable status have been mounted, however. Elizabeth Warren's Accountable Capitalism Act, introduced in 2020, frontally targets shareholder primacy. It would require a federal charter for all companies with gross receipts exceeding $1 billion, a charter that would require the board to pursue the public benefit and to perpend to stakeholder interests. The proposal goes on to grant the franchise to elect 40 percent of board seats to employees.[187] Other rumblings have come from political sources as diverse as Bernie Sanders and Marco Rubio. The latter put out a report, *American Investment in the 21st Century*, containing a blistering attack on shareholder primacy as

[182] *Id.* at 1309-10.
[183] *Id*. at 1286-88.
[184] *Id*. at 1250.
[185] *Id*.
[186] *Id.* at 1305-06.
[187] Accountable Capitalism Act §§ 2,5,6, S.3348 (115th Congress 2017-2018)

the source of the nation's economic ills.[188] Of course, the road from such political threats and legislative proposals to accomplished regulation is long one. Corporate governance is not going to be federalized anytime soon. But at least one item in the current stock of governance proposals has found its way into legislation. The Inflation Reduction Act of 2022 slaps down a one percent excise tax on share repurchases by public companies.[189] It is a minor change, financially speaking. But a barrier has been breached.

2 Threats to the Institutions.

a. Progressive. Meanwhile, the big shareholding institutions, who, unlike the shareholders of portfolio companies, enjoy no historic exemption from legal accountability, face regulatory threats on their own account. Just like managers, they need to keep an eye over their shoulders for oncoming regulatory initiatives, increasingly so. As we have seen, the Big Three's growing size and influence has attracted a great deal of attention, prompting allegations of price fixing and abuse of power.[190] A long list of progressively-motivated regulatory reform suggestions sits on the table. These include bust ups, mandated divestitures, portfolio restrictions, voting restrictions, mandated stewardship, pass through voting schemes, and internal reorganization.[191]

There results a high-powered incentive for the institutions to take steps to defuse the threat, and maybe even curry favor with a view toward a more accommodating regulatory environment.[192] Professor Jeff Schwartz makes the case for such an account of recent events. He dismisses portfolio gain as a motive, doing a simple calculation, already presented above,[193] showing that even substantial portfolio gains yield only a trivial return to the institutions themselves by the time they filter back through the minimal index fund asset charge.[194] Like Barzuza, Curtis, and Webber, he concludes that we need to look elsewhere for an explanation. He turns to regulatory preemption, painting a textured picture of vulnerability. The picture centers on federal securities laws, within which the Big Three and its portfolio products operate and which up to now have come down on them only lightly. Thus does the outcry regarding Big Three voting power, with its long agenda of regulatory fixes,[195] pose a cognizable threat to a highly successful business model. In Professor Schwartz's view, there resulted a sudden lurch from passivity to social positioning.

The descriptive account is cogent. The question goes to its normative implications: Does the political gloss justify or undercut?. Professor Schwartz reaches the negative conclusion,

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[188] AMERICAN INVESTMENT IN THE 21ST CENTURY 22-35 available at https://www.rubio.senate.gov/public/_cache/files/9f25139a-6039-465a-9cf1-feb5567aebb7/4526E9620A9A7DB74267ABEA5881022F.5.15.2019.-final-project-report-american-investment.pdf.
[189] Inflation reduction Act of 2022, § 4501,H.R.5376, 117th Congress (2021-2022).
[190] *See* Schwartz, *supra* note 116, at 37-38 (describing attacks on their voting records from both politicians on the left and on the right).
[191] *Id.* at 38-39. See also Goshen & Levit, supra note 101, at 57-68 (suggesting breakup by means of a mandatory limit on assets under management).
[192] *See* Schwartz, *supra* note 116, at 34-35. *See also* Rock, *supra* note 142, at 25.
[193] *See supra* text accompanying note 122.
[194] Schwartz, *supra* note 116, at 23-25.
[195] *Id.* at 5-7, 38-39.

dismissing the turn to social shareholding as "pandering."[196] Pious references to stewardship are "rigmarole."[197] Moreover, new regulation could be beneficial for the clients even as its preemption clearly benefits the asset managers. It follows that the institution's recent governance activity amounts to an illegitimate traversal of the public/private divide: For an institution to use its voting power to impose a business result at a portfolio company in order to advance its own political agenda is to hand the vote over to the politicians and leave us with a backdoor intervention in corporate business by the government.[198] As between the asset managers and their clients, this is a breach of trust—a failure to vote in the clients' best interests.[199] Milton Friedman could not have put it better.

Schwartz concludes that the only legitimate way to do social shareholding to poll the clients and vote in accordance with their preferences.[200]

b. Conservative. If the institutions were catering to politicians in their shift to ESG activism, it stands to reason that their attention was directed leftward. Whether the topic is climate change, antitrust, or investor protection, progressive politicians historically are more likely to generate legislative initiatives constraining big businesses.

But the political background is dynamic. The Big Three completed their turn to social shareholding only to witness the radical right come out of the MAGA woodwork fulminating about ESG investment and woke corporate policies.[201] There followed a countervailing political threat with very different governance implications. Politicians in a number of Red states, prodded by the energy industry, are attacking ESG. Investment policy at public pension funds is the primary target, but proposed legislation goes farther to forbid state actors to do any business biased in favor of actors with ESG credentials.[202] BlackRock is a direct target—Florida and six other states have announced plans to withdraw funds under management with the firm.[203] Republicans in Washington D.C. are getting in on the act with legislation aimed at private sector pension funds.[204]

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[196] *Id*. at 7.
[197] *Id.*
[198] *Id.*
[199] *Id,* at 8.
[200] *Id.* at 9.
[201] *See, e.g.*, Andrew Ross Sorkin, *Deal Book: States take Action against 'Woke C.E.O.s'*, N.Y. TIMES, July 29, 2022; Joe Patrice, *Republicans Warn 51 Biglaw Firms To Stop Telling Clients About Climate Change Or Else!*, Above the Law, Nov. 7, 2022, available at https://abovethelaw.com/2022/11/republicans-warn-51-biglaw-firms-to-stop-telling-clients-about-climate-change-or-else/.
[202] Saijel Kishan & Danielle Moran, *Republicans Ramp Up Anti-ESG Campaign for 2023*, BLOOMBERG, Dec 29, 2022, available at https://www.bloomberg.com/news/articles/2022-12-29/republicans-prepare-to-ramp-up-their-anti-esg-campaign-in-2023?srnd=politics-vp&sref=2QDtM1XQ.
[203] *Id*. There also is evidence of pushback from the right. See Steven Mufson, *The Conservative Battle Against 'Woke' Banks is Backfiring*, WASH. POST, Feb. 28, 2023 available at https://www.washingtonpost.com/climate-environment/2023/02/28/climate-change-wall-street-investments/.
[204] Opinion, ESG Investing Fight Is Less Than Meets the Eye, Bloomberg, Mar. 6, 2023, available at https://www.bloomberg.com/opinion/articles/2023-03-06/republicans-esg-investing-fight-is-less-than-meets-the-eye?sref=2QDtM1XQ. They would be bringing back a prohibition imposed during the Trump administration and reversed by the Biden administration. President Biden threatens a veto. *Id*.

