**SHAREHOLDER PREFERENCES AND CORPORATE BEHAVIOR**

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The preferences of equity investors are not monolithic. While some equity investors prefer that companies singularly focus on the pursuit of profit and share value maximization, others see things differently and prefer that companies sacrifice profit and share value in service to some other objective. In particular, as our country’s social and environmental problems have grown in both scope and depth, and as faith in the curative abilities of the political process has waned, a meaningful portion of investors appear willing to trade at least some corporate profit for corporate decisions that can aid in the correction of these problems. Others continue to prefer that corporations solely seek to maximize share value. And yet others prefer that corporations deviate from share-value-maximizing behavior in ways that further the investors’ own personal advantage.

To what extent does the existence of this willing-to-sacrifice bloc of investors currently affect firm behavior and should changes be made in existing corporate governance arrangements to make firms more sensitive to their preferences? This article applies the teachings of corporate governance and the tools of financial economics to bring some analytical clarity to resolution of these increasingly important questions concerning firm behavior. The article focuses its attention on the country’s dominant form of productive enterprise—the dispersed ownership publicly traded for-profit corporation with shareholders as its residual claimant. It inquires whether heterogeneity in the preferences of the economy’s equity investors regarding the extent to which firms should pursue share value maximization will cause firm behavior to be different than in the counterfactual world in which investors uniformly prefer that firms focus only on share value maximization.

Given current corporate governance arrangements, the decision as to how such a firm operates is in the first instance made directly by the firm’s managers, not by its equity investors, whether actual or potential. The existence of investors with preferences other than share value maximization can potentially affect firm behavior in only indirectly. One way is through the election of directors pledged to make the firm conform with these preferences. The other is in through the effect of these preferences on the multiple elements that go into the incentive structure within which a firm’s managers operate, something the article works through.

One potential pathway through which shareholders with this willing-to-sacrifice preferences could affect firm behavior is through the shareholder franchise. Our analysis raises significant doubts about the effectiveness of this pathway. Under current corporate governance arrangements, the only relevant binding shareholder votes concern who will be the directors, and our analysis shows that this will be an ineffective means of translating the preferences of profit-sacrificing shareholders to real corporate change. Some commentators have championed modifications to these governance arrangements that might cause managers to be more receptive to such shareholders’ preferences. These changes in governance arrangements would, however, come with costs that might well overwhelm any social gain. Specifically, they will divert political energy from its focus on the public political process where that energy can be applied more efficiently in attaining results. And, whatever these modifications do accomplish in making managers more receptive to the preferences of such shareholders, they are likely as well to lead to changes in firm behavior that simply benefit managers.

Some investors clearly compose their portfolios taking into account whether they approve of the behavior of the firms in which they invest, while others do not. This sorting represents a second potential pathway by which the economy’s willing-to-sacrifice equity investors may affect corporate behavior. There are both theoretical and empirical grounds for believing that such sorting may have some impact on share prices and through this on firm behavior, though neither proposition is close to being resolved with any certainty. Relative to altering existing governance arrangements for the purpose of giving the economy’s willing-to-sacrifice equity investors a chance to alter corporate behavior, reliance on a price-based mechanism for reforming corporate behavior has some clear advantages. Modifying corporate behavior through sorting is a process that could be further promoted through more socially oriented mandatory securities disclosure. The difficult question is whether the sorting-induced changes in firm behavior from imposition of such mandates if such mandates are likely great enough to justify their considerable costs.

The paper’s analysis can be leveraged to advance discussion of a number of ongoing debates in corporate law scholarship. One example is corporate purpose: should it be to maximize share value or should it be, as proponents of CSR, ESG, and stakeholderism see it, to serve, to some extent at least, one or more other ends? The literature advocating these alternative ends approaches to corporate governance tends to be thin on how to get from here to there. We conclude that even if a substantial portion of the economy’s equity investors would prefer sacrificing profits in furtherance of some such end, it is unlikely to lead organically to major changes in corporate behavior. We identify and evaluate the fundamental changes in our corporate governance arrangements that would be needed for these preferences to make a difference.

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**Introduction**

For most of the last few decades, the primary focus of academic literature concerning dispersed ownership publicly traded corporations has been on minimizing the agency costs, with the shareholders being the principal and the managers the agent.[[3]](#footnote-3) In this literature, a corporation’s shareholders were assumed, either explicitly or implicitly, to all agree that they wanted it to behave in a way that maximizes the value of the corporation’s shares.[[4]](#footnote-4) In recent years, however, it has become increasingly clear that the individuals who make equity investments in such corporations, whether directly or through investment funds, are in fact not uniform in their preferences.

This article seeks to step back and, appealing to first principles, provide some understudied analytic precision to two basic questions: (1) how, if at all, these preference differences among the economy’s equity investors are likely to affect corporate behavior, and (2) whether the recognition that these differences exist necessitates changes in corporate and securities law as some commentators suggest. This paper seeks to answer these two basic questions with regard to equity investors in what is the dominant kind of productive enterprise in the United States: the dispersed ownership publicly traded for-profit corporation with shareholders as its residual claimant.[[5]](#footnote-5) Although the answers we derive may not be directly applicable to dispersed ownership firms abroad, the paper can serve as a template for a study of them as well.[[6]](#footnote-6) To date, little in the academic literature has seriously analyzed the implications for corporate behavior where some of the economy’s equity investors in dispersed ownership firms want firms to do something other than maximize share value. [[7]](#footnote-7) This is a real gap given that such investors clearly exist in substantial numbers and questions relating to their impact have significant relevance to myriad ongoing debates in corporate law scholarship.

Throughout, when we refer to an equity investor in any such corporation, we include both any person who holds the shares of the corporation directly and any person who has an equity interest in it derivatively through investment in a fund that holds the firm’s shares.[[8]](#footnote-8)

Differences among equity investors in their preferences concerning how any given corporation should behave have become obvious in many areas. Environmental and other social concerns have, for example, led some of these investors to prefer that firms behave in ways that deviate from share value maximization in furtherance of some such social aim, while other investors prefer that they still adhere to that traditional goal. Taking things in a different direction, consider the substantial overlap of share ownership in the same oligopolistic industry by broad-based index investment funds—the so-called common ownership phenomenon[[9]](#footnote-9) A wealth-maximizing individual who has invested in such a fund is thus concerned with the combined profitability of multiple firms in that industry. This means that she would wish that each such firm competed less aggressively than would be profit maximizing.[[10]](#footnote-10) In contrast, a wealth-maximizing individual who is invested, directly or indirectly, in just one firm in that industry would wish that it would profit maximize.[[11]](#footnote-11)

Given the current structure of corporate governance in the United States, the behavior of the typical publicly traded dispersed-ownership corporation is in the first instance determined by its managers. Thus, when we ask how the preferences of equity investors affect such a firm’s behavior, we are asking how, if at all, these preferences affect managerial incentives. At one end of our inquiry, we have each firm’s managerial incentive structure. At the other end, we have the economy’s equity investors. Such an investor, by her own decisions or by delegation to the managers of the funds in which she chooses to invest, (1) determines which firms’ shares, directly or indirectly, compose her portfolios, and (2) exercises the shareholder franchise with respect to the firms in this portfolio.[[12]](#footnote-12)

The first question we seek to answer is positive. Given existing governance arrangements, will the heterogeneity that we see today in investor preferences cause managers in a meaningful number of instances to significantly modify firm behavior? In other words, is firm behavior significantly different than it would have been if, as has traditionally been assumed, all investors simply desired the firm to maximize share value? Answering this question requires an inquiry into (1) how any given distribution of preferences among the economy’s equity investors affects the ways that their respective portfolios are composed and the shares in these portfolios are voted, and (2) how, in turn, the resulting set of portfolios and electoral outcomes affect managerial incentives. This inquiry involves reference to the entire panoply of devices that the academic corporate governance literature has identified as potential mechanisms directly or indirectly influencing managerial decision-making.

The second question we seek to answer is normative. Should current governance arrangements be altered so that the preferences of those prepared to sacrifice share value maximization in favor of some other end lead to a greater modification in managerial behavior than what we think is occurring today?

In answering this second, normative question, we do not start with any preconceptions that shareholders have certain inherent rights to shape the behavior of the corporations in which they invest. Established dispersed ownership corporations are major players in society’s decisions as to what products and services to produce, how they are produced, and who gets them, and as to how the gross revenues from the sale of their goods and services are split up among their employees, investors, and the suppliers of other factors of production.[[13]](#footnote-13) These decisions are shaped by both a variety of market forces and the forces of governmental regulations, taxes, and subsidies explicitly keyed to a corporation’s behavior. What rights shareholders should have and how shareholder preferences should be accounted for need to be seen as operating within this larger world of the forces shaping a corporation’s behavior. Specifying shareholder rights should be a purely instrumental exercise involving a determination of what arrangement can be expected to lead to the socially most desirable outcomes.

Put another way, our normative inquiry goes to the fundamental question how various members of society participate in the decisions that shape the behavior of the type of corporations under study. Suppose some portion of the economy’s equity investors prefers that a given corporation act in some profit-sacrificing way. These investors clearly can act on this preference through their participation in the governmental political process. They may also have some influence on the corporation’s behavior by simply not being equity investors in that corporation.[[14]](#footnote-14) The normative question addressed in this paper is whether in addition, for those of this set of the economy’s equity investors who, directly or indirectly, actually hold shares in this corporation, existing corporate governance arrangements should be modified so that it is more likely that the corporation’s behavior is more likely to be changed via the corporate franchise as well.

It is helpful at the outset to identify the outer bounds of our efforts here. We confine our analysis throughout to the current arrangement in which a corporation’s shareholders, and its shareholders alone, are the ones who elect its board of directors. While some scholars have advanced proposals that would expand the franchise so that other stakeholders have a role in choosing management,[[15]](#footnote-15) we do not address that circumstance here. These proposals involve an entirely different project about which this paper has little to say other than to note that in any arrangement where investors remain as at least one class of residual claimants, they need control rights in order to protect against being taking advantage. Enterprises with multiple classes of residual claimants with control rights have been viewed by some eminent scholars as tending to have high governance costs.[[16]](#footnote-16)

Part I of this article starts with the observation that all equity investors prefer, everything else being equal, that the corporations whose shares they hold behave in the ways that leads these corporations to have higher share values rather than lower ones. Everything is not necessarily always equal, however. Thus, any given investor in a particular corporation may prefer that it behave in a way that, despite reducing share value, furthers some other end. Part I describes three different, not necessarily mutually exclusive, kinds of ends for which some of a firm’s shareholders might be willing to sacrifice share value. The first involves the situation where the corporation’s share value maximizing behavior would result in a market imperfection, for example generating a negative externality such as pollution or exercising market power to constrain output and charge a high price. In this situation, an investor might prefer that the corporation behave in a different way, one that would reduce or eliminate these adverse social consequences, even if doing so would reduce share value.[[17]](#footnote-17) Second, an investor may wish the corporation to act in a way that, though reducing share value, would, in her eyes, generate a fairer distribution of wealth. Examples would be the corporation paying its workers more than a competitive wage or selling its output for less than a competitive price. Third, the investor may wish the corporation to deviate from share value maximization to benefit her personally in ways other than by providing her dividends or capital gains. She may wish it, for example, to provide her favorable terms when the corporation buys inputs from, or sells outputs to, either herself or another firm in which she directly or indirectly has an equity interest. Or she may wish the corporation to compete less aggressively with another firm in the same industry in which she has such an interest.[[18]](#footnote-18) In sum, while many investors in a corporation may wish it simply to maximize share value, others would be willing to sacrifice some share value in furtherance of other ends. As a result, a corporation’s shareholders can differ in their preferences concerning its proper objective.

Our analysis of the potential pathways by which the existence of investors willing to sacrifice share value might possibly influence managerial behavior proceeds in two stages. The first stage, undertaken in Part II, assumes that while many investors in a firm may have ends they wish the firm would pursue even if doing so will sacrifice share value, they compose their equity portfolios for ordinary financial reasons unrelated to their views concerning each firm’s behavior. In other words, in Part II, we take the initial existing shareholder makeup of each of the firm’s public firms as fixed and randomly drawn from the body of the economy’s equity investors. The presence of profit sacrificing investors in the economy means that, under this assumption, each firm’s shareholder base will include some shareholders solely desiring profit maximization and others desiring a deviation from profit maximization for one or more reasons. Because each equity investor’s choice as to what corporations’ shares are, directly or indirectly, compose her portfolio, is assumed not to take these preferences into account, the composition of the shareholder body of each corporation should resemble the composition of equity investors generally in these regards, with any differences due primarily to chance.

Part II addresses, for each of the three share-value-sacrificing categories identified in Part I, the likelihood, if any, that the presence of some shareholders having such a preference will affect a corporation’s behavior. We conclude that under current governance arrangements, where the only binding shareholder votes of relevance concern who will be the directors, the existence of shareholders favoring some share-value-sacrificing end is unlikely to alter significantly most corporations’ behaviors. In other words, these corporations would not behave significantly differently than if all their shareholders favored share value maximization. This conclusion is derived using the first-stage, Part II, assumption that investors compose their equity portfolios for ordinary financial reasons unrelated to their views concerning each firm’s behavior. However, as we will see when we discuss the second stage analysis in Part III, this conclusion is not undermined by dropping this assumption and recognizing that an investor’s views about a firm’s behavior can affect whether they include its shares in the investor’s portfolio. Indeed, in certain regards, it is reinforced.

In the hope of increasing the sensitivity of firm behavior to the existence of shareholders with other-end-seeking share-value-sacrificing preferences, some commentators recommend alterations in these governance arrangements to allow shareholders binding votes concerning specific share-value-sacrificing corporate behaviors. To be fully effective, this might also require more pass through voting to the beneficiaries of the pension and investment funds that hold a significant portion of the shares of the corporations under study. In any event, the increased number of socially oriented non-binding precatory resolutions receiving a majority vote in recent years[[19]](#footnote-19) suggests a real possibility that such reforms would indeed lead to more occasions where the existence of such shareholders changes firm behavior.

As will be further developed in Part II, we view these seemingly reasonable reforms as unwise for a number of reasons. In particular, for such reforms to work, in essence an alternative political system needs to be created relating to each publicly traded corporation. Just like with the governmental political system, in these alternative political systems, the process by which corporate voters become informed and their votes mobilized would consume substantial resources and require considerable energy from public spirited persons. This need for resources and energy suggests that the adoption of these reforms may not lead to as much change in corporate behavior as their proponents hope. And to the extent that the reforms are responsible for significant change, that may come at an under recognized cost. The development of this alternative political system would not occur in a vacuum. The energies of persons seeking to reform corporate behavior to meet social ends are finite and they will need to decide where to dedicate these energies. If shareholders are allowed to use the franchise to bind management to specific corporate behavior, these redirected energies are likely to come at the expense of efforts to reform the governmental political system and to push that system to better control corporate externalities and to achieve more equity in society. Despite current frustrations, these energies will likely more efficiently achieve the ends that reformers seek if channeled into the public sphere. There they can be concentrated to affect the behaviors of a broad swath of firms, rather than being dispersed among piece-meal battles affecting many individual firms. Also, for these reforms to work, they likely will require a relaxation of the governance system’s current constraints on management. That will often lead to corporate behaviors that benefit managers in ways that sacrifice share value without advancing any kind of social ends.

In Part III, we engage in the second stage of the analysis and add in the possibility that some investors will be influenced in composing their portfolios by whether they approve of a given firm’s behavior. Relative to composing a portfolio on purely financial grounds, this may take the form of not holding the shares of firms the behavior of which the investor disapproves of (“identity investing”). Or it could take the form of affirmatively seeking to hold the shares of firms the behavior of which the investor disapproves in order to change that behavior toward promoting some share-value-sacrificing social end (“transformative investing”). We argue that despite some institutional investor justifications for resisting divestment on the grounds that they have a greater ability to transform corporate behavior by “reforming from within,” genuine transformative investing is relatively rare because it involves holding the shares of a firm the investor would not hold for ordinary financial reasons based on the slim prospect that the firm has enough other transformative investors interested in the same share-value-sacrificing end that they will be able to vote a change in behavior.

Identity investing appears to be more common. What, though, are its effects on corporate behavior? On the one hand, identity investors have, by their very choice of portfolio composition, forgone the possibility of voting to change the behavior of the firms of which they disapprove. This is why dropping the analysis of Part II first-stage assumptions actually reinforces our conclusions that under existing corporate arrangements, the existence of investors preferring share-value-sacrificing ends is unlikely to meaningfully affect corporate behavior through the franchise. On the other hand, if identity investors favoring a particular share value sacrificing end are sufficient in number and command sufficient resources, it is possible that, by refusing to hold the shares of firms the behavior of which they disapprove, they will depress the price of these firms’ shares. The prospect of a lower share price may in turn influence managers to abandon such behavior. However, it is unclear based on either theory or existing empirical studies whether the current level of identity investing has yet achieved the critical mass necessary to achieve any such meaningful change in behavior, and if it has not, how likely it will in the future.

We observe, though, that relative to governance arrangement reforms as a way of achieving socially oriented changes in corporate behavior, reliance of the price effects of identity investing has a number of attractions. Among others, it does not consume the political energy that could be used to reform the governmental political system and to push for governmental actions that better control market failures and reduce inequity. And it does not require a socially costly lessening of the existing constraints against managers acting in self-interested ways. It relies instead on information-cost-economizing market mechanisms by which managers, who continue to seek to maximize their share prices, seek to detect changes in behavior whereby the share price depressing effects of not maximizing cash flow are compensated by the share price increasing effects of the identity investors that the changes would attract. Interestingly, the primary policy implication of encouraging this pathway to reforming corporate behavior would be in the area of securities disclosure, where, so far, the advocates of more socially oriented disclosure and those of purely financial disclosure have been largely talking past each other.

The article’s mode of analysis and findings in Parts I, II, and III can be leveraged to advance the discussion of a number of ongoing debates in corporate law scholarship including the debate over corporate purpose. Is it to maximize share value or is it, to at least some extent, to serve one or more other ends? The major reform movements of recent years – Corporate Social Responsibility (CSR), Environment, Social, and Governance (ESG), and stakeholderism – share in common support for the latter position, whatever, if any, are their differences. In this regard, in Part IV, we reach three conclusions. First, the literature advancing the various strains of the alternative ends approach is surprisingly thin on how to get from here to there. Our analysis suggests that it may well be that a significant portion of the economy’s equity investors would, if fully informed, prefer certain deviations share value maximization in furtherance of other ends, but that it is highly unlikely that if so, this fact would organically lead to major changes in corporate behavior. Fundamental changes in our current corporate governance arrangements would be a precondition. Second, because shareholders are not well informed concerning the extent to which changes in corporate behavior would further ends that they support or the costs of these changes in terms of share value, directors and managers, even if they wished to do what shareholders would prefer if they were so informed, lack any reliable guides. Third, the analysis here suggests efficiency and equity in the economy will not be advanced by two of the prominently discussed kinds of fundamental changes in corporate governance arrangements: broadening the scope of the shareholder franchise to allow for votes concerning specific business decisions and softening the sticks and carrots that incentivize managers to maximize share value through an easing of fiduciary duties. These conclusions are important because if these fundamental alterations are necessary for shareholder preferences to change corporate behavior but unlikely to be adopted, it would be better to steer policy analysis concerning how to correct for the problems of corporate behavior in other directions.

Part V concludes.

1. **Taxonomy of Shareholder Differences**

Most standard economic models of corporate governance posit that equity investors in the economy’s public corporations homogeneously prefer that these firms act solely to maximize share value.[[20]](#footnote-20) Observation in the real world suggests otherwise. While it is true that all equity investors prefer that the corporations in which they invest their money behave in ways that result in a higher share value rather than a lower one, the behavior of any given public corporation has impacts touching upon the variety of other ends valued by these investors as well. Some of the economy’s equity investors, who can be referred to as its “profit maximizers,” prefer that firms stay focused on share value maximization despite these other ends. Others among the economy’s equity investors, the “profit sacrificers,” see things differently and prefer that particular firms to sacrifice some share value in order to further one or more of those other ends. While the ends giving rise to profit sacrificing preferences are myriad, we think they fall into three non-mutually exclusive general categories, as set out below, which we believe spans the entire universe of the preferences of profit sacrificers.

1. *Market Imperfections*

The presence of market imperfections—which may arise from circumstances such as externalities, market power, or information asymmetries—means that the behavior that maximizes a corporation’s share value is not necessarily the one that maximizes its net contribution to society’s total wealth. In this situation, some equity investors may prefer that it behave in the former fashion and others prefer that it behave in the latter fashion. Understanding the reason why requires reference to the story of how, in the absence of any market imperfections, a corporation that is maximizing the value of its shares (the future expected flow of residuals to its shareholders discounted to present value) would in fact maximize its contribution to society’s total wealth, a concept often referred to as the “first theorem of welfare economics.”[[21]](#footnote-21) The idea is that in such an environment, the amount that the firm pays as expenses is the value at the margin of what the corporation takes from, or how it otherwise negatively impacts, the world in order to produce its output. And the amount it receives as revenue for this output is the value at the margin of what it gives back to the world. The difference – its residuals – is its contribution to society’s total wealth.

The real world, though, has market imperfections. Producing a corporation’s output may, for example, involve the release of carbon and other pollutants, negative impacts on the world for which it may pay nothing or, more generally, pay less than the conduct’s social cost.[[22]](#footnote-22) In deciding how, and how much, to produce, the share value maximizing corporation does not fully take into account these negative impacts. Similarly, when a corporation with market power maximizes share value, it will produce at a level whereby its price is greater than its marginal cost, i.e., it in fact could contribute more to social welfare than it does if it instead produced at a higher level with a commensurate lower price.[[23]](#footnote-23) And, if a corporation knows negative things about the qualities of its product that its customers do not, the price consumers are willing to pay may exceed what in fact is its value to them.

In any such situation, an imperfection-correcting deviation from share-value-maximizing behavior can lead in aggregate to more benefit than harm to society as a whole.[[24]](#footnote-24) Most people are other-regarding to some extent at least. Because of this, some of a corporation’s equity investors may well prefer that it deviate from share value maximizing behavior in order to improve the aggregate welfare of their fellow human beings even if that means they sacrifice something in terms of share value.[[25]](#footnote-25) There will likely be differences among the corporation’s equity investors in this regard, however, with some wishing the corporation not to deviate at all, some a little bit to partially correct for the imperfection, and others to deviate more for a fuller correction. In other words, these equity holders will likely differ among themselves on the rate, if any, at which each would trade off the net benefits to others versus her resulting loss in share value.

In this connection, it needs to be recognized from the start that a shareholder induced deviation of share value maximization is not the only way that society handles these imperfections. Traditionally, the primary way has been through governmental imposed rules on corporate behavior backed by fines and criminal sanctions and by behavior shaping taxes and subsidies. Corporations are then invited to maximize share value within this market imperfection correcting governmental framework. A corporation can also end up making its maximum contribution to society by acting in a share value maximizing way if its managers or workers on the input side or customers on the output side who care about the imperfections impose a high enough price should it not correct its behavior with regard to the imperfections.[[26]](#footnote-26) Proponents of adding to the influence of shareholders who care about these imperfections are driven in part by a feeling that these other ways of handling the imperfections are not working adequately.

