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ESG'S DEMOCRATIC DEFICIT: WHY CORPORATE GOVERNANCE CANNOT PROTECT STAKEHOLDERS

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ABSTRACT

The environmental, social, and governance (ESG) movement has garnered significant attention over the past several years. This movement generally purports to focus on addressing the interests of all corporate stakeholders, such as employees, customers, the environment and the public at-large, rather than focusing solely on shareholder value. To accomplish this goal, proponents of ESG contend that corporate governance provides the best mechanism. However, this Note argues that such an approach would be detrimental. Corporate governance is a body of law and standards were created first and foremost to provide protections for shareholders vis-à-vis corporate managers; whereas, the government created distinct bodies of law to provide protection for other stakeholder groups vis-à-vis the corporation. In attempting to channel safeguards for every stakeholder group through a body of law intended to address only one such relationship, proponents of ESG are enabling a system of "self-regulation" for corporations that is both unproductive and undemocratic. Instead of outsourcing such a fundamental responsibility to shareholders and corporate boards, the government should step in to directly address the growing set of ESG issues that demand immediate attention.

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INTRODUCTION

IN the midst of growing public resentment towards big business in the United States, newly elected President Theodore Roosevelt addressed a joint session of Congress in his 1901 State of the Union.[1] Foreshadowing the trust-buster moniker for which he later became known, President Roosevelt illuminated his position towards the growing concentration of economic power among large corporations.[2] He explained:

> Great corporations exist only because they are created and safeguarded by our institutions; and it is therefore our right and our duty to see that they work in harmony with these institutions. . . .Therefore, in the interest of the whole people, the Nation should . . . assume power of supervision and regulation over all corporations . . . .[3]

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1 President Theodore Roosevelt, First Annual Message (Dec. 3, 1901), https://www.presidency.ucsb.edu/documents/first-annual-message-16; *see* Leroy G. Dorsey, *Theodore Roosevelt and Corporate America, 1901-1909: A Reexamination*, 25 PERCEPTIONS OF THE PRESIDENCY 725, 726–27 (1995).

2 *See Roosevelt and the Trusts*, OH. ST. UNIV. DEP'T HIST., https://ehistory.osu.edu/exhibitions/1912/trusts/roosevel (last visited Nov. 19, 2022).

3 President Theodore Roosevelt, *supra* note 1.

In the years that followed, President Roosevelt would utilize various mechanisms available to the federal government in order to curb market abuses by corporations.[4] When President Roosevelt's presidency ended in 1909, the United States had made significant progress towards rebalancing the relationship between corporations and the public at-large. Such a role for the federal government remains essential to this day. However, recent efforts among prominent private sector actors, which on their surface appear focused on making corporations behave more responsibly, threaten to shift the balance of power significantly towards corporations at the expense of the interests of corporate stakeholders and the public at-large.

At the turn of the 19th century, corporations were largely unregulated in the United States.[5] While, at the founding, corporations were subject to close scrutiny at the state level, state governments were stripped of their primary means of controlling corporations after a Supreme Court decision in 1819 held that the state legislatures did not have an absolute right to amend or repeal corporate charters.[6] As a result, corporations became progressively more powerful, culminating in the "Gilded Age" of the 1870s to 1900s, an era characterized by high concentrations of wealth, abject poverty, and inequality.[7] In response to the widespread public discontent that followed, the government passed sweeping market reform legislation, such as the Sherman Anti-Trust Act, aimed at protecting consumers and other market participants.[8] In doing so, the federal government carved out its role of protecting the public from the excesses of corporations by creating and strengthening distinct areas of law governing relationships of the corporation with specific stakeholder groups. This approach, consistent with the public interest theory of regulation, continued into the ensuing decades.[9] For example, in the wake of the Great Depression, the National Labor Relations Act created the framework for

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[4] *See* Laura Phillips Sawyer, *US Antitrust Law and Policy in Historical Perspective* 7–8 (Harv. Bus. Sch., Working Paper No. 19-110, 2019).

[5] *See* Susan Pace Hamill, *From Special Privilege to General Utility: A Continuation of Willard Hurst's Study of Corporations*, 49 AM. U. L. REV. 81, 112–13 (1999).

[6] Robert E. Wright, *For- and Non-Profit Special Corporations in America, 1608-1860*, *in* RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW 480, 490 (Harwell Wells ed., 2018); Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518, 675–77 (1819).

[7] *See* JACK BEATTY, AGE OF BETRAYAL: THE TRIUMPH OF MONEY IN AMERICA, 1865–1900 (2007).

[8] Sherman Act, Pub. L. No. 108-237, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§1-7); *see* Dorsey, *supra* note 1, at 726-27.

[9] Michael Hantke-Domas, *The Public Interest Theory of Regulation: Non-Existence or Misinterpretation*, 15 EUR. J.L. & ECON. 165, 165–66 (2003); *see also* George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3, 3 (1971); Richard A. Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335, 335–36 (1974).

federal labor law that provided improved safeguards for employees,[10] and the Chandler Act significantly reformed bankruptcy law to provide greater protections for creditors.[11] Likewise, as a result of the social movements of the 1960s, the government passed monumental legislation such as the Civil Rights Act of 1964, which forbade employers from discriminating against protected classes in hiring, promoting, and firing,[12] and the National Environmental Policy Act, which established federal environmental law to limit the negative effects of corporations on the environment.[13] These examples demonstrate the crucial role that the federal government played and continues to play in establishing the rules of the game for corporate relationships with stakeholders.

In parallel with the bodies of law developed by the federal government to protect key stakeholder groups, a separate and distinct body of law developed to govern the internal affairs of the corporation and, specifically, the relationship between shareholders and corporate directors and managers. Inherent to the corporate form is the separation of ownership and control, whereby management power is delegated from shareholders, the owners of the corporation, to directors and managers, who run the day-to-day activities of the business.[14] This separation raises the potential for agency problems, in which corporate managers, the agents, neglect their duties or behave self-interestedly to the detriment of shareholders, the principals.[15] In order to address these problems, which have plagued corporations since their inception, an apparatus referred to as corporate governance law took shape.[16] Included in this body of law are state regulations, which provide the general architecture for corporate governance and create liability for directors and mangers when they disregard their duties, and federal regulations, which focus on disclosure of material information in order to avoid information asymmetries between directors and mangers on the inside and shareholders and potential investors on the

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10 National Labor Relations Act of 1935, Pub. L. No. 74–198, 49 Stat. 449 (codified as amended 29 U.S.C. § 151–169).

11 Bankruptcy Act of 1938 (Chandler Act), Pub. L. No. 75–696, 52 Stat. 840.

12 Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (codified as amended 42 U.S.C. § 1971 et seq. (2006)).

13 National Environmental Policy Act of 1969, Pub. L. No. 91–100, 83 Stat. 852 (codified as amended 42 U.S.C. § 4321 et seq.).

14 *See* John Armour et al., *Agency Problems and Legal Strategies*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 29 (Reinier H. Kraakman et al. eds., 3d ed. 2017).

15 *Id.* at 29-30.

16 *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 311 (T. Nelson & Sons 1852) (1776) (discussing agency problems in early corporations); *infra* notes 45–47 and accompanying text.

outside.[17] Furthermore, securities exchanges promulgate rules that protect shareholder interests while institutional investors, asset managers, and proxy managers collaborate to establish corporate governance standards and engage with corporations to encourage their adoption.[18] Together, these sources constitute the framework for corporate governance which is focused – first and foremost – on managing the relationship between shareholders and corporate managers. Thus, corporate governance facilitates a system through which shareholders and corporate managers work together to create long-term value for shareholders. Meanwhile, the government enables shareholders and managers to pursue this goal so long as they are compliant with the distinct bodies of law created to provide protection to specific stakeholder groups.

The growing traction of the environmental, social, and governance (ESG) movement threatens to obscure this system.[19] The ESG movement generally purports to be concentrated on compelling corporations to behave more responsibly towards stakeholders.[20] Driven mainly by prominent private sector actors such as BlackRock and the Business Roundtable, the ESG movement advocates for a business environment in which corporations "are truly committed to meeting the needs of all stakeholders" and "[the] economy serves all Americans."[21] While on the surface such goals suggest a fundamental change of the purpose of corporations, which have historically focused on creating long-term shareholder value, a closer look at the strategies employed the biggest proponents of ESG demonstrates otherwise.[22]

Instead of deferring to the institutions and procedures traditionally tasked with protecting stakeholder interests when the market fails to provide satisfactory solutions, proponents of ESG claim that corporate governance is the best mechanism available to solve the most pressing stakeholder issues. Central to this argument is the idea that stakeholder risks are investment risks

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17 Adam O. Emmerich et al., *United States*, *in* THE CORPORATE GOVERNANCE REVIEW 409, 409 (Willem J. L. Calkoen ed., 8th ed. 2018).

18 *Id.* at 409-12, 415-16.

19 For a typical overview of ESG, see *ESG 101: What is Environmental, Social and Governance?*, MSCI, https://www.msci.com/esg-101-what-is-esg (last visited Apr. 26, 2022).

20 *See, e.g.*, Letter from BlackRock's Glob. Exec. Comm. to BlackRock's Clients (Jan. 14, 2020), https://www.blackrock.com/corporate/investor-relations/2021-blackrock-client-letter (introducing "[s]ustainability as BlackRock's New Standard for Investing").

21 *Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans (last visited Mar. 5, 2023).

22 Judd F. Sneirson, *The History of Shareholder Primacy, from Adam Smith Through the Rise of Financialism*, *in* CORPORATE LAW, CORPORATE GOVERNANCE AND SUSTAINABILITY 73, 73–74 (Beate Sjafjell & Christopher M. Bruner eds., 2019).

and, therefore, serving all stakeholders will serve shareholders best.[23] Therefore, since corporate governance is concerned with shareholder interests, corporate governance provides the apparatus to successfully address stakeholder interests, as well. In tasking a system that is intended only to manage the relationship between shareholders and managers with the responsibility of determining the necessary safeguards for every corporate stakeholder relationship, the ESG movement would upend the current system and create a situation in which the private sector is trusted with regulating itself. In addition to the lack of incentivize corporate managers have to pursue stakeholder focused strategies, such a system would be detrimental from both a regulatory and democratic perspective.[24]

First, as demonstrated throughout US regulatory history, there are distinct bodies of law that govern corporate relationships with specific stakeholder groups.[25] In line with the public interest theory of regulation, when the private sector fails to provide adequate protections for stakeholders, it should be the government that steps in to do so.[26] In suggesting that corporate governance is better equipped to provide such protections, the ESG movement is promoting the ability of private markets to determine their own standards in relation to stakeholder groups, without the need for government intervention. Therefore, the ESG movement appears to be more aligned with a competing theory of regulation, known as the economic theory of regulation.[27] The economic theory of regulation contends that markets and private orderings are better able to provide protections for stakeholders than government regulation, since government regulators are incompetent and corrupt and so would only make things worse.[28] Closely associated with this theory is the shareholder primacy model, which holds that shareholders should maximize shareholder value.[29] Ironically, these are the exact theories that the ESG movement explicitly claims

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23 *See, e.g.*, Letter from Larry Fink, Chairman & Chief Exec. Officer, BlackRock, to CEO (Jan. 14, 2020), https://www.blackrock.com/corporate/investor-relations/2020-larry-fink-ceo-letter ("Larry Fink's 2020 letter to CEOs" on "[a] [f]undamental [r]eshaping of [f]inance").

