CODETERMINATION AND ESG: VIABLE ALTERNATIVES TO SHAREHOLDER PRIMACY?

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In 2018, in response to growing concerns over corporate wealth, wage stagnation, and income inequality, Senator Elizabeth Warren proposed a bill that would require U.S. companies with more than one billion dollars in annual revenue to obtain federal corporate charters. Perhaps the most dramatic requirement of this proposed federal law is that it would mandate that at least forty percent of the board members of a corporation subject to the law be elected by employees. As this note will show, the proposal would depart significantly from the recent history of U.S. corporate law. Over the past few years, however, U.S. corporations have been adopting their own internal changes to ensure greater representation of stakeholder interests—those of employees, customers, and neighbors, as well as other constituencies—in corporate decision making within a framework commonly referred to as ESG (Environmental, Social, and Governance). This note provides a comparative analysis of the advantages and disadvantages of board codetermination, largely through discussion of its historical existence under German law, and ESG in order to determine whether government-enforced

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stakeholder representation or private ordering provides a better solution to the socioeconomic problems Senator Warren, as well as others, currently seeks to address.

I. INTRODUCTION

In modern U.S. corporate law, "a corporation's directors and officers have a fiduciary duty to maximize shareholder wealth."[1] While this "profit-maximizing norm" requires neither that directors focus on short-term over long-term gains, nor that they ignore other important constituencies, the norm provides the corporation with a "residual goal" or "objective function": maximizing returns to shareholders.[2] However, state corporation statutes, under which U.S. corporations are chartered, do not require profit maximization.[3] U.S. corporations throughout the first half of the twentieth century often did not act purely to maximize profits. As U.S. Senator Elizabeth Warren of Massachusetts has stated, "[f]or much of U.S. history, the answers were clear. Corporations sought to succeed in the marketplace, but they also recognized their obligations to employees, customers and the community."[4] In fact, the Business Roundtable, an association of chief executives of leading U.S. companies,[5] stated as late as 1981 that "corporations have a responsibility, first of all, to make available to the public quality goods and services at fair prices, thereby earning a profit that attracts investment to continue and enhance the enterprise, provide jobs and build the economy."[6]

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1. ROBERT CHARLES CLARK, CORPORATE LAW 678 (1986). This note will refer to this understanding of the corporation as either the *profit-maximizing*, *shareholder-centric*, or *shareholder primacy* model of board conduct.

2. *Id.* (emphasis omitted) (stating that the fiduciary duty is "subject to numerous duties to meet specific obligations to other groups affected by the corporation").

3. *Id.*

4. Elizabeth Warren, *Companies Shouldn't Be Accountable Only to Shareholders*, WALL ST. J. (Aug. 14, 2018), https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687.

5. *About Us*, BUSINESS ROUNDTABLE, https://www.businessroundtable.org/about-us (last visited Oct. 29, 2019).

6. Andrew C. Sigler, *Business Forum; Reader Comment; Roundtable Reply*, N.Y. TIMES (Dec. 27, 1981), https://www.nytimes.com/1981/12/27/business/business-forum-reader-comment-roundtable-reply.html.

However, a powerful countervailing tendency began to gain significant traction in the latter part of the twentieth century. This tendency traces its origins to *Dodge v. Ford Motor Co.*, the classic case entrenching shareholder primacy.[7] In deciding a shareholder suit that arose in response to Ford president Henry Ford's declaration that the company would no longer issue dividends, but instead should reinvest in the company, the Michigan Supreme Court held that:

> [I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders it would not be the duty of the courts to interfere.[8]

But, as former Delaware Chancellor William Allen has noted, *Dodge* received little attention until the 1960s.[9]

Instead, the concept of profit maximization developed through academic discussion,[10] later common law decisions,[11] the "deregulation environment championed by President Reagan, and the takeover wars of the mid-1980s."[12] In his 1970 article *The Social Responsibility of Business Is to Increase Its Profits*—one of the most influential contributions to the development of the shareholder-centric model of corporate governance[13]—Milton Friedman argued that the corporate executive

7. CLARK, *supra* note 1, at 679 (citing *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919)).

8. Dodge v. Ford Motor Co., 170 N.W. 668, 683–684 (1919).

9. David J. Berger, *In Search of Lost Time: What If Delaware Had Not Adopted Shareholder Primacy?*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES 48, 50 (Steven Davidoff Solomon & Randall Stuart Thomas eds., 2019) (quoting William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 CARDOZO L. REV. 261, 263 (1992)).

