The Promise of Diversity, Inclusion, and Punishment in Corporate Governance

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Motivated in part by a desire to change corporate behavior in a more pro-social direction, a number of governance inclusion mandates have been proposed that would require a corporate board to include diverse individuals or representatives of a constituency. This article applies the economic insights of the Coase theorem to determine if and how such mandates will affect corporate activities. The boardroom is a "Coasian bubble" in which the abilities to bargain and contract are greatly enhanced; inclusion of interests in the boardroom allows those interests to be taken into account. Inclusion also results in some transfer of corporate surplus from shareholders to the newly included. This implies that corporate behavior may not change since all those represented in the boardroom have incentives to maximize corporate surplus. Exceptions are where inclusion enables efficient contracting that was otherwise infeasible or if the included group has significant interests that are subject to corporate externalities. The latter channel is most likely to result in more pro-social corporate behavior since such interests represent significant "skin in the game" for avoiding corporate malfeasance. Skin in the game can also be manufactured through ex post liability, such as by making a represented constituency liable for corporate failures or misbehavior; further, such liability may be necessary so that incentives are not degraded where the constituency receives benefits that are not in the nature of residual claims. Viewed through this lens, constituency mandates, in which directors are accountable to groups with significant interests, show some promise for promoting socially beneficial corporate behavior; diversity mandates, in which diverse but atomistic directors generally lack such accountability (at least as proposed), do not.

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Introduction

The modern concern over corporate[1] purpose is one of socially optimal behavior and is premised on the notion that the corporate drive for profit is at odds with various social ends such as economic and social stability, environmental protection, and even the preservation of American democracy.[2] The prominence and power of the largest business entities in the United States give rise to fear that their behaviors pose grave threats, while at the same time, their size and name-brand status make them increasingly convenient targets for various forms of governmental intervention.[3]

1. This Article sometimes uses the term "corporate" in the loose sense of a business entity and "corporate governance" to apply to the governance of such entities. Such usage is not technically correct in a legal context, as applied to increasingly-common forms of business associations such as the limited liability company and limited partnership, some of which are quite large and even publicly traded. However, such a use is etymologically defensible, as "corporate" derives from the Latin "corporare," meaning to form into a body, which is a concept that is applicable to business entities generally. This happens also to be the way in which the Accountable Capitalism Act uses the term, including, as it does, "bod[ies] corporate," LLCs, and actual corporations in the new category of U.S. corporations. Accountable Capitalism Act, S. 3215, 116th Cong. § 2(4)(A)(i) (2020). The same caveat applies, *mutatis mutandis*, for this Article's usage of terms such as "corporate board room."

2. *See, e.g.*, Press Release, Elizabeth Warren, Senator, U.S. Senate, Senator Warren to Business Roundtable: Your 2019 Commitment to 'Promote an Economy that Serves All Americans' Was an Empty Publicity Stunt (Sept. 17, 2020), https://www.warren.senate.gov/newsroom/press-releases/senator-warren-to-business-roundtable-your-2019-commitment-to-promote-an-economy-that-serves-all-americans-was-an-empty-publicity-stunt [https://perma.cc/2H8M-7MKS] (discussing the purpose of the Accountable Capitalism Act to reverse "harmful corporate trends" that have arisen because of the drive for corporate profits); Jillian Ambrose, *Major Global Firms Accused of Concealing Their Environmental Impact*, GUARDIAN (June 16, 2019, 1:13 PM), https://www.theguardian.com/environment/2019/jun/16/major-global-firms-accused-of-concealing-their-environmental-impact [https://perma.cc/AL9Z-ZUDZ] (alleging a lack of transparency from major corporations regarding their effect on the environment); Siva Vaidhyanathan, *Making Sense of the Facebook Menace: Can the Largest Media Platform in the World Ever Be Made Safe for Democracy?*, NEW REPUBLIC (Jan. 5, 2021), https://newrepublic.com/article/160661/facebook-menace-making-platform-safe-democracy [https://perma.cc/YCA2-H54R] (asserting the lack of incentives for corporations to shift their focus from gaining profit to preserving democracy).

3. *See, e.g.*, Gretchen Morgenson, *A Bank Too Big to Jail*, N.Y. TIMES (July 15, 2016), https://www.nytimes.com/2016/07/17/business/a-bank-too-big-to-jail.html [https://perma.cc/26NM-

Traditionally, the alignment of corporate incentives and societal goals has been accomplished with a combination of two approaches that limit externalized harms: *ex post* adjudication and through various degrees of command-and-control regulation.[4] Examples of *ex post* adjudication include the tort system and private securities litigation, which place the out-of-pocket costs (of, say, cancer victims or defrauded investors, respectively) onto the firm.[5] While command-and-control regulation applies to some extent in most industries, it is particularly prevalent in areas such as banking or energy production, in which government regulators mandate and monitor measures designed to promote the safety and soundness of the financial system or the integrity of the environment.[6]

Recent initiatives, however, reflect a new approach (at least for the United States) that attempts to intercede directly in the internal governance of the corporation. Most notably, this is done by selecting who may govern the firm—what we refer to generally as a "governance inclusion mandate." The Accountable Capitalism Act, a plank of Senator Elizabeth Warren's recent presidential bid, would require that 40% of a corporation's directors should be selected by its employees.[7] Throughout this Article, we refer to

4HJE] (analyzing Justice Department reluctance to prosecute large financial institutions that are capable of causing global financial crises).

4. *See* M. Todd Henderson & James C. Spindler, *Taking Systemic Risk Seriously in Financial Regulation*, 92 IND. L.J. 1559, 1560, 1594–95 (2017) (discussing how bank regulation may include both *ex post* regulation and *ex ante* (command-and-control) regulation).

5. *See* James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After* Dura Pharmaceuticals, 95 GEO. L.J. 653, 667–68 (2007) (describing damages requirements under both the tort of fraud and federal statutory securities fraud claims).

6. *See* Henderson & Spindler, *supra* note 4, at 1594–95 (discussing the prevalence of command-and-control regulations in stable industries, such as energy production); Daniel H. Cole & Peter Z. Grossman, *When Is Command-and-Control Efficient? Institutions, Technology, and the Comparative Efficiency of Alternative Regulatory Regimes for Environmental Protection*, 1999 WIS. L. REV. 887, 914 (arguing that command-and-control regulation can be efficient given certain conditions). Other aspects of financial services such as insurance (largely regulated at the state level) and asset management (by the SEC) are treated similarly. Utilities and healthcare are other obvious examples with significant command-and-control regulation. *See* Omar Al-Ubaydli & Patrick McLaughlin, *RegData: A Numerical Database on Industry-Specific Regulations for All United States Industries and Federal Regulations, 1997–2012*, 11 REG. & GOVERNANCE 109, 119 (2017) (quantifying the degree to which various industries are regulated). The methodology is based on a count of binding constraints in the Code of Federal Regulations, aggregated at the industry level. Various aspects of financial services, utilities, and resource extraction make up four of the top five most heavily regulated industries. *See* Patrick McLaughlin & Oliver Sherouse, *The McLaughlin-Sherouse List: The 10 Most-Regulated Industries of 2014*, MERCATUS (Jan. 21, 2016), https://www.mercatus.org/publications/regulation/mclaughlin-sherouse-list-10-most-regulated-industries-2014 [https://perma.cc/6J72-ER9N] (listing petroleum and coal products manufacturing, electric power generation, nondepository credit intermediation, and depository credit intermediation as four of the top five most-regulated industries in 2014).

7. *See* Accountable Capitalism Act, S. 3215, 116th Cong. § 6(b)(1) (2020) ("Not less than 2⁄5 of the directors of a United States corporation shall be elected by the employees of the United States

such requirements—where a certain constituency is granted governance representation by legislative or regulatory act—as "constituency mandates." California's Assembly Bill 979 requires boards to include, based on the size of the board, scheduled numbers of females and members of "underrepresented communities," subject to self-identification.[8] Nasdaq has recently proposed a similar rule for listed companies.[9] We refer to these as "diversity mandates," which differ from constituency mandates in that the diverse director is not required to be appointed or elected by any particular constituency.

The main motivation for these mandates is the conjecture that inclusive boards will, somehow, make better decisions than laissez-faire, market-constituted boards. This is premised, at least in some cases, on the belief that different demographic groups (or combinations thereof) manifest different preferences or even abilities.[10] An alternative is that inclusion mandates

corporation"); Elizabeth Warren, *Accountable Capitalism Act*, ELIZABETH WARREN, https://www.warren.senate.gov/imo/media/doc/Accountable%20Capitalism%20Act%20One-Pager.pdf [https://perma.cc/42SY-5PLR] (requiring a United States corporation to ensure that at least 40% of the corporation's directors are selected by the corporation's employees). According to Senator Warren's description of the Act, the Act is motivated by a desire to "balance the interests of all of [American corporations'] stakeholders, including employees, customers, business partners, and shareholders," by encouraging corporate long-term reinvestment (as opposed to shareholder distributions) to produce "broad-based growth." *Id.*

8. *See* A.B. 979, 2019–2020 Cal. Assemb., Reg. Sess. (Cal. 2020), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/B8QM-JREW] (requiring a minimum number of corporate directors to be from underrepresented communities depending on the size of the corporation's board).

9. *See* Press Release, Nasdaq, Nasdaq to Advance Diversity through New Proposed Listing Requirements (Dec. 1, 2020), https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01 [https://perma.cc/L2AF-5YMF] (requiring most Nasdaq-listed companies to have diverse directors with at least one identifying as female and at least one other identifying as an underrepresented minority); The Nasdaq Stock Mkt. LLC, Self-Regulatory Organization Filing of Proposed Rule Changes (Form 19b-4) 3 (Dec. 1, 2020), https://listingcenter.nasdaq.com/assets/RuleBook/Nasdaq/filings/SR-NASDAQ-2020-081.pdf [https://perma.cc/PLB3-P487] [hereinafter Nasdaq (Form 19b-4)] (proposing the adoption of a diverse-board-representation rule to require Nasdaq companies to have at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority or to explain why the board does not meet this diversity rule). Board diversity also typically counts toward ESG ratings, which are increasingly of concern to companies as ESG investing grows in prominence. *See* Neesha-ann Longdon, Dimitri Henry & Caitlin Harris, *Diversity and Inclusion as a Social Imperative*, S&P GLOBAL RATINGS (Aug. 3, 2020), https://www.spglobal.com/ratings/en/research/articles/200803-environmental-social-and-governance-diversity-and-inclusion-as-a-social-imperative-11573860 [https://perma.cc/23CE-LVYY] (stating that a decline in ESG performance—which may come from failing to develop an inclusive workforce—can result in a loss of both customers and profit); *Making Sense of ESG*, PWC: IN THE LOOP (Oct. 29, 2020), https://www.pwc.com/us/en/cfodirect/publications/in-the-loop/esg-reporting-controls.html [https://perma.cc/5QYC-PLDJ] (articulating how investment strategies increasingly involve ESG, which leads to investors calling on companies to promote enhanced diversity and inclusion practices).

10. *See* A.B. 979 § 1(r), 2019–2020 Cal. Assemb., Reg. Sess. (Cal. 2020), http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/7SDB-

promote persons or groups with better incentives into the boardroom, leading to more pro-social corporate decisions.

The question of whether governance-inclusion mandates will lead to better social decisions, and why, is one that we address in this Article. Conceptually, there is a vast continuum of potential inclusion mandates from which the policy designer may pick. At the one end lie decisions made by a narrow constituency, such as the corporate board or even just the company's founder, with little if any accountability to anyone other than, perhaps, shareholders.[11] At the other end lies full democratization, in which an enterprise is run by the public or its government representatives. In between, there exists a panoply of demographic choices (perhaps give the local townsfolk a say? creditors? labor? trade partners?). These may be coupled with various accountability mechanisms (do minorities get to choose the minority directors, or does the board nominate them and the shareholders at large elect them?). Finally, once a party or group is given a seat at the table, it must be decided what are to be the rights and responsibilities that those constituents shall bear. Shareholders bear the potential loss of their investments, but it is not obvious what value an included person or group ought to put at risk. Thus, there is a great degree of freedom in how one may design an inclusion mandate—but, to date, there is little analysis of how they should be designed.

