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Managerial Fixation and the Limitations of Shareholder Oversight

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BlackRock's recent public letters to the CEOs of the companies in which it invests have drawn substantial attention from stock market actors and observers for their conspicuous call on corporate CEOs to focus on sustainability and social impacts on non-shareholder stakeholders. This Article explores the market changes that propelled BlackRock into a position to make such a call, and whether institutional shareholders can be effective monitors of these broad social goals. It argues that while corporate attention to non-shareholder stakeholders can improve firm value, shareholder oversight of these stakeholder relationships will not succeed in having this effect.

In the past several decades, U.S. institutional shareholders have come to exert significant influence over corporate managers. In the wake of this shift, concerns have arisen about how shareholders are using their power to influence corporate managers. Described herein as "managerial fixation" on shareholders, these discussions raise concerns about negative stakeholder impacts and a loss of firm value.

The team production theory of corporate law explains why, when shareholders are disproportionately influential, other stakeholders' interests will be neglected to the detriment of corporate value. This theory leaves open the question of why shareholders cannot simply use their influence to remedy the problem. This Article fills that gap.

Even when shareholders are financially incentivized to use their power to promote the interests of other stakeholders, they will lack the information about stakeholder relationships necessary to do so effectively. This asymmetry of information means that shareholders cannot incorporate stakeholder information into their assessment of firm value, so managing to shareholder expectations will not maximize the value created by stakeholder relationships. Thus, a solution to managerial fixation must entail reducing shareholders' proportional influence over managerial decision-making vis-à-vis the corporation's other stakeholders. This Article concludes by offering two proposals for governance mechanisms that would encourage this reallocation of managerial attention.

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INTRODUCTION

BlackRock is the world's largest asset manager with $6.84 trillion of assets under management as of June 30, 2019.[1] That is, it is the largest among a global class of institutional investors that pool the smaller investments of individuals and other institutions (such as pension funds) and invest them on behalf of their clients. Each year, BlackRock's chief executive, Larry Fink, publishes a "Letter to CEOs" that is addressed to the CEOs of the corporations in which BlackRock invests on behalf of its clients. The letter describes BlackRock's strategies and priorities for the upcoming year and elucidates what it will be looking for in the companies in which it invests. Given BlackRock's prominent position in the capital markets, this letter is usually eagerly anticipated and extensively analyzed in the business press. The 2018 letter, entitled "A Sense of Purpose," ignited a great deal of commentary due to its conspicuous call on corporate CEOs to focus on sustainability and impacts on non-shareholder stakeholders.[2]

To encourage this "sense of purpose," Fink states in his letter that BlackRock will devote additional resources to more effectively engaging with corporate managers on issues of long-term growth and stakeholder relationships.[3] While the letter is artfully phrased to leave open a number of possible paths forward for BlackRock, the commitment of resources and discussion of increased engagement with managers implies an expanded role for BlackRock in holding corporations accountable for their stakeholder impacts.[4]

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1. *Introduction to Blackrock*, BLACKROCK, https://www.blackrock.com/sg/en/introduction-to-blackrock (last visited Mar. 20, 2020).The next two largest asset managers are Vanguard and State Street which, together with BlackRock, are often referred to as the "big three." Combined, the "big three" manage over $11 trillion of assets. Taken together, they represent the largest shareholder in ninety percent of S&P 500 firms. Given their ubiquity as substantial shareholders, the "big three" are watched closely by corporate managers and other market observers. Their relatively large shareholdings grant them substantial influence over corporate managers. Jan Fichtner et al., *Hidden Power of the Big Three? Passive Index Funds, Re-Concentration of Corporate Ownership, and New Financial Risk*, 19 BUS. & POL. 298, 298–300 (2017).

2. Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (last visited Mar. 20, 2020) [hereinafter Fink, *2018 Letter to CEOs*] ("To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate."). Fink wrote an updated letter in 2019, which extends this theme. The 2019 letter did not garner as dramatic a reaction as the 2018 letter, likely because it is not as novel and merely builds on the themes from the 2018 letter. *See* Larry Fink, *Larry Fink's 2019 Letter to CEOs: Purpose & Profit*, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited Mar. 20, 2020). His 2020 letter focusses on climate change and corporate environmental impacts. *See* Larry Fink, *Larry Fink's 2020 Letter to CEOs: A Fundamental Reshaping of Finance*, https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter (last visited Mar. 20, 2020).

3. Fink, *2018 Letter to CEOs*, *supra* note 2 ("We . . . intend to double the size of the investment stewardship team over the next three years [to] . . . foster even more effective engagement with your company by building a framework for deeper, more frequent, and more productive conversations.").

4. While other plausible interpretations exist, this Article focuses on the interpretation that Fink expects corporate CEOs to be accountable, in some manner, to BlackRock for their corporations' impacts on other stakeholder groups.

One of the most-cited reactions to Fink's letter was from billionaire investor Sam Zell, who lamented during a television interview, "I didn't know Larry Fink had been made God."[5] While this reaction was clearly an expression of frustration with Fink's position, it also draws attention to the extent to which Fink's letter was a departure from existing norms and potentially an expansion of BlackRock's influence. This raises two questions. First, what has changed in the U.S. public equity markets that caused a prominent shareholder like BlackRock to call for socially responsible management by CEOs?[6] Second, will the approach that the letter represents—shareholder oversight of corporate social impacts—succeed? This Article explores these two questions and concludes that (1) Fink's letter was precipitated by a decades-long trend of shareholder empowerment which gave rise to concerns about corporate governance, and (2) regardless of their incentives, influence and investment horizon, shareholders cannot effectively serve as monitors of social impact.

Corporations are a government creation that originated from a desire to create a structure that would enable business enterprises to commit large amounts of capital to long-term pursuits in furtherance of the public interest. The motivation behind establishing the corporate form was to create an entity that simultaneously furthers the interests of both investors and other constituencies. Corporations provide employment, goods and services, and investment returns, all of which can create a positive social impact, though they can also contribute to negative externalities such as environmental degradation. Thus, the interests of the various parties affected by corporate actions—its stakeholders—can be symbiotic. Most importantly for the purposes of this Article, there is a substantial extent to which positive impacts on non-shareholder stakeholders can increase returns to shareholders. Fink's letter calls on corporate CEOs to capitalize on this coincidence of interests.

For close to a century now, discussions about corporate governance and regulation have focused on concerns about shareholder-manager agency costs.[7] The central concern raised by these discussions is that dispersed and passive shareholders will be unable to monitor corporate managers, to the detriment of firm value. In recent years, however, these agency costs have diminished

5. Berkeley Lovelace, Jr., *Billionaire Sam Zell: BlackRock's Larry Fink is "Extraordinarily Hypocritical" to Push Social Responsibility*, CNBC, https://www.cnbc.com/2018/01/16/sam-zell-blackrock-ceo-fink-is-hypocritical-to-push-social-responsibility.html (last updated Jan. 16, 2018, 10:33 AM).

6. This Article does not assume that Larry Fink is entirely sincere about the benevolent position he espouses in his letter. The letter, however, was in response to widespread calls on institutional shareholders to use their power to redirect corporate attention to other stakeholders. *See infra* Subpart II.B. Other prominent institutional shareholders have also heeded this call and published similar communications. *See Business Roundtable Redefines the Purposes of a Corporation to Promote "An Economy that Serves All Americans"*, BUS. ROUNDTABLE (Aug. 19, 2019), https://www.businessroundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans. The analysis herein is not an evaluation of the likelihood that Larry Fink, specifically, will succeed in his purported efforts to refocus corporate CEOs on social issues. Rather, it is an evaluation of whether this approach—institutional shareholders using their ample influence monitor other stakeholder impacts—will be successful.

7. *See infra* Subpart II.A.1

substantially. Developments in financial theory led to extraordinary growth in institutional investments, which have dramatically reduced the dispersion of shareholdings.[8] Regulatory efforts aimed at increasing shareholder influence, together with the private proxy advisory industry, have reduced investor passivity and collective action problems. With this newfound influence, institutional shareholders have been able to press corporations to amend their charters and bylaws to increase their power further. Thus, what was once considered the "master" economic problem facing corporations has substantially diminished.[9]

In the wake of these changes, however, new concerns have arisen about the apparent downsides of highly empowered shareholders. Often discussed under the heading of concerns about "short-termism,"[10] these discussions point out that in corporate managers' zealous efforts to please shareholders, other corporate stakeholders' interests appear to have been devalued. This Article argues that this apparent stakeholder neglect derives not from a subgroup of shareholders with particularly short investment horizons, but more broadly from the disproportionate influence of public shareholders as a class. Thus, even very long-term shareholders such as BlackRock (or its competitors) can be contributors, rather than solutions, to this problem. This Article therefore uses the term "managerial fixation" to describe this perceived lack of attention to non-shareholder stakeholders in order to emphasize the role of managerial attention to shareholders and de-emphasize distinctions in investment horizons. Somewhat ironically, this lack of attention to non-shareholder stakeholders is widely believed to come at the expense of long term firm value and thereby returns to shareholders themselves.[11] So, substantially reducing the problem of shareholder-manager agency costs does not appear to have worked to unequivocally maximize firm value.

Margaret Blair and Lynn Stout's team production theory of corporate law provides a useful framework for understanding why concerns about managerial fixation have arisen in the wake of shareholder empowerment. The team production theory argues that shareholder power is properly limited because shareholders are only one of many constituencies whose firm-specific investments are necessary for corporate production.[12] The inputs of other stakeholders such as creditors, customers, employees, suppliers and the

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8. Institutional investors currently hold eighty percent of U.S. equity securities. Charles McGrath, *80% of Equity Market Cap Held by Institutions*, PENSIONS & INVS. (Apr. 25, 2017, 1:00 AM), http://www.pionline.com/article/20170425/INTERACTIVE/170429926/80-of-equity-market-cap-held-by-institutions#.

9. Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1910–11 (2013).

10. Refers to the idea that corporate managers may be making decisions to please shortsighted shareholders at the expense of long-term, sustainable growth.

11. *See infra* Subpart I.B.

12. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250 (1999).

environment are also necessary for a corporation to produce goods and services, and a successful corporation must take steps to attract optimal quantities of those inputs as well. Under this theory, if shareholders become disproportionately influential, managerial attention will be drawn away from the other stakeholders to the detriment of firm value.

The team production theory largely predicts recent concerns about managerial fixation. It predicts that disproportionately powerful shareholders would divert managerial attention from other stakeholders. It also predicts that this managerial fixation will come at the expense of firm value, giving shareholders ample incentives to solve the managerial fixation problem. Team production leaves open the question of whether shareholders can simply use their substantial influence to monitor and optimize corporations' stakeholder impacts. Observers concerned with short-termism have called on influential shareholders to do precisely that, and Fink's letter is a response to that call. This Article seeks to fill this gap and argues that such efforts will inevitably be ineffective because shareholders lack access to the information necessary to effectively evaluate the interests of other stakeholder groups.

Public shareholders are not perfectly informed. Corporate managers have access to information about their firms to which public shareholders do not have access. Prominent in this category of private information is information about the corporation's relationships with its non-shareholder stakeholders. Corporations' relationships with their stakeholders are governed by agreements that are, to varying degrees, incomplete. At-will employees and customers, in particular, have very incomplete agreements with corporations, meaning most, if not all, terms of agreement are not explicitly specified. Even the more specific contracts, such as those with suppliers and creditors, will still have unspecified terms and will need to be negotiated repeatedly over the course of the corporation's life. Stakeholder agreements are therefore the subject of ongoing negotiations between firm managers and the relevant stakeholders. Managing these relationships is the role of a corporate manager, and it exposes managers to vital information about those stakeholder relationships to which shareholders are not privy. This information is not reducible to metrics that can be effectively transferred to shareholders, and public shareholders, by their nature, are not positioned, nor do they have the expertise, to be intimately involved in the management of other stakeholder relationships. Thus, information asymmetries will prevent shareholders from being effective monitors of other stakeholder interests.

The implication of this analysis is that shareholders' proportional share of managerial attention should be reduced vis-à-vis that of other stakeholders. The usual objection to any reduction in shareholder power is that eliminating shareholder oversight essentially frees managers to pursue their own interests at the corporation's expense. While some managerial rent-seeking may well result from reducing shareholder influence, the magnitude of that cost is far from clear. And, as this Article demonstrates, there can be costs associated with disproportionately empowered shareholders as well. So, concerns about managerial agency costs should not overshadow the potential costs of managerial fixation. Nonetheless, shareholders may be able to direct managerial attention to other stakeholders while reducing the likelihood or magnitude of agency costs by pressuring corporations to look internally to adopt stakeholder-protective procedures and mechanisms. They can do this by pressing for corporate responsibility reporting to the board of directors and stakeholder metrics in executive compensation formulas.

The remainder of this Article proceeds as follows: Part I describes the fundamental social and economic functions of corporations, and defines the boundaries of the analysis herein. Part II describes the principal-agent problem, how it has diminished in recent decades, and the resulting concerns about managerial fixation. Part III summarizes the team production theory of the corporation and its implication that shareholder empowerment has come at the expense of firm value. It then describes how shareholders are limited in their ability to use their power to monitor corporate outcomes for other stakeholder groups. Part IV proposes two ways in which shareholders can use their substantial influence to encourage managers to direct meaningful attention to other stakeholder relationships.

I. CORPORATIONS' SIMULTANEOUS SOCIAL AND ECONOMIC EFFECTS

While Fink's call for attention to corporate social outcomes may have come as a surprise to many modern market observers, the ability of corporations to serve broad social and economic goals has long been a core characteristic of the corporate form. This Part briefly describes the socially-oriented origin of U.S. corporations, which sought to capitalize on the corporate form's unique capacity to provide benefits for both shareholders and the broader public. It then explores the complexities of the relationship between a public corporation's shareholders (such as BlackRock)[13] and its other stakeholders (such as the employees, customers and communities that Fink mentions in his letter)[14] and defines the parameters of the remainder of the analysis herein.

A. THE FUNDAMENTAL SOCIAL AND ECONOMIC PURPOSE OF U.S. CORPORATIONS

Corporations exist as a business entity type in the United States because state governments have enacted and maintained corporation laws that allow corporations to be formed in their states.[15] The existence of corporations is

13. BlackRock holds shares on behalf of its investor clients. It is the registered owner and thus, votes the shares it holds for its clients, while its investor clients are the beneficial owners of the shares with a right to the economic benefits of the shares." *See, e.g.*, 2019 INVESTMENT STEWARDSHIP ANNUAL REPORT, BLACKROCK 23 (2019), https://www.blackrock.com/corporate/literature/publication/blk-annual-stewardship-report-2019.pdf (referring to BlackRock's clients as "the asset owners").

14. *See* Fink, *2018 Letter to CEOs*, *supra* note 2.

15. *See, e.g.*, DEL. CODE ANN. tit. 8, § 101 (2020).

therefore the result of government action, and corporations are often the objects of extensive governmental regulation and attention. Governments created the corporate form because of its potential to create unique social benefits, and governments regulate corporations largely in an attempt to control the negative externalities they create.[16]

Historically, the first corporate charters in the United States were granted to organizations that today we would call charitable organizations, such as hospitals and universities.[17] These organizations made direct requests to state legislatures for corporate charters. Governments were motivated to grant these charters to ensure these organizations could continue to provide public services notwithstanding the individual choices or circumstances of the contributors of capital.[18]

As the U.S. economy developed and evolved, corporate charters were increasingly granted to more profit-driven endeavors such as banking and the construction of turnpikes, which, while not charitable, nevertheless provided important public services.[19] These were endeavors that required substantial capital inputs, and that provided clear and important public services that would be substantially inhibited if capital contributors were able to withdraw their contributions.[20] In the nineteenth century United States, as industrialization set in and business practices expanded their geographic scope, the utility of a corporate charter proved to have a much broader application. In an attempt to democratize the corporate form, states began to adopt statutes making corporate formation publicly available (that is, not requiring a specific appeal to a legislature for a charter),[21] and the number of incorporated organizations increased dramatically.[22] States adopted statutes allowing for the formation of corporations because they recognized the social utility of amassing capital from unrelated investors and directing it to business organizations that operated across geographic boundaries and over indefinite periods of time.