They have also been threatening lawyers: five GOP senators dispatched a letter to a list of law firms associated with ESG initiatives, announcing plans to use Congressional oversight power to investigate antitrust violations committed in the service of ESG objectives.[205]

Unsurprisingly, the Big Three are adjusting. In October 2021 Blackrock announced a program allowing its fund investors to instruct it as to how to vote their shares.[206] Says Larry Fink, there is a growing "revolution in shareholder democracy," and voting "should be as easy to do so as it is to buy a mutual fund or E.T.F. on your mobile phone today."[207] He is right about that. But he also appears to be addressing the rightward political threat with a show of a return to governance passivity at the asset management level. The rest of the Big Three fell right into step, imitating BlackRock's "Voting Choice"[208] program with flow through schemes of their own.[209]

There is a lot of fine print. BlackRock's plan offers choices to pooled vehicles and separate accounts making up 47 percent of its equity index assets under management.[210] One year into the scheme, $609 billion of its $3.8 trillion assets under management have signed up to participate.[211] It follows that BlackRock is by no means out of the voting game. The matter would not be settled even if it was, for the anti-woke fight is less about institutional proxy voting and activism than about institutional portfolio management and the place of ESG investing therein. That fight will not be over anytime soon.

3. Comments.

This is not the first time that corporate economic power has excited regulatory threats. The unfolding pattern bears comparison to the precedent history of managerialism. As we have seen,[212] management followed a classic strategy of regulatory preemption in its dealings with the post-New Deal big stick state. A cooperative political equilibrium prevailed for a quarter century. But, when the state lost its big stick and the climate turned anti-regulatory, management promptly did an about face and fought the government tooth and nail. Arguably, it acted in its shareholders' interest during both phases of history.

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[205] Kihan & Moran, *supra* note 202.
[206] See BlackRock, BlackRock Expands Voting Choice to Additional Clients June 13, 2022 available at https://www.blackrock.com/corporate/newsroom/press-releases/article/corporate-one/press-releases/2022-blackrock-voting-choice.
[207] Andrew Ross Sorkin, et al., *DealBook, BlackRock Sees a 'Revolution' Coming in Corporate Governance*, N.Y. TIMES, Nov. 3, 2022 available at https://www.nytimes.com/2022/11/03/business/dealbook/blackrock-investors-esg-corporate-governance.html.
[208] See BlackRock, Empowering Investors through Voting Choice, Nov. 2022 available at https://www.blackrock.com/corporate/literature/publication/voting-choice-factsheet.pdf.
[209] *See* Vanguard, Piloting Proxy Choice for Individual Investors, Nov. 2, 2022 available at https://corporate.vanguard.com/content/corporatesite/us/en/corp/articles/piloting-proxy-choice-for-individual-investors.html; State Street Global Advisors Extends Proxy Voting Choice to More Investors, Dec. 13, 2022 available at https://www.yahoo.com/now/state-street-global-advisors-extends-120000671.html.
[210] *See* BlackRock, *supra* note 208, at 2.
[211] *Id.* at 1.
[212] *See supra* text accompanying notes 42-44.

The pattern respecting today's institutional shareholders works differently. The start point is the same, with corporate actors catering to progressive regulators. But, as befits an era lacking in consensus, the preemptive move, instead of calming the waters, triggered a backlash with negative financial consequences for the poster child companies. Retreat has followed. Whether the retreat will placate red state politicians out for the blood of financial elites is another question. Significantly, the defensive innovation chosen, pass-through voting, not only signals a return to passivity, it structurally diminishes the asset managers' power and thus their political salience. Managers of operating companies lack this easy opt out.

One suspects that we are unlikely to see anything resembling the institutions' lurch to social shareholding in the foreseeable future. Meanwhile, there is no need to choose among client sensitivity, market imperatives, and political preemption in our account of the Big Three's approach to corporate governance. A capacious, thickly textured motivational picture works better. Professor Dorothy Lund provides just this, nodding to both customer demands and political threats, leaving the fund managers straddling the public/private divide while looking for moderate solutions suitable to the broadest swath of their client bases.[213] Whether such a strategy can succeed against a divided political landscape is today's burning governance question.

E. Evaluation: The Legitimacy of Institutional Social Shareholding

This Part has described several closely-related "firsts." We saw CSR, rebranded as ESG, ascend to the governance agenda's top rung for the first time. We also saw the big institutional shareholders concomitantly shake off their governance lethargy to play an activist role on selected social issues, for the first time assuming a measure of responsibility in their capacity as shareholders. Finally, we saw the same institutions find themselves for the first time in the political crosshairs, grappling with the same sort of public accountability problems that have long confronted the managers of operating companies.

How have the institutions done? Did they legitimately turn to social shareholding?

[213] Clearly, she says, the institutions must attend to their clients' preferences—successful competition for clients is their only available path to growth for their businesses. Lund, *supra* note 166, at 12-13. But she rejects the picture of catering to millennials. She depicts a broader client base including not just individuals but institutions like pension funds and corporate managers, clients whose political preferences are more moderate, a moderation arguably reflected in the institutions' limited social agendas. The institutions simultaneously try to avoid regulatory backlash, which means they must be seen to pursue the public interest but without treading on the toes of politicians. The upshot, both on the private and the public side, is moderation. The institutions, she says, will never incorporate the full progressive agenda. *Id*. at 3-4. Lund accompanies this reading with a nuanced characterization of the regulatory role being played. She experiments with an analogy to private industry self-regulation, but finds none of the earmarks of self-regulation to be present, as would be the case if an industry association was promulgating a code of conduct. *Id.* at 36. The Big Three are instead making rules for companies in the manner of administrative agencies, but doing so in unregulated space a regards companies that are not actually bound to obey. She concludes that this is something new, something on the private side of the divide. Credit ratings agencies provide the closest analogy. *Id.*

Let us review the prevailing accounts of Big Three motivations, highlighting their public and private colorations. Portfolio gain is the closest to a purely private account. Action taken with intent to increase returns is pure capitalism, whatever the public coloration of the action taken. Unfortunately, since the activist institution doesn't get a cut of its clients' capital gains, this fails as an explanation. It can still serve as a justification, albeit a somewhat hollow one.

Competition for clients among the institutions resonates much better as an explanation. And, since companies compete to meet customer demands on the private side of the divide, the account stays on the private side, enhancing its justificatory weight. Unfortunately, the customers themselves cross the divide, for the customer preferences in question concern public policy. Barzuza, Curtis, and Webber work hard to minimize this, depicting institutions acting in the teeth of a risk of right-wing political backlash.[214] But there remains an inference of public motivation, for whatever the political risks there were also cognizable political rewards.

Schwartz's account lies entirely on the public side, there to reverse Berle's mid-twentieth century result. Berle's managers performed public functions to placate regulators and stave off new regulation and simultaneously to satisfy their employees and customers. Legitimacy followed, in part due to the broad base of satisfied constituents and in part due to substantive approval. Significantly, the shareholders, which arguably were the losers, were expunged from Berle's picture, having been written off earlier in *The Modern Corporation*. Schwartz brings them back in the form of the institutional clients to deliver us at the door of Friedman's "other people's money" condemnation: management is operating on the public side of the line for self-interested reasons while selling its clients down the river, in effect taxing them. The logic is impeccable. But how safe are the assumptions? Might the clients not share the fund managers' interest in regulatory preemption? Regulatory intervention ultimately increases the service providers' cost base and hits the clients in their pocketbooks, something to which thrifty index fund investors are particularly averse. There is also a question whether the clients in fact object to initiatives tied to climate change and gender diversity. One strongly suspects that they do not, at least outside of Red state political gatherings.

