# Corporate Practice Commentator

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## Table of Contents

The Social Benefits of Control............................................ 259
*Emilie Aguirre*
The Limits of Individual Prosecutions in Deterring Corporate Fraud................................................................. 319
*Samuel W. Buell*
Activist Directors: The Evolution of Hedge Fund Activism in the S&P 500 ..................................................... 403
*Anna Christie*
Stakeholder Engagement ..................................................... 503
*Brett H. McDonnell*



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# Other Business Organizations Titles by Robert B. Thompson:

*O'Neal and Thompson's Close Corporations and LLCs: Law and Practice*
*O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members*

# THE SOCIAL BENEFITS OF CONTROL*

*Emilie Aguirre***

## ABSTRACT

*When firm founders want to increase access to capital, one traditional route has been to take the firm public. Most public firms allow equal voting rights for all shareholders, so by going public, founders and early insiders inevitably give up a certain amount of control over the firm. More recently, however, a governance structure known as multiclass shares has exploded in popularity. Multiclass share structures separate voting rights from economic rights, allowing insiders to retain control while still raising money on public markets. Because multiclass structures can allow insiders to extract private benefits at the expense of outside shareholders, they are frequently criticized by both scholars and commentators as threats to good governance. Yet this narrow focus on maximizing shareholder financial returns fails to consider a myriad of other factors motivating firm governance choices, especially for the growing number of firms pursuing objectives beyond profit.*

*This Article contributes to the scholarly literature on the efficacy of multiclass structures by adding more nuance and complexity to the traditional understanding. Specifically, it argues that multiclass structures can generate underappreciated and val-*

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*uable social benefits of control. The social benefits of control accrue in two main ways. First, multiclass structures help solve a challenging private contracting problem among socially conscious firm insiders and outsiders. Second, they promote declining public markets by neutralizing a key reason why firms with objectives beyond profit may choose to stay private. These insights reveal that there are a range of benefits to multiclass structures that must be balanced with the costs traditionally highlighted by corporate law scholars.*

Introduction
I. Governance of Publicly Traded Firms
  A. Publicly Traded Firms and the Rise of Multiclass Shares
  B. Critiques of Multiclass Share Structures
II. Firms with Objectives Beyond Profit
  A. Managerial Benefits: Supporting Rare and Effective Leadership Expertise
  B. Market Benefits: Protecting Against Short-Termism and Activist Investors
III. The Social Benefits of Control
  A. Enabling Private Contracting for Social Good
  B. Promoting Public Capital Markets
IV. Addressing Potential Criticisms of Using Multiclass Structures to Enhance Social Goals
  A. Anticipating Criticisms
  B. Solutions to Ensure Accountability and Send Valuable Costly Signals
    1. *Event-Based Sunset Provisions*
    2. *Improved Disclosure and Metrics*
    3. *Oversight Measures*
  B. Implementing the Proposed Solutions
Conclusion

## INTRODUCTION

In 2004, Google went public with a curious governance provision known as a multiclass share structure.[1] Through a technical feat of corporate governance that concentrates insiders' voting rights, the multiclass structure enabled Google's founders and early insiders to retain control over the firm even after offering

[1] Google Inc., Registration Statement (Form S-1), at 2 (Apr. 29, 2004). Google is now known as Alphabet, but this Article will continue to use its more publicly known name, Google.

up Google's shares on the public markets.[2] Although at first glance this choice might seem an obscure or dull matter of corporate governance, it has stoked vociferous debate and has had reverberating effects in the twenty years since Google's initial public offering ("IPO").[3]

Indeed, the former Commissioner of the Securities and Exchange Commission ("SEC"), Robert Jackson, has called multiclass structures "antithetical to our values as Americans," illustrating the deep personal value systems and perceived threats to democracy at stake.[4] How could a seemingly technical and esoteric matter of corporate governance kick off such a heated contest? Scholars intensely debate whether multiclass shares are value-enhancing products of private bargaining or antidemocratic threats to shareholder value.[5]

But this Article argues that this discourse fails to consider broader societal benefits that multiclass structures may provide. It shows how the mainstream debate misses a critical set of public functions that multiclass structures can serve, particularly when adopted to support firm social initiatives. This Article is the first to consider multiclass structures as they apply and function within the growing area of social responsibility in business. It demonstrates how these controversial and highly critiqued

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[2] Emily Chasan, *Google's Multi-Class Stock Structure Made Alphabet Move Unique*, Wall St. J.: CFO BLOG (Aug. 12, 2015, 4:49 PM), https://www.wsj.com/articles/BL-CFOB-8866 [https://perma.cc/YD3Q-EFEY].

[3] Robert J. Jackson, Jr., Comm'r, U.S. Sec. & Exch. Comm'n, Address at University of California Berkeley School of Law: Perpetual Dual-Class Stock: The Case Against Corporate Royalty (Feb. 15, 2018), https://www.sec.gov/news/speech/perpetual-dual-class-stock-case-against-corporate-royalty [https://perma.cc/93QR-2L5M] (explaining the concerns with dual-class stock as well as the negative impacts on middle class investors if dual-class companies are banned from major indices).

[4] *Id.*; *see also* Lucian A. Bebchuk & Kobi Kastiel, *The Untenable Case for Perpetual Dual-Class Stock*, 103 Va. L. Rev. 585, 602-04 (2017) ("Two fundamental problems arise from the use of dual-class stock: entrenchment and low equity holdings.").

[5] *See generally* Gregory H. Shill, *The Social Costs (and Benefits) of Dual-Class Stock*, 75 Ala. L. Rev. 221, 226 (2023) (noting that "[a] substantial literature has sprung up to debate how to measure and optimize dual-class tradeoffs for investors"); Bernard S. Sharfman, *A Private Ordering Defense of a Company's Right To Use Dual Class Share Structures in IPOs*, 63 Vill. L. Rev. 1, 2-3, 7 (2018) (arguing in favor of multiclass share structures as beneficial outcomes of private bargaining); Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 Geo. Wash. L. Rev. 687, 693-707 (1986) (explaining that the New York Stock Exchange's longstanding opposition to multiclass share structures was due to its "commitment to encourage high standards of corporate democracy"); Bebchuk & Kastiel, *supra* note 4 (arguing that companies with long-term dual-class structures face substantial governance risks and costs to shareholder value).

structures can actually have quite a bit of public value in certain contexts.

Explaining this public value first requires some background on typical corporate governance in publicly traded firms. Traditionally, publicly traded firms have used what are known as single-class share structures. Under this model, when investors buy a share in the firm on a public market, they receive one vote in the company for every share they buy. Those who invest more of their money in a given company receive more votes in the company.[6] This one-share-one-vote model ensures that shareholders have equal voting rights that correspond to their financial stakes in the firm.[7]

But multiclass structures do away with the one-share-one-vote model.[8] Instead, they create multiple classes of stock that carry different voting rights for different shareholders. The end result is that insiders retain voting power that exceeds their economic stake in the firm. For example, Google has three classes of stock. Holders of Class A stock are entitled to one vote per share, holders of Class C stock are entitled to no votes per share, and holders of Class B stock are entitled to *ten* votes per share.[9] Class B shares are not publicly traded and held only by a small group of founders and insiders.[10] Multiclass structures ensure that the shares owned by insiders have greater cumulative voting rights than the shares sold to public investors.[11] Google's governance choice thus guaranteed its founders and early insiders would retain control over the firm while still getting to access public markets.

Going public is appealing because it can offer companies significantly more capital than remaining private or getting acquired.[12] It also confers a high degree of prestige. But the tradeoff is that going public also usually dilutes insiders' voting

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[6]*One-Share-One-Vote Rule*, NASDAQ, https://www.nasdaq.com/glossary/o/one-share-one-vote-rule [https://perma.cc/6HRD-YXSG] (defining the one-share-one-vote model).

[7]*Id.*

[8]Jill Fisch & Steven Davidoff Solomon, *The Problem of Sunsets*, 99 B.U. L. Rev. 1057, 1064-65 (2019) (explaining that dual-class stock "responds to the evolving reality of capital market structure").

[9]Nathan Reiff, *Top Google (Alphabet) Shareholders*, Investopedia, https://www.investopedia.com/articles/markets/011516/top-5-google-shareholders-goog.asp [https://perma.cc/3SVM-QLD5] ("[Google's] class A shares . . . are traded as common stock, with a one-share-one-vote structure. . . . [Its class C shares] have no voting rights. [Google] also has class B shares, which are held by the founders and other insiders and which have 10 votes per share.").

[10]*Id.* ("Alphabet's class B shares are not publicly traded.").

[11]Fisch & Solomon, *supra* note 8, at 1060.

[12]*See* Shill, *supra* note 5, at 227; Requests for Startups, *Going Public vs.*

stakes, eliminating their control over the firm.[13] Multiclass structures, however, give founders and early insiders the best of both worlds: They can secure the prestige and capital of public markets without reducing their own power over the firm.[14]

Although multiclass structures have a long history in the United States, Google was a modern "pioneer" of the structure.[15] Its IPO set off a cascade of influential firms adopting multiclass structures.[16] These structures have exploded in popularity since the early 2000s, increasing in prevalence by over 500 percent, including in nearly half of all tech IPOs in recent years.[17] It is estimated that firms with multiclass structures had an aggregate market value of over $4 trillion as of 2018.[18]

As a result, when an investor—even a powerful institutional investor—buys stock in some of the most important firms in the world, including Google and Meta (previously known as Facebook), that stock does not come with meaningful voting rights. It is perhaps unsurprising that the sharp rise of multiclass structures has fueled a roiling debate on the importance, or lack thereof, of maintaining democratic principles in publicly traded firms.

Despite their explosion in popularity, multiclass structures are highly contentious. Many scholars and practitioners criticize them as threats to good governance because they entrench insid-

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*Being Acquired*, MEDIUM (Nov. 12, 2016), https://medium.com/the-mission/going-public-vs-being-acquired-8a05e2370c3f [https://perma.cc/R7U2-HPSE].

[13]Shill, *supra* note 5, at 227 ("Early in the lifecycle of a company, founders face a dilemma: they need capital to grow but don't want to give up control.").

[14]*Id.* ("Dual-class stock offers a solution: by decoupling voting power from cash-flow rights, it gives investors the economics of ownership while keeping founders in control."); Reiff, *supra* note 9 (explaining that Google's founders and other insiders own Class B stock, which is not publicly traded and has 10 votes per share).

[15]GARY SHORTER, CONG. RSCH. SERV., IF11992, DUAL CLASS STOCK: BACKGROUND AND POLICY DEBATE 1 (2021) (calling Google "the [dual-class stock] tech pioneer in 2004").

[16]Tech firms with multiclass structures include Meta (previously known as Facebook), Snap, Dropbox, Lyft, Groupon, Fitbit, Kayak, Blue Apron, Zoom, Roku, Chewy, and TripAdvisor. *Id.* Nontech firms include Coca-Cola, Ford Motor Company, Nike, Levi Strauss, Hyatt Hotels, New York Times, News Corp., CBS, Comcast, and Liberty Mutual. *Id.*

[17]Shill, *supra* note 5, at 225 ("The proportion of initial public offerings (IPOs) that are of founder-controlled companies has increased by over 500% in recent years."); SHORTER, *supra* note 15 ("According to some reporting, in a given recent year, nearly half of tech IPOs have involved multi-class shares."); Dhruv Aggarwal, Ofer Eldar, Yael V. Hochberg & Lubomir P. Litov, *The Rise of Dual-Class Stock IPOs*, 144 J. FIN. ECON. 122, 123 (2022) ("[A]lmost 30 percent of initial public offerings (IPOs) in 2017-2019 had dual-class structures.").

[18]Sharfman, *supra* note 5, at 3.

ers and insulate them from voting accountability to outside shareholders.[19] Removing voting accountability and reducing insiders' relative economic stakes in the firm heightens the risk that insiders will engage in shirking and self-dealing.[20] Although some see multiclass structures as the value-enhancing result of bargaining in corporate governance,[21] many others condemn the perverse incentives these structures generate for insiders to extract personal benefits at the expense of shareholder value.[22] These personal benefits are known as the "private benefits of control."[23]

The private benefits of control may be economic, in the form of financial gain for insiders, or they may be idiosyncratic, maximiz-

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[19] *See, e.g.*, Rick Fleming, Investor Advocate, Sec. & Exch. Comm'n, Speech at the International Corporate Governance Network Miami Conference: Dual-Class Shares: A Recipe for Disaster (Oct. 15, 2019) (describing "the increased use of dual-class shares" as a "troubling trend"); *Corporate Governance Principles for US Listed Companies*, Inv. Stewardship Grp., https://isgframework.org/corporate-governance-principles [https://perma.cc/XS6L-8GAH] ("Companies should adopt a one-share, one-vote standard and avoid adopting share structures that create unequal voting rights among their shareholders."); Institutional Shareholder Servs., the Tragedy of the Dual Class Commons 3 (2012), http://online.wsj.com/public/resources/documents/facebook0214.pdf [https://perma.cc/5CG8-PJGW] ("[D]ual class structures create a vulnerability not unlike the tragedy of the commons, where individual actors working to maximize their own self interest collectively diminish or destroy the resources they share."); Jackson, Jr., *supra* note 3 ("[Y]ou have a structure that undermines accountability: management can outvote ordinary investors on virtually anything.").

[20] Shill, *supra* note 5, at 242.

[21] Sharfman, *supra* note 5, at 30; Bernard S. Sharfman, *How Dual Class Shares in IPOs Can Create Value*, Univ. of Oxford: Fac. L. Blogs (Aug. 25, 2017), https://blogs.law.ox.ac.uk/business-law-blog/blog/2017/08/how-dual-class-shares-ipos-can-create-value [https://perma.cc/AQJ6-T8UJ].

[22] *See, e.g.*, Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537, 540-41 (2004); Evangelos Benos & Michael S. Weisbach, *Private Benefits and Cross-Listings in the United States*, 5 Emerging Mkts. Rev. 217, 219 (2004).

[23] Benos & Weisbach, *supra* note 22, at 219 ("Private benefits [of control], sometimes called control benefits, are benefits that accrue to managers or shareholders that have control of the corporation, but not to minority shareholders."); Dyck & Zingales, *supra* note 22, at 541 ("The common feature of all the above examples is that some value, whatever the source, is not shared among all the shareholders in proportion of the shares owned, but it is enjoyed exclusively by the party in control. Hence, the name private benefits of control."); Ronald W. Masulis, Cong Wang & Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J. Fin. 1697, 1720 (2009) ("[W]hen a dual-class company has both classes of its stock publicly traded, the superior-voting class tends to trade at a premium relative to the inferior-voting class. . . . [This] reflects the private benefits of control available to controlling shareholders.").

ing the nonfinancial personal utility of those who retain control.[24] For example, Meta CEO Mark Zuckerberg maintains his controlling stake in Meta not just to achieve personal financial gain but also to flexibly pursue his personal vision for the company as he pleases, irrespective of market forces.[25] He may do so to gain personal power, achieve global dominance, shape American democracy, impact political agendas on critical issues like privacy and artificial intelligence, or achieve any other number of personal reasons that may also evolve over time.[26]

Current discussions of multiclass structures center on minimizing the private benefits of control to maximize financial returns to shareholders.[27] From this perspective, there are perhaps two rationales for why firm leaders would adopt multiclass structures—and why investors would agree to them. First, firm leaders and investors may believe that entrenching insiders will enhance the financial value of the firm, lowering the cost of capital.[28] Alternatively, outside shareholders may accept that insiders wish to extract value at their expense, increasing the

[24]*See, e.g.*, Dyck & Zingales, *supra* note 22, at 540 ("The theoretical literature often identifies private benefits of control as the 'psychic' value some shareholders attribute simply to being in control. . . . Another traditional source of private benefits of control is the perquisites enjoyed by top executives. . . ."); Benos & Weisbach, *supra* note 22, at 219 ("[Private benefits of control] can be non-pecuniary, such as the ability to direct a company's resources to a cause one agrees with . . . [or] a preference for glamorous projects. . . . Alternatively and more substantially, [they] can have an enormous direct financial effect on minority shareholders. . . ."). *See generally* Masulis et al., *supra* note 23, at 1697 (studying how the "divergence between insider voting and cash flow rights affects managerial extraction of private benefits of control").

[25]Zuckerberg does so by using a combination of dual-class shares and voting structures that ensures he retains control. *See* Emily Stewart, *Mark Zuckerberg is Essentially Untouchable at Facebook*, VOX (Dec. 19, 2018, 11:19 AM), https://www.vox.com/technology/2018/11/19/18099011/mark-zuckerberg-facebook-stock-nyt-wsj [https://perma.cc/EH7G-4L7U]. *See generally* Daniel Wells, Note, *Shareholder Inequity in the Age of Big Tech: Public Policy Dangers of Dual-Class Share Structures and the Case for Congressional Action*, 13 NE. U. L. REV. 41 (2021) (explaining Zuckerberg's great voting power even though he owns just 14 percent of his company's shares).

[26]*See* Stewart, *supra* note 25 ("Anything that requires a shareholder vote, he gets to ultimately decide whether it's going to get a majority or not. . . .").

[27]Bebchuk & Kastiel, *supra* note 4, at 602 ("[P]articipants in this debate have focused on whether a dual-class structure is likely to be efficient. . . ."). Those in favor of multiclass structures also couch their arguments exclusively in terms of financial returns. *See* Sharfman, *supra* note 5, at 30 (arguing that multiclass share structures are value enhancing products of private bargaining over corporate governance entirely from the perspective of maximizing firm financial returns).

[28]*See* Sharfman, *supra* note 5, at 21 (arguing that investors would only accept a multiclass structure where there is "wealth-maximizing efficiency that results from the private ordering of corporate governance arrangements" or

cost of capital, but the firm is so valuable and important that owning discounted shares is better than owning no shares at all. In this case, the multiclass structure is simply the cost of doing business with, for example, Google or Meta.

Yet this discourse overlooks a growing number of firms that buck the conventional rationales for multiclass structures. These companies seek to achieve not just firm financial returns or personal gain for insiders, but a set of firm objectives that extend beyond profit. A range of firms have benefited from the protection multiclass structures offer to firm social goals, including, for example, Allbirds (a sustainable wool footwear and apparel company),[29] Warby Parker (an eyewear company),[30] Veeva (a cloud computing company),[31] and Nike (an athletic footwear and ap-

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because they recognize "that agency costs are not the only costs of governance that need to be minimized").

[29]Allbirds adopted a dual-class share structure, which is a multiclass structure with just two classes of common stock. Allbirds Class A stock carries one vote per share and Class B carries ten votes per share. *See Sustainability Guide and Practices*, ALLBIRDS, https://www.allbirds.com/pages/sustainable-practices#reality [https://perma.cc/8P4J-GUHF]; Allbirds, Inc., Registration Statement (Form S-1), at 15 (Aug. 31, 2021) [hereinafter Allbirds Registration Statement]; Lauren Thomas, *Allbirds Shares Surge 90% in Eco-Friendly Shoe Maker's Market Debut*, CNBC (Nov. 3, 2021, 7:53 AM), https://www.cnbc.com/2021/11/03/allbirds-ipo-bird-to-start-trading-on-the-nasdaq.html [https://perma.cc/3LN2-XZYQ] (detailing Allbirds' initial public offering). Allbirds' social goals include a foundational commitment to sustainability and "revers[ing] climate change through better business." *Sustainability Guide and Practices*, *supra*. "Multiclass share structure" is a broader term encompassing firms like Google that have three or more classes of stock.

[30]Warby Parker has three classes of common stock, which each carry different voting rights. Class A stock carries one vote per share, Class B carries ten votes per share, and Class C carries no votes. Warby Parker, Inc., Registration Statement (Form S-1), at 63 (Aug. 24, 2021) [hereinafter Warby Parker Registration Statement]. Warby Parker's founders hold all outstanding shares of its Class B stock. *Id.* ("[O]ur Co-Founders and Co-CEOs, Neil Blumenthal and Dave Gilboa, if they choose to act together, will have the ability to control all matters submitted to stockholders for approval, including controlling the outcome of director elections."). The differential voting rights effectively give the founders control over the company. *Id.*; *see also Warby Parker*, B LAB GLOB., https://www.bcorporation.net/en-us/find-a-b-corp/company/warby-parker [https://perma.cc/Y885-6QY6] (detailing that Warby Parker obtained its B Corp certification in May 2011). Warby Parker's social goals include a commitment to donating free glasses to communities in need. Lucy Handley, *Dave Gilboa and Neil Blumenthal: A Vision for Business*, CNBC, https://www.cnbc.com/warby-parkers-dave-gilboa-and-neil-blumenthal-a-vision-for-business [https://perma.cc/9H27-XQQP] (last updated Apr. 8, 2020, 11:29 A.M.).

[31]Veeva Systems, Inc. has two classes of common stock. Class A stock carries one vote per share and Class B stock carries ten votes per share. Veeva Systems, Inc., Registration Statement (Form S-1) (Oct. 15, 2013) [hereinafter Veeva Systems Registration Statement] ("The holders of our outstanding Class

parel company).[32] At these firms and others like them, leaders increasingly use multiclass structures to support firm objectives beyond profit.

It is important briefly to articulate what this Article means by "firms with objectives beyond profit." The Article defines these firms as those that pursue initiatives that are not just related to firm financial performance but also seek to achieve a "public benefit," defined broadly in Delaware General Corporation Law[33] as the generation of "a positive effect (or reduction of negative effects)," for any person or entity other than shareholders, including positive effects that are "artistic, charitable, cultural, eco-

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B common stock will hold approximately 98.8% of the voting power of our outstanding capital stock . . . and our executive officers and directors and their affiliates will hold approximately 74.0% of the voting power. . . ."). Veeva's social goals include its stated commitment to "leading in stakeholder capitalism." Press Release, Veeva Systems, Inc., Veeva Becomes First Public Company To Convert to a Public Benefit Corporation (Jan. 13, 2021), https://www.veeva.com/wp-content/uploads/2021/01/Veeva-Becomes-First-Public-Company-to-Convert-to-a-Public-Benefit-Corporation.pdf [https://perma.cc/6AC2-KL9Q]. It adopted a multiclass structure at its IPO in 2013 and in 2021, it became the first publicly traded and largest ever company to convert to the public benefit corporation legal form. *Id.*; *see* Adam Sterling, Amelia Miazad & Dickson L. Louie, *Veeva Systems: The Journey to Converting to a Public Benefit Corporation*, *in* BERKELEY L. EXEC. EDUC. CASE SERIES 1, 2 (2022), https://executive.law.berkeley.edu/wp-content/uploads/2022/02/Veeva-Systems-The-Journey-to-Converting-to-a-Public-Benefit-Corporation-Case-Study.pdf [https://perma.cc/SY3C-M5JZ] (describing the process and business rationales behind converting to a public benefit corporation).

[32] Nike has a dual-class share structure that effectively entrenches control in founder Phil Knight and his son Travis Knight. *See* Investor News Details, *Nike, Inc. Chairman Phil Knight Converts 5.7 Million Shares*, NIKE, INC. (Jan. 14, 2005), https://investors.nike.com/investors/news-events-and-reports/investor-news/investor-news-details/2005/NIKE-Inc-Chairman-Phil-Knight-Converts-57-Million-Shares/default.aspx [https://perma.cc/V3HE-ZNBH] ("Mr. Knight [will] continue to retain direct ownership of approximately 92 percent of Nike's outstanding Class A shares. . . ."); NIKE, Inc., Annual Report (Form 10-K) (July 25, 2024) (explaining that Travis Knight now "has a significant role in the management of the Class A Common Stock"). Class A stockholders elect 75 percent of the board of directors while Class B stockholders elect the remaining 25 percent. *Id.* ("[H]olders of Class A Common Stock elect three-quarters of the Board of Directors. . . ."); NIKE, Inc., Proxy Statement (Schedule 14A) (July 20, 2023) (explaining that Class A stockholders elect nine directors and Class B stockholders elect four directors). Nike's social goals include promoting racial justice and gender equity in the sporting world, including through recent campaigns featuring Colin Kaepernick, Serena Williams, and the U.S. Women's National Soccer Team. Some of the company's social initiatives have led to public backlash and short-term financial losses, underscoring its genuine commitment to these causes. *Nike's 'Dream Crazy' Advert Starring Colin Kaepernick Wins Emmy*, GUARDIAN (Sept. 16, 2019, 11:46 AM), https://www.theguardian.com/sport/2019/sep/16/nikes-dream-crazy-advert-starring-colin-kaepernick-wins-emmy [https://perma.cc/SJ89-4FLK].

[33] DEL. CODE ANN. tit. 8, § 362(b) (2024).

nomic, educational, environmental, literary, medical, religious, scientific or technological [in] nature."[34] This definition is intentionally capacious and open to interpretation of the individual firm and its contracting partners.[35] A firm's public benefit could span a wide range of topics and is ideologically agnostic. For example, it might include eliminating food waste, combating climate change, promoting religious ideals, seeking racial equity, or curing a disease.[36] This Article also uses the term "prosocial firms" to describe firms with objectives beyond profit, and the terms "social purpose," "social performance," and "social goals" interchangeably with "objectives beyond profit," "public benefit," and "nonfinancial goals."

It is important to emphasize that the definition of firms with objectives beyond profit is necessarily self-directed and intentionally broad, as per Delaware General Corporation Law. Under this definition, firm leaders identify the social purpose for the individual firm and should then pursue and report on that purpose in a way outsiders can meaningfully assess and verify. A firm's social purpose is whatever its leaders define and commit to—and its contracting partners, including investors and employees, agree to—within the broad ambit of "public benefit."[37]

Firms may also display a spectrum of commitment to their objectives beyond profit. On one end of the spectrum, firm leaders may view social goals on equal footing with profit goals and be willing to trade off significant amounts financially to achieve the objectives beyond profit. For example, Allbirds pursues environmental sustainability goals that have been core to the company since its founding. Its leaders seem willing to trade off short-term financial gains to achieve the prosocial objectives, as evidenced by the firm's ongoing social commitments despite struggling

[34] *Id.*

[35] Thomas J. White III, Note, *Benefit Corporations: Increased Oversight Through Creation of the Benefit Corporation Commission*, 41 J. LEG. 329, 341 (2015) ("[T]he architects of the model legislation intentionally decided to leave the language broad.").

[36] *See id.*

[37] What matters is not so much the ways in which a firm's leadership chooses to pursue social goals—whether through core business strategy, through a donative business model such as buy one give one, through ad hoc social initiatives, or even perhaps through corporate philanthropy. Rather, what matters is that firm leadership defines the social goals for the firm and then demonstrates the verifiable commitments necessary to achieve them. The verifiability element enables outsiders to assess firm commitment to stated social goals. This bottom-up definition also helps address disingenuous or deceptive firm statements—such as greenwashing or bluewashing. The importance is complying with firm leadership's own stated definition of firm social goals in a way that outsiders, including investors, consumers, and employees, can credibly assess.

financially since going public.[38] Firms further down the spectrum of commitment may pursue social initiatives earnestly and robustly but more secondarily to profit.[39] For example, at Nike, social goals, such as improving racial equity, are meaningful and part of firm strategy but still may be more peripheral and contested than at a firm like Allbirds.[40]

Firms with objectives beyond profit have significant potential to achieve both social impact and financial performance, but they are also highly susceptible to failure and to the loss of firm social objectives.[41] As the firm grows, this susceptibility heightens, and it can be increasingly difficult to maintain social performance.[42]

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[38] Joseph Zwillinger, co-Founder and co-CEO of Allbirds acknowledged the struggle to balance gains with social responsibility. He said:

> We've always believed that it's important to tell our shareholders what they're getting into. We're a public benefit corporation, which means we have an equal focus on fiduciary responsibility and environmental conservation. It's no easy feat to balance these things, but we believe it's achievable through rigorous assessment. We don't want to be a company that greenwashes. We want to meet or exceed our commitments, and we believe that our shareholders understand this and support it.

*Allbirds Sprints Toward Sustainability*, PWC (Feb. 28, 2023), https://www.pwc.com/us/en/tech-effect/innovation/allbirds-sustainability-interview.html [https://perma.cc/37FP-KNNB]; *see also* Dani James, *From Warby Parker to On, Here's How Disruptors Are Doing Post-IPO*, RETAILDIVE (Oct. 3, 2023), https://www.retaildive.com/news/dtc-stocks-post-ipo-warby-parker-on-allbirds [https://perma.cc/64VJ-UQU6] ("Allbirds' stock price has plummeted since going public and a rebound has yet to appear.").

[39] Given the broad ambit afforded by the business judgment rule, it seems unlikely that traditional corporations would run into fiduciary duty trouble for articulating and acting on firm social goals. *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 90 (2004) (describing the business judgement rule as a rule of abstention rather than a standard of liability).

[40] *Compare* Rashida Beal, *Is Nike's Corporate Social Responsibility Just Marketing Genius?*, MEDIUM (Nov. 16, 2021), https://medium.com/stronger-content/is-nikes-corporate-social-responsibility-just-marketing-genius-4243a4064f4a [perma.cc/JAC3-3W5B] ("Nike certainly isn't perfect, and many criticize the brand for its own shortcomings. In reality, the brand is still working through its own processes and policies but has ingrained CSR in its culture."), *with Allbirds Sprints Toward Sustainability*, *supra* note 38 ("We're a public benefit corporation. . . . We don't want to be a company that greenwashes. We want to meet or exceed our commitments, and we believe that our shareholders understand this and support it.").

[41] *See generally* Julie Battilana & Silvia Dorado, *Building Sustainable Hybrid Organizations: The Case of Commercial Microfinance Organizations*, 53 ACAD. MGMT. J. 1419 (2010) (showing that organizations with both social and financial objectives—known as hybrid organizations—face inherent tensions among their social and financial goals); Emilie Aguirre, *Beyond Profit,* 54 U.C. DAVIS L. REV. 2077 (2021) [hereinafter Aguirre, *Beyond Profit*] (same).

[42] *See* Aguirre, *Beyond Profit*, *supra* note 41, at 2148 (arguing that "no matter how [social startups] choose to legally incorporate, privately order themselves, or scale up, business law fails to provide them with a durable com-

For example, Etsy was once lauded as an example of a socially conscious business that managed to do good while operating on a large scale.[43] Yet shortly after it went public, Etsy lost several key elements of its social performance, including the dismissal of its socially conscious CEO and the elimination of its third-party certification of firm social performance.[44]

Multiclass structures, however, can help protect firms against the loss of social goals. They may do so by entrenching rare and valuable specialized leadership skills in these prosocial firms that generally experience greater organizational fragility, helping them to organize more effectively.[45] Multiclass structures can also help prosocial firms overcome significant public market barriers to success that have little to do with the strength of the firm's business model.[46] Housing control in prosocial insiders can help protect these firms from third-party short-termism and activist investors, which both often threaten firm performance.[47]

Despite the growing prevalence of firms using multiclass

mitment mechanism to help counter the losses of strategic and managerial control at scale").

[43]*Id.* at 2079-80.

[44]*Id.*

[45]Operating a firm with social and financial objectives is difficult and requires specialized leadership skills due to greater organizational susceptibility to failure. Because such leadership skills are still relatively rare, when a manager demonstrates an ability to effectively achieve social and financial performance simultaneously, this skill set should not be discounted or treated as fungible. When a prosocial firm is poised to go public with its social and financial objectives both intact, it points to successful leaders who have managed to maintain both social and financial performance through the challenges of scaling up. *See* James E. Austin & Herman B. "Dutch" Leonard, *Can the Virtuous Mouse and the Wealthy Elephant Live Happily Ever After?*, 51 Cal. Mgmt. Rev. 77, 81-84 (2008); Aguirre, *Beyond Profit*, *supra* note 41, at 2095.

[46]*See* Aguirre, *Beyond Profit*, *supra* note 41, at 2148.

[47]Publicly traded firms are subject to short-term pressures and quarterly reporting requirements that can be at odds with firm social goals, which are frequently controversial in the short term or yield longer-term returns on investment. Prosocial firms are also vulnerable to the threat of activist investors, who often target firm social goals. *See* Aguirre, *Beyond Profit*, *supra* note 41, at 2106; Yaron Nili, Peer Group Governance 15 n.118 (Aug. 31, 2023) (unpublished manuscript) (on file with author); Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1029 (2007). For example, Vital Farms, which produces pasture-raised eggs, specifically noted in its SEC S-1 registration form that its "duty to balance a variety of interests may result in actions that do not maximize stockholder value." Vital Farms, Inc., Amendment No. 1 (Form S-1) (July 24, 2020) [hereinafter Vital Farms Amendment No. 1] (stating that post-IPO, existing shareholders will control 87 percent of shares). This kind of statement can easily invite targeting from activist investors in the absence of insider control. *See infra* Part II.B. It is also worth noting that, occasionally, activist investors may also buy up stakes in firms not to make a quick profit, but to effect social change. *See*

structures to help protect objectives beyond profit, the current legal discourse remains largely one-dimensional and centered around maximizing financial returns to shareholders. It focuses primarily on weighing the costs of private benefits of control against the benefits of value-enhancing bargaining for individual firms. This discourse overlooks the myriad other factors and relationships that motivate firm governance choices beyond maximizing shareholder profit— including the pursuit of prosocial goals. By focusing on minimizing private benefits of control, it ignores an important set of public functions that multiclass structures can serve.

This Article argues that multiclass structures may also provide underappreciated and valuable *social* benefits of control. These "social benefits of control" are amplified in firms with objectives beyond profit. This Article shows how the social benefits of control can accrue in two primary ways: by addressing a thorny private contracting problem and by promoting declining public markets.

Multiclass structures help solve a challenging contracting problem to bargain for firm social performance. Bargaining for firm social performance is generally difficult to achieve due to third-party interference from short-termist pressures and the threat of activist investors. Activist investors are parties who buy up an ownership stake in a company to pressure management to make changes—including to abandon or reduce preexisting firm social goals—to achieve a quick profit.[48] By more reliably ensuring the retention of firm social goals, multiclass structures enable socially conscious parties— including shareholders and employees—to bargain more effectively for firm social performance.[49] Without multiclass structures, prosocial firms risk becoming

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Jessica Camille Aguirre, *The Little Hedge Fund Taking Down Big Oil*, N.Y. TIMES MAG. (June 15, 2023), https://www.nytimes.com/2021/06/23/magazine/exxon-mobil-engine-no-1-board.html [https://perma.cc/TXR6-C995] [hereinafter Aguirre, *The Little Hedge Fund Taking Down Big Oil*].

[48] Kahan & Rock, *supra* note 47, at 1029. More recently, activist investors have also begun buying stakes in firms to attempt *increase* firm social or environmental performance. *See* Aguirre, *The Little Hedge Fund Taking Down Big Oil*, *supra* note 47. These socially conscious activist investors have achieved mixed results, including perhaps the most prominent example of Engine No. 1 failing to achieve much change after successfully winning three board seats at Exxon in a campaign to improve the company's approach to climate change. Ortenca Aliaj & Derek Brower, *Exxon Nemesis Engine No. 1 Drops Activism in Hunt for New Identity*, FIN. TIMES (Aug. 9, 2023), https://www.ft.com/content/dc94222a-e6d9-43fa-aada-51e45c6d6ad0 [https://perma.cc/FUX7-2WUT].

[49] The third-party pressures to eliminate or weaken firm social goals can undermine preexisting agreements that investors, employees, and others have made with the firm to achieve not just a financial return but also a social one. These parties are entitled to privately bargain for their prosocial preferences—especially considering corporate law has created an entire apparatus called the public benefit corporation to help support firms with objectives beyond profit

systemically unreliable contracting partners for the growing number of socially conscious investors and employees who seek to bargain for their prosocial investment and employment preferences.[50]

Multiclass structures also help promote contracting in public markets.[51] Public capital markets have steeply declined over the last thirty years as private companies increasingly avoid IPOs and public companies increasingly go private.[52] Scholars have argued that this decline is likely due to the growing availability of private capital, and perhaps secondarily to a desire to avoid the burdens of public company regulation and disclosure.[53] But for firms with objectives beyond profit, staying private can also help protect firm social performance by enabling founders and insiders to retain control over the firm, rather than diluting their

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and those who deal with them. DEL. GEN. CORP. L. §§ 361-368. The public benefit corporation is known as a benefit corporation in many jurisdictions outside of Delaware. CAL. CORP. CODE §§ 14600-14631; N.Y. BUS. CORP. L. §§ 1701-1709. This contracting problem applies to the full spectrum of social issues and ideologies—any firms (conservative or progressive) that seek to contract with outsiders to achieve a social financial return are subject to third-party interference with their preexisting agreements, regardless of the substance of the social goal. In its current structure, business law cannot yet solve this problem. *See infra* Part II.

[50]These socially conscious parties have prosocial preferences and are often willing to trade some financial compensation for the opportunity to invest in or work for a company with objectives beyond profit. *See infra* Part III.A.

[51]*See infra* Part III.B; Nicole Goodkind, *America Has Lost Half Its Public Companies Since the 1990s. Here's Why*, CNN (June 9, 2023, 8:33 AM), https://www.cnn.com/2023/06/09/investing/premarket-stocks-trading/index.html [https://perma.cc/5C9J-Q8P9] (stating that "[t]he count of publicly listed companies traded on US exchanges has fallen substantially from its peak in 1996"—when it "exceeded 8,000 companies"—"to just 3700" today); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 447-48 (2017).

[52]Goodkind, *supra* note 51; de Fontenay, *supra* note 51, at 447; William W. Clayton, *Private Equity Fund Bargaining: What We Know (and Don't Know)*, *in* RESEARCH HANDBOOK ON THE STRUCTURE OF PRIVATE EQUITY AND VENTURE CAPITAL (Brian Broughman & Elisabeth de Fontenay eds., forthcoming 2024) (manuscript at 1), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4598908 [https://perma.cc/KNR6-4M45] (stating that "[t]he global economy has been going private for many years, with global private market [assets under management (AUM)] growing by fourteen times since 2000 (compared to four-fold growth in public AUM over the same period)"); Brian Scheid & Gaurang Dholakia, *Global IPO Activity Cut Nearly in Half in 2022; Just 20 Launched in US During Q4*, S&P GLOB. MKT. INTEL. (Jan. 12, 2023), https://www.spglobal.com/marketintelligence/en/newsinsights/latest-news-headlines/global-ipo-activity-cut-nearly-in-half-in-2022-just-20-launched-in-us-during-q4-73793488 [https://perma.cc/78UT-6JCY].

[53]*See* de Fontenay, *supra* note 51, at 447 (explaining that "[f]irms no longer need to go public to raise large amounts of capital" and acknowledging popular explanations that point to "the rising regulatory costs of becoming and remaining a public company").

ownership stakes on the public market. Yet this private trend presents a broader problem, creating an unstable equilibrium in public markets that is important to address.[54] Because multiclass structures enable firms with objectives beyond profit to trade publicly while protecting otherwise susceptible firm social goals, they neutralize a key reason why firms with objectives beyond profit may choose to stay private. This boon to public markets is especially important to help counter the pernicious systemic effects that precipitously diminishing public markets have generated over the past thirty years.[55]

This Article proceeds as follows. Part I describes the typical governance of publicly traded firms and documents the rise of multiclass structures. It then considers critiques of multiclass structures and the problematic private benefits of control they may generate. Part II shows how multiclass structures may offer protection for firm social goals in two primary ways, generating both managerial benefits and market benefits. Part III is the core of the paper. It argues that multiclass structures can generate valuable and overlooked social benefits of control by addressing a private contracting problem and promoting declining public markets. These social benefits of control are amplified in firms with objectives beyond profit. Part IV addresses anticipated criticisms, then offers proposals for measures to help hold entrenched insiders accountable and avoid deception.

## I Governance of Publicly Traded Firms

This Part first outlines the corporate governance of a typical publicly traded firm with a single-class structure. It then explains the rise and appeal of the multiclass structure. It shows how, despite their popularity, multiclass structures are also widely criticized and pose potential threats to good governance. Importantly, this heated debate around multiclass shares centers on minimizing what are known as the private benefits of control to maximize financial returns to shareholders.

### *A. Publicly Traded Firms and the Rise of Multiclass Shares*

The prototypical publicly traded U.S. firm generally adopts a

[54] *See id.* at 451-52.

[55] Although operating privately may represent a rational choice for an individual firm, this trend has negative systemic effects, generating widespread transparency and information problems that create an unstable equilibrium for capital markets. M. Todd Henderson & Richard A. Epstein, *The Going-Private Phenomenon: Causes and Implications*, 76 U. CHI. L. REV. 1, 5 (2009) (describing how the "private model is worrisome (albeit efficient) because of its lack of transparency, either for investors or the public at large"); de Fontenay, *supra* note 51, at 451-52.

single-class structure when offering up shares in the company for purchase on a public exchange.[56] Under a single-class structure, the purchase of a share typically comes with not only cash flow rights but also proportionate voting rights in the firm.[57] As a result, when founders sell shares in the firm on public markets to raise money, they typically dilute their ownership stake—each share they sell is one less share they can vote.[58] These voting rights enable shareholders to have a say over important high-level company decisions, including the composition of the board—the entity that determines who serves as company executives.[59]

In the prototypical example, cash flow rights and voting rights are thus largely aligned, meaning those who vote on major company decisions are also those who stand to gain or lose financially from the outcomes. In theory, aligning cash flow rights and voting rights helps reduce the agency costs of separating firm ownership and control. It does so by minimizing opportunities for self-dealing by managers who run the firm but may not otherwise bear the direct financial burden of their decisions.[60]

But when firm founders and insiders adopt multiclass structures, they can entrench their own control despite trading on public markets. Unlike with single-class structures, where investors receive one vote per share purchased, multiclass structures

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**[Section I]**

[56]*See* Shill, *supra* note 5, at 230 ("Equal-voting structures . . . are more common than alternatives like dual-class stock.").

[57]*One-Share-One-Vote Rule*, *supra* note 6.

[58]*Cf.* Shill, *supra* note 5, at 230 ("The logic of unequal voting rights in common stock is clearest and perhaps the most common as a solution to the founder's dilemma, i.e., how to raise capital without giving up control.").

[59]Publicly traded firms are also subject to significant disclosure requirements and heightened regulatory oversight from the SEC. For example, public firms must publish quarterly earnings reports (Form 10-Q) and annual reports, including audited financial reports (Form 10-K). They must also report the occurrence of certain events such as company acquisitions, changes in control, the election and departure of officers and directors, and amendments to the charter or bylaws. *See generally Exchange Act Reporting and Registration,* SEC, https://www.sec.gov/education/smallbusiness/goingpublic/exchangeactreporting [https://perma.cc/A753-2ZND].

[60]These considerations and arrangements relate more broadly to the classic agency problem in corporate law, that those who manage the firm on a day-to-day basis are not those who have invested their capital in the firm. This separation of ownership and control creates problems of self-dealing from managers who do not bear the financial consequences of their decisions and protect investors who delegate day-to-day management of the firm. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 301-02 (1983).

separate cash flow and voting rights.[61] Firm leaders structure their equity offerings so that when investors buy shares in the firm, they receive rights to financial payouts but effectively *no* (or limited) voting rights.[62] As a result, no matter how big a stake an outside investor may amass, the multiclass structure ensures insiders will always retain control.[63] Insiders often use multiclass structures as "a tool to insulate the founder and the board from people (i.e., investors) who will question, critique, or impede the founder's vision" and who represent "outside, perhaps value-destructive, interests."[64]

To guarantee insider voting control, multiclass structures create two or more classes of stock with disparate voting rights.[65] A common arrangement is to issue Class B shares that have ten times the voting power as Class A shares to firm founders or other insiders and make only Class A shares available to the public.[66] However, the options for structuring multiclass shares abound.[67] For example, some firms, like Under Armour, Blue Apron, and Snap, simply issue common shares with no voting rights.[68] Others, like Palantir, use a multiclass structure that perpetually guarantees the cofounders at least 49.99 percent of total voting power.[69] Tesla has a complicated voting structure that effectively gives its CEO Elon Musk control over the

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[61] Shill, *supra* note 5, at 226 ("Dual-class stock simultaneously prevents meddling by shareholders and disenfranchises them."). There are additional structures to separate cash flow and control, such as pyramid structures and cross-ownership structures. These structures require forming additional entities, whereas differential voting rights structures can be accomplished within one legal entity. Pyramid structures and cross-ownership structures are more common in other parts of the world, including Europe and Asia. *See* Lucian Arye Bebchuk, Reinier Kraakman & George G. Triantis, *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* Concentrated Corporate Ownership 295, 296, 299 (Randall K. Morck ed., 2000).

[62] That is, outside investors receive cash flow rights and are residual claimants of the firm, but do not receive voting rights. Sharfman, *supra* note 5, at 7.

[63] Fisch & Solomon, *supra* note 8, at 1064-65.

[64] *Id.* at 1069.

[65] *Id.* at 1064; Yifat Aran & Elizabeth Pollman, *Ousted*, 25 Theoretical Inquiries in L. 231, 238 (2024).

[66] Fisch & Solomon, *supra* note 8, at 1064.

[67] *See id.*; Aran & Pollman, *supra* note 65, at 231.

[68] Vijay Govindarajan, Shivaram Rajgopal, Anup Srivastava & Luminita Enache, *Should Dual-Class Shares Be Banned?*, Harv. Bus. Rev. (Dec. 3, 2018), https://hbr.org/2018/12/should-dual-class-shares-be-banned [https://perma.cc/V48R-3L9K]; Dorothy S. Lund, *Nonvoting Shares and Efficient Corporate Governance*, 71 Stan. L. Rev. 687, 701 (2019).

[69] Aran & Pollman, *supra* note 65, at 242.

company with just a 22 percent equity stake in the firm.[70] No matter how they are structured, the upshot of multiclass shares is that they preserve voting power for select insiders by granting them access to a class of stock not available to the public. As a result, insiders retain voting rights that may far exceed their economic stakes in the firm.

### *B. Critiques of Multiclass Share Structures*

Perhaps unsurprisingly, multiclass structures raise serious concerns, creating tensions with many conventional conceptions of good governance. Although some scholars approve of multiclass share structures,[71] a robust corporate governance literature criticizes their use.[72] Scholars point out the serious risks multiclass structures pose to outside shareholders and to firm value.[73] Multiclass structures can aggravate preexisting agency concerns between managers and shareholders, as insiders who have voting rights disproportionate to their economic stakes in the firm bear fewer financial consequences of their decisions.[74]

Entrenching managers and separating voting rights and cash flow rights therefore expands insider latitude and incentive to engage in self-dealing and inappropriately extract personal gains at the expense of outsiders.[75] This inappropriate self-dealing and extraction of personal gains are known as the private benefits of

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[70]For outside shareholders to override Musk, they must accrue 89.5 percent of their vote, an extremely difficult figure to reach, effectively housing control in Musk. Ronald Orol, *How Elon Musk Controls Tesla With Only a Minority Ownership Stake*, STREET (Apr. 23, 2018, 2:15 PM), https://www.thestreet.com/investing/stocks/how-elon-musk-controls-tesla-with-only-a-minority-stake-14564491 [https://perma.cc/2JVG-ZZE5].

[71]*See* Daniel R. Fischel, *Organized Exchanges and the Regulation of Dual Class Common Stock*, 54 U. CHI. L. REV. 119, 136-40 (1987) (discussing why it may be efficient for insiders to retain control and use multiclass voting as a mechanism for preserving insider control); Sharfman, *supra* note 5, at 7 (arguing that "the use of the dual-class share structure in IPOs is a value-enhancing result of the bargaining that takes place in the private ordering of corporate governance arrangements"). Multiclass shares are also common in much of the rest of the world and especially in economies with many family firms that want to raise capital but retain family control over generations. *See* Kristian Rydqvist, *Dual-Class Shares: A Review*, 8 OXFORD REV. ECON. POL'Y 45, 45 (1992).

[72]*See* Bebchuk & Kastiel, *supra* note 4, at 602; Fisch & Solomon, *supra* note 8, at 1070-78; Bebchuk, Kraakman & Triantis, *supra* note 61, at 2.

[73]*See* Bebchuk & Kastiel, *supra* note 4, at 603.

[74]Masulis et al., *supra* note 23, at 1697.

[75]*See* Michael J. Barclay & Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J. FIN. ECON. 371, 372 (1989). Some scholars have debated the practical importance of voting rights, particularly given the availability of alternatives such as exit, litigation, and engagement to hold firm insiders accountable. *See* Fisch & Solomon, *supra* note 8, at 1093; Jill E. Fisch & Simone M. Sepe, *Shareholder Collaboration*, 98 TEX. L. REV. 863, 865 (2020)

control.[76]

The private benefits of control may be economic, in the form of increased financial gain, or they may be idiosyncratic.[77] For example, insiders may tunnel money to themselves or spend corporate resources on personal endeavors, reaping large personal financial benefits that can have a massive financial effect on outside shareholders.[78] Or, instead, insiders may seek fame and public recognition, a springboard for a political campaign, or other personal dreams that maximize their personal utility at the expense of outside shareholders.[79] Whether the private benefits of control are pecuniary or idiosyncratic, outsiders lack accountability mechanisms to discipline self-dealing insiders, problematically disadvantaging outsiders and reducing shareholder value.

Indeed, several empirical studies have found negative relationships between multiclass structures and firm performance, including lower firm value and higher levels of managerial extraction of private benefits of control.[80] Still others have argued that even if there may be *some* efficiencies to adopting multiclass

(arguing that shareholder collaboration has largely supplanted competition between shareholders and managers for control). It has also become increasingly common for outside shareholders to be able to oust even entrenched insiders when a company performs poorly. *See* Aran & Pollman, *supra* note 65, at 234-35.

[76] *See* Barclay & Holderness, *supra* note 75, at 372 (discussing the private benefits of control in large, diffusely held public corporations); Masulis et al., *supra* note 23, at 1698 ("[M]anagers with greater control rights in excess of cash flow rights are more likely to pursue private benefits at the expense of outside shareholders."); Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473, 476 (1992) ("We shall refer to [the nonmonetary elements in the entrepreneur's payoff] as the *private benefits* of the entrepreneur since they are not observable or verifiable by third parties.").

[77] Aghion & Bolton, *supra* note 76, at 476 ("The investor is only interested in the monetary returns of the project. The entrepreneur, who thought about the project and took the initiative of setting it up, cares not only about the monetary returns but also about other less tangible things such as reputation, specific human capital, effort, etc."); Dyck & Zingales, *supra* note 22, at 540 (explaining that having control itself provides value); Benos & Weisbach, *supra* note 22, at 219 (detailing noneconomic benefits such as aligning a company with a cause, taking on exciting projects, or developing personal skills).

[78] *See* Dyck & Zingales, *supra* note 22, at 540 ("Another traditional source of private benefits of control is the perquisites enjoyed by top executives."); Benos & Weisbach, *supra* note 22, at 219 ("[P]rivate benefits [of control] can have an enormous direct financial effect on minority shareholders.").

[79] *See* Benos & Weisbach, *supra* note 22, at 219 ("[Private benefits of control] can be non-pecuniary, such as the ability to direct a company's resources to a cause one agrees with, a preference for glamorous projects, or the use of a position for the enhancement of one's human capital." (internal citations omitted)).

[80] *See* Gregg A. Jarrell & Annette B. Poulsen, *Dual-Class Recapitalizations as Antitakeover Mechanisms: The Recent Evidence*, 20 J. FIN. ECON. 129, 147

structures at the time of *some* IPOs, any advantages likely erode over time.[81] For example, Professors Lucian A. Bebchuk and Kobi Kastiel show how immediate benefits such as founder leadership skills or protections from short-term market pressures soon recede while the costs of such arrangements rise, rendering perpetual multiclass structures highly problematic.[82] Even the New York Stock Exchange disallowed multiclass structures for nearly sixty years until the 1980s, and many jurisdictions around the world still limit or prohibit their use, including the United Kingdom.[83]

The fierce theoretical, empirical, and policy debates over multiclass structures focus nearly exclusively on minimizing private benefits of control to maximize shareholder returns.[84] Yet a rising number of publicly traded firms now also seek to pursue

(1988); Stijn Claessens, Simeon Djankov, Joseph P. H. Fan & Larry H.P. Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. Fin. 2741, 2743 (2002); Michael L. Lemmon & Karl V. Lins, *Ownership Structure, Corporate Governance, and Firm Value: Evidence from the East Asian Financial Crisis*, 58 J. Fin. 1445, 1447 (2003); Scott B. Smart, Ramabhadran S. Thirumalai & Chad J. Zutter, *What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values*, 45 J. Acct. & Econ. 94, 96 (2008) (finding that higher differentials between director and officer voting rights and cash flow rights is associated with lower firm value); Masulis et al., *supra* note 23, at 1699-1700 (finding managerial extraction of private benefits of control). *But see* M. Megan Partch, *The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth*, 18 J. Fin. Econ. 313, 314 (1987) (finding no significant association with shareholder value, or even positive value); Marcia Millon Cornett & Michael R. Vetsuypens, *Voting Rights and Shareholder Wealth*, 10 Managerial Decision Econ. 175, 186 (1989) (same); Valentin Dimitrov & Prem C. Jain, *Recapitalization of One Class of Common Stock into Dual-Class: Growth and Long-Run Stock Returns*, 12 J. Corp. Fin. 342, 347 (2006) (same).

[81]Bebchuk & Kastiel, *supra* note 4, at 602 ("[E]ven if a dual-class structure were to be efficient at the time of the IPO, it would likely become inefficient many years down the road.").

[82]They argue that, at most, only finite-life multiclass structures with sunset clauses should be legally available. These sunset clauses would trigger every ten to fifteen years or else require noncontrolling shareholder approval to continue the use of the multiclass structure. *Id.*

[83]*See* Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 979-85 (1989); Hong Kong Exchs. & Clearing Ltd., Concept Paper, Weighted Voting Rights 25-28 (2014); Bebchuk & Kastiel, *supra* note 4, at 600. On the other hand, in 2018, Hong Kong approved the use of dual-class shares in IPOs after long prohibiting them. Benjamin Robertson, *Hong Kong Adds Dual-Class Shares, Paving Way for Tech Titans*, Bloomberg (Apr. 24, 2018, 4:38 AM), https://www.bloomberg.com/news/articles/2018-04-24/hong-kong-approves-dual-class-shares-paving-way-for-tech-titans [https://perma.cc/K7SN-MLQP] (highlighting that Hong Kong's approval of dual-class shares amounts to the "biggest change to its initial public offering rules in two decades").

[84]*See* Aggarwal et al., *supra* note 17, at 125 (canvassing the literature on dual-class shares but not including reference to firms that may employ them to

objectives beyond profit and increasingly implement multiclass structures to support these nonfinancial goals. In evaluating multiclass structures, it is important also to consider these firms, and more broadly the myriad factors motivating firm governance beyond maximizing financial returns to shareholders.

## II Firms with Objectives Beyond Profit

Multiclass structures have increased in popularity amongst the rising number of firms that seek to pursue objectives beyond profit.[85] These firms have significant potential to produce social impact alongside financial performance,[86] but they are also highly susceptible to failure and loss of the social objectives over the long-term, especially as the firm grows larger.[87] Relatedly, firms

protect claimed social goals). In the article, the authors describe Veeva, a public benefit corporation with a dual-class share structure, and admirably consider many other firm factors, but not its stated commitment to stakeholder capitalism as a rationale for instituting and retaining a dual-class share structure. *Id.*

**[Section II]**

[85] *See* Shill, *supra* note 5, at 236; *see, e.g.*, Allbirds Registration Statement, *supra* note 29, at 15; Warby Parker Registration Statement, *supra* note 30, at 63; Veeva Systems Registration Statement, *supra* note 31, at 8. Again, the term "firms with objectives beyond profit" refers to a broad spectrum of companies that pursue nonfinancial goals—in addition to profit—to varying degrees. On one end of the spectrum are firms that pursue financial and nonfinancial goals on equal footing, with both sets of goals proving core to the organization. On the other end of the spectrum lie firms that primarily pursue financial goals but also have a more peripheral set of secondary nonfinancial goals. *See supra* Introduction; Emilie Aguirre, Pairing Purpose with Profit 2 (Apr. 30, 2021) (Ph.D. dissertation, Harvard University).

[86] These firms' valuable "social technology" can unlock new and lucrative market segments while also creating more attractive places to invest, work, and patronize. *See* Austin & Leonard, *supra* note 45, at 80 ("It is precisely because [these social icons] are different that they are appealing. . . . This constellation has created distinctive value propositions and powerful brand integrity. The social icons have cultivated new, high-growth market segments.").

[87] Prosocial firms are also more "likely to be fragile and easy to disrupt or destroy" as a result of these special attributes. *See* Austin & Leonard, *supra* note 45, at 80 ("While these special attributes make the social icons attractive and valuable, they are also likely to be fragile and easy to disrupt or destroy."); Battilana & Dorado, *supra* note 41, at 1419 ("[H]ybrid organizations [that pursue both social and commercial goals] are highly unstable and unlikely to retain their hybrid nature over time."); Alnoor Ebrahim, Julie Battilana & Johanna Mair, *The Governance of Social Enterprises: Mission Drift and Accountability Challenges in Hybrid Organizations*, 34 Rsch. Organizational Behav. 81, 82 (2014) ("Although social enterprises are viewed as promising vehicles for the creation of both social and commercial value, they are at risk of losing sight of their social missions in their efforts to generate revenue."); Wendy K. Smith & Marya L. Besharov, *Bowing Before Dual Gods: How Structured Flexibility Sustains Organizational Hybridity*, 64 Admin. Sci. Q. 1, 4 (2019) ("[C]hallenges persist in the long term due to changing organizational dynamics and

with objectives beyond profit have special characteristics that make it particularly difficult to retain nonfinancial objectives while trading publicly. This Part shows how prosocial firms face two extra sets of managerial and market challenges to success, and how entrenching control in prosocial insiders can help mitigate these challenges. In this way, multiclass structures may generate additional intrafirm benefits that strengthen their appeal for firms with objectives beyond profit.

### *A. Managerial Benefits: Supporting Rare and Effective Leadership Expertise*

Operating a firm that has both social and financial objectives is managerially challenging.[88] The inherent tensions that arise among various social and financial goals can pose special challenges for these firms,[89] which can also experience greater organizational fragility and risk of failure.[90] These firms are also highly susceptible to the loss or weakening of firm social goals, a phenomenon known as "mission drift."[91] Entrenching control in prosocial insiders can help mitigate these challenges, helping firm leaders to maintain the capacity to organize in a way that is effective.

An entire body of research in the management literature, known as "hybrid organizing," has arisen to study firms that

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environmental conditions, as well as ongoing tensions between dual elements."). As these firms grow larger and take on additional sources of outside capital—and thus subjected to greater outside influence—maintaining social performance alongside financial performance can grow even more challenging. *See* Aguirre, *Beyond Profit*, *supra* note 41, at 2095; Emilie Aguirre, Financing Social Startups 4 (Jan. 28, 2024) [hereinafter Aguirre, Financing Social Startups] (unpublished manuscript) (on file with author).

[88] *See* Battilana & Dorado, *supra* note 41, at 1420 (showing how organizations with both social and financial objectives—known as hybrid organizations—face inherent tensions among their social and financial goals). *See generally* Ali Aslan Gumusay, Michael Smets & Timothy Morris, "*God at Work": Engaging Central and Incompatible Institutional Logics Through Elastic Hybridity*, 63 ACAD. MGMT J. 124, 125 (2020) (exploring ways for firms to navigate the tensions inherent to operating organizations with social and financial objectives).

[89] *See* Battilana & Dorado, *supra* note 41, at 1420; Blake E. Ashforth & Peter H. Reingen, *Functions of Dysfunction: Managing the Dynamics of an Organizational Duality in a Natural Food Cooperative*, 59 ADMIN. SCI. Q. 474, 475 (2014); Julie Battilana, *Cracking the Organizational Challenge of Pursuing Joint Social and Financial Goals: Social Enterprise as a Laboratory To Understand Hybrid Organizing*, 21 M@N@GEMENT 1278, 1281 (2018).

[90] Austin & Leonard, *supra* note 45, at 79.

[91] *See* Battilana & Dorado, *supra* note 41, at 1420 (describing how organizations with social and financial goals face a significant challenge of striking a sustainable balance between their social and financial performance in order to avoid mission drift); Aguirre, *Beyond Profit*, *supra* note 41, at 2095.

pursue multiple objectives.[92] The hybrid organizing literature shows that to sustain dual goals successfully, firms must organize in specific ways.[93] For example, successful hybrid organizations often hire and socialize employees in a certain manner, selecting candidates with less job experience but a greater propensity to be socialized into a hybrid organizational identity and who have not yet been deeply steeped in either a profinancial (strictly for-profit) or prosocial (strictly charitable) job setting.[94] According to one study, these organizations also frequently spend significant time and resources aligning their training, promotion, and incentive systems to prioritize the successful pursuit of dual goals.[95] Successful hybrid organizations often set goals and implement certain firm activities and organizational structures to facilitate the coexistence of multiple objectives in tension with each other. For example, a firm may assign responsibility for social and financial tasks to separate employee groups and then create designated spaces for employees to discuss and negotiate the inherent tensions and tradeoffs they face.[96] Sustaining this approach requires effective management of the firm that is tailored to special considerations of hybridity. Perhaps unsurprisingly, successful hybrid leadership is both challenging and relatively rare.[97]

Original data drawn from four years of field work conducted at

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[92]*See generally* Julie Battilana & Matthew Lee, *Advancing Research on Hybrid Organizing - Insights from the Study of Social Enterprise*, 8 Acad. Mgmt. Annals 397, 397 (2014) (describing three decades of research on organizations with both business and charitable objectives).

[93]Battilana, *supra* note 89, at 1281 ("[I]dentify[ing] four pillars that seem to play a critical role in enabling organizations to pursue joint social and financial goals over time. . . .").

[94]Battilana & Dorado, *supra* note 41, at 1432.

[95]*Id.* at 1432-33.

[96]*Id.*; Battilana, *supra* note 89, at 1281; Ashforth & Reingen, *supra* note 89, at 474 (describing how an organization managed tensions inherent to the pursuit of both financial and social goals and finding that the "idealist-pragmatist duality was kept continually in play over time through oscillating decisions and actions that shifted power from one group to the other, coupled with ongoing rituals to repair and maintain relationships disrupted by the messiness of the process"); Julie Battilana, Metin Sengul, Anne-Claire Pache & Jacob Model, *Harnessing Productive Tensions in Hybrid Organizations: The Case of Work Integration Social Enterprises*, 58 Acad. Mgmt. J. 1658, 1658 (2015) (explaining the tensions inherent in organizations pursuing social and financial goals and finding that "one effective approach is to assign responsibility for social and economic activities to distinct groups while creating 'spaces of negotiation'—arenas of interaction that allow members of each group to discuss the trade-offs that they face").

[97]*See* Tyler Wry & Jeffrey G. York, *An Identity-Based Approach to Social Enterprise*, 42 Acad. Mgmt. Rev. 437, 438 (2017) (stating that "we know little about how, why, and with what consequences social entrepreneurs mix compet-

seven firms with objectives beyond profit further underscore the unique challenges facing these firms as they grow.[98] All seven firms studied faced significant managerial obstacles to maintaining social and financial objectives simultaneously at scale.[99] Five firms lost their hybridity, eliminating or substantially weakening their social objectives at some point as they grew.[100] For example, one CEO abandoned plans to serve low-income schools and communities, instead shifting the business model to serve higher-income areas.[101] Another firm experienced a public activist investor campaign to oust a CEO who was seen as too prosocial.[102] A third firm initially strengthened its social performance at the expense of financial performance, but eventually had to sell to an acquirer to avoid firm failure.[103] And another firm's venture capital investors deadlocked with the founder-CEO over his desire to pursue not just lucrative cryptocurrency operations but also to build a decentralized and open internet.[104] The sixth firm is still

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ing logics as they create new organizations" and finding that successful organizations "are more likely to result from the efforts of balanced entrepreneurs" as opposed to other types of entrepreneurs they identify); Battilana & Dorado, *supra* note 41, at 1423-24 (describing the challenge of hiring senior leaders with an "unprecedented combination of responsibilities"); Smith & Besharov, *supra* note 87, at 32 (explaining the challenges and importance of successful hybrid leadership, and how "an organization's leaders, and the cognitive frames they adopt, play a critical role in sustaining hybridity"); Julie Battilana, Anne-Claire Pache, Metin Sengul & Marissa Kimsey, *The Dual-Purpose Playbook*, HARV. BUS. REV. (Mar.-Apr. 2019), https://hbr.org/2019/03/the-dual-purpose-playbook [https://perma.cc/HE2P-ZUNZ] (describing the importance and challenges of dual-minded leadership in hybrid organizations and explaining how "[l]eaders must affirm, embody, and protect both the financial and the social side and address tensions proactively").

[98]This field work consists of a mix of ethnography, interviews, observations, archival data, and surveys. Harvard University's Institutional Review Board (IRB19-1761) approved this research. It also entails an additional two years of exploratory pilot research with several more firms of various sizes and stages. *See* Aguirre, Pairing Purpose with Profit, *supra* note 85, at 57.

[99]*See, e.g.*, Aguirre, Financing Social Startups, *supra* note 87.

[100]*Id.*; Interview with Participant 61 (Oct. 14, 2021).

[101]Interview with Participant 101 (Oct. 6, 2021) (stating that "a large part of the company's DNA was not just access for paying individuals," but also for low-income communities," but after several rounds of outside funding, the founder targeted more lucrative high-income areas under the new view that "if it's not profitable, we can't do it").

[102]Interview with Participant 61 (Oct. 14, 2021).

[103]Interview with Participant 103 (Mar. 1, 2019) ("They were either going to be acquired or they were going to be shut down . . . [the company] had a lot of purpose-minded individuals that had joined the organization that were really wedded to organic and/or the philosophies that also led them to be a non-profitable business.").

[104]Interview with Participant 105 (Feb. 25, 2021).

in the process of scaling up, and its leadership continues to experiment with sustaining nonfinancial goals, to varying degrees of success.[105] Leaders at just one firm out of the seven have managed to successfully retain hybridity at scale. At this company, called Buffer, management has sustained successful social initiatives over time in the face of significant outside pressures to become more focused on pursuing financial goals.[106] They did so by adopting a highly unusual approach to management, financing, and governance compared to typical startups.[107]

This empirical field research underscores the relative rarity of successful hybrid leadership at firms with objectives beyond profit. Prosocial firms have heightened susceptibility to failure and mission drift, which requires specialized hybrid leadership skills and expertise. When a prosocial firm is poised to go public with its social and financial objectives both intact, it points to successful hybrid leaders who have managed to maintain hybridity through the challenges of scaling up the firm.[108] These successful leadership skills should not be assumed to be fungible. Indeed, successful leaders of nonhybrid firms may not easily succeed at hybrid leadership.[109] The problems of rare hybrid leadership will likely decline as understanding in management

[105]This firm has the pseudonym TableTech. Its firm leadership continues to thoughtfully experiment with management practices to sustain nonfinancial goals and has faced both success and failure in this regard. Most recently, for example, it failed to sustain a social initiative to implement a four-day workweek. Julie Yen & Emilie Aguirre, *Navigating Tensions Between Well-Being and Productivity: How Win-Win Framing Contributed to the End of a 4-day Workweek Trial* (unpublished manuscript) (on file with author).

[106]The company explains,

> Whereas in the past we'd 'had it all' and achieved growth alongside creating a unique culture . . . it now started to feel like we had to choose between those things. It was suggested that some of the fundamentals . . . could be removed to . . . increase the growth rate. I refused to compromise on [those] . . . aspects of our culture.

*Hey! We're Buffer*, BUFFER, https://buffer.com/about [https://perma.cc/R622-UTJ2] ("Since 2013, we've been open with Buffer's finances and our team's salaries, among many other metrics."); *We Spent $3.3M Buying Out Investors: Why and How We Did It*, BUFFER, https://buffer.com/resources/buying-out-investors [https://perma.cc/PJN5-GX38].

[107]For example, Buffer exercised a highly unusual downside protection clause in its venture capital contract, buying out its venture capital investors when they fell short in supporting the firm's social objectives. Buffer's managers also adopted an approach of radical transparency at the company, including making all its financials public available. Leadership also implemented a four-day work week to support the wellbeing of its workforce. Aguirre, Financing Social Startups, *supra* note 87, at 31-32.

[108]*See* Aguirre, *Beyond Profit*, *supra* note 41, at 2117.

[109]In addition, effective hybrid management is often the product of experimentation at a particular firm, and best practices may need to be adapted

continues to grow and disseminate.[110] But at present, it can be critical to protect successful hybrid leaders with uncommon expertise.

Multiclass structures can support more effective hybrid management. By entrenching control in a team with proven hybrid leadership skills, multiclass structures can lock in rare and valuable managerial expertise that helps support the firm to organize effectively even as it grows larger.[111] Indeed, the literature on multiclass structures shows how founders and early insiders can play important leadership roles, in general, at any firm that goes public.[112] At firms with objectives beyond profit,

to transfer across firms. *See* ALNOOR EBRAHIM, MEASURING SOCIAL CHANGE 11 (2019) (identifying the importance of offering frameworks for performance management in the social sector that offer a degree of standardization but can also be tailored to the circumstances of individual firms).

[110]A better understanding of effective management may disseminate by, for example, updating MBA curricula, growing executive education, and increasing practitioner publications on the topic. At present, these leadership skills are likely somewhat uncommon among managers due to the relative novelty of pursuing social goals in mainstream for-profit firms. Consider, for example, the fact that business schools do not yet typically teach such skills as part of the standard MBA curriculum. *See First-Year Curriculum*, STAN. GRADUATE SCH. BUS., https://www.gsb.stanford.edu/programs/mba/academic-experience/curriculum/first-year [https://perma.cc/YC98-Z557] (featuring no required courses on social pursuits in business); *Wharton MBA Classes, Courses & Curriculum*, WHARTON, https://mba.wharton.upenn.edu/mba-curriculum [https://perma.cc/2ND9-9X59] (requiring no fixed core courses on social pursuits in business); *Required Curriculum*, HARV. BUS. SCH., https://www.hbs.edu/mba/academic-experience/curriculum/Pages/required-curriculum.aspx [https://perma.cc/8M3J-2NHT] (offering one short module on how "private firms can help address some of society's greatest challenges"); *see also* Julie Battilana, Brittany Butler, Marissa Kimsey, Johanna Mair, Christopher Marquis & Christian Seelos, *Problem, Person, and Pathway: A Framework for Social Innovators*, *in* HANDBOOK OF INCLUSIVE INNOVATION 61 (Gerald George et al. eds., 2019) ("In the last decade, the appetite for learning about social innovation has intensified, and universities around the world have tried to keep up by creating an array of new courses, certificates, and degree programs.").

[111]When a hybrid firm is successful enough to go public with its social and financial objectives both intact, it points to successful hybrid leaders who have managed to maintain hybridity through the challenges of scaling up. *See* Austin & Leonard, *supra* note 45, at 79 ("These small innovators have mastered what we call a 'social technology'—a special know-how—that embeds social values into their missions, production processes, product characteristics, organizational cultures, and relationships with their employees, their suppliers, and their consumers. This constellation has created distinctive value propositions and powerful brand integrity."); Aguirre, *Beyond Profit*, *supra* note 41, at 2117.

[112]*See* Bebchuk & Kastiel, *supra* note 4, at 604-05 ("At the time of the IPO, the founder of a company may have the special skills and deep knowledge of a specific industry and business to make her uniquely fit to be at the helm."). The authors go on to argue that these leadership advantages generally recede over time for typical profit-oriented firms. *Id.*

where leadership skills can be particularly specialized and uncommon, managers with a proven track record may play an even more important role in ongoing firm success and, therefore, even more valuable to protect.[113]

In addition, unlike at traditional firms where the benefits of retaining founders or early insiders at IPO are likely to recede over time, at firms with objectives beyond profit these benefits may persist for longer.[114] Organizational fragility continues over time at firms with nonfinancial goals, requiring ongoing protective mechanisms and management expertise in simultaneously maintaining social and financial performance. Preserving leaders with the rare ability to manage these firms may accrue benefits that endure over time in a way that traditional firms may not share.[115] As a result, the benefits of entrenching expertise using multiclass structures may be even more pronounced for firms with objectives beyond profit and over a longer timeframe. Effective hybrid leaders may be especially worth keeping.

Multiclass structures can add value by supporting effective management practices to retain firm social and financial performance in this challenging context. By entrenching control in successful hybrid leaders, they can help create conditions for success even after going public, generating an important intrafirm

[113] It is important to distinguish this claim of specialized expertise for prosocial leaders from the concept of "visionary leadership." Visionary leaders can be thought of as having a strategic vision and an ability to inspire. While successful prosocial leaders may incidentally share some of the attributes of visionary leaders, the claim in this Article is that prosocial leaders also have rare and valuable hybrid skill sets. *See* Nufer Yasin Ates, Murat Tarakci, Jeanine P. Porck, Daan van Knippenberg & Patrick Groenen, *Why Visionary Leadership Fails*, HARV. BUS. REV. (Feb. 28, 2019), https://hbr.org/2019/02/why-visionary-leadership-fails [https://perma.cc/ES2K-XD8Y].

[114] Bebchuk and Kastiel show that for traditional profit-oriented firms, any benefits that founders or early insiders may provide at the IPO are likely to recede over time. Bebchuk & Kastiel, *supra* note 4, at 611. In contrast, firms with objectives beyond profit remain susceptible over time to outside interference with firm social goals, suggesting ongoing value of protective leadership expertise.

[115] For example, traditional firms may reap more benefits from leaders with specialized expertise in running publicly traded firms, and founders or early insiders may not offer any particular comparative advantage. *See* Noam Wasserman, *The Founder's Dilemma*, HARV. BUS. REV. (Feb. 2008), https://hbr.org/2008/02/the-founders-dilemma [https://perma.cc/N7EM-E5TS]. Firms with objectives beyond profit may benefit from leaders with expertise in running public companies, but they *also* reap benefits from leaders who can successfully lead hybrid firms, creating advantages for skilled founders and early insiders to remain leading these firms. *See* Wry & York, *supra* note 97, at 447; Battilana & Dorado, *supra* note 41, at 1423-24; Smith & Besharov, *supra* note 87, at 8, 24-25, 27. *See generally* Battilana et al., *supra* note 97 (explaining all the challenges and importance of successful hybrid leadership).

benefit. These managerial benefits help explain why multiclass structures may be an especially appealing governance tool for leaders, investors, and employees of firms with objectives beyond profit.

### *B. Market Benefits: Protecting Against Short-Termism and Activist Investors*

In addition to these managerial benefits, multiclass structures can also provide important market benefits for firms with objectives beyond profit. Specifically, they can help protect prosocial firms from the short-termism inherent to public markets and from the threat of activist investors who specifically target firms with nonfinancial goals.

For firms with social goals, going public can present significant market barriers to success that may have little to do with the viability of the business model. Social initiatives may be controversial in the short-term and their return on investment—whether social or financial—may take years to realize.[116] As a result, operating a public company subjects firm leaders to short-term scrutiny and pressures that can make it difficult to take on social

[116]For example, Nike initially lost $3.75 billion in market capitalization and 4 percent of its stock value after announcing in September 2018 that NFL Quarterback Colin Kaepernick would be the face of its new campaign, after Kaepernick controversially kneeled during the national anthem at NFL games in protest of racism. But two years later, Nike's value rose $26.2 billion. The short-term hit due to the company taking a social and political stance did not prevent long-term financial gain a few years later. Tony Maglio, *Nike Loses $3.75 Billion in Market Cap After Colin Kaepernick Named Face of "Just Do It' Ads*, WRAP (Sept. 4, 2018, 8:02 AM), https://www.thewrap.com/colin-kaepernick-nike-stock-loses-4-billion-market-cap [https://perma.cc/XZU4-EZBZ]; Gabrielle Bernardini, *Nike's Revenue Increased Following Controversial Colin Kaepernick Campaign*, DISTRACTIFY (July 7, 2020), https://www.distractify.com/p/did-nike-lose-money-after-signing-kaepernick [https://perma.cc/3AWY-HCGW]. To take another example, Unilever's ten-year Sustainable Living Plan required significant financial outlays up front, including to reformulate products nutritionally, run public campaigns, reduce greenhouse gas impact and water usage, and improve sustainable sourcing, among others. But after ten years, the company achieved several long-term social and financial returns, supporting the proposition that "sustainable business drives superior business performance." UNILEVER, UNILEVER SUSTAINABLE LIVING PLAN 2010 to 2020 (2021), https://www.unilever.com/files/92ui5egz/production/16cb778e4d31b81509dc5937001559f1f5c863ab [https://perma.cc/F82C-XLE9] (indicating various ways in which achieving social goals also resulted in improved business performance); *see also* Miles Klee, *Companies That Get 'Woke' Aren't Going Broke — They're More Profitable Than Ever*, ROLLING STONE (Apr. 8, 2023), https://www.rollingstone.com/culture/culture-features/woke-companies-broke-profits-1234710724 [https://perma.cc/V8ZH-6H3U] (reporting on nine firms that may have experienced short-term financial hits from social initiatives that did not result in any long-term financial penalties for firm performance).

initiatives with longer-term payoffs.[117] For example, the requirement to publish quarterly earnings reports[118] creates pressure for managers to exhibit consistent economic growth and to demonstrate returns once every three months as opposed to a longer—often more realistic— time horizon.[119] These pressures incentivize managers to prioritize short-term perspectives and can disincentivize social initiatives that may have long-term net positive or neutral financial impact that is not reflected in a quarterly earnings report.

Trading publicly also exposes prosocial firms to outside—often activist— investors who threaten firm social goals.[120] Activist investors typically identify financially underperforming, publicly traded firms, buy a modest stake, and then campaign to imple-

[117] *See* Rachelle C. Sampson & Yuan Shi, *Are U.S. Firms Becoming More Short-Term Oriented? Evidence of Shifting Firm Time Horizons from Implied Discount Rates, 1980-2013*, 44 Strategic Mgmt. J. 231, 233-34, 249 (2023) (showing how short-termism has increased, including from "the threat of shareholder activism[,] [which] has been shown to lead firms to focus on short-term returns"). Short-termism places pressure on public companies to produce large financial returns as quickly as possible, leading to broader systemic problems as firms are "less willing to take on the risks associated with longer-term investments" and avoid "profitable strategies if payoffs are less transparent (e.g., R&D investment) or spread over a longer term." *Id.* at 233, 260; *see also* Abigail Salas, *Short-Term Thinking in U.S. Markets: A Growing Trend With Lasting Implications*, Mcdonough Sch. Bus. (Jan. 23, 2018), https://msb.georgetown.edu/newsstory/short-term-thinking-us-markets [https://perma.cc/9JQV-Y3TT] ("While [short-termism] provides an instant win for shareholders, it can lead to systemic problems down the road. Companies put less attention into employee training, research and development (R&D), and the long-term cost of strategies such as outsourcing or environmentally unfriendly practices.").

[118] SEC. Exch. Comm'n, Form 10-Q, General Instructions, https://www.sec.gov/files/form10-q.pdf [https://perma.cc/8P6V-GVYC] ("A quarterly report . . . shall be filed . . . after the end of each of the first three fiscal quarters of each fiscal year.").

[119] *See Short-Termism*, CFA Inst. Rsch. & Pol'y CTR (Oct. 29, 2019), https://rpc.cfainstitute.org/en/policy/positions/short-termism [https://perma.cc/6BZW-8URK] ("Federal securities laws are said to be one cause of financial-market short termism by encouraging Wall Street's quarterly earnings fixation. The regulations' quarterly reporting requirements exacerbate the problem, the argument goes."). Such quarterly reporting may not best capture long-term firm performance. *See* Frank Van Gansbeke, *Sustainability and the Downfall of Danone CEO Faber (2/2)*, Forbes (Mar. 20, 2021, 7:36 AM), https://www.forbes.com/sites/frankvangansbeke/2021/03/20/sustainability-and-the-downfall-of—danone-ceo-faber-22 [https://perma.cc/5SUA-BP8Z] (citing research "that long-term oriented companies exhibit superior performance in terms of revenue, net income, market capitalization, and job creation").

[120] Aguirre, *Beyond Profit*, *supra* note 41, at 2106. Activist investors buy shares in companies to influence company changes, usually to increase share price and make a short-term profit. Occasionally, activist investors may buy stakes in firms to effect social change. *See* Aguirre, *The Little Hedge Fund Taking Down Big Oil*, *supra* note 47.

ment changes in the firm that will lead to an immediate increase in share price.[121] They then sell their stake for a quick and lucrative profit.[122]

Firms with objectives beyond profit are especially susceptible to activist investors because these firms explicitly advertise prosocial initiatives that may seem to come at the expense of short-term profits. For example, Etsy provided generous employee benefits and invested in a state-of-the-art new headquarters in Brooklyn that furthered the company's deeply held value to generate employee well-being.[123] The multinational company Danone, which owns brands such as Activia, Oikos, and evian,[124] invested in "best-in-class soil health programs" and expensive product reformulations to improve the health profile of its product portfolio in furtherance of its goals to promote environmental and human sustainability.[125]

These initiatives required substantial financial investment that appeared at odds with maximizing share price. To outsiders, these financial investments may not obviously link to maximizing profit—and, in fact, may seem to negatively impact profit, at

[121] Of course, after buying up their stake, activist investors cannot unilaterally change the firm and must persuade the board to alter their policies. However, to do so is not simply a matter of convincing the rest of the shareholders to vote a certain way. Activist investors rely on a number of tactics to influence firm leadership and policies to achieve their desired outcomes, including publicity campaigns and threatened litigation or proxy fights. *See* Nili, *supra* note 47, at 15 n.118 (explaining that "hedge funds may apply public pressure to convince a designating company to change its governance, it could wage a proxy fight, or it could threaten litigation against current or former managers"); Kahan & Rock, *supra* note 47, at 1029.

[122] *See* Emily Washburn, *What's An Activist Investor-And How Do They Exercise So Much Control?*, FORBES (Feb. 3, 2023, 2:42 PM), https://www.forbes.com/sites/emilywashburn/2023/02/03/whats-an-activist-investorand-how-do-they-exercise-so-much-control [https://perma.cc/QZ33-PW9K] ("Activist investors . . . usually try to make money by investing in underperforming companies, trying to improve their performance and then selling their shares for profit."); Kahan & Rock, *supra* note 47, at 1064-66 (describing the extremely high profit structure of activist investor hedge funds).

[123] David Gelles, *Inside the Revolution at Etsy*, N.Y. TIMES (Nov. 25, 2017), https://www.nytimes.com/2017/11/25/business/etsy-josh-silverman.html [https://perma.cc/XHB8-KS5F].

[124] Danone is one of the world's largest yogurt producers. Its portfolio also includes Dannon, Silk plant-based milk, So Delicious dairy-free products, and International Delight creamers, among others. *Products and Brands*, DANONE, https://www.danone.com/brands.html [https://perma.cc/79PE-Y52H].

[125] Frank Van Gansbeke, *Sustainability and the Downfall of Danone CEO Faber (1/2)*, FORBES (Mar. 20, 2021, 7:30 AM), https://www.forbes.com/sites/frankvangansbeke/2021/03/20/sustainability-and-the-downfall-of-danone-ceo-faber-12 [https://perma.cc/67BU-FAKX].

least in the short run.[126] Indeed, activist investors mounted successful campaigns at both companies, explicitly targeting their objectives beyond profit.[127] Shortly after Etsy's IPO, activist investors successfully waged a publicity campaign that enabled them to elect new board members, fire the socially and environmentally oriented CEO, appoint a profit-oriented successor, and eliminate the firm's B Corp status.[128] What was once a shining example of socially conscious business quickly turned into a warning of the perils of going public.[129]

Activist investors also successfully targeted Danone. This company has had a long-standing, deep commitment to pursuing social and environmental goals alongside financial goals.[130] Danone's former CEO, Emmanuel Faber, was well-known for his commitment to environmental and human sustainability.[131] Under Faber's leadership, in 2020, Danone became the first

[126] These outsiders also may not appreciate how firm social goals often link intricately to firm financial performance, such that eliminating or weakening them can also trade off firm financial performance in the long run. For example, one C-Suite Executive of a major multinational company explained after acquiring a prosocial company that the acquirer did not understand that the social purpose was bound up in the business model—losing the social purpose entailed losing the business model. Aguirre, *Beyond Profit*, *supra* note 41, at 2088-89 n.39.

[127] Vivienne Walt, *A Top CEO Was Ousted After Making His Company More Environmentally Conscious. Now He's Speaking Out*, TIME (Nov. 21, 2021, 7:00 AM), https://time.com/6121684/emmanuel-faber-danone-interview [https://perma.cc/G7M8-UEWG]; Gelles, *supra* note 123; *Activist Investor Bluebell Takes Aim at Danone*, CNBC (Jan. 19, 2021, 8:41 AM), https://www.cnbc.com/video/2021/01/19/activist-investor-bluebell-takes-aim-at-danone.html [https://perma.cc/E2D4-QELW].

[128] Aguirre, *Beyond Profit*, *supra* note 41, at 2079-80. B Corp certification is a third-party certification administered by the nonprofit organization B Lab. B Lab was also instrumental in passing benefit-corporation legislation in jurisdictions across the United States. *See* Marcel Fukayama, *The Policy #BehindtheB: How We're Creating New Rules For the Global Economic System*, B LAB GLOB. (Mar. 17, 2022), https://www.bcorporation.net/en-us/news/blog/behind-the-b-inside-policy-at-b-lab [https://perma.cc/3XPU-UEDU]. To certify, companies must achieve and maintain a minimum score across a range of social and environmental factors. For example, firms might earn points by monitoring and recording waste production, paying all workers a living wage, or having a percentage of management come from underrepresented populations. B Lab enlists a Standards Advisory Council, an "independent, global, multi-stakeholder group with expertise in responsible and sustainable business" to develop its standards and commits to evolving continually its tools and strategies to measure social impact effectively over time. *About Our Standards*, B LAB GLOB., https://www.bcorporation.net/en-us/standards [https://perma.cc/JHA4-NBFU].

[129] *Id.*

[130] *Impact*, DANONE, https://www.danone.com/brands.html [https://perma.cc/GRA7-GTER].

[131] Walt, *supra* note 127.

publicly traded company to adopt France's new "Société à Mission" legal status, under which companies must articulate social and environmental goals, memorialize them in their bylaws, create a Mission Committee to monitor progress, and appoint a third party to verify the mission is achieved.[132] Faber also implemented a carbon adjusted earnings per share metric, which linked Danone's success directly to its environmental performance, among many other social and environmental initiatives.[133]

In May 2021, an activist investor targeted the firm to remove Faber, claiming he overemphasized firm social and environmental goals to the detriment of financial performance.[134] In mounting its campaign, the activist investor specifically stated that Faber "did not manage to strike the right balance between shareholder value creation and sustainability."[135] The activist investor succeeded, and Faber stepped down.[136]

Etsy and Danone are not alone. Activist investors have also specifically targeted firm social goals at Proctor & Gamble,[137] Unilever,[138] and Whole Foods,[139] among other firms. Many attribute the activist investor campaign at Unilever to the company being "too focused on social purpose rather than delivering profits for shareholders."[140] An activist investor's 2017 targeting of Whole Foods led to a conflict that then-CEO John Mackey referred to as a "morality play between conscious capitalism [or business for a higher purpose] and greedy, short-term financial capitalism."[141] The activist investor first managed to overhaul the Whole Foods

[132]*Sustainable Value Creation*, DANONE, https://www.danone.com/brands.html [https://perma.cc/GRA7-GTER].

[133]*See* Gansbeke, *supra* note 125.

[134]*Activist Investor Bluebell Takes Aim at Danone*, *supra* note 127.

[135]*Id.*

[136]Walt, *supra* note 127.

[137]Sharon Terlep, *Before Unilever, Nelson Peltz Took Aim at P&G's "Thicket?"*, WALL ST. J. (May 31, 2022, 7:32 PM), https://www.wsj.com/articles/before-unilever-nelson-peltz-took-aim-at-p-gs-thicket-11654019499 [https://perma.cc/N6BP-PBD3].

[138]*Id.*; Stephen Beard, *Is Unilever a "Woke" Company Headed for a Rude Awakening?*, MARKETPLACE (July 4, 2022), https://www.marketplace.org/2022/07/04/is-unilever-a-woke-company-headed-for-a-rude-awakening [https://perma.cc/W5ME-8RQY].

[139]Tom Foster, *The Shelf Life of John Mackey*, TEX. MONTHLY (July 2017), https://www.texasmonthly.com/news-politics/shelf-life-john-mackey [https://perma.cc/WUV4-ASXE]; Michael J. de la Merced & Alexandra Stevenson, *Rooted in Counterculture, Whole Foods' Founder Finds an Unlikely Refuge*, N.Y. TIMES (June 16, 2017), https://www.nytimes.com/2017/06/16/business/dealbook/whole-foods-john-mackey-amazon.html [https://perma.cc/SG8S-MHPA].

[140]Beard, *supra* note 138.

[141]Foster, *supra* note 139.

board, then pushed the company into a sale to Amazon—all in the span of just two months.[142] This brief two-month investment yielded a return of about $301 million for the activist investor.[143]

Activist investors can leverage even a small stake in the company into significant change at the firm. Often the mere threat of an activist campaign is enough to force substantial transformation. For example, the Unilever activist investors secured a seat on the board and effected significant company change after building just a 1.5 percent stake in the firm and despite some investors expressing concern about the loss of nonfinancial objectives.[144] Activist investors at Whole Foods overhauled the board and effectuated the sale to Amazon in just two months, largely by threatening to otherwise oust the CEO, coercing his cooperation.[145] Activists achieved the ousters at Danone via an effective publicity campaign.[146] It is not the case, then, that activist investor success necessarily indicates agreement or support from the majority of shareholders.[147] Rather, prosocial firms may inadvertently create an easy target for activists by publicly articulating nonfinancial objectives that seem at odds with short-term profit. Both short-termist pressures and activist investors, therefore, present significant challenges to publicly traded firms with objectives beyond profit.

As a result, multiclass structures can help neutralize short-termist and activist investor threats to social goals by protecting insiders who are dedicated to achieving social performance alongside financial returns. For example, companies like Allbirds and Nike can engage in prosocial initiatives that may take time

142 Merced & Stevenson, *supra* note 139.

143 *Id.*

144 *Unilever Names Activist Investor Nelson Peltz to Board*, CNBC (May 31, 2022, 3:08 AM), https://www.cnbc.com/2022/05/31/unilever-adds-billionaire-activist-investor-nelson-peltz-to-its-board.html [https://perma.cc/B6UN-AWUM]; *see* Jessica DiNapoli & Richa Naidu, *Activist Investor Peltz Meets Possible Unilever CEOs*, REUTERS (Oct. 25, 2022, 4:07 AM), https://www.reuters.com/business/retail-consumer/exclusive-activist-investor-peltz-meets-possible-unilever-ceos-2022-10-24 [https://perma.cc/9JK5-P8B7] ("Some investors have criticized the company for putting profits before more sustainable goals.").

145 Foster, *supra* note 139.

146 *See Activist Investor Bluebell Takes Aim at Danone*, *supra* note 127; Laurence Fletcher & Leila Abboud, *The Little-Known Activist Fund that Helped Topple Danone's CEO*, FIN. TIMES (Mar. 24, 2021), https://www.ft.com/content/dd369552-8491-40a2-b83b-9a1b2e32407a [https://perma.cc/69TY-72RF] ("Bluebell quickly became the public face of a campaign at Danone that eventually led to Faber's ousting last week.").