24 Lucian A. Bebchuk et al., *For Whom Corporate Leaders Bargain*, 94 S. CAL. L. REV. 1467, 1470-72 (2021).

25 *See infra* Section I.B.2.

26 *See supra* notes 8-9 and accompanying text.

27 *See* Andrei Shleifer, *Understanding Regulation*, 11 EUR. FIN. MGMT. 439, 440–42 (2005). R.H. Coase provides a broad assault on regulation from this perspective in *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). For specific critiques of the public interest theory of regulation from the perspective of proponents of the economic theory of regulation, see Posner, *supra* note 9 and Stigler, *supra* note 9.

28 Shleifer, *supra* note 27, at 440.

29 Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 252–53 (1999).

it is fighting against.[30] Thus, it indicates more accurately that the ESG movement is using the guise of stakeholderism to prevent the government from the regulations that would result in the government assuming its proper role of protecting stakeholder interests.[31]

Second, tasking corporate governance with determining what are essentially public policy objectives presents concerning issues of democratic legitimacy. According to the system advocated for by proponents of the ESG movement, shareholders are able to determine what is best for stakeholders, and corporate governance activities are capable of enforcing these standards among the thousands of corporations active in the United States. However, in addition to being cumbersome and convoluted, this is a task that is intended for a democratically elected government, the characteristics of which shareholders and boards of directors do not share. Most importantly, shareholders are not representative of the public, as they are skewed significantly by age, wealth, and race.[32] And, relatedly, engaging in corporate governance requires buying enough shares to impact the system, which almost always requires excessive amounts of capital, creating a significant barrier to entry and inequality in voting power.[33] Therefore, effective participation and voting equality, two fundamental attributes of a democratic system, are entirely absent from corporate governance.[34] As a result, expecting corporate governance to address the interests of the public and subsequently prescribe the appropriate safeguards for stakeholders would be highly problematic from a democratic perspective. Therefore, such a strategy should not be pursued.

This Note argues that stakeholder objectives cannot be addressed through corporate governance, as is advocated by the ESG movement. Instead, the most pressing stakeholder issues facing the United States and the global community require comprehensive government action in the bodies of law specifically created to provide stakeholder protections. This Note adds to existing literature on the topic of ESG by assessing the topic from the

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30 *See, e.g.*, Colin Mayer et al., *50 Years Later, Milton Friedman's Shareholder Doctrine is Dead*, FORTUNE (Sept. 13, 2020, 5:00 AM), https://fortune.com/2020/09/13/milton-friedman-anniversary-business-purpose/.

31 *See* Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 168–73 (2020).

32 Tim Smart, *Who Owns Stocks in America? Mostly, It's the Wealthy and White*, US NEWS & WORLD REP. (Mar. 15, 2021), https://www.usnews.com/news/national-news/articles/2021-03-15/who-owns-stocks-in-america-mostly-its-the-wealthy-and-white#.

33 *See* Franklin A. Gevurtz, *The Yin and Yang of Corporations and Democracy*, NE. U. L. REV. 25-26 (forthcoming 2022).

34 *See* Robert A. Dahl, *What Political Institutions Does Large-Scale Democracy Require?*, 120 POL. SCI. Q. 187, 193–95 (2005).

perspective of the broader regulatory environment. To this point, the legal literature on ESG has largely remained siloed within corporate governance law without a more wholistic analysis of corporate governance law in relation to other bodies of law, which is essential to understanding certain fundamental issues with the ESG movement. Part I discusses the evolution of the regulatory environment in which corporations operate, with specific attention to corporate governance law from the perspective of agency theory. Part II explains the corporate governance strategies proposed by the ESG movement to address stakeholder issues and presents an argument as to why such strategies would run counter to regulatory theory and democratic values. Finally, Part III advocates for comprehensive government action to adequately address stakeholder interests.

I. A PRINCIPAL-AGENT ANALYSIS OF CORPORATE GOVERNANCE

A. Historical Context

1. Origins

The most appropriate starting point for the origins of the corporation and its governing law is the sixteenth century and the emergence of the chartered company. Chartered companies, organized as joint-stock companies, were created for the purpose of financing trade and exploration.[35] Unlike corporations of today, these companies were willed into existence via royal charters, a largely political process by which monarchs granted corporations exclusive rights to trade in a particular area of the world.[36] Accordingly, these early corporations straddled the line between the public and private sectors.

The joint-stock company had significant advantages in the context of exploration and trade, especially when compared to partnerships, the only organizational alternative at the time.[37] However, the speculative nature of

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35 JOHN MICKLETHWAIT & ADRIAN WOOLRIDGE, THE COMPANY: A SHORT HISTORY OF A REVOLUTIONARY IDEA 17–18 (2003).

36 *See id.*; Philip J. Stern, *The Corporation in History*, *in* THE CORPORATION: A CRITICAL, MULTI-DISCIPLINARY HANDBOOK 21, 26 (Grietje Baars & Andre Spicer eds., 2017) ("[C]harters remained, in a sense, an act of dispensation granted through a political rather than administrative process, and not the product, like a partnership, of simply a contract among private individuals. Legally speaking, incorporation was a royal prerogative not a subject's right . . . .").

37 *See* Stern, *supra* note 36, at 25; *see also* John Armour et al., *What is Corporate Law?*, *in* THE ANATOMY OF CORPORATE LAW, *supra* note 14, at 1, 6 (describing the key characteristics of corporations that distinguish them from other business entities).

these early corporations had serious repercussions for their investors.[38] Because the corporation was an entirely new vehicle for pursuing a business venture, there were no formal institutional safeguards. Rather, the only public oversight to which corporations were subject was the ad-hoc intervention by the monarch.[39] This made investors highly susceptible to fraud. As a result, some of the most infamous market frenzies occurred during this period on account of the actions of corporations and their directors.[40] For example, in 1720, the Mississippi Company collapsed after efforts by the company's director to inflate its stock price resulted in a speculative rage that decimated the French economy.[41] The Mississippi Bubble, as it is now known, was one of the biggest financial crashes in history, surpassing even the Great Depression of the 1930s.[42] This and similar events in England resulted in widespread criticism of the corporate form which severely damaged its reputation.[43] In the ensuing decades, many reformers criticized the joint-stock company as dangerous and old-fashioned, citing the aforementioned bubbles as proof of the failed concept.[44] One such critic was Adam Smith.

In *The Wealth of Nations*, Smith levelled his own criticisms against corporations. Most significantly, Smith identified the agency problem inherent

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38 *See* MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 28 (describing early joint stock companies as "instruments of rampant financial speculation").

39 Stern, *supra* note 36, at 27 (describing the common practice among monarchs of attacking the validity of early corporations by accusing them of failing to live up to the terms of their charters or questioning the very validity or origin of the charter itself).

40 *See id.*

41 *See* MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 28-31.

42 *Id.*

43 Stern, *supra* note 36, at 27. A comparable scheme was employed by the directors of England's South Sea Company, which swindled thousands of English investors out of their money in what is referred to as the South Sea Bubble, another crash of historical proportion. *See* MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 31-33. The South Sea Bubble and the Mississippi Bubble were the result of similar tactics employed by directors of the respective corporations at the root of each of these crises. Regarding the overall scheme, both combined a monopoly trading franchise organized as a corporation. They also used similar marketing techniques including orchestrated newspaper hype, lending on margin, share subscriptions on generous instalment terms, and a degree of share price manipulation involving a succession of new issues at ever higher valuations. Finally, the various investment techniques, involving forward and option contracts as well as spot transactions, were similar. *See also* RICHARD DALE, THE FIRST CRASH: LESSONS FROM THE SOUTH SEA BUBBLE 40-46, 70-80 (2004). As corporations were essentially unregulated, there was nothing stopping these corporations from engaging in these harmful activities. For a detailed account of the Mississippi and South Sea Bubbles, which are described as the first "macro bubbles," *see generally* PETER M. GARBER, FAMOUS FIRST BUBBLES: THE FUNDAMENTALS OF EARLY MANIAS 85–123 (2000).

44 *See, e.g.*, MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 33-36.

to the corporate form. According to Smith, hired managers would not bring the same vigilance to the company's interests as an owner-manager (as in the case of a partnership or sole proprietorship) would.[45] Smith was so pessimistic about the diverging interests between owners and managers that he believed that the corporation would eventually die off.[46] While, as we know, Smith's prediction did not come to fruition, his recognition of the agency problem among shareholders and managers remains central to rules governing corporations today.

2. Corporations in the United States

When the corporate form migrated to the United States, the government – more specifically, the state legislatures – maintained the power to grant corporate charters to business enterprises.[47] Corporate charters were utilized in a number of specific areas considered vital to the development of the new country. For example, early states granted charters and monopoly rights to corporations to construct and administer universities, banks, churches, canals, and roads.[48] As is evident by these examples, corporations during this period were deployed for business activities characterized by their public interest orientation. This is not to suggest that corporations were akin to non-profit organizations; rather, it demonstrates that governments permitted businesses to utilize the corporate form and its subsequent opportunity for private gain

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45 SMITH, *supra* note 16, at 311 ("The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company."). Smith discusses chartered companies in detail on pages 311–319.

46 *See id.* at 318 ("The joint stock companies, which are established for the public-spirited purpose of promoting some particular manufacture, over and above managing their own affairs ill, to the diminution of the general stock of the society, can, in other respects, scarce ever fail to do more harm than good."). However, it is important to note that the views of early liberal observers like Smith were heavily influenced by the violence and monopoly rights associated with early corporations, which separated them from the modern, relatively less political, free-trade-oriented corporations of today. *See* Pepjin Brandon, *Between Company and State: The Dutch East and West India Companies as Brokers between War and Profit*, *in* THE CORPORATION, *supra* note 36, at 215, 215.