*B. Distribution*

The behavior of a corporation affects the wealth positions of persons beyond its equity investors, such as its workers, others in the communities in which it operates, and its customers. Any corporate behavior that deviates from share-value-maximizing behavior will likely leave some such persons better off and others worse off than if it did not deviate. The corporation may pay more for its inputs, for example labor, than the competitive wage. Or it may sell its output, perhaps a vital drug, for less than its marginal cost. Wholly aside from whether or not such a deviation in corporate behavior corrects for a market imperfection and increases total social welfare, any given investor may prefer that the corporation engage in the deviation because she prefers the deviation’s effect on the wealth positions of people in society relative to what those positions would be if the corporation maximized share value.

There are many reasons why the investor might have this preference. She might simply feel a greater affinity toward whoever would be the deviation’s particular gainers relative to her feelings toward its particular losers. Alternatively, in terms of the economy’s overall distribution of wealth, the pattern of a particular deviation’s winners versus losers may move that distribution in the direction of greater equality, an effect that the equity investor favors. The investor might also feel that the deviation is preferable because the winners’ gains correct for some historical injustice. On the other hand, it is also easy to imagine an equity investor being opposed to any deviation from share value maximization for distributional concerns. This might be because he does not feel that society’s wealth needs to be distributed more evenly. Alternatively, he may feel that it does, but explicitly or implicitly feel that distribution should be province of government tax and benefits policies, where the pie that is split being through these policies is maximized by actions that promote Kaldor-Hicks efficiency.[[27]](#footnote-27) Reliance on the government to do the redistribution may have the attraction to him that he and his fellow investors in the corporation do not sacrifice to promote a more equal distribution unless everyone else similarly situated to them wealth-wise sacrifices as well.

*C. Impact on the Individual Shareholder Beyond Receipt of Residuals*

How a corporation behaves affects each of its equity holders by the impact of that behavior on its residuals over time and hence on the value of the shares in which each equity holder has an interest. But the corporation’s behavior may affect these equity holders in other ways as well, with some so affected and others not. Examples include situations in which an equity holder, or an entity in which she has an interest, transacts with the corporation as a supplier of inputs (for example, as an employee), as a customer regularly purchasing its output, or in some one-off deal. In any of these cases, the equity holder would be better off if the terms of the transaction were more favorable to her than what would be share value maximizing terms. Similarly, some equity holders (common owners) of a corporation may have equity interests in one or more other corporations in the same oligopolistic industry corporation while the rest (non-common owners) do not. The common equity holder will benefit if the corporation chooses an output level lower than the share-value-maximizing one and the non-common will be harmed by this.[[28]](#footnote-28) A deviation from share value maximization may also benefit some equity holders and not others in terms of their tax status.

1. **The Influence of Shareholder Preferences Taking as Given the Existing Shareholder Makeup of Each Firm**

With this taxonomy in place, we can now turn to our primary positive question of interest: to what extent does the existence of investors who are willing to sacrifice share value to advance some other objective influence firm behavior relative to a world in which all investors desire share value maximization? Our analysis proceeds in two stages, where the first stage of the analysis, conducted in this Part, takes the initial existing shareholder makeup of each of the economy’s public firms as fixed. We drop this assumption in the next Part and consider a more complete environment in which investors to one extent or another sort themselves and choose the companies in which they invest based on their profit-sacrificing preferences and companies’ alignment with those preferences. The dissection of the question in this manner allows us to isolate how heterogeneous investor preferences can affect firm behavior though sorting mechanisms and through the shareholder franchise.

In this first-stage analysis constituting Part II, we take the initial existing shareholder makeup of each of the economy’s public firms as fixed and randomly drawn from universe of the economy’s equity investors. So any given firm’s shareholder base includes both profit maximizers and profit sacrificers, with each firm’s shareholder base resembling, on average, the composition of the economy’s equity investors generally.[[29]](#footnote-29) Based on this setup, we address whether the presence of profit sacrificing shareholders is likely to cause firms to deviate from share value maximization significantly more than if there were no shareholder preference heterogeneity and all shareholders were profit maximizers. We undertake this analysis by with regard to each of the three categories of profit sacrificing preferences delineated in Part I.

1. *The Role of Shareholders and Managers*

A fundamental feature of our current corporate law is that a corporation is managed under the direction and authority of its board of directors, who in turn choose the officials making day-to-day decisions (we will refer to the combination of the board and these managers as “management” or “managers”).[[30]](#footnote-30) The role of shareholders is legally circumscribed and limited to certain discrete matters such as electing directors (typically by majority vote), approving certain extraordinary transactions, cleansing interested party transactions, and voting on nonbinding (so-called “precatory”) proposals for management consideration. So in the first instance, the corporation’s managers, not its shareholders, are the persons who largely determine how the corporation behaves. The presence of shareholders with profit-sacrificing preferences that fall into any of the three categories delineated above can only affect corporate behavior, if at all, by their effects on and through the incentive structure within which firm managers operate. This is because it is this incentive structure, coupled with managements’ own preferences (shaped perhaps by their social environment) and information set, that, contingent on the markets for the corporation’s inputs and outputs, determine the corporation’s behavior.

This incentive structure is one with which we are already familiar from the study of the agency costs of management. It consists of a number of incentivizing sticks and carrots. The sticks involve a variety of threats: (i) the exercise of the shareholder franchise through a proxy fight (the threat of management being voted out of office by its existing shareholders) and related mechanisms, such as using proxy access to nominate competing directors and voting against unopposed directors; (ii) a hostile tender (the threat that some person will purchase enough shares to be able itself to vote management out of office); (iii) an activist campaign (the threat that some person purchases a foothold stake in the firm and then persuades a sufficient number of existing shareholders to vote to replace management); (iv) sale of a share position (the threat of a shareholder with a significant block of shares selling and thereby depressing share price to the disadvantage of the managers); and (v) fiduciary duties (the threat of a derivative suit against the firm’s directors and officers claiming that they are not acting in the best interests of the corporation and its shareholders). The carrots are the design of the managers’ compensation packages and the managers’ own shareholdings in the firm.[[31]](#footnote-31)

1. *The Interests of Management*

The starting point for figuring out how the incentive structure in which a firm’s managers work affect the decisions they make is to identify the managers’ own interests and how they may lead to decisions concerning the behavior of the firm that differ from what any particular shareholder might prefer. [[32]](#footnote-32) A manager’s position in the firm is likely to give her, to one extent or another, a variety of benefits. These would include the strictly self-interested ones of compensation, perquisites, power, prestige, the pleasure of benefiting her associates in the firm, and include as well the enjoyment of more other-regarding benefits in the forms of a virtuous reputation and a personal sense of doing social good.[[33]](#footnote-33)

*1. Managerial interests incentivizing resistance to deviations from share-value-maximizing decisions.* On a period-by-period basis, decisions that maximize the firm’s residuals – the difference between what it can sell its output for and the cost of producing that output – maximize the capacity of the firm to provide the managers with the strictly self-interested benefits. So, to the extent managers are impelled by seeking these benefits, they are inclined to make residual maximizing decisions. As will become clear when, in the sections below, we explore the forces making up the existing managerial incentive structure, this alignment between the management decisions that serve their own interests managerial interests and the ones that maximize share value poses a very serious impediment to the desires of any portion of shareholders willing to sacrifice share value in furtherance of some market imperfection correction or distributional end.[[34]](#footnote-34)

*2. Managerial interests incentivizing deviations from share value maximization.* On the other hand, the existence of these two more other regarding potential benefits – reputation and a sense of doing good – derive from interests that may sometimes favor managerial decisions consistent with the preferences of shareholders favoring deviations from sale value maximization.

The question explored below, though, is whether, even if they have parallel preferences, the existence of shareholders with such preferences makes any significant difference in the likelihood that managers will act based on these more other regarding interests. Based on these interests, the managers of some corporations may cause them to behave in ways that modestly deviate from share value maximization. This may occur, however, simply because the incentive structure within which they work gives them room to do so. In other words, they would have deviated whether or not the corporation had shareholders with such profit sacrificing preferences. Having said this, as we explore below, it is possible that a significant bloc of shareholders with such preferences may make a manager feel that her reputation will be enhanced more by undertaking the deviation than if there were no such shareholders.

It is worth noting that, ironically, the previous heyday of enthusiasm for managers pursuing these more other regarding interests goes back many decades to a time when the assumption among academic commentators was that shareholders had little or no influence and that managers of large public corporations were largely unconstrained.[[35]](#footnote-35)

1. *The Shareholder Franchise*

Under current corporate governance arrangements, shareholders cannot vote on individual business decisions. They do, however, vote for the directors who, directly or through the executives they appoint, make these individual business decisions. Thus, in principle, if a majority of a corporation’s shareholders prefer some deviation from share value maximization for reasons relating to any of the three categories of preference differences delineated above, the board, either to honor a pledge made to get elected or to enhance its chances of being reelected, might cause the corporation to behave accordingly. How often, though, does this happen under our current formal structure of corporate governance, where the shareholder mandate is largely confined to electing directors, and should that structure be reformed so that it happens more?

*1. The extent to which the franchise leads managers to make non-share-value-maximizing decisions to further market imperfection correcting or distributive (together., “socially oriented”) goals.* In recent years, we have seen investment funds and other institutional investors stressing, with more or less specificity, the need for environmentally and socially conscious corporate behavior, and in parallel we see many corporations pledging themselves to behave in these ways. In the last few years, there have also been a number of examples of a majority of a corporation’s shares being voted, pursuant to the Exchange Act’s Rule 14a-8, in favor of a precatory resolution in effect urging management to direct their corporations to behave in various socially oriented ways.[[36]](#footnote-36)

A few factors, though, make us skeptical that the shareholder franchise has resulted in any major socially-directed deviations from share value maximization. To start, most calls by equity investors, and pledges by corporations, to behave in a socially oriented way have been articulated as enhancing, not deviating from, share value maximization. Typically, the suggestion is that whatever would be lost in short term profits would be more than compensated for by an increase in longer term profits discounted to present value.[[37]](#footnote-37)

Indeed, to our knowledge, there has been no successful proxy fight or other effort to influence the composition of any corporate board based on a promise to implement a change for social ends where the proponents state that share value will likely decrease as a result.[[38]](#footnote-38) The absence of any such efforts at a minimum suggests that the existing incentive structure within which management acts does not include any kind of threat of job loss if they fail to implement socially-oriented policies that an accurate assessment would identify as share value reducing. And it may suggest that there are in fact few if any corporations where the holders of a majority of their shares would favor a socially oriented change in behavior if it were share value diminishing.

It should also be noted that, in some cases at least, the changes favored by those voting for precatory resolutions were not only promoted as share-value-enhancing, they may have been in fact. Although a corporation’s managers have very large information advantages relative to outsiders and have personal interests that, as noted, are often well served by making share-value-maximizing decisions, they may also live in their own bubble that allows them to self-justify continuing to do what has done in the past.[[39]](#footnote-39) A substantial vote in favor of the precatory resolution can be consciousness raising for these managers and puncture that bubble. From a policy point of view, to the extent that such cases exist, they provide an argument on the sides of making shareholder votes on such issuer easier or even making them more binding, but they are not examples of the more challenging issue of what to do in the face of shareholders who, for social or other reasons, prefer corporate behaviors that deviate from share value maximization.

All this said, it is possible that some of the socially-oriented franchise related activity in recent years has been the cause of changes in corporate behavior representing modest deviations from share value maximization. Suppose a significant portion of the corporation’s shareholders favor a resolution calling for a change in corporate behavior. The shareholder proponents of the change argue that the change is consistent with share value maximization, but an honest, serious analysis would suggest that it involves a deviation from that goal. The managers personally value the end sought by these shareholders. The existence of this shareholder backing may make the difference in prompting managers to make the change because, relative to that backing not being there, the managers feel that undertaking the action will do more to enhance their personal reputations. The same dynamic may be at work when directors are reelected after the corporation has pledged to behave in a manner akin to what a precatory resolution calls for. As noted above, the impact on personal reputation is one of the interests that managers can be expected to weigh when making any corporate decision. Although the other elements of our current larger overall system of corporate governance, discussed below, limit the room for such deviations from share value maximization, these limits are not watertight and hence modest such deviations, even persistent ones, can occur.

*2. Why has the franchise not resulted in more socially-oriented deviations from share value maximization?* If we are correct that the franchise has not resulted in anything more than at most quite modest socially-oriented deviations from share value maximization, why is this the case? This question requires an answer because there must be many corporations which engage in one or more share value maximizing behaviors where a majority of its equity investors, if fully informed as to the consequences of the behavior and the costs of avoiding it, would prefer that the corporation stop engaging in that behavior. Most equity investors are full human beings with a variety of values that can be impacted by the behavior of the corporations in which they have equity interests. There are likely many cases where the pro-rata cost to them of bringing the corporation’s behavior in line with their altruistic values is relatively low and is less than the utility gain that they receive from corporation modifying its behavior.[[40]](#footnote-40)

The likely answer to why the shareholder franchise appears to have led to so little in the way of such deviations is that there is no effective transmission belt connecting corporate action to what, if they were fully informed, would be their preferences. To start, even a person whose only investment was a substantial block of shares in a single corporation is often far from fully informed as to what the consequences of any given corporate action will be to others in society or to what it would cost in profits to avoid these consequences. The costs of acquiring and processing such information is one important reason why specific business decisions are delegated to a corporation’s directors and officers in the first place. But the problem goes far beyond this with the majority of shareholders of the typical dispersed ownership publicly traded corporation. A substantial portion of the equity interests in such a firm are held by individuals each of whose interest, whether obtained directly or indirectly through investment in a fund, represents just a tiny fraction of the firm. These individuals typically have equity interests in many other firms as well, in each case representing similarly tiny fractions. The typical such individual, despite possessing a degree of altruism, will just not find it worthwhile to become an informed voter, and to cooperate with others in ways that would permit them to act together on this altruism.[[41]](#footnote-41) If rational apathy applies to informed shareholder voting with respect to issues relating to a corporation’s profitability,[[42]](#footnote-42) it applies in spades to voting with respect to issues involving a corporation’s social impact, which in most cases is not the primary reason that the individual made the equity investment in the first place.[[43]](#footnote-43) Some commentators have suggested that a corporation should regularly poll their shareholders on their views as to how the corporation should behave in various socially relevant ways,[[44]](#footnote-44) but simply setting up this additional channel of communication cannot cure the more fundamental problems with relying on shareholder votes discussed here.

A possible response to this skepticism is that equity investors in such corporations can operationalize their altruistic side through delegation. Such an investor can acquire her interests in corporate equities by investing in a fund that promises it will vote the fund’s shares based on certain socially oriented values. Alternatively, if she holds shares of corporations directly, she can give her proxy to some voting collective of like-valued investors where an informed expert determines how these investors’ shares are voted.

These devices of delegation, even if they solved perfectly the problem of individual investor ignorance, will not, however, likely solve the transmission belt problem. Under current corporate governance arrangements, the key matter subject to a shareholder vote is the choice of directors. Once a year there is the single act of voting yes or no for at most a handful of director candidates. This process is unlikely to result in a choice of directors who will in turn go on to alter a corporation’s behavior that comes anywhere close to reflecting what would be preferred by the beneficial holders of a majority of its shares if each such investor were fully informed as to the negative impacts of the activity and the degrees of deviation from share value maximization needed to achieve different degrees of alleviation. To start, a critical consideration in deciding whether or not to vote for a particular candidate will be the traditional one of whether the candidate would be good at supervising the productive running of the firm, a question unrelated to these social issues. When it comes to social issues, many of a corporation’s activities will result in one or more kinds of harm to at least some members of society. Changes in corporate behavior may be able to alleviate each such kind of harm to one extent or another, with a greater deviation from share value maximization required for a greater amount of alleviation.[[45]](#footnote-45) Each equity investor in the corporation could, if fully informed as to the negative impacts of the activity and the degrees of deviation from share value maximization needed to achieve different degrees of alleviation, have a preference as to how much, if at all, he would want the corporation to deviate. Some investors would want no deviation, others would find the amount of alleviation accomplished by a modest deviation worthwhile but not more, and yet others would find worthwhile a greater deviation, with its greater alleviation.

The problem, though, goes beyond differences among equity investors in whether or not they want the firm to deviate from maximizing share value to further some given end and, for those who do, by how much. For some of the social issues that excite the most passion, there will be investors who will want to deviate to promote a given social end and others will actively oppose this end and want the corporation to deviate from share value maximization in the opposite direction.[[46]](#footnote-46)

Notwithstanding these points, there might be some ends in furtherance of which a deviation from share value maximization up to some certain point would garner the support of the holders of a majority of the equity interests in the firm (i.e., the deviation to the extent approved by the median voter on a share-weighted basis) if they were fully informed as to what the deviation would accomplish and at what cost. But the idea that a fund manager or expert proxyholder could accurately ascertain what the investors they represent would want if the investors themselves had this detailed knowledge is fanciful. The existence of any such majority is likely to get lost in the noise, particularly given the potentially wide range of issues that the fund manager or expert proxyholder would needs to consider and the number of firms she will need to do it for, and the difficulties she will have in ascertaining how much any given deviation by any given firm will further the end in question[[47]](#footnote-47) and how much each delegating equity investor is willing to sacrifice in share value for any furtherance of any particular value. [[48]](#footnote-48)

One might reply that this is exactly what the process of electing public officials looks like. Despite there being problems in the public sphere akin to the private sector ones identified in the preceding few paragraphs, some combination of the media, political parties, advocacy groups, polls, focus groups and lobbyists assure that the preferences of citizen voters across a wide variety of issue do, to some extent, get recognized and acted upon. This, though, requires substantial energy on the part of many people and the expenditure of substantial resources. We do not see the same kind of political infrastructure replicated with each of the country’s few thousand publicly traded dispersed ownership corporations because investors and others who might wish to mobilize them are not prepared to devote the energy and resources necessary to make that happen.

The shortfall does not stop here, however. Suppose that all these problems were overcome so that the persons who are elected a firm’s directors somehow knew every deviation from share value maximization with regard to which there would have been majority support from the equity investors had they been fully informed and promise to use their authority accordingly to authorize. There is still the problem of implementation. The principal agent problem is now more complex than if principal is simply asking for share value maximization. Given the information problems in their not having fully informed preferences in the first place, how are the shareholders to know whether the directors are fulfilling their promises. Moreover, the officers that the directors appoint and supervise will need discretion in carrying out this multiple task mandate involving multiple ends with their own tradeoffs among themselves, but these officials have their own personal interests. Multiple task principal-agent arrangements are inherently complicated.[[49]](#footnote-49) The use of high-powered incentives, such as a compensation scheme tied to indices purporting to measure progress in achieving certain social ends, cannot be more effective than the accuracy of the indices. Perhaps more serious, high-powered incentives will likely distort the results by giving prominence to the end most easily measurable. The use of low powered incentives, such as appeals to the consciences of managers, avoids this problem but, to give them scope to work, requires an incentive structure that permits considerable self-interested behavior on the part of the managers as well. The existence of this conundrum is another reason why use of the franchise has not resulted in anything more than, at most, quite modest socially-oriented deviations from share value maximization.

For all these reasons, with only the rarest exceptions, the only fights that we see over who should be a director are sparked by activist hedge funds and are based on purely economic concerns.[[50]](#footnote-50) The activist claims that a change in behavior is needed to increase share value or to prevent managers from obtaining non-arms-length benefits from the corporation. We do not find activists advocating for deviations from share value maximization in order to correct market imperfections or distributional concerns.

*3. Should the franchise be reformed to allow shareholder votes on specific business decisions?* A possible reform would be to expand the subject matter reach of the corporate franchise to allow shareholders to determine directly a corporation’s business decisions where they impact on some kind of social concern.[[51]](#footnote-51) The argument in favor of this reform might allow potential majorities to emerge and work their will with regard to a specified share value diminishing change in behavior in furtherance of some particular social end. These are the majorities that get drowned out by noise with the shareholder franchise limited to the general election for directors. The analogy in the governmental sphere would be the referendum device in states such as California that gives voters the opportunity to bypass the usual legislative process.

Two important articles by Oliver Hart and Luigi Zingales (“H&Z”) argue in favor of such a reform.[[52]](#footnote-52) Using a simple, elegant model, they argue that there are likely many corporations which engage in one or more behaviors where a majority of its shareholders would prefer that the corporation stop even though the shareholders would lose their pro-rata share of gain that the behavior generates. H&Z suggest that with this reform in place, there would be ways for equity holders in a firm who have a particular social concern to assure that their holdings be voted in an informed way to reflect this concern. To get around the rational apathy problems associated with becoming informed and voting, they suggest solutions involving delegation along the lines of what was discussed above: equity investors can join with other like-valued other investors by investing in a fund whose managers promise to vote in accordance with the group’s values. Alternatively, if the investors hold the shares in the firm directly themselves, they give their proxy to an expert voting service dedicated to the concern. The reform would allow the fund manager or proxy holding expert to vote for a specific corporate action rather than just for directors.

The model that H&Z employ to advocate for broadening the subject matter of the franchise in essence views investors as potential Kaldor-Hicks efficiency police, who aid society in advancing social welfare. These shareholders identify situations where a corporation’s share value maximizing behavior is associated with some market imperfection.[[53]](#footnote-53) In such a situation, a change in corporate behavior, though diminishing share value and thus diminishing each shareholder’s wealth, would leave society’s gainers ahead by more than it would leave its losers behind. H&Z imagine that any given shareholder, X, would vote for the firm to undertake the deviation from share value maximization where the deviation’s cost to her individually is less than the empathetic pleasure that X receives as a result of the *net* gain to rest of the world.

As established more rigorously in the Appendix to this article, we extend the H&Z model to suggest three propositions of interest to our inquiry here:

1. A necessary but not sufficient condition for X to vote in favor is that the deviation would be social welfare improving.
2. All else equal, the smaller X’s equity interest as a proportion of the total value of the company’s equity, the more likely that X will vote in favor of a social welfare improving deviation.

(III) All else equal, the greater the deviation’s social welfare improvement relative to its cost, the more likely that X will vote in favor of a social welfare improving deviation.

In the Appendix, we also provide a stylized example in which we imagine that shareholder X has an equity interest in a public company representing 1/100,000 of its total outstanding stock and that the net social benefit from the elimination of the externality generating behavior that that the deviation from share value maximization would bring is 1.2 times the cost to the company and hence to its shareholders.[[54]](#footnote-54) In that case, despite the cost to her, X would favor the deviation if she the empathetic pleasure she would obtain was anything more than about 1/20,000th the rest of society’s net benefit (the net gain from eliminating the externality minus the cost to all the company’s other shareholders). In other words, if the corporation’s total market capitalization was $1 billion (so that X’s equity interest would be worth $10,000) and society’s net benefit from the deviation is $20 million, she would vote to approve it if the pleasure she received from the rest of society enjoying this net benefit exceeded the pleasure she would enjoy from receiving $1,000.[[55]](#footnote-55)

From a Kaldor-Hicks efficiency perspective, one of the key functions of government is to correct market imperfections through regulation: prohibiting, taxing, or subjecting to liability negative externalities, outlawing anti-competitive practices or requiring marginal cost pricing, and requiring disclosures or imposing quality standards on goods and services. Any imperfection that continues to exist represents a regulatory failure on the part of government. H&Z’s proposed subject-broadening reform to the shareholder franchise would arguably help alleviate this failure by allowing private shareholders to step into the breach.[[56]](#footnote-56)

The key point, as illustrated by the stylized example described above and worked out in the Appendix, is that if she only has a small portion of the corporation’s shares, she is empathetically weighing the total society-wide excess of gains and losses if the corporation deviates, against her own small fraction of the total losses. So, even if she is only a little bit empathic, she will often want to vote yes.

