THE BENEFIT STANCE: RESPONSIBLE OWNERSHIP IN THE TWENTY-FIRST CENTURY

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I. Introduction

Ownership in the global equities markets is dominated by large institutions that manage the savings of beneficiaries with long investment horizons. These asset managers rely on incomplete investment models that betray the interests of their beneficiaries and threaten their collective future. The models encourage individual companies to compete without regard for health of the critical social and environmental systems that support the long-term value of those beneficiaries' diversified portfolios and lived experience. These naïve models ignore the growing cost of profit-driven negative externalities. This article examines the latest models of benefit corporation law, a new form of governance that overturns the rule of shareholder primacy, and argues that their principles should be expanded to cover the entire chain of investing, from savers to funds to asset managers and finally to the real economy.

Benefit governance is now a standardized option for corporations in 37 jurisdictions in the U.S, one Canadian province and two additional countries. The signal feature of the legislation is the option to reject shareholder primacy. There has been much debate over whether conventional law actually demands shareholder primacy, and thus whether benefit corporation legislation is necessary. This paper goes beyond that narrow question and argues that regardless of its legal status, shareholder primacy is a norm that serves as one component of a broader "company primacy" system, which is itself an unexamined application of orthodox market principles.

Accordingly, rooting out the growing social and environmental costs associated with shareholder primacy will entail going beyond corporate law, and revising the principles by which money is managed all along the investing chain—including the management of large pools of capital that asset managers allocate and steward on behalf of institutional clients. Merely rejecting the primacy of shareholder and individual company interests will not be sufficient, however. Primacy must be replaced with a model that preserves healthy market competition, while filtering out harmful behaviors. This will require recognizing the need for collective action and demanding that participants all along that chain adhere to standards that address the dangerous gaps between the real world and the mythical invisible market hand. These lacunae include the market's failure to factor in external costs and its tendency to preserve and magnify inequality. The new principles must also address practical impairments to market solutions, such as information asymmetry and bounded rationality.

This new perspective requires that capital stewards account for externalities, inequalities and practical realities before unleashing the power of markets as the primary mechanism for allocating capital. This can be accomplished through a conception of ownership that includes the responsibility to create and preserve broad value across critical systems. This means applying benefit governance principles as imagined in the most recent statutes to investment trustees as well as corporate

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fiduciaries. Finally, the article proposes a Global Statement of Fiduciary Principle that drafters of laws, regulations and codes could use to implement benefit governance throughout the fiduciary chain and around the globe.

Part II will provide a brief history of benefit corporation law. Part III will show that shareholder primacy is just a part of larger system of market orthodoxy and Part IV, how that larger system fails to properly steward capital. Part V explains how benefit corporation has evolved from merely ending shareholder primacy to providing a coherent set of principles to replace it, and Part VI suggests that those principles should be applied throughout our system of capital stewardship, from savers to the real economy.

II. Prelude: benefit corporation law and corporate responsibility

In 2010, Maryland adopted a statute authorizing benefit corporations, and was quickly followed by other states around the U.S. These opt-in statutes establish a corporate form that (1) has a legally-recognized purpose beyond shareholder wealth creation, (2) creates express fiduciary duties that protect stakeholders and (3) requires disclosure with respect to those new duties. (Alexander 2018). The initial work of drafting and advocating for benefit corporation laws was undertaken by B Lab, a nonprofit entity based in Pennsylvania. (Alexander 2017).

B Lab had established a certification regime for corporate social and environmental impact. They did not want to certify companies that would privilege shareholders over other stakeholders, because such a stance would inevitably erode their positive impact. (Honeyman and Jana 2019). Accordingly, they designed the benefit corporation to provide an alternative more suitable for their certification regime. They then began advocating for its adoption and requiring certified B Corps to adopt the structure where available and necessary.

B Lab is part of a movement to create a more responsible business ecosystem. This movement has many guises: “corporate social responsibility,” “ESG (environmental, social and governance) integration,” and “corporate purpose” being the most prominent. Broadly speaking, this movement seeks to improve the impact of for-profit business by requiring firms to optimize social and environmental impact along with profits. This movement believes that corporate disregard for stakeholders (other than shareholders) leads to environmental degradation, growing inequality and social unrest.[2] This paper treats that belief as valid, and views treats corporate behavior as a root cause of dangerous trends such as atmospheric carbon concentration, species extinction, economic instability and untenable inequality, as well as morally unacceptable circumstances such as wage slavery and human rights abuses. (Austin 2019).

Many legal scholars studying the responsible business movement dispute the advice B Lab received and argue that conventional corporate law does not favor shareholders; while they agree that shareholder primacy is problematic, they argue that it does not exist as a legal mandate in corporate law. These scholars object to the benefit corporation movement, arguing that it is either a distraction or

[2]Others argue that humanity is better off than it has ever been. (Pinker, 2019). While Pinker may be correct that humanity enjoys an absolute level of material well-being far in excess of any previous generation, this circumstance does not compensate for the absolute amount of suffering that takes place in a world where more than 1.2 billion people live on less than $1.25 a day.(Malik, Jespersen and Kugler, 2014). Moreover, it does not address the environmental debt that such increased welfare may rely upon. (Wells, 2019)

counterproductive, because shareholder primacy is not the law or, if it is, it isn't enforceable or just doesn't matter. They also argue that establishing separate benefit corporation statutes will create a negative implication for conventional corporations, establishing shareholder primacy where it did not previously exist. This controversy and the history of the benefit corporation movement has been discussed at length elsewhere.