To address the question of how to engineer governance inclusivity, this article's analysis proceeds from two principal assumptions about what it means to be included in corporate governance and, in particular, in the corporate boardroom. First, the boardroom represents a sort of Coasian[12]

AGLD] ("More racially and gender diverse boards further the goals of the Sarbanes-Oxley Act of 2002, which pushed for more independent boards that decrease the likelihood of corporate fraud.").

11. Accountability to rank-and-file shareholders is not a given. Technology companies such as Google and Facebook have gone public with voting structures that entrench control in the hands of founders or important executives. *See* Lucian A. Bebchuk & Kobi Kastiel, *The Perils of Small-Minority Controllers*, 107 GEO. L.J. 1453, 1457 (2019) ("Companies have increasingly gone public with dual-class structures, including well-known names such as Alphabet (formerly Google), Berkshire Hathaway, Facebook, Ford, News Corp, Nike, and Viacom."). Prior to such developments, there has been a long-running debate over whether shareholders can and do exercise meaningful control over public companies. *See, e.g.*, Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 UNIV. CHI. L. REV. 751, 754 (2002) (putting forth the "managerial power approach" to account for the design of executive compensation, in which executives have the ability to "influence their own compensation schemes").

12. *See* R. H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 1 (1960) (examining the "actions of business firms which have harmful effects on others"). As discussed more fully below in Part III, a primary insight of Coase's work was that, absent transactions costs, private parties would be able to contract to a socially optimal result. *See id.* at 5–6 (explaining how contracting would optimize the allocation of resources between a hypothetical rancher and farmer). Also, while there is some difference of opinion on the spelling of the term "Coasian," we use the spelling used by Ronald Coase himself. *See* Peter Klein, *Coasian or Coasean?*, ORGS. AND MKTS. (Mar. 20,

bubble, in which its participants are able to bargain efficiently (or, at least, to a significantly greater degree than those outside it).[13] Second, directors' privileges represent a property right in that those possessing them will garner a greater fraction of corporate surplus, *ceteris paribus*, than those without. Overall, then, inclusion in the boardroom is a valuable right, and those so included will use it to maximize their objectives, whatever those may be. With such tools at hand, it is possible to say something about the channels through which inclusion mandates work and which types of inclusion mandates might have socially beneficial effects.

First, inclusion mandates have the salutary quality of allowing the firm to make its own decisions based on its own information and without relying upon the interference or guidance of government. In contrast, command-and-control regulation imposes restrictions or mandates based on what the regulator knows, which is likely to be significantly less than private actors; and *ex post* litigation depends upon lawmakers or courts writing administrable rules by which to redress easily identifiable harms. This distinction is becoming more important as corporations grow in size and influence and continue to innovate new business models and technologies; the ability of regulators to keep up with these developments is limited, as evidenced by the fact that much new command-and-control regulation is developed after crisis events.[14] Inclusion mandates, if they work, are a potential fix to such problems.

Second, by themselves, inclusion mandates do not necessarily change corporate behavior, though they certainly reapportion surplus; the parties in the Coasian bubble of the directors' room will engage in joint-welfare maximization, just as did those who occupied it in the status quo ante. Putting aside externalities (an important carve-out, addressed next), inclusion mandates should lead to little change in corporate behavior: the newly included constituencies will wish to maximize their newly awarded share of the corporate surplus and will generally engage in the same activity,

2011), https://organizationsandmarkets.com/2011/03/20/coasian-or-coasean/ [https://perma.cc/9PKJ-4QXN] (expressing that Coase used the spelling "Coasian" to refer to his own theory).

13. For a different and contrasting model of board inclusion, see Jens Dammann & Horst Eidenmueller, *Taming the Corporate Leviathan: Codetermination and the Democratic State* 41 (European Corp. Governance Inst., Working Paper No. 536/2020, 2020), which argues that including labor on the board prevents the corporation from effectively profit-maximizing.

14. *See, e.g.*, Howard H. Preston, *The Banking Act of 1933*, 23 AM. ECON. REV. 585, 585–87 (1933) (regarding the passage of the Banking Act of 1933 as a response to the Great Depression); Barack Obama, U.S. President, Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009) (transcript available at https://obamawhitehouse.archives.gov/the-press-office/remarks-president-regulatory-reform/) [https://perma.cc/JD5S-B7CQ]) (containing the speech of President Obama announcing reform initiatives in response to the financial crisis of 2007–2008, which ultimately led to the Dodd-Frank legislation). *See also infra* note 25.

regardless of social desirability.[15] The situation is essentially that of swapping out one set of business owners for another.

The third result comprises the two exceptions to this "same activity" result. First, inclusion can improve the ability of constituents of the corporation to contract, and therefore improve the efficiency of the outcome vis-à-vis the maximization of corporate surplus.[16] Second, and arguably more importantly, at least from a societal standpoint, is that inclusion will lead to socially beneficial changes where the included group would expect to bear what would otherwise be externalized harm. Representation of such a group changes the joint-welfare maximization calculus to take into account such harms. If the firm dumps its trash on constituency A, for example, putting constituency A's representative on the board might lead to discontinuing such practices.

Fourth, these improvements require that the board representative actually be accountable to the constituency she represents; if not, then her preferences do not fully internalize that of her constituency for purposes of the joint-welfare maximization. She could be co-opted or bought off, as her preferences are relatively small in intensity compared to that of the group from which she is drawn. This is a principal difference between constituency mandates and diversity mandates. While a more diverse board may enable a corporation to better achieve its stated purpose, a diversity mandate is unlikely to effect changes to that purpose since the mandates simply require that the board nominate, and the shareholders elect, an atomistic member of that group.[17] In contrast, by placing the board seat under the control of the

15. This relies on the ability to contract within the Coasian bubble. If suitable contracts cannot be written, then factors such as risk aversion of the included constituency could lead to changes in corporate decisions, such as increased conservatism, which we discuss in more detail in Part V. For a detailed discussion of the theoretical constraints that would face a firm entirely owned by labor, see Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 493 (1979).

16. An example, discussed in more detail below, is when including labor representation on a board overcomes contracting issues that keep employees from making efficient investments in firm-specific human capital. For a theoretical model and associated empirical tests, see Eirik G. Furubotn & Steven N. Wiggins, *Plant Closings, Worker Reallocation Costs and Efficiency Gains to Labor Representation on Boards of Directors*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 176, 187 (1984).

17. An emerging body of empirical literature addresses the potential benefits of more diverse boards, and this line of reasoning is behind many of the efforts to mandate a minimum level of board diversity. Much of the literature in support of this position is done by advocacy groups or consultants. *See, e.g.*, Vivian Hunt, Sara Prince, Sundiatu Dixon-Fyle & Kevin Dolan, *Diversity Wins: How Inclusion Matters*, MCKINSEY & COMPANY 3 (2020), https://www.mckinsey.com/~/media/McKinsey/Featured%20Insights/Diversity%20and%20Inclusion/Diversity%20wins%20How%20inclusion%20matters/Diversity-wins-How-inclusion-matters-vF.pdf [https://perma.cc/HP63-5HF4] ("This report shows not only that the business case remains robust, but also that the relationship between diversity on executive teams and the likelihood of financial outperformance is now even stronger than before."). The academic literature is more circumspect

represented constituency, constituency mandates can both improve the effectiveness of the corporation (by improving contracting) and change its purpose, by integrating the preferences of that full group into the joint-welfare maximization calculus.

Fifth, the value at risk of an included person or group can serve as a useful lever to push incentives in a pro-social direction. A constituency with much to lose from a corporate meltdown may help steer the corporate ship away from such meltdowns. Such interests may also be synthesized with *ex post* liability: if a constituency has control over corporate activity, then imposing liability on that constituency for corporate wrongs can lead to better corporate behavior. This has implications for policy issues such as bailouts (namely, represented constituents should generally not be bailed out) as well as the reach of corporate liabilities. In other words, inclusion mandates can provide a potential deep pockets defendant, overcoming problems of limited liability and judgment proofness that often accompany corporate malfeasance.[18]

Sixth, depending on how the constituency's claims on the firm are structured, corporate incentives may actually be worsened by an inclusion mandate. That is, if an included constituency obtains benefits that are not sensitive to corporate performance (or social outcomes), the firm is effectively less well-capitalized, and the constituency may drive corporate behavior in less desirable directions. Such results may be mitigated by subjecting the constituency to corporate losses or legal liability for corporate malfeasance.

Based on these insights, this article then provides guidance for the proper design of pro-social inclusion mandates, as well as some practical limitations on the scope of what inclusion mandates can accomplish.

* * *

Part I of this Article describes how U.S. corporate law has, traditionally, dealt with the question of corporate purpose. Part II describes inclusion mandates and proposals in the United States. Part III sets forth an economic analysis of inclusion mandates, relying on the Coase theory, and states the main results of the Article. Part IV discusses the case of labor inclusion in

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regarding the benefits of increased diversity. See Corinne Post & Kris Byron, *Women on Boards and Firm Financial Performance: A Meta-Analysis*, 58 ACAD. MGMT. J. 1546, 1557–58 (2015), who perform a meta-analysis and find limited effects on accounting variables and no effect on financial performance from greater board diversity. *See also* Jenny M. Hoobler, Courtney R. Masterson, Stella M. Nkomo & Eric J. Michel, *The Business Case for Women Leaders: Meta-Analysis, Research Critique, and Path Forward*, 44 J. MGMT. 2473, 2481 (2018) (examining female corporate leaders more generally and finding mixed results). For a recent academic treatment supporting the benefits of diversity, see Daehyun Kim & Laura T. Starks, *Gender Diversity on Corporate Boards: Do Women Contribute Unique Skills?*, 106 AM. ECON. REV. 267, 268–69 (2016).

18. *See infra* notes 22–24 and accompanying text.

Europe, on which there is significant economic and empirical literature, and interprets those results through the Coasian approach developed here. Part V concludes with a brief analysis of current mandates and proposals.

I. The Traditional Approaches to Corporate Purpose

A. *The Shareholder Wealth Maximization Norm and Its Limits*

The size and importance of modern corporate entities have given rise to concerns over whether the current system of corporate regulation is adequate. The traditional means for constraining business entity behavior has been to encourage firms to maximize their value but subject them to other legal requirements.[19] Corporate law itself has focused primarily on ensuring that management faithfully fulfills its value-maximization mandate on behalf of the firm's owners (which itself is subject to some interpretation), while leaving social congruence to other areas of law, such as tort, environmental, and securities law.[20]

These areas of outside, business-regulating, social-regarding law are typified by a mix of *ex post* liability and command-and-control regulation. *Ex post* liability regimes, as in the tort and securities context, subject the corporation to liability in the form of private litigation brought by injured persons or by public enforcers, such as state attorneys general on behalf of the public. Command-and-control focuses on activities in which dangers are considered too great or the potential harms too dispersed to be effectively

19. *See, e.g.*, Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html [https://perma.cc/J55N-Q3EP] ("[The corporate executive's] responsibility is to conduct the business in accordance with [the owners'] desires, which generally will be to make as much money as possible while conforming to the basic rules of the society . . . .").

20. *See id.* Friedman explained:

> Many a reader who has followed the argument this far may be tempted to remonstrate that it is all well and good to speak of government's having the responsibility to impose taxes and determine expenditures for such "social" purposes as controlling pollution or training the hard-core unemployed, but that the problems are too urgent to wait on the slow course of political processes, that the exercise of social responsibility by businessmen is a quicker and surer way to solve pressing current problems.
>
> Aside from the question of fact—I share Adam Smith's skepticism about the benefits that can be expected from "those who affected to trade for the public good"—this argument must be rejected on grounds of principle. What it amounts to is an assertion that those who favor the taxes and expenditures in question have failed to persuade a majority of their fellow citizens to be of like mind and that they are seeking to attain by undemocratic procedures what they cannot attain by democratic procedures.

