

ARTICLE

EXTERNALITIES AND THE COMMON OWNER

by Madison Condon

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This Article expands the consideration of the effects of common ownership from the industry level to the market-portfolio level and argues that diversified investors should rationally be motivated to internalize intra-portfolio negative externalities. This portfolio perspective can explain the increasing climate change-related activism of institutional investors, who have applied coordinated shareholder power to pressure fossil fuel producers into substantially reducing greenhouse gas emissions.

I. Introduction

The climate activism of investors of large companies presents two paradoxes for scholars of corporate governance. First, the theory behind the law of corporate governance rests on the assumption that shareholders' rational self-interest drives them to exercise their governance rights with the singular goal of maximizing corporate value.¹ Second, broadly diversified investors are typically described as poor monitors of corporate behavior.²

This Article argues that this paradoxical behavior can be explained by revising traditional corporate governance theory to account for institutional investors' motivations at a *portfolio* rather than a *firm* level. It argues that institutional investors' climate activism is motivated by their desire to mitigate climate change risks and damages to their economy-mirroring portfolios. Unchecked emissions contribute to an increase in global average temperature that is predicted to have a devastating effect on the world

economy. The institutional investors most active on corporate climate engagement have portfolios diversified across the entire economy. It is in their self-interest to reduce global emissions.

This Article contributes to the ongoing debate over common ownership by identifying the causal mechanisms by which institutional investors influence corporate directors into deviating from profit-maximizing objectives,³ adding to the growing understanding of the net welfare effects of common ownership.⁴ Diversified shareholder interests can diverge from the interests of concentrated shareholders and the objective of maximizing share price. This divergence undermines the efficiency-based rationale for shareholder primacy's ultimate service to social welfare maximization.⁵ While most scholars have argued that managers should prioritize diversified shareholder interests because they are better-aligned with the goal of increasing social welfare,⁶ this perspective has ignored diversified investor incentives to reduce inter-firm costs, and failed to consider the net welfare effects of common ownership.

This Article contemplates initial implications of diversified investor economy-wide control, including ambiguous net welfare effects and the concern that the market power to self-regulate operates as a form of unaccountable private governance.

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1. See, e.g., Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 STAN. L. REV. 923, 961 (1984); Henry Hansmann & Reinier Kraakman, *End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 69-70 (1991).
2. See, e.g., Lucian Bebchuk et al., *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89, 103 (2017); Edward B. Rock, *Institutional Investors in Corporate Governance* 12 (U. Penn., Working Paper No. 1458, July 21, 2015); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 472 (1991).

3. See Daniel P. O'Brien & Keith Waehrer, *The Competitive Effects of Common Ownership: We Know Less Than We Think*, 81 ANTITRUST L.J. 729, 761-64 (2017).
4. See Scott Hemphill & Marcel Kahan, *The Strategies of Anticompetitive Common Ownership* 7 (NYU Law and Economics Research Paper No. 18-29, Nov. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3210373.
5. See Hansmann & Kraakman, *supra* note 1, at 441; cf. Milton Friedman, *The Social Responsibility of Business Is to Increase Profits*, N.Y. TIMES MAG. (Sept. 13, 1970).
6. Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 434 (1998) (citing EASTERBROOK & FISCHEL, *supra* note 1, at 25-30, 339-40); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW*, 370-71, 380 (3d ed. 1986); Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 350 (1990); cf. Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 583-85 (2006).

II. Institutional Investors' Externality Internalization

This Article proposes that institutional investors are pursuing profit-maximizing objectives unrelated to any personal moral agenda by addressing negative externalities at their source, minimizing harms to their broader portfolio.

A. Portfolio-Maximizing Objective of Common Owners

Institutional investor equity ownership has reached unprecedented proportions. Due to the embrace of modern portfolio theory,⁷ most institutions diversify their public equity assets broadly across the stock market. Empirical studies on the market effects of concentrated ownership show that diversified investors maximize their portfolio returns by influencing choices made at the firm level.

A portfolio-wide investment strategy should look across industries. An owner whose portfolio success tracks the entire market should be motivated to curtail the negative externalities generated by individual portfolio firms if the owner's share of the cost of internalizing the externality are lower than its share of the benefits to the entire portfolio from the elimination of the externality.

