Saving Investors from Themselves: How Stockholder Primacy Harms Everyone

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We face many tough issues including poverty, climate change, social and economic inequality, the cost and quality of education and healthcare, stagnant wages, financial market instability, disease, and food security. Despite the existential threat that these concerns may raise, there is no consensus on whether or how to address them through regulation, taxation, or other government policy tools. Private enterprise, however, has tremendous potential to address these issues through technology, wages, supply chain maintenance, green operations, efficient delivery of goods and services, and a myriad of other outputs and outcomes.

In the U.S., the potential of the private sector to address these issues dwarfs that of the government. The 2015 federal budget was approximately $2.5 trillion (excluding transfer payments like Social Security), while the 2015 gross domestic product (GDP) was about $18 trillion. While numbers go up and down, total government spending (including state and local) typically accounts for about 20% of GDP when transfer spending is netted out. Consumer and business spending account for the other 80%. In light of these realities, harnessing the assets of the private sector is a critical pathway towards addressing pressing social and environmental issues.

However, the structure we use to allocate resources in the private economy actively precludes using assets in this manner. What I want to do here is describe the structural issue and how a new corporate governance model—the benefit corporation—can help to restructure our system of capital allocation. But we require more than a mere adjustment to corporate governance. I want to suggest that everyone along the investment chain, from corporate executives and directors to fund managers and individual investors, add an ethical component to their decision-making. I do not mean to suggest altruistic investing. What I am suggesting is that there is a better way to invest for private gain—one that

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will potentially produce a better outcome for all participants in the economy, including investors. The ethical principle is easy to state: *investors and managers should not seek gains by simply extracting as much value as possible from the economy, but instead should seek gains by building and sharing value with all stakeholders in their investments*. In other words, we need to restructure our system to encourage the investment of private capital in positive sum opportunities.

The current rules for allocating private capital are based on the idea of "stockholder primacy" and the pursuit of immediate increases to share value, which have become identified with a pre-governmental pure "free market." As Robert Reich points out in his recent book, *Saving Capitalism*,[1] there is really no such thing. There is no free market without rules that are created and enforced by government and social mores, and those rules affect outcomes. The rules in place today pit the interests of investors against those of other stakeholders rather than linking them. This is actually a fairly new construct and not a universal one. Pushing the market in a different direction—one that links the interests of all stakeholders—will return the U.S. to the model of stakeholder capitalism that prevailed after World War II. This model would deliberately allocate capital in order to create value for society as a whole, thereby addressing critical social and environmental issues. It would return U.S. capitalism to a system based on making rather than taking.

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We have to change the misconception that investors are best served by managers who attempt to "maximize stockholder value" while being neutral concerning all other stakeholders affected by their decisions. John Kay provides a comprehensive description of the mechanisms that allocate capital in his recent book, *Other People's Money*,[2] and I have borrowed his terminology. Kay describes the channels that allocate the savings of individuals to deposits and investments, which are then used to fund capital needs, including businesses investment and home mortgages. The investment channel directs a large portion of these assets into stocks and bonds, often indirectly through mutual and pension funds, insurance companies, and other institutions. A large part of that allocation goes to corporations and other limited liability entities, some publicly traded and some owned by small groups of investors.

The huge public markets garner most public awareness. For 2015, the market capitalization of U.S. public companies was more than $26

1. ROBERT B. REICH, SAVING CAPITALISM: FOR THE MANY, NOT THE FEW (2016).
2. JOHN KAY, OTHER PEOPLE'S MONEY: THE REAL BUSINESS OF FINANCE (2015).

trillion. That number, however, considerably understates the total value of the assets that those companies control because they are funded by debt, as well as equity. (If the markets are working reasonably well, the value of a corporation's total assets will roughly equal the aggregate value of its debt and equity.) As Kay describes, the investment channel serves several roles critical to a capitalist economy: it finds funding for new long-term investments, it provides stewardship for funds already invested, and it allows savers to store and transfer wealth, both within their lifetime and between generations. These functions are largely performed through financial intermediaries, including banks, brokers, pension funds, insurance companies, mutual funds, and other institutions. These institutions control roughly 70% of the U.S. stock market. In essence, they "own the economy," to quote commentators James Hawley and Andrew Williams.[3]