Id. But see Paul Krugman, *Why Libertarianism Doesn't Work, Part N*, N.Y. TIMES: PAUL KRUGMAN (May 14, 2010, 1:40 PM), https://krugman.blogs.nytimes.com/2010/05/14/why-libertarianism-doesnt-work-part-n/ [https://perma.cc/7KHX-JHEC] (criticizing the effectiveness of letting lawsuits inspire social responsibility given liability limits).

remedied by *ex post* litigation, and where the government regulators have significant subject matter expertise. Areas subject to prominent command-and-control include financial services, with prudential regulation designed to ensure the stability of the wider economy; utilities, where natural monopolies are closely monitored to ensure they do not abuse their market power; and industries or activities that pose risks of large environmental harms, such as mineral extraction and energy production.[21]

There are weaknesses in these traditional approaches that seem to be especially pertinent in modern times. Insolvency (or even the potential to become insolvent) undermines the incentives imposed by legal penalties, and recent economic history illustrates that certain business entities have the ability to amplify risk and inflict vast harm that they are, after all the dust has settled, unable to repay. Of recent note, environmental damage (such as PG&E),[22] financial meltdowns (such as Lehman and AIG),[23] or plain corporate failures (such as GM)[24] threaten harm far outstripping corporate resources, which render toothless additional financial penalties and also sometimes lead to taxpayer-funded bailouts or clean-ups. Corporate insolvency, combined with the limited liability of shareholders and other financial stakeholders, creates the problem of judgment proofness, and creates a risk that companies will take actions that may, *ex ante*, benefit themselves at the expense of overall social welfare, even in the presence of otherwise good laws and regulations.

Further, the ability of regulators to adapt to changing business conditions is debatable. Many examples of command-and-control regulation are written *ex post*, only after a crisis of some kind imposes large costs on society. An obvious and recent example is Dodd-Frank, enacted in the aftermath of the global financial crisis; but in fact post-crisis regulation has

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21. *See* McLaughlin & Sherouse, *supra* note 6 (listing the ten industries with the most regulatory restrictions, including: nondepository credit intermediation; depository credit intermediation; electric power generation, transmission, and distribution; petroleum and coal products manufacturing; and oil and gas extraction).

22. *See* Ivan Penn, *PG&E's Bankruptcy Filing Creates a 'Real Mess' for Rival Interests*, N.Y. TIMES (Jan. 29, 2019), https://www.nytimes.com/2019/01/29/business/energy-environment/pge-file-bankruptcy.html [https://perma.cc/R6R3-SGVJ] (explaining that PG&E's bankruptcy would likely prevent payouts for some of the wildfire damage it caused).

23. *See* Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1153 (2010) (noting that the losses on troubled financial assets assumed by Fannie Mae and Freddie Mac were borne by taxpayers); Daisy Maxey, *Expense Tally for Reserve Primary Since 'Breaking Buck': $16.6 Million*, WALL ST. J. (June 13, 2009, 11:59 PM), https://www.wsj.com/articles/SB124485814552011899 [https://perma.cc/6A6A-ULK2] (explaining how news of Lehman's failure "sent panic through the money-market fund industry and prompted the Treasury Department to offer a temporary guaranty program for money-market funds, set to expire in September").

24. Eric Beech, *U.S. Government Says It Lost $11.2 Billion on GM Bailout*, REUTERS (Apr. 30, 2014, 10:03 AM), https://www.reuters.com/article/us-autos-gm-treasury/u-s-government-says-it-lost-11-2-billion-on-gm-bailout-idUSBREA3T0MR20140430 [https://perma.cc/9WCY-DVM6].

been a long-standing pattern in financial services, harkening back to at least the Great Depression.[25] There are a variety of reasons to believe that the potential externalities imposed on society by large companies have likely worsened over the past few decades. Industrial concentration, as measured by the Herfindahl-Hirschman Index, has risen by 60% in the U.S. since 2000, with increases occurring in over three-fourths of non-financial sectors.[26] This has engendered a robust debate about market power—certainly, if the large firms that have aggregated market share have accumulated market power, then they are likely to be extracting surplus from a variety of constituents, including labor and consumers.[27] Even if the corporate winners in today's economy do not have market power, increasing size and concentration itself can generate negative externalities. Consider the stereotypical "one-factory town"—the entire local economy is exposed to financial distress at that factory, which it does not internalize (and which a local bodega does not generate). Such exposure of parts of the country to the auto industry was in part the motivation for bailing out GM.[28]

Further, business conditions are evolving rapidly, and regulators in the U.S. (and globally) are struggling to keep up. For example, the advent of the

25. Financial regulation passed in the wake of the Great Depression included the Banking Act of 1933 (which created the FDIC and instituted the Glass-Steagall separations of commercial and investment banking), the Securities Act of 1933, and the Securities Exchange Act of 1934 (which established the SEC). The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) was passed in 1989 during the savings and loan crisis. For a discussion of the historical context behind the major advances in financial regulation in the U.S., see generally Alejandro Komai & Gary Richardson, *A Brief History of Regulations Regarding Financial Markets in the United States: 1789 to 2009* (Nat'l Bureau of Econ. Research, Working Paper No. 17443, 2011), http://www.nber.org/papers/w17443 [https://perma.cc/84DR-UF7G].

26. Jeff Meli, Jonathan Millar & Adam Kelleher, *Increased Corporate Concentration and the Influence of Market Power*, 5 BARCLAYS IMPACT SERIES 4, 31 (2019), https://www.investmentbank.barclays.com/content/dam/barclaysmicrosites/ibpublic/documents/our-insights/MarketPower/Barclays-ImpactSeries5-MarketPower_final_2.4MB.pdf [https://perma.cc/DX4G-P6R8].

27. Simcha Barkai, *Declining Labor and Capital Shares*, 75 J. FIN. 2421, 2449 (2020) finds a link between lower labor share of output and increased concentration and corporate profits. One possible interpretation of this phenomenon is that increased concentration has reduced competition. Germán Gutiérrez & Thomas Philippon, *Declining Competition and Investment in the U.S.* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 23583, 2017), https://www.nber.org/papers/w23583 [https://perma.cc/GB7A-FP8C] associate increased concentration with a decline in competition in the U.S., and a corresponding reduction in investment in the corporate sector. An alternative explanation is that competition has actually increased, and as a result the most successful firms aggregate market share, but that this represents increased efficiency, not a rise in market power. *See* David Autor, David Dorn, Lawrence F. Katz, Christina Patterson & John Van Reenen, *The Fall of the Labor Share and the Rise of Superstar Firms*, 135 Q.J. ECON. 645, 648 (2020) (arguing that market concentration may be due to highly productive firms responding efficiently to changing market conditions).

28. *See* Mitchell Hartman, *What Did America Buy with the Auto Bailout, and Was It Worth It?*, MARKETPLACE (Nov. 13, 2018), https://www.marketplace.org/2018/11/13/what-did-america-buy-auto-bailout-and-was-it-worth-it/ [https://perma.cc/MQX3-V749] (citing a researcher's statement that the bailout prevented catastrophe for auto-dependent communities across the Upper Midwest).

gig economy has raised questions about how to define employment, as certain large technology companies potentially push protections usually afforded to employees through the business cycle onto society at large (e.g., through the extensive use of contractors as opposed to permanent employees, who are afforded benefits, severance, unemployment insurance, and such). California's recent attempt to address these issues through legislation was rejected by voters.[29]

Large and sophisticated entities also appear to be developing an edge relative to government itself. In some cases, the financial resources or sophistication of the regulated outweigh those of the regulators.[30] Innovation and technological development frustrate established methodologies of command-and-control. And it is increasingly argued that certain entities, whether through lobbying, government influence, or monopoly power, have the ability to subvert government itself. Facebook was widely blamed, for instance, for allowing Russian ads and misinformation leading to the election of Donald Trump.[31] In more recent times, Twitter and Facebook have de-platformed the President of the United States,[32] which presents a troubling display of power, even if wielded responsibly in this instance.

The goalposts have also moved. Issues such as social inequality, environmental concerns such as global warming, and even the preservation of American democracy have come to the fore.[33] It is hard to conceive of our traditional judicial system dealing competently with such issues, which present the specter of dispersed, unquantifiable, or inchoate harms. Command-and-control in some contexts may create an unwelcome intrusion of government, as it might if government were to attempt to substantively

29. Kate Conger, *Uber and Lyft Drivers in California Will Remain Contractors*, N.Y. TIMES (Nov. 4, 2020), https://www.nytimes.com/2020/11/04/technology/california-uber-lyft-prop-22.html [https://perma.cc/PZE5-HP4P].

30. For example, despite repeated whistleblower complaints made to the SEC, the Bernie Madoff Ponzi scheme was allowed to persist for sixteen years due to SEC inexperience, incompetence, and poor incentive structures. *See* OFFICE OF INSPECTOR GEN., U.S. SEC. & EXCH. COMM'N, CASE NO. OIG-509, REPORT OF INVESTIGATION: INVESTIGATION OF FAILURE OF THE SEC TO UNCOVER BERNARD MADOFF'S PONZI SCHEME (2009), https://www.sec.gov/files/oig-509-exec-summary.pdf [https://perma.cc/R2PW-CNGS] (cataloging the various complaints, investigations, and news articles about Madoff's fraud that the SEC inexplicably failed to act on).

31. *See* Scott Shane, *The Fake Americans Russia Created to Influence the Election*, N.Y. TIMES (Sept. 7, 2017), https://www.nytimes.com/2017/09/07/us/politics/russia-facebook-twitter-election.html [https://perma.cc/84SK-N4VU] (noting that Facebook and Twitter did not stop their platforms "from being turned into engines of deception and propaganda" prior to the 2016 election).

32. Georgia Wells, Jeff Horwitz & Deepa Seetharaman, *Twitter, Facebook Lock Trump Out of His Accounts*, WALL ST. J. (Jan. 6, 2021, 9:56 PM), https://www.wsj.com/articles/facebook-and-twitter-take-steps-to-remove-calls-for-violence-as-protesters-storm-u-s-capitol-11609971394 [https://perma.cc/N3U6-BTM6].

33. *See, e.g.*, Dammann & Eidenmueller, *supra* note 13, at 18 ("[C]oncentrations of corporate power that are so extreme as to undermine the functioning of our democratic institutions are incompatible with democratic processes and principles.").

regulate media companies. It would be much less troubling if business could simply be induced to behave in a more responsible fashion, whatever that entails.

B. Legal Approaches to the Judgment Proofness and Insolvency Problems

There have been some important developments addressing weaknesses in the traditional approach, largely aimed at the problems of corporate insolvency and judgment proofness. As a consequence of the ability to amplify risk and become insolvent overnight, methods of overcoming the general norm of limited liability for shareholders and, importantly, even stakeholders have become relatively common in the wake of corporate implosions. These legal mechanisms of shareholder and stakeholder liability are relevant when considering inclusion mandates, and thus a brief discussion of them here is warranted.

To first set the baseline, American corporate law, or at least the modern treatment of it, has tended to focus largely on what could be termed the problem of disloyal managers: how does one structure a business entity, whose capital is provided by remote and largely passive shareholders, to ensure that it is run by management for the benefit of those owners?[34] This is the familiar problem of the separation of ownership and control, most famously, if not first, elucidated in economic terms by Jensen and Meckling.[35] Methods in law and practice to solve the problems of disloyal management include shareholder election of the board and precise rules for

34. *See, e.g.*, Dorothy S. Lund & Elizabeth Pollman, *The Corporate Governance Machine*, COLUM. L. REV. (forthcoming 2021) (manuscript at 10), http://ssrn.com/abstract_id=3775846 [https://perma.cc/38XA-MDCU] (asserting that modern corporate governance has converged on ensuring faithful representation of shareholder interests).

35. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312 (1976) (explaining the inherent agency costs in the typical corporate form, which separates ownership and control). Legal attempts to address the problems of remote ownership and potentially disloyal agents date back to ancient times. Roman patriarchs, for example, could entrust family members (in the *pater familias*) or his slaves (in the *peculium*) with a business or property, and enjoyed agency-like protections; some commentators believe these prefigure modern organizational entities. *See* Henry Hansmann, Reinier Kraakman & Richard Squire, *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1357–60 (2006) (explaining how Roman families transacted business as a family unit or through its slaves, thus enjoying collective property ownership, credit cost shielding and other agency-like privileges). *See also* OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 51, 56–58 (Peter Smith 1952) (1920) (recognizing that agency principles were applied in the master and slave dynamic in ancient Roman culture). The idea of fiduciary duties as a stand-alone has been traced back to medieval English courts, in the context of feoffments or other property held in trust for the owner/grantor or his heirs. *See* David J. Seipp, *Trust and Fiduciary Duty in the Early Common Law*, 91 B.U. L. REV. 1011, 1034–36 (2011) (examining English judicial remedies' inherent characteristics of bestowing fiduciary duties on those who held temporary control over the property of another).

the delegation of authority within the corporate entity;[36] the creation of legal obligations such as fiduciary duties, which constrain self-dealing and require candor;[37] and baroquely detailed rules for what counts as actionable and non-actionable fiduciary conduct in contexts such as mergers and acquisitions.[38] More recent innovations have focused on issues such as the design and disclosure of incentive compensation, intended to align the incentives of managers with shareholders,[39] and evolving shareholder access to the corporate proxy.[40] Overall, the thrust of such mechanisms is to cause the managers to operate the firm to maximize corporate enterprise value. For a solvent firm, this is equivalent to maximizing shareholder value.

The corporate law itself and its academic commentators say relatively little about what should happen when the owners of a corporation behave badly with regard to outsiders—what one might term the "bad shareholder" problem.[41] That is, what should the consequences be when the shareholders cause (or allow) the corporation to undertake activity that *ex ante* benefits the firm, its current shareholders, or both, but presents the risk of harm to outsiders (or future shareholders) and leaves the corporation unable to pay for the damage that it has done? As a general rule, the limited liability of shareholders, under which shareholders only lose their contributions to the

36. *See, e.g.*, TEX. BUS. ORGS. CODE ANN. § 21.359 (West 2006) ("[D]irectors of a corporation shall be elected by . . . holders of shares.").

37. *See* Seipp, *supra* note 35, at 1034 (explaining that the creation of fiduciary duties owed by tenants to landlords required a reasonable accounting of money owed).

38. *See, e.g.*, Recent Case, *In re* Smurfit-Stone Container Corp. Shareholder Litigation, *No. 6164-VCP, 2011 WL 2028076 (Del. Ch. May 24, 2011)*, 125 HARV. L. REV. 1256, 1260 (2012) (detailing doctrinal treatment of merger consideration in the application of fiduciary duties).

39. *See* Proxy Disclosure Enhancements, Securities Act Release No. 9089, Exchange Act Release No. 61,175, Investment Company Act Release No. 29,092, 74 Fed. Reg. 68,333, 68,354 (Dec. 23, 2009), https://www.govinfo.gov/content/pkg/FR-2009-12-23/pdf/E9-30327.pdf [https://perma.cc/RJ7P-AE65] (describing enhanced mandatory disclosures about executive compensation); James C. Spindler, *Hidden Costs of Mandatory Long-Term Compensation*, 13 THEORETICAL INQUIRIES IN L. 623, 626–27 (2012) (analyzing the effect of mandatory long-term compensation reforms and arguing that they are likely counterproductive).

40. *See* Facilitating Shareholder Director Nominations, Securities Act Release No. 9136, Exchange Act Release No. 62,764, Investment Company Act Release No. 29,384, 75 Fed. Reg. 56,667, 56,669 (Sept. 16, 2020), https://www.govinfo.gov/content/pkg/FR-2010-09-16/pdf/2010-22218.pdf [https://perma.cc/9TM4-MZ6Y] (discussing a change in federal proxy rules in order to give shareholders greater insight and control into and over company management).

41. For examples of the relatively few treatments of the bad shareholder problem, see generally Squire, *supra* note 23; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010); James C. Spindler, *Optimal Deterrence When Shareholders Desire Fraud*, 107 GEO. L.J. 1071 (2019); and James Cameron Spindler, *Vicarious Liability for Managerial Myopia*, 46 J. LEGAL STUD. 161 (2017).

corporation and their future claims upon it, leaves creditor and judgment-creditor claims against the corporation frustrated.[42]

But exceptions to that rule do exist, and they are important in the modern world of business entities. Some small degree of protection for creditors is to be found in corporate statutes, such as those that limit shareholder distributions to surplus and (largely defunct) legal capital requirements.[43] But greater protections of outsiders arise from other areas. One of the better-known ways to confront the bad shareholder problem is the concept of shifting fiduciary duties in insolvency, in which management is held responsible for maximizing enterprise value, as opposed to just shareholder returns, as residual claimant status shifts from shareholders to creditors.[44] Additionally, violations of law are generally held to violate management's fiduciary duties, even if such violations would otherwise work to the benefit of shareholders.[45] These management-based recoveries, however, are underwhelming, posing both standing difficulties and a judgment proofness problem of their own. A derivative recovery against management for activity that benefits shareholders (at least in expectation) is a tenuous deterrent mechanism when the same shareholders are the only ones entitled to wield it, although such defects can sometimes be remedied.[46] Further, the attachable resources of management are likely paltry as compared to the scope and

42. *See* STEPHEN M. BAINBRIDGE & M. TODD HENDERSON, LIMITED LIABILITY: A LEGAL AND ECONOMIC ANALYSIS 9 (2016) (describing the general rule (and exceptions thereto) that corporate creditors can satisfy their claims only against assets of the firm, not its shareholders).

43. *See, e.g.*, John Mulford, *Corporate Distributions to Shareholders and Other Amendments to the Pennsylvania Business Corporation Law*, 106 U. PA. L. REV. 536, 536–37 (1958) (outlining the prohibition on shareholder distributions from anything other than surplus in the Business Corporation Law of Pennsylvania); Richard A. Booth, *Capital Requirements in United States Corporation Law* 15 (2005) (unpublished manuscript) (on file with Villanova University Charles Widger School of Law) (explaining that rules involving capital surplus offer a small amount of protection for creditors).

44. *See* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007) (explaining that "[w]hen a corporation is insolvent . . . creditors take the place of the shareholders" as derivative beneficiaries of fiduciary duties) (emphasis omitted).

45. *See* David Rosenberg, *Delaware's "Expanding Duty of Loyalty" and Illegal Conduct: A Step Towards Corporate Social Responsibility*, 52 SANTA CLARA L. REV. 81, 86–87 (2012) (highlighting that although it is not exactly disloyal, approval of profit-motivated illegal activity is a breach of a director's fiduciary duty); Elizabeth S. Miller & Robert A. Ragazzo, 20A Texas Practice Series, Business Organizations (3d ed. November 2020) § 36:11 ("[D]irectors have a duty to observe the law" and "they stand to be liable for taking illegal action.").

46. For potential damages problems as well, see Rosenberg, *supra* note 45, at 87–88, which highlights the unique challenge of imposing damages in the context of an illegal, but shareholder value-maximizing, action, resulting in a morality-based duty of loyalty toward outsiders. Receivership plays an important role in cases where the firm was solvent at the time of the conduct, but was subsequently rendered insolvent, since combined action by the receiver or trustee (who accedes to claims of the corporation and the equity holders) and creditors eliminates standing issues that might otherwise arise. *See In re* Bernard L. Madoff Inv. Sec. LLC, 721 F.3d 54 (2d. Cir. 2013).

magnitude of corporate activities, and such actions may provide little by way of *ex ante* deterrence.

What is needed, instead, to solve the bad shareholder problem is some way to overcome the limited-liability constraint. Veil piercing and substantive consolidation provide a path to attach at least certain shareholders' assets, though the circumstances under which they apply are limited.[47] What has emerged to fill the gap, in light of catastrophic implosions such as the Madoff Ponzi scheme, are a host of remedies that target some form of participation in or control over the business entity's bad conduct.[48] Interestingly, these remedies do not stop at shareholders and provide for liability of creditors and counterparties. The relevant doctrines include fraudulent conveyance, aiding and abetting breach of fiduciary duties, aiding and abetting fraud, establishing a principal-agent relationship, piercing the corporate veil, control person status under various statutes, and so on.[49] While the details and doctrines of each are varied and thus defy concise summarization, one might approximate these causes of action as holding counterparties of the corporation liable where they knew or should have known that the corporation or its personnel were engaged in some activity that was wrongful. The fact that various stakeholders face liability is especially important in the modern context of business outsourcing: hedge funds, for instance, often have few employees and outsource many of their functions (e.g., fundraising, valuation, administration, custody, and accounting) to others, such that responsibilities (and the assets to execute them) lie largely outside the hedge fund entity itself. As discussed in Part III, stakeholder liability is an important consideration in the design and

47. *See* BAINBRIDGE & HENDERSON, *supra* note 42, at 3 (recognizing that the law surrounding veil piercing theory is "not at all clear"); William H. Widen, *Report to the American Bankruptcy Institute: Prevalence of Substantive Consolidation in Large Public Company Bankruptcies from 2000 to 2005*, 16 AM. BANKR. INST. L. REV. 1, 1–2 (2008) (highlighting the limited court treatment of substantive consolidation).

48. *See, e.g.*, Jacqueline Palank, *Fairfield Investors, Citco Settle Madoff-Related Lawsuit*, WALL ST. J. (Aug. 13, 2015, 11:47 AM), https://www.wsj.com/articles/fairfield-investors-citco-settle-madoff-related-lawsuit-1439480840 [https://perma.cc/TB6T-AR84] (describing settlements and lawsuits involving a Madoff feeder fund, the fund administrator, and the feeder fund's auditor).

49. *See* Booth, *supra* note 43, at 25–31 (discussing multiple doctrines, including fraudulent transfer statutes, piercing the corporate veil, and others); Kenneth C. Johnston, Kellie M. Johnson & Joseph A. Hummel, *Ponzi Schemes and Litigation Risks: What Every Financial Services Company Should Know*, 14 N.C. BANKING INST. 29, 29, 34–35 (2010) (discussing how financial institutions are one party that faces claims like "breach of fiduciary duty, negligence, negligent misrepresentation, fraudulent transfers, aiding and abetting fraud, and aiding and abetting breach of fiduciary duty"); Sarah Schiferl, *Aiding and Abetting Breach of Fiduciary Duty: Lawyer Beware*, AM. BAR ASS'N (May 23, 2017), https://www.americanbar.org/groups/litigation/committees/business-torts-unfair-competition/practice/2017/aiding-and-abetting-breach-of-fiduciary-duty-lawyer-beware/ [https://perma.cc/KNJ2-PZHS] (discussing aiding and abetting breach of fiduciary duties).

effectiveness of inclusion mandates, and current law does provide some precedent for holding included parties liable.

II. U.S. Inclusion Mandates and What They Are Supposed To Do

Recent laws and proposals go beyond the traditional approach to corporate purpose by mandating inclusion of certain persons or groups in the corporate board of directors.

The Accountable Capitalism Act, if enacted, would mandate that large U.S. business entities make several significant changes. Corporations, limited liability companies, and other "bod[ies] corporate" with greater than $1 billion in annual revenues would be required to obtain a federal charter,[50] granted by a newly-created Office of United States Corporations.[51] Subject companies are charged with "creating a general public benefit," and directors and officers are required to manage the corporation so as to create such benefit.[52] The company's charter would be subject to revocation if the corporation is found to have "engaged in repeated, egregious and illegal conduct."[53] Political contributions must be approved by shareholders and the board of directors.[54] Directors and officers would be restricted from selling off their equity interests within five years of the grant or within three years of a stock repurchase.[55] Perhaps the most significant change is that subject entities would be required to have 40% of their directors chosen by employees.[56]

California's Senate Bill No. 826, enacted in 2018, applies to a publicly held corporation with its principal executive office in California. It sets forth minimum mandatory numbers of female directors (subject to self-identification) for such corporations, based on the size of the board (e.g., boards of six or more directors must have no fewer than three female directors).[57] Senate Bill 826 contains a lengthy list of legislative findings, which include that:

- More women directors will "boost the California economy, improve opportunities for women in the workplace, and protect California taxpayers, shareholders, and retirees."
- Female directors lead to better performance like higher earnings, higher return on equity, greater price to book value, instituting

50. Accountable Capitalism Act, S. 3215, 116th Cong. §§ 2(4)(A), 4(a) (2020).

51. *Id.* § 3.