With the advent of the corporation, equity investors were now protected from personal liability, not required to devote resources to actively managing

16. Eric C. Chaffee, *The Origins of Corporate Social Responsibility*, 85 U. CIN. L. REV. 347, 351 (2017).

17. Margaret M. Blair, *Reforming Corporate Governance: What History Can Teach Us*, 1 BERKELEY BUS. L.J. 1, 11–12 (2004).

18. Without a corporate charter, the business activities of these institutions would have been treated as partnerships under the law. Partners were entitled to withdraw their share of the partnership's assets upon request, and partnerships dissolved upon the death of a partner. These characteristics created uncertainty about the long or medium-term prospects of the partnership enterprise, which likely deterred investment. Granting a corporate charter allowed the organization's assets to be held by a fictional "legal person," permitting the organization to continue to provide important public services without interruption. *Id.*; *see also* Ralph Nader et al., TAMING THE GIANT CORPORATION 33 (1976).

19. Blair, *supra* note 17, at 12–13.

20. As they could in the traditional partnership form. *Id.* at 20; Nader et al., *supra* note 18, at 34.

21. ADAM WINKLER, WE THE CORPORATIONS: HOW AMERICAN BUSINESSES WON THEIR CIVIL RIGHTS 92 (2018) (noting that when direct appeals to the legislature were required to form a corporation, charters tended to be granted predominantly to the wealthy and well-connected).

22. Nader et al., *supra* note 18, at 36–38.

the enterprise,[23] and could sell their shares to an available buyer should they decide to end their investment. Moreover, equity holders were not permitted to withdraw their share of corporate assets, and the corporation survived its equity investors, giving investors greater assurance as to the long-term viability of the enterprise.[24] With these advantages, businesses formed as corporations could more easily attract capital. Via the corporate form, a much broader swath of society could benefit from the social and economic contributions of business activity.

As business professors Michael C. Jensen and William A. Meckling concluded in their seminal paper on the structure of the firm, "[t]he publicly held business corporation is an awesome social invention."[25] This is so because it encourages capital to flow from a broad array of relatively small investors to enterprises that can provide quality-of-life-enhancing goods and services to a large population over an extended period of time. The ability to simultaneously provide benefits to shareholders, consumers and other corporate stakeholders is therefore a foundational characteristic of the corporate form.[26]

B. The Relationship Between Shareholder and Other Stakeholder Interests

Acknowledging that the fundamental goal of corporations is to provide benefits to a variety of stakeholders raises the question of whether improved outcomes for non-shareholders contribute to or come at the expense of shareholder returns. The group of individuals impacted by a large, publicly traded corporation's actions—its "stakeholders"—is very broad and extends well beyond shareholders. As corporations have expanded in size and geographic scope, this group has only grown. Scholars and observers have variously identified numerous categories of corporate stakeholders, including employees, directors, shareholders, creditors, customers, suppliers,

23. This is an important characteristic that is discussed further in Subpart III.B.3.

24. Blair, *supra* note 17, at 4, 7.

25. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 357 (1976).

26. Substantial debate exists over whether corporations should be managed with an explicit focus on their social impacts. *See* Emily Winston, *Benefit Corporations and the Separation of Benefit and Control*, 39 CARDOZO L. REV. 1783, 1790–96 (2018). But even those who argue that corporations should be managed with no goal other than profits and shareholder returns, do so on the basis that this will result in the best economy-wide social outcome. *See, e.g.*, Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), https://timesmachine.nytimes.com/timesmachine/1970/09/13/issue.html (describing the adverse social effects of managers spending corporate resources to promote "social" causes: "Insofar as his actions in accord with his 'social responsibility' reduce returns to stockholders, he is spending their money. Insofar as his actions raise the price to customers, he is spending the customers' money. Insofar as his actions lower the wages of some employees, he is spending their money."); *see also* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1644 (2013) ("[S]hareholder ability to intervene and engage with companies provides long-term benefits to companies, shareholders, and the economy.").

governmental officials, communities, the environment, and society.[27] Because of the diversity of interests at stake, it is highly possible that conflicts will arise among stakeholder groups—that is, that the promotion of one stakeholder group's interests may come at the expense of the other. Given the longstanding focus on share price in corporate scholarship and practice (described in more detail in Part II herein), the question that most often arises is whether promoting the interests of non-shareholder stakeholders must result in a reduction in returns to shareholders.[28] That is, will focusing on other stakeholder impacts simply re-distribute some of the shareholders' slice of the pie to other groups? Or, might improving returns to non-shareholder stakeholders result in a larger pie that also results in a larger slice for shareholders? The approach described in Fink's letter is an effort to increase the size of the pie via attention to non-shareholder stakeholders.

Many scholars have endeavored to empirically test the relationship between shareholder and other stakeholder interests. While such studies are quite numerous, they fail to conclusively answer the question.[29] To highlight but a few divergent results, Allen Ferrell et al. compared firms' indicators of corporate social responsibility to their indicators of managerial agency problems and found a positive relationship between socially responsible firm activity and firm value.[30] In contrast, Kenneth Aupperle et al. surveyed firms to ascertain their social responsibility-orientation and found no relationship between social responsibility and profitability.[31] Situated halfway between these two outcomes,

27. *See, e.g.*, Blair & Stout, *supra* note 12, at 253 (identifying "employees, consumers, creditors, and other corporate 'stakeholders'"); *see also* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH 31–32 (1984) ("The list of stakeholders originally included shareholders, employees, customers, suppliers, lenders and society."); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, *in* U.S. CORPORATE GOVERNANCE 3, 4 (Donald H Chew & Stuart L. Gillan eds., 2009) ("Stakeholders include all individuals or groups who can substantially affect, or be affected by, the welfare of the firm—a category that includes not only the financial claimholders, but also employees, customers, communities and government officials."); WILLIAM H. CLARK, JR. & LARRY VRANKA, THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION: WHY IT IS THE LEGAL FORM THAT BEST ADDRESSES THE NEEDS OF SOCIAL ENTREPRENEURS, INVESTORS, AND, ULTIMATELY, THE PUBLIC, 5–6 n.21 (2013), http://benefitcorp.net/sites/default/files/Benefit_Corporation_White_Paper.pdf ("Key stakeholders in a business organization include customers, directors, employees, shareholders, suppliers, the community from which the business draws its resources, etc.").

28. The question of tradeoffs among non-shareholder stakeholders is also interesting but receives substantially less attention due to the historical primacy of shareholder interests. Though, as Part III will describe, the team production theory speaks to this issue.

29. *See* Michael L. Barnett, *Stakeholder Influence Capacity and the Variability of Financial Returns to Corporate Social Responsibility*, 32 ACAD. MGMT. REV. 794, 794 (2007) ("[A]fter more than thirty years of research, we cannot clearly conclude whether a one-dollar investment in social initiatives returns more or less than one dollar in benefit to the shareholder.").

30. Allen Ferrell, et al., *Socially Responsible Firms*, 122 J. FIN. ECON. 585, 585 (2016) ("[W]ell-governed firms that suffer less from agency concerns (less cash abundance, positive pay-for-performance, small control wedge, strong minority protection) engage in more CSR. We also find that a positive relation exists between CSR and value and that CSR attenuates the negative relation between managerial entrenchment and value.").

31. Kenneth Aupperle, et al., *An Empirical Examination of the Relationship Between Corporate Social Responsibility and Profitability*, 28 ACAD. MGMT. J. 446, 446 (1985) ("This study . . . did not find any

Shawn Berman et al. found that attending to non-shareholder stakeholders for strategic reasons enhances financial performance, whereas doing so for intrinsic reasons does not.[32] While the balance of evidence seems to weigh in favor of a positive relationship between attention to non-shareholder stakeholders and firm value, these studies point in a number of different directions regarding whether, to what extent, and in what circumstances this relationship exists.[33]

The difficulty in arriving at a determinative empirical conclusion about the relationship between shareholder and other stakeholder interests is not surprising given the diversity of stakeholder groups described above. We should expect results to vary based on which stakeholder groups are the subject of managerial attention, in what proportions, in what type of industry and in what type of business and political environment, among other factors.[34] It is quite easy to imagine ways in which too much concern for non-shareholder stakeholders could shrink the corporate pie. Excessively high wages or excessively low prices could cause a corporation to be unprofitable. However, excessively low wages or high prices could have a similar effect. Thus, a definitive answer to the question of whether shareholders benefit from managerial attention to other stakeholders is unattainable. The question is simply too broad.

Nonetheless, it should be uncontroversial that some level of attention to other stakeholders not only benefits shareholders, but is necessary to create any return to shareholders at all. A corporation must give some amount of attention to the needs of its employees in order to recruit and retain a workforce.[35]

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relationship between social responsibility and profitability. Specifically, varying levels of social orientation were not found to correlate with performance differences.").

32. Shawn Berman, et al., *Does Stakeholder Orientation Matter? The Relationship Between Stakeholder Management Models and Firm Financial Performance*, 42 ACAD. MGMT. J. 488, 488 (1999) ("The results provide support for a strategic stakeholder management model but no support for an intrinsic stakeholder commitment model.").

33. Empirical studies of this relationship are far too numerous to list here, but several additional examples include: Xin Deng, et al., *Corporate Social Responsibility and Stakeholder Value Maximization: Evidence from Mergers*, 110 J. FIN. ECON. 87 (2013) (finding that corporate acquirers with a stronger commitment to CSR performed better post-merger); Caroline Flammer, *Corporate Social Responsibility and Shareholder Reaction: The Environmental Awareness of Investors*, 56 ACAD. MGMT. J. 758 (2013) (finding stock price increases following reporting of responsible environmental behavior by companies); Preston E. Lee & Harry J. Sapienza, *Stakeholder Management and Corporate Performance*, 19 J. BEHAV. ECON. 361 (1990) (finding most indicators of stakeholder performance are associated with conventional measures of corporate profitability and growth). *But see* Ing-Haw Cheng, et al., *Do Managers Do Good with Other People's Money?* (Nat'l Bureau of Econ. Research, Working Paper No. 19432, 2013), https://www.nber.org/papers/w19432.pdf (finding that spending on CSR is partly due to agency problems).

34. *See* Barnett, *supra* note 29, at 795 ("The unique and dynamic characteristics of firms and their environments preclude stability in financial returns to CSR across firms and time, so we should not expect to empirically discern a consistent financial benefit—essentially, a universal rate of return—to a generic corporation for some given unit of social investment.").

35. *See* Peter Georgescu, *Just 100 Do Well by Doing Good*, FORBES (Jan. 10, 2018, 8:39AM), https://www.forbes.com/sites/petergeorgescu/2018/01/10/just-100-well-by-doing-good/#125d3fd86335 ("Increasingly, the only way to win is to treat your employees and customers as if they matter as much as your profits. . . . It's counter-intuitive to think you will earn more by increasing the largest cost of doing business, your payroll. But it works.").

Likewise, it needs to attend adequately to the preferences of its suppliers in order to attract supplies, and to the needs of its creditors in order to attract credit. Similar statements can be made for other corporate stakeholders as well, and without these stakeholder inputs the corporation cannot produce anything.[36] Therefore, there is some minimum level of attention to non-shareholder stakeholders that is required in order for the corporation to earn any profits that it can return to shareholders. And, it is safe to assume that the amount of stakeholder attention that will maximize corporate output and firm value is somewhere above this bare minimum. So, up to a point, focusing on the effects of corporate activity on groups other than shareholders can be expected to have a positive impact on shareholder returns. Larry Fink's letter appears inspired by a desire to reach that point, and this Article analyzes whether shareholders like BlackRock are capable of identifying the profit-maximizing mix of attention to non-shareholders stakeholders.

C. Parameters of Analysis

While the potential coincidence of shareholder and other stakeholder interests is an important phenomenon that should be exploited, it is certainly not the case that profit-seeking behavior by corporations can cure all social ills. Acknowledging this limitation, the scope of the analysis in this Article is circumscribed in two important ways.

First, not all stakeholder interests can be effectively promoted by corporate action. There will often be instances where responsibility for protecting stakeholder interests more appropriately and effectively falls to the government. Stakeholder interests can roughly be divided into three categories, depending on the extent to which corporate activity can effectively address them.

The first category comprises stakeholder interests that cannot be adequately protected by corporate management alone. Corporations need to induce stakeholders to contribute to the firm, whether in the form of employee time, customer purchases, or any other relevant input. However, this corporate demand will only work for the benefit of stakeholders where adequate competition exists for their contributions. Where well-functioning markets do not exist for stakeholder inputs, stakeholder interests will require government protection.

Perhaps most prominently, there is no naturally existing market for environmental inputs. As a public good, regulation is necessary to ensure that environmental resources are not depleted by corporate production. For other stakeholder groups, markets may naturally exist, but will require government intervention to function properly. For example, a well-functioning market for customers requires effective competition law, and the market for labor may require employment laws to ensure that employees have adequate bargaining

36. A corporation's need to attract inputs from an array of stakeholders is the basis of the team production theory of the corporation, which is discussed in detail in *infra* Subpart III.A.

power to create a robust market for their labor.[37] Interests in this first category require government intervention because corporate action alone cannot address them.

The second category comprises stakeholder interests that could be addressed by governmental regulation, corporate management, or by some combination of the two. Examples of second category interests include family leave or product safety. These are issues for which a society may believe there is a minimum standard below which no corporation should be permitted to fall. It is the role of government to set that minimum standard. However, above the minimum standard, corporate managers can choose the level that will attract the optimal stakeholder inputs to maximize the value of corporate production. Thus, most issues in this category will involve both government and management intervention, and the scope of possible corporate intervention will be a function of the minimum standards set by the government.

The third category comprises stakeholder interests that can only be effectively addressed by corporate managers. These interests include product development, employee development, and creating a culture of integrity and compliance.[38] Product development is a means by which corporations meet their customers' needs. Employee development and wellness programs are a means by which corporations further the interests of their employees in a manner that is specific to the corporation. And, creating a corporate culture of integrity and compliance promotes the interests of all stakeholders who are the beneficiaries of that integrity, including shareholders. These issues have very clear stakeholder impacts, but are very specific to the context of each individual corporation. As such, they are not appropriate areas for governmental intervention, and are instead issues to be addressed internally by corporate managers. Because this Article discusses corporate impacts on non-shareholder stakeholders, the discussion herein is limited to second and third category interests.

An additional boundary of the discussion arises from acknowledging that the specific quantity and composition of corporate attention to stakeholders that maximizes returns to shareholders may not be the same package of stakeholder attention that maximizes the net social benefit of a corporation's activities. While maximizing net social benefit is an appropriate goal for corporate activity

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37. *See, e.g.*, *If Wages are to Rise, Workers Need More Bargaining Power*, THE ECONOMIST (May 31, 2018), https://www.economist.com/finance-and-economics/2018/05/31/if-wages-are-to-rise-workers-need-more-bargaining-power; Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913, 1947–48 (1996) (describing how the threat of unionization disciplines corporate managers). Indeed, even Milton Friedman contemplated an important role for labor unions in exerting pressure on corporate managers. MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962) (arguing that corporate managers have no "social" responsibility to their employees because employees have labor leaders to represent their interests).

