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Oliver Hart, Nobel Laureate in Economics for 2016, and economist Luigi Zingales recently published an article justifying companies' pursuit of social objectives at the expense of profits from within the shareholder primacy framework. This Article highlights an important consequence of this approach: a new agency problem between managers and shareholders regarding social preferences. This Article provides two possible solutions to this agency problem: a bottom-up solution focused on shareholders' ability to submit proposals on such issues and a top-down solution based on an independent board sub-committee intended to identify social objectives and forward them for shareholder approval.

Keywords: corporate social responsibility, agency problem, agency costs, shareholder primacy, stakeholder primacy, shareholder proposals

JEL Classification: G30, G32, G34, G38, J33, K22, M14

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INTRODUCTION

What should the objective of a corporation be? Should it focus exclusively on maximizing profit, or should it promote other purposes, such as environmental sustainability and social justice? This Article aims to emphasize the ramifications of opting for the latter possibility: the new set of agency problems it generates, and how they can be addressed.

The standard justification for promoting social objectives is the stakeholder justification: many other stakeholders exist besides shareholders, such as workers, lenders, and the community and society at large, and it is legitimate, and sometimes imperative, that the corporation guide its actions in light of the interests of these other stakeholders, rather than solely according to the interests of shareholders.[1] Recently, an article by 2016 Nobel Laureate Oliver Hart and Luigi Zingales justified corporations' pursuit of social goals independent of the stakeholder justification,

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1. One of the earliest proponents of the stakeholder view was Merrick Dodd, in his well-known dispute with Adolf Berle, the chief proponent of the shareholder primacy view. *See* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Adolf Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). A new wave in support of the stakeholder view rose in the 1980s, in response to the takeover wave of the 1980s in the United States. *See* R. Edward Freeman & David L. Reed, *Stockholders and Stakeholders: A New Perspective on Corporate Governance*, *in* CORPORATE GOVERNANCE 189 (C. Huizinga ed., 1983); *see also* R. EDWARD FREEMAN, STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH (1984). The stakeholder theory of corporate law became a common topic for legal symposia in the early 1990s. *See* Brian Langille & Ronald Daniels, *The Corporate Stakeholder Conference: Introduction*, 43 U. TORONTO L.J. 297 (1993); David Millon, *New Directions in Corporate Law: Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373 (1993). Scholarship in support of the stakeholder view continues to be published to this day. *See* Justin Blount, *Creating a Stakeholder Democracy Under Existing Corporate Law*, 18 U. PA. J. BUS. L. 365 (2016); Iris Chiu, *Operationalising a Stakeholder Conception in Company Law*, 10 L. & FIN. MKTS. REV. 173 (2016); Thomas A. Kochan & Saul A. Rubinstein, *Toward a Stakeholder Theory of the Firm: The Saturn Partnership*, 11 ORG. SCI. 367 (2000); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

reinvigorating the debate regarding appropriate objectives for a corporation.[2] The authors argue that even if one accepts the shareholder primacy view—that the objective of the corporation should be maximizing *shareholder* welfare, and disregarding the interests of any other stakeholders—firms should not necessarily pursue maximization of profits exclusively. Given that shareholders may have social preferences besides maximization of profits, their welfare would be maximized only if those preferences were also taken into account by managers and the board.[3] As a result, maximization of shareholder welfare necessitates the promotion of social objectives at the expense of profits.[4]

This Article points to the consequences of accepting such a view—that management should pursue social objectives when shareholders have such preferences. It argues that there exists a *systemic* gap between managers and shareholders regarding social preferences. While shareholders may be willing to prioritize social preferences over profit maximization and sacrifice the latter for the former, managers are less inclined to do so. Managers are much more sensitive to profits than shareholders. This is for two reasons. The first is the nondiversification of managers relative to shareholders. While shareholders are diversified in their investments, with only a small portion of their physical capital typically invested in one specific corporation, managers' investments in the corporations they manage are less diversified. Managers' most valuable asset—human capital—is solely invested in the corporation they manage. The market value of their managerial skills is directly linked to the financial bottom line of the corporation.[5]

The second reason why managers are more sensitive to profits than shareholders is bonding mechanisms, such as options and bonuses. Many managers have such personal financial incentives, which increase their sensitivity to the profitability of the corporation relative to shareholders.[6]

Because of this systemic gap between managers and shareholders, a corporation's decisions that have a significant impact on social matters, such as environmental implications, should be delegated to shareholders to approve. While Hart and Zingales discuss the need for delegation due to the *possibility* of a gap in

2. Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. & ACCT. 247 (2017).

3. *Id.* at 249–50.

4. As Hart and Zingales note, *id.* at 251, a version of their central argument has been previously made. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 740, 796 (2005). For a discussion of where their argument and the argument in this Article departs from Elhauge, see *infra* Part IV.A.

5. For empirical evidence supporting the effect of past performance on CEO compensation, see Rajiv D. Banker et al., *The Relation Between CEO Compensation and Past Performance*, 88 ACCT. REV. 1, 4 (2013); D.H. Chen et al., *Executives and Employees: Comparison and Interaction of Incentive Effectiveness*, 5 MGMT. WORLD 160 (2015).

6. Their sensitivity to bottom line earnings may even be, in some instances, *too* strong, increasing the likelihood of financial misreporting. *See* Lucian A. Bebchuk & Jesse M. Fried, *Pay Without Performance: Overview of the Issues*, 17 J. APPLIED CORP. FIN. 8, 18 (2005); Peidan Hong, *The Literature Review on Compensation System Design*, 8 MOD. ECON. 1119, 1124–25 (2017).

the preferences of managers and shareholders,[7] this Article—based on the *systemic* gap in preferences—emphasizes the urgency of this delegation. In addressing this urgent need, this Article offers two methods through which decisions on social issues can be delegated to shareholders: a bottom-up model, through shareholder proposals, and a top-down model, through an independent subcommittee on the board that would delegate decisions regarding significant social issues to shareholders.

It is worth noting that this agency problem is also relevant to the stakeholder view of the corporation; managers may bend toward profit maximization even if it does not serve the interest of *any* stakeholders, including the shareholders. Yet, the problem is much more acute in the context of Hart and Zingales's argument for two reasons. The main reason is the dominance of the shareholder primacy view in U.S. legal discourse.[8] As a consequence, Hart and Zingales's argument brings this agency problem into the forefront of corporate policymaking. The second reason is that the stakeholder view of the corporation has agency problems woven into its basic structure: the corporation is supposed to benefit certain stakeholders that have no control over its decision-making process. Under such a framework, identifying an additional agency problem with shareholders is nearly superfluous.

This Article proceeds as follows. Part I outlines Hart and Zingales's argument in favor of corporations engaging in pro-social initiatives from within the shareholder primacy framework. Part II underscores the new agency problem that arises between managers and shareholders if a corporation is supposed to pursue social objectives in addition to financial objectives. Part II elaborates on the two sources for this new agency problem: nondiversification of managers' human capital and the bonding mechanisms that make them too sensitive to the financial

7. Hart & Zingales, *supra* note 2, at 249–50.

8. The Delaware Supreme Court, which, in regards to corporate law, is the highest court of the most important jurisdiction in the U.S., in which around half of U.S. corporations are incorporated, seems to have accepted the shareholder primacy view. It had stated that "[t]he board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners." Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998). In *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, it held that "concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder." Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). It is true that even the Delaware Supreme Court has also permitted directors, in some cases, to take decisions that seem to diverge from shareholders' interests and benefit other constituencies at their expense. *See e.g.*, Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140, 1140 (Del. 1989). Yet, as Lynn Stout has pointed out, they have done so using shareholder primacy rhetoric, hoping that, in the long-run, it will also benefit the shareholders in some ways. *See* Lynn A. Stout, *supra* note 1, at 1203. Many other scholars hold that the dominant view of the corporation's purpose in the U.S. is shareholder oriented, a view originally stated by Adolf Berle. Berle, *supra* note 1; *see* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 32 (2004); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 72 (2010); Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APPLIED CORP. FIN. 8, 8-9 (2001).

bottom line of the corporation. Part III presents two forms of addressing this new type of agency problem: the bottom-up form that enables individual shareholders to make proposals on social issues, and the top-down form that establishes an independent sub-committee on the board that identifies significant social issues and delegates decisions on such issues to shareholders. Part IV discusses possible objections to this analysis and proposed solutions. Part V concludes..

I. THE CASE FOR INCLUDING SOCIAL OBJECTIVES AS A NORMATIVELY DESIRABLE OBJECTIVE OF THE CORPORATION

One of the fundamental questions regarding the purpose of a corporation is whose interest the corporation is supposed to pursue. There are two schools that provide an answer to this question. One view claims that corporations should promote shareholder interests.[9] The corporation is their property, as they provided the capital to finance its initial activity.[10] In addition, because shareholders are the residual claimants—receiving their financial gain after other claimants such as lenders and workers—those claimants' aims are served by prioritizing shareholders.[11]

The second school claims that corporations should promote the interests of other stakeholders besides shareholders, such as workers, lenders, and even society at large.[12] One of the central arguments behind this claim is that equity is only one input among many necessary for the corporation's success, such as workers, lenders, markets, development of human and physical resources by society, and so on. Thus, there is no justification for corporations promoting the interests of only one stakeholder that provides resources to the corporation—namely, the shareholders—and not those of other contributing stakeholders.[13]

The first school has mostly dominated economic and legal scholarship. Professor Milton Friedman has provided the most prominent formulation of the view..[14] Friedman argued that shareholder primacy and profit maximization were inextricably connected. His central argument was a division of labor argument: even if shareholders might have social objectives other than profit making, they could

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9. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 2–5 (1991); MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962); Berle, *supra* note 1. Friedman presented his views more sharply in a New York Times article: Milton Friedman, Editorial, *A Friedman Doctrine: The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at SM17. For the adoption of this view by courts and other scholars, see *supra* note 8.