52. *Id.* § 5(b)–(c).

53. *Id.* § 9(c)(2)(A).

54. *Id.* § 8(b)(1).

55. *Id.* § 7(b)(1).

56. *Id.* § 6(b)(1).

57. S.B. 826, 2017–2018 Cal. S., Reg. Sess. § 2 (Cal. 2018), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB826 [https://perma.cc/N4FJ-DHJL].

stronger governance structures and "creat[ing] a sustainable future," better stock price performance, better performance during periods of recession, greater risk aversion, and taking less debt.

- Other countries such as Germany and Norway have instituted gender diversity quotas.
- Boards need to have "at least three women to enable them to interact and exercise an influence on the working style, processes, and tasks of the board."[58]

California's Assembly Bill No. 979 also applies to publicly held corporations whose principal executive office is located in California. It requires such corporations to have a minimum number of directors, based on the size of the board, from an "underrepresented community," defined as "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender."[59] As did Senate Bill 826, Assembly Bill 979 contains a lengthy recitation of legislative findings, which include:

- "[F]or every 10 percent increase in racial and ethnic diversity on the senior-executive team, earnings before interest and taxes rise 0.8 percent."
- "[T]he high tech industry could generate an additional $300 billion to $370 billion each year if the racial or ethnic diversity of tech companies' workforces reflected that of the talent pool."
- "Studies have shown that chief executive officers stand to gain from nondiverse boards. Studies have shown that culturally homogenous boards pay chief executive officers more than a culturally diverse board."
- "More racially and gender diverse boards further the goals of the Sarbanes-Oxley Act of 2002, which pushed for more independent boards that decrease the likelihood of corporate fraud."[60]

Nasdaq has recently proposed a diversity rule for listed companies.[61] The proposal would require most Nasdaq listed companies to provide statistical information on the diversity of the board and to "have, or explain why it does not have, at least two 'Diverse' directors on its board."[62] The term "Diverse" is defined as "a director who self-identifies as: (i) Female,

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58. *Id.* § 1.
59. A.B. 979, 2019–2020 Cal. Assemb., Reg. Sess. § 3 (Cal. 2020), https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979 [https://perma.cc/B8EE-7MYJ].
60. *Id.* § 1.
61. Nasdaq (Form 19b-4), *supra* note 9, at 1.
62. *Id.* at 6.

(ii) an Underrepresented Minority, or (iii) LGBTQ+."[63] According to the proposal, Nasdaq reviewed "dozens of empirical studies" and found that "diverse boards are positively associated with improved corporate governance and financial performance."[64] In particular, Nasdaq determined that:

> [C]ompanies with gender-diverse boards or audit committees are associated with: more transparent public disclosures and less information asymmetry; better reporting discipline by management; a lower likelihood of manipulated earnings through earnings management; an increased likelihood of voluntarily disclosing forward-looking information; a lower likelihood of receiving audit qualifications due to errors, non-compliance or omission of information; and a lower likelihood of securities fraud. In addition, studies found that having at least one woman on the board is associated with a lower likelihood of material weaknesses in internal control over financial reporting and a lower likelihood of material financial restatements. Studies also identified positive relationships between board diversity and commonly used financial metrics, including higher returns on invested capital, returns on equity, earnings per share, earnings before interest and taxation margin, asset valuation multiples and credit ratings.[65]

III. Inclusion Mandates and the Coasian Boardroom

A. *The Coasian Approach to Changing Corporate Behavior*

This section applies economic theory—and, in particular, the principle of Coasian bargaining and joint-welfare maximization—to examine the workings of inclusion mandates. The Coase theory stands for the proposition that, putting aside transaction costs, economic actors will bargain for the outcome that maximizes their joint welfare.[66] Such an outcome is economically efficient, in the sense that it maximizes the overall welfare of the bargainers and does not depend upon the initial allocation of legal or property rights.[67] In the example of Coase's original paper, a rancher's cattle might intrude upon and damage the neighboring farmer's fields; Coase's point was that the decisions of economic production did not depend upon whether the rancher was made liable for the damage, since, so long as the

63. *Id.* at 6.

64. *Id.* at 9.

65. *Id.* at 9–10.

66. *See* Coase, *supra* note 12, at 6 (noting that the Coase theorem predicts that when an economic actor engages in activity that harms another, the actors will bargain for a situation that maximizes the value of their combined production).

67. *See id.* (using the cattle-raiser–farmer hypothetical to illustrate that production will be maximized regardless of the initial property entitlement).

rancher and the farmer can bargain, they can achieve the efficient outcome (whether or not the rancher restrains his cattle, whether or not the farmer plants his fields, etc.).[68] Regardless of where the legal right is assigned, given efficient bargaining, the rancher and farmer should reach the same decision; if the grazing is more productive than the farming, they would jointly choose grazing, and vice versa. There are distributional consequences of the assignment of the right—assigning the right to the rancher makes him better off—but the decision as to the productive allocation of resources should not change. All bets are off, however, in the presence of significant transaction costs: if the rancher and farmer are unable to contract with one another, then the productive choice will generally not maximize their joint self-interest.[69] It is, of course, true that the assumption of costless, or even low-cost, bargaining is often unmet: transaction costs are real, contracts are incomplete, and markets do not exist for every conceivable good, service, or contingency.[70] But some situations are relatively low cost, and others, high cost, with Coasian joint-welfare maximization more or less likely, respectively, to take place.

Applying this to the corporate governance context, we conjecture that the corporate boardroom represents a "Coasian bubble," in which transaction costs associated with bargaining are indeed low. Those who are in the boardroom (or are faithfully represented in the boardroom) have about as good an ability as might exist to bargain with the corporation, and those outside of the corporate boardroom may have little or no opportunity for such bargaining. Inclusion in the boardroom is an opportunity to affect corporate behavior directly, and board meetings are an opportunity for debate, investigation, logrolling, and decision.[71] In contrast, the average Facebook user, for instance, has little ability to bargain with Facebook in any meaningful sense, apart from taking her business elsewhere; this is likely true even with regard to the aggregate mass of Facebook users. One of the principal effects of a corporate inclusion mandate is, therefore, that they affect who inhabits the Coasian bubble, in which transaction costs are low, and joint-welfare maximization can take place.

In many cases, the inclusion mandate's injection of a new player into the Coasian bubble of the boardroom will not affect corporate activity: joint-

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68. *Id.* at 6–8.

69. *See id.* at 16 (noting that "[o]ne arrangement of rights may bring about a greater value of production than any other" but that the costs to change rights distribution "may be so great that this optimal arrangement of rights, and the greater value of production which it would bring, may never be achieved").

70. Lee Anne Fennell, *The Problem of Resource Access*, 126 HARV. L. REV. 1471, 1478–79 (2013) ("[C]osts [from bargaining] are not zero, and indeed are routinely large.").

71. *See* WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 101–02, 105–08 (3d ed. 2009) (discussing the powers to direct corporate behavior given to board members).

welfare maximization of those inside the Coasian bubble will proceed just as before. If it was efficient for the corporation to manufacture widgets before the mandate, it is quite likely that the corporation will continue to manufacture those same widgets in the same way as before the inclusion mandate. This is similar to swapping out one shareholder for another; the changing identity of a corporation's owners will not typically change what it is that the corporation does.[72] If the preferences of investors A and B each consist of a desire to maximize their financial payoffs, then each will want the corporate entity to maximize profits and the net present value of shareholder distributions (equivalent, under fundamental asset-pricing theory, to share price). Unless they bring different information to bear on the issue, it is irrelevant to the corporation's direction which of investors A and B is the owner. Thus, the first prediction that one can draw is one of apparent frustration: for at least a large class of inclusion mandates (with important exceptions discussed below), corporate activity will remain invariant to inclusion of new persons or groups.

A second insight of the Coase theorem is that while the allocation of property rights may not (if transaction costs are low) affect the overall economic activity, it will affect the distribution of surplus arising from that behavior.[73] In the rancher–farmer context, making the rancher liable for trespass may not affect whether the cows trample the field, but imposing such liability does generally make the farmer better off and the rancher worse off.[74] In the inclusion mandate context, a board seat is equivalent to a property right: it confers the right to raise matters of procedure and inquiry, to guide and participate in corporate deliberations, and, most fundamentally, to vote on corporate decisions. With these powers—which create dynamics such as logrolling, agenda-setting, and holdout—those with board representation are more likely to get their way than those without it. As a general matter, inclusion mandates have the potential to take power, and thus value, away from shareholders and grant it to some other person or group.

Third, we can predict that, in two important classes of cases, inclusion mandates will change corporate behavior. The first is when inclusion may facilitate better contracting (say, between the firm and its employees or creditors) and, therefore, better achieve its existing goal of maximizing shareholder value.[75] Shareholders may benefit from more efficient outcomes, yet these benefits come at a cost, in the form of the corporate surplus that the

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72. *See* Julian Velasco, *The Fundamental Rights of the Shareholder*, 40 U.C. DAVIS L. REV. 407, 412 (2006) (arguing that "corporate law has never given shareholders very much power").

73. Coase, *supra* note 12, at 2–3.

74. *Id.*

75. For studies proposing such a channel, see *infra* Part IV.

now-included constituent can extract.[76] Note, however, that such changes of behavior are not necessarily pro-social and could, in fact, enable more rapacious but value-maximizing corporate conduct.

The other class of cases occurs when the new entrants have preferences that differ in a significant way from those occupying the Coasian bubble in the *status quo ante*. The main circumstance in which this will arise is where the included faction has payoffs that depend on corporate behavior but where those payoffs are other than corporate profits. The most likely candidate (based on current proposals) is labor, which draws wages out of cash flows, stands in the position of creditor with regard to pensions, and is sensitive to costly accoutrements such as safety and working conditions.[77] Other possibilities could include contract creditors such as banks and lending syndicates, significant commercial counterparties, and local communities whose economic ecosystems depend upon the business entity at issue. One could even imagine theoretical scenarios such as including Greenpeace, as a stand-in for the whales and polar bears, on the board of Exxon. With such inclusions, the corporate board must now entertain interests that are no longer profit-focused; indeed, some such interests were ones that the corporation could previously safely expropriate, such as the unfunded pension interests of labor or the interests of polar bears in ample sea ice.[78] These are the sorts of inclusion mandates that are likely to change corporate behavior in an arguably pro-social direction, though this does depend upon choosing wisely the interests that are represented and matching them to the desired ends. Note that it is equally possible to change corporate behavior for the worse; putting the Chinese Communist Party (CCP) on the board of Facebook, for instance, would seem unlikely to serve the ends of preserving American democracy.

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76. It may be that the gains from efficient contracting do not scale linearly with the degree of constituent representation, suggesting that an ideal balance from the shareholders' perspective is a positive but low level of constituent representation. For example, if awarding board seats to labor improves the credibility of information exchange between management and employees, then even a solitary board representative may be sufficient to capture those gains. This would come with less sacrifice of corporate surplus and potentially represent an overall gain to shareholders. As discussed in Part IV below, several studies have found a nonlinear relationship between labor board representation and shareholder value, where value initially increases and then decreases. *See, e.g.*, Larry Fauver & Michael Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673, 675, 677 (2006) (noting that a previous study concluded that the inclusion of employee representation on the board of a firm may sacrifice shareholder value in favor of payroll and that the present study confirms that conclusion).

77. *See supra* text accompanying notes 50–56.

78. We differentiate here between decisions that appear values based but maximize long-term profitability versus those that explicitly sacrifice profits in pursuit of other ends. For example, a company with a substantial carbon footprint faced with rising costs of capital due to an increase in ESG-focused stakeholders or regulators may find that profit maximization requires reducing its carbon footprint. This change would not be dependent on a constituency mandate, whereas a proactive reduction of fossil-fuel use at the expense of profitability would.