Each participant in the chain of investment has an up-the-line obligation to invest the funds in a manner that has the best balance of risk and return available. Pension fund managers look to maximize the value of their beneficiaries' contributions in order to ensure that pension obligations will be met and future contributions will be minimized. They hire investment managers who are charged with earning the best return they can on a risk-adjusted basis. Those managers in turn select stocks and expect the directors of the individual companies selected to maximize the return of the corporations on whose boards they serve. Not only do the managers select stocks, but they also choose directors and vote on other matters in order to fulfill their stewardship role. Again, this chain of investment and stewardship is governed by the upstream obligation of each manager: the directors have duties to stockholders, and the investment managers have duties to their beneficiaries, the savers, and the policyholders who are the ultimate source of the funds. These duties require that the fiduciaries manage the assets for the benefit of the investors and not for their own benefit or the benefit of anyone else.

These obligations come from a combination of laws, regulations, and customs that evolved in response to the growth of large corporations with many stockholders beginning towards the end of the nineteenth century. The separation of asset ownership from control of large amounts of assets created a concern that corporate officers and trustees would use the assets for their own benefit. This creates a classic agency problem: finding a way for the investor-principals to monitor the agent-officers without expending too many resources. Fiduciary duties are one solution we use to address

3. JAMES P. HAWLEY & ANDREW T. WILLIAMS, THE RISE OF FIDUCIARY CAPITALISM 100 (2000).

the agency problem in the investment chain. These duties require fiduciaries, such as corporate directors, to be careful and loyal but also give them almost complete discretion to make decisions within those parameters. In many ways, this model serves us well. There is plenty of opportunity for the managers to creatively manage capital with the threat of fiduciary challenges mitigating the risks of misappropriation by agents. However, with the passage of time, these duties have been strictly interpreted to require the fiduciary to consider *only* the interests of the equity investor. Custom has followed suit, and the role of investment managers and corporate officers has become generally understood to be creating value for stockholders. This has created an unintended collateral effect: the manager that controls the assets must ignore the best interests of all other stakeholders in the investment enterprise, including workers, customers, and communities. In today's capital markets, this doctrine of "stockholder primacy" pervades the rules that govern the investment channel from top to bottom. This simple rule may solve the agency problem, but it creates a huge "stakeholder problem."

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It may help to consider some examples. Mutual funds, public and private pension funds, and other institutional investors, along with individuals and others, own Exxon-Mobil, Apple, and General Electric. These institutions control enough stock to elect the directors. The directors hire the CEOs. The CEOs make strategic decisions. They decide where to drill, how to commercialize technologies, how carefully to monitor the practices of suppliers, and what businesses to acquire or divest. These decisions have enormous implications for society.

Following fiduciary principles, the asset managers invest in order to maximize their return, and the company managers in turn steward those investments to maximize returns to their stockholders. The metric used to measure this return is stock price and capital return (dividends, redemptions, and merger payments). And while it might be imagined that the long-term stock price is more important than the short-term price, economic theory (in the form of the efficient market hypothesis, which posits that stock prices reflect all available information) and financial practice (in the current focus on short-term performance) often measures stockholder return based on actual stock price rather than hypothetical future prices.

This dynamic has certainly played out in the current stock market. There is a great deal of stockholder activism based on raising stock prices in the immediate term, which often is accomplished by reducing expenses to raise earnings, even if those expenses may create value in the long term. While there are certainly disputes as to whether this is a fair description of what is happening in some or all activist campaigns, there is no question that directors are beholden to stockholders through both corporate voting and fiduciary law. For today's markets, the strongest indicator of stockholder return remains the current stock price.

However—and this is a critical point—even if directors try to reject the short-term model and forgo immediate profits in order to create longer term value, *that value must be for stockholders only*. Under prevailing practice in the U.S., it is not the ultimate purpose of corporations and the mandate of corporate directors to benefit workers, communities, or customers—only the stockholders. This trope was famously expressed by Milton Friedman in 1970 in the *New York Times Magazine* article titled *The Social Responsibility of Business Is to Increase Its Profits*.[4] And although the corporate law of the time may not have endorsed that statement, today's corporate law certainly does. Cases decided by the Delaware Supreme Court in the last two decades of the twentieth century state very clearly that the sole beneficiaries of directors' fiduciary duties are the stockholders.