10. Berle, *supra* note 1, at 1370.

11. EASTERBROOK & FISCHEL, *supra* note 9, at 36–39.

12. For examples of scholars supporting various versions of the stakeholder view, see *supra* note 1.

13. Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 (1999).

14. FRIEDMAN, *supra* note 9.

pursue those objectives elsewhere. The corporation maximizing profits would only increase their ability to pursue other social objectives elsewhere.[15]

Hart and Zingales's central aim is separating the shareholder primacy view from Friedman's maxim that corporations should strive to maximize profits. They claim that given that shareholders have other social preferences, maximizing shareholder welfare necessitates the corporation to pursue these social preferences.[16] Confining the corporation to pursue only *some* of the shareholders' preferences will lead to a suboptimal welfare level for shareholders.[17]

Hart and Zingales contest Friedman's argument that these social preferences could be pursued outside the corporate context. They note that some ethical activities are inseparable from corporate money-making activities, and thus shareholders will only be able to pursue these social preferences in the corporate context.[18] This inseparability mostly stems from technological constraints: pursuing some objectives requires technology that the corporation has and the individual could not obtain without great cost.[19]

The central example provided is the shareholder derivative action *Trinity Wall Street v. Wal-Mart Stores, Inc.*, in which Walmart shareholders aimed to curb the company's sales of high-capacity assault rifles.[20] The corporation's restrictions on sales of both guns and ammunition would clearly serve plaintiff shareholders' preference to reduce the number of gun deaths in the United States. A shareholder likely would not have a cost-effective alternative to confront the problem. The meager amount of resources from the shareholders' proportional share of the company proceeds from the sale of this weapon cannot be employed in any other significant way that would promote gun control. As further illustration, a corporation's pollution of a stream may not only cost a substantial amount to restore, but consumers might not be able to completely offset the damage done by the corporation.[21]

The alternative and more conventional method for the promotion of social goals—governmental spending and regulation—may also be ineffective in many cases. There may be political economic limitations that prevent the government from acting in certain spheres or even constitutional limitations that do not exist in the corporate sphere. For example, in *Trinity Wall Street*, gun and ammunition

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15. *Id.* at 114.

16. Hart & Zingales, *supra* note 2, at 249.

17. *Id.*

18. *Id.* at 250.

19. Other scholars have also considered the possibility of non-separable activities. *See* Ronald Bénabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 Economica 1, 11–12 (2010); Elhauge, *supra* note 4. Regarding other barriers facing the consideration of shareholder preferences, such as institutional investors that seem to stray away from the preferences of shareholders in their voting pattern on social shareholder resolutions, see Scott Hirst, *Social Responsibility Resolutions*, 43 J. Corp. L. 217, 218 (2017).

20. Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323 (3d Cir. 2015).

21. Hart & Zingales, *supra* note 2, at 249.

manufacturers may have an effective lobby for preventing legislative gun control,[22] and the Second Amendment constitutionally limits gun control legislation.[23] Restricting sales of weapons and ammunition on the corporate level may be the most effective way to reach those results.

Affirmative action may serve as another example demonstrating the efficacy of promoting social objectives at the corporate level, relative to state action. A corporation may adopt a policy in which minorities and/or women are preferred for certain jobs. Prioritization based on race or gender as an additional factor in the hiring process may impose costs for the corporation under certain circumstances, relative to decision-making based on maximization of revenue alone.[24] Yet, aside from the lighter constitutional limitations regarding race and gender affirmative action in the private sphere relative to the public sphere, a state-imposed affirmative action policy may engender racial tensions rather than work to move past them. In contrast, private policies in the corporate context are less likely to elicit such strong concerns.[25] Furthermore, in extreme cases in which the social purpose of affirmative action is not only promoting numerical equality across racial groups but also enhancing the social stature and self-esteem of certain groups, such bottom-up action may be much more effective than top-down affirmative action mandated by the state. The enhancement of the minorities' self-esteem may be much more limited because it was imposed on employers to hire them. In contrast, in the private corporate context, the affirmative action was adopted voluntarily and as such reflects more appreciation and respect toward the individual, enhancing his self-respect and self-esteem to a greater degree.[26]

If a shareholder wishes to promote a certain social objective at a certain cost, and if the most effective way to promote that objective is through corporate action, restricting the ability of the corporation to promote that objective decreases the shareholder's welfare level. If the overarching objective of the corporation is the maximization of shareholder welfare, the corporation should be permitted to

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22. Regarding the power and influence of the rifle lobby, see: JOSH SUGARMAN, NATIONAL RIFLE ASSOCIATION: MONEY, FIREPOWER & FEAR 27 (1992).

23. For an example of a case in which the Supreme Court found a gun-safety regulation violating the second amendment and struck it down, see *District of Columbia v. Heller*, 554 U.S. 570, 570 (2008) (striking down a D.C. gun-safety regulation that required all rifles and shotguns to be kept unloaded and disassembled or bound by a trigger lock because it determined that it violated the second amendment).

24. For an argument regarding the economic costs of affirmative action, see RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS 396 (1992). Yet, there are scholars who disagree with the position that affirmative action in the workplace will always impose a cost. *See, e.g.*, Harry J. Holzer & David Neumark, *What Does Affirmative Action Do?*, 53 INDUS. & LAB. REL. REV. 240, 250–53 (2000).

25. Regarding the private/public distinction that applies to affirmative action at the workplace, see Rebecca K. Lee, *The future of Workplace Affirmative Action After* Fisher, 89 ST. JOHN'S L. REV. 597, 612–18 (2016).

26. Regarding how the context in which a right or resource is conferred or given to an individual impacts her dignity, see Elizabeth S. Anderson, *What Is the Point of Equality?*, 109 ETHICS 287, 310–26 (1999).

promote its shareholders' social preferences and not necessarily required to maximize profits.

In Hart and Zingales's modeling of the argument, the corporation must decide between two courses of action: whether to adopt a pro-social strategy, which they label in the environmental context as the "clean" strategy for which the expected profits are π_{clean}; or a "dirty" strategy, in which the expected profits are π_{dirty}, given $\pi_{dirty}>\pi_{clean}$.[27] The dirty action will impose an external cost for society that equals *d*.[28] A shareholder's determination of whether the dirty strategy is worth more than the clean strategy is determined by a weighted average of the private payoff and the social cost. The model therefore hinges on the weight a shareholder attributes to the impact of the action on society relative to his private gains from the investment. The model assigns weights of λ_i for the social impact and $(1 - \lambda_i)$ for the private payoff given that by definition. Those weights will sum to 1 and $0< \lambda_i<1$.[29] Both payoffs are also affected by the investor's investment in the corporation (i.e., the fraction of shares he holds, which is denoted by α_1). As a result, a shareholder's payoff from the dirty action is weighted as follows:[30]

$$(1)\ (1 - \lambda_i)\ \alpha_1\ \pi_{dirty} + \lambda_i\ \alpha_1\ (\pi_{dirty} - d) = \alpha_1\ (\pi_{dirty} - \lambda_i\ d)$$

The parallel payoff from the clean action is:[31]

$$(2)\ (1 - \lambda_i)\ \alpha_1\ \pi_{clean} + \lambda_i\ \alpha_1\ \pi_{clean} = \alpha_1\ \pi_{clean}$$

Hart and Zingales conclude, therefore, that a shareholder will prefer clean over dirty if:[32]

$$(3)\ \pi_{clean} > \pi_{dirty} - \lambda_i\ d$$

The main point of their model is to demonstrate why a rational agent may prefer the clean strategy, even though it generates a lower personal payoff. It is important to note that they limit the model to a certain type of payoff. Hart and Zingales distinguish between decision payoffs and final payoffs: the payoff from the active decision, which is not necessarily equal to the final payoff the agent derives from the outcome of the decision.[33] The main source of difference between the two is the shareholder's sense of responsibility: the sense of responsibility may decrease his perceived payoff when making the decision, even though it has no effect on the final outcome. Hart and Zingales assume that their model applies only to decision payoffs when a shareholder feels responsible for a social cost. In contrast, for final payoffs, the investor does not feel responsible for the social cost and thus does not internalize or weigh it at all (i.e., $\lambda_i = 0$).[34] The central motivation for this problematic distinction is to explain why there may be an "amoral drift"—

27. Hart & Zingales, *supra* note 2, at 252–53.
28. *Id.* at 252.
29. *Id.* at 253.
30. *Id.*
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*

tilting the corporation toward the dirty action, even when for most shareholders, $\pi_{clean} > \pi_{dirty} - \lambda_i d$.[35] This is because individuals with a lower λ_i could take over the company by paying a higher price per share and shifting it toward a dirty course of action that would increase profits. In Hart and Zingales's framework, even though shareholders typically internalize social costs and would prefer the clean action in their decision payoff corporation, they may not be inclined—in a tender offer—to internalize the acquirer's likely preference for the dirty option and are willing to sell their shares for the high price the acquirer is offering.[36]

The next Part will refute the need for this problematic distinction to explain the disconnect between corporations' dirty actions and shareholders' preferences for clean actions. It will underscore a more systemic mechanism that will tilt corporations toward dirty actions, even with no risk of a potential takeover.