10. *See id.* at 49–50 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) as an example of a piece of scholarly writing that had an impact on the concept of profit maximization).

11. CLARK, *supra* note 1, at 679.

12. Berger, *supra* note 9, at 49–50.

13. CLARK, *supra* note 1, at 679; *see also* Warren, *supra* note 4 (noting Friedman's contribution to creating the theory that corporations should maximize shareholder returns).

is the agent of the owners of the corporation, namely, the shareholders.[14] Under this agency model, the executive's primary responsibility is to shareholders, and value creation provides a straightforward criterion on which to judge the executive's performance.[15] Thus, if the executive decides to make political or social decisions that reduce returns, much like Henry Ford in *Dodge*, she may be wasting the shareholders' money, potentially creating grounds for a derivative suit based on a breach of her fiduciary duty.[16] The Business Roundtable also bought in, announcing in 1997 that the "principal objective of a business enterprise is to generate economic returns to its owners."[17]

However, "many critics have urged that corporations must be involved more directly in setting and pursuing public goals"[18] due to the legal and theoretical weaknesses of the profit-maximizing model of corporate governance. First, as stated earlier, corporations are not legally bound to abide by shareholder primacy and thus need not pursue profit maximization at all costs.[19] While directors are fiduciaries, they

14. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG. (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html; *see also* Joseph L. Bower & Lynn S. Paine, *The Error at the Heart of Corporate Leadership*, HARV. BUS. REV., May–June 2017, at 50, 52 ("Yet the idea that corporate managers should make maximizing shareholder value their goal—and that boards should ensure that they do—is relatively recent. It is rooted in what's known as agency theory, which was put forth by academic economists in the 1970s. At the theory's core is the assertion that shareholders own the corporation and, by virtue of their status as owners, have ultimate authority over its business and may legitimately demand that its activities be conducted in accordance with their wishes.").

15. Friedman, *supra* note 14.

16. *See id.* (creating grounds for a shareholder's claim that an executive breached her fiduciary duty simply based on the executive's failure to prioritize the shareholder); *see also* Bower & Paine, *supra* note 14, at 60 (describing the general differences in approaches to corporate governance between "shareholder centered" and "company centered" regimes).

17. Warren, *supra* note 4.

18. CLARK, *supra* note 1, at 680.

19. *See* STEVEN PEARLSTEIN, BROOKINGS INST., SOCIAL CAPITAL, CORPORATE PURPOSE AND THE REVIVAL OF AMERICAN CAPITALISM 5 (2014), https://www.brookings.edu/wp-content/uploads/2016/06/BrookingsPearlsteinv5_Revised-Feb-2014.pdf (stating that corporations are not bound as such because "there are no statutes requiring companies to be run to maximize profits or share prices.").

owe their duty to the corporation itself, not to the shareholders. Courts in Delaware, where most major U.S. companies are incorporated, judge directors' compliance with this duty under the highly deferential "business judgment rule."[20] However, while leaders of public corporations believe that planning over a long time horizon would benefit "corporate performance, strengthen financial returns, and drive innovation," they also report feeling consistent pressure regarding short-term financial performance.[21]

Second, the model of shareholder primacy itself is flawed. Shareholders do not owe a fiduciary duty to the corporation, may buy and sell their shares as they wish, and "tend to be physically and psychologically distant from the activities of the companies they invest in."[22] Thus, shareholders may not be particularly well-suited to monitoring corporate boards, making the agency theory inapt.[23] Finally, shareholders are not a uniform bloc, but rather maintain divergent goals and approaches to risk.[24] For example, while "[e]ndowments may seek long-term growth . . . [y]oung investors may accept considerably more risk than their elders will tolerate."[25] This interest divergence may limit the shareholders' ability to carry out a

20. *Id.* at 9. The *Revlon* case, which imposes an enhanced obligation on directors in the face of an inevitable sale to "put the interests of shareholders first and accept the highest price offered for the company," represents a "narrowly-drawn exception to the business judgment rule." *Id.* (citing LYNN A. STOUT, THE PROBLEM OF CORPORATE PURPOSE (Brookings Inst., Issues of Goverance Studies No. 48, 2012)); *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. . . . The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").