B. Reduction of Systemic Climate Risks

Modern portfolio theory identifies two types of financial risk: economy-wide, systematic risk, and firm-specific, unsystematic risk.⁸ Systemic risk cannot be eliminated through diversification because its effects are felt economy-wide.⁹ Three types of climate change-related risks—transition risk, physical risk, and liability risk—so broadly affect the economy, they are considered systemic risks.¹⁰ Climate risk is a systemic risk that institutional investors can control.

C. Shareholder Activism for Climate Change Mitigation

For outcomes to be characterized as internalizing negative climate externalities, they must result in emissions reductions beyond regulatory and market forces. Diversified shareholders must be forcing firms to forgo profit at the expense of share value maximization. Shareholders might characterize these interventions as for the benefit of individual firms.

1. Outcomes Sought From Portfolio Companies

Investor climate activism targeting fossil fuel companies can be grouped into three categories of outcomes sought.

a. Emissions Reduction Targets

In 2017, a group of institutional investors joined the Climate Action 100+ initiative, asking peers to sign a pledge committing their shareholder power to pressuring companies to adopt long-term emissions reduction targets.¹¹ By the 2019 proxy season, 360 institutional investors had signed the pledge, controlling a combined \$34 trillion in assets.¹² Shareholder resolutions requesting emissions reductions targets have been increasing in frequency and gaining support.¹³ In 2018, 29 such proposals were filed.¹⁴

Institutional investors have also increasingly engaged in public-facing advocacy. In advance of the 2018 proxy season, investors managing a combined \$10.4 trillion in assets issued an open letter in the *Financial Times* urging oil and gas companies to make “concrete commitments to substantially reduce carbon emissions” and explain “how the investments they make are compatible with a pathway towards the Paris goal” of less than 2°C of warming.¹⁵

b. Suspension of Anti-Regulation Lobbying

Institutional investors pay increasing attention to the resources companies devote to lobbying efforts aimed at thwarting carbon regulation. In the 2018 proxy season, a coalition of 74 investors filed shareholder proposals at 14 emissions-intensive companies seeking disclosure of expenditures for lobbying.¹⁶ The proposals specifically targeted companies for membership in groups devoted to fighting climate regulation.¹⁷

c. Climate Risk Disclosure

Investors have pressed for disclosure of climate change-related risks. In the 2017 proxy season, 18 shareholder proposals requested that fossil fuel and utility companies undergo and disclose two-degree scenario analysis.¹⁸ The

7. See Harry Markowitz, *Portfolio Selection*, 7 J. FIN. 77, 79 (1952).

8. See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 168-70 (10th ed. 2011).

9. Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 200 (2008).

10. See UNIV. OF CAMBRIDGE INST. FOR SUSTAINABILITY LEADERSHIP, *UNHEDGEABLE RISK: HOW CLIMATE CHANGE SENTIMENT IMPACTS INVESTMENTS* 28 (2015), <https://www.cisl.cam.ac.uk/resources/publication-pdfs/unhedgeable-risk.pdf>.

11. *About Us*, CLIMATE ACTION 100+, <https://climateaction100.wordpress.com/about-us/>.

12. *Investors*, CLIMATE ACTION 100+, <https://climateaction100.wordpress.com/investors/>.

13. Maximilian Horster & Kosmas Papadopoulos, *Climate Change and Proxy Voting in the U.S. and Europe*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Jan. 7, 2019), <https://corpgov.law.harvard.edu/2019/01/07/climate-change-and-proxy-voting-in-the-u-s-and-europe/>.

14. *Id.*

15. Aberdeen Standard Investments et al., *Oil and Gas Groups Must Do More to Support Climate Accord*, FIN. TIMES (May 17, 2018), <https://www.ft.com/content/fda63c26-5906-11e8-b8b2-d6ceb45fa9d0>.

16. Press Release, Walden Asset Management, Institutional Investors Continue to Press Companies for Disclosure of Lobbying in 2018 (Mar. 9, 2018), <https://waldenassetmgmt.com/wp-content/uploads/2018/03/Announcement-of-2018-Lobbying-Disclosure-Resolutions-correct-Walden-Logo.pdf>.