If we modify Schwartz to pull in client satisfaction as an additional motivation we replicate Berle. This is what Lund has done. The Big Three in her account do their public/private straddle with sensitivity to both client and regulator preferences. An implication of legitimacy arises, albeit a contestable one. The contestant would be Friedman, who in his day successfully buried Berle's picture of corporatist harmony between big corporate producers, public consumers, and the big stick regulatory state.

How strong, then, is the implication of legitimacy? The accounts that pursue private-side strategies, looking to financial and product markets to legitimize the Big Three's voting power, are at best suggestive. There emerges no robust picture of the institutional shareholder doing governance as an actor at the margin in a competitive market. The comparison to the classic one

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[214] Barzuza, et al., *supra* note 116, at 1279-81.

company model of the shareholder, the model that animates shareholder primacy, is telling. That model gives us a residual interest holder without control power who enters and exits in an anonymous trading market. Financial incentives predominate overwhelmingly. The actor is not only unaccountable, but an effective conduit of market discipline operating entirely on the private side of the divide. None of the accounts of the Big Three even comes close to replicating this.

The alternative road, not taken in the commentary, would follow Berle to legitimate on the public side of the divide. The fact that the road has not been taken is unsurprising. Berle wrote against a background of public consensus. Today's partisan environment is qualitatively different. The atmosphere is unstable, the topics pursued are controversial, and Barzuza, Curtis, and Webber's warnings of political risk have proved well taken. Thus do we see Larry Fink, the Big Three's ideological trailblazer in its turn to social responsibility, do a *volte face*, turning the vote over to his clients. By passing the buck, he turns down the political stove and does so without any necessary sacrifice in his client relations. He thereby disempowers himself. But that does not seem like a bad thing to do when the power, however you exercise it, breeds value destructive business instability.

The implications for the legitimacy question are strongly negative. Even as we sit around arguing the question back and forth, the real-world trailblazer turns tail, his marginal political position deteriorating in the face of political flack. It seems that when it comes to the imposition of CSR, arguable legitimacy isn't enough. The case must be strong and airtight. And to make that case, one must turn the decision over to the beneficiaries. It also seems that our empowered intermediaries need to be very careful about how they exercise their power, which means in turn that they are not nearly as powerful as they seemed to be only a couple of years ago.

A turnabout from our sudden experience of shareholder responsibility is noted. The Big Three finally gave us identifiable and influential but noncontrolling shareholders, shareholders who could be held accountable for the exercise of their power. With Fink's retreat, our accountable actor goes up in smoke. We return to the traditional, safe, unaccountable public company shareholders of yore.

IV. THE NEW SHAREHOLDER PRIMACY

Let us freeze the frame at the moment the institutions wake up as ESG activists and ask about the event's implications for shareholder primacy. The effect is to diminish. The institutions have unmoored shareholder primacy's procedural consequence, shareholder power, from shareholder primacy's substantive motivation, shareholder financial gain. Does shareholder primacy as power without purpose make for a plausible anchor for corporate governance going forward?

If, on the one hand, one sticks to the classic agency cost template, the answer is no. Shareholder primacy connects shareholder financial return to efficient management and empowers shareholders to push management in an efficient direction. Without a motivating purpose, the empowerment lacks justification. If, on the other hand, one displaces agency cost functionalism with Friedman's shareholder owners, the answer potentially is yes. Owners get to do whatever they want, and the alternative of returning a full discretionary dispensation to the managers is unpalatable.

Oliver Hart and Luigi Zingales (HZ) expand on this point to make a formal case for modified primacy, a case built on the satisfaction of the owners' preferences. They construct a social shareholder in a single firm context as a rational economic actor. We get a shareholder with a preference for social responsibility operating in a rational expectations framework defined by an expanded notion of welfare enhancement. Although a public motivation remains, it is restated in the comfortable confines of economic theory. The problem comes when we transfer this newly modelled shareholder to the real-world context of institutional shareholding, where it takes us right back to the Big Three's legitimacy problem. The split between record and beneficial ownership problematizes justificatory reference to preference satisfaction. Quite simply, the wrong actors' preferences are being satisfied. Structural adjustments must be made accordingly.

A. Shareholders as Social Welfare Maximizers

Suppose we model the decisionmakers at the large institutions as concerned citizens who care a great deal about the climate emergency and are frustrated by regulatory gridlock in Washington, by the nation's the turn to political dysfunction, and by the failure of international coordination. The model makes it easy to account for their behavior. The waxing gravity of social and economic problems over time overcomes both the institutions' tendency toward passivity and their understandable tendency to prioritize shareholder value when dealing with governance issues. A tipping point is reached and they become active.[215]

HZ restate this "concerned citizen" explanation in economic terms, giving us a more complex model of the shareholder than that informing classical shareholder primacy. The HZ shareholder seeks financial returns but also can have an idiosyncratic preference for socially responsible results. Trade-offs result at particular firms, depending on the mix of greed and social

[215] For a discussion along these lines, see Rock, supra note 142, at 3.

responsibility in the preferences of the shareholder group. Shareholder primacy becomes more complicated in turn, incorporating alternative purposes--traditional shareholder value maximization (SVM) and a broader-based shareholder welfare maximization (SWM).[216]

The model is manifestly intended to salvage shareholder primacy and as such demands our close attention. Its behavioral fulcrum is a distinction between unaccountability, with which shareholders are comfortable, and irresponsibility, which bothers them. HZ pose that shareholders have no trouble holding portfolios containing shares of companies pursuing lines of business of which they do not approve—tobacco or armaments, for example—so long as they do not feel responsible for the companies' actions. Responsibility comes into the picture when a shareholder is asked to make a decision, as would be the case where a shareholder proposal asks a company to replace a dirty technology with a more expensive clean technology. Confronted with the question, an individual may put weight on doing the responsible thing, or within HZ's framework, the "socially efficient" thing.[217] Going farther, HZ assert that where a line of business poses a trade-off between profits and social disutility, shareholder populations will not universally favor SVM. If, instead of leaving all business planning to management, tradeoff situations were put to a shareholder vote, SWM will prevail in some cases.[218]

To show how companies might sort themselves out, HZ construct a formal model of shareholder voting. They suggest that in a company with shareholders holding large blocks, SVM will prevail—the potential loss to each shareholder of abandoning the more profitable line of business will outweigh the preference for social welfare. But as shares disperse and the economic stakes for individual shareholders get smaller, the cost-benefit balance shifts and SWM prevails, provided that a majority of the shareholders have a preference for social responsibility. [219]

A reformulation of shareholder primacy follows: companies should pursue SWM rather than SVM. Implementation implies a structural shift of power from management to the shareholders. Managers, selected for their business acumen rather than their social values, have no pertinent expertise to bring to bear in effecting the value/welfare tradeoff. It follows that a choice for SWM presupposes consultation with the shareholders, implying shareholder voting on the line of business and the business plan.[220] Structural adjustments are also required at the shareholder level because the preferences of institutional shareholders need to be displaced by the preferences of their beneficiaries.[221] Happily, these shareholder and beneficiary inputs will not be needed at every company. Some firms are more likely than others to pose tradeoffs between SVM and SWM.