21. *American Prosperity Project: A Nonpartisan Framework for Long-Term Investment*, ASPEN INST., https://www.aspeninstitute.org/programs/business-and-society-program/american-prosperity-project (last visited Oct. 31, 2019).

22. Bower & Paine, *supra* note 14, at 52.

23. *See id.* at 52 (noting that agency theory may not be able to handle the accountability vacuum premised by shareholder control).

24. *See id.* at 54 (recognizing that shareholders do not have the same objectives).

25. *Id.* at 54.

monitoring function—another failing of the shareholder primacy model.

In response to these perceived failings of the shareholder-centric model of the corporation, many have called for reform of U.S. corporate governance mechanisms. These calls for reform often fall into one of two camps: increased government oversight of directors or private ordering among directors and stakeholders.

On the side of government regulation, Senator Warren proposed the Accountable Capitalism Act in 2018.[26] The Act would require U.S. corporations with more than one billion dollars in annual revenue to receive a federal charter, which would ensure that directors "consider the interests of all major corporate stakeholders—not only shareholders—in company decisions," and would grant shareholders a right of action against directors who fail to fulfill those obligations.[27] Most significantly, the Act would implant stakeholder representation into the board, as employees would be entitled elect at least forty percent of the corporation's directors.[28]

Faced with the prospect of burdensome and potentially overbroad regulation, corporate advocates have encouraged directors and stakeholders to come together to reach private ordering solutions that would shift the relations between corporations and their stakeholders. For example, BlackRock Chief Executive Officer (CEO) Larry Fink, in his 2018 letter to CEOs, calls on boards interested in ensuring long-term value creation to respond not only to shareholders, but also to stakeholders.[29] Boards must consider their corporations' role in the community and assuage environmental, social, and governance (ESG) concerns.[30] Fink's letter reflects a growing corporate consensus that boards must contemplate not only shareholder returns, but also ESG matters. Recently, the Business Roundtable's 2019 update also abandoned "decades of long-held corporate orthodoxy" in favor of investing in employees,

26. Accountable Capitalism Act, S. 3348, 115th Cong. (2018).

27. Warren, *supra* note 4.

28. *Id.*

29. Larry Fink, *Larry Fink's 2018 Letter to CEOs: A Sense of Purpose*, BLACKROCK, https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter (last visited Oct. 31, 2019).

30. *Id.*

protecting the environment, and dealing ethically with suppliers.[31]

This note assesses the relative advantages and disadvantages of these two types of corporate governance reform. Part II will consider the example of Germany, which legally requires employee board representation, known as codetermination. It will then discuss previous attempts at codetermination in U.S. corporate and labor law and describe codetermination's theoretical and observed economic impacts in order to analyze the viability of this type of proposed government regulation. Part III will describe the development of ESG measures, their current adoption by U.S. corporations, and their theoretical and observed economic impacts. Part IV will compare these two potential avenues for reform in order to offer some projections regarding the future role of the board of directors in U.S. corporations, including whether one of the regimes is preferable and whether the two are compatible.

II. Codetermination

Under Senator Warren's proposed Accountable Capitalism Act, "[n]ot less than 2/5 of the directors of a United States corporation shall be elected by the employees."[32] While Senator Warren's proposal triggered reactions along politically partisan lines in the United States,[33] the idea is not without a contemporary analog—namely, Germany's system of codetermination. This part will describe the German system's legal foundation and prevalence, previous attempts at codetermination in the United States, and codetermination's theoretical and observed economic impacts.