47 Wright, *supra* note 6, at 176.

48 MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 49.

only where the object of such enterprises also aligned with the government's interest.[49]

However, in time, the relationship between corporate charters and the public interest began to wane. This was due to a confluence of factors, the first being legal. Most significantly, in 1819, the Supreme Court issued a ruling regarding the status of Dartmouth College, in which it held that corporations possessed private rights and so states could not rewrite their charters capriciously.[50] As a result, the decision removed the primary mechanism by which state governments exercised regulatory control over corporations. The second factor was political. Because of the relatively heavy and uncertain involvement of the state in the activities of corporations, businesspeople during this period overwhelmingly preferred partnerships and sole proprietorships. In response, some state recognized a potential opportunity to generate new business and began loosening their control over corporations.[51] Most notably, in 1837, the Connecticut legislature passed a law permitting businesses in many different industries, regardless of any public interest assessment, to incorporate without the need for a special charter. Other states reluctantly followed suit.[52] Finally, the third factor was economic. As the United States grew, certain

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49 This point is illustrated by an 1808 Virginia Supreme Court decision which stated that: "[Corporations] ought never to be passed, but in consideration of services to be rendered to the public . . . . It may be often convenient for a set of associated individuals, to have the privileges of a corporation bestowed upon them; but if their object is *merely* private or selfish; if it is detrimental to, or not promotive of, the public good, they have no adequate claim upon the legislature for the privilege." Currie's Adm'rs. v. Mut. Assurance Soc'y, 14 Va. (4 Hen. & M.) 315, 437–48 (Va. 1809) (emphasis added). In other words, as long as the government considers an enterprise to be promotive of the public good, the individuals to which the corporation is chartered are free to pursue their own private or selfish desires for profit.

50 Trs. of Dartmouth Coll. v. Woodward, 17 U.S. 518 (1819).

51 MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 52. This factor forms the foundation of the most developed evolutionary model explaining the development of corporate law in the U.S., referred to as the horizontal (state versus state) regulatory competition model, also referred to as the "race to the bottom." Amitai Aviram, *Evolutionary Models of Corporate Law*, *in* RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW, *supra* note 6, at 596, 606–11.

52 While states gave up chartering by special legislative act, they countered by instituting other regulations. For example, states typically limited the amount of capital a corporation could assemble; restricted the scope of corporate powers and purposes; limited the duration of a corporation from a period generally ranging from 20 to 50 years; placed limits on indebtedness; prohibited holding of stock in other corporations; and gave shareholders the power to remove directors at will and exercise broad veto power over proposed transactions. Lyman Johnson, *Corporate Law and the History of Corporate Social Responsibility*, *in* RESEARCH HANDBOOK ON THE HISTORY OF CORPORATE AND COMPANY LAW, *supra* note 6, at 570, 581.

businesses could be adequately capitalized only via the corporate form.[53] This was especially true of the railroad industry, which required immense amounts of capital and, consequently, induced widespread use of the corporate form.

These changes in incorporation rules led to the emergence of "big business" in the United States.[54] This was the era of the infamous robber barons, including the likes of Andrew Carnegie, J.P. Morgan, Cornelius Vanderbilt, and John D. Rockefeller. And, while corporations were making America richer,[55] the new structure of the economy faced significant backlash, particularly in regards to labor and monopoly.[56] For instance, in response to concerns over the enormous power and wealth concentrated among the country's largest corporations, Congress passed the Sherman Act in 1890.[57] Furthermore, after decades of battles (quite literally[58]) between corporations and labor unions, in 1914, the Wilson administration granted unions immunity from antitrust suits;[59] and, in 1916, Congress passed a series of bills that restricted working hours and child labor.[60] In effect, the federal government established novel and distinct bodies of federal law, regulating corporations specifically, that would ensure that these increasingly powerful entities would

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53 MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 64–67; *see* MATTHEW JOSEPHSON, THE ROBBER BARONS: THE GREAT AMERICAN CAPITALISTS, 1861-1901, at vii–viii (1934) (describing this era as "the paradise of freebooting capitalists, untrammeled and untaxed").

54 *See* MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 61–82.

55 LEON FINK, THE LONG GILDED AGE: AMERICAN CAPITALISM AND THE LESSONS OF A NEW WORLD ORDER 3–4 (2015). Though, as observed by Matthew Josephson, "[a]ll of this was achieved in a climactic quarter-century of our industrial revolution, with much haste, much public scandal, and without plan – under the leadership of a small class of *parvenus*." JOSEPHSON, *supra* note 53, at vii–viii.

56 MICKLETHWAIT & WOOLRIDGE, *supra* note 35, at 75–78.

57 Sherman Act, Pub. L. No. 108-237, 26 Stat. 209 (1890) (codified as amended 15 U.S.C. §§1-7); *see* William H. Page, *The Ideological Origins and Evolution of U.S. Antitrust Law*, *in* 1 ISSUES IN COMPETITION LAW AND POLICY (ABA Section of Antitrust Law 2008) (discussing the Sherman Act as partly a rejection of the view that government can never improve market outcomes by direct intervention).

58 *See Labor Wars in the U.S.*, PBS, https://www.pbs.org/wgbh/americanexperience/features/theminewars-labor-wars-us/ (last visited Apr. 19, 2022).

59 Clayton Antitrust Act of 1914, Pub. L. No. 108-237, 38 Stat. 730 (codified as amended 15 U.S.C. § 12-27).

60 Adamson Act of 1916, Pub. L. No. 64-252, 39 Stat. 721 (1916) (current version at 49 U.S.C. §§ 28301, 28302) (establishing an eight-hour workday with additional pay for overtime work for interstate railroad workers); Keating-Owen Child Labor Act of 1916, Pub. L. No. 64-249, 39 Stat. 675 (prohibiting the sale in interstate commerce of goods produced by children below a certain age in particular industries). The Keating-Owen Child Labor Act was struck down by the Supreme Court in Hammer v. Dagenhart, 247 U.S. 251 (1918). However, twenty years later, Congress passed the Fair Labor Standards Act, which provided similar protections and is still in force today. 29 U.S.C. § 203 (1938).

abide by minimum standards established via the political process and with the interests of the public first in mind. This approach is consistent with the public interest theory of regulation, whereby regulation seeks the protection and benefit of the public at large; accordingly, when markets fail, regulation should be imposed to maximize social welfare.[61]

While these federal regulatory schemes were effective at beginning to address a number of the most prominent societal concerns with corporations, one particular issue with the corporate form had yet to be considered in earnest. Specifically, in 1932, in the wake of the Great Depression, Adolf Berle and Gardiner Means identified the agency problem first alluded to by Adam Smith over 150 years before.[62] In their seminal publication, *The Modern Corporation and Private Property*, Berle and Means explained that, as a result of the significant growth of the number of investors in public markets, the shareholding of large public corporations in the United States were widely distributed among a vast number of shareholders.[63] This wide dispersal of shareholdings made it impossible for shareholders to perform their essential responsibility of monitoring the corporate actors that they elect. The economic rationale was quite straightforward: with wide dispersal of share ownership, no shareholder has enough skin in the game to spend the considerable amount of time and money necessary to effectively monitor directors and management. Thus, shareholder scrutiny, the essential private mechanism by which companies are held accountable, is rendered ineffectual.

While Adam Smith was the first to point out the agency problems associated with separating ownership from control, Berle and Means were the first to identify the practical implications of this theory in modern markets.[64] And, in doing so, they precipitated the growth of corporate governance law.[65] Thus, while the federal government continued to create and extend areas of law that regulated the corporation's relationships with the public more generally, a separate and distinct area of law developed in order to specifically address the agency issues between shareholders and company directors.

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[61] *See supra* note 9.

[62] ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[63] *Id.* at 1–10.

[64] *See* William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1381 (2007).

[65] *See* Liam Séamus O'Melinn, *Neither Contract Nor Concession: The Public Personality of the Corporation*, 74 GEO. WASH. L. REV. 201, 201 (2006) (explaining that Berle & Means "began the modern debate on corporate governance"); *see also* Lawrence E. Mitchell, *The Trouble with Boards* 14 (George Washington Univ. L. Sch. Pub. L. & Legal Theory, Working Paper No. 159, 2005), http://ssrn.com/abstract=801308 (referring to *The Modern Corporation and Private Property* as the "ur-text" of modern corporate governance).

B. Sources of Corporate Governance Law and Standards

As demonstrated first by Adam Smith and later by Berle and Means, the law of agency prefigures some of the basic problems in corporate law.[66] Agency law is one of the fundamental building blocks of market economies, as it facilitates the delegation of power and authority to bodies or individuals who deploy that power and authority, on behalf of the delegator, to further the specified goals for which the power is delegated.[67] Specifically, agency law attempts to enhance the probability that the delegated power will be used to further the goals of the delegator (the principal) and not to the ulterior personal preference of the delegatee (the agent).[68] While this relationship occurs in a multitude of different contexts, it is particularly relevant to corporations, when shareholders delegate authority to run the day-to-day activities of the company to the company's managers.[69] To decrease the agency costs[70] associated with this specific agency relationship, a number of different regulatory bodies and interested parties continuously develop a system of rules, practices, and processes by which companies are directed and controlled.[71] This system is known as corporate governance, the main sources of which include the

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66 *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 7 (6th ed. 2021); *see also* Judith Wylie et al., *Agency and Corporate Governance*, *in* ENCYCLOPEDIA OF CORPORATE SOCIAL RESPONSIBILITY 55 (Samuel O. Idowu et al. eds., 2013).

67 *See* DAVID KERSHAW, THE FOUNDATIONS OF ANGLO-AMERICAN CORPORATE FIDUCIARY LAW 23 (2018); ALLEN ET AL., *supra* note 66, at 7.

68 *See* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 93-94 (1985).

69 Armour et al., *supra* note 14, at 29.

70 Jensen and Meckling describe agency costs as the sum of bonding costs, monitoring costs, and the resulting residual loss. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). Bonding costs are fundamentally a tool for aligning the objectives of executives with those of shareholders. Monitoring costs are incurred when shareholders implement independent checks over how their investment is being used and these include complying with corporate governance codes, carrying out external audits, and having internal formalized control systems including internal auditing. There comes a saturation point where the monitoring and bonding costs incurred by shareholders outweigh the benefits to be gained, in terms of maximizing the value of the firm, and this is known as "residual loss." Wylie et al., *supra* note 66, at 55.