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[216] Oliver Hart & Luigi Zingales, The New Corporate Governance at 3, Law Working Paper N° 640/2022 April 2022 http://ssrn.com/abstract_id=4087738

[217] Oliver Hart & Luigi Zingales, Companies Should Maximize Shareholder Welfare Not Market Value at 4-6, Finance Working Paper N° 521/2017 http://ssrn.com/abstract_id=3004794.

[218] Hart & Zingales supra note 216, at 10.

[219] *Id*. at 7-17. For another formal analysis making this point, see Simkovic, supra note 12, at 19-31.

[220] Hart & Zingales *supra* note 216, at 14. Compare the comments of Rock, supra note 142, at 18-19 (posing a set of questions designed to show the difficulty of ascertaining the preferences of induvial investors).

[221] Hart & Zingales supra note 216, at 20-21 (suggesting roughed out guidelines or aggregated polling of preferences, or alternatively letting each institution establish a set of voting preferences so that investors can sort themselves out by selecting a congenial institution).

More particularly, (1) companies with political or market power, and (2) companies with a comparative technical advantage in remedying their own externalities are likely candidates for adoption of SWM.[222]

The latter, comparatively advantaged companies, provide a point of distinction HZ deploy to fend off Friedmanite criticism. Complete public/private separation, they assert, makes economic sense when the corporation in question has no comparative advantage. Charitable contributions are the paradigm case in which comparative advantage is absent. As between management and the shareholders, management is not better situated to choose charitable beneficiaries. Accordingly, the matter should be left to the shareholders and funds passed through to them.[223] With externalities and technologies things can work differently. To impose public/private separation where the company can solve a problem more cheaply than can a regulator leads to an inefficient result.[224]

The distinction is persuasive, but only within the framework posed by HZ, in which the goal is the achievement of efficient production. Friedman was operating within the wider sphere of political economy.[225] He wanted an impermeable public/private divide imposed even at the cost of production inefficiency.[226] In his view, any opening of a door to public purposes--even a little opening in search of short term economic gain--risks the loss of everything in the long run when opportunistic socialists push the door wide open, destroy the economy, and rob you of everything you have. HZ, narrowing Friedman's point, in effect restate it for a political economic context transformed by decades of deregulation.

B. Implications

HZ, by modelling an actor with an inclusive set of preferences, tie shareholder primacy to social welfare. Shareholders emerge as human beings who operate in society and occupy a planet rather than solely as financial interest holders in a particular firm. The model is redolent with implications: (1) It successfully folds social welfare into shareholder primacy while leaving shareholders comfortably unaccountable; (2) It depicts corporate pursuit of social welfare in an apolitical framework; (3) It makes a case for a radical new round of shareholder empowerment; (4) It traverses Friedman while remaining Friedmanite; and (5) It incidentally implies that social action based on the preferences of institutional shareholders is illegitimate.

The model's shareholder emerges with a quasi-public coloration, but not a political one. Berle's description of the golden age's socially responsible manager once again makes for a telling comparison. Berle depicted a corporate actor made socially responsible by virtue of pressure from both from regulators and customers in product markets. It is a political (and public) animal. HZ,

[222] *Id*. at 18.
[223] Or, at least, made subject to their statements of preference prior to disbursal to charities.
[224] *Id*. at 7, 11.
[225] *See supra* text accompanying notes 28-38.
[226] *Id*.

in contrast, give us the rational actor of economics making voluntary choices. The process context—voting by dispersed shareholders—is initiated for the purpose of preference ascertainment, with the model's shareholder making free choices from the private side of the divide. Indeed, the model imposes no public duties. The shareholders get an option to behave responsibly--they modify SVM only to the extent that it gratifies them to do so. Unaccountability retains its place in the structure. Political pressure could be worked into the model, of course, but only as a distortionary influence.

HZ teach an important lesson about shareholder primacy. To depart from the classic statement of financial purpose is to expand further the scope of shareholder power over the business plan at the expense of management discretion. This is because the welfare in SWM is preference based and the relevant preferences do not reveal themselves in nature. Financial preferences, in contrast, manifest themselves in the stock price, which provides management with a built-in decision-making guide. The only way to access social preferences is to conduct a poll, which means giving the shareholders a formal role in business planning.

Ironically, HZ's model, by disappearing the Big Three and passing the vote back to fund beneficiaries, also suggests an important lesson regarding institutional investors and social shareholding: So long as the institutions (as opposed to their beneficiaries) are making the voting choices, shareholder-directed social welfare cannot be about taking responsibility for the purpose of doing the right thing. In HZ's contemplation, only the economic beneficial owner of the shares—the one who makes the financial sacrifice—is positioned to do that. The analysis thus returns us to the Big Three's present political dilemma. Beneficiary consent cannot be assumed. It must be procured.

Beneficiary preference procurement is not the only structural barrier impeding real world implementation of HZ's regime of preference-based responsibility. The received legal model, which allocates exclusive authority for business planning to management, would have to be dismantled and reconstructed to allow for the determinative shareholder inputs. The reconstruction process would implicate a long list of process problems, among them the allocation of agenda control and access and the alleviation of manager-shareholder information asymmetries.[227] There is also an incentive problem. Today's managers get their own financial returns through SVM. Somehow, SWM would have to be keyed to provide financial rewards inside the company. Pass-though voting at the institutions may be the least daunting problem on the list.[228]

This leaves shareholder primacy in an awkward place, requiring structural reform to build in a transmission mechanism that channels shareholder inputs into business planning. Primacy's

[227] Dissenter's rights also could be suggested as an issue.
[228] Pass through voting has been a proposition on the policy table for a long time. See Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally, 43 Fed. Reg. 31945, 31950 (July 24, 1978). For recent discussions, see Saura Masconale & Simone M. Sepe, *Citizen Corp.—Corporate Activism and Democracy*, 100 WASH. U. L. REV. 257 (2022); Jill E. Fisch & Jeff Schwartz, Corporate Democracy and the Intermediary Voting Dilemma, working paper (2023) available at http://ssrn.com/abstract=4360428.

procedural leg, once the means to the end, now becomes the tail that wags the dog. Shareholder primacy's original purpose—production efficiency gets lost in the shuffle. It has not disappeared exactly, for we certainly wouldn't want to restore power to those nasty managers, but the original commitment to wealth creation is long gone.

V. THE EXISTENTIAL THREAT: CORPORATE PURPOSE

Let us review the new, socially-minded model of institutional shareholder from a progressive perspective. The model gets high marks for bringing pursuit of social welfare into the governance mainstream and for altering the theory of the corporation by impairing the purposive leg of shareholder primacy. At the same time, the model draws its mainspring from shareholder primacy's procedural leg, shareholder power. Thus based, there is nothing in the model that prevents the shareholders from changing their minds—it preserves shareholder optionality and in so doing subordinates social welfare. From a progressive perspective, then, the model takes a step in the right direction only to fail to accomplish the task appointed. Something more is needed.