II. THE NEW AGENCY PROBLEM IN THE CONTEXT OF SOCIAL PREFERENCES

The last section has presented the argument for permitting corporations to promote social objectives. Attributing such function to corporations gives rise to a new agency problem. There is a systemic and significant gap between managers and shareholders in the context of social preferences. Shareholders have a greater tendency to prioritize social preferences over profit maximization, while managers will have a tendency to prioritize profit maximization instead. The reason for this is that managers are much more sensitive to profits than shareholders. While managers' benefit from social objectives is similar to that of shareholders, managers' personal gain from every incremental increase in profits is much greater than that of shareholders. Because managers have to forgo a greater amount of gain for the same social benefit, they are more averse to promoting social preferences than shareholders. As a consequence, even in cases in which shareholders are willing to promote a social objective at the expense of profits, the corporation's managers may not implement the social objective even though it would maximize shareholder welfare.

Why should managers be more sensitive to profits than shareholders? There are two reasons for this: the nondiversification of managers relative to shareholders and the bonding mechanisms that apply to management.

A. Nondiversification of Managers Relative to Shareholders

Most shareholders are diversified in their ownership of stock. Unlike shareholders, though, the most valuable asset of managers—their human capital—is nondiversified. Its value is pegged, to some extent, to the performance of the corporation they manage. The value of their managerial skills on the market is

35. *Id.* at 255.

36. *Id.* at 256. Hart and Zingales are aware of the problematic distinction between shareholders' calculation of decision payoffs and final payoffs, and they have a separate section in which they justify the distinction. *See id.* at 266–70.

strongly influenced by the financial bottom line of the corporations they have managed.[37] For shareholders, a decrease of the profits of the corporation is a decrease in profits of one corporation out of the many that they hold in their portfolio.[38] For managers, though, the decrease in the profits of the corporation has a much more significant impact on their financial condition and welfare. Thus, management is likely to be more averse to promoting social objectives.[39]

For example, let us assume that a manager's future earnings depend on their corporation's relative past performance in its sector. Their expected compensation will increase by the same percentage the earnings of their corporation surpassed average earnings.[40] Let us assume that the corporation needs to decide whether to spend $2 million to reduce pollution in their production process. If it spends the $2 million, it will have net profits of $10 million, and if it does not, it will have net profits of $12 million. Excluding the past-performance component, the manager's expected future compensation is $1 million. If the average corporation in the sector posted $10 million in profits, the company's spending on pollution reduction will make the manager ineligible for the performance bonus. Instead of $1.2 million due to the past-performance component, their future compensation will be limited to $1 million. The manager's significant loss of 16.67% of their expected future compensation will cause them to object to such spending. This is true even if the manager is not planning to leave their present job; their expected compensation in alternative positions will impact their bargaining position in their present job.[41]

B. Bonding Mechanism

One of the central mechanisms for addressing the conventional agency problem—rooted in the managers' preference for leisure over work in contrast to the shareholders' preference that the managers should work in order to maximize profits—is through bonding mechanisms. In order to incentivize the manager to put the corporation's interests first, bonding mechanisms that increase a manager's

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37. *See supra* notes 5–6.

38. Since a study that demonstrated that a portfolio can reach 95% of the market's diversification by holding 32 stocks, most investment managers have compiled a portfolio of a minimum of 30 stocks. *See* Lawrence Fisher & James H. Lorie, *Some Studies of Variability of Returns on Investments in Common Stocks*, 43 J. BUS. 99, 117 (1970). In reality, most investors are even more diversified, as they hold ETFs that enable them to be fully diversified relatively cheaply.

39. Regarding how the nondiversification of managers in comparison to shareholders may cause them to diverge from shareholder preferences, see Guido Ferrarini et al., *Executive Pay: Convergence in Law and Practice Across the EU Corporate Governance Faultline*, 4 J. CORP. L. STUD. 243, 251–52 (2004).

40. Regarding the practice of benchmarking relative to peers, see Charles M. Elson & Craig K. Ferrere, *Executive Superstars, Peer Groups, and Overcompensation: Cause, Effect, and Solution*, 38 J. CORP. L. 487, 491 (2013).

41. The effect may be even more pronounced under a "winner takes all" compensation scheme that rewards the leading manager in the sector with less sensitivity to the absolute level of earnings. In such a context, even smaller spending may have a more significant impact on expected compensation if it determines whether the manager is leading in his sector or not. Regarding the prevalence of this compensation scheme, see Ferrarini et al., *supra* note 39, at 251–53.

sensitivity to the success of the corporation have been introduced: options and bonuses for reaching certain targets.[42]

When designing such bonding mechanisms, the main objective is to ensure that managers will have greater investment in the financial performance of the corporation. There is typically no concern that managers might be *too* sensitive to the corporation's financial performance: the greater managers' sensitivity, the better.[43] This situation changes, though, when shareholders' social preferences are accounted for. In such a scenario, there may be a situation in which a manager's concern with the financial outcomes *is too strong*. Options and bonuses create powerful incentives and extreme sensitivity to profit levels. In some cases they may generate "cliffs": if profits cross a certain point, the manager receives a windfall, but if they do not, even barely, the manager gets nothing.[44] In the case of bonuses, an increase of a dollar in a corporation's revenue may increase a manager's bonus by far more than a dollar.[45]

For example, let us assume that a manager is offered a bonus of $100,000 if they pass a threshold of $10 million of revenue per quarter. Assume that the marginal cost of every unit sold is half of its price. If revenue has crossed $9.85 million, the additional revenue of $150,000 will increase the manager's compensation by $100,000 while generating a net loss for the corporation: an increase of $75,000 in profits ($150,000 in revenue minus direct costs of $75,000) and the payment of the $100,000 bonus to manager. Given their incentives, the manager will be overly eager to increase sales, and may use environmentally "dirty" techniques, such as having salesmen driving door to door and increasing the fuel

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42. *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 226 (1990). Regarding optimal design of payment for performance, see Bebchuk & Fried, *supra* note 6, at 19–23.

43. There have been some claims that incentives for managers to generate profits may be too strong in respect to managing earnings. *See supra* note 6. There has also been some concern that performance-based payment may provide strong incentives for the short-run at the expense of the long-run. Bebchuk & Fried, *supra* note 6, at 18. But the point here is not that the incentive provided for the short-term may be too strong and at the expense of long-run incentives, but that performance-based incentives may be too strong in general.

44. Regarding the excessive risks of cliffs that will misalign managers with stockholders, see Yisong S. Tian, *Too Much of a Good Incentive? The Case of Executive Stock Options*, 28 J. BANKING & FIN. 1225, 1225 (2004) (arguing that when option wealth exceeds a certain fraction of total wealth, adding more options only decreases incentives to increase stock price); Zhiyong Dong et al., *Do Executive Stock Options Induce Excessive Risk Taking?*, 34 J. BANKING & FIN. 2518, 2518 (2010) (arguing that options may induce managers to tilt toward debt finance, even when it is a suboptimal finance structure for corporations and shareholders).

45. Even though this form of compensation means that a certain increase in revenue may cause a net loss to the company, it may still be an efficient form of compensation. Similarly to "tournament theory," it is possible that the most efficient form of compensation is one in which the employee receives a sum above his marginal product. *See supra* notes 39 and 41. Similar to a lottery, there may a low likelihood of reaching a certain threshold. Providing compensation for reaching a threshold that is greater than the marginal product is a powerful incentive to the employee to increase productivity, even though a smaller increase in productivity will not qualify for any bonus.

consumption of the company, even though shareholders want the company to become greener and consume less fuel.

This is an extreme illustration, one in which managers are extremely sensitive to an increase in their corporation's profits. This does not necessarily have to be the case in order for the gap between the interests of managers and shareholders to take place. It is sufficient that the managers' interest in increased profits is significantly higher than stockholders'. Consider Company ABC, which has one million shareholders, and the value of each shareholder's stock is $10. All shareholders have a portfolio of $10,000, thus the value of their stocks in ABC constitutes 0.1% of their portfolio. The board offers the manager 1,000 stock options; each option enables them to buy 100 stocks of the company for $12 a share. The strike date for the options is one year from when they receive the options, and they cannot sell the options to a third party. These options will be valuable only if the value of the corporation increases by over 20% in one year. If it does, the manager will be entitled to approximately 9% of the value of the increase over 20%.[46]

ABC faces a decision: whether to shift to using a cleaner form of fuel. Shifting to the cleaner fuel will impose an additional cost of $500,000. The new manager expects to increase the value of the corporation by 30% in a year, increasing its value by $3 million. If the company decides to use the cleaner fuel, the expected increase in the value of the corporation will be only $2.5 million. The expected financial implication of such a decision would be halving her bonus: from an expected $90,000 to an expected $45,000. This is a very strong financial impact for her, especially if the bonus is a large component in her compensation package. Thus, the manager will be strongly against the decision to shift to the cleaner fuel, although she may have general sympathy to environmental issues. The financial price she would have to pay to promote the environmental cause is just too heavy.

The situation is different for shareholders. They too will pay a financial price for the environmental decision to move to clean fuel. Their expected gain will decrease from 29.1% to 24.55%. They will bear an effective decrease of 46¢ in the value of the stock of the company they hold. The effect of such a decision on their portfolio would be meager, decreasing its value by 0.0005%. Even if both managers and shareholders value environmental issues to the same extent, their preferences

46. In case they exercise the options, there will be 1.1 million shares. If the value of the corporation is 12 million dollars, exercising the option has no economic impact on existing shareholders: their stake in the company has been reduced by the value of the company that has been increased proportionally by the proceeds the company received for the stock. Existing shareholders "pay a price" for the exercising of the options proportionate to the increase of the stock over the strike price of the option. For every marginal dollar increase in the stock's value over 12, they will bear a cost of 9 cents for exercising the options: the company does not get anything for the value of the stock above 12. A portion of the increase in value, which originally would go only to existing stockholders, will have to be shared with the party exercising the options: only 91 percent of it will go to original shareholders (1 million from the 1.1 million current stocks of the company). The other nine percent will accrue to the party exercising the options.

here will diverge if the value they attribute to such policy is in the wide range between 46¢ and $45,000, as shareholders will prefer to switch while managers will prefer not to switch.