In a separate paper, I show that even if shareholder primacy is not the law, benefit corporation statutes can serve an important function: the most recent statutes establish clarity as to how directors must address the delicate balance when trade-offs between shareholders and stakeholders become inevitable. (Alexander, forthcoming). This fills an important gap even where shareholder primacy is not an affirmative obligation: the scholars who dispute the existence of shareholder primacy do not describe or propose a workable model or principle of decision-making that will protect stakeholders while continuing to elicit equity investment.

In that paper, I examine the history of benefit corporation law, and discuss its evolution toward principles that accomplish this role as a meaningful substitute for shareholder primacy. This is exemplified by the recently adopted British Columbia Benefit Company Act (the "British Columbia Act"). In the rest of this paper, I show that that shareholder primacy is just one instance of a larger operating system error that exists throughout the global system of capitalism and that well-crafted corporate statutes like the British Columbia Act establish principles that can provide a model for addressing that larger system error.

III. Shareholder primacy: more than a governance rule

Whether or not corporate law has a primacy mandate requiring a new statute, it cannot be denied that capital markets measure company success by the returns they provide to shareholders through dividends, repurchases and increased share value. Successful startup companies are celebrated when they become "unicorns," meaning that their share value has reached a billion dollars. Warren Buffet is celebrated as the "sage of Omaha" because the company he leads has lifted its share price by buying other companies and raising theirs[3]

Despite broad discussion of corporate responsibility, public company CEOs never actually commit to prioritizing stakeholders over shareholders; they do not say things like, "after having studied the issues, our board has decided that in order to protect our stakeholders and act as good corporate citizens, we will adopt a science based target for reducing carbon emissions to our fair share of the world's budget, ensure a living wage is paid throughout our supply chain and pay our fair share of taxes, even though doing so will reduce the net present value of returns to shareholders over its lifetime, and thus reduce our share price." Instead, they simply talk about the importance of stakeholders.

We *want* corporations to do good, but the markets *insist* that they do well. To avoid any cognitive dissonance, many proponents of more responsible, stakeholder-oriented corporate conduct simply deny that there is any tradeoff between share value and positive social and environmental impact, at least as long as companies take a long term perspective. After a week of public discussion of its 2019 Statement of Purpose of a Corporation, which emphasized the importance of stakeholders, the Business Roundtable released a set of questions and answers that made this denial clear:

[3] A sage is defined as "[o]ne (such as a profound philosopher) distinguished for wisdom".

> *How will you resolve matters if the best interests of any one stakeholder conflict with the best interests of shareholders?*
>
> While we acknowledge that different stakeholders may have competing interests in the short term, it is important to recognize that the interests of all stakeholders are inseparable in the long term.

This is a dubious claim to say the least: it assumes that differing values can be equally compared and contrasted with or without a price. Even to the extent that such interests could be valued commensurably, there is no reason to believe they will always align. (Heath, 2011, Posner 2011). Presumably, the very reason that corporations are subject to laws and regulations is that legislators and regulators have determined that the behavior of value-maximizing corporations does not always align with what is best for society; unless we believe that jurisdictions around the world have crafted laws that fully address these market failures, it must be acknowledged that the alignment is imperfect, at a minimum.

But if shareholder primacy and corporate profit maximization do not lead to socially optimal solutions, why does the idea permeate our thinking? Why does the primacy of share value seem so instinctive to most of us (even as many of us argue against it in the abstract)? What is it that makes us expect corporations to produce profit as a first principle?

A. Agency theory

At the corporate level, the standard explanation for shareholder primacy often begins with the need to address the "agency problem," the concern that disparate shareholders do not have the capacity to directly manage their assets, so that management is left to a professional class. (Heath, 2011). The concern, classically articulated by Adolph Berle in a 1932 law review article, is that these managers will tend to use those assets to benefit themselves, rather than the shareholders, and that imposing a fiduciary duty to shareholders and only shareholders creates a clear rule, making such defection less likely. (Berle, 1932).

But this is not a complete answer; after all, other disparate stakeholders, such as employees and customers, might make a similar argument to claim the allegiance of management— who is protecting them in the corporate enterprise? However, the agency theory of shareholder primacy asserts that the need for representation is peculiar to shareholders, because they provide capital to the corporation *with no promise of return*.[4] Unlike lenders, workers, suppliers, customers and other stakeholders, shareholders have no legal or contractual rights to receive any specific value in exchange for their contribution. Instead, they receive what is left over (if anything) after everyone else is paid. This creates a sense that others can bargain for a fair exchange, but that in order to fairly and consistently reward the shareholders for the risk they take, those other stakeholders should not get more than they can bargain for. (Heath, 2018). Thus, it is argued, only shareholders are in the position of bearing pure "residual risk."[5]

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[4] The use of the term "shareholder" in this paper is meant to refer to the traditional common shareholder, who is entitled solely to the residual after all others are paid, including preferences on shares of stock. Recent case law in Delaware makes it clear that even among shareholders of different classes, it is the interests of those entitled to residual value that are to be favored by the directors. (Alexander 2018).

[5] In order for shareholders to assess the possible returns and risks, there must be an ex ante rule describing the portion of the residue to which they are entitled. The implication of shareholder primacy is that the share is 100% of the largest potential residue.