38. While the securities laws may, appropriately, mandate compliance procedures, creating a culture that fosters compliance is dependent on firm management. *See, e.g.*, Donald C. Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933, 949 (2017).

at a societal level, the analysis in this Article is more limited in scope. Fink's letter is a response to calls on shareholders to use their influence to direct corporate attention to other stakeholders. Such calls are not made with the hope that institutional investors will do so altruistically, but rather are based on a belief that doing so will financially benefit most shareholders.[39] Thus, in examining the limitations of the approach represented by Fink's letter, the analysis herein is limited to the economic space wherein attention to non-shareholder stakeholders can be expected increase returns to shareholders.

On the basis of the discussion above, the remainder of this Article proceeds from the premise that some corporate attention to non-shareholder stakeholders is necessary to maximize corporate value, and that the Fink letter and the calls to which it is a response represent an effort to push corporate managers toward the profit-maximizing level of stakeholder engagement. To that end, it focuses on the economic area where the interests of shareholders and other stakeholders coincide.

II. CURRENT STATUS OF U.S. EQUITY MARKETS

If attention to a corporation's non-shareholder stakeholders is, at least sometimes, expected to be conducive to shareholder returns, then Fink's letter seems unsurprising. He is merely asking BlackRock's investee companies to turn their attention to issues that will likely have a positive effect on returns to BlackRock's clients.[40] Nonetheless, it came as a surprise to many observers because it was a departure from recent past practices. This begs the question: what has changed? If managerial attention to other stakeholders is necessary to maximize returns to shareholders, why have shareholders not always focused on this issue? And, why is anyone surprised they are doing so now? This Part describes the substantial changes that have occurred in U.S. public equity markets over the past several decades and the theory underlying many of these changes. It then describes the concerns about corporate impacts that have arisen in the wake of these changes and explains the impetus to call on powerful shareholders like BlackRock to address these concerns.

39. Fink, *2018 Letter to CEOs*, *supra* note 2.

40. It is quite possible that Fink's purpose in crafting this letter was something other than a sincere intent to engage with BlackRock's investee companies on issues of social responsibility. Several other plausible explanations exist, including that the letter is either an attempt to avoid future regulation or a marketing ploy. The sincerity of the letter is not relevant to the argument made here. *See id*.

A. TODAY'S SHAREHOLDERS EXERT SUBSTANTIAL INFLUENCE OVER CORPORATE MANAGERS

1. *Theoretical Antecedent: Agency Cost Theory*

Concerns about shareholders' limited ability to monitor corporate managers have dominated discussions about corporate activity for decades, but many of the changes that have taken place in U.S. public equity markets over the last several decades have, to an extent, assuaged these concerns.

The origin of this discussion among U.S. legal scholars lies in Professors Adolf Berle and Gardiner Means' famous 1934 book, *The Modern Corporation and Private Property*.[41] Berle and Means conceived of shareholders as the owners of the corporation who were granted only limited rights to control the managers who they hire as agents to run their corporation. Berle and Means were concerned that these limited rights left shareholders without adequate control over managers, who could in turn manage corporations in furtherance of their own interests and to the detriment of shareholders and the corporate enterprise.[42] That is, the "separation of ownership and control" meant that shareholders, as principals, faced agency costs arising from their inability to adequately control their manager "agents." This concept was formalized into an economic theory by Professors Jensen and Meckling in 1976,[43] and has continued to dominate conversations about corporate control among practitioners and academics.[44]

Under this theoretical framework, the combined effects of legal constraints and the dispersion of share ownership in publicly traded corporations result in agency costs to shareholders. Corporate law in the United States grants shareholders only limited rights to control directors and officers, while primary

41. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). The earliest identification of this potential problem may have been in Adam Smith's *The Wealth of Nations* in 1776, where he pointed out the inadequate incentives facing managers who manage "other people's money." 1 ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 311 (1776) ("The directors of such [joint-stock] 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 copartner frequently watch over their own.").

42. BERLE & MEANS, *supra* note 41, at 116 ("[I]t is therefore evident that we are dealing not only with distinct but often with opposing groups, ownership on the one side, control on the other— a control which tends to move further and further away from ownership and ultimately to lie in the hands of the management itself, a management capable of perpetuating its own position.").

43. Jensen & Meckling, *supra* note 25.

44. Blair & Stout, *supra* note 12, at 248 ("Contemporary discussions of corporate governance have come to be dominated by the view that public corporations are little more than bundles of assets collectively owned by shareholders (principals) who hire directors and officers (agents) to manage those assets on their behalf."). A sample of prominent literature studying managerial agency costs includes: Lucian Bebchuk, et al., *What Matters in Corporate Governance?*, 22 REV. FIN. STUD. 783 (2009); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); Michael S. Rozeff, *Growth, Beta and Agency Costs as Determinants of Dividend Payout Ratios*, 5 J. FIN. RES. 249 (1982).

responsibility for managing the corporation lies with the board of directors.[45] Shareholders have the right to elect directors, vote on major transactions, inspect corporate books and records and file derivative suits.[46] These rights give shareholders the ability to approve of or intervene after board action, but they do not give shareholders the right to initiate any major corporate decisions.[47] In theory, shareholders' power to replace directors should incentivize directors to take actions that promote shareholders' interests.[48] However, in order for shareholders to use the limited rights they do hold to police corporate management, they must coordinate among themselves. Under state corporation law, a shareholder vote against corporate action requires a majority vote, and directors are elected by a plurality.[49] Agency costs arise when shareholders cannot or do not organize to use these rights to ensure the firm is managed for their benefit. When shareholdings are widely dispersed among many shareholders holding small percentages of equity, collective action problems make such coordination difficult.[50]

Concerns about shareholder-manager agency costs derive not only from concern about shareholders' own financial interests, but also from a belief that shareholders are the stakeholder group best positioned to maximize the total value created by firms.[51] This belief arises from characterizing shareholders as "residual claimants" to the corporation.[52] That is, shareholders are the group entitled to receive "whatever remains after all revenues have been collected and all debts, expenses and other contractual obligations have been paid."[53] In the "classical firm" that underlies agency cost theories, it is assumed that the non-shareholder stakeholders who contribute to the firm do so subject to contracts that specify the portion of firm value that each non-shareholder stakeholder will

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45. DEL. CODE ANN. tit. 8, § 141 (2020) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

46. *Id*. at §§ 211–212, 220, 251(c), 327.

47. Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 836 (2005) ("A central and well-settled principle of U.S. corporate law is that all major corporate decisions must be initiated by the board. Shareholders may not initiate any such decisions.").

48. *Id.* at 837. Shareholders may also signal discontent by selling their shares, though this option's availability is decreasing as more and more investors place their investments in index funds and ETFs, which invest in a particular group or "index" of companies and do not sell their shares unless a company no longer meets the criteria to be in the group. Dawn Lim, *Index Funds Are the New Kings of Wall Street*, WALL ST. J. (Sept. 18, 2019, 5:30 AM) https://www.wsj.com/articles/index-funds-are-the-new-kings-of-wall-street-11568799004.

49. DEL. CODE ANN. tit. 8, § 216. *But see infra* Subpart II.A.2 (describing the recent trend of public corporations adopting majority voting provisions).

50. Professor Mark Roe has argued that the dispersion of shareholders in the U.S. equity markets is itself a result of U.S. legal rules. MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE (1994).

51. Bebchuk, *supra* note 47, at 842–43 ("[I]ncreased shareholder power would be desirable only if it would operate to improve corporate performance and value.").

52. PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT 291 (1992).

53. *Id*.

receive.[54] With all amounts due to non-shareholder stakeholders fixed, the only way to increase the total amount of value created by the firm is to increase the "residual claim," which goes to the shareholders. Thus, it is argued, shareholders should control corporations so that they can maximize the residual claim and therefore maximize firm value.[55] If shareholders hire managers that they cannot adequately control, it is feared that managers will manage the corporation in a manner that improperly directs rents to the managers and therefore does not maximize firm value.[56] These theories, which characterize shareholders as firm owners and residual claimants, have driven corporate law scholars to focus squarely on shareholder agency costs as the defining problem in corporate law.

Subpart III.B will explore the ways in which real life corporations diverge from this classical model, and the implications for the limitations of shareholder oversight. In recent years, however, structural changes in the U.S. equity markets have empowered shareholders and therefore substantially reduced shareholder-manager agency costs, providing an opportunity to evaluate the results of their reduction. The following Subpart details these changes.

2. Shareholder Empowerment Trend

Over the past several decades, a number of trends have emerged that, combined, have drastically increased shareholders' influence over corporate management. The financial theories that facilitated these trends began to develop as early as the 1950s, while notable changes in the publicly traded equity markets accumulated over the following decades.

a. The Foundations of Modern Financial Theory Demonstrated the Wisdom of Diversified Passive Investment

In the 1950s through 1970s, several important financial theories were developed which continue to form the foundation of much thinking about financial markets. Modern portfolio theory, which originated in a paper by economist Harry Markowitz in 1952, describes how investment portfolios can be assembled to optimize or maximize expected return given the investor's preferred level of risk.[57] The capital asset pricing model, which established the tools to measure the risk, return and performance of investment portfolios, was also developed during this period.[58] Then, around 1970, the Efficient Capital Markets Hypothesis (ECMH) was established in a paper by economist Eugene

54. *Id*.

55. Via their residual control rights. "Residual control rights" refers to the rights to make decisions about the use of corporate assets that are not explicitly controlled by law or assigned to another by contract. *Id.* at 289.

56. *See infra* Subpart III.C.

57. Harry Markowitz, *Portfolio Selection*, 7 J. FINANCE 72, 77 (1952).

58. André F. Perold, *The Capital Asset Pricing Model*, 18 J. ECON. PERSP. 3, 3 (2004) ("The CAPM was developed in the early 1960s by William Sharpe (1964), Jack Treynor (1962), John Lintner (1965a, b) and Jan Mossin (1966).").

Fama.[59] The fundamental takeaway from the ECMH is that "*in an efficient market, the price of an asset fully reflects all available information about that asset.*"[60] The groundbreaking implication of the ECMH is that active trading in pursuit of speculative gains is useless, so employing the services of professional traders cannot consistently result in above-average returns.[61]

While these theories continue to be revised and questioned,[62] the foundational concepts they established remain very influential. Their combined implication for investors is that a prudent investor will invest in a passively managed, diverse portfolio.

b. The Consequent Institutionalization of Shareholdings

Institutional investors became increasingly prominent beginning in the 1980s in large part because they allowed individual investors to follow the investment advice suggested by the recently developed financial theories described above.[63] Institutional investors pool the smaller investments of many and invest them according to some strategy developed by the institution. This pooling of investment assets creates economies of scale and allows investors to outsource investment decisions to experts.[64] The message of the ECMH that above-market returns are not consistently attainable has drastically increased the popularity of index funds and exchange traded funds, which do not engage in active trading strategies.[65] The result is that very few households currently own stock directly. Those households that own stock instead generally hold their shares through institutional intermediaries.[66]

Institutional investors can take several forms and serve several purposes. BlackRock and its "big three" co-members, State Street and Vanguard, are prominent among these institutions.[67] They invest money on behalf of individuals and also other institutions such as retirement plans, endowments, and

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59. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FINANCE 383 (1970).The ECMH also has its origins in the work of Paul Samuelson. *See* Paul A. Samuelson, *Proof that Properly Anticipated Prices Fluctuate Randomly*, 6 INDUS. MGMT. REV. 41 (1965).

60. ANDREW W. LO, ADAPTIVE MARKETS 16 (2017); Fama, *supra* note 59, at 384.

61. LO, *supra* note 60, at 23.

62. In particular, the perfect efficiency of markets has been widely and convincingly questioned in response to crises such as the dot-com bubble and the Great Recession. *See, e.g.*, JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET: A HISTORY OF RISK, REWARD, AND DELUSION ON WALL STREET (2009); LO, *supra* note 60; Burton G. Malkiel, *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSP. 59 (2003).

63. LO, *supra* note 60, at 27 ("It's no exaggeration to say that the Efficient Markets Hypothesis was responsible for the emergence of the index mutual fund business.").

64. POONEH BAGHAI ET AL., MCKINSEY & CO., THE NEW GREAT GAME IN NORTH AMERICAN ASSET MANAGEMENT (2018), https://www.mckinsey.com/industries/financial-services/our-insights/the-new-great-game-in-north-american-asset-management.

65. Fichtner et al., *supra* note 1, at 298–300.

66. *See* Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite? A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870, 1872–73 (2017). In 2016, 44.4% of the U.S. households held fund shares. INV. CO. INST., 2017 INVESTMENT COMPANY FACT BOOK 112 fig.6.1 (57th ed., 2017).

67. *See* Fichtner et al., *supra* note 1, at 299.

insurance companies.[68] Beyond the "big three," there are many other smaller asset managers in the industry.[69] Moreover, many institutions such as insurance companies, pension funds, and sovereign wealth funds may also hold shares directly, without intermediation by an asset manager; thus they constitute another form of institutional investor.

Important among the ecosystem of institutional investors are hedge funds, which also pool the capital of smaller investors but use riskier investment practices than other funds, such as leverage, investment in derivatives and short selling.[70] A small but vocal subset of hedge funds also engages in activist strategies to force changes to the management of the companies in which they invest.[71] Hedge funds engage in activism by acquiring a substantial equity interest in a publicly traded corporation and using that position to press for changes in the capital structure or business plan of the corporation.[72] The fund presses for these changes because it believes they will increase the company's share price and thus allow for returns to the fund's investors upon sale of the shares. Activist hedge funds hold largely undiversified investments, giving them ample incentive to take on the costs of a campaign against corporate management.[73] While activist funds constitute a small minority of hedge funds, their influence far exceeds their market share, and executives are widely fearful of hedge fund activism.[74]

Importantly, activist hedge funds' ability to engage in activism depends on the existence of other institutional investors with sizeable stakes in the target corporation. Hedge funds themselves take on a sizeable stake in their target companies, but given the enormous market capitalization of most publicly traded corporations, they cannot take on a majority stake. Thus, they rely on the votes

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68. *See, e.g.*, *Our Clients*, BLACKROCK, https://www.blackrock.com/ca/institutional/en/our-clients?nc=true&siteEntryPassthrough=true (last visited Mar. 20, 2020); *Our Clients*, THE VANGUARD GRP., https://about.vanguard.com/our-clients/ (last visited Mar. 20, 2020).

69. *See* Liam Kennedy, *Top 400 Asset Managers 2018*: *10 years of Asset Growth*, INV. & PENSIONS EUR. MAG. (last visited Mar. 20, 2020), https://www.ipe.com/reports/special-reports/top-400-asset-managers/top-400-asset-managers-2018-10-years-of-asset-growth/10025004.article.

70. SEC, HEDGE FUNDS INVESTOR BULLETIN HEDGE FUNDS (2012), https://www.sec.gov/investor/alerts/ib_hedgefunds.pdf.

71. *See* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1046 (2007) (noting only five percent of hedge fund assets were devoted to activist activities in 2006); Strine, *supra* note 66, at 1885–86 n.47.