147 It also may not represent the perspectives of other important players at the firm, including employees, management, and others who deal with the firm such as suppliers and creditors. For example, employees at Etsy were highly displeased with the firing of their CEO. Gelles, *supra* note 123.

to realize social or financial value, and can even result in short-term financial losses,[148] without fear of short-termist activist investors because pro-social insiders retain control over the firm. In this way, multiclass structures generate an additional intrafirm benefit, further strengthening the appeal of multiclass structures for prosocial firms.

Despite these intrafirm benefits, many of the same general criticisms raised in Part I.B above still apply. In fact, some may consider these intrafirm benefits and, more generally, the achievement of privately and undemocratically determined so-called "social" goals simply to constitute another way for insiders to extract idiosyncratic private benefits of control at the expense of outside shareholders and firm value. Yet this Article argues that this discourse, and the framing in terms of financial shareholder value, misses an important set of additional considerations. Implementing multiclass structures in firms with objectives beyond profit may generate not only intrafirm benefits and private benefits of control but also a broader set of societal advantages—what this Article calls the *social* benefits of control.

## III The Social Benefits of Control

Multiclass structures generate underappreciated and valuable social benefits of control that are amplified in firms with objectives beyond profit. This Part argues that these social benefits of control accrue in two primary ways. First, multiclass structures help solve a challenging private contracting problem among socially conscious firm insiders and outsiders, and especially shareholders and employees. Second, they can also promote declining public capital markets by neutralizing a key reason why firms with objectives beyond profit may choose to stay private, protecting prosocial insiders from the threat of short-termist outsiders. Both of these outcomes accrue not just to the benefit of an individual firm or set of shareholders but to the broader benefit of society.

### *A. Enabling Private Contracting for Social Good*

An increasing number of socially conscious parties seek to deal with companies that commit to achieving not just financial performance but also social performance. These parties include

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[148] *See* Maglio, *supra* note 116 (showing that Nike lost $3.75 billion after its Colin Kaepernick add campaign promoting racial equity); Bernardini, *supra* note 116 (showing that Nike's value was up $26.2 billion two years after its Kaepernick campaign); *Allbirds Sprints Toward Sustainability*, *supra* note 38 (stating that Allbirds has created aggressive sustainability targets and is meeting them); James, *supra* note 38 (showing that Allbirds' stock price has dropped since its IPO).

investors, employees, and suppliers, among others.[149] For example, a growing class of investors prefer to deploy capital in firms that generate social impact, even if it means trading off some pecuniary gain.[150] A growing number of employees prefer to work for firms with social goals, even if it means trading off some compensation to do so.[151] A growing contingent of suppliers and service providers prefer to work with companies that share their social commitments, even if they do not command the highest price.[152] These parties increasingly structure their contracts with firms to achieve social goals in addition to financial goals. Take, for example, when corporate clients of law or consulting firms require a certain degree of racial or ethnic diversity on the teams staffing their projects.[153] These groups all deal with the firm on the understanding that its leaders will pursue not just financial

**[Section III]**

[149]Michal Barzuza, Quinn Curtis & David H. Webber, *The Millennial Corporation: Strong Stakeholders, Weak Managers*, 28 STAN. J.L. BUS. & FIN. 255, 255 (2023); LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 95-96 (2012) ("One problem with *homo economicus* . . . is that a purely rational and purely selfish person is a functional psychopath. . . . The scientific data now demonstrates beyond reasonable dispute that the vast majority of human beings are at least to some degree 'prosocial.'").

[150]Barzuza et al., *supra* note 149, at 259; *see* Jill E. Fisch & Adriana Z. Robertson, *What's in a Name? ESG Mutual Funds and the SEC's Names Rule*, 96 S. CAL. L. REV. 1417, 1420 (2024).

[151]Barzuza et al., *supra* note 149, at 276-78. Indeed, public interest lawyers—and perhaps law professors—who work at nonprofit charities, including many universities, rather than maximizing individual profit by working at a big law firm may relate to the idea of trading off overall monetary gain in exchange for achieving social impact. That social impact could include representing indigent clients, mentoring students, adding knowledge to the world, or making systemic change.

[152]Interview with Participant 8 (Jan. 11, 2024) ("There is not one meeting that I have with suppliers where we don't talk about sustainability. . . . And that's a big change. . . ."). He also noted that "suppliers know that if they come with sustainable ideas th[e] [company] will pick on it instead of having just a stupid price negotiation. . . . [A]ll of a sudden, that sustainability becomes a competitive advantage. . . ."). *Id.*

[153]*The Imperative for Law Firms to Embrace Diversity: A Call To Action from In-House Counsel*, LEGAL.IO (Nov. 8, 2023), https://www.legal.io/articles/5450963/The-Imperative-for-Law-Firms-to-Embrace-Diversity-A-Call-to-Action-from-In-House-Counsel [https://perma.cc/4AFG-DA4Q] ("In-house counsel are clear in their message: they want to see law firms not only staff their matters with diverse talent but also provide meaningful opportunities for these individuals to engage with clients. . . ."); Christine Simmons, *170 GCs Pen Open Letter to Law Firms: Improve on Diversity or Lose Our Business*, AM. LAW. (Jan. 27, 2019, 3:00 PM), https://www.law.com/americanlawyer/2019/01/27/170-gcs-pen-open-letter-to-law-firms-improve-on-diversity-or-lose-our-business [https://perma.cc/NUF5-MUSE].

returns but also publicly represented and contracted-for firm social goals.

Firms make representations of their social goals in various ways that may elicit reliance from investors, employees, and others. For example, publicly traded companies may commit to social goals in their articles of incorporation, B Corp certification documents, or SEC filings such as registration statements and quarterly and annual disclosures. Vital Farms, a pasture-raised eggs company, specifically noted in its S-1 that its "duty to balance a variety of interests may result in actions that do not maximize stockholder value."[154] The Allbirds S-1 publicizes the company's B Corp certification and public benefit corporation status and pledges the "alignment of financial and environmental benefits" at the firm, as well as its desire to "serve as a driving force in a new age of sustainable enterprise."[155] Allbirds describes its deep commitment to social goals on the first page of its S-1, explaining how "every aspect of [the] company is woven together with this mission."[156] These representations are not just public relations exercises or mere pufferies for a voluntary annual report or press release. Rather, they appear in legally binding regulatory disclosures and as evidence provided to qualify for third-party B Corp certification of their business practices.

Those who deal with these firms understandably rely on these representations. Shareholders buy stock at a certain price expecting not just a financial return but also a social one.[157] Employees agree to a certain level of compensation in exchange for working at a firm that pursues its stated social goals.[158] Suppliers and other service providers deal with the firm at a certain price or rate with the understanding it will pursue its objectives beyond profit.[159] When shareholders, employees, suppliers, and others contract with these firms, they do so with the clear understanding—and promise—that they will receive not just a financial return but also firm social performance.

Yet the consistent threat of third-party interference renders these contracts for social performance flimsy and unreliable. Existing shareholders, employees, and other parties who contract with the expectation of receiving a social return cannot depend-

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[154] Vital Farms Amendment No. 1, *supra* note 47, at 10.

[155] Allbirds Registration Statement, *supra* note 29, at 1.

[156] *Id.*

[157] *See* Barzuza et al., *supra* note 149, at 280 ("Several recent experimental studies confirm investors' stated willingness to pay for social responsibility.").

[158] *Id.* at 276-77.

[159] *See* Min Zhang, Lijun Ma, Jun Su & Wen Zhang, *Do Suppliers Applaud Corporate Social Performance*, 121 J. BUS. ETHICS 543, 545 (2014) ("[S]ocial responsibility helps a firm to obtain more trade credit from suppliers. . . .").

ably protect their contracts from the outside threats of short-termism and activist investors, because both often exert pressures to eliminate or diminish firm social goals.[160] The structural realities of public markets make it difficult for publicly traded firms with single-class models to retain their social performance—and to make good on their contractual commitments.[161]

Perhaps one response is that nonbreaching parties should simply be compensated for any breach that may occur, just as in other contracting contexts. But when these contracts are undermined, there is little recourse to make nonbreaching parties whole. How can a firm compensate the nonbreaching shareholder, employee, or supplier for the lost social impact suffered? Here the parties have explicitly indicated ex ante that financial compensation is inadequate—in fact, each contracting party often specifically chooses to forgo the highest possible financial return to achieve some social return. It is therefore little consolation for shareholders who contracted for a social return that they can exit and sell their stock for a higher price on the market if an activist investor targets their firm. This recourse means they can never receive the social benefit of their bargain and they are always inherently undercompensated.

Employees, suppliers, and others who contract with the firm are even worse off. In addition to being inherently undercompensated for breach, it is even harder for these parties to exit the firm should breach occur.[162] A nonbreaching employee can seek new employment, and a supplier can seek a new buyer, but these pathways are generally quite burdensome to pursue and much more challenging than selling stock on a public exchange. Employees and suppliers usually make significant firm-specific investments in reliance on their contracting partners. For example, employees may move residences and enter into long-

[160] *See supra* Part II.B.

[161] Nor does it solve the problem for firms simply to contract with executives to employ them in perpetuity. These contracts can simply be breached, and damages paid, as is frequently the case with so-called golden parachutes that are prevalent in executive contracts. *See* Adam Hayes, *Golden Parachute: Definition, Examples, Controversy*, INVESTOPEDIA (Mar. 11, 2021), https://www.investopedia.com/terms/g/goldenparachute.asp [https://perma.cc/6VWR-UQYC] ("Golden parachutes are lucrative severance packages inked into the contracts of top executives that compensate them when they are terminated."). And if the damages are so high as to be prohibitive, the contract would not meaningfully differ from a multiclass structure—except that at least in a multiclass structure, the executive also has some economic stake in the firm.

[162] The literature in employment economics and labor antitrust illustrate how changing jobs can be very difficult and involve substantial costs for employees. ERIC POSNER, HOW ANTITRUST FAILED WORKERS I (2021) ("New evidence suggests that many labor markets around the country are not competitive but instead exhibit considerable market power enjoyed by employers. . . .").

term leases or mortgages to be closer to their workplace or build up firm-specific skill sets and expertise that are not easily transferrable.[163] Suppliers often change their entire production processes to conform to the requirements of a single buyer.[164] The switching costs of finding a new employer or buyer can therefore be quite high, if not prohibitive.

In addition, for shareholders, employees, and suppliers, exit from the firm may signal an ex post expression of disagreement with firm trajectory. But it does not provide a reliable ex ante contracting option nor adequate compensation in case of breach. Without further protections, these outcomes lead to a situation where socially conscious leaders of publicly traded firms cannot dependably bargain with investors, employees, or suppliers to achieve nonfinancial firm objectives. Powerful third-party interference inhibits private dealing among these parties, creating a serious contracting problem.

This outcome is particularly puzzling given that most jurisdictions in the United States, including the most important ones in corporate law, have recently created an entire corporate law apparatus designed to enable and regulate firms with objectives beyond profit.[165] Public benefit corporation law requires firm leaders who adopt this form to manage the business to achieve the firm's stated social goals alongside financial performance and to account for the interests of materially affected nonshareholder stakeholders.[166] Perhaps if corporate law did not permit firms to pursue nonfinancial objectives, this contracting problem would not be so troublesome. But policymakers have explicitly,

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[163] *See* Heli S. Wang & Jay S. Barney, *Employee Incentives to Make Firm-Specific Investments: Implications for Resource-Based Theories of Corporate Diversification*, 31 Acad. Mgmt. Rev. 466, 466 (2006) ("[A] great deal of research in organizational economics suggests that employees who make firm-specific investments risk opportunistic actions by the firms. . . . Once employees make firm-specific investments, firms can systematically extract wealth from these employees, and employees have few ways they can protect themselves.").

[164] *See* Niels J. Pulles, Chris Ellegaard & Jasper Veldman, *The Interplay Between Supplier-Specific Investments and Supplier Dependence: Do Two Pluses Make a Minus?*, 49 J. Mgmt. 1430, 1431-32 (2023) ("[S]upplier dependence [on a focal buyer] is a source of uncertainty that affects the behavior of the supplier. Specifically, for the dependent supplier, the future actions of the high-volume buyer are unknown, which leads to a situation in which the supplier's continued success is uncertain.").

[165] *See, e.g.*, Del. Gen. Corp. L. §§ 361-368; Cal. Corp. Code §§ 14600-14631; N.Y. Bus. Corp. L. §§ 1701-1709; Nev. Rev. Stat. § 78B.

[166] *See* Del. Gen. Corp. L. § 365 (requiring boards to "manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation").

legislatively authorized and legitimated prosocial firms through the recent creation of an entire corporate law apparatus. Surely contracting for social goals—which is required for these firms to comply with their legal obligations—is permissible for these firms at the very least.

Yet even public benefit corporation law does not protect parties who wish to contract for both social and financial returns.[167] Despite legally enabling firms with objectives beyond profit, public benefit corporation law provides no meaningful enforcement or accountability mechanisms to practically enable these firms to persist and survive, or to protect them from third-party interference with firm social goals.[168] For example, public benefit corporation laws do not mandate meaningful third-party oversight of firm social performance, require only nominal (and underenforced) annual or biennial reporting on how a firm has pursued its social goals, and do not provide meaningful penalties for failing to abide by the articulated duties to pursue social goals or account for materially affected stakeholders.[169] They also do not address third-party interference with preexisting contracts for social performance.

The advent of public benefit corporation law and the rise of socially conscious investors, employees, suppliers, and other parties underscore the growing public support for achieving social goals in business. But this legal apparatus and these parties' various attempts to privately order for social and financial returns consistently fall short.[170] Neither business law nor private contracting yet provides a reliable solution for the growing class

[167] There is, of course, symbolic value of public benefit corporation law. For example, it helps normalize the pursuit of social goals in business in the public consciousness. However, symbolic value falls short of providing the practical support that these firms also need to persist and survive.

[168] Aguirre, *Beyond Profit*, *supra* note 41, at 2106; *see* DEL. GEN. CORP. L. §§ 361-368.

[169] *See* DEL. GEN. CORP. L. § 366. The minimal disclosure requirements in public benefit corporation law are largely unenforced, decentralized, and unstandardized. Firms have little consequence if they do not comply with the requirement to publish an annual or biennial report. There is no central agency like the SEC overseeing disclosure, and no central repository to access firm reports, making the reports difficult to locate, particularly en masse. Public benefit corporation law does not provide enforcement rights for beneficiaries of the firm's social objectives unless they own at least 2 percent of the company's stock, nor does it restrict public benefit corporation firm activity or dividends. DEL. GEN. CORP. L. § 367; NEV. REV. STAT. § 78B.190; *see* J. Haskell Murray, *An Early Report on Benefit Reports*, 118 W. VA. L. REV. 25, 34 (2015) (finding an 8 percent compliance rate among benefit corporations in Hawaii, California, New York, and Virginia through 2014).

[170] For example, Allbirds was thwarted in its attempt to conduct a "sustainable IPO," various mutual funds have failed in attempts to properly market

of socially conscious firm leaders, investors, employees, and others who wish to bargain for social goals in publicly traded firms.[171]

Absent another solution, these parties must either forgo public markets or live in fear of their contracts failing. Forgoing public markets would have serious consequences and untenable implications. For example, it would eliminate many, if not most, retail investors from prosocial firms because private markets have more challenging investment requirements and procedures than easily accessible and liquid public markets.[172] Excluding socially conscious firm leaders, investors, employees, and suppliers from public markets—and thereby foreclosing the meaningful investment, employment, supplier, and other opportunities that public markets afford—cannot be the solution. Indeed, the growing public support for prosocial firms, including in corporate law, suggests these firms should be made more accessible and not less.

In the absence of another viable solution in corporate law or private contracting, corporate governance can help address this

themselves as prosocial, and sustainability-linked loans have seen a sharp rise but have led to only nominal impacts. These and many other examples indicate the groundswell of public support for prosocial firms, which nevertheless continue to fall short. *See* Blair Palese, *Allbirds' SPO and the Equity Value of ESG*, GREENBIZ (Nov. 10, 2021), https://www.greenbiz.com/article/allbirds-spo-and-equity-value-esg [https://perma.cc/6V4K-LNLU] ("As Allbirds listed on NASDAQ last week, its chief financial officer announced that the company was dropping its claim to be the first 'sustainable' IPO—an 'SPO'—due to objections from the Securities and Exchange Commission."); Fisch & Robertson, *supra* note 150, at 1419-20 (describing proposed SEC rules to regulate mutual funds that deceptively label their products as prosocial to take advantage of a groundswell of consumer demand for prosocial investment products and noting that prosociality is "rife with ambiguity"); Nakita Q. Cuttino, *Private Debt for Public Good*, 76 FLA. L. REV. 637, 644-46 (2024) (explaining the shortcomings of private lending that holds itself out to be prosocial or sustainable).

[171] *See* Aguirre, *Beyond Profit*, *supra* note 41, at 2148 (arguing that "no matter how [social startups] choose to legally incorporate, privately order themselves, or scale up, business law fails to provide them with a durable commitment mechanism to help counter the losses of strategic and managerial control at scale").

[172] *See Private Equity Funds*, U.S. SEC. EXCH. COMM'N, https://www.investor.gov/introduction-investing/investing-basics/investment-products/private-investment-funds/private-equity [https://perma.cc/5PF2-LD9J] ("A private equity fund is typically open only to *accredited investors* and *qualified clients*. Accredited investors and qualified clients include institutional investors, such as insurance companies, university endowments and pension funds, and high income and net worth individuals." (citations omitted)); Mary Hall, *How to Invest in Private Equity*, INVESTOPEDIA (Jan. 29, 2022), https://www.investopedia.com/articles/mutualfund/07/private_equity [https://perma.cc/CAX7-UQ39] ("Private equity investing is not easily accessible for the average investor. Most private equity firms typically look for investors who are willing to commit as much as $25 million. Although some firms have dropped their minimums to $250,000 . . . this is still out of reach for most people.").

challenging problem of bargaining for firm social performance.[173] When multiclass structures entrench prosocial insiders, they neutralize short-termist pressures and activist investors who seek to undermine the firm's preexisting contracts for social performance for their own financial gain. By insulating the social goals for which all parties have contracted, multiclass structures enable firm leaders to maintain their contractual commitments to preexisting shareholders, employees, and other parties who bargained for a joint social financial return.

Perhaps if Danone, Etsy, and Unilever had used multiclass structures, they may have avoided activist campaigns that threatened firm social goals, including by ousting socially committed CEOs, eliminating B Corp certification, and altering firm strategies to reduce or eliminate objectives beyond profit.[174] In contrast, Allbirds, Nike, Warby Parker, and other firms with multiclass structures have retained their social initiatives and leadership teams even in the face of public controversy over nonfinancial firm objectives and even sometimes through short-term financial struggles.[175]

Using corporate governance to solve this problem is appropri-

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[173] This benefit could apply to any firm where investors, employees, suppliers, or others wish to contract for idiosyncratic preferences and not just for maximizing financial value. This social benefit of control could therefore be even broader than presented here.

[174] *But see* Aran & Pollman, *supra* note 65, at 234 (showing how multiclass structures do not protect entrenched insiders wholesale). However, in Aran's and Pollman's formulation, insiders are generally ousted for mismanagement events, often egregious ones. *Id.* at 243, 245-46, 249, 250-52, 253-55 (explaining ousters that occur following performance problems, legal concerns, and employee and public pressure resulting from CEO mismanagement). They do not provide examples of ouster of prosocial insiders who did not perform well enough financially. The persistence of Allbirds' founders throughout its disappointing financial performance underscores this point, as does the persistence of firm founders during Warby Parker's early financial struggles and Nike's controversial and initially costly social campaigns.

[175] For example, both Warby Parker and Allbirds have maintained B Corp certification even through periods of financial struggle, and Nike continued with controversial social campaigns despite an initial boycott and drop in stock price. *See Warby Parker*, *supra* note 30 (showing that Allbirds is still a certified B Corp); *Allbirds Sprints Toward Sustainability*, *supra* note 38 (stating that "Allbirds established aggressive sustainability goals, [and is] backing them up with results"); Maglio, *supra* note 116 (stating that Nike "lost about $3.75 billion in market cap" after doing an ad campaign with Colin Kaepernick); Mary Meisenzahl, *Warby Parker Stemmed Losses by Focusing Away From Ecommerce*, DIGIT. COM. 360 (Mar. 1, 2023), https://www.digitalcommerce360.com/2023/03/01/warby-parker-stemmed-losses-by-focusing-away-from-ecommerce [https://perma.cc/3YE7-MTQY] ("Warby Parker lost over $100 million in 2022, but losses were significantly less than those in 2021."). Still, Nike and Warby Parker have posted successful performance both socially and financially over the long term. Two years after its controversial campaign, Nike's value was up

ate given that corporate law has explicitly sought to enable firms with objectives beyond profit through the enactment of public benefit corporation law but continues to fall short in allowing these firms to survive in practice.[176] Firm actors have attempted to protect their mutually desired social goals in contract but continue to fall short due to third-party interference. Here, where corporate law has sought without success to enable these firm actors, and firm actors have sought without success to memorialize their evolving preferences in contract, it is especially appropriate for corporate governance to fill the gap and provide an avenue to achieve the desired ends.

Multiclass structures, therefore, represent one of the only ways publicly traded firms can reliably contract to pursue objectives beyond profit. Without them, the systemic threats to achieving bargained-for social performance risk turning these firms into unreliable contracting parties and foreclosing the opportunity to bargain for social performance in publicly traded firms wholesale. This contracting problem also risks closing off public markets to the growing number of firm leaders, investors, employees, and others who seek not just financial but also social returns on their investments of capital and labor. In this way, corporate governance can serve an important function enabling private contracts that reflect the continually evolving preferences of firm insiders and outsiders.

### *B. Promoting Public Capital Markets*

Better enabling this private contracting also helps open public

$26.2 billion and in 2023 Warby Parker reported its strongest revenue growth year-to-date. Allbirds has retained its social performance despite ongoing financial struggles. *See* James, *supra* note 38 ("Since its public debut, the eyewear company has yet to record an annual net income."); Bernardini, *supra* note 116 ("[S]ince Nike's new deal with Kaepernick, the sportswear company's value is reportedly up $26.2 billion." (citation omitted)); Klee, *supra* note 116 (discussing that Nike experienced short-term financial hits from firm social initiatives that did not result in any long-term financial penalties); *Warby Parker Announces Third Quarter 2023 Results*, WARBY PARKER (Nov. 8, 2023), https://investors.warbyparker.com/news/news-details/2023/Warby-Parker-Announces-Third-Quarter-2023-Results/default.aspx [https://perma.cc/ZW58-TQ5F].

[176] Recall that public benefit corporations are legally mandated to pursue objectives beyond profit and to account for stakeholders beyond shareholders. DEL. GEN. CORP. L. § 362. In addition, scholars also often argued that an animating purpose of corporate law is to enable private ordering in firms. *See* James Cox, *Corporate Law and the Limits of Private Ordering*, 93 WASH. U. L. REV. 257, 260-61 (2015) ("[S]ome leading scholars embrace private ordering as the desired norm within corporate law. . . . In any case, the default rule is tailored toward what the legislature believes most, but not all, of an organization's stakeholders would agree to if contracting were efficient."). Current public benefit corporation law does not meet that standard, underscoring the appropriateness of using corporate governance in this context.

markets to a broader set of firm leaders, investors, and employees. By targeting a key reason why firms with objectives beyond profit may choose to go or stay private, multiclass structures make public markets a more attractive option to these firms and the parties who deal with them. Lowering these barriers can help restore waning public capital markets, generating beneficial systemic effects.[177]

Public markets have steeply declined in recent decades since their peak in 1996.[178] Although the past few decades have produced significant economic growth, including a robust IPO market in 2023, this growth has occurred against the backdrop of an overall plunge in IPOs and a simultaneous surge in public companies going private.[179] Scholars have persuasively attributed these trends to the deregulation and ready availability of private capital and perhaps secondarily to desires to avoid the regulatory burdens of going and staying public.[180]

The trend to stay or go private may be a rational choice for individual firms, but it results in deleterious systemic effects. This trend problematically reduces corporate transparency for both investors and the general public because private firms are not subject to significant disclosure requirements.[181] This lack of transparency is problematic on its face and also leads to broader

[177] This benefit arguably applies not just to firms with objectives beyond profit, but for all firms that adopt multiclass structures.

[178] Goodkind, *supra* note 51; de Fontenay, *supra* note 51, at 447.

[179] de Fontenay, *supra* note 51, at 447; Rachel Gerring & Mark Schwartz, *Bull or Bear? Key Factors that Will Shape the US IPO Market in 2024*, EY (Jan. 18, 2024), https://www.ey.com/en_us/ipo/trends [https://perma.cc/CN5C-6TMP] ("In 2023, the number of IPOs on US exchanges increased by 42% vs. 2022, but IPO proceeds grew by more than 160%, driven by several large high-profile IPOs."); Hugh MacArthur, Rebecca Burack, Graham Rose, Christophe de Vusser, Kiki Yang & Sebastien Lamy, *Private Equity Outlook in 2023: Anatomy of a Slowdown*, BAIN & CO. (Feb. 27, 2023), https://www.bain.com/insights/private-equity-outlook-global-private-equity-report-2023 [https://perma.cc/MM4R-46ZZ]; Clayton, *supra* note 52 (manuscript at 1, 1 n.2) (stating that "[t]he global economy has been going private for many years, with global private market [assets under management (AUM)] growing by fourteen times since 2000 (compared to four-fold growth in public AUM over the same period)" and pointing out that "over the past five years investors poured $6.4 trillion of new capital commitments into private equity funds [while] [g]lobal IPO markets . . . raised only $1.5 trillion over the same period"); Scheid & Dholakia, *supra* note 52.

[180] *See* de Fontenay, *supra* note 51, at 447 (explaining that "[f]irms no longer need to go public to raise large amounts of capital" and acknowledging popular explanations that point to "the rising regulatory costs of becoming and remaining a public company").

[181] Henderson & Epstein, *supra* note 55, at 5 ("[T]he private model is worrisome (albeit efficient) because of its lack of transparency, either for investors or the public at large.").

negative effects. For example, Professor Elisabeth de Fontenay shows how the going-private trend creates an unstable equilibrium for capital markets, with private companies taking advantage of the disclosures of publicly traded companies while avoiding the same degree of regulatory scrutiny or burden themselves.[182] The going-private trend and reduction in corporate transparency thus also creates a freeriding problem that threatens the quality and utility of public disclosures.[183] Robust and successful securities markets, which underpin our entire economic system, are premised on the critical value of disclosure. Distorting the quality and utility of disclosure therefore raises significant cause for alarm.

There are also increasingly compelling reasons to go or stay private for firms with objectives beyond profit beyond the ready availability of private capital and the desire to avoid regulatory burden. Operating a public company subjects firm leaders to short-term scrutiny and outside pressures that can make it difficult to retain social initiatives that may be controversial in the short term or may not immediately realize financial value.[184] In addition, trading publicly exposes firms with social goals to activist investors who seek to eliminate or weaken firm social goals to make a quick profit.[185] Going private eliminates these outside threats and pressures, ensuring that third parties cannot undermine firm social goals even during times of controversy or in the face of short-term financial challenges.

Patagonia is perhaps the most famous and extreme example. Its founder recently chose "going purpose" rather than "going public," transferring ownership of the company to a trust that will ensure ongoing commitment to firm social goals after the founder retires.[186] Although extreme in some ways, Patagonia's decision reflects the broader trend of firms avoiding trading publicly, including to help protect firm social goals.

But multiclass structures provide a reliable way for firms to go or stay public and still protect their social goals from outside threats. It is important to consider the motivation of firm leaders—who decide whether to go public or stay private—in this context. Reducing the risks that a firm leader will be ousted for being too prosocial or that the firm will weaken or lose its social

[182] de Fontenay, *supra* note 51, at 451-52.

[183] *Id.* at 451.

[184] *See supra* Part II.B.

[185] *Id.*

[186] *Patagonia's Next Chapter: Earth Is Now Our Only Shareholder*, PATAGONIA (Sept. 14, 2022), https://www.patagoniaworks.com/press/2022/9/14/patagonias-next-chapter-earth-is-now-our-only-shareholder [https://perma.cc/YF4B-JMTJ] ("[T]he company is 'going purpose' instead of 'going public." ').

goals because of outsider interference significantly improves the appeal of an IPO. Multiclass structures therefore reduce the relative attractiveness of staying private for firms with objectives beyond profit.

Indeed, when evaluating the value of multiclass structures, it is important to consider the appropriate counterfactual. If the counterfactual to adopting a multiclass structure is that firms will instead continue to trade publicly and adopt a single-class structure, then perhaps multiclass structures in their current form generate a net loss by allowing firms to reap the benefits of trading publicly while extracting unfettered private benefits of control at society's expense. But if the counterfactual is, instead, that firms will choose to go or stay private, with the associated negative systemic effects, then multiclass structures may actually present an attractive second-best solution not just for individual firms, but for society more broadly.[187] The decline of public markets and rise of private markets perhaps points to a firm preference for staying private. This preference suggests there may be some truth to the second counterfactual and, therefore, greater value to multiclass structures in promoting public markets.[188]

Because the multiclass-structure solution is systemic and applies to a wide swath of firms, it could help meaningfully promote public markets by lowering barriers to entry for the rising number of firms with objectives beyond profit. Opening public markets to this growing class of firms and creating more attractive avenues to an IPO could help counter the decades-long trend toward staying or going private. By enabling firms to go public while still preserving social performance, multiclass structures can therefore promote declining public markets to the broader benefit of society, generating a second important social benefit of control.[189]

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[187] This reasoning could apply more broadly, not just to firms with objectives beyond profit but to any firm that adopts a multiclass structure.

[188] The availability and prevalence of multiclass structures may have contributed to more recent improvements in IPO markets. *See* Shill, *supra* note 5, at 251 ("[D]ual-class technology firms now account for a majority of the IPO market by value."); Aggarwal et al., *supra* note 17, at 124.

[189] Where multiclass structures help firms go or stay public, it could also help democratize the benefits of these firms, making them more widely available to investors, employees, consumers, and others. Staying private may help protect firm social goals, but it also frequently trades off scale and accessibility. Incentivizing firms with social goals to stay private could risk leaving socially conscious firms accessible only to narrow, more well-off segments of the population. Aguirre, Financing Social Startups, *supra* note 87.

## IV Addressing Potential Criticisms of Using Multiclass Structures to Enhance Social Goals

Notwithstanding the valuable social benefits of control, there are important potential criticisms to address when implementing multiclass structures, including in firms with objectives beyond profit. This Part attends to two primary anticipated criticisms: accountability problems and deception problems. It then offers proposals to address these criticisms and optimize multiclass structures for success in firms with objectives beyond profit.[190]

### *A. Anticipating Criticisms*

Using multiclass structures in firms with objectives beyond profit invites two primary and related anticipated criticisms: an accountability problem and a deception problem. The first problem is generally applicable to all firms with multiclass structures, while the second problem is more specific to firms with objectives beyond profit.

The first potential criticism of multiclass structures relates to the basic agency problem identified in Part I.B. Removing insider accountability to outside shareholders risks managerial and insider self-dealing.[191] This general concern of accountability applies to all multiclass structures, including those used in firms with objectives beyond profit.[192] Wherever insiders have voting rights that are disproportionate to their economic stakes in the firm, there is a concern because these insiders bear fewer financial consequences of their decisions, increasing their incentives to engage in inappropriate self-dealing at the expense of outsiders.[193] For firms with objectives beyond profit specifically, it

**[Section IV]**

[190]These proposals could also apply to multiclass structures more broadly, including in conventional single-profit objective firms. Further research into this topic would be fruitful.

[191]*See supra* Part I.B.

[192]It is also possible this criticism is overstated, as outside shareholders can simply exit the firm by selling their shares if they disagree with insider management. They can also litigate for breach of fiduciary duties or collaboratively engage with insiders to achieve desired outcomes. These options raise broader questions about the importance of shareholder voting and democracy that are beyond the scope of this paper but an important subject for future work. *See* Fisch & Solomon, *supra* note 8, at 1093 ("[T]o an extent, the debate over dual class and sunsets has a tendency to overlook broader questions about the role and purpose of voting rights in publicly traded companies."). However, these solutions, while potentially feasible for shareholders, do not address employees, suppliers, and others with whom the firm contracts. *See supra* Part III.A.

[193]*See* Masulis et al., *supra* note 23, at 1697 ("[I]nsiders controlling disproportionally more voting rights than cash flow rights bear a smaller proportion of the financial consequences of their decisions. . . ."); Barclay & Holder-

is critical to address this critique because the social benefits of control can only accrue when firm leaders are held accountable to their stated social goals.

The second potential criticism is a deception problem. This problem applies more specifically to multiclass structures in prosocial firms. Some firm leaders may overstate or lie about their commitments to social goals—commonly known as "greenwashing" or "bluewashing"[194]—and instead use multiclass structures as a clandestine way to entrench themselves and extract private benefits of control. For example, a founder may claim to implement a multiclass structure to pursue social goals, but actually use it to amass personal wealth and power. Some have argued that Mark Zuckerberg has pursued this pathway at Meta, hiding an unqualified pursuit of financial gain behind a claimed facade of generating positive social change.[195] Because information about social performance is challenging to ascertain,[196] it can be difficult—if not impossible—for those who deal with the firm to accurately distinguish between firms with genuine commitments to social performance and those that make false claims.[197]

At present, talk is cheap: Any firm can claim a commitment to

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ness, *supra* note 75, at 372.

[194]Timothy McClimon, *Bluewashing Joins Greenwashing as the New Corporate Whitewashing*, FORBES (Oct. 3, 2024), https://www.forbes.com/sites/timothyjmcclimon/2022/10/03/bluewashing-joins-greenwashing-as-the-new-corporate-whitewashing [https://perma.cc/AS8B-APUQ] (defining "greenwashing" as "any kind of advertising or marketing in which 'green' public relations or promotions are deceptively used to persuade the public that a company's products, policies, and programs are environmentally friendly when they may be doing little to assist the environment in practice" and "bluewashing" as "like *greenwashing* but focused more on social and economic responsibility rather than the environment").

[195]Stewart, *supra* note 25; Emily Bell, *Mark Zuckerberg's Facebook Mission Statements Hide his Real Aim*, GUARDIAN (Mar. 10, 2019), https://www.theguardian.com/media/commentisfree/2019/mar/10/mark-zuckerberg-facebook-mission-statements-hides-his-real-aim [https://perma.cc/P9XM-W9UM] (stating that "[s]ocial media founders proclaim their idealism, like modern day messiahs," but "all they want is global market domination" and questioning "whether Facebook would be a different entity if it hadn't hidden its business model behind statements about social change and a global ideology of connectivity").

[196]Subhash Abhayawansa & Shailesh Tyagi, *Sustainable Investing: The Black Box of Environmental, Social, and Governance (ESG) Ratings*, 24 J. WEALTH MGMT. 49, 52-53 (2021) (explaining that there is a gap in actual ESG performance and measurements of ESG performance).

[197]Indeed, the fact that firms frequently engage in greenwashing and bluewashing, deceiving the public about their environmental and social performance, underscores the potential problem deception may pose in this context. McClimon, *supra* note 194.

social performance that it may or may not intend to realize in practice. As a result, socially conscious investors, employees, and other contracting parties struggle to reliably distinguish firms that genuinely share their social commitments from firms with mere cheap talk.[198] Costly signals make talk more expensive. Only firms with genuine commitments are willing to expend valuable resources to achieve social performance. Firms that adopt costly signals thus indicate to the market their authenticity, whereas those unwilling to dedicate resources to social performance expose themselves as greenwashers. To garner social benefits of control, authentic firms need a more meaningful and costly way to signal their commitments to social performance and facilitate better matching with like-minded contracting parties.[199]

### *B. Solutions to Ensure Accountability and Send Valuable Costly Signals*

In summary, implementing multiclass structures in firms with objectives beyond profit runs the risk that insiders will either stray or deceive. Addressing the valid agency concerns raised will require firms to implement additional accountability measures for entrenched insiders.[200] To deal with the potential deception problem, firms must establish more reliable ways to distinguish authentic firm leaders from deceptive ones by sending costlier signals of their commitments to the market. In the absence of a superior solution in corporate law,[201] to enable greater accountability and costlier signaling, this Article proposes implementing

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[198]Bruce I. Jacobs & Kenneth N. Levy, *The Challenge of Disparities in ESG Ratings*, 2 J. Impact & ESG Investing 107, 108-10 (2022).

[199]The concept of costly signaling comes from the economics literature. It refers to taking costly actions to signal quality to a potential bargaining partner to reduce information asymmetries between parties. For example, a college football coach sends a costly signal when they "visit[] area high schools in a Hummer™ limousine emblazoned with the school's logo to denote a resource-rich environment to prospective recruits." Brian L. Connelly, S. Trevis Certo, R. Duane Ireland & Christopher R. Reutzel, *Signaling Theory: A Review and Assessment*, 37 J. Mgmt 39, 40 (2011) (explaining that signaling theory is about "how one party may undertake actions to signal its underlying quality to other parties" and "is fundamentally concerned with reducing information asymmetry between two parties"). The authors further explain that "[s]ignal cost is so central to signaling theory that some refer to it as the "theory of costly signaling."D" *Id.* at 45. *See generally* Michael Spence, *Job Market Signaling*, 87 Q.J. Econ. 355 (1973) (first identifying costly signaling); John G. Riley, *Silver Signals: Twenty-Five Years of Screening and Signaling*, 39 J. Econ. Lit. 432 (2001) (showing that sellers of above-average quality products can signal quality by taking costly action that uninformed buyers can use to assess quality).

[200]These additional accountability measures could apply more broadly to any firms that use multiclass structures, which are all subject to this valid concern.

[201]For example, if public benefit corporation law imposed adequate account-

event-based sunset provisions, improved disclosures, and enhanced oversight alongside multiclass structures in this context.

1. *Event-Based Sunset Provisions.* A sunset provision is one that automatically converts a multiclass structure to a single-class structure upon a predetermined date or event.[202] Although time-based sunsets are by far the most common,[203] they raise several concerns that limit their utility, particularly in the context of firms with objectives beyond profit.[204]

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ability and protective mechanisms for firms with objectives beyond profit, they would not need to turn to multiclass structures to achieve their aims. At present, corporate law does not provide this option.

[202]Fisch & Solomon, *supra* note 8, at 1078 ("A sunset provision provides that, upon some pre-specified date or event, the high vote stock converts to low vote stock, effectively extinguishing the dual class structure.").

[203]*See id.* at 1086 ("[Event-based sunsets] have received far less investor attention than time-based sunsets."); Andrew William Winden, *Sunrise, Sunset: An Empirical and Theoretical Assessment of Dual-Class Stock Structures*, 3 COLUM. BUS. L. REV. 852, 870, 950-51 (2018) (finding a sharp increase in time-based sunset provisions after 2010).

[204]Though many prominent scholars and practitioners have championed the use of time-based sunsets to help address agency criticisms associated with multiclass shares, these provisions raise several issues. Time-based sunsets are premised on the notion that while a multiclass structure may have some value at the time of IPO, that value declines over time while the costs grow. Bebchuk & Kastiel, *supra* note 4, at 590. The sunset period selected is generally largely arbitrary; it is not clear any firm can actually determine ex ante the appropriate sunset period given the numerous variables at play. Fisch & Solomon, *supra* note 8, at 1081-82 (asserting that "the length of the sunset period appears to be arbitrary and does not seem to correlate with any theory about the length of time necessary for a founder to implement his or her vision" and that "[i]t is also uncertain whether any time-based sunset at the IPO stage can successfully align founder vision with control"). Sunset clauses also fail to address insider shirking or self-dealing in real time, and they create a moral hazard problem, increasing incentive to shirk and self-deal as the sunset date approaches. John C. Coffee, Jr., *Dual Class Stock: The Shades of Sunset*, CLS BLUE SKY BLOG (Nov. 19, 2018), https://clsbluesky.law.columbia.edu/2018/11/19/dual-class-stock-the-shades-of-sunset [https://perma.cc/CRH5-5WQM] (describing the "sharp cliff" for founders when time-based sunsets are about to expire); Fisch & Solomon, *supra* note 8, at 1083. Some scholars have proposed retention provisions whereby outside shareholders vote on a one-share-one-vote basis whether to extend the multiclass structure before the sunset expires. Martijn Cremers, Beni Lauterbach & Anete Pajuste, *The Life-Cycle of Dual Class Firm Valuation* 5-6 (Eur. Corp. Governance Inst., Working Paper No. 550/2018, 2022) (supporting retention votes at seven years); Letter from Ash Williams, Chair, Council of Institutional Inv'rs, Ken Bertsch, Exec. Dir., Council of Institutional Inv'rs, & Jeff Mahoney, Gen. Counsel, Council of Institutional Inv'rs, to Elizabeth King, Chief Regul. Officer, Intercontinental Exch. Inc. 5 (Oct. 24, 2018), https://www.cii.org/files/issues_and_advocacy/correspondence/2018/20181024NYSEPetitiononMulticlassSunsetsFINAL.pdf [https://perma.cc/Y3EE-TNRD] (proposing to require firms with dual-class structure to have a

Event-based sunsets, on the other hand, are less common but offer significant possibilities as both accountability and costly signaling mechanisms for prosocial firms.[205] Where event-based sunsets do exist, they typically trigger when insiders' ownership stakes in the firm dilute below a certain threshold, in an effort to ensure insiders retain an adequate economic stake in the game.[206] But event-based sunsets have great potential beyond their current typical use.

In particular, event-based sunsets enable creative but objective standards for behavior that insiders cannot contravene without losing their control over the firm. For example, firms with objectives beyond profit could implement event-based sunsets that trigger if the firm does not meet predetermined socially oriented metrics that correspond to firm social goals, such as maintaining B Corp certification or reducing greenhouse gas emissions by a certain amount. Firm leaders can easily tailor sunsets to their firm's social purpose, ensuring broad applicability across firms with varying objectives beyond profit.

Event-based sunsets help deliver both accountability and costly signaling. They deliver accountability by providing significant consequences for insider shirking and self-dealing, helping to protect against firm leaders straying.[207] They also help address scenarios where well-intentioned firm leaders may, even if they

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mandatory sunset provision of seven years or less but permit them to allow shareholders to vote to retain dual-class structure). Retention provisions do not resolve information asymmetries that make it difficult for outsiders to properly assess whether insiders are adequately performing—a risk that compounds for firms with objectives beyond profit, which may not disclose much or any information about their nonfinancial performance. Fisch & Solomon, *supra* note 8, at 1084-86. For firms with objectives beyond profit, time-based sunset provisions also do not address the fact that these firms require ongoing protection from the threats of short-termism and activist investors and the benefits of entrenching insiders may persist longer than for traditional firms. The protective effect of entrenching prosocial leaders may be just as important in the first year of trading publicly as in the seventh or tenth year.

[205]Event-based sunsets may also offer significant benefits for traditional firms without objectives beyond profit. Fisch & Solomon, *supra* note 8, at 1086 ("[Sunsets] should focus more precisely on objective events that are more likely to result in the founder losing track of his or her mission or being overly incentivized to favor his or her own interests. This Article terms such provisions 'event-based sunsets.' ").

[206]Aggarwal et al., *supra* note 17, at 126 ("The recent debate over sunsets has focused on two main types of sunsets [including] . . . 'ownership sunsets,' which convert dual-class firms into single-class firms when the controllers' economic stake falls below a certain threshold.")

[207]Fisch & Solomon, *supra* note 8, at 1086 (explaining that event-based sunsets "focus more precisely on objective events that are more likely to result in the founder losing track of his or her mission or being overly incentivized to favor his or her own interest" rather than linking arbitrarily to the "mere pas-

initially appear quite skilled, nevertheless do a poor job running a public company. They recognize that the skill sets needed to be an entrepreneur do not always line up with the skill sets needed to run a public company.

These sunsets generate costly signals by allowing firms to more clearly indicate ex ante the scope and content of their specific commitments. Clearer ex ante articulations enable outsiders to better determine both how serious a firm is about social performance in general, and whether the content of this firm's specific objectives align with their own. For example, perhaps a firm claims to be committed to objectives beyond profit but has weak or nonexistent event-based sunsets in place. Or perhaps a firm claims commitment to mitigating climate change, water usage, and socioeconomic diversity, but only has water-related sunsets in place. Event-based sunsets would better equip outsiders to sort amongst firms that claim to have objectives beyond profit and to match only with those with whom they personally align. These sunsets therefore provide well-tailored safeguards against firm leaders straying or deceiving, helping provide accountability for insiders and costly signals for outsiders.

But event-based sunsets alone do not solve every concern associated with multiclass structures in firms with objectives beyond profit.[208] These firms would also benefit from additional measures to improve accountability and costly signaling, including improved disclosure and oversight.

2. *Improved Disclosure and Metrics.* Firms with objectives beyond profit that implement multiclass structures should also consider adopting improved disclosure processes. Improved disclosure would help outsiders to better identify agency problems and could also signal ex ante a firm's genuine commitment to achieving social performance. At present, outsiders at these firms receive a lack of quality information about firm performance.[209] The lack of information inhibits outsider ability to reliably assess insider financial performance.[210] In the same vein, it also impedes assessing firm social performance. Information problems result

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sage of time").

[208]For example, event-based sunsets do not deal with tricky succession issues that occur when an insider departs, becomes incapacitated, or dies. The issue of how to identify, transition to, and protect the next exceptional firm leader is an important area for future work. *See* Fisch & Solomon, *supra* note 8, at 1089-91.

[209]*See* Jacobs & Levy, *supra* note 198, at 108-10 (describing the general discrepancies between ESG ratings and ESG performance).

[210]*See* Fisch & Solomon, *supra* note 8, at 1085 ("When voting on whether to retain the dual class structure, public shareholders have the benefit of knowing how the firm has performed subsequent to the IPO, and they have the enhanced transparency of that performance afforded by the public reporting process.").

both from information asymmetries—when insiders withhold information from outsiders—and from underdeveloped metrics—when insiders fail to adequately track information in ways that enable meaningful reporting.[211] To help address these information problems, firm leaders should adopt improved disclosure processes and develop enhanced metrics.

At present, firms are not subject to any minimum standards, oversight, or verification of their claims of social performance.[212] As a result, it makes it challenging both to hold firm leaders accountable and to assess the veracity of their claims about objectives beyond profit. Firms that choose to consistently disclose additional information about their social performance can therefore set themselves apart. For example, a firm could commit to reporting on its social performance in its annual SEC filings. Providing these types of regular disclosures would enable improved assessment of firm social performance and progress. In addition, colocating social performance disclosures with financial disclosures would enable more efficient assessment of both dimensions of firm performance and signal the relative importance of both sets of objectives to the firm.

But to *report* on social performance, firms must first develop meaningful metrics to *measure* social performance. Currently, firms are left entirely to their own discretion in terms of the quantity and quality of the information they provide on social performance.[213] The lack of standardized metrics, both within and across firms, makes it difficult to assess actual social performance, to compare across firms, and to distinguish authentic firms from those that greenwash or bluewash.[214]

In conjunction with improved disclosure, these firms should

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[211] *Two in 5 Companies Struggle with ESG Supply Chain Data*, Green Bus. J., https://greenbusinessjournal.co.uk/two-in-5-companies-struggle-with-esg-supply-chain-data [https://perma.cc/GHB7-CMQF] ("[M]ost companies don't monitor the full supply chain (84%); and . . . the vast majority (73%) find it challenging to determine which data to track.").

[212] This is true even if they are incorporated as a public benefit corporation. *See* Part III.A (discussing the lack of accountability for public benefit corporations).

[213] *See* Del. Gen. Corp. L. § 366.

[214] Because social metrics currently lack standardization across the market—in comparison to financial metrics like revenue or earnings before interest, taxes, depreciation, and amortization ("EBITDA") on which all firms report—it is particularly important for firms to develop individual social metrics. *Financial Reporting Standards*, CFA Institute, https://www.cfainstitute.org/en/membership/professional-development/refresher-readings/financial-reporting-standards [https://perma.cc/MM8M-R9WE] ("Financial reporting standards provide principles for preparing financial reports and determine the types and amounts of information that must be provided to users of financial statements, including investors and creditors, so that they may make informed decisions.");

also formulate standardized internal metrics that they can tailor to their individual circumstances.[215] For example, a firm might distill topline metrics that represent the firm's key objectives beyond profit, such as water usage, reduced greenhouse gas emissions, and percentage of employees from underrepresented groups.[216] Once a firm selects these key metrics, it should consistently report on them year over year to enable standardized assessment at the firm level and tracking of progress over time.[217]

Improved disclosures and metrics would help address accountability criticisms. These measures establish greater accountability for entrenched firm leaders by shining a light on their

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Jason Saul, *Fixing the S in ESG*, STAN. SOC. INNOVATION REV. (Feb. 22, 2022), https://ssir.org/articles/entry/fixing_the_s_in_esg [https://perma.cc/B88D-9TBL] ("[Q]uantifying social impact is a challenge."); BNP PARIBAS, ESG GLOBAL SURVEY 2021, at 9 https://securities.cib.bnpparibas/app/uploads/sites/3/2021/09/bnp-paribas-esg-global-survey-2021.pdf [https://perma.cc/2RE2-XRER] ("[T]here is an acute lack of standardisation around social metrics."); UNILEVER, *supra* note 116, at 6 ("When we set our Unilever Sustainable Living Plan targets ten years ago, we didn't realise how hard it would be to measure our progress. Finding an impact indicator that works across all our initiatives has proved especially difficult."). The report also identified "lessons for the future," including to "[e]xamine bespoke social indicators for specific interventions" and "[e]ncourage the standardisation of measurement tools, indicators and benchmarks." *Id.* Developing social metrics can enable firms to provide meaningful information to investors despite underdeveloped market-wide standardization in social performance metrics. But while these metrics could vary by firm, they should remain mostly consistent within each firm so that investors can properly benchmark and assess social performance over time. *See* EBRAHIM, *supra* note 109 (proposing four frameworks for performance management in the social sector that offer a degree of standardization but can also be tailored to the particular circumstances of individual firms).

215 EBRAHIM, *supra* note 109.

216 For example, Warby Parker publishes an Annual Impact Report that includes many social metrics, largely anecdotal. *See generally Annual Reports*, WARBY PARKER, https://investors.warbyparker.com/financials/annual-reports/default.aspx [https://perma.cc/EL4Q-CAPR]. For many of these metrics, the report includes figures for the four preceding years, which assists in tracking over time. However, the report is somewhat long and largely narrative. *See id.* The content may also vary from year to year. *See id.* As a result, it can be difficult to assess firm social performance and comprehensively track progress over time. Distilling the eighty-page report into key metrics reflecting each of the company's top social goals that are trackable over time, and including them alongside financial reporting, would help better enable insider accountability and outsider assessment.

217 Of course, efforts at standardization must allow for understandable shifts in firm social goals, recognizing both that firms may meet their social targets and that social priorities may change over time. *See* UNILEVER, *supra* note 116, at 6 ("In 2010, things looked very different. . . . [S]ome issues have accelerated faster than anyone could have imagined, while others have come to the fore in ways no one anticipated. We've had to adapt quickly, listen and in some cases break from the status quo.").

behaviors.[218] To hold insiders accountable, outsiders must first be able to accurately assess their performance. As a result, increasing and improving disclosures is a necessary condition for achieving insider accountability.

These measures would also help address the deception criticism by enabling outsiders to move beyond assessing a firm's claims, which may be flimsy, unsubstantiated, or even deceptive, to assessing its actual performance. They assist outsiders in better differentiating among three categories of firms: those with authentic social goals, those that are dishonest and engage in greenwashing or bluewashing, and those that are well-meaning and aspire to social performance but do not measure or substantiate their claims.[219] These measures would help serve as a costlier signal to outsiders about the authenticity and content of firm commitments.

3. *Oversight Measures.* Finally, firms may also consider adopting internal and external oversight mechanisms to help monitor and safeguard firm social performance in real time. These oversight mechanisms would help identify and correct accountability and deception problems proactively as they arise. For example, a firm might designate a social guardian on the board of directors who is responsible for championing the firm's social goals or instate social guardians elsewhere in the organizational chart. These social guardians could serve on an independent social impact board, comprise an entire mission or sustainability department, or work as representatives in existing departments to protect and further firm social performance.

If meaningfully vested with institutional power, social impact boards, departments, and representatives would serve as backstops for firm objectives beyond profit. They could also offer specialized expertise on achieving firm social goals alongside financial performance. For example, Ben & Jerry's relies on a perpetual external board to protect the company's "values" and "integrity."[220] This board is empowered to further the brand's social mission and to block or reverse firm decisions that external

[218] *See* Stavaros Gadinis & Chris Havasy, *The Quest for Legitimacy: A Public Law Blueprint for Corporate Governance*, 57 U.C. Davis L. Rev. 1581, 1628 (2024) ("Transparency has become synonymous with good governance.").

[219] *See* Fisch & Robertson, *supra* note 150, at 1446-47 (noting that investors do not know which firms are genuinely pro-social and which are not).

[220] When Ben & Jerry's experienced stalling financial performance after trading publicly for sixteen years, its co-Founders sought an acquirer to help save the firm. Unilever purchased Ben & Jerry's for about $366 million in 2000. As part of the deal, the Ben & Jerry's cofounders negotiated several contractual provisions to help protect the social goals they had pursued while leading the firm. They were likely able to negotiate these provisions in part because of the brand equity they built over twenty-two years in operation prior to the acquisi-

board members deem to stray too far from the company's traditional core values.[221] It has exercised that power on several occasions, including most controversially when the board announced in July 2021 that Ben & Jerry's would no longer sell ice cream in Israel's occupied territories.[222] When the Ben & Jerry's parent company tried to reverse the decision, the external board sued for violation of the contractual agreement that granted the board purview over the brand's social mission.[223]

Experience in other jurisdictions also underscores the importance of instating internal social mission champions in firms with objectives beyond profit. For example, firms in France that adopt that jurisdiction's socially oriented legal status must create a Mission Committee to monitor progress toward achieving the firm's articulated social goals.[224] Firms that adopt Italy's socially oriented corporate form must appoint one person as an "impact

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tion. The founders partnered with Unilever in large part because of Unilever's demonstrated commitment to preserving Ben & Jerry's values. Austin & Leonard, *supra* note 45, at 94 ("The Unilever-appointed CEO of Ben & Jerry's, Yves Couette, recalled the origin of the [social impact] board, which he saw as 'an amazing statement of humility and cooperation' on the part of Unilever. . . .").

[221]The board consists of five businesspeople with a long history at the company and a deep knowledge of its founders, values, mission, and identity. It functions similarly to a traditional board of directors in some ways, including meeting regularly and deliberating about firm strategic directions. The external board has a perpetual legal contract. If Unilever's board of directors should ever breach, members of the external board can sue for enforcement. *Id.* at 94, 96. To further the brand's social mission, the board has appointed social activist members like Anuradha Mittal, founder of a think tank devoted to promoting causes like environmental and indigenous rights, who went on to become board chairperson a decade later. Devin Leonard & Dasha Afanasieva, *How Ben & Jerry's Ended Up at War with Itself*, BUSINESSWEEK (Feb. 14, 2023, 12:01 AM), https://www.bloomberg.com/news/features/2023-02-14/ben-jerry-s-israel-controversy-set-off-unilever-battle [https://perma.cc/55UD-DULW].

[222]Leonard & Afanasieva, *supra* note 221. Additional examples of board actions include endorsing Occupy Wall Street and joining a farm worker rights organization to champion higher wages and a worker-driven human rights program in the dairy industry. *Ben & Jerry's and Migrant Justice Jointly Announce Groundbreaking Success*, PR NEWSWIRE (July 25, 2018, 3:26 PM), https://www.prnewswire.com/news-releases/ben—jerrys-and-migrant-justice-jointly-announce-groundbreaking-success-300686620.html [https://perma.cc/CH3T-D57S].

[223]The parties eventually settled for undisclosed terms, and the external board remains. Leonard & Afanasieva, *supra* note 221.

[224]France enacted the "Société à Mission" legal status in 2019 for firms pursuing prosocial goals. Firms that adopt this legal status must articulate social and environmental goals and memorialize them in their bylaws, much like public benefit corporations in the United States. Unlike in the United States, however, French law requires firms to enact a separate mission committee to monitor progress toward achieving these goals. The mission committee must include at least one employee and produce an annual report alongside the

manager" to oversee the pursuit of the social goals articulated.[225] The Mission Committee and impact manager requirements in France and Italy emphasize the importance of instituting internal processes specifically to safeguard firm objectives beyond profit.

Internal oversight would help provide the tailored guardrails these firms need to address the accountability and deception criticisms associated with multiclass structures. Structuring a firm's corporate governance to integrate its objectives beyond profit would not only help ensure accountability of firm leaders, it would also send a meaningful signal of authenticity to the market if the commitment was significant enough. Firms could differentiate themselves by the extent to which they empower internal champions of the objectives beyond profit and prioritize these objectives in their governance structures and organizational charts, providing important information to those who seek to deal with the firm.

Firms may also consider implementing external oversight measures to help address accountability and deception criticisms. External oversight measures could include independent audits or third-party certifications of firm social performance.[226] For example, a firm might enlist a third-party monitor to periodically certify compliance with articulated firm social goals.[227] The French Société à Mission legal status underscores the importance of external oversight, requiring firms to appoint a third party to

firm's annual management report. "*Raison D'être,*" DANONE, https://www.danone.com/about-danone/sustainable-value-creation/danone-societe-a-mission.html [https://perma.cc/59RW-YJHU]; Loi 2019-486 du 22 mai 2019 relative à la croissance et la transformation des entreprises [Law 2019-486 of May 22, 2019 relating to the growth and transformation of businesses], JOURNAL OFFICIEL DE LA REPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], May 23, 2019.

[225]In Italy, firms that elect to form as a Società Benefit must articulate the firm's "purpose(s) of common benefit" in the articles of association. The appointed impact manager oversees the pursuit of the common benefits articulated. *English Information*, SOCIETÀ BENEFIT, https://www.societabenefit.net/english-information [https://perma.cc/DGT4-R2QS].

[226]Some have also argued for a newly created federal agency that would oversee firm social and environmental behavior. Future work should consider whether it would be preferable to house third-party oversight of firm social performance in a new agency analogous to the SEC. Press Release, SEC, SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors (Mar. 21, 2022), https://www.sec.gov/news/press-release/2022-46 [https://perma.cc/SJ3J-B58C].

[227]Interview with Participant 8 (Jan. 11, 2024) (explaining how under the firm's newest commitments to social goals, they are not permitted to publicly communicate any improvements on sustainability matters without a confirmed audit from a third-party).

verify achievement of the social mission.[228] A firm might also attain B Corp certification, the highest current third-party standard available for the pursuit of social goals in business.[229] Warby Parker and Allbirds maintain B Corp certification to help ensure external verification of their progress toward articulated firm social goals while operating with multiclass structures.[230] Because B Corp requires recertification every three years, continually updates its certification standards to comply with evolving best practices, and compels firms to continually improve their scores over time,[231] it can provide a degree of meaningful third-party oversight of firm social performance.

Employing these kinds of external oversight measures provides important outside accountability to insulated firm leaders in the pursuit of social performance. It would also signal to outsiders the authenticity of firm commitments, because insiders not only invite external oversight of their behaviors but also bear the financial cost of doing so. Oversight mechanisms are therefore a valuable tool for both accountability and costly signaling for firms with objectives beyond profit that adopt multiclass structures.

### *B. Implementing the Proposed Solutions*

These measures should be implemented either voluntarily or through legal mandate. There are compelling reasons for firms with objectives beyond profit to voluntarily adopt event-based sunsets, improved disclosure, and additional oversight. Voluntary implementation has several benefits. Perhaps most compelling, it would generate costlier signals to the market because firm action is deliberate, burdensome, and not externally imposed. Firm leaders who genuinely seek to achieve social performance will be will-

[228] Danone, *supra* note 224; Loi 2019-486, J.O. at p. 109 (establishing the Société à Mission legal status and requiring independent third-party verification of firms' articulated social and environmental objectives). This requirement goes a meaningful step further than U.S. public benefit corporation requirements and Italy's Società Benefit, which nod to the importance of third-party oversight but only require firms to report the third-party standards they have adopted to assess their own impact. *See* Michael R. Littenberg, Emily J. Oldshue & Brittany N. Pifer, *Delaware Public Benefit Corporations - Recent Developments*, Harv. L. Sch. F. Corp. Governance (Aug. 31, 2020), https://corpgov.law.harvard.edu/2020/08/31/delaware-public-benefit-corporations-recent-developments [https://perma.cc/ZJ5S-2PME] ("The PBC also is not required to obtain third-party certification unless required by its certificate of incorporation."); *English Information*, *supra* note 225.

[229] *See supra* note 128 and accompanying text.

[230] *Warby Parker*, *supra* note 30; *Allbirds, Inc.*, B Lab Glob., https://www.bcorporation.net/en-us/find-a-b-corp/company/allbirds-inc [https://perma.cc/BVE8-FFXF].

[231] *Guide to B Corp Recertification*, B Lab Glob., https://usca.bcorporation.net/recertification [https://perma.cc/4W65-C6MW].

ing to bear the cost of measures that help them reach firm social goals, while those who primarily seek to deceive or extract private benefits of control will be unwilling to take on additional costs of heightened accountability and transparency. Voluntary adoption enables authentic firm leaders to differentiate themselves from deceptive firm leaders who falsely represent commitments to social performance.[232] It would spotlight authentic firm leaders who expend significant resources on firm social goals, helping separate the wheat from the proverbial chaff.

State legislatures should also amend their jurisdictions' public benefit corporation law to require greater accountability to objectives beyond profit for publicly traded benefit corporations with multiclass structures.[233] For example, public benefit corporation law could require firms with multiclass structures to adopt event-based sunsets linked to their objectives beyond profit, mandate minimum levels and intervals of disclosure of social performance metrics, require installation of a meaningfully empowered social impact board, or compel more rigorous third-party oversight such as maintaining B Corp certification or auditor compliance. These measures could help ensure that all firms that elect to incorporate as public benefit corporations and implement multiclass structures have some degree of accountability to their stated commitments to social goals.[234]

These amendments to public benefit corporation law would not only help improve accountability, they would also help improve signaling to the market. Firms would only opt into the public

[232]On the buy side, this differentiation can also provide more meaningful information for institutional investors, who themselves seek to attract retail investors by deploying capital into firms with social goals. At present, distinguishing among these firms presents a significant challenge. Fisch & Robertson, *supra* note 150, at 1446-47.

[233]Although outside the scope of this Article, it is worth noting that the benefits of these accountability and signaling measures could also extend to more traditional firms with multiclass structures. Implementing event-based sunsets, improved disclosures, and additional oversight mechanisms could help address criticisms of multiclass structures in general.

[234]These amendments would also help make public benefit corporation law more meaningful and less redundant or symbolic. However, to date, there is little political motivation for such change. Indeed, Delaware recently amended its public benefit corporation law to offer *less* accountability to public benefit corporations, changing the voting threshold to reincorporate from a public benefit corporation from 75 percent to 50 percent majority. *See* DEL. GEN. CORP. L. §§ 242(b), 251, 363; An Act To Amend Title 8 of the Delaware Code Relating to the General Corporation Law, H.B. 341, 150th General Assembly, § 17 (Del. 2020); Jill Fisch & Steven Davidoff Solomon, *The "Value" of a Public Benefit Corporation*, *in* RESEARCH HANDBOOK ON CORPORATE PURPOSE AND PERSONHOOD 68 (Elizabeth Pollman & Robert B. Thompson eds., 2021) ("In August 2020, Delaware amended its statute to make it easier for existing PBCs to convert back to traditional corporations.").

benefit corporation form if they were willing to comply with the heightened requirements, sending a meaningful signal of their authenticity and commitment to pursuing objectives beyond profit.[235] As a result, enhancing public benefit corporation law in this way would also help outsiders to distinguish among authentic and inauthentic firms, supporting improved sorting and matching mechanisms for an increasingly complex set of investors, employees, suppliers, and others who deal with the firm. In addition, better supporting sorting and matching among contracting partners would improve private contracting and make public markets more enticing, helping promote the social benefits of control.[236]

Whether firms adopt them voluntarily or mandatorily, these measures would help address potential criticisms associated with multiclass structures in firms with objectives beyond profit, better supporting social benefits of control.

## CONCLUSION

This Article addresses the rise in popularity of multiclass share structures and the intense debates they have sparked over good governance. Multiclass structures entrench insiders, enabling them to retain control over the firm that is disproportionate to their economic stake. They allow insiders at powerful firms like Meta, Alphabet, and Nike to direct firm activity with little oversight from or accountability to outside shareholders. Scholars and practitioners hotly contest whether multiclass structures represent desirable and value-enhancing products of private bargaining, or anti-democratic threats to shareholder value.

But scholars have failed to consider whether multiclass structures may provide any broader societal benefits outside the narrow paradigm of minimizing private benefits of control to maximize financial returns to shareholders. This mainstream discourse overlooks the myriad other factors and relationships that motivate—and are affected by—firm governance choices, including especially the growing number of firms that seek to achieve not just financial performance but also social performance. Firms like Allbirds, Warby Parker, and even Nike

[235] Indeed, if public benefit corporation law were amended in this way, one might expect to see instructive reincorporation in both directions—current public benefit corporations with inauthentic social aspirations would reincorporate as nonpublic benefit corporations rather than comply with new requirements, while nonpublic benefit corporations with true social aspirations would reincorporate as public benefit corporations to benefit from the form's new signals of legitimacy and accountability.

[236] B Lab would also be well-served to consider incorporating additional such measures into B Corp certification requirements for firms with multiclass structures.

increasingly claim to implement multiclass share structures to protect their pursuit of social goals alongside profit. This oversight is particularly troubling given not only the rising number of companies using multiclass structures to support firm social goals, but also the growing prevalence of socially conscious investors, employees, and others who seek to bargain with these firms.

This Article is the first to consider multiclass structures in the growing context of firms with objectives beyond profit. It argues that multiclass structures can produce important but overlooked social benefits of control, and not just private benefits of control as conventionally believed. This Article demonstrates how these controversial and highly critiqued governance structures may actually provide quite a bit of societal benefit in certain settings by addressing a private contracting problem and promoting declining public markets.

In making this argument, this Article contributes toward scholarly conversations in corporate law and corporate governance in the following three ways. First, it shows how multiclass structures can advantageously enable private contracting among socially conscious parties that is otherwise difficult or impossible to achieve. It enables socially conscious shareholders at firms like Warby Parker and Allbirds to more confidently invest in these companies knowing that the firms' social performance has a greater degree of protection. Second, it demonstrates how multiclass structures can promote declining public capital markets to the broader benefit of society. It does so by providing a more appealing public option for firms with social goals that would otherwise need to stay private to protect their social performance. Third, it anticipates potential criticisms and proactively proposes accountability and signaling mechanisms to address these critiques. Doing so would help optimize multiclass structures to deliver the valuable social benefits of control.

# THE LIMITS OF INDIVIDUAL PROSECUTIONS IN DETERRING CORPORATE FRAUD*

*Samuel W. Buell***

*Fifteen years after the largest financial scandal and economic crisis in a century, discussion of the problem of corporate crime too often borders on cliché. Endless calls from Congress, the media, the public, many scholars, and even the Justice Department itself, to recommit, over and over, to locking up more managers and executives to deter corporate wrongdoing portray the problem as relatively straightforward and blame legislative and executive failure of will. Through examination of the litigation record from over 100 prosecutions spanning the period from the 2008 financial crisis to the present, this Article presents evidence that relying on individual prosecutions to deter the most significant corporate crimes, especially those involving fraud in the financial sector, is less promising than believed. Structural features of crimes in the largest corporate organizations have made securing individual convictions and imprisonment, especially at senior levels, a chancy project for prosecutors. The Article further argues that its evidence relating both to failure rates and causes of those failures should point policymakers and enforcers beyond hackneyed calls for perp walks and prison and toward deeper thinking about a full suite of preventive tools, especially regulatory design.*

**TABLE OF CONTENTS**

INTRODUCTION
I. WHY "NO BANKERS IN JAIL"
A. *The MBS Catastrophe*
1. *Arguments for Criminal Conduct*

---

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2. *MBS-Related Cases*
   a. Tourre (Goldman)
   b. Stoker (Citi)
   c. Litvak
   d. Bear Stearns
   e. Underwriting Theory and FIRREA Settlements
   f. Serageldin
   g. Lehman Brothers

B. *Benchmark Frauds: Libor and Forex*
   1. *Allen and Conti (Rabobank)*
   2. *Connolly and Black (Deutsche Bank)*
   3. *U.K. Prosecutions ("Lord Libor" et al.)*
   4. *Forex Trading Prosecutions*

C. *Generalizations*

II. INDIVIDUAL LIABILITY BEYOND SECURITIES MARKETS
   A. *BP and the Gulf Spill*
   B. *GM and the Ignition Switch*
   C. *VW and the Defeat Device*
   D. *Boeing and the 737 MAX*

III. WHAT IS TO BE DONE?
   A. *More Prosecutors and Agents*
   B. *New Substantive Criminal Law*
   C. *Stronger Civil Liability*
   D. *Whistleblowing Regimes*
   E. *Corporate Liability*
   F. *Advanced Compliance Management*
   G. *Ex Ante Regulation*

CONCLUSION

APPENDIX A

APPENDIX B

APPENDIX C


## INTRODUCTION

Public discussion of the subject of corporate crime in the United States is becoming clichéd. On September 22, 2010, in the wake of the largest and most widely infuriating economic crisis since the 1930s,[1] the Senate Judiciary Committee convened one of numerous congressional hearings to discuss causes of the crisis

[1] An excellent summary of research on causes of the crisis, which does not address criminal liability, is John M. Griffin, *Ten Years of Evidence: Was Fraud a Force in the Financial Crisis?*, 59 J. Econ. Lit. 1293 (2021); *see also* Alan S.

and responses. The chair, Senator Edward Kaufman of Delaware, began by declaring,

> [W]e have seen very little in the way of senior officer or board room-level prosecutions of the people on Wall Street who brought this country to the brink of financial ruin. Why is that? . . . If criminal conduct contributed to the financial meltdown, then the people responsible should be investigated, prosecuted, and sent to prison. . . . Criminals on Wall Street must be held to account; otherwise, one of the great foundations of this country—our capital markets—will simply fade away.[2]

More than thirteen years later, on December 13, 2023, the same Senate committee convened a hearing on "Ensuring Accountability for Corporate Criminals." Committee Chair Richard Durbin opened the hearing this way:

> Countless companies have settled multi-billion dollar lawsuits outside of court, but far too often, the executives responsible for the decisions that led to those lawsuits have escaped prosecution and liability. . . . Corporate executives have little incentive to change their criminal conduct without fear of real consequences for their actions. . . . There cannot be two systems of justice—one for wealthy corporations and executives, and one for everyday Americans.[3]

What happened over the thirteen intervening years that explains why even a cataclysmic financial crisis and great recession, with all the attention and outrage that ensued, failed to change the game when it comes to punishing and deterring fraud and other forms of criminal conduct in the corporate sector? Answering this question remains highly important, especially because the U.S. Justice Department (DOJ) has vocally committed itself—in response to harsh criticism within and outside of congressional oversight—to the basic model of deterrence that has governed the federal approach to corporate crime since at least the early 1990s.

Under that model, prosecutors use the unforgiving American rule of corporate criminal liability (respondeat superior, or master-servant liability, as to any crime by any corporate agent,

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BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD (2013); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009).

[2] *Investigating and Prosecuting Financial Fraud After the Fraud Enforcement and Recovery Act: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. 1-4 (2010) (statement of Sen. Edward E. Kaufman).

[3] Press Release, Dick Durbin, U.S. Sen., Durbin Delivers Opening Statement During Senate Judiciary Committee Hearing on Ensuring Accountability for Corporate Criminals (Dec. 12, 2023), https://www.durbin.senate.gov/newsroom/press-releases/durbin-delivers-opening-statement-during-senate-judiciary-committee-hearing-on-ensuring-accountability-for-corporate-criminals.

with no defense for a company's compliance efforts[4]) to force corporations to cooperate with criminal investigations, including by agreeing to penalties in settlement processes. The purpose of doing so, according to the Department's policies, is not even primarily to make crime expensive for corporations but to help prosecutors collect otherwise elusive evidence of criminal violations so that corporate managers and executives are subject to individual criminal sanctions, including imprisonment.[5] According to a wide consensus of policymakers and academics, this is the best way to dissuade other such persons from breaking the law.[6] Over the last decade, the DOJ has doubled and tripled down on its commitment to this vision.[7]

This enforcement model has a strong foundation in neoclassical deterrence theory and influential ideas about behavioral and organizational psychology.[8] Together, these intellectual traditions support the view that business actors will weigh fear of imprisonment heavily against the potential financial rewards of lawbreaking, and corporate managers cannot dismiss the risk of personal conviction nearly as easily as the potential costs to their firms of corporate liability.[9] The probability of apprehension looms as large, or larger, in this calculus than the absolute quantity of

[4]*See* Samuel W. Buell, *Corporate Criminal Liability, in* RESEARCH HANDBOOK ON CORPORATE LIABILITY 106 (M. Petrin & C. Witting eds., 2023).

[5]*See* U.S. Dep't of Just., Just. Manual § 9-28.010 (2018).

[6]*Id.*

[7]*See United States Attorneys' Offices Voluntary Disclosure Policy*, U.S. DEP'T OF JUST. (Feb. 22, 2023), https://www.justice.gov/d9/2023-07/usao_voluntary_self-disclosure_policy_0.pdf; Memorandum from Lisa Monaco, Deputy Att'y Gen., U.S. Dep't of Just., to all U.S. Att'ys, Further Revisions to Corporate Criminal Enforcement Policies Following Discussions with Corporate Crime Advisory Group (Sept. 15, 2022) [hereinafter DOJ Corporate Crime Memorandum], https://www.justice.gov/d9/pages/attachments/2022/09/15/2022.09.15_ccag_memo.pdf; Memorandum from Sally Quillian Yates, Deputy Att'y Gen., to all U.S. Att'ys (Sept. 9, 2015) [hereinafter Yates Memo], https://www.justice.gov/d9/pages/attachments/2015/09/10/individual_accountability_for_corporate_wrongdoing_dag_memo2.pdf.

[8]Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 198, 208 (1968); Jennifer Arlen & Lewis A. Kornhauser, *Battle for Our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct*, 2023 U. ILL. L. REV. 673, 683 (2023); Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 689 (1997); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 834 (1994).

[9]*See, e.g.*, JOHN C. COFFEE, JR., CORPORATE CRIME AND PUNISHMENT: THE CRISIS OF UNDERENFORCEMENT 57 (2020); Julie R. O'Sullivan, *Is the Corporate Criminal Ecosystem Defensible?*, 47 J. CORP. L. 1047, 1056-57 (2022); Brandon L. Garrett, *The Corporate Criminal as Scapegoat*, 101 VA. L. REV. 1789, 1823 (2015).

punishment, especially incarceration.[10] Given familiar optimism biases and the enormous size of the corporate sector relative to public enforcement institutions, deterrence can only be effective if individual corporate wrongdoers worry that conviction and punishment are material possibilities.[11] This requires that the government visibly bring cases within a variety of industries that look familiar to actors within those industries and that such cases succeed.

The more the government embraces this model, the less things appear to change. Given the limitations on available data, a large-scale empirical study of the deterrent effects of criminal law in the business realm is virtually impossible.[12] Observers constantly

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[10] *See* Arlen & Kornhauser, *supra* note 8, at 723-24. How much punishment is sufficient to produce individual deterrence is an important question that this Article will not address. In theory, many more visible instances of punishment in the corporate sector should produce deterrence even with modest prison sentences. *See* Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Nonprosecution*, 84 U. Chi. L. Rev. 323, 345 n.71 (2017); Jennifer Arlen & Samuel W. Buell, *The Law of Corporate Investigations and the Global Expansion of Corporate Criminal Enforcement*, 93 S. CAL. L. Rev. 697, 707 (2020). Moreover, higher levels of punishment are no longer an available substitute for more convictions because sentencing guidelines in federal court, where most corporate crime is prosecuted, are already very high for many white-collar crimes. *See* Samuel W. Buell, *Is the White Collar Offender Privileged?*, 63 Duke L.J. 823, 835-41 (2014) [hereinafter Buell, *Privileged?*]; Samuel W. Buell, *Reforming Punishment of Financial Reporting Fraud*, 28 Cardozo L. Rev. 1611, 1646 (2007).

[11] *Cf.* Eugene Soltes, Why They Do It: Inside the Mind of the White-Collar Criminall (2016) (recounting interviews of convicted offenders in which they relate personal accounts consistent with theories of optimism bias).

[12] Corporate crime, and the effects of legal instruments directed at its control, are not visible in the absence of enforcement, levels of which are low in relation to arrests and prosecutions for street crimes. Without the ability to measure the denominator of the frequency with which financial fraud, bribery, money laundering, and the like are committed within corporations, there can be no estimating the causal relationship between enforcement and violations. In addition, selection effects in litigation are notoriously complicated and are aggravated in this setting by the abundant discretion of prosecutors. Kevin M. Clermont & Theodore Eisenberg, *Litigation Realities*, 88 Cornell L. Rev. 119, 138 (2002); George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. Legal Stud. 1, 31, 34 (1984); William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 Mich. L. Rev. 505, 538-39 (2001); Marc L. Miller & Ronald F. Wright, *The Black Box*, 94 Iowa L. Rev. 125, 158 n.80 (2008); *see also* Miriam H. Baer, Myths and Misunderstandings in White-Collar Crime 39-53 (2023) (explaining the extensive difficulties in measuring white-collar crime). Two papers have sought alternative sources for inferring levels of corporate crime, but neither is able to measure the incidence of prosecutable criminal violations in the corporate sector. Eugene F. Soltes, *The Frequency of Corporate Misconduct: Public Enforcement Versus Private Reality*, 26 J. Fin. Crime 923, 923 (2019) (examining the frequency of offenses within firms based on companies' own internal investigative data); Dorothy S. Lund & Natasha

lament, however, that prosecution and conviction rates do not rise as much as policy commitments would suggest they should and that scandal after major corporate scandal—with the exception of the occasional nearly one-person fraud band like a Bernard Madoff, Elizabeth Holmes, or Samuel Bankman-Fried—results in no senior person landing in prison.[13]

There is a widely shared explanation for this situation: the DOJ and Congress simply have not devoted sufficient resources and effort to the task. Not enough investigators, not enough prosecutors, not enough indictments, not large enough budgets, and not enough government personnel with zeal to carry out the mission—as opposed to appetites for press conferences, headlines, and the revolving door. On this account, the cases are there—they just are not getting made.

This line of argument emanated in the first instance from journalists[14] and filmmakers,[15] who channeled understandable global outrage over massive systemic harms caused by the 2008

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Sarin, *Corporate Crime and Punishment: An Empirical Study*, 100 TEX. L. REV. 285, 290 (2021) ("We recognize, however, that the implications that can be drawn from this data are necessarily limited due to imperfections in these datasets. For one, our data proxy for corporate misconduct, which may not correlate perfectly with corporate crime."). Additionally, there is the theoretical problem of what level of deterrence of corporate crime is efficient. Given enforcement and error costs, the optimal level of deterrence clearly is not 100 percent. This Article adopts the prevalent assumption that current deterrence levels are too low.

[13] *See, e.g.*, Lund & Sarin, *supra* note 12, at 305 n.88.

[14] *E.g.*, JESSE EISINGER, THE CHICKENSHIT CLUB: WHY THE JUSTICE DEPARTMENT FAILS TO PROSECUTE EXECUTIVES (2017) [hereinafter EISINGER, THE CHICKENSHIT CLUB]; MATT TAIBBI, THE DIVIDE: AMERICAN INJUSTICE IN THE AGE OF THE WEALTH GAP (2014); JEFF CONNAUGHTON, THE PAYOFF: WHY WALL STREET ALWAYS WINS (2012); YVES SMITH, ECONNED: HOW UNENLIGHTENED SELF INTEREST UNDERMINED DEMOCRACY AND CORRUPTED CAPITALISM (2010); Colin Barr, *Where Are the Subprime Perp Walks?*, CNN (Sept. 16, 2009, 3:40 AM), https://money.cnn.com/2009/09/15/news/subprime.perpwalk.fortune/index.htm; Matt Taibbi, *Ten Years After the Crash, We've Learned Nothing*, ROLLING STONE (Sept. 13, 2018), https://www.rollingstone.com/politics/politics-features/financial-crisis-ten-year-anniversary-723798/; Matt Taibbi, *The People v. Goldman Sachs*, ROLLING STONE (May 11, 2011), https://www.rollingstone.com/politics/politics-news/the-people-vs-goldman-sachs-245191/; Lydia DePillis, *10 Years After the Financial Crisis, Have We Learned Anything?*, CNN BUS. (Sept. 13, 2018), https://money.cnn.com/2018/09/13/news/economy/financial-crisis-10-years-later-lehman/index.html; Jesse Eisinger, *Why Only One Top Banker Went to Jail for the Financial Crisis*, N.Y. TIMES MAG. (Apr. 30, 2014) [hereinafter Eisinger, *Why Only One*], https://www.nytimes.com/2014/05/04/magazine/only-one-top-banker-jail-financial-crisis.html; Jesse Eisinger, *The Feds Stage a Sideshow, While the Big Tent Sits Empty*, N.Y. TIMES: DEALBOOK (Dec. 8, 2010, 3:09 PM), https://archive.nytimes.com/dealbook.nytimes.com/2010/12/08/where-are-the-financial-crisis-prosecutions/; William D. Cohan, *How Wall Street's Bankers Stayed Out of Jail*, ATLANTIC (Sept. 15, 2015), https://www.theatlantic.com/magazine/archive/2015/09/how-wall-streets-bankers-stayed-out-of-jail/399368/; Joe Nocera,

crisis in the banking sector. Soon the view became entrenched and found its way into scholarly treatments of the crisis and of corporate crime.[16] Meanwhile, it became a repeated theme in the

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Opinion, *The Hole in Holder's Legacy*, N.Y. TIMES (Sept. 29, 2014), https://www.nytimes.com/2014/09/30/opinion/joe-nocera-the-hole-in-holderslegacy.html; Joe Nocera, *Biggest Fish Face Little Risk of Being Caught*, N.Y. TIMES (Feb. 26, 2011), https://www.nytimes.com/2011/02/26/business/economy/26nocera.html; Peter Schweizer, *Obama's DOJ and Wall Street: Too Big for Jail?*, FORBES (May 7, 2012, 5:36 PM), https://www.forbes.com/sites/realspin/2012/05/07/obamas-doj-and-wall-street-too-big-for-jail/; Frank Rich, *Obama's Original Sin*, N.Y. MAG. (July 1, 2011), https://nymag.com/news/frank-rich/obama-economy/presidents-failure/; George Packer, *A Dirty Business*, NEW YORKER (June 20, 2011), https://www.newyorker.com/magazine/2011/06/27/a-dirty-business; Editorial, *Going Soft on Corporate Crime*, N.Y. TIMES (Apr. 10, 2008), https://www.nytimes.com/2008/04/10/opinion/10thu2.html; Editorial, *No Crime, No Punishment*, N.Y. TIMES (Aug. 25, 2012), https://www.nytimes.com/2012/08/26/opinion/sunday/no-crime-nopunishment. html. Jed Rakoff, a prominent federal judge, lent credibility to these takes when, as he sat on the primary trial court hearing MBS-related matters, he published a harsh criticism of prosecutorial inaction. Jed S. Rakoff, *The Financial Crisis: Why Have No High-Level Executives Been Prosecuted*?, N.Y. REV. BOOKS (Jan. 9, 2014), https://www.nybooks.com/articles/2014/01/09/financial-crisis-why-no-executive-prosecutions/.

As did the candid comments of such circumspect figures as Nobel laureate Ben Bernanke. Darrell Delamaide, *Delamaide: Even Bernanke Asks How Bankers Avoided Jail*, USA TODAY (Oct. 6, 2015, 8:26 PM), https://www.usatoday.com/story/money/columnist/2015/10/06/delamaide-bernanke-bankers-jail-comments/73459416/; Susan Page, *Ben Bernanke: More Execs Should Have Gone to Jail for Causing Great Recession*, USA TODAY (Nov. 13, 2015, 11:38 AM), https://www.usatoday.com/story/news/politics/2015/10/04/ben-bernanke-execs-jail-great-recession-federal-reserve/72959402/.

[15] Charles Ferguson released his documentary *Inside Job* in 2010, which won the Oscar at a ceremony in which Ferguson used his acceptance speech to decry the government's failure to jail bankers. INSIDE JOB (Sony Pictures Classics 2010); Peter Lattman, *'Inside Job' Wins Oscar*, N.Y. TIMES: DEALBOOK (Feb. 28, 2011, 7:48 AM), https://archive.nytimes.com/dealbook.nytimes.com/2011/02/28/inside-job-wins-oscar/; *see also 60 Minutes: Prosecuting Wall Street* (CBS News television broadcast Dec. 4, 2011); *Frontline: The Untouchables* (PBS television broadcast Jan. 22, 2013). Five years later, Adam McKay released his popular fictional account of the MBS market collapse based on Michael Lewis' bestseller, a film that featured Steve Carrell's character virtually howling to the skies about the entire market having been "a fraud." THE BIG SHORT (Paramount Pictures 2015).

[16] Several years after the crisis, Brandon Garrett published a widely cited book on corporate prosecutions, which provided the first comprehensive treatment of the modern practice of settling criminal cases with companies through deferred and nonprosecution agreements. BRANDON L. GARRETT, TOO BIG TO JAIL: HOW PROSECUTORS COMPROMISE WITH CORPORATIONS (2014). The book is descriptive; however, because Garrett naturally included criticisms and policy observations, *id.* at 250-88, and because "Too Big to Jail" is a memorable phrase, others used the title in support of a variety of criticisms of ineffective white-collar enforcement. *See, e.g.*, Court E. Golumbic & Albert D. Lichy, *The "Too Big to Jail" Effect and the Impact on the Justice Department's Corporate Charging Policy*, 65 HASTINGS L.J. 1293, 1295 (2014) (discussing how the DOJ's "perceived role in

halls of Congress and on campaign trails that continues to this day.[17]

causing the [2008 financial] crisis prompted members of Congress, the press, and the public to question whether the agency has maintained a de facto policy that certain corporations 'too big [sic] jail' given their size and economic significance"); Prem Sikka, *Too Big to Jail: Why Crackdowns on Dodgy Finance Have Been So Ineffective*, GUARDIAN (Oct. 6, 2021, 6:00 AM), https://www.theguardian.com/commentisfree/2021/oct/06/crackdowns-finance-government-laws-regulation-pandora-papers.

Others have written normatively since 2008 on the importance of individual prosecutions and the lack thereof. *See* COFFEE, *supra* note 9, at 57; GREGG BARAK, THEFT OF A NATION: WALL STREET LOOTING AND FEDERAL REGULATORY COLLUDING (2012); JENNIFER TAUB, BIG DIRTY MONEY: THE SHOCKING INJUSTICE AND UNSEEN COST OF WHITE-COLLAR CRIMEE (2020); William K. Black, *Why CEOs Are Able to Loot with Impunity—and Why It Matters, in* HOW THEY GOT AWAY WITH IT 171 (Susan Will, Stephen Handelman, & David C. Brotherton eds., 2013); Mary Kreiner Ramirez, *Criminal Affirmance: Going Beyond the Deterrence Paradigm to Examine the Social Meaning of Declining Prosecution of Elite Crime*, 45 CONN. L. REV. 865 (2013); Amy J. Sepinwall, *Faultless Guilt: Toward a Relationship-Based Account of Criminal Liability*, 54 AM. CRIM. L. REV. 521 (2017); Todd Haugh, *The Most Senior Wall Street Official: Evaluating the State of Financial Crisis Prosecution*s, 9 VA. L. & BUS. REV. 153 (2015); Henry N. Pontell et al., *Too Big to Fail, Too Powerful to Jail? On the Absence of Criminal Prosecutions after the 2008 Financial Meltdown*, 61 CRIME L. & SOC. CHANGE 1, 1-3 (2013); William K. Black, *The Department of Justice "Chases Mice While Lions Roam the Campsite": Why the Department Has Failed to Prosecute the Elite Frauds That Drove the Financial Crisis*, 80 UMKC L. REV. 987, 988 (2012); Anton R. Valukas, *White-Collar Crime and Economic Recession*, 2010 U. CHI. LEGAL F. 1, 12-19; Don Mayer et al., *Crime and Punishment (or the Lack Thereof) for Financial Fraud in the Subprime Mortgage Meltdown: Reasons and Remedies for Legal and Ethical Lapses*, 51 AM. BUS. L.J. 515, 515-16 (2014); Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay*, 127 HARV. L. REV. 1991, 2023-29 (2014) (reviewing CONNAUGHTON, *supra* note 14); Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283 (2013); Henry N. Pontell & Gilbert Geis, *The Trajectory of White-Collar Crime Following the Great Economic Meltdown*, 30 J. CONTEMP. CRIM. JUST. 70 (2014); Sandra D. Jordan, *Victimization on Main Street: Occupy Wall Street and the Mortgage Fraud Crisis*, 39 FORDHAM URB. L.J. 485 (2011); Jeff Madrick & Frank Partnoy, *Should Some Bankers Be Prosecuted?*, N.Y. REV. BOOKS (Nov. 10, 2011), https://www.nybooks.com/articles/2011/11/10/should-some-bankers-be-prosecuted/.

*But see* Gregory M. Gilchrist, *Individual Accountability for Corporate Crime*, 34 GA. ST. U. L. REV. 335 (2018). Securities law scholars too have stressed the importance of individual liability to the policing of financial markets. *See, e.g.*, Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 24-29 (2007); Amanda M. Rose, *The Multienforcer Approach to Securities Fraud Deterrence: A Critical Analysis*, 158 U. PA. L. REV. 2173, 2176 (2010); Donald C. Langevoort, *On Leaving Corporate Executives "Naked, Homeless and Without Wheels": Corporate Fraud, Equitable Remedies, and the Debate over Entity Versus Individual Liability*, 42 WAKE FOREST L. REV. 627 (2007).

[17]*E.g., The Need for Increased Fraud Enforcement in the Wake of the Economic Downturn: Hearing Before the S. Comm. on the Judiciary*, 111th Cong. 3

While there are ample reasons to study how the political economy of Congress, executive branch capture dynamics, and other forms of agency cost in government hamper the effort to prosecute corporate crime, a story of insufficient commitment is too simplistic. Indeed, this account has grown to impair understanding corporate crime and how to respond to it. The purpose of this Article is to show—through qualitative empirical examination of over a decade of criminal and civil litigation—that the more fundamental, and difficult, problem with the dominant model of how to attack corporate fraud is that convictions are much harder to obtain than observers believe.

In the years between Senator Kaufman's 2010 hearing and Senator Durbin's 2023 hearing, the government prosecuted many cases involving fraud in the trading of securities in large financial institutions, including multiple cases centered on the dealing of the mortgage-backed securities (MBS) products at the heart of the financial crisis that first propelled so much of the ongoing discussion about individual liability. A study of these cases, which this Article will supply, demonstrates that the government often fails, or nearly fails, to secure jury verdicts and appellate affirmances when proceeding against corporate actors for all but the most flagrant crimes.