H&Z are in essence proposing to establish a corporation-by-corporation set of mini-political systems to fill in for the government’s shortfalls in regulating market imperfections.[[57]](#footnote-57) At an abstract level, this seems like a reform that would move the world in a desirable direction, at least to anyone who values Kaldor-Hicks efficiency. Unlike in the H&Z model, however, the typical shareholder, as we have already discussed, does not start out being informed concerning what externalities are being generated by each corporation in which she has equity interests, what it would cost to correct them, and what would be gained. The relevant policy question is: would a real world implementation of a subject-broadening shareholder franchise result in social gains exceeding any resulting costs.

The costs of this broadened shareholder mandate would include the costs of implementation such as the mechanics of voting and, importantly, the costs associated with having shareholders acquire and process the information necessary to use the vote meaningfully and with mobilizing their votes,[[58]](#footnote-58) and the diversion of political energy and resources from the public political sphere that such firm by firm efforts would imply, all topics we have already begun to address in the discussion above concerning using director elections as a vehicle to promote eternality-reducing deviations from share value maximization. This interaction between, and comparison of, efforts to control corporate behavior through governmental action and efforts to do so through the proposed H&Z reform is a matter deserving of deeper study, something we would like to pursue in further work. At this point, all we can say is that the diversion of political energy and resources would appear to us to be a serious problem.

The costs of the proposed H&Z reform would also include error costs where, for example, the share-value-maximizing behavior from which a majority vote to deviate is not in fact associated with any market imperfection (the vote having been prompted, perhaps, by a party who is in fact only interested in changing the corporation’s behavior for private gain but who falsely claims the existence of a market imperfection), or where the share-value-maximizing behavior would have been associated with a market imperfection but the substitute behavior adopted by shareholders involves an over-correction.

Equally important, perhaps, as discussed further below, for the subject-matter-broadened franchise to be effective in changing corporate behavior, there will need to be some softening of the other elements of our current system of corporate governance. These other elements all shape the management’s incentive structure in ways that encourage share-value-maximizing behavior. Unless there is such a softening, corporate managers, who will be tasked with implementing the change in policy, will be motived to frustrate it. Yet a softening of these elements will most likely result in managers running the company in a more self-serving fashion. The social welfare losses arising from the company being run in a way that serves management’s private interests at the cost of shareholders may overwhelm the social welfare gains from the market imperfection corrections that a broadened franchise might yield.[[59]](#footnote-59)

The new attention on harnessing corporate effort to solve social ends appears to be prompted by a general sense that the governmental political system is not doing its job. Reforming corporate governance is viewed as the next best, and more attainable, alternative. Things may not be as simple as it might first appear, however. As discussed in the conclusion to this paper, making this next best alternative work will itself require large amounts of political activity, energy that perhaps is better directed at fixing the first best system.[[60]](#footnote-60)

*4. Deviations from share value maximization to further redistributional ends.* The H&Z model is strictly about correcting market imperfections, not about distribution. In their model, if the corporation changes behavior, the voting shareholder gets equal pleasure in proportion to the gains of every gainer, whether the gainer is rich or poor, and similarly experiences equal sadness in proportion to the losses of every loser. Social concern-based shareholder efforts to change corporate behavior, however, often reflect at least in part distributive concerns. For example, climate-change inducing-carbon emissions will likely negatively impact the poor around the world more than the rich. Similarly, calls for a corporation to embrace diversity in hiring and promotion may at least in part reflect the proponent’s desire for the corporation to use its resources to correct for the injustices suffered by various marginalized groups due to a long history of discrimination that has infringed on their income earning potential. Such distributive concerns could just as easily prompt use of a subject-broadened franchise as could market imperfection concerns.

To the extent that such distributive concerns would motivate use of the subject-broadened franchise reform, one can again view it as making up for some kind of governmental failure. As with corporate action to correct for a market imperfection, only a small portion of the cost of corporate behavior that achieves some kind of redistributive end will be borne by each ordinary shareholder. Still, she bears considerably more cost than she would as a taxpayer if the redistribution was done by the government directly or if the government compensated the corporation for the cost of deviating from share value maximization to advance some redistributive end, because then the cost would be spread across the whole tax base. Also, spreading it across the nation’s whole tax base rather than across just across the corporation’s shareholders will transfer wealth from rich to poor more systematically, because while shareholders are on average richer than the average citizen, a substantial portion of all stock is held directly or indirectly by people of relatively modest means.[[61]](#footnote-61) Still, if one approves of whatever redistribution does occur from the corporate action, one would view adoption of the subject-broadened franchise and its use for distributive concerns as moving the world in the right direction, even if it is an imperfect substitute for government action.

One possibility is that distributive and market-imperfection-correcting based uses of a subject-broadened franchise would complement each other. In essence, the distributive concern motivates shareholders to vote to have the corporation deviate from share value maximization in a way that at the same time corrects for a market imperfection. Without this distributive concern, the proponents would not have acted and the inefficiency would have remained.

Another possibility, however, is that distributive-concern-based use of the subject-broadened franchise, rather than increasing efficiency, might in fact decrease it. If one puts any value on efficiency and a given distribution-driven use of the subject-broadened franchise decreases it, that efficiency decrease is by definition unfortunate. At a minimum its use raises the question of the tradeoff involved: whether the gains to the poorer members of society are worth the costs to others.

But there is more to the discussion than this. The distributive-concern-based use of a subject-broadened franchise that leads to an efficiency-diminishing change in a corporation’s behavior raises a tricky “public-private divide” issue. The question in essence is whether the holders of a majority of a corporation’s shares should be able to force the minority to give up share value in order to improve the wealth position of some third party? While every individual in entitled to his or her own view of what is a just distribution of wealth, we tend to think of conscious decisions to mandate the taking wealth from one person and giving it to another as something that should be decided within the constitutionally structured public sphere.

Saying this does not conclusively show that distribution-oriented shareholder mandated deviations from share value maximization are inappropriate or that the fact that a subject-broadened franchise can be used in this fashion necessarily means it would be a bad reform. After all, when it comes to legal reforms aimed at increasing efficiency, most persons would approve of at least in some of them even though the private behavior that they prompt will result in losers as well as winners. The difference, though, is that if the overall legal regime regulating the wide range of human activities tends to promote efficiency, it will likely leave everyone better off than if it does not, even though any individual efficiency enhancing measure has losers as well as winners. That, by definition, is not true of an efficiency-diminishing redistribution and so use of the broadened franchise for redistribution would raise more complicated issues than its use for market imperfection corrections.

Efficiency-diminishing or distribution-oriented deviations from share value maximization initiated by shareholder majorities are subject to one more telling criticism that is related to this public/private divide issue. There is an alternative way that shareholders who have redistributive concerns can move wealth in the direction they want without the corporation deviating from share value maximization. The distribution-oriented shareholders, in an act of charity, can then send the persons who would be the beneficiaries of the redistributive deviation an amount equal to their pro-rata share of what they would have given up had the corporation engaged in the deviation plus their pro-rata share of the extra wealth created by the corporation because it did not deviate. Whether or not this alternative would transfer as much wealth to the beneficiaries as if the corporation had engaged in the deviation depends on the facts of the particular case. Even if it does not transfer as much, though, this alternative has the virtue that the majority does not force the minority to contribute to a cause that the majority felt worthwhile and the minority did not.[[62]](#footnote-62)

*5. Differences among shareholders in the direct effects of a corporation’s actions.* For the large, dispersed ownership corporation, there can also be differences among its shareholders in how they wish it to behave due to some being, or owning stock in, suppliers or customers of the corporation. These differences would generally be of second order importance, however. As such, they are extremely unlikely to influence who is elected a director and what policies the directors pursue. Nor, if the franchise were reformed to allow votes on specific business issues, would any majorities likely form around providing non-share-value-maximizing pricing for particular kinds of transactions with the issuer.

One exception to this second order observation is where a corporation’s workers own a significant portion of its shares through, for example, an employee share ownership program of a pension scheme. This resembles a situation where a corporation has two classes of residual claimants each of which has control rights. As Henry Hansmann has observed, such arrangements have very high governance costs and tend not to endure for long, with one of the two classes retaining the residual claims and control rights (usually, but not always, the capital suppliers) and the other having just a contractual relationship with the corporation.[[63]](#footnote-63) A possible solution is to make the corporation a worker’s cooperative where capital is provided entirely through debt, and workers, who would not be the sole residual claimants, have sole control rights. Another solution would be to sanitize the workers’ shares of the right to vote, meaning that they would need to rely on the self interest of the other shareholders to act in ways that would maximize the value of the workers’ shares.

The ownership by investment funds operated by the large management companies (Blackrock, Vanguard, State Street) of shares of all the competing firms in an oligopolistic industry, such as the airlines, is another exception to the second order observation, one we have considered in an earlier article. [[64]](#footnote-64) In contrast to the alarm sounded by some commentators,[[65]](#footnote-65) we concluded that at least at current ownership levels, the interests of the non-common owners in the companies adopting share-value-maximizing output levels will prevail over those of the common owners.

What, though, about a deviation from share value maximization that may benefit some shareholders of a corporation and not others in terms of their tax status? Rather than a head on confrontation, the problem is usually resolved through the “clientele effect,” whereby shareholders sort themselves out without suffering a loss in value through one of the two groups purchasing shares in a corporation that better caters to their tax needs. As for differences among shareholders with regard to risk preferences or time horizon over which they seek to realize their gains, modern finance theory suggests that the problem is largely solved through transactions in a liquid, efficient secondary trading market.[[66]](#footnote-66)

1. *The Other Features of the Corporate Governance Framework*

In addition to the franchise, the other elements of the prevailing corporate governance managerial incentive structure includes both sticks and carrots. The sticks of a threat of a hostile takeover, an activist hedge fund campaign, a price-depressing sale of shares, and a suit against directors or officers for breach of fiduciary duties. The carrots are the managers’ compensation packages and their own shareholdings in the firm.

As has been explored extensively over the last few decades in the literature concerning the agency costs of management, all these sticks and carrots in general push managers in the direction of maximizing share value. Each of these elements is considered below under the assumption that a meaningful subset of the firm’s shareholders wish the corporation to deviate from share value maximization in furtherance of some aim related to any the three ways in which investor preferences could disagree delineated in Part I: concern about market imperfections, concern about wealth redistribution, and the effects of the corporation’s behavior on the shareholders themselves in ways beyond the receipt of dividends and capital gains. The overall conclusion is that for publicly traded, dispersed ownership corporations, the force of each these elements pushing managers in the direction of share value maximization does not appear significantly lessened by the existence of the subset of shareholders seeking a deviation. And certainly none of these elements appears to be a vehicle by which shareholders seeking such a deviation could affirmatively incentivize managers to accommodate their desires.

*1. The hostile tender offer.* A hostile tender offer occurs when a bidder seeks to purchase a sufficient number of shares from the target’s shareholders such that the bidder can, against the will of the incumbent target managers, replace them through an eventual acquisition. The corporate governance literature generally argues that the threat of a hostile tender offer disciplines firm managers from deviating too far from share value maximization because they do not want to lose their jobs.[[67]](#footnote-67) The idea is that where a firm’s managers fail to maximize share value, a hostile bidder can offer to purchase the firm’s shares from current shareholders at a price reflecting a premium, but one that is less than the value of the shares if it were run in a share value maximizing fashion. Upon gaining control of the target firm and replacing its managers, the acquiror will cause the new management to maximize the firm’s share value, thereby yielding a gain.

The fear of such a hostile tender offer will tend to deter a firm’s managers from deviating from share value maximization in furtherance of some other aim even if a meaningful subset of the firm’s shareholders were prefer that it do so. And if the managers of a firm nevertheless engaged in such a deviation, they would risk being replaced by an acquirer who would eliminate the deviation. As long as a majority of shareholders are willing to sell at a premium, the power of this stick to incentivize managers to maximize share value would not be weakened by the shareholders who prefer its managers behave otherwise.[[68]](#footnote-68) Certainly, no wealth-maximizing bidder would rationally mount a tender offer for the purpose of eventually causing the acquired firm to adhere to the preferences of the firm’s shareholders who want a deviation from share value maximization, and we have seen no counter examples. Such an offer would result in a loss vis-à-vis the purchase price, not a gain.

*2. The activist hedge fund.* The activist hedge fund’s standard business model involves four steps: (i) identify a firm where a change in the way it is run would increase its share price, (ii) acquire a foothold stake in the target firm of perhaps 5-7% of its outstanding shares, (iii) persuade enough other of the target’s shareholders of the desirability of the change to constitute a majority vote to oust the incumbent managers if they do not adopt the change, and (iv) sell the shares at a profit after the change is adopted and the share price increases to reflect the improvement. As with the hostile tender offer, no wealth-maximizing activist would rationally mount a campaign for the purpose of causing a firm to adhere to the preferences of the firm’s shareholders who want a deviation from share value maximization, and again we have seen no counterexamples. The difference from a hostile tender offer, however, is the central role of shareholder voting. Thus, if there were a situation where a firm’s managers have already implemented a deviation from share value maximization preferred by a meaningful number of shareholders, particularly by large investment funds, an activist would be much less likely to launch a campaign to reverse the situation because, even though it would raise share price should it succeed, it would have a significantly smaller chance of success in the first place.

*3. Sale of share blocks.* When a large block of shares is sold all at once, this often has a negative influence on price. The corporate governance literature suggests that where the holder of a large block wishes management to change course, the threat of sale can sometimes persuade managers, who fear such a price drop, to do what the block holder wishes. [[69]](#footnote-69) This is very unlikely to work however, where the block shareholder wishes managers to change corporate behavior in some way that would deviate from share value maximization. To start, the managers would be just as afraid of the price drop that the change in behavior would cause as they would from of any drop in price from the sale. Also, microstructure economics teaches us that the reason that a share sale can depress price is because the market infers from the seller’s order the possibility that the seller has negative nonpublic information not reflected in the price prior to the sale, an inference that would not be correct here.[[70]](#footnote-70) Even if the price does drop initially in response to the sale, when nothing comes out subsequently to suggest the existence of any negative news, the price will quickly regain what it lost.[[71]](#footnote-71) A short-lived price dip is unlikely to significantly hurt managers and is thus not a credible threat.

*4. Fiduciary duties.*  The duty of care requires a corporation’s directors and officers to exercise reasonable care that the actions they take are in the best interests of the corporation. The duty of loyalty requires a director or officer who has an interest in a proposed corporate action to behave fairly toward the corporation, in essence prohibiting her participation in any decision unless she can affirmatively show that the action is in the best interests of the corporation. Breach of either of these duties can subject the director or officer to suits seeking injunctive relief or monetary damages.

Understanding each of these duties depends on the concept of the “best interests of the corporation.” A corporation is an artificial legal person. What its best interests are thus must be a legal construct as well, created in some fashion out of a selection of the interests of several types of actual individuals that have a stake in the decisions that the corporation makes. The ALI Corporate Governance Principles, for example, provides in part: “[A] corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain.”

To the extent that the concept of the best interests of the corporation relates to the interests of individual shareholders rather than simply what generates the most net cash flow for the corporation over time discounted to present value, an argument could be made that the best interests of the corporation is the decision that maximizes the interests of the average shareholder. Suppose, for example, that there is evidence that for social reasons a majority of shareholders preferred some deviation from share value maximization (say the successful passage of a precatory resolution, a resolution adopted pursuant to a subject-broadened franchise, or directors elected on the pledge they would undertake the deviation) but the officers and directors are ignoring this majority preference. Although we have not found any examples to date, these circumstances could conceivably be the basis of a derivative suit under the theory that the best interests of the average shareholder would be better served if the corporation undertook the deviation. If in this instance management’s behavior is potentially the violation of any duty, however, it is likely the duty of care. This is because the behavior involved a failure to advance the purposes of the corporation,[[72]](#footnote-72) rather than a conflict of interest on the part of managers, as would be required for a breach of the duty of loyalty. Because of the business judgment rule, successful duty of care cases are rare even when the claim is that the managers were failing to pursuing profits. This is because judges do not view themselves as business experts, and so they are reluctant to second guess management as to what decisions best further the purposes of the corporation.[[73]](#footnote-73) This rationale would presumably extend non-share-value-maximization aims as well.

*5. Executive compensation.* Executive pay packages have traditionally involved some mix of fixed salary with a share-price-based component as well. The share-price-based portion obviously incentivizes managers to maximize share value and that incentive is not weakened solely because some meaningful percentage of shareholders prefer for social reasons that the corporation do otherwise.[[74]](#footnote-74)

Corporations now also routinely tether executive compensation to environmental, social, and governance (ESG) metrics.[[75]](#footnote-75) This aspect of executive compensation does not provide any real incentives for firm managers to undertake the ESG activities targeted by the included metrics where the activities would be antithetical to share value maximization, however. As has been documented elsewhere, ESG-based compensation is a very small component of managers’ overall compensation, and recent studies show that ESG-based compensation accounts for just a couple of percentage points of total executive yearly pay.[[76]](#footnote-76) More relevant to our analysis, executives’ ESG-based compensation is negligible in relation to executives’ stock-based compensation.[[77]](#footnote-77) So, regardless of the effect of current ESG metrics on ESG activity generally, it seems highly implausible that those metrics work in any way to incentivize firm managers to undertake *share value lessening* ESG activity, especially given that the accompanying drop in share value would reduce the much larger portion of the manager’s compensation that is set by the company’s share price.[[78]](#footnote-78)

**III. Factors Affecting the Shareholder Makeup of Firms and Their Implications for Firm Behavior**

In Part II of this article, we conducted the first stage of our inquiry into whether the existence of equity investors with profit-sacrificing preferences can influence corporate behavior. In that first stage, we took the initial existing shareholder makeup of each of the economy’s public firms as fixed and resembling, on average, the composition of the economy’s equity investors generally. Any difference in the composition by preference of a firm’s shareholder body (i.e., any difference in the profile of differing preferences) from the composition by preference of equity investors in general was assumed to be due to chance. This would be the result where, although the economy’s equity investors as a group might differ among themselves in terms of their preferences concerning how they wish various corporations to behave with respect to any possible deviations from share value maximization, but when each investor decided what issuers’ shares to include in her portfolio, these preferences played no role. Under this assumption, we addressed in Part II, for each of our three categories of shareholder preferences, how differences among shareholders in the way that they want the firm to behave would affect, if at all, the firm’s behavior.

As discussed there, it is perfectly easy to imagine a public corporation where the holders of a majority of its equity interests would, if they were fully informed, prefer that it refrain from, or engage in, certain behaviors even though this choice of behaviors is not the one that most enhances the value of the firm’s shares. Our conclusion, however, was that, with current corporate governance arrangements, the existence of such equity holders (whether their preferences are only incipient or are actually activated by knowledge of the relevant facts) is unlikely to prompt a significant change in firm behavior. For one thing, it is unlikely to result in the election of directors who pledge to act on these preferences. And, with possibly small exceptions, it is unlikely to change the structure of incentives in which the managers make their decisions, a conclusion based on a review of all the components of our system of corporate governance that shape this structure of incentives. Firm managers can be expected as a general matter to remain as focused on share value maximization as if, as has been traditionally assumed, shareholders in fact had homogenous preferences in favor of solely pursuing that goal. Current corporate governance arrangements could be changed to allow for a broadening of the shareholder mandate, but the energy and resources necessary to make the parallel set of private political systems work involves its own set of problems that likely either doom the reform from significantly achieving its aims or undermine effective first-best public regulation.

In this Part, we conduct the second stage of our analysis and relax the assumption that each public firm’s shareholder makeup by preference is fixed. This second step is necessary because, contrary to the assumption in Part II, the economy’s equity holders are not locked in to the companies in which they are invested. Some of these equity holders in fact clearly do sort themselves according to their preferences and prefer to be invested in firms that further certain ends, particularly social ones, even though doing so reduces the firms’ cash flows, or at least avoid firms, such those in the oil, gas, and coal industries, whose share-value-maximizing behavior leads to negative externalities that concern them. In recent years, “green” and other socially oriented funds have attracted a meaningful portion of the total market, and it is very possible that this phenomenon will grow in the future.[[79]](#footnote-79) Moreover, many institutional investors such as universities, other endowed nonprofits, and public pension funds have enunciated social criteria that help shape the content of their portfolios.

A firm’s shareholder base is therefore not immutable as stipulated in Part II, but instead will be shaped in part by the firm’s expected behavior and how that behavior aligns with investor preferences. This additional feature of the analysis requires us to examine what consequences, if any, an endogenous shareholder base has on (i) what agenda will get persons elected as the directors of each of the economy’s public firms, and (ii) the prices at which the shares of these corporation’s trade. Changes with regard to either of these factors can affect managerial incentives and in turn managerial decision-making and the behavior of a firm. This examination involves both the positive exercise of considering the consequences of these complications under existing corporate governance arrangements and the normative exercise of considering whether proposed changes in such arrangements would alter these consequences and if so whether the reforms would desirable. We conduct that analysis below. For brevity of exposition, we focus on the circumstance in which profit sacrificers’ preferences fall within one of the first two of the three categories of preferences described in Part I and so those investors’ reasons for wanting a deviation from share value maximization is because of some social consequence of firms’ behavior, either because of a market imperfection or a distributional consideration, or both.[[80]](#footnote-80)

*A. Different Types of Investing*

Each corporation has a body of shareholders who have potentially differing preferences concerning the social consequences of its behavior. In Part II, we assumed that any difference in the composition by preference of its shareholder body from the composition by preference of equity investors in general is due to chance. In other words, in Part II, each equity investor or her delegee was assumed to compose her portfolio without regard to the social consequences of the behavior of the corporations chosen.

In this Part III, we add nuance to the analysis and subdivide equity investing into three types: “unconstrained investing,” “identity investing,” and “transformative investing.” We believe these three types span the universe of equity investing in terms of the relationship between the views of an investor concerning the social impact of a corporation’s behavior and the presence or absence this corporation’s shares in her portfolio. The latter two types, it will be seen, allow for the possibility, assumed away in Part II, of sorting among public companies in terms of the preferences of their shareholders with regard to the social consequences of their behavior.

– *Unconstrained investing.* The unconstrained investor conforms to the assumptions of Part II and composes her portfolio without regard to the social consequences of the behavior of the corporations chosen. Such an investor may well have preferences as to how the corporations in which she is invested behave and in certain cases, at least if fully informed, would prefer that they deviate from share value maximization to one extent or another to pursue social ends that concern her. She may reason, however, that the behavior of any corporation in which she is invested would almost certainly be the same if someone else owned those shares instead. Given this, she may conclude that her views as to a corporation’s behavior should not matter as to which corporations’ shares to hold.

– *Identity investing.* Identity equity investors acquire and then continue to hold only the shares in corporations whose behavior they or their delegees approve of from a social point of view. The reason for this approval may simply be that the corporation is in a line of business that permits it to share value maximize without offending this investor’s social concerns. Alternatively, the approved corporation may only be able to meet approval by deviating from share value maximization but is in fact doing so. While unconstrained investors make their equity decisions without regard to the social consequences of the firms in which they invest, identity investors see things differently and affirmatively base their buy and sell decisions on those social consequences. But in contrast to the transformative investors discussed below, identity investors do not take equity positions in companies for the express intention of altering corporate behavior, though they may not necessarily be passive with respect to those companies in which they have invested.

– *Transformational investing.* Transformational investing involves the following scenario. Imagine an equity investor willing to sacrifice a certain amount of wealth in order to achieve some social aim. She or her delegee identifies a corporation that is currently not furthering this aim. She purchases some of its shares with the intention of changing the firm’s behavior in a way that furthers this social aim, aware that for the corporation to do so, it must appreciably deviate from share value maximization. Once the transformational investor takes her equity position, she will rely on the threat or use of the franchise to cause the firm’s managers to alter corporate conduct in some way. Self-evidently, it is unlikely that an investor would be motivated to make a purchase with this plan in mind unless she thought there are a sufficient number of other prospective purchasers with the same plan in mind or of existing shareholders who would prefer the change.