Purposivism comes to bear at this point to reverse the subordination. Unlike Larry Fink's letters or the latest climate change proposal, which modify substantive shareholder primacy at the level of practice but make no concessions respecting shareholder power, purposivism poses an existential threat to both legs of shareholder primacy. It wants to hardwire a commitment to social welfare into the corporation's structure and to contain the shareholders' power to prioritize their own returns. It aspires to make shareholders accountable for the first time in the history of corporate law.

This Part IV lays out purposivism's main points, highlighting implications for shareholder primacy and corporate legal theory. Section A describes the precepts of purposivism, contextualizing it both within corporate law and corporate legal theory, and goes on to point out the principal objections thereto. Section B follows purposivism to its logical end point, as embodied in the approach of Professor Colin Mayer, who offers a fully developed alternative to agency-based shareholder primacy. With Mayer, corporate legal theory finally realizes on aspirations first articulated back in 1932 in Berle and Means's *The Modern Corporation and Private Property*.

A The Corporate Purpose Movement

Corporate purpose is a movement. But it is not a movement spearheaded by a person or organization. Nor does it have a clearcut historical start point. Some cite Larry Fink's 2018 letter,[229] quoted above. The citation is fair--Fink made corporate purpose a leading agenda item in governance politics. But that moment of political salience came after a long gestation.[230]

The meaning of varies with the context. On the business side, "mission driven" enterprises make "mission statements" to facilitate the articulation of business objectives, drawing on a vast advisory literature as they do so.[231] This business concept is politically neutral: when a corporation

[229] *See, e.g.*, Rock, *supra* note 142, at 4-5.
[230] See Strine, supra note __, at 21-22; Strine, supra note 100, at 414-15.
[231] See Elizabeth Pollman, *The History and Revival of the Corporate Purpose Clause*, 100 TEX L REV. 1423,1444-45 (2021), quoting Peter Drucker, quoted in turn in Fred R. David, *How Companies Define Their Mission*, 22 LONG RANGE PLAN. 90, 90 (1989): "A business is not defined by its name, statutes, or articles of incorporation. It is

seeks to make social contributions in addition to creating shareholder value,[232] its "mission" includes social as well as shareholder-oriented business objectives;[233] when a corporation is one hundred percent financially oriented, its "mission" is not social. Within CSR, where corporate purpose has long been a discussion point, things work differently. Here corporate purpose takes on a progressive political coloration.[234]

Recently (and more pointedly), corporate purpose has been the central concept in a welfarist expansion the menu of legal business forms. Socially-minded founders now can organize their startups as benefit corporations (B Corps) pursuant to charters that make an explicit commitment to social goals. B Corps first surfaced in 2006 as a product of a private certification initiative.[235] Statutory adjustments followed in many states--Delaware amended its corporate code in 2014 to add the B Corp as an organizational alternative.[236] What began as a trend in corporate organization broadened into a movement within corporate governance when a critical mass of actors at producing companies, investment institutions, governance intermediaries, law firms, and law and business schools adjusted their priorities to weight social concerns more heavily.

What exactly do these people want? Unfortunately, there is no generally accepted specification.[237] It is easier to point out what purposivism is not. It can, for example, be sharply distinguished from the governance approach articulated by HZ. HZ channel the turn to social welfare through shareholder primacy, suggesting that basic decisions concerning lines of business and cost externalization should be passed to the shareholders. In the HZ model, social welfare is whatever the shareholders say it is. If the shareholders don't push for it, it is not on the table. The commentaries assayed in this Article's Part III, with their various explanations and justifications for institutional social activism,[238] similarly minimize any impairment of the process leg of shareholder primacy. Significantly, none of the commentaries includes a substantive endorsement of welfarist results.

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defined by the business mission. Only a clear definition of the mission and purpose of the organization makes possible clear and realistic business objectives."

[232] *See* Thakor, *supra* note 168, at 6- 9-10 (summarizing academic literature on the topic).

[233]See Carroll & Brown, supra note 126, at 53-54.

[234] See *id.*at 48 ("Among the leading contenders to capture the attention of scholars and practitioners have been the following major concepts or thematic frameworks: business ethics, stakeholder management, sustainability, corporate citizenship, conscious capitalism, creating shared value and corporate purpose-driven businesses.")

[235] See Ryan Honeyman, *A Look at the History of the B Corp Movement* (2014) available at https://www.triplepundit.com/story/2014/look-history-b-corp-movement/41536.

[236] *See* DEL. CODE ANN. tit. 8, § 365; Michael R. Littenberg, Emily J. Oldshue & Brittany N. Pifer, *Delaware Benefit Corporations—Recent Developments*, Aug. 31, 2020 available at https://corpgov.law.harvard.edu/2020/08/31/delaware-public-benefit-corporations-recent-developments/.

[237] Professor Roe ascribes "purpose pressure" a causal role in the occurrence of the events just recounted in Part III. *See* Roe, *supra* note 7, at 5-6 (speaking of "ESG and CSR pressure" and "purpose pressure" as synonyms). One thing that is clear is that some want nothing to do with it, whatever it is. *See, e.g.*, Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?*, 99 TEX. L. REV. 1309, 1339 (2021), who profess themselves to be corporate purpose skeptics, who "do not believe that corporate purpose can be used to compel corporations to act as benevolent social planners." They offer purpose more or less as it appears in the managerial literature, as a focal point for constituent expectations. *Id*. at 1341.

[238] *See supra* text accompanying notes 167-200.

Purposivism, in contrast, makes the endorsement. It poses the existence of results that objectively enhance social welfare and seeks to effect such results in the boardroom, whether or not the shareholders prefer to do so. It attacks both legs of shareholder primacy, displacing shareholder value as the corporation's purpose and denuding the shareholders of the power to steer the ship back in the own direction of their own financial interests.

B. The Legal Context

How might we adjust the legal corporation to implement purposivism? There is a ladder of possibilities.[239] We will start at the bottom rung with the law in place and ascend step by step to a top rung on which we mandate an exclusive social purpose.

Corporate law addresses purpose at two junctures, in its organizational framework and its regime of fiduciary duty. The organizational provisions are permissive. A corporation may specify a line of business in its charter but need not do so; it suffices to state that the corporation's purpose is "to engage in any lawful act or activity."[240] This does two things. First, it consigns purpose statements to a law practice backwater. The careful practitioner accepts the invitation to leave the matter open in the legal documentation, leaving it to the business people to articulate the mission. Second, it triggers a question whether the law indeed does impose shareholder value enhancement as the corporation's legal purpose. The best answer, in Delaware law, is that, yes, it does. But it is an answer reached based on a careful drawing of inferences from the statute and the cases. There is no bright line statutory directive.[241]

Now let us turn to the fiduciary regime.[242] Under this, even as shareholder returns occupy the legal pride of place, there remains social running room. Incidental pursuit of social objectives is permitted subject to a reasonableness standard. In addition, management can take advantage of the business judgment rule's zone of discretion to work social initiatives into the business plan. The zone's boundaries are unspecified, however. Subterfuge is involved in their negotiation. A board processes its way to a socially oriented result, relying on counsel to articulate business justifications. Shareholder pressure in favor of welfarist results, whether applied informally or communicated through formal but nonbinding proposals, provides valuable air cover for such initiatives.[243] Short of a formal shareholder ratification, however, such shareholder ministrations do not explicitly figure into the legal framework.[244]