71 Wylie et al., *supra* note 66, at 55 ("Any policy, legislation, or code which seeks to address the issues of control and accountability between [shareholders and managers] must have the principles of agency theory at its core.").

following: state law, federal law, securities exchanges, proxy advisors, and institutional investors.[72]

1. State Law

Both public and private companies are governed by the laws of the state in which they are incorporated. Corporate law can thus be found in the general corporation law statutes of individual state codes and in the state court decisions that interpret and apply these statutes. State corporate law governs the basic aspects of a company's existence and a company's actions, including, for example, the incorporation and shareholder voting processes.[73] Apart from these and other general housekeeping matters, state corporate law attempts to control conflicts of interests within the corporation by granting rights and imposing duties on specific corporate constituencies, including, most importantly, shareholders and managers.[74]

Individuals that own shares of a corporation's stock are viewed as owners of the corporation; for this reason, state corporate law grants certain exclusive rights to shareholders.[75] At the most fundamental level, shareholders have a right to share in the corporation's profitability, which may be divided proportionally based on the number of shares held by each respective shareholder.[76] This is referred to as shareholders' "economic rights."[77] Second, and most relevant to corporate governance, shareholders have a right to take part in corporate elections, referred to as "control rights."[78] This includes voting for directors to run the corporation and voting on proposals for fundamental changes affecting the corporation, such as mergers or liquidation. The shareholder franchise established under state corporate law thus enables the centralized management structure from which the corporate form derives much of its utility.[79] However, in order to constrain the ability of directors—

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72 Emmerich et al., *supra* note 17, at 409.

73 Armour et al., *supra* note 37, at 1–2.

74 *Id.* at 2.

75 *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 437–39 (2006) (recognizing the perspective of shareholders as owners as the traditional view of the corporation). *But see* Lynn A. Stout, *New Thinking on "Shareholder Primacy,"* 2 ACCT. ECON. & L. 6 (2012) (arguing that shareholders are not the corporation's ultimate owners, since corporations are independent legal entities that own themselves).

76 Velasco, *supra* note 75, at 413–16. Shareholders also have certain information rights under state corporate law; however, these are weaker than the information provided for under the federal securities regulatory regime, which is discussed in Section B.2. *Id.* at 420–21. Finally, shareholders have litigation rights. *See infra* text accompanying note 87.

77 *Id.* at 413-16.

78 *Id.* at 416–20.

79 ALLEN ET AL., *supra* note 66, at 189.

acting as agents—to pursue their own interests at the expense of shareholders—acting as principals—corporate law exercises its most important role of imposing certain duties on directors.

State corporate law explicitly grants the board of directors, as opposed to shareholders, the authority to manage the "business and affairs" of the corporation.[80] However, the board of directors does not do this directly; rather, it is responsible for appointing and supervising corporate officers who run the day-to-day operations of the corporation, subject to the same duties as directors.[81] In addition to appointing and supervising officers, the board is tasked with making certain major decisions for the corporation. For example, the board may:

> determin[e] corporate policy with respect to products, services, prices, wages and labor relations[;] . . . . fi[x] executive compensation, pension, retirement, and other plans[;] . . . . decid[e] if dividends should be declared, if new shares should be issued, or if other financing and capital changes should be made[;] . . . . [and] propos[e] certain extraordinary corporate matters such as amendments to the articles of incorporation, mergers, asset sales, and dissolutions.[82]

In carrying out these responsibilities, directors must abide by two primary fiduciary duties, which result from their agency relationship with shareholders and are established under state corporate law. These core duties, owed to the corporation and its stockholders, include the duty of care and the duty of loyalty.[83] With respect to the duty of care, directors are obliged to act with the amount of care which an ordinarily careful and prudent person would use in similar situations.[84] Courts have interpreted this duty to essentially require

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80 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2020); *see also* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

81 Nevertheless, the board remains ultimately responsible for the management of the corporation.

82 WOLTERS KLUWER, THE CORPORATION HANDBOOK: AN INTRODUCTION TO CORPORATIONS FOR THE LEGAL PROFESSIONAL 30-34 (2020), https://www.wolterskluwer.com/en/expert-insights/powers-and-duties-of-corporation-directors-and-officers.

83 *See* ALLEN ET AL., *supra* note 66, at 259; Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996). Certain states have constituency statutes that permit the board of directors to consider the interests of constituencies other than the stockholders, such as employees, customers, suppliers, and creditors. *See, e.g.*, 15 PA. STAT. AND CONS. STAT. § 515(a). The DGCL contains no such provision.

84 *See, e.g.*, N.Y. BUS. CORP. LAW § 717(a); CAL. CORP. CODE § 309(a). While not codified in Delaware, a duty of care has been developed in caselaw along similar lines. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

directors to be fully and adequately informed when making decisions for the corporation.[85] On the other hand, the duty of loyalty obliges directors to act in good faith for the benefit of the corporation and its shareholders. Courts have interpreted this duty to require directors to act in the best interest of the corporation, not for their own personal benefit.[86] If directors violate either of these duties, shareholders have a right under state corporate law to sue the directors on behalf of the corporation.[87] In effect, these duties act as the most significant limitation to the decision-making authority of corporate directors.

However, it is necessary to point out that this standard is relatively deferential to the board of directors.[88] In accordance with judicial interpretation of the duties of care and loyalty, absent a situation in which directors are grossly negligent, lining their own pockets, or committing outright fraud, shareholders may not challenge decisions of the board, even if such decisions turn out to be misguided.[89] Thus, while directors are required to exercise their duties in the best interest of the corporation and its shareholders, they are given wide discretion under state corporate law to determine what "best interest" entails. This has important implications in the context of board decisions which address the objectives of corporate stakeholders other than shareholders, which will be discussed in Part II.[90] Furthermore, it is indicative of the fact that corporate law is principally concerned with preventing directors from taking advantage of their authority as agents to pursue their own interests at the expense of shareholders, an issue which has plagued the corporate form since its inception.

Accordingly, state corporate law produces the fundamental architecture of corporate governance. By establishing rules for corporate elections, imposing fiduciary duties on directors, and assigning to shareholders the right to vote for

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85 *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996).

86 *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

87 Referred to as shareholders' "litigation rights." *See* Velasco, *supra* note 75, at 421–24.

88 *See* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 279–80 (1998) (stating that "the shareholder primacy norm is nearly irrelevant to the ordinary business decisions of modern corporations. . . . Outside the takeover context . . . , application of the shareholder primacy norm . . . is muted by the business judgment rule").

89 This protection is referred to as the "business judgment rule." eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 40 (Del. Ch. 2010) ("When the business judgment rule applies, the board's business decisions 'will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgment' for the board's notions." (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971))).

90 One crucial upshot of this is that directors are not required per se to maximize shareholder value, except in exceptional circumstances in which a hostile takeover of the corporation is inevitable.

directors and to sue directors who violate their duties, state corporate law creates the structure necessary for addressing the most critical issues associated with the corporate form. In prescribing to this role, state corporate law carves out a distinct position for corporate governance in the broader regulatory environment to which corporations are subject. Specifically, state corporate law distinguishes corporate governance as the legal apparatus which addresses first and foremost the agency issues among constituencies *within* the firm and, in particular, those issues arising from the agency relationship between shareholders and directors. The remaining sources of corporate governance law and standards thus serve to supplement and facilitate this process.

2. Federal Law

Public corporations are also governed by federal law. Although corporate governance is generally considered a matter of state law, Congress has enacted legislation, and the SEC has adopted its own rules and regulations, that monitor various aspects of the governance of public corporations directly. This includes, most prominently, the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley),[91] passed in the wake of the Enron scandal and Dot-com Bubble, and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank),[92] passed in the wake of financial crisis of 2008. In addition, despite the fact that Congress had not directly regulated such matters as the composition, role, and function of directors of public corporations until it passed Sarbanes-Oxley,[93] federal law has exerted considerable indirect influence on corporate governance via the Securities Exchange Act of 1934 (the Exchange Act).[94]

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[91] Sarbanes-Oxley Act of 2002, Pub. L. 107–204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 USC). In order to protect investors from fraudulent financial reporting by corporations, the SEC created rules pursuant to Sarbanes-Oxley to address issues such as the composition of the audit committee of the board of directors, the adoption of company codes of ethics and disclosure of information about the board of directors and its committees. *See* Lawrence E. Mitchell, *The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1189–90 (2003).

[92] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified as amended 15 U.S.C. § 78o). Although primarily consisting of financial regulation, Dodd-Frank created a number of new corporate governance rules relating to areas such as executive compensation and proxy voting procedures. Emmerich et al., *supra* note 17, at 411.

[93] Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, 26. REGUL. 26, 28 (2003).

[94] *See* Adam C. Pritchard, *Corporate Governance, Capital Markets, and Securities Law*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 1062 (Jeffery N. Gordon & Wolf-Georg Ringe eds., 2018).

Congress passed the Exchange Act in the midst of the Great Depression with the goal of protecting investors in secondary markets and discouraging speculative frenzies.[95] The Exchange Act sought to achieve these goals by implementing a "philosophy of full disclosure," through which federal securities law could prevent management from taking advantage of secrecy to self-perpetuate, paying excessive salaries, or engaging in other abusive practices to the detriment of shareholders.[96] Accordingly, pursuant to the Exchange Act, publicly-traded corporations must file periodic financial reports with the SEC.[97] And, in order to incentivize accurate disclosure, the Exchange Act contained antifraud provisions which impose liability for false or misleading statements or omissions in public company disclosures.[98] In addition, in order to make managers more accountable in the shareholder voting process, the Exchange Act also mandates disclosure in connection with the solicitation of proxies.[99]

Accordingly, while state corporate law establishes the fundamental architecture necessary for corporate governance, federal securities law ensures that investors and shareholders can make informed decisions within such a structure. Therefore, despite the fact that it is silent on corporate governance, the Exchange Act and its mandatory disclosure regime has a significant impact on the governance of public corporations and, in essence, on the agency relationship between shareholders and managers.[100] For this reason, a number of commentators have observed that federal securities law, rather than corporate law, plays the most important role in corporate governance today.[101]

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95 STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 1 (5th ed. 2019).

96 J. Robert Brown, Jr., *Corporate Governance, the Securities and Exchange Commission, and the Limits of Disclosure*, 57 CATH. U. L. REV. 45, 47 (2007); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 477-78 (1977) (quoting Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972)).

97 Securities Exchange Act of 1934, §§ 13(a), 15(d), 15 U.S.C. §§ 78m-1, o-6.

98 The primary antifraud provision in the Exchange Act is Rule 10b-5. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j.

99 Specifically, Section 10C(c)(2) of the Exchange Act and Item 407(e)(3)(iv) of Regulation S-K require each issuer to disclose in any proxy or consent solicitation materials for an annual shareholders' meeting. Securities Exchange Act of 1934 § 10(C)(c)(2), 15 U.S.C. § 78j-3(c)(C)(2); 17 CFR § 229.407 (2016). *See* CHOI & PRITCHARD, *supra* note 95, at 38.

100 *See* Bainbridge, *supra* note 93, at 27 (explaining that, "on its face, . . . the Exchange Act says nothing about regulation of corporate governance").

101 *See* Brown, *supra* note 96, at 46–47; Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 806 (2006) ("disclosure has become the most important method to regulate corporate managers and disclosure has been predominantly a federal, rather than a state, methodology." (quoting Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859, 861 (2003))).