In the remainder of this Part, we start by considering the likely prevalence of each of these three types of investing. We then analyze how introducing identity and transformative investors into the mix alters, if at all, the conclusions of Part II with regard to the low likelihood that U.S. dispersed ownership public corporations will deviate significantly from share value maximization to advance some social end even if a meaningful portion of the economy’s equity investors would prefer that. We look at this question both in terms of how introducing identity and transformative investors affects this likelihood through the operation of the franchise and through its effect on share prices.

*B. The Prevalence of the Different Types of Equity Investors*

Equity investors have traditionally been portrayed in the finance literature as unconstrained investors. They are modeled as simply seeking to construct a portfolio of equities that maximizes their risk-adjusted return without regard to the social impact of the behavior of the issuers that are included. [[81]](#footnote-81) This is true of active investors, who seek to achieve risk-adjusted results in excess of overall market returns by purchasing what they view as underpriced stocks and selling or selling short what they view as overpriced ones. And it is true of passive investors who do not seek to outguess the market and simply try to use diversification to minimize risk relative to expected return.

The discussion below suggests that as of today, the world has not changed so much that this modeling in fact no longer accurately describes most equity investors with regard to most of their portfolio composition decisions. Still, identity investing appears to be playing a meaningful role and one that may grow. Transformative investing is a conceptually possible third route, but our research does not reveal any meaningful amount of it going on and there are good theoretical reasons for thinking its future development would face tough odds.

*1. Identity investing.* Identity investing comes in two flavors: negative and positive. Although each approach divides the universe of issuers into two categories, those whose shares can be included in the investor’s portfolio and those that cannot, the way each flavorgoes about making the division differs.

*a. Negative identity investing.* Negative identity investing involves identifying issuers whose social impact is sufficiently disapproved of that the investor does not wish to hold their shares. This might start by a review of the issuers currently in a portfolio and the sale of ones whose social impact is found to be sufficiently offensive. To be consistent, it would also involve establishing a screen which would bar the future acquisition of issuers that behave in the same disapproved ways. Outside of avoiding issuers that meet the disapproval criteria, however, the investor engages in unconstrained investing.

The easiest places to spot instances of negative identity investing are university and other nonprofit endowments and public worker pension funds. Whether on their own accord or subject to the pressure of various stakeholders, the trustees of many of these entities have divested their portfolios of the shares of corporations that are viewed as acting in socially undesirable ways. This has been largely confined, however, to shares in all firms in a select group of industries such as oil, gas, coal, tobacco and domestic firearms.

It is difficult to measure exactly how the portfolios of the entities that engaged in such divestment are different than if they had remained pure unconstrained investors. It is reasonable to assume, though, that if the entity had remained a purely unconstrained investor across the board, its holdings in each divested industry as percentage of its public corporation portfolio would over time have approximately averaged the ratio of the capitalization of that industry to the capitalization of the market as a whole.[[82]](#footnote-82) Whatever it would have invested in in the shares of these disfavored industries, it would need to invest elsewhere, presumably in other public equities that are not disapproved of,[[83]](#footnote-83) and will do so in the fashion of an unconstrained investor.

Many retail investors making their own portfolio choices may engage in a similar kind of negative identity investing. It seems likely that most such retail investors do not consider the behavior of most corporations when they are composing their portfolios. But many of them might, however, refuse to include, for example, any tobacco stocks, because the social consequences of a tobacco company’s behavior are highly salient and offend them greatly. The extent of such retail investor negative identity investing, however, is hard to ascertain.

*b. Positive identity investing.* Positive identity investing involves only holding shares in issuers whose behavior is affirmatively approved of. What is approvable depends on the investor. The net could be as wide as including any corporation that does not affirmatively offend certain social values held by the investor. In other words, it would include any firm in a line of business that permits it to share-value-maximize without offending any of these social concerns plus any firm that is only able to avoid offending these concerns by deviating from share value maximization and but in fact is doing so.[[84]](#footnote-84) Alternatively, the net might be narrower with the only approved firms being ones whose behavior affirmatively furthers a certain social value held by the investor, again whether the firm can behave this way while maximizing share value or, to do so, it needs to deviate from that but does.

The key distinction between negative and positive identity investing is how the screening is articulated. With the negative version, the language will be what negatives to avoid and the investor can invest in anything that the standards do not prohibit. With positive version, the language will be what positives to look for and the investor can only invest in things that the standards affirmatively permit. By the nature of things, though, positive identity investing is likely to result in a much more restricted list of issuers in which the investor can invest.

The most obvious positive identity investors are the green and ESG investment funds. A review of their prospectuses suggest that they confine themselves to investing in certain specified industries or in firms meeting certain positive criteria measured by some kind of indices.

*2. Transformational investing.* The pure transformational investment route, while conceptually possible, seems unlikely to occur in reality to any significant extent. The first thing to note is that it is very unlikely to be practiced by ordinary retail investors buying shares on their own. This is because, to be effective, there would need to be enough shareholders, each acting on her own, to do the same thing at about the same time such that they end up constituting a majority of a firm’s shareholders. Then these investors would need to be willing to actively involve themselves in the firm’s governance. The coordination problems for all this are just too great. For any given potential individual considering investing for transformational reasons, unless she has a reasonable expectation that she will be joined by enough others to reach a majority, the purchase would just leave her as an isolated owner of shares in a company whose behavior she does not even like. While it certainly might be the case that some investors who would wish to be transformational inherently value the act of trying to affect corporate change, whether or not successful, we expect most of these individuals to channel their reform efforts to other arenas that may better offer the potential for change.

What about some green or other socially oriented investment funds banding together, perhaps with the help of university and other nonprofit endowments and public pension funds, to accomplish what individual shareholders almost certainly could not? For such an investment fund, the problem is that as it currently markets itself, it suggests to prospective investors that their expected risk-adjusted rate of return, after accounting for fees, will approximate what can be expected from an investment in a market-based index fund.[[85]](#footnote-85) However optimistic is the public rhetoric concerning the impact on returns of a proposed socially-oriented change in corporate behavior, the fund managers will need to make a realistic assessment of its impact on share value. If a share value maximizing corporation changes its behavior in a way that significantly deviates from share value maximization, its price will fall commensurately. Purchasing the shares of such a corporation and then inducing to make this change in behavior can be expected to lead to a capital loss. A fund that markets itself as providing something approximating the returns available from a market-based index fund will not last very long if it makes such purchases.[[86]](#footnote-86)

The trustees of a university, endowed nonprofit, or public pension fund will not be under the same market pressures, but they will still be aware that the capital loss expected to follow such an acquisition will come at the expense of the entity’s primary mission. Also, at least to date, the stakeholder and political pressures on them with regard to socially responsible investing have been to divest as a negative identity investor, not acquire as a transformational acquirer.

In essence, such a “green activist” effort would be like a traditional proxy fight,[[87]](#footnote-87) except that the participants, rather than seeking a change in management that they expect will increase share value, will be seeking a change in management (or its policies) that they expect will serve some social aim while in fact decreasing share value. Traditional proxy fights today are very rare, having been replaced by the hostile takeover and the activist hedge fund campaign. This is primarily because costs of running the fight on the insurgent side is too great relative to the potential gain in the value of the instigator’s initial holdings unless they are substantial portion of the total.

Here the situation is even more forbidding. Who would be the instigator willing to bear these costs when the result will be a financial loss, not a gain? And even if there were such an instigator, at the moment, it is not clear that there are institutional investors – green or ESG investment funds, university and non-profit endowments and public pension funds – that are willing to trade off return for furthering some social end and that together possess a sufficiently large portion of most corporations’ share electorates to combine with the instigator to form a majority in favor of the change. Also, certain provisions of the Exchange Act constraining and imposing obligations on “control groups” would discourage such activity. In any event, we are not aware of any such efforts to date. As for the alternatives, we have already discussed how unlikely is a hostile tender offer or activist campaign aimed at causing a share value maximizing corporation to change its behavior to deviate in furtherance of some other end.[[88]](#footnote-88)

*C. The Impact of Investor Sorting on the Use of the Franchise to Affect Corporate Behavior*

In Part II, we concluded that it was unlikely under current governance arrangements that the corporate franchise will lead most U.S. dispersed ownership public corporations to deviate significantly from share value maximization in order to further some social end. The analysis there, however, assumed that there was no sorting among public companies in terms of the preferences of their shareholders with regard to the social consequences of the firms’ behaviors. All investors were either profit maximizers or unconstrained investors. How does the discussion here concerning the routes by which sorting might occur – identity investing and transformative investing – change that conclusion? We think surprisingly little.

Holding fixed any price effects caused by investor sorting for the moment, consider first negative identity investing. Self-evidently, if social considerations lead an investor not to invest in a given corporation, this investor’s preferences are not going to lead to any votes being cast in favor of the corporation changing its behavior in the direction of the shareholder’s preferences. Indeed, although we are skeptical it would matter, her negative identity investing could work in the opposite direction: she otherwise might have been a shareholder in the corporation and voted in a way that changed its behavior in the direction of her preferences.[[89]](#footnote-89)

Positive identity investing is also unlikely to change the conclusion in Part II. If the shareholder purchases or continues to hold the shares of a corporation whose behavior she approves of, it is already acting in accordance with her preferences and so her vote is not needed. The only time it might matter is if the approved behavior requires a deviation from share value maximization and its continuation becomes under threat, whether by management, an activist hedge fund campaign, or a hostile takeover attempt. If, because of positive identification investing sorting, enough of its shareholders prefer the continuation of the deviation, their votes could be sufficient to thwart management’s plan to change or the hedge fund’s campaign, and a refusal to sell could thwart any hostile takeover attempt. Research does not reveal that this has ever happened to date, however.

In theory, sorting due to transformative investing will, if it succeeds, by definition alter the conclusions of Part II. The whole point of the strategy is to permit either the threat or actual use of the franchise to change corporate behavior. In reality, however, as we explored above, we see no examples of it and think it is unlikely to occur to any significant extent in the future.

*D. The Price Effect of Investor Sorting*

In addition to any effects that operate through the franchise, investor sorting also might influence corporate behavior by modifying share prices. If some investors base their equity positions on considerations beyond share value maximization, then the accompanying preference-based buying and selling decisions of those investors, relative to a world in which there was no investor sorting, could affect the demand of the subject equities and therefore their prices. Because, as we have seen in Part II, share prices are integral to the workings of managerial incentive structures,[[90]](#footnote-90) a linkage between a firm’s share price and the extent to which it adheres to the preferences of the profit sacrificers among the economy’s equity investors could incentivize the firm’s managers to adjust the firm’s behavior to be more in line with those preferences. Also, a firm’s cost of capital is determined in part by its share price, with an inverse relationship between the two, so investor sorting that causes the share prices of some firms to fall would cause those firms to have a higher cost of capital, relative to other firms. Firms with higher costs of capital on average will implement fewer new or replacement real investment projects and grow slower relative to firms with lower costs of capital, all else equal, or actually shrink.

In this section, we analyze this is potential route by which the non-share value maximizing preferences of some of the economy’s equity investors could alter corporate behavior. Our focus will be on the particular circumstance in which the profit sacrificers are identity investors concerned with mitigating negative externalities, such as their climate-warming CO2 omissions, but the analysis could carry over to the presence among the economy’s equity investors of any end involving the sacrifice of firm profits.[[91]](#footnote-91) To make things concrete, suppose that a set of firms each generate an externality in the form of pollution, while all other firms do not pollute. A subset of the economy’s equity investors prefer that the polluting firms reduce their externalities by undertaking some change that would come at the expense of firm profits. Further suppose that these profit sacrificers are identity investors, who refuse to include within their portfolios the shares of the polluting firms and thus steer all their equity investing dollars toward holding the shares of the rest of the firms in the economy, an investment approach that we will label a “divestiture.” The remainder of the economy’s equity investors are profit maximizers.[[92]](#footnote-92)

At first blush, at least, it is plausible to think that divestiture by the profit sacrificers would reduce demand for the shares of the polluting firms, which, relative to the rest of the firms, would lower the polluting firms’ share prices and raise their respective costs of capital. The desire to get off or stay off the divestiture lists of such investors, so as to avoid this price effect, might incentivize the managers of firms that are polluting to change their operations. Thus, the managers of any given corporation, in deciding how to use its existing capacity, will be discouraged from starting or continuing uses that pollute. And the potential effects of polluting on the firm’s cost of capital might deter the managers from implementing new real investment projects that pollute.

Economic theory is not clear, however, whether, in equilibrium, there would in fact be a price effect, at least a meaningful one. One approach to the question, based on arbitrage, suggests there would be no such effect.[[93]](#footnote-93) Return to the example above, but take as a starting point that the economy’s equity investors either include no profit sacrificers or, as in Part II, if there are profit sacrificers among them, the profit sacrificers are all unconstrained investors. Under modern portfolio theory, all shareholders will hold fully diversified portfolios comprised of shares in both the polluting firms and the non-polluting firms. In this situation, according to CAPM and the standard model of share pricing, each company’s share price would equal the future cash flow expected to be received by the holder of that share discounted to present value at a rate reflecting its systematic riskiness.

Now, introduce sorting. In other words, suppose that the economy’s equity investors do include profit sacrificers and some of them start following the identity approach to investing and refuse to continue to include in their portfolios the shares of firms engaging in pollution. The share prices of polluting firms might initially fall.[[94]](#footnote-94) This, however, would create a situation where a dollar of expected future cash flow is available in the market for less by acquiring shares in the polluting firms than by acquiring shares in the non-polluting firms. In other words, any investor can get the same expected future dollar for less by purchasing shares in a polluting firm.[[95]](#footnote-95) If she held shares in the non-polluting firm, she could sell those and buy shares of the polluting firm representing the same number of future expected dollars. This would provide her with the same future cash flow while pocketing the difference in price between the two.[[96]](#footnote-96)

Consider the market dynamics of this situation. Many attentive investors, whether they are investors who prefer that all firms maximize share value, or ones who do not but are unconstrained in composing their portfolios, would sell shares of non-polluting firms and buy shares of polluting firms, resulting in a narrowing of the difference in share prices of the two firm types. Further, professional arbitrageurs would sell short the shares of the non-polluting firm and buying long ones of the polluting firm. By doing so, they would be hedged in terms of future cash flow while again being able to pocket the difference in price between the two companies’ shares. The resulting narrowing of the gap in the firms’ share prices caused by these activities would be expected to continue until an equilibrium is reached whereby the price of an expected future dollar is the same for both kinds of firms.[[97]](#footnote-97) In essence, the wedge between the polluting firms’ equity prices and the firms’ fundamental value that developed when the boycott first occurred would incentivize the purchase of shares of the polluting firms, which would cause those firms’ share prices to rise and, eventually, revert in equilibrium to their original levels.[[98]](#footnote-98)

More nuanced financial models, however, do predict that sorting arising from an anti-pollution divestiture might in fact have some kind of enduring price impact, with the open questions being rather what is the size of that impact and how a price impact of any given size might affect firm behavior. Consider, for instance, the model developed by Berk and Binsbergen.[[99]](#footnote-99) As in our example here, their model postulates two types of firms—clean firms and dirty firms—and two types of investors—so-called “ESG investors,” whose preferences are such that they only hold shares of clean firms, and other investors, who hold shares in all firms, both clean and dirty. [[100]](#footnote-100)

Berk and Binsbergen’s model is based on the sensible notion that for an ESG investor to successfully divest, other investors must be willing to absorb the divested shares instead. Holding these divested shares causes the absorbing investors to become less effectively diversified, in that their portfolios will be over-weighted in shares of polluting firms relative to the ratio of the polluting firms’ aggregate capitalization to that of the market as a whole.[[101]](#footnote-101) This needed loss of diversification creates the linkage between the divestiture and the discount rate for the dirty firm’s future cash flows. In essence, because the non-ESG investors, to absorb the divested shares, will become less effectively diversified, those shares must be priced lower relative to their expected future cash flows in order to induce the non-ESG investors to hold them.

Berk and Binsbergen’s model predicts that the boycott it models generates some effect on the dirty firms’ stock price and cost of capital, but there remains the empirical question of whether the effect is meaningful. They go on to parameterize their model with current observables and conclude that the effect of a boycott on the price of the dirty firm’s stock price is too low to be of significance in influencing the dirty firms’ managers. A primary reason is that the prices of the stocks in the real world of firms that they label as dirty and those of the ones that they label as clean are, when each is bundled together, highly correlated. Thus, when the non-ESG investors purchase the boycotted stock from the ESG investors, they do not lose much of the benefits of diversification and, for this reason, are willing to hold at a very minor discount the dirty stock that the ESG investors are unwilling to hold.[[102]](#footnote-102)

When Berk and Binsbergen parameterize the model’s variables including the degree of risk substitutability between the shares of dirty firms and the shares of clean firms as measured by the correlation between the returns of dirty and clean firms, they find that the ESG investors’ divestiture of dirty firms only raises the cost of capital and discount rate of those firms by 0.44 basis points (less than one half of one hundredth of one percent).[[103]](#footnote-103) They take this effect to be trivial and it would be hard to argue otherwise.[[104]](#footnote-104) So the ultimate takeaway from their work is that their model shows it is theoretically possible that divestiture of the sort hypothesized in the example here could result in a meaningful price effect, but that their attempt at measuring this empirically does not provide support for the idea that identity investors are currently having a meaningful price impact.

It is possible, however, to argue with how Berk and Binsbergen parametrized their model: they had to make number of choices and sharp categorizations and assumptions.[[105]](#footnote-105) Indeed, other researchers have developed and estimated asset pricing models that show a much more pronounced price effect caused by investor sorting, at least in certain time periods. Consider the work by Oliver Zerbib, who develops and estimates an asset pricing model that, like Berk and Binsbergen’s model, theoretically predicts a potential price effect from sorting.[[106]](#footnote-106) When estimating the model over the same time period considered by Berk and Binsbergen, Zerbib finds, also like Berk and Binsbergen, that divestiture has had a negligible effect on divested firms’ returns.[[107]](#footnote-107) Zerbib, however, does find a meaningful price effect in other time periods, including a longer time period encompassing the one considered by Berk and Binsbergen, thereby concluding that “the effect of exclusionary screening on the cost of capital is not necessarily negligible.”[[108]](#footnote-108) Other researchers have similarly found a non-trivial price effect caused by divestiture.[[109]](#footnote-109)

In sum, while the asset pricing models developed in the literature show that investor sorting can have a price effect as a matter of theory, attempts to estimate empirically how much vary significantly.

Regardless of what empirical result one adopts, in order to evaluate whether a price effect is economically meaningful, it is important to specify exactly the channels by which a price effect could affect firm behavior. Assume in the discussion that follows, that a divestiture results in some kind of non-negligible price effect. We focus on a firm that is currently engaging in polluting activities which, if the divestiture had not occurred with its price effect, would have been considered unambiguously maximizing its share price. Once the divestiture occurs, the managers become aware of the more favorable rate at which the market will discount the firm’s future cash flow to extent that they are not engaging in polluting activities. Given how the usual suite of corporate governance devices affect managerial incentives, however, the divestment will lead management to change the firm’s behavior only to the extent, if any, that doing so actually enhances the firm’s share price.

Consider first the effect of the divestiture’s price impact on the ways that management utilizes the firm’s existing productive capacity. Management’s focus in making this choice is on its share price. The standard financial economic model of an issuer’s share price is that it reflects the market’s best estimate of the issuer’s expected future dividends and other distributions to shareholders discounted to present value,[[110]](#footnote-110) which in turn depend solely on the firm’s expected net cash flow. Thus, management will redirect the use of this capacity to non-polluting activities only to the extent, if any, that doing so favorably affects the calculation of the operation’s future expected cash flow discounted to present value. This will only be the case if the loss in the amount of expected future cash flow is more than compensated for by the lower rate at which the remaining cash is discounted. In other words, it is not enough that abandoning the activity leads to a market price that implies that each dollar of expected future cash flow is discounted by the market at a lower – i.e., more favorable – rate, what the studies discussed above seek to test. Instead, the increase in the value of each dollar of expected future cash flow resulting from the discount rate improvement needs to be more than enough to compensate for the fact that the change to the non-polluting use of the firm’s productive capacity will reduce the size of this future expected cash flow.[[111]](#footnote-111)

The effect of the divestiture on the discount rate when it comes to new investment – i.e. on the firm’s cost of capital – is more certain, but slower acting. To maximize share value, the managers will want to implement every proposed project that has a positive net present value. Relative to before the divestiture, after it, polluting projects will have a higher discount rate relative to non-polluting ones. This means that it is more likely than before that a polluting project proposal will be found not to have a positive net present value. Still, among the polluting project proposals, the only ones that will not be implemented will be those that will not have a positive net present value using the implied discount rate resulting from the divestiture sorting price but would have had a positive net present value if the sorting had not occurred. In terms of the timing of impact on the level of something like pollution, a redirection of investment of this sort is slow acting and it may take decades for a firm’s productive capacity to be so altered that the redirection shows its full effects.

It is also worth commenting on the empirical studies showing that polluting firms have a lower stock price than clean firms relative to current earnings.[[112]](#footnote-112) These studies, however, do not establish that the polluting firms’ lower stock price is the result of identity investors avoiding their shares and that leading to the polluting firms’ expected future earnings being discounted at a higher rate. Polluting firms on average may have one or more other attributes, unrelated to a sorting-induced higher discount rate, that can lead to having a lower price relative to their current earnings. For example, because of the industries in which polluting firms are concentrated (think “smokestack industries”), their expected future earnings may be lower than those of the non-polluting firms (think of the concentration of “growth stocks” in high tech, low polluting industries). It is also possible that the industries in which polluting firms are concentrated have associated with them higher discount rates for reasons relating to the inherent riskiness of their future cash flows rather than a sorting-induced reason. The studies showing inferior price-earnings ratios for polluting firms do not rule out these alternative explanations of their results.

To summarize, while there is strong theoretical support for the proposition that sorting can generate price effects, at least in the circumstance considered above, the empirical findings to date are mixed as to whether the realized price effect is meaningful or not. But even if sorting has or is expected to generate non-trivial price effects, there are important reasons why those price effects may not result in significant changes in the socially negative corporate behaviors that spawned them, particularly in the shorter run.

*E. Policy Implications*

What are the policy implications of this second stage analysis that recognizes that investors in the composition of their portfolios may sort according to their preferences with regard to firm behavior? At the most general level, this boils down to two sub questions: one is whether identity investing should actually be discouraged and the other being should it somehow be facilitated.

To the extent that it is genuinely individual preferences at work, it is going to be hard to argue that there are good grounds for public policies that somehow hinder identity investing. To start with, there is not yet clear empirical evidence that any kind of identity investing has even had a meaningful price effect, let alone that it has significantly altered firm behavior. Even if there were stronger evidence that it did change firm behavior, that impact seems perfectly appropriate from an efficiency point of view if an investor’s utility function is included in the calculation. Moreover, although it is imaginable the externality-correcting aspect of it could represent ill-informed overkill, at anything like what appears to be today’s level of identity investing, any effect on corporate behavior that it has will probably helpful in reducing externalities. And, while it would lead to winners and losers like most developments in the market, it would not appear to lead to, or reinforce, any inequities.