31. David Gelles & David Yaffe-Bellany, *Shareholder Value Is No Longer Everything, Top C.E.O.s Say*, N.Y. Times (Aug. 19, 2019), https://www.nytimes.com/2019/08/19/business/business-roundtable-ceos-corporations.html?action=click&module=RelatedLinks&pgtype=Article.

32. Accountable Capitalism Act, S. 3348, 115th Cong. § 6(b)(1) (2018).

33. *See, e.g.*, Justin Fox, *Why German Corporate Boards Include Workers*, Bloomberg (Aug. 24, 2018), https://www.bloomberg.com/opinion/articles/2018-08-24/why-german-corporate-boards-include-workers-for-co-determination (quoting the responses of Vox's Matthew Yglesias—that the proposal would "save capitalism"—and the National Review's Kevin Williamson—that the proposal would constitute "the largest seizure of private property in human history").

A. *A Comparative Example: Codetermination in Germany*

German codetermination sprouted from cultural "values of democracy, mutuality and solidarity that guilds and unions had promoted since the middle ages" as a means for remedying labor unrest in the wake of the upheavals of the industrial revolution.[34] From the nineteenth century through the early twentieth century, German employers "experimented with various systems to give workers a voice in company affairs, mainly in the form of employee-chosen work councils that deliberated over workplace conditions."[35] Germany's Worker Protection Act (*Arbeiterschutzgesetz*) of 1891 required employers to "let workers express a view, and an elected work council could be part of this."[36] However, the provision merely provided a suggestion, and adoption remained relatively meager through the first years of the twentieth century.[37]

However, the massive human costs of World War I spurred the German Empire to enact the Auxiliary Service Act (*Hilfsdienstgesetz*) of 1916, which required every adult male to join the workforce, but which also made work councils compulsory for workplaces with more than fifty employees.[38] Following the War, "unions and employer groups agreed to make the councils permanent" by ratifying them into law in 1920.[39] The Supervisory Council Act (*Aufsichtsratgesetz*) of 1922 went on to require employee representation on a corporation's supervisory board.[40] During the National Socialist era, however, labor representation collapsed, as the regime abolished

34. Ewan McGaughey, *The Codetermination Bargains: The History of German Corporate and Labour Law* 13 (London Sch. Econ. Law, Soc'y & Econ. Working Papers, Paper No. 10/2015, 2015) (citing HANS JÜRGEN TEUTEBERG, GESCHICHTE DER INDUSTRIELLEN MITBESTIMMUNG IN DEUTSCHLAND [HISTORY OF INDUSTRIAL CODETERMINATION IN GERMANY] 118–19 (1961)), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2579932.

35. Fox, *supra* note 33 (internal quotations omitted).

36. McGaughey, *supra* note 34, at 19 (citing Gesetz betreffend Abänderung der Gewerbeordnung [Law Regarding Amendment of the Industrial Code], June 1, 1891, REICHSGESETZBLATT [RGBL] at 261, § 134(d) (Ger.)).

37. *See id.* (stating, notably, that "an elected work council *could* be part of this" (emphasis added)).

38. *Id.* at 21.

39. Fox, *supra* note 33.

40. McGaughey, *supra* note 34, at 24 (citing Gesetz über die Entsendung von Betriebsratsmitgliedern in den Aufsichtsrat [Law on the Delegation of

codetermination in 1934.[41] The defeat of Nazi Germany and the founding of West Germany would reverse this brief anti-labor trend.

In 1949, (West) Germany adopted a new constitution (*Grundgesetz*),[42] and, though it did not explicitly require codetermination, it did state that "[p]roperty entails obligations,"[43] implicitly reflecting a "cross-political agreement on the principle of codetermination."[44] The Mining Codetermination Act (*Montan-Mitbestimmungsgesetz*) followed in 1951 and codified the equal division of the supervisory board between representatives of labor and management among corporations in the mining and metallurgy industries.[45] The Works Constitution Act (*Betriebsverfassungsgesetz*) of 1952 then "introduced a right to one third of the supervisory board to be employee representatives, and work councils became compulsory" across industries.[46] These work councils engage in local-level negotiation of workplace issues, unlike the national collective bargaining representatives in the United States,[47] discussed below. Most significant, the Codetermina-

Members of the Work Council in the Supervisory Board], Feb. 15, 1922, REICHSGESETZBLATT, Teil I [RGBL I] at 209 (Ger.)).