I want to be clear. This fact does not prevent for-profit corporations from doing a lot of good or acting for the benefit of the different stakeholders, *as long as those actions in turn benefit its stockholders*. And, of course, treating customers, workers, and the community ethically and committing to do so can be an excellent strategy for creating stockholder value, particularly over the long term. Any such commitment, however, is contingent on the conduct continuing to benefit the stockholders. In practice, directors generally have very broad discretion under the business judgment rule to decide when such stakeholder commitments are beneficial to stockholders, but there must be a connection. Moreover, when it comes time to sell the company there is no long term for stockholders. As a result, directors are not allowed to take the interests of workers, customers, or other stakeholders into account in a sale—they must simply sell to the highest bidder, and there are dozens of Delaware corporate cases reinforcing this point.

But is there anything wrong with that? Don't we want the free market to find the best use for capital by finding its most profitable use? This question, however, is based on an assumption that has no factual support: that high profits to the capital provider is a proxy for the efficient use of capital. The obvious flaw in that assumption is that capital may be used in a manner that shifts costs to other stakeholders—creating "negative

4. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970 (Magazine).

externalities." Such a use of capital may provide profit to common stockholders, but a negative return to society (think about a use that includes a lot of pollution). Relying on stockholder primacy to address agency costs imposes a different cost: it requires asset managers to play a negative-sum game with other stakeholders, if that game will give the investors the greatest return. And, in the "free market" created by stockholder primacy, each available value-destroying profit opportunity is pursued until equilibrium is reached.

But, it is not simply bad for the economy overall. In the long run, stockholder primacy hurts the stockholders themselves. Why? First, stockholder primacy restricts the ability of corporate managers to employ strategies of commitment that would actually increase long-term value for stockholders. Colin Mayer, a finance professor at Oxford University, explains this phenomenon in the book *Firm Commitment*.[5] Mayer shows that an entity that employs the share value maximization principle destroys its own long-term value. He argues that when someone deals with a corporation bound by stockholder primacy, they know that any commitment the corporation makes is contingent on either legal compulsion or continuing value creation for stockholders. This contingency creates antagonism and legalistic relationships that deter the creation of durable long-term value with trusted partners. The following passage from *Firm Commitment* provides the example of inducing employees to make valuable commitments when a company cannot commit back:

> If there is an active labour market and it is easy for them to obtain alternative employment at any time, then it is the firm not the employees which is exposed. The employees have made no commitment, whereas it may be costly for the firm to train new workers every time that an existing one resigns. Now it is the potential employees who would like to be able to demonstrate commitment to gain employment but are incapable of doing so on their own. The firm offers a means of achieving this. It can do it financially by delaying payment of their wages, thereby making it costly for them to depart prematurely before the firm has recovered its investments in training them. Alternatively, it can encourage commitment by making employment in the firm a valued attribute in its own regard, reflecting strong employee affinity with the goals and values of the organization. Critical to both forms of control of firms over their employees is their corresponding trust in the firm—trust that the firm will not expropriate their deferred payments by, for

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

> example, engaging in reckless investments and trust that it really will uphold the values to which it aspires. That is why the balancing of commitment and control in the firm is so vital to its successful operation.[6]

Unfortunately, any commitment to that better business model is contingent under stockholder primacy. So when entering into a relationship with a community or customer, a corporation is unable to make a deep commitment, a fact that is known to the other party. Lynn Stout, in her book, the *Shareholder Value Myth*,[7] describes the problem as a conflict between current ("ex ante") stockholders and their future ("ex post") selves. The ex ante stockholders want the upfront value of committing, while the ex post stockholders want to get even more value by defecting:

> There is an inevitable conflict between shareholders' ex ante interest in "tying their own hands" to encourage their own and other stakeholders' firm-specific contributions, and their ex post interest in opportunistically trying to unbind themselves to unlock capital and exploit others' specific contributions. This conflict—a conflict between shareholders' ex ante selves and their ex post selves, if you will—puts public corporations governed by the rules of stockholder primacy at a disadvantage when it comes to projects that require firm-specific investments. Rejecting shareholder value thinking, and instead inviting boards to consider the needs of employees, customers, and communities, allows boards to usefully mediate not only between the interests of shareholders and stakeholders, but between the interests of ex ante and ex post shareholders as well.[8]

In fairness, I must point out that Professor Stout makes this argument in support of her argument that stockholder primacy is *not* the current law; while I agree wholeheartedly with her policy analysis, I do not believe the case law supports her. I will discuss these cases later.