A more interesting question is whether identity investing should be facilitated by regulation. Here, the extent to which it affects firm behavior is more critical, although there is a bit of a “chicken or the egg” aspect to the inquiry. The less controversial issue relates to mandating disclosure by investment *funds* that purport to support investing related to particular social ends. If investors cannot rely on the claims of fund sponsors, less such investing will occur and investors may end up paying management fees for something they are not getting.[[113]](#footnote-113)

The more controversial issue is mandatory *issuer* disclosure, since it is expensive for a corporation to gather and credibly report on its activities’ social impacts along multiple dimensions.[[114]](#footnote-114) To the extent that a substantial amount of identity investing is already occurring with regard to some social concern and having an impact on prices, the case for mandatory disclosure relating to the effects of a corporation’s activities with regard to this social concern is as strong as it is for information useful in predicting its future cash flows. The issue is whether, at least as of now, these prerequisites are met with respect to any social concern, a matter concerning which our review of the empirical literature suggests the jury is still out. The even more complicated issue relates to social concerns that are not already generating significant, price altering identity investing. The question is whether with disclosure, substantial firm-behavior-altering identity investing will arise. The best argument for experimenting with providing the disclosure where there seems a real potential for such identity investing is as follows: using disclosure appears to us to be a more attractive way of achieving socially oriented changes in corporate behavior relative to the proposed franchise broadening reforms discussed in Part II.[[115]](#footnote-115) Reforming corporate behavior through the pricing effects of identity investing does not consume the political energy that could be used to reform the governmental political system and to push for governmental actions that better control market failures and reduce inequity. And it does not require a socially costly lessening of the existing constraints against managers acting in self-interested ways since managers would be continuing to maximize share value, just guided by altered share prices and cost of capital considerations. The costs of disclosure rather prime the pump for what is really a savings in information costs overall. Relative to behavior reform via corporate governance alterations, behavior reform via identity investing relies instead on information-cost-economizing market mechanisms by which managers, who continue to seek to maximize their share prices, seek to detect behaviors whereby the share price depressing effects of not maximizing cash flow are compensated by the share price increasing effects of the identity investors that the behaviors would attract.

1. **Application of the Analysis to the Corporate Purpose Debate**

Parts I, II, III provide a systematic analysis of the effect on firm behavior when a portion of the economy’s equity investors prefer a deviation from share value maximization in furtherance of some other end. This analysis can be leveraged to advance the discussion of a number of ongoing debates in corporate law scholarship. In this Part IV, we provide an example by applying the analysis to the important and longstanding debate concerning the proper purpose of the corporation. Is it to maximize share value or is it, to at least some extent, to serve one or more other ends? The major reform movements of recent years – Corporate Social Responsibility (CSR), Environment, Social, and Governance (ESG), and stakeholderism – share in common support for the latter position, whatever, if any, are their differences. We will generically refer to all three simply as the “alternative ends” approach to corporate purpose.

As developed below, the analysis in this paper helps illuminate the debate over corporate purpose in at least three ways. First, the literature advancing the various strains of the alternative ends approach is surprisingly thin on how to get from here to there. Our analysis suggests that it may well be that a significant portion of the economy’s equity investors would, if fully informed, prefer certain deviations share value maximization in furtherance of other ends, but that it is highly unlikely that if so, this fact would organically lead to major changes in corporate behavior. Fundamental changes in our current corporate governance arrangements would be a precondition. Second, because shareholders are not well informed concerning the extent to which changes in corporate behavior would further ends that they support or the costs of these changes in terms of share value, directors and managers, even if they wished to do what shareholders would prefer if they were so informed, lack any reliable guides. Third, the analysis here suggests efficiency and equity in the economy will not be advanced by two of the prominently discussed kinds of fundamental changes in corporate governance arrangements: broadening the scope of the shareholder franchise to allow for votes concerning specific business decisions, and softening the sticks and carrots that incentivize managers to maximize share value through an easing of fiduciary duties.[[116]](#footnote-116)

1. *Corporate Purpose: Shareholder Primacy Versus the Alternative Ends Approach*

The corporate purpose debate is centered on the question of the proper role of a corporation in society.[[117]](#footnote-117) Cast in the language of economics, this debate interrogates the nature of the objective function that corporations should maximize. Though dissenting voices have grown much louder in recent years, the leading vision of corporate purpose among commentators in the United States has been, at least since the 1970s, shareholder primacy. Shareholder primacy posits that corporate activity should be singularly directed at advancing the interests of the corporation’s shareholders.[[118]](#footnote-118) When paired with the usual assumption that a corporation’s shareholders all want the firm to maximize share value, shareholder primacy reduces to the proposition that corporations should endeavor to maximize share value as a normative matter. [[119]](#footnote-119)

Proponents of shareholder primacy recognize that an unconstrained corporation seeking to maximize share value will not necessarily be acting in a way that maximizes social welfare. As discussed in Part I, the existence of market imperfections means that share value maximization can result in inefficient outcomes characterized by supra-competitive output prices, sub-competitive input prices including wages, or externalities, depending on the precise nature of the market imperfection.[[120]](#footnote-120) Primacy advocates, however, believe that correction of these inefficient outcomes is most appropriately within the province of the government and best addressed through the government’s tax and spend and regulatory policy.[[121]](#footnote-121) Most proponents of shareholder primacy would also view as inequitable the pre-tax-and-transfer distribution of wealth in a world of share-value-maximizing corporations. But we do have taxes, including a progressive income tax, and transfers many of which are aimed at lower income citizens. Shareholder primacy advocates would argue that if further wealth redistribution is still needed, it is best undertaken by more in the way of governmental taxes and transfers and by individual charity, rather than by corporations charging less than competitive prices for their outputs or paying more than competitive prices for their inputs.[[122]](#footnote-122) Implicit in these positions is the belief that, though well short of ideal, the government maintains a workable ability to enact efficiency-enhancing regulation and to redistribute income in a manner consistent with societal preferences.

Much of the increasing scholarly interest in alternative ends approaches to corporate purpose stems from a sense that the problem of corporate externalities is getting more serious, especially in connection with climate change, which is widely regarded as an existential threat. There is also a wide-spread sense that the after-tax-and-transfers distribution of wealth is still too unequal and getting more so. These twin concerns, each in one way or another characterizable in terms of the unsatisfactory impact of share-value-maximizing corporate behavior on persons other than shareholders, has been combined with increasing skepticism concerning the government’s capacity to remedy them. The solution in the eyes of some scholars is an alternative ends approach to corporate purpose, whereby corporations deviate from share value maximizing behavior in furtherance of the needs of these other persons.[[123]](#footnote-123) In essence, their vision—whether it goes under the banner of CSR, ESG, or stakeholderism[[124]](#footnote-124)—is grounded in the belief that many of the persistent social and economic ills we observe today can be traced to corporations’ drive to generate profit and to a government that is no longer capable of enacting curative regulation, in part because of the significant influence that corporations have on the political process.[[125]](#footnote-125) Prominent corporate and political leaders and large institutional investors have added their voices to those of these scholars, also calling for corporations to adopt an alternative ends approach, although it is unclear how much is serious and how much just lip service to what has become a popular idea. Perhaps the most well-known example is the since-qualified 2019 statement of the Business Roundtable, in which a consortium of 181 CEOs of leading corporations announced that they support a stakeholder theory of corporate purpose.[[126]](#footnote-126)

1. *The Likelihood of Organic Change Absent a Fundamental Alteration in Existing Corporate Governance Arrangements*

Let us put aside for now whether an alternative ends approach to corporate purpose is desirable and address the question of implementation. It is reasonable to assume that a significant portion of the economy’s equity investors would, if fully informed, prefer that corporations at least to some extent adopt an alternative ends approach given current constraints. Assume for a moment that there are no changes in corporate law, with shareholders being the only voters for directors and specific business decisions being the exclusive province of directors and managers. How likely is it that the presence of these (perhaps only incipient) shareholder preferences will organically lead to major changes in corporate behavior? In other words, is it likely that an alternative ends approach to corporate purpose will arise simply through private ordering?

While there are exceptions, the corporate law literature concerning the purpose debate has largely avoided engaging with this adoption question and instead focused attention on critiquing and evaluating the various competing visions of corporate purpose. This blind spot is noteworthy given the amount of significant attention the corporate purpose question has been receiving in the academic literature.

A leading exception is the work by Lucian Bebchuk and Roberto Tallarita.[[127]](#footnote-127) In their article, Bebchuk and Tallarita evaluate the adoption question by focusing on managerial incentives and analyze whether the prevailing corporate governance structure incentivizes managers to adopt a stakeholder approach to corporate purpose. Bebchuk and Tallarita answer in the negative, concluding managers operating within the prevailing managerial incentive structure do not have meaningful incentives to adopt stakeholderism.[[128]](#footnote-128) Bebhcuk and Tallarita therefore show that the current managerial incentive scheme firmly embeds shareholder primacy as the corporate objective.

Bebchuk and Tallarita’s approach of evaluating the adoption question by focusing on corporate managers and their incentives is the analytically appropriate first step given the centrality of managers to corporate decision-making. This focus is particularly valuable given that much of the corporate governance literature concerning the alternative ends approach to the corporate purpose largely assumes away or disregards managerial incentives. But Bebchuk and Tallarita’s analysis does not consider how the chances of corporations adopting an alternative ends approach to their corporate purpose is affected by the likely reality that a significant portion of the economy’s equity investors would, if fully informed, prefer some meaningful deviations from share value maximization in furtherance of other ends. In other words, the more complete articulation of the adoption question is, holding fixed current corporate law, can we expect corporations to deviate in these ways.

Parts I, II, and III above provide a negative response to this more complete articulation of the adoption question, buttressing the conclusion of Bebchuk and Tallarita that stakeholderism will not organically displace shareholder primacy. Our point can be illustrated through a simple stylized example. Consider a simple economy where all firms produce the same product but half the firms are polluters, and the other half are non-polluters because, some years back, they incurred a one-time fixed cost to pay for a costly technology that enabled them to produce without polluting. Suppose that all firms have adopted a shareholder primacy perspective and that all investors are purely profit-minded. The polluting firms could pay for the technology that would allow them to produce without polluting, but have chosen not to because it would decrease their profits.

Now, suppose that a portion of the economy’s equity investors become more sensitive to social issues and abandon their pure profit-minded preferences. To the extent that they are aware of the harm to the downstream residents and the costs to the polluting companies of remedying the problem, they would want the polluting firms to stop doing so even though it would diminish profits. So, in terms of the typology in Part I, the economy now includes both profit maximizers and profit sacrificers, where the profit sacrificers, if fully informed, would want firms to deviate from unconstrained share value maximization when that objective imposes this external cost on others.

The analysis in Part II predicts that, holding firms’ shareholders bases as fixed, the fact that some investors would, if informed, want the polluting firms to change will not, by itself, cause firms to adopt that vision of corporate purpose. The profit sacrificing shareholders of each polluting firm would, to the extent they are informed, want the firm to stop polluting while its profit maximizing shareholders would want the firm to continue to adhere to a shareholder primacy perspective. The polluting company is likely to change only if, in the election of directors, the positions of the candidates on this issue become salient, enough of the socially oriented shareholders become aware of both the gains to the downstream residents, and the costs to the company from a remedy and view the gains as worth the costs, and among all the issues relevant to choosing for whom to vote, the pollution issue is for the socially minded shareholders decisive. For the reasons discussed in Part II, at least in real world versions of this story, it is unlikely that all of these conditions will be met. Moreover, the other elements of the prevailing corporate governance managerial incentive structure can be expected to continue to incentivize the polluting firm’s managers to not abandon share value maximization despite this turn in the social mindedness of many of its shareholders.

Suppose the corporate governance structure of these polluting firms could each be changed so that shareholders could vote on individual business decisions, an example of which would be the decision to stop polluting. This would increase the chance that any one firm’s behavior could be changed via the shareholder franchise, but there is no guarantee. For the reasons discussed in Part II, such a change may come at a high cost. It would include, to assure managerial implementation of the shareholder will, a softening of the sticks and carrots of the managerial decision structure in ways that would also allow corporate behavior to be changed in ways that simply satisfy the managers’ self-interest. With respect to our stylized example, consider first the effort needed in the first instance to change each firm’s governance system to allow shareholder votes on business decisions. That effort could have been directed instead at trying to improve the overall effectiveness of the political system. Furthermore, even after these fundamental governance alterations are made, for any *one* firm to actually stop polluting, the resources spent to get a majority of shareholders to become aware of the facts and vote to end the pollution could instead be more efficiently directed to causing government to enact a taxes or fines that would end the pollution by *all* the firms.

The analysis of Part III predicts that investor sorting theoretically offers an alternative path for investor preferences to cause firms to adopt a stakeholder approach through a price effect. Investors who want the polluting firms to stop could, as identity investors, divest the stock of these firms.[[129]](#footnote-129) That divestment might cause each polluting firm’s price to fall and its cost of capital to rise because the equity investors in the economy who do not care about the pollution will need to be incentivized to sacrifice diversification to be the exclusive holders of the shares the polluting firms. This might induce the managers of the polluting firms, who continue to be incentivized to maximize share value, to stop polluting, but this is far from certain. For the reasons discussed in Part III, any price effect might be trivial and, even if not, the reduction in the discount rate from ending pollution may not buoy share price as much as the extra costs would depress it. Still, this pathway to change would be more efficient in terms of information costs and would not require a softening of the sticks and carrots in managerial incentive structure that could lead to the inefficiency of greater managerial self-serving behavior. And through its effect on cost of capital might, by gradually altering the nature of firms’ productive capacity, lead to more meaningful changes in behavior.

*C. The Presence of Profit Sacrificing Shareholders is Not Sufficient to Provide Reliable Guides*

The precise contours of what the proponents of the alternative ends approach to corporate purpose call for tend to be unclear. At its most general level, the alternative ends approach would expand a firm’s objective function so that, in addition to shareholder interests, it also includes benefitting the interests of others who might be affected by the corporation’s conduct.[[130]](#footnote-130) But as been explained elsewhere, there is lack of clarity in the literature about whose interests should be included in the corporate objective.[[131]](#footnote-131) The literature also does not make clear how the various interests that should be credited are to be weighed against one another by the managers of a corporation that adopts the alternative ends approach.[[132]](#footnote-132) To take an example, while many articulations of the alternative ends approach to corporate governance would include the firm’s employees as non-shareholder constituents whose interests (beyond what they can obtain through explicit or implicit contracts) the corporation should consider when making corporate decisions. The literature does not take a clear position, however, on how those interests should be weighed vis-à-vis shareholder interests. So, if a firm’s stock price would drop by 15% if it were to increase the wages of its hourly employees by 10%, it is unclear whether such a change would or would not be normatively justified under an approach where one of the corporation’s alternative ends is the welfare of its employees.

The point that we can add here is that because shareholders are not well informed concerning the extent to which changes in corporate behavior would further ends that they support or the costs of these changes in terms of share value, directors and officers, even if they wished to do what shareholders would prefer if the shareholders really were informed, lack any reliable guides. In the end, for these incipient socially minded preferences to become reliable guides, there would need at a minimum to be the fundamental reform of allowing shareholder votes to determine discrete business decisions involving deviations from share value maximization and the development of the costly firm-by-firm political system that we have described in Part II to inform voters and mobilize their votes.

*D.* *What an Examination of the Role of Shareholder Preferences Cannot Add to the Corporate Purpose Debate*

We should make clear that we share many of the externality and equity concerns that motivate the proponents of the alternative end approach to corporate governance. We too would prefer the outcome they would favor when it comes to any instance where a corporation is maximizing share value in the presence of a market imperfection. It would be a social improvement if the corporation were somehow constrained so that it instead would adopt whatever behavior it would have followed as a share value maximizer had that imperfection been corrected even though, so constrained, its share value would be lower. We also understand why the normative attractiveness of the alternative ends approach has grown as the governmental political system has seemed unable to keep up with the increasingly negative impact of share value maximizing corporate behavior in the presence of uncorrected market imperfections and with the increase in inequality.

Nevertheless, the analysis here suggests efficiency and equity in the economy overall will not be advanced by two of the prominently discussed kinds of fundamental changes in corporate governance arrangements: broadening the scope of the shareholder franchise to allow for votes concerning specific business decisions and softening the sticks and carrots that incentivize managers to maximize share value and softening the sticks and carrots that incentivize managers to maximize share value.[[133]](#footnote-133) Commentators have suggested many other fundamental changes in current corporate governance arrangements besides these two.[[134]](#footnote-134) Evaluating how effective these other alternatives would be at meeting these challenges and what their costs would be is beyond the scope of this paper, other than to observe that the existence of incipient socially minded shareholder preferences to deviate from share value maximization in favor of some other end will probably not affect that evaluation very much. Moreover, it is not clear that any kind of fundamental alteration in current corporate governance arrangements is likely. If no such alteration is likely, our conclusion that without one a corporation will probably not deviate from share value maximizing behavior even if a significant portion of its shareholders would, if fully informed, wish it do so, suggests that it would be better to steer in other directions policy analysis concerning how to correct for problems in corporate behavior.

**V. Conclusion**

Investors have dissimilar preferences. While some investors prefer that companies singularly focus on the pursuit of profit and share value maximization, other investors feel differently and want companies to sacrifice profit and share value in service to some other objective. Examples abound. Consider a company whose business operations results in the firm generating an externality in the form of excessive greenhouse gas emissions. Actual or potential shareholders of the company may want the company to abate those emissions even if that externality amelioration comes at the expense of the company’s profitability and share value. As our country’s social and environmental problems have grown in both scope and depth, and as faith in the curative abilities of the political process has waned, investors appear increasingly willing to trade corporate profits for corporate decisions that can aid in the correction of the many social and environmental problems that are now commonplace.

Will these differing investor preferences actually affect firm behavior? More precisely, if the preferences of the economy’s equity investors are divergent, how will firm behavior be different than in the counterfactual world in which investors had homogenous preferences and all investors preferred that firms focus solely on share value maximization. This article has sought to make some headway towards answering that foundational question with a focus on the country’s dominant form of productive enterprise—the dispersed ownership publicly traded for-profit corporation with investors as its residual claimant.

As a framing for its substantive analysis, the article first developed a taxonomy of categories of matters over which investors might have conflicting preferences with respect to share value maximization: (1) the extent to which a given corporation should deviate from share value maximization to correct a market imperfection, such as a firm-generated externality; (2) the extent to which a given corporation should deviate from share value maximization in order to redistribute wealth; and (3) the extent to which a given corporation should deviate from share value maximization so that the investor can benefit materially in ways other than the provision of dividends or capital gains. While we consider these three categories to be exhaustive, they are not mutually exclusive, as an investor’s specific reasons for wanting a given firm to deviate from share value maximization may fall within more than one of the three categories.

The article’s mode of analysis is grounded in the proposition that the question of how equity investor preference heterogeneity affects firm behavior must ultimately be seen in terms of how it affects *managerial* decision-making. This is because a firm’s decisions are in the first instance made by its managers, not by its investors, actual or potential. To conduct its substantive analysis, the article has proceeded in two steps. In the first step, the article took as given firms’ shareholder configurations and assumed that the makeup of the shareholder body of any particular public firm was representative of equity holders in the economy in general with regard to the kinds of preferences under study. Given that fixed shareholder configuration, the article evaluated, for each of the three identified categories of differences in investor preferences, whether the presence of heterogeneity in investor preferences can be expected to cause managers to forego share value maximization relative to a circumstance in which all shareholders wanted the firm to maximize share value.

By systematically working through each of the primary devices that the academic corporate governance literature has identified as potential mechanisms that directly or indirectly influencing managerial decision-making, the article finds that the pressure that each device applies to managers of publicly traded dispersed ownership corporations to remain focused on share value maximization is likely unaffected by the presence of shareholders who want managers to abandon that objective. While certain changes to current corporate governance arrangements recommended by some commentators might cause managers to be more receptive to shareholder preferences for curtailing share value maximization in furtherance of some other end, these changes come with costs that may well overwhelm any social gain arising from greater managerial sensitivity to the shareholders who would prefer to sacrifice profits to further some other end.

In reality, however, shareholder configurations of publicly traded firms are not immutable. Through their buy and sell decisions, investors can self-select and sort into firms in a way that can better align the composition of their portfolios with their personal preferences. Accordingly, in the second step of its analysis, the article relaxed the assumption that firms have a fixed shareholder base and evaluated whether the presence among the economy’s equity investors of ones preferring to sacrifice profits in furtherance of some other end can affect corporate behavior through the mechanism of investor sorting.

The article structured its analysis on the two channels through which investor sorting can affect corporate behavior. First, investor sorting can affect corporate behavior through the franchise because it can change the firm’s shareholder base and thus result in a new preference configuration of those empowered to vote in shareholder elections. Second, investor sorting can affect corporate behavior through price effects. If investor sorting causes some firms’ share prices to fall—for instance, because those firms engage in some socially undesirable activity that prompts a subset of investors to divest the firms’ equity—then those firms’ managers may be incentivized to modify corporate behavior in the first instance in order to avoid investor sorting and the accompanying drop in share price.

The article readily ruled out the franchise as potential channels for divergent shareholder preferences to affect managerial incentives and hence corporate behavior even in the presence of sorting due to identification investing. Its conclusion regarding the price effect, requires more qualification. If shareholder sorting causes the market to discount at a more favorable rate the future cash flows of the embraced firms relative to the divested ones, then this could result in sufficiently favorable effects on the price of the shares that managers would be incentivized to have their firms behave differently. Additionally, this price effect would reduce the embraced firms’ costs of capital, allowing them to grow faster relative to the boycotted firms. The empirical findings to date, however, are mixed as to whether any currently realized price effect is meaningful and is it also uncertain whether additional investor sorting would generate a meaningful price response. But even if sorting has or is expected to generate non-trivial price effects, there are important reasons why those price effects may not result in significant or immediate changes to corporate behavior. At the same time, reliance on a price-based mechanism for reforming corporate behavior has clear advantages to one based on changing the prevailing governance structure and can be readily promoted through more socially-oriented securities disclosure.

The article’s mode of analysis and its findings open new lines of future research that can aid in the resolution of important, ongoing debates in corporate law scholarship. As an example, the article applied its analytical apparatus to the longstanding corporate purpose debate. It shows, among other things, that even if a substantial portion of the economy’s equity investors would, if fully informed, want corporations to deviate from share value maximization in furtherance of other ends, this is unlikely to happen absent fundamental changes in current corporate governance arrangements.

**Appendix**

Investor X has an equity interest in Corporation A. The question addressed is whether investor X, if fully informed, would favor A deviating from share value maximization in furtherance of some particular externality eliminating goal.

Definitions

Cx = the cost to X in the reduced value of her shares from if A engages in the deviation

Cy = the aggregate cost to the rest of the corporation’s shareholders in terms of the reduced value of their shares if the corporation engages in the deviation

δ = CX + CY (the cost to A and hence to its shareholders of the deviation)

G = the aggregate gains of everyone whose position is improved by the change in A’s behavior represented by the deviation (for example, the improvement in the lives of people who were suffering from smoke being emitted by a factory run by A where the deviation is shutting the factory down)

L = the aggregate losses of everyone whose position is hurt by the change in A behavior (in the same example, persons who lost their jobs from the factory’s closure)

h = G – L (the net of the gains and losses by persons affected by the change in A’s behavior)

λX = X’s empathy factor (i.e., the ratio of pleasure or pain measured in dollar terms that X receives from changes in the wealth positions of everyone else).

