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Of Chameleons and ESG

There is no separating government from private sector structures and incentives. Nowhere is that more clearly seen than in debate over corporate social responsibility.

BY ANN M. LIPTON

At some point, every business law student will read the case of *AP Smith Manufacturing Co. v. Barlow*. The New Jersey Supreme Court was confronted with the question whether the directors of AP Smith Manufacturing were permitted, over the objections of some of the company's stockholders, to cause the company to donate $1,500 to Princeton University. The court answered that corporate charitable contributions are, in fact, a permissible use of corporate resources. Included among its justifications—in 1953, at the height of the cold war—was this, in part quoting Princeton's president:

> [I]f private institutions of higher learning were replaced by governmental institutions our society would be vastly different and private enterprise in other fields would fade out rather promptly. . . . "[D]emocratic society will not long endure if it does not nourish within itself strong centers of non-governmental fountains of knowledge, opinions of all sorts not governmentally or politically originated. If the time comes when all these centers are absorbed into government, then freedom as we know it . . . is at an end."

In other words, private corporations must advance the public good in order to forestall communism.

On the other side of the ledger, 17 years later, Milton Friedman published his famous essay in the *New York Times*, "The Social Responsibility of Business Is to Increase Its Profits." His core argument was that if corporate managers were to use shareholder resources to advance the public good—to "spen[d] someone else's money for a general social interest"—they would be engaging in "pure and unadulterated socialism."

Then again, in 2020, the CEO of MSCI, a financial services company, argued that investing with a view to a corporation's environmental and social performance—ESG investing, as we will discuss—is necessary to "protect capitalism. Otherwise, government intervention is going to come, socialist ideas are going to come." But three years later, Elon Musk, the CEO of Tesla and owner of the company formerly known as Twitter, said in an interview that investing based on a corporation's environmental and social performance is "communism rebranded."

Apparently, then, businesses must protect the system of private enterprise with socially responsible behavior that forestalls government action, *and* they must avoid socially responsible behavior, else they assume governmental functions and ultimately destroy private enterprise.

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Illustrations by Robert Neubecker

As this article will demonstrate, the entire conversation is misleading. Its fundamental error is the assumption that there is any possibility of separating the government from private enterprise. In fact, the government is inextricably linked with private enterprise, encouraging its structure and policing its incentives. There is no getting the government out of the corporation—and nowhere is that seen more clearly than in modern controversies over corporate social responsibility and ESG.

Taming Corporations

The corporate form is a uniquely efficient manner of doing business. A corporation is recognized as an entity independent of its shareholders, employees, and directors, which enables it to hold property in its own name, to sue and be sued, and—unlike the humans associated with it—to live indefinitely. In contrast to the business forms that preceded it, such as the general partnership, investors in corporations are not liable for the business's debts. Thus, if the corporation incurs significant liabilities, an investor might lose all of the capital she committed to the enterprise, but her personal assets are shielded from the corporation's creditors. As a practical matter, then, corporate shareholders can claim all of the benefits of corporate activity, but if the corporation becomes insolvent, many of the losses fall on others.

These features of the corporate form are so valuable that originally they were very hard to obtain. States granted the right to incorporate on a case-by-case basis, and usually only for public works projects, such as bridges, canals, and roads, while state politicians maintained seats on corporate boards. Corporations were, in a sense, arms of the state, akin to an early form of administrative agency or public–private partnership.

At that time, the organizing document that formed the corporation—the charter—would delineate the precise actions the entity was authorized to take, occasionally down to the prices it could charge to the public. That was unsurprising, because often the corporation's funding came from the clients it was intended to serve. The corporation might be forced to dissolve after a period of time, such as 10 years. There were prohibitions on corporations' ability to hold stock in other companies, preventing managers from creating a corporate empire. Transformative decisions, such as a merger or a charter amendment, would require the unanimous vote of the stockholders—which was very difficult to achieve and not realistically possible if shareholdings were dispersed. These limits were functionally the only form of corporate regulation that existed, and through them, the corporation's very existence was conditioned on assurances that it would be run to benefit society as a whole.

Over time, as the economy developed, the special charter system came under stress. Charters were viewed as a form of political patronage, and advocates demanded that they be made available to all businesses. Meanwhile, once corporations began doing business across state lines, the charter no longer served as an effective form of regulation; chartering states, after all, had no interest in regulating the behavior of the corporation when it operated elsewhere. Eventually, charters became available pursuant to a uniform administrative process, and the regulatory restrictions fell away. Business regulation moved out of corporate law—out of the charter—and was replaced with what we call "external regulation," such as antitrust law, employment law, and so forth.

Freed from these constraints, corporations grew to massive size; by the beginning of the 20th century, the giant corporations were capable of exercising power over huge swaths of the economy, and after World War I, securities ownership rapidly dispersed among the population. That raised the question whether corporations should be run solely to serve the interests of their shareholders—that is, to earn as much profit as possible—or whether instead they should be run with a view toward benefiting all of their stakeholders, including employees, customers, and surrounding communities. The argument has continued ever since.