In all, this Article will document over 100 enforcement actions, the majority criminal. Two groups of cases were selected from within this data for close examination. First, the Article describes a series of fully litigated prosecutions arising from the three largest scandals in the financial industry between 2008 and the early 2020s: trading in MBS before and during the Great Recession, the "Libor" interest rate benchmark manipulation affair, and the "Forex" currency benchmark collusion matter. Second, to consider

(2009) (statement of John S. Pistole, Deputy Dir., FBI); *Turmoil in the U.S. Credit Markets: The Genesis of the Current Economic Crisis*: *Hearing Before the S. Comm. on Banking, Hous. & Urb. Affs.*, 110th Cong. 28 (2008); *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight & Gov't Reform*, 110th Cong. 60, 64 (2008); Press Release, Sherrod Brown, U.S. Sen., Sens. Brown, Grassley Press Justice Department on "Too Big to Jail" (Jan. 29, 2013), https://www.brown.senate.gov/newsroom/press/release/sens-brown-grassley-press-justice-department-on-too-big-to-jail; Letter from Sen. Charles E. Grassley, Ranking Member, Comm. on the Judiciary, to Eric H. Holder, Jr., Att'y Gen., U.S. Dep't of Just. (Dec. 13, 2012), https://www.grassley.senate.gov/imo/media/doc/HSBC-12-13-12-letter-to-Holder-no-criminal-prosecutions.pdf; S.A. Miller, *Bernie Sanders Wants Wall Street Execs Jailed for 2008 Financial Crisis*, WASH. TIMES (Oct. 6, 2015), https://www.washingtontimes.com/news/2015/oct/6/bernie-sanders-wants-wall-street-execs-jailed-2008/; Jonathan Allen, *Read Hillary Clinton's Big Economic Speech*, VOX (July 13, 2015, 4:40 PM), https://www.vox.com/2015/7/13/8953349/Clinton-economic-speech-transcript; DEMOCRATIC PLATFORM COMM., 2016 DEMOCRATIC PARTY PLATFORM (2016), https://democrats.org/wp-content/uploads/2018/10/2016_DNC_Platform.pdf.

how this Article's concern applies outside of fraud in the financial industry, four of the most egregious recent cases from other industrial sectors will be discussed: the British Petroleum spill in the Gulf, the General Motors ignition switch fiasco, the Volkswagen emissions cheating case, and the Boeing 737 MAX disaster.

In the finance cases, only 13 prison sentences were imposed out of nearly 60 criminal actions.[18] In the non-finance cases, only one prison sentence has been imposed out of over a dozen prosecutions to date.[19] These are starkly high failure rates in a federal criminal justice system that produces overall conviction rates approaching 100 percent.[20] In considering the financial sector cases, this Article includes civil enforcement actions to demonstrate that, where civil and criminal liability were both authorized, civil enforcers had no easy path to sanctioning when criminal prosecutors refrained from acting—even though civil liability could be imposed on proof by only a preponderance of the evidence and often could be premised on mere negligence.

This underappreciated litigation evidence challenges the model for deterring corporate crime that continues to dominate public discussion of the problem, particularly among policymakers and enforcers. It is beyond dispute that more convictions would enhance deterrence. But more cases, the evidence suggests, will not translate to a higher probability of conviction in any given case. After all, it would be surprising if, for well over a decade, prosecutors have been focusing their attentions on the least viable cases involving major corporate wrongdoing while leaving lots of easily convictable managers and executives undisturbed. A further concern is that some deterrence theory has suggested that visibly ineffective enforcement can be worse than nonenforcement.[21]

To be sure, there are strong retributive and expressive arguments for prosecuting serious cases of corporate wrongdoing, regardless of whether such prosecutions promise to change the behavior of other corporate actors—and perhaps even if such prosecutions will have a low success rate. To see the point incandescently, one need only juxtapose mass incarceration for il-

[18] See *infra* Appendices A-C, for tables summarizing and individually reporting all civil and criminal enforcement actions in the three categories of finance cases.

[19] *See infra* Subpart II.C.

[20] John Gramlich, *Fewer Than 1% of Federal Criminal Defendants Were Acquitted in 2022*, PEW RSCH. CTR. (June 14, 2023), https://www.pewresearch.org/short-reads/2023/06/14/fewer-than-1-of-defendants-in-federal-criminal-cases-were-acquitted-in-2022/.

[21] *See, e.g.*, Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71, 84-85 (2003); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1796 (2000).

legal drug sales and low-level property crime with the treatment of those who built the legal opiate industry and became hugely rich off it.[22] This Article does not argue that the pursuit of individual corporate prosecutions should be de-emphasized in any way. Public resources could be much greater in the effort to deal with corporate crime. They should be.[23] The Article's intended audience is those—particularly in the policy, media, and scholarship realms— who argue that general deterrence can be enhanced, perhaps even easily, through more indictments of mid-level and senior personnel.[24]

Moreover, this Article's treatment of the litigation record will show that the government's underappreciated failure rate in, so to speak, big-ticket corporate cases cannot be dismissed as the simple result of biases in favor of wealthy and often white criminal defendants harbored by judges and jurors. Such an explanation is discordant, after all, with the powerful and consistent public sentiment against corporate wrongdoers expressed in survey data.[25]

Close examination of litigation reveals both bad and good news. The bad news is that impediments to individual convictions in the corporate context are often structural and therefore cannot be easily surmounted. The application of existing criminal prohibitions, particularly anti-fraud laws and especially their mens rea requirements, to legal and productive economic activities presents difficult issues of line-drawing that allow room for arguments and doubts of the sorts ordinary criminal litigation rarely

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[22] The government's documented misfeasance over many years in handling the investigation and prosecution of Purdue Pharma is a signal instance of unacceptably weak corporate enforcement, by any measure, at both the institutional and individual levels. *See* PATRICK RADDEN KEEFE, EMPIRE OF PAIN: THE SECRET HISTORY OF THE SACKLER DYNASTY 262-85 (2021).

[23] Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL'Y REV. 265, 272-76 (2014).

[24] The argument that corporate wrongdoers should be more often indicted to express public condemnation, to air revealing facts in litigation, or even to inflict the reputational and other costs of indictment for deterrent purposes runs into the ethical constraint that prosecutors, at least in federal court, may not seek an indictment in the absence of proof sufficient to satisfy a jury beyond a reasonable doubt. Justice Manual, *supra* note 5, § 9-27.220. While the current Deputy Attorney General has told prosecutors to be less concerned about indicting cases that might be lost, she of course cannot intend relaxation of ethics. *See* DOJ Corporate Crime Memorandum, *supra* note 7.

[25] *E.g.*, Mitchell Ogisi, *Majority Worldwide Sees Widespread Corruption in Businesses*, GALLUP (May 10, 2012), https://news.gallup.com/poll/154571/Majority-Worldwide-Sees-Widespread-Corruption-Businesses.aspx (finding that 60% of Americans believed corruption is widespread in business).

involves.[26] On top of that, the government often encounters a dilemma of needing to initiate individual corporate prosecutions at, roughly speaking, the line or working level where actus reus and mens rea are most amenable to proof. Jurors and judges, who are concerned only with the cases before them, often respond favorably to arguments that such lower-level actors were "just doing their job" or were "scapegoats" for misconduct and breakdowns properly attributed to the corporation as a whole and its senior managers. Problems in proving criminal intent and in ascribing responsibility within large organizations grow continuously as the size and complexity of multinational firms increase and their activities and personnel span more legal systems, economies, and cultures. These problems get more severe as examination of individual responsibility moves upward through the corporate ranks.[27]

The good news, if one can call it that, is that more clearly understanding the structural nature of corporate crime and corporate prosecutions can point legislators and policymakers in the direction of effective reform—and beyond repetitive calls for more prison for executives that have dominated discussion of American corporate scandals for two decades or more.

This Article's ambitions are primarily empirical. There will not be space for a full examination of instrumental alternatives. However, this Article will conclude by considering a variety of alternative interventions and their relative promise. Increases to prosecution and investigative personnel is an avenue limited by the structural obstacles this Article's evidence illuminates and with additional downsides associated with bureaucratic agency costs that have not been adequately appreciated. Reform of substantive white-collar criminal law is always an option but would require serious departures from core principles of criminal liability that debates in this field tend to minimize. Enhanced civil liability and enforcement is an easier path theoretically, provided that lawmakers are willing to beef up not just the size but also the form of civil sanctions. Whistleblowing regimes, ever

[26] I have explored this phenomenon in prior theoretical work. *See, e.g.*, SAMUEL W. BUELL, CAPITAL OFFENSES: BUSINESS CRIME AND PUNISHMENT IN AMERICA'S CORPORATE AGE 58-65 (2016) [hereinafter BUELL, CAPITAL OFFENSES]; Buell, *Privileged?, supra* note 10, at 841. My objective in this Article is to demonstrate this problem empirically, rather than reworking theoretical ground covered elsewhere.

[27] For a complete treatment of the seemingly yawning gap between enforcement of white-collar offenses and the nearly countless and expansive prohibitions on such conduct on the statute books, see BAER, *supra* note 12. For a summary of the book's argument, see BUELL, CAPITAL OFFENSES, *supra* note 26, at 1-6. This Article stresses impediments in economic, industrial, institutional, and sociological form, while Baer focuses on crime definition and punishment rules. The story told here points to less ready solutions.

more popular (except within the corporate sector), merit greater attention and experimentation. Corporate liability must continue to be emphasized, principally as a means of increasing the probability that individual crimes will be detected. The still young science of corporate compliance must continue to advance toward the cause of preventing crime in the first instance.

Most importantly, retreats from effective regulation must be halted and reversed in a wide variety of industries. These retreats have spurred the institutions of criminal prosecution—through ad hoc settlement policies and practices pursued while in an ex post litigation posture—to occupy the awkward role not only of designers of corporate compliance and governance systems but of judges in the first instance of what industrial practices should be tolerated or prevented.[28] This dynamic is practically guaranteed to accelerate because, as this Article will suggest and future work will explore, ineffective regulation produces corporate crime, often in forms that would not exist but for the shape of inapt regulatory structures and ineffective enforcement.

Part I of this Article will lay out the evidence that demonstrates the limits of the dominant model for deterring corporate crime by focusing on prosecutions and civil enforcement actions concerning fraud in securities markets. Part II will address broader questions about the prospects of individual corporate prosecutions from industries outside the financial sector. Part III will compare the instrument of individual prosecutions to alternative tools for reducing or preventing corporate crime in light of the Article's findings. A conclusion and appendices displaying litigation results follow.

## I Why "No Bankers in Jail"

This Part considers over 100 enforcement actions, most of them criminal, brought since 2008 in three major scandals in the finance industry: dealing in MBS before and during a historic real estate bubble collapsed, trading interest rate derivatives priced off benchmark rates such as "Libor," and trading currency derivatives priced off a benchmark known as "Forex" or "FX." Only 13 sentences of imprisonment have been imposed from these actions, which have spanned the United States and the United Kingdom. Studying the litigation record in a selection of these cases will demonstrate the difficulties in proving criminality of

[28] *See* Lisa Kern Griffin, *Inside-Out Enforcement, in* PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT 110-25 (Anthony S. Barkow & Rachel E. Barkow eds., 2011); *see also* Arlen & Kahan, *supra* note 10, at 352-53; Lawrence A. Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigations and Reform*, 66 FLA. L. REV. 1, 44 (2014).

traders of financial products, especially on the dimension of intent, even when the government possesses seemingly damning documentation and enjoys the cooperation of co-conspirators—fruits of investigation almost always obtained because corporations are incentivized to cooperate by the threat of liability and the offer of reduced sanctions.[29]

### *A. The MBS Catastrophe*

#### *1. Arguments for Criminal Conduct*

The current argument for more individual prosecutions has its genesis in the government's response to the financial crisis following the collapse of the market for mortgage-backed securities in 2008 and 2009. Thus, this Article first takes up enforcement actions related to that market.[30] While these cases might seem like old news, their full litigation record has materialized only in the last few years, long after casual observers had firmly made up their minds on the merits.

Three theories of fraud have been advanced in public discussion of MBS practices and reflected, to varying degrees, in the cases that the government did bring involving MBS. The first theory, what we might call Fraud on the Buyer, describes the fraud as the conduct of the sellers in the MBS market toward the buyers of the securities.[31] On this theory, those profiting from selling to others positions that were long (bullish on) MBS—and thus, especially late in the market, long the ability of highly leveraged American homeowners to make their mortgage payments in a home-price bubble—defrauded those buyers because

**[Section I]**

[29]Notes accompanying the Article's appendices provide details about search methodology and the nature of all criminal and civil enforcement actions relating to these three scandals, including cases not discussed in the body of the Article. *See infra* Appendices A-C and accompanying notes. Cases discussed in the body of the Article were selected because they either (1) went to trial, produced an available transcript of the trial proceedings, and included what appeared to be strong government proof, or (2) left other significant records, such as appellate rulings or extensive media coverage of the trial, that allow for inferences about obstacles the government encountered in litigation.

[30]This Article does not consider prosecutorial efforts to sanction mortgage fraud at the retail (homebuyer) level. *See* U.S. Dep't of Just., Off. of the Inspector Gen. Audit Div., Audit of the Department of Justice's Efforts to Address Mortgage Fraud (2014), https://oig.justice.gov/reports/2014/a1412.pdf. While growth in fraudulent acquisition of home purchase financing played an important role in producing the systemic crisis of 2008-09, loan origination was sufficiently separate from the securitization market that prosecution of originators for fraud could not realistically have led to prosecution of MBS traders and underwriters or their supervisors.

[31]*See, e.g.*, Madrick & Partnoy, *supra* note 16.

the long positions were, at a certain point, excessively risky investments that soon became nearly worthless.[32]

MBS deals on the scale that caused macroeconomic damage were conducted between large financial institutions. The buyers and sellers in these deals were typically traders at separate, and often competing, corporations in the financial markets.[33] Because MBS were traded over the counter in a sophisticated market, it is difficult or impossible to establish any special legal duty running between buyer and seller. It is black-letter law that even a common-law civil fraud claim cannot be based on the absence of a seller's disclosure unless the seller has a legal duty of candor toward the buyer, a duty that cannot be found without a fiduciary-type relationship.[34]

Any prosecution of an MBS seller for a Fraud on the Buyer thus had to be grounded on either (1) a false representation to the buyer or (2) a novel argument that heightened duties of disclosure did in fact apply in these relationships.[35] The material facts usually described as undisclosed in these deals had to do with either the riskiness of the mortgage loans underlying the securities ("stated income" loans, loans with no cash down payments, buyers with very low credit ratings, etc.) or the selling bank's own position with regard to the MBS product or the market generally (the seller was net short (bearish on) the market and believed the market was near collapse, the seller was invested on the other side of the same product being marketed in the deal, or the like).[36]

The second, related theory might be called Underwriting Fraud. On this theory, financial institutions packaging and selling large quantities of MBS products did not follow or insist upon underwriting procedures that were minimally adequate or consistent with representations or understandings about how underwriting would be conducted.[37] Some sellers—there were many of them, especially Countrywide—allowed huge quantities of home

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[32] *See id.*

[33] *See id.*

[34] *See* Samuel W. Buell, *What Is Securities Fraud?*, 61 DUKE L.J. 511, 545-47 (2011).

[35] See United States v. Finnerty, 533 F.3d 143, 151 (2d Cir. 2008), and United States v. Dial, 757 F.2d 163, 171 (7th Cir. 1985), for analyses of which types of nondisclosures constitute fraud in securities trading markets.

[36] *See* BUELL, CAPITAL OFFENSES, *supra* note 26, at 59.

[37] *See* Tomasz Piskorski et al., *Asset Quality Misrepresentation by Financial Intermediaries: Evidence from the RMBS Market*, 70 J. FIN. 2635, 2636 (2015) (reporting evidence that home loans underlying many MBS products were riskier than as described in disclosures to unwitting buyers, without addressing questions of legal liability); Press Release, U.S. Dep't of Just., Bank of America

loans to be securitized without real scrutiny or application of standards about the riskiness of the loans.[38] They then knowingly foisted these egregious products upon their buyer counterparties without informing them of the fact that underwriting procedures were deficient, relaxed, or disregarded.[39] Buyers of these products, the argument goes, were victims not simply because they were induced to buy exceedingly risky derivatives but because they were misled about the safety processes sellers applied to those products before taking them to market.[40]

The third theory, which might be called Accounting Fraud, has to do with the books of the financial institutions themselves. Some were so deep into the MBS market, including on the long side, and were sufficiently expert in where that market stood, that at a certain point late in the bubble they knew their own firms were much riskier to their investors than their financial reporting conveyed.[41] By not disclosing the truth and, at least in the case of Lehman Brothers, taking steps to manage their books to conceal the true risk of loss and insolvency they bore, the institutions defrauded their investors in the debt and equity markets.[42] Or so it has been asserted.

### *2. MBS-Related Cases*

These three theories were not extensively tested, of course. That is a pillar of the case against the government's handling of post-crisis enforcement. However, the theories were substantially more tested than many accounts have allowed. Some were even subject to trials.[43] Others were explored sufficiently to have left behind material that helps assess them.[44] In this section, the legal record will be canvassed to demonstrate that the dominant narrative around liability for conduct in the MBS markets of the aughts has misrepresented the barriers to widespread enforcement. That point, in turn, supports the main argument of this Article that individual liability is not the ready tool for deter-

to Pay $16.65 Billion in Historic Justice Department Settlement for Financial Fraud Leading up to and During the Financial Crisis (Aug. 21, 2014), https://www.justice.gov/opa/pr/bank-america-pay-1665-billion-historic-justice-department-settlement-financial-fraud-leading (describing the DOJ's civil case under FIRREA statute based largely on underwriting failures).

[38] Piskorski, *supra* note 37, at 2658-59.

[39] *Id.*

[40] *See* Madrick & Partnoy, *supra* note 16.

[41] *See* Report of Anton R. Valukas, Examiner at 732-1053, *In re* Lehman Bros. Holdings Inc., 433 B.R. 113 (Bankr. S.D.N.Y. 2010) (No. 08-13555).

[42] *Id.* at 853-84.

[43] *See infra* Subpart I.A.2.

[44] *See infra* Subpart I.A.2.

ring corporate fraud that many observers believe it to be.

The story that emerges is not only about wins and losses but also about the difficulty of persuading juries beyond a reasonable doubt that an individual actor—with a face and a story to tell—in a large, complex, and mostly legal process clearly acted with the knowledge and purpose to wrong others. Given the government's struggle to paint a clear picture of criminal intent at the trader level, individuals at more senior levels within financial institutions would have been even less plausible candidates for ascription of criminal liability, though they indisputably bore moral and professional responsibility for what happened on their watches.

**a. Tourre (Goldman)**

Start with the case that government enforcers appear to have believed was their best shot at establishing that large MBS deals could be fraudulent. In a case of the Fraud on the Buyer type, the SEC reached a $550 million settlement with Goldman Sachs, including a mild concession that the firm had made "a mistake," for Goldman's packaging and sale in 2007 of an MBS product called Abacus 07-AC1 (Abacus).[45] No individual was criminally prosecuted. The SEC sued one Goldman employee, a vice president on a trading desk named Fabrice Tourre, who was 28 at the time of the deal, in a civil case filed in the Southern District of New York.[46] Tourre, with Goldman funding his defense, chose to try the case and lost. He was ordered to pay $850,000 in fines and disgorgement.[47] The SEC had no easy path to this modest civil enforcement win, which the jury provided reluctantly even

[45]Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), https://www.sec.gov/news/press/2010/2010-123.htm. Among types of products in this market, Abacus was a credit default obligation (CDO). *See* Dan Wilchins & Karen Brettell, *Factbox: How Goldman's ABACUS Deal Worked*, REUTERS (Apr. 16, 2010, 4:32 PM), https://www.reuters.com/article/world/factbox-how-goldmans-abacus-deal-worked-idUSTRE63F5CZ/. The DOJ decided not to pursue Goldman criminally on this matter and took the unusual step of announcing that decision, explaining that there was insufficient proof of criminal liability. David Ingram & Aruna Viswanatha, *U.S. Justice Department Drops Goldman Financial Crisis Problem*, REUTERS (Aug. 9, 2012, 10:02 PM), https://www.reuters.com/article/idUSBRE879036/.

[46]*See generally* Complaint, SEC v. Tourre, 4 F. Supp. 3d 579 (S.D.N.Y. 2014) (No. 10-CV-3229). An SEC lawyer later provided reporters with internal emails to explain that he had failed in his efforts to persuade superiors to bring broader allegations against both Tourre's Goldman Sachs supervisors and personnel of a hedge fund on the short side of the transaction. *See* Jesse Eisinger, *Why the S.E.C. Didn't Hit Goldman Sachs Harder*, NEW YORKER (Apr. 21, 2016), https://www.newyorker.com/business/currency/why-the-s-e-c-didnt-hit-goldman-sachs-harder.

[47]Nate Raymond & Jonathan Stemple, *Big Fine Imposed on Ex-Goldman*

on a preponderance of the evidence standard.

Goldman, primarily in the person of Tourre, acted as the dealer on the transaction, constructing and marketing it for a $15 million fee.[48] The buyers—those going long on the portfolio of mortgages referenced by the securities—were a German bank, a Dutch bank, and another financial services company.[49]

At the same time, Goldman constructed and sold a short position on the same product to Paulson and Company, a hedge fund led by John Paulson, who is reported to have reaped $5 billion in 2010 from his strategy of shorting the late MBS market, including $1 billion from his short play on Abacus.[50] Because no such trade can be consummated without both a long and a short, and investment houses such as Goldman often profit from intermediating such deals rather than holding large positions in them, Goldman's dealing with a short investor was unexceptional. The home loans securitized in the deal were, as all involved knew and intended, high on the scale of default risk.[51] MBS products founded on such loans were common, especially late in the market's rise, and produced high profits for buyers with sufficient risk tolerance—but only so long as home values continued to increase across the United States.[52]

The SEC's theory of fraud was not that Goldman could not sell such long positions to willing buyers, of course. It was that Goldman did not disclose a highly material fact about the deal to the buyers and affirmatively acted to mislead them about that fact.[53] The German bank, which had been a heavy consumer of MBS products, knew well that the market was becoming riskier. The bank eventually decided that it would close more such deals only if the mortgages in a securitized portfolio had been blessed by a "selection agent," a credible third-party inspector paid a fee to review the products underlying the deal and lend its reputational capital to approving them, in the manner of a credit rating

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*Trader Tourre in SEC Case*, REUTERS (Mar. 12, 2014, 2:53 PM), https://www.reuters.com/article/idUSBREA2B112/.

[48]Complaint, *supra* note 46, at 3.

[49]*Id.* at 15-19.

[50]*See* Svea Herbst-Bayliss, *Paulson's $5 Billion Payout Shocks, Raises Questions*, REUTERS (Jan. 28, 2011, 8:17 PM), https://www.reuters.com/article/idUSTRE70R7CS/; Eisinger, *supra* note 46.

[51]Complaint, *supra* note 46, at 5-9.

[52]Zachary S. Gilreath*, The Culprit of the Great Recession: A Detailed Explanation of Mortgage-Backed Securities, Their Impact on the 2008 Financial Crisis, and the Legal Aftermath, 13 J. BUS. & TECH. L. 319, 329 (2018)*.

[53]Complaint, *supra* note 46, at 2.

agency.[54] A firm named ACA was selected for this task.[55]

Meanwhile, Goldman extensively discussed with Paulson, the short investor, which types of loans would be included in the deal. Goldman allowed Paulson to review and alter the portfolio of loans so that it would be more to his firm's liking—that is, riskier of default.[56] Paulson's position as short investor, including his role in micromanaging the portfolio prior to approval by ACA and closing, was not disclosed to the buyers or ACA.[57] A metaphorical oversimplification of the SEC's theory might be that a bookie induced a gambler to bet on the Packers to beat the Bears without being told that the bookie could call the coach of the Packers and direct the coach to start second-string players.

The government's argument was that ACA would not have given its approval to the deal, and thus the German buyers would not have purchased the product, had ACA known that a massively short investor was permitted to hand-pick risky mortgages for the package of securities.[58] Goldman, the government believed, actively concealed the full nature of Paulson's involvement to ensure the success of the deal: in the framing of the SEC's counsel, Tourre "tricked" ACA into believing that Paulson was there only as a small equity investor on the long side.[59] Paulson's active selection role, in the short position, was not a common feature of MBS deal construction and was the critical fact that made the government believe it could prevail, at least civilly, on a fraud charge.

As the trial began, Tourre, whose Goldman compensation was $1.7 million in 2007,[60] faced a few bad facts. In the midst of the deal discussions, he had sent an email to his girlfriend about the MBS market, saying, "The whole building is about to collapse anytime now. [With Tourre] standing in the middle of all these complex highly-levered exotic trades that he created, without necessarily understanding all the implications of those monstrosities."[61] He wrote another email in which he described the experience of sitting in a meeting on the deal that both

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[54] *Id.* at 7-8.

[55] *Id.*

[56] *Id.* at 9-11.

[57] *Id.* at 11-13.

[58] *Id.* at 11-15.

[59] Transcript of Trial at 68:3-22, SEC v. Tourre, 4 F. Supp. 3d 579 (S.D.N.Y. 2014) (No. 10-CV-3229) [hereinafter Tourre Transcript].

[60] *Id.* at 55:8-57:14, 68:3-22, 71:3-5, 73:6-15, 76:3-10, 82:5-7.

[61] *Id.* at 57:1-6.

Paulson and ACA attended as "surreal."[62] This comment seemed to indicate Tourre's understanding that ACA was oblivious about why a Paulson employee was really there. An important term sheet on the deal did not say anything about Paulson, only stating that the portfolio was selected by ACA.[63] With a "let's discuss," Tourre had forwarded to another employee at Goldman an email that seemed to indicate that ACA believed Paulson to be an equity investor (long) in the transaction.[64] "Let's discuss," the SEC argued, indicated that Tourre had read the email and worried that ACA was being misled.[65]

Tourre's defense stressed several points to the jury: (1) the purpose of a synthetic securities product like this credit default obligation (CDO) is to have a bet with two sides, and it is a zero-sum game "like playing fantasy baseball"; (2) everyone knew that Paulson was massively shorting the housing market, a fact that was all over the financial press; (3) everyone knew "storm clouds" were gathering over the market and the disagreement was only about when it would rain and how hard; (4) the parties to Abacus were "the most sophisticated financial institutions in the United States and around the world"; (5) it was "industry standard" to have investors for whom an MBS deal was constructed make suggestions about what to include; and (6) another division of ACA ended up taking a modest long position on the deal, evidence that ACA thought the structure was "bullet proof."[66] In his testimony, Tourre told the jury that he could not recall why he had described the Paulson-ACA meeting as "surreal" and that he did not believe he had read all of the forwarded emails reflecting ACA's belief that Paulson was a long investor.[67]

The ACA witnesses said they did not know about the short investor's role in portfolio selection and that fact would have killed the deal for them.[68] However, an ACA witness conceded on cross-examination that knowing about Paulson would not have affected ACA's "credit process" and that "ACA . . . did its collateral work the same regardless."[69] The information about Paulson, he said, would not have affected their "standards" but would have af-

[62] *Id.* at 2073:16-24.

[63] *Id.* at 73:3-15.

[64] *Id.* at 2576:12-13

[65] *Id.* at 2576:11-25, 2577:5-25, 2578:1-25, 2579:1-3.

[66] *Id.* at 84:5-85:8, 86:1-15, 87:22-25, 88:7-11, 91:15-23, 97:7-15, 1020:9-24.

[67] *Id.* at 2074:2-25, 2575:4-2576:1, 2577:10-2579:3, 2583:4-11, 2590:13-2592:25.

[68] *Id.* at 1470:4-1471:2.

[69] *Id.* at 1626:1-17, 1676:12-25.

fected "whether we wanted to do the transaction."[70]

In summation, the defense described Tourre as "an easy mark, a scapegoat, the sole person here you can find because he wrote some immature emails late at night to his girlfriend."[71] His counsel argued to the jury, "[S]ophisticated investors who care about things, things that are material to them, should be expected to confirm them," and emphasized that Goldman retained $90 million of the long position after trying to sell it to others, something one would not do with a deal designed to fail.[72]

The SEC's complaint alleged fraud under both Rule 10b-5 and Section 17 of the Securities Act of 1933.[73] The jury was instructed, as SEC counsel emphasized in summation, that on a Section 17 claim, the SEC did not have to prove intent to defraud, only negligence.[74] Following the verdict, jurors recounted 13 hours of heated deliberations after an initially deep divide over liability.[75] They described Tourre as both a "scapegoat" and a "willing participant."[76] Jurors did say they saw "Wall Street greed" in the case, while one said Tourre was a lower-level employee who was pulled into the case, observing, "[T]he machine is made up of cogs and he was a willing part of that."[77] Defense arguments that it was "industry practice" not to disclose information about who was on the short side of this type of synthetic MBS deal resonated with some jurors.[78]

In the case that enforcers seemed to believe had the best fraud facts among all MBS deals that were examined, the government won a very close trial when facing only the civil burden of proof and being allowed to argue for liability based only on negligence.

[70] *Id.* at 1680:18-23. He further explained that knowing someone was both long and short would not have mattered but "when it's pure short, it was a direct bet against something ACA was working diligently on . . . a bet against something that was designed to fail." *Id.* at 1780:7-11.

[71] *Id.* at 104:4-7.

[72] *Id.* at 2705:12-14, 2731:1-14.

[73] *See* Buell, *supra* note 34, at 540-65.

[74] *Id.* at 2617:7-21. The jury found Tourre liable on the Section 17 claims and one of the Rule 10b-5 claims. *Id.* at 2845:9-2846:12. Only the SEC can prove securities fraud involving mere negligence, as Section 17 does not allow for either a private right of action or criminal liability. *See* Buell, *supra* note 34, at 540-65.

[75] Susanne Craig et al., *In Complex Trading Case, Jurors Focused on Greed*, N.Y. TIMES: DEALBOOK (Aug. 2, 2013, 9:12 PM), https://archive.nytimes.com/dealbook.nytimes.com/2013/08/02/in-complex-trading-case-jurors-focused-on-greed/.

[76] *Id.*

[77] *Id.*

[78] *Id.*

Once the evidence had been scrutinized in court, the unusual Paulson aspects of the deal did not seem so unambiguously damning. The defense did a competent job of pointing out that ACA not only had access to the relevant information needed to assess the risk of default but also that ACA's risk assessment process would have been the same either way.

Thus, it is no surprise that the DOJ passed on the burden of proving both materiality and criminal intent to defraud beyond a reasonable doubt in the Goldman matter.[79] The Abacus-Tourre case is, with respect to its full record, strong evidence that fraud, much less criminal fraud, would have been very difficult if not impossible for the government to prove to the satisfaction of a jury in any MBS deal conducted between traders at large financial institutions.

On the basis of Abacus and other transactions, some asserted that Goldman Sachs had committed fraud in the MBS market by selling long positions, even as the firm began (prudently it turned out) to hedge its own MBS holdings with short positions, through products purchased largely from the insurer AIG.[80] These moves, together with government money that later became available to both Goldman and AIG, helped Goldman avoid worse fates than other firms after the crash.[81]

Of course, when Goldman traded derivative products with other financial institutions and intermediated such deals, it was dealing, at least in the legal sense of the words, with customers and not clients.[82] No theory of fraud would support the idea that a seller in an arm's length market, absent a fiduciary-type relationship, has an obligation to advise the buyer that the buyer should not do the deal. To state the obvious, there is no long-short trade in derivatives such as these MBS products unless the parties harbor differing views on the future of the market. There was plenty to be angry about in Goldman's involvement in the MBS market but little material, it turned out, to carry that anger over into criminal convictions.

[79]For further discussion of civil versus criminal intent, see Buell, *supra* note 34, at 540-65.

[80]*SEC Charges Goldman Sachs with Fraud*, PBS News Hour (Apr. 16, 2010, 1:43 PM), https://www.pbs.org/newshour/economy/sec-charges-goldman-sachs-with-fraud.

[81]Goldman CEO Lloyd Blankfein was called before a congressional hearing at which he and the firm were accused of misleading their own "clients" into buying products the firm knew were bad investments and often took the short side on. *Wall Street and the Financial Crisis: Hearing on the Role of Investment Before the Permanent Subcomm. on Investigations*, 111th Cong. 130-92 (2010).

[82]*See* Steven M. Davidoff et al., *The SEC v. Goldman Sachs: Reputation, Trust, and Fiduciary Duties in Investment Banking*, 37 J. Corp. L. 529, 550 (2012).

**b. Stoker (Citi)**

The SEC filed an enforcement action in another MBS case that had Abacus-like facts and was also premised on a Fraud on the Buyer theory. This one involved a product constructed and marketed by Citigroup called Class V Funding III, a synthetic CDO.[83] Citigroup settled with the SEC for $285 million, neither admitting nor denying liability for the transaction, while the employee who captained the deal and was sued, Brian Stoker, tried the case with the help of Citi-funded counsel.[84] Stoker defeated the SEC.[85] The DOJ took no action in the matter.

This MBS deal did not include the behavior of an outside short investor allowed to pick loans for the reference portfolio, like Paulson in the Tourre case. Rather, the SEC's theory of fraud rested on the fact that Citi, having chosen a block of risky assets for the reference portfolio, took a $500 million short position on the product without disclosing that fact to the buyers who went long.[86] Citigroup earned a fee of $85 million for the deal, on top of winning on its short play.[87]

This was a bad look after the market collapse and bailout money, to be sure. But an examination of what happened at the trial is further revealing of the barriers to proving fraud in this context, much less criminal fraud. Stoker was the deal manager at Citi. Again, the deal included the participation of a portfolio manager with the job of arranging and reviewing the mortgage loan assets that would be referenced in the trade. CSAC, a component of Credit Suisse, performed this function to the buy-

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[83]*See* Complaint at 1, SEC v. Stoker, No. 11-CIV-7388 (S.D.N.Y. Oct. 19, 2011).

[84]Stoker's trial was somewhat lost in the noise from a kerfuffle in which the assigned judge in the Southern District of New York, Jed Rakoff, rejected the SEC's and Citigroup's proposed consent decree for failing to allege intentional fraud or requiring Citigroup to admit wrongdoing. SEC v. Citigroup Glob. Mkts. Inc., 827 F. Supp. 2d 328, 331 (S.D.N.Y. 2011). The Second Circuit reversed, ruling that Judge Rakoff had exceeded the limited purview of a trial court in deciding whether to approve a consent decree. SEC v. Citigroup Glob. Mkts. Inc., 752 F.3d 285, 295 (2d Cir. 2014).

[85]*See* Brian Stoker Found Not Liable, SEC Litigation Release No. 22541, No. 11-Civ-7388 (Nov. 21, 2012), https://www.sec.gov/litigation/litreleases/lr-22541.

[86]*See* Complaint, *supra* note 83, at 2; Trial Transcript at 43:19-45:3, SEC v. Stoker, 873 F. Supp. 2d 605 (S.D.N.Y. 2012) (No. 11-CIV-7388) [hereinafter Stoker Transcript]. Stoker's counsel asked almost every witness on cross-examination whether the witness believed that the product was "designed by Citi to fail" and, of course, all said no. *Id.* at 554:7-16, 721:10-19, 750:3-25.

[87]Citigroup Global Markets Inc.: Brian Stoker, SEC Litigation Release No. 22134, No. 11-CV-7388 (Oct. 19, 2011), https://www.sec.gov/litigation/litreleases/lr-22134.

ers' satisfaction.[88] At some point in the deal, a trading component of Citigroup proposed 25 assets for inclusion in the securities, which CSAC accepted. Citi later bought a short position on those 25 assets. Stoker was clearly aware of these facts, although he denied knowing all the details.

The proof was straightforward and the facts not much in dispute.[89] The SEC based its argument primarily on the offering documents stating that CSAC selected the assets without disclosing Citi's role in asset selection.[90] At the conclusion of the trial, the SEC's counsel told the jury the case rested on four points: the assets were not selected solely by CSAC, but also by Citi; Citi purchased protection (a short position) on the 25 assets it asked to be included; Citi believed those assets would perform poorly;[91] and Citi did not disclose these facts to the long investors.[92] The SEC also emphasized that its complaint, as in the Tourre action, was based on Section 17 of the Securities Act (which does not include criminal liability), and thus the jury needed only to find Stoker negligent to hold him liable.[93]

The SEC's best witnesses, naturally, were the buyers of the long positions, the major one being Ambac, a large financial institution with a focus on insurance markets that lost $305 million on the deal.[94] The Ambac witnesses were more helpful to the SEC, saying they cared whether the portfolio was "adversely selected" but saw no indication that it was, and that they believed CSAC selected the assets.[95] If Ambac had known that Citi selected 25 assets in the pool, an Ambac manager testified, he would not have recommended the deal to his firm's committee, and it would

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[88]Stoker Transcript, *supra* note 86, at 1149:20-1150:3.

[89]On the frequently asserted point that juries cannot be expected to understand sophisticated finance, which hampers the party bearing the burden of proof, the Tourre and Stoker trials produced reasonably comprehensible testimony and arguments, but not without exceptions. From a Citi witness at the Stoker trial:

> The conversations were around that assets and liabilities had been mismatched dramatically, the arbitrage was extreme in the capital structure, so the equity returns were higher. There was more cash flow to play with returns within the capital structure. . . . The difference was that the arbitrage now permeated from CDOs, synthetic CDOs, rather than from cash bonds.

*Id.* at 431:4-15.

[90]*Id.* at 54:18-55:24.

[91]*Id.* at 1359:11-1360:21.

[92]*Id.* at 1874:14-25.

[93]*Id.* at 1901:18-1902:11, 1917:11-18.

[94]*Id.* at 1164:15-1165:11, 1213:15-20.

[95]*Id.* at 1157:20-1160:15, 1189:9-1190:8, 1190:19-1192:9, 1193:6-11.

not have gone through.[96] However, the same witness testified that it would not have mattered to Ambac if Citi had asked CSAC to approve specific assets,[97] that Ambac was aware that Citi took a short position, and that it was not material to Ambac what Citi did with the risk on the other side of the transaction.[98] Ambac drew a fine line between the materiality of knowing in general that "adverse selection" was going on (problematic for doing the deal) and the quality of the assets themselves, with CSAC's approval, making all of the assets acceptable (not problematic for doing the deal).

Stoker's counsel argued that buyers such as Ambac were sophisticated players in the CDO market with as much access as Citi to information about the assets.[99] He urged the jurors not to allow hindsight bias to affect their assessment of what would have been negligent in the CDO market in 2007.[100] He called synthetic CDO transactions a form of "legal gambling" among "the most sophisticated bettors on Wall Street" that was well known to, and permitted by, the SEC and Congress.[101] He developed testimony showing that the arranging bank in a CDO is obligated to make payments to the buyer but can do lots of things with that risk, including holding it or hedging it, and that it was normal for the form of that position to vary.[102] Thus, he argued, there was no negligence by Stoker, much less intentional fraud.[103] Stoker's counsel also got before the jury that Citi, overall, was net long the MBS market by almost $40 billion at the time of the Class V Funding III transaction.[104]

Given the SEC's reliance, as in the Tourre matter, on Section 17, the judge instructed the jury on negligence only.[105] Nonetheless, the jury found Stoker not liable on both of the SEC's claims.[106] Unusually, the jury sent a telling note to the judge with

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[96] *Id.* at 1218:24-1219:13.

[97] *Id.* at 1234:2-23.

[98] *Id.* at 1311:9-16.

[99] *Id.* at 59:7-25.

[100] *Id.* at 60:11-22.

[101] *Id.* at 62:15-17, 64:19-25, 1943:8-1944:17. Counsel said blaming a bank worker in the CDO market is like blaming a casino worker for the problems gambling causes. *Id.* at 1947:8-1948:23.

[102] *Id.* at 62:18-64:6, 67:6-23, 1629:2-24.

[103] *Id.* at 60:11-22, 76:1-20.

[104] *Id.* at 617:2-619:22. And he pointed out that Citi took an equity position in the transaction as well, placing them in the riskiest long position as to one slice of the deal. *Id.* at 1474:13-1475:20.

[105] *Id.* at 2009:10-22, 2012:6-2013:5.

[106] *Id.* at 2036:23-2037:14.

its verdict, which the court read aloud: "This verdict should not deter the SEC from continuing to investigate the financial industry, to review current . . . regulations . . . and modify existing regulations as necessary."[107] In post-verdict interviews, a juror who authored the joint note said that he wanted to know why the CEO was not on trial, while another juror said it did not make sense to "pin the blame on one person" "given the crazy environment" of the market.[108]

The Stoker trial, about a transaction that differed marginally, if at all, from routine large MBS deals, demonstrates the problem the government faced in proving fraud in this market. In arm's length trades between sophisticated financial corporations, a claim of fraud, at least criminal fraud, must be based on a false statement, a failure to disclose in the face of a fiduciary-like duty of disclosure (evidence of which was lacking in these cases), or a failure to state what would be necessary to prevent an otherwise truthful representation from being clearly misleading—plus proof of the high mens rea of intent to defraud.[109] In the Abacus and Class V Funding III transactions, the government thought it found two specific deals that varied enough from the norm of such trades to clear the lower civil bar. One did, but barely and only on a negligence standard. The other did not, for reasons that defense arguments and the jury's verdict made clear rested on the fundamental nature of the parties and the market.

### c. Litvak

The government's most successful effort to secure a criminal conviction for fraud in the sale of MBS products was its prosecution in federal court in Connecticut of Jesse Litvak, a trader for Jeffries & Company. Perhaps ironically, Litvak was convicted in connection with the sale of distressed MBS traded post-collapse, when financial institutions were attempting to recover salvage

[107] *Id.* at 2037:9-14.

[108] *See* Peter Lattman, *S.E.C. Gets Encouragement from Jury That Ruled Against It*, N.Y. Times: Dealbook (Aug. 3, 2021, 5:23 PM), https://archive.nytimes.com/dealbook.nytimes.com/2012/08/03/s-e-c-gets-encouragement-from-jury-that-ruled-against-it/. In light of the SEC's failure to establish even negligence by an actor who could be readily proven to have been aware of most or all material particulars of the Class V Funding III deal, it is implausible to think the government would have had more success, civilly or criminally, pursuing more senior officials at Citi. Of course, persons serving as jurors, even those who heard the evidence from Stoker's trial, could not be expected to understand what an actual trial of such a case would involve.

[109] There is some question whether this third theory can support a criminal charge of securities fraud. *See* Buell, *supra* note 34, at 555-56.

value from heaps of broken products.[110]

Because the value of such securities was both low and highly debatable in 2010, price negotiation was freewheeling, enhancing opportunities for fraud. Litvak was convicted twice for telling fibs to his counterparties in post-crisis MBS trades about such things as how much he had paid for a security, whether he was trading for his own book or someone else's, or how much he expected to earn on a deal—to jawbone them into a better price for Litvak.[111] His conversations were a recorded matter of record, per brokerage house procedures. And, of course, Litvak's behavior occurred at a time when all involved knew that MBS, and sales practices around them, had come under enormous scrutiny.

Still, the Second Circuit Court of Appeals reversed Litvak's convictions both times—in long appellate opinions that followed complex, expensive trials. The court's opinions conceded that the government had a facial case against Litvak for securities fraud but quarreled both times with the trial court's handling of key evidentiary issues involving experts and other witnesses.[112] These evidentiary disputes mattered a great deal, and caused both reversals, because they went to whether Litvak was given a fair opportunity to air claims that his fabrications were not material in this market and that the routine use of them at his firm and in the market, when he was acting in no special agency or broker role on behalf of his counterparties, showed that he uttered his fibs in good faith, without intent to defraud.[113]

The appellate court clearly saw the question of what sharp traders in a kind of securities flea market—a novel, murky one at that—might do and say to gain marginal advantage over one another as borderline territory in which to situate a criminal prosecution for fraud. Despite considerable resources devoted to the prosecution, in jurisdictions not known to be hostile to securities enforcement, the government was unable to imprison Litvak even with recorded lies to show two juries. After the second reversal

[110]United States v. Litvak (*Litvak I*), 808 F.3d 160, 165, 190 (2d Cir. 2015); United States v. Litvak (*Litvak II*), 889 F.3d 56, 59, 72 (2d Cir. 2018).

[111]*Litvak I*, 808 F.3d at 167; *Litvak II*, 889 F.3d at 72.

[112]*Litvak I*, 808 F.3d at 167; *Litvak II*, 889 F.3d at 72.

[113]The first opinion objected to the trial court's exclusion of expert testimony about how the distressed MBS market operated and what information traders relied on in determining prices. *Litvak I*, 808 F.3d at 182. The second opinion found reversible error in the trial court having allowed a counterparty to testify that Litvak was acting as his "agent" (and thus would have owed candor), a mischaracterization of a market involving arm's length dealing. *Litvak II*, 889 F.3d at 68.

on appeal, the government dismissed its case.[114]

The government was able to secure and uphold one conviction of a post-crisis trader of distressed MBS, Michael Gramins of Nomura Securities, who negotiated sales using misrepresentations much like those Litvak employed.[115] It must have helped the government's case against Gramins a great deal that prosecutors could show both that Gramins acted after the indictment of Litvak and that Gramins had attended a compliance session at which the Litvak indictment and specific examples of Litvak's misrepresentations were discussed as things not to say—after which Gramins went back to lying to his counterparties.[116] The trial court set aside the jury's guilty verdict in Gramins for the same reasons Litvak's conviction was reversed the second time: admission of testimony that incorrectly suggested Gramins was performing an agency role while making these trades, and thus bore a heightened duty.[117] This time, the appellate court reversed the ruling below and reinstated the conviction, finding that the disputed testimony had not portrayed Gramins as an agent.[118] Nonetheless, separate juries acquitted three other Nomura traders prosecuted for similar conduct during the same period.[119]

Consider the resources involved in convicting Litvak and Gramins, defending or losing those convictions on appeal, and trying the other cases to acquittals. Even with the much easier context for the government in proving fraud once MBS had cratered in value and issues of misconduct in the sale of MBS were front and center in the financial markets. And even with the ability to show that Gramins had been trained on how not to commit fraud based on the government's theory of fraud in Litvak. These cases do not suggest a winning path for prosecutors to have followed in a mistakenly abandoned campaign against fraud in pre-crash MBS trading. Rather, they show the improbability of securing more than a handful of, or fewer, convictions against traders, even with extensive resources and recorded false statements.

### d. Bear Stearns

A familiar milepost in accounts of the DOJ's handling of the MBS fiasco is the prosecution in the Eastern District of New

[114]*Litvak II*, 889 F.3d at 72.

[115]United States v. Gramins, 939 F.3d 429, 436, 457 (2d Cir. 2019).

[116]*Id.* at 439-40.

[117]*Id.* at 452.

[118]*Id.* at 449-50.

[119]*See infra* Table A3. A jury could not reach a verdict on one count as to one of the Nomura defendants; the government chose not to retry that single charge.

York of Ralph Cioffi and Matthew Tannin of Bear Stearns, an investment firm that famously collapsed during the financial crisis. Cioffi and Tannin managed a hedge fund portfolio for Bear Stearns that contained MBS-related assets.[120] The prosecutors' theory was that the defendants continued to recruit and accept investors into the fund even as they knew that the MBS market was teetering and the fund was not sound.[121] The government's case rested largely on emails in which Cioffi and Tannin shared alarming statements about their lack of confidence in the MBS market and their fear of impending collapse.[122]

A Brooklyn jury, not likely full of citizens admiring of bank traders and executives, acquitted Cioffi and Tannin.[123] In post-verdict interviews, jurors reported that the government did not have a clear enough case to satisfy its burden of proof.[124] Defense counsel had done an effective, if perhaps obvious, job of showing other emails in which Cioffi and Tannin took different views about the market.[125] They were portrayed as uncertain actors debating risk in an uncertain market.[126] One juror observed that they had simply been chosen as scapegoats for the larger crisis, and another said that she saw nothing wrong in their conduct and would hire them to invest her own money.[127]

It is difficult to evaluate the standard claim in public discussion over post-crisis prosecutions that the Bear Stearns trial loss

[120] *See* Indictment at 2-3, United States v. Cioffi, 668 F. Supp. 2d 385 (E.D.N.Y. 2009) (No. 08-CR-00415).

[121] *See id.* at 7-8; Grant McCool, *Ex-Bear Stearns Men Lied, US Says in Trial Closing*, REUTERS (Nov. 5, 2009, 1:32 PM), https://www.reuters.com/article/id/USN05122946/; Zachery Kouwe, *Final Arguments Against 2 in Bear Stearns Fraud Case*, N.Y. TIMES (Nov. 5, 2009), https://www.nytimes.com/2009/11/06/business/06bear.html. Because both defendants were acquitted, negating further appeal, the transcript of their trial is not on file.

[122] Kouwe, *supra* note 121.

[123] Grant McCool & Michael Erman, *Jury Acquits Ex-Bear Stearns Hedge Fund Managers*, REUTERS (Nov. 11, 2009, 2:51 AM) https://www.reuters.com/article/idUSLNE5AA001/.

[124] *Id.*

[125] *See* Roger Parloff, *Bear Stearns Case: Not So Simple*, CNN FORTUNE MAG.: LEGAL PAD (Oct. 15, 2009, 9:46 AM), https://money.cnn.com/2009/10/15/news/companies/bear_stearns_trial.fortune/index.htm.

[126] *Id.*

[127] McCool & Erman, *supra* note 123; Stacie-Marie Ishmael, *The* U.S. v. Cioffi *and Tannin, or How Not to Scare Would-Be Fraudsters*, FIN. TIMES (Nov. 11, 2009), https://www.ft.com/content/eb226849-e596-3f20-8c6c-8d9a240930b2. Professor Coffee, in his recent book criticizing the DOJ's approach to corporate prosecutions, also attributes the government's loss in the case to the ambiguity of the defendants' email communications and the fact that they were "trying to keep a sinking ship afloat" rather than filching from victims in the more classic manner of white-collar criminals. COFFEE, *supra* note 9, at 22-23.

scared the DOJ away from pursuing more fraud cases against traders at large institutions. Prosecutors of course observed the result and thought about its implications. Prosecutors know that every jury and every courtroom is unique and are used to viewing a single outcome at the trial level reasonably and in context. Still, the Bear Stearns result seemed to rest on prosecutors having encountered a more ambiguous picture about fraud at trial than, at the indictment stage, they had anticipated being able to paint. If the lesson was that better evidence of intentional deceit would be needed to sustain convictions out of activities in the MBS market, that seemed a reasonable conclusion to draw. However, it seems far too much to conclude that the Bear Stearns result simply scared DOJ prosecutors away from spending any more resources on the question of whether there was fraud in MBS transactions. No person involved has said anything of the sort.

### e. Underwriting Theory and FIRREA Settlements

The most financially impactful enforcement measure the government took in response to the MBS market collapse was when—after limited prosecution success and abundant criticism of its failure to act—the DOJ turned its efforts to a mostly forgotten statute called the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).[128] This law, enacted at the time of the savings and loan banking crisis of the late 1980s, provides the DOJ with power to sue civilly, on a preponderance of the evidence standard, to recover financial penalties for violations of the criminal fraud statutes.[129] In other words, the government must prove the elements of criminal fraud, but only under a more likely than not standard. Also, of course, no one can be punished with imprisonment.[130]

The DOJ cleverly invoked FIRREA's application to MBS trading and underwriting practices as a vehicle to extract billions of dollars from the largest surviving financial institutions for their practices in packaging and marketing MBS products.[131] Nearly every institution chose to settle and move on without litigating

[128] 12 U.S.C. § 1833a.

[129] *Id.* § 1833a(e)-(f).

[130] *See id. § 1833a(a)*-(b).

[131] *See, e.g.*, Press Release, U.S. Dep't of Just., Federal and State Partners Secure Record $13 Billion Global Settlement with JPMorgan for Misleading Investors About Securities Containing Toxic Mortgages (Nov. 19, 2013), https://www.justice.gov/opa/pr/justice-department-federal-and-state-partners-secure-record-13-billion-global-settlement.

the question of whether there had been fraud.[132] FIRREA provides no mechanism for individual criminal prosecution, and the DOJ did not seek civil penalties from any individual.[133]

However, not every FIRREA case settled. Bank of America (BOA) chose to contest its liability for some of the allegedly fraudulent underwriting practices of Countrywide, an entity that BOA acquired at the government's urging when the financial crisis was at its peak of systemic risk.[134] The government's civil case for fraud against BOA, as successor to Countrywide's liability, was based on the development and use at Countrywide of a program called the "High Speed Swim Lane."[135] This was a means of rushing very risky mortgages into securitized portfolios without following previous underwriting procedures that were more discerning on metrics of borrower risk.[136]

The government prevailed against BOA at a trial in the Southern District of New York but lost on appeal before the Second Circuit. The appellate court ruled that Countrywide had not defrauded purchasers of securities in the manner alleged, on simple logic.[137] At the time Countrywide entered into a master agreement with buyers (primarily government entities Fannie Mae and Freddie Mac), its representations about underwriting processes were not false, much less intentionally so, the court said.[138] The government had no proof that the seller (Countrywide) did not at that time intend to fulfill its contractual commitments. When Countrywide later relaxed underwriting procedures, it may have done so in breach of contract, but it made no representation to the buyers at the time that it was doing anything, one way or the other, with its underwriting procedures, much less did

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[132]*See, e.g.*, Press Release, U.S. Dep't of Just., Wells Fargo Agrees to Pay $2.09 Billion Penalty for Allegedly Misrepresenting Quality of Loans Used in Residential Mortgage-Backed Securities (Aug. 1, 2018) [hereinafter Press Release, *Wells Fargo*], https://www.justice.gov/opa/pr/wells-fargo-agrees-pay-209-billion-penalty-allegedly-misrepresenting-quality-loans-used; Press Release, U.S. Dep't of Just., General Electric Agrees to Pay $1.5 Billion Penalty for Alleged Misrepresentations Concerning Subprime Loans Included in Residential Mortgage-Backed Securities (Apr. 12, 2019), https://www.justice.gov/opa/pr/general-electric-agrees-pay-15-billion-penalty-alleged-misrepresentations-concerning-subprime.

[133]*See* Press Release, *Wells Fargo, supra* note 132 (explaining that FIRREA authorizes the DOJ to "seek civil penalties against financial institutions that violate various predicate offenses").

[134]United States *ex rel.* O'Donnell v. Countrywide Home Loans, Inc., 822 F.3d 650, 653 (2d Cir. 2016).

[135]*Id.*

[136]*Id.* at 654-55.

[137]*Id.* at 666.

[138]*Id.* at 663-64.

it make any false representation. Thus, there was no fraud either at execution of the contract or during its performance. The court saw this as a problem of breach in a course of dealing contract, not fraud.[139]

Whether the Second Circuit's analysis was right about the line between breach and fraud (there is an argument that the court was wrong), the government's theory about disregarded underwriting commitments and reckless underwriting practices failed as a vehicle for establishing even civil liability. For those who argued that the difficulties in convicting one MBS trader for defrauding another in a particular sale could have been avoided by turning to theories about bad underwriting (as most know, there was lots of evidence of shockingly weak practices late in the bubble), the Second Circuit's decision in the BOA matter, which was civil only and included no individual defendant, should be sobering.

### f. Serageldin

Kareem Serageldin, a former Credit Suisse manager who supervised the bank's global "structured credit trading" operation,[140] warrants comment because he has been described as "the only Wall Street executive sent to jail for his part in the financial crisis."[141] Serageldin, like any trading desk boss, was principally concerned with the profit and loss numbers he showed the bank's top management from the books under his supervision.[142] He had a record at Credit Suisse of running a shop that produced very well. In early 2007, as tremors began to roll across the U.S. housing market, Serageldin's division was heavily invested in credit instruments that were forms of MBS and were long the U.S. home loan market.[143]

As the books began to turn against his team, Serageldin made two bad decisions. First, he permitted his traders to begin marking their positions differently, and without solid basis, to conceal

[139] *Id.* at 658.

[140] *See* Joe McGrath, *The Making of a Mismarker: The Case of the Only Banker Jailed in the U.S. for His Role in the Financial Crisis*, 2020 U. Chi. L. Rev. Online 44, 44 (2020).

[141] Eisinger, *Why Only One, supra* note 14.

[142] *See* Indictment at 5-6, United States v. Serageldin, No. 12-CR-00090 (S.D.N.Y. 2013); Complaint at 15-18, SEC v. Serageldin, No. 12-CV-00796 (S.D.N.Y. Feb. 1, 2012); Transcript of Plea Proceeding at 15-22, *Serageldin*, No. 12-CR-00090; Transcript of Sentencing Hearing at 5-8, *Serageldin*, No. 12-CR-00090.

[143] *See* McGrath, *supra* note 140, at 45.

mounting losses.[144] This was possible because of the inherently subjective question of value associated with complex, often bespoke, MBS products traded over the counter, with no index or exchange mediating the question of book value. Second, Serageldin sent internal emails that landed in the hands of the SEC, in which he essentially stated that the team was engaged in mismarking and that it needed to be hidden from supervisors.[145] When the mismarking was discovered, Credit Suisse was compelled to restate its earnings downward, over two quarters of 2007, by over $1 billion.[146] The bank fired Serageldin and reported its findings to the government.[147]

Once the SEC had charged Serageldin and two others, the DOJ recognized low-hanging fruit.[148] Following the indictment, Serageldin decided not to attempt the kind of rationalization-based defenses that Fabrice Tourre and Brian Stoker used in their litigations with the SEC. He pled guilty to securities fraud, explaining to the judge that he decided to engage in wrongful conduct to protect and maintain his reputation within Credit Suisse.[149] The U.S. Sentencing Guidelines called for a term of approximately five years in prison.[150] The judge observed that Serageldin had been influenced by the culture within the bank, that the "financial world [had been going] rather berserk" at the time, and that the court could "infer" (the judge referenced no evidence) that Serageldin's crime "was duplicated by many others in many other departments."[151] The judge sentenced Serageldin to 30 months in prison.[152]

Two observations are relevant to this Article from the limited record of Serageldin's case. First, this case involved accounting fraud stemming from the marking of the value of a bank's MBS books, not fraud in the sale or purchase of any MBS instrument with a counterparty. Accounting misconduct may be a more tractable route to a fraud prosecution of corporate personnel than cases of trading fraud between sophisticated players in securities markets. Thus, the question is whether it is right to think that

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[144] *Id.*

[145] *See* Indictment, *supra* note 142, at 12-14.

[146] *See* McGrath, *supra* note 140, at 45.

[147] See Eisinger, *Why Only One, supra* note 14.

[148] It is not clear why the DOJ charged only Serageldin among those sued by the SEC. A reasonable inference is that Serageldin was the author of the most damning emails.

[149] Transcript of Plea Proceeding, *supra* note 142, at 2, 15, 20-21.

[150] *Id.* at 10.

[151] Transcript of Sentencing Hearing, *supra* note 142, at 38-51.

[152] *Id.* at 51.

provably criminal mismarking of books, or other forms of financial reporting fraud, was widespread within financial institutions holding long positions in MBS, as the judge in Serageldin's case speculated. Second, Serageldin made the error of confessing to fraud in emails, doing so under the noses of senior management of a large public company that, given its SEC reporting and auditing obligations, had no choice but to report the fraud and sacrifice Serageldin once it discovered the mismarking.

It is reasonable to infer that Serageldin was approached by prosecutors, through his counsel, about whether he could testify that anyone above him at the bank was aware of the mismarking—something that could have earned him a further sentence reduction. Apparently Serageldin could not, and indeed emphasized his efforts to hide his conduct from his supervisors when he tried to express remorse to the sentencing judge. All things considered, Serageldin's case seems a poor vehicle for the argument alluded to by his judge, and pursued at length by one journalist,[153] that many more such cases were hanging low in the banking orchard if only prosecutors had been willing to pick them.

**g. Lehman Brothers**

To address the question of whether accounting fraud prosecutions might have been the winning law enforcement response to the collapse of the MBS market, it is necessary to take up the well-known case of bankrupted Lehman Brothers.[154] In short, the main vehicle for Lehman's misportrayal of itself was a deal structure called "Repo 105," which allowed Lehman to engage in over $100 billion of transactions that the rules (maybe) allowed Lehman to treat as income-generating sales but were in substance only more borrowing.[155]

Enron had used an analogous vehicle almost a decade earlier, which played a large role in the company's bankruptcy but no part in the ensuing criminal prosecutions.[156] The problem for prosecutors in both the Lehman and Enron instances was that professional advisors blessed the deal structures and their accounting treatment, even if later forensic reviews proved those advisors to have been arguably wrong about the structures'

[153] EISINGER, THE CHICKENSHIT CLUB, *supra* note 14, at ix.

[154] *See* BUELL, *supra* note 26, at 13-17.

[155] Report of Anton R. Valukas at 732, 797-800, *In re* Lehman Bros. Holdings Inc., No. 08-13555 (S.D.N.Y. 2010).

[156] *See* Peter J. Henning, *In Lehman's Demise, Some Shades of Enron*, N.Y. TIMES: DEALBOOK (Mar. 12, 2010, 8:00 PM), https://archive.nytimes.com/dealbook.nytimes.com/2010/03/12/in-lehmans-demise-some-shades-of-enron/.

permissibility.[157] These approvals presented a nearly absolute barrier to convicting of criminal fraud any executive who relied on them. Without evidence—a damning email or testimony about an overly candid meeting, for example—that a corporate manager in this context contemporaneously knew the advice to be bogus, intent to defraud is impossible to prove in the face of reliance on such advice, especially in a criminal case.[158]

In one way, accounting fraud is a more viable theory of prosecution than trading fraud, at least in the context of large public banking corporations. When the victims are shareholders and the math is a matter of an official record that the company and its management have owned—as a regulatory condition of offering shares on public markets—it is more straightforward for a prosecutor to prove deception than in the far murkier area around what sophisticated traders may or may not say or do when negotiating over-the-counter deals.[159] This distinction explains much about how the government's "Enron era" prosecutions arose and succeeded.[160]

On the other hand, however, accounting and public financial

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[157] *See id.*; *see also* Report of Anton R. Valukas, *supra* note 155, at 794-95.

[158] It is black-letter law in federal court that a good-faith belief in the propriety of one's conduct based on reliance on professional advice negates the required element of intent to defraud. *See, e.g.*, United States v. Dees, 34 F.3d 838, 842 (9th Cir. 1994); United States v. Dunn, 961 F.2d 648, 650 (7th Cir. 1992); United States v. Preston, 634 F.2d 1285, 1294 (10th Cir. 1980).

[159] For extensive discussion of the problem of criminal fraud based on statements in negotiations, see the argument between majority and dissent in *United States v. Weimert*, 819 F.3d 351, 370-71 (7th Cir. 2016) (Flaum, J., dissenting).

[160] Some ask why it has not been possible to send many more CEOs to prison given that the CEOs of both Enron and Worldcom, among others, received long sentences in the early 2000s. *Sarbanes-Oxley's Lost Promise: Why CEOs Haven't Been Prosecuted*, REUTERS (July 27, 2012, 5:45 PM), https://www.reuters.com/article/idUS3512973425/; *You Asked, We Answered: Why Didn't Any Wall Street CEOs Go to Jail After the Financial Crisis?*, MARKETPLACE, https://features.marketplace.org/why-no-ceo-went-jail-after-financial-crisis/ (last visited Aug. 2, 2024). Almost all of these cases were securities fraud prosecutions based on accounting fraud: misreporting quarterly and annual financial results and misleading shareholders and other investors when speaking publicly about those results. *See, e.g.*, United States v. Ebbers, 458 F.3d 110, 125-26 (2d Cir. 2006); United States v. Skilling, 554 F.3d 529, 534-35 (5th Cir. 2009). With public shareholders, including many retail investors and employees, as the victims of the misrepresentations and a clear numerical record based on the extensive reporting regime for large companies, crimes became provable high on the corporate ladder once C-suite level employees could be charged with cases that left them little choice but to cooperate and testify about closed-door meetings. *See* Jonathan M. Karpoff et al., *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 582-84 (2008). Still, large parts of what misled observers about the financial situation of Enron played no role in the criminal case because, like Lehman Brothers' Repo 105 borrowing stratagem, they had been approved—even if questionably—by lawyers and accountants, making

reporting are thickly enmeshed in a process involving lawyers, auditors, and other gatekeepers and intermediaries. This process implicates the vast, thorny, and always contestable matter of what the highly detailed accounting and reporting rules allow. Repo 105 and structures like it are designed to achieve a result that chafes against the spirit of the reporting regime while hewing to its letter.[161] The idea is to bake in a defense to liability. An analogy is to sophisticated tax shelters. Sometimes the clever idea might turn out not to work legally. But proving beyond a reasonable doubt that a non-expert who paid for the idea knew it would not work is almost always a losing proposition for the government.[162]

It is thus not surprising that the collapse of the MBS market did not produce a wave of prosecutions of personnel from companies that were long the market for defrauding the companies' investors about how risky those firms were. One can assert that prosecutors might have found such cases if the DOJ had devoted more resources to the project. But this claim should be viewed skeptically given the ample incentives, including the availability of private class actions, for others to ferret out accounting fraud.

Lehman, with the massive tome of forensic work filed by an examiner appointed by the bankruptcy court, is a case in point. We know what prosecutors likely would have found because much of the work was done for other reasons. Leaks to the *New York Times* later revealed that, after a major investigation, top SEC personnel heatedly debated whether to file civil charges in connection with Repo 105 and concluded that even a regulatory case was not winnable.[163] Lehman Brothers thus stands as better evidence for the claim that individual prosecutions following the

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proof of intent to defraud by senior executives almost impossible. *Enron's Lawyers: Eyes Wide Shut?*, FORBES, https://www.forbes.com/2002/01/28/0128veenron.html (June 6, 2013, 2:09 PM). Good faith belief in the propriety of an accounting treatment can negate proof of intent to defraud. *Ebbers*, 458 F.3d at 125-26; United States v. Simon, 425 F.2d 796, 805-06 (2d Cir. 1969).

[161] *See* Jacob Goldstein, *Repo 105: Lehman's 'Accounting Gimmick' Explained*, NPR (Mar. 12, 2010, 11:55 AM), https://www.npr.org/sections/money/2010/03/repo_105_lehmans_accounting_gi.html.

[162] For example, in the government's largest-ever criminal case involving fraudulent tax shelters, the defendants were the professional advisers who designed and sold the shelters, while the taxpayers were effectively treated as victims. *See* Letter from David N. Kelley, U.S. Att'y, S.D.N.Y., to Robert S. Bennett, Att'y for KPMG (Aug. 26, 2005), https://www.justice.gov/archive/usao/nys/pressreleases/August05/kpmgdpagmt.pdf; Indictment, United States v. Stein, No. 05-CR-888 (S.D.N.Y. 2005); TANINA ROSTAIN & MILTON C. REGAN, CONFIDENCE GAMES: LAWYERS, ACCOUNTANTS, AND THE TAX SHELTER INDUSTRY (2016).

[163] Ben Protess & Susanne Craig, *Inside the End of the U.S. Bid to Punish Lehman Executives*, N.Y. TIMES: DEALBOOK (Sept. 8, 2013, 8:57 PM), https://

MBS fiasco stood mostly out of reasonable reach for the government than as evidence, as it sometimes has been used,[164] for the argument that the government left plenty of prosecutable cases on the table.

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To summarize, the government prosecuted eight employees of financial institutions in connection with MBS dealing.[165] Five were acquitted, one pled guilty, and two were convicted at trial, with one conviction overturned on appeal.[166] The SEC tried two cases, losing one and winning the other. The agency settled with 32 persons, 20 of whom agreed to pay fines.[167] The average civil fine was just over $800,000.[168]

The preceding examination of MBS-related enforcement actions reveals a flaw in the argument that the government has failed to pursue readily achievable deterrence benefits from a much greater number of individual prosecutions. In its current form, that argument was greatly driven by reactions to the handling of MBS matters. It has been easy to assert that cases that were never brought could have been won, because those cases never existed to test the proposition. But enough MBS cases were brought or examined through other means, and a sufficient litigation record exists, to demonstrate that a greater will to charge more people criminally would have been unlikely to alter

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archive.nytimes.com/dealbook.nytimes.com/2013/09/08/inside-the-end-of-the-u-s-bid-to-punish-lehman-executives/. Jesse Eisinger has argued that there might have been another angle in Lehman, also parallel to Enron: prosecution based on public statements just prior to bankruptcy about the viability of the firm, particularly a statement by Lehman's chief financial officer that the firm "remains very strong." EISINGER, THE CHICKENSHIT CLUB, *supra* note 14, at 245. While some such qualitative statements were part of the prosecutions of former Enron Chairman Kenneth Lay and former CEO Jeffrey Skilling, the statements could be tied to underlying accounting fraud in which the executives were implicated. *See Skilling*, 554 F.2d at 554. It would be highly questionable for a prosecutor to bring a criminal securities fraud case based solely on a statement like "strong."

[164] I thus disagree with Professor Coffee that "there was sufficient evidence of fraud by senior Lehman officers that a reasonably aggressive prosecutor might have brought the case under the circumstances." COFFEE, *supra* note 9, at 27. Coffee nods to the issue of professional advice but does not explain how a prosecutor could have surmounted that problem. *Id.* He mentions a prior prosecution that succeeded involving a failing liquidity situation in a banking institution. *Id.* However, the citation is not to the record of that case but to a brief passage in Jesse Eisinger's book. *See* EISINGER, THE CHICKENSHIT CLUB, *supra* note 14, at 242.

[165] *See infra* Table A1.

[166] *See infra* Table A1.

[167] *See infra* Table A2.

[168] *See infra* Table A2.

the deterrent effects of post-crisis enforcement.

### *B. Benchmark Frauds: Libor and Forex*

The purpose of this Article is to advance debate about individual liability for corporate crime generally, beyond arguments about the housing-related financial crisis of 2008 and after. Staying within the realm of securities dealing, one can find an even more extensive record of telling prosecutions in the first big banking scandal to arise after the MBS meltdown. This was known as the Libor affair, though it is more accurately described as a collection of misconduct involving interest rate benchmark manipulation.[169]

These cases seemed to come to the DOJ as manna from heaven, at a time when the government had endured withering criticism for its prosecutorial response to the financial crisis.[170] Big bank traders were discovered, through recorded online chats, to have manipulated major market indices used to price trillions of dollars in transactions globally while saying things like "there's bigger crooks in the market than us guys!" and "i'm not setting libor 7 [basis points] away from the truth . . . i'll get [the bank] banned if i do that."[171] The record was awash in explicit discussions about manipulating data that was supposed to be objective, to make trading positions more profitable.

As it turned out, most of the Libor defendants avoided prison. They convinced judges and juries, as argued by some in the MBS market, that they did not act with sufficient criminal intent and dealt with knowledgeable counterparties who were well aware

[169]Libor stands for the London interbank offered rate. *See* Miranda Marquit, *What Is Libor and Why Is It Being Abandoned*, FORBES (Feb. 16, 2023, 10:09 AM), https://www.forbes.com/advisor/investing/what-is-libor/. The most informative articles on the phenomenon in legal scholarship are Gina-Gail S. Fletcher, *Benchmark Regulation*, 102 IOWA L. REV. 1929 (2017), and Andrew Verstein, *Benchmark Manipulation*, 56 B.C. L. REV. 215 (2015).

[170]*See* Fletcher, *supra* note 169, at 1932-34.

[171]*See* Floyd Norris, *After the Fraud, the Fog Around Libor Hasn't Lifted*, N.Y. TIMES (Oct. 31, 2013), https://www.nytimes.com/2013/11/01/business/after-fraud-the-fog-around-libor-hasnt-cleared.html; Statement of Facts to Non-Prosecution Agreement between the United States Department of Justice, Criminal Division, Fraud Section and UBS AG (Dec. 18, 2012) [hereinafter UBS Non-Prosecution Agreement], https://www.justice.gov/iso/opa/resources/6942012121911725320624.pdf. Two book-length treatments of the facts of the Libor scandal reward the reader with interest in delving deeper. *See generally* LIAM VAUGHAN & GAVIN FINCH, THE FIX: HOW BANKERS LIED, CHEATED AND COLLUDED TO RIG THE WORLD'S MOST IMPORTANT NUMBER (2017); DAVID ENRICH, THE SPIDER NETWORK: HOW A MATH GENIUS AND A GANG OF SCHEMING BANKERS PULLED OFF ONE OF THEE GREATEST SCAMS IN HISTORY (2017).

the market was a shark tank.[172] From at least 42 prosecutions in the United States and the United Kingdom, only 11 persons were convicted at trial, while 9 pled guilty. Of the 20 convicted individuals, only 9 served any time in prison. There were 11 acquittals, 15 dismissals, and 4 appellate reversals.[173] British regulators brought 12 civil enforcement cases and the SEC none. In the UK, 12 individuals received industry bans and four were fined, with the average fine at £186,250.

Before turning to specific prosecutions, the modus operandi in these benchmark frauds worked as follows.[174] Many large financial institutions have trading desks that engage in derivative transactions known roughly as interest rate swaps. Traders across the world make deals—sometimes to help institutions hedge rate volatility risk, and sometimes to chase profits from betting on rate movements—constructed around four major components.[175] The first is the interest rate being traded on itself, which might be the benchmark rate in London (Libor), Europe (Euribor), or Tokyo (Tibor). The second is time (tenor), that is, the period after which the trade will settle, expressed in months. The third is the negotiated rate specific to the deal (e.g., "Libor plus 10 basis points," or hundredths of one percent). The fourth is the currency and market in which the interest would accrue (e.g., U.S. dollars on deposit in London).

In a common deal form, Sue at Bank Huge in London and Hal at Giant Bank in New York might enter into a swap agreement in which Sue will take the risk of a floating rate in the contract and Hal will be guaranteed a fixed rate up front—for example, over six months, on U.S. dollars in London, at Libor plus 10 basis points. Whether Sue makes out from taking the upside risk, or Hal ends up the winner by having taken the fixed position, depends on what happens over those six months to Libor, which is the one element of the deal that fluctuates.

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[172] *See, e.g.*, Jason Breslow, *Lanny Breuer: Financial Fraud Has Not Gone Unpunished*, PBS: FRONTLINE (Jan. 22, 2013), https://www.pbs.org/wgbh/frontline/article/lanny-breuer-financial-fraud-has-not-gone-unpunished/.

[173] A complete summary of the case dispositions is provided *infra* Tables B1 & B2. A full list of individuals against whom actions were brought, with specific results in each case, is provided *infra* Tables B3 & B4.

[174] In addition to the sources cited in note 171 *supra*, good descriptions of the evidence in the cases and the modus operandi of the fraud are found in the statements of facts accompanying the DOJ's settlements with major banks in the Libor affair. *See, e.g.*, Letter from Denis J. McInerney, U.S. Dep't of Just. Att'y, to Gray Spratling, Esq., and David P. Burns, Esq. (Dec. 18, 2012) [hereinafter DOJ Letter], https://www.justice.gov/iso/opa/resources/1392012121911745845757.pdf; UBS Non-Prosecution Agreement, *supra* note 171.

[175] *See, e.g.*, UBS Non-Prosecution Agreement, *supra* note 171, at 8-9, 41.

The fraud comes when Sue realizes that, by virtue of working at Bank Huge, she can affect what number Libor will be on the day six months later when her deal with Hal settles—and that Hal won't know Sue plans to manipulate Libor or is doing so. Conveniently for a trader who earns profit-based bonuses, the risk for Sue in such deals begins to disappear. Sue could do this because of the way an independent organization called the British Banking Authority (BBA) administered Libor. The BBA set the rate daily by asking a panel of the biggest banks, including Bank Huge in the hypothetical, what they presently were paying in interest to borrow cash from each other in the London market in the short term (i.e., overnight loans). Each day, the BBA discarded the top and bottom quartiles and averaged the remaining banks' submissions to produce Libor.

All Sue needed was a way to influence Bank Huge's submissions to the BBA. This turned out to be easy. At bank after bank, the lowly "rate submitters" who sent the daily reports to the BBA were happy to please the highly compensated traders by moving the number to suit the traders' needs, depending on what interest rate derivative deals on the traders' books were maturing on any day. And all were happy to talk about doing so on recorded instant messaging systems within the banks.

Fraud prosecutions would seem to unfold easily from this. If Sue got Bank Huge's submitter to lower the daily submission by some basis points on the day her trade with Hal came up for settling—a little will do a lot in this market, because the deals have huge notional values totaling into the trillions of dollars—and Libor ended up lower that day, Sue made more money off her trade with Hal than she otherwise would have. And Sue's undisclosed manipulation of an ostensibly reliable and objective benchmark, without Hal's knowledge, defrauded Hal, putting riskless profits into Sue's pocket. One could argue that Sue affirmatively lied to Hal when she said let's do this deal at "Libor plus 10 basis points," knowing that Hal believed "Libor" to mean a credible independent benchmark when Sue knew that, in this context, it really meant "Libor as I later manipulate it in my favor."

This conduct seemed to involve clearer and more provable criminality than allegations of fraud in the MBS market. The manipulation could be shown easily from recordings and quantified to the dollar in how it benefited the perpetrators. The chats were full of incriminating statements about how the traders were getting away with a big, improper play and should be careful not to be too flagrant about it.[176] Despite all of this, prosecutors reaped very poor results.

### *1. Allen and Conti (Rabobank)*

Anthony Allen and Anthony Conti worked in London for Rabobank, a Dutch financial institution with U.S. operations. Conti was a rate submitter for Rabobank.[177] Allen, as head of the cash desk in London, was his supervisor.[178] Prosecutors in the Southern District of New York mostly used the bank's record of electronic communications to show that Conti frequently accommodated requests from traders to alter daily submissions to the BBA to favor positions coming due for settlement, and that Allen knew and approved this, sometimes doing it himself.[179] The government's theory of fraud was stated in terms of the defendants' "responsibility to act honestly and fairly" in setting LIBOR as a "good-faith estimate of borrowing" and to use "their honest, best estimate of Rabobank's borrowing costs" when reporting to the BBA.[180]

The government called as witnesses several co-conspiring Rabobank employees who pled guilty in hopes of receiving lower sentences. Most prominent among them was Paul Robson, a trader who, in a chat with another trader who pled guilty, wrote the best line in the vast trove of electronic communications from the Libor-related investigations: "There's bigger crooks in the market than us."[181] Allen, one of the two trial defendants, was on record saying to another trader, "I am fast turning into your Libor bitch," shortly followed by, "No worries, mate, glad to help."[182] Allen chose to take the stand. His testimony attempting to explain these communications, not surprisingly, lacked credibility even on the dry trial record.[183]

This picture would seem to show about the best evidentiary and legal case for fraud inside a major financial institution that a prosecutor in this era could hope to come across. Nevertheless, the case encountered obstacles and, ultimately, failed due to a defect of criminal procedure. The Allen and Conti prosecution remains telling because the procedural error was of a type that

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[176] *See id.* at 28, 34.

[177] *See* Trial Transcript at 62:5-20, United States v. Allen, No. 14-CR-00272 (S.D.N.Y. 2015).

[178] *Id.*

[179] *See id.* at 328:4-343:3, 357:19-360:14.

[180] *Id.* at 63:16-23, 77:9-16.

[181] *Id.* at 92:17-93:13.

[182] *Id.* at 1449:9-25.

[183] *Id.* at 1208:18-1209:6, 1211, 1219:8-1224:9.

can easily reoccur in cross-border investigations. Moreover, an ensuing appellate opinion in a related case contradicted even the government's central theory of liability.[184]

The defense emphasized throughout the trial that, at the relevant time, the major banks engaged with each other in few or no short-term cash lending transactions.[185] The emergence of the financial crisis, and a global credit squeeze, dried up that market. Daily Libor submissions, therefore, were only an "estimate" or a "rough number," and an answer to a "hypothetical question."[186] Robson conceded on cross-examination that, on his own initiative, he wrote to the BBA well before there was any investigation and complained that banks were submitting inaccurate numbers— that he had called the whole process "a charade."[187] Another cooperating trader testified that he understood that if numbers were kept within a reasonable range, the bank's submissions could account for the preferences of traders, but that he later viewed this as manipulation after he realized that he was getting "free money."[188]

The defense also stressed that requests by traders who were involved in submissions were routine and often stated out loud in groups, that no one said not to do it, and that Libor was widely considered within Rabobank to be a "made up number."[189] Defense experts argued that Rabobank's submissions were mostly in line with those of other banks and were what one would expect given its credit rating on most relevant days.[190] One expert testified that the credit structure of such banks is so complex that it would be impossible to tell from submission data alone whether there had been manipulation.[191] The defense received a jury instruction, based on settled law, that good faith in this context would negate criminal intent.[192]

Now perhaps the Libor affair begins to look a little more like the MBS cases. It turns out, as it so often does in the large

[184]United States v. Connolly (*Connolly II*), 24 F.4th 821 (2d Cir. 2022).

[185]*See, e.g.*, Trial Transcript, *supra* note 177, at 82:1-8.

[186]*Id.* at 79:4-9, 81:20-82:8, 83:15-23, 97:8-17, 105:7-25, 1093:8-1094:11. Conti, who faced a less damning written record, argued in part that he may have told traders what they wanted to hear but that he did not join the scheme when it came to his submissions. *Id.* at 95:11-18.

[187]*Id.* at 424-428:5, 517:21-518:7, 543:1-12. It was also brought out that Robson testified in a denial and obfuscation posture when examined by British authorities prior to the U.S. case. *Id.* at 470-72.

[188]*Id.* at 741:14-23, 750:7-751:1, 800:14-801:9.

[189]*Id.* at 262:1-23-263:7-20.

[190]*Id.* at 991:1-23, 1122:9-21.

[191]*Id.* at 1038-39:21.

[192]*Id.* at 1634:13-24.

corporate context, that fraud and similar offenses arise within and are incentivized by, if you will, wiggle room—room that exists due to legal, regulatory, cultural, and market contexts. That same room provides the foundation and framework for defenses that complicate or block prosecutors' paths to conviction.

Concededly, the jury convicted Allen and Conti. The trial judge, who called the case a "clear-cut and blatant fraud," sentenced both to modest prison terms.[193] Indeed, the judge described the case at the sentencing hearing as an example of how punishing individuals is a more effective deterrent than extracting penalties from companies.[194]

Yet, even after all the government expended in charging, preparing, and trying the case, Allen and Conti never served their sentences. The Second Circuit reversed their convictions and ordered the case dismissed on Fifth Amendment grounds.[195] Before the U.S. prosecution, Allen and Conti had been compelled to provide testimony to the United Kingdom's securities market regulator.[196] Under English law, the terms of this compulsion provided Allen and Conti with "use immunity" but not "derivative use immunity"—in other words, their statements could not be used against them as trial evidence, but their testimony could be used in any way to develop a case based on other evidence.[197]

Under U.S. law, mere "use immunity" does not provide the protection guaranteed by the Fifth Amendment and thus is insufficient to compel statements by a defendant invoking the right against self-incrimination.[198] Before he was charged in the United States, Robson, the government's key human source at both the grand jury and trial stages, heavily exposed himself, at his counsel's urging, to the transcripts of Allen's and Conti's compelled testimony in the United Kingdom.[199] For American prosecutors subsequently to use Robson as a witness was to make derivative use of Allen's and Conti's statements—because the

[193] Sentencing Transcript at 51-52, United States v. Allen, No. 14 CR 00272 (Mar. 10, 2016) (No. 242) [hereinafter Allen Sentencing Tr.]. Four other Rabobank defendants pled guilty, and one remained a fugitive; none received more than three months in prison. Nate Raymond, *Ex-Rabobank Trader Turned U.S. Cooperating Witness Spared Prison*, REUTERS (Nov. 14, 2016, 3:00 PM), https://www.reuters.com/article/idUSKBN1392CL/.

[194] Allen Sentencing Tr., *supra* note 193, at 54-55.

[195] United States. v. Allen, 864 F.3d 63, 101 (2d Cir. 2017).

[196] *Id.* at 68.

[197] *Id.* at 91.

[198] Kastigar v. United States, 406 U.S. 441, 462 (1972).

[199] David Rundle, *Case Note:* Allen *and* Conti, WILMERHALE (Aug. 2, 2017), https://www.wilmerhale.com/en/insights/blogs/wilmerhale-w-i-r-e-uk/case-note-allen-and-conti.

government could not prove that Robson's testimony was unaffected by having studied the defendants' compelled statements. Therefore, Allen's and Conti's convictions were obtained in violation of their constitutional rights and were reversed.[200]

The Fifth Amendment issue in the Rabobank prosecutions has no substantive relation to the provability of the Libor fraud. Still, other than guilty pleas of several cooperating witnesses that resulted in little or no prison time, the government achieved nothing in its Rabobank prosecutions. And, as will be discussed next, even if there had been no Fifth Amendment issue, Allen and Conti likely would have won reversal of their convictions—on the more central argument that they committed no crime at all.

### *2. Connolly and Black (Deutsche Bank)*

Deutsche Bank was another prominent global financial institution caught going deep into the practice of using benchmark interest rate submissions to favor the books of its traders in the interest rate derivatives market. In April 2015, the bank settled with the DOJ, with its London subsidiary pleading guilty to wire fraud and the parent bank entering into a deferred prosecution agreement under which it admitted manipulating Libor and participating in a price-fixing conspiracy with other banks involving Libor manipulation.[201] Deutsche Bank agreed to pay a total of $1.7 billion in penalties and disgorgement to various prosecutors and regulators.[202] The DOJ charged four Deutsche Bank employees criminally, two of whom pled guilty while agreeing to testify, and two of whom took the government to trial in the Southern District of New York.[203]

The trial defendants were Matthew Connolly and Gavin Black. Connolly directed a trading desk in New York.[204] Black supervised two trading desks in London.[205] The jury convicted both defendants.[206] Given the fate of the case against Connolly and Black, it will not add value to this Article to expend space on the

[200] *Allen*, 864 F.3d at 101.

[201] *See* Press Release, U.S. Dep't of Just., Deutsche Bank's London Subsidiary Agree to Plead Guilty in Connection with Long-Running Manipulation of Libor (Apr. 23, 2015), https://www.justice.gov/opa/pr/deutsche-banks-london-subsidiary-agrees-plead-guilty-connection-long-running-manipulation.

[202] *Id.*

[203] Stewart Bishop, *Ex-Deutsche Traders Rip Libor Fraud Claims as Trial Begins*, LAW360 (Sept. 18, 2018, 6:32 PM), https://www.law360.com/articles/1083988.

[204] *Id.*

[205] *Id.*

[206] Stewart Bishop, *2 Ex-Deutsche Traders Convicted of Libor-Rigging*, LAW360 (Oct. 17, 2018, 3:25 PM), https://www.law360.com/articles/1092738/2-ex-

trial record. Suffice it to say that the recorded communications and cooperating witness testimony painted a similar picture to that in other Libor cases. As can be seen from the government's published allegations against Deutsche Bank, Connolly and Black participated in conversations in which traders asked for changes in the bank's Libor submissions and were accommodated, and the conduct was open and at least tacitly approved within the bank.[207]

The trial judge was not a fan of the government's case. At sentencing, without explaining who else she thought might have been prosecutable at Deutsche Bank, she called the defendants "very minor participants" and "proxy wrongdoers," describing Black as "a bit player" and Connolly as "hardly a player at all."[208] She did not follow the Sentencing Guidelines and did not sentence either defendant to prison, while allowing Black to serve a term of home confinement at his residence in the United Kingdom.[209] Before sentencing, the judge issued an opinion in which she excoriated the government for what she described as its lazy reliance on Deutsche Bank's outside counsel to investigate the wrongdoing in the case.[210] The point of her opinion was to explain why she considered, but ultimately rejected, a ruling that the defendants' Fifth Amendment rights had been violated when they had been compelled by Deutsche Bank to make statements to the bank's counsel that, given the government's delegation of the investigation, were virtually induced by state action.[211] In other words, the prosecutors in the Deutsche Bank case narrowly avoided the Fifth Amendment fate of the prosecution in the Rabobank case.

While the trial judge was openly skeptical about the government's handling of the investigation and the relative culpability of the charged defendants, the appellate court concluded that Connolly and Black were innocent. On January 27, 2022, the Second Circuit reversed their convictions entirely, ruling that

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deutsche-traders-convicted-of-libor-rigging.

[207]*See* Statement of Facts at 9-10, United States v. Deutsche Bank AG, No. 3:15-cr-00061-RNC (D. Conn. Apr. 23, 2015), https://www.justice.gov/sites/default/files/opa/press-releases/attachments/2015/04/23/db_statement_of_facts.pdf.

[208]Stewart Bishop, *Ex-Deutsche Bank Traders Dodge Prison for Libor Rigging*, LAW360 (Oct. 24, 2019, 9:37 PM), https://www.law360.com/articles/1213252/ex-deutsche-bank-traders-dodge-prison-for-libor-rigging.

[209]*Id.*

[210]United States v. Connolly (*Connolly I*), No. 16 Cr. 0370 (CM), 2019 WL 2120523, at *13 (S.D.N.Y. May 2, 2019).

[211]*Id.* at *15.

their manipulation of Libor was not fraud.[212] The court's reasoning suggested that it would have reversed virtually any conviction in the Libor matter.

The court concluded that Deutsche Bank's submissions to the BBA were not lies because the submitters gave reasonable answers to a hypothetical question.[213] Why they chose the specific answer they gave on any day was beside the point. The court relied heavily on the failure of the BBA—which was widely seen as weak, understaffed, and untalented[214]—to regulate its own process competently. The BBA instructed each bank on the panel to submit the "rate at which it could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size [at the specified time]."[215] This instruction, the court said, called for an estimate of a hypothetical transaction. If Deutsche Bank could have borrowed at the rate it submitted on a relevant day—a matter the government would not have been able to disprove—then there was no false statement and, thus, no fraud.[216] (The government had shown that the submitters used a methodology for estimating the rate in the absence of trader requests and that the submitters believed they were acting wrongfully when they included the trader requests in calculating their estimates.)[217]

The Second Circuit's analysis in *Connolly* was, in my opinion, wrong.[218] But that is not material to this Article. Again, the government conducted a major investigation with the cooperation of a large financial institution and charged at least four individuals closest to the conduct at issue, obtaining the cooperation and testimony of two of them, and no one went to prison. The one case that proceeded to trial relating to Deutsche Bank was reversed on appeal, on a theory that calls into question the government's belief that benchmark manipulation, at least for Libor, could be a crime at all. Two additional Deutsche Bank em-

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[212] *Connolly II*, 24 F.4th 821, 824 (2d Cir. 2022).

[213] *Id.* at 835.

[214] VAUGHAN & FINCH, *supra* note 171, at 50.

[215] *Connolly II*, 24 F.4th at 825.

[216] *Id.* at 835-37.

[217] *Id.* at 830.