Fourth, it is important to consider who, actually, is being allowed inside the Coasian bargaining bubble of the boardroom. This question boils down to: to whom, if anyone, is the director accountable? In the name of board diversity, California might well mandate that corporate boards should include a minority director, but (as implemented) such a director will be nominated by the board and voted on by the shareholders-at-large. In contrast, the Accountable Capitalism Act would allow for a corporation's laborers to elect board members (whether or not the board member is herself working class).[79] This is a fundamental difference between diversity and constituency mandates as they have been put forth, but in theory, at least, it need not be so: one could imagine that a diversity candidate could be elected by the diverse group of which she is a member. The importance of this issue is that the question of who chooses presents markedly different incentives for the director; whether or not corporate behavior will be altered, and to what end, depends upon the character and magnitude of the incentives that the director represents. As an atomistic individual, a director's preferences are small in magnitude relative to corporate lucre; as a faithful representative of a group, the director's preferences are, simply, larger. It is easier to buy off or co-opt an atomistic director at the Coasian bargaining table than it is to buy off an entire group; at the least, the price in the latter will be significantly higher. If the desired result is to change corporate behavior, group representation and accountability are more likely to effect such change.

B. *Constituencies and Corporate Liability*

Inclusion mandates work in the social interest when the included constituency has significant interests at stake that corporate action potentially imperils. Greater value at risk creates a greater incentive to avoid corporate calamities. These interests may be naturally occurring, as they are to some extent in the case of labor or creditors, but there is, in fact, no reason why such interests could not be synthesized.

One obvious way to manufacture socially desirable interests is through the imposition of *ex post* liability on the constituency; this allows *ex post* liability to capitalize upon the additional resources that the constituency possesses.[80] As discussed above in Part II, a fundamental limitation on the pro-social behavior of business entities is that business owners (ultimately, the shareholders and other financial claimants of the firm) bear limited liability, creating the problem of judgment proofness. In the event that the corporation lacks the resources to pay judgments against it, the limited liability of corporate owners frustrates the deterrent function of *ex post*

79. Accountable Capitalism Act, S. 3215, 116th Cong. § 6 (2020).

80. *See* Henderson & Spindler, *supra* note 4, at 1591 (explaining the benefits of *ex post* liability as a regulatory option).

liability.[81] By adding constituent interests, however, the judgment proofness problem can be mitigated if the constituency is held accountable and has something to lose. Accordingly, constituencies who are granted a seat in the boardroom could be made liable, to at least some extent, for the entity's violations of law and would steer the corporate ship accordingly. There is precedent for stakeholder liability already, as discussed in Part I, and the representation of a significant pecuniary interest in the boardroom, so to speak, could quite possibly make that interest forfeitable, to some degree at least, under current law. But, in any case, if the constituency can provide greater skin in the game for corporate decision makers, the potential to improve social welfare increases as well.

What, exactly, this value at risk should look like is up for debate—but there is certainly a wide range of choices. As an example, perhaps labor's pensions might be fair game: engaging in harmful activities to inflate pensions is similar, if not identical, to engaging in harmful activities to inflate share price. Alternatively, one should ask whether a represented constituency should continue to enjoy such representation after a corporate failure; if shareholders face a wipeout of their equity, it may make sense for a constituency to have its claims extinguished as well. Under the Accountable Capitalism Act, however, labor would continue to enjoy the benefits of board representation even after a bankruptcy and restructuring.[82]

C. *Without Liability, Incentives May Be Worse*

As it turns out, the imposition of liability may be necessary in order to make constituency decision-making better rather than worse. The reason is that value maximization will only occur when those inside the Coasian bubble are the residual claimants of the firm. If the included constituency is able to extract value from the company (or others) without sharing in any downside created, the potential for negative externalities increases. This is true even if the constituency's preferences are at least as social-regarding as those of shareholders.

Consider first a simple case without an inclusion mandate. In the *status quo ante*, a firm has assets of 10, trade-credit liabilities of 5, and shareholder equity of 5. The firm is considering a project that has a 50/50 chance of success/failure, with respective payoffs of 4/-5. The firm, governed by its shareholders, will reject the project. This is socially optimal.

81. *See id.* at 1565, 1592 (describing the problem of judgment proofness in effective regulation through *ex post* liability).

82. *See* S. 3215 § 6 (requiring 40% employee representation on the board but making no provision for terminating that representation in the event of a restructuring). This is also the case with labor representation in Germany. *See infra* Part IV.

Take the same firm after the passage of a constituency mandate. The firm is subject to a constituency mandate in favor of Constituency X. As a result, 2 in value is transferred from shareholder equity to Constituency X, which is not attachable by the firm's creditors. The firm's assets are 8, trade credit remains at 5, and shareholder equity is now 3. When offered the same project, shareholders and Constituency X will jointly accept it. This is socially suboptimal.

The problem arises here because the firm's joint decision makers, the newly included constituency and equity, have interests that are prior to the claims of others upon the firm. This means that the capitalization of the firm is effectively reduced, such that the judgment proofness of the firm is more likely to come into play and will have a stronger effect upon the firm's decisions.

Such a concern has at least three potential fixes. First, the deleterious effect of including Constituency X would be undone if Constituency X's benefits were subject to attachment for the firm's debts. Further, social optimality may be improved by making Constituency X liable beyond the value that it appropriates from the firm. If Constituency X has sufficiently deep pockets and is subject to unlimited liability, for example, the firm would reject any negative NPV project, no matter the risk spread.[83]

Second, even if there are potentially negative incentives that accompany a constituency, these may be countered by the positive effects of including them. Take labor as an example. By including labor, value will be transferred from shareholders to labor, some in the form of a funded pension and some in the form of higher wages going forward. The funded pension and current wages are not attachable by creditors under current law, analogous to Constituency X in the above example.[84] However, the future wages are subject to loss (depending on what happens to labor after bankruptcy), creating an incentive for the long-term health of the organization.[85] Which

83. A risk-averse constituency with deep pockets would reject a negative NPV project but not a positive NPV project that has negative cash flows in some states of the world, so long as that constituency is able to hedge its downside risk (such as by selling off some of the positive NPV), which implicitly assumes that its claims on the firm are at least partially tradeable. We discuss in Part IV below the potential for wealth effects arising from untradeable claims to constrain positive NPV investments.

84. *See* Fiona Stewart, *Benefit Protection: Priority Creditor Rights for Pension Funds* 24–25 (Org. for Econ. Co-Operation and Dev., Working Paper on Insurance and Private Pensions No. 6, 2007), https://dx.doi.org/10.1787/267415864801 [https://perma.cc/X3V7-B7G7] (explaining that the Pension Benefit Guarantee Corporation cannot attach assets of bankrupt companies to protect pensioners).

85. It is well established that firms reduce employment following bankruptcy (while this is obvious for firms that liquidate, it is true in restructurings as well). *See, e.g.*, Edith Shwalb Hotchkiss, *Postbankruptcy Performance and Management Turnover*, 50 J. FIN. 3, 11 n.13 (1995) ("The median declines in revenues, assets, and employees from the fiscal year end preceding

effect will dominate is unclear, but it is at least possible that such an inclusion mandate could be, on net, beneficial.

Third, the structure of the constituency's benefits from corporate representation is important. It is better, *ceteris paribus*, for a constituency to receive benefits in the form of a residual interest (such as equity, for a solvent firm) than as a prior interest, such as debt or a share of cashflows without regard to profitability. Wages are somewhat problematic, and funded pensions are perhaps more so.

IV. The Case of European Labor Inclusion

Labor is an obvious potential constituency. Labor is universal, has a multiplicity of potential channels through which its influence on a corporation could affect outcomes, has been proposed under Senator Warren's Accountable Capitalism Act, and is already included as a constituency in some countries—most notably in the German system of "co-determination," in which workers have some measure of decision-making control.[86] A wide range of theoretical arguments has been advanced regarding the effects of allocating employees partial or total control. Some of the studies are explicitly about control in the form of board seats, while others focus on ownership, such as through employee stock-ownership plans, or both. A number of commentators have argued that there are benefits to allocating at least some control of a corporation to labor. Each of these can be interpreted as circumstances in which there are high costs to efficient bargaining, which can be overcome by bringing labor inside the Coasian bubble. For example, Freeman and Lazear (1995) construct a model in which labor control can increase investment in firm-specific human capital.[87] If firms cannot credibly commit to rewarding employees for these types of human-capital investments, then employees will underinvest in these skills,

bankruptcy to the first full fiscal year following bankruptcy are each close to 50 percent."). More relevant for this discussion is the observation that employees of firms that file for bankruptcy have reduced future lifetime earnings, regardless of whether or not they remain at the firm post-bankruptcy. *See* John R. Graham, Hyunseob Kim, Si Li & Jiaping Qiu, *Employee Costs of Corporate Bankruptcy* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 25922, 2019) ("The present value (PV) of [employees'] earnings losses from the year of bankruptcy to six years afterward is 67% of pre-bankruptcy annual earnings.").

86. *See, e.g.*, Richard Freeman & Edward Lazear, *An Economic Analysis of Works Councils*, *in* WORKS COUNCILS: CONSULTATION, REPRESENTATION, AND COOPERATION IN INDUSTRIAL RELATIONS 27, 29 (Joel Rogers & Wolfgang Streeck eds., 1995) ("Most Western European countries mandate elected works councils in enterprises above some size and give the councils rights to information and consultation about labor and personnel decisions. Germany gives councils co-determination over some decisions as well.").

87. *Id.* at 28. Such capital is considered important given the relevance of tenure at a firm to wage regressions in the labor-economics literature. *See, e.g.*, Robert Topel, *Specific Capital, Mobility, and Wages: Wages Rise with Job Seniority*, 99 J. POL. ECON. 145, 149 tbl.1 (1991) (finding that the relative negative wage impact of a termination increases with tenure of the employee).

leading to an efficiency loss.[88] Bringing labor into the boardroom keeps management (and shareholders) from expropriating these investments and, thus, overcomes the commitment issues that led to the inefficiency.

A different channel involves overcoming information asymmetries. Furubotn and Wiggins (1984) argue that labor representation on the board facilitates credible exchange of information between labor and management.[89] This exchange can occur in either direction. For example, feedback from labor directly to senior management can improve operational efficiency. Alternatively, improved visibility of a company's condition during times of stress could expedite concessions from labor. Information can also flow from labor to shareholders regarding management, such as through monitoring. Examining data on German firms, Fauver and Fuerst (2006) provide evidence that labor representation on boards can protect against expropriation of surplus by management or large shareholders, to the benefit of shareholders more broadly.[90] Overall, representation within the boardroom facilitates transparency, communication, and monitoring that is otherwise difficult to maintain.

Importantly, however, the incentives of labor differ significantly from those of shareholders. Labor's future wages and pension benefits amount to fixed claims on the firm, and labor is likely to be more risk averse than shareholders, given an inability to diversify.[91] The overall effects of including such interests in decision-making are, from a social-welfare perspective, ambiguous. As an example of possible social benefit, Lin, Schmid, and Xuan (2018) examine German firms and suggest a role for labor akin to that of banks.[92] Employees are likely to have preferences that are closely aligned with those of bank lenders or other creditors, such as high levels of risk aversion.[93] Employees also have access to information that outside monitors do not, and therefore can play that role efficiently. They find that firms with employee representation have lower borrowing costs as a result.

88. *See* Freeman & Lazear, *supra* note 86, at 49 ("[O]ne would expect workers in enterprises with strong councils to have greater loyalty to their firm and to be more eager to invest in firm-specific skills than workers in other firms.").

89. Eirik G. Furubotn & Steven N. Wiggins, *Plant Closings, Worker Reallocation Costs and Efficiency Gains to Labor Representation on Boards of Directors*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 176, 187 (1984).