Shareholder vs. Stakeholder Primacy

The special features of the corporate form—unlimited life, limited liability, tradeable shares, and centralized management—enable corporations to amass vast resources, concentrating power in a handful of managers to direct and coordinate the labor of thousands, or even millions, of people. Corporations, and their controllers, thus exercise a great deal of power over how economic resources are allocated, over how political decisions are made, and over the daily lives of the American public.

Corporate power may ultimately benefit society. It may be used to build necessary infrastructure, conduct critical research, supply necessary goods and services, achieve technological advances, and produce great works of art. Corporations contribute to human flourishing by providing financial security to investors; income, training, and advancement opportunities to employees; and creative outlets for entrepreneurs.

At the same time, corporate power can be abused. Corporations may damage the environment, or mistreat their workers, or produce goods that are shoddy or dangerous, or form monopolies that stifle innovation. For that reason, society regulates corporations, to promote the benefits of the form while limiting the harms. Corporations must comply with rules regarding their hiring practices and their relationships with employees, their workplace and product safety, and their treatment of the environment and natural resources. While disagreements are many and varied over precisely what regulations are necessary, most would agree that some sort of regulation is appropriate.

The debate over shareholder primacy concerns whether these regulatory systems—which, in broad strokes, operate by setting floors and ceilings on certain kinds of corporate behavior—are sufficient to protect the public and to ensure that corporations behave in a prosocial manner. In other words, the debate concerns whether—within these floors and ceilings—corporate managers should use their remaining discretion to generate the maximum potential profit for their shareholders or whether, instead, their discretion should be channeled toward balancing the interests of all stakeholders, including customers, employees, and the general public.

The shareholder-primacist view is that corporate managers should use their discretion to act solely in shareholders' interests. Other corporate constituencies—such as creditors and employees—can protect their interests with contractual terms. Communities can protect their interests with business regulation. Shareholders, by contrast, receive only whatever assets remain after the corporation pays its bills. Therefore, if managers strive to maximize profits, they will necessarily first have satisfied obligations to other constituencies, making all parties better off.

Moreover, shareholders are the only group with no specific entitlements: By definition, they receive only the corporate "residual," namely, what remains after the corporation meets its obligations to others. The reassurance they get in exchange for that vulnerability is that managers will attempt to earn as much profit as they can.

According to shareholder primacists, if corporations violate the law—if their products are not safe or if they pay below minimum wage or if they dump pollutants—they will have to pay various legal penalties, which will diminish their profits. Beyond that, markets also extract a price for misbehavior. Contractual counterparties such as customers, creditors, and employees will not do business with exploitative firms, and this will inflict further financial penalties on bad actors.

In the end, then, this school of thought holds, these twin forces—markets and government regulation—will make profits very difficult to achieve unless corporations behave in a manner that the public as a whole judges to be prosocial. It is therefore unnecessary for corporate managers to go further and consciously seek to share corporate wealth with stakeholders; that will occur naturally, as a result of profit seeking on shareholders' behalf. Between democratically imposed governmental regulation and the invisible hand of a market reflecting popular sentiment, the interests of shareholders and the interests of the general public will become aligned.

Stakeholder theorists disagree. In their view, the corporate form—controlled by shareholders, who are the only constituency with the ability to elect directors—is so powerful that it can evade regulatory and market sanctions. Corporations are mobile; they can relocate operations to a new state, or a new country, in search of fewer regulations and fewer costs. Governments are slow and underfunded, and may not be able to detect lawbreaking easily, especially when corporations employ a complex bureaucratic structure that is impenetrable from the outside. Corporations can drag out legal disputes for years, so any penalties are ultimately paid far in the future, at dollar figures well below the true costs of the harm they inflict. And corporate resources can be marshalled to lobby politicians and thus prevent new regulations from being enacted in the first place.

Nor can markets be depended upon to exert discipline. In a world where corporations evade regulation in general, they can also evade antitrust regulation in particular, allowing a small number to exercise outsized market power and impose onerous terms. Corporations can also use their political power to rig the legal ground rules, so that, for example, consumers and employees are routinely forced to arbitrate disputes without the protections of class-action procedures.

There is no getting the government out of the corporation . . . .

Consider the examples of Amazon and Starbucks. As of this writing, both are engaged in aggressive antiunionization campaigns—with Starbucks only recently demonstrating signs of softening—and both have been found to have repeatedly violated the law. However, the National Labor Relations Board has no power to impose financial penalties. That means lawbreaking is, functionally, cost-effective.

These are the types of arguments stakeholderists make when maintaining that we should arrange matters so that corporate boards do not run the company solely to benefit the shareholders. If markets and government regulation are insufficient to channel corporate behavior in a prosocial direction, then corporate boards must take on that responsibility directly.