41. *Id.* at 30; *see* Fox, *supra* note 33 (noting the rise of the anti-labor trend in the 1930s); Karl Loewenstein, *Law in the Third Reich*, 45 YALE L.J. 779, 800 (1936) (stating that the German "Labor Code of January 20, 1934 . . . abolish[ed] collective rights of organized labor").

42. GRUNDGESETZ [GG] [BASIC LAW], *translation at* https://www.gesetze-im-internet.de/englisch_gg/index.html.

43. *Id.* art. 14(2).

44. McGaughey, *supra* note 34, at 35 (citing Regierungsentwurf [Cabinet Draft], DEUTSCHER BUNDESTAG: DRUCKSACHEN [BT] 1/117 (Ger.)).

45. Gesetz zur Ergänzung des Gesetzes über die Mitbestimmung der Arbeitnehmer in den Aufsichtsräten und Vorständen der Unternehmen des Bergbaus und der Eisen und Stahl erzeugenden Industrie [MontanMitbestGErgG] [Amendment to the Law on Worker Codetermination in Supervisory Boards and Management Boards of Companies in the Mining, Iron, and Steel Industries], Aug. 7, 1956, BUNDESGESETZBLATT, Teil I [BGBL I] at 642, last amended by Gesetz [G], Apr. 24, 2015, BGBL I at 642, § 5 (Ger.), https://www.gesetze-im-internet.de/montanmitbestgergg/BJNR007070956.html.

46. McGaughey, *supra* note 34, at 37 (citing Betriebsverfassungsgesetz [BetrVG] [Work Constitution Act], Oct. 11, 1952, BGBL I at 681 (Ger.)).

47. SUSAN R. HOLMBERG, ROOSEVELT INST., FIGHTING SHORT-TERMISM WITH WORKER POWER: CAN GERMANY'S CO-DETERMINATION SYSTEM FIX AMERICAN CORPORATE GOVERNANCE? 14 (2017), https://rooseveltinstitute.org/wp-content/uploads/2017/10/Corp-Gov_FINAL.pdf.

tion Act of 1976 (*Mitbestimmungsgesetz*) requires German companies with "more than 2,000 employees to have half their supervisory boards chosen by employee vote."[48] Mandatory codetermination applies regardless of whether the corporation is a public corporation (*Aktiengesellschaft*, or AG) or limited liability company (*Gesellschaft mit beschränkter Haftung*, or GmbH), as well as across groups of companies, meaning that German "corporations have no recourse but to accept [codetermination] and to come to terms with it."[49]

It is important to note that, unlike in the United States, where public corporations are monitored by a single board of directors responsible for "both managerial and supervisory responsibilities,"[50] Germany mandates a two-tiered board system for public corporations.[51] The executive management board (*Vorstand*) oversees the corporation's objectives and their implementation.[52] The non-executive supervisory board (*Aufsichtsrat*), of which labor representatives make up half the members, monitors the management board's decisions.[53] Stakeholder interests, beyond profit maximization, circumscribe the supervisory board's power, and lay at the heart of codetermination in general.[54]

48. Mitbestimmungsgesetz [MitbestG] [Codetermination Act], May 4, 1976, BGBL I at 642, § 1 (Ger.), http://www.gesetze-im-internet.de/mitbestg/__1.html; Fox, *supra* note 33.

49. Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 22, 53 (2011); *see also* MitbestG, § 1 (Ger.) (stating that the law is applicable to companies organized as public corporations (*Aktiengesellschaft*) or limited liability companies (*Gesellschaft mit beschränkter Haftung*)).

50. David Block & Anne-Marie Gerstner, One-Tier vs. Two-Tier Board Structure: A Comparison Between the United States and Germany 6 (2016) (unpublished seminar paper), https://scholarship.law.upenn.edu/fisch_2016/1.

51. Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BGBL I at 1089, last amended by Gesetz [G], July 17, 2017, BGBL I at 2446, § 30 (Ger.), http://www.gesetze-im-internet.de/englisch_aktg/englisch_aktg.html.

52. Block & Gerstner, *supra* note 50, at 23.

53. *Id.* at 23, 47.

54. *See* Tom Hamilton, *The Anglo-Germanic Board Architecture Debate: An Historical and Philosophical Analysis*, 1 N.E. L. REV. 9, 25 (2013) (stating that the "German view of the company is tempered by considerations of the public interest" and "[p]ublic interest concerns lay behind the imposition of the aufsichtsrat and codetermination.").

In contrast to the shareholder primacy of U.S. corporate law discussed above,

> German law distinguishes between "the company" as a legal form and "the enterprise" as a whole[,] and the German Corporate Governance Code defines "the interest of the enterprise" as "the common duty of the management and supervisory boards to contribute, in accordance with the principles of the social market economy, to the continued existence of the company and to sustainable added value."[55]

The German approach follows a company-centric view, in which the firm exists as a "social and economic organism" governed by complex ethical and legal responsibilities to shareholders, stakeholders, and society as a whole.[56] Indeed, "[a]n explicit duty to promote shareholder value is not found in German law."[57]

Nevertheless, despite labor's representation on supervisory boards under German law, the division of power between shareholders and labor is not perfectly equal. Instead, the chairman of the supervisory board, who always represents shareholders, maintains a tie-breaking vote,[58] suggesting that shareholders still maintain some form of primacy even if, in comparison to shareholders the United States, their power is greatly constrained by labor representation on the supervisory board.

Recent reforms have augmented the responsibilities and powers of the supervisory board in German corporations, bringing it more in line with the U.S.-style unitary board.[59]

55. *Id.* at 24 (first quoting Christine Windbichler, *The Public Spirit of the Corporation*, 2 EURO. BUS. ORG. L. REV. 795, 801 (2001); and then quoting DEUTSCHER CORPORATE GOVERNANCE KODEX [DCGK] [GERMAN CORPORATE GOVERNANCE CODE], § 3.8, para. 1 (amended 2017), *translation at* https://www.dcgk.de/en/code.html (Ger.)).

56. Bower & Paine, *supra* note 14, at 60.

57. Hamilton, *supra* note 54, at 10 (citing ALAN DIGNAM & MICHAEL GALANIS, THE GLOBALIZATION OF CORPORATE GOVERNANCE 274 (2009)).

58. *Id.* (citing Horst Siebert, *Corporatist verses Market Approaches to Governance*, *in* CORPORATE GOVERNANCE IN CONTEXT 281, 287–88 (Klaus J. Hopt et al. eds., 2005)).

59. *See* Jan Lieder, *The German Supervisory Board on Its Way to Professionalism*, 11 GERMAN L.J. 115, 116–17 (2010) (tracking the reform over time of the law governing supervisory boards).

The Law on Control and Transparency of Enterprises (*Gesetz zur Kontrolle und Transparenz im Unternehmensbereich*) of 1998 and, in particular, the Law on Transparency and Disclosure (*Gesetz zur weiteren Reform des Aktien- und Bilanzrechts, zu Transparenz und Publizität*) of 2002 required that the management board inform the supervisory board of all important company issues, thereby seeking to remedy the information asymmetry that sometimes arose from management's reluctance to discuss critical issues with representatives of labor.[60] The law also shifted the power of receiving audit reports on management from the management board to the supervisory board, eliminating an important conflict of interest and improving the supervisory board's oversight capabilities.[61] The 2002 reform established the German Corporate Governance Code, which emphasizes the close cooperation between the management and supervisory boards and increases disclosure requirements on both.[62] The Code also recommends that supervisory boards develop committees, in particular an audit committee, that were previously lacking in German corporate governance; however, these audit committees are now adopted by Germany's largest corporations.[63] The law also obligates the supervisory board to create "a checklist with fundamental decisions to be taken by the management board that the supervisory board shall approve," giving the supervisory board increased oversight over business decisions.[64]

Codetermination has its origins in the nineteenth century German welfare state, though recent reforms have given the supervisory board powers similar to those already exercised by American unitary boards. However, while Germany's codetermination regime, with equal employee representation on a supervisory board responsible for monitoring the management board, may appear fundamentally to be a stark depar-

60. *See id.* at 116, 119–20 (citing AktG, § 90(1) (Ger.)) (explaining how legal reform improved the flow of information from the management board to the supervisory board).