Even more critically, stockholder primacy destroys the ability to build value in other companies. Large institutional owners end up owning most of the market in order to be sufficiently diversified. Small asset owners (such as 401(k)s) would be wise to have the same diversification through the ownership of diversified mutual funds. The returns of such broad owners ("universal owners") are reduced when the existing corporate law regime actively encourages the managers of a huge portion of our economy to dump negative externalities onto the system in order to

6. *Id.* at 150–51.

7. LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC (2012).

8. *Id.* at 85.

"create value" for their individual companies. For these investors (including most of the savers atop the investment chain), the most important factor in the return they receive is not whether they can beat the market by finding individual companies that outperform—instead, the most important factor is how the market performs. It is estimated that general market performance ("beta") contributes about 80% to a diversified portfolio's performance while particular choices ("alpha") contributes only 20%. Companies that create systemic risks and costs are likely to damage the market in its entirety. This is precisely what the financial sector did by chasing individual returns in the mortgage market, leading to the financial crisis, which hurt the stockholders of all companies, to say nothing of the dislocation and costs suffered by homeowners.

These two points—the value of commitment in a single corporation and the importance of universal ownership—are closely linked. The creation of value through commitment to stakeholders highlights a critical distinction in methods for creating stockholder value. One way is simply to obtain as much profit as legally possible, whether that profit comes from creating value in the world or from simply extracting value from other stakeholders. Thus, a company guided by stockholder primacy might switch to a cheaper fuel that increases its carbon footprint in order to increase its profits. However, that company has not really created value—it has just taken value from everyone else (by increasing climate risk) in order to achieve a short-term profit. In contrast, a company that practices stakeholder values would be more likely to save money by increasing efficiency and lowering its carbon footprint. Furthermore, a company that could commit to internally accounting for carbon costs is more likely to earn the trust of communities, consumers, and workers, thereby creating shared, real value.

Thus, the shared, real value created for a company through stakeholder commitments is much better for a universal owner because that value is more likely to benefit its entire portfolio. In contrast, investing in a corporation that might maximize its own value by exporting negative externalities is a losing game for diversified investors, as well as for the system as a whole. So universal investors should, as a general rule, prefer holistic value maximizers, not chasers of individual advantage. But it is not just about portfolios. Savers also care about the world they live in. The practice of stakeholder values will contribute to the value of the other forms of capital that savers depend on—their own human capital, the natural capital of our planet, and the social capital of a peaceful and just society. Stockholder primacy requires companies to ignore these crucial forms of capital that we all rely on.

Common sense tells us that investors should want corporations to be able to pursue these value-maximizing strategies, but the current investment paradigm precludes it. The system through which we allocate most of our productive capital actively encourages businesses to "create stockholder value" by heaping costs and risks onto the system—onto their own owners—in preference to actually building value. This benefits no one, except short-term players who siphon value from the rest of the economy.

How did we get to this irrational place? Stockholder primacy is a relatively recent development. Although stockholder primacy as a means of addressing the agency problem was debated for much of the late twentieth century, the prevailing sentiment appeared to lean toward stakeholder, not stockholder principles. In 1951, the chairman of Standard Oil could describe corporate managers with no thought of stockholder primacy: "The job of management is to maintain an equitable and working balance among the claims of various directly affected interest groups . . . stockholders, employees, customers, and the public at large."[9]

No hedge fund manager would be satisfied if the chairman of Exxon-Mobil were to take such a position today, but the view prevailed during the years of post-war prosperity to the great benefit of anyone broadly invested in the U.S. economy. Reich describes the change as follows:

> In fact, in the first three decades following World War II . . . . [t]he large corporation was in effect "owned" by everyone with a stake in how it performed. The notion that only shareholders count emerged from a period in the 1980s when corporate raiders demanded [that] managers sell off "underperforming" assets, close factories, take on more debt, and fire employees in order to maximize shareholder returns.[10]

The story of stockholder primacy's ascendance is complex. It involves the collapse of the postwar monetary agreements, the globalization of the capital markets, and the influence of economic theory typified by Milton Friedman, but also championed by the law and economics movement. But the Delaware courts provided the capstone for the model of stockholder primacy with a series of decisions in the 1980s.