The perennial reply—one that has been offered in defense of shareholder primacy since 1932—is that the stakeholder model offers no alternative principle to guide managerial decision-making. In practical effect, it licenses boards of directors to make use of corporate resources to advance their personal values, which may not be reflective of society's values. Few would argue that Mark Zuckerberg, for example, or Elon Musk should be trusted with deploying the resources of Facebook or Tesla—resources committed by investors in hopes of earning a financial return—to impose their own vision of the social good. Henry Ford was a fabulously successful businessman in his day, but he was also a virulent antisemite who at one time tried to force his employees to conform to his vision of civic virtue. The mere fact that corporate moguls have the skills to run a successful business is no guarantee that they have the moral judgment—let alone the democratic legitimacy—to use the resources at their command to engage in their own brand of social engineering.

Redefining Shareholder Primacy

This debate has been replayed, in one form or another, for nearly a century, but recently a new solution has been proposed: Instead of giving corporate managers free rein to reallocate any surplus value generated by the corporation, *shareholders* will make those decisions. They will decide whether and to what extent they desire to sacrifice corporate profits to achieve social goals. Investors can choose to invest only in prosocial companies, or to vote for policies they believe to be prosocial. If enough investors participate in this project, and if they share similar values, prosocial companies will find it easier to raise capital, and managers of prosocial companies will receive more support from their shareholder base. In the end, companies will behave in a more prosocial manner because they are responding to the demands of their investors.

Investors, the theory goes, will be willing to sacrifice profits because they will reap the benefits in their capacities as nonshareholders. Investors, after all, also exist as consumers, employees, and inhabitants of the planet. They may prefer higher wages, better working conditions, safer products, and a cleaner environment. They may also have an ethical desire to avoid earning profits via exploitative means. And, after all, if investors are the ones who are entitled to corporate profits in the first place, they should be able to reallocate those profits to workers or to the community or to saving the environment if they choose to do so. This proposal solves the "Henry Ford problem": it provides a mechanism for generating more prosocial corporations without relying on the moral instincts of America's business elite.

One criticism of this approach, recently voiced by multiple candidates for the Republican presidential nomination, is that it functions as an end run around the legislative process. It's an attempt by advocates to win policy concessions that they cannot win through the procedures of democracy. To which the stakeholderist response is something like hearty agreement.

After all, the premise of stakeholderism is that the regulatory process is, in fact, insufficient to constrain corporate antisocial impulses. Government is sclerotic and dysfunctional. Policies that Americans overwhelmingly support do not get traction. Voter suppression—procedures that make it difficult for Americans to register to vote and cast a ballot—and gerrymandering and Senate malapportionment render politicians no longer responsive to the public they serve. And corporations can use their vast resources—representing the contributions of thousands or millions of individuals—to influence political outcomes in a manner that trumps the will of the electorate.

Yet, goes the argument, these problems do not plague *corporate* democracy. In corporate law, there is no gerrymandering. There is nonpartisan election administration. There are no complex voter registration requirements. Not only is mail-in voting uncontroversial, but shareholders can also vote by telephone and over the internet. In the political realm, candidates are permitted to lie to voters. In the corporate realm, we call that securities fraud.

Consider other legal developments. In *Citizens United v. FEC* (2010), the Supreme Court placed responsibility for curbing corporate excesses squarely on the shoulders of shareholders. The Court held that corporate political spending is protected First Amendment speech, to be constrained—if at all—"through the procedures of corporate democracy." Similarly, in *Burwell v. Hobby Lobby Stores, Inc.* (2014), the Court held that at least some corporations are capable of having *religious* interests, which then must receive recognition and accommodation by the legal system, including, under some circumstances, mandatory exemptions from generally applicable laws. These interests are derived from the religion of the corporations' shareholders, in accordance with ordinary procedures for corporate decision-making.

Thus, the Supreme Court placed on shareholders the responsibility to direct the corporation's social behavior in addition to its economic path. If the U.S. Constitution requires that corporations be permitted to use their vast resources to influence the very political system we rely upon to constrain their behavior—and if corporations may even be relieved of the burden of legal compliance, depending on the religious commitments of their shareholders—then, goes the logic, the only remaining avenue for society to reassert control over corporate behavior is via shareholder activism.

To be sure, this is not exactly a theory of stakeholder capitalism. The proposal takes as a starting point that any excess returns of the corporation *belong to the shareholders initially to direct.* The corporation is still being run to benefit shareholders; it is simply that shareholders are permitted to decide they want something other than (or in addition to) profits. And there are good reasons to believe that the capital class has no more legitimacy to make social policy than do corporate CEOs. People with stakes in the stock market tend to be white men who are older, wealthier, and more conservative than the general public.

But the larger practical problem is that individual shareholders are difficult to mobilize. Dispersed and rationally passive, they are unlikely to monitor corporate elections and vote, or trade, in sufficient volume to impact corporate behavior. Indeed, ever since shareholding became widespread after World War I, there have been efforts to harness the great mass of shareholders to redirect corporate activity in a more prosocial direction. In the early part of the 20th century, shares were marketed to consumers and employees on the theory that these groups would curtail corporate misbehavior. Through the 1950s, women tried to use their power as shareholders to have women seated on corporate boards. In 1970, Ralph Nader spearheaded "Campaign GM" to persuade the shareholders of General Motors to restructure the board in the public interest. These efforts largely failed.