72. Strine, *supra* note 66, at 1886.

73. John C. Coffee Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. LAW 545, 548 (2016).

74. *See, e.g.*, THE ACTIVIST INVESTING ANNUAL REVIEW 2018, ACTIVIST INSIGHT 3 (2018), https://www.srz.com/images/content/1/5/v2/155375/The-Activist-Investing-Annual-Review-2018-HiRes.pdf (documenting the trend of increased activist activity over the last several years); Nabila Ahmed et al., *The World's Most Feared Investor*, BLOOMBERG, https://www.bloomberg.com/graphics/2017-elliott-management/ (last updated Aug. 22, 2017); William D. Cohan, *Starboard Value's Jeff Smith: The Investor CEOs Fear Most* (Dec. 3, 2014), http://fortune.com/2014/12/03/starboard-capitals-jeff-smith-activist-investor-darden-restaurants/.

of other institutional shareholders to be able to credibly threaten to vote out directors. [75]

The percentage of institutional holdings of publicly traded stock has steadily increased since 1980.[76] Institutional investors currently hold approximately eighty percent of U.S. equities.[77] The result is that shareholdings today are much more concentrated than they have been historically. Institutional investors hold a larger percentage of shares in any one company than virtually any individual investor could. Thus, the dispersion of shareholdings, which was a principal impediment to shareholders' ability to exercise their rights, has substantially decreased.

c. Laws and Regulations Are Directed at Increasing Shareholder Influence Over Corporate Management

While individual investors' desire to diversify and invest passively resulted in more concentrated shareholdings, regulators, concerned about agency costs, simultaneously implemented legal and regulatory changes that increased the power of the shareholder franchise against a backdrop of state corporation law that is shareholder-focused.[78] A few prominent examples are described below.

In 1988, the Department of Labor (DOL) issued its "Avon Letter," stating that investment advisers managing retirement accounts are required to cast a vote on every matter up for shareholder vote.[79] The DOL considered voting these shares to be consistent with the advisers' fiduciary duties. This imposed a voting requirement on many investment funds, increasing the number of shareholder votes cast in corporate elections.[80] In 2003, the Securities and Exchange Commission (SEC) issued a similar rule, requiring investment advisers to "adopt

75. They may also rely on the support of other activist funds, a phenomenon referred to as "wolf pack" activism. *See* Strine, *supra* note 66, at 1871.

76. *See* Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEX. L. REV. 987, 995–98 (2010); Serdar Çelik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, 2013 OECD J. 93, 94 (2014), https://www.oecd.org/corporate/Institutional-investors-ownership-engagement.pdf; OECD, OECD INSTITUTIONAL INVESTORS STATISTICS 2009–2016 (2017), https://read.oecd-ilibrary.org/finance-and-investment/oecd-institutional-investors-statistics-2017_instinv-2017-en#page1; Marshall E. Blume & Donald B. Keim, Institutional Investors and Stock Market Liquidity: Trends and Relationships (Aug. 21, 2012) (unpublished Working Paper), http://dx.doi.org/10.2139/ssrn.2147757.

77. *See* McGrath, *supra* note 8.

78. Robert C. Bird & Stephen Kim Park, *Organic Corporate Governance*, 59 B.C. L. REV. 21, 41 (2018) ("Shareholder empowerment has been the focal point of immense regulatory and organizational resources in the past couple decades."). Delaware, the state where most S&P 500 firms are incorporated, grants corporate managers substantial leeway in business decisions under the business judgment rule, but requires that business decisions have some nexus to shareholder returns. *See, e.g.*, eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 30 (Del. Ch. 2010) (clarifying that the promotion of a non-stockholder interests is not protected by the business judgment rule unless it will eventually lead to stockholder gain).

79. Daniel M. Gallagher, *Outsized Power & Influence: The Role of Proxy Advisers* 3 (Wash. Legal Found., Working Paper No. 187, 2014), http://www.wlf.org/upload/legalstudies/workingpaper/GallagherWP8-14.pdf; Re: Avon Products, Inc. Employee's Retirement Plan, 1988 ERISA Lexis 19, at *6 (Feb. 23, 1988). Specifically, investment advisers of funds with twenty-five percent or more of fund shares held in retirement accounts. 29 C.F.R. § 2510.3-101(f) (2020).

80. Gallagher, *supra* note 79, at 3–4.

policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients" and disclose information about those votes to their clients.[81] This rule extended the influence of the Avon Letter beyond just funds managing substantial retirement accounts.

In 1992, the SEC enacted changes to proxy rules to make it easier for shareholders to make 14a-8 shareholder proposals by limiting the circumstances under which doing so would trigger filing requirements and restrictions.[82] Rule 14a-8 requires corporations to include shareholder proposals in their proxy materials if certain requirements are met.[83] Such proposals can address social and environmental issues, shareholder rights issues, or other corporate policies.[84] While 14a-8 proposals are precatory and therefore non-binding, they can signal shareholder discontent to corporate managers. This reform therefore increases shareholders' voice.[85] Indeed, the ability to place shareholder proposals on the proxy statement was a key contributor to the fifth trend described below.

In 2010, an amendment to New York Stock Exchange Rule 452 prohibited brokers from voting shares in director elections when they have not received instructions from their customers as to how to vote ("uninstructed shares").[86] Prior to this amendment, brokers could vote uninstructed shares at their discretion.[87] Because brokers tended to vote uninstructed shares in favor of management, this rule change reduced the number of shares voted in favor of management, increasing the relative weight of shareholder votes against management.[88]

The 2011 "Say on Pay" rules adopted as a result of the Dodd Frank Act require an advisory (non-binding) shareholder vote on compensation packages

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81. Final Rule: Proxy Voting by Investment Advisors, Exchange Act Release No. IA-2106, 79 SEC Docket 1673 (Jan. 31, 2003).

82. 17 C.F.R. § 240.14a-8 (2020). SEC ANN. REP. viii (1992), https://www.sec.gov/about/annual_report/1992.pdf. The 1992 rule changes limited the circumstances under which shareholder communications in advance of a proposal would be considered "proxy solicitations." Proxy solicitations trigger filing requirements and restrictions. *See* Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233, 236 (2000).

83. The requirements include a minimum stake in the company and requirements as to length of the proposal and timing for filing. If these requirements are not met, the corporation may exclude the proposal only if it falls into one of thirteen substantive categories that the SEC deems inappropriate for shareholder action. 17 C.F.R. § 240.14a-8; Scott Lesmes, *Frequently Asked Questions About Shareholder Proposals and Proxy Access*, MORRISON & FOERSTER LLP (2017), https://media2.mofo.com/documents/frequently-asked-questions-about-shareholder-proposals-and-proxy-access.pdf.

84. *Shareholder Proposal Developments During the 2017 Proxy Season*, GIBSON DUNN (June 29, 2017), https://www.gibsondunn.com/shareholder-proposal-developments-during-the-2017-proxy-season/ (noting that, in 2017, shareholder proposals on social issues were most common, followed by environmental, proxy access, and political disclosure).

85. Bird & Park, *supra* note 78, at 39 ("The shareholder proposal mechanism is the most widely recognized and formal method for shareholders to exercise their voice in corporate decision-making.").

86. Howard B. Dicker et al., WEIL BRIEFING: SEC DISCLOSURE AND CORPORATE GOVERNANCE 1 (2009), http://www.weil.com/~/media/files/pdfs/Weil_Briefing_SEC_CG_July_9.pdf.

87. *Id.*

88. Stephen Choi et al., *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 874 (2010).

for executives.[89] The "Say on Pay" rules are intended to allow shareholders to put management on notice if they are displeased with the compensation provided to executives. This rule gives corporate executives yet another incentive to please shareholders.

This list is not comprehensive, and efforts to further empower shareholders via legislative or regulatory means continue.[90] With respect to SEC rulemaking, the SEC's mission prominently includes protecting investors,[91] so it is unsurprising that it would regularly issue rules that "constrain management's ability to disregard shareholder demands."[92] The effect of any regulation that enhances shareholders' ability to influence management works to reduce the "separation of ownership and control."

d. Proxy Advisors Arise, Which Facilitate Coordination Among Institutional Shareholders

In the midst of the abovementioned changes, a private industry of proxy advisory firms, or proxy advisors, arose. Proxy advisors compile and analyze information about publicly traded companies on the basis of which they make recommendations to institutional investors about how to vote their shares.[93] Proxy advisors became prominent in the 1990s to help the increasingly popular institutional investors reduce their costs of voting.[94] In a minority of cases, an institutional investor will completely outsource its voting function to the proxy advisor. More often, the institutional investor will pay only for advice and a voting recommendation.[95] The proxy advisory industry is extremely concentrated with one firm, Institutional Shareholder Services (ISS), enjoying dominant status and two firms (ISS and Glass Lewis) enjoying duopolistic control.[96]

Proxy advisors enhance institutional investors' ability to overcome collective action problems and substantially reduce the costs of complying with the DOL and SEC voting requirements. While the institutionalization of

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89. Press Release, SEC, SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act (Jan. 25, 2011), https://www.sec.gov/news/press/2011/2011-25.htm.

90. *See* Lucian Bebchuk et al, *Towards the Declassification of S&P 500 Boards*, 3 HARV. BUS. L. REV. 157, 158 (2013); Lucian A. Bebchuk & Robert J. Jackson, *Toward a Constitutional Review of the Poison Pill*, 114 COLUM. L. REV. 1549, 1551 (2014); William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 669–73 (2010) (describing the "law-reform agenda" put forth by shareholder proponents to further empower shareholders through lawmaking).

91. Along with maintaining fair, orderly and efficient markets and promoting capital formation. *See The Role of the SEC*, SEC https://www.investor.gov/introduction-investing/basics/role-sec (last visited Mar. 20, 2020).

92. Bird & Park, *supra* note 78, at 35.

93. Choi et al., *supra* note 88, at 870–71.

94. George W. Dent, Jr., *A Defense of Proxy Advisors*, 2014 MICH. ST. L. REV. 1287, 1289 (2014).

95. Choi et al., *supra* note 88, at 870–71.

96. JAMES K. GLASSMAN & HESTER PEIRCE, MERCATUS CTR. AT GEORGE MASON UNIV., MERCATUS ON POLICY: HOW PROXY ADVISORY SERVICES BECAME SO POWERFUL 1 (2014), https://www.mercatus.org/system/files/Peirce-Proxy-Advisory-Services-MOP.pdf.

shareholdings did notable work to reduce the collective action problems faced by shareholders, even with institutions' relatively large shareholdings, they still rarely hold a controlling interest in a firm.[97] Thus, coordination among shareholders is still required to garner enough votes to reject a management proposal. Moreover, many institutional investors, such as mutual funds and index funds, exist specifically to provide diversification and therefore are invested in a very large number of companies.[98] So, even though institutions may hold a relatively large percentage of a corporation's shares, the breadth of their holdings means that casting an informed vote at every company could be prohibitively costly. Proxy advisors enjoy economies of scale, and by disseminating recommendations widely to many institutional investors, they can make it easier for institutions to coordinate a vote against management. Moreover, the fact that there are only two real players in the proxy advisory industry bolsters their ability to coordinate votes, as the proxy advice available in the market is essentially limited to two perspectives which do not always diverge.[99]

e. Shareholders Press for Changes Within the Corporation That Will Further Increase Their Influence

As structural changes have condensed shareholdings, regulatory changes have increased shareholder influence, proxy advisors have decreased the cost of coordinated voting, and shareholders have utilized their newfound strength to press for changes within public corporations that further enhance their power.

First, publicly traded corporations have moved away from plurality voting.[100] Under Delaware corporate law, the vote of only a plurality, not a majority, of outstanding shares is required to elect a director.[101] However, in recent years, institutional investors have exerted pressure on publicly traded corporations to adopt a majority-voting standard.[102] As of 2015, close to ninety percent of S&P 500 firms had majority voting requirements.[103] Requiring a majority vote makes it substantially more difficult for directors to win reelection,

97. Activist hedge funds typically have between six and eight percent when they go public with their campaigns. Strine, *supra* note 66, at 31. Large asset managers such as BlackRock, Vanguard, and Fidelity rarely hold more than a ten-percent stake in a corporation. *See* Fichtner et al., *supra* note 1, at 312 tbl.2.

98. WILLIAM A. BIRDTHISTLE, EMPIRE OF THE FUND: THE WAY WE SAVE NOW 24 (2016).

99. GLASSMAN & PEIRCE, *supra* note 96.

100. Choi et al., *supra* note 88, at 872.

101. DEL. CODE ANN. tit.8, § 216 (2020).

102. *Majority Voting for Directors*, COUNCIL OF INSTITUTIONAL INV'RS., https://www.cii.org/majority_voting_directors (last visited Mar. 20, 2020) ("For many years CII has urged companies to adopt majority voting if a shareholder proposal to adopt the reform received majority support. In the summer of 2016 CII launched a broader campaign to encourage all companies in the Russell 3000 index to adopt majority voting, regardless of their history with related shareholder proposals.").

103. Carol Bowie, *ISS 2016 Board Practices Study*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (June 1, 2016), https://corpgov.law.harvard.edu/2016/06/01/iss-2016-board-practices-study/.

and the threat of losing reelection makes directors eager to please shareholders.[104]

Second, at shareholders' behest, publicly traded corporations have been dismantling their staggered boards.[105] Historically, most corporations had "staggered" or "classified" boards, meaning only one third of board members were up for election each year.[106] Staggered boards constrain shareholders' ability to force changes in management, because they can, at most, replace only one third of the board each year; replacing the entire board would take three years. In recent years, many institutional investors have pressured the companies in which they invest to "de-stagger" their boards.[107] As of 2016, ninety percent of S&P 500 firms had "de-staggered" boards,[108] giving shareholders more opportunities to remove directors and thus more influence over their decision making.

Moreover, in 2010, under the authorization of the Dodd Frank Act, the SEC implemented "proxy access" rules to require companies to include in their proxy materials director candidates nominated by certain shareholders.[109] However, the United States Court of Appeals for the D.C. Circuit overturned the rule in 2011.[110] In the face of the D.C. Circuit's ruling, institutional shareholder activists effectively pressured many corporations to adopt bylaw changes establishing proxy access at the corporation level.[111] As of February 1, 2018, sixty-five percent of S&P 500 companies had adopted proxy access provisions,[112] though very few shareholders have utilized their proxy access to date.[113]

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104. Choi et al., *supra* note 88, at 873.

105. *Id.*

106. *Id.*

107. Often with the assistance of Harvard Law School's Shareholder Rights Project. *121 Companies Agreed to Move Towards Annual Elections*, SHAREHOLDER RIGHTS PROJECT, http://www.srp.law.harvard.edu/companies-entering-into-agreements.shtml (last visited Mar. 20, 2020).

108. Lyuba Goltser & Kaitlin Descovich, *ISS Board Practices Study Reflects Focus on Board Accountability*, WEIL GOVERNANCE & SEC. WATCH (Mar. 22, 2017), https://governance.weil.com/whats-new/iss-board-practices-study-reflects-focus-on-board-accountability/.

109. Facilitating Shareholder Director Nominations, Exchange Act Release Nos. 33-9136; 34-62764; IC-29384, 99 S.E.C. Docket 694 & 439 (Aug. 25, 2010).

110. Bus. Roundtable v. SEC, 647 F.3d 1144, 1144 (D.C. Cir. 2011).

111. DAVID WEBBER, THE RISE OF THE WORKING-CLASS SHAREHOLDER: LABOR'S LAST BEST WEAPON 63–70 (2018).

112. *Corporate Governance Report: Proxy Access—Now a Mainstream Governance Practice*, SIDLEY (Feb. 1, 2018), https://www.sidley.com/en/insights/newsupdates/2018/02/proxy-access.

113. As of July 2017, only one instance of a shareholder using proxy access had occurred. Marc S. Gerber, *Proxy Access: Highlights of the 2017 Proxy Season*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (July 1, 2017), https://corpgov.law.harvard.edu/2017/07/01/proxy-access-highlights-of-the-2017-proxy-season/.