It should be noted that in most cases, the value gap between shareholders and managers is not as large as described above. The shareholders' preference to opt for the green option is not relevant only to Company ABC but also may be relevant to other companies that form part of their portfolio. Thus, the real cost for the decision to opt for clean fuel is not only 46¢. As this decision may pertain to many other companies in their portfolio, the cost may be substantially higher. Yet this point does not alter the analysis above. Even if cleaner fuel were relevant to all the companies in their portfolio, the cost of opting for such an option across all companies would be $455. This is still a much smaller number than the $45,000 cost to the manager. And in reality, the cost for shareholders with diversified portfolios will never reach this amount, as any individual issue and its inseparability from business activity is unlikely to be relevant to all corporations. In any case, this example clarifies why there is a systemic gap between managers and shareholders regarding their willingness to trade off a corporation's profits for a social objective.

In terms of Hart and Zingales's model, the argument above could be modeled in the following way. Its key point is that there are two types of λ: λ_i—the weight *investors* attribute to social costs—and λ_m—the weight *managers* (and other insiders, including board members) attribute to social cost. The weight is not identical to individuals in both spheres, but the weight of the latter is typically higher than the weight of the former:

$$(4)\ \bar{\lambda}_\imath > \bar{\lambda}_m$$

As equation (3) demonstrates in the Hart-Zingales model, α does not have an effect on the decision whether to opt for the dirty or clean course of action because it equally impacts the payoffs of both courses of action. This will make it simpler to compare to the decision of a manager and his affiliates, who are not impacted directly by the shares he owns. So, for modeling the decision of the manager and his affiliates, we use only λ and omit α. The model for the decision facing the manager, similar to that of the investor in equation (1) above, will be

$$(5)\ (1 - \lambda_m)\ \pi_{dirty} + \lambda_m\ (\pi_{dirty} - d).$$

As a result, even in instances in which the investor would prefer a clean course of action, i.e.,

$$(6)\ \pi_{clean} > \pi_{dirty} - \lambda_i\ d,$$

the manager and his affiliates would prefer the dirty course of action. This is reflected in equation (4), from which it could be derived that

$$(7)\ \lambda_i > \lambda_{m,}$$

and as a result, it is plausible, although not necessary, that

$$(8)\ \pi_{dirty} - \lambda_m\ d > \pi_{clean} > \pi_{dirty} - \lambda_i\ d.$$

In other words, managers and their affiliates would choose the dirty course of action even though investors would choose a clean course of action.

In order to achieve this result—the inherent likelihood that managers and their affiliates may resist social policies preferred by shareholders—there is no need for the distinction made by Hart and Zingales between decision payoffs and final payoffs and no need to focus solely on cases in which there is a potential takeover. This result applies to all corporations, more generally than Hart and Zingales have claimed in their model.

III. ADDRESSING THE NEW AGENCY PROBLEM

Enabling corporations to promote the social preferences of their shareholders will require overcoming this agency problem of managers that are systematically reluctant to pursue such policies. The best solution for overcoming the problem is delegating decisions that involve potential social implications to shareholders.[47] This Part will discuss how this should be done.

While suggestions to delegate decision-making on social matters to shareholders have been made and partially discussed by Hart and Zingales,[48] the systematic gap between managers and stockholders underscored in this Article turn these suggestions from mere possibility to necessity. This delegation is not worth considering because there *may* be differences between managers and stockholders; the systemic gap *requires* shifting decision-making on these matters from managers to shareholders.

Delegation of decision-making on social matters is the only effective way to address the agency problem that arises in the context of these matters. Other vehicles for mitigating this agency problem will not be as effective. When faced with the conventional agency problem between shareholders and managers, the vehicles lawyers, industry actors, and scholars have proposed are legal duties—such as the duties of loyalty;[49] institutional investors;[50] independent directors and boards'

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47. The discussion here regarding increasing shareholder input on certain issues is reminiscent of the discussion by Bebchuk and Jackson on increasing shareholder input on corporate political speech. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83 (2010). They even point out the relevance of their argument to social issues implicated in this Article, such as corporate charitable contributions. *See id.* at 91 n.21. Yet, there is a significant difference between the grounds for increasing shareholder involvement in their article and the one in this Article. They point to the importance of the issues at hand and to the fact that they are not necessarily connected to the corporations' core business, without pointing to a systematic gap between shareholders and managers on those issues. *Id.* at 89–91. This Article goes a step further and points to the systematic gap between the preferences of shareholders and managers serving as a stronger justification for increasing the input of shareholders on such issues.

48. Hart & Zingales, *supra* note 2, at 264.

49. *See* ROBERT CHARLES CLARK, CORPORATE LAW 34 (Aspen Publishers, Inc. 1986); Zohar Goshen, *Controlling Corporate Agency Costs: A United States-Israeli Comparative View*, 6 CARDOZO J. INT'L & COMP. L. 99 (1998); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927 (1983).

50. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 819 (1992). In 2003, the SEC adopted rules that required mutual funds to develop policies and procedures with respect to voting shares in their portfolio companies and disclosing their votes on an annual basis. 17 C.F.R. §§ 270.30b1-4; 275.206(4)-6 (2003).

independent special committees[51] and facilitation of direct engagement of shareholders.[52] The first two proposals cannot effectively address the agency problem in the context of social issues, which leaves only the latter two as viable options for addressing this agency problem. This Part will explore the latter two options after discussing why the former two will be ineffective.

The imposition of an enforceable duty of loyalty under which managers are obligated to serve the interests of shareholders will be difficult to implement in the social context: in order to make an allegation that the officers have diverged from the best interests of the shareholders, there must be a clear picture of what the best interests of shareholders actually are. Given the wide array of possible objectives of shareholders when admitting social goals, it is hard to determine whether officers have actually diverged from the shareholders' interest as a whole. Indeed, even under the premise that the only legitimate objective is profit maximization, it is quite complicated to determine if officers have diverged from this goal.[53] It is much more complicated to make such a determination when it could implicate a wide array of objectives.

Institutional investors—who have greater resources and expertise for monitoring managers—can reduce this agency problem at the margins, though they do not address the core issue: shareholders' preference ranking of different social objectives. There may be funds with a social agenda in which the investor can invest and promote some social objective besides profit maximization. A few examples of such funds are Parnassus Endeavor,[54] Eventide Gilead,[55] and funds that invest in indexes of socially responsible corporations, such as the Vanguard FTSE Social Index.[56] Even major conventional funds typically have solid commitments to

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51. Regarding the historical shift toward independent directors, see Jeffery N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

52. There are other mechanisms for addressing agency problems, such as hedge fund activism. *See* Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 47–49 (2012); *see also* Ronald J. Gilson & Jeffery N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 896–901 (2013). *Contra* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1028–41 (2007). Aside from the dispute regarding whether hedge funds actually diminish agency problems or might exacerbate them, they are not relevant to the context of social objectives. It may seem that other private actors, such as Trinity Wall Street in the *Walmart* case, have a similar function in this context, but this is not accurate. The power of hedge funds is mostly derived from the tendency of institutional investors to support their campaign. This is not the case for social private funds. Hirst, *supra* note 19. For this reason, social private funds should not be treated differently from any other shareholder, regardless of their size.

53. Elhauge, *supra* note 4, at 776–82.

54. *Parnasus Endeavor Fund*, PARNASSUS INV., https://www.parnassus.com/parnassus-mutual-funds/endeavor/investor-shares/[https://perma.cc/8UFC-UZBH] (last visited Mar. 3, 2019).

55. *Eventide Gilead*, EVENTIDE FUNDS, https://www.eventidefunds.com/our-products/ [https://perma.cc/HMN7-YTDW] (last visited Mar. 3, 2019).

56. *Vanguard FTSE Social Index Fund Investor Shares*, VANGUARD GROUP, https://personal.vanguard.com/us/FundsSnapshot?FundId=0213&FundIntExt=INT&funds_disable_redirect=true [https://perma.cc/V7GW-2RYK] (last visited Mar. 3, 2019).

sustainable investing, such as the California Public Employees Retirement System (CalPERS).[57] But without direct shareholder engagement, these funds are not chosen to reflect shareholder preferences. A fund devoted to environmental issues may not necessarily match the preferences of the investor; it may be more or less willing to forgo profit maximization for environmental benefits or even value specific environmental benefits differently. When taking into account a wider dimension of issues, including gender equality, gun control, and wealth redistribution, it is even less likely that the fund's preferences will match those of the investor, particularly given the interplay between various social issues. Furthermore, most socially responsible institutional investment funds do not engage with the corporation in order to promote and reflect its values, but instead divest stock of corporations that do not function in accordance with their own values.[58] Thus, institutional investors—as actors removed from the shareholders—are an ineffective tool for steering the corporation from one decision to the other.[59]

There are two alternative methods in which decision-making regarding social objectives can take place: a bottom-up model, through shareholder proposals regarding these issues, and a top-down model, mandating the board to bring certain issues to a shareholder vote. Both forms will be discussed, as well as their relationship to one another.

A. Bottom-up: Shareholder Proposals Regarding Social Issues

Shareholder proposals are a promising mechanism for enabling stockholders to voice their social preferences. Shareholders have the right under Rule 14a-8 to include their proposals in the company's proxy materials.[60] These proposals can be related to any "general economic, political, racial, religious, social or similar

57. *Sustainable Investing*, CALPERS, https://www.calpers.ca.gov/page/investments/governance/sustainable-investing [https://perma.cc/W3JB-58G9] (last visited Mar. 3, 2019).