While this argument is not without force—shareholders are uniquely at risk due to their status as first loss, pure residual risk bearers-- the agency theory alone cannot explain the resilience of shareholder primacy. It is inevitable that other stakeholders will bear some residual risk as their fortunes vary with the fortunes of the enterprise. Workers' jobs are more secure and raises more likely if a company does well, and customers relying on steady and consistent access to goods and services suffer when a company fails. (Collier, 2018). Moreover, shareholder primacy does not simply cover the relationship between shareholders, the corporation and other stakeholders who bargain with it—it also demands that companies put the interests of shareholders before the interests of communities affected by corporate operations that have no contractual or legal relationship with shareholder primacy—and here it departs from its role as a purely internal corporate governance mechanism. To fully explain the appeal of shareholder primacy, we must look beyond its use as a restraint on managers.

B. Shareholder primacy and market fundamentalism

The explanation for the strength of shareholder primacy lies largely in our collective belief in the power of markets to create value. Market fundamentalism justifies shareholder primacy as more than a mere protective device: it postulates that returns to shareholders come from profits, which represent the excess of the market value of goods and services over the market price that the company paid for the labor and goods that went into production. Accordingly, profit represents value created. Therefore, the higher the profit, the more value creation. (Easterbrook and Fischel, 1991, Heath, 2011). Thus, market theory claims that shareholder primacy doesn't just protect shareholders, but that it also leads to increased overall welfare through the proper pricing of goods, services, labor and resources. Shareholder primacy is simply an application of the neoliberal consensus that relies on markets to create a vibrant economy. (Basu, 2011, Pearlstein, 2018).

The influence of market purism on shareholder primacy is best exemplified by Milton Friedman's declaration that "The Social Responsibility of Business is to Increase Its Profits." The combination of these two ideas—that the market is the best mechanism for allocating resources and that profits measure successful allocation and stewardship-- is responsible for the unyielding influence of shareholder primacy in today's capital markets. As neoliberal economics has gathered strength as an intellectual force, shareholder primacy has gathered strength in the corporate world. (Reich 2015).

Of course, these ideas did not originate with Friedman. Adam Smith used the metaphor of the invisible hand to describe the value-enhancing effects of the profit motive in the eighteenth century, famously stating that "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest." However, the formalization of this idea came about in the twentieth as the First Fundamental Theorem of Welfare Economics. (Basu, 2011). Orthodox economics centers on this proof that voluntary exchanges create value and lead to equilibriums that are optimal—at least in the sense that no one can be made materially better off without making someone else worse off. (Heath, 2011). As discussed below, a closer look at what the First Theorem actually says reveals important gaps in market fundamentalism, and thus shareholder primacy, and explains why allowing shareholder value to unconstrainedly guide corporate behavior is so dangerous.

C. Modern Portfolio Theory

In addition to agency and free market arguments, the feedback loops that invigorate shareholder primacy are strengthened by the current investing milieu, which features the institutionalization of the equity markets and the adoption of Modern Portfolio Theory (MPT). (Youngdahl, 2014). Whereas fifty years ago, equity was held largely in the accounts of individuals, it is now primarily owed by institutions. (Hawley, 2016). In part, this reflects the advent of MPT, which enables those institutions to own equity. MPT showed that the greater returns available from equity could be achieved without an undue increase in risk if portfolios were adequately diversified. (Hawley, Johnson and Waitzer, 2016). Over the last fifty years, equity markets have come to be dominated by large institutional holders practicing MPT—so there are large pools of savings invested into equity markets that are diversified and invested for the long term.

MPT directs investors to monitor success by whether a company or portfolio exceeds or matches the returns on similarly risky securities. This variance from the market return is called "alpha," while "beta" is the term used for the market return. Under MPT, beta is treated as an uncontrollable variable that investors work within, while increasing alpha is the job of investment managers. (Hawley and Lukomnik, 2016). This means that investors measure a company's success based upon *shareholder return relative to other companies* and not on the return of the market overall. (Davis, Lukomnik and Pitt-Watson, 2016). Thus, under the prevailing theory of investing, which governs the allocation and stewardship of most of our private investment capital, no one takes responsibility for overall market performance. Only outperformance of other companies is rewarded. As we shall see, this is an ideal medium in which to grow shareholder primacy.

In sum, shareholder primacy is thought to both protect shareholders from wayward agents and to maximize societal wealth. In order to enforce that primacy, we measure asset managers by their relative performance. Seen in this light, shareholder primacy is not just an internal corporate governance regime; it is a key feature of an economic system based on the superiority of market mechanisms for creating value. Market fundamentalism claims that directors' focus on increasing returns to shareholders not only protects the shareholders but also maximizes overall economic productivity. (Heath, 2011). However, for shareholder primacy to perform these functions, the market model that equates true value with the value returned to shareholders at the company level must reflect the real world.

It does not.

IV. The invisible hand's blind spots

Corporate profits at individual companies do not actually equate with societal value, at least not with any type of one-to-one correspondence. Shareholders as a class are not served by shareholder primacy and MPT, neither of which assign value to maintaining the healthy systems shareholders collectively rely upon. Accordingly, universal owners are not served by investment managers who focus only on alpha. Rather, "[w]hile the ability of ESG investing to create alpha is interesting and valuable, the ability of ESG to change beta may be the more important question." (Hawley and Lukomnik, 2016). The flaw that leads to this error is a basic misunderstanding of what the First Theorem actually says—how markets actually work.