90. Fauver & Fuerst, *supra* note 76, at 691.

91. Jensen & Meckling, *supra* note 15, at 485–86.

92. *See* Chen Lin, Thomas Schmid & Yuhai Xuan, *Employee Representation and Financial Leverage*, 127 J. FIN. ECON. 303, 304 (2018) (arguing that employees and lenders share a lower risk appetite than equity owners).

93. These channels are often linked. For example, employees are likely to prefer stability in order to protect any quasi-rents they earn, for example, through returns to firm-specific human capital, which they may only be willing to develop because of their ability to influence management.

However, increased risk aversion can lead to negative effects of labor control. The classic theoretical argument is made by Jensen and Meckling (1979), who identify a number of reasons why a firm owned and managed by employees would be less efficient than one managed exclusively to maximize shareholder value.[94] In particular, investment decisions could be constrained because the claims of employee-owners are not tradeable.[95] For example, utility-maximizing employees may reject investment projects that value-maximizing shareholders would choose to pursue, if a significant enough fraction of employees' wealth was tied up in the firm and would be at risk if the project failed.[96] Similarly, because current employees have a short horizon, they only consider cash flows that occur during their careers. Such a firm would not make a positive NPV investment where much of the value is generated after most of the current employees would have retired.[97]

These examples show how awarding board seats to labor can also introduce new constraints to bargaining. While, on the one hand, better commitment and information flow represent reductions to the costs of bargaining, the non-tradability of labor's claims introduces new costs. If the surplus transferred to labor is meaningful vis-à-vis employees' wealth, then the efficient outcome—that which maximizes joint welfare—becomes increasingly risk averse.

The empirical literature contains evidence in support of both the pros and cons of labor control. The richest literature examines the experience of labor representation in Germany. Under this system, known (in English) as

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94. *See* Jensen & Meckling, *supra* note 15, at 480–81 (identifying the impossibility of pure rental, a time-horizon problem, a common-property problem, a non-transferability problem, and a control problem).

95. *See id.* at 481 ("[W]orkers' claims on firm cash flows are contingent on employment with the firm and are nonmarketable.").

96. Consider the following simple one-period example. Assume a firm is worth 10, split between shareholders, who retain 90% of the surplus, and employees, who extract 10% of the surplus in the form of a bonus at the end of the period if the firm survives. Shareholders maximize wealth and employees maximize utility, which is given by the utility function $U = \sqrt{(W)}$. Employees are paid a wage of 1 up-front, which is equivalent to a riskless wealth endowment. The firm can invest in a new project that generates net cash flows of –10 if it fails (wiping out all the surplus) or x if it succeeds. Assuming a 10% chance of failure, shareholders would choose to pursue this project if $x > 1.11$, the level above which pursuing the project increases expected wealth (of both shareholders and employees). However, the expected utility of the employees must be greater than $\sqrt{(2)}$ for them to agree to the project—this is only true if $x > 1.32$; at that level, 10% of the upside is worth the chance of losing half of their current wealth. Of course, if employees could sell their claim on the firm, this problem would disappear. But employee claims are naturally difficult to trade, and then the risk aversion of the employees can result in underinvestment. In some cases, shareholders may be able to make side payments to labor—but there will be a range of projects whose NPV, while positive, is not high enough to compensate employees for risk of lost utility. That range is wider if employees are more risk averse and if they have more wealth tied up in the firm.

97. Such a firm may also reject projects that involved hiring more employees, which is a form of dilution.

codetermination, large German companies are required by law to have labor representation on their boards.[98] This law has existed in one form or another since 1952.[99] The specifics have varied over time, and the exact proportion of board seats that must be allocated to employees has varied. Currently, it is between one-third and one-half of seats, with the latter requirement binding for firms with greater than 2,000 employees.[100] This has provided ample fodder for analysis of labor representation, but other studies have looked at the U.S. and other countries as well.

Some studies have found that codetermination decreases firm value. For example, Gorton and Schmid (2000) find codetermination results in a notable decrease in Tobin's Q, utilizing the reunification of East and West Germany as a natural experiment.[101] Gorton and Schmid (2004) find a similar result in comparing firms with one-third versus one-half of board seats allocated to labor.[102] Others find the opposite effect. Fauver and Fuerst (2006) find that small increases in labor representation increase Tobin's Q.[103] Using French data, Ginglinger, Megginson, and Waxin (2011) also find that small increases in employee ownership increase firm value.[104] However, this study also finds that the effect is nonlinear—larger increases in labor control detract from firm value.[105] Fauver and Fuerst suggest that possibly both of the effects discussed above are at play.[106] Small amounts of labor control help overcome

98. For a summary of the legislative history of both codetermination and workers' councils in Germany and Sweden, see generally Julian Constain, Note, *A New Standard for Governance: Reflections on Worker Representation in the United States*, 24 FORDHAM J. CORP. & FIN. L. 408 (2019).

99. *See id.* at 414 ("The Works Constitution Act of 1952 (the '1952 Act') introduced the current conception of German codetermination."). The law was originally limited to industries outside of the coal-mining and steel industries, and companies with 500–2,000 employees were required to give one-third of their board seats to employees. *Id.* at 414–15. In 1976 it was expanded to include companies with more than 2,000 employees and require 50% labor representation for companies outside of the coal-mining and steel industries. *Id.* at 415.

100. *See id.* at 414–15 (noting that one-third representation is required for firms between 500 and 2,000 employees in size and one-half representation is required for firms greater than 2,000 employees in size).

101. Gary Gorton & Frank Schmid, *Class Struggle Inside the Firm: A Study of German Codetermination* 5–6 (Nat'l Bureau of Econ. Research, Working Paper No. 7945, 2000), https://www.nber.org/papers/w7945 [https://perma.cc/9TKB-KDQY].

102. Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EURO. ECON. ASS'N 863, 879 (2004).

103. *See* Fauver & Fuerst *supra* note 76, at 686 ("[F]irms with employee representation have a significantly higher median value for Tobin's Q than do firms without employee representation . . . .").

104. Edith Ginglinger, William Megginson & Timothée Waxin, *Employee Ownership, Board Representation, and Corporate Financial Policies*, 17 J. CORP. FIN. 868, 878 (2011).

105. *Id.*; *see also* Fauver & Fuerst, *supra* note 76, at 698 (while not finding that larger increases *detract* from firm value, concluding that labor representation in excess of one-half has a "generally positive but statistically insignificant" effect on firm value).

106. *See* Fauver & Fuerst, *supra* note 76, at 703 (noting the likely positive effects of information flows and the likely negative effects—on stock price—of prioritization of wages).

transaction costs associated with efficient contracting, particularly in industries that require coordination with labor, such as manufacturing.[107] However, higher levels of labor control lead to lower valuation, which they attribute to the heightened risk aversion of labor and the associated constraints on investing.[108]

Viewed again through the Coasian lens, the results that shareholder value eventually declines as labor representation increases may be consistent with improving social welfare. The Coase theorem applies only to the efficiency of outcomes, not the division of surplus. An efficiently run corporation with increased labor control should have reduced shareholder value: if board seats are indeed a type of property right, then labor should use its rights to extract value from shareholders. These gains for labor could come in the form of increased pensions, better working conditions, or higher wages, any of which may detract from shareholder value. In fact, it is exactly this transfer of value that many of the proponents of codetermination in the U.S. seek to achieve.[109]

The more pertinent question is if awarding labor some degree of control changes the behavior of a corporation in some consistent way. There is strong evidence of this from studies that look beyond shareholder value. Looking again at German data, Lin, Schmid, and Xuan (2018) find that companies with labor board representation have less volatile cash flows, engage in fewer (and more profitable) M&A transactions, reduce idiosyncratic risk, have lower borrowing costs, and deploy higher leverage.[110] Using U.S. data, Faleye, Mehrotra, and Morck (2006) find that companies with higher employee ownership may have lower investment, lower R&D, reduced operating risk, and consequently lower growth.[111] More recently, Rapp and Wolf (2019) find evidence that German firms weathered the global financial

107. *See id.* at 674, 701 (finding the effect of the interaction of employee representation and industry classification on firm value to be statistically significant and positive).

108. *See id.* at 703 (explaining how excessive employee representation on the board may cause labor itself to cause increased agency costs).

109. Senator Warren's campaign website makes clear that the motivation for her proposed ACA is to redirect corporate surplus towards workers: "Elizabeth has a plan to empower workers and transform corporate America so it produces broad-based growth that gets workers the wages they deserve." *Empowering Workers Through Accountable Capitalism*, WARREN DEMOCRATS, https://elizabethwarren.com/plans/accountable-capitalism [https://perma.cc/9AHW-HW78].

110. Lin, Schmid & Xuan, *supra* note 92, at 321 (attributing the higher leverage to a supply-side effect, namely that banks are willing to lend more, and at lower rates, as a consequence of labor's influence on the company).

111. Olubunmi Faleye, Vikas Mehrotra & Randall Morck, *When Labor Has a Voice in Corporate Governance*, 41 J. FIN. & QUANTITATIVE ANALYSIS 489, 493 (2006). They also find that companies with higher employee ownership exhibit lower growth in employees, indicating that existing employees are wary of diluting their claims by expanding headcount. *Id.* at 506, 509.

crisis more easily than firms based in other countries and laid off fewer employees.[112]

It is possible that financing the riskiest projects imposed externalities on workers or other stakeholders, such that abandoning them after the addition of labor to the board enhances efficiency. Possibly, labor's interests were not otherwise being appropriately internalized, or including labor on the board reduces some principal–agent problems between shareholders and management that encouraged value-destroying M&A.

Alternatively, it could be that awarding control rights to labor induces excessive conservatism, and the resulting decline in growth and innovation is costly to society in the long term. The existing literature is largely silent on this distinction, in part because the empirical work is typically constrained to cross-sectional analysis within individual economies. While this is understandable from an econometric standpoint—tests of cross-economy differences are subject to numerous confounders, compared to the sorts of quasi-natural experiments done within countries—it does limit the ability to derive insights about the U.S. economy from the international evidence.

However, a few very basic statistics suggest some possibilities.[113] For example, as of January 2021, the P/E multiple of the S&P 500 (based on 2021 consensus earnings) is nearly 22; at the same time, the P/E multiple of the DAX (the main German stock index) is 15.[114] This implies that either the cost of equity in Germany is higher than that in the U.S., or the expected growth rate of corporate earnings is lower, or both. Of course, this comparison ignores obvious sectoral differences between the two economies. The Information Technology sector, which has a particularly high multiple, is more heavily represented in the U.S., for example.[115] But that fact itself is

112. MARC STEFFEN RAPP & MICHAEL WOLFF, STRONG CODETERMINATION - STABLE COMPANIES: AN EMPIRICAL ANALYSIS IN LIGHTS OF THE RECENT FINANCIAL CRISIS 4 (I.M.U., Mitbestimmungsreport No. 51, 2019), https://www.econstor.eu/bitstream/10419/204837/1/1679444662.pdf [https://perma.cc/E3PT-PXDU].

113. We make the following comparisons for illustrative purposes only—the headlines themselves are enough to suggest that these issues warrant deeper exploration. A serious comparison across economies would need to account for a large number of factors, including (but not limited to) demographics, the role of government, the level of unionization, and other (non-board) labor protections, etc.

114. For the S&P 500, see S&P DOW JONES INDICES, MARKET ATTRIBUTES: U.S. EQUITIES JANUARY 2021, at 5 (2021), https://www.spglobal.com/spdji/en/documents/commentary/market-attributes-us-equities-202101.pdf [https://perma.cc/SAK6-WZN9] (estimates of S&P 2021 P/E ratio expected to be 21.9, as of January 2021). For the DAX, see *DAX Index (Germany): P/E Ratio & Yield*, GLOBAL FINANCIAL DATABASE BY SIBLIS RESEARCH, https://siblisresearch.com/data/dax-pe-ratio-yield/ [https://perma.cc/889J-55Y6] (estimates of 15.06 as of December 31, 2020).