Recently, however, a dramatic shift in the nature of investing breathed new life into the project. Whereas once upon a time individuals invested directly in the market, in the 1970s and 1980s individuals began investing through institutions, such as pension funds and, more commonly, mutual funds. Mutual funds in particular have exploded in popularity, in part because of changes to the tax code and changes to the regulation of retirement plans, making them an attractive option for employers that provide retirement benefits to their employees. Today, the three largest mutual fund complexes, together, control nearly 25 percent of the shares of the companies that make up the S&P 500.

Unlike individuals, institutional shareholders are regulated by law. They must monitor their holdings and, if appropriate, cast votes on behalf of their beneficiaries. The new institutional concentration of the shareholder base, and the legal obligations that have followed, finally make feasible the long-held dream of shareholder social activism.

More Money, More Problems

Whereas once it might have been impossible to imagine the great mass of retail shareholders exercising such influence over corporate policy, now that we have a consolidated, professionalized investing class, that goal seems more attainable. But if institutional investors are encouraged to use their governance powers to exert social control over corporate behavior, that only presents a new problem. Managers of mutual fund companies have no more legitimacy to effectuate social policy than do the CEOs of corporate America; the "Henry Ford problem" has merely been pushed down to the investor level.

In fact, for almost as long as there have been mutual fund companies and pension funds, there have been concerns that trustees might use beneficiary assets to further their own interests. As a result, these intermediaries are subject to a host of regulations that either require, or at least strongly encourage, that they maximize asset values, without regard for other concerns. For example, the Employee Retirement Income Security Act (ERISA), which regulates private pension plans, requires fund trustees to act solely in the financial interests of the fund. Pension funds for public employees usually have similar standards. The 401(k) plans through which many investors obtain their mutual fund shares are likewise regulated by ERISA. These plans permit employees to select from an employer-determined menu of fund options, and, with limited exceptions, funds may not be included on the menu if they would sacrifice financial value to achieve some other kind of social objective. Not

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only do those rules limit how retirement money may be used, but they also influence the rest of the mutual fund industry; mutual fund companies must sponsor funds that focus on maximizing financial value if they want a slice of the retirement plan business.

Moreover, mutual funds and pension funds exist within a larger corporate ecosystem that continually encourages both investors and their portfolio firms to push for profit maximization. Activist hedge funds—private funds, available exclusively to wealthy investors—have adopted a business model of purchasing shares in companies they perceive to be insufficiently profitable, using their governance rights to push for wealth-maximizing governance changes. These strategies are unavailable to ordinary mutual funds due to regulations of their permissible activities. But hedge funds today are much bigger than they were 30 years ago, because Congress and the Securities and Exchange Commission (SEC) widened exemptions from the federal securities laws placing limits on their size. Consequently, they can amass more capital and target more companies with bigger threats.

These hedge funds cannot act unilaterally, of course; they rely on the voting support of other shareholders, namely, the mutual funds and pension funds that generally must maximize profits for their beneficiaries. In the 1990s, the SEC paved the way for greater collaboration by amending the proxy-voting rules in ways that made it easier for hedge fund activists to lobby other shareholders to support their preferred policies and candidates.

Additionally, corporate executives and, increasingly, corporate boards are paid in stock and stock options, incentivizing them to keep stock prices high. That, too, is at least partly a product of federal law: the securities laws require that companies disclose the relationship of executive pay to shareholder returns, and until recently they offered tax breaks for performance-based pay.

These regulations and incentive structures create a thick barrier against enlisting institutional investors to encourage corporations to sacrifice profits in favor of a social agenda. For the project to work, then, a new argument must be advanced: that prosocial corporate behavior does not sacrifice profits at all.

Enter ESG

ESG stands for "environmental, social, and governance," and the phrase refers to a particular approach to investing and, correlatively, to managing a company. The theory is that investors (and therefore corporate boards) should attend to how their business affects, and is affected by, the environment; to how their business affects, and is affected by, relationships with employees, customers, and communities; and to some notion of "good" corporate governance, involving transparency to investors and the public, protections against self-dealing, and giving investors a voice in how the corporation is run. Investors may choose to invest in companies that score highly on ESG metrics, or they may cast their votes to express a preference for management to adopt ESG policies—to mitigate the environmental impact of the corporation's actions, to improve working conditions, and so forth—all as part of an effort to mitigate risks in the investor's portfolio.

The ESG acronym was first coined by the United Nations, as part of an effort to persuade the largest financial institutions in the world that a globalized economy required a set of minimum standards of conduct, in order to avoid backlash and hostility to industrial development. Undoubtedly, the UN was moved to act not out of concern for the wellbeing of the capital class, but out of concern for local populations injured by corporate activities. At the time, the UN focused on problems such as exploitation of labor in the developing world, corruption of local officials, and the destruction of natural resources. But earlier efforts to appeal to the moral instincts of institutionalized shareholders had failed, so now the UN adopted a new tactic: enlightened self-interest. The claim was that good corporate citizenship would open up new profitable markets, and bad behavior would close them off. The UN worked closely with major asset managers to develop a set of principles, and ESG as an investing approach was born.