17. See CERES, Engagement Tracker, available at <https://engagements.ceres.org/> [hereinafter CERES, Engagement Tracker].

18. Cristina Banahan, *Doubling Down on Two-Degrees: The Rise in Support for Climate Risk Proposals*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE &

proposals received an average of 41% support, with three passing with majority approval.¹⁹ In the 2018 season, 12 of the 20 shareholder proposals related to two-degree scenario analysis were withdrawn prior to voting due to board acquiescence.²⁰

2. Legitimacy of Firm-Specific Business Purpose

This investor activism targets the managers of individual companies to change corporate objectives at the firm level. These objectives serve the purpose of maximizing long-term portfolio returns, to the detriment of firm-specific returns.

a. Assessing Outcomes

The outcomes identified above may not serve profit maximization at the targeted firm. The extent to which a firm-specific rationale is lacking serves as further evidence that investor motivations are guided by net portfolio returns.

Emissions Reduction Goals: Investors argue that the company is failing to adequately prepare for government regulation and the growth of renewable alternatives.²¹ Institutional investors argue that they have a better understanding of the growth needed to meet expected demand than the executives within the energy industry. The business rationale for meeting emissions targets remains unclear.

Disclosure of Lobbying: In one set of shareholder proposals requesting disclosure of lobbying expenditures, institutional investors argued that “investors are concerned lobbying can pose reputational risks if it contradicts a company’s publicly stated positions.”²² If disclosure is necessary because information on spending is not already publicly available, it is unclear where this reputational risk would originate. Disclosure would open the companies up to broader public sanction.²³

Disclosure of Climate Risk: Demand for disclosure of energy companies’ exposure to climate risk is typically justified by the argument that they are inadequately prepared for the carbon-regulated future. This “transition risk” comes from a failure to adapt in time to a less carbon-intensive economy.²⁴ If climate risks are indeed mispriced,

investor statements regarding climate risk disclosure remain puzzling. A better explanation might be that retaining control in the company provides benefits to the wider portfolio. Index funds, who cannot sell their shares, have been some of the most vocal investors in demanding disclosure of climate risk.²⁵ Index funds are not supposed to be particularly concerned about firm-specific valuations or disclosure. Increased firm-level disclosure may ensure that the firm’s stock is more accurately priced, but this accuracy reduces only idiosyncratic risk.²⁶

b. Portfolio Purpose and Retail Opposition

Internalization of harmful climate externalities benefits the portfolio at the expense of the externality-generating firms. If these climate outcomes are in the best interest of the company, one would expect concentrated shareholders to lend their support. It appears, however, that they give less support to climate-related resolutions than their institutional co-owners.

3. Impact on Emissions Reductions

Under this theory of externality-internalization, economists are beginning to explore whether diversified investor ownership leads to emissions reductions in portfolio companies.²⁷

Emissions Goals: Of the outcomes sought by shareholders, explicit emissions reductions goals have the clearest causal relationship to actual emissions reductions.

Corporate Lobbying: Investors are asking companies not only to disclose their spending on lobbying efforts to oppose carbon regulation, but also to refrain from such spending or proactively support emissions-limiting laws.

Disclosure of Climate Risk: Forcing companies to assess their carbon budget exceedances exposes the potential social undesirability of their business models. Transparent acknowledgement of plans at odds with combatting global warming enables regulators to better target their interventions.

Socially undesirable corporate practices can be reduced through disclosure alone.²⁸ Disclosure can also lead to decreased future emissions through limiting the capital that is allocated to the exploration and development of fossil fuel reserves. Disclosure of two-degree scenario analyses can correct both market-wide misassessment of risk or

FIN. REG. (Jan. 23, 2018), <https://corpgov.law.harvard.edu/2018/01/23/doubling-down-on-two-degrees-the-rise-in-support-for-climate-risk-proposals/>.

19. *Id.*

20. Andrew Logan, *The Hidden Story of Climate Proposals in the 2018 Proxy Season*, CERES (May 29, 2018), <https://www.ceres.org/news-center/blog/hidden-story-climate-proposals-2018-proxy-season>.