Now let us go a rung up the ladder, referencing the "constituency statutes" included in the corporate codes in 44 states (but not Delaware).[245] These modify statutory standards of directorial

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[239] For a useful conceptualization, *see* Fisch & Solomon, *supra* note 237, at 1331-32.
[240] DEL. CODE ANN. tit. 8, § 102(a)(3).
[241] See Edward Rock, *Business Purpose and the Objective of the Corporation* 7-8, working paper 2020 available at https://ssrn.com/abstract=3724710.
[242] For a further description, *see supr*a, Part II, Section A.2.
[243] *See supra* note 142.
[244] Majority shareholder ratification of questionable board decision can remove a fiduciary cloud subject to an exception for waste. *See* Lewis v. Vogelstein, 699 A.2d 327, 334-36 (Del Ch. 1997).
[245] *See* Francis J. Aquila, *Considering the Corporate Purpose* (2020) available at https://www.sullcrom.com/files/upload/PLJ_FebMar20_InTheBoardroom.pdf.

conduct, permitting consideration of impacts on other constituents and surrounding communities.[246] The sections nominally expand the board's discretionary envelope.[247] They also provide a liability shield in the event a shareholder challenger alleges a bad faith breach of fiduciary duty in connection with a socially motivated board decision. But they have not been used as a legal portal for displacing shareholder value with social welfare as the corporation's purpose.[248] The result is unsurprising, for these sections do not direct the board to manage the corporation in the public interest. Indeed, the opposite is the case. They imply that shareholder value is paramount, even as other interests sometimes need to be balanced in a complicated world.

At the ladder's next rung, we encounter statutory provisions facilitating incorporation as a B Corp. Corporate purpose here plays a foundational role. Delaware's formulation sets out two mandates. First, the charter must specify "one or more specific public benefits to be promoted by the corporation."[249] Second, the board "shall" manage the corporation "in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation."[250] These provisions give us an alternative, purposive corporate form, at least on paper. The directive for even handed balancing between public benefit and shareholder value negates the substantive leg of shareholder primacy and takes the corporation's managers across the divide from private to public territory, bidding them to straddle the line. But it does not thereby deliver us to a social corporation because it leaves in place a conventional corporate governance structure, and shareholder primacy's procedural leg along with it. The shareholders retain the franchise, and nothing in the set up prevents them from electing a board inclined to tip the public/private balance in their own favor.[251] Furthermore, a shareholder group disenchanted with public benefits and attendant opportunity costs can by majority vote amend the charter to opt out of B Corp status.[252]

Publicly-traded B Corps do exist, but only fifteen of them.[253] A negative inference results as regards the purpose movement's influence on the ground. Give the B Corp's ready availability, a groundswell of demand for incorporation in a public-regarding form would have yielded a much larger number. It follows that purposivism is more a topic for discussion in corporate governance circles than it is a force presently revolutionizing business plans. It is a way of expressing disquiet with shareholder primacy.

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[246] See, e.g., IND. CODE ANN., §23-1-35-1(d).
[247] Their primary utility lies antitakeover defenses, where they permit constituent interests to be referenced.
[248] See Fisch & Solomon, supra note 237, at 1334-37 (opining that constituency statutes have not had a tangible impact on corporate operations).
[249] DEL. CODE ANN. tit. 8, § 362(a)(1).
[250] DEL. CODE ANN. tit. 8, § 362(a). The section includes a Business judgment shield protecting a given director's balancing decisions from second guessing by shareholder plaintiffs. See DEL. CODE ANN. tit. 8, § 362(b).
[251] There would be a litigation risk for cooperative board members, however. See DEL. CODE ANN. tit. 8, § 367.
[252] Delaware originally required a 90 percent supermajority for opting in and out. Those provisions were removed in 2020 so that the regular charter amendment provision applies. *See* Littenberg, et al., *supra* note 236. Under DEL. CODE ANN. tit. 8, § 242(b), such an opt out group would need the prior approval of the board of directors.
[253] As of December 22, 2022. In addition, 23 regular publicly traded companies had at least one subsidiary organized as a B Corp. Impact Assessment, Publicly Traded B Corps, Dec. 22, 2022, available at https://kb.bimpactassessment.net/support/solutions/articles/43000632643-publicly-traded-b-corps.

There is also a follow-on strategic implication. If purposivism cannot realize its aspirations on the ground, where the law now opens a door for company-by-company implementation, it needs the sovereign to give it a leg up in the form of a mandate. In recognition of this, we step up one more rung and cross the line that separates the law that is from the law that might be to take the B Corp form and make it mandatory. In this new world, all business corporations are B Corps that state a public objective and straddle the public private divide. All the problems just described carry over, with one exception. Now the door to opting out by shareholder vote is shut.

We now reach the next-to-last rung. Here we posit a new version of the B Corp which provides for charters that specify the purpose of public benefit enhancement with no qualifying mention of balancing. Alternatively, we can go up one last rung and posit this directive as a state mandate. We thereby achieve a corporation that no longer straddles the public/private divide, at least as a formal proposition. The hardwired public purpose displaces both shareholder primacy's substantive leg and its procedural leg, in the latter case by constraining the discretion of the board to cater to shareholder financial interests. C. Problems at the Top Rungs

C. Problems at the Top Rungs

Recall that on the ladder's antepenultimate rung, where the B Corp's managers balanced shareholder value and social welfare, the remission of ultimate control to the shareholders threatened to undermine the integrity of the contemplated regime. The problem persists at the top two rungs. Even as we draft documentation that ties the board's hands and disempowers the shareholders, we have not and cannot entirely eradicate the shareholders and their financial interest. The entity remains a business corporation. Solvency is its life's blood and sustainability (and thus stability) is essential to the satisfaction of the expectations of its non-shareholder constituents. To achieve these minimal goals, there must be a margin at which shareholder profit trumps social welfare. The top rung corporation's board of directors must accordingly continue to trade off the public against the private.

To see why, return to Friedman's perfect competitor,[254] which sits at the margin where competitive demands denude management of all discretion. Room for balancing opens up only with the support of competitive slack. The top rung social directive becomes operative only at this point, directing the board to eschew balancing and devote the rents to the public good. But even here limitations intrinsic to the for-profit business form rise to constrain the social directive's potency. The shareholders remain the owners, vested with the franchise and a powerful incentive to install managers who prioritize return on equity.[255] It follows that despite the mandate, an astute board of directors will find its way back to balancing, looking to increase shareholder financial returns even as it attends to other constituent interests and externality minimization.

Effective top rung reform accordingly implies more than just a one-line directive to pursue social welfare in a charter or statute. Extensive structural adjustments would be required to realize

[254] *See supra* text accompanying note 30.
[255] *See* Rock, *supra* note 142, at 29.

the business form contemplated.[256] To assure the presence of public regarding boards, constraints on shareholder electoral choices would be needed.[257] Management incentive compensation, now pegged to the performance of the stock, would have to be rethought from the ground up.[258] Guidelines regarding public/private tradeoffs[259] also might make sense, for, as we have seen, balancing is not so easily eradicated. There also is an "in-and-out" question. Under present law the shareholders are in and all other stakeholders are out. Purposivism moves the line, bringing stakeholders inside as beneficiaries of management duties. But which ones?[260] Employees and communities presumably would come inside, but what about the bondholders and bank lenders who provide most of the capital?