58. Hart & Zingales, *supra* note 2, at 266.

59. In addition to the information problem that institutional investors do not know the preferences of their shareholders, there might be an agency problem between institutional investors and their shareholders, even when institutional investors are aware of the preferences of their shareholders. As a general matter, retail investor support for shareholder social proposals has been found to be 70%, and the support of institutional investors in the same study was 27.6%. There is no reason to think that there is a systemic difference between the preferences of retail shareholders and investors in those institutional investors, supporting the claim that there may be gap in the preferences of the institutions themselves and their investors. *See* Hirst, *supra* note 19.

60. 17 C.F.R. § 240.14a-8 (1998).

causes."[61] Such proposals are actually used for a wide array of issues: gun control,[62] discrimination,[63] environmental justice,[64] and social justice.[65]

Yet, there is one impediment for the use of shareholder proposals to reflect shareholders' preferences regarding social issues. Rule 14a-8(i)(3) enables the corporation to exclude proposals "if the proposal deals with a matter relating to the company's ordinary business operations."[66] This exclusion is fairly wide, and it enables the corporation to exclude many public policy proposals. As some scholars have noted, this exclusion stands in tension with the permission granted to public policy proposals, with one even naming it "a near-perfect bureaucratic Catch-22."[67] This problem is sufficiently severe that the Securities and Exchange Commission has drafted a proposal that would explicitly limit the exclusion regarding public policy proposals to apply only when they involve micromanaging proposals.[68]

The Capital Cities/ABC Inc. case provides an example for how the ordinary business exclusion reduces shareholders' ability to make public policy proposals.[69] Shareholders in that case proposed that the company would provide information regarding the composition of its workforce and employment practices, especially in terms of sex and race. The company excluded the proposal from its proxy, claiming that the proposal pertained to ordinary business, and was backed by the SEC.[70] The Commission reaffirmed its position that employment-related proposals should be classified as pertaining to the company's ordinary business and excluded a proposal

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61. Proposed Proxy Rules, 36 Fed. Reg. 25,432, 25,432-33 (proposed Dec. 31, 1971) (to be codified at 17 C.F.R. pt. 240). The SEC instituted this change in reaction to Campaign GM, in which shareholders submitted proposals for the creation of a social responsibility committee. GM excluded the proposal, arguing that such considerations were irrelevant to the corporation's function. The SEC required the inclusion of the proposal and changed the regulation in order to clarify that such a proposal should not be excluded unless completely detached from the business of the issuer. *See* Donald Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign GM*, 69 MICH. L. REV. 419, 421, 423 (1971).

62. *See supra* note 20 and accompanying text; *see also Shareholder Proposal Developments During the 2015 Proxy Season*, GIBSON DUNN (July 15, 2015), https://www.gibsondunn.com/shareholder-proposal-developments-during-the-2015-proxy-season/ [https://perma.cc/R6B3-LY5R].

63. Thirty-four diversity-related proposals have been submitted by shareholders in the 2017 proxy season. *See Shareholder Proposal Developments During the 2017 Proxy Season*, GIBSON DUNN (June 29, 2017), https://www.gibsondunn.com/shareholder-proposal-developments-during-the-2017-proxy-season/ [https://perma.cc/76Q7-BBCE]. In addition, nineteen proposals regarding pay gaps have been proposed. *Id.*

64. One hundred forty-four environmental proposals have been submitted by shareholders in the 2017 proxy season, of which three have actually been approved by the majority of the shareholders. *Id.*

65. Fourteen proposals regarding pay disparity have been submitted during the 2017 proxy season. *Id.*

66. 17 C.F.R. § 240.14a–8(i)(7) (2018).

67. *See* Alan R. Palmiter, *The Shareholder Proposal Rule: A Failed Experiment in Merit Regulation*, 45 ALA. L. REV. 879, 892 (1994).

68. Procedural Requirements for Proponents—Rule 14a–8, 41 Fed. Reg. 29,982, 29,984 (proposed July 20, 1976) (to be codified at 17 C.F.R. pt. 240).

69. Capital Cities/ABC Inc., SEC No-Action Letter, 1991 WL 178633 (Apr. 4, 1991).

70. *Id.*

from the proxy in a similar decision regarding Cracker Barrel.[71] However, the SEC has retracted a bit from this apparent blanket limitation on proposals regarding employment by redefining "ordinary business" as excluding issues that "would transcend the day-to-day business matters and raise policy issues" that are of "widespread public debate."[72] While this change of view has enabled shareholders to raise employment issues in proposals, it has not diminished uncertainty regarding the boundaries between public issues and ordinary business on this issue or within other subjects, in what has been described as "an interpretive nightmare."[73]

The uncertainty generated by the ordinary business criterion is a serious problem. But there is a much bigger problem regarding this criterion: that in light of the justification for why corporations should promote social objectives, it is plainly wrong. Shareholder proposals are a means by which shareholders can impact the corporation to promote the social objective they support. The central justification for why they should promote these social objectives through the corporation in which they own shares, and not privately, is that these social objectives are inseparable from the corporations' activities.[74] It follows that the preference of the shareholder pertaining to the ordinary business course of the corporation only reinforces the case for permitting to surface it and does not serve as a reason to exclude it. The more a certain social objective is inseparable from the corporation's business activity, the stronger the justification that it should be executed by the corporation. The main reason that a social objective is inseparable from the corporation's business activity is that there is a synergy between the corporation's business activity and the promotion of the social objective.[75] One would expect to find greater synergies as the two are combined more strongly together. The strongest combination is when the social objective is woven into the heart of the corporation's business activity—its ordinary business.[76] Thus, the set of cases where one might expect the rationale for promoting social objectives by the corporation to be the strongest are exactly the set of cases in which promoting social objectives is strongly restricted under the current rule.

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71. Cracker Barrel Old Country Stores, Inc., SEC No-Action Letter, 1992 WL 289095 (Oct. 13, 1992).

72. Amendments to Rules on Shareholder Proposals, 63 Fed. Reg. 29,106, 29,108 (May 28, 1998) (to be codified at 17 C.F.R. pt. 240).

73. Adrien K. Anderson, *The Policy of Determining Significant Policy Under Rule 14a-8(i)(7)*, 93 DENV. L. REV. ONLINE 183, 196 (2016).

74. *Supra* note 19.

75. *See* Aseem Kaul & Jiao Luo, *An Economic Case for CSR: The Comparative Efficiency of For-Profit Corporations in Meeting Consumer Demand for Social Goods*, 39 STRATEGIC MGMT. J. 1650, 1651 (2018). Kaul and Luo focus on the competitive advantage of business to provide the public good at a lower cost, but the competitive advantage can also apply to producing a good of higher quality. Examples of high-quality public goods that businesses can produce more effectively than the government include Microsoft's partnership with the American Association of Community Colleges in forming an education program for IT workers or Marriott's paid classroom and on-the-job training for unemployed individuals. *See* Michael E. Porter & Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV. 78, 89 (2006).

76. Kaul & Luo, *supra* note 75, at 1662–63; Porter & Kramer, *supra* note 75, at 88–89.

The case of proposals promoting gender and racial equality provides a sharp example. The Commission has restricted proposals regarding employment policy because such proposals pertain to the core of the corporation's ordinary business. It is true that employment policy pertains to the corporation's ordinary business, but that is exactly what makes the promotion of that goal in the corporate context the most effective way to promote it. One of the key aspects of gender and racial equality is preserving the dignity of disadvantaged individuals who suffer from discrimination. It is possible to compensate them for the disadvantages and provide them with cash grants either in the private or public sphere. But such compensation may only further infringe their dignity by underscoring their inferiority to others.[77] Thus, the most effective way to promote equality and preserve disadvantaged individuals' dignity is supposedly in ways that emphasize their value, such as hiring them. In this respect, a voluntary commitment of a corporation to hire them is much more valuable than a mandate by the State that requires a corporation to hire them. With respect to the objective of enhancing their dignity, a legal mandate may be self-defeating: hiring as a consequence of a forced mandate by the State does not emphasize the value of the individuals from these classes and may even backfire.[78]

The *Walmart* gun prevention case is an additional example of how promoting social objectives in the context of ordinary business may generate the desired benefit most effectively.[79] The decision of which products to sell in Walmart stores among the millions of products it sells is a pure ordinary business decision. This is why the Third Circuit validated the exclusion of the shareholder proposal.[80] Yet, it is exactly this business function that controls the gun prevention objective. If Walmart were no longer ordinarily involved in the selling of high-capacity magazines and weapons, those weapons' availability would decrease. As Hart and Zingales have noted, this may be the most effective way to promote the objective.[81] Since the State may be constitutionally prohibited from imposing shareholders' desired limitations, the corporation controls the most effective target for promoting that goal—distribution—and in many cases this target is tied inherently to the corporation's ordinary business.[82]

These examples illustrate how the ordinary business context may be the most effective venue for integrating business and social objectives. If shareholder proposals are the mechanism through which shareholders would be able to express their social preferences, the ordinary business limitation must be eliminated. Other scholars have made arguments against the ordinary business limitation,[83] and

77. LAWRENCE MEAD, THE NEW POLITICS OF POVERTY: THE NONWORKING POOR IN AMERICA 194 (1992); Anderson, *supra* note 26; Frank Munger, *Dependency by Law: Poverty, Identity and Welfare Privatization*, 13 IND. J. GLOBAL LEGAL STUD. 391, 410 (2006).

78. Munger, *supra* note 77.

79. Trinity Wall St. v. Wal-Mart Stores, Inc., 792 F.3d 323 (3d Cir. 2015).

80. *Id.* at 344–45.