These cases held that corporations exist primarily to generate stockholder value. Accordingly, the nation's most important corporate law jurisdiction viewed the maximization of stockholder wealth as the primary indicator of whether directors are complying with their fiduciary duties. In

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9. Robert B. Reich, *How to Avoid These Layoffs?*, N.Y. TIMES, Jan. 4, 1996, at A21.
10. REICH, *supra* note 1, at 18.

1985, when Revlon tried to defend itself against a hostile takeover by Ron Perlman, arguing that the takeover would hurt bondholders, the Delaware Supreme Court held that directors owe their duties to stockholders only. Further, because the directors had decided to sell the company, there was no "long run" for the stockholders. Therefore, immediate stockholder wealth maximization had to be the sole objective for directors, even if Perlman's high bid might destroy large amounts of bondholder value (or, by extension, worker or community value). In his academic writings, the Chief Justice of the Delaware Supreme Court has adopted a reading of the Delaware case law consistent with the stockholder primacy model and has summarized it with the following proposition: "[T]he object of the corporation is to produce profits for the stockholders and . . . social beliefs of the managers, no more than their own financial interests, cannot be their end in managing the corporation."[11]

As a result of these developments, our capital is now allocated to work against our interests. In a chapter written for the *Cambridge Handbook of Institutional Investment and Fiduciary Duty*, Raj Thamotheram and Aidan Ward provide a chilling example of how this thinking leads companies to act in a manner that hurts all investors:

> What is the price of a bee? And more generally, where does the extinction of bee populations—and with bees much of agriculture as we know it—fit into discounted cash flow and other investment/risk decision-making tools? The simple answer is that they don't.
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> To summarize, the scientific case that one class of pesticides, neonicotinoids, are particularly dangerous to bees is now very clear (Maxim and van der Sluijs 2013). . . . [T]he biggest producers of these chemicals . . . have also played leading roles in the powerful industry push back against regulatory action. Already too late, the industry has persuaded some supportive governments to back further delay (Jolly 2013). . . . [T]he role of investors is very important but hidden. Investors incentivize corporate management to worry (much) more about shareholder returns than helping to cause a form of ecocide that could be economically disastrous for asset owners and their members. In addition, investors show no real stewardship activity to counterbalance the effect of company management who use shareholder money to lobby for what is not in the real interests of the end-beneficiaries.[12]

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11. Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 151 (2012).

12. Raj Thamotheram & Aidan Ward, *Whose Risk Counts?*, *in* CAMBRIDGE HANDBOOK OF INSTITUTIONAL INVESTMENT AND FIDUCIARY DUTY 207, 211 (James P. Hawley et al. eds., 2014).

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This stockholder primacy model was the structure under which I practiced law for twenty-six years. As a partner at a Delaware law firm, I worked on preferred stock financings, IPOs, mergers, hostile takeovers, proxy contests, corporate governance, and fiduciary issues. My practice was based on some fairly simple rules and principles. Directors are elected by stockholders and have the full authority to manage the corporation once elected, but must do so prudently and unselfishly to create a financial return for stockholders.

That basic structure—stockholder-elected directors manage the corporation, but must do so carefully and loyally for the financial benefit of the stockholders—underlies nearly every question that comes up in corporate law disputes. The stockholder primacy paradigm drove much of the advice I gave to clients. While corporations could certainly be good employers and valuable resources to the community, that was not their *raison d'etre*—corporate law was about creating value for the stockholders, who owned the corporation and elected its managers to oversee their investment. For corporate lawyers, these are simple, nonideological facts. They view the corporate form as a brilliant legal technology that allows entities to raise large sums of money from disaggregated investors, who can diversify their investments across many entities, allowing corporations to take risks and create value. The underlying ethos is that investors are willing to risk their capital with complete strangers because they know that there is a system in place to protect them: elected directors who are obligated to be loyal to stockholders. Agency problem solved.