21. See, e.g., EXXON MOBIL, EXXON EMISSIONS TARGETS PROPOSAL 2019, <https://www.osc.state.ny.us/press/docs/xom-resolved.pdf>.

22. *Investor Coalition Files Proposals at 50-Plus Companies on Lobbying Activities*, PENSIONS & INV. (Mar. 9, 2018, 12:00 AM), <https://www.pionline.com/article/20180309/ONLINE/180309806/investor-coalition-files-proposals-at-50-plus-companies-on-lobbying-activities>.

23. See, e.g., Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1212, 1294-95 (1999).

24. See RISKY BUSINESS, THE ECONOMIC RISKS OF CLIMATE CHANGE IN THE UNITED STATES (2014), https://riskybusiness.org/site/assets/uploads/2015/09/RiskyBusiness_Report_WEB_09_08_14.pdf.

25. See, e.g., Gabriel T. Rubin, *Show Us Your Climate Risks, Investors Tell Companies*, WALL ST. J. (Feb. 28, 2019, 5:30 AM), <https://www.wsj.com/articles/show-us-your-climate-risks-investors-tell-companies-11551349800>.

26. See Merritt B. Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 253 (2009).

27. See José Azar et al., *The Big Three and Corporate Carbon Emissions Around the World* (working paper, on file with author); Sophie Shive & Margaret Forster, *Corporate Governance and Pollution Externalities of Public and Private Firms*, (Feb. 21, 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3339517.

28. Andrew Schatz, Note, *Regulating Greenhouse Gases by Mandatory Information Disclosure*, 26 VA. ENV’T L.J. 335, 336 (2008).

intentional misstatements leading to mispricing, which can have a regulating effect.²⁹

This opens managers to liability for fraudulent misstatements and decreases the incentives for managers to conceal risk exposure. Disclosure in the form of two-degree scenario analysis requires the company to show how it would respond to regulation, and allows investors to assess the likelihood of such comprehensive regulation.

D. Internalization of Climate Externalities: Cost-Benefit Analysis of Climate Intervention

Predicting economy-wide costs of climate change is extremely challenging. What matters is how institutional investors themselves perceive the risks. For an investor diversified across the economy, climate damages' impact will result in proportional impacts to cash flows.³⁰

Consider a hypothetical analysis BlackRock makes when weighing whether to take a measure to curtail production at Chevron and Exxon. Assume it forces each company to reduce its emissions by 40%, resulting in that company's share price falling by 20%. If it loses 20% of the value of each of these assets, it will lose \$6.3 billion total.

Emissions reduction was modeled using William Nordhaus' Dynamic Integrated Climate Economy Model (DICE). The business-as-usual pathway was modeled, first as a baseline, and then again, removing 1% of industrial emissions each year through 2100. The difference in the value of damages between these two model runs was compared, aggregated over 100 years, and discounted 7%. DICE predicts that by intervening, BlackRock could avoid damages to its portfolio of \$9.7 billion. It would be in BlackRock's economic interest to pursue this intervention.

This is an oversimplification of the trade offs an investor must analyze. A full understanding of the supply and demand effects of firm-specific targeting requires economic modeling beyond the scope of this Article.

III. Ability and Incentives of Common Owners

While investors deny their ability to influence inter-firm competition, they advertise their power to pressure firms into reducing emissions. In addition, the internalization of portfolio externalities provides institutional investors with an *incentive* to intervene.

A. Mechanisms for Influencing Managers

Scholars have identified several ways investors could influence managers to undertake portfolio-maximizing behavior.³¹

Board Elections: BlackRock's Larry Fink has said that the ability to vote against management serves as an "implicit sanction" and that this power has led to "serious" corporate changes.³²

Compensation: Several studies have found that managerial compensation is less likely to be tied to relative firm performance when the firm shares more common owners with industry competitors.³³

Direct Communications: Institutional investors regularly communicate with corporate management on climate-related issues. BlackRock has argued that "meetings behind closed doors can go further than votes against management."³⁴ Climate Action 100+ announced its intent to seek "private, not public proposals."³⁵