81. Hart & Zingales, *supra* note 2, at 249.

82. *Id.*

83. *See supra* notes 67, 73.

proposals have been made unsuccessfully by the SEC.[84] This Article adds an additional argument as to why the limitation should be repealed in the context of social proposals.

While this argument does state that the range of shareholder social proposals should be extended to ordinary business issues, it does not intend that shareholder proposals should not be restricted. On the contrary, it may support some restrictions that other scholars have been opposed to. An example is proposals related to risk. In 2005, the SEC applied the ordinary business limitation to proposals dealing with risk issues that focus on "an internal assessment of the risks or liabilities that the company faces as a result of its operation that may adversely affect the environment or the public's health."[85] Yet in 2008, it retreated from this ruling, stating that the limitation may have been too broad, causing an "unwarranted exclusion of proposals that relate to the evaluation of risk but . . . focus on significant policy issues."[86]

With respect to proposals regarding financial risks and liabilities, the implications of the Article's argument would conflict with the SEC's decision. The SEC would apply the ordinary business limitation to proposals regarding these issues. If the main function of shareholder proposals is surfacing preferences in which there is a potential systemic gap between shareholders and managers,[87] the ordinary business limitation should not apply to issues regarding financial risks. On issues that impact the corporation's financial bottom line, there is no systemic gap between shareholders and managers. The fact that managers address certain risks in ways that some shareholders disagree with is not due to a systemic disregard for financial risks but because their assessment of the risks differs from those of the specific shareholders making the proposal. A proposal based on a differing view from management's professional assessment of the financial risks facing the corporation should be covered by the ordinary business limitation. It second-guesses management's discretion regarding the corporation's core business issues, where there is no systemic gap between shareholders and managers that leads to a misalignment of preferences.[88]

84. Procedural Requirements for Proponents—Rule 14a–8, 41 Fed. Reg. at 29,982, 29,984.

85. SEC Staff Legal Bulletin No. 14C (CF), (June 28, 2005); *see also* Appendix (listing Staff letters permitting inclusion of proposals regarding health and environmental concerns and consequences from 2000 to 2007).

86. SEC Staff Legal Bulletin No. 14E (CF) (Oct. 27, 2009).

87. *See supra* note 19.

88. Some scholars note that there is also a systemic gap in the preferences of stockholders and managers towards risk, but that gap is in the opposite direction—managers are more risk-averse because of their low diversification and stockholders are risk-lovers because of their diversification. *See* Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981); Goshen, *supra* note 49, at 103. Yet, shareholder proposals regarding risks do not stem from this gap—shareholder proposals are mostly for decreasing rather than increasing risk. *See* GIBSON DUNN, *supra* note 63.

B. Top-down: Board Committee that Identifies and Delegates Social Matters to Shareholders

An alternative to relying on shareholder proposals is establishing a committee on the board, one which identifies potential significant social issues that shareholders would be interested in promoting even at the expense of profits. The committee would not make unilateral decisions regarding these issues but would call for shareholder input before making decisions on the issues. Even if the committee is fully independent, it could not make the decision itself because the appropriate decision depends on the preferences of the shareholders.

There are two forms in which the committee could channel the input of shareholders. The first is through a formal vote—with proxy material and all other formalities. Such a vote would be binding and would require the corporation to act according to the outcome of the vote. The second is through an informal vote. The committee can choose to poll only a fraction of shareholders to get an impression of their preferences regarding the social issue. This informal procedure is much cheaper because it neither requires proxy materials nor attempts to reach all shareholders. This form, therefore, suits decisions that must be executed in a short time frame. It is also a more fitting form for treating shareholder feedback as non-binding.

Soliciting shareholder preferences, even when these preferences are non-binding, may still be an effective tool for prescribing the corporation's actions. This can be a similar mechanism to that of say-on-pay, in which stockholders voice their view regarding compensation packages and affect compensation decisions even though their views regarding the compensation package are non-binding.[89] Using a "soft-law" reputational device may be especially fitting in the case of determining the actions a corporation should take in order to promote a certain goal. In complex situations, an inflexible rule to determine what course of action should be taken is ineffective. In such situations, it is better to utilize softer mechanisms.[90] This is the ground for excluding shareholders' proposals regarding ordinary business activity; business decisions are highly context-sensitive, and thus, determining by a simple maxim how the corporation should act is not appropriate.[91] Setting a vague principle is also impractical and costly, requiring the regulator to constantly be involved in "elaboration costs."[92] Thus, a reputational device, such as a non-formal vote or poll of shareholders, may be especially appropriate in the context of providing the corporation with the objective it should strive to promote; it leaves some flexibility

89. 17 C.F.R. §§ 229, 240, 249 (2003).

90. Poonam Puri & Simon Kupi, *Say on Pay, Soft Law and the Regulatory Focus on Enforcement and Transparency*, *in* THE CHANGING LANDSCAPE OF GLOBAL FINANCIAL GOVERNANCE AND THE ROLE OF SOFT LAW 172, 185 (Friedl Weiss & Armin J. Kammel eds., 2015).

91. *Id.*

92. Julia Black et al., *Making a Success of Principles-Based Regulation*, LAW & FIN. MKT. REV., 191, 201 (2007).

for the corporation but makes it fully accountable for unjustified ignorance of shareholder preferences.[93]

Soliciting shareholder preferences may have an additional effect to the reputational one: it may give rise to a duty of loyalty and duty of care for directors and managers to pursue the objective the shareholders have expressed. Managers and officers owe a duty of loyalty and duty of care toward the corporation. But under the shareholder primacy framework, the ultimate goal of the corporation is to promote shareholder welfare. Unless shareholders voice special preferences, it is assumed that their preference—and as a consequence, the corporation's objective that the managers and directors have a duty to promote—is maximization of profits. When they express other preferences, this may also affect managers' duty of care and duty of loyalty, which may now require them to promote the objective expressed by the shareholders. It may be possible that the managers will be liable even if they maximize profits, if they neglect the objectives expressed by the shareholders.[94] It is certainly possible that the expressed preference of the shareholders will alter the substance of the duty of care and duty of loyalty. Yet the actual effect of such change is quite questionable. Even when there is one clear objective—maximization of profits—the business judgment rule virtually nullifies the duty of care, making it impractical to impose liability as a consequence of violation of the duty.[95] The business judgment rule will most likely apply to some extent in cases in which the manager has pursued certain interests of shareholders, such as maximization of profits, but not their ultimate interests, such as promotion of social objectives. Thus, it would be highly unlikely that any liability will be imposed on managers and directors based on shareholders voicing their preferences.

The function of the committee proposed here is different from that of a standard social responsibility committee. The function of a standard social responsibility committee is to engage the corporation in as many social activities as is feasible.[96] The performance of such committees is evaluated in accordance to the amount of social activities the corporation engages with: the more, the merrier.[97] For example, studies evaluating the efficacy of social responsibility committees have used the listing of the corporation on the Dow Jones Sustainability Index as a proxy for its efficacy.[98] The inclusion in the Index is based on public information and questionnaires it receives from companies regarding their environmental and social

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93. Puri & Kupi, *supra* note 90, at 222–24.

94. Hart & Zingales, *supra* note 2, at 263–64.

95. Elhauge, *supra* note 4, at 739.

96. For an example of a study which assumes that the function of the social responsibility committee is to "positively impact corporate social performance," see Edian Eberhardt-Toth, *Who Should Be on a Board Corporate Social Responsibility Committee?*, 140 J. CLEANER PRODUCTION 1926, 1926 (2017).

97. Pierre-Marie Dupuy, *Soft Law and the International Law of the Environment*, 12 MICH. J. INT'L L. 420, 430 (1991).

98. Eberhardt-Toth, *supra* note 96, at 1929.

practices.[99] As a company invests more in these dimensions, it will receive a higher score that will enable it to be included in the Dow Jones Sustainability Index.[100]

The function of the committee proposed in this Article and the measurement of its efficacy are different. The committee's function is to make sure that shareholders' voices are heard on social issues and not necessarily that the corporation should act to promote social objectives. Its efficacy can be measured by alternative indicators, such as the number of times the committee has passed on certain issues to shareholders.

These functional differences have an important implication regarding the desired structure of the committee. For both types of committees, it is desirable that members will be independent.[101] Yet for a conventional social responsibility committee, it may be desirable that the board's chair be part of the committee and that its membership be drawn from the senior members of the board.[102] The reason for this is that the main function of the committee is influencing the corporation's decision-making, so it is important that the committee be comprised of the most influential members of the board.[103] This is not the case in the type of committee suggested in this Article; its main function is not influencing the decision makers in the corporation but making sure that the voice of shareholders will be heard regarding certain issues. Thus, the clout of the directors on the committee is much less significant. Furthermore, it may be desirable that such prominent members of the board not sit on the committee. Influential board members, such as the chairman, are less independent than other members. Even if the chairman is formally independent, he is more susceptible to capture by the CEO.[104] Thus, the degree of influence of board members may be inversely correlated to the degree of their independence. If influence is not as crucial for the committee proposed in this Article, it is better that the degree of independence not be traded off for it.

This top-down model does not necessarily decrease the engagement of shareholders on these issues. While it seems that in and of itself it does not permit shareholders to independently raise social issues they would like to address, the model may still increase the impact of shareholders. More shareholders may be willing to be involved and support a social issue that a formal sub-committee of the corporation has raised in comparison to supporting that issue in the context of a shareholder proposal made by an individual who has a personal obsession for a

99. *Measuring Intangibles: RobecoSAM's Corporate Sustainability Assessment Methodology*, ROBECOSAM 8 (2018), https://www.robecosam.com/media/d/0/1/d013178bf9bfae863cbea53a27584ac1_measuring-intangibles-csa-methodology_tcm1011-15705.pdf [https://perma.cc/69WS-JA72].