3. Private Sources of Corporate Governance Rules & Standards

While not a source of law, corporate governance rules and standards have been promulgated by a number of actors in the private sector, including stock exchanges, institutional investors, and proxy advisors.[102] First and foremost, corporations listed on the New York Stock Exchange (NYSE) and the Nasdaq must comply with the listing rules created by these exchanges. These listing rules concern a number of aspects of corporate governance, such as director independence,[103] shareholder voting rights,[104] audit committee procedures,[105] compensation and nominating committee procedures,[106] and company codes of conduct.[107] Exchanges enforce these rules by threatening public reprimand, temporarily suspending trading for repeat offences, and permanently delisting for perennially or egregiously non-compliant corporations.[108]

Second, corporate governance standards are influenced by institutional investors and, more specifically, the asset managers who control these funds. With the dramatic rise in passive investing over the past two decades, shareholdings in US public corporations have experienced a substantial concentration in the hands of asset managers who administer passive funds.[109] To illustrate, the three largest asset managers, BlackRock, State Street, and Vanguard, currently own an average of 20.5% of outstanding shares in S&P 500 companies, and, together, they are the largest shareholder in 88% of those companies.[110] Using these holdings as a bargaining chip, asset managers and

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[102] Emmerich et al., *supra* note 17, at 410–11.

[103] NYSE, Inc., Listed Company Manual § 303A.01-02 (2009); NASDAQ, Inc., Listing Rule 5605(b)(1), (a)(2) (2009).

[104] NYSE, Inc., Listed Company Manual § 303A.08, 312.00, 313.00 (2009); NASDAQ, Inc., Listing Rule 5635, 5640 (2018).

[105] NYSE, Inc., Listed Company Manual § 303A.06–07 (2009); NASDAQ, Inc., Listing Rule 5605(c) (2020).

[106] NYSE, Inc., Listed Company Manual § 303A.04–05 (2009); NASDAQ, Inc., Listing Rule 5605(d)–(e) (2020).

[107] NYSE, Inc., Listed Company Manual § 303A.10 (2009); NASDAQ, Inc., Listing Rule 5610 (2010).

[108] Emmerich et al., *supra* note 17, at 410.

[109] *See generally*, Lucian A. Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721 (2019) (examining the large, steady, and continuing growth of the Big Three index fund managers — BlackRock, Vanguard, and State Street Global Advisors).

[110] *See* Caleb Griffin, *Margins: Estimating the Influence of the Big Three on Shareholder Proposals*, 73 SMU L. REV. 409, 417, 419 (2020) (stating that BlackRock, Vanguard, and State Street Global Advisors are referred to as the Big Three, as they are the world's three largest asset managers, collectively managing over $21 trillion in assets); Robin Wigglesworth & Harriet Agnew, *BlackRock Surges past $10tn in Assets Under Management*, FIN. TIMES (Jan. 14, 2022),

institutional investors can apply pressure on boards of directors to adopt practices that may not be required by law or the relevant listing standards. Examples of practices encouraged by these institutions include adopting a majority vote standard for electing directors,[111] separating the positions of chairman of the board and CEO,[112] and eliminating staggered boards.[113] More recently, asset managers and institutional investors have encouraged corporations to adopt more ESG-friendly business practices.[114] In order to persuade corporations to adopt these measures, these institutions engage with

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https://www.ft.com/content/7603e676-779b-4c13-8f46-a964594e3c2f (stating that BlackRock has AUM of approximately $10tn as of January 2022); Chris Flood, *Vanguard Refuses to End New Fossil Fuel Investments*, FIN. TIMES (May 25, 2022), https://www.ft.com/content/435a9384-8711-4b99-95a8-d55e962343c6 (stating that Vanguard has AUM of $8.1tn as of January 31, 2022); Press Release, State St. Corp., State Street Corporation Announces Time Change for its First-Quarter 2022 Financial Results and Conference Call Webcast (Mar. 30, 2022), https://investors.statestreet.com/investor-news-events/press-releases/news-details/2022/State-Street-Corporation-Announces-Time-Change-for-its-First-Quarter-2022-Financial-Results-and-Conference-Call-Webcast/default.aspx (stating that State Street has AUM of $4.1tn as of December 31, 2021). For comparison, the total market capitalization of the US stock market as of December 31, 2021 was around $53 trillion. *Total Market Value of U.S. Stock Market*, SIBLIS RSCH., https://siblisresearch.com/data/us-stock-market-value/ (last visited Jan 22, 2023).

111 *See, e.g.*, BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: PROXY VOTING GUIDELINES FOR U.S. SECURITIES 8–9 (2022).

112 *See, e.g.*, *id.* at 9–10.

113 *See, e.g.*, *id.* at 8; s*ee generally*, Joseph A. McCahery et al., *Behind the Scenes: The Corporate Governance Preferences of Institutional Investors*, 71 J. FIN. 2905 (2016).

114 *See* Rodolfo Araujo & Garrett Muzikowski, *Boards Face Backlash as ESG Tips the Scales During 2021 Proxy Season*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Dec. 17, 2021), https://corpgov.law.harvard.edu/2021/12/17/boards-face-backlash-as-esg-tips-the-scales-during-2021-proxy-season/ ("Large institutional investors not only backed environmental and social shareholder proposals like never before, but they also voted against the reelection of directors at portfolio companies where ESG management was perceived as ineffective.").

the board directly[115] or, if the corporation does not comply, threaten to use their large shareholdings to vote against directors of such corporations.[116]

Third, corporate governance standards are shaped by proxy advisory firms, which research and promulgate corporate governance standards.[117] For example, in 2022, proxy advisory firms announced policy updates on the topics of board diversity, multi-class voting structures, and climate-related management and shareholder proposals.[118] In order to motivate companies to adopt their policies, proxy advisory firms monitor public companies to determine whether or not they comply with these standards and subsequently issue voting recommendations to shareholders based on each respective corporation's compliance with the published standards. The two most prominent proxy advisory firms are ISS and Glass Lewis, who, together, control 90% of the proxy service market, providing recommendations to institutional investors with almost $20 trillion in AUM.[119] The considerable influence of ISS and Glass Lewis on shareholder voting has been well documented.[120] For instance, Shu finds that a negative recommendation from

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[115] Institutional investors and asset managers generally prefer to engage with boards rather than to divest from a company. John C. Friess, *Board Diversity Shareholder Suits: Diverging Materiality Tests Under Rules 10B-5 and 14A-9*, 11 MICH. BUS. & ENTREPRENEURIAL L. REV. 155, 192–93 (2021) (citing Michelle Edkins, *The Significance of ESG Engagement*, *in* BLACKROCK & CERES, 21ST CENTURY ENGAGEMENT: INVESTOR STRATEGIES FOR INCORPORATING ESG CONSIDERATIONS INTO CORPORATE GOVERNANCE 4 (2017); *see also* Patrick Temple-West, *The ESG Investor's Dilemma: To Engage or Divest?*, FIN. TIMES (Jan. 26, 2021), https://www.ft.com/content/814cbd2c-00db-41b7-91af-28435301a8a2 (describing the costs and benefits of divestiture versus engagement); *see also* Eleonora Broccardo et al., *Exit vs. Voice* (Eur. Corp. Governance Inst. Fin., Working Paper No. 694/2020, 2020) (finding that engagement is more effective than divestiture at pressuring firms to act in socially responsible manner).

[116] *See, e.g.*, Saijel Kishan, *BlackRock Voted Against 255 Directors for Climate Issues*, BLOOMBERG (July 20, 2021, 3:28 PM), https://www.bloomberg.com/news/articles/2021-07-20/blackrock-voted-against-255-directors-for-climate-related-issues.

[117] *See, e.g.*, *About ISS*, ISS, https://www.issgovernance.com/about/about-iss/ (last visited Oct. 15, 2022) ("[ISS] empowers investors and companies to build for long-term and sustainable growth by providing high-quality data, analytics, and insight.").

[118] *ISS and Glass Lewis Issue Voting Policy Updates for 2022*, GIBSON DUNN (Dec. 13, 2021), https://www.gibsondunn.com/iss-and-glass-lewis-issue-voting-policy-updates-for-2022/.

[119] *See* Chong Shu, *The Competitive Landscape of the Proxy Advice Market*, THE CLS BLUE SKY BLOG (June 25, 2020), https://clsbluesky.law.columbia.edu/2020/06/25/the-competitive-landscape-of-the-proxy-advice-market (noting that "[i]n 2017, ISS control[led] 63 percent of the proxy service market for mutual funds in the U.S. ($13.4 trillion assets from 134 fund families), and Glass Lewis control[led] 28 percent of the market ($6.0 trillion assets from 27 fund families).").

[120] *See* Andrew F. Tuch, *Proxy Advisor Influence in a Comparative Light*, 99 B.U. L. REV. 1459, 1464–66 (2019) (explaining the role and influence of US proxy advisors); *see, e.g.*, Jennifer E. Bethel

ISS against a particular director's election makes ISS customers 21% more likely than other investors to vote against this director.[121] Likewise, a negative recommendation from Glass Lewis makes its customers 29% more likely to vote against the director.[122]

Together, exchanges, institutional investors and asset managers, and proxy advisory firms supplement state and federal regulation with rules and standards that facilitate corporate governance processes. And, like the corporate governance laws they supplement, these sources of rules and standards manage the agency relationship between investors and directors. For instance, exchange listing rules related to corporate governance must be approved by the SEC, and, therefore, must be in accordance with the SEC's mission to protect investors.[123] In addition, when asset managers and institutional investors engage in corporate governance activities, they are under a fiduciary obligation to act in the best interest of those whose money is invested; accordingly, they monitor and engage with the board of directors to ensure that the board is exercising its delegated authority in a manner that protects and enhances the value of the client's or beneficiaries' assets.[124] Likewise, proxy advisory firms, by monitoring corporations and providing voting recommendation, attempt to minimize information asymmetries in the shareholder voting process in order promote long-term growth for investors and companies.[125] This results in a complex system of corporate governance laws, rules, and standards that govern the agency relationship within the corporation between shareholders and directors.

& Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, 31 FIN. MGMT. 29, 46 (2002) (finding that a negative ISS recommendation is associated with 13.6% to 20.6% fewer shares voting in favor of management proposals, depending on the topic of the proposal); Jie Cai et al, *Electing Directors*, 64 J. FIN 2389, 2403–04 (2009) (directors facing uncontested elections who received negative ISS recommendations got 19% fewer votes).

121 Chong Shu, The Proxy Advisory Industry: Influencing and Being Influenced 2 (USC Marshall Sch. of Bus. Rsch. Paper, 2021).

122 *Id.*

123 Securities Exchange Act of 1934 § 19(b)(1), 15 U.S.C. 78s(b)(1); *About the SEC*, U.S. SEC. & EXCH. COMM'N., https://www.sec.gov/about.shtml (Nov. 22, 2016).