The cumulative result of these forces has been that corporate managers today are extremely attentive to shareholder concerns.[114] The fact that shareholders have successfully pressed for majority voting, de-staggering boards and proxy access demonstrates the extent to which their influence had increased prior to those changes. With these changes in place, their influence can only be greater. Evidence is abundant that corporate directors and managers are now substantially more attentive to shareholder concerns than they have been in the past.[115] And, the interaction among the various types of institutional shareholders means even institutions like BlackRock—which are often thought of as inactive shareholders—can exert significant sway over corporate managers because their votes will decide whether a hedge fund's activist campaign succeeds.[116]

Under the traditional principal-agent conception of the corporation, this is cause for celebration. What those theories deem the most important economic problem facing corporations appears to have largely been resolved.[117] However, overcoming shareholder agency costs has not proven to be a panacea for optimizing corporate performance. Instead, in the wake of this apparent resolution of the agency costs problem, new concerns have arisen about how corporations are managed.

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114. *See* Bratton & Wachter, *supra* note 90, at 720–21; Kahan & Rock, *supra* note 76, at 995–98; Rock, *supra* note 9, at 1910–11.

115. *See, e.g.*, MAURITIUS INST. OF DIR., ENGAGING WITH SHAREHOLDERS—A GUIDE FOR BOARDS, 4 (2014), https://www.afcgn.org/wp-content/uploads/2013/11/engaging-with-shareholders-FINAL.pdf ("[O]ver the last few years, due to new developments in the global environment, shareholder engagement has taken a new dimension with the relationships between shareholders and issuers demanding more attention."); Paula Loop et al., *The Changing Face of Shareholder Activism*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Feb. 1, 2018), https://corpgov.law.harvard.edu/2018/02/01/the-changing-face-of-shareholder-activism/#more-104497 (providing advice to corporate managers on how to prepare for activism by institutional investors); Lisa Pham & Manuel Baigorri, *Companies Engaging with Shareholders More to Avoid Public Activist Campaigns*, BUSINESSDAY (Dec. 27, 2017), https://www.businesslive.co.za/bd/companies/2017-12-27-companies-engaging-with-shareholders-more-to-avoid-public-activist-campaigns/; *SEC—NYU Dialogue on Securities Markets Regulation, Topic: Shareholder Engagement*, YOUTUBE (Jan. 19, 2018) https://www.youtube.com/watch?v=QouhJ20J90U (discussing, at 2:58:20, how corporate directors are feeling the pressure of increased shareholder activism from both active and passive investors, and indicates that corporate boards are increasingly challenged by the task of attending to their corporations' shareholders and proxy advisors).

116. John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 19 (Harvard Law School, Program on Corporate Governance Working Paper No. 2019-5, 2018), http://dx.doi.org/10.2139/ssrn.3247337 ("[I]ndex fund managers have and are increasingly using multiple channels to influence public companies of all sizes and kinds. Their views . . . matter intensely to the way the core institutions in the U.S. economy are operating. When a large company's performance lags, it is at risk of being targeted by a hedge fund activist. When that occurs, the attitude of the index funds towards that company's management and strategy will determine whether the index funds will support, oppose or be neutral regarding the hedge fund's proposals. In decisions both ordinary and extraordinary, ranging from cost-cutting to technology investments, M&A transactions to expenditures on corporate compliance, the perceived pressure on the board will matter.").

117. Rock, *supra* note 9, at 1910 ("[S]ince the early 1980s, the U.S. system has shifted from a manager-centric system to a shareholder-centric system.").

B. RECENT CONCERNS ABOUT CORPORATE ACTIVITY—"SHORT-TERMISM" OR "MANAGERIAL FIXATION"

While the shareholder empowerment trend has worked to lessen the long-concerning "separation of ownership and control," many observers and market actors have raised new concerns about how shareholders are using this newfound power to influence corporate managers. These concerns are often referred to as concerns about "short-termism"—in reference to the idea that corporate managers may be making decisions to please shortsighted shareholders at the expense of long-term, sustainable growth. Many of those concerned about short-termism have called on powerful shareholders to use their influence to redirect managerial attention to the long term.[118] Asset managers like BlackRock, whose clients are largely investing for long term goals such as retirement, are often considered particularly well-suited to resolve these concerns. In response to these calls, Larry Fink's letter specifically addresses short-termism, as do similar public communications by State Street and Vanguard.[119]

The concept of short-termism is quite broad, and over time a number of perceived flaws in the capital and financial markets have been categorized as problems of short-termism. Professor Lynne Dallas has meticulously catalogued the many market forces that have arguably contributed to the problems associated with short-termism.[120] She identifies a number of structural, informational, behavioral and incentive problems in firms and markets that may contribute to short termism.[121]

118. *See, e.g.*, ASPEN INST. BUS. & SOC'Y PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT (Sept. 9, 2009), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/overcome_short_state0909_0.pdf; CFA CTR. FOR FIN. MARKET INTEGRITY/BUS. ROUNDTABLE INST. FOR CORP. ETHICS, BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET MANAGERS, INVESTORS, AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE (2006), https://www.cfainstitute.org/en/advocacy/policy-positions/breaking-the-short-term-cycle; POLICY COMM. FOR THE COMM. FOR ECON. DEV., RESTORING TRUST IN CORPORATE GOVERNANCE: THE SIX ESSENTIAL TASKS OF BOARDS OF DIRECTORS AND BUSINESS LEADERS 14–15 (2010), https://www.ced.org/pdf/Restoring-Trust-in-Corporate-Governance.pdf; MATTEO TONELLO, REVISITING STOCK MARKET SHORT-TERMISM (2006), https://ssrn.com/abstract=938466.

119. Fink, *2018 Letter to CEOs*, *supra* note 2 ("Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders. It will succumb to short-term pressures."); R. William McNabb III, *An Open Letter to Directors of Public Companies Worldwide*, VANGUARD (Aug. 31, 2017), https://about.vanguard.com/investment-stewardship/governance-letter-to-companies.pdf ("[W]e promote principles of corporate governance that we believe will enhance the long-term value of [our investors'] investments."); Ronald P. O'Hanley, *Proxy Letter*, STATE ST. GLOB. ADVISORS (Jan. 26, 2017), https://www.ssga.com/investment-topics/environmental-social-governance/2017/Letter-and-ESG-Guidelines.pdf ("Each year our asset stewardship team identifies specific areas that may impact value over the long term.").

120. Lynne L. Dallas, *Short-Termism, the Financial Crisis, and Corporate Governance* 37 J. CORP. LAW 264 (2012).

121. Structural problems include how periods of low interest rates encourage firms (and individuals) to incur too much debt, how competition for funds among asset managers cause asset managers to invest in assets that will produce short term returns, and how technological advances that have increased the speed of trading have also increased volatility, which increases pressure on firms to engage in earnings management. *Id.* at 269–70, 273. Informational asymmetries between managers and markets can also foster "myopia" by creating a prisoner's

The lesson from Professor Dallas's extensive list is that there are numerous potential sources of pressures on investors and managers that could lead to value-reducing decision-making. But, the vast majority of these pressures are driven by shareholders. Broadly, she points to forces that encourage investors and analysts to over-value the short term and the way in which those perspectives impact managerial decision-making.[122] Any time a manager is making decisions based on how they will appear to the market, the perspectives of shareholders are driving those decisions. The many structural, informational and behavioral problems of investors can easily be transferred to corporate managers who are strongly incentivized to please their corporations' very influential shareholders. Thus, the increasing influence of shareholders described in the prior Subpart contributes to and exacerbates "short-term" or otherwise misdirected pressures.

This investor influence is feared to be value-reducing because when corporate managers focus narrowly on meeting investors' imperfect demands, they neglect other important value-creating interests. Examples of value-reducing activities by corporate managers include:

> "[O]ffering price discounts to temporarily increase sales, engaging in overproduction to lower costs of goods sold . . . and reducing discretionary expenses aggressively to improve margins," such as research and development expenses, maintenance expenses, marketing expenses, employee-training expenses, or employee downsizing with the loss of experienced workers.[123]

Many of these activities come at the expense of returns to corporate stakeholders such as employees and customers. These types of measures may allow managers to report results that appeal to investors in the short run, in the form of increased profits and therefore increased share prices. However, they may also result in less productive companies in future periods. This is a recurring theme in discussions of short-termism—the idea that short-termism reduces firms' long term value *because* it causes managers to neglect value-creating stakeholder interests.

This Article shifts the focus of discussion by arguing that non-shareholder stakeholders will always receive relatively less attention as shareholders gain

dilemma between firms, incentivizing managers to provide misleading (and unsustainable) signals to the market, disincentivizing value creation, and causing managers to disregard useful private information about a course of action if that information cannot be effectively communicated to the market. *Id.* at 268. She argues that the behavioral biases of market actors contribute to short-termism by causing them to over-discount the potential impact of low-frequency shocks, feel excessively optimistic about the future, and follow the short-term behavior of groups. *Id.* at 270. Finally, firm managers are incentivized to engage in short term behavior for personal reputational and financial reasons and to maintain or bolster the firm's reputation. *See id*. at 269–73.

122. *See* Dallas, *supra* note 120.

123. Dallas, *supra* note 120, at 278 (quoting Sugata Roychowdhury, *Earnings Management Through Real Activities Manipulation*, 42 J. ACCT. & ECON. 335, 336 (2006)); *cf.* DOMINIC BARTON ET AL., MCKINSEY GLOB. INST., MEASURING THE ECONOMIC IMPACT OF SHORT-TERMISM 7 (2017) (finding that firms with a long-term focus invested more in R&D, hired more employees, and exhibited better financial performance than those with a short-term focus).

more influence. This is so regardless of who those shareholders are and what their investment horizon might be. Managerial attention is a finite resource. A greater proportion of managerial attention to shareholders must mean a smaller proportion devoted to other stakeholders. Therefore, problems of value-reducing stakeholder neglect are really problems of disproportionate shareholder power, broadly, which need not be attributable to time horizon, or short-termism.

The concept of short-termism, while widely discussed, is not universally accepted. A number of empirical studies have sought to measure whether short-termism exists and the extent to which it is caused by shareholder pressures. The results have pointed in divergent directions.[124] As was the case for the studies of stakeholder engagement discussed in Subpart I.B above, the potential sources of short-term pressure are so diverse and interconnected, that conclusively proving or disproving the existence of this phenomenon is likely an insurmountable task, at least in the foreseeable future.

A prominent theoretical objection to the concept of short-termism is its implications for the existence of efficient capital markets.[125] If shareholders are regularly able to force changes in a corporation that lead to a short-term increase in stock price, that implies that the market for these stocks is regularly inefficient. In an efficient market, the current price of a stock should reflect all publicly available information about the future cash flows to the company, and so any expected future decrease should be reflected today.

These objections lose much of their force when the problem is framed as arising from a misallocation of managerial attention and not as a question of investment horizon. Viewed in this light, the most relevant characteristics of the capital markets identified by the short-termism discussion are: (1) the substantial influence that shareholders have over corporate managers; (2) the resultant

124. Studies supporting the existence of short-termism include: John Asker et al., *Corporate Investment and Stock Market Listing: A Puzzle?*, 28 REV. FIN. STUD. 342, 384 (2015) (finding that public companies whose stock prices are most sensitive to earnings news are less responsive to changes in investment opportunities); Francois Brochet et al., *Speaking of the Short-Term: Disclosure Horizon and Managerial Myopia*, 20 REV. ACCT. STUD. 1122, 1132 tbl.3 (2015) (finding the content of corporate conference calls indicate myopic behavior among managers); Martijn Cremers et al., Short-Term Investors, Long-Term Investments, and Firm Value (unpublished working paper) (finding that an inflow of short-term institutional investors predicts an increase in the likelihood that firms cut investment in research and development). Studies questioning the existence of a short termism problem include: Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1117 (2015) (finding no evidence that hedge fund activism causes temporary short term stock price increases); Alex Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, 64 J. FIN. 2481, 2481–82 (2009) (showing that transient shareholders in the U.S. markets can encourage investment); and Joel F. Houston et al., *To Guide or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance*, 27 CONTEMP. ACCT. RES. 143, 179 (2010) (finding no increase in long-term investment after firms cease earnings guidance).

125. *See* Robert Anderson IV, *The Long and Short of Corporate Governance*, 23 GEO. MASON L. REV. 19, 31 (2015); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 532–33 (2002); Tim Worstall, *The Problem With Hillary: If Investors Are Short Term Then How Can We Have Investment Bubbles?*, FORBES (Aug. 2, 2015, 5:26 AM), https://www.forbes.com/sites/timworstall/2015/08/02/the-problem-with-hillary-if-investors-are-short-term-then-how-can-we-have-investment-bubbles/#8ba8a6fd9775.

devaluation of the needs and preferences of other stakeholders; and (3) the consequent loss in firm value. Focusing on these characteristics means that empirical tests of changes in firm value at different points in time are substantially less relevant because the argument is no longer dependent on a particular time frame. Moreover, the efficient markets objection loses its relevance because the market's ability to value the company is not deemed to change over time. Rather, shareholders are deemed consistently unable to accurately value stakeholder relationships across time periods.[126] The remainder of this Article will therefore use the term "managerial fixation" to refer to this problem in order to emphasize the central role played by managers' disproportionate attention to shareholders, as a class, and leave to the side questions of time horizon.

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As the above discussion has demonstrated, the problem of agency costs arising from the "separation of ownership and control" has substantially diminished. However, resolving this problem does not appear to have resulted in optimally performing corporations. Instead, new concerns about short-termism have arisen, which point to the existence of value-reducing managerial fixation that agency cost theories cannot explain.[127] The following Part describes an alternative theory of the corporation, the team production theory, which predicts and provides an explanation for these apparent problematic consequences of the shareholder empowerment trend.

III. TEAM PRODUCTION AND SHAREHOLDER LIMITATIONS

Contrary to the theories focused on shareholder-manager agency costs discussed above, Margaret Blair and Lynn Stout's team production theory of corporate law asserts that shareholders' rights are properly limited. The team production theory[128] focuses on an alternate economic problem faced by corporations—that of team production—to explain the roles of shareholders, corporate boards and other corporate constituencies. The team production theory provides a compelling explanation for the concerns about managerial fixation that have arisen in the wake of a great wave of shareholder empowerment. However, it leaves unanswered questions about shareholders' limited ability to correct for managerial fixation. This Part describes the team production theory's explanatory power and proposes a response to those unanswered questions.

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126. *See infra* Subpart III.B for a description of this limitation.

127. Dallas, *supra* note 120, at 273 ("Unlike the well-known agency cost theory, which holds that agency costs are minimized when managers are disciplined by market pressures . . . managerial myopia theories explain why managers 'caring too much' about current stock prices leads to myopic decision making.").

128. As is discussed below, Blair and Stout's team production theory of corporate law is based on theoretical work about team production in economic literature. Unless otherwise specified, all references to "team production" or the "team production theory" herein refer to Blair and Stout's team production theory of corporate law, and not the underlying economic theories.

A. TEAM PRODUCTION

1. Overview of the Team Production Theory of Corporate Law

The team production theory asserts that viewing shareholders as the owners of corporate assets who should be empowered to control those assets is not only normatively undesirable but also descriptively inaccurate. As a descriptive matter, it acknowledges that equity owners are, indeed, the common owners of firm assets in businesses formed as proprietorships, partnerships and closely held firms. Corporations, and especially publicly held corporations, however, are quite different. As was discussed in Subpart I.A above, the corporate form originated from a desire to ensure equity capital contributors could not freely withdraw their assets from the business.[129] Thus, the forfeiture of control over assets is a fundamental characteristic of the corporate form. This is why corporate shareholders don't exhibit any of the rights in a corporation that are associated with ownership or control and why their rights to control the corporation and its assets are explicitly and substantially limited by law.[130]

As a normative matter, the team production theory does not view shareholder-manager agency costs as the primary economic problem faced by corporations because shareholder equity is not the only input necessary for corporate production. Instead, this theory focuses on the problem of organizing joint production in teams, or "team production."