100. *Id.*

101. Eberhardt-Toth, *supra* note 96, at 1927.

102. *Id.* at 1927-28.

103. *Id.*

104. Bevis Longstreth, *Boards Fail When Executives Are Captured*, FIN. TIMES (Feb. 11, 2016), https://www.ft.com/content/8dc26bb4-cf1a-11e5-92a1-c5e23ef99c77 [https://perma.cc/8ZEE-FMJX].

certain issue.[105] This might even be the case when the shareholder is an active investor, such as a fund, because it is an actor without a formal function in the corporation. The main advantage of this format of shareholder engagement is that it sifts out the noise of unserious proposals. The flood of proposals, including those that are completely superfluous, is one of the major critiques of the shareholder proposal mechanism, as each proposal necessitates the cost of adding it to the proxy material.[106] The top-down mechanism addresses this disadvantage of the alternative bottom-up mechanism.

It is possible to combine both mechanisms so they will complement each other: enable both bottom-up and top-down mechanisms for shareholder input on social issues. It may seem that the major benefits of the top-down mechanism will evaporate under such a combination: seemingly it will not eliminate the flood of proposals, for example. Yet, it may be that instituting a sub-committee that is supposed to elicit views on social issues will reduce overall shareholder social proposals, given that a dedicated outlet exists for those views. By appointing a sub-committee whose main function is to oversee such issues, shareholders will be "relieved" from their "guarding" duty and will not generate such proposals independently.

The question of which of these mechanisms is more effective and whether they are actually complementary is an issue best determined by empirical analysis examining the magnitude of each of the effects discussed above.

IV. POSSIBLE OBJECTIONS

There are three main objections to the framework for justifying and facilitating corporate engagement with social objectives laid out in this Article. The first is that shareholders may actually be less social than managers. The second is that even if shareholders are more sensitive to social objectives than managers, they may be *too* sensitive, exceeding the socially optimal level of a corporation's engagement in social activities. The third is that the delegation of social issues to shareholders will decrease the possibility to detect potential synergies between social and business activities.

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105. This is supported by the finding that retail investors are mostly pro-management in their proxy voting. *See* Jill E. Fisch, *Standing Voting Instructions: Empowering the Excluded Retail Investor*, 102 MINN. L. REV. 11, 15 (2017).

106. *See* Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 177 (2001) (pointing to the fact that the costs of the proposals are not justified: they have no positive effect—only seldom do they receive a majority and do not have a positive impact on stock price). In addition to Roberta Romano, proponents of a director-centered approach to corporate law object to enhancing shareholder proposals or any other enhancement of shareholder powers. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561 (2006); Stephen Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 623–24 (2006); Stephen Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 985 (2001); Martin Lipton & Steven A. Rosenblum, *Election Contests in the Company's Proxy: An Idea Whose Time Has Not Come*, 59 BUS. L. 67 (2003).

A. Are Stockholders Actually More Pro-social Than Managers?

The argument of this Article is based on the premise that shareholders tend to be more social than managers. Not all scholars agree with this analysis. For example, Einer Elhauge argues that dispersed shareholders are *less* social than managers.[107] The idea is that dispersed shareholders are insulated from social and moral norms and sanctions, while managers are not. Social preferences are mostly generated by exposure to these social and moral norms.[108] Greater exposure to the social norms and sanctions that pertain to a certain situation increases the likelihood that one would take the proper action.[109] For example, direct connection with a worker in poor conditions motivates improving his work conditions. There is a difference in the social sanction for someone directly exposed to a situation calling for action and someone only indirectly exposed to the situation. People will view differently individuals who are exposed to such hardships, have the power to amend it, and yet do not do anything in comparison to those who have not been exposed to the situation directly. As a consequence, managers who are more exposed to social norms and sanctions are more prone to making pro-social decisions. Elhauge argues that in order to enhance corporations' engagement with social issues, which he too believes is optimal, *managers* should have more discretion regarding these issues.[110] In most cases, a manager's central function is pursuing shareholder welfare. Yet, because these social and moral norms and sanctions have an important role in complementing formal legal norms, managers' greater exposure to these social and moral norms and sanctions align their interests in this domain with the social interest.[111]

There are two responses to Elhauge's assertion that managers are more social than shareholders. The first is that Elhauge's comparison between managers and shareholders takes into account only the gap in their pay-offs from social decisions. Even if one agrees with Elhauge's analysis regarding that social gap, nothing can be inferred regarding the likelihood that managers will make social decisions without an analysis of the gap for the alternative profit-maximizing decision. Even if managers derive greater benefits than shareholders from social decisions, if they derive even greater benefits than shareholders in profit-maximizing decisions, they will still tilt toward profit maximization. What matters is their relative benefits from the two types of decisions. As explained above, managers derive substantial benefit from profit-maximizing decisions, due to bonding mechanisms and the nondiversification of managers' human capital.

However, Elhauge's argument poses a parallel problem for the argument in this Article and to Hart and Zingales's premise as well. Pointing to the greater

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107. Elhauge, *supra* note 4, at 796–805.
108. *Id.* at 740.
109. *Id.*
110. *Id.* at 796.
111. *Id.*

benefits of managers from profit-maximizing decisions does not imply anything if they may have even greater benefits from social decisions. Furthermore, one can argue that even in respect to profit-maximizing decisions, the value of such decisions to managers may be lower than shareholders. If the value-maximizing decision is regarding a risky project in the far future, its value to managers may be lower than that of shareholders: managers are more conservative in their risk preferences because of their lack in diversification. As a consequence, they may attribute lower value to future risky projects, and may be more willing than shareholders to trade off such projects for social purposes. The central question is which of the managers' benefits is greater in comparison to the stockholders': profit-maximizing decisions or social decisions?

The evidence seems to point to the former. Data regarding activist engagement of shareholders reflects that shareholders mostly press corporations to enhance their promotion of environmental and social goals, rather than to decrease their investment in social and environmental objectives.[112] From the 916 shareholder proposals in the 2016 proxy season, 299 were aimed at enhancing the corporation's engagement in promoting social and environmental objectives.[113] Among the environmental proposals, the most common proposals focused on emissions, especially greenhouse gas emissions, and monitoring the companies' compliance with the Paris Climate Accord's goal of keeping the global temperature increase below two degrees Celsius.[114] Other proposals are focused on diversity (59 proposals),[115] limiting operation in conflict zones (17 proposals),[116] and a sustainable minimum wage (6 proposals).[117] If Elhauge's thesis that managers benefit more from social decisions were true, one would expect to find at least a similar number of proposals in the other direction, in which shareholders propose scaling down social objectives. However, of the 916 proposals, none are of this nature. This data regarding proposals is partial—in most cases the majority votes are against the proposals. Submission of a proposal requires a single shareholder to execute. Yet one would expect symmetry in the submission of proposals between

112. *Shareholder Proposal Developments During the 2016 Proxy Season*, GIBSON DUNN (2016), https://www.gibsondunn.com/wp-content/uploads/documents/publications/Shareholder-Proposal-Developments-2016-Proxy-Season.pdf [https://perma.cc/EN8K-MFF7].

113. *Id.* at 5.

114. *Id.* at 38.

115. *Id.* at 42.

116. *Id.* at 43.

117. *Id.* at 44. The low acceptance rate of these resolutions does not necessarily represent broad shareholder views, but rather the decisions of institutional investors, who control over 70% of the stocks traded. As Scott Hirst noted, there is a significant gap between the preferences of shareholders and how institutional investors vote on their behalf in shareholder proposals regarding social issues. *See* Hirst, *supra* note 19, at 231. In polls and actual votes, it appears that over 70% of shareholders support such resolutions, but on average only 27.6% of the mutual funds he examined voted for such resolutions. *See id.* at 227, 230. Namely, if votes of institutional investors would have reflected the actual preferences of shareholders on behalf of which they hold the shares, many more social resolutions would have passed. *See id.* at 230–31.

pro-social goals and pro-profits goals if there weren't any systemic preference gap between shareholders and managers.

B. Aren't Stockholders Too Sensitive to Social Objectives, Exceeding the Social Optimum?

The premise of this Article, as in much of corporate legal scholarship, is based in shareholder primacy: the corporation, and its management, should strive to maximize shareholder welfare.[118] One of the central justifications for this view is that the interests of shareholders are aligned closely with the interests of society at large.[119] This theory is a classic case of Adam Smith's "invisible hand" at work: shareholders' maximization of welfare maximizes social welfare at large. But is this necessarily the case in shareholders' decisions to *sacrifice* and not *promote* their own welfare? At first glance, the answer to this question may seem simple—the reason why shareholders are willing to sacrifice their own financial welfare is because it promotes social welfare. Thus, the decision to sacrifice personal welfare should be at least as effective in promoting social welfare as decisions to promote personal welfare.

Yet, some may raise the concern that this is not the case when shareholders delegate the authority to decide whether the corporation should engage in social activity that would sacrifice its own profits. In such cases, their decision will not be aligned with the social optimum because of the rational apathy problem. Shareholders' decisions will not reflect a process in which they weigh their costs and the corporation's relative to the benefit for society. The extremely low expectancy that their vote would be decisive in any way may make its economic value negligible to them, and they may disregard it all together. The value shareholders may derive from their voting is not outcome based, but participation based: it is not derived from the increase in the expectancy that their preferred policy is more likely to be implemented, but from their support of a certain position *per-se* independent of its probability of being actually implemented; their subject sense of responsibility.[120] A different version of this argument is that the main source of value of the vote for the shareholders is its symbolic value, which applies only when they vote for social issues. In other words, shareholders value their vote as a means for expressing values to which they are committed. Thurman Arnold has pointed out the "symbolic" nature to various forms of behavior in the market and its regulators.[121] Marcel Kahan and Edward Rock have applied Arnold's "symbolic" view of market and political activity to the realm of corporate governance and the functioning of

118. *See supra* note 8.