Shareholder Proposals: The success of institutional investors' climate activism can be seen in the number of shareholder proposals that were withdrawn prior to being brought to a vote in recent years: 38 in 2017 and 39 in 2019.³⁶ Because withdrawn proposals signify that the investor has been appeased, they are "one of the best indicators of activists' success."³⁷

B. Liability for Violation of Fiduciary Duty

While shareholders are under no legal obligation to vote their shares in the best interest of the corporation, asset managers have a duty to individual retail investors.³⁸ Further, managers and directors have a fiduciary duty to undertake actions in the best interest of their company.³⁹

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31. Einer Elhauge, *How Horizontal Shareholding Harms Our Economy—and Why Antitrust Law Can Fix It* 33-42 (Working Paper, Aug. 2019), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3293822.
 32. Tim Wallace, *Index Funds Must Use Their Huge Power Over Companies, Says BlackRock Chief Larry Fink*, TELEGRAPH (Apr. 29, 2018, 8:43 PM), <https://www.telegraph.co.uk/business/2018/04/29/index-funds-must-use-huge-power-companies-says-blackrock-chief/> (last visited Jan. 28, 2020).
 33. Miguel Antón et al., *Common Ownership, Competition, and Top Management Incentives* 2-3 (Ctr. for Econ. Stud. & Info Inst., Working Paper No. 6178, 2018), <http://ssrn.com/abstract=2802332> (last visited Jan. 28, 2020).
 34. Sarah Krouse et al., *Meet the New Corporate Power Brokers: Passive Investors*, WALL ST. J. (Oct. 24, 2016), <https://www.wsj.com/articles/the-new-corporate-power-brokers-passive-investors-1477320101> (last visited Jan. 28, 2020).
 35. Lewis Braham, *Climate Change: Big Investors Bring Big Clout to the Debate*, BARRON'S (Apr. 27, 2018), <https://www.barrons.com/articles/big-investors-bring-big-clout-to-climate-battle-1524838935>.
 36. See CERES, Engagement Tracker, *supra* note 17.
 37. Virginia Harper Ho, *Risk-Related Activism: The Business Case for Monitoring Nonfinancial Risk*, 41 J. CORP. L. 647, 689 (2016).
 38. See, e.g., Ann M. Lipton, *Family Loyalty: Mutual Fund Voting and Fiduciary Obligation*, 19 TENN. J. BUS. L. 175 (2017).
 39. Thomas A. Lambert & Michael E. Sykuta, *Calm Down About Common Ownership*, 41 REG. 28, 31 (2018); O'Brien & Wachrer, *supra* note 3, at 765-66.

29. Fox, *supra* note 26.

30. UNEP FINANCE INITIATIVE & PRINCIPLES FOR RESPONSIBLE INVESTMENT, UNIVERSAL OWNERSHIP: WHY ENVIRONMENTAL EXTERNALITIES MATTER TO INSTITUTIONAL INVESTORS (2011).

1. Investor Duty to Underlying Beneficiaries

A voting strategy that minimizes portfolio-wide negative externalities is likely not in the best interests of an individual investor whose assets are concentrated in the industry generating the externality. The practice of voting all funds in the same way is customary. If institutional investors are able to provide plausible business-purpose cover for the voting strategy, their true intentions may go undetected and unpunished.

Many institutional investors do not face this intra-beneficiary conflict. Pension funds pay out to all plan participants from one fund, so each beneficiary's diversification is the same. For these investors, it is arguable that their fiduciary duties *require* them to internalize firm-generating externalities to maximize portfolio returns. That only certain types of institutional investors face this conflict of fiduciary duties may explain their varying levels of climate engagement.

2. Fiduciary Duties of Managers

Firm managers have a fiduciary duty to manage in the best interests of “the corporation and its shareholders.”⁴⁰ The business judgment rule (BJR) protects managers from liability for decisions made under “any rational business purpose.”⁴¹ A court “begins with the presumption that . . . the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”⁴² The increasing acquiescence to shareholder demand for climate risk disclosure easily satisfies this standard.