A. Externalities and inequality

The market model of the invisible hand addresses only the value of exchanges to those *within a closed value chain* such as a corporation and its suppliers, workers, customers and others in economic privity. But it ignores costs imposed or benefits visited on those outside that value chain: externalities, which Austin has called the "dropped stitch of 20th century economics." (Austin, 2019). For example, if I have excess gasoline and you have an empty tank, we may both be financially better off by engaging in a voluntary exchange. But if the exchange now allows you to put the gasoline in your tank and burn it, *other people who were not parties to that exchange will be affected by the emissions from the tank*. Orthodox economics acknowledges this, but tends to view those externalities as flies in the ointment, so that while it acknowledges that government must regulate negative externalities, it also asserts that government should use a light touch, in order to preserve as many possible voluntary exchanges—and thus as active an invisible hand—as possible.

Another acknowledged failing of the invisible hand is that the fairness of its output in is determined by its input.[6] It provides for "Pareto" optimization, which means all participants have the opportunity to improve their wealth through trade, but no one will incur a loss; it does not guarantee any move toward a more equal distribution if the initial allocation of value was unequal—and if initial distributions are unequal, it may create a power dynamic that leads to an even great inequality of distribution, even if no one ends up worse off in absolute terms. (Collier, 2018). Moreover, the failure to address the starting point inequalities may lead to inefficiencies. Think of the not-so-smart nephew placed in charge of the family business. Demoting him to promote a talented and loyal employee might create more economic value for society to share but might not come about by free market action in a world where being a nephew was a valuable asset.[7]

There are other imperfections in the invisible hand. One is information asymmetry: voluntary bargains struck in partial ignorance will not necessarily lead to the best use of resources. (Heath, 2011). Another is the well-known concern with bounded rationality. People just are not that good at making rational voluntary exchanges, so relying on such exchanges to improve everyone's overall welfare may not always work, even if the problems of externalities and equity are addressed.[8] Relatedly, preferences (and awareness of opportunities for exchange) change over time. Finally, the equilibriums predicted by the invisible hand may be unstable, whether due to consumer rejection of equilibrium solutions (Basu, 2011) or social instability from growing inequality. (Morelli, 2016).

B. How shareholder primacy hurts universal shareholders

Added together, these flaws mean that shareholders as class are not protected by shareholder primacy or MPT, which focuses on the value of individual companies relative to the value of peers. (Atkinson, forthcoming). It is tautological that shareholders together receive one value that all shareholders must divide, so this competition among companies for shareholder return would be helpful in the aggregate only if it led to greater overall performance. Moreover, most shareholders are "universal owners," meaning they are broadly diversified through mutual and index funds. (Hawley and Williams 2000). Their interests are thus largely identical with the interests of shareholders as a class. In other words, capital owners with such broad holdings benefit when markets rise overall, rather than from besting other market participants. That is where shareholder primacy and market orthodoxy become problematic.

As discussed above, shareholder return does not reflect the costs of externalities like pollution, resource depletion or harmful social inequality. Instead, those costs are borne by the economy and population as a whole, and can endanger the stable, healthy systems that a rising stock markets depend upon. While individual companies can externalize costs in a race to outperform, universal owners

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[6] The proof that markets create wealth does not imply that that rising tide of wealth will lift all boats or trickle down or satisfy any other metaphor about shared wealth. Market participants only create Pareto optimal equilibriums, meaning some people will be better off, and no one worse off. If A and B start with 10 units and 100 units respectively, the market may lead to B achieving 101 or 200 units and A remaining with 10, but never with A going to 99 and B ending with 90. (Basu, 2011).

[7] Consider the importance of legacy in the US college admissions process.

[8] See, e.g., the bread maker in my pantry.

internalize much of the costs through a lowered return on their diversified portfolio: there are significantly fewer externalities for these investors with respect to financial return.[9] I have discussed this idea extensively elsewhere (Alexander, 2018a), but one statistic to keep in mind is that for a diversified investor, 80% or more of return is based on market performance rather than the performance of individual holdings—and of course, for indexed investors, the number is 100%, subject to expenses. Moreover, those ultimate beneficial holders are human beings, who derive utility from the condition of the world in which the financial return will be used, whether by themselves, their friends and family or by future generations.

This is no rounding error. The annual value we receive from the endangered global ecosystem is greater than global GDP. (Austin 2019). As Austin says:

> Hence, far from externalities being peripheral, they may be the main event! In other words, more of the environmental and social exchanges that shape our wellbeing may be unpriced than priced, yet we increasingly steer by the priced exchanges only.

And even beyond their own individual utility, these individuals also presumably desire to live in a fair world in which those who are accidentally powerful are not able to oppress those who are accidentally without power. Or to put it into human terms, we should be safe in assuming that a vast majority of U.S. 401(k) savers would not have chosen to endanger the 1,129 workers burned to death in the Rana Plaza factory fire in order to improve the profits of the apparel companies in which they were invested. But even if it were not an issue of morality—if we wished to hew as closely as possible to *homo economicus*—no one knows what the future holds for them or those they care about; there is a Rawlsian veil of ignorance over everyone's future that should selfishly push them toward some level of fairness of outcome.[10]

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[9] This is not to say the class of beneficial owners does not have different interests from other individuals. We can certainly imagine an economy in which global threats like climate change are addressed, and in which most of the population thrives, but in which the global supply chain still includes modern slavery and other unacceptable working conditions imposed on those too poor to receive any benefit from rising share prices. Some of the costs of externalities and inequality these will fall on universal owners, but others may not. The self-interest of universal owners can address the former, but not necessarily the latter, although the line between the two may be hard to draw.