SX = the fraction of the total value of A’s equity possessed by X

E = h/δ (the externality improvement ratio)

Assumptions

0 < λX ≤ 1 (X is assumed to be empathetic to the changes in the welfare of others, but the change in her welfare prompted by a change in theirs will not be greater than the change they experience themselves, i.e., it is not going to be greater than their own changes in welfare).

Criterion for X to favor the deviation

Cx < λX(G - L- Cy) (X will vote in favor of the deviation if and only if the cost to her, Cx, is less than the empathetic pleasure that X gets from (G -L - Cy)).

Because Cx = sXδ, this condition can be alternatively expressed as – SXδ + λX [(h - (1 - SX)δ] > 0.

Proposition I:

A necessary but not sufficient condition for X to favor the deviation is that it would be social welfare improving, i.e., CX + CY < G – L (also expressed as δ < h or E > 1).

Proof

(1) Cx < λX(G - L- Cy) (the condition that must obtain for X to favor the deviation)

(2) (1/λX)Cx + CY < G – L (multiplying (1) both sides by 1/ƛX and rearranging)

(3) (1/λX)Cx + CY ≥ CX + CY (since 1/λX ≥ 1)

So, for Cx < λX(G - L- Cy), CX + CY < G – L (also expressed as δ < h or E > 1).

Proposition II

All else equal, the smaller X’s equity interest as a proportion of the total value of the company’s equity, the more likely that X will vote in favor of a social welfare improving deviation.

Proof

First, assume that the deviation is social welfare improving, so that E>1.

Next, recall that X will favor the deviation if and only if:

(4) - SXδ + λX [(h - (1 - SX)δ] > 0 (the alternative expression for the criterion for X to favor the deviation)

This decision rule can be rewritten as follows:

(5) λX [(h - (1 - SX)δ]> sXδ

(6) λX > SXδ/[(h - (1 - SX)δ]

(7) 1/λX < [(h - (1 - SX)δ]/SXδ

(8) 1/λX < h/SXδ - [(1 - SX)δ]/SXδ

(9) 1/λX < E/SX - [(1 - SX)/SX] (E being defined as equal to h/δ, with E>1 by assumption)

(10) 1/λX < (E - 1 + SX)/SX

So, X will favor the deviation if and only if:

(11) λX > SX/(E - 1 + SX)

Because E > 1 by assumption, the derivative of the right-hand size of (11) with respect to SX is positive. So, the smaller is SX, the smaller X’s empathy factor, λX, can be for X to still favor the deviation.

Proposition III

All else equal, the greater the deviation’s social welfare improvement relative to its cost, the more likely that X will vote in favor of a social welfare improving deviation.

Proof

Refer again to (11). The greater E = h/δ (the externality improvement ratio) is, the smaller X’s empathy factor, λX, can be for X to still favor the deviation.

A Stylized Example

Suppose that SX = 1/100,000, i.e., X owned 1/1000 of 1% of a publicly traded company, and that E = 1.2, i.e. the net social benefit from the impact of A’s externality eliminating behavior change is 1.2 times the cost to A and thus to its shareholders. Based on equation (11), for X to favor the deviation:

λX > SX/(E - 1 + SX) = 0.00001/(1.2 – 1 + 0.00001) = 0.0001/0.2001 = 0.00005

1. \* Arthur Levitt Professor of Law, Columbia Law School. [↑](#footnote-ref-1)
2. \*\* Professor of Law, UC Davis School of Law. We thank Zohar Goshen, Dorothy Lund, Josh Mitts, and Alex Raskolnikov, as well as participants at Columbia Law School’s 10-10 Faculty Workshop and the 2024 National Business Law Scholars Conference, for helpful suggestions. [↑](#footnote-ref-2)
3. *See, e.g.*, Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 Colum. L. Rev. 767, 769 (2017) (“For the last forty years, the problem of agency costs has dominated the study of corporate law and governance.”) [↑](#footnote-ref-3)
4. As but one example, consider the model developed in the seminal 1976 article by Jensen and Meckling, in which all of a firm’s non-managerial shareholders are assumed to derive utility from their equity interest solely through their investment’s effect on their wealth or cash flow. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 314 (1976) (assumption P.5). Profit maximization is the standard economic assumption of firm behavior across all market structures. *See* Andreu Mas-Colell, Michael D. Whinston & Jerry R. Green, Microeconomic Theory 317 (perfectly competitive firms maximize profits), 384 (monopolists maximize profit), 387-400 (oligopolists maximize profits) (1995). [↑](#footnote-ref-4)
5. This type of corporation has stock traded on an exchange and there is no single shareholder or organized group of shareholders maintains control over its decisions. Such firms constitute 96.4% percent of the S&P 500 publicly traded firms and 91.6% percent of the entire Russell 3000 such firms. *See* Kosmas Papadopoulos, “CEO Ownership, Corporate Governance, and Company Performance” by (Harvard Law School Forum on Corporate Governance, 2019, https://corpgov.law.harvard.edu/2019/05/13/ceo-ownership-corporate-governance-and-company-performance/). As of 2015, this corporate type represented 90.12% of total capitalization of S&P 1500 companies. *See* Edward Kamonjoh, “Controlled Companies in the Standard & Poor’s 1500” by (IRRC Institute, 2016, https://bpb-us-w2.wpmucdn.com/sites.udel.edu/dist/8/12944/files/2022/08/Controlled-Companies-IRRCI-2015-FINAL-3-16-16.pdf). Although privately held firms, most prominently the so-called “unicorns,” have increased in importance and gathered much attention, a recent article by Mark Roe and C.Y. Wang emphasize publicly-traded corporations’ central role in the economy, noting that they employ almost 30% of the total workforce, have increased their level of investment as a percentage of GDP over the last 30 years, and have a total capitalization that has grown over this period of time from about 50% of GDP to 100% of GDP. Mark Roe & C.Y. Wang, *Half the Firms, Double the Profits: Public Firms’ Transformation, 1996-2022, J Law Fin. & Acct (forthcoming), available at https://papers.ssrn.com/sol3/papers.cfm?abstract\_id=4372070*.

   The fact that the typical public firm does not have a single shareholder or organized group of shareholders maintaining control of its decisions does not mean that it does not necessarily have a relatively small number of holders each possessing a smaller concentration of corporations shares who, though they are independent of each other and do not coordinate on a regular basis, can, when it comes to how to vote their shares in any given instance, would have no difficulty in communicating and negotiating with each other and with the corporation’s management, , something that is in fact quite common. *See* Clifford G. Holderness, *The Myth of Diffuse Ownership in the United States*, 22 Rev. Fin. Studies 1377 (2009). As discussed in Part II.D.2 *infra*, the existence of such holders is a factor that can very much be part of the firm’s managerial incentive structure. [↑](#footnote-ref-5)
6. We confine our focus to U.S. firms because control structures and other legal and institutional features abroad vary considerably from those in the United States. We note, however, that publicly traded corporations with dispersed shareholdings, though less dominant than in the United States, are still important. *See* Gur Aminadav & Elias Papaioannou, *Corporate Control around the World*, 75 J. Fin. 1191, 1203 (2020) (across the globe in 2012 43% of publicly traded firms weighted by market capitalization (including U.S. firms) were widely held in the sense that no single shareholder had holdings giving it more than 5% of the votes). [↑](#footnote-ref-6)
7. Prominent scholars identified this blind spot more than twenty years ago. *See* Henry Hansmann, The Ownership of Enterprise (2000) 40 (“[U]nlike agency costs, the costs of collective decision making have been largely neglected in the literature on corporate control and the economics of organizational form.”). Since that time, some scholars have critiqued the corporate governance literature for failing to accurately describe the preferences of shareholders of dispersed publicly traded corporations, *see, e.g.*, Daniel J.H. Greenwood, *Fictional Shareholders: For Whom are Corporate Managers Trustees, Revisited*, 69 S. Cal. L. Rev. 1021 (1996), but they have not systematically explored whether and how shareholder preference heterogeneity can affect the behavior of those firms. In contrast to the literature on dispersed publicly traded corporations, with its assumption that all shareholders prefer the corporation to maximize share value, literatures relating to other types of corporations have more fully engaged the issue of heterogeneous shareholder preferences. For instance, analysis of intra-shareholder conflicts has been a dominant focus of the academic literature on closely-held corporations, *see, e.g.*, Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. Pa. L. Rev. 1735 (2001), and also has received some attention in the literature on venture-backed startups. *See, e.g.*, Robert P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. Rev. 37 (2006); Elizabeth Pollman*, Startup Governance*, 168 U. Pa. L. Rev. 155 (2019)*. See also* Simone M. Sepe, *Corporate Agency Problems and Dequity Contracts*, 36 J. Corp. L. 113 (2010) (analyzing inter-investor conflicts and agency issues in a corporation with diverse investor types); Robert P. Bartlett, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. Rev. 37 (2006) (analyzing the implications of divergent investor preferences in venture capital funded start-ups); Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. Pa. L. Rev. 785 (2003) (analyzing the means by which controlling shareholders can extract private-control benefits at the expense of minority shareholders and discussing associated legal doctrine). [↑](#footnote-ref-7)
8. We recognize, of course, part of what makes the study of corporate governance complicated is that, although this ultimate residual claimant chooses the fund in which she invests and can freely exit, in many cases, despite the pass through voting schemes that some funds now offer some investors, she does not directly determine how her pro-rata interest is voted or, with a managed fund, even in which firms she will hold an interest. [↑](#footnote-ref-8)
9. Matthew Backus, Christopher Conlon & Michael Sinkinson, *Common Ownership in America: 1980-2017*, 13 Am. Econ. J.: Microeconomics 273, 285 (2021). [↑](#footnote-ref-9)
10. José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. Fin. 1513 (2018). [↑](#footnote-ref-10)
11. Merritt B. Fox & Menesh Patel, *Common Ownership, Do Managers Really Compete Less,* 39 Yale J. Reg. 136 (2022). [↑](#footnote-ref-11)
12. The model for this, though it in fact involves shares held by a fund rather than directly, is BlackRock’s expansion of its Voting Choice option to retail investors invested in the iShares Core S&P 500 ETF, encompassing roughly three million or more U.S. retail shareholder accounts. *BlackRock Expands Voting Choice to Millions of U.S. Retail Shareholder Accounts*, iShares (Feb. 13, 2024), https://www.ishares.com/us/literature/press-release/blackrock-expands-voting-choice-february.pdf. These retail investors, though, only have the option of choosing from six very broad-based proxy voting policies, three from ISS (Socially Responsible Investment (SRI) Policy, Catholic Faith-Based Policy, and Global Board-Aligned Policy) and three from Glass Lewis (Benchmark Policy, Climate Policy, and Corporate Governance-Focused Policy). *See Empowering Investors through BlackRock Voting Choice*, BlackRock, https://www.blackrock.com/corporate/about-us/investment-stewardship/blackrock-voting-choice (last visited Feb. 28, 2024). [↑](#footnote-ref-12)
13. Despite the sustained dominance of this business type, *see supra* note 3, in recent years there has been an increase in business organizations that seek to advance social objectives to one extent or another. *See, e.g.*,Jens Dammann, *Publicly Traded Public Benefit Corporations: An Empirical Investigation*, 29 Stan. J. L. Bus. & Fin. 265 (2024) (discussing and evaluating public benefit corporations); Ofer Eldar, *The Role of Social Enterprise and Hybrid Organizations*, 2017 Colum. Bus. L. Rev.92 (2017) (discussing and evaluating social enterprises). [↑](#footnote-ref-13)
14. This possibility is explored in Part III *infra.* [↑](#footnote-ref-14)
15. See, e.g., Brett M. McDonnell, *From Duty and Disclosure to Power and Participation in Social Enterprise*, 70 Ala. L. Rev. 77 (2018). [↑](#footnote-ref-15)
16. Hansmann, *supra* note 5at 44; Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26; J. L. & ECON. 395 (1983); Eugene Fama, *Contract Costs and Financing Decisions*, 63 J. BUS. 571 (1990). [↑](#footnote-ref-16)
17. In addition to an externality, negative or positive, a market imperfection may arise because of the presence of market power and informational asymmetries. [↑](#footnote-ref-17)
18. Even if a given firm’s shareholders all agree on the firm’s objective, they may nonetheless disagree on the best way to achieve that shared objective. In particular, conditioned on whatever other ends, if any, they want the corporation to serve, a firm’s shareholders will want the corporation to maximize its share value but may differ in how they would like the firm to behave based on differences in beliefs as to what corporate behavior will in fact result in such share value maximization. Because the subject of our inquiry concerns the circumstance in which investors have divergent views on the objectives of firm behavior, rather than divergent views on the way firms can best achieve a given objective, we do not address this source of investor preference heterogeneity. [↑](#footnote-ref-18)
19. An August 2023 report by Sullivan & Cromwell indicated that 43 proposals in the social or environmental area received a majority vote in 2022 and the first half of 2023 (out of 428 voted on). *See* Sullivan & Cromwell LLP, *2023 Proxy Season Review: Part 1* (2023), https://www.sullcrom.com/SullivanCromwell/\_Assets/PDFs/Memos/sc-publication-2023-proxy-season-review-part-1.pdf. For example, seven of the ones receiving a majority vote asked for racial equity audits, one voiced support for allowing collective bargaining, four asked for greater transparency with respect to political spending. *See id.* Seventeen of the successful proposals were related to the environment and, respectively, called for a variety of measures including emissions targets, climate transition plans, reducing plastic use and stopping deforestation. *See id.* [↑](#footnote-ref-19)
20. *See* *supra* note 2. [↑](#footnote-ref-20)
21. *See* Louis Makowski & Joseph M. Ostroy, *Perfect Competition and the Creativity of the Market*, 39 J. ECON. LITERATURE 479 (2001); Kenneth J. Arrow & Gerard Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 Econometrica 265, 268 (1954). [↑](#footnote-ref-21)
22. Symmetrically, a share value maximizing firm will, from a social point of view, underperform costly activities that have positive externalities, for example when it trains young workers and is unable to fully capture a large portion of the resulting lifetime improvement in their productivity. Some profit sacrificers will want a firm to provide some public good. The failure of a share value maximizing firm that might be well positioned to provide such a good is an extreme version of a market failure due to positive externalities. [↑](#footnote-ref-22)
23. This is only true in terms of static efficiency, however. The prospect of being able to price above marginal cost is a major spur for innovation, which also leads to social benefits. Figuring out the socially most beneficial point of tradeoff for any industry is an extraordinarily complex and inexact task, which may make it a poor candidate except in the most extreme cases for shareholders deciding when a deviation from share value maximization is pro social. [↑](#footnote-ref-23)
24. In making this statement, we are, as is standard in most law and economics analysis, equating a Kaldor-Hicks improvement with enhanced social welfare. In other words, the change may make some people better off and others worse off, but the welfare improvement for those made better off exceeds the welfare reduction of those made worse off as measured by whether the winners would be willing in a hypothetical bargain to pay off the losers. Whether in the last analysis one regards a Kaldor-Hicks improvement arising from a change in a corporation’s behavior to be socially desirable depends as well on how one views the distributional impact of the change and whether, if the distributional impact is negative, that outweighs the increase in society’s net wealth. [↑](#footnote-ref-24)
25. In some instances, shareholders may want the firm to undertake a social good but where the desired conduct also will ultimately benefit the firm and its shareholders. The usual example is a firm that treats its workers or consumers well, which is expected to translate into long term gains for the company. We would not consider shareholders desiring such a change as profit sacrificers, even if they do not connect the desired social change with eventual corporate gain. Below, we discuss the reasons why shareholders might identify share value maximizing opportunities overlooked by the firm’s managers. *See* Part II.C.1, *infra*. *See also* note 128 *infra* (discussing enlightened shareholder value). [↑](#footnote-ref-25)
26. *See* Michal Barzuza, Quinn Curtis & David H. Webber, The Millennial Corporation: Strong Stakeholders, Weak Managers, 28 Stan. J. L. Bus. & Fin. 255 (2023). [↑](#footnote-ref-26)
27. Kaldor-Hicks efficiency is one of the two leading normative criteria in economics. An outcome is Kaldor-Hicks efficient if there are no Kaldor-Hicks improvements possible. *See* note 22, *supra* (definition of a Kaldor-Hicks improvement). Kaldor-Hicks efficiency is a less demanding notion of efficiency than Pareto efficiency, the second normative criteria in economics, in that a Pareto efficient outcome, i.e., an outcome where there is no reorientation of resources that would make one person strictly better off and all others no worse off, need not be Kaldor-Hicks efficient. [↑](#footnote-ref-27)
28. *See* Fox & Patel, *supra* note 9, at 161-65. Common owners’ preferences may also embody aspects of the market imperfection-type preferences discussed above on the theory, advocated by some scholars, that common owners prefer that each of the firms in which they are invested curtail their negative externalities to the extent those externalities affect other any other firm in which they are invested. *See, e.g.*, Madison Condon, *Externalities and the Common Owner*, 95 Wash. L. Rev. 1 (2020). *See also* Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. Corp. L. 627 (2022) (asset managers of large, diversified funds want corporate activity to minimize economy-wide harm). [↑](#footnote-ref-28)
29. As will be clear during our second stage analysis in Part III, our assumption here of no investor in this part is equivalent to a world in which all investors are, to use the terminology from Part III, “unconstrained.” [↑](#footnote-ref-29)
30. *See, e.g.*, DGCL § 141(a). [↑](#footnote-ref-30)
31. While many other factors influence managerial incentives, *see, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, 121 Colum. L. Rev. 2563 2578-609 (2021) (discussing other aspects of the corporate governance framework), the constituents identified in the text above are the ones that have the most salient influence. [↑](#footnote-ref-31)
32. At least since Berle and Means put forth their managerial theory of the firm, scholars have recognized that the interests of management can diverge from those of shareholders. *See* Adolf Berle & Gardiner Means, The Modern Corporation and Private Property (1932). *See also* Michael C. Jensen, A Theory of the Firm: Governance, Residual Claims, and Organizational Forms 144-45 (2000) (summarizing the primary ways in which managerial and shareholder incentives may diverge); Merritt B. Fox, Finance and Industrial Performance in a Dynamic Economy 121-23 (same). [↑](#footnote-ref-32)
33. *See, e.g.*,Fox, supra note 30, at 121-23. [↑](#footnote-ref-33)
34. This conclusion requires at least a modest qualification, however. When it comes managerial decisions concerning the use of the existing productive capacity of the firm, the decisions that maximize the firm’s residuals – what provides the resources to satisfy all but the last two benefits, reputation and a personal sense of doing good – are consistently the decisions that will maximize share value. This may or may not be true of decisions concerning new investment in the firm’s productive capacity, i.e., whether to replace worn out or obsolescent capacity or to create new capacity. The qualification arises in the situation where the cash flow generated by the firm’s current operations exceeds what would be needed to fund all the non-negative net present value (NPV) project ideas that the firm has generated. Share value maximization generally requires the return of this surplus to the firm’s shareholders. However, using this surplus to implement some negative NPV investment proposals – i.e., ones that will produce a positive cash flow but will decrease share value because shareholders could be expected to earn a higher risk-adjusted return simply investing in the market – can enhance the firm’s ability over time to provide these strictly self-interested managerial interests. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am. Econ. Rev. 323 (1986).