A few years ago, when I was chairing the Delaware Bar committee (the Council) that recommends changes to the Delaware General Corporation Law, we were approached by B Lab, a nonprofit organization that works to make business a force for good. Among other projects, B Lab certifies companies as being good corporate citizens (like a Fair Trade mark for corporations). B Lab has two requirements for certification—first, the company must meet a strict standard of social and environmental performance; second, the company must have a corporate governance model that mandates good corporate citizenship. For corporations, however, that second aspect violates the stockholder primacy model central to traditional corporate law. Thus, B Lab was lobbying state legislatures to adopt a statute they had drafted called the Model Benefit Corporation Law (MBCL). The MBCL contains a number of provisions that require corporations to follow a stakeholder model. When a state adopts the MBCL or similar statutory provisions, corporations created under that state's general corporation law can opt into the new provisions and become "benefit corporations."

In Delaware, our reaction to B Lab's proposal was far from positive. The corporate bar was very comfortable with the way that corporate law worked and cognizant of the tremendous value the corporate form had produced over time. Even progressive corporate lawyers, who believed that corporate behavior with respect to social and environmental issues was problematic, did not think those issues should be addressed by changing corporate law. Instead, there was consensus that those issues could be better addressed with laws and regulations that protected society and the environment—better to allow the free market for capital to work its magic, find the most profitable (and therefore most productive) use, and let the government regulate any bad behavior.

However, the Council was encouraged by the Governor and the Secretary of State to undertake a review of the concept, particularly in light of Delaware's national leadership in corporate law and the growing interest in the benefit corporation movement. With the assistance of B Lab, members of the Council met with entrepreneurs and investors who championed the concept. As a result of this process, the Council determined that Delaware ought to offer businesses the ability to operate in the form of a benefit corporation. In 2013, Delaware adopted a statute allowing corporations to opt in to a structure where the duties of directors extend beyond stockholders to include all stakeholders. I was personally convinced and became one of the drafters of the Delaware's benefit corporation statute, eventually giving up my partnership. I am now Head of Legal Policy at B Lab.

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Benefit corporation legislation has now been adopted in thirty-two U.S. jurisdictions, as well as Italy, and is being considered elsewhere. There are approximately 4,500 benefit entities (a few states authorize benefit LLCs, in addition to corporations) in the U.S. For the most part, these entities are small companies without significant outside investment. There are, however, a significant number that have raised money from venture capital funds and other professional investors. These investors include some of the most well-known venture investors—Founders Fund, Benchmark Capital, Andreessen Horowitz, and Union Square Ventures. Some of these companies are doing quite well and will be candidates for IPOs in the not-too-distant future. One KKR-backed company, Laureate Education, has already filed its registration with the SEC in anticipation of going public. Laureate is a massive for-profit higher education company with more than $4 billion in annual revenue and campuses in twenty-eight countries.

We are, then, at an inflection point. State legislatures, including Delaware, have created a new path for the investment channel to follow—the $26 trillion in public company equity capital can, through IPOs and conversions of traditional companies, begin to be applied to enterprises that work to build value for all stakeholders. Whether this will happen is a critical question and a policy debate we ought to be having. Most public companies are currently required to measure their success by one metric: stockholder value. There is no room under the stockholder primacy model for a corporation to credibly commit to long-term social and environmental responsibility, even if doing so could potentially produce value for the corporation on a risk adjusted basis and that behavior would overall benefit its investors because of their diversity of interests. Yet tens of trillions of dollars of our economy are controlled under this counterproductive construct. As a society, we would clearly be better off if some or all of this capital was deployed under benefit corporation principles, so that directors could choose the path that was best for all stakeholders—or could at least consider all stakeholders in the mix.

The policy question is whether the introduction of benefit corporation law, by giving corporations an opportunity to reject stockholder primacy, is sufficient to address our current issues of capital allocation. The model is optional, and investment managers must be convinced that investing in stakeholder values will satisfy their duties to their beneficiaries. Remember that I earlier referred to two levels of fiduciary relationships: director to stockholders and asset managers to beneficiaries. The stockholder value model infects both the latter and former. Asset managers compete on the basis of short-term returns. This is understandable. Current and past financial performance seems like the only reliable financial metric available. Moreover, the efficient market hypothesis, which posits that stock price reflects all available information, provides intellectual support for such a metric. However, even if current stock prices were a valid indicator of company performance, it is important to emphasize that this is an irredeemably flawed measuring stick for diversified investors *because it ignores the effect of company performance on portfolio performance*.