124 For asset manager fiduciary duties, see LENORE PALLADINO & RICK ALEXANDER, ROOSEVELT INST., RESPONSIBLE ASSET MANAGERS: NEW FIDUCIARY RULES FOR THE ASSET MANAGEMENT INDUSTRY 13 (2021). For institutional investor fiduciary duties, see KEITH L. JOHNSON, INT'L INST. FOR SUSTAINABLE DEV., INTRODUCTION TO INSTITUTIONAL INVESTOR FIDUCIARY DUTIES 12–13 (2014).

125 *See, e.g.*, *About ISS*, *supra* note 117 ("[ISS] empowers investors and companies to build for long-term and sustainable growth by providing high-quality data, analytics and insight.").

II. CORPORATE GOVERNANCE AND STAKEHOLDERISM

A. The ESG Movement

In recent years, corporations have come under heightened pressure to be more socially and environmentally responsible.[126] For example, corporations are being urged to commit to carbon neutrality,[127] reduce energy consumption,[128] address the gender and race wage gap,[129]and increase diversity.[130] While this pressure has been applied consistently by a subset of politicians and of the population for nearly a century,[131] it has increased significantly over the past several years as prominent private sector actors, such as the Business Roundtable and World Economic Forum, have begun making these demands.[132] This movement, which generally purports to focus on delivering value to all of a corporation's stakeholders, such as employees, suppliers, and the public at-large, rather than focusing solely on shareholder

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126 *See, e.g.*, Patrick Temple-West, *Boards Face Growing Pressure from ESG Petitions*, FIN. TIMES (Oct. 17, 2021), https://www.ft.com/content/e3b09230-1f52-4a79-a680-1532dffc4be8.

127 *See*, *e.g.*, Georgina Rannard, *Climate Change: Top Companies Exaggerating Their Progress - Study*, BBC (Feb. 7, 2022), https://www.bbc.com/news/science-environment-60248830/.

128 *Id.*

129 *See, e.g.*, *How Gender Fits into ESG?*, S&P GLOB. (Feb. 24, 2020), https://www.spglobal.com/en/research-insights/articles/how-gender-fits-into-esg; Subodh Mishra, Institutional S'holder Servs., Inc., *Gender Pay Gap*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 7, 2022), https://corpgov.law.harvard.edu/2022/03/07/gender-pay-gap/.

130 *See, e.g.*, Saijel Kishan, *Investors Pressure Corporate America with Record Diversity Push*, BLOOMBERG (Apr. 22, 2021, 8:51 PM), https://www.bloomberg.com/news/articles/2021-04-22/investors-pressure-corporate-america-with-record-diversity-push.

131 *See* C. A. Harwell Wells, *The Cycles of Corporate Social Responsibility: An Historical Retrospective for the Twenty-First Century*, 51 U. KAN. L. REV. 77, 78–82 (2002) (explaining that "[l]egal debates over corporate social responsibility stretch from the 1930s to the twenty-first century.").

132 In August 2019, the Business Roundtable (BRT) – an influential nonprofit lobbyist association consisting of CEOs of major US companies – issued a statement on its view of the proper purpose of a corporation. *Statement on the Purpose of a Corporation*, *supra* note 21. In the statement, the members of the BRT committed to lead their companies for the benefit of all stakeholders, including customers, employees, suppliers, communities, and shareholders. This move was considered by many commentators to be a necessary and monumental change in the direction of corporate America. It also served as a catalyst for widespread adoption of the stakeholderism doctrine among highly influential private sector leaders and institutions. For example, shortly thereafter, the World Economic Forum – a global NGO consisting of major international corporations and thought leaders – issued a similar statement calling for a transition from shareholder capitalism to stakeholderism. Klaus Schwab, *Why We Need the 'Davos Manifesto' For a Better Kind of Capitalism*, WORLD ECON. F. (Dec. 1, 2019), https://www.weforum.org/agenda/2019/12/why-we-need-the-davos-manifesto-for-better-kind-of-capitalism/.

value, is referred to as ESG.[133] While the core tenets of this movement vary among its many proponents, its leading voices share a common philosophy. Specifically, they believe in pursuing stakeholder objectives not as an end in and of itself, but as a means of achieving long term shareholder value.[134] Furthermore, and crucially relevant to this Note, they believe that these objectives are best pursued via the practices and procedures provided for in corporate governance law.

ESG is perhaps exemplified best by the frequent public statements delivered by Larry Fink, CEO of BlackRock, the world's largest asset manager with nearly $10 trillion in AUM.[135] Fink is one of the leading voices, if not the leading voice, on ESG.[136] In a letter to CEO's written in January 2020, Fink argued in favor of a corporate strategy that addresses the needs of all stakeholders, stating: "[A] company cannot achieve long-term profits without embracing purpose and considering the needs of a broad range of stakeholders."[137] The letter also explained that companies that do not adequately take into account stakeholder interests "will encounter growing skepticism from the markets, and in turn, a higher cost of capital."[138] In effect, Fink labels companies that do not adopt a stakeholder-focused strategy (which he calls "ESG" strategies) as an investment risk; and, by corollary, he labels companies that do adopt a stakeholder-focused strategy as more likely to be profitable in the long-term.[139] However, Fink's letter was not only about explaining the overarching theory behind ESG. Rather, Fink's letter to CEO's, in conjunction with his letter to clients released on the same day, also contained a game plan that BlackRock would use to address the situation at hand.[140]

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133 *See generally*, *What Is Environmental, Social, and Governance (ESG) Investing*, INVESTOPEDIA (Sept. 27, 2022), https://www.investopedia.com/terms/e/environmental-social-and-governance-esg-criteria.asp.

134 In perhaps the most influential academic article in this space, Lucian Bebchuk and Roberto Tallarita refer to those who consider stakeholder factors as a means to the end of shareholder as proponents of "enlightened shareholder value." Bebchuk & Tallarita, *supra* note 31, at 108–10. Alternatively, there are those who treat "stakeholder welfare as an end in itself rather than a mere means." *Id.* at 114–15. The former category dominates the ESG debate today.

135 Wigglesworth & Agnew, *supra* note 110.

136 *See* Leslie Norton, *Larry Fink: Sustainable Investing Is About Profits, Not Taking a Stand*, MORNINGSTAR (Jan. 18, 2022), https://www.morningstar.com/articles/1075068/larry-fink-sustainable-investing-is-about-profits-not-taking-a-stand.

137 Letter from Larry Fink, Chairman & Chief Exec. Officer, BlackRock, to CEO, *supra* note 23.

138 *Id.*

139 *Id.* ("Our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors.").

140 Letter from BlackRock's Glob. Exec. Comm. to BlackRock's Clients, *supra* note 20.

According to Fink, these new initiatives would include making ESG integral to portfolio construction and risk management; exiting investments that present a high ESG risk; launching new investment products that screen companies that perform poorly according to ESG standards; strengthening engagement with companies on ESG issues; voting against directors at companies that underperform on ESG issues; and encouraging improved disclosure of ESG-related information.[141] This approach, indicative of the ESG movement as a whole, has been enabled by the sources of corporate governance law and standards identified in Part I.

For example, state corporate law establishes the basic governance structure that the ESG movement plans to utilize to achieve its aims.[142] In addition, the relatively deferential standard of the business judgment rule shaped by state courts provides directors substantial protection against breach of fiduciary duty claims if they choose to pursue ESG strategies.[143] In terms of federal law, the SEC is pursuing an aggressive role in ESG by proposing a mandatory disclosure regime for ESG-related information in order to enable shareholders to assess company ESG performance.[144] Furthermore, among the private sector sources to corporate governance standards, asset managers and institutional investors are progressively incorporating ESG into their investment and corporate governance strategies.[145] And, finally, proxy advisors are increasingly making recommendations in favor of shareholder proposals and prospective directors

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141 *Id.*

142 *See supra* Section I.B.1.

143 Bebchuk & Tallarita, *supra* note 31, 113 n.67 ("The court may hold forth on the primacy of shareholder interests, or may hold forth on the importance of socially responsible conduct, but ultimately it does not matter. Under either approach, directors . . . will be insulated from liability by the business judgment rule." (citing STEPHEN M. BAINBRIDGE, CORPORATE LAW 248 (3d. ed. 2015))).

144 *See* Press Release, U.S. Sec. & Exch. Comm'n., SEC Announces Enforcement Task Force Focused on Climate and ESG Issues (Mar. 4, 2021), https://www.sec.gov/news/press-release/2021-42 (describing climate risks and sustainability as "critical issues for the investing public and our capital markets").

145 State Street and Vanguard have ESG policies that essentially mirror BlackRock's. *See Environmental, Social and Governance*, STATE ST. GLOB. ADVISORS, https://www.ssga.com/fr/fr/institutional/etfs/about-us/asset-stewardship (last visited Nov. 19, 2022) ("Our stewardship program utilizes a risk-based approach to identify material ESG thematic topics deemed to have the most material impacts on the long-term value of our portfolio companies."); *Policies*, VANGUARD, https://corporate.vanguard.com/content/corporatesite/us/en/corp/how-we-advocate/investment-stewardship/reports-and-policies.html (last visited Nov. 19, 2022) (describing its intention to act on ESG opportunities and risks, pursuant to its fiduciary duty to manage investments in the best interest of clients).

that fit ESG objectives.[146] In leveraging activities such as engagement, voting, disclosure, and divestment, which find their source in corporate governance law, the ESG movement essentially contends that corporate governance can successfully address the needs of all of a corporation's stakeholders.

However, corporate governance law is not the proper body of law for addressing stakeholder issues. Rather, it is a poor substitute for socio-economic regulation in already existing areas of law that were created to deal with these specific issues. Underlying this conclusion is the fundamental idea that corporate governance is a body of law and standards intended first and foremost to address the agency relationship between shareholders and managers, and not the issues that arise between the corporation and its various other stakeholders.

B. The Proper Scope of Corporate Governance Law

Even if corporate governance could overcome various impediments to addressing stakeholder objectives,[147] it would be inappropriate, as it is not the body of law that was created to protect stakeholder interests. Corporate governance law developed as a result of the numerous failings of the corporation to adequately manage the agency relationship between shareholders and directors.[148] However, corporate governance is not the only body of law governing corporations – in fact, it is far from it. Corporations interact with many different stakeholders, triggering distinct bodies of law that were specially created to deal with issues that arise within the context of these relationships. For example, corporations deal with suppliers under the legal requirements created by commercial law; employees under labor law; creditors under bankruptcy law; competitors and customers under antitrust law; the environment under environmental law; et cetera. Furthermore, there are bodies of law that regulate industries of systemic importance, such as banking and insurance law. Through this complex set of rules and regulations, the US legal system steps in to address a corporation's relationships with all its stakeholders

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146 *See, e.g.*, *ESG*, ISS, https://www.issgovernance.com/esg/ (last accessed Nov. 19, 2022) (describing its ESG services that enable clients to identify material social and environmental risks and opportunities).