The team production problem is an economic problem that has been studied by economists since the 1970s.[131] It arises when the production of some output requires the inputs of many individuals.[132] The whole of the output produced by the team will be greater than the sum of the inputs produced by any individual,[133] and so there will be greater positive contribution to the economy if teams come together to jointly produce things. However, making a contribution to the team

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129. This allows more security for long-term business endeavors. *See supra* Subpart I.A.

130. Blair & Stout, *supra* note 12, at 261; DEL. CODE ANN. tit. 8, §§ 211–12, 220, 251(c), 327 (2020). Nonetheless, shareholders do have rights that other stakeholders do not have. Blair and Stout acknowledge that the mere fact that shareholders are the only stakeholder group with any such rights does seem to imply that they enjoy a favored position vis-à-vis other stakeholders. Nonetheless, they proffer two possible explanations as to why shareholders alone have voting rights. First, shareholder voting rights, when properly limited, may serve the interests of all stakeholder groups, not just shareholders. A poorly managed corporation can compromise returns to all team members, but granting voting rights to all stakeholders would be untenable. So, the shareholders serve as a backstop in instances of extreme managerial misconduct. Second, the voting rights could be seen as compensation to shareholders for the unique risks they take on as equity investors. Equity investors have much less access to management, and their voting rights can be seen as making up for that distance. Blair & Stout, *supra* note 12, at 312–14.

131. Blair & Stout, *supra* note 12, at 265 ("One of the first serious attempts by economists to explore the problem of organizing joint production in teams can be found in a 1972 paper . . . ." (citing Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972))).

132. *Id.* at 265 ("[D]efined team production as 'production in which 1) several types of resources are used . . . 2) the product is not a sum of separable outputs of each cooperating resource . . . [and] 3) not all resources used in team production belong to one person.'" (citing Alchian & Demsetz, *supra* note 131)).

133. *Id.* at 269.

involves uncertainty and therefore risk with respect to whether any one contributor of resources will be adequately compensated for her contribution. Individuals will be unwilling to contribute to the team if they do not have assurances that they will receive a share of the profits from the production that exceeds their opportunity cost of participating. And, the profits from production will be a function of the quality and quantity of contributions to the team.[134] The economic problem, then, is how to attract and maintain high-quality inputs to the team.[135]

While potential team members could hypothetically contract to an agreement about allocating profits, there is no efficient time at which team members could do so. If the team members agree ex ante to a division of the surplus, all team members will have incentives to shirk. However, if they attempt to divide up shares of profit ex post, all team members will be incentivized to engage in rent-seeking, the prospect of which could deter any individual from contributing to the team in the first place.[136]

One solution to this problem identified in the economic literature is to insert an outsider into the productive activity who can control the team's assets, allocate assets among team members, and fire individual team members or break up the team.[137] While this arrangement requires the individual team members to cede some control of their productive capacity, it also limits shirking and deters rent seeking so that the team members feel confident they will receive an adequate share of the profit generated by the team production. The outsider is referred to as a "mediating hierarch" whose role is to "exercise [] control in a fashion that maximizes the joint welfare of the team as a whole."[138] The mediating hierarch is charged with ensuring potential team contributors that their expected return from engaging in team production exceeds the cost of ceding some control over their productive capacity.

Corporations are entities engaged in team production. They require the "firm-specific investments" of many—equity capital, lending, supplies, labor, customers, environmental resources—in order to produce goods and services that we hope will have a net positive social impact on the economy.[139] Blair and

134. Alchian & Demsetz, *supra* note 131, at 778–79.

135. While early work on the economic problem of team production emphasized designing incentives to prevent shirking among employees once they were part of the firm. *Id.*; *see also* Bengt Holmstrom, *Moral Hazard in Teams*, 13 BELL J. ECONOMICS 324 (1982). Blair and Stout rely more heavily on the later work of Rajan and Zingales, which emphasized the prior need to attract specific investments to the firm before the problem of preventing shirking can ever arise. Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECONOMICS 387, 390 (1998).

136. Blair & Stout, *supra* note 12, at 249-50.

137. *Id.* at 274 (citing Rajan & Zingales, *supra* note 135, at 422).

138. *Id.* at 271.

139. While early economic work on team production focused on the productive inputs of employees—see Alchian & Demsetz, *supra* note 131, and Holmstrom, *supra* note 135—Blair and Stout explicitly expand the realm of relevant team members to also include shareholders, creditors, and community members, etc. on the basis that these groups also make firm-specific investments that contribute to the corporation's productive capacity. Blair & Stout, *supra* note 12, at 276 n.61.

Stout argue that in corporations, the board of directors plays the role of the mediating hierarch.[140] The board's allegiances, therefore, should be not only to shareholders, but to all the individuals whose "firm-specific investments" are essential to optimizing corporate output. In the board's role hiring and supervising the chief executive officer, it should ensure that the CEO's allegiances are similarly broad. This theory acknowledges that, while shareholder capital, and oversight, are essential to corporate output, so are the inputs of many other stakeholders.[141] The board should thus act as a mediating hierarch "whose job is to balance team members' competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together."[142]

Because the team production theory argues that boards should be accountable to all team members, it views shareholders' control rights as properly limited. That is, the fact that shareholders have limited rights under corporate law, and that they face collective action problems in exercising those rights, is a positive attribute, not a flaw, in corporate law.[143] If shareholders (or any other team member) were able to easily use their control rights to advocate for their own self-interest, this would disrupt the equilibrium of stakeholder interests that the board is tasked with maintaining, and thereby disincentivize the contribution of "firm-specific investments" from the neglected stakeholders.[144]

In more concrete terms, if shareholders are disproportionately influential, corporate managers will devote a larger proportion of their attention to shareholders and therefore a smaller proportion of their attention to other stakeholders, such as employees. A decreased share of attention to employees will cause managers to be less familiar with or attentive to the preferences and desires of their employees. If, as a consequence, employee interests are neglected, we should expect the firm to attract fewer, or less qualified, employees. With a smaller or less qualified workforce, production will suffer as will profit, or firm value.

Under the team production theory it is therefore desirable that shareholders may only be able to exert control in cases of extreme managerial misconduct so that managers can devote adequate attention to all stakeholders. Only by doing so can they attract to the firm the quality and quantity of inputs necessary for maximizing firm value.[145]

140. *Id.* at 319.

141. *Id.* at 278.

142. *Id.* at 281.

143. *Id.* at 321–22.

144. John Armour et al., *Agency Problems, Legal Strategies and Enforcement* 3 (European Corp. Governance Inst., Working Paper No. 135/2009), https://ssrn.com/abstract=1436555 (noting that agency costs exist between a firm and its non-shareholder stakeholders).

145. Blair & Stout, *supra* note 12, at 312.

2. *Implications for Current Trends*

Margaret Blair and Lynn Stout's seminal article developing the team production theory was published in 1999,[146] at a time when the trend toward increased shareholder power was in motion, but shareholders had not yet reached the level of unprecedented influence that they enjoy today.[147] However, applying the theory to the current state of the U.S. equity markets—in which shareholders have very substantial influence over corporate managers—the team production theory would predict an outcome that substantially resembles current concerns about short-termism, or managerial fixation.

The team production theory predicts that if shareholders were to amass substantial influence over management, management would be forced to devote relatively less attention to the needs of other corporate stakeholders, and we would expect that their interests would be neglected, to the detriment of corporate production. Recent concerns about short-termism, or managerial fixation, point to a fear that this outcome has, indeed, come to pass. Shareholders in the public U.S. equity markets currently exert an unprecedented level of influence over corporate managers.[148] In the wake of this change came discussions of short-termism, which this Article argues is actually a problem of managerial fixation. These discussions point to the neglect of non-shareholder stakeholders such as employees, creditors, customers, suppliers and communities.[149] These constituencies are stakeholders that make firm-specific investments under the team production theory.[150]

The team production theory therefore provides a useful starting point to explain the managerial fixation that has arisen in the wake of shareholder empowerment. It implies that the empowerment of shareholders has led to the neglect of other stakeholders and that disproportionately powerful shareholders can always be expected to have this result. It also explains why shareholder empowerment not only negatively impacts stakeholders, but also can reduce the value of firms. It points out that corporations need the inputs of all their stakeholders to produce goods and services. If stakeholders' interests are not adequately addressed, the corporation will not succeed in attracting the mix of stakeholder inputs to the firm that will optimize the corporation's output.

Team production thereby also provides an answer to the question of what market changes precipitated Larry Fink's letter. It suggests that the very force that gave Larry Fink a visible public platform—shareholder empowerment—led to managerial fixation, calls on powerful shareholders to protect other

146. *Id.*

147. Rock, *supra* note 9, at 1910 (discussing the process of shareholder empowerment began in the 1980s).

148. *See e.g.*, Kahan & Rock, *supra* note 71, at 1022; Rock, *supra* note 9, at 1922–23; Bratton & Wachter, *supra* note 90, at 720–21.

149. *Supra* Subpart II.B.

150. The often-mentioned concerns about research, development, and innovation, while not specifically the direct interests of a specific group of team members, are nonetheless issues that are important to both customers who desire new and improved products and employees in innovative roles at the corporation.

stakeholder interests,[151] and finally Fink's letter and similar reactions from other institutions.[152]

The next logical question, then, is whether this approach can work. Can we expect that powerful shareholders such as BlackRock can wield their influence so as to monitor and improve a corporation's relationships with its other stakeholders? To this inquiry, team production provides a somewhat paradoxical response. Team production predicts two outcomes to follow from disproportionate shareholder empowerment: (1) that other stakeholders' interests will be neglected and (2) that that neglect will come at the cost of firm production and value. These outcomes are paradoxical because we expect firm value to be of paramount concern to shareholders. Shareholders are well incentivized to ensure they use their influence in a manner that does not impair firm value. The questions remains, then, why shareholders cannot simply use their substantial influence to monitor other stakeholders' interests and thereby reduce the costs of managerial fixation. The following Subpart explores why shareholders cannot be effective monitors of corporate impacts on other stakeholders, in spite of their financial incentives to do so.

B. Shareholder Limitations

Team production explains how managerial attention to non-shareholder stakeholders promotes firm value by improving the quality or quantity of those stakeholders' inputs. A number of studies support this connection between stakeholder management and increasing firm value,[153] and the Fink letter and the trend of which it is a part are an acknowledgment by market participants, including shareholders, that attention to other stakeholders is necessary to maximize shareholder returns.[154] Thus, at least initially, there appears to be logic to the approach of calling on shareholders to resolve problems of managerial fixation. If institutional investors are currently the constituency with the greatest influence over management decision-making, it would seem a fitting solution to have them use their influence to ensure corporate managers are effectively tending to the interests of other stakeholder groups.

Nonetheless, while this coincidence of interests provides investors with the incentives to advocate for other stakeholders, insurmountable information asymmetries prevent them from accessing the information necessary to do so effectively. Only the stakeholders themselves can provide the necessary information about what they require to induce their participation in the corporate team, and they do not reveal this information to shareholders. The remainder of

151. *See* Dominic Barton & Marc Wiseman, *Focusing Capital on the Long Term*, HARV. BUS. REV., Jan.–Feb. 2014, https://hbr.org/2014/01/focusing-capital-on-the-long-term; Bratton & Wachter, *supra* note 90, at 720–21; Kahan & Rock, *supra* note 76, at 995–98; Rock, *supra* note 9, at 1910–11.

152. *See supra* note 115.

153. *See supra* Subpart I.B and accompanying notes 27–36.

154. *But see supra* note 6.

this Subpart explores the origins of these information asymmetries and the obstacles to overcoming them.

1. *Incomplete Stakeholder Contracts*

As was discussed in Subpart II.A.1 above, agency cost theories that argue in favor of shareholder empowerment are based on the assumption that contracts with all non-shareholder stakeholders are complete. Discussions of "contracts" in this context refer to a broad category of agreements between corporations and their stakeholders. These agreements do not always take the form of legally binding documents signed by both parties. The term "contracts" here includes legally binding agreements, but also less formal "relationships characterized by reciprocal expectations and behavior."[155] To say that a contract is complete is to say that every possible contingency is contemplated by the contract.[156] If a contract is complete, then no matter what state of the world arises in the future, the contract will tell the parties exactly what their obligations are in that scenario. However, in reality, creating a complete contract is virtually impossible. As Professors Paul Milgrom and John Roberts describe:

> Complete contracting requires freely imagining all the myriad contingencies that might arise during the contract term, costlessly determining the appropriate actions and division of income to take in each contingency, describing all these verbally with enough precision that the terms of the contract are clear, arriving at an agreement on these terms, and doing all this so that the parties to the contract are motivated to follow its terms.[157]

It is easy to see that such a level of specificity is not realistically possible in almost all cases, as the number of future states of the world is probably infinite. Thus, the classical assumption that all contracts with non-shareholder stakeholders are complete is not true.[158] Instead, these contracts will be incomplete to varying degrees.

Some stakeholder contracts, such as those with lenders, may be rather detailed even if incomplete. Contracts for corporate loans are generally negotiated at length among sophisticated parties with sophisticated lawyers, and contemplate a number of future scenarios. Nonetheless, the option for future renegotiation of terms always remains open, uncontemplated future states of the world are always possible,[159] and a healthy corporation will negotiate a number of debt agreements over the course of its life. Thus, corporate managers will have repeated opportunities to negotiate and renegotiate the terms of debt over

155. William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385, 388 (1990) (suggesting that the term "contracting relationships" may better capture this broader conception of "contracts").

156. Oliver Hart, *Incomplete Contracts and Control*, 107 AM. ECON. REV. 1731, 1732 (2017).

157. MILGROM & ROBERTS, *supra* note 52, at 289.

158. Hart, *supra* note 156, at 1732 ("Actual contracts are not like this, as lawyers have realized for a long time.").

159. *See, e.g.*, Gregory H. Shill, *Boilerplate Shock: Sovereign Debt Contracts as Incubators of Systemic Risk*, 89 TUL. L. REV. 751, 755 (2015) (discussing how standard contract terms in debt contracts can have unexpectedly detrimental effects in the event of large economic shocks).

time. Other stakeholder contracts, such as corporations' agreements with at-will employees are highly incomplete in that they have very few specified terms.[160] Most U.S. employees are employed "at-will" and thus not subject to any specific employment contract.[161] So, the bargain between an employee and her employer about most employment terms—schedule, work responsibilities, grounds for termination—are not specified ex ante but rather allow for flexibility over time.

Because of the existence of these contractual gaps, the members of a particular stakeholder group are continually engaged in ongoing negotiations with the corporations to fill in these gaps as new situations arise. Professors Edward Rock and Michael Wachter have described how, in non-union workplaces, norms have arisen according to which employers will only terminate employees for-cause, even though the at-will employment doctrine requires no such constraint.[162] They explain that these norms have developed because if potential employees knew that they could be terminated arbitrarily, they would not choose to join the firm in the first place.[163] That is, in the jargon of team production, employees need ex ante assurance that the corporation's management will act as an effective mediating hierarch to protect their interests adequately before they will commit their firm specific investments to the corporation. A norm against arbitrary termination provides some assurance to potential employees that the firm will not act in a way that makes an employee's choice to join the firm ex post costly to the employee.[164] Thus, by devoting resources and attention to employee needs and preferences, a corporation can glean information from employees and potential employees about what assurances are necessary to promote employee recruitment, retention, and productivity. It can then fill contractual gaps in a way that will optimally attract employees to the firm.

Similar scenarios can be crafted for other stakeholder groups. Consumers present a very similar case because customer contracts are usually similarly incomplete. Businesses, fundamentally, should be striving to provide goods and services demanded by their consumers. They should be engaging with their consumers to understand what products and services will induce the consumers to purchase the corporation's goods or services. Even in the realm of more highly specified contracts such as a loan agreement, when an unanticipated event occurs that, for example, could lead to the corporation not meeting one of its covenants,

160. Rock & Wachter, *supra* note 37, at 1917 (describing non-union internal labor markets as examples of highly incomplete contracts).