Certainly, there are plausible arguments for how prosocial corporate behavior can contribute to the bottom line. Climate change is perhaps the most obvious example: investors would be irresponsible if they did not attend to whether their assets are at risk of being hit by wildfires, or flooding, or excessive heat. Additionally, governments around the world are requiring that companies reduce carbon emissions, and investors may, purely as a financial matter, want to know that their portfolio companies will be able to comply cost-effectively.

A similar claim can be made about social factors. If companies mistreat their employees, they will be unable to attract the strongest performers; they may experience high turnover and labor unrest, all of which will cut into profits. If they do not diversify their workforces, they may be vulnerable to discrimination lawsuits, or—more subtly—they may miss marketing opportunities and fall behind on cultural trends. Before the Civil Rights Act became law in 1964, activists boycotted segregated businesses and demanded they hire Black workers. The movement was successful in persuading businesses to diversify, not out of a sense of social responsibility, but because public backlash made diversity a *financial* concern.

Additionally, companies with strong reputations may be able to avoid regulation in the first place. For example, several tech companies recently signed on to a voluntary pledge about ethical development of artificial intelligence. They may be acting out of a sense of moral responsibility, but the more plausible explanation is that

they want to persuade Congress that extensive regulation is unnecessary. And it is likely not a coincidence that the Business Roundtable—an association of CEOs—came out in 2019 with a new statement rejecting shareholder primacy and declaring a commitment to serving all stakeholders, including customers and employees. At the time, the Democratic presidential primary was in full swing, with Elizabeth Warren and Bernie Sanders gaining momentum. In that context, the Roundtable's statement read as a preemptive attempt to demonstrate that further corporate regulation was not needed.

This is the argument articulated by the *AP Smith Manufacturing Co. v. Barlow* court back in 1953 and echoed by MSCI's CEO in 2020: When corporations practice good citizenship, they forestall the need for government intervention, thus minimizing government's size and enlarging the space for private enterprise. For that reason, Professor Jonathan Macey once referred to ESG as "nothing shy of a remarkable libertarian turn in the history of American law."

Thus, even though ESG is used in common parlance as a moral approach to investing, among professional asset managers it is typically discussed as an approach to financial risk management. And that argument is not at odds with shareholder primacy: to the contrary, it is the premise that justifies shareholder primacy as the fulcrum of corporate law. Corporate CEOs are permitted to operate massive enterprises that exercise extraordinary power over American life without any concern for the public *other than* the mandate to maximize shareholder wealth, all because of the baseline assumption that society has arranged institutions so that profits cannot be achieved through antisocial behavior. And if that is how matters are arranged, investors *should* in fact seek to invest in prosocial companies; prosociality *should* be a predictor of profit. If it is not, shareholder primacy has failed.

But here's the rub: The original stakeholderist premise—the argument that took us down this path in the first place—was that the regulatory system is *insufficient* to align profit seeking with the social good. And if *that* is correct, then a focus on *financial* ESG will not, in fact, encourage corporations to become better social actors at all.

Consider climate change. It is certainly reasonable for companies to develop transition plans if they anticipate new regulations that will limit greenhouse gas emissions. And it is completely unnecessary if they can lobby the regulations out of existence. It may be reasonable for companies to develop strong reputations with consumers or employees, but press releases and public statements may work just as well as changes to substantive behavior—a practice known as "greenwashing."

Thus, we end where we began. An idea for plugging regulatory gaps in a shareholder-primacist system ends up buttressing it.

Politics by Other Means

Today, ESG is controversial, and that is not a coincidence; if ESG began life as a mechanism of effectuating politics by other means, it was inevitable that politics would push back. Evaluating companies' environmental performance often means considering climate change, and evaluating its social performance often means evaluating its approach to diversity, equity, and inclusion (DEI). These are topics that are politically controversial. Objecting politicians tend to deny that these principles have any relationship to financial value; while the evidence on that score is mixed, there is reasonable cause for suspicion that ESG was developed in order to justify advocacy for corporate social behaviors that, in earlier eras, would have been treated as exercises in pure stakeholderism. Moreover, at least with respect to some aspects of the typical ESG agenda, the question of their financial value has a recursive quality that makes the truth difficult to evaluate.

Take, for example, the corporate commitments to diversity that were announced in the wake of the George Floyd protests. Corporations rapidly hired more Black officers and directors, but then just as rapidly slowed new appointments. DEI officers were suddenly in high demand, but the positions turned over quickly, because hires did not feel their efforts were supported or that the companies had any articulable goals. Companies continue to add women to their boards, but slowly, and largely as a result of natural attrition. These efforts, in other words, suggest that corporations are not making changes they believe will improve operational functioning; instead, they are seeking a degree of *social legitimacy* by appealing to an audience.

The impulse is not unlike efforts to demonstrate good corporate citizenship in order to ward off onerous regulation: a diverse board may not *itself* contribute to value, but it may put a softer face on corporate power in order to ward off backlash against its exercise.