We have to change both investing concepts and the understanding of fiduciary law as applied to investment fiduciaries. Briefly, the problem is that Modern Portfolio Theory is still the dominant investing theory and managers follow it because they believe that following the dominant theory protects them from liability. In his article, *The Time Has Come for* *a Sustainable Theory of Fiduciary Duty in Investment*,[13] Jay Youngdahl makes this point in clear language: "[L]awyers tell trustees that the trustees will be sued and 'lose their house' if they deviate from the Wall Street model."[14] This is exactly the line that I have heard from pension fund staff. Youngdahl goes on to quote Steve Lyndberg of Domini Social Investments as to the damage done by contemporary investment models:

> [T]he dominant theory of investing today, Modern Portfolio Theory, is based on a definition of success that fails to acknowledge the extent to which investments at the portfolio level can affect the overall financial markets . . . . [T]he benefits that accrue from the practice of this theory are at best part of a zero-sum game and available to only a limited number of investors.[15]

The law and theory are aggravated by the fact that asset managers are compensated based on "beating the market," or at least not trailing it, so that they are forced to take this short-term approach of investing in companies that increase share price by assaulting the system. We need to stop compensating asset managers in this fashion. We need to make sure that the fiduciary rules that govern asset managers are clear about this. And we need investor fiduciaries to start thinking like benefit corporation directors.

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The good news is that there is every reason to think that the ultimate capital providers—you and I, through our pensions, 401(k) plans, insurance policies, and other investments—have the right incentive to insist on a model where investment managers take a long-term, broader market view of their obligations. We want the market to rise long-term so we can pay for college, fund retirement, and retain the wealth we have built for our children or others. Moreover, we want a peaceful, vibrant, and thriving society located on a healthy planet. These desires all counsel that we look for investments that build shared and durable value, rather than chase short-term gains and impose negative externalities.

Many individuals in the investment community understand these concerns. Principles for Responsible Investment,[16] a sustainability initiative affiliated with the United Nations, now has signatories worldwide with $59 trillion under management. The initiative

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13. Jay Youngdahl, *The Time Has Come for a Sustainable Theory of Fiduciary Duty in Investment*, 29 HOFSTRA LAB. & EMP. L.J. 115 (2011).

14. *Id.* at 117.

15. *Id.* at 125.

16. PRINCIPLES FOR RESPONSIBLE INVESTMENT, https://www.unpri.org/ [https://perma.cc/5RNZ-USU9].

promulgates six principles intended to lead investment fiduciaries to integrate environmental, social, and governance issues into their investment strategies. The organization describes its commitment as follows:

> As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios . . . . We also recogni[z]e that applying these Principles may better align investors with broader objectives of society.[17]

Forward-looking asset managers, like CalPERS,[18] which manages $300 billion of pension assets for California's public employees, understand the issue, as illustrated by a statement from their investment beliefs: "As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods but could have a material impact on company or portfolio returns."[19]

Hermes Investment Management, a well-known U.K. pension advisor, is very clear about the broad concern of universal owners and the unsustainability of negative-sum strategies:

> Most investors are widely diversified; therefore it makes little sense for them to support activity by one company which is damaging to overall economic activity. . . . [I]t makes little sense for pension funds to support commercial activity which creates an equal or greater cost to society by robbing Peter to pay Paul.[20]

In addition, recent guidance from the Department of Labor has made it easier for private pension plans to include ESG factors into their investment models, and some interpret the advice as allowing such plans to consider the effect of the investments on pensioners' quality of life beyond the health of the plan. In another intriguing development, the influential Robert Eccles and Tim Youmans of Harvard Business School have embarked on a project to collect statements worldwide from boards

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17. *The Six Principles*, PRINCIPLES FOR RESPONSIBLE INVESTMENT, https://www.unpri.org/about/the-six-principles [https://perma.cc/Y7JD-MUKN].

18. CalPERS, https://www.calpers.ca.gov/ [https://perma.cc/GGR2-TEKK].

19. CalPERS, *Our Views Guiding Us into the Future* 10 (May 2015), https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf [https://perma.cc/R3UK-HLT7].

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of directors to identify the stakeholders material to the corporation, what their interests are, and how the board weights them. The project is conceived as a direct response to the prevailing ideology of stockholder primacy.