    In this regard, aspects of the current corporate governance system that push *toward* share value maximization and against the preferences of managers to make certain negative NPV investments can act consistently with the preferences of shareholders who seek to reduce over time the size of an externality producing industry. To the extent they are correct in their prediction of sharply reduced demand for oil in future decades, oil company shareholders who call for an end to exploration and development and warn against “stranded assets” would be an example of persons favoring share value maximization where managers to serve their own needs are charting a non-share-value-maximizing course. On the other hand, the preferences of management to make some such negative NPV projects replacing warn out productive capacity can align with the preferences of shareholders who seek to avoid the social dislocations associated with the layoff of workers and with damage to the economies of rust belt communities. Here, aspects of the current corporate governance system that push toward share value maximization work contrary to the interests of both management and these particular shareholders. [↑](#footnote-ref-34)
35. In the famous Dodd versus Berle debate of the 1930s, both sides assumed that the managers of large public corporations were largely unconstrained, but Dodd in particular wanted managers to be “professionals” and use this discretion to do a certain amount of social good in the same way as was expected of members of the more traditional learned professions such as law, medicine, the clergy, and the professoriate. *See* A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049, 1073 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145, 1147 (1932); Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Not*e, 45 Harv. L. Rev. 1365 (1932). This idea still had currency among some prominent commentators in the late 1950s. *See* Kingman Brewster, Jr., *The Corporation and Economic Federalism,* in Edward Mason, ed., The Corporation in Modern Society 72-84 (1959). [↑](#footnote-ref-35)
36. *See* note 17 *supra.* [↑](#footnote-ref-36)
37. It is possible that the corporate behaviors called for by these efforts are in fact share value decreasing despite the claims that they are share value enhancing. The proponents, in their enthusiasm, may have engaged in wishful thinking and overestimated the expected gains relative to the costs of their proposals. Alternatively, and more cynically, the proponents may not have sincerely believed that their social aims can be accomplished without a sacrifice in terms of share value but claimed otherwise to encourage its adoption or, should the proposal succeed, to protect it from legal challenge as a violation of the directors’ duty of care. If any of these possibilities is the case, however, it would be impossible to say that any change in corporate behavior resulting from the proponents’ efforts reflects an informed preference by the body of the firm’s shareholders to sacrifice share value for some market-imperfection-correcting or distributional aim. [↑](#footnote-ref-37)
38. Consider the following well-known example. In late 2020, the hedge fund Engine No. 1 acquisition of a stake in Exxon Mobil and subsequently mounted a proxy fight to replace four members of Exxon Mobil’s board. This might appear to be a counterexample, but it is not. The stated objective of Engine No. 1’s proxy fight was to cause Exxon Mobil to take additional steps to lower the company’s greenhouse gas emissions. The fund’s articulated benefit of the desired corporate change was not purely to achieve environmental benefit but rather because the desired change would increase the company’s long term profitability by avoiding investments that would later become “stranded assets” as demand declined. *See* Engine No. 1’s Letter to Exxon Mobile’s Board of Directors (Feb. 22, 2021), https://reenergizexom.com/materials/letter-to-the-board-of-directors-february-22. [↑](#footnote-ref-38)
39. It is a matter of scholarly debate whether there are many opportunities for shareholder pressure to nudge managers toward a “win-win” change that is both pro-social and share-value enhancing. On one side, Alex Edmans, for example, has recently published a book aimed at teaching managers ways they could increase share value by doing socially useful things. *See* Alex Edmans, Grow the Pie: How Great Companies Deliver Both Purpose and Profit (2020). Ryan Bubb and Robert Bartlett take a similar position. They note that such “win-win” initiatives often involve increased costs in the short run that are more than compensated for in the longer run. They suggest that the market has an easier time apprehending the near-term increased costs than appreciating the longer term benefits, meaning that its share price’s initial reaction to undertaking such an initiative will be negative. They argue that managers should thus engage in “enlightened” share value maximization rather than focusing so much on current share price. *See* Robert P. Bartlett & Ryan Bubb, Corporate Social Responsibility through Shareholder Governance, 97 S. Cal. L. Rev. 417, 458-59 (2024). *See also* note 128 *infra.* Other leading scholars, however, are skeptical that firms frequently engage in such “short-termism.” *See, e.g.*, Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 Bus. Law. 977 (2013); Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Funds Activism*, 115 Colum. L. Rev. 1085 (2015). [↑](#footnote-ref-39)
40. One piece of evidence that equity investors are willing to accept lower returns as the cost of the corporation reducing some negative externalities is an empirical study suggesting that privately held firms pollute less than comparable publicly held ones. *See* Sophie A. Shive & Margaret M. Forster, *Corporate Governance and Pollution Externalities of Public and Private Firms*, 33 Rev. Fin. Stud. 1296 (2020). This may suggest that if a portfolio investor was as well informed a control investor is likely to be about the negative effects arising from share value maximizing behavior and the costs of avoiding them, she too would favor this lower level of pollution despite the cost to her. However, the implications of this finding for portfolio investors in public corporations is unclear, because there is a confounding factor: for a person holding a control block of a private corporation’s shares, the corporation is likely to be much more part of the shareholder’s identity and so she is likely to be more concerned about any damage to society caused by the corporation. [↑](#footnote-ref-40)
41. Einer Elhauge suggests that when an individual’s equity interests in a firm are indirect through a fund, she is even more insulated from the social consequences of its actions than where she made the decision on her own to acquire the interest through directly owning the shares as part of her portfolio. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733, 817 (2005). This observation seems correct along multiple dimensions. First, if she is the person making the decision to acquire shares directly for herself, she presumably has done so based on some kind of knowledge concerning the issuer, at least where it was motivated at least partially by speculation. If she acquires her equity interest through a fund, that is absent. Second, where her equity interest was acquired through a fund, she is that much less likely to feel any sense of identity with the firm and hence somehow responsible for its actions. [↑](#footnote-ref-41)
42. It has been long recognized that incurring the costs of becoming informed to monitor whether management is acting to maximize share value involves a collective action problem. Unless one owns 100% of the shares, one will not fully collect on the rewards from the effort. Moreover, even if one incurred the cost to become well informed and that effort revealed that management was not maximizing share value, if one only owns a small portion of the firm’s equity, it is unlikely one’s vote to change management will be determinative. Change would only occur if the holders of a majority of the shares acted similarly. *See* Easterbrook & Fischel, *supra* note 14, at 395-98. There is ample evidence that ordinary retail investors are apathetic when it comes to voting on ordinary matters. *See, e.g.*, Kobi Kastiel & Yaron Nili, *In Search of the “Absent” Shareholders: A New Solution to Retail Investors’ Apathy*, 41 Del. J. Corp. L. 55, 61-66 (2016) (providing data). [↑](#footnote-ref-42)
43. For a discussion of how, if at all, social considerations are relevant to an investor’s decision to acquire an equity interest in a firm, see Part III *infra.* [↑](#footnote-ref-43)
44. *See, e.g.*, Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. Fin. & Acct. 247 (2017) (hereinafter, *Shareholder Welfare*); Jill Fisch, *Purpose Proposals*, 1 U. Chi. Bus. L. Rev. 113 (2022). Presumably, the sentiments of the substantial portion of equity interests held indirectly by individual investors through investment and pension funds could be ascertained by the funds passing these polling inquiries on to their ultimate beneficiaries. [↑](#footnote-ref-44)
45. A classic example of such harm would be a particular form of air pollution. Deviations from share value maximization can also generate positive benefits to society, for example worker training programs extensive enough that, at the margin, the corporation is spending more to fund that it will recoup from a worker’s enhanced productivity. These positive effects raise the same kind of issues as the negative ones. [↑](#footnote-ref-45)
46. For example, when it comes to birth control or abortion, some investors will want the corporation to provide employees more in the way of these services than would be share value maximizing, while others would want to prohibit the corporation from providing such services even if their exclusion the firm’s package of benefits is a non-share-value-maximizing decision because of the negative effect on recruiting and retaining talented employees. Moreover, the same action, whether or not a deviation from share value maximization, can promote one social end while harming another. An example would be closing a polluting factory that results in the firing of employees who have little in the way of alternative jobs. [↑](#footnote-ref-46)
47. Robert Bartlett and Ryan Bubb argue, for example, that a broad-based green index fund is not “well positioned” to act as an informed voter because doing so would require so much interaction and study of each individual firm in order to calculate what changes in behavior would accomplish how much environmental improvement at what cost. *See* Bartlett & Bubb, *supra* note 37, at 472. Given that a standard managed fund pursuing just high risk-adjusted returns needs to know a great deal about which company in which it invests, it would appear organizationally possible for a fund promising to vote in a “green” way to gather such information. More likely the problem is an unwillingness on the part of investors to pay fees great enough to support such a staff. Also, the knowledge that is really need includes a lot of complexities about the whole economy. Taking carbon as an example, even if a was able to determine much carbon would be reduced for a given firm’s given deviation from share value, that is not necessarily the best externality to eliminate from a social welfare point of view. It may be better, for example, to push automakers to stop selling large gas powered SUVs than to push airlines to curtail intercontinental flights even when the measures involve similar reductions in share value. There are many close substitutes for providing personal transportation but not for providing fast intercontinental travel [↑](#footnote-ref-47)
48. The empirical evidence to date suggests that funds do not do a very good job at ascertaining how their investors wis their funds to vote. A study by Jonathan Zytnick, for example, finds very little correlation between investor preferences and fund voting. *See* Jonathon Zytnick, *Do Mutual Funds Represent Individual Investors?* (2021), https://papers.ssrn.com/abstract=3803690.Some commentators have suggested that corporations [↑](#footnote-ref-48)
49. *See* Bengt Holmstrom & Paul Milgrom, *Multitask Principal–Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J. Law. Econ. Org. 24 (1991). [↑](#footnote-ref-49)
50. *See, e.g.*, note 36 *supra* (discussing Engine No. 1’s proxy fight at Exxon Mobile). [↑](#footnote-ref-50)
51. Presently, state corporate law, at least as a default, only provides for a shareholder vote with respect to certain discrete matters, such as electing directors and some corporate acquisitions and does not provide for a shareholder that would bind the corporation with respect to specific business decisions, See, e.g., DGCL 211(b) (shareholder election of directors) & 251(c) (shareholder voting for a merger with another Delaware corporation). This could be amended to provide for such shareholder votes. For this change to be effective, there would also need to be an expansion of the scope of the federal rules concerning what shareholders can vote on by proxy. This would require revising what is excludable under Rule 14a-8(i)(7)’s ordinary business exclusion. *See* Amendments to Rules on Shareholder Proposals, Exchange Act Release No. 40018, 63 Fed. Reg. 29106, 29108 (1998), https://www.govinfo.gov/content/pkg/FR-1998-05-28/pdf/98-14121.pdf (“The policy underlying the ordinary business exclusion rests on two central considerations. The first relates to the subject matter of the proposal. Certain tasks are so fundamental to management’s ability to run a company on a day-to-day basis that they could not, as a practical matter, be subject to direct shareholder oversight. Examples include . . . decisions on production quality and quantity . . . . The second consideration relates to the degree to which the proposal seeks to ‘micro-manage’ the company by probing too deeply into matters of a complex nature upon which shareholders, as a group, would not be in a position to make an informed judgment.”). [↑](#footnote-ref-51)
52. *See* Hart & Zingales, *Shareholder Welfare*, *supra* note 42; Oliver Hart & Luigi Zingales, *The New Corporate Governance*, 1 U. Chi. Bus. L. Rev. 247 (2022) (hereinafter, *Corporate Governance*). [↑](#footnote-ref-52)
53. Interestingly, H&Z headline in the title of one of their articles that their proposed reform is one of promoting *shareholder welfare* maximization.  *See* Hart & Zingales, *Shareholder Welfare*, *supra* note 42. They, however, do not provide any normative justification for this why it is an important policy goal to maximize the welfare of this particular class of persons as opposed to trying to maximize the welfare of society as a whole. Nor do they explicitly recognize that the only way that their proposal would increase shareholder welfare is because of the empathetic pleasure that a firm’s shareholders would accrue from net reductions in Kaldor-Hicks inefficiencies. [↑](#footnote-ref-53)
54. This may seem like a modest benefit to cost ratio from eliminating an externality, thereby suggesting X could have an even smaller empathy factor and still favor the deviation. It should be noted, however, that the more glaring externalities are likely to already the targets of government regulation since on average the most political energy would be devoted to correcting them. [↑](#footnote-ref-54)
55. Note that as shareholder X’s equity interest increases, she needs to receive higher empathetic pleasure from elimination of the externality to support its elimination, all else equal. In the example above, it is therefore much less likely that a controlling shareholder or a shareholder of a closely held corporation will want to eliminate the externality. This point is the basis of Kahan and Rock’s observation that even if society somehow were able to rely on dispersed ownership firms to rectify social ills by leveraging their shareholders’ preferences to affect social change, that would at best be a partial solution because the shareholders of other important corporation types would not as readily follow suit. *See* Marcel Kahan & Edward Rock, *Corporate Governance Welfarism*, 15 J. Legal Analysis 108, 122-23 (2023). [↑](#footnote-ref-55)
56. In the H&Z model, if a shareholder is asked to vote on whether a corporation should engage in a behavior that will maximize share value but which, because the maximization would occur in the presence of some market imperfection, is not Kaldor-Hicks efficient, she will feel a sense of responsibility for that behavior. To the extent that she is an empathetic person, if the corporation deviates from that behavior so as to behave in a fashion that was less profitable but was Kaldor-Hicks efficient, she would enjoy some net pleasure since by definition the gainers gains would exceed losers’ losses. In deciding how to vote, she would weigh that net pleasure against her pro-rata share of the decline in share value. We find this sense-of-responsibility concept a little questionable since the likelihood that her vote will change anything is vanishingly small. Perhaps H&Z adopt it because the very existence of the vote would tweak each shareholder’s conscience. That though raises the interesting question of who would call for this conscience tweaking vote in the first place. We would find a more realistic assumption (and one that would not change the core of their results) to be that when an investor wants the corporation to change behavior, it is not because she is a shareholder. She would want it to change even if she were *not* a shareholder, indeed even more intensely. She is an empathetic person who, if she were not a shareholder, would unambiguously enjoy net pleasure if the corporation would change: the fact that the deviation results in a net gain to society means that the joy she would receive from the gainers’ gains would exceed the sadness she would feel for the losers’ losses. She *is* a shareholder, however. This means, on the one hand, that under the subject-broadening reform, she would be able to vote to have the corporation change, but, on the other, she will be one of the losers in terms of the resulting loss in share value. [↑](#footnote-ref-56)
57. For H&Z, the vicarious pleasure that people obtain from the elimination of an externality elimination is like a public good. Its cost is fixed and everyone enjoys it. The larger the group across which the fixed cost can be spread, the less is the burden among each of the persons paying and the thus the more likely to will be created. [↑](#footnote-ref-57)
58. *See* Bartlett & Bubb, *supra* note 37, at 475-76 & 481-82. [↑](#footnote-ref-58)
59. *See, e.g.*, Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. Pa. L. Rev. 2063, 2065 (2001). Roe suggests that changes to allow deviations from share value maximization undermine managerial accountability and raise agency costs by more readily allowing corporate managers to pursue their own personal agendas. These consequences would in turn would impair not just the interests of the corporation’s shareholders, but also the persons that deviations are supposed to benefit, and also undermine economic progress and social welfare more generally. [↑](#footnote-ref-59)
60. In addition, any social choice mechanism, including voting in either the public sphere and the corporate one, is subject to Arrow’s Impossibility Theorem, which shows that no social choice mechanism, i.e., any mapping of individual preferences to collective choice, can simultaneously satisfy a set of reasonable properties. Whether broadening the mandate as a supplement to public regulation ameliorates or aggravates the problem is worthy of further investigation. In this connection, seeGrant Hayden & Mathew Bodie *Arrow’s Theorem and the Exclusive Shareholder Franchise,* 62 Vand. L. Rev. 1217 (2009) (analyzing the shareholder vote in isolation, disputing that the theorem justifies shareholder primacy). [↑](#footnote-ref-60)
61. It should be noted, though, that a key reason why many tax scholars favor the corporate income tax is that it is an easier way to extract tax revenues from very wealthy people than taxing them directly, but this reasoning is subject to the same objection. [↑](#footnote-ref-61)
62. It might be argued that the redistribution motivated deviation from share value maximization would be in the form of goods or services that the corporation is particularly well suited to provide, whereas the alternative involves providing the beneficiaries cash. This argument, though, raises a variety of additional issues. One response would be that if the recipients instead receive cash but in fact want the service or good, the corporation would likely be perfectly happy to supply it at market prices in return for this cash. And if they would rather have some other product or service, they are better off with receiving cash. But there are, in turn, replies to this response. One is that no market accessible to the recipients may develop by which they would be able to acquire the service or good. Another is that the persons wishing the redistribution only wish to bestow on the less well off the corporation’s particular service or product, not cash. This reply, though, is yet in turn subject to questions concerning paternalism and why they could not buy the service or product to give to the beneficiaries. [↑](#footnote-ref-62)
63. *See* Hansmann, *supra* note 5. *See also* Eugene Fama, *Contract Costs and Financing Decisions*, 63 J. BUS. 571 (1990) [↑](#footnote-ref-63)
64. Merritt B. Fox & Menesh S. Patel, *Common Ownership: Do Managers Really Compete Less,* 39 Yale J. Reg. 136 (2022) [↑](#footnote-ref-64)
65. *See, e.g.*, José Azar, Martin C. Schmalz & Isabel Tecu, *Anticompetitive Effects of Common Ownership*, 73 J. Fin. 1513 (2018). [↑](#footnote-ref-65)
66. Richard Brealey, Stewart Meyers, & Franklin Allen, Principles of Corporate Finance (2023). [↑](#footnote-ref-66)
67. *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 Harv. L. Rev. 1161, 1174 (1981) (“[S]hareholders benefit even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover, and the process of reducing agency costs leads to higher prices for shares.”); *see also* Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. Fin. 737, 756 (1997). (“Takeovers are widely interpreted as the critical corporate governance mechanism in the United States . . . .”). [↑](#footnote-ref-67)
68. If a firm’s managers have already adopted a deviation that a majority of shareholders prefer, this same majority might be unwilling to sell to an acquirer that would end the deviation since they already indicated a willingness to give up some wealth to further another end. And the same consideration might make the takeover more expensive even if there only a minority of such shares since the aquiror may need to acquire a larger portion of the shares of the shareholders not favoring the deviation. On the other hand, if the shareholders favoring the deviation were not fully informed and hence underestimated the cost involved, the premium offer might make the true cost salient and that might be higher than they are willing to bear. [↑](#footnote-ref-68)
69. *See, e.g.,* Anat R. Admati & Paul Pfleiderer, *The “Wall Street Walk” and Shareholder Activism: Exit as a Form of Voice*, 22 Rev. Fin. Stud. 2645, 2647 (2009). [↑](#footnote-ref-69)
70. *See, e.g.*, Lawrence R. Glosten & Paul R. Milgrom, *Bid, Ask, and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders*, 14 J. Fin. Econ. 71, 72 (1985); Larry Harris, Trading and Exchanges: Market Microstructure for Practitioners 300 (2002). [↑](#footnote-ref-70)
71. *See* Merritt B. Fox, Lawrence R. Glosten & Gabriel Rauterberg *Informed Trading and Its Regulation,* 43 J. Corp. L. 817, 827 (2018) (professional traders who find no new information to justify a price change trade in the opposite direction). [↑](#footnote-ref-71)
72. The American Law Institute’s Principles of the Law, Corporate Governance: Analysis and Recommendations (ALI Corporate Governance Principles) describes the duty of care as follows: “A director or officer has a duty to the corporation to perform the director’s or officer’s functions in good faith, in a manner that [they] reasonably believe[] to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances.” Principles of the Law, Corporate Governance: Analysis and Recommendations § 4.01(a) (Am. L. Inst. 2005). [↑](#footnote-ref-72)
73. Rather than a negligence standard, Delaware courts generally apply a gross-negligence standard in evaluating director duty of care claims. *See, e.g.*, *McMullin v. Beran*, 765 A.2d 910, 921 (Del. 2000). This reflects the concepts behind the business judgment rule. The seminal case describing the logic of the business judgment rule is *Dodge v. Ford Motor Co.*,204 Mich. 459 (1919). [↑](#footnote-ref-73)
74. Of course, if a majority of shareholders wished a deviation from share value maximization in support of some social end and they either elected a board pledged to support that or, pursuant to a franchise broadening, voted specifically for such a change in behavior, the directors could include in the managers’ compensation packages some measure of how well the corporation was performing vis a vis this social goal. As noted earlier, however, doing so has its own problems. *See* II.C.2 *supra.*