[218] Samuel Buell, *The Second Circuit Was Wrong in Reversing Ex-Deutsche Bank Traders' Libor Convictions*, CLS BLUE SKY BLOG (Feb. 7, 2022), https://clsbluesky.law.columbia.edu/2022/02/07/the-second-circuit-was-wrong-in-reversing-ex-deutsche-bank-traders-libor-convictions/. *But see* Rupert Macey-Dare, Could, Would, Should—Should Not and Could Not—the Hypothetical Questions at the Heart of USA v. Connolly & Black, and All Libor Panel Interest Rate Submission Cases 8-22 (Jan. 4, 2023) (unpublished paper) (available on SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4317020).

ployees who pled guilty have been permitted, based on the *Connolly* ruling, to withdraw their pleas, and their cases have been dismissed.[219]

### *3. U.K. Prosecutions ("Lord Libor" et al.)*

Prosecutors had marginally more success in the Libor scandal in the Southwark Crown Court in London, where the United Kingdom's Serious Fraud Office (SFO) obtained eight convictions out of 24 prosecutions, all eight of which resulted in at least the issuance of a prison sentence. Of the remaining 16 individuals charged in the United Kingdom, 11 were acquitted and five defeated extraditions from Germany or France.[220] The most prominent convicted person was Tom Hayes, a trader for the Swiss bank UBS who became known in the press as "Lord Libor."[221] Hayes initially received a 14-year sentence.[222]

It is not possible in this Article to account for the effect in the Libor matter of differences between the American and British legal systems' procedural approaches to the investigation and prosecution of corporate crime.[223] In the Libor cases, efforts to obtain trial transcripts from the Crown Court were unsuccessful.

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[219] *See* Erik Larson, *Ex-Deutsche Bank Trader Gets Guilty Plea Tossed Out, $1 Million Fine Returned*, Bloomberg (Aug. 5, 2022, 3:46 PM), https://www.bloomberg.com/news/articles/2022-08-05/ex-deutsche-bank-trader-gets-guilty-plea-tossed-1-million-back; Andy Verity, *Interest Rate "Rigger" Guilty Conviction Thrown Out*, BBC (Sept. 6, 2022), https://www.bbc.com/news/business-62801918.

[220] *See supra* note 219; *see also* Richard Crump, *SFO Closes Libor-Rigging Probe Without More Charges*, Law360 (Oct. 18, 2019, 1:29 PM), https://www.law360.com/articles/1210909/sfo-closes-libor-rigging-probe-without-more-charges.

[221] *See infra* Table B3.

[222] Kate Beioley & Joe Miller, *Lawyers' Six-Figure Bonuses Dry Up as Job Cuts Gather Pace*, Fin. Times (Feb. 12, 2023) https://www.ft.com/content/a7d2447c-d951-42b6-aedf-5769ce7d58bd.

[223] For more extensive discussion of British procedure in corporate cases, as well as that in several European jurisdictions, see Arlen & Buell, *supra* note 10, at 728-52. Most observers believe that prosecutors and regulators in the United Kingdom have a harder, rather than an easier, time obtaining enforcement results than in the United States. *See* Chris Blackhurst, *The SFO Should be There to Pursue Major Cases of Fraud and Economic Crime, Not Make Money*, Independent (Sept. 18, 2020, 5:49 PM), https://www.independent.co.uk/independentpremium/business/sfo-lisa-osofsky-uk-serious-fraud-office-economic-crime-us-fbi-b485236.html; Kirstin Ridley & Carolyn Cohn, *UK Regulator's Head of Enforcement to Step Sown in 2023*, Reuters (Oct. 18, 2022, 2:02 PM), https://www.reuters.com/world/uk/uk-regulators-head-enforcement-step-down-2023-2022-10-18/; Lorna Emson et al., *Is the United States More Effective than the United Kingdom at Prosecuting Economic Crime?*, Macfarlanes (May 7, 2021), https://www.macfarlanes.com/what-we-think/in-depth/2021/is-the-united-states-more-effective-than-the-united-kingdom-at-prosecuting-economic-crime/; *see also* Anita Anand, *The Enforcement of Financial Market Crimes in the Can-*

However, Hayes's bank, UBS, did settle criminally in the United States with the DOJ.[224] One can see from the details of that settlement that Hayes, who worked for UBS in Tokyo, was a compulsive, legendary, and exceptionally successful manipulator of Libor.[225] Hayes was all over UBS's recorded chats telling the bank's submitters, who were highly obliging,[226] that he needed Libor "skewed" low or high from one day to the next.[227] Hayes and the submitters were explicit that they were discussing moving UBS's submissions away from "reality" and the "truth."[228] A cash broker outside the bank said in a chat with Hayes, "mate yur getting bloody good at this libor game . . . think of me when yur on yur yacht in Monaco wont yu."[229]

Exposing himself to liability in both the United States and the United Kingdom, Hayes took Libor manipulation to its highest level by developing a network of contacts both at other banks and at brokerage houses (which intermediate some trades in the interest rate derivatives markets) with whom Hayes conspired to trade favors.[230] Hayes agreed with traders at other banks to skew Libor submissions to assist each other's positions. He extensively bribed outside cash brokers, who were a source for data used in banks' Libor submissions, to alter their own reporting about Libor in his favor.[231] His bribing of the brokers included arranging meaningless trades so the brokers could pad their commissions.[232]

The case against Hayes based on the written record was exceptionally strong even within the Libor affair, no matter where or how it had been tried. Hayes, whose psychology was complex,[233] further damaged his legal situation by lying and minimizing when UBS commenced its internal investigation (UBS was the first bank to investigate and then negotiate with the DOJ), then confessing extensively to the SFO, after which he testified at trial

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*ada and the United Kingdom, in* CORRUPTION AND FRAUD IN FINANCIAL MARKETS: MALPRACTICE, MISCONDUCT AND MANIPULATION (C. Alexander and D. Cummings eds., 2019).

[224]*See* DOJ Letter, *supra* note 174, at 1.

[225]*See, e.g., id.* at 15.

[226]Hayes said at one point, "They just set it where we ask." *Id.*

[227]*Id.* at 10.

[228]*Id.* at 11.

[229]*Id.* at 24.

[230]*Id.* at 20.

[231]*See, e.g., id.* at 9, 18, 23; ENRICH, *supra* note 171, at 175-76, 221.

[232]ENRICH, *supra* note 171, at 175-76.

[233]*See, e.g.*, VAUGHAN & FINCH, *supra* note 171, at 158; ENRICH, *supra* note 171, at 175-76. Both books dwell on Hayes's biography and profile.

once again maintaining his innocence.[234] Still, the defense appears to have effectively raised the relevant issues about the BBA's incompetence and the fuzziness of the Libor definition.[235] In a later, separate trial—to Hayes's disbelief—a London jury acquitted all six outside brokers with whom Hayes had conspired to manipulate Libor.[236]

Hayes's conviction was affirmed on appeal, but his sentence was deemed "excessive" given his age and mental condition and reduced from 14 to 11 years.[237] He served less than six years in custody.[238] Then, in July 2023, the United Kingdom's Criminal Case Review Commission referred Hayes's case to the Court of Appeal, in light of the U.S. ruling in *Connolly*, for reconsideration of whether the correct legal standard was applied in prosecuting Hayes.[239] While the Court of Appeal did not provide Hayes with relief from his conviction, it did grant Hayes permission to pursue his claims in the Supreme Court of the United Kingdom.[240] His conviction may yet be erased entirely. The SFO's other large share of the transatlantic Libor matter was a set of prosecutions involving 10 employees of Barclays that resulted in two trials, one producing convictions and the other ending in acquittals.[241]

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[234] *See* Enrich, *supra* note 171, at 318-403, 419-44; Vaughan & Finch, *supra* note 171, at 160-61.

[235] Enrich, *supra* note 171, at 244; Vaughan & Finch, *supra* note 171, at 50-60.

[236] Vaughan & Finch, *supra* note 171, at 31, 67, 85, 148. The broker defendants argued that they had been duping Hayes and, despite their chortling in the recorded chats, took no action to help him. *See* David Enrich, *Six Ex-Brokers Acquitted of Libor Rigging in London*, Wall St. J. (Jan. 27, 2016, 7:22 PM), https://www.wsj.com/articles/london-jury-acquits-six-brokers-of-libor-manipulation-frauds-1453908372.

[237] Vaughan & Finch, *supra* note 171, at 168.

[238] Ellen Milligan & Harry Wilson, *Libor Trader Tom Hayes Set for Release After Nearly Six Years in Jail,* Bloomberg (Jan. 29, 2021, 9:48 AM), https://www.bloomberg.com/news/articles/2021-01-29/libor-trader-tom-hayes-set-for-release-after-nearly-six-years.

[239] Alistair Gray, *Tom Hayes Wins Right to Conviction for a Second Time*, Fin. Times (July 6, 2023), https://www.ft.com/content/8ad9ff51-cd0c-46ba-a67d-0235563cc750.

[240] Sam Tobin, *UK Libor Trader Hayes Given Route to Appeal Rate-Rigging Conviction at Supreme Court*, Reuters (May 21, 2024, 3:49 PM), https://www.reuters.com/world/uk/uk-libor-trader-hayes-given-route-appeal-rate-rigging-conviction-supreme-court-2024-05-21.

[241] Simon Bowers, *Libor-Rigging Trial: Jury Finds No Defense in "Just Doing My Job,"* Guardian (July 4, 2016, 2:08 PM), https://www.theguardian.com/business/2016/jul/04/barclays-libor-convictions-a-major-victory-for-sfo; Jane Croft & Caroline Binham, *Former Barclays' Traders Acquitted in SFO Libor Case*, Fin. Times (Apr. 6, 2017), https://www.ft.com/content/77d5a24a-1aae-11e7-bcac-6d03d067f81f.

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In whole, the prosecution record in London may have surpassed that in New York, but English prosecutors ran into obstacles and setbacks of their own, and their cases included the strongest one uncovered globally (Hayes). Still, a federal judge in New York granted the DOJ's motion to dismiss the DOJ's charges against Hayes, which were filed but never prosecuted, due to the Second Circuit's ruling in *Connolly*.[242] Hayes might have avoided prison altogether had he been able to navigate the risky path of arranging to be prosecuted in the United States first. Given the straightforward nature of the theory of fraud in Libor, and the extraordinarily explicit record of criminal conversations, the litigation results in both the United States and the United Kingdom stand as strong evidence that even the best-looking cases for prosecution of financial institution employees can turn out to be expensive failures.

### *4. Forex Trading Prosecutions*

Before judges and juries had even begun to signal to the DOJ that the Libor cases were not the "slam dunks" they had seemed, major banks were caught manipulating another trading market governed by benchmarks. Global currencies produce a massive, multi-trillion-dollar market in derivatives trading—due to their size, influence, diversity, economic importance, and constant fluctuations.[243] The most important benchmark used to set deal terms in that market, known as the "FX" or "Forex" market, is the daily 4:00 p.m. "London Fix."[244] Corporate and securities scholar Andrew Verstein describes this benchmark as "derived from trades mostly executed by a dozen sophisticated intermediaries during a narrow band of time, that are consciously submitted or omitted based on the effect on the benchmark."[245] Verstein observes, "On the head of this pin dance all the angels of the world's largest financial market."[246]

Here was another opportunity for traders to secretly manipulate a benchmark, while working together, to get "free money" when deals with unwitting counterparties settled. Once again, large banks' compliance operations, and regulators and prosecutors in both the United States and United Kingdom, discovered the activity, which some participants at multiple banks referred

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[242]*See* Order and Motion to Dismiss Charges, United States v. Hayes, No. 17-CR-00750 (S.D.N.Y. 2022).

[243]*See* Verstein, *supra* note 169, at 235-36.

[244]*Id.* at 235.

[245]*Id.*

[246]*Id.*

to in recorded Bloomberg chats detailing their agreements as their "cartel."[247]

Enforcement actions ensued. Citibank, Barclays, JPMorgan Chase, UBS, and RBS all agreed to plead guilty and paid several billion dollars in penalties.[248] HSBC entered into a deferred prosecution agreement in a separate case.[249] The government's case was based on anti-competitive violations, primarily Sherman Act offenses, in which traders across multiple banks agreed to manipulate the London Fix.[250]

Fewer individuals were charged in the FX affair than in the Libor matter, perhaps because the chat record implicated a smaller number of traders and was not as extensive. Eight individuals across five banks faced criminal charges, with two more receiving nonprosecution agreements in exchange for cooperation.[251] Of the eight charged, two pled guilty (resulting in non-imprisonment sentences), one defeated extradition, and five went to trial.[252] The three resulting trials produced guilty verdicts against two traders tried separately,[253] who received prison terms of eight months and two years, respectively, and not guilty verdicts for three traders who were tried together.[254] In the United Kingdom, the SFO closed its Forex investigation in 2016 without bringing charges, stating that the evidence was insufficient to

[247]Transcript of Record at 408:17-409:21, United States v. Usher, No. 17-CR-00019 (S.D.N.Y. 2018).

[248]Press Release, U.S. Dep't of Just., Five Major Banks Agree to Parent-Level Guilty Pleas (May 20, 2015) [hereinafter Press Release, *Five Major Banks*], https://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas.

[249]*See* Deferred Prosecution Agreement, United States v. HSBC Holdings PLC, No. 18-CR-00030 (E.D.N.Y. 2018).

[250]Press Release, *Five Major Banks, supra* note 248.

[251]*See infra* Tables C1 & C3.

[252]*See infra* Tables C1 & C3.

[253]*See*United States v. Aiyer, 33 F.4th 97, 104, 131 (2d Cir. 2022); Press Release, U.S. Dep't of Just., Former Global Head of HSBC's Foreign Exchange Cash-Trading Found Guilty of Orchestrating Multi-Million Dollar Front-Running Scheme (Oct. 23, 2017), https://www.justice.gov/opa/pr/former-global-head-hsbcs-foreign-exchange-cash-trading-found-guilty-orchestrating. The HSBC defendant, Mark Johnson, was not alleged to have been a participant in the benchmark manipulation "cartel," but rather was discovered having used confidential information to trade ahead of client positions. *Id.* The JP Morgan defendant, Akshay Aiyer, was convicted of a Sherman Act violation based on his participation in the manipulation conspiracy. Press Release, U.S. Dep't of Just., Former Foreign Exchange Trader Sentenced to Prison for Price Fixing and Bid Rigging (Sept. 17, 2020), https://www.justice.gov/opa/pr/former-foreign-exchange-trader-sentenced-prison-price-fixing-and-bid-rigging.

[254]*See infra* Tables C1 & C3.

support convictions.[255] Civilly, in the United States, the Federal Reserve and Office of the Comptroller of the Currency pursued nine actions, obtaining seven industry bans and two fines averaging $612,500.[256]

As in the MBS and Libor matters, it is illuminating to examine what happened at the trial in the Southern District of New York at which a jury acquitted the three traders—one each from JP Morgan, Citibank, and Barclays.[257] The testimony of Matt Gardiner, the government's chief cooperating witness, who participated in the "cartel," was explicit that the co-conspirators at different banks discussed their trading books with each other and frequently took, or refrained from taking, positions in the market that would have affected the London Fix to help each other, while using coded language to reduce the risk that compliance personnel would detect their activity.[258]

Prosecutors walked Gardiner through recorded chats in which the group discussed altering their trading activities to manipulate the London Fix and chortled about how the activity was profiting their books, including one trader delightedly saying that he was "having my best week ever."[259] Gardiner testified that when the Libor investigations reached the news, the traders became concerned that compliance personnel would question their activities, and Gardiner's supervisor instructed him to stop using the word "fix" in Bloomberg chats to reduce the likelihood their conversations would be flagged.[260] Still, they continued to coordinate with each other.

However, cross-examination established that Gardiner had no idea that what he was doing might violate U.S. anti-competition law, on which he had never been trained. He said that his understanding that his conduct was illegal only "evolved" when he began talking to U.S. lawyers and negotiating with American

[255]Press Release, Serious Fraud Off., SFO Closes Forex Investigation (Mar. 15, 2016), https://www.sfo.gov.uk/2016/03/15/sfo-closes-forex-investigation/.

[256]*Id.*; Press Release, U.S. Dep't of Just., Former Global Head of HSBC's Foreign Exchange Cash-Trading Found Guilty of Orchestrating Multi-Million Dollar Front-Running Scheme (Oct. 23, 2017), https://www.justice.gov/opa/pr/former-global-head-hsbcs-foreign-exchange-cash-trading-found-guilty-orchestrating.

[257]United States v. Usher, No. 17-CR-00019, slip op. at 2480-81 (S.D.N.Y. Oct. 26, 2018).

[258]Transcript of Record at 463-509, 552:10-17, United States v. Usher, No. 17-CR-00019 (S.D.N.Y. Oct. 12, 2018).

[259]*Id.*

[260]*Id.* at 770-75.

prosecutors.[261] He said he did not consider himself to have been participating in a criminal conspiracy or that anything he was doing was wrong, or even constituted price-fixing, as opposed to sharing of information.[262] On the argument that it was relevant to Gardiner's state of mind, the defense was able to get before the jury that the SFO had issued a statement saying the evidence in the FX matter was insufficient to bring charges.[263]

The government, while opening its summation by playing a recording in which one defendant said, "in the cold light of day, it's going to look f-ing awful,"[264] emphasized to the jury that good faith was not a defense under the Sherman Act (as it is in a prosecution for fraud) and that the prosecution only needed to prove that the defendants intended to do what they did and that the conduct fit the definition of bid-rigging, not that they knew it was illegal.[265] The defense attorneys, who disclaimed to the judge that they were pursuing a defense of "everybody does it,"[266] emphasized over and again that the defendant traders did not think they were doing anything wrong and did not try to hide the essential facts about their trading activity.[267] The defense also argued that the government never introduced any evidence to prove that the defendants' conduct affected prices, and that the defendants shared information but did not coordinate on specific trades.[268] The jury acquitted all three defendants in less than a day.[269]

Speaking to the press after the verdict, the traders said they could not understand how the long arm of American law was able to pull them from London into a New York court to be tried for violating a statute that they had no knowledge of or training on.[270] They maintained that it had been routine for traders to share "market color" and that it made no sense that the three of them were plucked out of hundreds of traders for prosecution.[271]

[261] *Id.* at 1186:2-25, 1187:14-22.

[262] *Id.* at 954:20-955:15.

[263] *Id.* at 857:7-858:15.

[264] *Id.* at 2281:13-25.

[265] *Id.* at 2289:7-13, 2292:19-25.

[266] *Id.* at 2015:13-20.

[267] *Id.* at 2335:23-2344:14.

[268] *Id.* at 2359:14-2360:11, 2368:15-2371:22, 2408:22-2409:3, 2415:9-15. It likely would have been impossible for prosecutors to prove a price effect in this context given the enormous size and complexity of the currency markets.

[269] *Id.* at 2481:1-2483:21.

[270] Katie Martin & Caroline Binham, *Cleared British Traders Put US Justice on Trial*, FIN. TIMES (Nov. 25, 2018), https://www.ft.com/content/673237ba-ef22-11e8-89c8-d36339d835c0.

[271] *Id.*

Likely the DOJ selected these traders because they left behind the most probative record of recorded chats and made the terrible mistake of referring to themselves as a cartel. Still, it was not enough for convictions. Jury deliberations are of course secret, but a plausible inference given the trial record is that the defense—regardless of the court's instructions on mens rea—persuaded the jury that they should not impose a criminal conviction on traders who may have gamed the system but did not do so believing they were violating the law or even doing something aberrant or wrongful.

Previous work has examined why the idea of awareness of wrongdoing matters so much with the enforcement of many white-collar crimes—and why there is a substantial and often hidden normative foundation to the idea.[272] While mistake of law is not a legal defense to most white-collar offenses, the application of mens rea requirements such as intent to defraud, intent to obstruct justice, or willful violation of law frequently involve, at least in cases involving more novel commercial activities, consideration of whether a defendant chose to pursue a course of conduct known to be wrongful. Defense lawyers, juries, judges, and the public share this basic intuition. It thus presents a real consideration for prosecutors when determining whether they are likely to succeed with a case for fraud or similar offenses in a market where the conduct at issue was widespread and notorious. The Forex prosecutions, among others discussed in this Article, appear to support this point.

### *C. Generalizations*

To summarize, across the three most prominent and widespread banking scandals since 2010—MBS, Libor, and Forex—prosecutors in the United States and the United Kingdom obtained and upheld only 19 convictions out of 58 prosecutions, with only 13 of the convicted individuals sentenced to imprisonment.[273] Prosecutors have both tried and struggled to impose criminal punishment on persons dealing in securities products within large institutions. The evidence of what occurred in litigation of these cases casts doubt on the idea that more determined and resourced investigative and prosecution campaigns in the financial sector could have produced significantly better results and much greater deterrent effects.

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[272] *See* Samuel W. Buell & Lisa Kern Griffin, *On the Mental State of Consciousness of Wrongdoing*, 75 Law & Contemp. Probs. 133, 133-34 (2012); Samuel W. Buell, *Novel Criminal Fraud,* 81 N.Y.U. L. Rev. 1971, 1973-76 (2006); Samuel W. Buell, *Culpability and Modern Crime*, 103 Geo. L.J. 547, 548-49 (2015).

[273] *See infra* Appendices A-C.

That is not to say that the government should not have pursued the cases it selected or that prosecutors should not continue to be active in the sector. A visible criminal and civil enforcement presence in the financial markets is essential to overall health of the markets. Prosecutions of serious miscreants, especially at the highest levels, can produce important expressive benefits—in terms of rule of law and equality—when cases arise that provide opportunities for wins. But observers and critics should be more realistic about how often such cases will arise and about the enormous resources and time that must be spent in pursuit of cases that may offer, as in the MBS and Libor affairs, well below even odds.

The difficulties the government encountered at trial and appeal in the cases discussed to this point stemmed from the nature of the conduct giving rise to litigation. With sophisticated dealing in complex financial products or the elaborate financing structures of major corporations, there are almost always questions about the line between fraud and what is normal, expected, misunderstood, not intended, done in good faith, common in the workplace, directed by someone else, and so on. Only rarely do the Bernard Madoffs of the world commit their crimes within the Goldman Sachs and JP Morgans of the world.

In contrast to media views and mass public opinion, persons required to act in the roles of judges and jurors respond to arguments that individuals working within large organizations and corporate cultures might not have meant to be doing something they understood to be seriously wrong, and thus might not deserve to be imprisoned, at least according to common moral intuitions. Without many successful prosecutions of lower and mid-level corporate personnel to produce inside witnesses, prosecutions of high-level personnel will almost always lie out of reach. When individuals are on trial, especially mid-level employees, jurors and judges seem drawn to the idea that it is really the corporations, with their incentives, cultures of greed, inattention, pressures and so on, that are responsible and at least some employees do not deserve to be made scapegoats.

## II Individual Liability Beyond Securities Markets

This Article's close study of securities prosecutions does not leave space for a detailed treatment of whether difficulties in the government's enforcement efforts in the financial sector also characterize the litigation record with corporate crime outside that realm. Nonetheless, a brief discussion of a handful of prominent examples points to similar barriers standing between prosecutors and large numbers of individual convictions.

### *A. BP and the Gulf Spill*

When the Deep Horizon drilling rig exploded in the Gulf of

Mexico on April 20, 2010, killing 11 workers and devastating an economically critical ecosystem, the DOJ, with the eventual cooperation of British Petroleum (BP), undertook a massive investigation alongside other federal agencies.[274] From the outset of the disaster, a story took hold that BP's management carried out an aggressive strategy of pursuing deeper and more risky drilling sites, without sufficient attention to safety.[275] BP was eventually compelled to plead guilty, considered the sternest outcome at the corporate level short of a trial and sentencing.[276]

Despite massive forensic work, the DOJ was not able to tie events on the rig to senior management sufficiently to support a criminal charge.[277] This was not surprising, as events unfolded at Deep Horizon faster than would have allowed for extended involvement of corporate management. Indeed, the government's account of the disaster tied causation of the explosion to the failure of personnel on the rig to raise alarm bells soon enough for those onshore to intervene.[278] Absent evidence of micromanagement uncommon in a company so large, no theory would have permitted imposing liability on senior personnel for the specific events in the Gulf on the ground that they chose a generally riskier strategy for BP's offshore operations.

The government indicted four individuals in the Deep Horizon disaster. The DOJ fully lost two of the cases and mostly lost the other two, obtaining minor guilty pleas only.[279] Robert Kaluza and Donald Vidrine, the most senior BP employees working at the well site, were charged with homicide under an old federal maritime law, the Seaman's Manslaughter Act, which requires a showing of only negligence for conviction.[280] The district judge

**[Section II]**

[274]*See* John M. Broder, *BP Shortcuts Led to Gulf Oil Spill, Report Says*, N.Y. TIMES (Sept. 14, 2011), https://www.nytimes.com/2011/09/15/science/earth/15spill.html.

[275]*Id.*

[276]*See* Guilty Plea Agreement at 1, United States v. BP Expl. & Prod., Inc., No. 12-CR-00292 (E.D. La. 2012).

[277]*Id.* at 9-10.

[278]*Id.* at 15.

[279]Carrie Johnson, *Jury Acquits Ex-BP Exec of Lying in Oil Spill*, NPR (June 6, 2015, 2:59 PM), https://www.npr.org/2015/06/06/412314705/jury-acquits-ex-bp-exec-of-lying-in-oil-spill.

[280]*See* Walter Pavlo, *Two Years After Ruling, BP Engineer Still Carries Burden of Prosecution*, FORBES, https://www.forbes.com/sites/walterpavlo/2018/01/08/two-years-after-ruling-bp-engineer-still-carries-burden-of-prosecution/ (Apr. 14, 2022, 2:05 PM).

dismissed these charges before trial.[281] The Fifth Circuit affirmed, ruling that while a platform such as the Deep Horizon is a seagoing craft, the statute applies only to personnel operating vessels in a navigational capacity (i.e., sailors), not to individuals on board to do jobs such as drilling for oil.[282] Kaluza and Vidrine additionally faced charges for violating the Clean Water Act (CWA), also a negligence offense.[283] Vidrine pled guilty to a single misdemeanor CWA count, which would not likely have resulted in prison time, and died a short time later.[284] Kaluza proceeded to trial and was acquitted of violating the CWA.[285]

David Rainey, BP's head of exploration for the Gulf region, was charged with a post-explosion crime: misleading the government about the scale of the spillage from the seabed during the lengthy remediation effort by BP and federal agencies.[286] A jury acquitted Rainey.[287] Kurt Mix, a BP engineer involved in the disaster response who helped cap the well, was charged with obstruction of justice for deleting text messages from his phone a year later.[288] The government dropped the obstruction charge when Mix agreed to plead guilty to a misdemeanor violation of the Computer Fraud and Abuse Act.[289] He was placed on six months' probation.[290]

These results make evident why prosecutors never got off square one in establishing criminal liability of any of BP's corporate managers. Even more easily satisfied theories of criminal liability could not be established for those closest to the explosion. The institutional size and structure of a massive corporation, as well as the nature of decision-making, delegation, and division of labor in such organizations, can frustrate the

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[281] *Id.*

[282] United States v. Kaluza, 780 F.3d 647, 664 (5th Cir. 2015).

[283] *See* Pavlo, *supra* note 280.

[284] *Id.*

[285] *Id.*

[286] Press Release, U.S. Dep't of Just., BP Exploration and Production Inc. Agrees to Plead Guilty to Felony Manslaughter, Environmental Crimes, and Obstruction of Congress Surrounding Deepwater Horizon Incident (Nov. 15, 2012), https://www.justice.gov/opa/pr/bp-exploration-and-production-inc-agrees-plead-guilty-felony-manslaughter-environmental.

[287] *See* Johnson, *supra* note 279.

[288] Press Release, U.S. Dep't of Just., Former BP Engineer Arrested for Obstruction of Justice in Connection with the Deepwater Horizon Criminal Investigation (Apr. 24, 2012), https://www.justice.gov/opa/pr/former-bp-engineer-arrested-obstruction-justice-connection-deepwater-horizon-criminal.

[289] Walter Pavlo, *Government Drops Obstruction Charges Against Former BP Engineer Kurt Mix*, FORBES, https://www.forbes.com/sites/walterpavlo/2015/11/06/government-drops-obstruction-charges-against-former-bp-engineer-kurt-mix/ (Nov. 6, 2015, 12:11 PM).

[290] *Id.*

project of imposing individual responsibility under the core principles of criminal liability.

### *B. GM and the Ignition Switch*

In 2014, General Motors (GM) recalled millions of passenger automobiles after it discovered that it had engineered and built them with a faulty ignition switch. The switch could rotate out of position during operation and, due to other design flaws, cause power steering to fail and prevent airbags from deploying.[291] Over 120 people died because of GM's faulty engineering and its years-long failure to discover and rectify the problem.[292] One woman in Texas was even charged with manslaughter when a passenger died after her GM vehicle failed during normal operation.[293] (The case was later dismissed.)

In one way, the GM ignition switch scandal was a prototypical corporate crime. The company killed people because it was trying too hard to drive down costs for cheap vehicles by finding manufacturing shortcuts, while it paid far too little attention to safety and internal communication and reporting systems.[294] In every sense, it was the organization and its culture that caused what happened and bore responsibility for it. In another way, the case was atypical in that the problem arose more from omission than commission. It was nearly impossible to identify GM employees who knew about both the switch defect and its role in causing accidents.[295] The heart of the disaster lay in the company's inability to have personnel with the relevant pieces of knowledge communicate with each other.[296] Using each hand to point at persons sitting on either side of someone in a meeting as the individuals responsible for an issue was known as "the GM salute"; "the GM nod" was everyone indicating in a meeting that something should be done and then no individual taking responsibility to follow up.[297]

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[291] *See* Buell, *supra* note 26, at xi-xv.

[292] David Shepardson, *GM Compensation Fund Completes Review With 124 Deaths*, Detroit News (Aug. 24, 2015, 5:13 PM), https://www.detroitnews.com/story/business/autos/general-motors/2015/08/24/gm-ignition-fund-completes-review/32287697/.

[293] Jeff Glor, *Texas Woman Cleared of Death Linked to Defective GM Ignition Switch*, CBS News (Nov. 24, 2014, 8:02 PM), https://www.cbsnews.com/news/texas-woman-cleared-in-death-linked-to-gmdefect/.

[294] *See generally* Anton R. Valukas, Jenner & Block, Report to Board of Directors of General Motors Company Regarding Ignition Switch Recalls (2014), https://www.aieg.com/wp-content/uploads/2014/08/Valukas-report-on-gm-redacted2.pdf.

[295] *Id.* at 1.

[296] *Id.*

[297] *Id.*

In a widely criticized criminal settlement,[298] the DOJ permitted GM to enter into a deferred prosecution agreement and pay a $900 million penalty.[299] If anything could be said for a lenient settlement other than the too-big-to-fail truth that "what is good for GM is good for America,"[300] it was that, once GM management finally realized the problem, the company conducted a thorough investigation through outside counsel and not only shared all of its findings with the government but also published them.[301] Although extensive civil litigation remains underway, forensic work identified only a single arguably culpable employee: a lower-level engineer who realized the problem with the switch and corrected it without filing the required paperwork, presumably to cover the original error, which made it harder for anyone at the company to tie the switch defect to accidents.[302] The government did not charge this person with a criminal offense, perhaps because a theory of federal criminal liability for such an internal cover-up was lacking.[303]

At least part of what would have impeded the government from making a big, multi-defendant prosecution out of the GM affair was the law. Even the legal theory in the deferred prosecution agreement at the corporate level, based in part on wire fraud involving the sale of the cars to retail customers, might have

[298] *See, e.g.*, David M. Uhlmann, Opinion, *Justice Falls Short in G.M. Case*, N.Y. TIMES (Sept. 19, 2015), https://www.nytimes.com/2015/09/20/opinion/Sunday/justice-falls-short-in-gm-case.html; Drew Harwell, *Why General Motors' $900 Million Fine for a Deadly Defect Is Just a Slap on the Wrist*, WASH. POST (Sept. 17, 2015, 3:31 PM), https://www.washingtonpost.com/news/business/wp/2015/09/17/why-general-motors-900-million-fine-for-a-deadly-defect-is-just-a-slap-on-the-wrist/.

[299] *See* Harwell, *supra* note 298.

[300] The oft-repeated quote turns out to be apocryphal. *See* Ellen Terrell, *When a Quote is Not Exactly a Quote: General Motors*, LIBR. OF CONG. BLOGS (Apr. 22, 2016), https://blogs.loc.gov/inside_adams/2016/04/when-a-quote-is-not-exactly-a-quote-general-motors/.

[301] *See generally* VALUKAS, *supra* note 294.

[302] *See id.* at 95-102; *see also* Veronica Root Martinez, *Complex Compliance Investigations*, 120 COLUM. L. REV. 249, 289-90 (2020) (arguing that GM could have better identified red flags if they had taken steps such as aggregating settlement data).

[303] Nathan Bomey & Kevin McCoy, *GM Agrees to $900M Criminal Settlement Over Ignition-Switch Defect*, USA TODAY (Sept. 17, 2017, 6:37 PM), https://www.usatoday.com/story/money/cars/2015/09/17/gm-justice-department-ignition-switch-defect-settlement/32545959/ ("U.S. Attorney Preet Bharara left the door open to prosecuting specific GM employees. But he said it's difficult to pin blame on an individual who may have had only partial knowledge of a backward bureaucratic process that led to tragedy.").

faced difficulties had it been litigated.[304] More broadly, federal criminal law, even with its thousands of provisions, includes neither an offense of careless automobile engineering nor one of failing properly to report vehicle defects. And there is no general federal manslaughter statute.[305] As measured by the historical use of manslaughter doctrine, it would have been novel and aggressive for a state prosecutor to attempt to pin a far-flung death at the consumer level on engineers or managers in Michigan.[306] Ultimately it is not realistic to think that prosecutors had a viable path to imprisoning senior executives, or perhaps any employee, for the grave misdoings at GM.

### *C. VW and the Defeat Device*

If one asked those who follow corporate crime which recent major case was most appropriate for criminal charges against senior executives, a common answer would be Volkswagen (VW). Between 2009 and 2015, the German automobile behemoth pursued a strategy of selling diesel cars in the United States intentionally built with software, called a "defeat device," that misled regulators and consumers about illegal levels of nitrous oxide emissions produced during normal operation.[307] This strategy, known to be unlawful from the beginning, was hatched and approved at the highest levels of the company.[308] Here was a corporation that outright decided to break the law and lie about it to achieve its competitive objectives. Even after a handful of enterprising researchers at West Virginia University uncovered the scheme, VW continued to mislead American regulators.[309]

Executives indeed were indicted.[310] But the international dimension of the VW case has complicated outcomes. The corporation pled guilty in the United States and paid a fine of $4.3 billion.[311] German prosecutors, toward whom American prosecu-

[304] *See* Nick Werle, Note, *Prosecuting Corporate Crime When Firms are Too Big to Jail: Investigation, Deterrence, and Judicial Review*, 128 Yale L.J. 1366, 1411-12 (2019).

[305] *See* James W. Harlow, Note, *Corporate Criminal Liability for Homicide: A Statutory Framework*, 61 Duke L.J. 123, 126-27 (2011).

[306] *See generally* Samuel W. Buell, *Criminally Bad Management, in* Research Handbook on Corporate Crime and Financial Misdealing 59, 62-65, 70 (Jennifer Arlen ed., 2018).

[307] *See* Rule 11 Plea Agreement at Ex. 2-11, United States v. Liang, AG, No. 16-CR-20394, 2016 WL 5542730, at *5-7 (E.D. Mich. Sept. 9, 2016); Jack Ewing, Faster, Higher, Farther: the Volkswagen Scandal 150 (2017).

[308] Ewing, *supra* note 307, at 150-51, 154.

[309] *Id.* at 215-16, 223-24.

[310] *Id.* at 334.

[311] Press Release, U.S. Dep't of Just., Volkswagen AG Agrees to Plead Guilty

tors have acted with comity, have charged 15 of the most culpable persons in the case, including former CEO Martin Winterkorn.[312] The wheels of German justice turn more slowly than those of German cars. And public access to the details of criminal proceedings is restricted. Several defendants are presently being tried in German proceedings expected to last months or more.[313] Winterkorn and others await trial and have won long delays.[314]

Because the approach of German law to white-collar crime has been more lenient than the American approach, in both offense definition and punishment,[315] it is difficult to predict whether serious prison terms will be imposed on anyone in the VW prosecutions. In the United States, the DOJ charged eight individuals in federal court.[316] Two individuals have been convicted and sentenced to 40 months and 60 months in prison respectively, with one permitted to serve his sentence in Germany.[317] The remaining six, including Winterkorn, stand beyond the government's grasp unless the DOJ successfully pursues extradition.[318]

One could see VW as an exception proving the rule. It was truly extraordinary for top executives of a major global firm to

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and Pay $4.3 Billion in Criminal and Civil Penalties; Six Volkswagen Executives and Employees are Indicted in Connection with Conspiracy to Cheat U.S. Emissions Tests (Jan. 11, 2017), https://www.justice.gov/opa/pr/volkswagen-ag-agrees-plead-guilty-and-pay-43-billion-criminal-and-civil-penalties-six.

[312] Michael Nienaber, *German Prosecutors Charge More VW Managers in Emissions Scandal*, REUTERS (Apr. 24, 2021, 6:27 AM), https://www.reuters.com/business/autos-transportation/german-prosecutors-charge-more-vw-managers-emissions-scandal-dpa-2021-04-24/.

[313] Nathan Eddy, *Four Ex-VW Managers Stand Trial in Germany Over Diesel Fraud*, AUTO. NEWS EUR. (Sept. 16, 2021, 7:06 AM), https://europe.autonews.com/automakers/four-ex-vw-managers-stand-trial-germany-over-diesel-fraud.

[314] *Id.*

[315] *See* Thomas Weigend, *Sentencing and Punishment in Germany, in* SENTENCING AND SANCTIONS IN WESTERN COUNTRIES 188, 198 (Michael Tonry & Richard S. Frase eds., 2001).

[316] Press Release, U.S. Dep't of Just., IAV GmbH to Pay $35 Million Criminal Fine in Guilty Plea for Its Role in Volkswagen AG Emissions Fraud (Dec. 18, 2018), https://www.justice.gov/opa/pr/iav-gmbh-pay-35-million-criminal-fine-guilty-plea-its-role-volkswagen-ag-emissions-fraud; *see also* Second Superseding Indictment at 8-10, United States v. Dorenkamp, No. 2:16-cr-20394 (E.D. Mich. Jan. 11, 2017).

[317] *See* Court Docket, United States v. Liang, No. 2:16-CR-20394 (E.D. Mich. 2016).

[318] Press Release, U.S. Dep't of Just., Former CEO of Volkswagen AG Charged with Conspiracy and Wire Fraud in Diesel Emissions Scandal (May 3, 2018), https://www.justice.gov/opa/pr/former-ceo-volkswagen-ag-charged-conspiracy-and-wire-fraud-diesel-emissions-scandal (stating that Winterkorn and five others are "believed to be . . . German citizen[s] and to reside in Germany").

expressly agree to break the law and leave a record of their decisions to do so. Prosecutors cannot expect to encounter such cases with frequency, although even the VW prosecutions have not easily yielded prison sentences. Or perhaps VW is evidence of a newer rule for individual liability in corporate crime. With market developments continuing to globalize corporate wrongdoing, the DOJ has sought to prosecute more corporate wrongdoing across international borders.[319] In such cases, the DOJ may increasingly find obstacles to the ordinarily routine first step of taking defendants into custody.

### *D. Boeing and the 737 MAX*

The deadliest corporate crime of recent vintage was the fiasco of the Boeing Company's rollout of its 737 MAX aircraft. On October 29, 2018, a 737 MAX operated by Indonesian carrier Lion Air crashed into the Java Sea after takeoff, killing all 189 persons on board.[320] Several months later, on March 20, 2019, an Ethiopian Airlines 737 MAX crashed near Ejere, Ethiopia on takeoff, killing all 157 on board.[321] In both cases, causation of the crashes and deaths lay with Boeing. The company had designed the aircraft to accommodate a larger engine that required changes in the 737's operating system that confused pilots whom the company deliberately chose not to provide with adequate instruction on how to handle the new system.[322]

In the Boeing case, the trouble for prosecutors was that it is not a federal crime to cause an airline crash by failing to properly train a pilot. The theory of criminal liability in Boeing had to be based on the company's interactions with the Federal Aviation Administration (FAA), a weak, arguably captured agency that Boeing persuaded to permit the company to distribute the aircraft without providing pilots of previous 737 models with in-person

[319]Nicole M. Argentieri, Acting Assistant Att'y Gen., Crim. Div., Remarks at the American Bar Association 10th Annual White Collar Crime Institute (Oct. 10, 2023), https://www.justice.gov/opa/speech/acting-assistant-attorney-general-nicole-m-argentieri-delivers-remarks-american-bar.

[320]David Schaper, *Boeing 737 Max Software Fix and Report on Fatal Crash Expected This Week*, NPR (Mar. 26, 2019, 10:09 PM), https://www.npr.org/2019/03/26/707050572/boeing-737-max-software-fix-and-report-on-fatal-crash-expected-this-week.

[321]*Id.*

[322]*See generally* Peter Robison, Flying Blind: the 737 Max Tragedy and the Fall of Boeing 137-39 (2021). Robison's account is comprehensive and fully situates the causes of the disaster within the corporate history, structure, and culture of Boeing. *See id.* at 132-33 (discussing pressure applied by Boeing management to decrease costs and increase efficiency, often at the expense of quality).

simulator training on the altered flight control system.[323] (Pilots were certified for the MAX by completing a program installed on an iPad.)[324] In a deferred prosecution agreement with the DOJ, harshly criticized for its leniency and subject to ongoing litigation,[325] Boeing admitted that it conspired to defraud the FAA by concealing the extent and implications of innovations in the aircraft's operating system.[326] The company wanted to ensure that the FAA would not require expensive in-person retraining of pilots that would have raised the plane's price to a level inconsistent with Boeing's marketing strategy.[327]

The DOJ prosecuted a single individual: Mark Forkner, Boeing's lead technical pilot for the 737 MAX project.[328] Under the DOJ's theory, Forkner could be proven to have (1) understood the company's intense desire to persuade the FAA not to require in-person retraining, (2) understood the danger of pilots not reacting in a fully informed way to the new operating system, and (3) interacted directly with the FAA while minimizing the impact of the new system.[329] In one email, Forkner said to a colleague, "so I basically lied to the regulators (unknowingly)"; in another, he described FAA personnel as "dogs watching TV."[330] A jury in Fort Worth acquitted Forkner after less than two hours of delibera-

[323] *See* Deferred Prosecution Agreement at A-6, United States v. Boeing Co., No. 4:21-CR-005-O (N.D. Tex. 2022); *see also* United States v. Boeing Co., No. 4:21-CR-5-O, 2022 WL 13829875, at *6 (N.D. Tex. 2022).

[324] *See Boeing Co., 2022 WL 13829875, at *2*.

[325] *See, e.g.*, John C. Coffee, Jr., *Nosedive: Boeing and the Corruption of the Deferred Prosecution Agreement*, HARV. L. SCH. F. CORP. GOVERNANCE (May 25, 2022), https://corpgov.law.harvard.edu/2022/05/25/nosedive-boeing-and-the-corruption-of-the-deferred-prosecution-agreement/; *Boeing Gets Prosecution Deferred Families Get Justice Denied*, CORP. CRIME REP. (Jan. 11, 2021, 9:47 PM), https://www.corporatecrimereporter.com/news/200/boeing-gets-prosecution-deferred-families-get-justice-denied/. For recent developments, see Benjamin Mullin, *Boeing Violated Settlement Over 737 Max Problems, Justice Dept. Says*, N.Y. TIMES (May 14, 2024), https://www.nytimes.com/2024/05/14/business/boeing-justice-department-settlement.html; David Shepardson, *Boeing 737 Max Plea Deal Withstands Challenge from Victims' Families*, REUTERS (Feb. 10, 2023, 1:07 PM), https://www.reuters.com/legal/us-judge-rejects-family-members-bid-reopen-boeing-737-max-plea-deal-2023-02-10/; Michael Laris, *Judge Rules DOJ Violated Rights of Boeing Max Victims in Prosecution Deal*, WASH. POST (Oct. 21, 2022, 10:28 PM), https://www.washingtonpost.com/transportation/2022/10/21/boeing-max-justice-department/.

[326] Deferred Prosecution Agreement, *supra* note 323, at A-1, A-5.

[327] *See id.* at A-6.

[328] *See* Indictment at 4-5, United States v. Forkner, No. 4:21-CR-268-O (N.D. Tex. 2021).

[329] *See id.* at 5-7.

[330] Dominic Gates, *Why Boeing Pilot Forkner Was Acquitted in the 737 MAX Prosecution*, SEATTLE TIMES (Mar. 26, 2022, 11:12 AM), https://www.seattletimes.com/business/boeing-aerospace/why-boeing-pilot-forkner-was-

tions, likely because his defense raised doubts about whether Forkner, who was not an engineer, realized the extent and implications of the changes to the aircraft.[331]

Some—including, of course, Forkner's lawyer—have argued that Forkner was a "scapegoat" or a "fall guy" served up by the company to appease compliant prosecutors.[332] While there might be something to that, it is not clear how a more determined prosecutor could have established the level of knowledge and intent that would have been required to convict anyone else at Boeing of defrauding the FAA. A prosecutor would have needed to prove, beyond a reasonable doubt, knowledge and understanding of the details of the engineering problem and its training implications, along with knowledge of and participation in specific discussions with the FAA about pilot certification requirements. As in the GM and BP cases, connecting engineering details to senior, non-engineer management personnel within an extremely large corporation can be difficult, even with visibility into all internal records and access to all witnesses. Ironically, the frightening January 5, 2024, midair blowout on an Alaska Airlines 737, and subsequent reporting on the incident, pointed again to failures of systems and engineering controls and seems to offer no further support for theories of criminal liability of individuals within Boeing.[333]

The SEC's later administrative settlement with Boeing, in which the company neither admitted nor denied negligence liability under Section 17 of the Securities Act, was based on the effect on Boeing's stock price of statements made by its CEO about how the company was responding to the crashes and government investigation.[334] The SEC alleged that it was fraud for the CEO in a press release to call the aircraft "as safe as any airplane that has ever flown the skies" when the company knew that re-evaluation of the software system was underway.[335] To put it mildly, that statement would not have been a compelling basis on which to transform a case about engineering failures and deaths into a criminal prosecution of Boeing's CEO for

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acquitted-in-the-737-max-prosecution/.

[331] *See id.*

[332] *Id.*

[333] *See* James Glanz et al., *How Did a Boeing Jet End Up With a Big Hole?*, N.Y. TIMES (Jan. 23, 2024), https://www.nytimes.com/interactive/2024/01/23/business/boeing-alaska-airlines-door-plug.html.

[334] Boeing Co., Securities Act Release No. 11105 (Sept. 22, 2022), https://www.sec.gov/files/litigation/admin/2022/33-11105.pdf.

[335] *Id.* at 2.

defrauding the company's shareholders.[336]

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The objective of the preceding part has been to suggest—anecdotally, of course—that it may be unrealistic to expect successful prosecutions of significant numbers of individuals in large corporate scandals, even outside the context of fraud within financial institutions. While financial fraud presents special problems due to the nature of the crimes, as explored in Part I, obstacles to individual prosecution can arise from the realities of the large corporate form, even in instances of risks and harms associated with consumer products or industrial processes that do not involve complex securities. This Article now turns to the implications of its argument that increased individual prosecutions are as readily available a means of dealing with corporate wrongdoing as many have believed them to be.

## III What is to Be Done?

The goal of this Article has been to marshal evidence to dissuade the reader from believing that increased commitment of prosecutors to indicting more individuals is a simple path to significantly reducing levels of corporate crime. Reform of corporate regulation is far too complex and broad a topic for adequate treatment in an already lengthy article. However, a reader moved, or perhaps even persuaded, by the preceding argument will want to have in view where else attention might be placed in the important project of reducing corporate wrongdoing. This Part will briefly address the comparative prospects of alternative tools for controlling corporate crime.

### *A. More Prosecutors and Agents*

Start within current institutions of criminal prosecution. It is undeniable that the number of federal investigators (primarily FBI, IRS, Postal Service, and Treasury agents) and prosecutors is extremely small in relation to the massive size of the modern corporate economy.[337] More personnel should be urged and welcomed by anyone concerned with the incidence of fraud, bribery, and environmental and consumer harms in large corporations, and the continued attractiveness of those behaviors within

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[336] *See* Emily Strauss, *Is Everything Securities Fraud?*, 12 U.C. IRVINE L. REV. 1331, 1333-34 (2022) (documenting and questioning practice of sanctioning a nearly limitless variety of corporate misconduct as securities fraud on theories of price impact flowing from nondisclosure of later revealed misconduct).

**[Section III]**

[337] *See* Richman, *supra* note 23, at 273.

the incentive systems in which corporate personnel work.[338]

This Article's findings should be concerning, however, for those who might think that more enforcers would translate naturally into more punishment—at least of the sorts of behaviors that produce sophisticated, sustained, and harmful corporate crime. More agents and prosecutors would not have reversed the outcome in any case discussed in this Article. Elbow grease is not going to get past barriers to criminal liability that this Article has shown arise from the nature of transactions in many markets and industries, and the complexity of decision-making within very large corporations.

More assets would produce more cases, because government actors need to show they are doing the job they were hired to do. The question is, what kinds of cases? A likely product would be more cases that are relatively unimportant to systemic deterrence, rather than more deep digging at the highest levels followed by more convictions of senior personnel of the largest corporations. A thrust of Parts I and II of this Article was to expose the difficulties prosecutors run into even when they select what look like the most provable cases within corporate scandals and competently present evidence obtained through corporate cooperation. The project of dealing with corporate crime would not advance if it followed a path comparable to the one that has characterized the federal government's decades-long approach to narcotics control: the addition of agents and prosecutors who, needing to compile records and justify funding, select lower-level, easier cases that add prisoners but make little dent in the overall problem.

### *B. New Substantive Criminal Law*

In many of the cases discussed in this Article, prosecutors encountered problems associated with proving that individuals engaging in what might broadly be described as misconduct on the job acted with sufficient knowledge of relevant facts and improper intent to be found liable. This difficulty increases as enforcement scrutiny rises the corporate ladder to examine the conduct of managers who are often several steps removed from the knowledge and action that comprise ground-level misconduct. Lowering this bar for prosecutors could be expected to ease paths to conviction, producing more frequent punishment and greater deterrence.

Exploring how to redefine business crimes is beyond the ambit of this Article. To have a significant impact, such moves would need to be relatively radical, would have to be accomplished

[338] *See id.* at 276.

legislatively, and would amount to an admission that more effort toward individual prosecutions under present legal regimes will not be sufficient to accomplish deterrence objectives.[339]

There are two major challenges for a criminal law reform agenda in this field. First, the most obvious path to easing conviction, given this Article's findings, would be to lower the mens rea for serious corporate crimes by, for example, making it a felony for a corporate manager to be reckless (to disregard known serious risks) or negligent (to fail to consider serious risks) about whether a firm's sales personnel are causing customers to be materially misled or engineers are signing off on dangerous industrial processes. Such moves would challenge longstanding commitments in Anglo-American criminal law about the level of individual moral fault required to justify imprisoning a person for any substantial period.[340] Maybe such a debate is due, but its stakes should be fully faced.

Second, substantially altering crime definitions changes the nature of what is being deterred. If making crimes easier to prove is the path to more deterrence, one must consider whether broader offense definitions would end up deterring conduct well beyond the undesirable activities that motivated law reform. Criminalizing negligent or reckless management has the downside of discouraging many forms of risk-taking, including possibly the sorts of acceptable risks that businesses take when pursuing socially valuable profits and innovations.[341] As this Article has shown, one of the reasons that it can be difficult to prove criminal fault in the business context is that employees act in an environment largely consisting of legal and socially approved conduct. This makes line-drawing difficult, and accurately identifying who has crossed lines even harder. Moving the lines

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[339] I have engaged with the question previously in more depth. *See, e.g.*, Samuel W. Buell, *The Responsibility Gap in Corporate Crime*, 12 Crim L. & Phil. 471, 473-77 (2018); Samuel W. Buell, *Culpability and Modern Crime*, 103 Geo. L.J. 547, 547 (2015) [hereinafter Buell, *Culpability*]; Samuel W. Buell, *Novel Criminal Fraud*, 81 N.Y.U. L. Rev. 1971, 1973 (2006); Buell, *Criminally Bad Management, supra* note 306, at 70; Samuel W. Buell, *Fraud, in* Palgrave Handbook of Applied Ethics and Criminal Law 265 (L. Alexander & K. Ferzan eds., 2019). For a detailed argument that *clarification* and *rationalization* of federal white-collar crimes, rather than expansion of offenses, would produce more publicly satisfying enforcement processes, see BAER, *supra* note 12, at 174-200.

[340] *See* Buell, *Culpability, supra* note 339, at 549.

[341] A striking post-financial-crisis statute in the United Kingdom, which does not appear to have been enforced against anyone, makes it a serious crime to (1) be a senior manager of a financial institution, (2) participate in a decision or fail to prevent a decision, (3) which decision caused the failure of the institution, (4) while aware that the decision risked the failure of the institution, and (5) having acted below what can reasonably be expected of a person in one's position. United Kingdom Financial Services Act 2013 § 36.

would require rethinking the fundamental question of what is socially desirable. New lines will also turn out to be hard to draw and police, because most industrial activities will not be relegated to the status of prohibited black markets.

### *C. Stronger Civil Liability*

If individual prosecutions involving many corporate crimes are difficult due to the high criminal burden of proof and frequently demanding mens rea requirements, then civil regulatory enforcement may be a more promising route to the imposition of wider liability.[342] The burden of proof is lower in civil cases, and some regimes, including securities regulation, allow for liability on a showing of only recklessness or negligence, or in some instances strict liability.[343] Corporate actors arguably can be motivated through economic incentives provided by fines; these incentives, after all, often explain decisions to engage in misconduct in the first instance.

This Article has provided some evidence, however, that imposition of even civil liability in contested cases can be difficult for the government. This, coupled with inexperience in the field of trial lawyering, may partly explain why civil regulators are so conditioned to negotiate settlements with both firms and individuals across so many cases and industries.[344] Settlements, of course, produce lower penalties. The question of whether civil regulatory sanctions are high enough to deter has long loomed over civil enforcement, especially in the financial sector.[345] Problems include whether individuals are frequently insolvent in relation to a sufficiently deterrent sanction; whether laws and markets concerning insurance and indemnification defang the effect of monetary sanctions; whether Congress has provided steep enough statutory penalties; and whether the probability of successful enforcement is high enough to influence individuals who may have succeeded at work because of high appetite for risk and consistent overconfidence. The civil settlement data in the financial industry cases detailed in the Appendices to this Article show individual

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[342] *See* Vikramaditya S. Khanna, *What Rises from the Ashes?*, 47 J. CORP. L. 1029, 1041-42 (2022).

[343] *See, e.g.*, 15 U.S.C. § 77q (Section 17(a) of the Securities Act of 1933); 33 U.S.C. § 1319 (Clean Water Act enforcement); *see also* Miriam Baer, *The Information Shortfalls of Prosecuting Irresponsible Executives*, 70 DEPAUL L. REV. 191, 197 (2022) (discussing and critiquing strict liability for corporate managers).

[344] *See* Speech from Luis A. Aguilar, Comm'r, SEC, A Stronger Enforcement Program to Enhance Investor Protection (Oct. 25, 2013), https://www.sec.gov/news/speech/2013-spch102513*l*aa (stating that SEC settles roughly 98 percent of its enforcement cases); *see also* Samuel W. Buell, *Liability and Admissions of Wrongdoing in Public Enforcement of Law*, 82 U. CIN. L. REV. 505, 509 (2013).

[345] *See, e.g.*, Buell, *supra* note 344, at 517.

fine levels that intuitively do not appear large enough to have potent deterrent effects.[346]

Opportunities surely remain for redesign of civil enforcement regimes and institutions that might produce a greater level of fear among corporate actors about severe or total loss of wealth and livelihood from decisions to commit fraud and other offenses. If a deficit from too infrequent success in salient individual prosecutions is a public sense of insufficient accountability for misconduct within corporations, perhaps civil enforcement regimes could be fortified with types of penalties—such as wider availability of individual suspensions and debarments within industries—that would produce greater expressive effects from enforcement as well as more effective deterrence.

### *D. Whistleblowing Regimes*

The best instrument for increasing the probability of sanctions, and thus deterrence, is to increase the frequency with which corporate crimes are detected. More instances of detection would not change the probability of conviction and punishment in any given case. But collecting more cases at the input end of the criminal enforcement process could, following investigation and sorting, yield a greater number of winnable cases at the output end.

The currently most popular idea for enhancing the detection of corporate crime is whistleblower incentives.[347] Corporate conduct cannot be surveilled by law enforcement in the manner used to investigate, for example, narcotics trafficking or organized crime. Large corporations are complex, opaque, and generally engaged in lawful activity. The government most often obtains its leads through the following means: (1) voluntary corporate self-reporting, provided in return for leniency in corporate settlements; (2) routine surveillance activities of certain markets, like securities exchanges and banking systems, by civil regulators; (3) investigative journalism; and (4) disclosure of corporate crimes by individuals seeking leniency who happen to be charged for other offenses.[348] If limited to these avenues, the government is forced into a mostly passive role in searching for cases to investigate. When statutes grant agencies the power to offer financial rewards to those who can lead investigators to corporate

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[346] *See infra* Appendices A-C.

[347] *See, e.g.*, Usha R. Rodrigues, *Optimizing Whistleblowing*, 94 Temp. L. Srev. 255, 265 (2022); Geoffrey Christopher Rapp, *Beyond Protection: Invigorating Protections for Sarbanes-Oxley Corporate and Securities Fraud Whistleblowers*, 87 B.U. L. Rev. 91, 97 (2007).

[348] *See, e.g., How Investigations Work*, SEC, https://www.sec.gov/enforcement/how-investigations-work (May 14, 2024).

crimes, agents and prosecutors have more leverage for surfacing misconduct.

While the False Claims Act is old,[349] the whistleblower award regime under federal securities laws is still fairly new.[350] There is much more to be learned about the balance of costs and benefits in whistleblower regimes and the optimal design and administration of such systems. To return to the idea of adding more prosecutors and agents, enhancing enforcement personnel may be most effective if coupled with greater incentives for persons inside corporations to reveal crimes.[351] Again, without better means of detecting serious offenses, the addition of prosecutors and agents may only produce increased case filings that do not address the most serious and higher-level corporate behaviors that too often evade legal control.

### *E. Corporate Liability*

A main theme in the case for greater imposition of individual liability has been a belief that corporate criminal liability does not adequately deter because it does not sufficiently affect managers and employees of public companies and because the government has been unwilling to impose sufficiently harsh or crippling penalties on corporations.[352] This view somewhat misses the current objective with which corporate criminal liability is practiced, for better or worse.[353] The DOJ's primary use of corporate criminal liability is as a lever to extract from corporations evidence that otherwise would be difficult and expensive for prosecutors to acquire.[354] Relatedly, the DOJ uses the threat of corporate liability to incentivize firms to take measures to prevent employee

[349]*See*31 U.S.C. § 3729; Jacob T. Elberg, *Health Care Fraud Means Never Having to Say You're Sorry*, 96 Wash. L. Rev. 371, 373 (2021) (examining recent false claims act enforcement practice).

[350]*See*15 U.S.C. § 78u-6; Jennifer B. Poppe & Joe K. O'Connell, *Whistleblower Protection Under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 45 SEC. Reg. L.J. 391, 393 (2017); Philip G. Berger & Heemin Lee, *Did the Dodd-Frank Whistleblower Provision Deter Accounting Fraud?*, 60 J. Acct. Rsch. 1337, 1338 (2022).

[351]A related avenue is to consider how law enhances or reduces incentives for outsiders to uncover fraud. *See, e.g.*, Peter Molk & Frank Partnoy, *The Long-Term Effects of Short Selling and Negative Activism*, 2022 U. Ill. L. Rev. 1, 58-59.

[352]For recent articles canvassing debates and sources on corporate criminal liability, a starting point is the collection at 47 J. Corp. L. 861 (2022).

[353]*See* Arlen & Buell, *supra* note 10, at 705-09.

[354]In its recent policy announcement emphasizing the centrality of corporate self-reporting and timely cooperation to leniency in sanctioning, the Biden DOJ could not have been more explicit about its commitment to this theory. *See* Monaco, *supra* note 7, at 6-9.

crime before it occurs.[355] The more direct criticism is thus that the DOJ has not been following through on its use of corporate criminal liability to produce more individual convictions and punishment.[356]

This Article has raised questions about how easily prosecutors can be expected to secure individual convictions even when corporations have cooperated and assisted prosecutors in locating, acquiring, organizing, and understanding often far-flung and complex evidence. Still, prosecutors would play a much weaker hand with corporate crime if they lacked the lever of corporate liability to enhance their investigative capabilities. The Yates Memo's direction to prosecutors to show their work on translating corporate cooperation into individual sanctioning was a welcome development.[357] The DOJ should continue to monitor and disclose whether corporate criminal settlements produce individual cases. However, observers should be realistic about how reliably the government, even with full corporate cooperation, can convert settlements into individual convictions.[358]

### *F. Advanced Compliance Management*

Law need not concern itself with deterring corporate crimes that do not occur because they have been prevented by non-legal instruments. If law never intervenes, no sanctions are imposed, and both individuals and corporations have avoided the costs of enforcement. This is the primary reason why all large corporations operate compliance programs and why corporate law imposes a duty of care on officers and directors to monitor and prevent employee crime.[359]

Compliance is all the rage.[360] The field is still young, perhaps promising that management science may evolve to a point of

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[355] *See id.* at 2, 9-10.

[356] *See* Garrett, *supra* note 9, at 1790-91.

[357] Yates Memo, *supra* note 7, at 6.

[358] There remain deterrent reasons for imposition of corporate criminal liability even if individual prosecutions cannot be achieved. *See* Samuel W. Buell, *A Restatement of Corporate Criminal Liability's Theory and Research Agenda*, 47 J. CORP. L. 937, 941 (2022); Samuel W. Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L.J. 473, 500 (2006).

[359] *See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 968-70 (Del. Ch. 1996)*; *In re* Boeing Co. Derivative Litig., No. 2019-0907, 2021 WL 4059934, at *24 (Del. Ch. 2021).

[360] *See, e.g.*, Martinez, *supra* note 302, at 254-56; Miriam H. Baer, *Compliance Elites*, 88 FORDHAM L. REV. 1599, 1600-02 (2019); Stavros Gadinis & Amelia Miazad, *The Hidden Power of Compliance*, 103 MINN. L. REV. 2135, 2138-40 (2019); James A. Fanto, *The Professionalization of Compliance: Its Progress, Impediments, and Outcomes*, 35 NOTRE DAME J.L. ETHICS & PUB. POL'Y 183, 184-86 (2021); Roy Shapira, *A New* Caremark *Era: Causes and Consequences*, 98 WASH.

greater effectiveness in operating firms within the confines of the law. As exceedingly important as this instrument is in understanding how to deal with corporate crime, one should not get carried away. The reason corporations must worry so much about compliance is that there are powerful incentives—which one can see abundantly in the cases discussed in this Article—for individuals to commit corporate crimes. Those incentives, just like the compliance programs that try to deal with their consequences, are products of corporate management. A corporation engaging in compliance efforts, particularly in industries like finance and pharma that run on high levels of bonus-driven compensation, can be a bit like an owner who trains an attack dog and then constantly struggles up and down the street with the leash to keep the dog from biting.[361]

Integration of the legal field of compliance studies and fields of management science have a long way to go before we can understand how to effectively reconcile profit incentives with controls against law violations. Indeed, the present consensus around the need for wider imposition of individual criminal liability has grown over the same decades that compliance studies, compliance engineering, and legal incentives for strong compliance have boomed.[362] The modern conception of corporate compliance has been helping but not exactly working. The DOJ's recent enforcement actions are replete with stories of weak and ignored compliance systems even at the largest brand-name firms that should have the greatest incentives to manage prudently. This is not a reason for pessimism on the project of internal prevention of corporate crime, but rather cause to urge that the field of compliance needs more study, more experimentation, and more thinking about how to deal with its basic structural challenge.

### *G. Ex Ante Regulation*

When I teach a survey course in corporate crime each year, a recurring theme in class discussion is the relationship between each scandal under study and the background regulatory framework that applies to the industry in question. It is not just that the regulations and regulators failed to prevent the problem.

U. L. REV. 1857, 1858-59 (2021); John Armour et al., *Taking Compliance Seriously*, 37 YALE J. ON REG. 1, 10-11 (2020).

[361]The DOJ has made a recent move to try to alter incentives by providing corporations with greater rewards for clawing back compensation from wrongdoers and bonusing employees who devote efforts to compliance. *See* Memorandum from the U.S. Dep't of Just., The Criminal Division's Pilot Program Regarding Compensation Incentives and Clawbacks 1-3 (Mar. 2, 2023), https://www.justice.gov/criminal-fraud/file/1571941/download.

[362]*See, e.g.*, Gadinis & Miazad, *supra* note 360, at 2138-40; Fanto, *supra* note 360, at 184-86.

It is that, over and over, regulation explains the problem—by constituting the target zone and motivation for the misconduct.

Boeing hit its price target for the 737 MAX by steamrolling FAA personnel whose job it was to require pilots to undergo sufficient training on a new flight system. Volkswagen cheated thousands of buyers about the performance of its diesel engines by easily deceiving the EPA's robotic and predictable emissions testing system. Traders exploited manipulable benchmark indices to generate easy profits in interest rate and currency markets. Other traders used their freedom to play with mark-to-market accounting to hide severe book losses in over-the-counter deals involving bespoke derivative instruments. The story repeats over and over when a corporate scandal erupts, and the backward-looking examination of causation follows.

It is an obvious point, but one that cannot be repeated too often. Good regulation, reliably enforced, is a far more desirable way to referee the line between corporate profit-making and corporate misconduct than a federal prison. Perhaps corporate criminal law has grown so much as a field in the last several decades because regulation has been pummeled by a long, massively funded attack on "big government," "the regulatory state," "wasteful regulation," and the like.[363] It is much harder politically for corporations to say they find crime acceptable than to say that "regulations" (some of which carry criminal penalties) are stifling economic growth. If the project of managing corporate activity to keep Americans safe from fraud, pollution, corruption, and other abuses has turned to criminal punishment while beating a retreat from ex ante regulation, that is a shame. Valuable ground may have been lost. But no one should be under the illusion that indicting more individuals when corporate scandals erupt is a winning strategy for taking back that ground. Future work should more closely examine the relationship between regulatory regimes and corporate crime with the goal of shaping regulations to be more effective, or at least not criminogenic.

## CONCLUSION

This Article has sought to persuade the reader that individual prosecutions are not as readily available a means of reducing the incidence of corporate crimes as believed, at least within large corporations and especially in financial markets. The current

[363] *See, e.g.*, Peter M. Shane, *The Quiet GOP Campaign Against Government Regulation*, Atlantic (Jan. 26, 2017), https://www.theatlantic.com/politics/archive/2017/01/gop-complicatesregulation/514436/; Michael Waldman, Opinion, *Supreme Court's Next Target: The Regulatory State*, Brennan Ctr. for Just. (May 2, 2023), https://www.brennancenter.org/our-work/analysis-opinion/supreme-courts-next-target-regulatory-state.

contrary belief, which has its origins in the potent politics of the financial crisis of 2008 to 2009 and the Great Recession, has been enduring. The impulse is understandable, in part because deterrence theory has pointed for so long, and so strongly and intuitively, to the power of threatening profit-and-loss-motivated individuals with meaningful risks of imprisonment.

Yet few corporate miscreants seem to land in prison in relation to the size of the corporate sector and the incidence of corporate scandals. The objective in Parts I and II of this Article was to show, through a close study of litigation on the ground, how that results at least as much from the difficulty of obtaining convictions as from the government's taste for seeking indictments. Structurally, corporate crime involves problems of criminal intent and individuation of responsibility for corporate actions that institutional design in criminal enforcement cannot alone solve. Thus, as Part III of the Article explored, debate about how to deal with corporate crime should take that difficulty more seriously and treat it as cause for paying greater attention to alternative means of control, especially projects of ex ante regulation that have lost influence and are too often motivators for corporate crime rather than the barriers those projects ought to be.

## APPENDIX A[364]

## MORTGAGE-BACKED SECURITIES CRIMINAL & CIVIL OUTCOMES

### TABLE A1: MBS CRIMINAL PROSECUTION SUMMARY

| | GUILTY PLEA | TRIAL CONVICTION | ACQUITTAL | OVERTURNED | TOTAL |
|---|---|---|---|---|---|
| Overall Outcomes | 1 | 2 | 5 | 1 | 8 |
| Subject to Imprisonment | 1 | 1 | — | 1 | 2 |

[364]Comprehensive data on all MBS-related civil-enforcement actions was gathered by searching the SEC's list of financial crisis-related civil enforcement actions centered on individuals charged with fraud related to mortgage-backed securities. *See, e.g., SEC Enforcement Actions Addressing Misconduct That Led to or Arose From the Financial Crisis*, SEC, https://www.sec.gov/spotlight/enfactions-fc.shtml (July 5, 2019) (listing every enforcement action brought by SEC in response to the 2008 Financial Crisis). While there is no central repository for DOJ criminal prosecutions, a search of "mortgage-backed securities" prosecutions on www.justice.gov generated press releases indicating five criminal prosecutions had been brought by the DOJ. Searching "mortgage-backed securities individual prosecutions" on news databases *Bloomberg, The Wall Street Journal*, and *Thomson Reuters*, those five prosecutions were identified and were then further researched by reference to their criminal docket entries.

| | GUILTY PLEA | TRIAL CONVICTION | ACQUITTAL | OVERTURNED | TOTAL |
|---|---|---|---|---|---|
| Average Sentence | 30 mo. | 0 mo.[a1] | — | — | 10 mo. |
| Average Time in Custody | 26 mo. | 4 mo.[d1] | — | — | 11 mo. |

[a1] Michael Gramins was sentenced to two years' probation.

[d1] Jesse Litvak spent eight months in custody before the Second Circuit overturned his conviction; Gramins was never in federal custody.

## TABLE A2: MBS CIVIL ENFORCEMENT SUMMARY

| | LIABLE | NOT LIABLE | SETTLED | TOTAL |
|---|---|---|---|---|
| Overall Outcomes | 1 | 1 | 32 | 34 |
| Fines | 1 | 0 | 20 | 21 |
| Average Fine | $650,000 | — | $813,324 | $805,547 |
| Disgorgements | 1 | 0 | 12 | 13 |
| Average Disgorgements | $175,463 | — | $4,452,851 | $4,123,821 |

## TABLE A3: MBS MAJOR CRIMINAL PROSECUTIONS

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | SENTENCE |
|---|---|---|---|---|---|
| R. Cioffi | Bear Stearns | D.O.J.[a1] | Not Guilty | Nov. 10, 2009 | None |
| M. Tannin | Bear Stearns | D.O.J. | Not Guilty | Nov. 10, 2009 | None |
| K. Serageldin | Credit Suisse | D.O.J. | Guilty Plea | Apr. 12, 2013 | 30 mo. |
| J. Litvak | Jeffries | D.O.J. | Conviction O.T.[d1] | Apr. 26, 2017 | 24 mo. |
| R. Shapiro | Nomura | D.O.J. | Not Guilty | June 15, 2017 | None |
| T. Peters | Nomura | D.O.J. | Not Guilty | June 15, 2017 | None |
| D. Demos | Cantor Fitzgerald | D.O.J. | Not Guilty | May 10, 2018 | None |
| M. Gramins | Nomura | D.O.J. | Trial Conviction | Dec. 30, 2020 | 2 yrs. probation |

[a1] Department of Justice.

[d1] Conviction overturned on appeal.

## TABLE A4: MBS CIVIL ENFORCEMENT ACTIONS

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | BAN/ FINE |
|---|---|---|---|---|---|
| C. Crittenden | Citigroup | S.E.C.[a1] | Penalty Imposed | July 29, 2010 | $100k fine |
| A. Tildesley Jr. | Citigroup | S.E.C. | Penalty Imposed | July 29, 2010 | $80k fine |
| B. Morrice | New Century | S.E.C. | Penalty Imposed | July 30, 2010 | $791k[d1] |
| P. Dodge | New Century | S.E.C. | Penalty Imposed | July 30, 2010 | $550k |
| D. Kenneally | New Century | S.E.C. | Penalty Imposed | July 30, 2010 | $188k |
| A. Mozilo | Countrywide | S.E.C. | Penalty Imposed | Oct. 15, 2010 | $67.5MM, ban |
| D. Sambol | Countrywide | S.E.C. | Penalty Imposed | Oct. 15, 2010 | $5.52MM, ban |
| E. Sieracki | Countrywide | S.E.C. | Penalty Imposed | Oct. 15, 2010 | $130k fine, ban |
| J. Kelsoe Jr. | Morgan Keegan | S.E.C. | Penalty Imposed | June 22, 2011 | $500k fine |
| J. Weller | Morgan Keegan | S.E.C. | Penalty Imposed | June 22, 2011 | $50k fine |
| R. Merk | Charles Schwab | S.E.C. | Penalty Imposed | Nov. 21, 2011 | $150k fine |
| R. Cioffi | Bear Stearns | S.E.C. | Penalty Imposed | June 18, 2012 | $800k |
| M. Tannin | Bear Stearns | S.E.C. | Penalty Imposed | June 18, 2012 | $250k |
| K. Daifotis | Charles Schwab | S.E.C. | Penalty Imposed | July 17, 2012 | $325k |
| B. Stoker | Citibank | S.E.C. | Not Liable | Aug. 6, 2012 | None |
| S. McMurty | Wells Fargo | S.E.C. | Penalty Imposed | Aug. 14, 2012 | $25k fine, susp. |
| L. Premo | Evergreen | S.E.C. | Penalty Imposed | Jan. 7, 2013 | 5 yr. ban |
| K. Seragel-din | Credit Suisse | S.E.C. | Penalty Imposed | Jan. 21, 2014 | $1MM Disg. |
| D. Higgs | Credit Suisse | S.E.C. | No Penalty | Jan. 21, 2014 | None |
| F. Siddiqui | Credit Suisse | S.E.C. | No Penalty | Jan. 21, 2014 | None |
| S. Siddiqui | Credit Suisse | S.E.C. | No Penalty | Jan. 21, 2014 | None |
| F. Tourre | Goldman Sachs | S.E.C. | Liable | Mar. 27, 2014 | $857k |
| R. Syron | Freddie Mac | S.E.C. | Penalty Imposed | Apr. 9, 2015 | $250k donation |
| P. Cook | Freddie Mac | S.E.C. | Penalty Imposed | Apr. 9, 2015 | $50k donation |

| DEFEN-DANT | INSTITU-TION | GOV. AGENCY | RESOLU-TION | RESOLU-TION DATE | BAN/ FINE |
|---|---|---|---|---|---|
| D. Bisenius | Freddie Mac | S.E.C. | Penalty Imposed | Apr. 9, 2015 | $10k do-nation |
| E. Dallavec-chia | Fannie Mae | S.E.C. | Penalty Imposed | Sept. 21, 2015 | $25k fine |
| T. Lund | Fannie Mae | S.E.C. | Penalty Imposed | Sept. 21, 2015 | $10k fine |
| J. Flannery | State Street | S.E.C. | Penalty O.T.[r1] | Dec. 9, 2015 | $6.5k fine, ban |
| J. Hopkins | State Street | S.E.C. | Penalty O.T. | Dec. 9, 2015 | $65 fine, ban |
| D. Mudd | Fannie Mae | S.E.C. | Penalty Imposed | Aug. 11, 2016 | $100k fine |
| W. Morales | Common-wealth | S.E.C. | Penalty Imposed | Feb. 15, 2016 | $130k fine |
| R. Shapiro | Nomura | S.E.C. | Penalty Imposed | Oct. 3, 2018 | $200k fine |
| T. Peters | Nomura | S.E.C. | Dismissed | Nov. 6, 2019 | None |
| M. Gramins | Nomura | S.E.C. | No Pen-alty | Apr. 26, 2022 | None |

[a1] Securities and Exchange Commission.

[d1] Where “fine” is not specified, the total refers to total fine + disgorgement + interest owed.

[r1] Penalty Overturned on Appeal.

## APPENDIX B[365]

## LIBOR CRIMINAL & CIVIL OUTCOMES

### TABLE B1: LIBOR CRIMINAL PROSECUTION SUMMARY (UNITED STATES & UNITED KINGDOM)

| | GUILTY PLEA | TRIAL CONVICTION | ACQUITTAL | OVERTURNED | DISMISSED/UNRES | TOTAL |
|---|---|---|---|---|---|---|
| Overall Outcomes | 6 | 10 | 11 | 4 | 15 | 42 |
| Subject to Imprisonment | 3 | 6 | 0 | 0 | 0 | 9 |
| Average Sentence | 14 mo. | 46 mo. | — | — | — | 33 mo. |

### TABLE B2: LIBOR CIVIL ENFORCEMENT SUMMARY

| | LIFETIME BAN | FINE | BOTH | WITHDRAWN | TOTAL |
|---|---|---|---|---|---|
| Overall Outcomes | 12 | 4 | 4 | 0 | 12 |

[365] Comprehensive data on all Libor criminal prosecutions was gathered by referencing DOJ and SFO press-release references to the number of prosecutions brought and Thomson Reuters' investigation summary chart. Next, those cases were identified by searching "Libor criminal prosecutions" and "Euribor criminal prosecutions" in various media databases, including *Bloomberg, The Wall Street Journal*, and *Thomson Reuters. See SFO Concludes Investigation into LIBOR Manipulation*, SERIOUS FRAUD OFF. (Oct. 18, 2019), https://www.sfo.gov.uk/2019/10/18/sfo-concludes-investigation-into-libormanipulation/ (stating SFO brought criminal charges against 13 individuals); *DOJ LIBOR Manipulation Investigation Chart*, THOMSON REUTERS 1-7 (Dec. 31, 2023), https://uk.practicallaw.thomsonreuters.com/w-001-0975?originationContext=document&transitionType=DocumentItem&contextData=(sc.Default)&ppcid=8997b4ac1790465b99579163e37f39b2&comp=pluk&firstPage=true (detailing the DOJ's Libor prosecutorial and investigative activity); *see, e.g.*, Nate Raymond, *Ex-Deutsche Bank Trader Pleaded Guilty in U.S. to Libor Scheme: Records*, REUTERS, (June 22, 2016, 12:50 PM), https://www.reuters.com/article/us-deutsche-bank-libor-crime/ex-deutsche-bank-trader-pleaded-guilty-in-u-s-to-libor-scheme-records-idUSKCN0Z81X5 (chronicling the prosecutions of Matthew Connolly and Gavin Black). Comprehensive data on all Libor civil-enforcement actions was gathered by referencing the Commodity Futures Trading Commission's (CFTC's) press release on Libor fines and by searching the U.K. Financial Conduct Authority's (FCA's) website for all individuals banned and fined in connection with the Libor scandal. *See* Press Release, Commodity Futures Trading Comm'n, CFTC Orders the Royal Bank of Scotland to Pay $85 Million Penalty for Attempted Manipulation of U.S. Dollar ISDAFIX Benchmark Swap Rates (Feb. 3, 2017), https://www.cftc.gov/PressRoom/PressReleases/7527-17 (listing all Libor-related fines, none of which were levied against individuals); *see, e.g.*, Press Release, Fin. Conduct Auth., FCA Decides to Ban Tom Hayes (Aug. 11, 2017), https://www.fca.org.uk/news/press-releases/fca-decides-ban-tom-hayes; Press Release, Fin. Conduct Auth., FCA Fines and Bans Former RBS Trader, Neil Danziger (Aug. 1, 2018), https://www.fca.org.uk/news/press-releases/fca-fines-and-bans-former-rbs-trader-neil-danziger.

| | LIFETIME BAN | FINE | BOTH | WITH-DRAWN | TO-TAL |
|---|---|---|---|---|---|
| Average Fine | — | £186,250[a1] | — | — | — |

[a1] All 12 major Libor enforcement actions were undertaken by the U.K.'s Financial Conduct Authority (FCA).

### TABLE B3: LIBOR CRIMINAL PROSECUTIONS (UNITED STATES & UNITED KINGDOM)

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | SENTENCE |
|---|---|---|---|---|---|
| T. Hayes | UBS | S.F.O.[a1] | Tr. Conviction | Aug. 2015 | 11 yr. |
| D. Read | ICAP | S.F.O. | Tr. Conviction | Jan. 28, 2016 | None |
| C Goodman | ICAP | D.O.J. | Not Guilty | Oct. 26, 2018 | None |
| D. Wilkinson | ICAP | S.F.O. | Jury Acquittal | Jan. 28, 2016 | None |
| T. Farr | ICAP | S.F.O. | Jury Acquittal | Jan. 28, 2016 | None |
| J. Gilmour | ICAP | S.F.O. | Jury Acquittal | Jan. 28, 2016 | None |
| N. Cryan | ICAP | S.F.O. | Jury Acquittal | Jan. 28, 2016 | None |
| J. Merchant | Barclays | S.F.O. | Tr. Conviction[f1] | July 2016 | 6.5 yr. |
| P. Johnson | Barclays | S.F.O. | Guilty Plea | July 2016 | 4 yr. |
| J. Mathew | Barclays | S.F.O. | Tr. Conviction | July 2016 | 4 yr. |
| A. Pabon | Barclays | S.F.O. | Tr. Conviction | July 2016 | 21 mo. |
| P. Robson | Rabobank | D.O.J.[d1] | Guilty Plea | Nov. 2016 | T.S.,[r1] 2 yr. S.R.[g1] |
| P. Thompson | Rabobank | D.O.J. | Guilty Plea | Nov. 2016 | 3 mo. |
| L. Stewart | Rabobank | D.O.J. | Guilty Plea | Feb. 2017 | T.S., 2 yr. S.R. |
| T. Yagami | Rabobank | D.O.J. | Guilty Plea | Mar. 2017 | T.S., 2 yr. S.R. |
| S. Contogoulas | Barclays | S.F.O. | Jury Acquittal | Apr. 29, 2017 | None |
| R. Reich | Barclays | S.F.O. | Jury Acquittal | Apr. 29, 2017 | None |
| A. Allen | Rabobank | D.O.J. | Conviction reversed | July 2017 | 1 yr., 1 day |
| A. Conti | Rabobank | D.O.J. | Conviction reversed | July 2017 | 1 yr., 1 day |
| A. Kraemer | Deutsche | S.F.O. | Not Guilty | June 29, 2018 | None |

| DEFEN-DANT | INSTI-TU-TION | GOV. AGENCY | RESOLU-TION | RESOLU-TION DATE | SENTENCE |
|---|---|---|---|---|---|
| C. Bittar | Deut-sche | S.F.O. | Guilty Plea | July 19, 2018 | 64 mo. |
| T. Parietti | Deut-sche | D.O.J. | Plea With-drawn; Dis-missed | Aug. 5, 2022 | None |
| S. Bohart | Bar-clays | S.F.O. | Not Guilty | Mar. 26, 2019 | None |
| M. Curtler | Deut-sche | D.O.J. | Plea With-drawn; Dis-missed | Sept. 6, 2022 | None |
| A. Haus-child | Deut-sche | S.F.O. | Not Guilty | July 5, 2019 | None |
| J. Vogt | Deut-sche | S.F.O. | No Extradi-tion | June 10, 2020 | None |
| A. Ghara-gozlou | Deut-sche | S.F.O. | No Extradi-tion | June 10, 2020 | None |
| K. Kap-pauf | Deut-sche | S.F.O. | No Extradi-tion | June 10, 2020 | None |
| C. Ber-mingham | Bar-clays | S.F.O. | Tr. Convic-tion | Dec. 9, 2020 | 5 yr. |
| C. Palombo | Bar-clays | S.F.O. | Tr. Convic-tion | Dec. 9, 2020 | 4 yr. |
| M. Con-nolly | Deut-sche | D.O.J. | Conviction Reversed[h1] | Jan. 2022 | None |
| G. Black | Deut-sche | D.O.J. | Conviction Reversed | Jan. 2022 | None |
| T. Mo-tomura | Rabo-bank | D.O.J. | Fugitive | Unre-solved | None |
| M. Bescond | SocGen | D.O.J. | Lit. Ongoin-g[aa1] | Unre-solved | None |
| D. Sindz-ingre | SocGen | D.O.J. | Lit. Ongoing | Unre-solved | None |
| T. Hayes | UBS | D.O.J. | Dismissed | Oct. 27, 2022 | None |
| R. Darin | UBS | D.O.J. | Indicted, no trial | Not Tried | None |
| D. Read | ICAP | D.O.J. | Dismissed | Not Tried | None |
| C. Good-man | ICAP | D.O.J. | Dismissed | Not Tried | None |
| D. Wilkin-son | ICAP | D.O.J. | Dismissed | Not Tried | None |
| S. Esper | SocGen | S.F.O. | No Extradi-tion[dd1] | Unre-solved | None |
| P. Mory-oussef | Bar-clays | S.F.O. | No Extradi-tion | Unre-solved | 8 yr. |

[a1] U.K. Serious Fraud Office

[d1] U.S. Department of Justice

[f1] Conviction Obtained at Trial

[aa1] Case Not Closed or Resolved

[r1] Time Served

[g1] Supervised Release

[h1] Conviction Overturned on Appeal

[dd1] France Refused to Extradite to the U.K.

## TABLE B4: LIBOR CIVIL ENFORCEMENT ACTIONS

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | BAN/FINE |
|---|---|---|---|---|---|
| M. Gardiner | R.P. Martin | F.C.A.[a1] | Penalty Imposed | 2015 | £210k fine, ban |
| M. Johnson | R.P. Martin | F.C.A. | Penalty Imposed | 2016 | £105k fine, ban |
| S. Scott | RBS | F.C.A. | Penalty Imposed | 2016 | Ban |
| J. Katz | Barclays | F.C.A. | Penalty Imposed | Aug. 26, 2016 | Lifetime Ban |
| C. Ashton | UBS | F.C.A. | Penalty Imposed | Aug. 11, 2017 | Lifetime Ban |
| M. Weston | Deutsche | F.C.A. | Penalty Imposed | 2018 | £180k fine, ban |
| P. Little | RBS | F.C.A. | Penalty Imposed | Jan. 2018 | £250k fine, ban |
| R. Usher | UBS | F.C.A. | Penalty Imposed | June 2018 | Lifetime Ban |
| R. Ramchandani | Deutsche | F.C.A. | Penalty Imposed | Sept. 14, 2018 | Lifetime Ban |
| J. Mathew | Barclays | F.C.A. | Penalty Imposed | Oct. 30, 2018 | Lifetime Ban |
| T. Farr | ICAP | F.C.A. | Penalty Imposed | May 29, 2019 | Lifetime Ban |
| C. Bermingham | Barclays | F.C.A. | Penalty Imposed | Sept. 27, 2021 | Lifetime Ban |

[a1] U.K. Financial Conduct Authority

## APPENDIX C[366]

## FOREX CRIMINAL & CIVIL OUTCOMES

### TABLE C1: FOREX CRIMINAL PROSECUTION SUMMARY

| | GUILTY PLEA | TRIAL CONVICTION | ACQUITTAL | NO EXTRADITION | TOTAL |
|---|---|---|---|---|---|
| Overall Outcomes | 2 | 2 | 3 | 1 | 8 |
| Subject to Imprisonment | 0[a1] | 2 | 0 | 0 | 2 |
| Average Sentence | 2 yr. S.R. | 16 mo. | — | — | 8 mo. |
| Average Time in Custody | 0 days | 10 mo. | — | — | 5 mo. |

[a1] Jason Katz and Christopher Cummins were both sentenced to time served plus supervised release and were not imprisoned before pleading guilty.

[366] Comprehensive data on all Forex criminal prosecutions was gathered by first referencing DOJ and SFO's Forex wrap-up press releases detailing the number of prosecutions brought. Next, "Forex individual prosecutions" were searched in media databases *Bloomberg, The Wall Street Journal, Thomson Reuters*, and *Law360*, the cases referenced in the agency press releases were found, and further research was done by reference to each case's docket number. *See* Press Release, Serious Fraud Off., SFO Closes Forex Investigation (Mar. 15, 2016), https://www.sfo.gov.uk/2016/03/15/sfo-closes-forex-investigation/ (explaining that zero Forex criminal prosecutions were brought in the UK); Press Release, U.S. Dep't of Just., Three Former Traders for Major Banks Indicted in Foreign Currency Exchange Antitrust Conspiracy (Mar. 9, 2017), https://www.justice.gov/opa/pr/three-former-traders-major-banks-indicted-foreign-currency-exchange-antitrust-conspiracy (stating that the DOJ criminally had charged six individuals to that point); Stewart Bishop, *HSBC FX Exec Said, 'I Think We Got Away with It,' Jury Hears*, LAW360 (Oct. 6, 2017, 10:39 PM), https://www.law360.com/articles/972351/hsbc-fx-exec-said-i-think-we-got-away-with-it-jury-hears (covering four additional DOJ Forex criminal prosecutions); *see generally* Docket, United States v. Usher, No. 1:17-CR-00019 (S.D.N.Y. 2018) (showing dockets for Richard Usher, Rohan Ramchandani, and Christopher Ashton). Comprehensive data on all Forex civil-enforcement actions was gathered by referencing FCA's list of Forex fines as well as the OCC and Federal Reserve's civil-enforcement actions from 2013 through May 2022. *See* Press Release, Fin. Conduct Auth., FCA Fines Barclays €284,432,000 for Forex Failings (Nov. 17, 2021), https://www.fca.org.uk/news/press-releases/fca-fines-barclays-%C2%A3284432000-forex-failings (listing every Forex fine imposed, which included only banks and zero individuals); *see, e.g.*, Final Decision at 1, *In re* Ashton, FRS Docket No. 16-015-CMP-1 (May 19, 2017) (banning and fining Christopher Ashton).