[10] I considered whether this paper should draw a line, and only discuss revisions to shareholder and company primacy for which "selfish," utilitarian arguments can be made, such as the systemic concerns of universal owners and the lived experience of their beneficial owners. While the discussion could in fact stop there, and still indicate that universal owners have significant motivation to overcome the collective action concerns that individual companies face with respect to systemic concerns such as climate change and market stability, there are three important reasons for extending the theory to areas that tend towards altruism. First, the line is not at all clear: there may be great risk to long-term social stability if the class of individuals who do not benefit from equity investing are forced to continue to bear the external costs of a business model that supports the wealthier segment of the populations. Second, the achievement of an altruistic purpose through responsible business practice raises the same collective action barriers raised by the purely financial concerns of universal owners. In other words, if a shareholder wants all workers at companies she owns to receive a living wage, the solution is not dependent on whether her motivation is to selfishly preserve the system in which her assets are invested or to altruistically ensure she is not benefitting from the mistreatment of others. Whatever her motivation, a living wage requirement that has a negative effect on the discounted cash flow of a firm cannot be imposed on some companies but not others without competitive disadvantage for the companies or asset managers that own the former. If we are discussing collective action among companies and investors to address corporate cost

The forgoing descriptions are oversimplified but nevertheless suggest that what we characterize as problems created by shareholder primacy are problems inherent in orthodox market economics (or in applying such principles where they make no sense), which problems are exacerbated by pushing them through a corporate form with limited liability that attempts to maximize residual value for shareholders.

V. Benefit corporation governance: replacing shareholder primacy at the corporate level

The initial benefit corporation movement recognized that something was wrong with shareholder primacy and passed laws to eliminate it. The initial versions of the statute, however, did not establish principles that would guide a board in the absence of a shareholder primacy mandate.[11]

If shareholder primacy is a flawed application of market economics, what rules would be are more consistent with the way markets actually function? Directors, who have great discretion in managing the assets of other people, need guiding principles. Without primacy or some positive principle to replace it, shareholders will be in an awkward position: they give up control of their capital with no promise of return and take the risk of being first in line to lose their investment if the firm fails. Their reward for this is the residual—whatever is left after everyone else involved in the enterprise is paid. Shareholder primacy protects shareholders from this problem and thus encourages equity investment by requiring directors to optimize that residual. It also implements a market-based economic model intended to increase social welfare, although, as discussed above, that model is flawed.

Public discussion around the problem of shareholder primacy often suggests that firms should simply make an additional commitment to stakeholders to complement the duty already owed to shareholders, leaving to managers the balancing of those interests in some reasonable manner. Indeed, this was the path that the initial versions of the benefit corporation statutes followed, with some modifications. (Alexander, 2018). But simply allowing directors to use discretion with respect to stakeholders in order to address these concerns may leave the agency problem unaddressed and have unintended effects on social welfare. Simply allowing managers to balance the interest of a multitude of stakeholders and do what "seems fair" is unlikely to be satisfactory and may ultimately increase the cost[12] of first risk capital that has been so advantageous to the economy. (Heath, 2011). Indeed, it may stifle the flow or divert it to closely held enterprises where investors can firmly maintain control, perhaps resulting in reduced stakeholder welfare. On the other hand, a director discretion model may simply be ineffective, as directors using their own discretion may fail to take serious steps to protect stakeholders from external costs and exploitation in order to attract capital or increase their own returns on equity compensation.

Thus, the admirable goal of the initial benefit corporation movement—eliminating shareholder primacy—really only does half the job. A benefit corporation statute must also create clear replacement principles that adequately address the agency problem and promise a predictable methodology for

externalization, it is an apt time to discuss collective action for altruistic reasons, as well. The third reason for considering altruistic motivations for decision making in business and investing is that at some juncture, we simply need to construct the world we want to live in, rather than trying to accommodate what we perceive to be possible in a world of homo economici.

[11] The initial benefit corporation statutes, and their evolution toward the form discussed at the end of this section, are discussed in a separate paper. (Alexander, forthcoming).

[12] Equity investors demand a premium based on risk. Uncertainty as to how the residual value of a corporation will be distributed increases that risk; accordingly, a fiduciary rule that permits arbitrary division of excess value among stakeholders will tend to increase the cost of capital, so that other stakeholders will ultimately be accommodated a smaller return than in a more certain governance regime.

determining the return that accrues to first loss residual equity. The principles must also work to optimize social value within a market economy in order to preserve capitalism and retain political support.

The most recent versions of benefit corporation statutes reflect the need to fill this gap. B Lab's original model of a benefit corporation statute has been updated and revised by drafters around the world to begin to establish principles that replace the pure market model of shareholder primacy. (Alexander, forthcoming). The most recent version, the British Columbia Act, represents the fullest expansion of a new principle; it requires directors to act responsibly and sustainably, which is defined as follows:

> "responsible and sustainable manner", in relation to the conduct of a benefit company's business, means a manner of conducting the business that:
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> (a) takes into account the well-being of persons affected by the operations of the benefit company, and
>
> (b) endeavours to use a fair and proportionate share of available environmental, social and economic resources and capacities.

This language, which pulls corporate law in an unprecedented direction, not only rejects the idea that corporations should simply compete for the highest profit—it specifies that in place of that primacy concept, corporations should consider the external costs that their actions create and also specifically consider their use of common resources.