147 *See, e.g.*, Bebchuk & Tallarita, *supra* note 31, at 164-75 (finding that corporate leaders have strong incentives not to protect stakeholders beyond what would serve shareholder value, acceptance of stakeholderism should not be expected to produce material benefits for stakeholders).

148 *See supra* Section I.B.

when the private sector fails to provide the level of protection that society considers adequate.

This approach is consistent with the public interest theory of regulation, according to which regulation is used by the government to overcome market failures and achieve socio-economic policy objectives.[149] The evolution of the legal environment in which corporations operate can be viewed in this context. When courts prohibited ad-hoc intervention by the government into the affairs of early 19th century-chartered companies in the US, corporations were left largely unregulated.[150] In response to the market failures that followed, the government passed legislation to create certain mandatory requirements for corporations when dealing with specific stakeholder groups. For instance, when the rapid economic expansion of the late 19th century led to industry consolidation that restricted healthy competition and increased prices for consumers, Congress passed the Sherman Act to prevent monopolization by establishing rules for corporations' relationships with competitors and consumers.[151] Similarly, abuses by employers during this era culminated in the National Labor Relations Act of 1935 and the Fair Labor Standards Act of 1938, which established the framework for federal labor law and govern a corporation's relationship with its employees.[152] Furthermore, when studies regarding the negative effects of first-generation pollutants increased rapidly during the 1960s, the federal government responded with the National Environmental Policy Act (NEPA).[153] NEPA and subsequent legislation such as the Clean Air Act and the Clean Water Act created rules for corporations when engaging in activities that affect the environment.[154] Finally, in response to rampant discrimination in public and private sector employment, the Civil Rights Act of 1964 provided protections for race, color, religion, sex, or

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149 *See supra* note 9; *see also* Shleifer, *supra* note 27, at 440 (explaining that the public interest theory of regulation has been used to justify regulation over the twentieth century).

150 *See* Hamill, *supra* note 5, at 113–14.

151 Sherman Act, Pub. L. No. 108-237, § 2, 26 Stat. 209, 209 (1890) (codified as amended 15 U.S.C. § 2); s*ee* Sawyer, *supra* note 4, at 1–2.

152 National Labor Relations Act of 1935, Pub. L. No. 74–198, 49 Stat. 449 (codified as amended 29 U.S.C. § 151–169); Fair Labor Standards Act of 1938, Pub. L. No. 75–718, 52 Stat. 1060 (codified as amended 29 U.S.C. §§ 201-19); *see also* U.S. Bureau of Labor Statistics, *Labor law highlights, 1915–2015*, MONTHLY LAB. REV. (Oct. 2015), https://www.bls.gov/opub/mlr/2015/article/pdf/labor-law-highlights-1915-2015.pdf.

153 National Environmental Policy Act of 1969, Pub. L. No. 91–100, 83 Stat. 852 (codified as amended 42 U.S.C. § 4321 et seq.).

154 Clean Air Act, Pub. L. No. 88–206, 77 Stat. 392 (1963) (codified as amended 42 U.S.C. § 7401); Clean Water Act of 1972, Pub. L. No. 92-500, 86 Stat. 816 (1972) (codified as amended 33 U.S.C. §§ 1251–1387).

national origin in the workplace.[155] These examples demonstrate the mainstream approach to regulating corporations that is consistent with the public interest theory of regulation.

The narrative espoused by proponents of ESG creates the appearance of consistency with the public interest theory of regulation. They claim that the mechanisms provided for under corporate governance law enable the market to solve stakeholder issues. As a result, there is no market failure for the government to address with regulation, except insofar as regulation can be used to facilitate the corporate governance process.[156] In terms of the mechanics, proponents of the ESG movement suggest that, based on the growing body of evidence concerning how ESG can influence the long-term profitability of a company, shareholders will want their companies to address stakeholder objectives. In order to utilize corporate governance to achieve these goals, shareholders will collectively decide which ESG standards are best and will engage with directors and management at every public company to encourage them to adopt these measures. If directors and management fail to do so, shareholders exercise their rights under corporate governance law to vote them out or sell their shares. Furthermore, to make shareholder engagement even more informed and effective, the SEC will mandate disclosure with respect to public companies' ESG practices, and proxy advisors will process all of the available information to make recommendations consistent with ESG principles. In the end, because shareholders want companies to be ESG friendly, the corporate governance process will successfully encourage every company to act more responsibly towards stakeholders.

This process seems especially cumbersome and convoluted in light of the fact that the law already provides for a robust set of regulatory options to deal with a corporation's relationship with its various stakeholders. But, instead of deferring to the formal mechanisms in place to regulate these relationships, the ESG movement attempts to channel every standard of behavior for every stakeholder relationship through a body of law that was created only to align the interests of shareholders and management. In effect, the ESG movement suggests that the market can solve the most pressing issues of public interest, rendering government involvement unnecessary. However, by attempting to bend the public interest theory to fit its narrative, the ESG movement more accurately suggests that they support a competing theory, known as the

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155 Civil Rights Act of 1964, Pub. L. No. 88-352, 78 Stat. 241 (codified as amended 42 U.S.C. § 1971 et seq.); *see also* U.S. Bureau of Labor Statistics, *supra* note 152, at 5–7.

156 *See* Wolf-Georg Ringe, *Investor-Led Sustainability in Corporate Governance* 35 (Eur. Corp. Governance Inst., Working Paper No. 615/2021, 2021).

economic theory of regulation.[157] According to this theory, which is closely associated with Chicago School of Economics, markets and private orderings, such as those between shareholders and directors provided for under corporate governance law, can take care of most market failures without any government intervention at all.[158] This is considered preferable to regulation since government regulators are incompetent and corrupt, and so they would make things worse. This critique of the public interest theory has been highly influential. For instance, it was the theoretical foundation for the deregulatory period in the United States during the 1970s and 1980s, when stakeholder-focused federal regulation was substantially weakened.[159] Furthermore, it is a significant component of shareholder primacy model, which holds that shareholder interests should be first priority in relation to all other corporate stakeholders.[160] Despite the fact that the ESG movement overtly criticizes this theory, it ironically advocates for a process entirely consistent with it.[161] In essence, the ESG movement emphasizes the ability of the market, enabled by corporate governance law, to solve stakeholder issues to such a degree that it

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157 *See* Shleifer, *supra* note 27, at 440–42. R.H. Coase provides a broad assault on regulation from this perspective in *The Problem of Social Cost*, 3 J.L. & ECON. 1, 1–44 (1960). For specific critiques of the public interest theory of regulation from the perspective of proponents of the economic theory of regulation, see Posner, *supra* note 9; Stigler, *supra* note 9.

158 Shleifer, *supra* note 27, at 440–42.

159 *See* Sam Peltzman, *The Economic Theory of Regulation After a Decade of Deregulation*, BROOKINGS PAPERS ON ECON. ACTIVITY, 1989, at 1, 2 (referencing a "reduction or substantial elimination of regulatory constraints whose scope is unprecedented in modern American history").

160 *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36–37 (1991) (arguing that shareholders are the ultimate "owners" and sole "residual claimants" in corporations, therefore, economic efficiency is served best when directors and executives maximize "shareholder wealth"). *But see* Blair & Stout, *supra* note 29 (arguing that shareholders cannot own corporations because corporations are legal entities that own themselves, therefore shareholder primacy is based on a faulty assumption). Shareholder primacy is most often associated with Milton Friedman and his influential piece *The Social Responsibility of Business is to Increase its Profits*, N.Y. TIMES, Sept. 13, 1970 (§ SM), at 17.

161 For example, a press release by the Business Roundtable after their 2019 statement has the following subheading: "Updated Statement Moves Away from Shareholder Primacy, Includes Commitment to All Stakeholders." It states further, "Each version of the document issued since 1997 has endorsed principles of shareholder primacy – that corporations exist principally to serve shareholders. With today's announcement, the new Statement supersedes previous statements and outlines a modern standard for corporate responsibility." Press Release, Bus. Roundtable, *Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans'* (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans.

appears entirely consistent with the shareholder primacy model and the economic theory of regulation.

Yet, proponents of ESG declare that they are not opposed to regulation on stakeholder issues.[162] They state that there is an important role for the government to play in addressing these issues, but there are certain situations where corporate governance is more appropriate.[163] However, their actions indicate that they strongly favor a minimal role for the government and the significant discretion granted to major private sector institutions that is characteristic of the economic theory of regulation. For instance, despite claiming that they are open to regulation to address climate change, US public companies employ hordes of lobbyists to fight against such initiatives.[164] Other companies simply do nothing to advocate for regulatory strategies to address pressing ESG issues. For example, despite their insistence on the importance of ESG issues to long-term shareholder value, major asset managers such as BlackRock have no records of lobbying on behalf of any ESG-related issue with the federal government, besides issues that would give them broader discretion to enforce ESG via corporate governance.[165] Furthermore, in a pledge by many prominent asset managers and institutional investors across the world committing to support efforts to increase environmental regulations, only four US asset managers were signatories (the Big Three were noticeably absent).[166] Therefore, the political issues that are often cited as reasons in favor of the private sector regulating itself are largely of the private sector's own

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[162] *See* Alex Edmans, *Is Sustainable Investing Really a Dangerous Placebo?*, OXFORD BUS. L. BLOG (Nov. 3, 2021), https://www.law.ox.ac.uk/business-law-blog/blog/2021/11/sustainable-investing-really-dangerous-placebo (claiming that most responsible investors support regulation).

[163] *See, e.g.*, *Q&A for Alex Edmans's Webinar on "ESG: Do We Need It and Does It Work?"*, ALEX EDMANS (Nov. 3, 2021), https://alexedmans.com/wp-content/uploads/2021/11/Indiana-QA.pdf (stating that governments should encourage disclosure of certain ESG metrics, but that government regulation requiring companies to meet particular ESG standards is "highly problematic.").

[164] *See, e.g.*, Niall McCarthy, *Oil and Gas Giants Spend Millions Lobbying to Block Climate Change Policies*, FORBES (Mar. 25, 2019, 8:06 AM), https://www.forbes.com/sites/niallmccarthy/2019/03/25/oil-and-gas-giants-spend-millions-lobbying-to-block-climate-change-policies-infographic/?sh=3ad3b3797c4f/.

[165] *See Bills Lobbied By BlackRock Inc, 2021*, OPEN SECRETS, https://www.opensecrets.org/federal-lobbying/clients/bills?cycle=2021&id=D000021872 (last visited Oct. 10, 2022).