## TABLE C2: FOREX CIVIL ENFORCEMENT SUMMARY

| | LIFETIME BAN | FINE | BOTH | DISMISSED | TOTAL |
|---|---|---|---|---|---|
| Overall Outcomes | 7 | 2 | 2 | 2 | 9 |
| Average Fine | — | $612,500 | — | — | — |

## TABLE C3: FOREX CRIMINAL PROSECUTIONS

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | SENTENCE |
|---|---|---|---|---|---|
| S. Scott | HSBC | D.O.J.[a1] | No Extradition[d1] | July 31, 2018 | None |
| R. Usher | JPMorgan | D.O.J. | Not Guilty | Oct. 26, 2018 | None |
| R. Ramchandani | Citibank | D.O.J. | Not Guilty | Oct. 26, 2018 | None |
| C. Ashton | Barclays | D.O.J. | Not Guilty | Oct. 26, 2018 | None |
| J. Katz | Barclays | D.O.J. | Guilty Plea | Oct. 14, 2020 | T.S.,[f1] 2 yr. S.R.,[r1] fine |
| C. Cummins | Citibank | D.O.J. | Guilty Plea | Oct. 22, 2020 | T.S., 2 yr. S.R., fine |
| M. Johnson | HSBC | D.O.J. | Tr. Conviction[g1] | Nov. 2, 2020 | 2 yr., 3 yr. S.R., fine |
| A. Aiyer | JPMorgan | D.O.J. | Tr. Conviction | May 5, 2022 | 8 mo., 2 yr. S.R., fine |
| F. Cahill | HSBC | D.O.J. | N.P. Agreement[h1] | Not Tried | None |
| D. Khot | HSBC | D.O.J. | N.P. Agreement | Not Tried | None |

[a1] Department of Justice
[d1] U.K. Refused to Extradite to the U.S.
[f1] Time Served
[r1] Supervised Release
[g1] Conviction Obtained at Trial
[h1] Non-Prosecution Agreement

## TABLE C4: FOREX CIVIL ENFORCEMENT ACTIONS

| DEFENDANT | INSTITUTION | GOV. AGENCY | RESOLUTION | RESOLUTION DATE | BAN/FINE |
|---|---|---|---|---|---|
| M. Gardiner | UBS | Fed. Reserve[a1] | Penalty Imposed | July 2016 | Lifetime Ban |
| M. Johnson | HSBC | Fed. Reserve | Penalty Imposed | Oct. 5, 2016 | Lifetime Ban |
| S. Scott | Barclays | Fed. Reserve | Penalty Imposed | Oct. 5, 2016 | Lifetime Ban |

| DEFEN-DANT | INSTI-TU-TION | GOV. AGENCY | RESOLU-TION | RESOLU-TION DATE | BAN/FINE |
|---|---|---|---|---|---|
| J. Katz | Bar-clays | Fed. Re-serve | Penalty Imposed | Jan. 4, 2017 | Lifetime Ban |
| C. Ashton | Bar-clays | Fed. Re-serve | Penalty Imposed | May 19, 2017 | Lifetime Ban |
| M. Weston | Bar-clays | Fed. Re-serve | Penalty Imposed | July 21, 2017 | Lifetime Ban |
| P. Little | Bar-clays | Fed. Re-serve | Penalty Imposed | Apr. 2021 | Lifetime Ban, Fine |
| R. Usher | JPMor-gan | O.C.C.[d1] | Dismissed | No Pen-alty | None |
| R. Ram-chandani | Citibank | O.C.C. | Dismissed | No Pen-alty | None |

[a1] U.S. Federal Reserve

[d1] U.S. Federal Office of the Comptroller of the Currency

# ACTIVIST DIRECTORS: THE EVOLUTION OF HEDGE FUND ACTIVISM IN THE S&P 500*

*Anna Christie***

*The prevailing rhetoric associated with hedge fund activism is almost universally negative. This Article provides new evidence of activist hedge fund behavior that contradicts this dominant narrative. The principal argument of the Article is that the conventional picture of hedge fund activism requires updating to account for the phenomenon of activist board representation.*

*This Article makes two general contributions to academic and policy debates on hedge fund activism. First, it analyzes original, hand-collected data on all activist hedge fund campaigns at S&P 500 companies from 2010 to 2019. Currently, there is continued reliance on empirical studies of hedge fund activism that originate from the mid-2000s. However, hedge fund activism has evolved considerably over the past twenty years since these studies were published. Activist hedge funds now increasingly target America's largest companies—the S&P 500. An analysis of such campaigns has never before been seen in the literature. The study therefore contributes up-to-date insights on the activist campaigns most likely to have an outsized impact on companies, the economy, stakeholders, and society. Second, it demonstrates that a relatively new form of activism—activist board representation—manifests very differently to traditional perceptions of hedge fund activism. Now the most common campaign strategy, the appointment of activist directors can have a positive impact on target companies. In particular, activists seeking board seats often propose changes to corporate strategy and operations. This signifies a longer-term approach to substantive value creation, rather than the short-term*

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*financial engineering that activist hedge funds are commonly criticized for engaging in. The striking differences observed in campaigns where activist directors are sought, versus those campaigns where they are not, prompts some necessary reflection of the pervasive critiques of hedge fund activism.*

## ARTICLE CONTENTS

INTRODUCTION
I. ACTIVIST HEDGE FUNDS AND SHORT-TERMISM
  A. THE NARRATIVE OF SHORT-TERMISM
  B. BEYOND THE NARRATIVE: ACTIVIST HEDGE FUNDS AND SHORT-TERMISM
II. ACTIVIST BOARD REPRESENTATION
  A. THE EVOLUTION OF HEDGE FUND ACTIVISM
  B. RESEARCH QUESTIONS AND HYPOTHESES
III. ACTIVIST BOARD REPRESENTATION: AN EMPIRICAL STUDY
  A. SAMPLE CONSTRUCTION AND DATA DESCRIPTION
  B. DATA ANALYSIS
  C. DISCUSSION AND IMPLICATIONS
CONCLUSION
APPENDIX

## INTRODUCTION

"Who Bleeds When the Wolves Bite?" asked Leo Strine Jr., former Chief Justice of the Delaware Supreme Court, in his 2017 Yale Law Journal article critiquing the impact of activist hedge funds on human investors.[1] The prevailing rhetoric associated with activist hedge funds is almost universally negative. Vivid imagery of "Wall Street 'wolf packs' hunting down companies to close and jobs to eliminate"[2] depicts hedge fund activists as a destructive force in corporate governance. Activist hedge funds are accused of "attacking" companies, and their strategies are described as "edgy practices, accounting gimmickry, or never-ending cycles of spin-offs and mergers."[3] Overall, the picture presented is that activist hedge funds promote short-termism to the detriment of long-term sustainable value creation at the compa-

[1] Leo E. Strine Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 Yale L.J. 1870, 1874 (2017) [hereinafter *Who Bleeds*].

[2] Mark J. Roe, Missing the Target: Why Stock Market Short-Termism Is Not the Problem 5 (2022) [hereinafter Roe, Missing the Target].

[3] *Who Bleeds, supra* note 1, at 1874.

nies they target.

However, many cases of hedge fund activism do not neatly fit this caricature. An example is Starboard Value's proxy contest at Darden Restaurants in 2014. Here, Starboard presented a 294-page slide deck explaining in intricate detail how the activist hedge fund planned to execute a turnaround of the company.[4] The proposals largely focused on strategy and operations rather than resembling the short-term financial wizardry that activist hedge funds are commonly criticized for engaging in.[5] Similarly, an activist campaign by Trian Partners at Procter & Gamble ("P&G") in 2017 involved the hedge fund presenting a ninety-three-page white paper detailing the shortcomings of P&G's corporate strategy.[6] Uniquely, Martin Lipton, a vocal opponent of the campaign strategies of activist hedge funds, praised Trian's approach, noting that Trian's campaign sought to "promote longterm investment and growth."[7]

There are countless other examples of activist hedge funds presenting extremely detailed proposals to corporate management and the broader shareholder base which articulate in impressive depth the perceived flaws in the strategy and operations of target companies. These campaign tactics thus focus on substantive value creation rather than personifying the types of financial engineering that activist hedge funds are typically accused of. What else was different about these campaigns? In each of these campaigns, the activist hedge fund sought board representation. In the case of Darden, the strength of Starboard's proposal and the widespread dissatisfaction of other investors with the incumbent management led to a historic and unprecedented victory where the activist hedge fund succeeded in replacing the entire board of Darden with their own director nominees.[8] At P&G, Trian's founder Nelson Peltz also joined the board, despite narrowly losing his proxy fight.[9] These cases were outliers where activist campaigns proceeded to a full shareholder vote to

[4] Starboard Value, Transforming Darden Restaurants (2014), http://www.share-holderforum.com/dri/Library/20140911_Starboard-presentation.pdf.

[5] *Id.* at 5.

[6] Trian Partners, Revitalize P&G Together 3 (2017), https://trianpartners.com/wp-content/uploads/2017/01/Trian-PG-White-Paper-9.6.17-1.pdf.

[7] Martin Lipton, *The Trian/P&G Proxy Contest*, Harv. L. Sch. F. on Corp. Governance (Sept. 11, 2017), https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/.

[8] Stephen Foley, *Starboard Sweeps away Entire Darden Board*, Fin. Times (Oct. 10, 2014), https://www.ft.com/content/1be89158-5086-11e4-9822-00144feab7de.

[9] Siddharth Cavale, *P&G Appoints Peltz to Board Despite Losing Proxy Battle*, Reuters (Dec. 16, 2017, 5:39 AM), https://www.reuters.com/article/

determine whether activist hedge fund nominee(s) should join the board.[10] However, there are many other cases at very large companies where activist hedge funds sought and secured minority representation on the target company board, either for one of their own managers or for carefully chosen non-affiliated independent directors. Anecdotal evidence therefore suggests that the campaigns seeking board representation generally also involve the activist hedge funds putting forward detailed proposals on strategy and operations, rather than demanding quick returns to shareholders, such as dividends or share buybacks.

Hedge fund activism differs from activism by traditional institutional investors in several fundamental ways. Kahan and Rock have noted that such activism usually entails significant changes "to specific aspects of a company's business or management (such as share buy-backs, spin-offs, mergers, or the composition of the board of directors),"[11] higher costs,[12] and is characterized as "strategic and ex ante."[13] Hedge funds could hold great promise as active shareholders, but their tactics are critiqued for being infamously short-termist. Could activist board representation be associated with more beneficial forms of hedge fund activism rather than embodying the short-term financial engineering narrative that plagues activist hedge funds? This Article explores the question of whether the conventional portrayal of hedge fund activism requires updating to account for the phenomenon of activist board representation. Are activist hedge fund campaigns for board representation different in fundamental ways from campaigns that do not seek board representation? Should this particular form of hedge fund activism be encouraged rather than discouraged? While early activist hedge fund campaigns may have focused primarily on financial or balance sheet activism, it is investigated whether activist board representation has become a strategy of choice in the United States, especially among the largest companies and the most formidable activist hedge funds.

This Article contributes to multiple central debates in corporate governance and makes several important contributions to these academic and policy debates, as follows. This Article fills a gap in the literature by analyzing very recent cases of hedge fund activism at Standard & Poor's ("S&P") 500 companies. A study of

business/pg-appoints-peltz-to-board-despite-losing-proxy-battle-idUSKBN1E92ZA/.

[10]Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, 137 J. FIN. ECON. 1, 6 (2020) [hereinafter *Dancing with Activists*].

[11]Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1029, 1034, 1043-44 (2007).

[12]*Id.* at 1066.

[13]*Id.* at 1069.

activist campaigns at such large companies has not been seen in the literature before. I contribute a hand-collected dataset covering all activist hedge fund campaigns at S&P 500 companies from 2010 to 2019. The data presents original, up-to-date, empirical evidence of activist campaigns at the most economically and socially significant companies in the United States. Hedge fund activism is a fast-moving phenomenon and even very recent academic scholarship on hedge fund activism contains caveats due to a reliance on empirical studies which analyze hedge fund activism only until the mid-2000s.[14] The lack of an up-to-date study of activist campaigns at large companies has also led some scholars to downplay the potential impact of activist hedge funds due to assumptions that their campaigns primarily target smaller companies.[15] The new data that is analyzed in this Article can help to avoid such caveats being necessary in future academic scholarship as well as more generally contributing recent evidence to aid policy debates on hedge fund activism. Moreover, by focusing specifically on the largest companies and the most high-profile activist hedge funds, the study enables a precise evaluation of the actors that are most likely to have an outsized impact on stakeholders and society. The dataset therefore makes a significant contribution to understanding of recent activist hedge fund campaigns at large companies in the United States.

This Article is also the first empirical study to provide an in-depth comparison of activist hedge fund board representation campaigns with non-board level campaigns at S&P 500 companies, thus shedding light on what is now the most common form of hedge fund activism. A key contribution of this Article is to demonstrate that activist campaigns for board representation manifest differently from activist campaigns that do not involve a request for board representation. First, in terms of investment horizon, the average duration of activist board representation campaigns is significantly longer than the average duration of non-board level campaigns (approaching an average duration of four years, when the activist secures at least one board seat, compared with an average duration of nineteen months for non-

[14] *See infra* Part III.A.1.i.; John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 581 (2016) (noting that "all of these studies end generally no later than hedge fund interventions initiated in 2007").

[15] *See infra* Part III.A.1.ii.; BRIAN R. CHEFFINS, THE PUBLIC COMPANY TRANSFORMED 372 (2018) ("Gilson and Gordon likely overestimate the clout of activist hedge funds, which is significant but has been compromised from a governance perspective by the continued bias in favor of targeting smaller companies. . . .").

board level campaigns).[16] This permits an analysis of this form of hedge fund activism against the pervasive narrative of short-termism. The capital commitment involved in activist board representation campaigns is also much larger. In terms of campaign objectives, it is uncommon for activist hedge funds to engage in strategic and operational activism without also requesting at least one board seat. There is, therefore, a strong association between activist board representation and the activists seeking strategic and operational change. Activist hedge funds are also much more likely to campaign for, and succeed in, removing the Chief Executive Officer ("CEO") when they secure representation on a target company's board. At forty-six percent of S&P 500 companies where activists were successful in securing board seats, the CEO stood down within one year of the board seat(s) being granted.[17] For non-board level campaigns, only thirteen percent of CEOs exited within one year of activist involvement, which more closely resembles baseline CEO turnover.[18] Overall, an analysis of the striking differences in the campaigns when activist hedge funds pursue board representation, versus those campaigns where they do not, contributes new evidence of activist hedge fund behavior that contradicts current, dominant narratives. Perhaps most importantly, the analysis demonstrates that activist board representation campaigns tend to involve a longer-term approach to value creation through strategic and operational changes, rather than the short-term financial engineering that activist hedge funds are commonly criticized for.

This Article is organized as follows. Part I discusses short-termism, which is the most dominant critique of hedge fund activism. It explores the power of the short-termism narrative, and how activist hedge funds have largely failed in countering this narrative with their own competing account of management excess and waste. Part II introduces the phenomenon of activist hedge fund board representation and presents a theory and hypotheses on the potential value that might be associated with this type of activism. The theoretical discussion focuses on several key research questions that inform the empirical study that follows. Part III tests the hypotheses presented in the preceding Part II through an empirical study analyzing activist board representation campaigns at S&P 500 companies between 2010 and 2019. The empirical study analyzes 228 activist-target event pairs at 165 distinct S&P 500 companies during the ten-year period. Part IV concludes.

[16] *See infra* Part III.B.2.ii; *see also infra* Table 4.

[17] *See infra* Chart 16.

[18] *See infra* Chart 16.

# I Activist Hedge Funds and Short-Termism

## A. *The Narrative of Short-Termism*

Most discussions of hedge fund activism tend to be framed negatively— situating activism as a threat the board needs to defend itself against—rather than gleaning any positive insights from activist hedge fund campaigns. For example, Stevelman and Haan note that "activist hedge funds represent a trenchant, destabilizing force in contemporary governance."[19] Of all the criticisms of hedge fund activism, the "sharpest and most comprehensive criticism" is that it "exacerbates an already serious problem of 'short-termism' in the executive suite."[20]

Given the assumption, and repeated assertion, that hedge fund activism is necessarily short-termist,[21] there is barely any discussion on whether different forms of activism accurately fit this common description. More specifically, what has been overlooked in the literature to date is an analysis of forms of hedge fund activism that may manifest differently from the traditional portrayal. The fact that this piece of the debate is missing from the literature may be in part due to the narrative of short-termism pervading an analysis of hedge fund activism. This often reduces any meaningful discussion on hedge fund activism in the press, in politics, and sometimes even in academic literature, to generalized statements about the short-term nature of such funds and their activism. Roe and Shapira outline that the "narrative is simple: stock traders and shareholder activists, looking for a

**[Section I]**

[19] Faith Stevelman & Sarah C. Haan, *Boards in Information Governance*, U. PA. J. BUS. L. 179, 202 (2020) [hereinafter *Information Governance*] (citing literature discussing the likely deleterious effects of activist campaigns and noting that "[i]n their attempts to alter corporate financial or operating affairs in order to capture a greater, immediate surplus, activist hedge funds represent a trenchant, destabilizing force in contemporary governance").

[20] Kahan & Rock, *supra* note 11, at 1083.

[21] *Id.* (describing activist hedge funds as coming close to being the "archetypal short-term investor" and noting that "[s]hort-termism may thus pervade much that hedge funds do"); *Who Bleeds, supra* note 1, at 1874, 1907; Martin Lipton, *Important Questions About Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Mar. 9, 2013), https://corpgov.law.harvard.edu/2013/03/09/important-questions-about-activist-hedge-funds/ [hereinafter Lipton, *Important Questions*]; William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 658-59, 710-11 (2010); Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 564 (2006) ("[T]he hedge fund is likely to favor policies by the firms in which it invests that produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term."); Coffee & Palia, *supra* note 14, at 548 (describing the academic support for the theme of activist hedge funds having an "excessively short-term orientation").

quick profit, systematically induce large public corporations to manage for the short-run."[22] Not only is the narrative simple; it is also powerful. Roe and Shapira note that "[a]mong policymakers, the media, and executives, the consensus is that the short-termism problem is widespread and pernicious—and getting worse."[23]

This pervasive belief in the detrimental effects of short-term hedge fund activism can impair a genuine and thorough analysis of any positive impact that such activism may have, and stifle discussion on what might be learned from recent phenomena such as hedge fund appointed activist directors. Moreover, while it is acknowledged that there may undoubtedly be cases of "bad activism,"[24] this should not preclude serious discussion on the positive attributes of activist campaigns or an analysis of whether some forms of hedge fund activism may actually be more socially beneficial than others.

### 1. *The Power of the Short-Termism Narrative*

The problem of stock market short-termism has generally been accepted in politics, in the media, and by the public. Roe notes that the "fear that stock-market-driven short-termism is seriously harming the US economy is pervasive"[25] and that "[s]tock-market-driven short-termism is the rare corporate structural issue that both resonates with the public and has a place in political rhetoric."[26] Roe had noted in the 1990s that "the rhetoric of anti-short-termism, like the rhetoric of patriotism, is simple and widely supported."[27] This seems to be even more true today. The imagery associated with the role that activist hedge funds play as destructive short-term actors is equally powerful and prevalent. Routinely attacked for their perceived short-term focus, activist hedge funds have been termed "hit-and-run activists" by Hillary Clinton.[28] A German politician also described activist hedge funds as "swarms of locusts that fall on companies,

[22] Mark J. Roe & Roy Shapira, *The Power of the Narrative in Corporate Lawmaking*, 11 HARV. BUS. L. REV. 233, 234, 271-72 (2021).

[23] *Id.* at 234.

[24] The phrase "bad activist" is used in recent commentaries on hedge fund activism. *See* Jennifer G. Hill, *Good Activist/Bad Activist: The Rise of International Stewardship Codes*, 41 SEATTLE U. L. REV. 497, 498 (2018).

[25] ROE, MISSING THE TARGET, *supra* note 2, at 2.

[26] *Id.* at 3.

[27] MARK J. ROE, STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE 243 (1994).

[28] Brandon Kochkodin & Caleb Melby, *Hillary Clinton Faults "Hit-and-Run" Activist Investors*, BLOOMBERG (July 24, 2015), https://www.bloomberg.com/news/articles/2015-07-24/hillary-clinton-faults-activist-investors-hit-and-run-tactics.

stripping them bare before moving on."[29] Other vocal critics such as Martin Lipton have described activist hedge funds as "preying" on corporations[30] and exacerbating short-termism, which he describes as a "disease that infects American business."[31] Indeed, as Gilson and Gordon point out, "[a]ctivism battles often are cast as the struggle by management to pursue long-term strategies in the face of pressure to maximize in the short term."[32] The phrases most often used portray activists as aggressors and their interventions as adversarial. For example, commentators talk about activist "attacks" and boards of directors are encouraged by their advisers to "forestall an attack" and be ready to "defend vigorously."[33] Moreover, there is vivid imagery of "Wall Street 'wolf packs' hunting down companies to close and jobs to eliminate."[34] Roe and Shapira explore the role of narrative power, noting that the combination of short-termism's "negatives [being] easily stated, easily understood, and regularly repeated" boosts its narrative power and popularity.[35]

### 2. *The War of the Narratives*

Studying actual activist hedge fund campaigns reveals a

[29] *Locust, Pocus*, ECONOMIST (May 5, 2005), https://www.economist.com/node/3935994 (quoting the comments of Franz Muntefering, former Chairman of the Social Democratic Party in Germany, who also argued that the associated profit-maximizing strategies of activist funds were a long-term threat to democracy).

[30] Lipton, *Important Questions, supra* note 21 ("In what can only be considered a form of extortion, activist hedge funds are preying on American corporations to create short-term increases in the market price of their stock at the expense of long-term value.").

[31] Martin Lipton, Jay W. Lorsch & Theodore N. Mirvis, *The Proposed "Shareholder Bill of Rights Act of 2009,"* HARV. L. SCH. F. ON CORP. GOVERNANCE (May 12, 2009), https://corpgov.law.harvard.edu/2009/05/12/the-proposed-shareholder-bill-of-rights-act-of-2009/ ("Short-termism is a disease that infects American business and distorts management and boardroom judgment. But it does not originate in the boardroom. It is bred in the trading rooms of the hedge funds. . . ."); *see* Anna L. Christie, *The New Hedge Fund Activism: Activist Directors and the Market for Corporate Quasi-Control*, 19 J. CORP. L. STUD. 1, 1-2 ("Other vocal critics describe hedge funds as 'preying' on companies and exacerbating short-termism, which is described as a 'disease that affects American business."D').

[32] Ronald J. Gilson & Jeffrey N. Gordon, *Board 3.0: An Introduction*, 74 BUS. LAW. 351, 358 (2019) [hereinafter *Board 3.0: An Introduction*].

[33] Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1154 n.131 (2015) (citing Martin Lipton & Sabastian V. Niles, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov. 21, 2013), https://corpgov.law.harvard.edu/2013/11/21/dealing-with-activist-hedge-funds-2/; Alan M. Klein, *Shareholder Activism in M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Feb. 26, 2014), https://corpgov.law.harvard.edu/2014/02/26/shareholder-activism-in-ma-transactions/).

[34] ROE, MISSING THE TARGET, *supra* note 2, at 5.

[35] Roe & Shapira, *supra* note 22, at 235.

competing narrative, similar to the "*anti*-managerial narrative" that was popular during the 1980s deal decade.[36] Roe and Shapira describe this as "lazy executives protecting their fiefdoms with 'poison pills' and 'greenmail' (a cousin, presumably, of blackmail) to unjustly enrich themselves (sometimes with 'golden parachutes') and run down corporate America at workers' and the economy's expense."[37] Attempts to promote a similar anti-managerial narrative—which is reflective of the agency problems of stealing and shirking—can be seen from the statements made by some hedge fund activists in their campaigns over the years. For example, Daniel Loeb, of the activist hedge fund Third Point, is well known for his "poison-pen letters" to corporate executives. In 2005, he addressed the CEO of Star Gas Partners, stating "[i]t is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites."[38] He also highlighted corporate perks in another letter to the CEO of Intercept in 2004, criticizing the CEO for "tooling around in a luxurious business jet, possibly sipping Cristal champagne cocktails at shareholder expense."[39] More recently, during his campaign at Sotheby's in 2013, Loeb noted that "Sotheby's senior management feasted on organic delicacies and imbibed vintage wines at a cost to shareholders of multiple hundreds of thousands of dollars."[40] Other activist hedge fund managers have used similar tactics and language. David Einhorn of Greenlight Capital entitled his investor presentation at The St. Joe Company in 2010 "Field of Schemes," while accusing the company of "not accurately accounting for the value of its assets."[41] Carl Icahn has similarly critiqued CEOs and boards as evidenced in his campaign at Motorola in 2008, where he argued "[i]t is essential to the future of Motorola that its directors realize that the *board*, especially at this precarious time, is *not a country club or a fraternity*. . . ."[42]

Despite the vivid language used by activist hedge funds to

[36] *Id.* at 274.

[37] *Id.*

[38] Lina Saigol, . . . *Yours Truly, Dan Loeb*, Fin. Times (Oct. 3, 2013), https://www.ft.com/content/908e63c4-2c20-11e3-8b20-00144feab7de.

[39] *Id.*

[40] Samantha Sharf, *Poison Pens: 7 of the Best Barbs from Activist Investors*, Forbes (Sept. 29, 2014, 8:39 AM), https://www.forbes.com/sites/samanthasharf/2014/09/29/poison-pens-7-of-the-best-barbs-from-activist-investors/?sh=273c48647cf9.

[41] *Id.*

[42] Matteo Tonello, *The Activism of Carl Icahn and Bill Ackman*, Harv. L. Sch. F. on Corp. Governance (May 29, 2014), https://corpgov.law.harvard.edu/2014/05/29/the-activism-of-carl-icahn-and-bill-ackman/ (emphasis altered).

conjure images of managerial stealing or shirking, it does not seem that activist hedge funds won the war of the narratives. Roe and Shapira have noted that a narrative of "executives at public companies entrenching themselves for power, prestige, and pay at the expense of share-holders, employees, and society overall" is "perhaps equally compelling."[43] Yet the short-termism narrative is much more widespread and popular. When similar anti-managerial narratives were used during the deal decade, corporate lawmaking nevertheless "shifted first to disciplining greedy, underperforming executives and then to blocking their opponents, the greedy raiders."[44] Since then, the short-termism rhetoric has prevailed, despite raiders reinventing themselves into more palatable activist or engaged shareholders.[45] Beyond that, the narrative of short-termism has strengthened in power over the decades that followed.[46] Indeed, this narrative has potentially gained even more power due to the fact that short-termism has been viewed as a cause of the global financial crisis, and as a contributing factor to the global climate crisis.

### 3. *Increasing Narrative Power: ESG*

The short-termism problem increased in visibility during and after the global financial crisis. Some commentators have argued that it was pressure from activist shareholders that was "directly responsible for the short-termist fixation that led to the [2008-2009] financial crises."[47] The most important issues facing society, such as the climate crisis and other environmental damage, are also increasingly presented as problems of short-termism. In short, it is argued that governments and corporations have put economic growth or short-term profits ahead of the long-term preservation of the planet. For example, at the World Economic Forum in Davos in 2023, the climate activist Greta Thunberg accused the political and business elite of "prioritizing self-greed, corporate greed and short-term economic profits above people and

[43] Roe & Shapira, *supra* note 22, at 275.

[44] *Id.* at 274.

[45] *But see generally* Zohar Goshen & Reilly S. Steel, *Barbarians Inside the Gates: Raiders, Activists, and the Risk of Mistargeting*, 132 YALE L.J. 411, 415 (2022) (arguing that the conventional wisdom about corporate raiders and activist hedge funds—raiders break things and activists fix them— is wrong).

[46] Roe & Shapira, *supra* note 22, at 275 (noting that the "narrative faded because the media no longer bought in" or alternatively, "because wealthy and aggressive raiders and hedge fund activists could not credibly promote a narrative of their fighting greedy executives for the benefit of the American people" or ultimately, "because the idea was felled by narrative entrepreneurs who promoted a more powerful narrative, namely that stock-market-driven short-termism was causing American economic decay").

[47] Bebchuk, Brav & Jiang, *supra* note 33, at 1095.

above planet."[48] Statements like this have resulted in the short-termism narrative gaining even more traction and power in recent years, as it is fueled by rightful anger regarding environmental and social harm. Roe explains that "[b]roader social and economic reasons help to explain why stock market short-termism is seen as seriously pernicious. . . ."[49] The narrative has become part of the Environmental, Social, and Governance (ESG) movement, as it is "intertwined in public rhetoric with conceptualizations of corporate social responsibility, corporate purpose, and the need to emphasize corporate attention to the environment, stakeholders, and the risk of climate catastrophe, the so-called ESG issues."[50]

However, Roe and Shapira criticize the conflation of environmental and social problems and short-termism, arguing that "[e]nvironmental degradation, for example, is often portrayed as due to stock market short-termism, when it primarily emanates from the corporation's ability to offload costs externally to third parties, *not* from investors' time horizons."[51] Environmental damage is stated to be a "problem of *externalities*, not of short-termism."[52] Roe argues that a misstatement of the problem can confuse a discussion of the appropriate solution.[53] In the context of environmental damage, Roe and Shapira insist "[t]he proper remedy is *not* to alter the firms' time horizons, but to alter their (and our individual) incentives to internalize the externalities, via, say, a carbon tax."[54] Similarly, with hedge fund activism, an assumption that all (or most) hedge fund activism campaigns are short-termist in nature can lead to an unwillingness to consider campaigns on their merits, or a push for policies and regulations that curb or deter *all* hedge fund activism. It is argued here that it would be preferable to have clear conclusions on whether hedge fund activism is in fact short-termist, and most importantly what *types* of activist strategies may be short-termist. Unfortunately, when activists make proposals at target companies, they are often immediately lambasted for being rooted in short-termism

[48]Sam Meredith, *Greta Thunberg Says Davos Elite Are Prioritizing Greed and Short-Term Profits over People and the Planet*, CNBC (Jan. 19, 2023, 7:33 AM), https://www-cnbc-com.cdn.ampproject.org/c/s/www.cnbc.com/amp/2023/01/19/greta-thunberg-says-davos-prioritizing-short-term-profits-overplanet.html.

[49]ROE, MISSING THE TARGET, *supra* note 2, at 10.

[50]*Id.* at 5.

[51]Roe & Shapira, *supra* note 22, at 236; *see also* ROE, MISSING THE TARGET, *supra* note 2, at 5-6 (noting that "these corporate responsibility considerations are for the most part not time horizon issues").

[52]Roe & Shapira, *supra* note 22, at 249.

[53]ROE, MISSING THE TARGET, *supra* note 2, at 7.

[54]Roe & Shapira, *supra* note 22, at 249.

rather than critics being open to the possibility that there might be a "legitimate disagreement on corporate strategy,"[55] which should lead to rigorous analysis of the merits of the particular activist proposal to determine whether it contributes to sustainable value creation.

### 4. *The Effect of a Strong Narrative*

Bebchuk, Brav, and Jiang note the " 'myopic-activists' claim that has been playing a central role in debates over shareholder activism and the legal rules and policies shaping it."[56] In particular, "[i]nvoking the long-term costs of activism has become a standard move in arguments for limiting the role, rights, and involvement of activist shareholders."[57] This strong narrative is also consistently used and repeated in the political rhetoric focused on activist hedge funds. It is so powerful that it has even engendered bipartisan political support. One example of this is the Brokaw Act, which was co-sponsored by Senators Elizabeth Warren and Bernie Sanders in 2016. This was the first attempt at federal legislation aimed at regulating and restricting the "financial abuses being carried out by activist hedge funds who promote short-term gains at the expense of long-term growth."[58] Although the legislation ultimately failed, it was re-introduced in 2017 as a bipartisan reform proposed by both Democrat and Republican senators.[59] Overall, therefore, short-termism is clearly an extremely common and powerful critique of hedge fund activism.

## B. *Beyond the Narrative: Activist Hedge Funds and Short-Termism*

Due to the narrative's strength and its potential influence in corporate lawmaking, it is important to delve more deeply into the actual implications for corporate governance. Looking beyond the simple narrative that is repeated in the media and in politics, there have been some more serious critiques of activist hedge

[55] *Id.* at 257.

[56] Bebchuk, Brav & Jiang, *supra* note 33, at 1087.

[57] *Id.* at 1088.

[58] Portia Crowe, *Bernie Sanders and Elizabeth Warren Are Going After Activist Hedge Funds*, BUS. INSIDER (Mar. 18, 2016, 9:08 AM), https://businessinsider.com/elizabeth-warren-sponsors-activist-hedge-fund-bill-2016-3?r=US&IR=T.

[59] The Brokaw Act was originally proposed in March 2016 by United States Senators Tammy Baldwin and Jeff Merkley, and was re-introduced in August 2017 as a bipartisan reform with Republican Senator David Perdue, but ultimately failed. *See generally* Alon Brav, J.B. Heaton & Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, 11 J. BUS. ENTREPRENEURSHIP & L. 329 (2018).

funds and short-termism in academic literature. Here, short-termism is not portrayed as simplistically as it is in the political and media rhetoric. Rather, short-termism has been discussed as "the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism."[60]

It has been argued that "hedge fund activism . . . exacerbates an already serious problem of 'short-termism' in the executive suite."[61] The short-termism (or myopic-activists') argument essentially proceeds on the basis that the short-term investment horizons of activist hedge funds will induce target company directors and managers to pursue short-term profits and appreciation of the company's share price at the expense of the long-term success of the company. Whether this actually proves to be the case in practice is vigorously debated by scholars. Overall, short-termism is viewed as absolutely critical to debates on whether activist hedge funds are heroes or villains. Indeed, Kahan and Rock have noted that "[o]ne's views about whether hedge fund activism, on the whole, is desirable or undesirable are likely to turn on one's stand on the short-termism problem."[62] There are various theories why activist hedge funds may have short-termist tendencies.

### 1. *The Business Model of Activist Hedge Funds*

First, the business model of activist hedge funds may predispose them to short-term investments and behavior. Coffee and Palia have highlighted that "[t]he archetypal 'transient investor' is probably the hedge fund. . . ."[63] Strine has also similarly noted that "many activist investors hold their stock for a very short period of time and may have the potential to reap profits based on short-term trading strategies that arbitrage corporate policies."[64] Indeed, there are logical reasons why activist hedge funds may be more short-term oriented in their outlook compared to some other types of investors, namely their business model and, in particular, the compensation structure that is typical for hedge fund managers.

Activist hedge fund managers have traditionally been remunerated using a formula whereby they charge fees of two percent of

[60]Kahan & Rock, *supra* note 11, at 1087.

[61]*Id.* at 1083.

[62]*Id.*

[63]Coffee & Palia, *supra* note 14, at 574.

[64]Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 8 (2010) [hereinafter *One Fundamental Corporate Governance Question*].

the assets under management combined with a performance fee of twenty percent of the gains made by the portfolio.[65] Therefore, the price at which activist hedge funds buy and sell stocks is absolutely crucial to the hedge fund manager's overall compensation. In order to generate a strong performance fee for the manager, the fund ideally needs to secure quick returns that outperform the market. This business model and compensation structure relies upon hedge fund managers maximizing returns on multiple investments, then exiting to invest in new targets. If they are not able to do this, their ultimate investors might choose to withdraw their funds and switch to another fund with superior financial performance.[66] Some argue that this may lead to activist hedge funds "sacrificing the future for a quick buck."[67]

Concerns also relate to the fact that the short-term focus of hedge funds might resultingly induce directors and managers themselves to engage in short-termist behavior due to fear of activist intervention (a concern that Bebchuk, Brav, and Jiang have labelled the "counterproductive-accountability claim").[68] In the same vein, Strine has argued that as directors are "increasingly vulnerable to pressure from activist investors," this may lead them to "sacrifice long-term performance for short-term shareholder wealth."[69] This concern may be further legitimized by the fact that directors and managers themselves may similarly have short-term interests at heart. Indeed, the compensation of boards of directors and the incentives of CEOs and other managers historically revolve around short-term targets. For example, it has been argued that a typical CEO would weigh results dur-

[65]The traditional "two and twenty" fee model dates back to 1949 with the founding of AW Jones & Co, considered by many to be the world's first hedge fund. More recently, hedge funds may remunerate their managers with variations of this model, especially in the light of much lower fees charged by passive index-tracking funds. *See* Lindsay Fortado, *Hedge Fund Investors Question '2 and 20' Fees*, FIN. TIMES (June 6, 2017), https://www.ft.com/content/291081ba-49df-11e7-a3f4-c742b9791d43.

[66]Coffee & Palia, *supra* note 14, at 572-73.

[67]*See* Bebchuk, Brav & Jiang, *supra* note 33, at 1136; *see also* Anabtawi, *supra* note 21, at 564 (showcasing an example of a hedge fund-shareholder raising capital for a new fund that "[a]s part of its marketing effort, it wants to show impressive returns on its prior fund" in an effort to generate such returns the fund "is likely to favor policies by firms . . . that produce short-term gains, even if a more patient investment orientation would generate higher returns over the long term").

[68]Bebchuk, Brav & Jiang, *supra* note 33, at 1087, 1095; *see also* Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1676-78 (2013) (analyzing the fears of activist interventions).

[69]Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 790-91 (2015).

ing their own expected tenure above longer-term results.[70]

### 2. *Short-Termist Campaign Tactics*

In addition to highlighting the general incentives that fund managers undoubtedly have to generate high returns as quickly as possible, critics of hedge fund activism most often draw attention to the type of campaign strategies that activists may pursue that can be viewed as short-termist. As a general criticism, there is the accusation that activist hedge funds effectively engage in "pump and dump" schemes. The tenor of this criticism is that all activist hedge funds do is "create a short-term spike in the target stock's price, then exit, leaving the other shareholders to experience diminished profitability over the long-run."[71] The implication is that there will ultimately be longer-term value destruction, with hedge funds only achieving a "short-term bump in the stock price" in order to "book quick profits" and then "bail out, leaving corporate management to clean up the mess."[72] Although the stock price of a company should theoretically be an accurate representation of the present value of expected future cash flows, the market may be much better at valuing short-term projects and visible quarterly earnings rather than complex longterm technologically sophisticated projects[73] or indeed risks such as the impact of climate change.[74] Therefore, there can be a valuation bias in favor of the types of "quick fix" actions that hedge funds are known for implementing. Strine also argues that activist hedge funds "can easily depart and not 'eat their own cooking.' "[75]

More specifically, it is advocated that certain types of changes that hedge fund activists might promote may diminish the value of the corporation in the long run.[76] The first general category of such campaign strategies is what can be described as "balance sheet activism," where activist hedge funds "sway and bully management to . . . meet the quarterly targets and disgorge cash in extra dividends or stock buy backs in lieu of investing in

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[70] Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 Bus. Law. 977, 980 (2013) (noting that the average tenure for a CEO in the United States is seven years).

[71] Coffee & Palia, *supra* note 14, at 549.

[72] Bill George, *Activists Seek Short-Term Gain, Not Long-Term Value*, N.Y. Times (Aug. 26, 2013, 10:56 AM), https://archive.nytimes.com/dealbook.nytimes.com/2013/08/26/activists-seek-short-term-gain-not-long-term-value/.

[73] Roe, Missing the Target, *supra* note 2, at 78.

[74] *See generally* Madison Condon, *Market Myopia's Climate Bubble*, 2022 Utah L. Rev. 63 (explaining the underpricing of corporate climate risk).

[75] *One Fundamental Corporate Governance Question, supra* note 64, at 8.

[76] *Who Bleeds, supra* note 1, at 1872, 1938.

long-term growth."[77] Bebchuk, Brav, and Jiang categorize these types of interventions as "investment-limiting" interventions and include within the category (i) increased leverage; (ii) increased shareholder payouts (whether through dividends or stock buybacks); and (iii) reduced long-term investment in research and development.[78] These forms of hedge fund activism were pervasive, at least in the 2000s, and they do still form part of the activist playbook. Strine has pointed out that "[i]t is easy to find examples of activism designed to encourage boards to increase leverage in order to pump up immediate returns to stockholders."[79] This prevailing narrative regarding activist hedge funds persists to the present day, in that they are viewed as "primarily financial engineers interested in the largest possible profit in the shortest period of time."[80]

### 3. *Empirical Evidence on Short-Termism*

One measure of short-termism is how long activist hedge funds remain invested in the companies they target. In 2007, it was noted that the median holding period for activist hedge fund investments was around fifteen months.[81] In terms of results, empirical studies have generally shown that hedge fund activist campaigns typically result in short-term gains for shareholders.[82] This price spike tends to center around the announcement of

[77]Ira M. Millstein, *Re-Examining Board Priorities in an Era of Activism*, N.Y. TIMES (Mar. 8, 2013, 3:52 PM), http://dealbook.nytimes.com/2013/03/08/re-examining-board-priorities-in-an-era-of-activism/.

[78]Bebchuk, Brav & Jiang, *supra* note 33, at 1136-38; *see also* Coffee & Palia, *supra* note 14, at 549, 553, 573-77 (noting that activist hedge fund interventions often involve increases in leverage and shareholder payouts and decreases in investment, particularly long-term investment in research and development); William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375, 1379 (2007) (noting that hedge funds typically seek sale of the company, a division, or a large cash payment from a special dividend or stock repurchase). On research and development, see generally the study by Brav, Jiang, Ma, and Tian, presenting empirical evidence that firms targeted by hedge fund activists actually experience an improvement in innovation efficiency despite a tightening in R&D expenditures. Alon Brav, Wei Jiang, Song Ma & Xuan Tian, *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. ECON. 237 (2018).

[79]*One Fundamental Corporate Governance Question, supra* note 64, at 13 n.44.

[80]Anabtawi, *supra* note 21, at 580.

[81]Bebchuk, Brav & Jiang, *supra* note 33, at 1104 tbl.2.

[82]Empirical studies tend to demonstrate short run average abnormal returns ranging from three percent to nine percent for various samples and event windows. For a survey of the empirical literature on this point, see Alon Brav, Wei Jiang & Rongchen Li, *Governance by Persuasion: Hedge Fund Activism and Market-based Shareholder Influence* 39 (Eur. Corp. Governance Inst., Working Paper No. 797/2021, 2022), https://ssrn.com/abstract=3955116 [herein-

activism itself. For example, studies in the 2000s on hedge fund activism in the United States have documented that the filing of a Schedule 13D by an activist hedge fund results in positive share price spikes of around eight percent.[83] Further data confirming this effect is available in a study published by Bebchuk, Brav, and Jiang, where it was discovered that the average abnormal returns for the twenty-day period before and after an activist investor files a Schedule 13D are approximately six percent.[84] Therefore, the available empirical evidence in relation to abnormal short-term gains from activist intervention is quite clear. This has led some proponents of hedge fund activism to argue that "this positive market reaction to the appearance of a hedge fund activist is consistent with the view that activists provide benefits to, rather than impose costs on, the targets of their campaigns."[85]

With respect to the long-term effects of hedge fund activism, however, the empirical evidence tends to be more mixed. Some opponents of hedge fund activism argue that the short-term stock

after *Governance by Persuasion*].

[83]Coffee & Palia, *supra* note 14, at 551 (citing Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1755-57 (2008) [hereinafter *Hedge Fund Activism*] (documenting an average 7.2% abnormal buy-and-hold return in twenty days post-Schedule 13D filing for the overall sample and an average (median) abnormal return of 8.4% for campaigns in which a hedge fund describes a new and explicit agenda in the Schedule 13D beyond a general statement of maximizing shareholder value in the filing)); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187, 207-11, 225-26 (2009) (noting a mean (median) size-adjusted return of 7.3% (4.9%) and 10.2% (8.9%) during event windows five days and thirty days post-filing, respectively); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 328-29 (2008) (noting that firms targeted by activists earn a mean size-adjusted return of 3.39% around the 13D filing date, using an event window of two days pre- and post-filing); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 366-67 (2009) (noting that the immediate returns to activism are approximately 3.5% over a fifteen-day event window); *see also* Bebchuk, Brav & Jiang, *supra* note 33, at 1121 (explaining a summary of the empirical evidence documenting the initial positive (short-term) stock market reaction to activist hedge fund interventions); *see generally* Marco Becht, Julian Franks, Jeremy Grant & Hannes Wagner, *Returns to Hedge Fund Activism: An International Study* (Eur. Corp. Governance Inst., Working Paper No. 402/2014, 2017), https://ssrn.com/abstract=2376271 (noting that disclosures of activist interventions are accompanied by an average of 6.4% of positive abnormal stock returns).

[84]Bebchuk, Brav & Jiang, *supra* note 33, at 1122 (noting that the average abnormal return in a forty-day window surrounding the filing of a Schedule 13D in their sample of activist interventions from 1994 to 2007 are approximately 6%).

[85]*Id.*

price spikes that arise upon an activist intervention are reversed over time, as market myopia fails to account for the likely negative long-term stock returns.[86] Some studies indeed suggest that there is no statistically significant change in the longterm operating performance of targeted companies.[87] By contrast, Bebchuk, Brav, and Jiang have analyzed the long-term effects of hedge fund activism (which they define as a five-year period following activist intervention) and contend that "[o]verall, the analysis of stock returns carried out . . . provides no support for the claim that activist intervention makes shareholders of target companies worse off in the long term."[88] There is no real consensus on this point, and scholars continue to debate whether the short-term gains from activist intervention are reversed in the long run. It can also prove difficult to empirically test whether hedge fund activism is beneficial in the long run, as there are so many intervening variables affecting corporate performance following an activist intervention.

### 4. *Conflicts Between Shareholders*

If hedge fund activism causes corporations to be worse off in the long run, long-term shareholders such as pension funds or index funds would similarly be worse off. This would necessarily create a conflict between the interests of short-term activist hedge fund investors and longer-term investors.[89] In fact, many commentators do consider the interests of shortterm shareholders

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[86] *See id.* at 1120-21 ("[O]pponents of hedge fund activism believe that the initially positive stock-market reaction to activist interventions represents inefficient, myopic market pricing that fails to reflect the subsequent negative returns that are experienced by long-term shareholders and make such shareholders worse off."); *see also* Kahan & Rock, *supra* note 11, at 1084 (noting that "[f]or the shortterm trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from *myopia*: . . . undervalue[ing] long-term investments relative to short-term investments" and therefore, "[i]f the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with longterm trading horizons").

[87] See summary of empirical studies of shareholder activism presented in Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN., 55, 61-62 tbl.2, 66-67 (2007) (concluding that the results of studies of the long-term stock performance of targeted companies have been mixed, and that virtually all studies of long-term operating performance have reported no statistically significant changes in the operating performance of targeted companies).

[88] Bebchuk, Brav & Jiang, *supra* note 33, at 1130 ("[T]he market does not fail to appreciate the long-term consequences of activism as insulation advocates fear it does. Rather, the stock appreciation accompanying activists' initial announcement reflects the market's correct anticipation of the intervention's effect, and the initial positive stock reaction is not reversed in the long term.").

[89] Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*,

and long-term shareholders to inevitably be in conflict. However, it may be that most shareholder conflicts can be overcome, as hedge funds ordinarily need the support of long-term shareholders in order to succeed in their campaigns.[90] This is especially the case at larger companies, where hedge funds necessarily own a smaller percentage of the stock. It is also increasingly the case with the rise of index investment and the concentration in power among asset managers.[91]

Overall, it is undeniable that the most vocal criticism of hedge fund activism is short-termism, whether that be through the narrative repeated in politics and the media, or through a more thorough academic analysis of the incentives of activist hedge funds and corporate boards of directors.[92] Therefore, it would be unusual for any assessment of hedge fund activism to take place in the absence of a discussion on short-termism. Although some commentators argue that short-termism is not a problem, or that shortterm goals are not necessarily incompatible with the long-term success of the corporation,[93] to ignore the short-termist critique would leave any analysis open to immediate criticism in terms of hedge funds' potential short-term orientation.

The most common counter argument is to emphasize the virtues of hedge fund activism in terms of shareholder democracy reducing shareholder-manager agency costs.[94] As highlighted earlier, drawing attention to management excess or corporate fraud is key to the narrative that hedge fund activists themselves promote through public statements about their target companies. This Article instead focuses on data shedding light on the reality of more recent activist hedge fund campaigns at the largest companies in the United States.

## II Activist Board Representation

### A. *The Evolution of Hedge Fund Activism*

Proxy contests are not a new concept. Beginning in the 1950s,

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60 Stan. L. Rev. 1255, 1290 (2008).

[90] Kahan & Rock, *supra* note 11, at 1027.

[91] Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 Colum. L. Rev. 2029, 2033 (2019); Jill Fisch, Assaf Hamdani & Steven Davidoff Solomon, *The New Titans of Wall Street: A Theoretical Framework for Passive Investors*, 168 U. Pa. L. Rev. 17, 19 (2019).

[92] Coffee & Palia, *supra* note 14, at 548; Kochkodin & Melby, *supra* note 28; Lipton, *supra* note 21; Lipton, Mirvis & Lorsch, *supra* note 31.

[93] *See generally* Bebchuk, Brav & Jiang, *supra* note 33, at 1154.

[94] For a discussion of shareholder-manager agency costs, see John Armour, Henry Hansmann & Reinier Kraakman, *Agency Problems and Legal Strategies, in* the Anatomy of Corporate Law: a Comparative and Functional Approach 29-30 (Reinier Kraakman et al. eds., 3rd ed. 2017).

there were various high-profile battles for the control of companies in the United States.[95] However, hedge fund activism did not become a fundamental part of the United States corporate governance ecosystem until the 2000s,[96] and activist board representation is an even more recent phenomenon. Armour and Cheffins draw a distinction between "offensive" and "defensive" shareholder activism, with hedge funds representing the archetypal offensive shareholder activist.[97] Activist hedge funds identify target firms and purposefully invest in them to pursue an activist agenda, whereas other institutional investors tend to be reactionary and will usually only engage in activism to protect existing holdings.[98]

However, as discussed in Part I, activist hedge funds have consistently been criticized for being short-termist.[99] In particular, they are accused of engaging in financial wizardry rather than making substantive long-term improvements to target company strategies and operations.[100] Despite the existence of empirical studies arguing that hedge fund activists create longterm as well as short-term value, the popular narrative is still that they are short-term actors. For example, as recently as 2017, Strine argued that "the stories behind the empirical data cited by hedge fund activists seem to mostly involve financial engineering. . . . the scholars have not yet put names of companies to the data, to show how the hedge fund has improved corporate operations in a durably valuable way."[101]

Indeed, in 2014, the activist hedge fund Starboard Value made history by succeeding in its campaign to replace the entire board of an S&P 500 company, Darden Restaurants.[102] Described as

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**[Section II]**

[95] *See* John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why?—The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1752-53 (2007) (discussing the Young proxy contest for the control of the New York Central Railroad in 1954); *see also* John Armour & Brian Cheffins, *Stock Market Prices and the Market for Corporate Control*, 2016 U. ILL. L. REV. 761, 781 (identifying 398 proxy contests between 1900 and 1965).

[96] Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 75-81, 102 (2011) (discussing the history of the direct antecedents to activist hedge funds).

[97] *Id.* at 56-57.

[98] *Id.*

[99] *See supra* note 21 and accompanying text.

[100] *See supra* note 21 and accompanying text.

[101] *Who Bleeds, supra* note 1, at 1953.

[102] Foley, *supra* note 8.

"the ugliest shareholder revolt of 2014,"[103] Starboard's strategy for Darden was contained in a public 294-page white paper, which explained in intricate detail how the activist hedge fund planned to execute a turnaround of the company, particularly with regard to deficiencies in strategy and operations at the underperforming Olive Garden restaurant chain.[104] Starboard's campaign commenced after it was contacted by frustrated Darden shareholders, who persuaded the hedge fund to invest in and target the company.[105] Despite holding less than ten percent of the shares in Darden, Starboard's campaign culminated in the activist hedge fund securing sufficient shareholder votes to replace all of Darden's incumbent board with twelve new nominees. Ten of the nominees were seasoned executives who had expertise in the food and drinks industry or in corporate turnarounds, who were not affiliated with the hedge fund. The elected slate also included two representatives from Starboard—its founder, Jeff Smith, and its head of research. The change in leadership at Darden ultimately appeared to result in a very effective turnaround, with the company's share price rising by nearly sixty percent in the eighteen months following the hedge fund's intervention.[106]

Boardroom coups initiated by shareholders, such as Starboard's campaign at Darden, are extremely rare events. Indeed, this campaign was the first and last time (to date) that an activist hedge fund took complete control of an S&P 500 company's board in the United States.[107] However, less extreme examples of minority board representation by activist hedge funds are much more commonplace.

This Part introduces activist board representation as a fundamental phenomenon in the evolution of hedge fund activism over the past decade. The theory on activist board representation and prior empirical studies on hedge fund activism form the foundation to develop several hypotheses about how activist board representation might manifest differently to other types of hedge fund activism.

This Article accepts that challenge and seeks to explore whether this short-term narrative accurately reflects modern-day hedge fund activism. Critics take issue with activist hedge funds

[103] *Darden Restaurants: Back for Seconds*, FIN. TIMES (Mar. 25, 2015), https://www.ft.com/content/50d307f2-d260-11e4-9c25-00144feab7de.

[104] STARBOARD VALUE, *supra* note 4.

[105] OWEN WALKER, BARBARIANS IN THE BOARDROOM: ACTIVIST INVESTORS AND THE BATTLE FOR CONTROL OF THE WORLD'S MOST POWERFUL COMPANIES 49 (2016).

[106] Michael J. de la Merced, *Starboard Value's Rise to Activist Prominence*, N.Y. TIMES (Apr. 27, 2016), https://www.nytimes.com/2016/04/28/business/dealbook/starboard-values-rise-to-activist-prominence.html.

[107] WALKER, *supra* note 105, at 41-68; data analyzed *infra* Part III.

engaging in what is sometimes termed "balance sheet activism," which involves quick returns of cash to shareholders through increased dividends or share buybacks. This Article shows, however, that activist hedge funds can often become much more involved in company strategy and operations than the financial wizardry critics suggest. The hand-collected dataset, which forms the basis for the empirical study in Part III, systematically analyzes the types of activism that hedge funds are now engaging in at the biggest companies in the United States.

### B. *Research Questions and Hypotheses*

This Section outlines the research questions that motivated the empirical study and develops the hypotheses that are tested in the study. Overall, this Article seeks to explore the evolution of hedge fund activism and whether activist board representation is associated with fundamentally different types of behavior on the part of activist hedge funds, compared to cases where the funds do not seek or secure board representation.

#### 1. *Prevalence of Activist Board Representation*

***Research Question 1 — Is activist board representation becoming a more common form of hedge fund activism?***

The first research question explores whether activist board representation is becoming more prevalent. Anecdotal evidence suggests that it is, but the empirical study in Part III seeks to explore the prevalence of this phenomenon more systematically. When hedge fund activism rose to prominence in the 2000s, board representation was already a relatively common campaign objective pursued by activist hedge funds. For example, a study conducted by Brav, Jiang, Partnoy, and Thomas discovered that 24.8% of activist campaigns in the United States from 2001 to 2006 involved activist hedge funds seeking board representation.[108] In Brav, Jiang, Partnoy, and Thomas' sample, the campaigns in the dataset were divided into cases where the activist hedge fund sought board representation without a proxy contest or confrontation with existing management (11.6% of events) and cases where the hedge fund launched a proxy contest in order to replace board directors (13.2% of events).[109] Another empirical study conducted around the same time by Klein and Zur, which focused on a sample of campaigns conducted between 2003 and 2005, found that 27% of campaigns in the sample involved a request for a change in the board of directors' composition (41 out of 151

[108] *Hedge Fund Activism, supra* note 83, at 1743.
[109] *Id.*

events).[110] Finally, in a study conducted by William Bratton analyzing activist campaigns from 2002 until mid-2006, it was noted that larger targets (large and mid-capitalization companies) predominated in the cash payout and asset sale groups, and were underrepresented when it came to board representation or proxy contests, with only 18% of large or mid-cap firms surrendering board seats.[111] Bratton uses this datapoint to make the argument that large firms could afford to pay off activists and return to normalcy, rather than having to surrender board seats.[112]

Although none of the studies specifically focus on the S&P 500, prior to 2010, activist board representation campaigns were uncommon at S&P 500 companies. No previous empirical study specifically analyzes activist board representation prior to 2010. However, some relevant data can be extracted from prior literature on hedge fund activism more broadly. For example, Bebchuk, Brav, Jiang, and Keusch authored a paper analyzing settlement agreements between hedge fund activists and target companies from 2000 to 2013.[113] The events in their dataset were mainly identified through Schedule 13D filings, but were also supplemented with news searches to identify activists who launched public campaigns with stock ownership below 5%.[114] In their appendix, they separate out "notable activist campaigns" that took place at large target companies with at least $7 billion in market capitalization.[115] Analyzing this data reveals that there were only six cases between 2000 and 2009 where S&P 500 companies concluded settlement agreements with activist hedge funds for board representation.[116] This data does not include *unsuccessful* attempts at board representation (as it only analyzes settlement agreements between activists and target companies), and it also excludes cases involving proxy contests that went to a shareholder vote (again, as it only considers negotiated settlements). Nevertheless, this is useful data, especially given that many or most activist board representation campaigns result

[110] Klein & Zur, *supra* note 83, at 197 tbl.1.

[111] Bratton, *supra* note 78, at 1416.

[112] *Id.*

[113] *Dancing with Activists, supra* note 10, at 4.

[114] *Id.*

[115] *Id.* at 35 tbl.A.1.

[116] *Id.* An analysis of the authors' data reveals that they only identified six activist settlements at S&P 500 companies where activist hedge funds secured the appointment of new directors in the ten-year period from 2000 to 2009 (Time Warner/Icahn in 2006, Home Depot/Relational Investors in 2007, Motorola/Icahn in 2008, Yahoo/Icahn in 2008, Sara Lee/ValueAct Partners in 2008, and Intuit/Relational Investors in 2009).

in settlement in any event.[117]

Further evidence of the incidence of activist board representation campaigns at S&P 500 companies prior to 2010 can be found in Bratton's study.[118] Here, only 9 out of 114 target companies (8%) targeted from 2002 to 2006 were constituents of the S&P 500. Activists secured board representation at two of those companies (22% of the S&P 500 companies targeted).[119] Combining these two sources of data from prior empirical studies results in only eight identified cases of activist board representation at S&P 500 companies from 2000 to 2009.

Reports from the industry have also suggested that activist board representation may be on the rise. For example, a report by Lazard highlighted that 2016 was a record year for activist hedge funds succeeding in placing nominees on corporate boards in the United States. In the report, it was noted that activist hedge funds gained 131 board seats in total from 149 campaigns to secure board representation.[120]

### *Research Question 2 — Is activist board representation becoming a more successful form of hedge fund activism?*

A related research question concerns how successful activist board representation campaigns are, with the caveat that reporting success rates is problematic as they are endogenous to the underlying engagement choices. The study by Brav, Jiang, Partnoy, and Thomas does not report the number or percentage of such campaigns that ultimately led to activist hedge funds actually securing board representation. The authors do report a success rate of 40.6% for activist hedge fund events generally, where success was defined as the activist hedge fund achieving its main stated goals.[121] However, this figure was not broken down to report the success rate for board representation campaigns specifically.

In a more recent working paper, surveying activist hedge fund data from 1994 to 2018, Brav, Jiang, and Li note that "in close to half of proxy contests, the dissident wins at least one seat."[122] However, this study averages the results from campaigns in recent years with campaigns from the 1990s and 2000s. Given

[117] *See infra* Part II.B.7.

[118] *See generally* Bratton, *supra* note 78.

[119] *See id.* at 1429-32. The relevant target company/hedge fund pairs were Massey Energy/Third Point in 2005 and H. J. Heinz/Trian Partners in 2006.

[120] John C. Coffee, Jr., Robert J. Jackson, Jr., Joshua R. Mitts & Robert E. Bishop, *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board?*, 104 CORNELL L. REV. 381, 386 & n.4 (2019).

[121] *Hedge Fund Activism, supra* note 83, at 1744.

[122] *Governance by Persuasion, supra* note 82, at 14.

that hedge fund activism has evolved considerably since the 1990s and early 2000s, averaging the results of activist campaigns over such an extended time period is not necessarily helpful for analyzing current trends in hedge fund activism.

The Klein and Zur study did report success rates of different types of campaign strategies. Here, they noted that hedge funds generally enjoyed a 60% success rate overall in their campaigns, but that they succeeded in achieving board representation in 73% of campaigns (or 30 out of 41 attempts).[123] Overall, this translated into activist hedge funds achieving board representation at slightly less than 20% of the companies in the sample (30 out of 151 events).[124] At the time, Klein and Zur noted that their findings ran counter to evidence presented by Bebchuk that "U.S. shareholders' ability to replace the board of directors is 'largely a myth.' "[125] Klein and Zur also observed, however, that the success rate of activist hedge funds securing board representation was lower than the success rate for financial activism. Indeed, in their sample, activist hedge funds had a 100% success rate in getting the target company to buy back its own stock or initiate a cash dividend.[126] The success rate of financial activism was therefore higher than the success rate of activist board representation, meaning that other forms of activism were even less successful and brought the overall average success rate for all campaigns down to 60%. Although the sample size used in this study was relatively small, this finding is consistent with the view that in the early to mid-2000s, financial or balance sheet activism was a more prevalent and a more successful strategy than seeking activist board representation.

The above research questions and discussion leads to the following hypotheses:

***Hypothesis 1 — Activist board representation campaigns are increasingly prevalent at S&P 500 companies.***

***Hypothesis 2 — Activist board representation campaigns are increasingly successful at S&P 500 companies.***

While early activist hedge fund campaigns may have focused more on financial or balance sheet activism, it is explored here whether activist board representation has become a strategy of choice in the United States, especially among the largest companies and the most formidable activist hedge funds.

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[123] Klein & Zur, *supra* note 83, at 211.

[124] *Id.* at 212.

[125] *Id.* at 211-14 (citing Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 711 (2007)).

[126] *Id.* at 211.

There are several potential reasons why we might expect there to be more campaigns focusing on board representation now, compared with the earlier examples of hedge fund activism.

### i. Low Hanging Fruit

First, there is some evidence to suggest that in the 2000s, activist hedge funds may have focused on "low-hanging fruit" by targeting cash-rich companies that could quickly and easily redistribute cash to shareholders.[127] In Bratton's empirical study, it was noted that the results "imply that the activists grabbed low-hanging fruit in the first three years, [2002 to 2004], searching thereafter among a depleted stock of prime targets."[128] So, even by the end of 2004, it seems that such targets were less readily available than they had been at the beginning of the decade. Moreover, in a more recent review of the empirical evidence, Brav, Jiang, and Li noted that "under-performing firms with cash flow problems were low-hanging fruit for the first generation of activist investors while in the post-financial crisis period hedge funds have had to identify targets with issues that are not associated with the traditional fundamental performance metrics such as ROA."[129] Perhaps these types of target companies with excess cash balances are less common in the present day. This could be for a number of reasons, including that there is a prominent activist defense industry of advisors who help to ensure that companies are less vulnerable to being targeted by activist hedge funds. Therefore, opportunities to target cash-rich "low-hanging fruit" may be less plentiful nowadays. There is also the issue that institutional investors and other longer-term shareholders may be reluctant to support such tactics on the part of activist hedge funds, especially if they are perceived as short-term financial engineering that is ultimately harmful to long-term shareholders. Instead, activist hedge funds may be forced to gravitate towards more substantive forms of activism such as campaigns involving strategic and operational change.

### ii. Institutional Investor Support

Second, as alluded to above, substantive activist strategies may be more palatable to long-term institutional investors compared with balance sheet activism, which may be viewed as financial engineering. It has always been the case that activist hedge funds cannot succeed in their campaign goals alone. They generally

[127]Bratton, *supra* note 78, at 1394-95.

[128]*Id.* at 1395.

[129]*Governance by Persuasion, supra* note 82, at 33. Return on Assets (ROA) is a financial ratio used to determine how profitable a company is relative to its total assets.

hold a minority stake in a company—often less than a ten percent shareholding—which means that they rely on the support of other investors to succeed in their campaigns.[130] This support comes principally from institutional investors rather than retail investors, as institutions are the biggest shareholders at most public companies.[131] Financial or balance sheet activism is usually not appealing to long-term institutional investors, so such investors may object to activist hedge fund interventions of this nature. For example, State Street Global Advisors recently stressed that they had "identified certain actions as potential red flags for long-term investors as they raise questions about the motivations behind the actions and potential implications for sustainable value creation."[132] One red flag identified was "[f]ocusing on financial engineering such as share buybacks, leveraged dividends, spin-offs and M&A, which could add value in the short term but may also undermine long-term value."[133] Therefore, it is clear that institutional investors are less likely to support activist campaigns that focus on financial activism, as opposed to campaigns that at least appear to focus on more substantive long-term value creation. Hedge fund activist board representation may be more appealing to long-term institutional investors if they perceive it as demonstrating a longer-term commitment on the part of the activist hedge fund, or if it is combined with strategies where the hedge fund is making a more substantive contribution to long-term value creation at the company. Whether institutional investors support activist board representation campaigns could also potentially depend a lot on the identity of the proposed director nominees.

Activist hedge funds are repeat players, so the success of their campaigns also matters for their reputation and the potential success of future campaigns. Therefore, it is beneficial if activists can tailor their strategies to ensure that long-term institutional investors are supportive of their campaigns.

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[130] *Hedge Fund Activism, supra* note 83, at 1732 (analyzing a dataset of hedge fund activism campaigns from 2001 to 2006 and noting that "[t]he median maximum ownership stake for the entire sample is about 9.1%"); *see also infra* Part III.C.1.ii (finding that on average, activist hedge funds hold roughly a six percent shareholding and thus rely on support from institutional investors during campaigns).

[131] Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. Rev. 721, 725 (2019) (noting that over the last fifty years, institutional investors have come to hold a majority of the equity of public companies in the United States).

[132] State Street Global Advisors, Protecting Long-Term Shareholder Interests in Activist Engagements 2 (Apr. 2020).

[133] *Id.*

### iii. A Means to an End

Third, activist board representation could simply be viewed as a means to an end or as an intermediary step that is needed for activist hedge funds to achieve other goals. Activist hedge funds primarily aim to increase the value of their shares.[134] Indeed, there are various different tactics that activist hedge funds can use to try to improve the stock price of a target company. Some of these tactics are entirely feasible to implement from outside of the boardroom.

The primary example is financial or balance sheet activism, which can involve increased dividends or share buybacks. A board seat is unlikely to be necessary for the activist hedge fund to push through such a change. Similarly, it may be possible to obtain a takeover premium for the shares by putting the target company into play as a takeover target.[135] However, if the fundamental problem at a company is its strategy or operations, it may be difficult for an activist hedge fund to effect change from outside of the boardroom.

Although hedge funds can potentially try to pursue these other types of activism without having the benefit of one or more board seats, having access to the board can expedite progress towards their desired goals and render their campaigns more likely to succeed. Some types of activist interventions—such as strategic or operational activism—are likely to be much more effective if the activist hedge fund has at least one board seat which gives the fund access to strategic discussions. Without board representation, it may be difficult for activist hedge funds to ensure that their value-creating strategies are being effectively implemented. Therefore, we might simply see an increase in activist board representation because it is a *necessary prerequisite* in order for activist hedge funds to achieve campaign goals relating to corporate strategy or operations. Similarly, if an activist hedge fund seeks to replace the CEO or remove other managers, board representation can also result in activist directors holding positions on key board committees which would give them a direct role in choosing the next CEO of the company. Another related benefit of a board seat, as outlined below, is the potential access to information that such a board seat will afford the activist hedge fund. This can be particularly useful for changes to strategy and operations.

Bebchuk, Brav, Jiang, and Keusch have made a similar "means

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[134] *Governance by Persuasion, supra* note 82, at 37 ("More than any other type of shareholder activist, hedge funds are results-driven.").

[135] *See generally* Greenwood & Schor, *supra* note 83, at 363 (explaining that returns associated with activism are often actualized when activists force target firms into a takeover and collect a takeover premium).

to an end" argument to rationalize their analysis of settlement agreements between hedge fund activists and target companies.[136] Here, the evidence showed that settlement agreements tend to focus on changes in board composition as opposed to containing any specific agreement to implement the type of operational changes that activists ultimately seek.[137] However, the analysis also demonstrated that settlements were often followed by major changes that were not specifically contracted for in the agreement itself, such as increases in CEO turnover, increased payouts to shareholders, and a higher likelihood of a sale or going-private transaction.[138] Therefore, activist board representation may indeed be a necessary or effective precondition to activists implementing these types of changes at target companies.

### iv. Access to Information

Finally, another primary motivator for activist hedge funds to seek board representation may be the access to confidential information that a board seat gives them.[139] Once hedge funds secure board representation, they have access to confidential company documents and data that they would not otherwise be able to access.[140] Activists are also sometimes given board observer status in settlement agreements, which shows that access to the board and the associated information that status provides is valuable to hedge fund activists even if formal board representation is not secured.[141]

The issue of activists and information asymmetry is multifaceted. From one perspective, activist hedge funds can help to *address* the informational challenges faced by independent directors on the monitoring board. Kastiel and Nili describe this as overcoming the "informational capture" of the board, as activist hedge funds have the resources to collect and analyze a vast

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[136] *Dancing with Activists, supra* note 10, at 2, 12-17.

[137] *Id.* There are various legal reasons why this may be the case. *See* Coffee, Jackson, Mitts & Bishop*, supra* note 120, at 397 (noting that "directors, as fiduciaries, cannot contract away their discretion").

[138] *Dancing with Activists, supra* note 10, at 3, 25-30.

[139] Another way that activists can obtain information is by a "220 demand," which refers to the right of a shareholder, under § 220 of the Delaware General Corporation Law, to examine certain corporate books and records for any proper purpose. Sujeet Indap, *Shareholders Win a New Legal Tool to Challenge M&A Deals*, FIN. TIMES (Feb. 12, 2018), https://www.ft.com/content/bb2ed60a-0d39-11e8-839d-41ca06376bf2.

[140] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 403-05.

[141] *Id.* at 401-02 n.51 (noting that "in approximately 8% of the settlements in our dataset the activist instead settles for board 'observer' rights, in which the new director gains access to the boardroom before her formal appointment to the board").

amount of information, and activist-appointed directors can rely on their "back office" at the hedge fund to enable them to contribute more substantively to the company's strategy.[142] Therefore, activist-appointed directors can *contribute* information, and thus strategies, to the rest of the board. From another perspective, activist hedge funds may want board access in order to *obtain* inside information from management. Hamdani and Hannes argue that the primary benefit to a hedge fund of activist-appointed directors is that these directors gain access to the company's nonpublic information and are able to share this information with the activist hedge fund.[143] The hedge fund can then further analyze the information and help to formulate corporate strategies.[144] Therefore, there can be a two-way information flow.

However, there is a potential "dark side"[145] associated with activist hedge funds having access to confidential inside information. Coffee, Jackson, Mitts, and Bishop go so far as to argue that hedge fund activism, and in particular wolf pack activism, may be fueled by subsidies caused by access to material, non-public information.[146] In an analysis of 475 private settlement agreements from 2000 to 2015, the authors discovered that once an activist-nominated director joins a target board pursuant to a settlement agreement, an abrupt pattern of "information leakage" follows, with the result that the target company's share price begins to anticipate future public disclosures.[147] Therefore, the authors argue that new agency costs may arise from hedge fund activism and especially from hedge fund managers joining target company boards.[148]

For all of the above reasons, it might be expected that we see more activist board representation campaigns in recent years, compared to the earlier years of hedge fund activism, which were explored in the aforementioned empirical studies. The combination of fewer available target companies that would be classified as "low-hanging fruit," the likely institutional investor support

[142] Kobi Kastiel & Yaron Nili, *"Captured Boards": The Rise of "Super Directors" and the Case for a Board Suite*, 2017 WIS. L. REV. 19, 63-64, 66; Assaf Hamdani & Sharon Hannes, *The Future of Shareholder Activism*, 99 B.U. L. REV. 971, 995-96 (2019).

[143] Hamdani & Hannes, *supra* note 142, at 995.

[144] *Id.*

[145] Kahan & Rock examined what they called the "dark side" of activism, defined as "instances where the interests of activist hedge funds conflict with those of their fellow shareholders. . . ." Kahan & Rock, *supra* note 11, at 1027, 1072-77.

[146] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 389-90, 435, 439.

[147] *Id.* at 382, 386-87, 389, 408-14, 455.

[148] *Id.* at 385.

for activist board representation campaigns, the likelihood that activist board representation may be a necessary precondition to engaging in strategic or operational activism, and the access to information that a board seat affords, may provide credibility for the theory that activism has evolved to focus more on board representation. Therefore, more campaigns for board representation are likely, and it is predicted that these campaigns may often be successful, especially if there is widespread institutional investor support for such campaigns.

### 2. *Investment Horizon*

Part I explored the narrative that activist hedge funds are short-term actors. Leo Strine has recently noted that "[t]he rise that most hedge funds seek must occur within a relatively short time period, because many activist hedge funds have historically retained their positions for only one to two years at most."[149] However, activists themselves have emphasized that they take longer-term positions in companies when they secure board representation. For example, Jeffrey Ubben, the former head of ValueAct Capital, noted that "[i]n firms where it has board seats ValueAct holds its positions for two to four years. . . ."[150] Similarly, Nelson Peltz, the founder of Trian Partners, has stated that "[w]e are accused of being short term investors. But the average length of stay in an investment is five years. At Fidelity it's 18 months. . . ."[151]

Previous empirical studies have estimated the average or median investment duration of activist hedge fund campaigns. In Brav, Jiang, Partnoy, and Thomas' study of activist events from 2001 to 2006, which is the most highly cited study, the median investment period for completed activist hedge fund interventions was approximately one year, with an overall duration of all the events (including those that were ongoing and had not been exited yet) being closer to twenty months.[152] This figure is repeated in much of the subsequent and recent literature on hedge fund activism to exemplify the point that activist hedge funds are short-termist and will rarely stay invested in target

[149] *Who Bleeds, supra* note 1, at 1892.

[150] *An Investor Calls*, ECONOMIST: BRIEFING (Feb. 7, 2015), https://www.economist.com/briefing/2015/02/05/an-investor-calls.

[151] *Who Bleeds, supra* note 1, at 1892 n.71 (citing Kerry A. Dolan, *Trian's Nelson Peltz on Why He's a Nicer Investor than People Think*, FORBES (June 21, 2016, 9:00 AM), https://www.forbes.com/sites/kerryadolan/2016/06/21/trians-nelson-peltz-on-why-hes-a-nicer-investor-than-people-think/?sh=5742293b4f95).

[152] *Hedge Fund Activism, supra* note 83, at 1731-32.

companies beyond two years.[153]

Most of the other key studies published in the 2000s did not specifically measure investment duration. One that did was Boyson and Mooradian's study of activist campaigns between 1994 and 2005.[154] Here, they divided campaigns "into three categories: communication only (or 'investment purposes only'), communication then aggressive, and aggressive only."[155] For communication only firms, the study found that the mean duration of activist campaigns was about one and one-third years. For the other two categories, the average duration of the campaigns was longer, at just over two years.[156]

This discussion leads to the third research question and related hypothesis that are investigated in the empirical study in Part III:

***Research Question 3 — Is activist board representation associated with a longer-term investment approach on the part of the activist hedge fund?***

***Hypothesis 3 — Activist hedge funds that successfully secure board seats are likely to stay invested in target companies longer than activists without board seats.***

There are various intuitive and legal reasons why activist board representation may be associated with longer investment periods. Intuitively, if the activist is seeking board representation to propose strategic and operational changes while on the board, then these strategies are likely to take longer to implement and thus pay off financially, compared to returns of cash to shareholders where the impact is much more immediate. Another potential reason why activist hedge funds might adopt a longer-term perspective when they seek and secure board representation is a regulatory one. In the United States, a hedge fund will become an "insider" that is subject to Section 16 of the Exchange Act if it has a ten percent stock ownership or a representative on the company board under the SEC's "director by deputization"

[153] For example, *Who Bleeds, supra* note 1, at 1892 & n.70 cites this data in support of the proposition that "many activist hedge funds have historically retained their positions for only one to two years at most," and Coffee & Palia, *supra* note 14, at 566 & nn.74-77 cite this study alongside other studies to highlight that most activists "do not appear to hold for the long run" and "specialize in shortterm interventions."

[154] Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RSCH. 169, 170 (2011).

[155] *Id.* at 175.

[156] *Id.* at 178-79.

theory.[157] As a result, the activist would have to disclose any change in its interest and disgorge any profits from "short-swing" trading, i.e., trading within any six-month period. This imposes some practical limitations on activist hedge funds selling stock when they hold a board seat.

There may also be restrictions on selling stock in the settlement agreements that are negotiated between activist hedge funds and target companies. For example, in some settlement agreements, it is a condition that the activist continues to hold a certain stake in the target company in order to retain its seat on the board.[158]

### 3. *Capital Commitment*

Relatedly, it might be expected that activist hedge funds would commit more capital to a target company when they have board seats, reflecting their increased commitment to the company for the longer-term. The capital committed by activist hedge funds has been reported in previous studies, but this has never before been broken down into cases where the activist hedge fund sought or secured board representation, and cases where it did not. In the study by Brav, Jiang, Partnoy, and Thomas, the median maximum ownership stake held by activist hedge funds in the sample was 9.1%, with no distinction being made between different types of campaign.[159] This number is expected to be higher than in my sample because it included a broader range of U.S. public companies, not just the S&P 500. Similarly, in Bratton's study, the median percentage of stock held in small capitalization companies was 9.8%, whereas for large capitalization companies

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[157]Securities Exchange Act of 1934 § 16, (codified at 15 U.S.C. § 78p (2012)). Cases on "director by deputization" may take into account the following factors, among others: the director regularly shares confidential information with the investor; the director has a relationship with the investor that allows the investor to influence the director's decisions; the director has a relationship with the investor that allows the director to routinely influence the investor's investment policy generally or with respect to the issuer; or the director performs his or her duties for the benefit of the investor rather than for the issuer.

[158]An example of this from the United Kingdom is ValueAct's settlement agreement with Rolls-Royce, where the activist hedge fund could only retain its seat on the board provided its stake in Rolls-Royce did not fall below 7.5%. Peggy Hollinger, *Rolls-Royce Agrees ValueAct Board Deal*, FIN. TIMES (Mar. 2, 2016), https://www.ft.com/content/3809a222-e04b-11e5-9217-6ae3733a2cd1; Press Release, Rolls-Royce, Rolls-Royce Appoints Bradley Singer as a Non Executive Director (Mar. 2, 2016), https://otp.investis.com/clients/uk/rolls-royce1/rns/regulatory-story.aspx?newsid=678255&cid=171; Press Release, Rolls-Royce, Summary of Key Terms in Relationship/Confidentiality Agreement Between Rolls-Royce Holdings plc, The ValueAct Group and Bradley Singer Dated 3 May 2018 (May 3, 2018), https://www.rolls-royce.com/~/media/Files/R/Rolls-Royce/documents/about/Key-Terms-of-Relationship-Agreement-with-ValueAct.pdf.

[159]*Hedge Fund Activism, supra* note 83, at 1732.

(over $5 billion in market capitalization) it was 6.7%.[160] Again this was not broken down into types of campaign. Primarily, my empirical study seeks to discover whether activist hedge funds commit to a higher percentage of the target company's shares when they seek and secure board representation.

This leads to the fourth research question and its related hypothesis, both of which are explored in the empirical study in Part III:

***Research Question 4 — Do activist hedge funds hold larger stakes in the target company when they appoint activist directors, compared to cases where they have no board seats?***

***Hypothesis 4 — Activist hedge funds that seek and secure board seats may also take a larger ownership stake.***

#### 4. *Campaign Objectives*

***Research Question 5 — Do activist hedge funds pursue different types of strategies when they seek board representation?***

A fundamental question is whether activist hedge funds are pursuing different types of strategies when they seek board representation, compared to when board representation is not sought.

#### i. Strategy & Operations

There are a multitude of anecdotal examples of activist hedge funds submitting detailed business plans and proposals for long-term strategic and operational improvements at target companies. In addition to Starboard Value's campaign at Darden, another well-publicized example was the proxy contest launched by Trian Partners to obtain one seat for its founder, Nelson Peltz, on the board of P&G in 2017.

P&G, with a market capitalization of around $225 billion, was the largest company ever to be subject to a proxy contest.[161] Trian invested $3.5 billion in P&G, which gave the activist hedge fund

[160] Bratton, *supra* note 78, at 1389.

[161] Julie Creswell, *Nelson Peltz Declares Victory in Procter & Gamble Proxy Fight*, N.Y. TIMES (Nov. 15, 2017), https://www.nytimes.com/2017/11/15/business/procter-gamble-nelson-peltz.html. This was not P&G's first experience as the target of hedge fund activism. *See* Jessica Wohl, *Procter & Gamble Brings Back Former CEO to Fix Company*, REUTERS (May 23, 2013, 9:02 PM), https://www.reuters.com/article/us-procter-ceo/procter-gamble-brings-back-former-ceo-to-fix-company-idUSBRE94M1AW20130524 (discussing how in 2013 Procter & Gamble succumbed to pressure from Pershing Square to replace the chairman and CEO of the company with the former chairman and CEO).

a 1.5% stake in the company.[162] P&G's shareholder base was somewhat unusual for an S&P 500 company as it had a more dispersed shareholder base. P&G had around three million shareholders and a high proportion of individual shareholders (generally employees or former employees).[163] During the campaign, Trian put forward a ninety-three-page whitepaper entitled "Revitalize P&G Together,"[164] which detailed the issues it sought to correct at P&G through its campaign.

Unusually, Martin Lipton, a vocal opponent of hedge fund activism, highlighted that the P&G whitepaper was unique in many ways: as Trian was seeking to promote sustainable long-term investment and growth, it was not seeking to break up P&G, and was not seeking to cut pensions, reduce Research and Development ("R&D"), marketing expense, or capital expenditures. Additionally, Trian was not proposing to replace P&G's current CEO or any directors.[165] P&G itself had already engaged in many of the techniques that hedge fund activists are traditionally criticized for, including layoffs, share buybacks, dividend increases, and substantial cost cutting.[166]

This anecdote serves to illustrate some of the theory motivating the next hypothesis. As demonstrated by the P&G whitepaper, activist hedge funds have the expertise and resources to conduct extensive research on target companies from outside of the boardroom. They can then present their proposals to management and to investors through their whitepapers. However, unlike financial or balance sheet activism, it would be very difficult for an activist hedge fund to implement any strategic or operational proposals from outside of the boardroom. Doing so requires access to the board and to management. Therefore, a board seat would seem to be a necessary precursor to executing change of this nature. This leads to the following hypothesis:

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[162] Adam Hartung, *The Case for Trian's Nelson Peltz Joining P&G's Board*, FORBES (Oct. 31, 2017, 10:13 AM), https://www.forbes.com/sites/adamhartung/2017/09/07/the-case-for-trians-peltz-joining-the-pg-board/.

[163] PROCTER & GAMBLE, 2017 ANNUAL REPORT 9 (2017); Svea Herbst-Bayliss & Siddharth Cavale, *Procter & Gamble Foresees Proxy War Victory, Peltz Refuses to Concede*, REUTERS (Oct. 10, 2017, 3:06 PM), https://www.reuters.com/article/business/procter-gamble-foresees-proxy-war-victory-peltz-refuses-to-concede-idUSKBN1CF0CE/.

[164] TRIAN PARTNERS, *supra* note 6.

[165] Martin Lipton, *The Trian/P&G Proxy Contest*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 11, 2017), https://corpgov.law.harvard.edu/2017/09/11/the-trianpg-proxy-contest/.

[166] Anna Nicolaou & Scheherazade Daneshkhu, *The Hedge Fund, the CEO and the Fight for P&G's Future*, FIN. TIMES (Oct. 13, 2017), https://www.ft.com/content/a4c4d59e-aff7-11e7-beba-5521c713abf4.

***Hypothesis 5a — Activist board representation may be accompanied by more substantive strategic and operational activist strategies rather than the financial engineering that activist hedge funds are commonly criticized for engaging in.***

### ii. Balance Sheet Activism

Related to the general question posed in Research Question 5 above, the empirical study also investigates whether balance sheet activism is less prevalent in cases where activist hedge funds seek and secure board seats. Again, the intuition is that a strategy involving balance sheet activism would be less likely to accompany requests for board seats. There are several reasons for this. One is that if balance sheet activism were the only goal, it would not be necessary for the activist hedge fund to secure a board seat in order to succeed in its campaign. The company's cash position can be analyzed from outside of the boardroom and the activist hedge fund would not need special access to inside information in order to implement this strategy in practice. Rather, it would simply be a case of whether the company management were willing to accede to this demand or not. Moreover, as noted earlier, longer-term institutional investors may not be supportive of hedge funds pursuing financial or balance sheet activism as a primary campaign strategy, and it also may be the case that targets classified as low-hanging fruit in this respect are diminishing or non-existent. Overall, this analysis leads to the following hypothesis:

***Hypothesis 5b — Activist hedge funds may be less likely to engage in financial or balance sheet activism when they seek or secure board representation.***

### 5. *CEO Turnover*

The next research question concerns CEO turnover and is as follows:

***Research Question 6 — Are target company CEOs more often replaced when an activist hedge fund secures board representation?***

In 2008, Brav, Jiang, Partnoy, and Thomas argued that "hedge fund activism is not kind to CEOs of target firms."[167] In particular, they discovered that during the year after an activist hedge fund campaign is announced, the CEO turnover rate increases by almost ten percentage points and average CEO compensation

[167] *Hedge Fund Activism, supra* note 83, at 1732.

declines by approximately $1 million.[168] More recently, reports on activist campaigns by organizations such as Lazard have revealed that CEO turnover is higher at companies targeted by activists. For example, in a report by Lazard in 2017, it is noted that CEO turnover at activist targets averaged 23% compared to 12% for nontargets.[169] Similarly, the study by Bebchuk, Brav, Jiang, and Keusch on activist settlement agreements outlines that although only 3% of settlement agreements provide for the CEO's departure as a contract term, 18.6% of CEOs depart within a year of the relevant settlement agreement.[170]

Logically, activist hedge funds may need a representative on the board and certain key committees in order to contribute in a meaningful way to discussions for a replacement CEO. Therefore, intuitively it might seem likely that CEO turnover would be higher when an activist hedge fund seeks and secures board representation. This leads to the following hypothesis:

***Hypothesis 6 — Activist board representation may be associated with CEO departures, as a board seat may be helpful for an activist hedge fund to successfully oust the CEO.***

### 6. *Types of Activist Director*

Activist director nominees can either be affiliated directors who work at the activist hedge fund, or non-affiliated directors who are selected by the hedge fund, often due to their depth of business acumen in a particular industry or due to an impressive track record in executing corporate turnarounds. Studies of hedge fund activism in the early 2000s showed that it was much more common in the past for affiliated directors to be appointed. For example, in a dataset of activist campaigns from 2002 to 2006, it was noted that when activists gained seats on the board, 81% of those joining the board were activist fund principals with only 19% of directors appointed by activist hedge funds being non-affiliated.[171] More recent studies have continued to emphasize the prevalence of hedge fund employees on director slates. For example, in a study conducted by Coffee, Jackson, Mitts, and Bishop that analyzed 475 settlement agreements between target

[168] *Id.*

[169] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 388 n.10 (citing LAZARD'S SHAREHOLDER ADVISORY GROUP, REVIEW OF SHAREHOLDER ACTIVISM-3Q 2017 1 (2017)).

[170] Lucian A. Bebchuk, Alon Brav, Wei Jiang & Thomas Keusch, *Dancing with Activists*, HARV. JOHN M. OLIN DISCUSSION PAPER SERIES, no. 906, 2017, at 16, 50 tbl.4.

[171] Bratton, *supra* note 78, at 1412.

companies and activist hedge funds, they found that "[a]pproximately 70% of fund-nominated director slates include a hedge fund employee."[172]

There have been criticisms of activist hedge fund managers joining the boards of companies. One commonly asserted criticism is that activist hedge fund managers are highly unlikely to have a better idea of how to run a company than the incumbent directors.[173] It is argued that many activist hedge fund managers, perhaps experts in financial structuring and governance, may lack the experience to serve on a corporate board and may not have the industry expertise that is often required.[174] When seeking board representation and nominating directors, activist hedge funds may choose whether to propose their own investment managers as candidates or to put forward non-affiliated experienced industry executives. They often put forward a combination of the two if they are seeking multiple board seats.

Another dark side of activist hedge fund managers themselves joining the board relates to the earlier critique by Coffee, Jackson, Mitts, and Bishop regarding information leakage.[175] One of the main empirical findings of their study on activist settlements was that "[t]he increased leakiness is strongly associated with the appointment of directors who are also employees of the activist investor as opposed to the industry experts typically appointed to the target's board pursuant to an activist settlement."[176]

Given the various advantages and disadvantages of affiliated versus non-affiliated activist-appointed directors, this leads to the following research question:

***Research Question 7 — Are most activist directors appointed by activist hedge funds affiliated with the hedge fund, or are they non-affiliated directors?***

The hypothesis here is that the evolution of hedge fund activism has led to pressure on activist hedge funds to appoint a higher proportion of nonaffiliated directors to corporate boards, although it is anticipated that this may vary by hedge fund.

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[172] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 381-82.

[173] *See* Stephen M. Bainbridge, *Preserving Director Primacy by Managing Shareholder Interventions, in* RESEARCH HANDBOOK ON SHAREHOLDER POWER 231, 232 (Jennifer G. Hill & Randall S. Thomas eds., 2015) (noting that some shareholder interventions "are motivated by an activist's belief that he or she has better ideas about how to run the company than the incumbents, which may be true sometimes but often seems dubious").

[174] Yaron Nili, *Servants of Two Masters? The Feigned Hysteria over Activist-Paid Directors*, 18 U. PA. J. BUS. L. 509, 540 (2016).

[175] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 391.

[176] *Id.*

***Hypothesis 7 — Activist hedge funds are more likely to appoint nonaffiliated directors, rather than affiliated directors.***

### 7. *Activist Settlements*

***Research Question 8 — Are most activist directors appointed through negotiated settlement agreements or through proxy contests?***

Another research question explored is whether activist board representation is most commonly secured through a proxy contest or through a settlement agreement negotiated between the activist hedge fund and the target company.

***Hypothesis 8 — Activist board representation is more likely to be secured through settlement agreements rather than proxy contests.***

Here, the hypothesis is that board representation is more likely to be secured through settlement agreements, rather than the campaign for board representation proceeding to a proxy contest and full shareholder vote. The upward trend in activist settlements was indeed reported in a recent paper by Bebchuk, Brav, Jiang, and Keusch. In that paper, the authors conducted a study of activist settlement agreements between 2000 and 2015 and found that "[w]hile such settlements used to be rare, they now occur with significant frequency."[177] Although their data applied to a broader range of companies and activists and did not focus specifically on activist board representation, it is expected that my data would also reflect this general trend and reveal a similar pattern. Specifically, the authors found that activists formally start a proxy contest in 12% of activist campaigns, with only 38% of those cases then proceeding to a full shareholder vote.[178] Similarly, relying on studies by Lazard, Coffee, Jackson, Mitts, and Bishop have noted that "the vast majority of the directors placed on the board as a result of activist pressure is appointed through privately negotiated settlements, thus allowing management to avoid the risk of a proxy contest."[179] The Lazard data showed that after 2014, the proportion of board seats won via settlements rather than proxy contests increased considerably from 66% in 2014 to 84% in 2015, 88% in 2016, and 86% in 2017.[180]

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[177] *Dancing with Activists, supra* note 10, at 2.

[178] *Id.* at 6.

[179] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 388 (citing LAZARD SHAREHOLDER ADVISORY GROUP, REVIEW OF SHAREHOLDER ACTIVISM — Q1 2018 1 (2018)).

[180] LAZARD, 2018 REVIEW OF SHAREHOLDER ACTIVISM 8 (2018), https://www.lazard.com/research-insights/annual-review-of-shareholder-activism-2018/.