One element that even the British Columbia Act lacks is a direction as to what to do once externalities, inequalities and other market failures are accounted for. Assuming that a company is controlled by shareholders, the reasonable expectation should be that it would maximize the residual value available to shareholders. This conduct would both address the agency concern and, more importantly, operationalize the pricing function championed by Adam Smith and formalized in the First Theorem, as described in Heath, 2011:

> Under the correct circumstances, competition will push prices toward the level at which markets clear (i.e., suppliers will not be left with unsold merchandise, and consumers will not be left with any unmet demands.) When this occurs, it means society has succeeded in minimizing the overall amount of waste in the economy.

Presumably, the work of establishing the "correct circumstances" for such a market function will have been done by mangers following the principles of the benefit corporation statute that address market failures, creating a healthy platform for competition.

However, while interposing these principles at the corporate level addresses the market failures in theory, modifying rules and norms at the firm level will not be sufficient to address the market orthodoxy that governs corporations. In order to work in practice, the principles should be applied throughout the investment chain in order to address the flaws of market fundamentalism and profit primacy.

VI. Benefit governance and ownership

A. Benefit corporation law: significant but insufficient

To summarize, shareholder primacy is an instantiation of flawed free market theory that turns the invisible hand into a destructive fist. Benefit corporation law seeks to reverse that instantiation, and the British Columbia Act does a superior job in preserving the benefits of the market mechanism while addressing its flaws. But an analysis that operates only at the corporate level sidesteps the critical question of how the providers of equity capital—the shareholders who control most of these enterprises-- will approach these issues.

The corporate form has created significant wealth by allowing multiple individuals to pool their savings, which can be used to fund large enterprises that provide critical goods, services and employment. This legal technology has been combined with the protection of property rights necessary to maintain free markets in order to create a global economy driven by capital seeking return. To a very large degree, capital has been able to maintain control over business, by insisting on control rights in exchange for providing risk capital. Given the nature of risk capital—its first loss position and absence of any guaranteed return—it is not surprising that it retains this control when it can.

If this circumstance is likely to continue, how much does the availability of the benefit corporation option really matter? If there continues to be a free market for capital, won't the absence of collective action mechanisms mean that a significant portion of that capital will continue to invest in enterprises that exploit negative externalities, insist on as much share of the gain as possible and take advantage of human nature and informational deficits? This is the equilibrium that the market will always default to, as any company that fails to do so will lag in return, and suffer an increased cost of capital, or be pressured by the market for corporate control to change its ways. (Greenfield, 2018). The fact that common resources are preserved if most companies act responsibly, but not so preserved when most companies do not, *and that individual irresponsible companies can receive an increased return in either environment*, establishes a classic prisoners' dilemma, in which the equilibrium that is best for everyone (majority responsible behavior) is unstable, because every individual actor can maximize its own return by acting irresponsibly, regardless of what others do. (Basu 2011).

The feedback mechanisms creating this unhealthy cycle are exacerbated by the fact that most assets are controlled through a chain of fiduciaries who manage these assets on behalf of others. For example, a pensioner may have a pension fund that relies on an asset manager, who in turn relies on advisors, who ultimately invest the capital into corporations managed by directors. Each party is a link in a chain of relationships that ultimately end with the beneficiary pensioner.[13] Fiduciaries along this chain must determine if it is legal, wise or moral to do anything other than seeking to increase the individual values of the equities and other assets in their portfolios. It may be argued that it would be problematic for them to address about pollution or equality as stand-alone issues, because the corpus isn't their money "to give away," however beneficent the intention. Moreover, their individual decisions to protect stakeholders (by divestment for example) might be futile in a competitive environment where other profit seekers would pursue the foregone profit opportunity.

Thus, even if benefit corporation statutes evolve into British Columbia Act-like statutes that establish principles that replace shareholder primacy and clearly call for the preservation of important systems, they will not have a significant effect on the impact of market failures, without collective action by institutional investors to make significant use of them. Sporadic use of the form by a small subset of

[13] Other institutions have similar relationships: insurance companies invest for the benefit of their insureds, sovereign wealth funds for citizens and foundations and endowments for the populations they are intended to benefit.

companies focused on sustainability cannot address the crucial systemic issues that require collective action throughout the economy. Unless there is a shift that moves most corporations to be or act like benefit corporations, there is a risk that the growing cost of externalities will overwhelm the gains in societal wealth secured through private enterprise in the last two centuries. (Quigley, forthcoming).

B. Benefit ownership

But to state this concern is also to name its solution—or at least a large part of it. Universal owners dominate the investment universe and shareholder primacy does not serve them. Corporate decisions that increase the bottom line and the net present value of future returns by exploiting externalities degrade the ecosystem that these owners rely upon. In particular, corporations can compete effectively by depleting common resources, like available carbon sinks and freshwater, and from limiting their contribution to public goods through tax avoidance.