    There are situations where there is shareholder vote relating to executive compensation, but it is not at all clear that where a majority of shareholders favor a deviation from share value maximization in furtherance of some other aim, they would be able to introduce into the managerial compensation package some kind of reward for furthering this end. For example, stock exchange rules require shareholder approval of equity compensation plans. *See* Intercontinental Exch., Inc., NYSE Listed Company Manual § 303A.08 (2021); NASDAQ, Inc., The NASDAQ Stock Market LLC Rules, Rule 5635. Also, tax considerations may prompt the board to put particular compensation plans to shareholder vote. *See* Charles M. Yablon, *Overcompensating: The Corporate Lawyer and Executive Pay*, 92 Colum. L. Rev. 1867, 1892 n.69 (1992). Further, shareholders can try to influence executive compensation indirectly, but the available mechanisms are blunt means for affecting corporate change. For example, the Dodd-Frank Act provided shareholders with the right to vote on executive compensation through a say-on-pay vote, but that vote is non-binding on the board and simply affords shareholders an up-or-down vote on the board-determined executive compensation program for certain top-level executives. *See* 17 C.F.R. § 240.14a-21. Consistent with the advisory role of the say-on-pay vote, scholars have yet to identify a clear empirical relationship between the outcome of a say on pay vote and the amount of executive compensation. *See, e.g.*, Jill E. Fisch, Darius Palia & Steven Davidoff Solomon, *Is Say on Pay All About Pay? The Impact of Firm Performance*, 8 Harv. Bus. L. Rev. 101, 102 (2018) (“Academic studies have reached inconsistent results about the effect of low say on pay votes but have generally failed to find conclusive evidence that issuers reduce executive pay packages in response to lower approval rates.”); *see also* Fisch et al., *supra*,at 107-109 (discussing empirical findings). For a discussion of other indirect mechanisms available to shareholders to affect executive compensation, see Randall S. Thomas & Kenneth J. Martin, *The Effect of Shareholder Proposals on Executive Compensation*, 67 U. Cin. L. Rev. 1021, 1043-55 (1999). [↑](#footnote-ref-74)
75. In 2023, over 75% of S&P 500 firms included ESG metrics in their executive compensation schemes. *See* Matteo *Tonello, ESG Performance Metrics in Executive Pay*, *Harvard Law School Forum on Corporate Governance* (2024), https://corpgov.law.harvard.edu/2024/01/15/esg-performance-metrics-in-executive-pay/. *See also* Adam B. Badawi and Robert P. Bartlett, *ESG Overperformance? Assessing the Use of ESG Targets in Executive Compensation Plans* (2024), https://papers.ssrn.com/sol3/papers.cfm?abstract\_id=4941016 (evaluating the use of ESG targets in executive compensation). [↑](#footnote-ref-75)
76. *See, e.g.*, Lucian Bebchuk & Roberto Tallarita. *The Perils and Questionable Promise of ESG-Based Compensation*, 40 J. Corp L. 37, 52 (2022) (finding that of the S&P 100 firms that include ESG metrics in their executive compensation schemes, “in most cases, ESG metrics account for only 1.5%–3% of the total CEO pay,” with the higher percentage outliers still only connecting a small fraction of CEO pay to ESG metrics). [↑](#footnote-ref-76)
77. Consider the findings in David I. Walker, *The Economic (In)significance of Executive Pay ESG Incentives*, 27 Stan. J. L. Bus. & Fin. 318, 334-38 (2022). As a rough approximation for how strongly ESG metrics incentivize firm managers to undertake ESG activities at the expense of share value, Walker calculates, for thirteen leading companies, the ratio of executives’ yearly ESG-linked compensation dollars to their “total incentive dollars,” which is comprised of executives’ stock, options, and bonuses granted in the current year, their stock and options grants from prior years that remain outstanding, and their holdings of their company’s shares. *See id.* at 322 & 337-38. Walker finds that the average ratio of ESG-based incentive dollars to total incentive dollars is just 1.1%, with the median ratio just 0.2%. *See id.* at 339. [↑](#footnote-ref-77)
78. *See also id.* at 321 (“The economics incentives to advance ESG goals created by these [executive pay schemes] are simply dwarfed by the incentives to maximize share value”). [↑](#footnote-ref-78)
79. *See* Michal Barzuza, Quinn Curtis & David H. Webber, The Millennial Corporation: Strong Stakeholders, Weak Managers, 28 Stan. J. L. Bus. & Fin. 255 (2023). [↑](#footnote-ref-79)
80. We discuss in footnote aspects of the analysis as it relates to the circumstance in which sacrificers’ preferences fall within the third category in Part I. [↑](#footnote-ref-80)
81. *See, e.g.*, Harry Markowitz, *Portfolio Selection*, 7 J. Fin. 77 (1952) (the utility an investor derives from an investment assumed to be determined solely the investment’s expected value and standard deviation); William F. Sharpe, *Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk*, 19 J. Fin. 425 (1964) (same). More recent financial economic models do envision circumstances in which investors might care about issuers’ social impact. *See, e.g.*, *infra* note 90. [↑](#footnote-ref-81)
82. This is obviously true of a broad-based index fund. It should also be true of a managed fund investing with the goal of achieving portfolio returns that, risk-adjusted, are superior to that of the market. Such a fund will still use diversification to reduce risk. Of course, to meet its goal of beating the market, it will need to deviate from being fully diversified when it buys what it perceives to be underpriced securities and sells or sells short what it perceives to be overprice securities. These deviations should cancel out over time, however, because it is similarly likely to identify overpriced securities as underpriced ones. [↑](#footnote-ref-82)
83. There is no reason to think that the events that prompted such an entity to divest would also reduce the portion of an institution’s portfolio that wishes to keep invested in public equities. [↑](#footnote-ref-83)
84. This is distinguished from unconstrained investing because the investor will not hold the shares of the issuer unless the firms in the industry have been affirmatively vetted as not offending the investors social concerns. [↑](#footnote-ref-84)
85. Consider, for instance, Arjuna Capital, which manages Arjuna 350, a domestic equity fund that follows a transformational approach. *See, e.g.*, Arjuna Capital, *350 Equity* (2024), https://arjuna-capital.com/s/Arjuna-Capital-350-Equity-Strategy-Fact-Sheet-2Q2024.pdf. The fund’s long term annualized return net of fees is similar to that of the S&P 500. *See* Arjuna Capital, *Historical Performance*, https://arjuna-capital.com/s/Arjuna-Capital-Global-350-Performance-Net-Gross-as-of-6302024-bn8z.pdf (since inception in November 2025, Arjuna 350’s annualized return net of fees was 12.3% and the S&P 500’s annualized return during that time was 12.9%). [↑](#footnote-ref-85)
86. A fund could avoid this problem by marketing itself as dedicated to engaging in transformational acquisition disclose that its risk-adjusted returns will be meaningfully below the expected return from a market-based index fund. We are not aware of any such fund, however, a fact which may suggest that most equity investors are not really willing to significantly trade off financial returns for socially beneficial corporate behavior. [↑](#footnote-ref-86)
87. In a proxy fight, an insurgent shareholder tries to secure proxies from the corporation’s other shareholders for the purpose of voting those shares in favor of one or more competing directors supported by the insurgent, who seeks to replace the incumbent directors. For discussion of the relevance of traditional proxy fights in shaping corporate governance and managerial incentives, seeLucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal. L. Rev. 1071, 1077-82 (1990). [↑](#footnote-ref-87)
88. *See* Part II.D, *supra.* [↑](#footnote-ref-88)
89. There may sometimes be a simultaneous effect working in the opposite direction. As noted in the text, some kind of public divestment or boycott campaign is often what prompts some persons or entities who had been holding a corporation’s stock to engage in negative identity investing and dispose of these shares. Others, though, decide not to sell. Among these shareholders, the campaign, though not prompting them to sell, raises their consciousness concerning the corporate behavior giving rise to the boycott and provides them with information. This may be sufficient to crystalize their preferences in favor of the corporation altering this behavior. Institutions that decide not to sell in the face of such a campaign often signal their sympathy with the need for the corporation to change, but say they will be more effective at doing so if the retain the shares and “engage” with management. There is some logic in this response. To the extent they have an opportunity to vote in accordance with their now crystalized preferences, they are likely to do so. Without the campaign, they might not have. Still, for a corporation whose shareholder base is buffeted by these divestment campaign crosswinds, we doubt the effect of the impact on voting of the crystalized preferences among the shareholders remaining will outweigh the loss of the votes by the shareholders who do sell. [↑](#footnote-ref-89)
90. For instance, a drop in a firm’s equity price would decrease managers’ stock-based compensation and increase the prospect of a proxy fight. [↑](#footnote-ref-90)
91. While we leave for future work analysis of sorting and price effects under different specifications of the economy’s profit sacrificers, it is worth noting here that the analysis will vary depending on the assumed preferences of those sacrificers. Most important, those preferences will influence the likelihood of investor sorting. For instance, suppose that instead of falling within the “market imperfection” category developed in Part I, profit sacrificers fall within the third category, that is, investors who want one or more firms to forgo share value maximization because those firms’ operations affect the investor in some way beyond just the receipt of residuals. As discussed in Part I, one driver of these preferences is the common ownership circumstance, in which some of a firm’s shareholders have a concurrent equity interest in one or more of the firm’s rivals and therefore prefer the firm abandon share value maximization in order to increase those rival firms’ profitability. Investor sorting may be very limited in this circumstance. The extensive common ownership we currently observe among publicly traded companies is largely the result of the dominance of large index funds. Because index funds base their buy and sell positions on replicating the composition of a particular market index, the funds’ very nature precludes the possibility that they will make their buying and selling decisions based on their profit sacrificing preferences. This will not necessarily be the case for other types of shareholders within the third category developed in Part I. Take another shareholder type within this category: shareholders who prefer that firms deviate from share value maximization because of the differential tax treatment of capital gains and dividends. More shareholder sorting can be expected in this circumstance than in the common ownership circumstance because of the findings of the literature on the clientele effect, which postulates and shows that investors make buy and sell decisions based on firms’ dividend policies. [↑](#footnote-ref-91)
92. This specification emulates the framework of models developed in the financial economics literature to evaluate the effect of a socially conscious shareholder base on asset prices. *See, e.g.*, Robert Heinkel, Alan Kraus & Josef Zechner, *The Effect of Green Investment on Corporate Behavior*, 36 J. Fin. & Quant Analysis 431 (2001) (modeling two investor types, where one type refuses to hold the shares of a subset of firms); H. Arthur Luo & Ronald J. Balvers, Social Screens and Systematic Investor Boycott Risk, 52 J Fin. & Quant. Analysis 365 (2017) (similar); Jonathan Berk & Jules H. van Binsbergen, *The Impact of Impact Investing* (2024), https://papers.ssrn.com/sol3/papers.cfm?abstract\_id=3909166 (similar). *See also* Oliver Davis Zerbib, *A Sustainable Capital Asset Pricing Model (S-CAPM): Evidence from Environmental Integration and Sin Stock Exclusion*, Rev. Fin. 1345 (2022) (modelling two investor types, where one type refuses to hold the shares of a subset of firms and holds the shares of every remaining firm but at an amount determined by the extent of the firm’s externality). [↑](#footnote-ref-92)
93. For more discussion of arbitrage in the context of impact investing, see Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value*, 44 J. Corp. L. 205, 217 (2018). [↑](#footnote-ref-93)
94. As the profit sacrificers reallocate their investment dollars to the non-polluting firms, the share prices of those firms might initially rise. [↑](#footnote-ref-94)
95. In order to isolate the effect of the divestiture, assume that all firms’ future cash flows are the same in expectation and have the same risk characteristics. [↑](#footnote-ref-95)
96. *See* Myron S. Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Price*, 45 J. of Bus. 179, 182 (1972) (“[T]he market will price assets such that the expected rates of return on assets of similar risk are equal. If any particular asset should be selling to yield a higher expected return due solely to the increase in the quantity of shares outstanding . . . investors seeing these profit opportunities would soon arbitrage them away”). [↑](#footnote-ref-96)
97. Of course, arbitrage may not operate so perfectly in actual markets. *See, e.g.,* Jeffrey Wurgler & Ekaterina Zhuravskaya, *Does Arbitrage Flatten Demand Curves for Stocks?*, 75 J. Bus. 583 (2002) (empirically showing that arbitrage can be hindered when stocks lack close substitutes). [↑](#footnote-ref-97)
98. There is an interesting circularity in the question of whether, at least as a large and enduring phenomenon, sorting will have a significant effect on corporate behavior through its effect on price. Suppose that despite sorting being widespread for a period of time, it was seen not have a sufficient effect, if any, on share price to meaningfully alter the behavior of the economy’s firms. Identity investing might decline as shareholders rationally question why they continued to sort when it had no effect on firm behavior. One reason, however, why this scenario might not play out, or at least not fully, is the possibility that many identity investors may gain inherent disutility simply by being associated with firms that operate in certain industries or engage in certain conduct and thus sort even in the absence of any casual linkage between their investment approach and changes in corporate behavior. [↑](#footnote-ref-98)
99. *See* Berk & Binsbergen, *supra* note 90. [↑](#footnote-ref-99)
100. *See also* *supra* note 90 (other similar models). [↑](#footnote-ref-100)
101. The ESG investors similarly will be over-weighted in the shares of the clean firms, but that apparently is a cost they are willing to bear due to their preferences. The non-ESG investors have no affirmative preference for dirty firms. [↑](#footnote-ref-101)
102. In addition to the correlation between dirty and clean stocks, the other parameters that determine the magnitude of the price effect in Berk and Binsbergen’s model are (i) the percentage that the dirty shares represent as a proportion of the total capitalization of the market of both dirty and clean shares; (ii) the ratio of the wealth of ESG investors and the wealth of other investors; and (iii) and the historical market risk premium over the safe asset. *See* Berk & Binsbergen, *supra* note 90, at 13. With respect to comparative statics, the price effect increases with the percentage of dirty shares, because non-ESG investors have limited wealth and must be further induced to purchase additional dirty shares. See id. at 14. There is also a positive relationship between the price effect and the ratio of the wealth of ESG investors and the wealth of other investors, as the latter term measures the relative influence of ESG investors. *See* Berk & Binsbergen, *supra* note 90, at 13. [↑](#footnote-ref-102)
103. Berk & Binsbergen, *supra* note 90, at 15. [↑](#footnote-ref-103)
104. *Id.* at 3. Under their baseline analysis, *see infra* note 103, and holding fixed all other parameters, ESG investors would need to make up more than 80% of all investable wealth for there to be a 1% increase in the cost of capital of dirty firms relative to clean firms. *See id.* at 3, 19. [↑](#footnote-ref-104)
105. As noted, in addition to the degree of risk substitutability, three other parameters govern the extent of the price effect in Berk and Binsbergen’s model. *See* note 100 *supra*. Berk and Binsbergen set the following parameter values in their baseline analysis: risk substitutability equal to 93%; percentage of dirty shares as a proportion of total market capitalization equal to 27%; ratio of wealth of ESG investors to other investors equal to 2%; and historical market risk premium of 6%. *See* Berk & Binsbergen, *supra* note 90, at 14-15. They derive the first two values using data from 2015 to 2020 and the third value using data from 2021. *See id.* at 14-15. Berk and Binsbergen conduct three other parametrizations of their model but the increase in the dirty firms’ costs of capital – and hence discount rate – caused by the divestiture does not exceed 11 basis points in any of those parameterizations. *See* Berk & Binsbergen, *supra* note 90, at 16-17. [↑](#footnote-ref-105)
106. Zerbib, *supra* note 90. In Zerbib’s model, ESG investors engage in sorting by both divesting the shares of a subset of firms and by weighting their equity holdings in the remaining firms by the extent of those firms’ negative externalities. *See id.* at 1351-52. [↑](#footnote-ref-106)
107. *See id.* at 1379. [↑](#footnote-ref-107)
108. *See id.* at 1375 (finding an 2.79% exclusion effect of the divested stocks over the period December 1999 to December 2006). [↑](#footnote-ref-108)
109. *See* Luo & Balvers, *supra* note 90, at 379 (estimating a 16% annualized factor risk premium for divested stocks); Heinkel, Kraus & Zechner, *supra* note 90, at 379 (under two different parameterizations, finding a difference of 5.6% and 13% in dirty firms’ cost of capital and clean firms’ cost of capital). [↑](#footnote-ref-109)
110. *See* Brealey, Myers & Allen, *supra* note 64, at 83. [↑](#footnote-ref-110)
111. Presumably, in the real world, there is not a light switch whereby a firm is either just clean or dirty. There are different degrees of dirtiness with more investors seeking to avoid holding the dirtier ones. Hence,relative to the discount rate for the clean firms, the discount rate penalty for the dirtier firms is bigger than for the less dirty ones. [↑](#footnote-ref-111)
112. *See, e.g.*, Paula Castro, Cristina Gutiérrez-López, María T. Tascón, Francisco J. Castaño, *The Impact of Environmental Performance on Stock Prices in the Green and Innovative Context*, 320 Journal of Cleaner Production 1 (2021). [↑](#footnote-ref-112)
113. While some argue that ESG funds do not actually offer investment exposure to ESG goals – i.e., are “greenwashing” – there are studies showing otherwise. *See, e.g.*, Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 Mich L. Rev. 393 (2021). [↑](#footnote-ref-113)
114. For an early and well-known argument in favor of mandatory social disclosure, see Cynthia A. Williams, *The Securities Exchange Commission and Corporate Social Transparency*, 112 Harv. L. Rev. 1197 (1999). [↑](#footnote-ref-114)
115. For an opposing point of view, based on the conclusion that the price effect from sorting is small, *see* Eleonora Broccardo, Oliver Hart & Luigi Zingales, *Exit Versus Voice*, 130 J. Pol. Econ. 3101, 3117-120 (2022). The article does not contend with the implementation costs of acting through a broadened franchise, however. [↑](#footnote-ref-115)
116. As discussed in the Introduction, assessing the efficiency and equity implications of a third such kind of fundamental change – adding to the electorate for choosing directors other corporate stakeholders beyond the shareholders – involves a whole other kind of analysis that is beyond the scope of this paper. [↑](#footnote-ref-116)
117. The history of the corporate purpose debate has been well-documented in the literature. *See, e.g.*, Dorothy Lund & Elizabeth Pollman, *Corporate Purpose*, in The Oxford Handbook of Corporate Law and Governance \_\_ (Jeffrey N. Gordon & Wolf-Georg Ringe eds. 2024); Stavros Gadinis & Amelia Miazad, *A Test of Stakeholder Capitalism*, J. Corp. L. 47, 59-62 (2021). [↑](#footnote-ref-117)
118. *See* Lund & Pollman, supra note 115. *See also* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439, 439 (2001) (“There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”). [↑](#footnote-ref-118)
119. It is perhaps for this reason that shareholder primacy is sometimes referred to as shareholder wealth maximization. *See, e.g.*, Lynn M. LoPucki, *The End of Shareholder Wealth Maximization*, 56 U.C. Davis L. Rev. 2017 (2023). Because shareholder primacy is based on the notion corporate activity should be directed at advancing the interests of the corporation’s shareholders, an alternative generalization of that theory of corporate purpose is that a corporation should endeavor to maximize *the welfare or utility* of its shareholders. *See, e.g.,* Hart & Zingales, *Shareholder Welfare*, *supra* note 42. As we noted earlier, however, Hart and Zingales do not provide any normative justification for this why it is an important policy goal to maximize the welfare of this particular class of persons as opposed to trying to maximize the welfare of society as a whole. *See supra* note 51 and accompanying text. [↑](#footnote-ref-119)
120. Part I.A *supra.* [↑](#footnote-ref-120)
121. *See, e.g.*, Lucian A. Bebchuk and Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 Cornell L. Rev. 91, 94 (2020). A share value maximizing corporation can also be constrained by the concerns held by actual and potential managers, employees, and customers, any of whom may refuse to do business or do it only less favorable terms if the corporation engages in a behavior with impacts they disapprove of. *See* I.A *supra.*  An obvious response to this perspective is that corporations’ significant influence on the political and legislative process enables them to shape regulation in their own favor, thereby precluding effective curative regulation*. See infra* note 123 and associated text. [↑](#footnote-ref-121)
122. For a classic statement of the position that income taxes and transfers are the best method for redistribution, *see* Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. Legal Studies 667 (1994). Issues of efficiency and equity can overlap where a corporation has market power in either an input or output market. The situation is complicated, however, by the fact that the prospect of greater than competitive prices can spur innovation. *See* note 21 *supra*. [↑](#footnote-ref-122)
123. *See, e.g.*, Colin Mayer, Prosperity: Better Business Makes the Better Good (2018); Lynn Stout, The Shareholder Value Myth (2012); Elhauge, note 39 *supra*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247 (1999). *See also* Martin Lipton, *Stakeholder Governance and the Eclipse of Shareholder Primacy*,

     *Harvard Law School Forum on Corporate Governance* (2022), https://corpgov.law.harvard.edu/2024/05/07/stakeholder-governance-and-the-eclipse-of-shareholder-primacy/; Leo E. Strine, Jr., *Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock*, Bus. Lawyer (2021), Another strand of the literature takes direct aim at the assumptions and implications of shareholder primary, rather than advocating for stakeholderism per se. *See, e.g.*, Frank Partnoy, *Shareholder Primacy is Illogical*, in Research Handbook on Corporate Purpose and Personhood 186 (E. Pollman & Robert B. Thompson, eds. 2021). For additional critiques of shareholder primacy, see Lynn A Stout, *Bad and Not-so-Bad Arguments for Shareholder Primacy*, 75 Cornell L. Rev. 1189 (2002). [↑](#footnote-ref-123)
124. Neither the literature nor popular commentary are uniform in their use of the term “stakeholderism.” *See* Lisa Fairfax, *Stakeholderism,* *Corporate Purpose, and Credible Commitment*, 108 Va. L. Rev. 1163, 1191 (2022) (“As an initial matter, the multitude of labels by which stakeholderism has been referred (ranging from stakeholder capitalism to Corporate Social Responsibility (“CSR”), Environmental, Social, and Governance (“ESG”), and sustainability) underscores a certain lack of clarity related to the theory’s meaning and contours.”). [↑](#footnote-ref-124)
125. *See, e.g.*, Jill Fisch, *The “Bad Man” Goes to Washington: The Effect of Political Influence on Corporate Duty*, 75 Fordham L. Rev. 1593, 1604-608 (2006) (describing how corporations actively participate in and affect the creation of the law to which they are subject). Indeed, it is this very political influence itself that has caused some scholars to champion a alternative ends approach to corporate purpose. *See, e.g.*,David G. Yosifson, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility after Citizens United*, 89 N.C. Law Rev. 1197 (2011). [↑](#footnote-ref-125)
126. *See* Business Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote “An Economy that Serves All Americans*,*”* (2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans (stating that the 181 signatories to the statement, “commit to lead their companies for the benefit of all stakeholders — customers, employees, suppliers, communities and shareholders”). Two years later, the Business Roundtable appeared to backpedal, explaining that its 2019 statement “is not a repudiation of shareholder interests in favor of political and social goals” and instead “reflects the fact that for corporations to be successful, durable and return value to shareholders, they must consider the interests and meet the fair expectations of a wide range of stakeholders in addition to shareholders.” *See* Business Roundtable, *Business Roundtable Statement on the Purpose of a Corporation, Two Year Anniversary* (2021), https://opportunity.businessroundtable.org/purposeanniversary. [↑](#footnote-ref-126)
127. Bebchuk & Tallarita, *supra* note 119. Fairfax, *supra* note 122, appears to be the only other analysis of the adoption question in the literature. In that article, Fairfax applies the theory of credible commitment to analyze whether there are significant obstacles to achieving stakeholderism. *See id.* A few other articles consider adoption issue but their focus is on other issues in the corporate purpose debate. *See, e.g.*, Dorothy S. Lund, *Corporate Finance for Social Good*, 121 Colum. L. Rev. 1617, 1619-21 (2021); Edward B. Rock, *For Whom is the Corporation Managed in 2020?*, *The Debate Over Corporate Purpose*, 76 Bus. Law. 363, 394 (2021); Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 Yale J. on Reg. 499, 504-505 (2020). [↑](#footnote-ref-127)
128. *See* Bebchuk & Tallarita, *supra* note 119, at 139.  Others have expressed a similar perspective. *See, e.g.,* Lund, *supra* note 125, at 1620-21; Rock, *supra* note 125, at 394; Lipton, *supra* note 125, at 505.

     [↑](#footnote-ref-128)
129. While the clean firms would also be maintaining a shareholder primacy perspective, this would not concern the socially concerned investors because the clean firms are not polluting. [↑](#footnote-ref-129)
130. Under a shareholder primacy perspective, a firm would advance stakeholder interests so long as that would also advance shareholder interests, but a stakeholder perspective values stakeholder interests for their own sake. One open question is the extent to which firm managers readily undertake conduct that in the first instance advances stakeholder interests but also would ultimately benefit the firm’s shareholders, including because it would increase long-term shareholder value. The notion of “enlightened shareholder value” or “ESV” concerns the circumstance where agency costs cause firm managers to not undertake conduct that would benefit stakeholders and, in the process, also would benefit shareholders. *See* Michael C. Jensen, Value Maximization, Stakeholder Theory, and the Corporate Objective Function, 12 Bus. Ethics Quarterly 235, 245-46 (2002). *See also* Virginia E. Harper Ho, *“Enlightened Shareholder Value”: Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. Corp. L. 59 (2009); Bartlett & Bubb, *supra* note 37, at 429-31; Dorothy S. Lund, *Enlightened Shareholder Value, Stakeholderism, and the Quest for Managerial Accountability*, in Research Handbook on Corporate Purpose and Personhood 91 (E. Pollman & Robert B. Thompson, eds. 2021). [↑](#footnote-ref-130)
131. *See, e.g.*, Bebchuk and Tallarita, *supra* note 119, at 119 (“Stakeholderists have largely avoided offering answers to these questions [regarding the specific stakeholder groups whose interests should be taken into account], or even a methodology for reaching such answers. Instead, supporters of pluralistic stakeholderism have largely dealt with these questions by assigning them to corporate leaders to resolve at their discretion”); Fairfax, *supra* note 122, 1191 (2022) (“There is . . . a decided lack of clarity with respect to the concerns and groups whose interests are to be pursued under stakeholderism”). [↑](#footnote-ref-131)
132. Stakeholder theorists envision directors as mediating stakeholder interests but do not provide a clearly implementable decision rule. *See, e.g.*, Blair & Stout, *supra* note 121, at 325 (“[C]orporate directors as mediating hierarchs enjoy considerable discretion in deciding which members of the corporate coalition receive what portion of the economic surplus resulting from team production. Although the board must meet the minimum demands of each team member to keep the coalition together, beyond that threshold any number of possible allocations among groups is possible.”). For critiques of stakeholderism based on the difficulty or impossibility of weighing and balancing of stakeholder interests, see, e.g., Stephen M. Bainbridge, *In Defense Of The Shareholder Wealth Maximization Norm: A Reply To Professor Green*, 50 Wash. & Lee L. Rev. 1423 (1993); Bebchuk and Tallarita, *supra* note 119, at 119-23 (discussing the difficulties of weighing and balancing of stakeholder interests). *But see* Colin Mayer, *Shareholderism Versus Stakeholderism – a Misconceived Contradiction. A Comment on “The Illusory Promise of Stakeholder Governance” by Lucian Bebchuk and Roberto Tallarita*, 106 Cornell L. Rev. 1859, 1865-67 (2020) (responding to critique of stakeholderism based on the weighing and balancing of stakeholder interests). [↑](#footnote-ref-132)
133. Fiduciary duties are typically articulated as just advancing the interests of the corporation and its shareholders. *See, e.g.*, *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) (“[D]irectors owe fiduciary duties of care and loyalty to the corporation and its shareholders.”), but they could be broadened by the courts or the legislature (as some did with constituency statutes) to allow the consideration of other ends. This would more readily allow managers to further stakeholder interests without the threat of litigation based on alleged violations of their fiduciary duties. It is unclear how much difference this would make in any event. Even in the absence of a broadened articulation of managers’ fiduciary duties, the business judgment rule affords corporate managers the ability to advance stakeholder interests in certain circumstances without judicial scrutiny. *See, e.g.*, Elhauge, note39 *supra*, at 763-69; Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 Vand. L. Rev. 1, 77-81 (2022). [↑](#footnote-ref-133)
134. State corporate law could be reformulated so that non-shareholder stakeholders are also given the right to vote in corporate elections. *See, e.g.*, McDonnell, *supra* note 13. They could be guaranteed seats on the board. For example, in Germany, a certain percentage of the board seats of publicly traded corporations with over 500 employees must be held by employee representatives. *See, e.g.*, Irene Bucelli, Silvia Gatti & Federica Soro, *Worker Participation: Employee Ownership and Representation, Harvard Law School Forum on Corporate Governance* (2020), https://corpgov.law.harvard.edu/2020/01/23/worker-participation-employee-ownership-and-representation/. Legislation could be enacted that obligates corporate managers to consider the interests of all stakeholders when making a business decision. For example, Senator Warren’s “Accountable Capitalism Act” would require large corporations to obtain a federal charter that obligates their directors to “consider the interests of all corporate stakeholders” *See* Sen. Elizabeth Warren, Warren Introduces Accountable Capitalism Act (2018), https://www.warren.senate.gov/newsroom/press-releases/warren-introduces-accountable-capitalism-act. So-called constituency statutes, which have been enacted by many states but not Delaware or California, broadened the interests that corporate directors may consider when assessing the corporation’s best interests. *See, e.g.*, Minn. Stat. § 302A.251, Subd. 5 (“In discharging the duties of the position of director, a director may, in considering the best interests of the corporation, consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation.”). For a discussion of constituency statutes, see Michal Barzuza, *The State of State Antitakeover Law*, 95 Va. L. Rev. 1973, 1995-97 (2009). The obligations of directors would then be similar to the obligation imposed on the managers of public benefit corporations. Directors of public benefit corporations are required to take stakeholder interests into consideration, *see, e.g.*, DGCL§ 365(a) (“The board of directors [of a public benefit corporation] shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation’s conduct, and the specific public benefit or public benefits identified in its certificate of incorporation”), though some have argued that this legal requirement has not caused publicly-traded public benefit corporations to materially abandon the shareholder primacy model. *See* Jill E. Fisch & Steven Davidoff Solomon, *The “Value” of a Public Benefit Corporation*, in Research Handbook on Corporate Purpose and Personhood 68 (E. Pollman & Robert B. Thompson, eds. 2021). Finally, corporate governance reforms might alter managerial incentives in a manner that better promotes stakeholderism, for instance by better tying managerial compensation to stakeholder outcomes. *See* notes 73-76 *supra* and associated text. [↑](#footnote-ref-134)