In their own study of settlement agreements between 2000 and 2015, Coffee, Jackson, Mitts, and Bishop reported that "[t]he period 2011-2015 saw a substantial increase in the number of settlements with activist investors, and the first public criticisms by diversified institutional investors of activist behavior."[181]

Settlement agreements are a less adversarial mechanism through which activist hedge funds can achieve their goals. The increased prevalence of negotiated settlements may therefore reflect a less adversarial and more collaborative approach to activism on the part of both the activists and the target companies. While a proxy contest is necessarily hostile, a settlement agreement can be seen as a collaborative or cooperative alternative.[182] Settlement agreements involve concessions by the activist and by the target company. Ordinarily, the activist will agree to a "standstill," refraining from pursuing further activist activities, and sometimes also prohibiting the activist from acquiring additional stock.[183] In return, the target company will accede to some of the activist's demands, for example, by agreeing to appoint candidates nominated by the activist fund to the target company board.[184]

More cynically, one could view settlements as incumbent managers following the path of least resistance in seeking to avoid adverse publicity or a defeat in a proxy contest, or hoping to retain their executive positions if they appease hedge fund activists with board seats. Scholars have criticized this "backroom deal-making"[185] and have stated that "[s]killed at spin control, management would rather settle than fight."[186] Long-term institutional investors have also criticized settlement agreements between activist hedge funds and corporate management, arguing that they can be disenfranchised through this process.[187] Here, the short-term versus longterm arguments usually come into play, which also illustrates the significance of the concerns over activist hedge fund short-termism to other investors. Concerns of disenfranchisement were initially raised by global asset managers in 2016, most vocally by State Street Global Advisors. Their

[181] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 390-91.

[182] *Dancing with Activists, supra* note 10, at 4.

[183] *Id.*

[184] *See id.* at 12-17 (discussing findings that settlement terms tended to focus on board composition).

[185] Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 389.

[186] *Id.* at 395.

[187] Rakhi Kumar & Ron O'Hanley, *Protecting the Interests of Long-Term Shareholders in Activist Engagements*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 17, 2016), https://corpgov.law.harvard.edu/2016/10/17/protecting-the-interests-of-long-term-shareholders-in-activist-engagements/.

concerns were repeated again more recently, where they highlighted that "[o]ver a three year period from 2016-2018, 84% of board seats gained by activists were conceded through settlement agreements; a 15% increase over the 2013-2015 period levels, where 73% of seats were conceded through settlement agreements."[188] Large asset managers and other long-term investors continue to emphasize the importance of target boards engaging with them when an activist campaign is initiated.[189] One example is in BlackRock's Larry Fink's Letter to CEOs in 2018, where he urged companies to engage with long-term shareholders early and bring other critical stakeholders to the table when activists offer valuable ideas.[190]

Regardless of the underlying motives of target company management, or the opinions of institutional investors, it seems that activists are becoming increasingly successful at swiftly obtaining board representation through settlements with target companies. Companies sometimes emphasize that they are working cooperatively with activists and often reach agreements with activists during the early stages of intervention. One example is JANA Partners' agreement with Tiffany & Co. to add three non-affiliated directors to the Tiffany board, which was announced before the market was even aware that the activist was a 5% shareholder.[191]

The addition of activist directors is a very common condition of settlement agreements. Bebchuk, Brav, Jiang, and Keusch's study which considered activist settlement agreements from 2000 (because settlements were rare before 2000) to 2013, noted that almost 84% of settlements stipulate the addition of new directors.[192] More unusually, some companies have even gone so

[188]STATE STREET GLOBAL ADVISORS, *supra* note 132, at 1-2.

[189]Michael Flaherty, *Big Funds Push Back Against Activist Investor Settlements*, REUTERS (July 18, 2016, 3:22 PM), https://www.reuters.com/article/us-activist-investors-idUSKCN0ZY2DP.

[190]Larry Fink, *A Sense of Purpose*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 17, 2018), https://corpgov.law.harvard.edu/2018/01/17/a-sense-of-purpose/ [hereinafter 2018 Letter from Larry Fink] (stating "[w]here activists do offer valuable ideas—which is more often than some detractors suggest—we encourage companies to begin discussions early, to engage with shareholders like BlackRock, and to bring other critical stakeholders to the table. But when a company waits until a proxy proposal to engage or fails to express its long-term strategy in a compelling manner, we believe the opportunity for meaningful dialogue has often already been missed").

[191]Michael Flaherty, *Tiffany Adds Three Directors in Pact with Activist JANA*, REUTERS (Feb. 21, 2017, 5:24 PM), https://www.reuters.com/article/us-tiffany-jana-idUSKBN1601AC ("The deal with JANA jolted the company's stock and came before the market was even aware the hedge fund was a shareholder.").

[192]*Dancing with Activists, supra* note 10, at 4, 14 tbl.5.

far as to invite activist intervention or activist directors. For example, General Electric's CEO Jeff Immelt invited activist Nelson Peltz of Trian Partners—which did not own shares in the company—to become involved in GE. Trian ultimately invested $2.5 billion, which was its biggest investment to date at the time, and an affiliated representative of Trian Partners joined the board.[193]

There are various reasons why target companies may choose to settle rather than allow the activist campaign to proceed to a proxy contest and shareholder vote. The first is cost and time. Proxy contests are expensive and consume a lot of management time. In the United States, running a proxy contest for board representation can prove to be incredibly costly (both for the activist and the target company). Indeed, more than ten years ago the average cost of a proxy fight in the United States was believed to be in excess of $10 million.[194] Trian's proxy contest at P&G was reported as the most expensive in history, costing Trian $25 million, with P&G reportedly spending anywhere between $35 million and $100 million on its defense.[195] Another motivation for target company managers and directors to settle with an activist may be to try to preserve their own positions by appeasing the activist. Coffee, Jackson, Mitts, and Bishop argue that "the CEO's job is imperiled, unless he or she settles."[196]

## III Activist Board Representation: An Empirical Study

### A. *Sample Construction and Data Description*

#### 1. *Hedge Fund Activism at S&P 500 Companies*

This study analyzes activist hedge fund campaigns at S&P 500

[193]David Benoit, *Activism's Long Road from Corporate Raiding to Banner Year; Change in Tactics Let Industry Move Beyond Controversial Past*, WALL ST. J. ONLINE (Dec. 26, 2015), https://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910. Trian later invested $3.5 billion in P&G. Michael Flaherty, *Trian Takes $3.5 Billion Stake in Procter & Gamble*, REUTERS (Feb. 14, 2017, 7:00 PM), https://www.reuters.com/article/business/trian-takes-35-billion-stake-in-procter-gamble-idUSKBN15T35E/#:~:text=(Reuters).

[194]Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 611 (2013) (noting that "a campaign ending in a proxy fight has average costs of $10.71 million").

[195]Hartung, *supra* note 162; Chris Isidore & David Goldman, *Procter & Gamble Declares Victory in Expensive Proxy Fight*, CNN (Oct. 10, 2017, 11:49 AM), https://money.cnn.com/2017/10/10/news/companies/procter-gamble-proxy-fight/index.html. *See also* Anna Christie, *The Agency Costs of Sustainable Capitalism*, 55 U.C. DAVIS L. REV. 875, 927-34 (2021) (outlining the cost of Engine No. 1's proxy contest at ExxonMobil).

[196]Coffee, Jackson, Mitts & Bishop, *supra* note 120, at 388. The CEO's job may also be imperiled even if they do settle. *See supra* Part II.B.5.

companies in the period from 2010 to 2019. Although S&P 500 companies make up approximately 14% of the total number of public companies in the United States,[197] they represent over 80% of the total market capitalization of the entire U.S stock market.[198] Therefore, the most economically significant companies are constituents of the S&P 500 index.

The decision to focus exclusively on S&P 500 companies[199] is a departure from the prior empirical literature on hedge fund activism, which has generally analyzed activism at a wider range of U.S. public companies.

### i. Prior Hedge Fund Activism Datasets

It is useful to compare the dataset in my study to previous datasets of hedge fund activist campaigns. The datasets used in prior empirical studies on hedge fund activism are summarized in the table below:

### Table 1 — Prior Empirical Studies of Hedge Fund Activism

This table shows the sample years, total activist events, and total target companies in the samples studied in the most often cited prior empirical studies of hedge fund activism.

| PAPER | SAMPLE YEARS | TOTAL ACTIVIST EVENTS | TOTAL TARGET COMPANIES |
|---|---|---|---|
| Brav, Jiang, Partnoy & Thomas (2008)[200] | 2001 — 2006 | 548 | |

**[Section III]**

[197]*See* S&P DOW JONES INDICES, S&P 500 (CLP) (Sept. 30, 2024), https://www.spglobal.com/spdji/en/idsenhancedfactsheet/file.pdf?calcFrequency=M&force_download=true&hostIdentifier=48190c8c-42c4-46af-8d1a-0cd5db894797&languageId=1&indexId=92465107 [hereinafter S&P 500 FACTSHEET] (representing that there are 504 S&P 500 companies); FT WILSHIRE, FT WILSHIRE 5000 INDEX 1 (June 30, 2021), https://assets-global.website-files.com/60f8038183eb84c40e8c14e9/6132007be5f0a49e7a5f652a_ft-wilshire-5000-fact-sheet.pdf [hereinafter WILSHIRE 5000 FACT SHEET] (noting that there are 3,544 listed companies in the United States with readily available price data). Reference is often also made to the Russell 3000 index, which represents approximately 98% of the investable U.S. equity market. FTSE RUSSELL, RUSSELL 3000 INDEX 1 (Aug. 31, 2024), https://www.ftserussell.com/analytics/factsheets/home/search (search "Russell 3000").

[198]S&P 500 FACTSHEET, *supra* note 197.

[199]See *infra* Part III.A.1.ii for a discussion on the rationale behind focusing on the S&P 500.

[200]Compiled by purchasing a list of Schedule 13D filings made by activist

| PAPER | SAMPLE YEARS | TOTAL ACTIVIST EVENTS | TOTAL TARGET COMPANIES |
|---|---|---|---|
| Clifford (2008)[201] | 1998 — 2005 | 788 | |
| Klein & Zur (2009)[202] | 2003 — 2005 | 151 | |
| Bratton (2007)[203] | 2002 — mid-2006 | 130 | 130 |
| Greenwood & Schor (2009)[204] | Q3 1993 — Q3 | 784 | |
| | 2006 | | |
| Briggs (2007)[205] | 2005 — mid-2006 | | 52 |

hedge funds at U.S. public companies between 2001 and 2006. Brav, Jiang, Partnoy & Thomas, *Hedge Fund Activism, supra* note 83, at 1737 (noting that the authors purchased a list of all Schedule 13D filers during the period 2001 to 2006 from LiveEdgar and then manually filtered out the non-hedge fund filers). This generated a sample of 1,059 activist events (548 actively/publicly pursued campaigns and 511 passive/private campaigns) at 882 unique target companies. *Id.* at 1739, 1741-42. The final sample in this dataset comprised 1,059 hedge fund-target pairs at 882 unique target companies. However, this sample included 511 events where there was no active campaign to achieve specific goals, leaving 548 active campaigns at an unspecified number of target companies. *Id.* at 1741-42. The Brav, Jiang, Partnoy, and Thomas dataset has been further extended and analyzed in subsequent papers. For example in a law review article by Bebchuk, Brav, and Jiang, an extended version of the dataset covering campaigns from 1994 to 2007 was referred to. *See* Bebchuk, Brav & Jiang, *supra* note 33, at 1098; *Dancing with Activists, supra* note 10 (citing Alon Brav, Wei Jiang, Song Ma & Xuan Tian, *supra* note 78). An updated version of the dataset involving "4,657 hedge fund activist events spanning the time period 1994 through 2018" is also referenced in a 2022 working paper by Brav, Jiang, and Li. *See Governance by Persuasion, supra* note 82, at 4.

[201]*See* Clifford, *supra* note 83, at 326 (utilizing Schedule 13D filings and yielding a sample of 788 activist events between 1998 and 2005).

[202]Klein & Zur, *supra* note 83, at 187 (examining Schedule 13D and 13D/A filings of 151 activist events between 2003 and 2005). Here, the sample was considerably smaller due to the three-year date range and because the dataset was restricted only to instances where activist hedge funds had filed Schedule 13Ds and cases where they had actively and publicly pursued campaigns. *Id.* at 195.

[203]Bratton, *supra* note 78, at 1385 (utilizing press releases to create a sample of activist events at 130 firms from January 1, 2002, to June 30, 2006).

[204]Greenwood and Schor constructed a dataset of activist filings with the Securities and Exchange Commission ("SEC") (Schedule 13D and DFAN14A filings, which are filed with the SEC by investors who intend to or are engaged in a proxy fight with a firm's management) from 1993 to 2006, consisting of 784 activist events initiated by 139 hedge funds. Greenwood & Schor, *supra* note 83, at 364. Events were defined as "instance[s] in which an activist files a 13D filing announcing 5% ownership and an intention to influence the management of the company." *Id.* at 365 tbl.1.

[205]Thomas W. Briggs, *Corporate Governance and the New Hedge Fund*

| PAPER | SAMPLE YEARS | TOTAL ACTIVIST EVENTS | TOTAL TARGET COMPANIES |
|---|---|---|---|
| Boyson & Mooradian (2011)[206] | 1994 — 2005 | 418 | 397 |

As shown in the table above, all of these studies focused on activist hedge fund campaigns up to 2005 or 2006, making the data nearly twenty years old. This emphasizes the need for a study of the evolution of hedge fund activism and a fresh analysis of modern-day techniques utilized by activist hedge funds at the most economically significant companies in the United States.

### ii. Focus on the S&P 500

There were various rationales for my decision to focus on S&P 500 companies and to depart from the data collection methods in prior literature. With respect to the focus on S&P 500 companies, prior literature found that hedge fund activists tend to target smaller companies. For example, Bratton noted that "hedge funds concentrate their attention on the small capitalization sector"[207] and Brav, Jiang, Partnoy, and Thomas found in their widely cited study that "hedge funds are less likely to target larger firms because the fund would need to invest a large amount of capital in order to amass a meaningful stake."[208]

Reliance on these empirical studies from the 2000s has led to a general perception that hedge fund activism continues to primarily focus on smaller companies to the present day. This can sometimes also be used as an argument to downplay the impact of hedge fund activism. Brian Cheffins states in his 2018 book, *The Public Company Transformed*, that "Gilson and Gordon likely overestimate the clout of activist hedge funds, which is significant but has been compromised from a governance perspective by the continued bias in favor of targeting smaller companies as well as by the episodic nature of hedge fund interventions."[209] However, as my empirical study shows, since the empirical stud-

*Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 695 (2007) (compiling hand-gathered SEC filings for activist campaigns which took place in 2005 and the first eight months of 2006). This resulted in a sample of fifty-two activist targets. *Id.* at 696.

[206]Boyson & Mooradian, *supra* note 154, at 170 (covering 13D filings from 1994 to 2005 including 418 activist events involving 111 hedge funds and 397 target firms).

[207]Bratton, *supra* note 78, at 1387.

[208]*Hedge Fund Activism, supra* note 83, at 1752.

[209]CHEFFINS, *supra* note 15, at 372. Cheffins does also note that "[c]aveats aside, hedge fund activism has been a meaningful shareholder value catalyst and likely will remain so for the foreseeable future." *Id.*

ies documenting activism in the 2000s, activist hedge fund behavior has changed considerably. The largest and most prominent activist hedge funds have increasingly targeted some of the biggest companies in the United States.[210]

This Article fills a gap in the literature by analyzing the previously unexplored hedge fund activism at S&P 500 companies. It is undoubtedly true, as Martin Lipton states, that "no company should consider itself immune from activism. No company is too large, too new or too successful."[211] The empirical data presented here can also help to avoid caveats that were necessary in very recent academic scholarship. For example, in Coffee and Palia's survey in 2016, it was necessary to caveat that the studies did not cover data later than 2007 and that hedge fund activism had substantially changed in the intervening time.[212]

A reliance on studies that primarily focus on smaller companies and that analyze hedge fund behavior prior to more recent changes in such behavior may be of limited usefulness and could even result in a misrepresentation of current activist hedge fund behavior. As illustrated in Part I, the narrative on activist short-termism is strong. Therefore, it is important to have a clear picture of the current activities of activist hedge funds at the most economically significant companies in order to assess whether accusations of short-termism are well-founded or not.

In addition to documenting recent trends of activists targeting large companies, compiling a dataset of activist campaigns at S&P 500 companies enables a focus on the most economically significant companies and the most prolific, high-profile activist hedge funds in the United States. These companies and activists are the most likely actors to have an outsized (positive or negative) impact on stakeholders and society more generally. As noted above, the S&P 500 is significant as these companies represent over eighty percent of the total market capitalization of the U.S. stock market. It also follows that activism at such companies would similarly have an outsized impact on the economy at large. As one example of the stakeholder impact, S&P 500 companies

[210] *See infra* Part III.B.1.ii.

[211] Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sep. 2, 2022), https://corpgov.law.harvard.edu/2022/09/02/dealing-with-activist-hedge-funds-and-other-activist-investors-5/; Martin Lipton, *Dealing with Activist Hedge Funds and Other Activist Investors*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 6, 2021), https://corpgov.law.harvard.edu/2021/10/06/dealing-with-activist-hedge-funds-and-other-activist-investors-4/.

[212] Coffee & Palia, *supra* note 14, at 54 ("[A]ll of these studies end generally no later than hedge fund interventions initiated in 2007. Since that time, hedge fund activism has accelerated substantially and altered its targets, thus having impacts that these studies may not capture.").

employ approximately seventy percent of the overall workforce of Russell 3000 companies.[213] Further, on a global scale, large U.S. companies tend also to have an outsized role in the global economy. In 2022, 5 of the top 10 largest companies in the world were U.S. companies, and 40 of the top 100 companies ranked by sales, profits, assets, and market value were American.[214] For publicly traded companies ranked by market capitalization, 63 of the largest 100 companies were U.S. companies.[215]

As S&P 500 companies are likely to have the biggest impact on stakeholders and the global economy, it is useful to study activist campaigns at these firms separately. Activism at small-cap companies can be quite different from activism at large-cap companies. The players involved also often tend to be different. For example, my data shows that there is only a small group of very large activist hedge funds that target S&P 500 companies.[216] On the other hand, a much broader range of activist hedge funds target smaller companies.[217] To avoid averaging out results that then present a distorted picture of what actually happens at the largest companies, it is helpful to study the biggest companies in the United States separately to obtain a clear picture of what form hedge fund activism takes at these important companies.

Despite the wider general remit of earlier papers, one key paper did separately mention the importance of activism at major companies and by high-profile activist hedge funds. Bebchuk,

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[213]*See Who Bleeds, supra* note 1, at 1886 & n.50 ("[H]owever attractive it is for politicians to talk about small business being the engine for job growth, the reality remains that public companies are the most vital source of jobs in our economy.").

[214]Forbes, *Forbes Global 2000 List 2022: The Top 200*, https://www.forbes.com/sites/for-besstaff/2022/05/12/forbes-global-2000-list-2022-the-top-200/?sh =465d096b3290 (last visited Oct. 16, 2024); *see also* Cheffins, *supra* note 15, at 10 (stating that U.S. companies accounted for 38 of the top 100 companies by revenue in 2017).

[215]PWC, Global Top 100 Companies - by Market Capitalisation 8 (2022), https://www.pwc.com/gx/en/audit-services/publications/top100/pwc-global-top-100-companies-by-market-capitalisation-2022.pdf; *see* Cheffins, *supra* note 15, at 357 (showing that American companies comprised 55 of the top 100 in 2017 and 35 of the top 100 in 2008).

[216]*See infra* Part III.B.1. & Table 3 (showing that only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company in the ten years from 2010 to 2019 and that six activist hedge funds were responsible for more than two-thirds of all activist board representation campaigns at S&P 500 companies).

[217]For example, there were 197 distinct activist hedge funds in the Clifford study, 139 distinct activist hedge funds in the Greenwood & Schor study, and 111 distinct hedge funds in the Boyson & Mooradian study. Clifford, *supra* note 83, at 326; Greenwood & Schor, *supra* note 83, at 364; Boyson & Mooradian, *supra* note 154, at 175.

Brav, Jiang, and Keusch included tables of activist campaign data at "notable targets" and by "notable activists."[218] This data more closely resembles the activists and target companies in my study, although there is only an overlap of three years between our sample periods.

Regarding the data collection methods, precisely following the data collection methodologies in the prior foundational literature—where the datasets were compiled by purchasing lists of Schedule 13D filings—would have resulted in a significant number of high-profile modern-day activist hedge fund campaigns at S&P 500 companies not being captured in the initial data gathering process. In the 2000s, this methodology made sense as the logical starting point because activist hedge fund campaigns at large-cap companies were very rare. However, as discussed above, in the past decade activist hedge funds have increasingly targeted higher profile economically significant large-cap S&P 500 companies. The larger market capitalization of these companies results in the activists generally holding a lower percentage of the target company shares, compared to the percentage held at small or mid-cap companies—often below the five percent level which triggers the requirement to file a Schedule 13D.[219] Therefore, an alternative starting point for data collection was necessary for my study to ensure that those important cases would be appropriately captured.

### 2. *Data Collection*

My study analyzes activist hedge fund events during a ten-year period from January 1, 2010, until December 31, 2019. Given the hypothesis and anecdotal evidence that activist hedge fund strategies have evolved considerably in recent years, the date range of 2010 to 2019 was chosen to reflect the most recent activist campaigns and the most relevant, up-to-date, activist hedge fund strategies. This is an important contribution to the literature by virtue of the recent nature of the campaigns alone, as it is the most up-to-date study of the constantly evolving phenomenon of

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[218] *Dancing with Activists, supra* note 10, at 6, 35 tbl.A.1, 36 tbl.A.2 (defining "notable targets" as firms with a market capitalization of $7 billion and above, and "notable activists" as activists with four or more interventions between 2000 and 2013).

[219] In Brav, Jiang, Partnoy & Thomas' sample, it was noted that "[r]elatively few targeted companies are large-cap firms, which is not surprising given the comparatively high cost of amassing a meaningful stake in such a target." *Hedge Fund Activism, supra* note 83, at 1730. The Klein & Zur study and the Greenwood & Schor study also omit activism below the five percent reporting threshold. *See* Klein & Zur, *supra* note 83, at 195; Greenwood & Schor, *supra* note 83, at 364.

hedge fund activism.[220]

Moreover, my study is the first to provide an in-depth comparison of activist board representation campaigns with non-board-level campaigns. In this respect, it was desirable to focus on the most up-to-date campaigns as board-level activist campaigns were rare at S&P 500 companies prior to 2010.[221] A cut-off of December 31, 2019, was used for the activist intervention to have begun. To provide the fullest data for investment duration, activist hedge fund exits were recorded up to June 30, 2022.

**i. List of S&P 500 Companies**

As the S&P 500 index is regularly reconstituted, the first step of the data collection process involved constructing a comprehensive list of all companies that were constituents of the S&P 500 during the sample period. This involved manually compiling a list of companies that were constituents of the S&P 500 at some point during 2010 to 2019 using publicly available sources that identified the date each specific company was added to or removed from the S&P 500 index.[222] The original resource used for this purpose contained some duplicates (for example when companies had changed name), so the information was manually checked against other publicly available lists of S&P 500 companies and verified with Google searches of each specific company. This exercise resulted in a final list of 700 unique S&P 500 constituent companies, which were recorded together with the date each company was added to or removed from the S&P 500 index.

**ii. Activist Campaigns**

Once the list of S&P 500 constituent companies was complete, the second step was to conduct searches to determine whether there had been activist campaigns at these companies. In order to be included in the dataset, the activist campaign had to have taken place at a company that was in the S&P 500 at the time

[220]The most up-to-date empirical studies on hedge fund activism tend to study data up to the first half of the 2010s. For example, Krishnan, Partnoy, and Thomas used a large dataset of hand-collected information on activist interventions from January 1, 2008, to May 1, 2014. *See* C.N.V. Krishnan, Frank Partnoy & Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J. Corp. Fin. 296, 296, 298 (2016). Other recently published studies, such as the comprehensive study of worldwide hedge fund activism by Becht, Franks, Grant, and Wanger, consider campaigns in the previous decade. *See* Becht, Franks, Grant & Wagner, *supra* note 83, at 2934 (analyzing hedge fund activism in 23 countries during the period 2000-2010).

[221]*See infra* Chart 4.

[222]Leo Smigel, *The S&P 500 Historical Components & Changes*, Analyzing Alpha (Oct. 13, 2023), https://analyzingalpha.com/sp500-historical-components-and-changes.

the activist campaign began. I used a professional database of shareholder activism events—Activist Insight (Insightia),[223] rather than purchasing lists of Schedule 13D filings—to generate a preliminary list of companies targeted by activist hedge funds. The sources of information used and cross-referenced in the Activist Insight database are wider than Schedule 13D filings as they include other SEC filings (for example Activists' 13F filings), press releases, news and trade publications, and company websites.

I, therefore, conducted a search in Activist Insight for all activist campaigns at U.S. companies. The results of this search were then cross-checked against the list of the 700 S&P 500 companies (compiled in step one above). This manual process resulted in a list of 501 matches where S&P 500 companies had been the target of some form of activist intervention. This list included all recorded types of activism by any type of shareholder activist.

To account for any errors in the Activist Insight database, I then conducted extensive Google and Factiva searches on the remaining 199 companies that were to be excluded from the sample, to uncover any activist hedge fund campaigns that may not have been identified by the Activist Insight database. This process identified three additional target companies[224] that had not been listed in the Activist Insight search, which were then added to give a total of 504 target companies. There was no opportunity to cross-check my dataset against any of the other datasets referred to above, as my dataset contained campaigns from 2010 to 2019, and the previous empirical studies all analyzed activist campaigns up to 2005 or 2006. It was possible to cross-check some of my data (for the first three years from 2010 to 2013) against a more recent paper by Bebchuk, Brav, Jiang, and Keusch on activist settlements, as this paper included data from 2000 to 2013.[225]

### iii. Activist Hedge Fund Campaigns

The third step in the sample construction process was to manually filter out the campaigns where the activist investor was not an activist hedge fund. "There is no central database of activist hedge funds,"[226] nor is there a universally agreed upon definition

[223] Diligent Market Intelligence, https://www.insightia.com/ (Activist Insight is now called Diligent Market Intelligence).

[224] JCPenney, Perrigo Company, and Transocean.

[225] *See infra* Part III.C.1. However, this article only contained details of settlements, and not, for example, unsuccessful proxy contests.

[226] *Hedge Fund Activism, supra* note 83, at 1736.

of a hedge fund.[227] Rather, it has been noted that "the term 'hedge funds' is loosely defined."[228] Therefore, identifying activist hedge fund campaigns always involves some element of judgment in determining whether an activist investor is appropriately classified as a hedge fund.[229]

Activist Insight also did not have a search function to search by a particular type of activist.[230] Therefore, it was not possible to search for campaigns conducted only by activist hedge funds. Instead, I manually compiled a list of activists that had targeted each of the target companies. From the list of 504 target companies, 336 companies were easily identified as targets of activist hedge funds, as they involved campaigns by at least one major, well-known, activist hedge fund.[231] Next, 85 of the 504 companies were clearly identified not to be targets of activist hedge funds. Instead, these companies were targeted by public pension funds,[232] labor unions,[233] individual "gadfly" investors,[234] other shareholder organizations,[235] family foundations,[236] and

[227] FINANCIAL SERVICES AUTHORITY, HEDGE FUNDS AND THE FSA, DISCUSSION PAPER 16, 8 (2002), https://webarchive.nationalarchives.gov.uk/ukgwa/20130202110317mp_/ http://www.fsa.gov.uk/pubs/discussion/dp16.pdf.

[228] *Governance by Persuasion, supra* note 82, at 9.

[229] *See Hedge Fund Activism, supra* note 83, at 1736-37 (noting that various steps were taken to decide whether activists should be classified as hedge funds including searching the internet for their websites and news articles describing them, and calling them to ask for their self-classification); Greenwood & Schor, *supra* note 83, at 364 (noting that the authors used company websites, newspaper articles, and the Center for International Securities and Derivatives Markets ("CISDM") hedge fund database to determine whether or not the activist was a hedge fund or another type of investor).

[230] It is possible to search for campaigns initiated by a particular activist hedge fund, e.g., Elliott Management, but it is not possible to search for all campaigns undertaken by activist hedge funds.

[231] These well-known activist hedge funds included Blue Harbour Group, Corvex Management, Elliott Management, Icahn Enterprises, JANA Partners, Marcato Capital Management, Pershing Square Capital Management, Relational Investors, Sachem Head Capital Management, Starboard Value, The Children's Investment Fund Management (TCI), Taconic Capital Advisors, Third Point, Trian Fund Management, and ValueAct Capital.

[232] Such as the California Public Employees' Retirement System (CalPERS), the California State Teachers' Retirement System (CalSTRS), and the Office of the New York State Comptroller.

[233] Such as the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) and United Steelworkers.

[234] Such as John Chevedden, James McRitchie, Nick Rossi, Kenneth Steiner, William Steiner, Myra Young, and Jing Zhao.

[235] Such as As You Sow, Majority Action, the Sierra Club, and SumOfUs.

[236] Such as the Nathan Cummings Foundation.

religious organizations.[237] The activists targeting the remaining 83 companies were more ambiguous as they were less wellknown and so required further investigation and research to determine whether they would be appropriately classified as activist hedge funds. For these cases, I undertook a similar approach to that taken in previous literature by searching the internet for the websites of the funds to determine how they self-described and also by conducting general Google and Factiva searches for news articles describing the funds.[238]

At the conclusion of this process, 55 of the 83 remaining target companies were identified as the targets of at least one activist hedge fund and thus were retained in the sample, which now comprised 391 target companies overall.[239]

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[237] Such as Mercy Investment Services, Sisters of St. Francis of Philadelphia, and Province of St. Joseph of the Capuchin Order, Inc.

[238] A similar approach was taken in the Brav, Jiang, Partnoy & Thomas, Bratton, Clifford, and Klein & Zur studies. *See Hedge Fund Activism, supra* note 83, at 1737 (noting that the authors searched the internet for the websites of the filers and news articles describing them in order to classify them into hedge funds and nonhedged funds); Bratton, *supra* note 78, at 1386 (noting that some funds on the author's list of hedge funds might object to the "hedge fund" denomination, for instance Relational Investors, which operated solely as a long-term equity investor and ran no short positions); Clifford, *supra* note 83, at 326 (noting that the author confirmed "that the activist in each filing [was] indeed a hedge fund through the fund's webpage, other web searches, or published media reports"); Klein & Zur, *supra* note 83, at 195 (noting that several sources were used to verify the classification including the "funds' Internet web sites, investor journals, Factiva, and newspaper and magazine articles to determine if the filer [was] recognized as being a hedge fund or other type of fund").

[239] Additional funds that were classified as activist hedge funds are as follows: Alken Asset Management, Altimeter Capital Management, Atlantic Investment Management, Barington Capital Group, BlueMountain Capital, Breeden Capital Management, Cadian Capital Management, D E Shaw Investment Management, Eminence Capital, Eton Park Capital Management, GAMCO Investors, HG Vora Capital Management, Hudson Executive Capital, Krupa Global Investors, Impactive Capital, Land and Buildings Investment Management, Paulson & Co., Perry Capital, PL Capital, P Schoenfeld Asset Management, Sandell Asset Management, SpringOwl Asset Management, Steel Partners, and Stonerise Capital Management. There is some divergence in the literature regarding how GAMCO Investors (formerly known as Gabelli Asset Management) should be classified and whether its campaigns should be included in a dataset of activist hedge fund events. Kahan and Rock describe GAMCO as an activist hedge fund. Kahan & Rock, *supra* note 11, at 1039. Klein and Zur include GAMCO in their non-hedge fund sample of "other entrepreneurial activists." Klein & Zur, *supra* note 83, at 195. Greenwood & Schor note that GAMCO is an "investment management company that offers mutual funds to retail investors in addition to a number of investment advisory services and products to institutional and high-net worth individual investors," including hedge fund investments. Greenwood & Schor, *supra* note 83, at 364 n.4. Greenwood &

### iv. Dates of Campaigns

Activist campaigns were only included in the sample if the campaigns were initiated during the period from January 1, 2010 to December 31, 2019. Therefore, the fourth step in the process was to filter out any companies that were targeted either prior to 2010 or after 2019. Seven companies were identified as having been exclusively targeted before 2010, 32 companies were identified as exclusively targeted from 2020 onwards, and a further one company was targeted both before 2010 and after 2020 but not during 2010 to 2019.[240] Removing these 40 campaigns that fell outside of the designated date range resulted in an updated list of 351 target companies.

### v. Actively Pursued Campaigns

The fifth step was to filter out the instances where the activist hedge fund campaigns were not actively pursued in public, namely when an activist held shares in the target company but there was no record of any active campaign. These activist holdings were included in the original sample as the Activist Insight database uses quarterly 13F filings of hedge funds as a data source, in addition to any 13D filings. Such cases could include instances where activist hedge funds passively held shares and never made the switch to an activist intervention during the relevant date range, or cases where no activism was publicly reported or disclosed as it consisted purely of private interactions with management.

To identify which campaigns in the sample were not actively pursued, I used the campaign information that is held in the Activist Insight database and supplemented this data with

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Schor chose not to classify all of GAMCO's events as hedge fund events, as it is not clear whether the investment is being made either by and for its hedge fund, mutual fund, or other account. However, they include GAMCO events when the press release or 13D spells out activist demands. *Id.* at 364 n.3.

Funds that were not classified as activist hedge funds included Arjuna Capital (sustainable investor), Bluescape Energy Partners (private equity firm), Blum Capital (private equity firm), Cascade Investment (private holding company of Bill Gates), CtW Investment Group (labor activist group), Dana Investment Advisors (asset manager/investment advisor), Driehaus Capital Management (boutique investment advisor), Elevation Capital (private equity firm), Driehaus Capital Management (investment advisor), New Mountain Vantage Advisers (no outside investors), NorthStar Asset Management (sustainable wealth manager), Red Mountain Capital Partners (private equity firm), Sageview Capital (private equity firm), and Southeastern Asset Management (employee owned, no outside investors).

[240] Note that these figures do not represent the total number of companies targeted pre-2010 and post-2019 because target companies were not removed from the sample if they were also targeted by a hedge fund from 2010-2019, in addition to being targeted either pre-2010 or post-2019.

extensive internet and Factiva searches to determine whether there was any news coverage of the campaigns or any public campaign statements made by any of the activists involved.

At the conclusion of this process, 172 of the 351 target companies were identified not to be the targets of active or public campaigns. This proportion of active versus dormant campaigns (dormant campaigns representing 49% of the sample, or 172/351 target companies) is very similar to the findings of Brav, Jiang, Partnoy, and Thomas, where 48.3% of their sample of activist events were instances where there was no record of public activism to achieve specific goals.[241] In 166 of the 172 cases that I identified, there was no 13D filing by the activist hedge fund. The activists also generally held quite small shareholdings in the company (typically less than 0.5%), and there was no record of any public statements or campaign strategy. In six cases, Schedule 13Ds had been filed, yet there was no record of any active campaign during the relevant date range. Overall, these cases seem to be examples of options to engage in activism, rather than private campaigns, although it is not possible to determine this definitively. After removing these 172 companies, 179 target companies remained in the sample as examples of active campaigns pursued by hedge funds.

### vi. S&P 500 Index Reconstitution

As outlined in step one above, the date a company was added to or removed from the S&P 500 index was previously recorded. Activist campaigns were only included in the sample if they began while the company was a constituent of the S&P 500 index. Therefore, the sixth and final step in the data filtering process was to exclude any campaigns that took place either before or after a company was added to or removed from the S&P 500 index. Through this final filtering process, another fourteen target companies were removed from the sample.

### vii. Final Sample

At the conclusion of the above six-step procedure, there was a final sample of 165 S&P 500 companies that had been actively targeted by at least one activist hedge fund during the ten-year sample period. The actual number of hedge fund-target company pairs was larger than this, at 215 event pairs, as various companies were targeted by multiple activist hedge funds. Several companies were also targeted more than once by the same

[241] *See Hedge Fund Activism, supra* note 83, at 1741, 1742 tbl.1 (discussing that these campaigns were included in the total sample and events reported, even though it was not possible to conduct analysis on these campaigns due to their passive/private nature).

hedge fund, bringing the total number of actual activist events to 228. This final sample size was smaller than the samples used by Brav, Jiang, Partnoy, and Thomas (548 active events), Clifford (788 events), Greenwood and Schor (784 events), and Boyson and Mooradian (418 events), but larger than the samples used by Klein and Zur (151 events), Bratton (130 activist-company pairs), and Briggs (52 target companies).[242]

## B. *Data Analysis*

Following construction of the sample, data was gathered to test the hypotheses and answer the research questions set out in Part II. Despite the fact that hedge funds fall outside of much regulation, there are two U.S. securities laws that require hedge funds to publicly disclose the holdings in their portfolios.

First, Section 13(d) of the Securities Exchange Act of 1934 requires that any investor, including a hedge fund, file a Schedule 13D with the U.S. Securities and Exchange Commission ("SEC") within ten days of acquiring more than five percent of any class of securities of a publicly traded company if the investor has an interest in influencing the management of the company.[243]

Second, Section 13(f) of the Securities Exchange Act of 1934 provides that institutional investors managing more than $100 million must file a Form 13F each quarter detailing the number of shares the investor holds in exchange-traded companies.[244] Therefore, hedge funds with significant assets under management must make quarterly Form 13F filings to report their holdings.

As noted earlier, this study went beyond many of the previous studies as it included campaigns where no Schedule 13D was filed. Form 13F filings were particularly useful for this purpose, as Schedule 13D filings were not made for many of the activist campaigns in the sample. One of the major reasons for the lack of Schedule 13D filings is that a significant amount of capital is required to acquire a five percent stake in a large-cap S&P 500 company. In many of the sample events at the target companies,

[242]*Hedge Fund Activism, supra* note 83, at 1741,1742 tbl.1; Clifford, *supra* note 83, at 326; Greenwood & Schor, *supra* note 83, at 364; Boyson & Mooradian, *supra* note 154, at 170; Klein & Zur, *supra* note 83, at 187; Bratton, *supra* note 78, at 1385-86 (focusing on "hedge fund activists and other investment institutions that act like them" rather than limiting their study to activist hedge funds); Briggs, *supra* note 205, at 696.

[243]Securities Exchange Act of 1934 § 13(d) (codified at 15 U.S.C. § 78m (2018)).

[244]Securities Exchange Act of 1934 § 13(f) (codified at 15 U.S.C. § 78m (2018)).

a Schedule 13D was not filed as hedge funds engaged in activism with less than a five percent stake. Overall, of the 228 activist events, there was a Schedule 13D filed in 99 activist campaigns (43.4% of the sample) and no Schedule 13D filed in 129 activist campaigns (56.6% of the sample).

This approach had the advantage of being more inclusive to capture more activist campaigns, and in particular to provide crucial data on the most recent campaigns and the evolution of hedge fund activism at S&P 500 companies. However, due to the variation in the information available in the different types of filings (Schedule 13Ds versus Form 13F filings), there was some imbalance in the dataset regarding the precision of information recorded for 13D and 13F events. This is mostly relevant to the investment horizon variable and is discussed further in that section below.

### 1. *Prevalence of Activist Board Representation*

#### i. Methodology

The next crucial stage of the process was to classify campaigns according to whether board representation was sought. Campaigns were classified as activist board representation campaigns where at least one of the strategies pursued by the activist hedge fund was to seek board representation. This included cases where the activist attempted to replace a subset of directors and cases where the activist aimed to take control of the board. The campaigns classified as non-board level included all other activist events where board representation was not one of the publicly stated goals.

Data on the specific campaign strategies pursued by the activist hedge funds were gathered from a number of different sources including filings with the SEC (using the EDGAR filing database); the Activist Insight database; news reports gathered from Factiva searches; the activists' own websites and activist campaign websites; and general internet searches.

#### ii. Results

In total, there were 126 activist board representation campaigns at 101 unique companies and 102 non-board level campaigns at 85 unique companies. There was some overlap in the companies targeted: of the non-board level campaigns, 26 campaigns (at 21 unique companies) took place at companies that were also the target of board representation by other activist hedge funds (either at the same time or at a different time).

As noted above, activist campaigns initiated up to the end of 2019 were included in the sample. Whether an activist board representation campaign fell within the sample period was determined using the date the 13D was filed or the media announcement date, as opposed to the date when board representation was sought or gained. Therefore, a couple of cases were included when 13Ds were filed before the end of 2019, but the board seats were not secured until 2020.[245]

Table 2 summarizes the total number of activist board representation campaigns and non-board level campaigns for each year of the study.

**Table 2 — Activist Board Representation and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)**

This table shows the distribution of all activist board representation campaigns and non-board level campaigns that were launched at S&P 500 companies between calendar years 2010 and 2019. The relevant date used for the board representation campaigns is the date the board campaign was announced. The relevant date used for the non-board level campaigns is the date of the 13D or the media announcement.

| YEAR | ACTIVIST BOARD REPRESENTATION CAMPAIGNS | PERCENTAGE OF TOTAL CAMPAIGNS | NON-BOARD LEVEL CAMPAIGNS | PERCENTAGE OF TOTAL CAMPAIGNS | TOTAL CAMPAIGNS |
|---|---|---|---|---|---|
| 2010 | 5 | 56% | 4 | 44% | 9 |
| 2011 | 8 | 73% | 3 | 27% | 11 |
| 2012 | 11 | 48% | 12 | 52% | 23 |
| 2013 | 11 | 41% | 16 | 59% | 27 |
| 2014 | 13 | 46% | 15 | 54% | 28 |
| 2015 | 23 | 58% | 17 | 42% | 40 |
| 2016 | 14 | 70% | 6 | 30% | 20 |
| 2017 | 16 | 70% | 7 | 30% | 23 |
| 2018 | 11 | 48% | 12 | 52% | 23 |
| 2019 | 12 | 55% | 10 | 45% | 22 |
| 2020 | 2 | | | | 2 |
| Total | 126 | 55% | 102 | 45% | 228 |

To revisit the research questions and hypotheses presented in Part II, Research Question 1 asked whether activist board representation is becoming a more common form of hedge fund activism at S&P 500 companies and Hypothesis 1 was that activist board representation campaigns are increasingly prevalent at

[245] These cases were LKQ Corporation, where a 13D was filed on September 12, 2019, and board representation was granted on August 14, 2020, and Nielsen Holdings NV, where a 13D was filed on August 13, 2018, and board representation was granted on April 30, 2020.

S&P 500 companies.

The below charts outline the number of activist board representation campaigns by year, the number of non-board level campaigns by year, and the percentage of each type of campaign per year.

**Chart 1 — Number of Activist Board Representation Campaigns at S&P 500 Companies (2010 to 2019)**

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

Chart 1 shows that in terms of the number of activist board representation campaigns, there is a steady increase from 2010 until 2015 when activist board representation campaigns peaked, followed by some slight decreases from 2016 to 2019 (although the number of campaigns still remained above 2010 to 2013 levels).

**Chart 2 — Number of Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

Chart 2 illustrates that the number of non-board level campaigns also decreased after 2015, so activist hedge fund campaigns peaked generally in 2015, before decreasing somewhat from 2016 to 2019.

**Chart 3 — Percentage of Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

In terms of the percentage of total campaigns, Chart 3 shows that activist board representation campaigns were more common than non-board level campaigns from 2015 to 2017, before being more evenly split with non-board level campaigns in 2018 and 2019.

Overall, 55% of campaigns in the sample involved the activist hedge fund seeking board representation. In the first half of the decade (2010 to 2014), 49% of campaigns at S&P 500 companies involved requests for activist board representation, and in the second half of the decade (2015 to 2019), 60% of activist campaigns at S&P 500 companies sought board representation.

I did not systematically analyze data prior to 2010, as my sample focused specifically on campaigns from 2010 to 2019. However, Section II.B.1 above discussed the prevalence of activist board representation at S&P 500 companies prior to 2010. It was noted there—by combining results of two prior empirical studies—that there were only eight identified cases of activist board representation at S&P 500 companies from 2000 to 2009. There were some pre-2010 cases that I filtered out of my dataset during the steps identified in Section A.2.(d) above. When I filtered out these pre-2010 campaigns, the cases I identified were consistent with those reported in the Bratton and Bebchuk studies, with the addition of one further target company/hedge fund pair that I identified.[246] Therefore, it is estimated that there were only around nine campaigns for activist board representation at S&P 500 companies between 2000 and 2009.[247] This can be compared to 126 campaigns from 2010 to 2019. This is depicted in the chart below, to demonstrate the growth of activist board representation campaigns at S&P 500 companies in the past 20 years since 2000.

**Chart 4 — Activist Board Representation Campaigns at S&P 500 Companies (2000 to 2010)**

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

Research Question 2, which was presented in Part II, concerned whether activist board representation is becoming a more successful form of hedge fund activism. Hypothesis 2 was that activist board representation campaigns are increasingly successful. Part II presented some evidence of the success of activist board representation campaigns in earlier years, although this was not systematically investigated in any of the studies. The prior studies also concerned a broader range of companies than the S&P 500. Conceptually, it may be easier for activist hedge funds to succeed at smaller companies compared to some of the largest and most powerful companies in the United States.

However, my study revealed very high success rates for activist board representation campaigns at S&P 500 companies from 2010 to 2019 (success being defined in terms of the activist hedge fund securing at least one board seat). Indeed, the campaigns were almost always at least partially successful. In only 16 out of the 126 activist board representation campaigns studied (13%) did the hedge fund fail to secure any board representation at all. In 110 activist board representation campaigns, the activists secured

[246] This was Pershing Square's unsuccessful proxy contest at Target Corporation in 2009.

[247] This may not fully capture all of the activist board representation campaigns at S&P 500 companies between 2000 and 2009, since I did not specifically collect this data in a rigorous manner. However, it is believed to be a reasonable estimate relying on the findings of the prior studies referred to.

at least one board seat, which is an overall success rate of 87%. Therefore, it seems that not only is activist board representation a more prevalent strategy at S&P 500 companies, it is also a very successful strategy.

### iii. Board Campaigns by Hedge Fund

The reported success rates of these campaigns may also be a feature of the specific types of activist hedge funds that target S&P 500 companies. The data revealed that a limited number of activist hedge funds initiate activist board representation campaigns, whereas a wider group of activist hedge funds are involved in non-board level campaigns. Table 3 below details the number of activist board representation campaigns and non-board level campaigns by activist hedge fund.

**Table 3 — Activist Board Representation and Non-Board Level Campaigns at S&P 500 Companies by Activist Hedge Fund**

This table shows the number of activist board representation campaigns and non-board level campaigns that were launched at S&P 500 companies between calendar years 2010 and 2019 by hedge fund. The hedge funds are ranked in order of the largest number of activist board representation campaigns that they initiated.

| ACTIVIST HEDGE FUND | NUMBER OF BOARD REPRESENTATION CAMPAIGNS | PERCENTAGE OF TOTAL BOARD CAMPAIGNS | NUMBER OF NON-BOARD LEVEL CAMPAIGNS | PERCENTAGE OF TOTAL NON-BOARD LEVEL CAMPAIGNS |
|---|---|---|---|---|
| Icahn Enterprises | 23 | 18.3% | 6 | 5.9% |
| Elliott Management | 21 | 16.7% | 5 | 4.9% |
| Trian Fund Management | 11 | 8.7% | 2 | 2.0% |
| ValueAct Capital Partners | 11 | 8.7% | 5 | 4.9% |
| Starboard Value | 10 | 7.9% | 5 | 4.9% |
| JANA Partners | 9 | 7.1% | 11 | 11.0% |
| Pershing Square Capital Management | 6 | 4.8% | 5 | 4.9% |
| Corvex Management | 5 | 4.0% | 6 | 5.9% |

| ACTIVIST HEDGE FUND | NUMBER OF BOARD REPRESENTATION CAMPAIGNS | PERCENTAGE OF TOTAL BOARD CAMPAIGNS | NUMBER OF NON-BOARD LEVEL CAMPAIGNS | PERCENTAGE OF TOTAL NON-BOARD LEVEL CAMPAIGNS |
|---|---|---|---|---|
| Third Point Partners | 4 | 3.2% | 10 | 9.8% |
| Relational Investors | 4 | 3.2% | 6 | 5.9% |
| Land & Buildings | 3 | 2.4% | | |
| D E Shaw Investment Management | 3 | 2.4% | | |
| Sachem Head Capital Management | 2 | 1.6% | 2 | 2.0% |
| Other | 14 | 11.1% | 39 | 38.2% |
| Total | 126 | | 102 | |

Table 3 illustrates that only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company in the ten years from 2010 to 2019 and six activist hedge funds (Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners, Starboard Value, and JANA Partners) were responsible for more than twothirds (67.4%) of all activist board representation campaigns at S&P 500 companies. Therefore, a very small group of formidable activist hedge funds are responsible for the majority of activist board representation campaigns at S&P 500 companies.

It is clear from this table that board representation has become the strategy of choice for a handful of activist hedge funds. Funds such as Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners, and Starboard Value in particular initiate many more activist board representation campaigns at S&P 500 companies than they do non-board level campaigns. Funds such as JANA Partners, Pershing Square Capital Management, and Corvex Management appear to take a more mixed approach to their campaign strategies as their campaigns are more evenly distributed between activist board representation and non-board level campaigns.

The activist hedge funds listed in Table 3 are also the largest activist hedge funds in the United States.[248] The evolution in the tactics used by these major activist hedge funds has largely

[248] The largest activist hedge funds in the United States (by assets under management in 2022) are: D.E. Shaw Investment Management ($60 billion); El-

driven the growth of activist board representation in S&P 500 companies since 2009.

## 2. *Investment Horizon*

### i. Methodology

The investment duration of each activist hedge fund investment was estimated using multiple sources. The goal was to estimate as precisely as possible the date the activist hedge fund purchased shares in the target company and the date the activist hedge fund exited the target company. I identified the date the hedge fund purchased shares in each target company using four principal types of sources. If the activist holding was announced simultaneously with the filing of a Schedule 13D, the date of the Schedule 13D filing was used. Similarly, if the activist or the company made a media announcement regarding the activist holding, the specific date of purchase listed in the announcement was used. Extensive news searches were conducted in Factiva (using the activist hedge fund and target company names as keywords) and Google to gather this information. Additionally, if a proxy statement was filed, the specific date the activist bought shares in the company was extracted from the Schedule 13A form.

Brav, Jiang, and Li recently noted that "a large majority of the hedge fund activism events begin, and are announced by, the filing of Schedule 13D with the U.S. Securities and Exchange Commission" and that "Schedule 13D filings have been the primary information source for virtually all empirical studies of hedge fund activism in the U.S."[249] However, in my sample, there was a higher proportion of activist events that *did not* feature a Schedule 13D compared to events that did. Of the 228 activist events, there was a Schedule 13D filed in 99 events, and no Schedule 13D filed in the remaining 129 events. The distribution of 13Ds compared to 13Fs was also not uniform between activist board representation and non-board level campaigns. In the sample, 74 out of the 126 activist board representation events (58.7%) involved a Schedule 13D filing, with the remaining 52 events relying upon information in 13F filings (41.3%). For the non-board level campaigns, only 25 events involved Schedule 13D filings (25%), with 77 events being based upon 13F data (75%).

For the campaigns where activist board representation was

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liott Management ($56 billion); Icahn Enterprises ($21 billion); Pershing Square Capital Management ($19 billion); Third Point Partners ($16 billion); ValueAct Capital ($16 billion); Trian Fund Management ($8 billion); Sachem Head Capital Management ($6 billion); Starboard Value ($5 billion); Corvex Management ($3 billion); and Jana Partners ($2 billion).

[249] *Governance by Persuasion, supra* note 82, at 12-13.

sought, a precise date when the activist hedge fund purchased shares in the target company could be identified (using one of the sources described above) for 73 out of 126 events (57.9%).[250]

For the remaining 53 events involving requests for activist board representation (42.1%), the best information available to estimate when the activist purchased the shares was quarterly 13F filings. Form 13F filings must be filed each quarter. Therefore, this information enabled me to identify in which specific quarter the activist bought the shares, although it was not possible to pinpoint the exact day of purchase. In these cases, the mid-point in the quarter was used as the date of purchase, as this represented the best estimate with the lowest overall error rate. To illustrate, if an activist hedge fund disclosed the holding on its September 30, 2018, 13F filing, but not on its June 30, 2018, filing, the mid-point of August 15, 2018 was used as an estimated date of purchase. This date could be incorrect by up to forty-five days. However, this was the best information available from SEC filings for these events. For the non-board level campaigns, the same process was used. Here, a specific purchase date was identifiable in 43% of cases (44 out of 102 events), with the remaining 57% (58 out of 102 events) relying on 13F information.

To ascertain the date the activist hedge fund exited the investment, a similar process was followed. Given that using the mid-point ascertainable from 13F data could result in the purchase date being incorrect by up to forty-five days and also the exit date being incorrect by up to forty-five days, some data on investment duration could theoretically be incorrect by up to ninety days (three months). However, this was the best information available for my study and for any previous empirical studies that report the investment duration of activist hedge fund campaigns. The same approach was used with regard to the activist board representation cases and the non-board level cases to ensure consistency.

In the study by Brav, Jiang, Partnoy, and Thomas, the authors used multiple sources to determine the "exit date," including 13F data for the first quarter-end when the hedge fund's holding in the target company drops below one percent or one million dollars. These dates have the same error rates as was an issue for my study, and the authors acknowledge that the sources only allow them to form "estimates of the hedge fund's investment

[250]There were 13Ds in 74 out of 126 events (58.7%), but the 13D filing was not always done at the same time as the activist purchasing shares in the target company.

duration."[251]

### ii. Results

Research Question 3 asked whether activist board representation is associated with a longer-term investment approach on the part of the activist hedge fund. The hypothesis was that activist hedge funds that successfully secure board seats are likely to stay invested in target companies longer than activists without board seats.

The results of my study show that the average investment period of exited investments for campaigns where activists secured seats on the board is three years and one month (3.06 years). The median is two years and eleven months (2.87 years). However, this investment duration underestimates the average investment period of cases of activist board representation. Given the recent nature of the dataset, many of the investments where activists secured board representation have not been exited (twenty-two out of 102 successful events, or twenty-two percent). Assuming an exit date of June 30, 2022, as a cutoff for the study, the average investment duration of investments that have not been exited would be five years and nine months (5.71 years) and the median would also be five years and nine months (5.71 years). If all those investments had in fact been exited on June 30, 2022, the overall average duration of activist board representation campaigns would increase to three years and eight months (3.63 years) overall. The median would increase to three years and four months (3.30 years). These figures clearly underestimate the overall investment duration for the dataset of activist board representation campaigns, as twenty-two percent of campaigns are still ongoing, which will bring the overall average further upward. The complete picture of the overall average investment duration of the activist board representation campaigns in this sample will not be available for some years into the future but will clearly exceed three years and eight months.

It should be noted that the above investment durations are for *successful* activist board representation campaigns. If the unsuccessful campaigns are also included, the average duration is slightly lower, at two years and ten months (2.86 years) for exited campaigns (with a median of two years and nine months (2.75 years)) or an average of three years and five months (3.41 years) if ongoing campaigns (twenty-two out of 114 events, or nineteen percent) are included (with a median of three years two months (3.15 years). The difference between these two sets of averages can largely be explained by activist hedge funds exiting the investment after they failed to secure board representation or

[251] *Hedge Fund Activism, supra* note 83, at 1748-49.

deciding to withdraw their campaign, as well as other intervening events such as the company being acquired.

By way of comparison, the average investment period of exited investments for non-board level campaigns is much shorter, at nineteen months (1.61 years). The median is fifteen months (1.25 years). Notably, these figures are more consistent with the findings in the Brav, Jiang, Partnoy, and Thomas study regarding holding periods, where it was highlighted that "[t]he median holding period for completed deals is about 1 year" and that an estimate for all events (including those not exited yet) is "closer to 20 months."[252]

These investment periods present a more accurate representation of the overall picture for non-board level activism as there are much fewer non-board level campaigns that have not been exited as of June 30, 2022 (six of ninety-six events, or seven percent) compared to the activist board representation events. If these ongoing events are included in the overall average investment duration, the average would only increase slightly to twenty-one months (1.79 years) (with a median of fifteen months (1.27 years)).

**Table 4 — Investment Periods for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)**

This table shows the average and median investment periods for activist board representation and non-board level campaigns at S&P 500 companies, differentiating further between exited and current campaigns as well as successful board representation and all board representation campaigns. T-statistics and significance levels are reported for all comparisons of mean.

| | **INVESTMENT PERIOD OF EXITED CAMPAIGNS** | **INVESTMENT PERIOD OF CURRENT CAMPAIGNS (AT 30 JUNE 2022)** | **OVERALL INVESTMENT PERIOD (AT 30 JUNE 2022)** |
|---|---|---|---|
| **Average Investment Periods (Standard Deviations)** | | | |
| Successful Board Representation Campaigns | 3.06 (1.55) | 5.71 (2.18) | 3.63 (2.02) |
| All Board Representation Campaigns | 2.86 (1.57) | 5.71 (2.13) | 3.41 (2.05) |
| All Non-Board Level Campaigns | 1.61 (1.38) | 4.54 (1.35) | 1.79 (1.55) |
| **Median Investment Periods** | | | |

[252] *Hedge Fund Activism, supra* note 83, at 1731-32.

| | INVESTMENT PERIOD OF EXITED CAMPAIGNS | INVESTMENT PERIOD OF CURRENT CAMPAIGNS (AT 30 JUNE 2022) | OVERALL INVESTMENT PERIOD (AT 30 JUNE 2022) |
|---|---|---|---|
| Successful Board Representation Campaigns | 2.87 | 5.72 | 3.30 |
| All Board Representation Campaigns | 2.75 | 5.72 | 3.15 |
| All Non-Board Level Campaigns | 1.25 | 4.22 | 1.27 |

| ***T*-STATISTICS FOR COMPARISON OF AVERAGE INVESTMENT PERIODS** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | | Mean | S.D. | *n* | *t* | *df* | |
| **Investment Period of Exited Campaigns** | Successful Board vs. All Non-Board | **3.06** | 1.55 | 80 | 6.42*** | 16 | |
| | | **1.61** | 1.38 | 90 | | 0 | |
| | All Board vs. All Non-Board | **2.86** | 1.57 | 92 | 5.69*** | 17 | |
| | | **1.61** | 1.38 | 90 | | 8 | |
| **Investment Period of Ongoing Campaigns** | Successful Board vs. All Non-Board | 5.71 | 2.18 | 22 | 1.62 | 13 | |
| | | 4.54 | 1.35 | 6 | | | |
| | All Board vs. All Non-Board | 5.71 | 2.18 | 22 | 1.62 | 13 | |
| | | 4.54 | 1.35 | 6 | | | |
| **Overall Investment Period (Combined)** | Successful Board vs. All Non-Board | **3.63** | 2.02 | 102 | 4.51*** | 21 | |
| | | **1.79** | 1.55 | 96 | | 7 | |
| | All Board vs. All Non-Board | **3.41** | 2.05 | 114 | 5.24*** | 22 | |
| | | **1.79** | 1.55 | 96 | | 0 | |
| *S.D.*: standard deviation, *n:* sample size, *t*: T-statistic, *df*: degrees of freedom, *, **, ***: statistically significant at $p<.05$, $p<.01$, and $p<.001$, respectively (one-tailed); means of significant differences are highlighted in bold font. | | | | | | | |

Regardless of the method of computation, it is estimated that, on average, the investment duration of activist board representation campaigns is between 78% and 103% longer than the duration of non-board level campaigns.

Comparison of means using a one-tailed heteroscedastic $t$-test showed that the average investment duration of activist board representation campaigns is significantly longer than the average investment duration of non-board level campaigns, both looking at the investment period of only exited campaigns and the investment period of all (exited and ongoing) campaigns combined. The results were consistent irrespective of whether I compare only successful activist board representation campaigns and all non-board level campaigns ($t(160) = 6.42$, $p < .001$, and $t(217) = 4.51$, $p < .001$, respectively) or all activist board representation campaigns and all non-board level campaigns ($t(178) = 5.69$, $p < .001$, and $t(220) = 5.24$, $p < .001$). The same significance levels were obtained when relaxing to a two-tailed $t$-test.

Previous studies have used the median investment duration of activist campaigns, rather than the average.[253] If using the median investment duration, the median board representation campaign is between 120% and 160% longer than the median non-board level campaign.

Charts 5 and 6 below depict the average and median investment periods for activist board representation campaigns and non-board level campaigns detailed above.

**Chart 5 — Average Investment Period for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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**Chart 6 — Median Investment Period for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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Chart 7 below shows the distribution of investment periods for activist board representation campaigns and non-board level campaigns. Here, we can see that the most common investment period for non-board level campaigns is less than one year, and the most common investment period for activist board representation campaigns is between three and four years.

**Chart 7 — Distribution of Investment Periods for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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[253] *See, e.g., Hedge Fund Activism, supra* note 83, at 1731-32 (noting that the median holding period for analyzed deals was approximately one year).

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### iii. Longest Campaigns

While three years and eight months is the average duration of successful activist board representation campaigns (assuming exits on June 30, 2022), there are numerous campaigns with investment periods significantly exceeding this average. In twenty-two campaigns at twenty companies (19% of the activist board representation events or 20% of the companies targeted), the hedge fund was (or has been) invested in the target company for a period of more than five years. Such investment periods represent a considerable deviation from the traditional description of activist hedge fund behavior. This can be seen from Chart 7 above, and the longest board representation campaigns in the sample are also outlined in Table 5 below.

**Table 5 — Activist Board Representation Campaigns with Investment Periods Exceeding 5 years**

Activist board representation campaigns initiated at S&P 500 companies between 2010 and 2019 where the activist hedge fund has been invested for a period of more than five years (data on exits collected up to June 30, 2022).

| | COMPANY | YEAR BOARD SEATS SOUGHT | ACTIVIST HEDGE FUND | INVESTMENT PERIOD (YEARS) (AT JUN. 30, 2022) | ONGOING OR EXITED (AT JUN. 30, 2022) |
|---|---|---|---|---|---|
| 1. | CBRE Group, Inc. | 2012 | ValueAct Capital Partners | 10.52 | Ongoing |
| 2. | Mondelez International, Inc. (formerly Kraft Foods) | 2014 | Trian Fund Management | 10.13 | Ongoing |
| 3. | Wells Fargo & Company | 2016 | GAMCO Investors | 8.38 | Ongoing |
| 4. | General Electric Company | 2017 | Trian Fund Management | 7.13 | Ongoing |
| 5. | Sysco Corporation | 2015 | Trian Fund Management | 7.13 | Ongoing |
| 6. | Citrix Systems, Inc. | 2015 | Elliott Management | 7.06 | Ongoing |
| 7. | Conagra Brands, Inc. | 2015/2019 | JANA Partners | 7.04 | Ongoing |
| 8. | Hess Corporation | 2013 | Elliott Management | 6.88 | Exited |

| | COMPANY | YEAR BOARD SEATS SOUGHT | ACTIVIST HEDGE FUND | INVEST-MENT PE-RIOD (YEARS) (AT JUN. 30, 2022) | ONGOING OR EX-ITED (AT JUN. 30, 2022) |
|---|---|---|---|---|---|
| 9. | United Airlines Holdings, Inc. | 2016 | Altimeter Capital Management PAR Capital Management (joint) | 6.43 | Ongoing |
| 10. | MGM Resorts International | 2015 | Land & Buildings | 6.42 | Exited |
| 11. | Bank of New York Mellon Corporation | 2014 | Trian Fund Management | 6.38 | Exited |
| 12. | The Williams Companies Inc | 2013/2016 | Soroban Capital Partners | 6.26 | Exited |
| 13. | Arconic (now Howmet Aerospace Inc.) | 2016/2017 | Elliott Management | 6.23 | Exited |
| 14. | Chesapeake Energy Corporation | 2012 | Icahn Enterprises | 6.17 | Exited |
| 15. | Seagate Technology Holdings PLC | 2018 | ValueAct Capital Partners | 6.13 | Ongoing |
| 16. | Chipotle Mexican Grill, Inc. | 2016 | Pershing Square Capital Management | 5.82 | Ongoing |
| 17. | The Procter & Gamble Company | 2017 | Trian Fund Management | 5.62 | Ongoing |
| 18. | The Dow Chemical Company | 2014 | Third Point Partners | 5.57 | Exited |
| 19. | Advance Auto Parts, Inc. | 2015 | Starboard Value | 5.39 | Exited |
| 20. | Baxter International Inc. | 2015 | Third Point Partners | 5.13 | Exited |
| 21. | Microsoft Corporation | 2013 | ValueAct Capital Partners | 5.01 | Exited |

It is clear from this table that some activist hedge funds tend to focus on longer-term investments more than others, even within the activist board representation subsample. Most prominently, Trian Fund Management has been invested for more than five years in five out of ten (fifty percent) of its activist board representation corporate targets. Trian clearly does not embody the typical critique of activist hedge funds as short-term investors, as the average tenure of its investments where the fund secured activist board representation from 2010 to 2019 is five years and seven months (and rising, as four of the campaigns are ongoing).

Table 6 below outlines the duration of Trian's investments when it secured board representation.

**Table 6 — Trian Fund Management Activist Campaigns**

Activist board representation campaigns initiated at S&P 500 companies between 2010 and 2019 by Trian Fund Management (data on exits collected up to June 30, 2022).

| | COMPANY | YEAR BOARD SEATS SOUGHT | ACTIVIST DIRECTORS APPOINTED | INVESTMENT PERIOD (YEARS) (AT JUN. 30, 2022) | CURRENT SHAREHOLDER OR EXITED (AT JUN. 30, 2022) |
|---|---|---|---|---|---|
| 1. | Mondelez International, Inc. (formerly Kraft Foods) | 2014 | 1 affiliated | 10.13 | Current |
| 2. | General Electric Company | 2017 | 1 affiliated | 7.13 | Current |
| 3. | Sysco Corporation | 2015 | 2 affiliated | 7.13 | Current |
| 4. | Bank of New York Mellon Corporation | 2014 | 1 affiliated | 6.38 | Exited (sold shares) |
| 5. | The Procter & Gamble Company | 2017 | 1 affiliated | 5.62 | Current |
| 6. | Family Dollar Stores, Inc. | 2011 | 1 affiliated | 4.94 | Exited (acquired by Dollar Tree, Inc.) |
| 7. | DuPont (E.I. du Pont de Nemours and Company) | 2015 | 0 (unsuccessful proxy contest) | 4.30 | Exited (merged with Dow Chemicals) |

| | COMPANY | YEAR BOARD SEATS SOUGHT | ACTIVIST DIRECTORS APPOINTED | INVESTMENT PERIOD (YEARS) (AT JUN. 30, 2022) | CURRENT SHAREHOLDER OR EXITED (AT JUN. 30, 2022) |
|---|---|---|---|---|---|
| 8. | Pentair plc (2 campaigns) | 2018 | 1 affiliated | 3.63 | Exited (sold shares) |
| 9. | Trane Technologies (formerly Ingersoll Rand) | 2012 | 1 affiliated | 3.52 | Exited (sold shares) |
| 10. | PepsiCo, Inc. | 2015 | 1 affiliated | 3.25 | Exited (sold shares) |

It is also worth noting here that Trian Fund Management is also atypical of the activist hedge funds in the dataset as it exclusively put affiliated directors on the boards of target companies. In each case of a successful board representation campaign, the director appointed was a representative of Trian.[254]

### iv. Shortest Campaigns

On the other hand, there are some activist board representation campaigns with significantly shorter than average investment periods. Twelve activist campaigns (10% of the activist board representation events or 12% of the companies targeted) had an investment period of less than one year. The shortest campaigns in the sample are outlined in Table 7 below:

**Table 7 — Activist Board Representation Campaigns with Investment Periods Less than 1 year**

Activist board representation campaigns initiated between 2010 and 2019 where the activist hedge fund was invested for less than one year (data on exits collected up to June 30, 2022).

[254] At Mondelez, Nelson Peltz (Trian's CEO and a Founding Partner) sat on the board from 2014 to 2018, then was replaced by Peter May (Trian's President and a Founding Partner) from 2018 to 2022; at General Electric, Edward Garden (Trian's CIO and a Founding Partner) has sat on the board since 2017; at Sysco, Nelson Peltz sat on the board from 2018 to 2021, then was replaced by Joshua Frank (Co-Head of Research and a Trian Partner) in 2021; at BNY Mellon, Edward Garden sat on the board from 2014 to 2019; at P&G, Nelson Peltz sat on the board from 2017 to 2021; at Family Dollar, Edward Garden sat on the board from 2011 to 2015; at Pentair, Matthew Peltz (a Trian Partner) sat on the board in 2018; at Trane Technologies, Nelson Peltz sat on the board from 2012 to 2014; and at PepsiCo, Nelson Peltz sat on the board from 2015 to 2016.

| | COMPANY | YEAR BOARD SEATS SOUGHT | ACTIVIST HEDGE FUND | INVESTMENT PERIOD (YEARS) (AT JUN. 30, 2022) | ONGOING OR EXITED (AT JUN. 30, 2022) |
|---|---|---|---|---|---|
| 1. | Electronic Arts Inc. | 2011 | Relational Investors | 0.50 | Exited |
| 2. | Allergan, Inc.* | 2014 | Pershing Square Capital Management | 0.58 | Exited (acquired) |
| 3. | Dell Inc.* | 2013 | Icahn Enterprises | 0.65 | Exited (acquired) |
| 4. | Bristol-Myers Squibb Company | 2017 | JANA Partners | 0.75 | Exited |
| 5 | Dollar Tree, Inc.* | 2019 | Starboard Value | 0.75 | Exited (withdrew) |
| 6. | Harris Corporation | 2016 | JANA Partners | 0.76 | Exited |
| 7. | Family Dollar Stores, Inc.* | 2015 | Elliott Management | 0.76 | Exited (acquired) |
| 8. | Newell Brands Inc. | 2018 | Starboard Value | 0.77 | Exited |
| 9. | The Clorox Company* | 2011 | Icahn Enterprises | 0.84 | Exited (withdrew) |
| 10. | PetSmart Inc.* | 2014 | JANA Partners | 0.82 | Exited (acquired) |
| 11. | Sempra Energy | 2018 | Elliott Management | 0.93 | Exited |
| 12. | Genzyme Corporation | 2010 | Icahn Enterprises | 0.98 | Exited (acquired) |

Six of these twelve events were unsuccessful activist board representation campaigns (indicated with *). As the above table shows, in these six instances, the campaigns were exited either when the activist hedge fund withdrew its campaign (two campaigns) or when the target company was acquired (either by another listed company or by a private equity fund) (four campaigns).[255] There is one additional campaign (Genzyme Corporation) where the activist was successful in the board representation campaign, but the company was shortly thereafter

[255]Dell was taken private by founder and CEO Michael Dell and private equity firm Silver Lake Partners in 2013; Family Dollar Stores, Inc. was acquired by Dollar Tree, Inc. in 2014; Allergan was acquired by Actavis in 2015; and PetSmart was bought by a private equity consortium led by BC Partners Ltd. in 2015.

acquired.[256]

However, there are five campaigns[257] where the activist secured board seats by way of settlement with the target company and nevertheless still exited the investment within a year. This was atypical in the dataset. These campaigns generally involved the activists' campaign strategies not going to plan, or they involved the activist hedge fund teaming up with a private equity partner whose representatives were on the board and who remained invested in the company for a longer period.[258]

### 3. *Capital Commitment*

#### i. Methodology

I also measure and report the size of the activists' maximum stakes in the target companies, as a percentage of outstanding shares of the target company. This information comes from the Schedule 13D filing or the subsequent amendments to the 13D filings (Schedule 13D/A forms). For the non-Schedule 13D events, the information is collected from press releases, other news, or Form 13Fs. I record the highest percentage holdings by the filing party in the target company.

#### ii. Results

The average size of an investment for successful activist board representation campaigns is 6.35% of the shares or a median of 6.37%. If unsuccessful campaigns are included, this reduces to an average of 6.12% or a median of 6.00%. By way of comparison, the average size of investment for non-board level campaigns is 3.65% of the shares or a median of 2.80%. This also reduces to an average of 3.52% or a median of 2.67% if the overlap cases—companies that were also targeted for board representation—are removed.

**Table 8 — Average Relative Size of Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010-2019)**

The table shows the average relative size of stake for activist

[256] Genzyme was acquired by Sanofi in 2011.

[257] Relational Investors' campaign at Electronic Arts, JANA Partners campaign at Bristol-Myers Squibb, JANA Partners campaign at Harris Company, Starboard Value's campaign at Newell Brands, and Elliott Management's campaign at Sempra Energy.

[258] For example, in Elliott Management's campaign at Sempra Energy, Elliott had joined forces with the private equity firm Bluescape Energy Partners to appoint directors to the board and persuade the company to conduct a strategic review of its business. The directors appointed to the board were affiliated with Bluescape rather than Elliott. Elliott sold its shares less than a year later, but Bluescape remains invested in the company four years later.

board representation and non-board level campaigns at S&P 500 companies, differentiating further between successful board representation and all board representation campaigns. T-statistics and significance levels are reported for the comparisons of mean.

| ***T*-STATISTICS FOR COMPARISON OF AVERAGE RELATIVE SIZE OF STAKE** | | | | | | |
|---|---|---|---|---|---|---|
| | Mean / % | S.D. / % | *n* | *t* | *df* | |
| Successful Board vs. All Non-Board | **6.35** | 4.36 | 99 | 5.05*** | 180 | |
| | **3.65** | 3.19 | 97 | | | |
| All Board vs. All Non-Board | **6.12** | 4.43 | 114 | 4.77*** | 204 | |
| | **3.65** | 3.19 | 97 | | | |
| *S.D.*: standard deviation, *n:* sample size, *t*: T-statistic, *df*: degrees of freedom, *, **, * * *: statistically significant at $p<.05$, $p<.01$, and $p<.001$, respectively (onetailed); means of significant differences are highlighted in bold font. | | | | | | |

Comparison of means using a one-tailed heteroscedastic *t*-test showed that the average size of investment for successful activist board representation campaigns is significantly higher than the average size of investment for non-board level campaigns, $t(180) = 5.05$, $p < .001$, and the same held true when comparing all board representation campaigns to non-board level campaigns, $t(204) = 4.77$, $p < .001$. The same high significance levels were obtained using a two-tailed *t*-test.

**Chart 8 — Average Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

TABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE

**Chart 9 — Median Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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The above Charts, 8 and 9, depict the average and medium stakes for activist board representation campaigns and non-board level campaigns, and Chart 10 below illustrates the distribution of the average stakes that the activist hedge funds hold in their target companies.

**Chart 10 — Distribution of Average Maximum Stake for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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### 4. *Campaign Objectives*

#### i. Methodology

Various sources were used to discover the objectives and campaign tactics of the activist hedge fund campaigns. Firstly, in the cases where a Schedule 13D was filed, Item 4 of the Schedule 13D filing requires that the activist declare its reasons for acquiring the target company shares, "especially if the intention is to engage in a merger and acquisition activity, seek a sale of any material amount of the issuer's assets, pursue a change in its capitalization or dividend policy, or propose other types of corporate changes."[259] As a result, 13D filings are useful sources of information regarding the activists' plans. Once the initial Schedule 13D is filed, there is also a requirement for activists to promptly file Schedule 13D amendments if there is any material change in their plans for the company. Secondly, as my dataset involved such large, prominent S&P 500 companies, and mostly involved high-profile activist hedge funds, many of the campaigns were publicly announced either in news articles or on specially designed websites launched by the activist hedge funds to accompany their campaign. Such websites, and the white papers or discussion papers that were often posted to these websites, gave incredibly detailed information regarding the purpose of the activist hedge funds' campaigns. Extensive searches were carried out on Google and Factiva to find relevant news articles and campaign websites. Thirdly, the Activist Insight website also contained summaries of campaign strategies used for activist campaigns at different target companies, together with links to further news articles. Combining all of these sources enabled me to build up a comprehensive picture of the strategies that were being pursued at each target company.

Therefore, beyond the categorization of campaigns into activist board representation or non-board level campaigns, I also recorded the activist hedge funds' proposed motives for each campaign. Here, I used four general categories of objectives, with various subcategories as detailed below:

**Category 1 — Financial / Balance Sheet Activism**

a. Dividends
b. Excess Cash / Share Repurchase
c. Capital Structure / Recapitalization
d. Sell Assets

The first category is similar to the "Capital Structure" category used in the study by Brav, Jiang, Partnoy, and Thomas, where

[259] *Governance by Persuasion, supra* note 82, at 13.

the authors recorded if the activist campaign focused on a reduction of excess cash, an increase in firm leverage, or higher payouts to shareholders using either dividends or share repurchases.[260] As noted previously, this is the most commonly criticized form of hedge fund activism that is strongly associated with the short-termist financial engineering narrative.

**Category 2 — Strategic / Operational Activism**

a. Business Focus
b. General Strategy / Growth Strategy
c. Operational Efficiency / Cost Cutting
d. Business Restructuring

Again, this category was relatively similar to the "Business Strategy" category used in the study by Brav, Jiang, Partnoy, and Thomas.[261] Here, the authors included general operational efficiency, cost-cutting and tax efficiency-enhancing proposals within the business strategy category, as well as proposals to spin-off divisions or refocus the business strategy, and playing an activist role in a pending merger or acquisition, generally by asking for a better price when the firm is the target of the acquisition or by trying to stop the pending acquisition.[262] I included spin-offs in the below category on M&A activism, but it equally could have been included in this category. I also included activist intervention in mergers and acquisitions in a separate M&A category.

**Category 3 — M&A Activism**

a. Push for Sale of Company/Merger
b. Oppose Sale of Company/Merger
c. Spin-off / Sale of Business Division
d. Support Acquisition of Third Party
e. Oppose Acquisition of Third Party
f. Oppose Price/Terms of Merger

Brav, Jiang, Partnoy, and Thomas included a separate category for "Sale of Target Company," which included activism urging the sale of the target company either to a third party (which comprised the majority of cases) or to take over the company themselves.[263] In their study, other mergers and acquisitions re-

[260] *Hedge Fund Activism, supra* note 83, at 1741, 1742 tbl.1.
[261] *Id.*
[262] *Id.*
[263] *Id.*

lated activity was included in the "Business Strategy" category.[264]

**Category 4 — Governance Activism**

a. Remove/Replace CEO
b. Separate Chairman & CEO
c. Board Composition & Independence
d. Eliminate Staggered Board
e. Other Governance

Finally, this category was also similar to the final category of "Governance" in the study by Brav, Jiang, Partnoy, and Thomas. In that category, the authors included rescinding takeover defenses (declassifying the board or revoking poison pills), ousting the CEO or chairman, challenging board independence and fair representation, demanding more information disclosure and questioning potential fraud, and challenging the level or pay-for-performance sensitivity of executive compensation.[265]

When analyzing the campaign strategies, I excluded from the total number of events multiple campaigns at the same company and the non-board level campaigns at companies that were also targets of activist board representation, to avoid double-counting strategies or outcomes. Therefore, the total number of events was 189 as the total number of activist board representation events was 115 (rather than 126) and the total number of non-board level events was 74 (rather than 102).

**ii. Results**

**Table 9 — Summary of Events by Activist Hedge Fund Campaign Objective**

This table includes 189 events. The table reports the summary of the events sorted by hedge funds' campaign objectives. Columns 1 and 2 report the number of events, and the percentage among all events, of each category. Columns 3 and 4 list the number of events, and the percentage among all events, for activist board representation campaigns. Columns 5 and 6 list the number of events, and the percentage among all events, for non-board level campaigns (where the target company was also not the target of an activist board representation campaign). Percentages sum up to more than 100% since one event can have multiple objectives.

[264] *Id.*

[265] *Id.* at 1741,1742 tbl.1, 1744.

| | ALL EVENTS | | BOARD REPRESENTATION CAMPAIGNS | | NON-BOARD LEVEL CAMPAIGNS | |
|---|---|---|---|---|---|---|
| **Categories** | **Number of Events (1)** | **% of Sample (2)** | **Number of Events (3)** | **% of Cases (4)** | **Number of Events (5)** | **% of Cases (6)** |
| **Financial/Balance Sheet Activism** | | | | | | |
| Dividends | 16 | 8.5% | 11 | 9.6% | 5 | 6.8% |
| Excess Cash / Share Repurchase | 47 | 24.9% | 29 | 25.2% | 18 | 24.3% |
| Capital Structure / Recapitalization | 14 | 7.4% | 7 | 6.1% | 7 | 9.5% |
| Sell Assets | 30 | 15.9% | 21 | 18.3% | 9 | 12.2% |
| **Strategic/Operational Activism** | | | | | | |
| Business Focus | 24 | 12.7% | 23 | 20% | 1 | 1.4% |
| General Strategy/ Growth Strategy | 50 | 26.4% | 47 | 40.9% | 3 | 4.1% |
| Operational Efficiency/Cost Cutting | 55 | 29.1% | 48 | 41.7% | 7 | 9.5% |
| Business Restructuring | 31 | 16.4% | 27 | 23.5% | 4 | 5.4% |
| **M&A Activism** | | | | | | |
| Push for Sale of Company/ Merger | 49 | 25.9% | 27 | 23.5% | 22 | 29.7% |
| Oppose Sale of Company/ Merger | 5 | 2.6% | 3 | 2.6% | 2 | 2.7% |
| Spin-off/ Sale of Business Division | 60 | 31.7% | 43 | 37.4% | 17 | 23% |
| Support Acquisition of Third Party | 9 | 4.8% | 4 | 3.5% | 5 | 6.8% |

| | ALL EVENTS | | BOARD REPRE-SENTATION CAMPAIGNS | | NON-BOARD LEVEL CAM-PAIGNS | |
|---|---|---|---|---|---|---|
| **Catego-ries** | **Number of Events (1)** | **% of Sample (2)** | **Number of Events (3)** | **% of Cases (4)** | **Number of Events (5)** | **% of Cases (6)** |
| Oppose Acquisi-tion of Third Party | 12 | 6.3% | 3 | 2.6% | 9 | 12.2% |
| Oppose Price/ Terms of Merger | 3 | 1.6% | 1 | 0.9% | 2 | 2.7% |
| **Governance Activism** | | | | | | |
| Remove/ Replace CEO | 34 | 18% | 31 | 27% | 3 | 4.1% |
| Separate Chair-man & CEO | 4 | 2.1% | 4 | 3.5% | 0 | 0% |
| Board Composi-tion and Indepen-dence | 20 | 10.6% | 15 | 13% | 5 | 6.8% |
| Elimi-nate Stag-gered Board | 6 | 3.2% | 5 | 4.3% | 1 | 1.4% |
| Other Gover-nance | 41 | 21.7% | 35 | 30.4% | 6 | 8.1% |

The below charts illustrate the comparisons in campaign strategies between activist board representation campaigns and non-board level campaigns.

**Chart 11 — Financial or Balance Sheet Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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Firstly, for financial or balance sheet activism, activist board representation campaigns and non-board level campaigns present reasonably similar. The only major difference is a slightly higher incidence of campaigns where the activist pushes for the company to sell assets when they also campaign for board representation (18.3% of campaigns compared to 12.2% of campaigns).

**Chart 12 — Strategic and Operational Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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For strategic and operational activism, there are major differences between the strategies campaigned for in activist board representation campaigns compared with non-board level campaigns. The chart shows that strategic and operational activism is almost always accompanied by a request for activist board representation.

**Chart 13 — M&A Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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For M&A activism, there are not major differences, although there is a larger proportion of activist board representation campaigns that advocate for spin-offs or sale of business divisions (37.4% compared to 23% of cases). As noted earlier, spin-offs could have been included within the strategic and operational activism category.

**Chart 14 — Governance Activism for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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Finally, for governance activism, hedge fund activists are much more likely to campaign to replace the CEO when they are requesting board representation. In 27% of cases involving activist board representation, there is also a request to replace the CEO, compared to only 4.1% of non-board level campaigns.

In the study by Brav, Jiang, Partnoy, and Thomas, it was highlighted that different types of campaign objectives generate different abnormal returns for activists. In their 2001 to 2006 data, Merger and Acquisition ("M&A") activism that was aimed at selling the target company proved to generate the highest abnormal returns, with an average of 8.54%. Activism associated with business strategy also generated high returns, averaging 5.95%.[266] By contrast, activism targeting capital structure and governance issues generated smaller average returns for hedge

[266] *Hedge Fund Activism, supra* note 83, at 1759.

funds, at 1.47% and 1.73%.[267]

### 5. *CEO Turnover*

#### i. Methodology

In Section 4 above, it was noted that in 27% of campaigns involving activist board representation, there was a request to replace the CEO, compared to only 4.1% of non-board level campaigns. As requests to replace the CEO seemed a particularly common campaign strategy for activist board representation campaigns, I also analyzed the outcome of these campaigns in terms of whether the CEO was ultimately replaced while the activist intervention was ongoing.

Data on CEO replacements could be gleaned from analyzing the Form 8-K filings for the relevant companies and also by conducting Google and news searches. The departure of CEOs from S&P 500 companies was always reported in the media, so it was relatively easy to collect information on the dates CEOs stood down and to confirm this using the official Form 8-K filings available from the SEC EDGAR Database.

#### ii. Results

During the activists' tenure, there were 68 new CEOs at the 101 companies that were targets of activist board representation (68 out of 112 events, or 61% of events, as joint campaigns were excluded). At 55% of these 101 companies (56 companies), the CEO was replaced at least once during the activist's tenure. The number of actual CEO replacements is higher than the number of companies where the CEO was replaced because there were multiple CEO replacements at ten companies.[268] If only successful activist board representation campaigns are included, the CEO was replaced at 56% of companies successfully targeted (50 out of 90 companies). In non-board level activist campaigns, the CEO

[267] *Id.*

[268] At Alliance Data Systems, the CEO was replaced twice in 2019 during ValueAct Capital's tenure; at Arconic (now Howmet Aerospace), the CEO was replaced four times during Elliott Management's tenure (in 2016, 2017, 2018, and 2019); at Citrix Systems, the CEO was replaced twice during Elliott Management's tenure (in 2015 and 2017); at CSX Corporation, the CEO was replaced twice in 2017 during Mantle Ridge's tenure; at Iron Mountain, the CEO was replaced twice during Elliott Management's tenure (in 2011 and 2012); at JCPenney Company, the CEO was replaced twice during Pershing Square Capital Management's tenure (in 2011 and 2013); at Perrigo Company, the CEO was replaced twice during Starboard Value's tenure (in 2017 and 2018); at Wells Fargo, the CEO was replaced twice during GAMCO's tenure (in 2016 and 2019); at Xerox, the CEO was replaced twice during Carl Ichan's tenure (in 2016 and 2018); and at Yahoo!, the CEO was replaced twice during Third Point's tenure (in 2012 and 2017).

was replaced in 17% of campaigns (11 out of 64 companies) and 15% of events (11 out of 74 events), as illustrated in Chart 15 below.

**Chart 15 — Percentage of Companies with CEO Replacements for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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One plausible interpretation of this data would be that if activist board representation campaigns have a longer investment period, the CEO is more likely to be replaced during the activist's tenure. Other studies have examined whether CEOs have stood down within a certain time following activist intervention. For example, in the Brav, Jiang, Partnoy, and Thomas study, they noted that "[d]uring the year after the announcement of activism . . . the CEO turnover rate increases by almost [ten] percentage points" for their sample of activist events from 2001 to 2006.[269] Therefore, to avoid that (legitimate) criticism, I also collected data on how soon CEOs left after the activists were granted board seats, and in particular whether CEOs stood down within a year of the activist being granted board seats.

**Chart 16 — Percentage of Companies with CEO Replacements Within One Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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In 46% of companies where activists were successful in securing board seats, the CEO stood down either shortly before board seats were granted to the activist or within one year of the board seats being granted (41 out of 90 companies). Similarly, if this exercise is repeated for the non-board level campaigns (measuring from the date of activist involvement rather than when the board seats were granted), the percentage of non-board level campaigns where CEOs exited within one year of activist involvement is 13% (8 out of 64 companies).

A 2021 report by Lazard outlines that the baseline CEO turnover for S&P 500 companies is between 10% and 12% each year.[270] Therefore, it seems that non-board level activism does not have

[269] *Hedge Fund Activism, supra* note 83, at 1732.

[270] LAZARD, 2021 REVIEW OF SHAREHOLDER ACTIVISM 16 (2022), https://www.lazard.com/media/451963/lazards-q4-2021-review-of-shareholder-activism_vf.pdf.

much effect on CEO turnover, whereas activist board representation increases the likelihood of CEO turnover significantly.

As noted in Part II, activist hedge fund campaigns are not thought to be kind to CEOs of target firms.[271] The above data on CEO turnover shows that hedge fund activism is much less kind to CEOs when activists seek and secure board representation, compared to cases where there is no activist board representation.

### 6. *Types of Activist Director*

#### i. Methodology

As noted in Part II, activist director nominees can either be affiliated directors who work at the activist hedge fund, or non-affiliated directors who are selected by the hedge fund. I recorded data on whether each director who secured a board seat was affiliated or non-affiliated with the hedge fund. This information was readily obtainable from news reports publicizing the appointment of the directors, and this information was also confirmed by checking the official Form 8-K filing with the SEC. Whether a director was affiliated or non-affiliated was also simple to ascertain simply by conducting a Google search of who the director was. This information was also often reported in settlement agreements negotiated between the activist hedge fund and the target company. Therefore, there were many different ways to verify the information regarding the relevant director's affiliation.

#### ii. Results

Of the 218 board seats gained by hedge fund activists at S&P 500 companies in campaigns launched between 2010 and 2019, 74 seats (34%) were secured by directors affiliated with the activist hedge funds and 144 seats (66%) were secured by non-affiliated directors. Although there is some variability from year to year, in the more recent years of the sample, the proportion of affiliated directors has generally decreased, as shown in the chart below.

**Chart 17 — Number of Affiliated and Non-Affiliated Directors by Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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The clear trend, therefore, is towards the appointment of nonaffiliated directors as opposed to hedge fund principals themselves

[271] *See supra* Part II.B.5 (citing *Hedge Fund Activism, supra* note 83, at 1732).

taking seats on boards. In each year of the sample since 2014, the number of nonaffiliated directors has been higher than the number of affiliated directors. In some campaigns, there were a mix of affiliated and non-affiliated directors appointed.

**Chart 18 — Percentage of Affiliated and Non-Affiliated Directors by Year for Activist Board Representation Campaigns and Non-Board Level Campaigns at S&P 500 Companies (2010 to 2019)**

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The appointment of affiliated or non-affiliated directors does, however, tend to vary by hedge fund. For example, Trian Fund Management and ValueAct Capital Partners always had at least one affiliated director on the board of target companies, without exception. Indeed, Trian exclusively put affiliated directors on the boards (which was atypical behavior compared to other activist hedge funds).[272] By way of comparison, in almost all of Elliott Management's campaigns, non-affiliated directors were appointed rather than representatives from the hedge fund itself.

Activist hedge funds tended to stay invested in target companies longer when there was at least one affiliated director on the board. The average investment period for campaigns where at least one affiliated director was appointed was three years and nine months (3.79 years) compared to two years and eight months (2.70 years) when only non-affiliated directors were on the board.

### 7. *Activist Settlements*

#### i. Methodology

As noted earlier, activist campaigns can either proceed to a shareholder vote through a proxy contest, or be settled by a negotiated agreement between the activist hedge fund and the target company. Proxy contests were heavily publicized and reported, and were also detailed in the Activist Insight database. Settlement agreements are filed with the SEC, so they are also publicly available.