Critical to this analysis, *the community of universal investors is not subject to the competitive dynamic that impairs systemic thinking*—they are all effected roughly equally by operational changes at any one company, eliminating the temptation to seek outperformance through defection from any agreement to forgo market failure exploitation. They should thus have the ability to pursue the collective action required to address it, and to achieve a stable equilibrium that will not be eroded by prisoner's-dilemma pressures. (Hawley and Williams, 2000). Yet, there is little evidence they do so. Asset managers and owners continue to be judged and rewarded by their ability to track and beat markets, and not by their contribution to overall rising markets. While investors talk about using ESG factors in investing, it is generally considered a strategy for outperformance, or, at best, a consideration permitted only with respect to investments that have already satisfied risk and reward requirements. There are virtually no large investment managers who would say they would like an individual company in its portfolio to sacrifice shareholder return over the long term in order to spare the broader market the costs of such performance (although, for the most part, the strategy among asset owners and managers is just denial that such situations exist). Institutions continue to push individual company (or portfolio) outperformance as the most important investing factor, even though more than 80% of their return is based on something else. (Alexander, 2018).

If this potential exists, why have universal holders been unable (or unwilling) to require companies that they control to preserve valuable systems? Perhaps the huge gains in productivity made through markets as we built an industrial and information economy outweighed the recognizable externalities for a long period of time, encouraging the adoption and calcification of the current investment system and its focus on competition rather than collective action. Perhaps there is an inevitable imbalance in feedback, as investors can constantly compare individual company and portfolio returns but cannot compare actual market returns to what might have been had externalities been reduced. Presumably, there is also an entropic weight to moving from the disorder of a market system to the increased order demanded by collective action. Nevertheless, if the planet is reaching limits with respect to resources and society is reaching limits as to unfairness, the cost of externalities and inequality will outweigh further gains from unfettered competition, even as we are stuck in a financial system whose primary feedback loops involve financial return on a company-by-company and portfolio-by-portfolio basis.

While the benefit corporation movement suggests a recognition that something is amiss with shareholder and company primacy, no similar framework has been suggested for universal investors, who have a much greater potential to authentically address market failures and the systemic risks they engender. Moving beyond shareholder primacy will require that institutions first reject this idea of company/portfolio primacy so that companies can comfortably address market failures. If institutions continue to foster company primacy, companies will continue to feel pressure to do all the things that a rejection of shareholder primacy is meant to counter. When an investment manager is judged and compensated based on whether her portfolio outperforms a portfolio with a similar risk, she will be motivated to ignore the external costs and inequality that the portfolio companies generate.[14] Any movement to implement benefit governance at companies will have to be accompanied—and perhaps preceded-- by a similar change in the governance and philosophy of the investment industry.

Market participants representing the interests of these investors could take such a step by applying the ideas that have evolved in the benefit corporation statutes and migrating them into the fiduciary chain, whether through persuasion, legislation or public engagement. In other words, investors and their fiduciaries have an opportunity to rectify market failures of global capitalism by adopting principled benefit governance at the ownership level. This would mean taking the items from benefit corporation statutes that best address the systemic concerns of a universal owner and applying them to investing governance.[15]

For example, because the first interest of universal owners is in preserving healthy systems, investment fiduciaries can account for systemic costs when allocating capital or exercising control rights over it. Individual corporations that raid common resource pools or otherwise take actions that exploit social or environmental systems can be disciplined by fiduciaries representing universal owners. The universal owner can be comfortable that if it persuades a portfolio company to act responsibly through engagement, and competitors of that company seek an advantage by continuing to irresponsibly, the universal owner's relative returns will be protected by the overlap of its ownership with that of other universal owners.[16] Perhaps the best means of protecting these common resources is to work with similarly situated investors to impose minimum sustainability parameters on all corporations that are controlled by the universal owner community; if so, creation and implementation of such guardrails will become the job of those fiduciaries.

The point is not that universal owners have better knowledge or more resources than others for playing this gatekeeper role. It is that they are the only market participants who can avoid the prisoner's dilemma facing companies, active portfolio managers and others in the business ecosystem. Nor is it necessary that they implement rules that are perfect. By simply raising the minimum standard of conduct for all firms, they will allow competition to work in a way that is less dangerous to critical environmental and social systems. This is particularly true with respect to issues of fairness. To a large extent, the potential of universal owners to create a level playing field with a minimum fairness standard is as important as the standard itself: it can change the direction of competition.

C. Fiduciary code

Simply eliminating corporation-based shareholder primacy will not address large social and environmental concerns, both because it does not create a viable principle to reverse course, and because companies alone cannot take the collective action needed to do so. What is needed is a code of

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[14] A corporate director or executive compensated with equity will have the same incentive.

[15] While this article focuses on the universal owner, that fact is that all owners, as a class could be better off taking the benefit stance, even if they were not diversified. (Hansen and Lott, 1996). However, if ownership stakes are concentrated, there is more temptation to fall into the trap of the prisoners' dilemma, because the investors can outperform when their companies defect.

[16] Of course, some competitors, such as family owned companies, may be outside the portfolio, but if universal owners work together, they have the potential to reach a very large percentage of the economy through ownership, supply chain management and influence over regulation.

conduct for fiduciaries throughout the investing chain, from asset owners to managers to boards of individual companies. All of these entities and their advisors are involved in taking the savings of ordinary people, or their insurance premiums, or the corpora of endowments and foundations meant to benefit them and funneling these assets to and applying them in the real economy, where goods and services are produced for everyone's benefit. In so doing, their overarching principle should be to ensure that a healthy planet and population is preserved for those ordinary people as both investors and sentient beings, without violating basic principles of fair play and justice that undergird the societies in which we live.

What principles might guide such a code?