Similar behavior is evident at the level of mutual fund asset managers, who are capable of exercising tremendous influence over the firms in their portfolios. They, too, have ostentatiously committed to diversifying public company boards and, for a time, to encouraging a green-economy transition. These commitments, as well, proved to be somewhat weak, suggesting that mutual funds, like operating companies, treated their public stances as a mechanism for legitimating their power and keeping regulators at bay.

But when ESG is undertaken for appearances' sake rather than for its operational significance, the implications are different depending on whether it originates from asset managers or from portfolio companies. When operating companies seek to avoid regulation or public backlash—if only through image management—their efforts redound to their shareholders' benefit; these actions are entirely consistent with shareholder primacy. If asset managers, by contrast, are using the investments of their beneficiaries to polish their own images vis-à-vis regulators and the public, those benefits redound to the investors in the *asset managers* and not to the *fund* investors, whose assets are being used to curate the managers' public personas. This has been characterized as an agency problem: the mutual fund company is using beneficiaries' assets to establish itself as a "good actor." That said, even if the asset manager's motivations are less than pure, its beneficiaries can benefit from the approach. Suppose that the asset manager is cynically attempting to evade regulatory scrutiny by visibly "overseeing" its portfolio firms: If those firms, as well, can avoid greater regulation by cooperating in the appearance of being "tamed," then, ultimately, the firms will benefit financially (and syllogistically, so will the fund's beneficiaries).

There is, in other words, a cooperative quality to the project in which asset managers display their efforts to curb corporate excesses and corporate boards display a degree of acquiescence in being curbed. As Marcel Kahan and Edward Rock put it, "we need to believe that in even—and especially—the largest corporations, there are individual shareholders who collectively own and control those corporations. Because shareholders exercise control over managers, perhaps mediated through markets, it is acceptable that a small group of managers control huge concentrations of capital for which they are paid princely sums."

But if corporate America is seeking a degree of social legitimacy with representative inclusion of historically marginalized groups, what has become painfully obvious is that to some segments of the American public, diversity may in fact suggest a *lack* of legitimacy. And the fact that a company seeks *social* legitimacy through a communications strategy is itself communicative: it suggests that diversity is profitable, which means there is a *market* for diversity, that diversity is mainstream. *That* statement invites a dispute over what constitutes the mainstream, with corporate profitability now serving as a proxy for public acceptance. The effort itself invites attempts to *reduce* corporate profitability in order to establish a *lack* of mainstream credibility.

That, perhaps, is the best way to understand the organized boycott movements that targeted Bud Light, for seeking the endorsement of a trans influencer, and Target, for featuring trans-inclusive and gay pride merchandise. Though there is every reason to believe these companies were attempting to expand their markets rather than to take a position on public policy, opponents of trans- and gay-inclusive policies sought to demonstrate the popularity of their own cause by establishing that diverse marketing is unprofitable.

After the Supreme Court overruled *Roe v. Wade* in *Dobbs v. Jackson Women's Health Organization* in 2022, certain shareholder advocates requested that companies disclose their policies for helping women employees receive abortion care if they were employed in states where the procedure was restricted. The shareholder proponents argued that this was a financial issue—women would not want to work in states that restricted abortion access, and unwanted pregnancies would cause employee attrition—and therefore relevant to investors. Despite that framing, the symbology was inescapable: these shareholders wanted companies to affirm that abortion care is profitable—and therefore popular—by providing access. ISS, a proxy advisor firm that provides voting recommendations to institutional clients, agreed as to the financial relevance of these policies and recommended that shareholders support greater disclosure. Shortly thereafter, when more of these proposals came up for votes, ISS reversed course, warning that if companies disclosed that they were providing support for abortion care, they might become targets for political protest and, potentially, regulatory action by more restrictive states. In other words, the liberal side tried to link abortion access and corporate profitability, while conservatives tried to do the opposite.

All of which is to say: ESG as a *financial* strategy is vulnerable to exactly this kind of dialectic, and if political fights and backlash rob otherwise profitable strategies of some of their utility, at some point it will become more profitable to drop them. And that is going to be truer of practices that were adopted more for their public symbolism than out of any deeper belief in their functional contributions. Thus, in the wake of anti-ESG backlash—and in a general economic slowdown as well—businesses have begun at least a partial retreat from some DEI efforts. That, too, is part of the shareholder-primacy story: corporations will respond to the demands of the market, without judgment as to the merit of those demands.

It is useful to consider the conflagration between the Disney Corporation and Florida's Governor Ron DeSantis through this lens. Disney, as a company, has over time come to embrace and cultivate its gay fan base, which, among other things, organizes lucrative "Gay Days" at Disney's Florida theme park. That history notwithstanding, when DeSantis backed a parental rights bill, colloquially known as "Don't Say Gay," which prohibited discussion of sexual identity in schools, Disney's CEO, Bob Chapek, initially announced that the company would not be taking a position on the bill, because the company preferred to remain neutral on political matters.