115. *Compare* Craig Israelsen, *Sector by Sector in the S&P 500 with ETFs*, ETF.COM (Feb. 9, 2021), https://www.etf.com/sections/etf-strategist-corner/sector-sector-sp-500?nopaging=1 [https://perma.cc/H2LV-HQ8F] (showing that the information technology sector is 27.6% of the

informative—the increased concentration of high-growth, innovative sectors in the U.S. is very likely to be endogenous to the structure of the U.S. economy, which could include factors like board representation.

An example in the Autos sector is worth noting. Dammann and Eidenmueller (2020) point to better employee relations at Daimler-Benz versus Tesla after the onset of COVID-19 as evidence of the beneficial effect of codetermination.[116] Better relations between labor and management may indeed be a benefit. But this example makes the potential costs quite clear as well. Tesla stock traded in a relatively narrow range from 2014 to the middle of 2019 while the viability of the company's ambitious plans remained in question.[117] The stock has subsequently generated a return of over 1,000% as it has proven a path to profitability and has gone from being worth less than Daimler-Benz to being worth over eleven times more.[118] Despite the obvious autos-related IP that exists within Germany, it is possible that Tesla was only viable in the U.S.—the German structure may not be hospitable to a company that would make long-term, money-losing investments over many years on

S&P 500 index, as of December 31, 2020), *with DAX 30 Index Sector Weightings*, GLOBAL FINANCIAL DATABASE BY SIBLIS RESEARCH, https://siblisresearch.com/data/dax-30-sector-weights/ [https://perma.cc/2ZX4-Q6GC] (showing that the weight of the information technology sector in the DAX is only 13.99%, as of December 31, 2020). *See also* S&P DOW JONES INDICES, *supra* note 114, at 15 (reflecting that the P/E multiple of information technology was 26.5x as of January 2021).

116. Dammann & Eidenmueller, *supra* note 13, at 54–55.

117. *See, e.g.*, Jason Aten, *Elon Musk Has a Plan to Make Tesla Profitable by Raising Prices and Making It Harder to Change Your Mind*, INC. (Oct. 18, 2019), https://www.inc.com/jason-aten/elon-musk-has-a-plan-to-make-tesla-profitable-by-raising-prices-making-it-harder-to-change-your-mind.html [https://perma.cc/6B4D-8W2N] ("Te[sl]a has a problem—it makes amazing cars, but it doesn't make any money."). On February 28, 2014, Tesla closed with a share price of $48.96 and on October 7, 2019, it closed at $47.54 (effectively unchanged over a period in excess of five and a half years); over that period, the price reached a high of $77.92 on September 18, 2017, and a low of $28.21 on February 9, 2016. *Tesla, Inc. (TSLA)*, YAHOO FINANCE (Apr. 1, 2021), https://finance.yahoo.com/quote/TSLA [https://perma.cc/A4LP-ASV8].

118. Tesla stock began increasing in late 2019 and reached an all-time high (closing price) of $729.77 on January 4, 2021 (and has since increased even more). *Tesla, Inc. (TSLA)*, *supra* note 117. Based on an estimation from shares outstanding as of April 6, 2021 (959.85 million), that high translated into a market capitalization of approximately $747 billion. *Id.* On January 4, 2021, the market capitalization of Daimler AG was approximately €61 billion on the same date (based on a closing share price of €56.9 and 1.07 billion shares outstanding). *Daimler AG (DAI.DE)*, YAHOO FINANCE (Apr. 1, 2021), https://finance.yahoo.com/quote/DAI.DE [https://perma.cc/PJP8-T5J9]. Based on the dollar-to-euro FX rate on that day (0.8163), TSLA was worth over 10 times Daimler on that day. *USD/EUR (USDEUR=X)*, YAHOO FINANCE (Apr. 1, 2021), https://finance.yahoo.com/quote/USDEUR=X/ [https://perma.cc/UZ5J-E9DA]. For a popular press discussion of the drivers of the sharp increase in TSLA price over this time, see Charley Grant, *Tesla's Stock Is the Original GameStop*, WALL ST. J. (Jan. 27, 2021), https://www.wsj.com/articles/tesla-stock-is-the-original-gamestop-11611798484 [https://perma.cc/8KY8-H8KY]. The ratio was clearly lower before the sharp increase in TSLA. For example, on October 7, 2019, the ratio was 0.92 (i.e., TSLA was worth less than Daimler). *See Tesla Inc. (TSLA)*, *supra* note 117 (displaying a closing price of $47.54); *Daimler AG (DAI.DE)*, *supra* (displaying a closing price of €43.81, or $51.48).

an unproven idea, even if it had the potential to become one of the world's most valuable companies.

Another area of potential exploration is the relationship between labor board representation and corporate malfeasance. As discussed above, "skin in the game" maintains appropriate incentives to limit bad corporate behavior. However, the German system limits the extent to which labor is held accountable for corporate malfeasance.[119] In the event of a restructuring, labor would retain seats on the new board, so long as the restructured company was large enough to qualify for codetermination. In this sense, labor's share of the corporate surplus in Germany is senior, at least to that of shareholders; we predict that one consequence of this structure is a limited incentive for monitoring and reporting on malfeasance. The relationship of this structure to some high-profile corporate scandals in Germany cannot be ignored. For example, some commentators have argued that the relationship between senior management and labor fostered by codetermination played a role in the emission scandal at VW.[120] At the same time, the material fines and penalties paid by VW across the globe have been paid by shareholders.

V. A Recipe for Pro-Social Inclusion Mandates and Some Brief Observations on the Proposals

A. *Summing up the Coasian Framework*

These economic insights lead to an understanding of what might make an inclusion mandate deliver corporate behavior that is beneficial to overall social welfare. The corporation is faced with an array of potential projects, among which may be some that generate large business profits at the expense of external harm. What would lead the corporate board to internalize those externalities to a greater extent and, thus, make better social choices?

In order to alter corporate behavior, the inclusion mandate must bring inside the Coasian bubble of the boardroom a person or group with significantly different incentives. To avoid external harms, these different preferences must include a greater regard for those external harms. Because

119. Although labor would retain its representation on a restructured firm post-bankruptcy, the structure of the German bankruptcy process does typically involve the appointment of a trustee, who makes decisions on behalf of the various stakeholders. Thus, the influence of labor is interrupted, in a sense, during bankruptcy itself. *See* Jens Dammann & Horst Eidenmüller, *Codetermination: A Poor Fit for U.S. Corporations*, 2020 COLUM. BUS. L. REV. 870, 917–18 (explaining that codetermination is "practically irrelevant in German corporate restructurings" because of the appointment of an administrator to manage the firm's assets during bankruptcy).

120. *See generally* JACK EWING, FASTER, HIGHER, FARTHER: HOW ONE OF THE WORLD'S LARGEST AUTOMAKERS COMMITTED A MASSIVE AND STUNNING FRAUD (2017) (arguing that due to its particular structure, VW labor had substantial power over the choice of the Chief Executive, and was potentially willing to look the other way on malfeasance so long as employment, wages, and benefits continued to rise, ultimately contributing to the corporate scandal).

the magnitude of corporate profits is large for large entities, those preferences must be of a large magnitude themselves to not be overwhelmed by a share of corporate lucre. This likely entails accountability of the board representative to some population that stands under the shadow of potential corporate externalities; constituency mandates have the potential to do well on this front. Traditional *ex post* liability is, further, complementary with such constituency mandates. Individuals, while they may have different preferences, have relatively little variation in their preferences compared to corporate resources; rather, only aggregated preferences of large numbers of like-minded persons will rival corporate-sized incentives. This is likely to be an innate failing of diversity mandates, at least with regard to their effectiveness at altering corporate purpose in a more pro-social direction.

Last, but certainly not least, depending on the structure and other particulars, an inclusion mandate does have the capacity to make things worse. This would occur where the included constituency's claims on the corporation are not residual ones; if they are not, then they put the constituency in the position of being able to expropriate other interests.

B. Recommendations on U.S. Inclusion Mandates

Turning to the inclusion mandates that are currently enacted or proposed in the United States, some recommendations come to mind. A main and obvious distinction is between diversity and constituency mandates. Diversity mandates may well improve the effectiveness with which corporations maximize shareholder value. We can easily imagine that a diverse board is less likely to function like an "old boys' club" and more likely to challenge management, thus remediating a principal–agent problem between shareholders and board members. The California diversity mandate specifically cites evidence that diverse boards pay CEOs less than non-diverse boards, which is possible evidence of stricter oversight of management.[121] In keeping with this line of reasoning, the California and Nasdaq diversity mandates both cite better value creation as justification for diverse boards.[122] For example, the California statute cites improvements to earnings, return on equity, and price-to-book ratio, all obviously linked to long-term shareholder value.[123] Both mandates also cite reduced fraud and

121. *See* A.B. 979 § 1(p), 2019–2020 Cal. Assemb., Reg. Sess. (Cal. 2020) ("Studies have shown that culturally homogenous boards pay chief executive officers more than a culturally diverse board.").

122. *See supra* note 65 and accompanying text; A.B. 979 § 1(m)–(n) (citing consulting reports concluding that with diversity comes correlative increases in earnings and revenue); S.B. 826 § 1(c), (g), 2018 Cal. S., Reg. Sess. (Cal. 2018) (citing independent studies concluding that companies and their boards perform better when women serve on their boards of directors).

123. S.B. 826 § 1(c)(1)–(2).

better financial reporting.[124] To the extent that fraud and misreporting destroy long-term shareholder value (which would be the case if they are the product of managerial short-termism, for example), then the same logic regarding the benefits of diverse boards applies.

However, the Coasian analysis would imply skepticism of the claim that diverse boards would systematically engage in less corporate malfeasance that risked the realization of a negative externality but did maximize shareholder value *ex ante*. Similarly, it seems unlikely that diverse boards would be more risk-averse and use less leverage, as claimed by the California statute (leaving aside the issue that, unlike avoiding fraud and other forms of malfeasance, which is at least pro-social, it is unclear that a more risk-averse corporate sector is a positive change for society).[125] Our analysis highlights that many of the characteristics of board representation necessary to effect these changes in corporate behavior are lacking in diversity mandates, as currently construed. They create no accountability of the directors to anyone other than the rest of the board (which nominates them) and the shareholders at large (who elect them). It seems likely that extant boards would nominate diverse directors who are otherwise just like them, and shareholders would elect and incentivize directors so as to maximize shareholder profits, just as before. To the extent diverse directors have different preferences, the typical large corporation will have plenty of resources to overcome even significant differences in individual preferences. Though it seems unlikely that these diversity mandates will change corporate behavior significantly (other than perhaps to make the company run even more efficiently and/or ruthlessly than before), they do not worsen incentives either: diverse directors have interests that are residual in nature, being accountable, ultimately, to the firm's residual claimants.

The Accountable Capitalism Act, as a constituency statute, would award 40% of the board seats of large business entities to representatives of labor.[126] This seems certain to effect a significant change in the preferences represented in the Coasian bubble of the board room: labor has interests in wages, working conditions, and pensions, all of which differ significantly from equity interests. Because labor's claims are ones that may otherwise be expropriated through risk-taking or restructuring, the Act has the potential to improve incentives by bringing otherwise externalized harms into the boardroom. The main drawback, however, of the Act is the lack of accountability of labor: as written, labor retains its representative interest no

124. *See* A.B. 979 § 1(r) (postulating that diverse boards would work to decrease corporate fraud); S.B. 826 § 1(c)(3) (citing a study concluding that boards with more women have a high level of transparency).

125. *See* S.B. 826 § 1(c)(5)(C) (claiming that "[c]ompanies with women on their boards tend to be somewhat risk averse and carry less debt, on average").

126. *See supra* note 56 and accompanying text.

matter what happens, apart from the relatively unlikely event that the entity simply ceases to exist.[127] If corporate malfeasance forces the entity through Chapter 11, labor emerges on the other side with its board representation (and at least its funded pensions) intact; this effectively reduces the capitalization of the company and creates opportunities for expropriating others that did not exist before. An improvement would be to give labor additional skin in the game through either a different structuring of its claims or by making labor's assets subject to *ex post* liability for corporate malfeasance.

127. *See supra* note 82 and accompanying text.