161. The at-will employment presumption, which is recognized in all U.S. states except Montana, is stated as, "[a]bsent an agreement, statutory provision, or public-policy rule to the contrary, an employment relationship is terminable at the will of either party." RESTATEMENT OF EMP'T LAW § 3.01 (AM. LAW INST., 2006).

162. Rock & Wachter, *supra* note 37, at 1917.

163. *Id*. at 1930 ("If the firm could discharge without cause, it could use such a threat to appropriate an additional share of the joint surplus ex post. The threat of such ex post appropriation would . . . stand in the way of optimal investments in match ex ante.").

164. Blair & Stout, *supra* note 12, at 272.

the corporation must negotiate with the creditor to an outcome that preserves as much of the firm's value as possible.

Given that stakeholder relationships are not, in fact, complete contracts, residual returns can be distributed not only to shareholders, but also to these other stakeholders as a result of the negotiation of their unspecified contract terms. This means that the unspecified contract terms are areas where residual control is exercised.[165] That is, the right to make decisions about undefined contract terms is part of the residual control, and it can either be granted to shareholders (as agency cost theories suggest) or to corporate managers (via the board as "mediating hierarch," as the team production theory suggests). The question then becomes which group—shareholders or managers—can exercise this control in a manner that maximizes firm value.

A key observation in answering this question is that a corporation's relationships with its stakeholders are its means to creating value. It cannot produce profit without employees, customers, and other inputs.[166] Therefore, exercising residual control is not simply a matter of making choices about how to distribute the residual returns among stakeholders. Rather, the quantity of residual return available for distribution is a function of the manner in which residual control is exercised. So, maximizing profit, and thus the residual return, depends on engaging with stakeholders in a manner that optimizes the quality and quantity of their inputs to the corporation. Control over these decisions should therefore go to the party that is best able to negotiate stakeholder contracts. The following two Subparts describe why shareholders are not the best-equipped party.

2. Information Asymmetries

When attention to stakeholder concerns is expected to have a positive impact on share price, shareholders will nonetheless be poorly positioned to monitor management attention to these issues due to information asymmetries between shareholders and managers.

Underlying agency cost theories is an assumption that shareholders have all the information they need to effectively maximize firm value. If markets were strong form efficient—that is, if all material public and nonpublic information about a company were incorporated into its stock price—then it would be appropriate for boards to act as agents that specifically and exclusively do the bidding of shareholders.[167] If shareholders possessed all possible information about the value of the firm, they would then always be the group best positioned to maximize firm value. However, most can agree that markets are not strong

165. Hart, *supra* note 156, at 1732.

166. *See* R. EDWARD FREEMAN ET AL., STAKEHOLDER THEORY: THE STATE OF THE ART 12 (2010) ("[T]he only way to maximize value sustainably is to satisfy stakeholder interests."); *supra* Subpart I.B.

167. Bratton & Wachter, *supra* note 90, at 696 ("[S]trong-form efficiency would support a nearly unassailable case for shareholder empowerment.").

form efficient.[168] Instead, firm managers have private information to which the firm's shareholders do not have access, so informational asymmetries exist between corporate managers and shareholders.[169] Consequently, markets will not always accurately value a firm,[170] and mediating between market signals and inside information becomes what Professors William Bratton and Michael Wachter call the "intrinsic management function."[171] That is, what we want from corporate managers is that they combine signals from the market with the inside information about the company that they have, and use that to make management decisions that maximize firm value.

In their article analyzing the role of shareholder empowerment in the 2008 financial crisis, Bratton and Wachter describe the crisis as having been precipitated by managers who were too focused on meeting the demands of imperfectly informed shareholders.[172] In the years preceding the financial crisis, high-risk business strategies worked very well in the sense that they resulted in high returns to shareholders.[173] Shareholder appetite for these high returns strongly incentivized managers to continue investing in mortgage-backed securities, even as it became increasingly evident that the mortgage bubble was unsustainable and the magnitude of the risks involved was extraordinary. Managers of financial firms had access to information about these risks that shareholders did not have, but strong pressures from shareholders seeking ever-increasing returns prevented most managers from acting on this inside information.[174] The result, we now know, was that many mispriced assets plummeted in value as housing prices began to fall, forcing a liquidity crisis, an enormous government bailout, and a deep economic recession.

Focusing on the 2008 financial crisis, Bratton and Wachter's discussion emphasizes unobservable financial risk that made shareholder signals dramatically inefficient in the lead up to the crash.[175] However, financial risk is not the only type of information that can be unobservable to shareholders. The effects of many stakeholder-affecting management decisions are similarly unobservable to shareholders because this information is revealed during the internal and ongoing negotiation of incomplete contract terms with those stakeholders. The management of stakeholder relationships happens on an ongoing basis within the corporation, and managers therefore have access to

168. COLIN READ, THE EFFICIENT MARKET HYPOTHESIST: BACHELIER, SAMUELSON, FAMA, ROSS, TOBIN, AND SHILLER 105 (2013); Bratton & Wachter, *supra* note 90, at 691.

169. Bratton & Wachter, *supra* note 90, at 696–97.

170. *Id.* at 696 ("Information asymmetries make it difficult for the market to project accurately the free cash flows that the corporation will produce.").

171. *Id.* at 697.

172. *See id.* at 656.

173. *Id.* at 721.

174. *Id.* at 722 ("[T]he result of not giving the market what it wants can be painful. The new corporate policy is unlikely to be rewarded precisely because the stock market believes the existing high-leverage corporate strategy, duly ratified by a rising stock price, is the correct one.").

175. *Id.* at 723.

information about those negotiations that shareholders do not have.[176] This asymmetry of information means that shareholders cannot incorporate this information into their assessment of the firm's value, so managing to shareholder expectations cannot be expected to maximize the value created by these relationships. Shareholder opinions about how to optimize stakeholder relationships will not be as well-informed as the opinions of managers. So, managing to shareholder expectations will force managers to ignore value-enhancing information to which they have ready access, to the detriment of firm value.[177]

3. *Challenges to Overcoming Information Asymmetries*

If informational asymmetries prevent shareholders from effectively acting on their incentives to monitor and protect other stakeholder interests, the next logical question is whether those information asymmetries can be overcome by transferring to shareholders the information they lack. This Subpart argues that they cannot for at least two reasons: (1) the passive nature of public stock market investments and (2) the complexity, and thus costs, of reporting on stakeholder outcomes.

First, the passivity of shareholders is a characteristic fundamental to public stock markets.[178] Blair and Stout's team production theory is explicitly a theory of public corporations.[179] Shareholders in public corporations are passive, retrospective monitors of corporate behavior[180] who voluntarily cede ultimate control to the board of directors.[181] While modern shareholders may have substantial influence over corporate managers, including the board of directors, it is an influence that originates outside the corporation. Public shareholders are

176. One notable exception to this may be the instance in which a shareholder represents an important constituent group of the corporation. Professor David Webber has described in detail the success that pension funds have had in engaging in shareholder activism on behalf of workers. WEBBER, *supra* note 111, at 178–79. In such a case, the shareholder may have better information than usual about the stakeholder relationship. *Id.* However, such situations are limited to a unique class of shareholders and unique instances of alignment between those shareholders and stakeholder issues facing the corporation. *Id.* These instances, while an important antidote to managerial fixation, do not overcome the more general observation that *most* shareholders will lack adequate information about *most* stakeholder relationships to effectively monitor those relationships. *Id.*

177. William W. Bratton & Michael L. Wachter, *Shareholders and Social Welfare*, 36 SEATTLE U. L. REV. 489, 506 (2013) ("[A]s you move away from an offer on the table to buy the company . . . to continuous business decisionmaking over time, the meaning of a market-price signal becomes less and less clear and information asymmetries present more of a problem.").

178. The term "passive" is used here in a broad sense to refer to a fundamental characteristic of public stock markets. While, the term "passive" is often also used to describe as class of investment funds that are not actively managed, that is a much narrower concept and is not the intended meaning here.

179. Blair & Stout, *supra* note 12, at 256 ("[T]he team production approach may help explain why so many large enterprises are organized as publicly-traded corporations, rather than as partnerships, limited liability corporations, closely held companies, or other business forms that give investors tighter control.").

180. Jean Tirole, *Corporate Governance*, 69 ECONOMETRICA 1, 9–10 (2001).

181. DEL. CODE ANN. tit. 8, § 141 (2020).

not involved in managing the internal workings of the firm.[182] This is in stark contrast to privately owned businesses that are often closely held by their founders or by professional private equity or venture capital firms. In privately held firms, it is common that equity holders will be intimately involved in firm management.[183] The choice to operate as a public firm, on the other hand, is a choice to abandon that model and instead distribute equity to dispersed public shareholders.[184] Similarly, a choice by an investor to purchase shares of a publicly traded corporation is a choice to invest in a highly liquid asset that will not require the investor's ongoing attention as a manager.[185] The advantages of this passivity would be lost if shareholders were to engage deeply in overseeing the internal operations of the corporation. Only an intimate involvement in the internal affairs of the corporation could meaningfully reduce the stakeholder information asymmetries between managers and shareholders. By their nature, public shareholders are neither positioned nor equipped to engage in this type of involvement.

Second, information about a corporation's relationships with its many stakeholders is qualitatively very distinct from financial information and therefore not readily reduced to numerical metrics. Those working in the area of social enterprise have been at the forefront of developing metrics to measure social output. The issue has continuously presented numerous challenges, not the least of which is the sheer number of stakeholders affected by business actions. Professor Sarah Dadush, in an extensive analysis of two leading indicators used in the impact investing investment market, concluded that these "tools do not in fact measure impact because [social and environmental impacts are] too complicated and controversial to evaluate."[186] Professor Galit Sarfaty conducted an extensive study of the "leading standard for corporate sustainability reporting,"[187] and concluded that the use of quantitative indicators to measure corporate sustainability is problematic.[188] Among other issues, the indicators promote only superficial compliance while their weaknesses are often overlooked due to the "authoritative quality of numbers."[189] Thus, the most extensive recent efforts to create reporting metrics on social outcomes have substantial deficiencies.

182. CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008) ("[I]t is well established that stockholders of a corporation subject to the DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.").

183. Blair & Stout, *supra* note 12, at 281, 251–52 n.8–9 (describing how most state laws do not require private firms to operate through a board and instead default to direct management by equity owners).

184. *Id.* at 322.

185. Blair, *supra* note 17, at 43–44.

186. Sarah Dadush, *Impact Investment Indicators: A Critical Assessment*, *in* GOVERNANCE BY INDICATORS 392, 423 (Kevin E. Davis et al. eds., 2012).

187. Galit A. Sarfaty, *Measuring Corporate Accountability Through Global Indicators*, *in* THE QUIET POWER OF INDICATORS: MEASURING GOVERNANCE, CORRUPTION, AND THE RULE OF LAW 103, 105 (Sally Engle Merry et al. eds., 2015).

188. *Id.*

189. *Id.*; *see also* Dadush, *supra* note 186, at 423.

Moreover, the types of stakeholder interests that are most relevant to firm value will differ from corporation to corporation. Different corporations require different employees, have different customers, and have unique relationships with their other stakeholders. One key characteristic of financial reporting under the U.S. securities laws that has made that disclosure system effective is that it requires standardized reporting that is comparable across companies.[190] This type of standardization is not reasonably achievable in the realm of stakeholder relationships because the relevant stakeholder groups and the relevant aspects of those relationships will vary across companies. Moreover, these relationships are vast, complex and dynamic. As a corporation's business strategy changes over time, the optimal mix of stakeholder inputs will also change. Thus, the relevant data points for disclosure would be a constantly moving target. Any attempt to comprehensively report on stakeholder relationships would be prohibitively expensive due to the ongoing and nuanced nature of these relationships.[191] As Professors Rock and Wachter have noted, "[i]t is always more difficult to prove a case to a third party than to learn the facts independently."[192] Moreover, very detailed disclosure on stakeholder relationships would likely reveal information about internal strategy that could compromise corporations' competitive positions. Managerial attention is therefore best focused on managing the corporation's incomplete contracts with its stakeholders in a manner that induces optimal contributions to the firm rather than attempting to convey this information to external shareholders.

4. Possible Shareholder Interventions

In theory, we can imagine an extreme version of shareholder input on stakeholder matters, with shareholders opining on very specific aspects of stakeholder relationships, such as specific employment policies. The foregoing discussion predicts that they would do so ineffectively. In practice, however, it is very unlikely that shareholder input on these issues would take such specific form. As described above, the trend of shareholder empowerment has been driven by the increased prominence of institutional investors, the largest of which own shares in thousands of companies around the world. It is implausible that these large asset managers would involve themselves on such a granular level with internal corporate policies. Doing so across their enormous portfolios would be prohibitively costly.

A more plausible scenario envisions shareholders asking companies for more generic indicators that they believe represent good stakeholder management. Indeed, the Fink letter and similar communications from other

190. Mary Jo White, Chair, *The Path Forward on Disclosure*, SEC (Oct. 15, 2013), https://www.sec.gov/news/speech/spch101513mjw#_ftn14 ("[T]he Commission adopted the first version of Regulation S-K—an overarching single, uniform set of rules that form the core of the integrated disclosure regime that we have today.").

191. Bratton & Wachter, *supra* note 177, at 506 ("Complete disclosure is not cost-beneficial, period.").

192. Rock & Wachter, *supra* note 37, at 1932.

large institutional investors has sent precisely this message to public companies, and companies have begun to respond.[193] Lawyers from the prestigious corporate law firm Cleary Gottlieb Steen & Hamilton LLP recently advised their corporate clients as follows:

> [W]e are starting to see evidence, through the annual letters, interviews and other public-facing interactions, that investors have become more sophisticated about what they expect from companies . . . . [T]he recent letters and sentiments express nuanced and increasingly specific views about investor expectations, and companies that wish to court favorable impressions would be wise to understand the individual expectations.
>
> . . . .
>
> [T]hat ideally results in taking investor concerns into consideration when crafting disclosure, ESG reports, investor day presentations, analyst calls and other forums for public interaction.[194]

Given that these messages from institutional investors appear to have had real effects on the behavior of corporate managers, the most innocuous result of this messaging would be that it does not meaningfully impact how corporate managers manage their other stakeholder relationships. Perhaps corporate managers believe that shareholders, despite their messaging, will not meaningfully follow up on these public requests. In such a case, the costs to the corporation would be only the costs of compliance with the shareholders' requests. Though the quote above suggests this cost is not insignificant.

If, however, such requests by shareholders impact management activities in any way, it will circumscribe the decisions left available to the manager, reducing her agility in responding to changes in the firm or the product markets. For example, if shareholders request or prefer certain results on customer retention, a desire to please shareholders could lead managers to ignore new and potentially profitable market segments if doing so meant losing existing customers. Or, if management implements shareholder-approved employment policies, those policies will not be specific to any one firm and are unlikely to fit within the unique culture of any one company. The possible ways in which this intervention could play out are infinite, but the common result is that if managerial decisions about stakeholder relationships are driven by shareholder expectations, managers will be left with less flexibility to incorporate their superior information into these decisions.

So, direct shareholder involvement in stakeholder relationships is not likely to occur. However, less specific shareholder interventions can still circumscribe

193. In an indication that corporate managers are responding to requests like those in the Fink letter, in August 2019, the Business Roundtable—an organization comprised of the CEOs of leading corporations—issued a statement by 181 CEOs committing to lead their companies for the benefit of all stakeholders. *Business Roundtable*, *supra* note 6.