Finally, state corporate law would have to go. It is deeply embedded on the private side of the public/private divide.[261] Charter competition assures that it stays there.[262] To see why, hypothesize a state that mandated either the B Corp form or the top rung social corporate form for all large companies, and did so in the teeth of management and shareholder opposition. All of the subject corporations could and promptly would reincorporate elsewhere, relying on the commerce clause to force the socially conscious state of origin to admit them back to do business.[263] Not that charter competition implies that the public/private divide cannot be crossed—B Corps do that. But they do so on a strictly voluntary basis. Mandatory pursuit of social welfare presupposes preemptive federal chartering.

Purposivism, in short, implies radical law reform. The usual feasibility objections follow, right out of a standard playbook. Law reform opponents play a burden of proof game. They assert that the proponent of change bears the burden of justification, including a requirement of specification. All outcomes on all scenarios must be clearly laid out in advance or the burden is not met. Opponents of purposivism move accordingly.[264] Where, they ask, are the regulations

[256] This would, in Rock's words, "disrupt the coherence of the corporate form." *Id*.
[257] For a blueprint as to how to do this, *see* Elliott J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343 (1981).
[258] Id. at 99, 121.
[259] Id. See also Fisch & Solomon, supra note 237, at 1344 ("a corporation's purpose statement must be sufficiently concrete that stakeholders can ascertain whether the corporation is operating in a manner that is consistent with that purpose").
[260] Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 98 (2020).
[261] So embedded that even manifest inefficiencies are tolerated in order to satisfy the pecuniary interests of the providers of capital. Limited liability, along with board management, was historically the corporate form's defining characteristic of co characteristic. Economic analysis conducted decades ago showed beyond peradventure that it is an inefficient feature of the business form. See generally Henry Hansmann, & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991). There is no sign of a law reform movement. Indeed, the appearance of limited liability companies makes it more easily available than ever.
[262] We might describe this as the "genius" of corporate law. Cf. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).
[263] Cite
[264] See, e.g., Fisch & Solomon, supra note 237, at 1337 ("[C]orporate purpose statements . . .are neither concrete nor enforceable. A purpose statement saying that a corporation will promote the interests of its workers, unlike a minimum wage law, neither identifies the way in which worker interests will be protected nor allows workers or a regulator to enforce those interests.")

that determine the trade-offs?[265] What metrics tell you when to elevate shareholder interests over employee interests or *vice versa*? [266] Absent such specifications, purposivism, it is argued, hands management a blank check, enhancing its power.[267] We would end up in a new managerialist era, undoing decades of efforts to reduce agency costs.

These points, while standard, are still well-taken. Purposivism makes no sense whatsoever as a one-line add-on to the present legal superstructure. Within that structure it is best left where it is—as a voluntary exercise useful for coordinating contributors of capital and labor and channeling their expectations.[268]

D. Reconstructing the Conceptual Framework

The problem lies less with purposivism than with the conceptual framework within which its proponents try so diligently but unsuccessfully to cabin it, a framework defined by the Friedmanite public/private divide and a theory of the firm based on property rights. Were we to stop thinking in those terms, maybe a public-regarding corporation could make all the sense in the world.

Professor Colin Mayer is pursuing just such a conceptual project. He sets forth a conceptual framework for corporate production rooted in a general equilibrium notion of efficiency, a goal which, by definition, ignores the categories of public and private. It seeks to free the economic theory of the firm from the partial equilibrium set up that equates production efficiency with management agency cost reduction, a set up with which corporate legal theory has been saddled for the past half century.

Mayer begins with a frontal assault on Friedman. The public/private ordering line, he says, is "fundamentally flawed."[269] Blank check remission of ancillary problems to regulation no longer works well. It might have made sense decades ago when operations were based on physical assets in place. Now, with value arising in intangible sources like brands, reputation, and knowledge, the old regulatory tools cannot keep up. Insiders at corporations know more than do state actors and do not hesitate to exploit the knowledge gap. Interdependencies among companies and between companies and the outside world—on supply chains, social frameworks, the environment, and natural assets—now matter more than formerly.[270] Scale economies arise on a global basis. All of this leaves state regulators intrinsically unable to do the job assigned by Friedman. It follows that instead of leaving private actors to their own devices and looking to the state for rules of the game, we should start over.

[265] Bebchuk & Tallarita, supra note 260, at 98,114-15.
[266] Rock, supra note 142, at 29.
[267] Bebchuk & Tallarita, supra note 260, at 98-99.
[268] Fisch & Solomon, supra note 237, at 1341.
[269] Colin Mayer, The Future of the Corporation and the Economics of Purpose 2, ECGI Working Paper Series in Finance, Working Paper N° 710/2020 (November 2020)[hereinafter Mayer, Purpose].
[270] Colin Mayer, What is Wrong with Corporate Law? The Purpose of Law and the Law of Purpose 4-5, ECGI Working Paper Series in Law, Working Paper N° 649/2022 June 2022 [hereafter Mayer, Corporate Law].

Mayer, having dispensed with the Friedmanite conceptual framework, looks to corporate purpose for a substitute approach. By purpose, he means a functional objective for the firm,[271] which should be neither aspirational nor descriptive but built around problem solving.[272] Corporations, says Mayer, should profitably solve problems of people and the planet, where profit is defined as return net of the costs of avoiding and remedying problems.[273] "Purpose," he adds, "is associated with enhancing the wellbeing and prosperity of shareholders, society and the natural world."[274] A formal purpose statement at a particular corporation can add particulars, by (1) providing a basis for trust in the firm's commitments to deliver public as well as private benefits, and (2) defining what are and are not the corporation's legitimate sources of profits.[275]

There are additional specifications in respect of (1) the firm's legal boundaries, (2) the concept of profit, and (3) the bundle of rights and duties encompassed by the notion of ownership. As regards legal boundaries, Mayer wants to widen them in pursuit of a markedly different notion of in and out. The present legal firm brings in the shareholders as the privileged interest and leaves all other constituents out. At the same time, costs are narrowly defined as out-of-pocket costs of production as incurred by the corporation itself. Externalities, which economically are every bit as much costs of production, lie outside of the framework used to tally profit and loss. Mayer wants to change all of this, bringing inside all constituents to whose interests the firm has committed itself and sweeping all costs into the profit calculation.[276]

The idea is to bring the theory of the corporation into line with the actual economics of production, thereby better aligning incentives. In Mayer's view, the existing formulation has the perverse effect of removing the shareholders from the role of residual risk bearer. He thereby refers not to their position as junior claimants in reorganization or liquidation but to their economic position as regards the going concern's everyday actions. So long as profits sweep in only internal costs, shareholders benefit financially when these costs are cut, making victims of redundant

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[271] Mayer, Purpose, supra note 269, at 2. See also Mayer, Corporate Law, supra note 270, at 8:

> [There] is an inherent problem in the way in which business has been conceived, namely that private interest does not correspond to the public except in very particular circumstances where the functioning of competitive markets and contracts is so complete and efficient that perfect competition and contracts prevail everywhere. Without this, the failure of markets results in the failure of business and a reliance on regulation that has proven increasingly incapable of meeting the challenge. This imposes an intolerable strain on government and our democratic systems to bridge the divide between those who advocate for the unrestrained operation of markets and businesses, and those who seek to tie them down with the heavy hand of regulation and enforcement . . . It is this potential conflict between the financial inducement of profit and the delivery of human, social and environmental benefits that lies at the heart of the division between the private and public purpose of business.