C. Incentive to Intervene: Amending Model of Rational Reticence

As institutional investors grew in size, scholars predicted that they might develop a solution to the separation of ownership from control.⁴³ Dispersed stakes concentrated under the oversight of fund managers might justify spending resources on firm monitoring to seek higher returns.⁴⁴ More recently, scholars agree that these predictions have not been borne out; institutional investors lack the capacity and the incentive to intervene.⁴⁵

40. N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

41. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

42. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 36 (Del. Ch. 2010).

43. Adolf Berle, *Implications of the Corporate Revolution in Economic Theory*, in ADOLF BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 81 (Harcourt, Brace and World rev. ed. 1968).

44. See, e.g., Bernard Black, *The Value of Institutional Investor Monitoring: The Empirical Evidence*, 39 UCLA L. REV. 895 (1992); Alfred Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

45. Lucian A. Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy* 12 (EUROPEAN CORP. GOVERNANCE INST., Working Paper Series in Law No. 433, 2018).

Institutional investors face their own collective action problems. They rarely own more than 10% of any company.⁴⁶ This leads to the “free-rider dilemma”⁴⁷ and the “rational apathy” problem.⁴⁸ However, any accurate model of the agency costs of institutional investors must account for the investors' motivations at the *portfolio level*.

In certain cases, the cost of firm-specific intervention may be overcome by benefits accruing to the wider portfolio. Because institutional investors increasingly hold portfolios that mirror one another's asset diversification,⁴⁹ they share similar portfolio-wide incentives. This is especially true of interventions that require a coordinated effort across firms, like limiting fossil fuel production. Here, reduction in supply only results in lower emissions if it is undertaken over a large enough portion of the industry, which incentivizes investors to coordinate through coalitions like Climate Action 100+.⁵⁰

IV. Implications of Diversified Shareholder Objectives

Most scholars have argued that the goals of diversified shareholders are more closely aligned with that of society and should be prioritized. There are reasons to be cautious about embracing this phenomenon as socially desirable: (1) the net welfare effects of common ownership are yet to be fully considered and (2) the ability of asset managers to “self-regulate” suggests this concentration of power can function as a form of private governance, raising questions regarding democratic accountability and the potential to displace the role of “traditional” government.

A. Welfare Effects

This Article outlines one positive welfare effect that can occur: the internalization of negative externalities. An additional “bright side” of common ownership has also been greater investment in innovation.⁵¹

While the world's largest investors may have an economic incentive to mitigate the harms climate change impose on their portfolios, this incentive is not aligned with the *socially* optimal level of emissions.

46. 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, 868-69 (2013).

47. Roberta Romano, *Institutional Shareholders and Corporate Governance in the U.S.*, in CORPORATE GOVERNANCE IN THE U.S. AND EUROPE: WHERE ARE WE NOW? 52, 55 (Geoffrey Owen et al. eds., 2006); Robert C. Pozen, *The Role of Institutional Investors in Curbing Corporate Short-Termism*, FIN. ANALYSTS J. 10 (Sept./Oct. 2015).

48. Lisa M. Fairfax, *The Future of Shareholder Democracy*, 84 IND. L. REV. 1259, 1268-69 (2009); Rock, *Significance of Institutional Shareholder Activism*, *supra* note 2.

49. See Matthew Backus et al., *Common Ownership in America: 1980-2017*, at 22-23 (NBER Working Paper 25454, 2019).

50. See, e.g., Press Release, CERES, Nearly 400 Investors With \$32 Trillion in Assets Step Up Action on Climate Change (Sept. 14, 2018), <https://www.ceres.org/news-center/press-releases/nearly-400-investors-32-trillion-assets-step-action-climate-change>.

51. Miguel Antón et al., *Innovation: The Bright Side of Common Ownership?* (Working Paper June 21, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3099578.

Asset owners care about some externalities more than others depending on the aggregate impact on their portfolio. That is why common ownership can result in both the socially desirable internalization of climate externalities and the socially undesirable collusion to raise prices, resulting in deadweight welfare loss.