194. Pamela L. Marcogliese, et al., *Synthesizing the Messages from BlackRock, State Street, and T. Rowe Price*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REGULATION (Feb. 28, 2019), https://corpgov.law.harvard.edu/2019/02/28/synthesizing-the-messages-from-blackrock-state-street-and-t-rowe-price/.

managerial options in ways that could force the firm to ignore or undervalue value-creating stakeholder information.

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Information asymmetries exist between public shareholders and the corporations in which they invest that make shareholders unable to effectively monitor managers' attention to other stakeholders, and reporting to shareholders cannot solve this asymmetry due to the nature of the information. The result is that corporate managers will only be able to engage effectively with other stakeholders if they are not unduly beholden to the preferences of shareholders. Therefore, as Bratton and Wachter have argued, shareholder empowerment should not be seen as a cure-all for perceived flaws in corporate activities,[195] and calling on shareholders to exert their substantial influence to monitor stakeholder relationships will be ineffective.

If managerial fixation is caused by shareholder empowerment but shareholders are ill equipped to overcome the resulting stakeholder neglect, the solution would seem to lie in reducing shareholders' relative influence over corporate managers such that they are not in a position to opine on matters of stakeholder relationships. The prospect of limiting shareholder power, however, inevitably brings with it questions about how managers will use their newfound freedom. The following Subpart considers that question.

C. Too Many Masters?

Perhaps the most frequent objection to a broad stakeholder view of the corporation is that freeing corporate managers from strong shareholder oversight leaves them essentially unmonitored. In the words of Professors Frank Easterbrook and Daniel Fischel, "a manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither."[196] The crux of this concern is that any time management is not meeting the needs of one of its "masters," it can always claim to be acting in the interest of one of its other "masters," even if it is actually only promoting the self-interest of the managers themselves.

However, this objection is convincing only if the detrimental effects of less shareholder oversight are greater than the detrimental effects of more shareholder oversight. As has been discussed herein, disproportionate shareholder power appears to have resulted in meaningful costs to corporations and their shareholders.[197] Thus, the question becomes which scenario results in

195. Bratton & Wachter, *supra* note 90, at 672–74.

196. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 38 (1991).

197. Bratton & Wachter, *supra* note 177, at 506 ("[Shareholder proponents] pose an agency-cost win-win situation—empower the shareholders and reduce the costs—with no acknowledgment that doing so might trigger countervailing costs.").

greater net cost (or benefit)—weaker shareholders or stronger ones. While attempting such a calculation is beyond the scope of this Article, some initial observations call into question how great a cost results from reduced shareholder influence.

Preliminarily, reducing the relative power of shareholders is not akin to eliminating shareholder oversight. Instead, it means reducing the proportion of managerial attention dedicated to meeting shareholder demands.[198] Regardless of the strength of shareholders' voting power, corporate managers remain subject to fiduciary duties under corporate law, and only shareholders can trigger judicial intervention for a perceived violation of fiduciary duties.[199] So, a reduction in relative shareholder influence will not leave corporate managers entirely free from shareholder oversight. Shareholders with relatively less power will maintain their rights granted by state corporation law and thereby their ability to, at a minimum, serve as a backstop against extreme managerial misconduct.[200]

Additionally, a corporate manager subject to less than rigorous shareholder scrutiny will not operate with complete disregard for the well-being of the corporation. In terms of economic incentives, corporate executives care about their reputational capital and can be expected to work to ensure the companies they lead appear successful.[201] More broadly, ample evidence demonstrates that humans generally are not strictly "rational" economic utility-maximizing beings.[202] We can reasonably expect that most corporate managers care about doing their job well and are sometimes willing to sacrifice some amount of their own well-being to benefit other corporate constituencies.[203] So, we can expect that CEOs, in the absence of tight shareholder oversight, will care about the success of the corporations they lead and therefore will take steps to optimize the stakeholder inputs available to their corporations.

Moreover, what the team production theory elucidates is that non-shareholder stakeholders are not a general and ill-defined group under the heading of "community." Rather, they are specific groups whose inputs are necessary to corporate production. In a well-functioning economy, there should be competition for stakeholder inputs, and this market for inputs can create an

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198. Both Bratton and Wachter, as well as Blair and Stout, point out that the scope of shareholder rights is appropriately limited by existing corporate law. Bratton & Wachter, *supra* note 90, at 662 ("The prevailing legal model of the corporation privileges the decisionmaking authority of the board of directors . . . . As a legal matter, directors are not agents of the shareholders."); *see also* Blair & Stout, *supra* note 12, at 321–22.

199. Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. LAW 637, 662 (2006).

200. Blair & Stout, *supra* note 12, at 283.

201. GREGG D. POLSKY & ANDREW C.W. LUND, CAN EXECUTIVE COMPENSATION REFORM CURE SHORT-TERMISM? 1, 6 (2013), https://www.brookings.edu/wp-content/uploads/2016/07/Issues-in-GS-58-Mar-2013-polsky-lund.pdf.

202. *See* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 6–8 (2008).

203. LYNN STOUT, CULTIVATING CONSCIENCE: HOW GOOD LAWS MAKE GOOD PEOPLE 8 (2011).

accountability mechanism for management.[204] Displeased employees, suppliers or customers can decline to contribute to the corporation, to the detriment of production and shareholder returns.[205] Since even somewhat less powerful shareholders will still have oversight ability, and since managers care about their personal and firm reputations, the need to attract stakeholder inputs will ensure some level of managerial attention to these groups.

Thus, reducing the relative power of shareholders could result in additional rent seeking by managers, but this rent-seeking will usually be limited by the managers' desire to appear to be successfully managing their companies. Moreover, it is far from clear how the cost of this rent-seeking behavior compares to the costs of managerial fixation. Given this ambiguity, the default to shareholder empowerment as a solution to all corporate imperfections seems unwarranted. And, in particular, when the problem we are trying to solve derives directly from disproportionate managerial attention to shareholders, as is the case for managerial fixation, additional shareholder influence cannot be expected to resolve the issue.

IV. POSSIBILITIES FOR REFORM: USING SHAREHOLDER INFLUENCE TO REDUCE SHAREHOLDER INFLUENCE

Larry Fink's letter was a response to widespread concerns about managerial fixation, and the prior Part provided a theoretical explanation of both how managerial fixation arises and how it may interfere with corporate value maximization. As the above discussion has demonstrated, we cannot expect shareholder oversight of stakeholder relationships to solve problems of managerial fixation. However, the trends that have facilitated shareholder empowerment cannot easily be reversed. The increased popularity of institutional investors will not likely abate in the near future.[206] Nor will the prominent role of proxy advisors, in spite of extensive debate about their usefulness.[207] Scholars have called upon regulators to cease prioritizing shareholder empowerment,[208] but much of the shareholder empowerment trend has been a consequence of private activity outside of regulatory control.[209] And, the prospect of shareholders voluntarily relinquishing the additional power they have accumulated over the years seems unlikely.

Thus, rather than considering how to reverse shareholder empowerment, this Article takes a more practical approach and offers two methods by which today's powerful institutional shareholders could use their substantial influence

204. Though, maintaining well-functioning markets is a first category interest that will require government intervention. *See* discussion *supra* Subpart I.C.

205. Bratton & Wachter, *supra* note 177, at 492–93 (noting the constraints on managers posed by product markets and organized groups such as labor and trade associations).

206. Absent large and unforeseen market changes.

207. GLASSMAN & PEIRCE, *supra* note 96, at 2.

208. Bratton & Wachter, *supra* note 90, at 727–28.

209. Rock, *supra* note 9, at 1910.

to reduce managerial fixation and effectively redirect managerial attention to other corporate stakeholders.

While shareholders will not be effective in any attempts to directly monitor a corporation's relationships with its many stakeholders, they can use their influence to promote the adoption of governance mechanisms that will encourage corporate managers to direct greater attention to other stakeholders. The proposals described below would rebalance the incentives faced by managers to encourage more and better stakeholder engagement. They would do so by realigning incentives in two ways. First, they would create explicit internal incentives for managers to engage with stakeholders, thereby capitalizing on managers' superior information about stakeholder relationships. At least as importantly, however, they would also reduce the existing incentives that managers have to focus narrowly on shareholder demands. If shareholders themselves advocate for these mechanisms of stakeholder engagement, this sends a credible signal to managers that engaging with stakeholders is what shareholders desire. Thus, managers will be less fearful that by attending to the needs of other stakeholders, they risk their jobs or reputations due to shareholder dissatisfaction.[210] Moreover, implementing accountability mechanisms for stakeholder outcomes could reduce the likelihood that managers use their additional flexibility to engage in rent seeking.

A. STAKEHOLDER IMPACT REPORTING TO THE BOARD

While public shareholders are not equipped to directly monitor a corporation's relationships with its other stakeholders, doing so is precisely the role of the board of directors. The board is tasked with managing the corporation,[211] which necessarily means managing the corporation's relationships with its many stakeholders. Indeed, Blair and Stout posit that the delegation of governance to a board of directors is a defining characteristic of a public corporation.[212] While, in practice, the CEO and other corporate executives will usually be the managers who directly engage with stakeholders, it is the board's responsibility to oversee the activities of the executives. Thus, to facilitate the board's oversight, shareholders should press for reporting on stakeholder outcomes to the board.

Professors Kose John, Jongsub Lee, and Ji Yeol Jimmy Oh conducted an empirical study of the informational value of corporate social responsibility (CSR) reporting by corporate managers to the board of directors.[213] CSR activities are largely activities directed at non-shareholder stakeholder groups. Indeed, the study assessed firms' CSR activities according to the categories:

210. POLSKY & LUND, supra note 201, at 6 (noting that the enhanced risk of termination by displeased shareholders is of utmost concern to corporate CEOs).

211. DEL. CODE ANN. tit. 8, § 141(a) (2020).

212. Blair & Stout, *supra* note 12, at 251–52.

213. Kose John et al., The Information Value of Corporate Social Responsibility (Apr. 12, 2018) (unpublished manuscript), https://ssrn.com/abstract=3119039.

community, corporate governance, diversity, employee relations, environment, human rights, and products.[214] These are all themes that directly affect non-shareholder stakeholder groups. They found that CSR reporting to the board resulted in "more informed advising and monitoring by the board."[215] They further found that the informational value of the CSR reporting was greatest in corporations where information asymmetries between the CEO and the board were the greatest.[216] Based on these findings, they posit that CSR reporting allows corporate boards to access firm-specific stakeholder information, thus enhancing the board's ability to play its supervisory role.[217] This result is not surprising given the foregoing analysis of how stakeholder relationships are determinative of firm value.

Stakeholders' firm-specific information is precisely the type of valuable information that managers can glean from the negotiation of their incomplete contracts with stakeholders, but to which shareholders have neither access nor the capacity to monitor effectively. The board of directors, by contrast, sits within the corporation, is by no means passive in its oversight of the company,[218] and indeed is legally obligated to take an active role in overseeing the corporation.[219] Thus, by requiring that this information is shared with an independent board of directors,[220] shareholders can reduce managerial agency costs by relying on the board's superior monitoring position, rather than attempting to engage in that monitoring themselves. Such a requirement would demonstrate shareholders' sincere interest in adequately managing to stakeholders while putting in place a mechanism that is capable of enforcing that commitment.

B. Stakeholder-Focused Executive Compensation Metrics

When seeking to adjust corporate managers' incentives, the most likely place to turn is usually to executive compensation. Traditionally, this tool has most often been used to align managers' incentives with those of shareholders.[221] However, as this Article has endeavored to demonstrate, managerial incentives appear to have drifted too far in the direction of shareholder incentives. Adjusting executive compensation to include metrics for non-shareholder stakeholders could moderate managerial fixation.

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214. *Id.* at 15.

215. *Id.* at 1.

216. *Id.* at 25.

217. *Id.*

218. As public company shareholders are. *See supra* Subpart II.B.3.

219. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

220. The independence of the board of directors is key to the findings of John, et al. Information asymmetries will generally be greater where the board is independent. CSR reporting can overcome those asymmetries, allowing the corporation to benefit from the independent perspective of outsider directors while avoiding some of the associated costs. John et al., *supra* note 213, at 1–2.

221. Rock, *supra* note 9, at 1917.

A 2017 study by Professors Caroline Flammer, Bryan Hong, and Dylan Minor found empirical support that stakeholder-focused compensation criteria successfully "direct managers' attention to stakeholders that are less salient but financially material to the firm in the long run."[222] This study thus provides compelling evidence that stakeholder compensation metrics can ameliorate managerial fixation. It does not conclusively prove that such metrics will always be successful. Indeed, as was discussed in Subpart III.B.3 above, developing metrics for environmental and social impacts has long proved challenging. Nonetheless, the prospect of internally developing stakeholder metrics that are specific to a particular business provides an opportunity to avoid the challenges that arise in attempts to create universally applicable metrics. Such internally developed metrics would be developed by managers with an intimate understanding of that particular corporation, and would be adjustable over time as corporate insiders determine that circumstances have changed so as to warrant a new or different stakeholder focus.

The idea of incorporating stakeholder criteria into executive compensation formulas is not a new one. As of 2013, thirty-seven percent of S&P 500 companies had adopted some stakeholder criteria in their compensation formulas.[223] As of 2013, this practice was most common among emission-driven industries and thus focused on emissions reduction and energy efficiency goals.[224] Nonetheless, related metrics could be developed for other corporate stakeholders such as employee retention or customer loyalty, and scholars and practitioners have already begun developing criteria for effective stakeholder compensation metrics.[225] Thus, shareholders can use their substantial influence to press for executive compensation packages that include substantive criteria for meeting stakeholder goals that are developed by and relevant to the individual corporation.

These two proposals are necessarily preliminary, and there are surely other possible approaches that could serve a similar function. The goal of this final Part is to begin thinking about ways that, given the current balance of power in

222. Caroline Flammer et al., Corporate Governance and the Rise of Integrating Corporate Social Responsibility Criteria in Executive Compensation: Effectiveness and Implications for Firm Outcomes 30 (Sept. 10, 2017) (unpublished manuscript), https://ssrn.com/abstract=2831694 ("[T]he adoption of CSR contracting leads to i) an increase in long-term orientation, ii) an increase in firm value, iii) an increase in CSR . . . iv) a reduction in emissions, and v) higher engagement in the development of 'green' innovations.").

223. *Id.* at 3.

224. *Id.*

225. *See* PRINCIPLES FOR RESPONSIBLE INV., INTEGRATING ESG ISSUES INTO EXECUTIVE PAY: A REVIEW OF GLOBAL UTILITY AND EXTRACTIVE COMPANIES 6 (2016), https://www.unpri.org/download?ac=1798 ("Companies should consult with their shareholders in identifying ESG metrics and attempt to achieve a thorough stakeholder mandate to enhance internal and external support."); Graham Kenny, *How Boards Can Rein in CEO Pay*, HARV. BUS. REV. (Dec. 1, 2014), https://hbr.org/2014/12/how-boards-can-rein-in-ceo-pay ("[B]oard[s] should be looking at causal connections between what's going on today and what's expected sometime hence: for instance, how employee results are driving customer results, and how those are propelling shareholder results.").

publicly traded corporations, shareholders can meaningfully provide opportunities to correct managerial fixation.

CONCLUSION

BlackRock's public declaration of commitment to social impacts garnered substantial attention because the current structure of the U.S. equity markets has granted BlackRock extraordinary power. This shift of power has raised many concerns about how shareholders influence public corporations' social and economic value. The solution to these concerns does not lie in exhorting shareholders to exercise their substantial power to protect the interests of other constituencies. Shareholders have inadequate information to do so effectively. Rather, the solution lies in rebalancing managerial attention among corporate stakeholders so that all stakeholders are incentivized to optimally contribute to corporate production.