Disney's employees, many of whom were located in Florida and directly affected by the law, reacted with fury. They rendered the company ungovernable with protests and walkouts, creating a public relations nightmare. In that context, Chapek did the absolute least he could do: after the bill was passed, when it was sure to become law, he finally declared Disney's opposition. The gesture was so hollow that the Human Rights Campaign, an LGBTQ+ advocacy group, initially refused Disney's accompanying $5 million donation. In any other context, Chapek's actions would be characterized as greenwashing.

From a corporate law perspective, Disney's response was not an example of social activism; it was a demonstration of shareholder primacy. The company felt, in real time, pressure on its ability to function, and it reacted. If workers had been demanding a raise, the company might have given them one. Instead, workers sought a political statement, and the company delivered the bare minimum it could, to buy labor peace. Which is exactly what a Delaware court held, when a shareholder later accused Disney of abandoning business motives and pursuing a political agenda.

Notwithstanding the weakness of Disney's opposition, DeSantis and the Florida legislature responded with fury, stripping Disney of control over a special tax district that encompassed Disney World. In some ways, it is tempting to claim that what befell Disney highlights the dangers of corporations' assuming political roles: it inspires the government to coopt business, exactly the consequence that Milton Friedman, one of the fiercest defenders of shareholder primacy, predicted. But it is impossible to avoid that Disney's "political" stance was, by all evidence, a profit-seeking one. And it became a profit-seeking one because a particular group of stakeholders (employees) had learned, through years of experience, that corporations such as Disney exert tremendous influence as social and political actors and frequently derive great financial benefits from doing so. Once that political influence was established, it was inevitable that various constituencies would seek to channel it in preferred directions.

Reshaping the Corporation—a Reprise

Though some of the objections to ESG are rooted in the assertion that it is unrelated to financial concerns, others arise from an explicit attempt to *protect* the practices that ESG investors shun. This strain of ESG opposition may be viewed as its own form of stakeholder capitalism, in that it hopes to shape corporate behavior through capital allocation, even at the expense of profits; the only difference is that the values expressed on the anti-ESG side are the opposite of those traditionally pursued by stakeholderism advocates.

For example, in Louisiana, John Schroder, then the state treasurer, announced in 2022 that he would no longer invest Louisiana trust funds—which support various state programs, such as education and health care—with BlackRock, due to its endorsement of a global transition to green energy. According to Schroder:

> This divestment is necessary to protect Louisiana from actions and policies that would actively seek to hamstring our fossil fuel sector. In my opinion, your support of ESG investing is inconsistent with the best economic interests and values of Louisiana. I cannot support an institution that would deny our state the benefit of one of its most robust assets. Simply put, we cannot be party to the crippling of our own economy.

That is not a claim that ESG investing—and in particular, investing with an eye on the effects of climate change—is unprofitable for investors; it is a claim that Louisiana trust funds should be used to support local industry, regardless of the effects on the value of the trusts themselves. And, to be fair, this is hardly an unusual position; other

It is useful to consider the conflagration between the Disney Corporation and Florida's Governor Ron DeSantis through this lens.

state funds have special rules that permit them to prioritize local projects. In other cases, politicians have claimed that ESG policies amount to a type of "social credit score" that targets industries supported by conservatives, and have sought to ban such practices. Between ideological opposition to the typical ESG priorities and distrust of its financial relevance, a budding ESG backlash has led to a slew of proposals to eliminate or limit the practice.

Shareholder proposals. One mechanism by which shareholders express their preferences—and influence corporate behavior—is by taking advantage of SEC Rule 14a-8, which allows shareholders to insert items on the corporate proxy ballot that will then be voted on by all shareholders at the next annual shareholder meeting. Rule 14a-8 has frequently been relied upon by shareholders offering social-responsibility/ESG proposals, such as proposals that companies report on the diversity of their workforce or on their greenhouse gas emissions. Rule 14a-8, in various forms, has existed since 1938, and conservatives have proposed to eliminate it or curtail it so it cannot be used for ESG topics.

Pension fund investing. Other proposals would limit private pension funds' ability to use ESG metrics when making investment decisions. ERISA already requires pension funds to make decisions only on a financial basis, but the Trump administration proposed a rule that would require funds to generate extensive documentation to justify their use of ESG factors specifically. More documentation requirements would have been imposed for pension fund voting of shares unless the fund adopted a blanket policy always to vote with management recommendations. Since then, House Republicans have offered various pieces of legislation to discourage pension fund use of ESG factors. The Biden administration went the opposite route; a new Labor Department rule permits pension funds to consider the financial impact of ESG factors. Congress voted to block the Biden rule, but Biden vetoed that action. Currently, 25 states are suing to suspend the Biden rule.

Climate disclosure. The SEC recently released new rules requiring public companies to disclose a battery of information about their exposure to climate-change risk and their emissions activity. Opponents of such disclosures have already declared their intention to challenge any climate change reporting requirements in court, and House Republicans have proposed legislation to prevent their implementation. Should these efforts succeed, investors would presumably find it more difficult to incorporate climate information into their investment analyses, which, among other things, could impact how and where capital is allocated throughout the economy.