#### ii. Results

In my dataset, 85% of events where activists sought board representation were settled (107 of 126 events). There were only eight events (6% of the activist board representation campaigns)

[272] In each of the successful campaigns initiated by Trian Fund Management at S&P 500 companies from 2010 to 2019, the appointed directors were fund principals at Trian. These individuals included Nelson Peltz (Trian's CEO and Founding Partner), as well as other Partners of Trian.

at seven companies in my sample that proceeded to a proxy contest.[273] All of the other board seats were gained through settlements. Additionally, one of the proxy contests—Trian Management's campaign at Procter & Gamble in 2017—also ultimately resulted in a settlement agreement. Only twelve events involved the activist hedge fund withdrawing or the campaign being unresolved, and one of the cases of withdrawal also resulted in a later settlement agreement (Carl Icahn's campaign at TEGNA Inc.).[274]

In terms of the actual number of seats gained via settlements compared to via proxy contests, of the 216 board seats gained, only fourteen board seats (6.5%) were gained via proxy contests, compared to 202 board seats (93.5%) being secured via settlement agreements. The fourteen seats gained via proxy contests are also heavily skewed by the twelve board seats won by Starboard Value in its campaign at Darden Restaurants in 2014. The other two board seats secured via a proxy contest were Carl Icahn's campaign at Forest Laboratories in 2012 and Alder Investment Management's campaign at International Game Technology plc in 2013. Therefore, in my dataset, no board seats were won at S&P 500 companies by activist hedge funds through proxy contests between 2015 and 2019. This shows how rare proxy contests are compared to negotiated settlements, at least for the major activist hedge funds that have initiated campaigns at the biggest companies in the United States. It also shows that when a target company does choose to fight an activist intervention for board seats, there is a reasonable chance of success. In the four proxy contests that were fought in the dataset between 2015 and 2019, the activist hedge fund was not successful in the shareholder vote. These campaigns were Trian Fund Management's campaign at DuPont in 2015, Trian Fund Management's campaign at Procter & Gamble in 2017, Greenlight Capital's proxy contest at General Motors in 2017, and Pershing Square Capital's proxy contest at Automatic Data Processing in 2017. Since the cutoff point in my dataset (campaigns initiated before 2020), there has been one other activist hedge fund campaign that proceeded to a full shareholder vote where the activist hedge

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[273]The companies were Forest Laboratories (Icahn Enterprises) in 2011 and 2012, International Game Technology (Ader Group) in 2013, Darden Restaurants (Starboard Value) in 2014, DuPont (Trian Fund Management) in 2015, General Motors (Greenlight Capital Management) in 2017, Procter & Gamble (Trian Fund Management) in 2017, and Automatic Data Processing (Pershing Square) in 2017. Between 2020 and 2023, after my sample period ended, there have only been two additional proxy contests at S&P 500 companies and both concerned ESG issues. These campaigns were Engine No. 1's campaign at ExxonMobil in 2021 and Icahn Enterprises' campaign at McDonald's in 2022.

[274]Albeit not one where the activist secured board representation.

fund successfully won seats. This was Engine No. 1's campaign at ExxonMobil in 2021.[275]

## C. *Discussion and Implications*

### 1. *Safeguards*

#### i. Minority Board Representation

The empirical analysis has suggested some likely virtues of activist board representation, especially in terms of the activist hedge funds generally having a more long-term investment horizon and potentially focusing on sustainable value creation through strategic and operational improvements. Of course, not all cases of activist board representation will have a positive impact on target companies.[276] Nevertheless, there are some safeguards inherent in minority board representation that do not operate in cases where activists take full control of the board (as the corporate raiders did in the 1980s). The criticisms directed at activist hedge funds are often similar to those made of corporate raiders (some of whom reinvented themselves as hedge fund activists). There are certainly examples of activist hedge funds attempting to overthrow entire boards. Starboard Value's successful campaign at Darden Restaurants has already been highlighted. Other examples are the campaigns launched at Yahoo!—where the activist hedge fund Starboard Value launched a proxy contest in 2016 to replace the entire board, including CEO Marissa Mayer[277]—and at Newell Brands—where Starboard Value again nominated a full slate of candidates to the board in 2018, including two directors who had very recently resigned from the board.[278] However, activist campaigns to take full control of corporate boards are very rare. When the phenomenon of activist board representation first emerged, it was noted that "hedge funds seek to elect a short slate of directors rather than seeking

[275] *See* Christie, *supra* note 195, at 927-34.

[276] A commonly cited example of destructive hedge fund activism involving board representation is Pershing Square's investment in JCPenney, where Bill Ackman of Pershing Square was appointed to the board. Coffee and Palia describe this case as "the best known example of such a financial disaster caused by aggressive intervention by hedge funds. . . ." as JCPenney's stock price fell almost sixty percent between the initial Schedule 13D filing and Ackman's eventual resignation from the board. Coffee & Palia, *supra* note 14, at 584.

[277] *See* Michael Flaherty & Supantha Mukherjee, *Starboard Launches Proxy Fight to Remove Entire Yahoo Board*, Reuters (Mar. 24, 2016, 5:18 PM), https://www.reuters.com/article/us-yahoostar-board-proxy-idUSKCN0WQ0D7/ (reporting on Starboard Value's proxy contest at Yahoo!).

[278] Nivedita Balu, Vibhuti Sharma & Harry Brumpton, *Starboard Nominates Candidates to Replace Newell's Board*, Reuters (Feb. 12, 2018, 3:35 PM), https://www.reuters.com/article/us-newell-brandsstar-board-idUSKBN1FW1G0/.

majority control of the board."[279] In the increasing number of cases where activist hedge funds secure board representation, this is still almost always a minority of the overall board. In my sample, although activist hedge fund activists secured between one and twelve board seats in their successful campaigns, the average number of board seats they secured (either for themselves or for non-affiliated directors) was two. Only 11 campaigns out of 110 successful activist board representation campaigns (10%) involved the activist securing more than three board seats,[280] and the case of Darden—where the entire board was replaced—was a clear outlier.

There are various levels of safeguards against "bad" cases of activist board representation. First, if activists seek minority board representation, they first have to persuade other shareholders to support their director nominees. This is obviously vital when there is a proxy contest and shareholder vote. However, as outlined earlier, most activist board representation campaigns result in a settlement between the target company and the activist rather than proceeding to a shareholder vote. Indeed, securing minority board representation by way of negotiated settlement is a much cheaper alternative both for the activist and the company rather than engaging in a proxy contest. Nevertheless, safeguards also operate when activists and target companies enter into a negotiated settlement to appoint activist directors. For example, it is good practice for target company managers to seek the views of other long-term shareholders on the proposed director candidates. As outlined earlier, global asset managers and other long-term shareholders are increasingly insisting that companies do so before settling with activists.[281]

Moreover, once activist directors are appointed, they will still need to convince the rest of the board to implement any proposed new strategies or changes (whether the director is affiliated with the activist hedge fund or not).[282] As Bebchuk, Brav, Jiang, and Keusch note, this situation differs from the corporate raiders of

[279] *Hedge Fund Activism, supra* note 83, at 1748.

[280] Starboard Value at Cerner Corporation (four seats); Icahn Enterprises at Chesapeake Energy Corporation (four seats); Mantle Ridge at CSX Corporation (five seats); Starboard Value at Darden Restaurants (twelve seats); Third Point at The Dow Chemical Company (four seats); Icahn Enterprises at Newell Brands (four seats); Starboard Value at Perrigo Company (five seats); Starboard Value at Symantec Corporation (now NortonLifeLock) (four seats); Icahn Enterprises at Xerox (five seats); Third Point Partners at Yahoo! (four seats); and Starboard Value at Yahoo! (four seats). *See infra* Appendix (detailing activist board representation campaigns in the dataset).

[281] *See supra* Part II.B.7.

[282] *See Dancing with Activists, supra* note 10, at 22 (explaining that activists are unable to dominate the boardroom without persuading other shareholders).

the 1980s who sought outright control of boards and could thus control corporate strategy entirely.[283] Therefore, there are various layers of safeguards to protect against "bad activism" or short-term strategies on the part of activist hedge fund nominees. Activist directors cannot act alone or push through strategies unless the rest of the board agrees.

### ii. The Role of Institutional Investors

Relatedly, as mentioned above, institutional investors play an increasingly important role as corporate governance intermediaries in activist campaigns. As demonstrated in the empirical study, the average activist hedge fund holding in activist board representation campaigns at S&P 500 companies is just over six percent. Support from institutional investors who hold a much larger proportion of the shares tends to be necessary for any activist campaign to succeed.[284] Institutional investors, therefore, provide valuable support to activists and operate as an important safeguard if activist proposals are not deemed to be in the best interests of the long-term success of the company.

Activist board representation is, however, a specific type of intervention that may appeal to longer-term institutional investors, as when activist hedge funds secure board representation they generally hold shares for longer periods compared to situations where no board representation is involved. The longer-term and more substantive commitment evidenced by activist hedge funds in such campaigns therefore mitigates some of the common concerns of financial wizardry associated with the perceived short-term "hit-and-run" motives of activist hedge funds. Activist hedge funds are also unique in pursuing this form of firm-specific activism that other investors are unlikely to have the capacity or the incentives to initiate. No other activist specializes in the appointment of activist directors who focus on strategy, operations, and turnaround. Activist board representation as a strategy has grown alongside the rise in power of institutional investors, which also may explain why it has become a more common strategy, especially at S&P 500 companies that tend to have particularly large institutional investor holdings.

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[283] *Id.*

[284] *See* Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum. L. Rev. 863, 896-901 (2013) [hereinafter *Agency Capitalism*] (outlining the importance of institutional investors in activist success).

### 2. *The Role of Activist Directors on the Board*

As noted earlier, most directors appointed by activist hedge funds are non-affiliated directors.[285] When proposing director nominees, activist hedge funds often criticize the lack of industry expertise of the current board, which is a potential issue with the part-time independent directors who feature prominently in the monitoring board model. This can result in the activist nominating industry experts or even former CEOs of the company, or experts in turnaround. There is usually a clear focus on strategy and operations and a motivation for the new directors to get involved in that strategy in order to improve corporate performance.[286]

For example, when JANA Partners announced that it had added three directors to the board of Tiffany & Co., through a settlement agreement with the company, the executives appointed were all industry specialists who were not affiliated with the hedge fund. The appointees were "Francesco Trapani, the ex-CEO of luxury retailer Bulgari; Roger Farah, co-chief executive of luxury brand Tory Burch; and James Lillie, a former CEO of the consumer products company Jarden Corp."[287] One of the directors (Trapani) was announced as joining Tiffany's CEO search committee and another of the directors (Farah) became Chairman of the board.

Overall, the activist directors nominated to target company boards may have deep industry expertise and therefore in some respects more closely resemble the directors of the old advisory board, rather than the monitoring board.

### 3. *Board Representation by Other Investors*

The major shareholder protagonists that appoint minority directors to boards are activist hedge funds, to the extent that board representation campaigns are now the most common type of hedge fund activism at S&P 500 companies. Board representation campaigns are, of course, not limited to activist hedge funds.[288] As briefly explained earlier, campaigns by other shareholders were excluded from the dataset.[289] Although other investors will sometimes nominate candidates to corporate

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[285] *See supra* Part III.B.6.ii & Chart 17.

[286] *See supra* Part III.B.4.ii, Table 9 & Chart 12 (analyzing data regarding activist focuses and strategies).

[287] Flaherty, *supra* note 191.

[288] *See supra* Part III.A.2.ii.

[289] *See supra* Part III.A.2.iii (noting that campaigns by public pension funds, labor unions, individual gadfly investors, other shareholder organizations, family foundations, and religious organizations were excluded from the dataset). Other studies, such as Klein & Zur, include all campaigns by "entrepreneurial

boards, there are various reasons why activist hedge funds are the primary instigators of activist board representation campaigns.[290] It is more challenging for other types of shareholders to nominate directors to corporate boards for various reasons.[291] One significant reason is the costs involved in doing so. Of course, it has already been shown that most activist hedge fund board representation campaigns—at least when they involve major hedge funds targeting S&P 500 companies—are settled rather than requiring a proxy contest or proceeding to a full shareholder vote.[292] However, that tends to be the case only for established players who already have a reputation for running successful activist board representation campaigns. The high costs involved in making a credible threat of a proxy contest means that there is a very small group of activist hedge funds that can successfully pursue activist board representation campaigns at S&P 500 companies.[293] As the data showed, between 2010 and 2019, only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company, and seven activist hedge funds (Icahn Enterprises, Elliott Management, Trian Fund Management, ValueAct Capital Partners, Starboard Value, JANA Partners, and Pershing Square Capital Management) were responsible for more than seventy-two percent of all activist board representation campaigns at S&P 500 companies.[294] Therefore, the strategy of seeking and securing board representation is somewhat restricted to the largest and most formidable activist hedge funds. New entrants or other investors may have to launch and conduct a full proxy contest in order to establish a reputation and to have future campaigns taken seriously by large corporations. An example of

shareholder activists," which is broader than activist hedge funds. Klein & Zur, *supra* note 83, at 187.

[290] *See* Anna Christie, *Board-Shareholder Engagement and Directors' Appointments, in* BOARD-SHAREHOLDER DIALOGUE: POLICY DEBATE, LEGAL CONSTRAINTS AND BEST PRACTICES 450, 457, 460-463 (Luca Enriques & Giovanni Strampelli eds., 2024) (outlining the myriad reasons activist hedge funds are the main instigators of activist board representation campaigns and discussing the rarity of asset managers themselves nominating directors to boards).

[291] *Id.*

[292] *See supra* Part III.B.7.ii (noting that eighty-five percent of activist board representation events were settled, whereas only six percent of activist board representation campaigns at seven companies in the sample proceeded to a proxy contest).

[293] *See supra* Part III.B.1.iii (showing six activist hedge funds were responsible for more than twothirds of all activist board representation campaigns at S&P 500 companies).

[294] *See supra* Part III.B.1.iii (showing that only thirteen activist hedge funds initiated more than one board representation campaign at an S&P 500 company in the ten years from 2010 to 2019).

this was the newly established activist fund Engine No. 1's campaign at Exxon,[295] which involved the fund reportedly spending approximately $30 million on their proxy contest.[296] Such costs are prohibitively expensive for most investors, who may have to pursue different strategies if they are seeking a refresh of the board. It is much more common for other investors (including non-governmental organizations, public pension funds, labor unions, religious organizations, or individual "gadfly" investors) to pursue their activist campaigns through the shareholder proposal mechanism, rather than by nominating directors to corporate boards.[297] Why do activist hedge funds still pursue board representation despite the high costs involved in these types of interventions that prove to be a major impediment for other types of investors? Activist hedge funds have stronger incentives to pursue costlier forms of activism because their concentrated holdings in a small number of portfolio companies, and their compensation structure, means that they can effectively capture a significant proportion of value-generating strategies.

#### 4. *Generalizability of Results*

This empirical study focused on activist board representation at S&P 500 companies. It is an open question whether the findings of the dataset could be generalized to a wider universe of companies in the United States. This would involve further data collection and analysis. There are likely to be some similar features of campaigns, especially if the same activist hedge funds are involved. However, a broader range of activist hedge funds target smaller companies, so there may well be some divergence in the specific strategies and other aspects of the campaigns.

In terms of generalization to campaigns in other countries, this Article focuses on activist hedge fund campaigns in the United States. The prevalence and relative success of activist hedge fund board representation campaigns varies considerably by jurisdiction. While activist board representation campaigns are very common in the United States, even at large S&P 500 companies, less than ten FTSE 350 companies[298] have been similarly targeted in the United Kingdom over the same time pe-

[295] Christie, *supra* note 195, at 927-34.

[296] Jennifer Hiller & Svea Herbst-Bayliss, *Exxon, Activist Spend over $65 mln in Battle for Oil Giant's Future*, Reuters (Apr. 15, 2021, 4:44 PM), https://www.reuters.com/business/energy/exxon-activist-spend-over-65-mln-battle-oil-giants-future-2021-04-15/.

[297] *See generally* Kobi Kastiel & Yaron Nili, *The Giant Shadow of Corporate Gadflies*, 94 S. Cal. L. Rev. 569 (2021).

[298] The FTSE 350 Index is a market capitalization weighted stock market index made up of constiutents of the FTSE 100 and FTSE 250 indices. The FTSE 100 Index comprises the largest 100 companies (by market capitalization)

riod since 2010.[299] Campaigns in continental Europe can be even more complex still, especially if there is a two-tier board structure or if companies have controlling shareholders. Recent analysis by Activist Insight has shown that in 2021 there were eighty-six campaigns for activist board representation in the United States[300] compared to forty-seven campaigns in the whole of Europe (including the United Kingdom).[301] These numbers have decreased since 2018 when there were 172 activist board representation campaigns in the United States and seventy-four campaigns in Europe.[302] Overall, it is clear that activist board representation is a phenomenon that is much more prevalent in the United States than in other jurisdictions. There are various potential legal and other reasons for this. One overarching reason is simply that activist hedge fund campaigns are much more common in the United States, but there are additional legal reasons why board-level activism in particular may not work so well as a strategy for activist hedge funds in other jurisdictions.

## CONCLUSION

More and more of America's largest companies are experiencing the phenomenon of activist directors. Activist board representation was rare prior to 2010, but over the past decade, it has become a core feature of activist hedge fund campaigns at S&P 500 companies. The specific ways in which hedge fund activism manifests differently when directors are appointed reveal several insights regarding the evolution of hedge fund activism. Most strikingly, the relentless focus on short-termism is called into question by the discovery that activist hedge funds focus much more on substantive, long-term strategy and operations when they seek and secure board representation. Routinely dismissed as financial engineers, there is a lack of attention paid to the positive aspects of activist hedge fund campaigns. However, an analysis of the reality of activist board representation campaigns does not neatly fit the short-termism narrative. To the contrary, these campaigns may result in activist directors contributing substantively to value creation over a much longer investment horizon

that have their primary listing on the London Stock Exchange. The FTSE 250 Index comprises the next largest companies not covered by the FTSE 100. *See* Ftse Russell, Ftse 350 Index 1 (2024), https://www.ftserussell.com/analytics/factsheets/home/search (search "FTSE 350 Index").

[299] Targets included National Express Group (Elliott Management) in 2011, Vesuvius (Cevian Capital) in 2012, Rolls-Royce (ValueAct) in 2015, Alliance Trust (Elliott Management) in 2015, Barclays (Sherborne Investors) in 2019, and FirstGroup (Coast Capital) in 2019.

[300] That either resulted in a settlement or went to a shareholder vote.

[301] Insightia, the Activist Investing Annual Review 8 (2022).

[302] *Id.*

than is commonly associated with activist hedge fund interventions. This revelation prompts some necessary and timely reflection of the traditional critiques of hedge fund activism.

## APPENDIX

### Activist Board Representation Campaigns (by year board seats sought)[303]

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLEMENT | SEATS GAINED |
|---|---|---|---|---|---|
| 1. | Take-Two Interactive Software, Inc. | 2010 | Icahn Enterprises | Settlement | 3 |
| 2. | Biogen Inc. | 2010 | Icahn Enterprises | Settlement | 2 |
| 3. | Genzyme Corporation (now Sanofi Genzyme) | 2010 | Icahn Enterprises | Settlement | 2 |
| 4. | Occidental Petroleum Corporation | 2010 | Relational Investors | Settlement | 1 |
| 5. | Motorola Solutions, Inc. | 2010 | Icahn Enterprises | Settlement | 1 |
| 6. | Motorola Mobility Holdings Inc. | 2011 | Icahn Enterprises | Settlement | 1 |
| 7. | JC Penney Company Inc. (now Penney OpCo LLC) | 2011 | Pershing Square Capital Management | Settlement | 2 |
| 8. | Iron Mountain Inc. | 2011 | Elliott Management | Settlement | 2 |
| 9. | Electronic Arts Inc. | 2011 | Relational Investors | Settlement | 1 |
| 10. | Forest Laboratories Inc. | 2011 | Icahn Enterprises | Vote | None |
| 11. | The Clorox Company | 2011 | Icahn Enterprises | Withdrew | None |
| 12. | Family Dollar Stores Inc. | 2011 | Trian Fund Management | Settlement | 1 |
| 13. | HP Inc. (formerly Hewlett Packard Company) | 2011 | Relational Investors | Settlement | 1 |
| 14. | Illinois Tool Works Inc. | 2012 | Relational Investors | Settlement | 1 |

[303] In this table, the date the board campaign was launched, rather than the year the seats were granted, has been used in order to capture the withdrawn or unsuccessful campaigns of activist board representation. The number reflects the distinct companies targeted rather than the total number of events.

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLE-MENT | SEATS GAINED |
|---|---|---|---|---|---|
| 15. | C.R. Bard, Inc. | 2012 | ValueAct Capital Partners | Settlement | 1 |
| 16. | Yahoo! (now Altaba) | 2012 | Third Point Partners | Settlement | 4 |
| 17. | BMC Software Inc. | 2012 | Elliott Management | Settlement | 2 |
| 18. | Chesapeake Energy Corporation | 2012 | Icahn Enterprises | Settlement | 4 |
| | Forest Laboratories Inc | 2012 | Icahn Enterprises | Vote | 1 |
| 19. | Ingersoll Rand plc (now Trane Technologies plc) | 2012 | Trian Fund Management | Settlement | 1 |
| | Motorola Solutions, Inc. | 2012 | ValueAct Capital | Settlement | 2 |
| 20. | Adobe Systems Incorporated (now Adobe Inc.) | 2012 | ValueAct Capital Partners | Settlement | 1 |
| 21. | ADT Corporation | 2012 | Corvex Management | Settlement | 1 |
| 22. | CBRE Group, Inc. | 2012 | ValueAct Capital Partners | Settlement | 1 |
| 23. | International Game Technology plc | 2013 | Ader Investment Management | Vote | 1 |
| 24. | Hess Corporation | 2013 | Elliott Management | Settlement | 3 |
| 25. | Dell Inc. | 2013 | Icahn Enterprises | Withdrew | None |
| | Forest Laboratories | 2013 | Icahn Enterprises | Settlement | 1 |
| 26. | Microsoft Corporation | 2013 | ValueAct Capital Partners | Settlement | 1 |
| 27. | Air Products & Chemicals, Inc. | 2013 | Pershing Square Capital Management | Settlement | 3 |
| 28. | Transocean Ltd. | 2013 | Icahn Enterprises | Settlement | 2 |
| 29. | Hologic, Inc. | 2013 | Icahn Enterprises | Settlement | 2 |
| 30. | The Williams Companies, Inc. | 2013 | Corvex Management Soroban Capital Partners (joint) | Settlement | 2 |
| 31. | WPX Energy, Inc. | 2013 | Taconic Capital Partners | Settlement | 1 |

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLE-MENT | SEATS GAINED |
|---|---|---|---|---|---|
| 32. | Compuware Corporation | 2014 | Elliott Management | Settlement | 2 |
| 33. | Mondelez International, Inc. (formerly Kraft Foods) | 2014 | Trian Fund Management | Settlement | 1 |
| 34. | eBay Inc. | 2014 | Icahn Enterprises | Settlement | 1 |
| 35. | Juniper Networks, Inc. | 2014 | Elliott Management | Settlement | 2 |
| 36. | QEP Resources, Inc. | 2014 | JANA Partners | Settlement | 1 |
| 37. | Darden Restaurants, Inc. | 2014 | Starboard Value | Vote | 12 |
| 38. | Allergan plc | 2014 | Pershing Square Capital Management | Withdrew | None |
| 39. | Walgreens Boots Alliance, Inc. | 2014 | JANA Partners | Settlement | 2 |
| 40. | Interpublic Group of Companies, Inc. | 2014 | Elliott Management | Settlement | 3 |
| 41. | Dow Chemical Company | 2014 | Third Point Partners | Settlement | 4 |
| 42. | PetSmart Inc. | 2014 | JANA Partners | Withdrew | None |
| 43. | Bank of New York Mellon Corporation | 2014 | Trian Fund Management | Settlement | 1 |
| | Juniper Networks, Inc. | 2014 | Elliott Management | Settlement | 2 |
| 44. | MSCI Inc. | 2015 | ValueAct Capital Partners | Settlement | 3 |
| 45. | DuPont (E.I du Pont de Nemours and Company) | 2015 | Trian Fund Management | Vote | None |
| 46. | EMC Corporation | 2015 | Elliott Management | Settlement | 2 |
| 47. | PepsiCo Inc. | 2015 | Trian Fund Management | Settlement | 1 |
| | eBay Inc. | 2015 | Icahn Enterprises | Settlement | 1 |
| 48. | TEGNA Inc. | 2015 | Icahn Enterprises | Withdrew | None |

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLE-MENT | SEATS GAINED |
|---|---|---|---|---|---|
| 49. | Zoetis Inc. | 2015 | Pershing Square Capital Management Sachem Head Capital Management (joint) | Settlement | 2 |
| 50. | MGM Resorts International | 2015 | Land & Buildings | Withdrew | None |
| 51. | Macerich Company | 2015 | Land & Buildings | Settlement | 2 |
| 52. | Conagra Brands, Inc. | 2015 | JANA Partners | Settlement | 2 |
| | Family Dollar Stores Inc. | 2015 | Elliott Management | Unresolved | None |
| 53. | Qualcomm Incorporated | 2015 | JANA Partners | Settlement | 3 |
| 54. | Citrix Systems, Inc. | 2015 | Elliott Management | Settlement | 1 |
| 55. | Baxter International Inc. | 2015 | Third Point Partners | Settlement | 1 |
| 56. | Sysco Corporation | 2015 | Trian Fund Management | Settlement | 2 |
| 57. | Pentair plc | 2015 | Trian Fund Management | Settlement | 1 |
| 58. | Twenty-First Century Fox, Inc. | 2015 | ValueAct Capital Partners | Settlement | 1 |
| 59. | Freeport-McMoRan Inc. | 2015 | Icahn Enterprises | Settlement | 2 |
| 60. | Yum! Brands, Inc. | 2015 | Corvex Management | Settlement | 1 |
| 61. | Advance Auto Parts, Inc. | 2015 | Starboard Value | Settlement | 3 |
| 62. | Autodesk, Inc. | 2015 | Sachem Head Capital Partners Eminence Capital Partners (joint) | Settlement | 3 |
| 63. | Viacom Inc. | 2016 | SpringOwl Asset Management | Withdrew | None |
| 64. | Xerox Corporation (now Xerox Holdings Corporation) | 2016 | Icahn Enterprises | Settlement | 3 |
| 65. | Arconic Inc. (now Howmet Aerospace Inc.) | 2016 | Elliott Management | Settlement | 3 |
| 66. | American International Group, Inc. | 2016 | Icahn Enterprises Paulson & Co (joint) | Settlement | 2 |

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLEMENT | SEATS GAINED |
|---|---|---|---|---|---|
| | Yahoo! (now Altaba) | 2016 | Starboard Value | Settlement | 4 |
| 67. | United Airlines Holdings | 2016 | Altimeter Capital Management PAR Capital Management (joint) | Settlement | 3 |
| | Xerox Corporation (now Xerox Holdings Corporation) | 2016 | Icahn Enterprises | Settlement | 1 |
| 68. | Harris Corporation | 2016 | JANA Partners | Settlement | 2 |
| | The Williams Companies, Inc. | 2016 | Corvex Management Soroban Capital Partners (joint) | Settlement | 2 |
| 69. | Wells Fargo & Company | 2016 | GAMCO Investors | Settlement | 2 |
| 70. | Chipotle Mexican Grill, Inc. | 2016 | Pershing Square Capital Management | Settlement | 2 |
| 71. | NRG Energy, Inc. | 2017 | Elliott Management | Settlement | 2 |
| | Arconic Inc. (now Howmet Aerospace Inc.) | 2017 | Elliott Management | Settlement | 3 |
| 72. | Perrigo Company plc | 2017 | Starboard Value | Settlement | 5 |
| 73. | Cognizant Technology Solutions Corporation | 2017 | Elliott Management | Settlement | 3 |
| 74. | CSX Corporation | 2017 | Mantle Ridge | Settlement | 5 |
| 75. | Bristol-Myers Squibb Company | 2017 | JANA Partners | Settlement | 3 |
| 76. | Tiffany & Co. | 2017 | JANA Partners | Settlement | 3 |
| 77. | Alliance Data Systems Corporation | 2017 | ValueAct Capital Partners | Settlement | 1 |
| 78. | General Motors Company | 2017 | Greenlight Capital | Vote | None |
| 79. | The Procter & Gamble Company | 2017 | Trian Fund Management | Vote & Settlement | 1 |
| 80. | Pulte Homes, Inc. | 2017 | Elliott Management | Settlement | 3 |

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLE-MENT | SEATS GAINED |
|---|---|---|---|---|---|
| 81. | Automatic Data Processing, Inc. | 2017 | Pershing Square Capital Management | Vote | None |
| 82. | EQT Corporation | 2017 | D E Shaw Investment Management | Settlement | 2 |
| 83. | General Electric Company | 2017 | Trian Fund Management | Settlement | 1 |
| 84. | Alexion Pharmaceuticals, Inc. | 2017 | Elliott Management | Settlement | 1 |
| | Xerox Corporation (now Xerox Holdings Corporation) | 2017 | Icahn Enterprises | Settlement | 5 |
| 85. | The AES Corporation | 2018 | ValueAct Capital Partners / Inclusive Capital Partners | Settlement | 1 |
| 86. | Lowe's Companies, Inc. | 2018 | D E Shaw Investment Management | Settlement | 3 |
| 87. | Seagate Technology | 2018 | ValueAct Capital Partners | Settlement | 1 |
| | Pentair plc | 2018 | Trian Fund Management | Settlement | 1 |
| 88. | Akamai Technologies, Inc. | 2018 | Elliott Management | Settlement | 2 |
| 89. | Newell Brands Inc. | 2018 | Icahn Enterprises Starboard Value | Settlement | 4 |
| | | | | 3 | |
| 90. | Navient Corporation | 2018 | Canyon Capital Advisors | Withdrew | 0 |
| 91. | Sempra Energy | 2018 | Elliott Management | Settlement | 2 |
| 92. | Symantec Corporation (now NortonLifeLock, Inc.) | 2018 | Starboard Value | Settlement | 4 |
| 93. | The Campbell Soup Company | 2018 | Third Point Partners | Settlement | 3 |
| 94. | Dollar Tree Inc. | 2019 | Starboard Value | Withdrew | None |
| | MGM Resorts International | 2019 | Corvex Management | Settlement | 1 |
| | Conagra Brands, Inc. | 2019 | JANA Partners | Settlement | 1 |
| | Navient Corporation | 2019 | Canyon Capital Advisors | Settlement | 2 |

| | COMPANY | YEAR | ACTIVIST HEDGE FUND | VOTE OR SETTLE-MENT | SEATS GAINED |
|---|---|---|---|---|---|
| | The Bristol-Myers Squibb Company | 2019 | Starboard Value | Withdrew | None |
| | eBay Inc. | 2019 | Elliott Management Starboard Value | Settlement | 1 |
| | | | | 1 | |
| 95. | Marriott International, Inc. | 2019 | Land & Buildings | Withdrew | None |
| 96. | L Brands, Inc. | 2019 | Barington Capital | Settlement | None (special adviser) |
| 97. | Cerner Corporation | 2019 | Starboard Value | Settlement | 4 |
| | Occidental Petroleum Corporation | 2019 | Icahn Enterprises | Settlement | 3 |
| 98. | Emerson Electric Company | 2019 | D E Shaw Investment Management | Settlement | 1 |
| 99. | Marathon Petroleum Corporation | 2019 | Elliott Management | Settlement | 1 |
| 100. | Nielsen Holdings N.V. | 2020 | Elliott Management | Settlement | 1 |
| 101. | LKQ Corporation | 2020 | ValueAct Capital Partners | Settlement | 1 |

# STAKEHOLDER ENGAGEMENT*

*Brett H. McDonnell***

INTRODUCTION
I. STAKEHOLDER ENGAGEMENT: WHAT AND WHY?
- *A. Stakeholders and Shareholders*
- *B. Types of Stakeholders*
- *C. Types of Engagement*
- *D. Corporate Governance*
- *E. Benefits and Costs of Stakeholder Engagement*

II. CURRENT STAKEHOLDER ENGAGEMENT PRACTICES
- *A. Methodology*
- *B. Data on Engagement Practices*
- *C. Engagement in More Detail*

III. CURRENT CORPORATE GOVERNANCE PRACTICES
- *A. Boards*
- *B. Officers*
- *C. Executive Compensation*
- *D. Correlations Among Practices*

IV. LESSONS AND POSSIBLE REFORMS
- *A. Best Practices*
- *B. Practices Worth Exploring*
- *C. Legal Reforms*

CONCLUSION

## INTRODUCTION

A debate rages over corporate purpose and fiduciary duty.[1] Should corporations be managed to maximize shareholder

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[1] Research Handbook on Corporate Purpose and Personhood, at ix-x (Elizabeth Pollman & Robert B. Thompson eds., 2021).

wealth?[2] Or should managers also give independent weight to the welfare of other stakeholders, including employees, customers, and others?[3] Statements favoring a stakeholder approach are increasingly common and come from such unlikely suspects as one of the largest institutional investors in the country[4] and the association of the CEOs of America's largest corporations.[5]

A common argument against the stakeholder approach is that it reduces managerial accountability.[6] But what if stakeholder governance were to actively empower stakeholders? Companies already engage their stakeholders, and that engagement could make managers more accountable.[7] Other benefits of stakeholder engagement include providing useful information about how to best meet their interests and concerns and increasing stakeholder loyalty.[8] Even on the shareholder-obsessed understanding of corporate purpose, engagement could benefit not only stakeholders but also shareholders through improved long-run profitability.

Stakeholder engagement has received much less attention from legal scholars than either shareholder engagement or corporate purpose.[9] And yet, large corporations today engage their stake-

[2]Milton Friedman, *A Friedman Doctrine—The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES, Sept. 13, 1970, at 17; FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 36-38 (1991); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 910-12 (2005); Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 550 (2003).

[3]Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 278 (1999); LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 104-05 (2012); LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 185-86 (2001); KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES 228-29 (2006); David Millon, *Radical Shareholder Primacy*, 10 U. ST. THOMAS L.J. 1013, 1013-14 (2013).

[4]Larry Fink, *Larry Fink's 2022 Letter to CEOs: The Power of Capitalism*, BLACKROCK (Jan. 18, 2022), https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter [https://perma.cc/426F-4PG8].

[5]*Statement on the Purpose of a Corporation*, BUS. ROUNDTABLE, https://opportunity.businessroundtable.org/ourcommitment/ [https://perma.cc/N9LB-ER3M] (last visited Feb. 10, 2024).

[6]Lucian A. Bebchuk & Roberto Tallarita, *The Illusory Promise of Stakeholder Governance*, 106 CORNELL L. REV. 91, 164-68 (2020) [hereinafter Bebchuk & Tallarita, *Illusory Promise*].

[7]*See infra* Section I.E.

[8]*See infra* Section I.E.

[9]A very significant exception is two recent articles by Stavros Gadinis and Amelia Miazad. Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1409-10 (2020) [hereinafter Gadinis & Miazad, *Social Risk*]; Stavros Gadinis & Amelia Miazad, *A Test of Stakeholder Capitalism*, 47 J. CORP. L. 47, 53-54 (2021) [hereinafter Gadinis & Miazad, *Test*]. For an

holders in a growing number of ways.[10] They meet with them, survey them, monitor them on X (formerly known as Twitter), partner with them, and sometimes involve them in more formal ongoing councils or panels. Occasionally they bargain with their workers through unions. Sometimes corporations engage with their stakeholders on controversial political topics like climate change or diversity and equity. Other times they engage with them on mundane but crucial topics like what customers think about a new product or how employees feel about the way their supervisor treats them. All of this counts as stakeholder engagement for this study. Internal corporate governance is changing too, as boards and new types of officers become involved.[11] What kinds of engagement are most frequently used? What groups of stakeholders are most frequently engaged, and how do the types of engagement differ for different stakeholders? What board committees are focused on stakeholders? How widely adopted are new positions such as the Chief Sustainability Officer (CSO) or Chief Diversity Officer (CDO)? How is the compensation of traditional officers changing in response to the new focus on stakeholders?

This Article starts answering these questions for the largest American corporations. It finds that companies are engaging with many stakeholders in many ways. However, stakeholder engagement has not yet become serious empowerment of any stakeholders beyond shareholders.

This Article examines existing stakeholder engagement by looking at what large corporations say they are doing.[12] Most large public companies now regularly release reports—often called sustainability or corporate responsibility reports—that discuss how they are addressing the interests of various stakeholders.[13] These reports typically say something about how the companies are engaging with those stakeholders and about the internal corporate governance mechanisms being used. Annual proxy statements also provide information about governance mechanisms.[14] This Article reviews those documents for the S&P 100 corporations and produces some simple measures of the extent and type of stakeholder engagement and governance arrangements that those corporations are reporting.

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overview of the lengthy literature on shareholder engagement, see Brett McDonnell et al., *Green Boardrooms?*, 53 CONN. L. REV. 335, 371-74 (2021) [hereinafter McDonnell et al., *Green Boardrooms?*].

[10] *See infra* Part II.

[11] *See infra* Part III.

[12] *See infra* Section II.A.

[13] *See infra* Section II.A.

[14] 17 C.F.R. § 240.14a-101 (2023).

Clearly there are problems with relying on such self-reporting, and one must take the results reported below with many grains of salt.[15] With no mandatory rules, there is wild variation in what companies choose to focus on and report.[16] Consider surveys of customer satisfaction with a company's products or services. Many companies choose to include such surveys in their reports as a form of customer engagement, as will this study, but many companies may not. Despite such limits, the sustainability reports do provide a readily available source of information to get a sense of what is going on, suggesting directions for future research using other sources of information.[17] I will argue that the undercounting may well understate the qualitative results presented here.

The documents suggest that employees are the stakeholder group that companies typically engage with in the most varied ways.[18] This makes sense, as employees are of central importance to the success of companies, they have much valuable information, and they are more readily identifiable and easier to reach than some other stakeholder groups.[19] The next most engaged types of stakeholders are customers.[20] The other stakeholder groups frequently mentioned in reporting on engagement are non-profits and local communities, suppliers, government, and academic individuals and institutions.[21]

As for the most common types of engagement, I find that lower-level interactions such as meetings, surveys, and social media are

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[15] *See infra* notes 136-39 and accompanying text.

[16] *See infra* notes 136-37 and accompanying text. This is a leading argument of those who call for mandatory ESG reporting.

[17] Gadinis and Miazad, for instance, interview persons involved in stakeholder engagement. *See* Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1430, 1439; *see also* Gadinis & Miazad, *Test*, *supra* note 9, at 55. Reviewing corporate disclosure gives less depth but covers a wider range of companies.

[18] *See infra* Part II.

[19] Brett H. McDonnell & Matthew T. Bodie, *From Mandates to Governance: Restructuring the Employment Relationship*, 81 MD. L. REV. 887 (2022); Brett H. McDonnell, *Employee Primacy, or Economics Meets Civic Republicanism at Work*, 13 STAN. J.L. BUS. & FIN. 334, 351 (2008) [hereinafter McDonnell, *Employee Primacy*]. *See generally* GRANT M. HAYDEN & MATTHEW T. BODIE, RECONSTRUCTING THE CORPORATION: FROM SHAREHOLDER PRIMACY TO SHARED GOVERNANCE (2020); Christopher M. Bruner, *Corporate Governance Reform and the Sustainability Imperative*, 131 YALE L.J. 1217, 1262-66 (2022); CHRISTOPHER M. BRUNER, THE CORPORATION AS TECHNOLOGY: RE-CALIBRATING CORPORATE GOVERNANCE FOR A SUSTAINABLE FUTURE 179-84 (2022); Kent Greenfield, *The Place of Workers in Corporate Law*, 39 B.C. L. REV. 283 (1998); MARGARET M. BLAIR, OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY (1995).

[20] *See infra* Table 1.

[21] *See infra* Part II.

most common.[22] More sustained engagement such as partnerships and formal advisory councils are not rare, but they are less common. Fullfledged empowerment giving stakeholders a formal role in corporate decisionmaking remains the least common type of engagement, with only the remnants of private unionization providing any kind of empowerment at all.

I also gathered information on the governance of relations with stakeholders at the board and officer level.[23] At the board level, I consider the composition of the board. I look at whether boards have any members who come from working in the government, non-profits, or academia (all of whom reports commonly treat as stakeholders). I also look at what board committee, if any, is charged with overseeing ESG (environmental, social, and governance) matters. An important question is the relative merit of assigning ESG oversight to the traditional nomination/corporate governance committee (the leading approach) versus creating a committee specifically devoted to ESG or sustainability matters.[24]

At the officer level, I examine the prevalence of two new executive positions, the Chief Sustainability Officer (CSO) and the Chief Diversity Officer (CDO).[25] Both are very common, as are councils of executive officers that coordinate on one or more ESG topic(s). I also find that a majority of companies report some connection between ESG matters and executive compensation, although that reporting is generally unclear and imprecise.[26]

The research reported here does not directly tell us about the desirability of stakeholder engagement because there is no attempt to correlate the measures generated with any outcome measures. But the research is suggestive. It helps us identify emergent common practices.[27] The research also identifies some practices that are much less widely used but are worth considering if we want to move from engagement to empowerment. The most aggressive of these are forms of employee empowerment. This could be done through unionization, works councils, or board representation.[28] Another way of engaging is through formal, ongoing advisory councils composed of representatives of one or

[22] *See infra* Table 1.

[23] *See infra* Part III.

[24] *See infra* Section III.A.

[25] *See infra* Section III.B.

[26] *See infra* Section III.C.

[27] *See infra* Section IV.A.

[28] *See* McDonnell, *Employee Primacy*, *supra* note 19; McDonnell & Bodie, *supra* note 19; Brett H. McDonnell, *From Duty and Disclosure to Power and Participation in Social Enterprise*, 70 ALA. L. REV. 77 (2018).

more types of stakeholders.[29]

Should any of these suggestions be legally imposed upon companies? I say no.[30] We are still learning what does and does not work, and about costs as well as benefits. The mix of costs and benefits varies from company to company, so that one-size-fits-all mandates are questionable. The only two practices that I would impose concern disclosure. I would mandate a format for disclosing stakeholder engagement.[31] I would also mandate that companies tying executive compensation to ESG-related matters provide more concrete details about that compensation.[32]

Though I do not suggest mandating any specific engagement practices, there are good reasons (albeit with counterarguments) to think that companies are likely to do too little stakeholder engagement and especially too little empowerment.[33] Therefore, I suggest ways that regulators might encourage some practices.[34] The main examples concern empowering employees. In an article with Matthew Bodie, I suggest that companies which adequately empower employees could be rewarded with lessened substantive or procedural requirements in various areas of employment regulation.[35] Following that lead, I consider ways that engagement with other stakeholders, perhaps through stakeholder councils, might be encouraged in other areas of regulation.[36]

The remainder of this Article is organized as follows. Part I provides some background, discusses some benefits and costs of engaging with stakeholders, and gives an overview of different kinds of stakeholders and of engagement. Part II presents the results of the research of company disclosure on forms of stakeholder engagement. Part III presents the results of the research on governance at the board and officer level. Part IV considers lessons learned and potential legal interventions. A conclusion follows.

## I Stakeholder Engagement: What and Why?

This Part sets the stage for the empirical investigation to fol-

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[29] *See infra* Section IV.B.

[30] *See infra* Section IV.C.

[31] *See infra* Section IV.C.

[32] *See infra* notes 289-94 and accompanying text.

[33] *See infra* notes 255-62 and accompanying text.

[34] *See infra* Sections IV.B-C.

[35] McDonnell & Bodie, *supra* note 19, at 931-33.

[36] *See infra* Section IV.C. Erik Gerding provides an example, arguing for regulatory preferences to encourage mutual insurance companies (which are owned by their customers, a very strong form of stakeholder empowerment). Erik F. Gerding, *Remutalization*, 105 Cornell L. Rev. 797, 847-48 (2020).

low in the next two Parts. Section I.A briefly reviews the ongoing discussion of corporate purpose and the relative position of shareholders and other stakeholders. Section I.B considers the leading categories of stakeholders, while Section I.C considers the leading ways of engaging with them. Section I.D briefly overviews relevant developments in corporate governance at the board and officer level. Section I.E examines the benefits and costs of engaging stakeholders.

### *A. Stakeholders and Shareholders*

The debate over the appropriate purpose for corporations goes back at least to the classic Berle-Dodd discussion of the early thirties.[37] It has heated up in recent years. After decades in which an exclusive focus on maximizing shareholder wealth was understood as the appropriate purpose for corporations by academics, lawyers, and businesspeople, that understanding is now up for grabs. Landmarks in the current discussion include a statement by the Business Roundtable, an organization of the CEOs of leading American corporations,[38] and recent annual letters from Larry Fink, CEO of the leading institutional investor BlackRock,[39] each advocating (albeit somewhat ambiguously) a stakeholderist position.[40]

As a matter of black letter law, it is surprisingly hard to find

**[Section I]**

[37]A.A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 Harv. L. Rev. 1049 (1931); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 Harv. L. Rev. 1145 (1932); A.A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 Harv. L. Rev. 1365 (1932).

[38]*Business Roundtable Redefines the Purpose of a Corporation to Promote 'An Economy That Serves All Americans*,' Bus. Roundtable (Aug. 19, 2019), https://www.business-roundtable.org/business-roundtable-redefines-the-purpose-of-a-corporation-to-promote-an-economy-that-serves-all-americans [https://perma.cc/EM88-HSZ9].

[39]*See* Fink, *supra* note 4.

[40]Debate and action over the role of corporations has spread out in many directions, leading to a proliferation of terms that reflect overlapping concerns and developments. I will often refer to stakeholderism, reflecting the debate over how corporations should reflect and reconcile the differing interests of various groups involved in and affected by what corporations do. Another common term is sustainability. Rooted in environmental concerns but spreading well beyond that, those advocating that corporations become more sustainable look at how corporations can meet current needs without compromising the needs of future generations. Bruner, *supra* note 19, at 1247-50. ESG, short for environmental, social, and governance, focuses particularly on developments in shareholder activism and corporate disclosure concerning environmental concerns, especially but not only climate change, and social concerns such as workforce diversity and human rights. Elizabeth Pollman, *The Making and Meaning of ESG*, Harv. Bus. L. Rev. (forthcoming) (manuscript at 3-12), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4219857 [https://perma.cc/FZ5U-

definitive guidance on this debate. For decades, the leading, and just about the only, case stating the shareholderist norm was *Dodge v. Ford Motor Co.*[41] Delaware, the leading state for corporate law, explicitly enshrined that position in the case of sale of corporate control in the eighties in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[42] and more recently generalized that rule to a broader set of circumstances in *eBay Domestic Holdings, Inc. v. Newmark*.[43] Many states, however, have constituency statutes which allow managers to consider other stakeholder interests.[44] And many states, including Delaware, have adopted benefit corporation statutes, in which managers are required to consider the interests of various stakeholders.[45] But the limited adoption of benefit corporation status and Delaware's dominance for ordinary corporations has led most commentators to treat Delaware's position as the leading statement of American corporate law.

The pro-stakeholder position comes in weaker and stronger positions. The much more common position (especially among practitioners rather than academics) argues that robust concern for various stakeholders boosts profits in the long run and is thus consistent with the interests of shareholders.[46] Stavros Gadinis and Amelia Miazad emphasize that concern for stakeholders may benefit shareholders by avoiding major risks that could torpedo profitability.[47] The stronger position recognizes that for some decisions, there really are choices to be made between shareholders and stakeholders (and also among different stakeholders), and that there should not be automatic priority favoring shareholders in such circumstances.[48] Those opposing one or both of these stakeholderist views make a variety of arguments. Of most relevance here is the question of accountability and the two

NWN2]. Corporate social responsibility is a somewhat older term for efforts to encourage corporations to behave in ways that cause less social and environmental harm. I shall use these various terms as mostly if not entirely synonymous.

[41] 170 N.W. 668, 684 (Mich. 1919).

[42] 506 A.2d 173, 182-85 (Del. 1986).

[43] 16 A.3d 1, 34 (Del. Ch. 2010).

[44] Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1230-31 (2004).

[45] Brett H. McDonnell, *Committing to Doing Good and Doing Well: Fiduciary Duty in Benefit Corporations*, 20 FORDHAM J. CORP. & FIN. L. 19, 30 (2014).

[46] *See* McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 344-45; *see also* Dorothy S. Lund & Elizabeth Pollman, Essay, *The Corporate Governance Machine*, 121 COLUM. L. REV. 2563 (2021).

[47] Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1426-40.

[48] *See, e.g.*, Blair & Stout, *supra* note 3, at 249. *See generally* COMPANY LAW AND SUSTAINABILITY: LEGAL BARRIERS AND OPPORTUNITIES (Beate Sjåfjell & Benjamin J. Richardson eds., 2015).

masters problem. On this argument, the shareholder wealth maximization norm provides a clear measuring rod for managerial decisions and performance. Managers themselves have a clear standard guiding them, and those who want to hold them accountable for alleged misconduct have a clear standard for judging if they have misbehaved. If one gives independent weight to the interests of stakeholders other than shareholders, though, then almost any decision can be rationalized as in the interest of some group. Clarity and accountability disappear.[49]

Moreover, shareholders are empowered to hold managers accountable, and insofar as a stakeholderist position would justify limits to that empowerment, that could decrease accountability.[50] Institutional investors have become much more active in recent years. Traditional activists focus on increasing shareholder value. They acquire substantial stakes in a target company, then apply pressure to adopt preferred measures such as higher dividends backed by the threat of a proxy fight to install new directors.[51] A newer breed of ESG activists focuses on broader, stakeholderist concerns, such as climate change and diversity of boards and workforces. They engage with companies in a variety of ways. These include shareholder proposals through the Rule 14a-8 process, informal direct conversations with managers, and most recently through proxy fights to replace directors, such as the successful campaign by activist investor Engine No. 1 to elect directors at Exxon Mobil.[52] Much academic attention has been devoted to both types of activist investors and to how companies are engaging with them.

Engagement with stakeholders, as opposed to shareholders, has received much less attention among legal scholars,[53] and yet it is already occurring. Engaging with stakeholders has the potential to assuage the accountability critique. I will consider this as well as other benefits of stakeholder engagement, along with some potential costs.[54] But first I will discuss what I mean by “stakeholders” and by “engagement.”

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[49] Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6, at 164-68.

[50] *Id*.

[51] *See* McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 374 & n.223.

[52] Bernard S. Sharfman, *The Illusion of Success: A Critique of Engine No. 1’s Proxy Fight at ExxonMobil*, 12 Harv. Bus. L. Rev. Online, art. 3, 2021, at 1.

[53] A significant exception is several recent articles by Gadinis and Miazad. *See supra* note 9. Stakeholder engagement has received more attention among scholars in other fields. For instance, see a review of 90 articles on stakeholder engagement in business and management journals by Johanna Kujala et al., *Stakeholder Engagement: Past, Present, and Future*, 61 Bus. & Soc’y 1136 (2022).

[54] *See infra* Section I.E.

### *B. Types of Stakeholders*

I repeatedly use the general term "stakeholders," but this refers to a range of different kinds of persons who interact with companies. Here I briefly consider the major kinds of stakeholders, why they matter to companies, and how the benefits and costs of engagement may differ among them.

Employees are perhaps the most significant of the stakeholders, and we shall see that they are the group companies engage with in the most ways. Employees do the actual work of providing the services or producing the goods that a company creates and sells. Attracting and retaining good employees is critical to become a flourishing business. Employees naturally acquire large and varied amounts of information about a business as a byproduct of doing their work.[55] This information combined with the importance of attracting good employees gives employees more power to hold managers accountable than other stakeholders. For these and other reasons, employees are more central to a business, more like insiders in a business, than all other stakeholders, and the benefits of employee engagement are typically greater than for other groups. By the same token, the costs of employee engagement may be greater as well. Conflicts between employees and shareholders or other stakeholders may be intense. Wages and benefits are usually among the leading expenditures for a business. Although up to some point higher wages and benefits may increase the pie for everyone by improving productivity, beyond that point, more for employees means less for everyone else. Employees may also conflict with shareholders and others over the nature of working conditions and the intensity of effort that employees are expected to provide.

Customers are also a critical stakeholder group. Without customers to buy a company's goods and services, the company cannot survive. It can grow only by expanding its customer base or the amount individual customers spend. So, retaining the loyalty of customers is crucial.[56] Customers know what they want, information that companies need to learn. Customers typically have less information about the internal functioning of a company than its employees possess, making them lesser vessels for holding managers accountable, but the threat of lowered sales is still a major potential accountability mechanism. On the other hand,

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[55] HAYDEN & BODIE, *supra* note 19, at 156-58; McDonnell, *Employee Primacy*, *supra* note 19, at 356; *see also* Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1440-47.

[56] Gadinis and Miazad provide useful examples of how companies during the COVID-19 pandemic engaged with their customers to help regain their trust that it was safe to return to do business with them. Gadinis & Miazad, *Test*, *supra* note 9, at 72-76.

customers also have a serious built-in conflict with other stakeholders: higher prices are bad for customers but provide more to distribute among other stakeholders to the extent that they do not reduce sales too much.[57]

Suppliers, like employees, also provide inputs to the production process of companies. Retaining the loyalty of suppliers may be important for companies, depending in part on how firm-specific inputs are. Where inputs are fungible, they can be bought on the market for the prevailing market price, but where they are firm-specific, the buying firm will have more trouble replacing a supplier that decides to withdraw.[58] Suppliers have information about the quality of what they supply and about conditions which may affect future availability and prices. This information is typically of less general importance than that possessed by employees and customers. Like employees and customers, suppliers have a built-in conflict when it comes to pricing what they sell to a company, though their conflicts are probably less wide-ranging than those of employees with shareholders and other stakeholders.[59]

Creditors are the other main suppliers of critical production inputs, along with shareholders, employees, and suppliers. Their ongoing loyalty is important, and they gain much information about a business through their relationship with it. Indeed, there is a significant literature on the role of creditors in corporate governance,[60] so they might well seem to be among the most important of stakeholder groups. Thus, it is somewhat surprising that the sustainability reporting documents I look at for this study typically do not list creditors as an identified stakeholder group or discuss their engagement with creditors. As a result, they will not feature in the analysis of this Article, which relies on those documents. It is an interesting question why companies do not conceptualize creditors as one of the stakeholder groups they engage with.[61] Perhaps it is because creditors already have a welldeveloped contractual set of provisions for protecting their

[57]Which depends upon the elasticity of demand. For more on the actual and potential role of consumers in corporate governance, see David G. Yosifon, *The Consumer Interest in Corporate Law*, 43 U.C. DAVIS L. REV. 253 (2009).

[58]OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 139 (1985).

[59]Gadinis and Miazad provide useful examples of how companies engaged with their supply chains during the COVID-19 pandemic. Gadinis & Miazad, *Test*, *supra* note 9, at 78-80.

[60]*See, e.g.*, Charles K. Whitehead, *Creditors and Debt Governance*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW 68 (Claire A. Hill & Brett H. McDonnell eds., 2012).

[61]Many corporate constituency statutes include creditors in their list of stakeholders—22 of the 32 constituency statutes as of 2019 did so. *See* Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6, at 117. However, the model benefit

interests, giving them substantial power in many business decisions through approval or veto rights. The kinds of weak engagement rights mostly discussed here are not needed for creditors who have more substantial rights.

The other stakeholders that are frequently identified in the documents analyzed in this Article, and in some cases included in corporate constituency and benefit corporation statutes, have a somewhat more tangential relationship to companies than those discussed above. They do not provide inputs or purchase outputs. However, they are frequently identified as stakeholders in the reporting that provides the main data for this study.[62] We shall see that these more peripheral stakeholders are the types that actually receive positions on corporate boards, rather than the more central stakeholders such as customers and employees.[63] And each of these categories does have some features that fit within the fuzzy definition of a stakeholder.

One important group is government regulators. Regulation can greatly increase the costs of doing business, so regulators must be appeased or persuaded. Regulators in turn care greatly about harms potentially generated by businesses. But regulators can protect those interests through, well, regulation—they do not need internal governance mechanisms to protect them, although as I shall discuss,[64] they may decide that companies with good mechanisms for protecting stakeholders do not need to be regulated as strictly.[65]

Local communities are often listed, by companies and in statutes, as a stakeholder group. Communities are a vague group. Communities may be represented by local governments, which fall into the regulator category. They may also be represented by non-profit or non-governmental organizations. Support for non-profits may be a way of improving the reputation of a company with employees, customers, and shareholders. Working with non-profits may also sometimes provide relevant kinds of information and expertise.

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corporation legislation does not include them in the list of stakeholders to whom benefit corporations owe a duty. WILLIAM H. CLARK, JR. ET AL., THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION: WHY IS IT THE LEGAL FORM THAT BEST ADDRESSES THE NEED OF SOCIAL ENTREPRENEURS, INVESTORS, AND, ULTIMATELY, THE PUBLIC, at app. A §§ 301(a), 303(a) (2013).

[62] 96 companies of the 100 in this study list non-profits or local communities as an engaged stakeholder group, 65 list government regulators, and 25 list academics.

[63] *See infra* notes 210-13 and accompanying text.

[64] *See infra* Sections IV.B-C.

[65] IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (Donald R. Harris et al. eds., 1992).

A final type of stakeholder identified with some frequency in sustainability reporting is academics. These may provide relevant information and expertise concerning production or marketing of a company's products. Perhaps some forms of engagement with academics may also provide some signaling to other, more critical, stakeholders, thereby improving a company's reputation. Of the stakeholders discussed here, academics have the weakest case for being labeled stakeholders, and probably matter the least to most companies. And we shall indeed see that companies report engaging less with them than with the other groups mentioned here, with the notable exception of the somewhat common placement of academics on corporate boards.

### *C. Types of Engagement*

What do I mean by stakeholder engagement, and in what ways can and do companies engage with their stakeholders? The AccountAbility Stakeholder Engagement Standard[66] provides a categorization fairly widely used by both practitioners and academics, and this Article uses it (with some changes) as the basis for its main measure of stakeholder engagement. It identifies ten levels of engagement.[67] The first of these is no engagement at all. The next three (monitor, advocate, and inform) involve communication in only one direction and are of limited interest. The first level of two-way interaction is "transact," which includes private finance initiatives and grant-making. This is of more interest, but is still both limited and ubiquitous, and so not studied here.

The next level is "consult," where an organization asks questions and receives answers. This includes surveys, focus groups, and meetings. We will see that these, or at least surveys and meetings, form the heart of the most quotidian stakeholder engagement practices studied here. Indeed, they are so common that some observers, and some companies, may not conceive of them as forms of stakeholder engagement, which causes a problem for this study given its reliance on voluntary self-reporting.[68] But surveys and meetings are important and useful forms of engagement. As we shall see,[69] gathering information is a main function of engagement, and surveys and meetings are good ways to do that. Surveys on their own are likely less important for the accountability function of engagement, although if used intelligently as measures for guiding executive compensa-

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[66] ACCOUNTABILITY, AA1000 STAKEHOLDER ENGAGEMENT STANDARD 5 (2015) [hereinafter STAKEHOLDER ENGAGEMENT STANDARD].

[67] *See infra* Chart 1.

[68] *See infra* Section II.A.

[69] *See infra* Section I.E.

tion,[70] they can be helpful for accountability as well.

Moving up the ladder, "negotiate" involves discussing issues with a goal of reaching consensus. This includes collective bargaining with workers. At the next level, "involve," the company and stakeholders learn together but act independently. This includes multi-stakeholder forums, advisory panels, and participatory decisionmaking processes. Such forums and panels will provide a key area of interest, where I find some degree of adoption currently but much potential for policies that encourage more engagement of this type.[71] The penultimate level is "collaborate," which involves joint decisionmaking and action. This includes joint ventures and partnerships.

The highest level of stakeholder engagement is "empower," in which decisions are delegated to stakeholders. This is the gold standard in the AccountAbility framework and for me as well. Empowerment involves the "[i]ntegration of stakeholders into governance, strategy and operations of the organization."[72] This includes workers electing board directors and works councils which include employee representatives and which are authorized to set various rules governing working conditions. Such empowerment for employees is legally entrenched in some countries, most notably through the codetermination system in Germany.[73] Such empowerment is so rare in the United States that I have revised the category to include unionization, which falls lower in the AccountAbility standard but which does give an organization representing workers the power to help set some working condition rules.

Some non-legal academics have used variations on this categorization to construct measures of stakeholder engagement.[74] This Article is patterned on that prior research. Like them, it creates measures by looking at self-reported stakeholder engagement in public disclosure. Two of those previous studies find

[70] *See infra* Section III.C.

[71] *See infra* Part IV.

[72] STAKEHOLDER ENGAGEMENT STANDARD, *supra* note 66, at 22.

[73] Grant M. Hayden & Matthew T. Bodie, *Codetermination in Theory and Practice*, 73 FLA. L. REV. 321 (2021).

[74] MARCO BELLUCCI & GIACOMO MANETTI, STAKEHOLDER ENGAGEMENT AND SUSTAINABILITY REPORTING 140 (Güler Aras ed., 2019); Giacomo Manetti, *The Quality of Stakeholder Engagement in Sustainability Reporting: Empirical Evidence and Critical Points*, 18 CORP. SOC. RESP. & ENV'T MGMT. 110 (2011) [hereinafter Manetti, *Quality of Stakeholder Engagement*]; Barbara Borgato et al., Stakeholder Engagement in Mandatory Non-Financial Reporting: First Results for First-Time Reporters in Italy (Oct. 31, 2019) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3479186 [https://perma.cc/P2FV-LJBN]; Peter Bruce & Rita Shelley, *Assessing Stakeholder Engagement*, 11 COMMC'N J. N.Z. 30 (2010).

(rather disapprovingly) that most engagement is at the level of consulting, not higher levels.[75] The current study provides more detailed analysis of what types of engagement are more frequently used for various types of stakeholders.

**Chart 1: Levels and Methods of Engagement[76]**

| LEVEL OF ENGAGEMENT | METHODS OF ENGAGEMENT |
|---|---|
| ***Remain Passive*** *No active communication* | *Stakeholder concern expressed through protest *Letters *Media *Websites etc. |
| ***Monitor*** *One-way communication; stakeholder to organization* | *Media and internet tracking *Second-hand reports from other stakeholders possibly via targeted interview |
| ***Advocate*** *One-way communication; organization to stakeholder* | *Pressure on regulatory bodies *Other advocacy efforts through social media *Lobbying efforts |
| ***Inform*** *One-way communication; organization to stakeholders, there is no invitation to reply* | *Bulletins and letters *Brochures *Reports and websites *Speeches, conferences, and public presentations |
| ***Transact*** *Limited two-way engagement; setting and monitoring performance according to terms of contract* | *Public-private partnerships *Private Finance Initiatives *Grant-making *Cause-related marketing |
| ***Consult*** *Limited two-way engagement; organization asks questions, stakeholders answer* | *Surveys *Focus groups *Meetings with selected stakeholders *Public meetings *Workshops |
| ***Negotiate*** *Limited two-way engagement; discuss a specific issue or range of issues with the objective of reaching consensus* | *Collective bargaining with workers through their trade unions |
| ***Involve*** *Two-way or multi-way engagement; learning on all sides but stakeholders and organization act independently* | *Multi-stakeholder forums *Advisory panels *Consensus building processes *Participatory decisionmaking processes *Focus groups *Online engagement tools |
| ***Collaborate*** *Two-way or multi-way engagement; joint learning, decision-making and actions* | *Joint projects *Joint ventures *Partnerships *Multi-stakeholder initiatives *Online collaborative platforms |
| ***Empower*** *New forms of accountability; decisions delegated to stakeholders; stakeholders play a role in shaping organizational agendas* | *Integration of stakeholders into governance, strategy, and operations of the organization |

### *D. Corporate Governance*

Effective stakeholder engagement involves more than the actual interaction between companies and stakeholders. One must also consider who is doing the engaging on the company

[75]Manetti, *Quality of Stakeholder Engagement*, *supra* note 74, at 117-19; BELLUCCI & MANETTI, *supra* note 74, at 143.

[76]STAKEHOLDER ENGAGEMENT STANDARD, *supra* note 66, at 22.

side, how that engagement is overseen, and how information from the engagement is used by the company. In other words, how does stakeholder engagement fit within the internal corporate governance structure?

There are two main levels of actors internally in corporate governance: directors and officers. At each level we can ask who is involved in engaging stakeholders. Consider first the board level. Here, there are at least two main questions one might ask. First, what is the background of the individual directors? Second, what set of directors is charged with oversight of ESG and stakeholder engagement—is it the full board, or one or more committees, and if the latter, which committees?

Over several decades, board composition has evolved from boards being composed mainly of inside officers of the company to a model focused on independent directors, who have no significant ties to the company beyond their status as directors. The CEO will almost certainly be a director, and there may be one or two other internal officers on the board, but a large majority of directors are independent.[77] Independence is conceived as a way to ensure that boards will more effectively monitor officers in the interest of protecting shareholders.[78] But from a stakeholder perspective, most independent directors are officers at other corporations. They thus do not directly represent the interests of stakeholders, although there is some evidence that board independence leads to better environmental performance.[79]

Among shareholder ESG activists, there has been a growing emphasis on ensuring that boards have directors with relevant environmental expertise. This activism has mostly occurred through informal engagement with the board,[80] though in one high-profile case, it occurred through a proxy fight.[81] The difference is significant: in the former, the board retains control over its composition; in the latter, it does not. Although most independent directors are officers at other corporations, it has long been true that a notable minority of directors come from other backgrounds. This includes officials at non-profit organizations,[82]

[77]Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 135-36 (2010); Usha R. Rodrigues, *The Fetishization of Independence*, 33 J. CORP. L. 447, 452-55 (2008).

[78]Fairfax, *supra* note 77, at 135-37; Rodrigues, *supra* note 77, at 454-56.

[79]Ruth V. Aguilera et al., *The Corporate Governance of Environmental Sustainability: A Review and Proposal for More Integrated Research*, 47 J. MGMT. 1468, 1476 (2021).

[80]McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 380-81.

[81]Sharfman, *supra* note 52.

[82]Shili Chen, Niels Hermes & Reggy Hooghiemstra, *Corporate Social*

former government officials,[83] and academics.[84] One function such directors may provide is representing a more public-spirited interest. In a different though related view, resource dependence theory conceives of directors as helping companies in accessing valuable resources or networks.[85] Directors coming from government, non-profits, or academia will bring different kinds of resources and connections than those from the corporate world.

None of these patterns involve non-shareholder constituencies directly appointing any directors—no public company (to my knowledge) allows the Sierra Club or Nature Conservancy to appoint (or even nominate) a director to represent the environment. But non-profit officers, government officials, and academics do represent several categories of stakeholders.[86] Were the stakeholders themselves electing these representatives, their presence on the board would be a level of empowerment that we do not see in U.S. public corporations. Other countries, notably Germany, have a system of codetermination for large companies in which employees appoint some directors.[87] Senators Warren and Sanders have proposed that for large American companies.[88] Even in the United States, non-public companies may have boards elected by stakeholders other than shareholders, for instance in the case of consumer, producer, or worker cooperatives.[89] There have been occasional examples of employee directors on the boards of public U.S. corporations and some variation over time,[90] but in recent decades that has not been common.[91]

The other question for ESG and stakeholder engagement at the board level is what body is charged with oversight of such

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*Responsibility and NGO Directors on Boards*, 175 J. Bus. Ethics 625 (2022).

[83] Richard H. Lester et al., *Former Government Officials as Outside Directors: The Role of Human and Social Capital*, 51 Acad. Mgmt. J. 999 (2008).

[84] Bill Francis, Iftekhar Hasan & Qiang Wu, *Professors in the Boardroom and Their Impact on Corporate Governance and Firm Performance*, 44 Fin. Mgmt. 547 (2015).

[85] Amy J. Hillman, Albert A. Cannella, Jr. & Ramona L. Paetzold, *The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change*, 37 J. Mgmt. Stud. 235, 238-39 (2000).

[86] *See infra* Section II.B.

[87] Hayden & Bodie, *supra* note 73.

[88] Accountable Capitalism Act, S. 3348, 115th Cong. (2018); Reward Work Act, S. 915, 116th Cong. (2019).

[89] Charles T. Autry & Roland F. Hall, the Law of Cooperatives 56-58 (2009).

[90] Perhaps most famously, UAW President Douglas Fraser was on the Chrysler board. Ewan McGaughey, *Democracy in America at Work: The History of Labor's Vote in Corporate Governance*, 42 Seattle U. L. Rev. 697, 736 (2019).

[91] *Id*. at 735-45.

matters.[92] Is it simply handled by the full board, or is one or more committee specifically charged with oversight? Most modern public company boards have three standard committees: Audit, Compensation, and Nomination and Governance.[93] The Audit Committee oversees the process of gathering and verifying financial information, including relations with the external auditor. The Compensation Committee oversees the compensation of directors and top officers. The Nomination and Governance Committee oversees the nomination of directors and the functioning of the board.[94]

Should ESG oversight be located in one of these committees, several of them, or in some other committee specifically devoted to all or some ESG matters? One observer notes that "companies will often amend a board-level committee charter to assign responsibility and authority with respect to ESG issues as a first step in developing an ESG program."[95] However, a growing number of companies have created special board committees focused on sustainability issues.[96] Leo Strine and Kirby Smith have an acute analysis of this question, focusing on how companies handle their workforce.[97] They argue that oversight of employee relations should be delegated to the Compensation Committee.[98] The same two authors plus Reilly Steel argue that oversight of various ESG matters should be parceled out to different standard committees that have a complementary focus.[99] They argue against creating a special committee devoted to ESG matters. This risks siloing ESG from the core business operations but will coordinate information flow more efficiently. However,

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[92]A prior question is whether the board oversees ESG matters at all. Even recently that was not a given, but that is rapidly changing. One study found that in 2019 only 56% of companies studied had board oversight of ESG matters, while in 2020 that percentage had jumped to 73%. Donnelley Fin. Sols., Board Oversight of Esg—now! 3 (2020).

[93]*See, e.g.*, PwC, Esg Oversight: the Corporate Director's Guide 28 (2022), https://www.pwc.com/us/en/services/governance-insights-center/pwc-esg-oversight-the-corporate-director-guide.pdf [https://perma.cc/W992-EN4Y].

[94]*Id*.

[95]E. Christopher Johnson, Jr. et al., *Profound Change: The Evolution of ESG*, 75 Bus. Law. 2567, 2606 (2020).

[96]Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1423.

[97]Leo E. Strine, Jr. & Kirby M. Smith, *Toward Fair Gainsharing and a Quality Workplace for Employees: How a Reconceived Compensation Committee Might Help Make Corporations More Responsible Employers and Restore Faith in American Capitalism*, 76 Bus. Law. 31 (2020).

[98]*Id*.

[99]Leo E. Strine, Jr., Kirby M. Smith & Reilly S. Steel, Caremark *and ESG, Perfect Together: A Practical Approach to Implementing an Integrated, Efficient, and Effective* Caremark *and EESG Strategy*, 106 Iowa L. Rev. 1885 (2021).

might a special ESG committee be more truly devoted to advancing ESG concerns than a traditional committee with an expanded scope?[100] We shall see that a substantial minority of the S&P 100 do have a special committee devoted to ESG oversight.

The other level of internal governance is that of the officers in charge of actually doing stakeholder engagement and making most decisions on behalf of the company. There is a basic choice here similar to that at the committee level. One could either delegate ESG decisions and stakeholder engagement to the operating officers who oversee the relevant matters within the company, or one could create specific officer positions (and also departments of employees under the direction of those officers) charged with ESG oversight and stakeholder engagement. The advantage of ESG-specific officers is they are more likely to assign high importance to such oversight and to work hard at improving their company's ESG performance,[101] including engagement with stakeholders. The disadvantage is that they may be siloed and relatively powerless.[102] One way of addressing this disadvantage is to create councils of officers that include both the mainline operational officers and the ESG officers to coordinate oversight. As we shall see, two relatively new officer positions have become quite widespread.[103] The Chief Sustainability Officer oversees a variety of ESG matters, often with a particular emphasis on the environment. The Chief Diversity Officer oversees efforts to diversify a company's workforce. Executive councils on ESG-related matters are also common.

As one thinks about the role of officers in engaging stakeholders and overseeing ESG matters, an important question is what incentive they have to pay serious attention to such questions. The incentive of the specialized CSOs and CDOs is relatively clear, since ESG concerns and the interests of stakeholders is their sole focus. But what about other officers? Insofar as they too have incentives to consider stakeholder interests, the concern about siloization is lessened, as we can be more trusting of those making operational decisions. In contrast, if officer compensation

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[100] *See* Gadinis & Miazad, *Test*, *supra* note 9, at 95-96.

[101] "[T]here is some evidence that having someone in a corporate responsibility or ethics role on the top management team will direct management time and resources to these issues and improve the company's social performance." David Hess, *The Management and Oversight of Human Rights Due Diligence*, 58 Am. Bus. L.J. 751, 782-83 (2021). But the evidence is not conclusive as to how much a CSO helps sustainability efforts. "The overall evidence on whether a CSO improves social performance is mixed." *Id*.

[102] A CSO "may represent more of a symbolic versus substantive governance mechanism." Gary F. Peters et al., *The Influence of Corporate Sustainability Officers on Performance*, 159 J. Bus. Ethics 1065, 1065 (2018).

[103] *See infra* Section III.B.

is tied only to financial returns, especially to short-term financial returns,[104] the concerns about siloization will be greater.

Companies and activist shareholders have recognized the importance of executive compensation. There has been an explosion of attention paid to this subject. Many companies have started to include some stakeholder concerns as a component of executive compensation, with advocates of stakeholder interests cheering this on,[105] although there are concerns about the adequacy of the measures being used.[106] Shareholders have begun to consider whether and how companies do this, with such considerations influencing their advisory say-on-pay votes.[107] There is much variety in how companies may take stakeholder concerns into account in compensation. Most often ESG is incorporated into the annual bonus component of compensation, though occasionally it is incorporated into the more long-term incentive compensation component.[108] Compensation may be tied to performance on a quantitative metric or based on qualitative evaluations of executive performance.[109] The type of stakeholder concerns considered vary quite a bit, with leading items some-

[104]There has been much debate over whether executive compensation as currently structured induces an excessive focus on short-term over long-term returns. For some of my thoughts on the subject, tending to share the concern over excessive short-termism, see Claire A. Hill & Brett H. McDonnell, *Short- and Long-Term Investors (and Other Stakeholders Too): Must (and Do) Their Interests Conflict?*, *in* RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 396 (Claire A. Hill & Steven Davidoff Solomon eds., 2016). Short-termism matters here insofar as stakeholder interests have a more significant impact on financial returns in the long run. Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1455.

[105]Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1419-21; Jannice L. Koors, *Executive Compensation and ESG*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Sept. 10, 2019), https://corpgov.law.harvard.edu/2019/09/10/executive-compensation-and-esg/ [https://perma.cc/MF3B-43D6]; Brian Breheny & Joseph Yaffe, *Executive Compensation Considerations for 2022 Annual Meetings*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 20, 2022), https://corpgov.law.harvard.edu/2022/01/20/executive-compensation-considerations-for-2022-annual-meetings/ [https://perma.cc/LK9S-L9NN].

[106]Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 697 (2016); WILLIS TOWERS WATSON, ESG AND EXECUTIVE COMPENSATION: HEARING FROM BOARD MEMBERS GLOBALLY 13-20 (2021); PHILLIPA O'CONNOR ET AL., PWC, LINKING EXECUTIVE PAY TO ESG GOALSS (2021), https://www.pwc.com/gx/en/issues/reinventing-the-future/take-on-tomorrow/download/Linking-exec-pay-ESG.pdf [https://perma.cc/U6GP-FMW8].

[107]EDELMAN, SPECIAL REPORT: INSTITUTIONAL INVESTORS 21 (2020), https://www.edel-man.com/sites/g/files/aatuss191/files/2020-11/Edelman%202020%C20Institutional%C20Investor%20Trust_FINAL.pdf [https://perma.cc/ZE7A-Z3TC].

[108]Lucian A. Bebchuk & Roberto Tallarita, *The Perils and Questionable Promise of ESG-Based Compensation*, 48 J. CORP. L. 37, 52 (2022) [hereinafter Bebchuk & Tallarita, *Perils*].

[109]*Id*. at 65-66.

times considered including performance on improving diversity and inclusion, workplace safety, and environmental goals.[110] Many applaud this move to incentivizing more sustainable behavior.[111] But there are also potential costs. Poorly designed compensation may have little effect. Or worse: it may have little effect on performance while serving as a way to pad the compensation officers receive.[112] A key question is how well and precisely performance is measured. ESG matters can be quite hard to measure accurately with quantitative metrics, but qualitative assessments run a major risk of leading to over-optimistic assessments.[113]

### *E. Benefits and Costs of Stakeholder Engagement*

Stakeholder engagement has a variety of potential benefits, which we have already begun to consider in our discussion of the types of stakeholders and the types of engagement. I will focus on three benefits: improved accountability, increased legitimacy, and enhanced information. These benefits may apply even if one focuses solely on profitability for the benefit of shareholders—more knowledge about what customers think about your product, e.g., will improve the marketing of that product, and hence it will increase profits. However, these benefits are even more important if one grants independent value to the direct impact on stakeholders themselves.[114]

Stakeholder engagement can make managers more accountable. This is particularly clear for the most aggressive engagement, which directly empowers some stakeholders to be involved in making some corporate decisions. An obvious example would be codetermination, where employees elect some board members.[115] Employees know how well their employer is promoting their interests, and if they are unhappy, their representatives on the board are in a position to pressure managers to do a better job. But even weaker forms of engagement where companies only elicit feedback from stakeholders (far and away more common than empowerment, as we shall see) can increase accountability. Engagement can inform stakeholders about what is going on within a business. This can make them more willing to be involved with the business, but it can also make them less willing to be involved if they are unhappy with what they learn. The

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[110] *Id*. at 57-61; Breheny & Yaffe, *supra* note 105.

[111] *See, e.g.*, Gadinis & Miazad, *Social Risk*, *supra* note 9.

[112] Bebchuk & Tallarita, *Perils*, *supra* note 108.

[113] *Id*.

[114] *See supra* Section I.A.

[115] Hayden & Bodie, *supra* note 73.

possibility of significant stakeholders (like employees or customers) deciding to cut ties if they are unhappy acts as a check on manager misbehavior.[116] Of course, this only works to the extent that stakeholders can tell what kind of job a company has done. For instance, if we think about customers, they can typically (though far from always) do a good job of telling how well a company's product or service has worked after buying it. However, when it comes to telling whether a company has believed responsibly in its treatment of its workers or the environment, it will generally be harder for customers to evaluate corporate claims of virtuous behavior. This is the problem of greenwashing, and it explains why much attention in the area of corporate sustainability has focused on improving the quality of corporate disclosure.[117]

Stakeholder engagement can also affect the perceived legitimacy and trust of a business among its stakeholders.[118] In addition to the information transmitted potentially improving their evaluation of the business as just noted, the act of engagement may be valued by some stakeholders in and of itself. People care about being treated fairly, and organizations which are seen as reaching out for their ideas and opinions may be seen as more legitimate. This in turn may make them more willing to be involved with the organization, improving its success.[119]

Stakeholder engagement can provide valuable information to companies.[120] Different stakeholders have different kinds of valuable information. Employees learn much about how a business functions as they do their jobs, and they obviously know a lot about how the workplace environment affects their own satisfaction. Customers know what they value in products and services. Non-profit organizations have expertise in specific areas that affect a business. And so on. Engagement can help companies

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[116] Gadinis and Miazad have stressed this accountability function of stakeholder governance. *See* Gadinis & Miazad, *Test*, *supra* note 9, at 56.

[117] Miriam A. Cherry, *The Law and Economics of Corporate Social Responsibility and Greenwashing*, 14 U.C. DAVIS BUS. L.J. 281 (2014).

[118] Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1444-46; GLOB. CORP. GOVERNANCE F., INT'L FIN. CORP., STAKEHOLDER ENGAGEMENT AND THE BOARD: INTEGRATING BEST GOVERNANCE PRACTICES 8-9 (2009) [hereinafter STAKEHOLDER ENGAGEMENT AND THE BOARD], https://documents1.worldbank.org/curated/en/791711468330347261/pdf/629800WP0Stake00Box0361496B0PUBLIC0.pdf [https://perma.cc/N423-TBGU].

[119] Tom R. Tyler & E. Allen Lind, *Procedural Justice*, in HANDBOOK OF JUSTICE RESEARCH IN LAW 65 (2002); E. ALLEN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (1988).

[120] Gadinis and Miazad have dwelled at length on this informational benefit of stakeholder engagement and provide many examples of it in action. *See generally* Gadinis & Miazad, *Test*, *supra* note 9.

learn some of that valuable information.

Though it has significant possible benefits, stakeholder engagement can come with significant costs as well. Most importantly, engagement may create conflicts. The interests of different stakeholders may differ, and engagement may sometimes exacerbate those differences (though other times it may ameliorate them).[121] Avoiding such conflict is a leading explanation for why corporations typically give voting power only to shareholders.[122] Those whose interests lose out in a conflict may feel their input was not truly valued. Conflict may also delay making decisions, leading companies to lose out on opportunities. Conflict costs are reduced by limiting engagement to below the empowerment level, but they are not eliminated. Even if management were mainly engaging with customers through social media, for instance, if a number of customers are upset and express their anger online, that can drain the time and emotional energy of managers who must deal with an onslaught of angry tweets. And such conflict can reduce the perceived legitimacy of the company with its customers—the opposite of what it intends to achieve through engagement.

A more obvious though probably less important cost of stakeholder engagement is that it takes time and money to do it. That time and money could possibly be spent on more valuable things, particularly if one is skeptical about the magnitude of the benefits of engagement. Diversion of managerial attention is perhaps the greatest concern along these lines.

Another, quite serious, concern is that stakeholder engagement may lure stakeholders and policymakers into overly trusting companies. This in turn may reduce pressure to enact legal and regulatory reforms that protect stakeholder interests.[123] Again, the extent to which stakeholders can accurately evaluate the behavior of companies becomes an important factor in the likely success of engagement.

## II Current Stakeholder Engagement Practices

This Part presents and discusses evidence on what types of stakeholder engagement practices the S&P 100 companies report that they currently engage in. Section II.A presents the methodology used in extracting information from the public reports of the companies. Section II.B presents the core data, discussing the

[121] Gadinis & Miazad, *Test*, *supra* note 9, at 83.

[122] Henry Hansmann, the Ownership of Enterprise (2000).

[123] Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6, at 171-73; Matteo Gatti & Chrystin Ondersma, *Stakeholder Syndrome: Does Stakeholderism Derail Effective Protections for Weaker Constituencies?*, 100 N.C. L. Rev. 167 (2021).

frequency of different kinds of engagement with the different kinds of stakeholders. Section II.C drills more deeply into several specific kinds of engagement, relating the results of Section II.B with existing literature.

### *A. Methodology*

The data presented in Section II.B and Part III comes from two kinds of public disclosure documents. The first is annual proxy statements that are required by federal securities law for public reporting companies. The contents of these statements are tightly regulated and thus relatively uniform across companies. The data taken from those documents concerns the background of directors, the allocation of responsibility for ESG oversight among board committees, and executive compensation, all analyzed in Part III below.

The other kind of disclosure document studied is regular sustainability or ESG reports (the term used varies). These reports are not required by securities or other law, but they have become extremely common for large public companies.[124] All of the S&P 100 companies looked at here had some such disclosure available.[125] Most companies produce an annual report, available in PDF form on the company's website. A few companies do not seem to produce a physical report or an online report in just one PDF, but rather have a section of their website devoted to sustainability or ESG issues. Because sustainability disclosure is voluntary, there is a great deal of variation in what and how companies report.[126] However, there is a lot of common ground as well. Several private standards have evolved to guide company disclosure, and most companies choose to follow one or more of those standards.[127] The disclosure is not at all limited to the issues of engagement and corporate governance discussed here. Most of the disclosure is about how companies are addressing major ESG topics and what kind of impact they are having. Reports typically include sections on employees, the environment, suppliers, the community, and governance, along with other possible topics.

I had research assistants first create narrative summaries for each company concerning their disclosure on stakeholder engagement (this Part) and governance of ESG matters (the next Part).

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**[Section II]**

[124]McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 359-60.

[125]In the case of Berkshire Hathaway, we were only able to find disclosure for a subsidiary, Berkshire Hathaway Energy.

[126]McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 362.

[127]*Id*. at 359.

These narrative summaries were organized using the relevant disclosure categories of the Global Reporting Initiative (GRI), perhaps the most widely used standard for general ESG matters. For stakeholder engagement, the disclosure items covered were disclosures 102-40 to 102-44, with disclosure 102-43 being the main item of interest.[128] For corporate governance, the disclosure items covered were some of disclosures 102-18 through 102-37.[129]

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[128] Glob. Sustainability Standards Bd., Glob. Reporting Initiative, Gri Standards (2016). The standards in this section are as follows:

- 102-40: "A list of stakeholder groups engaged by the organization." *Id*. at 29.
- 102-41: "Percentage of total employees covered by collective bargaining agreements." *Id*. at 30.
- 102-42: "The basis for identifying and selecting stakeholders with whom to engage." *Id*. at 31.
- 102-43: "The organization's approach to stakeholder engagement, including frequency of engagement by type and by stakeholder group, and an indication of whether any of the engagement was undertaken specifically as part of the report preparation process." *Id*.
- 102-44: "Key topics and concerns that have been raised through stakeholder engagement, including: i. how the organization has responded to those key topics and concerns, including through its reporting; ii. the stakeholder groups that raised each of the key topics and concerns." *Id*. at 32.

[129] *Id*. The standards I considered in this section are as follows:

- 102-18: "a. Governance structure of the organization, including committees of the highest governance body. b. Committees responsible for decisionmaking on economic, environmental, and social topics." *Id*. at 18.
- 102-19: "Process for delegating authority for economic, environmental, and social topics from the highest governance body to senior executives and other employees." *Id*.
- 102-20: "a. Whether the organization has appointed an executive-level position or positions with responsibility for economic, environmental, and social topics. b. Whether post holders report directly to the highest governance body." *Id*. at 19.
- 102-21: "a. Processes for consultation between stakeholders and the highest governance body on economic, environmental, and social topics. b. If consultation is delegated, describe to whom it is delegated and how the resulting feedback is provided to the highest governance body." *Id*.
- 102-22: "Composition of the highest governance body and its committees by: i. executive or non-executive; ii. independence; iii. tenure on the governance body; iv. number of each individual's other significant positions and commitments, and the nature of the commitments; v. gender; vi. membership of under-represented social groups; vii. competencies related to economic, environmental, and social topics; viii. stakeholder representation." *Id*.
- 102-29: "a. Highest governance body's role in identifying and managing economic, environmental, and social topics and their impacts, risks, and opportunities—including its role in the implementation of due diligence processes. b. Whether stakeholder consultation is used to support the highest governance body's identification and management of economic,

Many companies that use the GRI provide an index pointing to where the relevant disclosure is for each item, which gave a useful starting point in gathering information.

Once these narrative summaries were finished, my research assistants and I engaged in some basic content analysis by coding material of interest to stakeholder engagement and corporate governance.[130] For stakeholder engagement, I set up a categorization of different types of engagement, based with some modification on the AccountAbility Stakeholder Engagement Standards as discussed below.[131] Then, for each company, I and one of my research assistants coded the engagement practices disclosed by those companies. We then met to identify and resolve points where we coded differently. For a summary of the resulting measures of engagement, see Chart 2.

I looked at four of the AccountAbility levels of engagement: consult, involve, collaborate, and empower.[132] I did not include lower levels of engagement, since they mostly involve no or just one-way communication. The transact level is two-way, but the main example of that is grant-making, and contributions to nonprofits are completely ubiquitous and have been for many years, so little of interest would be gained by coding for that. At the consult level, I coded separately for four types of involvement: surveys, focus groups,[133] structured meetings, and social media.[134] Coding for whether a company used surveys or focus groups for a given type of stakeholder was generally straightforward, while the other two were somewhat less so. It was not always clear what counted as a structured, recurring meeting with stakeholders. For social media, the main source of ambiguity was whether a company simply sent messages to stakeholders (a one-way communication that would just qualify as informing in the AccountAbility scheme) or whether companies were also monitoring social media communications received from stakeholders of a

environment, and social topics and their impacts, risks, and opportunities." *Id*. at 22.

- 102-37: "a. How stakeholders' views are sought and taken into account regarding remuneration. b. If applicable, the results of votes on remuneration policies and proposals." *Id*. at 26.

[130]In the coding process, we worked from the summary, referring back to the underlying documents summarized where there was any ambiguity, unclarity, or missing information.

[131]*See infra* notes 133-35 and accompanying text.

[132]*See supra* Chart 1.

[133]The AccountAbility standards list focus groups under both the consult and involve levels; I chose to include them in the former.

[134]"Online engagement tools" are listed under the involve level in the AccountAbility standard, but the typical use of social media seems to better fit within the consult level.

given type.

The involve level includes advisory panels, both panels of one type of stakeholder and multi-stakeholder panels (I coded separately for these). I chose to include as a separate category within this level employee resource or affinity groups, which are not explicitly accounted for within the AccountAbility standards. These are formal organizations of employees with a shared characteristic, e.g., people of color, women, gay, religious, veterans, etc. It turns out that these are now ubiquitous in large U.S. corporations and are one of the phenomena worth further study identified in this Article.[135] The collaborate level mainly includes joint projects or partnerships. This was one of the main areas of ambiguity in coding, particularly for non-profits and local communities. The dividing line between simply giving money to a non-profit and partnering with it is quite fuzzy. In coding, I looked to see whether the disclosure used words like “partner” or “partnering” to describe relationships with organizations.

The definition I used of the highest level of engagement, empower, was rather different from that used by AccountAbility. That categorization envisions arrangements like board representation or works councils, in which stakeholders or stakeholder representatives are actively involved in making decisions. Such arrangements are fairly common in much of Europe, but not at all in the United States. In the companies studied here, I only found such arrangements in some European subsidiaries. Note that I treat the inclusion of certain kinds of stakeholders on the board, namely non-profit officers, former government officials, and academics, within the discussion of corporate governance mechanisms rather than as a director form of engagement through empowerment. Were the underlying stakeholders actually given the power to elect representatives on the board, that would be an instance of empowerment as measured here. But the board itself has the power to make nominations, and shareholders vote on those nominees. Moreover, these types of directors are not typically explicitly characterized as representing the stakeholders of which they are a part. Thus, it does not strike me as properly characterized as a form of stakeholder empowerment, and I do not take the AccountAbility standards or company disclosure as treating these types of directors as such. However, having persons drawn from such positions within stakeholders does strike me as noteworthy and worth discussing, which is why I examine that practice in the next Part. I decided to include unionization at the empower level, since unionization gives employers, through their union, the power to jointly (with their employer) make some major decisions.

[135] *See infra* Section II.C.