119. *See* EASTERBROOK & FISCHEL, *supra* note 9, at 36–39.

120. Hart and Zingales themselves adopt this framework. *See supra* note 33. See their methodological discussion regarding the framework. *Supra* at 266-70.

121. THURMAN W. ARNOLD, THE FOLKLORE OF CAPITALISM (1st ed. 1937).

shareholders. In their words: "[T]he battle against managerial agency costs, as Arnold would say, is a moral crusade, not a practical one."[122]

The ramification of this view is that shareholders may make decisions biased toward social objectives, which may have negative implications for society's welfare. Shareholders might be affected by the high symbolic value of their vote on such matters and vote in their favor even if practical considerations—the social benefits of the objective versus the corporation's costs—would caution against it.

However, even if we accept the possibility of "symbolic" activity that is not motivated by practical considerations in the realm of corporate governance and activism by shareholders, it should not be a serious concern in regard to conventional voting. The cases in which Kahan and Rock had discussed shareholder activism as motivated by symbolic consideration differ significantly from shareholder voting discussed in this Article. Kahan and Rock have focused on activist campaigns for abolishing practices such as poison pills and staggered boards, and the adoption of practices such as proxy access. The success of these campaigns was feasible, and in many cases these campaigns actually succeeded.[123] The symbolic value was not attached to the *attempt* to cause a certain outcome, independent of the chances of the attempt to succeed. The symbolic value was attached to the *actual* outcome but over-inflated its actual value.[124] In this sense, the symbolic value works as a second layer on top of a practice that *seems* at first to be of practical value, inflating its significance.[125] The case of individual shareholder voting is different. It lacks the first level of the apparent practical importance, and there is nothing to inflate. In this sense, the degree of irrationality that the symbolic value needs to justify is much stronger and thus seems less relevant and less concerning.

It is certainly possible that shareholders derive value from the participatory act per-se, and not from its impact on the outcome. But it may well be the other way around: that managers derive value from their participation in promoting a certain goal and not from the value of the goal itself. Prima facie, it seems more reasonable that a more active action as executed by managers has higher participatory value than a technical action of voting with limited public salience. In order to claim that the value to the shareholders stems from participation per-se, one must furnish evidence that that is actually the case. It is not self-evident at all.

C. Ineffectiveness of Corporations in Promoting Social Goals

Even given that a shareholder can influence a corporation to act in order to promote a certain social goal, the corporation may not be able to actually promote the goal. The outcome in respect to the social goal, does not depend only on the

122. Marcel Kahan & Edward Rock, *Symbolic Corporate Governance Politics*, 94 B.U. L. REV. 1997, 2036 (2014).

123. *Id.* at 2022, 2037.

124. *Id.* at 2036–37.

125. *Id.*

actions of one corporation, but on the equilibrium reached by the actions of all corporations. Even if a corporation abstains from executing a socially damaging action, it may not diminish the level of the social damage—other firms may execute the socially damaging action instead, and the only impact the shareholder initiative will have is diminishing the revenue of their company. For example, in the Walmart case, the shareholders' initiative may not have any impact on the quantity of high-capacity magazines sold, but only on the identity of the seller: instead of Walmart selling them, some other retailers would sell them. This is another reason why social goals should be promoted through the political sphere and not through the corporate sphere: only state regulation can achieve the optimal equilibrium required for promoting the social goal.

It is true that the political process has many advantages over the corporate sphere in promoting social goals and in most cases is the appropriate arena for promoting such goals. The argument in this Article does not claim that promoting social goals through the corporate sphere dominates promoting social goals through the political system. It only claims that there may be some cases in which the corporate sphere may have an advantage. It is true that there are some strategic problems in promoting social goals through the corporate sphere, such as the equilibrium problem noted above. But the political sphere pertain failures that eliminate its ability to promote certain goals—voting in the political process is over candidates and not over policies and social preference, the need to vote for a bundle of policies without knowing which coalition will form, and other collective action problems that the political system exhibits.[126] The argument proposed in this Article enables the individual to determine which of the systems is most appropriate for promoting her desired goals. If one of the systems is not effective in promoting her goal, she would most likely not opt for it. In other words, the argument in this Article enables a private-ordering mechanism, through which the individual will pick the system that is the most effective for promoting her desired goal.

D. Upstream / Midstream Changes in the Objectives of the Firm

One may argue that even if one accepts the central argument of this Article and enables firms to promote social preferences, it should be done only upstream—by being clearly stated at the IPO stage in the charter of the firm as a mechanism that enables shareholders to influence the firm to promote social goals.. When such mechanisms are adopted mid-stream, after the IPO, they would harm certain shareholders that expected that the firm would focus on profits, and now find themselves losing value.[127]

126. Regarding breakdowns in the transmission of individual preferences in the political process, see J.M. BUCHANON AND G. TULLOCK, THE CALCULOUS OF CONSENT: LEGAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962); J.M. BUCHANON, WHAT SHOULD ECONOMISTS DO (1979).

127. *See* Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments or Differential Treatment Between Opting in to a Firm's Charter, and*

It is true that the proposal would have greater legitimacy if it required the shareholder mechanisms to be installed at the time of the IPO. But it doesn't necessarily *have* to limit itself in that way. Setting a default where the firm has to promote profit-maximizing preferences, unless stated otherwise, provides a significant benefit to such preferences over other preferences of shareholders. The central argument of this Article is that there is no theoretical justification to discriminate between the two sets of preferences. It is true that a shareholder that preferred value maximization and assumed the other shareholders had the same preference, loses out when the other shareholders promote social goals. But the same is true to the same extent in the reverse direction: shareholders with pro-social preferences that assumed other shareholders had similar preferences lose out potentially to the same extent when the other shareholders pursue only profit maximization. The main justification for setting one of the sets of preferences as a default is empirically based, and not theoretically based: as long as one set of preferences is much more common than the other, it is justified that the shareholders assumed other shareholders held the more common preference. But if the dynamic of preferences keeps on shifting, and more shareholders have pro-social preferences, the justification for maintaining for-profit preference as the default weakens.[128]

E. Won't Delegation of Social Issues to Stockholders Decrease the Synergies from Such Engagement?

One of the primary justifications for corporations to engage in social activity is the synergies from combining the business and social activities. Each one of the spheres benefits the other: the business sees reputational benefits such as goodwill and branding from the social activity, and the social sphere benefits from the business's resources employed for furthering goals in this sphere. Knowledge of when and where these mutual benefits take place is extremely complex.[129] While managers in many cases have the skills to identify these opportunities, it is highly doubtful that shareholders have this knowledge.[130] Therefore, when making decisions regarding the social issues in which the corporation should engage, shareholders might

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Opting out of It in the Post-IPO Stage, 102 HARV. L. REV. 1820 (1989) (distinguishing between shareholders' opting-in decisions in the IPO stage and opting-out decisions regarding charter amendments in the post-IPO stage).

128. One may argue that, even if the preferences are equally common, there is still a strong justification for setting one of the preferences as the default in order to maintain stability and that each set of shareholder would not find himself in a different company from the one he has invested in. Yet stability also has a cost—eliminating flexibility and the ability of the firm to adopt itself to new opportunities and to the evolving preferences of its shareholders which aren't always stable. One cannot clearly determine ex-ante which one of the two dominates the other.

129. *E.g.*, Roy Shapira, *Corporate Philanthropy as Signaling and Co-optation*, 80 FORDHAM L. REV. 1889, 1935 (2012).

130. *Id.*

not fully take these complex synergies into account. As a consequence, social welfare will be reduced, as many of these potential benefits might not be recognized.

While it is plausible that managers have this knowledge and shareholders do not, managers can mitigate this gap by informing shareholders regarding possible consequences—positive and negative—of various social courses of action. Most likely, such disclosures will not entirely eliminate the gap. Even after receiving such information, shareholders are unlikely to fully understand the broad picture of each course of action, and thus will not accurately estimate the potential benefits when making a decision. Yet, such disclosures will significantly reduce any gap that exists and the social cost that results, increasing the likelihood that the benefits mentioned in this Article will surpass this limited cost.

CONCLUSION

This Article developed Hart and Zingales's argument justifying a corporation's pursuit of social objectives from within the shareholder primacy framework. It underscored the central consequence of the argument for taking into account shareholder preferences: generating a new agency problem between managers and shareholders. Managers systematically undervalue social initiatives in comparison to shareholders and thus will tend toward profit maximization even when shareholders clearly prefer to pursue other social objectives. This is due to both their nondiversification compared to shareholders and bonding mechanisms that increase their sensitivity to profits to a greater degree than shareholders. Hart and Zingales have raised the concern that there might be a gap between shareholders and managers in regard to social preferences, but did point out the roots for why there might exist a systemic gap. This observation has important ramifications: it increases the importance of delegating more power to shareholders. For this reason, this Article has analyzed more closely the types of methods through which shareholder input on social issues could be increased: top-down mechanisms, through facilitating shareholder proposals, and bottom-up mechanisms, such as delegation to shareholder vote by an independent subcommittee.

Hart and Zingales's powerful argument for taking into account shareholders' social preferences should not be rejected due to the new set of agency problems to which it gives rise. Rather, this new set of agency problems should be addressed effectively in order to enable corporations' internalization of shareholders' social preferences.