[272] Mayer, Purpose, *supra* note 269, at 2.

[273] *Id*.

[274] *Id*. at 2-3.

[275] Mayer, Corporate Law, *supra* note 270, at 8.

[276] See Colin Mayer, *Shareholderism versus Stakeholderism – A Misconceived Contradiction: A Comment on "The Illusory Promise of Stakeholder Governance" by Lucian Bebchuk and Roberto Tallarita* 4, ECGI Working Paper Series in Law, Working Paper N° 522/2020 June 2020 [hereafter, Mayer, Shareholderism] ("What accounts do not currently record are the costs of maintaining assets that a firm does not own but on which it depends, or the liabilities for which it is not contractually or legally obligated but nevertheless responsible because of its impacts on other parties. In its current form, accounting serves the purpose for which it is designed of being aligned with a property right but not a responsible owner or purposeful management view of the firm.")

employees, discarded suppliers, and abandoned communities. This makes the shareholders risk externalizers rather than risk bearers. This chain of causation, says Mayer, should be reversed—the shareholders should bear these risks, thereby establishing "the firm's trustworthiness to earn the trust of others as a trustworthy supplier, purchaser, employer, partner, debtor, neighbour, and citizen."[277] The start point must be the solution of people's problems--shareholder financial returns should follow only when problems have been solved.[278] The notion of profit must be adjusted accordingly, so as to sweep in all the costs—the costs of "maintaining human, social and natural as well as physical assets." The current system, with its focus on physical assets owned by the firm, is incapable of doing that.

We turn now to the notion of ownership. Recall that Berle and Means problematized the fact that the corporation's shareholder owners did not control the business. They made the point with an analogy to real and personal property—with a house or a car the owner took responsibility for the thing; because corporate shareholders did not similarly take responsibility, excessive power devolved on the managers.[279] There followed a drive to strengthen shareholder rights and diminish management discretion, a drive that lasted three-quarters of a century. Mayer takes the same property analogy and dismantles it. Shareholders as owners made sense in the manufacturing era, when producing wealth followed from physical assets.[280] Now companies produce with human, intellectual, and social assets, and depend on external parties to provide those assets even as the companies in turn impact on the providing parties.[281] Interdependencies result, interdependencies that change the legitimacy equation: "Far from being a right that derives from shareholders' investments in their companies, it is an obligation and responsibility to respect and uphold the interest of external parties on which they depend and impact."[282] Thus do shareholder *responsibilities* spring into Myer's ownership picture—*duties* to internalize costs and honor commitments.[283]

E. Comments

Berle and Means articulated a positive vision of the future in the *Modern Corporation's* last chapter, a chapter containing six famously inscrutable pages.[284] In their brave new world, managers would act as "purely neutral" technocrats making allocative decisions across groups in

[277] Mayer, Corporate Law, *supra* note 270, at 11.
[278] *Id*.
[279] BERLE & MEANS, *supra* note 40, at 356.
[280] Mayer, Purpose, *supra* note 269, at 5.
[281] *Id*.
[282] *Id*.
[283] *Id*. at 6-7. The duties of directors and officers also change in character as the set of beneficiaries widens. A purpose of producing profitable solutions and not profiting from producing problems implies that a wider body of beneficiaries than just shareholders should be subject to accountability: "[The board's] engagement and accountability should be aligned with the overall impact and resourcing, not just the financing, of its activities. . . . Achievement of the purpose requires a sense of ownership by everyone in the organization, not just those with formal ownership rights and those at the top. . . ." Colin Mayer, *The Governance of Corporate Purpose* 8, ECGI Working Paper Series in Law, Working Paper N° 609/2021 (September 2021).
[284] See William W. Bratton & Michael L. Wachter, *Tracking Berle's Footsteps: The Trail of the Modern Corporation's Last Chapter*, 33 SEATTLE U. L. REV. 849 (2010).

society "on the basis of public policy rather than private cupidity."[285] They would use their power for social betterment:

> Should the corporate leaders . . . set forth a program comprising fair wages, security to employees, reasonable service to their public, and stabilization of business, all of which will divert a portion of the profits from the owners of passive property, and should the community generally accept such a scheme as a logical and human solution of industrial difficulties, the interests of passive property owners would have to give way."[286]

Ninety years later, Mayer's purposivism takes up the job of describing just what a neutral corporate technocracy might look like. The best way to get across to the public side, he advises us, is to stop defining everything in Friedmanite terms while taking a technocratic point of view: Solve problems, making sure to account for all costs, and honor all commitments. With Mayer accountable shareholders finally make an appearance in corporate legal theory.

Implementation of such a program would be anything but simple. Each of ownership rights and profit and loss accounting would have to be reconfigured from the ground up, a project calling for a tremendous commitment of both technical wherewithal and political will. We shall not be expecting giant steps to be taken in Mayer's direction any time soon.

For present purposes, Mayer's value lies in showing us what purposivism would mean were we to take it seriously. So doing would entail not merely the modification but the destruction of shareholder primacy. Seeing this lets us put the recent public-regarding developments in corporate governance in perspective. They herald only a minor transformation of shareholder primacy. There has been no a structural shift toward a welfarist corporation, merely a handful of welfarist incidents.

CONCLUSION

Whereas management unaccountability was corporate law's central problem in the twentieth century, shareholder unaccountability is its central problem in the first part of the twenty first. Adolf Berle himself predicted this turn of events in *Power Without Property*, published in 1959.[287] He noted the trend toward shareholding by intermediaries.[288] These actors, he said, unbeholden to anyone, eventually would be able to "deliver a controlling vote at will."[289] Thus situated, they might well break "the self-selecting perpetuation of public company managements."[290] But a new problem of power without accountability[291] would follow--the separation of ownership benefit from ownership responsibility described in this Article.

[285] BERLE & MEANS, *supra* note 40, at 356. Berle and Means speculate that, thus redirected in this cooperative direction, the power of corporate actors could even eclipse that of state actors. *Id*. They do not expand on the point.
[286] *Id*. at 356.
[287] See BERLE, POWER, *supra* note 44.
[288] *Id.* at 18.
[289] *Id*., at 53.
[290] *Id*., at 59.
[291] *Id*., at 64.

Now, sixty-four years later, corporate governance finally is beginning to confront the problem, which is turning out to be complex. Actors at the Big Three began the process when they took up the ESG agenda in an attempt to make themselves accountable for their own power over corporate business planning. Shareholder primacy changed as result, but only its normative, purposive leg, which emerged diminished. The procedural leg remains untouched--we insist on shareholder power now more than ever. We would have to stop doing so were we ever to take social welfare seriously as corporate purpose.

Meanwhile, as we go about aligning ownership responsibility with ownership benefits, the mechanics of the exercise of shareholder power are undergoing modification. The institutions, their legitimacy at best questionable, are being pushed aside as we seek out the preferences of the beneficial owners. One suspects that the accompanying noise will once again drown out any reference to the underlying accountability problem.

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