Despite these positive developments, investment and corporate practice are still overwhelmingly dominated by the short-term, individual company perspective. Just read any financial publication or watch a business news channel. Even asset managers that sign on to PRI principles continue to compensate their portfolio managers on short-term, alpha metrics. Moreover, while the movement toward corporate social responsibility is admirably growing, this movement often seems to emphasize the direct value that individual companies achieve through responsible and sustainable practices—money saved through green initiatives, improved employee performance resulting from enlightened employment practice, etc. There is a palpable fear about openly committing to sharing value with other stakeholders; it just seems unbusinesslike. But, as I have tried to show, there are entirely sound reasons from the investor perspective for incorporating stakeholder values, whether it is increasing stock value by permitting real stakeholder commitment, increasing portfolio value by decreasing systemic costs, or improving the lives of beneficiaries by preserving the environment. We should not be embarrassed that doing the right thing creates value.

But, perhaps this all sounds a bit pat. Can investors really improve the lives of others with no sacrifice? What are the trade-offs? It is too easy to just assume that increased value for investors and stakeholders always converge, correct? Well, no and yes. No, for the reasons already addressed. By moving toward stakeholder values, the investment channel allocates assets to uses that create more value overall. By taking negative-sum opportunities off the table, the stakeholder model creates more aggregate value for stakeholders and stockholders to share. Thus, we should expect that eliminating stockholder primacy can enhance value for all parties, thereby solving the "stakeholder problem." It is just math.

But in one very significant way, consistent application of stakeholder values will take away a profit opportunity for investors—the opportunity to free ride. In a world where most of our capital is being invested in a responsible and sustainable manner, all investors would benefit from the good behavior. In such a world, there would continue to be opportunities to create value in the negative-sum way, because a bit of pollution or one lousy supply chain is not likely to greatly affect the market or portfolios of the investors. So, corporate management may be tempted to "cheat." Investment managers may be tempted to seek out the cheaters so they can free ride on the beta updraft while getting a little extra alpha for themselves. Each individual investor may feel that its best strategy is to look for extractive value, whether or not most investors do so. And, as long as our investment rules permit such activity, there is a real concern that profit seekers will feel constrained by competitive pressure to seek out these opportunities until equilibrium is reached, taking us back to stockholder primacy.

As I noted at the beginning, 80% of our capital assets are allocated through the investment channel and subject to this dilemma. Our public policy discussions focus on the government's role in addressing social issues, but the government only allocates 20% of our capital. We must have a public discussion that allows us to establish ethical investment principles enforced by laws and custom. Benefit corporation law is an excellent start, but much more needs to be done. I have addressed a number of opportunities that stockholder primacy denies to savers including the building of value based on genuine trust and commitment; the rationalization of broad portfolios so that their components are not wasting resources in a negative-sum game; and a portfolio that makes a positive contribution to all aspects of savers' lives, not just their bank accounts.

An honest appraisal of these opportunities has to recognize that they exist on a spectrum, not in discrete categories, and that there is not even strict separation between these opportunities and the sorts of goodwill and reputational value available to conventional corporations and investors today. At the same time, public policy influencers must recognize that one key concept underlies all of these opportunities: the shared benefits of driving capital to build positive value for all stakeholders. The best way to navigate this admittedly fuzzy landscape is to adopt a set of rules, including fiduciary law all the way up the investment chain that acknowledges that all stakeholders matter. It is simply too hard—and too dangerous—to determine when selfish negative-sum behavior might be better for the stockholders of a single corporation. By replacing stockholder primacy with stakeholder values up and down the investment chain, we can minimize the "costs" to stockholders of addressing the stakeholder problem. This rule will efficiently push us towards the correct side of the spectrum and also address the free rider problem.

This brings us to the ethical principle stated at the beginning: investors and managers should not seek gains by simply extracting as much value as possible from the economy, but should instead seek gains by simply building and sharing value with all stakeholders in their investments. There must be a commitment at the investor level, similar to the management level in a benefit corporation, to seek out stock value only by building real value. Investors and market participants that play by different rules need to be shunned and shamed. Integrating this ethic into the financial system is a beginning, not an end. Corporate and investment managers, as well as investors themselves, will have to do the hard work of figuring out where the value enhancing opportunities are, even though there will be disagreement on the importance and weight of various stakeholder interests. But, in order to at least get all that capital working in the right direction, we have to change the basic rules. Companies and investors must stop competing to take and start competing to create.