Brokerage regulation. Missouri adopted a rule requiring that customers sign explicit waivers in order to authorize brokers to make recommendations based on social and environmental goals beyond maximizing financial returns. These waivers must be periodically renewed. It is worth noting that Europe has adopted almost the opposite rule: brokers are required to inquire as to whether customers have any sustainability goals at the outset of the relationship.

Proxy advisors. These companies provide expert and informed voting recommendations to institutional clients. In part out of a perception that proxy advisors unduly favor ESG principles, politicians have proposed regulating them more tightly and limiting their activities. Previous regulations on proxy advisors, imposed by the SEC under the Trump administration, were repealed after Biden took office; that repeal is currently the subject of an industry legal challenge. Presumably, these changes would alter the voting behavior of institutional investors, either by shifting the recommendations they receive or perhaps by inhibiting voting on some topics altogether.

Lending criteria. Some proposed regulations would limit the ability of financial institutions to consider ESG criteria when assessing the likelihood of repayment by a particular borrower. In practical effect, such a rule would limit the ability of financial institutions to price certain risks when making decisions as to whether and how to extend banking services to potential clients. Among other things, such a shift could lower the cost of capital for industries that tend to be disfavored by the use of ESG criteria, such as oil, gas, and firearms.

Voting disclosures. Under President Biden, the SEC has adopted rules to require mutual funds to provide more detailed disclosure on how they vote the shares they hold, including on ESG matters. The SEC claims that this will allow investors in mutual funds to better understand how their assets are being managed. Multiple states have sued to block the rule on the ground that it is intended to empower activists to influence fund voting behavior.

Fiduciary obligations. Lawmakers in Texas have proposed to make it easier for shareholders of Texas-incorporated companies to sue corporate managers for violating their fiduciary duties if they take ESG considerations into account.

This is but a sampling of the measures that have been proposed or enacted; many were dead on arrival, but others may still become law or at least influence the direction of future regulation. Significantly, none would radically reform the landscape; they would simply shift the existing corporate governance framework in relatively minor ways. In that manner, what the proposals perhaps inadvertently demonstrate is that—just as was true from the earliest days of the business corporation—the state has an inescapable role in shaping corporate priorities. Originally, this was accomplished via regulation of the corporate form; today much (though not all) of the attention has shifted to the institutional investors that increasingly

exercise governance powers within the firm. The words differ, but the song remains the same.

What we see, then, is that whether or not shareholder primacy is the order of the day, regulators must constantly address the legal architecture governing corporations and their shareholders, in order to ensure that the corporation functions as designed. In the ESG space, that translates to regulators making explicit decisions about what investment strategies are, or are not, likely to be profitable, and placing regulatory burdens accordingly. In that sense, the debate between the *Barlow* court, on the one hand, and the Friedmanites, on the other, can never be resolved, because there is no strategy that will free corporations from the state.

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The U.S. Supreme Court has treated corporations as associations of shareholders, who themselves can decide the political valence of corporate activity. But power and authority within the corporate structure are dictated by law in the first instance; they do not exist in a Hobbesian state of nature. There is no first (preconstitutional) principle that requires corporations to have a particular governance structure, and the shape of the corporate form at the nation's founding—and even at the time of the Civil War—was dramatically different from the shape of the modern corporation.

In part as a result of securities regulation, tax policy, and labor policy, 80 percent of shareholders are institutions, and institutions are both regulable and regulated. Their size is controlled by law; they may be required, or not, to diversify their holdings or to hold only liquid assets. The compensation investment companies pay their managers is regulated, which affects these managers' incentives. We regulate how institutional investors make decisions and the duties of the advisors they hire. All of these legal choices affect their investment strategies, and thus how institutional shareholders exercise influence within the corporation. Other regulations address rights of shareholders within the corporation, including their ability to place items on the proxy ballot and their ability to coordinate with other investors.

Recently, it has been suggested that if shareholders are to decide whether corporations must act to maximize profit, decision-making power should be vested, in some fashion, in the retail investors who buy mutual fund shares. But how should that occur? Some have proposed that mutual funds should poll their beneficiaries and then take those preferences into account when casting ballots; legislation has also been offered to require that funds allow beneficiaries to cast their own ballots. Mutual funds have started experimenting with different systems voluntarily. But that only raises new regulatory questions. What disclosures will have to be made to retail investors, and what default rules will exist for those who do not make selections? How will shares be voted once a particular investor exits the fund?

In the field of architecture, there is a saying, "form follows function," meaning that the design of a structure should facilitate its purpose. In corporate law, however, function also follows form, in the sense that whatever structure is selected, it will guide how the corporation and its shareholders behave vis-à-vis society. And that structure is inevitably selected by political actors. There is no option not to decide.

But that also means that society has choices. If we dislike how corporations function, the ground rules can be altered. We can change how decision-makers are selected and the values they advance. The corporate build is not inevitable and in fact has taken on different forms at different times. We can decide how it should look today. ■

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