1. <u>Principles</u>

To address the problem of externalities, the fiduciary code must reject financial gain from costly externalities that ordinary savers internalize through their diversified investment portfolios or lived experience: everything in the system must be accounted for at its true cost. Even where the class of savers and investors may not internalize a cost (because it is imposed on those too disenfranchised to benefit from that system) business should not be engaging in practices that offend the basic principles of fairness. This will require collective action to address the challenge of the prisoner's dilemma. In addition, collective action is necessary because determining what is "fair" and what external costs are unacceptable is not a purely empirical exercise. Judgments will need to be reached, so that necessarily imperfect standards can be evenly applied across firms. Finally, compensation and other practices that promote company primacy and work against responsible corporate practices should be rejected throughout the fiduciary chain.

These principles do not reject the free market, capitalism or competition. If companies can meet investor-endorsed standards to ensure a level and sustainable playing field, free market competition would thereafter be the favored pricing mechanism designed to allocate resources throughout the economy.

The four principles behind such a code could be expressed as follows:

1. *True Cost Accounting*. Relevant impacts of decisions made within the investing system must be accounted for within that system. Market participants should reject elements of the system that encourage investors, intermediaries and businesses to make decisions that increase financial return to the investor, customer or business without accounting for external costs imposed on others. This includes rejecting rules that were developed to benefit savers by focusing on the clearest signals relevant to their own return, such as shareholder primacy.

2. *Humane Investing*. Investment and business decisions are made on behalf of the human beings who are beneficiaries of the funds invested and should reflect common human values. Because the chain of investing is long and diffuse, investment capital may be used in ways that exploit humans beings, the environment or animals in ways that the ultimate beneficiaries would object to, regardless of financial return. Where there is widespread agreement as to certain values (such as the unacceptability of modern slavery), business and investing decisions should reflect such agreement as a principle separate from financial return.

3. *Utilizing Collective Action*. Participants in the investing system should avoid freeriding and commons grazing. Many aspects of value that are ignored under doctrines like shareholder primacy are collective goods, such as the ecosystem services delivered by a healthy environment or the social stability created by fair distribution of wealth. Investors, intermediaries and companies should

participate in efforts at collective action to maintain the value of these resources. This includes (1) causing companies to refrain from lobbying against efforts to preserve or enhance common resources, and (2) imposing limits on investee behavior when governments do not act to protect common resources.

4. *Rejecting Harmful Competition for Capital.* The systemic changes necessary to address the issues of common goods and fairness will be undermined if significant amounts of capital are invested outside of a reformed system. Accordingly, these changes must reach across equity classes, so that less-regulated markets like private equity and venture capital do not have opportunities to externalize costs made unavailable to companies subject to public reporting regimes.

Once these principles are accounted for, fiduciaries would be expected to compete for profit. This would match the model implied by the First Theorem: profits do represent value created and fairly shared once externalities and inequality (and other market failures) are addressed.

2. A code: The Global Statement of Fiduciary Principles

A global statement of this principle might ask jurisdictions, SROs and NGOs to incorporate the need for responsibility and sustainability into relevant rule that involve the investing chain by using the British Columbia Act language and filling in any perceived gaps.[17] The following language uses the British Columbia Act as a starting point, but refines it to account for the principles described above:

Global Statement of Fiduciary Principle

Any jurisdiction, SRO or NGO that creates a law, rule, regulation or code that governs the governance of asset owners or managers or business entities shall incorporate the requirement that the fiduciaries conduct themselves in a responsible and sustainable manner such that their decisions endeavor to:

(a) fairly account for the well-being of persons affected by the operation of any corporation that the decision applies to,

(b) ensure that corporations use fair and proportionate shares of available environmental, social and economic resources and capacities and contribute fair and proportional amounts to the public good,

(c) incorporate principles of equity so that gains from commercial activity are fairly shared, and

(d) participate in cooperative efforts to ensure that all investment streams are covered by (a)-(c) and subject to standards that incorporate such principles.

[17] This is not meant to suggest that new rules are required for universal owners to begin working to address market failures under current legal rules, only that the more explicit the guidance, the easier the work will be. The ability of fiduciaries to legally take systemic effects into account under current law is discussed in many of the essays included in Hawley (2014) and Hebb (2016).

VII. Conclusion

The phenomenon of the benefit corporation is barely ten years old. It has established a beachhead in the business world, with thousands of firms forming as benefit corporations and billions of dollars being bet on its future. Yet its greatest value may be the potential to create a template for investors to reconceive of what success means in business. In that reconception lies the possibility for a robust reimagination of capitalism itself, in which the benefits of a market economy are preserved, but its inherent flaws are comprehensively addressed by actors within the system.

The latest model of the benefit corporation statute not only rejects shareholder primacy but also adopts new principles that directly address the failure of markets to account for externalities and inequality. Application of these concepts to the entire investment chain can ameliorate some of the greatest risks that we face in the twenty-first century.

The author hopes that those opposed to benefit corporation law on the basis that it is unnecessary to address shareholder primacy might re-examine the potential benefit of a clear statement of these positive principles in both the corporate law (either as a mandate for all companies or as an option) and in the law governing investment fiduciaries, even in jurisdictions where shareholder primacy is not the required by law. While there is no shareholder primacy imperative in those jurisdictions, there is also no clear expression of principles to guide fiduciaries to preserve and maintain common resources or to share gains equitably-- necessary elements of a successful economy that market mechanisms alone cannot supply. Without such clear guidance, the market will continue to relentlessly sow environmental and social debt and we or our children will reap the whirlwind.

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