**Chart 2: Types of Engagement Calculated and Presented in this Study**

| LEVEL OF ENGAGEMENT | TYPE OF ENGAGEMENT | DESCRIPTION |
|---|---|---|
| *Consult* | Survey | Formal surveys of members of a stakeholder group |
| *Consult* | Focus group | Focus group discussions with members of a stakeholder group |
| *Consult* | Meet | Formal meetings of members of a stakeholder group with company representatives or executives |
| *Consult* | Social media | Interactive use of social media, both monitoring and responding to communication from stakeholders |
| *Involve* | Employee resource group | Formal affinity groups |
| *Involve* | Council | Formal ongoing councils with representatives of one or multiple stakeholder groups |
| *Collaborate* | Collaborate | Partnerships or joint ventures |
| *Empower* | Empower | Unionization of > 5% of employees; council with stakeholder representatives and decisionmaking authority; stakeholders electing directors |

There are significant limits to using public disclosure, especially voluntary disclosure, as the source of information for my data. Most importantly, some companies may be more thorough than others in what forms of engagement they choose to include in their disclosure. If, for instance, a company does not mention that it engages its employees through an intranet, or that it surveys its customers, that may be because it does not do so, or because it does but did not see fit to disclose that.[136] I suspect that some variation particularly in the consult categories (especially surveys, meetings, and social media) is due to differences in disclosure rather than actual practices. Also, unregulated voluntary disclosure often gives an overly rosy view of what a company does and can be quite vague. Thus, ultimately, one would like to see other sources of information about engagement

[136] *See supra* notes 16-17 and accompanying text.

practices, including interviews[137] and surveys.

Still, public disclosure is readily available and easy to gather. Also, it is not subject to the selection bias that afflicts interviews and surveys. Thus, this disclosure at least provides a useful starting point. Moreover, differences in how companies choose to characterize some common types of engagement may themselves be of interest. If one company chooses to treat regular surveys of customer satisfaction as a form a stakeholder engagement while another does not, why might that be? A cynical explanation would be that the former company is stretching to include anything that might possibly be seen as stakeholder engagement as a way to make itself look good, in line with the greenwashing critique of corporate ESG disclosure. But, I would argue that customer surveys are a genuine and significant form of stakeholder engagement.[138] When well done, they can generate much useful information about how well a company is satisfying the interests of its customers—one of the main points of engagement.[139] A more customer-focused company may be more likely to take a broad view of the various ways in which it engages with its customers, thus discussing surveys as a form of engagement where a company that focuses less on its customers might take a more haphazard, limited approach to what it discloses and leave out such surveys.

Whatever one thinks about that last point, we must clearly try to adjust our understanding of the results on stakeholder engagement to account for the possible differences in what companies choose to disclose. As I discuss the results in Section II.B, I will do so, and suggest that most likely the undercounting effect of differences in disclosure should not change our qualitative conclusions very much. We should not put very much weight on the exact figures shown in Tables 1 and 2 concerning how many companies use different kinds of engagement for different kinds of stakeholders. But the ordinal rankings of which stakeholders are most heavily engaged, and what kinds of engagement are most often used, probably reflect the underlying reality pretty well given the likely direction of biases induced by differences in reporting. Indeed, the dominance of lower levels of engagement (probably more subject to under-disclosure) is likely even greater in reality than in the figures reported here.

### *B. Data on Engagement Practices*

Table 1 summarizes the core data gathered on the frequency of

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[137] Gadinis and Miazad have done tremendously helpful work based on interviews with professionals involved in stakeholder engagement. *See* Gadinis & Miazad, *Social Risk*, *supra* note 9; Gadinis & Miazad, *Test*, *supra* note 9.

[138] *See infra* notes 162-71 and accompanying text.

[139] *See supra* note 129 and accompanying text.

different types of engagement for different kinds of stakeholders. There are columns for eight different kinds of engagement: survey, focus, meet, social, employee resource group, council, collaborate, and empower.[140] The cells give the fraction of companies studied that engage in that type of engagement for that stakeholder group. Thus, 0.75 in the cell for employees and surveys means that three-quarters (75%) of companies in the S&P 100 say that they conduct surveys of their employees. Since I studied 100 companies, that means that 75 companies survey their employees. And so on for the other cells.

We can see various patterns in this table. By summing across a row, we find out how many different kinds of engagement the average company used for a type of stakeholder. Thus, companies on average say that they engage in with their employees using 3.26 of the 8 kinds of engagement activities studied here. That makes employees the mostengaged stakeholders by quite a margin. Next are customers with 1.38 activities, followed closely by non-profits at 1.30. Suppliers and governments are well behind that, with 0.85 and 0.71, respectively. Academics are behind that at 0.37, and others at just 0.02.

How might the likely tendency to undercount some types of engagement because some companies do not conceive of them as stakeholder engagement affect these results? The four items in the consult categories (survey, focus, meet, and social media) seem most prone to undercounting. These are common but fairly quotidian forms of interaction, particularly with respect to the two most-engaged types of stakeholders. For huge corporations like those studied here, the reported numbers for how many of those companies survey or meet with their employees and customers seem low. Simple surveys of employee or customer satisfaction might not code as stakeholder engagement of the sort addressed in sustainability reports for a number of companies. The number of companies that engage on social media, particularly with employees and customers, may also be low. Here, in addition to the "too common to count" issue, there is ambiguity as to what qualifies as adequately interactive social media use for purposes of this measure—that is often hard to tell from limited and vague disclosure. If all this does indeed lead to significant undercounting of these activities particularly for employees and customers, then the slightly higher measured lead of customers over non-profits may actually be notably bigger in reality—I suspect that is the case.

[140] *See supra* Chart 2.

**Table 1: Frequency of Type of Engagement by Type of Stakeholder**

| | SURVEY | FOCUS | MEET | SOCIAL MEDIA | ERG | COUNCIL | COLLABORATE | EMPOWER | TOTAL |
|---|---|---|---|---|---|---|---|---|---|
| **Employees** | 0.75 | 0.09 | 0.59 | 0.28 | 0.95 | 0.26 | 0.02 | 0.32 | 3.26 |
| **Customers** | 0.41 | 0.08 | 0.35 | 0.33 | 0 | 0.1 | 0.11 | 0 | 1.38 |
| **Suppliers** | 0.18 | 0 | 0.39 | 0.06 | 0 | 0.03 | 0.19 | 0 | 0.85 |
| **Govt** | 0.02 | 0 | 0.52 | 0.01 | 0 | 0 | 0.16 | 0 | 0.71 |
| **NGOs** | 0.09 | 0.01 | 0.4 | 0.06 | 0 | 0.05 | 0.69 | 0 | 1.3 |
| **Academics** | 0.04 | 0 | 0.08 | 0 | 0 | 0.02 | 0.23 | 0 | 0.37 |
| **Others** | 0.01 | 0.01 | 0 | 0 | 0 | 0 | 0 | 0 | 0.02 |
| **Multigroup** | 0 | 0 | 0 | 0 | 0 | 0.18 | 0 | 0 | 0.18 |
| **Total** | 1.5 | 0.19 | 2.33 | 0.74 | 0.95 | 0.46 | 1.4 | 0.32 | |

This varying level of engagement by type of stakeholder makes broad sense. As discussed above and below, and as I and others have argued at length elsewhere,[141] employees are the stakeholder group that is most intimately connected to businesses. They have the most useful information to gather, and their satisfaction with their relationship with a company is of greatest importance to that company's success. That customers show up next also makes good sense: no business can succeed without persuading people to buy what it sells, so keeping customers happy and learning what they like is critical. That the level of engagement with non-profits is almost as high as that with customers is perhaps more surprising—and as noted above, also quite possibly not true, as significant undercounting of surveys, meetings, and social media may affect the customer engagement measures much more than for non-profits. Suppliers are well behind non-profits, even though they would seem more important to the economic success of companies.

Table 1 also contains information about the types of engagement most frequently used. Summing down a column gives for how many of the seven types of stakeholders (including "others") the average company uses a particular form of engagement. The most used form is meetings, used for an average of 2.33 groups per company. This makes intuitive sense—meetings are a natural form of interaction, particularly for a group like employees.[142] The next most frequently used types of engagement are surveys

[141] *See* sources cited *supra* note 19.

[142] That only 59 companies show as meeting with their employees reveals

(1.5) and collaboration or partnerships (1.4). Employee resource groups are next, used by 95% of the companies. This is striking since this specific form can only be used for one type of stakeholder, employees, and almost all companies use it for that group. I shall have more to say about these types of organization below.[143] Social media only appears as used for 0.28 groups per company. Councils are used a similar amount—that, in contrast to social media, is if anything rather more than I would have expected. Companies make little use of focus groups.

The most aggressive form of engagement, empowerment, shows up at 32 companies. It is only used for employees, and for them, that represents unionization.[144] That actually seems like a large number of companies with unions, given that well under 10% of private sector employees are unionized. But, unions are more likely at larger employers such as those studied here, and I counted companies as using empowerment if at least 5% of their employees were unionized. That is a low threshold, and a higher threshold would reduce the 32% figure significantly.

Table 1 also reveals how the use of types of engagement varies by stakeholders. For employees, the most used forms of engagement are resource groups, surveys, and meetings, with each of those types used by a majority of companies. Engagement with customers is somewhat similar to that with employees but at a lower level: surveys, meetings, and social media are the most common form of engagement, but none of them is reported as being used by a majority of companies. For non-profits, by contrast, the most common form of engagement is collaborative partnerships.

How might the likely fact that many companies do not disclose some types of engagement affect these results? We saw above that the items in the consult category are most prone to such undercounting. That seems clearly true for meetings and surveys. These already show up as the most-used form of engagement, so the likely direction of bias suggests that they are even more strongly in the lead. We also saw that the use of social media may well be notably undercounted as well. I am less sure what to make of the very light reported use of focus groups. Even if the low use of focus groups is correct, the other three of the four consult items (survey, meet, social media) already appear as three of the five most-used forms of engagement, including the top two,

the limitation of looking to the voluntary disclosure documents used here— presumably all companies conduct regular meetings of various kinds with their employees.

[143] *See infra* Section II.C.

[144] Recall, I chose to count this as a form of empowerment. *See supra* Chart 2.

and the data probably undercounts those items more than any other. Thus, consultation, the lowest level of stakeholder engagement studied here, seems to prevail as being much more frequently used than higher levels of engagement.[145]

When constructing an index of engagement for individual companies to look at engagement by industry and to compare with the use of governance mechanisms discussed in Part III, I do not treat each type of engagement equally. Reflecting the AccountAbility hierarchy, the four types of involvement only receive a weight of 1, while the resource groups, councils, and collaborations receive a weight of 2 and empowerment a weight of 3. Table 2 redoes Table 1, but with those weights. The basic results just discussed remain, with the main difference being that non-profits show as more engaged with 2.04 than customers at 1.59. This reflects the fact that the main form of engagement with nonprofits is collaborative partnership, which receives a higher weight than the forms of involvement more frequently used with customers. However, given that the surveys, meetings, and possibly social media engagement with customers is, as discussed above, quite possibly significantly undercounted, and given that the non-profit collaboration category is perhaps the most ambivalently coded number in Tables 1 and 2, I would not attach a great deal of weight to that switch in the level of engagement with customers and non-profits.

**Table 2: Frequency of Type of Engagement by Type of Stakeholder, Weighted**

| | SURVEY | FOCUS | MEET | SOCIAL MEDIA | ERG (2) | COUNCIL (2) | COLLABORATE (2) | EMPOWER (3) | TOTAL |
|---|---|---|---|---|---|---|---|---|---|
| **Employees** | 0.75 | 0.09 | 0.59 | 0.28 | 1.9 | 0.52 | 0.04 | 0.96 | 5.13 |
| **Customers** | 0.41 | 0.08 | 0.35 | 0.33 | 0 | 0.2 | 0.22 | 0 | 1.59 |
| **Suppliers** | 0.18 | 0 | 0.39 | 0.06 | 0 | 0.06 | 0.38 | 0 | 1.07 |
| **Govt** | 0.02 | 0 | 0.52 | 0.01 | 0 | 0 | 0.32 | 0 | 0.87 |
| **NGOs** | 0.09 | 0.01 | 0.4 | 0.06 | 0 | 0.1 | 1.38 | 0 | 2.04 |
| **Academics** | 0.04 | 0 | 0.08 | 0 | 0 | 0.04 | 0.46 | 0 | 0.62 |
| **Others** | 0.01 | 0.01 | 0 | 0 | 0 | 0 | 0 | 0 | 0.02 |
| **Multigroup** | 0 | 0 | 0 | 0 | 0 | 0.36 | 0 | 0 | 0.36 |

[145] A result found in other studies as well. *See* sources cited *supra* notes 74-75.

| | SUR-VEY | FO-CUS | MEET | SOCIAL MEDIA | ERG (2) | COUN-CIL (2) | COL-LABO-RATE (2) | EM-POWER (3) | TO-TAL |
|---|---|---|---|---|---|---|---|---|---|
| **Total** | 1.5 | 0.19 | 2.33 | 0.74 | 1.9 | 0.92 | 2.8 | 0.96 | |

It is worth asking whether engagement with the different kinds of stakeholders is correlated with each other. That is, if a company engages more highly than average with its employees, is it also likely to engage more highly with its customers or other stakeholders? Table 3 suggests that the answer is yes. It shows the correlation for engagement with each type of stakeholder with that for every other type. All but two of the correlations are positive. Those two negative correlations are engagement with academics correlated with customers and governments. Of all the categories of stakeholders, companies engage the least with academics, so it makes some sense that the more-rare engagement with academics is rather more randomly related to engagement with other groups. Do the correlations among engagement with different groups reflect a real phenomenon, or are they due to the source of this data?[146] That is, do companies really tend to be either more or less engaged generally, across types of stakeholders, or is it just that some companies report their engagement more fully (and sometimes creatively) than others? Without other sources of data, I cannot say; I suspect that both are true.

[146] *See supra* Section II.A.

**Table 3: Correlation of Stakeholder Levels of Engagement**

| | EMPLOY-EES | CUSTOMERS | SUPPLIERS | GOVT | NGOS | ACADEMICS |
|---|---|---|---|---|---|---|
| **Employ-ees** | 1 | 0.260998363[aaa1] | 0.31108156[aaa1] | 0.02073666[aaa1] | 0.204246606[aaa1] | 0.034088033[aaa1] |
| **Custom-ers** | | 1 | 0.114115822[aaa1] | 0.22860309[aaa1] | 0.035386816[aaa1] | -0.02777168 |
| **Suppliers** | | | 1 | 0.01634329[aaa1] | 0.179016963[aaa1] | 0.070726829[aaa1] |
| **Govt** | | | | 1 | 0.158294341[aaa1] | -0.0160924 |
| **NGOs** | | | | | 1 | 0.035101966[aaa1] |
| **Academ-ics** | | | | | | 1 |
| ** p<0.05, * p<0.1 | | | | | | |

[aaa1] p<0.01,

The analysis done here is descriptive, not causal. An obvious and important question is what causes companies to be more or less engaged with their stakeholders. That question must mostly be left to future research. However, one piece of data that is easy to gather and could help shed some light is how engagement varies by industry in which companies are involved. The standard measure of a company's main industry is its NAICS code.[147] Table 4 reports on the overall engagement level (using the engagement index described above) for companies grouped by their high-level NAICS codes. For each industry grouping, it reports the average engagement level for companies in that group, with the industries listed from most to least engaged. Table 4 also reports the minimum and maximum individual company engagement index and the number of companies included within that group.

Do any interesting patterns emerge from Table 4? Not all that much, to be honest. There is not all that huge a difference between the various industries, for the most part, with a lot of variation within the groups. But there are perhaps a few suggestive points. The industry with the highest average level of engagement is energy companies and utilities.[148] One might be surprised to see this industry as the most virtuous in its engagement with stakeholders. But on reflection, perhaps that should not be a surprise at all. The industry is subject to high levels of regulatory and political pressure due to its environmental impacts. Engaging with stakeholders is one way of responding to that pressure. This point illustrates that, were one to try to correlate engagement with measures of impact, there may be a problem. Companies with problematic impacts may be induced to engage more with stakeholders. This type of endogeneity is a well-known problem in making causal inferences in studies of corporate governance.[149]

The other industry with a notably higher level of engagement is transportation.[150] One factor that helps explain this is that two of the three companies in the group are unionized, which is heavily weighted in the engagement index. If those companies were not unionized, the average engagement level would drop from

[147] *North American Industry Classification System*, U.S. Census Bureau, https://www.census.gov/naics/ [https://perma.cc/2Y78-GFC6] (last visited Feb. 10, 2024).

[148] The four companies in this group are ExxonMobil, NextEra Energy, Dominion Energy, and Duke Energy.

[149] *See generally* M. Babajide Wintoki, James S. Linck & Jeffry M. Netter, *Endogeneity and the Dynamics of Internal Corporate Governance*, 105 J. Fin. Econ. 581 (2012).

[150] The three companies in this group are Union Pacific, United Parcel, and FedEx.

15.33 to 13.33, which is still above average but only modestly so. As I will discuss below, we see very little engagement at the highest level of empowerment, so an industry where such engagement is common scores more highly. Of course, we are dealing with small numbers of companies here, so we cannot make too much of this.

At the other end of the spectrum, the information sector (which contains the most companies, fifteen) has a noticeably low level of average engagement. Only two companies in that group have an index above the average level for the full 100 companies studied, and at fifteen, even those two are not particularly high. The information sector is a disparate category,[151] and it includes some of the most influential companies in the world, such as Apple and Facebook/Meta. Not all, but many, of these companies face large numbers of consumers (in addition to Apple and Facebook, the category includes Walt Disney and mobile companies such as AT&T, Verizon, and T-Mobile). I would have thought that such companies would face above-average pressure to engage with stakeholders, but that expectation is not borne out by this measure of engagement. Is this an artifact of reporting? Is there a reason why the companies included in the information sector might be more likely to underreport some kinds of disclosure? We have seen that the kinds of engagement most likely subject to underreporting are surveys, meetings, and maybe social media, and particularly the use of these forms with customers. Many, though not all, of the companies in this category are pretty heavily customer-facing (e.g., Apple, Disney, and Facebook). My best guess would have been that such companies are more likely to report customer engagement than others, not less. I do not have a good explanation for this result.

**Table 4: Stakeholder Engagement by Industry**

| INDUSTRY | NAICS | AVERAGE | MIN | MAX | NO. OF FIRMS |
|---|---|---|---|---|---|
| **Mining, oil & gas, utilities** | 21-22 | 16 | 14 | 19 | 4 |
| **Transportation** | 48 | 15.33 | 14 | 17 | 3 |
| **Chemical mfg.** | 32 | 13.67 | 7 | 22 | 13 |
| **Health care** | 62 | 13.67 | 5 | 23 | 3 |
| **Finance & insurance** | 52 | 13.5 | 4 | 22 | 12 |
| **Administrative services** | 56 | 12.33 | 10 | 14 | 3 |

[151] The fifteen companies in this group are Apple, Cisco Systems, Texas Instruments, Intuit, Walt Disney, Comcast, PayPal, AT&T, T-Mobile, Verizon, Charter Communications, Facebook, Salesforce, Equinix, and Automatic Data Processing.

| INDUSTRY | NAICS | AVER-AGE | MIN | MAX | NO. OF FIRMS |
|---|---|---|---|---|---|
| **Management of companies** | 55 | 11.75 | 4 | 17 | 4 |
| **Wholesale trade** | 42 | 11.6 | 8 | 16 | 5 |
| **Retail trade** | 44-45 | 11.36 | 1 | 18 | 11 |
| **Food, apparel mfg.** | 31 | 11 | 6 | 15 | 5 |
| **Computer & electric part mfg.** | 33 | 10.83 | 1 | 17 | 12 |
| **Prof'l, scientific, & tech services** | 54 | 10.25 | 5 | 17 | 4 |
| **Information** | 51 | 8.6 | 4 | 15 | 15 |
| **Real estate** | 53 | 7.33 | 2 | 13 | 3 |
| **Food services** | 71 | 7 | 7 | 7 | 1 |
| **Other services** | 81 | 7 | 7 | 7 | 1 |

### *C. Engagement in More Detail*

The data presented in Section II.B suggests some interesting patterns that deserve more exploration. This includes the ubiquity of employee resource groups and the widespread use of surveys and social media. Much less common are advisory councils or panels, but these are used sometimes and are worth considering, possibly being a future path of expansion. Below I delve into a bit more depth on these topics, reviewing some of the literature on them.

One of the findings that I have found most striking is the ubiquity of employee resource groups (ERGs) or affinity networks. These do not receive attention among the corporate governance scholars with whom I hang out, and they seem to have received relatively limited attention even in the employment law literature. Yet ERGs have been around at least since the National Black Employees Caucus at Xerox in 1970.[152] They initially focused on black employees but have expanded to a variety of other groups over time.[153] My research demonstrates that ERGs are present in most of America's largest corporations.

Advocates argue that ERGs can serve a variety of purposes. The current research literature suggests that ERGs positively contribute to community, sustainability, diversity, and

[152] Hala Annabi & Mina Tari, *Are Women Affinity Groups Enough to Solve the Retention Problem of Women in the IT Workforce?*, *in* PROCEEDINGS OF THE 51ST HAWAII INTERNATIONAL CONFERENCE ON SYSTEM SCIENCES 5146 (2018), https://scholarspace.manoa.ha-waii.edu/server/api/core/bitstreams/7b5c4bb2-ff41-47ee-87a3-a1b1d6c33065/content [https://perma.cc/NN8X-NEK4].

[153] Joann S. Lublin, *Employee Resource Groups Are on the Rise at U.S. Companies*, WALL ST. J. (Oct. 31, 2021, 2:00 PM), https://www.wsj.com/articles/why-ergs-are-on-the-rise-11635532232 [https://perma.cc/ZYP3-MT2A].

visibility.[154] One article notes three main ways that ERGs can help an organization: "1) serve as focus groups to provide feedback for D&I strategists, 2) implement specific strategies, such as mentoring and onboarding, and 3) act as agents of cultural change in the organization."[155] ERGs may work with outside groups to promote efforts at increasing diversity.[156] Some suggest that ERGs may reduce EEOC complaints and litigation.[157]

On the other hand, ERGs can potentially create new risks of litigation as well.[158] Poorly run groups "can stifle productivity and camaraderie among employees, especially if the meetings turn into unproductive 'venting' sessions."[159] ERGs can also risk alienating those they seek to empower by labelling them exclusively as minorities.[160] Some research suggests that ERGs have generally not been effective at improving diversity within companies.[161]

Other than face-to-face meetings, the most common form of engagement used for a variety of stakeholders found in our results is surveys.[162] A large majority of S&P 100 companies survey their employees, and I found close to a majority survey their customers, likely a significant undercount.[163] The literature on surveys suggests several benefits they can provide. One is that stakeholders may appreciate the process of companies soliciting their views, increasing their trust in those companies. One author says that surveys "build[] citizens' . . . trust in the ser-

[154] Theresa M. Welbourne et al., *The Case for Employee Resource Groups: A Review and Social Identity Theory-Based Research Agenda*, 46 PERS. REV. 1816 (2017).

[155] Annabi & Tari, *supra* note 152, at 5147.

[156] Sabreena El-Amin, *Addressing Implicit Bias Employment Discrimination: Is Litigation Enough?*, 2015 HARV. J. RACIAL & ETHNIC JUST. ONLINE 1, 23.

[157] Aaron M. Glassman & Myron Glassman, *The Use of Affinity Groups by Fortune 100 Firms*, 17 J. BUS. DIVERSITY 104 (2017).

[158] *Id.*; Anne-Marie Vercruysse Welch et al., *Legal Traps Associated with Affinity Groups*, 33 ABA J. LAB. & EMP. L. 267, 276 (2018).

[159] Brittany L. Johnson, *Tips on Affinity Groups*, LAB. & EMP. L., Spring 2016, at 1, 8.

[160] Russell G. Pearce et al., *Difference Blindness vs. Bias Awareness: Why Law Firms with the Best of Intentions Have Failed to Create Diverse Partnerships*, 83 FORDHAM L. REV. 2407, 2417-18 (2015); Tyler W. Garvey, Comment, *Law Firm Diversity Scholarships: Good Intentions, Incomplete Solutions—Suggestions from the Eyes of a Diverse Candidate*, 16 BERKELEY J. AFR.-AM. L. & POL'Y 80, 90 (2014).

[161] Soohan Kim et al., *Progressive Corporations at Work: The Case of Diversity Programs*, 36 N.Y.U. REV. L. & SOC. CHANGE 171, 171 (2012).

[162] *See supra* Table 1.

[163] *See supra* Table 1.

vice providers."[164] Another says "[s]urveys can evoke stakeholder respect for the organization and increase organizational credibility."[165] An article focused on employee surveys argues "[s]urveys give employees the chance to feel heard."[166]

Surveys can also improve how companies function. They can provide information that helps companies improve their policies and decisions. For instance, "[s]urvey results can lead to revised policies, procedures, and systems within the value chain of suppliers . . . [and] more effective services and products that better meet consumer needs."[167] Relatedly, one article argues that employee surveys "are a vehicle for changing behavior."[168]

Surveys also pose some risks. Many of those surveyed are skeptical of them. "A 2014 survey found that 70% of employees do not respond to surveys and nearly 30% of them think they are useless."[169] That skepticism could be well-founded for a number of companies, as a concern of commentators is that many do not do a good job at translating the information learned from surveys into action. An article on pulse surveys of employees finds that issues include "[t]aking too much time to get to an action plan"; "[a]ssuming results will fully guide an action plan"; and "[n]eglecting to share the actions taken as a result of employee surveys."[170] Another article makes the following suggestion to companies as a way to improve: "do something [with] the results."[171]

Companies do not report using social media as an engagement technique as often as they report using surveys, but a substantial minority report using social media to engage employees or

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[164] MANJUNATH SADASHIVA, CIVICUS & PG EXCH., STAKEHOLDER SURVEYS 5 (2015), https://civicus.org/documents/toolkits/PHX_H_Stakeholder%20Survey.pdf [https://perma.cc/JD6W-VV8K].

[165] Terrie Nolinske, *Surveys from Stakeholders Make Good Business Sense*, NAT'L BUS. RSCH. INST., https://www.nbrii.com/customer-survey-white-papers/surveys-from-stakeholders-make-business-sense/ [https://perma.cc/DGU6-T8BK] (last visited Feb. 10, 2024).

[166] Scott Judd et al., *Employee Surveys Are Still One of the Best Ways to Measure Engagement*, HARV. BUS. REV. (Mar. 14, 2018), https://hbr.org/2018/03/employee-surveys-are-still-one-of-the-best-ways-to-measure-engagement [https://perma.cc/3RQX-J8VQ].

[167] Nolinske, *supra* note 165.

[168] Judd et al., *supra* note 166.

[169] Peter Cappelli & Liat Eldor, *Where Measuring Engagement Goes Wrong*, HARV. BUS. REV. (May 17, 2019), https://hbr.org/2019/05/where-measuring-engagement-goes-wrong [https://perma.cc/Z292-JGYV].

[170] Lauren Romansky et al., *How to Measure Inclusion in the Workplace*, HARV. BUS. REV. (May 27, 2021), https://hbr.org/2021/05/how-to-measure-inclusion-in-the-workplace [https://perma.cc/V368-HURL].

[171] Cappelli & Eldor, *supra* note 169.

customers, and this is probably a notable undercount.[172] A survey of businesses found that they consider the use of social media helpful in a variety of ways: "The survey questionnaire found that social media encouraged these businesses to adopt policies that were friendly towards their employees (51%), the environment (65%), the marketplace (67%), and the community (55%)."[173]

Furthermore, employees and customers increasingly expect companies to respond to their concerns expressed via social media. A survey of employees found that "82% of employees think that social media can improve work relationships and 60% believe social media support decision-making processes."[174] A survey of customers found that "[s]ince 2013 the number of customers who expect a response through social media has doubled, according to research from Sprout Social, yet seven out of eight messages to companies go unanswered for 72 hours."[175]

A higher level of stakeholder engagement comes with standing councils or panels of stakeholder representatives, who provide ongoing advice to management. Some councils have representatives of just one stakeholder group, while others feature representatives from multiple groups. I find these with some frequency, but they have potential for much greater use. Some have advocated such councils as a way to give stakeholders a more effective voice than current engagement practices.[176] J. Haskell Murray has advocated them for social enterprises.[177] A study of joint stakeholder-management panels in the UK found notable positive impacts on corporate decisionmaking.[178]

[172] *See supra* Table 1.

[173] Ananda Khanal et al., *The Influence of Social Media on Stakeholder Engagement and the Corporate Social Responsibility of Small Businesses*, CORP. SOC. RESP. ENV'T MGMT., June 2021, at 7.

[174] Lorenzo Bizzi, *Employees Who Use Social Media for Work Are More Engaged—but Also More Likely to Leave Their Jobs*, HARV. BUS. REV. (May 17, 2018), https://hbr.org/2018/05/employees-who-use-social-media-for-work-are-more-engaged-but-also-more-likely-to-leave-their-jobs [https://perma.cc/E4HP-29YC].

[175] Keith A. Quesensberry, *Social Media Is Too Important to Be Left to the Marketing Department*, HARV. BUS. REV. (Apr. 19, 2016), https://hbr.org/2016/04/social-media-is-too-important-to-be-left-to-the-marketing-department [https://perma.cc/GY75-4RTU].

[176] Aalt Colenbrander & Tineke Lambooy, *Engaging External Stakeholders in Dutch Corporate Governance*, 13 INT'L & COMPAR. CORP. L.J. 1, 19 (2018); STAKEHOLDER ENGAGEMENT AND THE BOARD, *supra* note 118, at 38.

[177] J. Haskell Murray, *Adopting Stakeholder Advisory Boards*, 54 AM. BUS. L.J. 61 (2017).

[178] Heiko Spitzeck, Erik G. Hansen & David Grayson, *Joint Management-Stakeholder Committees—A New Path to Stakeholder Governance?*, 11 CORP. GOVERNANCE 560, 562 (2011).

In my research, advisory councils of employees are by far the most common, with twenty-six companies having these. Most of these are diversity and inclusion councils. In six companies, I find health and safety councils. These are a sort of halfway house towards Germanstyle works councils. They focus on just one area, though an important one, and they are merely advisory, unlike works councils which have authority to set some kinds of rules. But they do provide an existing base for potential expansion to the works council system. The other kind of single-stakeholder advisory councils seen with most frequency are those with customer representatives, which makes sense since customers are probably the second-most critical non-shareholder group (after employees) for the success of most companies. I found nine companies with multi-stakeholder advisory panels. These go by names like Sustainability Advisory Council (AT&T),[179] Global Citizenship Advisory Council (Abbott Laboratories),[180] External Stakeholder Advisory Council (Wells Fargo),[181] and National Community Advisory Council (Bank of America).[182]

Wells Fargo is an interesting case for stakeholder councils. It established an external Stakeholder Advisory Council as a response to the series of scandals that have tarnished the bank's reputation.[183] Note that the Council's creation in response to scandal echoes a point above, namely that we should not neces-

[179] AT&T, STAKEHOLDER ENGAGEMENT 2 (2012), https://www.att.com/Common/about_us/downloads/stakeholder_engagement.pdf [https://perma.cc/A5M3-NTK7] ("AT&T Consumer Advisory Panel: Established in 2008, this panel is comprised of 19 national consumer leaders who meet quarterly with corporate leaders from AT&T to discuss ways that the company can better serve these communities and continue its efforts to become a more diverse and sustainable company.").

[180] ABBOTT LAB'YS, GLOBAL SUSTAINABILITY REPORT 2022, at 24 (2022), https://dam.abbott.com/en-us/documents/pdfs/abbott-citizenship/Abbott-2022-Global-Sustainability-Report-June-2023.pdf [https://perma.cc/9XY4-6K5Z] ("Global Citizenship Advisory Council[:] External experts who provide guidance on strategic sustainability issues, including risks and opportunities.").

[181] *Wells Fargo Launches Stakeholder Advisory Council*, WELLS FARGO (Dec. 21, 2017), https://newsroom.wf.com/English/news-releases/news-release-details/2017/Wells-Fargo-Launches-Stakeholder-Advisory-Council/default.aspx [https://perma.cc/2TUB-QRNC].

[182] *Key Governance Topics*, BANK AM., https://about.bankofamerica.com/en/making-an-impact/key-governance-topics [https://perma.cc/DKA3-W9RH] (last visited Feb. 10, 2024) ("In 2005, we formed our National Community Advisory Council, or NCAC, a forum made up of senior leaders from social justice, consumer advocacy, community development, environmental, and research organizations from whom we solicit independent external perspectives, guidance, and feedback.").

[183] *Wells Fargo Launches Stakeholder Advisory Council*, *supra* note 181; Daniel J. Morrissey, *The Promise of Stakeholder Advisory Councils*, 23 U. PA. J. BUS. L. 470, 477-79 (2021).

sarily expect to see serious stakeholder engagement exclusively or even primarily in the most virtuous companies—engagement may be a response to reputational and regulatory pressures and problematic businesses.[184] The initial seven members included the president of the Center for Responsible Lending, the CEO of Ceres, the CEO of the National Urban League, the CEO of UnisdosUS, the director of CSR at the Sisters of St. Francis of Philadelphia, the director of corporate governance at the California State Teachers' Retirement System, and the CEO of the National Community Reinvestment Coalition.[185]

Sister Nora Nash, one of the original seven members, "saw the purpose of the Council as bringing an outside view to the company's problems."[186] These issues include how the bank treats its workforce and its human rights policies in lending.[187] One article looking at the Wells Fargo Council concludes:

> If corporations are now "soulless" creatures, Stakeholder Advisory Councils may be a way to implant souls in them. If nothing more, those panels can serve as a bridge from corporations to society at large, sensitizing those firms to their impact on our common life and prodding them to serve the larger purposes of our nation.[188]

It will be interesting to see if the council helps at all.[189] There are decided limits to how far the bank is willing to go. The Committee for Better Banks, which has attempted to unionize bank employees, has pushed Wells Fargo to add an employee representative to its council, and the bank has resisted.[190] The AFL-CIO Reserve Fund attempted to introduce a shareholder proposal requesting the board to include an employee representative on the council, but the SEC allowed the bank to exclude the proposal from its proxy statement.[191] Given the central value that employees can bring to making managers more accountable—a value pretty obvious at Wells Fargo, where employees were quite

[184] *See supra* notes 148-49 and accompanying text.

[185] *Wells Fargo Launches Stakeholder Advisory Council*, *supra* note 181.

[186] Morrissey, *supra* note 183, at 503.

[187] *Id*.

[188] *Id*. at 504 (footnote omitted).

[189] I am a Wells Fargo customer. I can't say I have noticed an increase in corporate soul since 2017.

[190] Ross Kerber & Imani Moise, *Wells Fargo Workers Push for More Board Access, So Far in Vain*, REUTERS (June 12, 2018, 1:44 PM), https://www.reuters.com/article/us-wells-fargo-workers-idUSKBN1J82DJ [https://perma.cc/X4LR-S445].

[191] Letter from Jacqueline Kaufman, Attorney-Adviser, U.S. Sec. & Exch. Comm'n, to Elizabeth A. Ising, Gibson, Dunn & Crutcher LLP (Feb. 27, 2019), https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2019/aflcio022719-14a8.pdf [https://perma.cc/22QX-393N].

intimately familiar with the problems that led to the scandal—the board's opposition to an employee representative on its Council suggests that the board intends to strictly cabin the potential for the council to rock the boat. Obviously, whether councils like this have any impact depends in good part on whether management takes them seriously. Still, they represent an interesting path forward.[192]

Cigna may help bring together and make more concrete what these engagement practices look like. It scores the highest in the total engagement measure, getting a 23 in the weighted measure used in Table 2. How does Cigna score so highly? In good part, it does so by reporting use of all four of the lower types of engagement (meetings, surveys, social media, and focus groups) for both employees and customers, as well as some use of these for suppliers, governments, and nonprofits. It surveys its employees repeatedly, with pulse surveys,[193] an annual global engagement survey,[194] an ethics survey,[195] and a "Cigna Connection survey"[196] (one imagines survey fatigue may be an issue among Cigna employees). The company lists a variety of ways in which it meets with its employees, including quarterly town halls with the CEO[197] and discussions with members of the Work Environment Review Team.[198] Employees were involved in COVID-19 response focus groups.[199] Cigna employees interact with the company on social media in various ways, including a company intranet, email, an Advancing the Race Dialogue, and an online hub. Cigna connects with its customers through focus groups, customer satisfaction surveys, mobile apps, call centers, and in-person conversations.

Moving to a higher level of engagement according to the measures used here, Cigna has employee resource groups for many communities of its employees. These include Black, Asian, Latin, LGBTQ+, veteran, interfaith, and female employees.[200] It also codes as collaborating with non-profits through the activities

[192]Colenbrander & Lambooy, *supra* note 176; Spitzeck et al., *supra* note 178; Murray, *supra* note 177.

[193]CIGNA, 2020 CIGNA CONNECTS CORPORATE RESPONSIBILITY REPORT: THE POWER OF PURPOSE 114 (2020), https://www.cigna.com/static/www-cigna-com/docs/cigna-connects-2020-corporate-responsibility-report.pdf [https://perma.cc/XEW2-PXQ9].

[194]*Id*. at 93.

[195]*Id*. at 12.

[196]*Id*. at 93.

[197]*Id*. at 29.

[198]*Id*. at 14.

[199]*Id*. at 114.

[200]*Diversity, Equity, and Inclusion*, CIGNA GRP., https://www.thecignagroup.com/our-impact/esg/healthy-workforce/diversity-equity-and-

of the Cigna Foundation. This is the charitable giving and activities vehicle for the company. The disclosure here illustrates the ambiguity of this particular piece of coding. I look to phrasing discussing partnerships, and Cigna's disclosure concerning the Foundation states that its response to COVID-19 "included partnering with Give2Asia, the Centers for Disease Control and Prevention (CDC) Foundation, Feeding America, and other nonprofits on the front lines tackling food insecurity, mental health, and health care worker's needs."[201]

None of this is very exceptional. The practices are pretty basic, and other companies do similar things. Cigna just reports doing somewhat more of it than other companies do, and as noted repeatedly, it is hard to judge how much that difference reflects differences in reporting as opposed to reality. But even so, it is worth noting how widespread these basic practices of stakeholder engagement are.

Where Cigna does more distinctly stand out is in its use of a variety of stakeholder advisory councils. Cigna has joint management-employee safety committees that participate in the health and safety process.[202] It also has inclusion councils, composed of managers and employees, that focus on diversity and equity issues.[203] As we have seen, employee councils focused on safety or diversity are the two most common forms of stakeholder councils,[204] but few companies have both. Moving beyond employees, Cigna has a Health Disparities Advisory Council that consists of representatives from clients with significant populations in under-represented communities.[205] It also has a Health Equity and SDoH Governance Council which works with stakeholders on health equity issues.[206] I will argue that stakeholder advisory councils are the most cutting edge practice that moves closer to actively empowering stakeholders while still being currently used by a notable minority of companies.[207]

## III Current Corporate Governance Practices

Part II looked at the different ways in which companies engage with different kinds of stakeholders. But this only gets at a part of the engagement process. Within a company, who does the

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inclusion [https://perma.cc/B2PE-TMFM] (last visited Feb. 10, 2024).

[201] Cigna, *supra* note 193, at 77.

[202] *Id*. at 117.

[203] *Id*. at 97.

[204] *See supra* Section II.B.

[205] Cigna, *supra* note 193, at 56.

[206] *Id*.

[207] *See infra* notes 283-88 and accompanying text.

engagement, and what becomes of the information gained? Who oversees the process of engaging with stakeholders and of using the results of that engagement? In other words, how does stakeholder engagement fit within the corporate governance arrangements of companies? This Part looks at those questions. It does so using additional data gathered from voluntary and mandatory reports by the S&P 100 companies, as well as discussing the literature on the questions considered. Section III.A looks at board composition and organization. Section III.B looks at developments at the corporate officer level. Section III.C considers how compensation practices are evolving to encourage managers to consider ESG matters. Section III.D explores correlations among these various governance practices and the stakeholder engagement index.

### *A. Boards*

The board of directors is the highest level of governance within a corporation. Much legal and practical attention has been focused in recent decades on encouraging boards to be more actively involved in supervising the officers who run their company.[208] I thus start the examination of corporate governance with the board. I ask questions about board composition and board organization.

As noted above,[209] public company boards have moved to an independent director model where most board members have no significant financial ties to the company beyond what they receive as directors. To what extent are stakeholder perspectives represented in the occupational backgrounds of directors? Traditionally, three types of stakeholder groups have been somewhat commonly represented on boards: government, non-profits, and academia. These three groups are not as clearly stakeholders as some others like employees and customers, but we have seen that they are indeed often conceived of as stakeholders.[210] As noted above,[211] although having members of a stakeholder group could be conceived as empowerment, the highest level of stakeholder engagement, the fact that these kinds of directors are not elected by stakeholders themselves, nor generally even selected with stakeholder input, makes it more appropriate to consider such directors here, as an element of corporate governance. The common inclusion of these members of stake-

**[Section III]**

[208] *See supra* notes 77-78 and accompanying text.

[209] *See supra* Section I.D.

[210] *See supra* Section I.B.

[211] *See supra* notes 62-63 and accompanying text.

holder groups on boards does bear examining in a study of stakeholder engagement. How common are such directors?

That information is readily available from annual proxy statements, which give the background of company directors. From those documents, for each company I found all of the directors who had some significant employment experience in government, non-profits, or academia. The experience needed to be full-time, so for instance serving on the board of a non-profit or government advisory committee did not count. The experience did not need to be contemporaneous with service on the company's board—among other things, such a requirement would rule out government officials, who cannot serve on a board while working for the government but who quite frequently do serve on boards after leaving government. Using that definition, of the 100 companies studied, 20 had no representatives from any of the three categories. For those companies, all of the directors come from a for-profit business background. Looking at the three categories, 56 companies had at least one former government official on their board, 25 had a non-profit official, and 38 had an academic. Across all 100 companies, there was an average of 1.74 directors from one or more of the three categories. The average company had 1.19 different types of the three categories (the maximum here is 3, of course).

Thus, the inclusion of directors from these stakeholder groups is pretty common. Notably, though, the two most significant and mostengaged stakeholder groups of all, employees and customers, are not represented, aside from the internal officers that all boards still contain (in limited numbers). But top executive officers, those who serve on their company's boards, are quite a different kettle of fish from the average employees. In some respects, the interests of officers and employees do align, but in many others, they do not. Why are representatives of second-tier but not first-tier stakeholder groups included on company boards? One hypothesis is that the stronger interest of employees and customers may be perceived by boards as an obstacle: employee or customer representatives might more frequently and strongly conflict with the interests of shareholders.[212] Note also that although stakeholder representatives are common, in most companies, they are easily outweighed by directors who come from a for-profit background. The average public company board has around twelve directors,[213] and we have seen that on average under two of those come from government, non-profits, or

[212] *See supra* note 121 and accompanying text.

[213] Joseph E. Griesedieck, *How Many Directors Does a Board Need?*, Korn Ferry, https://www.kornferry.com/insights/this-week-in-leadership/board-of-directors-size [https://perma.cc/AH7M-EYUD] (last visited Feb. 10, 2024).

academia.

How are stakeholder interests overseen within the structure of boards? What group is assigned primary responsibility for oversight of ESG practices, including stakeholder engagement? There are several possibilities. The entire board could retain that responsibility, not delegating it to any committee. The responsibility could be divided up among a number of committees. It could be assigned to one of the three main traditional board committees (Audit, Compensation, Nomination/Governance). Or it could be assigned to a committee specially devoted to ESG matters.[214]

We see all of these possibilities in practice among the 100 largest corporations. A substantial majority of companies, 62, lodge primary responsibility for ESG[215] oversight in one of the three traditional committees, in almost all cases the Nomination/Governance Committee.[216] However, a substantial minority, 22, lodge primary responsibility within a special committee specifically devoted to sustainability.[217] Eleven companies have a hybrid between these two models—the traditional Governance committee is significantly expanded, so that ESG matters play a major role in the committee's functions, rather than being something of a tacked-on afterthought, as in most Governance committees charged with ESG oversight. The borderline between the hybrid model and the traditional Governance Committee model is not clear. In my research, I coded a committee as hybrid based on the committee's name containing language related to ESG, sustainability, or corporate responsibility, as well as the list of assigned topics for the committee featuring ESG matters as a major portion of the listed elements. In 5 companies, no committee is charged with ESG oversight. Note too that in 45 companies, including those that assign primary ESG oversight to one committee, the Compensation Committee is charged with oversight of a range of workforce matters, expanding beyond its traditional scope of executive compensation. Leo Strine is cheering on those

[214]*See supra* notes 92-100 and accompanying text.

[215]The companies sometimes refer to oversight of ESG matters, sometimes corporate (social) responsibility, sometimes sustainability, and sometimes list out the major categories of ESG, e.g., climate change, diversity, etc. On these overlapping categorizations, see *supra* note 40 and accompanying text. For similar results in a survey of the S&P's top 50 companies, see Lisa M. Fairfax, *Board Committee Charters and ESG Accountability*, 12 HARV. BUS. L. REV. 371, 375-77 (2022).

[216]Only one company, Alphabet, lodged primary responsibility in the Audit Committee. T-Mobile seems to assign equal responsibility to the Audit Committee and the Nomination and Governance Committee.

[217]These committees go by a variety of names. Ten committee names contain the term "Public Policy," 4 more also have the word "Public," 6 contain "Sustainability," and 6 contain "Responsibility" or "Responsibilities."

companies.[218] Although maybe he is not cheering too loudly. In most companies that assign broader responsibility to the Compensation Committee, the list of responsibilities looks mainly traditional, with one or two buried bullet points added to address human capital management. One wonders if the placement within the bullet points reflects a limited prioritization.[219]

These numbers are generally consistent with what other studies have found. A Deloitte study of the S&P 500 found the following distribution of committee responsibilities: 41% Nominating and governance committee; 28% Not disclosed; 10% ESG/ Sustainability committee; 8% Other committees; 7% Full Board committee; 5% Health and safety committee; and 1% Audit committee.[220] A study of 60 Toronto Stock Exchange companies found that 19 had "specialized" committees for ESG, 16 used the Governance committee for ESG oversight, 2 used the Audit committee, and 11 had multiple committees completing ESG oversight.[221]

In Section III.D and Table 5 below, I examine the correlation between the various governance practices discussed in this and the previous Parts. Those correlations contain a nugget of evidence concerning the choice between assigning ESG to a special committee versus a traditional committee. All of the correlations presented in Table 5 are positive. That includes a variable, Com, that gives an index for the type of committee to which ESG is assigned. The highest value for Com is defined as having a special committee. Thus, if the positive correlations suggest that the various practices that focus on stakeholder engagement and concern with ESG factors all tend to rise or fall together, then

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218 *See supra* notes 97-99 and accompanying text.

219 A typical example is Cisco Systems, in which the 15th of 23 bullet points targets human capital, including "diversity and inclusion, workplace environment and safety, and corporate culture." *Compensation and Management Development Committee*, Cisco (Dec. 8, 2022), https://investor.cisco.com/corporate-governance/compensation-and-management-development-committee/default.aspx [https://perma.cc/D6SR-UV8R]. A small number of companies have gone further. For example, Linde uses the term "Human Capital Committee." Of 19 bullet points listing duties and responsibilities, 7 cover matters related to non-executive employees. Linde, Charter of the Human Capital Committee of the Board of Directors 2-4 (2021) (on file with the Florida State University Law Review).

220 Kristin Sullivan & Jenny Lynch, Ctr. for Bd. Effectiveness, Deloitte, on the Audit Committee's Agenda 2 (2020), https://www2.deloitte.com/content/dam/Deloitte/fi/Documents/risk/us-november-OTACA-final.pdf [https://perma.cc/MAD3-EF4G].

221 Charles-Étienne Borduas et al., *ESG: What Boards of Directors Should Do Now*, Norton Rose Fulbright (Aug. 16, 2021), https://www.nortonrosefulbright.com/en-ca/knowledge/publications/bed17bb0/esg-what-boards-of-directors-should-do-now [https://perma.cc/GEF6-DYPF].

having a special board committee focused on ESG is one of those high-engagement and pro-ESG practices. In other words, companies with special board committees tend on average to engage more fully with their stakeholders and to have other governance features that stress stakeholder concerns more strongly. I would not put a lot of stress on how much these correlations reveal about the choice of how to structure board committees, but it is at least suggestive.[222]

### *B. Officers*

Though the board has ultimate responsibility in governing a corporation, much of the actual authority in directing and overseeing daily operations is delegated to a company's officers. Corporate law says relatively little about what officers a corporation must have,[223] and the range of positions varies greatly. Titles and power evolve, with some positions growing in popularity over time. The modern fashion for the titles of top officers is C-O, i.e., the chief [fill-in-the-blank] officer, such as the chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO), and so on. As discussed in Section I.D, two relatively new common positions are of much relevance to how companies deal with stakeholders: the chief sustainability officer (CSO) and the chief diversity officer (CDO).[224]

The CSO has exploded in a relatively short period of time. One study claims that Dupont named Linda Fisher the first CSO of a publicly traded U.S. corporation in 2004,[225] though other studies suggest the position goes back a few years earlier.[226] There has been an explosion in recent years so that the position is now

[222]A study looking at the correlation between company environmental performance and disclosure and various governance practices finds that the presence of CSR committees is correlated with better environmental performance. Jing Lu & Jun Wang, *Corporate Governance, Law, Culture, Environmental Performance and CSR Disclosure: A Global Perspective*, J. INT'L FIN. MKTS. INSTS. & MONEY, 2021, at 1.

[223]*See, e.g.*, DEL. CODE ANN. tit. 8, § 142.

[224]*See supra* notes 101-04 and accompanying text. Another position clearly of relevance is the Chief Human Resource Officer, or head of human resources by whatever name might be used, responsible for the oversight of many practices affecting the workforce. I chose not to include study of that position here because it has been around a lot longer than CSO and CDO and is by now basically ubiquitous at large companies.

[225]WEINREB GRP., THE CHIEF SUSTAINABILITY OFFICER 10 YEARS LATER: THE RISE OF ESG IN THE C-SUITE 2 (2021), https://weinrebgroup.com/wp-content/uploads/2021/05/Weinreb-Group-Sustainability-and-ESG-Recruiting-The-Chief-Sustainability-Officer-10-years-Later-The-Rise-of-ESG-in-the-C-Suite-2021-Report.pdf [https://perma.cc/VXH7-8VUQ].

[226]*The Rise of the Chief Sustainability Officer*, RENAISSANCE EXEC. FS. (Nov. 11, 2021), https://wp.ref.global/the-rise-of-the-chief-sustainability-officer/ [https://

standard, though not universal, for large public corporations.[227] Although Chief Sustainability Officer is the most common term, that is very far from uniform. Companies have used a wide range of titles to describe the position.[228] Examples include VP of Environmental Policy & Social Initiatives (Apple), Head of Corp Responsibility & Philanthropy (Visa), Senior VP of Corporate Affairs (Cisco Systems), Chief Impact Officer (Salesforce), Corporate Responsibility Officer (Accenture), VP for Corporate Citizenship (Texas Instruments), and ESG, Corporate Responsibility, Social Impact, & Sustainability Leader (ServiceNow, apparently determined not to miss out on any of the leading buzzwords). To some extent, the range of titles reflects some range in the scope of responsibilities. Some CSOs are mainly focused on environmental matters. Other CSOs oversee a wide range of ESG or sustainability topics. My research of the public filings[229] found that 84 of the 100 companies studied have a position that at least roughly corresponds to the CSO.

Having a CSO brings several potential benefits. A CSO can make sure that more resources are devoted to sustainability concerns.[230] Many CSOs were previously environmental advocates in other capacities and offer regulatory expertise and openness to regulators.[231] Employees may be more willing to discuss sustain-

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perma.cc/YUW3-VAFW] (noting that in 2001, there was 1 CSO; by 2011, there were 29; and in 2020, Fortune 500 companies hired more CSOs than the three previous years combined); Kathleen Miller Perkins & George Serafeim, *Chief Sustainability Officers: Who Are They and What Do They Do?*, *in* LEADING SUSTAINABLE CHANGE: AN ORGANIZATIONAL PERSPECTIVE 196, 197 (Rebecca Henderson, Ranjay Gulati & Michael Tushman eds., 2015) ("The number of companies with a full-time sustainability officer doubled between 1995 and 2003, and doubled again between 2003 and 2008.").

[227] In addition to the sources in the previous note, see Morgan Stanley, *The Rise of the Chief Sustainability Officer*, FIN. TIMES (July 20, 2021) (on file with author) (noting that in 2020, 31 Fortune 500 companies hired their first CSO).

[228] Though I have grouped these various titles together, some treat them separately. *See* DELOITTE, THE FUTURE OF THE CHIEF SUSTAINABILITY OFFICER: SENSE-MAKER IN CHIEF 7 (2021), https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/gx-fsi-future-of-the-cso-report.pdf [https://perma.cc/QL6X-6KYM] ("Fewer than 15 percent of survey respondents reported having a CSO in place, although nearly half had a Head of Sustainability or equivalent and a further 12 percent had a Head of ESG.").

[229] In some instances, we were unable to find a CSO (or CDO, see below) listed in the sustainability reports or proxy statement. In those case, we also did a Google search, which yielded a person filling the position for some companies (usually found via LinkedIn).

[230] *See supra* note 101 and accompanying text.

[231] Michael P. Vandenbergh et al., *The New Revolving Door*, 70 CASE W. REV. 1121, 1145 (2020).

ability concerns with CSOs than with other officers.[232] On the other hand, the creation of a CSO may be more symbolic than real.[233] One study found that "the presence of a CSO is associated with higher levels of pollution emissions. Nonetheless, we found that the CSO has a positive influence on a firm's environmental performance if faced with strict environmental regulations."[234] Thus, the effectiveness of the CSO position remains unproven. There has been rapid growth, as my study finds, but time will tell if the position has staying power.

The CDO has similarly recent origins and a similar (perhaps even more extreme) explosion in the last few years.[235] Indeed, CDOs currently have short tenures on average because as so many companies have hired their first CDOs, they have poached the existing CDOs at other companies.[236] As with CSO, the term CDO is the most common title, but there is considerable variation. For the most part, that variation is more bounded than in the case of CSO. For CDO, the main variations consist of adding other terms along with or instead of diversity in the title. Thus, one sees Chief Diversity and Inclusion Officer, or Chief Diversity, Equity, and Inclusion Officer, or Chief Belonging Officer, and so on. Coincidentally, I also found that 84 of the 100 companies have a CDO, the same number as for the CSO. Though most companies (72) therefore have both positions, some (12) have only

[232] Gadinis & Miazad, *Social Risk*, *supra* note 9, at 1443 n.213.

[233] *See supra* note 102 and accompanying text.

[234] Patricia Kanashiro & Jorge Rivera, *Do Chief Sustainability Officers Make Companies Greener? The Moderating Role of Regulatory Pressures*, 155 J. BUS. ETHICS 687, 687 (2019).

[235] An article published in 2007 says that "[a] few years back, these Chief Diversity Officer positions didn't exist. Today they're firmly established in the executive suite across a range of Fortune 500 companies—at Johnson & Johnson, Aon, Citi and American Express as well as at GE and Lehman Brothers." Sylvia Ann Hewlett, *The Rise of the Chief Diversity Officer*, HARV. BUS. REV. (Oct. 17, 2007), https://hbr.org/2007/10/the-rise-of-the-chief-diversit [https://perma.cc/258N-DDTT]. Another states that from 2020 to May 2021, "60 U.S. companies appointed their first-ever chief diversity officer (CDO)." Gena Cox & David Lancefield, *5 Strategies to Infuse D&I into Your Organization*, HARV. BUS. REV. (May 19, 2021), https://hbr.org/2021/05/5-strategies-to-infuse-di-into-your-organization [https://perma.cc/H47N-VTRN]. Reporting of trends since the research for this Article was completed suggest that, amidst controversy over DEI, some companies have eliminated their CDO position. *See* Te-Ping Chen & Lauren Weber, *The Rise and Fall of the Chief Diversity Officer*, WALL ST. J. (July 21, 2023, 12:06 PM), https://www.wsj.com/business/c-suite/chief-diversity-officer-cdobusiness-corporations-e110a82f [https://perma.cc/9Q43-KZ4C].

[236] Emma Jacobs, *The Evolution of the Chief Diversity Officer*, FIN. TIMES (Sept. 19, 2021), https://www.ft.com/content/6eac296d-acf6-4b41-9349-dc9723212914 [https://perma.cc/Y8ER-4P5F] ("Turnover is high among diversity professionals. . . . [T]he average tenure of a chief diversity officer in the US is 1.8 years in 2021, down from 3.1 years in 2018, partly indicative of poaching.").

a CSO, others (12) have only a CDO, and a few (4) have neither.

Some research suggests that CDOs may increase diversity and improve social accountability.[237] But that is so only if they are given adequate resources and authority, which is often not true.[238]

As discussed above and below, a problem with designating special officers and departments devoted to ESG or stakeholder concerns is that they may be siloed with little effective say over operational decisions. One way of addressing this problem is to establish committees of officers devoted to ESG matters. If those committees contain both specialized ESG officers and operational officers, then the former have a formalized avenue for influencing the latter officers who make actual operational decisions. I find that most, though far from all, mention[239] having one or more of these kinds of executive committees. I find that 70 of the companies studied mentioned having at least one such committee. Many of these mention more than one committee. Half of the companies (50) have a committee or council that covers sustainability or ESG broadly. Some committees focus on just one ESG item, with diversity (25 companies) and the environment (11 companies) being the most common. A few companies (7) have committees focused on other specific ESG topics, including product stewardship (Eli Lilly), innovation (3M), human rights (Mondelez International), investment (Prologis), safety (Crown Castle), political expenditures (Duke Energy), and security and privacy (T-Mobile).

### *C. Executive Compensation*

A major emerging trend is tying a portion of executive compensation to performance on matters of concern to stakeholders, including diversity, workplace safety, and the environment.[240] Since such compensation has the potential to strengthen the

[237] Frank Dobbin & Alexandra Kalev, *Why Diversity Programs Fail*, HARV. BUS. REV., July-Aug. 2016, https://hbr.org/2016/07/why-diversity-programs-fail [https://perma.cc/VKD7-HHSB].

[238] Chip Cutter & Lauren Weber, *Demand for Chief Diversity Officers Is High. So Is Turnover.*, WALL ST. J. (July 13, 2020, 7:00 AM), https://www.wsj.com/articles/demand-for-chief-diversity-officers-is-high-so-is-turnover-11594638000 [https://perma.cc/LE8B-4T74] ("The role has long been marked by high turnover, with many in the position, known as CDO, leaving over a lack of resources, unrealistic expectations and inadequate support from senior executives, according to current and former CDOs."); Cox & Lancefield, *supra* note 235 ("In one recent survey, 93% of leaders agreed that D&I agenda is a top priority, but only 34% believed that it's a strength in their workplace.").

[239] This may be an item that is not always mentioned in the reporting we examined, so our numbers are likely an undercount of the actual presence of such committees.

[240] *See supra* notes 104-13 and accompanying text.

incentive of mainline operating officers to consider such concerns, I included it in this study of the 100 companies. The primary source of data on this question was the companies' proxy statements, which contain extensive disclosure on executive compensation. This area has evolved so rapidly that with the collection of data spanning over about a year and a half, I needed to return to examine disclosure for companies for which I gathered data in the first wave of research, since many had added new components to executive compensation in the interim (I also needed to search again on the existence of CSOs and CDOs for these companies).

Although there is much extensive required disclosure for executive compensation, that disclosure does not yet require specific disclosure concerning whether and how companies link compensation to ESG matters. It shows. Much of the relevant disclosure is spotty and imprecise.[241] For each company, I tried to count whether it included an ESG component in compensation, and if so, whether that component uses quantitative metrics or is instead based only on qualitative evaluations. I could mostly determine an answer to the former (whether there is any ESG component to compensation), but the latter was often hard to determine, so the estimate of that number should be taken with some grains of salt. I would have liked to count what proportion of compensation is tied to ESG elements, but that was not possible to determine in the disclosure of many, really most, companies.

Those caveats made, I found that 61 companies have an ESG component in their executive compensation.[242] Of these, 18 (or thereabouts—this is the number that was quite hard to determine) used quantitative metrics as part of determining that ESG component of compensation.[243] Impressionistically, it appears that in most companies, the ESG component is a relatively small part of the total compensation package.[244]

Thus, this research confirms that ESG has become a common element in executive compensation. A majority of the top 100 corporations include some sort of element of ESG in determining

[241]For a similar concern, see Bebchuk & Tallarita, *Perils*, *supra* note 108.

[242]Note that the executives covered in this disclosure are the top five executives in a company. They thus would not include someone like the CSO or CDO, where ESG metrics would seem of obvious relevance. They are more generalist than that.

[243]For information on some of the metrics used, see Bebchuk & Tallarita, *Perils*, *supra* note 108.

[244]Bebchuk and Tallarita find that for the minority of companies for which they could determine the proportion of compensation tied to ESG elements, the proportion is typically quite small. *Id*.

executive compensation. However, the concerns about how companies are doing this are not assuaged. The imprecision and opaqueness of the disclosure itself does not inspire confidence.[245] The apparent reliance mainly on qualitative assessments rather than quantitative measures suggests a highly manipulable process, which could well increase officer pay while doing little to promote sustainability.[246] The impression that ESG components typically are a rather small part of compensation may somewhat alleviate the concern that officers are receiving a major bonanza here, but it increases the concern that the evolution of compensation so far is likely to be having little impact on the incentive of officers.

Lucian Bebchuk and Roberto Tallarita's study of ESG-based compensation covers the compensation of CEOs at the Fortune 100 companies as disclosed in 2021 proxy statements. It thus overlaps heavily with the study here, though they delve into deeper detail in their paper focused only on compensation in contrast to the broader focus of this study. I am much more favorably inclined to stakeholder governance than Bebchuk and Tallarita,[247] in good part because I envision stakeholder governance not as giving managers more discretion, but rather as making them accountable to a broader range of interests—hence this study. However, my review of current disclosure of ESG-based compensation leads me to a very similar conclusion as to the current state of that disclosure and the underlying compensation—it is very badly inadequate. It is hard to tell what companies are doing, and to the extent one can tell, it appears that for the most part they are giving little weight to ESG factors—which is probably just as well, since ESG is so imprecisely defined and measured that current practice probably enriches managers while giving little incentive to actually improve the world (or their company). Bebchuk and Tallarita conclude that activists and scholars should stop encouraging companies to tie compensation to ESG factors.[248] Below I suggest a different response, namely revising compensation disclosure requirements to improve the quality of disclosure.[249]

### *D. Correlations Among Practices*

In Part II, I found that the amount of engagement with different stakeholder groups was almost entirely positively correlated across companies. That is, companies that engage more with one

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[245] *Id.*

[246] *Id.*

[247] Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6.

[248] Bebchuk & Tallarita, *Perils*, *supra* note 108.

[249] *See infra* Section IV.C.

stakeholder group also tend to engage more with other stakeholders. Does a similar positive correlation hold true among the corporate governance practices considered here in Part III and between those practices and the stakeholder engagement considered in Part II?

The answer is yes. Table 5 shows the correlation across companies of a variety of measures:

- Engage: The measure of overall stakeholder engagement by a company discussed in the previous Part;
- Com: An index on board committees, set at 3 for companies with a special ESG committee, 2 for companies with a hybrid committee, 1 for companies that assign ESG responsibility to a traditional committee, and 0 for companies with no committee given responsibility over ESG;
- Dir Types: The number of different types of stakeholder directors (government, non-profit, academic) present on a company's board (this can be 0, 1, 2, or 3);
- Dir #: The total number of stakeholder directors (again, government, non-profit, or academic) present on a company's board;
- Off Ind: An index composed of adding three 1/0 indices, namely whether a company has a CSO, a CDO, and an ESG executive council (this can thus be 0, 1, 2, or 3);
- Comp 1: An index set at 1 if a company has an ESG component for executive compensation and 0 otherwise; and
- Comp 2: An index set at 2 if a company has an ESG component for executive compensation using quantitative metrics, 1 if it has an ESG component but does not use quantitative metrics, and 0 otherwise.

**Table 5: Correlation of Governance Practices and Stakeholder Engagement**

| | DIR TYPES | DIR # | COM | OFF INDEX | COMP 1/0 | COMP 2/1/0 | ENGAGE |
|---|---|---|---|---|---|---|---|
| **Dir Types** | 1 | 0.740508638[aaa1] | 0.089084487[aaa1] | 0.07956277[aaa1] | 0.18506456[aaa1] | 0.184607091[aaa1] | 0.165248926[aaa1] |
| **Dir #** | | 1 | 0.161039365[aaa1] | 0.16506985[aaa1] | 0.21804051[aaa1] | 0.123754657[aaa1] | 0.211799007[aaa1] |
| **Com** | | | 1 | 0.107612869[aaa1] | 0.530538701[aaa1] | 0.240473136[aaa1] | 0.164613779[aaa1] |
| **Off index** | | | | 1 | 0.247087673[aaa1] | 0.169201601[aaa1] | 0.445317624[aaa1] |
| **Comp 1/0** | | | | | 1 | 0.871049613[aaa1] | 0.296749643[aaa1] |
| **Comp 2/1/0** | | | | | | 1 | 0.331001576[aaa1] |
| **En-gage** | | | | | | | 1 |
| ** p<0.05, * p<0.1 | | | | | | | |

[aaa1] p<0.01,

Given the nature of these rather blunt measures, it is hard to interpret the size of the correlations. But, that they are all positive is at least suggestive. It would appear that not only do different kinds of stakeholder engagement tend to rise and fall together, but so do the kinds of governance mechanisms discussed in this Part. When I discussed the positive correlation among types of stakeholder engagement in Part II, I noted that it probably in part reflects differences in how companies report their engagement, although it probably reflects real underlying differences in that engagement as well.[250] With the governance practices discussed here, differences in reporting are, for the most part, likely to be less important. The background of directors and board committee functions are pretty objective and clearly discussed—there are still some borderline cases in classification, but they are less subject to variation based on how and what companies choose to disclose. It is true that some companies with CSOs and CDOs (and one also imagines executive committees) do not include those positions in their sustainability reporting, but that is fairly easy to check independently (though that is not perfect—presumably a few companies with a CSO or CDO were not counted). The only measures of governance that do appear to be notably manipulable by reporting are those concerning executive compensation. Even there, Comp 1, which simply counts whether a company has any ESG component to compensation at all, is probably mostly an accurate reflection of the underlying reality as of the time of the disclosure examined.

We have thus looked at how companies engage with a variety of stakeholders, and at how stakeholders and their concerns are incorporated into governance practices at the board and officer levels and in executive compensation. The results of the study of reporting on these matters by the S&P 100 corporations are mostly consistent with the existing literature on stakeholder engagement and ESG governance practices.[251] I find that companies are doing a considerable amount of engagement, that they are paying attention to stakeholder concerns at the board and officer levels, and that they are beginning to put their money where their mouth is when it comes to paying officers. What remains to be discussed is whether all of this is enough, or whether there is more that should be done, and if so, how that might be encouraged.

## IV Lessons and Possible Reforms

The core of this study, laid out in Parts II and III, is descriptive. It looks at what the largest American corporations are currently

[250] *See supra* note 146 and accompanying text.

[251] *See supra* Part III; *supra* Section II.C.

doing to engage with stakeholders and to address their concerns within the corporate governance structure. But inevitably (for a legal scholar, at least), one wants to ask if the resulting practices are as good as they could be, or if we should be doing more, or less, or different. This Part engages with that normative question. Section IV.A identifies that the best practices that emerge from the study are already widespread, but perhaps are worth adoption at companies that do not yet follow them and are worth improving and deepening at those which do follow them. Section IV.B identifies practices that the study shows are used occasionally though not as widely, but which may be worthy of wider adoption. For the most part, I treat these as suggestions to companies about what they might choose to do rather than as practices to be legally mandated. However, Section IV.C suggests ways that the law might usefully encourage improved stakeholder engagement without requiring it.

As discussed above, there is currently much discussion as to whether the proper objective of corporations is purely to maximize the (long-term) wealth of their shareholders or whether the interests of various corporate stakeholders deserve independent weight in the corporate objective function.[252] In this Part, I mostly evade that debate. Obviously, measures increasing stakeholder engagement will be more valuable if one gives independent weight to the interests of stakeholders. However, even with an exclusive focus on shareholder wealth maximization, we have seen that engaging with stakeholders still provides significant benefits.[253] Speaking pragmatically, incremental advances are more likely to follow from arguments stressing the benefits of such reform for shareholders as well as others.[254] More far-reaching empowerment of some stakeholders, especially employees, may however depend upon giving independent weight to their interests in the corporate objective function, given the higher potential costs.

### *A. Best Practices*

The study gives us some sense as to what the <u>most common</u> practices are. That does not necessarily mean they are <u>best</u> practices. But it is suggestive. If most of the largest, most successful companies are choosing to follow these practices, they must have something going for them. Companies typically do not get to where these companies are by making mostly foolish deci-

**[Section IV]**

[252] *See supra* Section I.A.

[253] *See supra* Section I.E.

[254] *See* Lund & Pollman, *supra* note 46.

sions; practices followed by so many of them most likely must be accomplishing something useful. Still, we must ask whether there are reasons why companies might be inclined to over-adopt some of these stakeholder-focused practices, or conversely, why they might under-adopt them.

As a first pass at the matter, under-adoption would seem more likely than over-adoption. American companies traditionally have been understood as focusing on advancing the interests of shareholders.[255] Insofar as stakeholder engagement may produce benefits for stakeholders that are not reflected in increased profits for shareholders, companies should be disinclined to adopt such forms of engagement. That is to say, the social value of some types of stakeholder engagement is likely to be greater than the private value to companies and their shareholders, and thus to be under-adopted (from a social perspective). This may especially lead to the under-adoption of practices with considerable costs, since social benefits outweighing those costs may not be fully recognized by corporations. For instance, this may explain why many companies have non-profit officers, government officials, and academics, but not employees or customers on the board—the conflict costs of the latter are higher.[256] Even if stakeholder engagement may lead to increased shareholder wealth in the long run (e.g., through reputational effects),[257] potential short-termism of managers and shareholders may undervalue the long-run benefits.[258] And the benefits from a stakeholder focus may be hard for managers to see and conceptualize, again leading to under-adoption.[259]

But some factors could lead to over-adoption by managers of stakeholder engagement and governance. Stakeholder capitalism may be a fad that many follow simply because others are doing it, even though the justification is weak. A stakeholder focus may also reflect managers imposing practices that benefit themselves at the expense of shareholders. The benefit may be narrow and venal, if (contra what I have argued) a stakeholder focus reduces accountability, giving managers more discretion to make decisions that benefit them.[260] The personal benefit to managers may instead be more subtle, with well-educated managers promoting the emerging woke values of their class, a charge about large

[255]*See supra* Section I.A.

[256]*See* Hansmann, *supra* note 122.

[257]Claire A. Hill, *Marshalling Reputation to Minimize Problematic Business Conduct*, 99 B.U. L. Rev. 1193, 1208 (2019).

[258]Hill & McDonnell, *supra* note 104.

[259]Claire A. Hill, *Employees, Expenses, and Externalities* (on file with author).

[260]Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6, at 164-68.

corporations made by many political conservatives today.[261] Big companies may face pressure to pay more attention to stakeholders, and managers may make concessions to them to avoid the personal costs of that pressure even if doing so does not benefit the business. Another possibility is that companies are adopting these practices as ways to stave off potential harmful regulation,[262] although how one evaluates that dynamic depends in part on how one evaluates the threatened regulation. If the threatened regulation would be socially beneficial and induce companies to address social harms on their own, that would seem to be a good outcome. If the threatened regulation is socially wasteful, or if it is a good regulation and a company's reaction staves off that regulation but is just window dressing, then the outcome is more disturbing.

Still, though there are some factors that could cause companies to go too far in adopting stakeholder engagement, the more plausible story about the main tendencies is that companies will tend to adopt valuable practices, with probably some tendency to not go far enough because stakeholders' interests do not receive a socially optimal weight. So, we should look at what this study has identified as the most widely adopted practices, and consider them as likely best practices which other corporations should consider adopting, and those which have adopted them should continue to improve and strengthen. It is of course possible that the most common practices are good for most large companies, but not for those that have not adopted them. This heterogeneity in the net benefits of practices is a major reason why I do not suggest legal mandates. Still, given the various reasons to expect companies to undervalue stakeholder engagement, it is quite possible that companies that have not yet adopted the most common practices would be better off if they did, or at least that society would be better off.

A striking fact is the prevalence of employee resource groups. Where once upon a time unions were the leading internal organization for employees in many companies, unions have greatly declined (though we see they remain at least something of a presence in a minority of companies), so that resource groups may now be the leading form of internal organization for employees in most large companies. This evolution is a loss for employee empowerment—unions, when they cover most of a company's employees, do far more to empower than employee resource groups. They have actual authority to act upon behalf of their members

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[261] *See generally* Stephen M. Bainbridge, *Corporate Purpose in a Populist Era*, 98 NEB. L. REV. 543 (2020); Saura Masconale & Simone M. Sepe, *Citizen Corp.—Corporate Activism and Democracy*, 100 WASH. U. L. REV. (2022).

[262] Bebchuk & Tallarita, *Illusory Promise*, *supra* note 6, at 164-73.

to bargain over working conditions, and they often cover all or most workers, rather than the segmentation that occurs with employee resource groups.[263]

Still, employee resource groups are what we now have to work with. Though their adoption is near-universal in the S&P 100, a few companies have yet to adopt them, and their prevalence probably becomes less universal as one looks at smaller companies. There remains room for more companies to adopt them.[264] Within those companies that have already adopted resource groups, work could be done to increase their effectiveness. A common recommendation is that groups should be linked to high-level executives within the company to increase their influence.[265] Companies can look to expand the number of resource groups within their organization to give more employees a chance to be involved with at least one resource group. More coordination between resource groups within a company may help, as may coordination with outside organizations.[266] Companies could provide more resources to resource groups—not just money, but also organizational support, e.g., giving time and staff to help organize retreats and other events.[267]

Two other quite widespread engagement practices are social media and surveys. Each of them may have room for extension, depending on the degree of undercount in this study. Surveys are already very common among employees, but many companies do not yet use them for customers (or at least, they do not report on it if they do), and surveys of suppliers may be worth adopting as well. The reported use of social media as a way to get feedback

[263]*Collective Bargaining*, AFL-CIO, https://aflcio.org/what-unions-do/empower-workers/collective-bargaining [https://perma.cc/CWA9-SUE9] (last visited Feb. 10, 2024) ("Collective bargaining is the process in which working people, through their unions, negotiate contracts with their employers to determine their terms of employment, including pay, benefits, hours, leave, job health and safety policies, ways to balance work and family, and more."). This point applies more for industrial unions than for craft unions.

[264]I have not been able to find thorough information on how widely adopted such organizations are.

[265]SUNDIATU DIXON-FYLE ET AL., MCKINSEY & CO., DIVERSITY WINS: HOW INCLUSION MATTERS 6, 46 (2020), https://www.mckinsey.com/~/media/mckinsey/featured%20insights/diversity%20and%20inclusion/diversity%20wins%C20how%C20inclusion%20matters/diversity-wins-how-inclusion-matters-vf.pdf [https://perma.cc/3QM2-DEM6]; Tiffani N. Darden, *The Law Firm Caste System: Constructing a Bridge Between Workplace Equity Theory & the Institutional Analyses of Bias in Corporate Law Firms*, 30 BERKELEY J. EMP. & LAB. L. 85, 114-15 (2009).

[266]El-Amin, *supra* note 156; Welbourne et al., *supra* note 154, at 1827; Annabi & Tari, *supra* note 152, at 5149-50.

[267]Sandra S. Yamate, *Minority Retention: What Are Other Firms Doing? (And Is It Working?)*, 55 PRAC. LAW. 17, 24, (2009).

from stakeholders of all kinds is less than I would have expected (customers are the group that have the greatest number of companies reporting the use of social media, and that is only a third of all companies—though, again, that may be a large undercount). Social media could be a useful way of aggregating information from a large number of stakeholders. A study of investor message boards shows that in the aggregate, through the wisdom of crowds, they provide useful information.[268] A Harris poll of consumers and executives found that the former appreciate it when business respond to their social media messages, and the latter expect their businesses to devote increasing resources to their social media interactions with customers.[269]

On the corporate governance side, we have seen that CSO and CDO positions have become quite widespread but are not yet universal among the S&P 100. These positions are spreading rapidly; I would not be surprised if they become nearly universal over the next few years. Innovations tend to spread from larger to smaller corporations, so I would expect that we currently do not yet see 84% adoption at all public corporations as we do with the S&P 100, but that these officer positions will continue to spread.[270] Also worthy of emulation is the use of inter-departmental executive committees to coordinate the oversight of stakeholder concerns. The exact nature of what sort of committees are useful will depend upon the nature of the business of different companies.

On the board side, a major question is how responsibility for oversight of stakeholder concerns should be assigned. The evidence from my research strongly suggests that not assigning oversight to any committee at all, thus leaving oversight to occur only at the full board level, is not the best practice. Only 5% of the companies studied did not assign such responsibility to any committee, and ESG has achieved enough importance that simply

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[268] *See generally* James S. Ang et al., *The Role of Social Media in Corporate Governance*, 96 THE ACCT. REV. 1 (2021).

[269] *The Future of Social Media: New Data for 2021 & Beyond*, SPROUT SOCIAL, https://sproutsocial.com/insights/data/harris-insights-report/ [https://perma.cc/9BAH7EYE] (last visited Feb. 10, 2024).

[270] A PwC survey of 1,640 companies worldwide found that about 30% had a fullfledged CSO position while another 50% had a position with a more limited role. *See* Peter Gassmann et al., *Empowered Chief Sustainability Officers: The Key to Remaining Credible and Competitive*, STRATEGY&, https://www.strategyand.pwc.com/de/en/unique-solutions/sustainable-impact-made-real/empowered-chief-sustainability-officers.html [https://perma.cc/2JGS-REPC] (last visited Feb. 10, 2024). A ZoomInfo 2020 study of Fortune 500 companies found that 39.4% had a CDO. Stephanie Tonneson, *Has Corporate America Reached a Tipping Point?*, MEDIUM (June 23, 2020), https://zoominfo.medium.com/has-corporate-america-reached-a-diversity-tipping-point-fabe8ff6f07c [https://perma.cc/G5RS-UR46].

leaving it to the full board is no longer adequate in today's world. But the proper division of responsibility among committees is unclear. The prevailing approach is to assign ESG oversight to the Nomination/Governance Committee, with many companies hiving off the employee component of ESG to the Compensation Committee. Among those companies which assign ESG oversight to the Nomination/Governance Committee, some have significantly expanded the formal scope of the committee, making ESG oversight a central defining concern rather than one additional bullet point among many functions assigned to the committee.[271] Although more detailed study than provided here is clearly needed, it seems that for companies which assign ESG to the Nomination/Governance Committee, this significant expansion of how the committee is conceived may well be desirable. That expansion resembles how Leo Strine and his co-authors advocate a reconception of the Compensation Committee to address employee matters.[272]

But recall that a significant minority of companies assign ESG oversight to a special committee. Moreover, there is a correlation between that and other pro-stakeholder practices.[273] Might that be a preferred approach? It would do more to assure that some directors are focusing attention on stakeholder concerns. But it could lead to siloing, and Strine argues that it may be more efficient and effective to address ESG concerns within already existing committees that handle related matters.[274] However, aside from workforce matters and the Compensation Committee, which Strine has focused on, it is not clear what other traditional committees are plausibly linked to any other specific ESG matters. The other two traditional committees are Audit and Nomination/Governance. Both have some claim to some degree of connection to ESG. The current practices surveyed here strongly suggest that, given the choice between the two, companies think that the Nomination/Governance Committee is a better home for ESG than the Audit Committee. But the Nomination/Governance Committee traditionally focuses almost exclusively on the board, so it is not clear that the kind of complementarity between that traditional focus and ESG applies in the same way that Strine argues is true for workforce issues and the Compensation Committee.

### *B. Practices Worth Exploring*

Some forms of stakeholder engagement are not as frequently

[271] *See supra* notes 217-18 and accompanying text.

[272] *See supra* notes 97-99 and accompanying text.

[273] *See supra* Table 5.

[274] *See supra* notes 97-99 and accompanying text.

used currently (in the United States, at least) as the best practices explored in Section IV.A, but are nonetheless of interest. They have the potential to push stakeholder engagement further and deeper. Here, I suggest that companies and society might well benefit were more companies to voluntarily adopt these practices. In Section IV.C, I will consider how if at all regulators might encourage such adoption.

We see very little engagement at the empower level, where stakeholders have some degree of actual decisionmaking authority. All we see there is some degree of unionization at a minority of companies, often covering a relatively small fraction of workers. Even at the next most-intense level of engagement, we see relatively low use of standing councils to seek formal, ongoing advice from stakeholders. We do see somewhat heavy use of collaboration or partnerships. However, the most frequent type of collaboration is with non-profits, with collaboration also somewhat common with governments and academics. It is rather uncommon with customers and very uncommon with employees. The collaboration we see is mostly in the form of side projects that do not go to the heart of corporate activity. Indeed, as noted above, it is hard to distinguish collaboration from simple charitable giving with non-profits. Thus, as other studies using a similar methodology have found,[275] what we see in stakeholder engagement is mostly consultation, where companies hear from their stakeholders but do not give much of a formal role to them in deliberation and decisionmaking.

The stakeholders most worthy of consideration for being empowered with affirmative decisionmaking authority are employees. Elsewhere, I and others have made the case that employees are, along with shareholders, the group who have the strongest claim to being given power within a corporation.[276] I have discussed three main benefits from engaging stakeholders,[277] and all are particularly strong for employees. Through involvement in the production and sales process, employees know much about what happens in a company, information that can be critical for improving performance. Their knowledge and motivation to help the company succeed means empowering them is a promising way to increase accountability. The centrality of employees to company functioning means that increasing their loyalty is quite valuable. Our data presented here reinforces this point, as employees are by a significant margin the group that the S&P companies most heavily engage with, including being

[275] *See supra* notes 74-75 and accompanying text.

[276] McDonnell, *Employee Primacy*, *supra* note 19; HAYDEN & BODIE, *supra* note 19.

[277] *See supra* Section I.E.

the only one that is ever actively empowered, through unionization.[278] Still, the costs of engagement and empowerment can be high for employees as well, particularly the key cost of conflict with other stakeholders, especially shareholders.[279]

How might companies more actively empower their workers? Expanded unionization is the most straightforward answer—unions of course should not be forced on employees, but most employers could do much less to discourage unionization. Unions still exist for some employees within a fair number of our largest corporations, and unionization was once more widespread. American law has a well-established framework for unions. As I will discuss in Section IV.C, that law could be amended to encourage more unionization, but even now, unions have a known role within American industry.

There are other options for empowering workers. The codetermination system of Germany, and some other European countries, provides the leading model. Beyond unions (also a part of the German model), employees are empowered at two levels. First, employees elect some members of the board.[280] Second, workers have representatives on works councils at the plant level, which address a variety of matters related to workplace conditions.[281] Either or both of these are options worth exploring at American companies.

A level of engagement one step below active empowerment but a step or two above current prevailing U.S. practices is the use of stakeholder advisory councils. These may have representatives of just one stakeholder group (most often employees) or multiple groups.[282] As some have argued,[283] these provide a more formal and sustained type of engagement, including direct and ongoing contact with the board and top officers. Haskell Murray claims "[t]he stakeholder advisory board would give the board of directors consistent and direct access to representatives of the other stakeholders, and much better visibility of peripheral stakeholder

[278] *See supra* Tables 1 & 2.

[279] *See* HANSMANN, *supra* note 122, at 1-5.

[280] *See* HAYDEN & BODIE, *supra* note 19, at 173-74. Germany has a two-level board. Employee directors are on the supervisory board which provides oversight, rather than on the management board that deals with more operational issues. The move to independent directors has made American public company boards look more like the supervisory board than the management board.

[281] *Id.*

[282] *See supra* Table 1.

[283] *See supra* notes 176-78 and accompanying text.

interests and priorities."[284] Advisory panels fall at a relatively high level on the AccountAbility categorization of engagement types.[285] We have seen that these are a somewhat common form of engaging with employees, with councils mainly used to address safety and diversity in the workplace.[286] I found only 9 companies with multi-stakeholder advisory panels. For companies that want to go beyond the modest current levels of engagement without providing actual decisionmaking authority to stakeholders, such advisory panels represent an alternative worth exploring.[287] Such stakeholder councils could be further used to move closer to stakeholder empowerment if boards were to look to them for suggestions for persons to nominate as directors.

### *C. Legal Reforms*

The discussion above of common best practices and of more occasional practices with promise is in the first instance meant as a discussion of options that companies can and should consider adopting on their own. For the most part, that is as far as I would go. I would not suggest mandating the practices discussed above. We are still learning about what works and what does not. Higher levels of engagement may have higher benefits, but also higher costs (particularly conflict costs that could ensue from empowering stakeholders). Practices that work when adopted voluntarily may not work when required. What works for some businesses may not work for others. These points suggest proceeding with caution and letting private experimentation continue so that we can learn more.

But there are a few legal reforms that are worth considering. The two mandates I would suggest are modest, and they concern disclosure. The first concerns disclosure about a company's stakeholder engagement itself. The SEC is in the process of considering new requirements for ESG disclosure. That disclosure could include reporting on how companies engage in stakeholder engagement. Under the current voluntary system, whether and where that disclosure exists varies quite a bit across companies. I can attest this makes finding and comparing company practices in stakeholder engagement harder than it needs to be. A few companies provided welcome relief in our research. These companies provided a chart. Along the rows were the stakeholder groups. Along the columns were categories of engagement types.

[284] Murray, *supra* note 177, at 97-98.

[285] *Supra* Chart 1.

[286] *Supra* Section II.C.

[287] See Murray, *supra* note 177, at 98-100, for useful discussion of various design questions, such as what stakeholders to include, selection of representatives, and information rights, among other matters.

The cells provided brief descriptions of how the company engaged with this stakeholder group using this type of engagement, with links to more detailed disclosure. If all companies followed that template, comparison would be much easier.

A bigger disclosure reform targets executive compensation. We have seen that current disclosure practices concerning the use of sustainability factors in executive compensation are far from clear.[288] It is often hard to tell what if any quantitative measures companies are using to measure ESG factors and how much weight they receive. I am somewhat hesitant to add more requirements to the already complex rules surrounding the disclosure of executive compensation, but given the growing interest in this area, some modest disclosure requirements that would help investors understand what companies are actually doing might help. Bebchuk and Tallarita, who provide more detail on the inadequacy of current disclosure, are skeptical that it can be improved.[289] One of their points is that improvement will require considerable shareholder pressure, because companies and their consultants do not have incentive to improve on their own. I agree, which is why I suggest a legal mandate to make more specific disclosure where companies choose to tie compensation to ESG factors.

Bebchuk and Tallarita have another, more fundamental concern. They argue that current use of ESG measures is quite fragmentary and piecemeal. They think this has the perverse effect of focusing on the interests of some stakeholders but not others, and even within one group of stakeholders of focusing on some of their interests but not others.[290] That is indeed an important question. But I tend to think that it is appropriate to focus more on the interests of some stakeholders than others. As I have argued above, current stakeholder engagement focuses most on the interests of employees, and then on customers, and that is appropriate.[291] With one exception, ESG compensation practice also seems to focus most on employees, and to a lesser extent customers,[292] so that seems roughly appropriate to me. The exception is the common use of compensation tied to environmental concerns, especially climate change. On the whole I think that climate change is best addressed through external regulation rather than through internal governance, including the use of

[288] *See supra* Section III.C.

[289] Bebchuk & Tallarita, *Perils*, *supra* note 108, at 64, 72.

[290] *Id*.

[291] *See supra* Parts II-III.

[292] *See* Bebchuk & Tallarita, *Perils*, *supra* note 108.

compensation.[293] However, given the massive threat posed by climate change and the political stalemate in enacting legislative measures to address it, encouraging executives to do more about it seems appropriate.

For more substantive reforms, I would nudge rather than mandate. Companies that adopt a preferred form of stakeholder engagement could be given a measure of regulatory relief in an area of regulation related to the relevant stakeholder. I have begun to describe how this might work for the most important potential reform, empowering employees through unions, board representation, or works councils, in a recent paper with Matt Bodie.[294] In our proposals, companies that have adopted adequately robust representation through employee directors, works councils, or unions could receive regulatory relief for various matters covered by the Fair Labor Standards Act, the Employee Retirement Income Security Act, or the Occupational Safety and Health Act. We more tentatively suggest that companies with adequately empowered employee resource groups might receive some procedural benefits under Title VII cases and investigations.

More generally, protecting groups and social interests through inflexible mandatory regulations can carry high costs when those mandates are set mistakenly or when the optimal settings vary significantly for different companies. Moving protection into corporate governance provides more flexibility to adjust to the mix of benefits and costs that specific companies face. As long as the relevant stakeholders are adequately represented within the governance process, we can rely on them to ensure that their interests are properly taken into account. For a similar proposal suggesting regulatory forbearance for companies that represent stakeholders other than employees, see Erik Gerding's suggestions for encouraging mutual insurance companies, in which the insured own the company.[295]

For stakeholders other than employees, we have seen than an enhanced advisory role through stakeholder councils rather than fullfledged decision rights will generally be the more appropriate path.[296] Regulatory relief could be tied to putting in place adequately selected and robust advisory panels. That relief would presumably be less significant than relief granted for robust empowerment of employees, since a merely advisory role would do less to protect the affected stakeholders. Various areas of substantive regulation could be modified in this way, depending

[293] McDonnell et al., *Green Boardrooms?*, *supra* note 9, at 390, 393, 406.

[294] McDonnell & Bodie, *supra* note 19.

[295] Gerding, *supra* note 36, at 847-48.

[296] *See supra* Section IV.A.

on the composition and use of stakeholder advisory councils within a company. Given the environmental focus of much work on sustainability, environmental regulation would seem a natural area to consider such an approach.

## CONCLUSION

The debate over stakeholder governance has ignored the present reality and future possibilities of stakeholder engagement. Stakeholder governance has been treated as an evolution in how the purpose of corporations and the duties of their managers should be understood. Few have asked whether and how it might create new mechanisms of accountability towards stakeholders.

We have seen that the present reality of stakeholder engagement is fairly extensive, and sensible as far as it goes. As one would expect, employees are the most engaged group, followed by customers and then by non-profits, suppliers, and government regulators. The most used forms of engagement include meetings and surveys. Employee resource groups are nearly universally used. Partnerships, social media, and councils are used less frequently, but still somewhat regularly.[297]

Stakeholder engagement has been built into internal governance arrangements as well. Most companies assign oversight of ESG matters to a specific board committee, with a significant minority creating a special committee for that purpose. The CSO and CDO officer positions have become quite widespread. An increasing number of companies are experimenting with ways to tie executive compensation to ESG practices and performance.[298]

And yet, the current reality falls well short of the future possibilities of stakeholder engagement. Current engagement mostly involves companies listening to what stakeholders have to say. It does not empower stakeholders to be more actively involved in corporate decisionmaking. Only such empowerment would bring strong accountability to stakeholder governance. The stakeholders most worthy of extensive empowerment are employees, who could be given more power through unionization, board representation, or works councils. Other stakeholders (especially customers) could be given more limited power through advisory stakeholder councils. I do not recommend mandating such stakeholder empowerment, but rather encouraging it through various forms of regulatory relief to companies adopting stakeholder empowerment mechanisms.[299]

[297] *See supra* Part II.

[298] *See supra* Section III.C.

[299] *See supra* Section IV.C.