[166] US signatories included only CalPERS, David Rockefeller Fund, United Nations Joint Staff Pension Fund, and Wespath. *Members*, UN ENV'T PROGRAM FIN. INITIATIVE, https://www.unepfi.org/net-zero-alliance/alliance-members/ (last visited April 22, 2022).

making.[167] This adds to growing sentiment that the major proponents of ESG are trying to appear more socially and environmentally conscious primarily to evade regulation.[168]

In essence, proponents of ESG proffer a system in which corporate governance, which is meant to align the interests of shareholders and management, will align the interests of corporations and all their stakeholders, amounting to what is fundamentally a system of "self-regulation." Accordingly, there is no need for intervention by the government to enact socio-economic policy addressing market failures because there are few, if any, to address. However, corporate governance was not created to solve stakeholder issues. Therefore, it should not be tasked, under the guise of ESG, with finding such solutions.

C. Shareholders as Democratic Representatives

In addition to bypassing bodies of law that were specifically created to address stakeholder objectives, the ESG movement raises concerning questions regarding democracy and representation. By relying on corporate governance, the ESG movement enables shareholders to assume the traditional role of a democratically elected government to establish the appropriate rules governing the relationship between a corporation and its many stakeholders. This is especially true with respect to many environmental and social issues under the ESG umbrella, which have traditionally been considered socio-economic policy issues within the purview of federal and state governments rather than as the subject of shareholder votes. While a democratically elected government has a mandate from society to represent and protect the public at-large, shareholders do not have such a mandate. Instead, corporations suffer from a considerable democratic deficit.

Charles Tilly defines democracy as "conformity of a state's behavior to it citizens' expressed demands," which Tilly measures as the degree to which relations between the citizens and the state feature "broad, equal, protected and mutually binding consultation."[169] Inherent in this definition are two crucial

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[167] *See* REBECCA HENDERSON, REIMAGINING CAPITALISM: HOW BUSINESS CAN SAVE THE WORLD 168–69 (2020) (advocating for corporations, via self-regulation, to play a "central role in solving the world's great problems" because government regulation is ineffectual).

[168] This claim has been levelled by the former chief investment officer for sustainable investing at BlackRock, who gained significant traction with his critique of ESG published on *Medium*. Tariq Fancy, *The Secret Diary of a 'Sustainable Investor' – Part 1*, MEDIUM (Aug. 20, 2021), https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139.

[169] CHARLES TILLY, DEMOCRACY 13–14 (2007).

elements: effective participation and voting equality.[170] With respect to the first element, the broader the franchise, the more democratic a particular system is, and, by corollary, the narrower the franchise, the less democratic a particular system is. In relation to stock ownership in the United States, despite the fact it is increasing, it consists of only a narrow subset of the population. Investors in the stock market represent only about half of all Americans.[171] And, this subset is unrepresentative of the population as a whole. For example, ownership of stock is concentrated among those with higher incomes. In fact, the wealthiest 10% of Americans own nearly 90% of all US stocks.[172] In addition, stock ownership is highly affected by race and ethnicity; 61% of white, non-Hispanic families owned stocks in 2019, while only 34% of Blacks and 24% of Hispanics did.[173] Share ownership is also skewed by age. For instance, investors aged 65 and older own 43% of the stock market.[174] This figure rises to 72% among investors aged 55 and older, despite the fact this represents only about 21% of the population as a whole.[175] In this context, it is undesirable to task shareholders with addressing traditional socio-economic policy areas via ESG and corporate governance because such mechanisms do not provide for effective representation.

The second element inherent to democracy is the notion of equality in electoral power among citizens.[176] Democracy rejects the idea that some individuals have a greater claim to decision making power than others;[177] however, this is a dominant feature in corporate governance, in which voting power is distributed based upon how many shares one owns.[178] This enables what is effectively a pay-to-play system in which the largest shareholders have the most voting power and, as a consequence, the most influence in corporate elections. As mentioned previously, the wealthiest Americans own an

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170 Gevurtz, *supra* note 33, at 25–26.

171 Lydia Saad & Jeffrey M. Jones, *What Percentage of Americans Own Stock*, GALLUP, https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx (May 12, 2022).

172 Robert Frank, *The Wealthiest 10% of Americans Own a Record 89% of All U.S. Stocks*, CNBC (Oct. 18, 2021, 4:48 PM), https://www.cnbc.com/2021/10/18/the-wealthiest-10percent-of-americans-own-a-record-89percent-of-all-us-stocks.html.

173 Smart, *supra* note 32.

174 *Id.*

175 *Id.*

176 *See* Gevurtz, *supra* note 33, at 26.

177 Thomas Christiano, *Disagreement and the Justification of Democracy*, *in* THE CAMBRIDGE COMPANION TO LIBERALISM 237, 238-39 (Steven Wall ed., 2015).

178 Henry Hansmann & Mariana Pargendler, The Evolution of Shareholder Voting Rights: Separation of Ownership and Consumption, 123 YALE L. J. 948, 998 (2014).

overwhelming majority of US stocks.[179] Furthermore, the single largest shareholder in US public companies is almost always one of the Big Three asset managers;[180] otherwise, it may be a hedge fund, an institutional investor, or a company founder. Accordingly, power is concentrated in the wealthiest individuals and the largest institutions. Therefore, in addition to the fact that at least half of the population is prohibited from engaging in corporate governance because they do not own shares, even among the shareholders that do own shares, voting power is highly unrepresentative.

As observed by Franklin A. Gevurtz, this system creates what amounts to an exorbitantly steep poll tax in order to exert any meaningful influence on corporate policy.[181] In fact, it is even worse than a poll tax, because there is a tax to engage in the voting process, *and* relative voting power is dependent upon how many shares one owns (i.e. how big of a tax one pays).[182] Such a mechanism may be appropriate when corporate governance activities are aimed at aligning the interests of shareholders and managers. However, if this system intends to address every stakeholder issue under the ESG umbrella, then the public will be relying upon a fundamentally undemocratic system to solve socio-economic policy issues that are rightly reserved for a democratically elected government. To briefly summarize, the mechanisms provided for under corporate governance law are ill-suited to address stakeholder objectives. First, there are other bodies of law that were created specifically for this purpose. And, second, corporate governance is inherently undemocratic. For these reasons, an alternative strategy to address stakeholder issues must be pursued.

III. A CALL FOR REAL ESG REGULATION

In response to corporate governance's ineffectiveness at addressing stakeholder interests, some policymakers advocate for an overhaul of corporate governance law in order to create a governance system for corporations that adequately represents the public at-large. For example, there are proposals that require directors to make decisions in the best interests of the public, rather than in the best interests of the corporation within the confines of the law.[183]

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179 *Supra* note 172 and accompanying text.

180 *See supra* note 110 and accompanying text.

181 *See* Gevurtz, *supra* note 33, at 27.

182 *Id.*

183 Press Release, Sen. Elizabeth Warren, Warren Introduces Accountable Capitalism Act (Aug. 15, 2018), https://www.warren.senate.gov/newsroom/press-releases/warren-introduces-accountable-capitalism-act. Many states have passed laws allowing, but not requiring,

However, this approach suffers from the same drawbacks as ESG. Reconfiguring corporate law to take into account stakeholders would require using tools that were created to align the interests of shareholders and managers to align the interests of shareholders and the public. This would dilute these tools' efficacy in addressing the shareholder-manager relationship and fall short of aligning corporate interests with the interests of the public.[184] Furthermore, as in the case of relying ESG's reliance on corporate governance as is, this strategy would outsource the quintessential responsibilities of a democratically elected government, namely to determine what is in the public interest and then act in the public interest, to corporate managers that cannot and should not represent the interests of the public at-large.[185] Directors should be empowered to make decisions that are in the best interest of the long-term value of the company, but – crucially – these decisions must be made within the confines of other areas of law which provide protections for the corporation's stakeholders. It is the responsibility of the government to provide these protections directly, and not outsource such an essential task to corporate boards.

Corporate governance was created to ensure that directors and managers use the power delegated to them by shareholders to increase the long-term value of the corporation. In doing so, it addresses a fundamental problem that has plagued corporations since the beginning, whereby managers line their own pockets or neglect their duties at the expense of shareholders.[186] These problems continue to this day, though they have been significantly curbed by corporate governance rules and regulations.[187] And, while there are possibilities for improvement within this body of law, these improvements should be directed at the specific relationship for which it was created.[188] In pursuit of its proper mission, there may be instances in which some stakeholder objectives

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directors to consider the interests of stakeholders other than shareholders. *See supra* note 83. Sen. Warren's bill goes one step further and would require directors to consider the interests of other stakeholders.

184 Bebchuk & Tallarita, *supra* note 31, at 164–68 (arguing that requiring boards to consider stakeholder interests will increase insulation and reduce accountability).

185 *See supra* Sections II.B-C.

186 *See supra* Section I.A.

187 *See supra* Section I.B.

188 *See, e.g.*, Katanga Johnson, *U.S. SEC Proposes Asking Companies to Say Why CEO Pay and Performance Often Don't Match Up*, REUTERS (Jan. 27, 2022, 5:48 PM), https://www.reuters.com/business/finance/us-sec-proposes-asking-companies-say-why-ceo-pay-performance-often-dont-match-up-2022-01-27/ (explaining a SEC proposal to adopt amendments to its disclosure rules that will require public companies to provide enhanced proxy and information statement disclosure about certain executive compensation and corporate governance matters).

are subsequently met. However, these are ancillary by-products of the corporate governance process that cannot be expected to amount to the comprehensive level of socio-economic reform that is needed to address society's most pressing ESG-related issues, such as climate change. Instead, these problems require direct government action.

This Note does not advocate for particular policy proposals with respect to ESG and stakeholder issues. However, as opposed to proponents of ESG, it does advocate first and foremost for solutions developed within the distinct bodies of law created to protect specific stakeholder groups and passed pursuant to the democratic processes created to adequately represent the public interest. In this way, society can utilize existing mechanisms befitting for the goals of ESG in order to strengthen stakeholder protections across the entire economy.

CONCLUSION

In conclusion, despite its claims that it represents a "fundamental reshaping" of markets that will increase stakeholder welfare, the ESG movement advocates for a system of "self-regulation" enabled by corporate governance that prescribes little government involvement in determining acceptable safeguards for stakeholders. This is an improper role for corporate governance to play, as it is intended primarily to address only the relationship between shareholders and corporate directors and managers. Furthermore, permitting shareholders and managers to use the corporate governance process to determine what amounts to socio-economic policy would raise concerning questions of democracy. Instead of relying on ESG to move the needle, the government should assume the role it has reserved throughout US history of stepping in to provide comprehensive solutions to stakeholder issues when the markets fail to do so. As stakeholder issues become more and more urgent, such a role is increasingly vital and necessary.