Institutional investors face many barriers to implementing their own interests in externality internalization. Optimal performance would require a general equilibrium model, which can simultaneously solve for all outcomes in the market, but does not exist in a perfect form.⁵²

B. Market Concentration and Investor as Regulator

By facilitating a coordinated decline in the supply of fossil fuel company products, institutional investors are encouraging a rise in the price of those products. From this view, institutional investors' imposition of emissions goals at the producer level can be analogized to a carbon tax, except the increased costs paid by consumers are collected as corporate profits rather than revenue for the government. Producers incur their own losses in both scenarios. Under the coordinated decrease in supply, suppliers sell fewer products, but at a higher price. The net effect on profits depends on the elasticity of the demand curve. Overall, the same desired outcome may be achieved, by organizing a supply-side restriction without having to lose revenue to taxes.

The insight that self-regulation of externalities through market power can cost *less*, from a portfolio perspective, than implementation of a Pigouvian tax, suggests that investors may have an incentive to preempt government action.

This Article makes a new contribution to the literature on voluntary corporate reduction of environmental harm. Several explanations have been advanced for the existence of private governance schemes. First, many of these initiatives exist in complement to public law.⁵³ Or they are an appeal to consumers or a reaction to environmental activist campaigns and motivated by the desire to avoid bad publicity. Commentators have neglected the influence of diversified investor self-interest. Under this explanation, private investors respond to the *absence* of government regulation. This explanation is consistent with traditional theories of utility-maximizing market actors.

Externalities have typically been seen as classic examples of market failure, requiring government intervention.⁵⁴ However, in the current political climate, the

Figure 1. Government-Imposed Pigouvian Tax

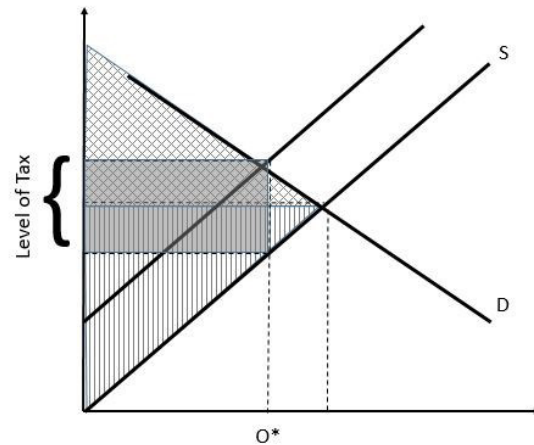
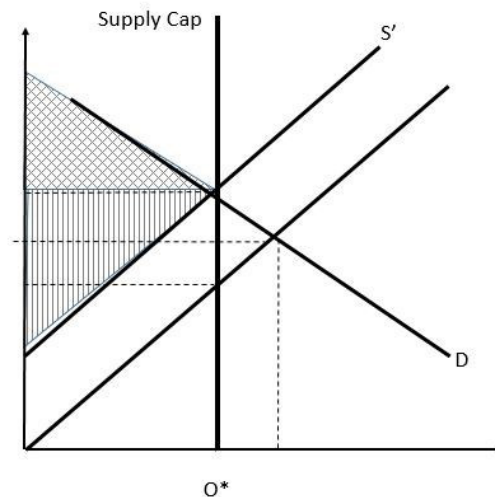


Figure 2. Investor-Imposed Supply-Side Restriction



world's largest asset managers have begun to serve as "surrogate regulators."⁵⁵

While we may celebrate the ability of institutional investors to combat climate change,⁵⁶ we should question the desirability of a democratically unaccountable financial behemoth making centralized resource allocation decisions.

It may be possible to design a legal regime that encourages the positive effects of common ownership, like the diminution of systemic risks, while preventing harmful anti-competitive behavior.

52. See, e.g., Letter from the Science Advisory Board (SAB), to E. Scott Pruitt, Admin., U.S. Env't Prot. Agency 1 (Sept. 29, 2017), [https://yosemite.epa.gov/sab/sabproduct.nsf/0/4B3BAF6C9EA6F503852581AA0057D565/\\$File/EPA-SAB-17-012.pdf](https://yosemite.epa.gov/sab/sabproduct.nsf/0/4B3BAF6C9EA6F503852581AA0057D565/$File/EPA-SAB-17-012.pdf).

53. Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2030 (2005).

54. RICHARD N.L. ANDREWS, *MANAGING THE ENVIRONMENT, MANAGING OURSELVES: A HISTORY OF AMERICAN ENVIRONMENTAL POLICY* 2 (1999).

55. Cf. Davis Hess, *Public Pensions and the Promise of Shareholder Activism for the Next Frontier of Corporate Governance: Sustainable Economic Development*, 2 VA. L. & BUS. R. 221, 235 (2007).

56. See, e.g., Nathan Atkinson, *If Not the Index Funds, Then Who?*, BERKELEY BUS. L.J. (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3341620&download=yes/ (last visited Jan. 28, 2020).

C. Shareholder Primacy and Efficiency-Framing

Much of the theory behind corporate law norms rests on the assumption that shareholders' rational self-interest drives them to exercise their governance rights with the goal of maximizing corporate value.⁵⁷ Consideration of common owner incentives challenges these core assumptions by showing that diversified shareholder interests can diverge from both the interests of concentrated shareholders and the objective of maximizing share price.⁵⁸

The interests of diversified and concentrated shareholders diverge in their preferences for how much risk a corporate manager should take on. Most scholars advocate that firm managers should serve the objectives of the diversified over the concentrated holder because this goal more closely conforms to the socially desired optimum.⁵⁹

Because idiosyncratic risk does not (theoretically) affect share price, this deference to diversified shareholders over concentrated ones does not implicate a deviation from the mandate of share price maximization.⁶⁰ While "most scholars" advocate that "management should manage with the interests of diversified stockholders in mind,"⁶¹ these arguments generally ignore the perverse inter-firm production effects this would bring about.

Economy-wide diversification means that investors become common owners of firms that compete and impose costs on one another. Proponents of shareholder primacy argue that requiring managerial devotion to shareholder interests is the best way to maximize aggregate social welfare.⁶² This argument assumes that individual firms lack market power to internalize externalities directly without ceding market share to competitors willing to externalize their costs.⁶³ This Article provides evidence that diversified

investors can implement externality internalization and deviation from share price maximization can improve portfolio efficiency. However, diversified institutional investor market power to internalize externalities comes along with the power to influence other inter-firm behaviors.

The portfolio-maximizing objective of common owners suggests that the advocates of managerial duty to diversified shareholders have not fully considered its perverse effects.⁶⁴ Beyond the market distortions that such a duty might enable, it is unclear how a manager could meet it. Shareholder value maximization as a theory of corporate purpose rests, in part, on the simplicity of measuring managerial success through a single metric.⁶⁵

V. Conclusion

Institutional investors have the economic incentive to function as "surrogate regulators," sacrificing individual firm profits for the benefit of the broader portfolio. This explanation of *why* institutional investors pressure firms to voluntarily reduce emissions has challenged the assumption that shareholders uniformly seek to maximize share value. Further, investors have the ability to carry out their portfolio-maximizing agenda through their power over both the market and managers. This explanation of *how* institutional investors are able to pressure firms into deviating from a profit-maximizing objective challenges the traditional view of diversified investor passivity.

Discussion of the appropriate legal response to common ownership has focused on the law of antitrust. This Article shows that corporate law must also respond given its failure to account for the behavior and influence of diversified investors.

57. See, e.g., Romano, *supra* note 1.

58. See Elhauge, *supra* note 31; cf. Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J.L. FIN. ACCOUNT. 247, 266-67 (2017).

59. *Id.*

60. STEPHEN ROSS ET AL., CORPORATE FINANCE 363-67 (10th ed. 2013).

61. Booth, *supra* note 6.

62. Hansmann & Kraakman, *supra* note 1.

63. See, e.g., Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14 J. APP. CORP. FIN. 8, 16 (2001).

64. See, e.g., Henry T.C. Hu, *New Financial Products, the Modern Process of Financial Innovation, and the Puzzle of Shareholder Welfare*, 69 TEX. L. REV. 1273, 1282 (1991).

65. See, e.g., Robert J. Rhee, *A Legal Theory of Shareholder Primacy*, 102 MINN. L. REV. 1951, 2008 n.249 (2018).