61. *See id.* at 122–25 (citing HANDELSGESETZBUCH [HGB] [COMMERCIAL CODE], § 321 (Ger.), https://www.gesetze-im-internet.de/englisch_hgb/index.html) (explaining the shift in responsibilities around the auditing process).

62. *Id.* at 125, 129 (citing AktG, § 161 (Ger.)).

63. *Id.* at 139–40 (citing DCGK, § 5.3.2 (Ger.)).

64. *Id.* at 127.

ture from recent U.S. corporate law, the concept was not always so foreign.

B. *Previous Attempts at Codetermination in the United States*

Shareholder primacy did not always dictate the residual goal of directors of U.S. corporations. As mentioned previously,[65] Senator Warren has noted that corporations for much of U.S. history recognized their obligations to other stakeholders, including employees.[66] However, this recognition never extended so far as explicit legal obligations, as under Germany's Codetermination Law. With the exception of a "small number of employee-owned enterprises," the United States historically "has had no experience with employee representation on corporate boards."[67] For example, in 1972, pilots for United Airlines who sought board representation received only five percent of the vote at the annual shareholder meeting.[68] The following year, a proposal by rubber workers at General Tire and Rubber Company for union representation on the board was rejected.[69] While some corporations have experimented with stakeholder directors, these directors nonetheless remain answerable to shareholders, as opposed to another defined constituency.[70] For example, in 1979, the United Automobile Workers union (UAW) proposed worker representation in its negotiations with Chrysler.[71] However, once elected to the board, Douglas Fraser, the president of the UAW, assumed a duty to serve "at the will of the stockholders," and could not even speak for all Chrysler employees, as not all were UAW members.[72]

For the most part, though, management and labor have both historically opposed the imposition of German-style codetermination on U.S. corporations. Corporate executives

65. *See supra* Part I.
66. Warren, *supra* note 4.
67. Clyde W. Summers, *Codetermination in the United States: A Projection of Problems and Potentials*, 4 J. Comp. Corp. L. & Sec. Reg. 155, 155 (1982).
68. *Id.* at 187 n.8.
69. *Id.*
70. *Id.* at 155.
71. William Serrin, *Chrysler Workers Seek Representation on Board*, N.Y. Times (Oct. 24, 1979), https://www.nytimes.com/1979/10/24/archives/chrysler-workers-seek-representation-on-board-no-public-reaction.html.
72. Summers, *supra* note 67, at 155.

have historically "viewed with horror the philosophy of codetermination."[73] While the Business Roundtable may have recognized a somewhat holistic view of the corporation in 1981,[74] just three years earlier it "rejected any form of codetermination as 'inconsistent with U.S. traditions and [the] style of management-labor relationships at arms length [sic].' "[75] Labor leaders have also rejected proposals similar to that of the UAW.[76] They have chosen to rely instead on the entrenched "system for employee representation in enterprise decision-making—the system of collective bargaining."[77] The National Labor Relations Act (NLRA), enacted in 1935, obligates an employer, in cases where there is a majority union, to bargain exclusively with the union's representatives to reach a contract that binds all employees, regardless of whether they are union members or not,[78] giving unions significant power in the adversarial bargaining process.

However, attitudes toward codetermination may have shifted since the 1970s and 1980s, particularly as union membership has declined to a mere 6.4% in the private sector, diminishing the role of the NLRA's collective bargaining regime.[79] For example, a 2018 poll of over 3,300 likely U.S. voters by Civis Analytics found that fifty-three percent support

73. *Id.* at 187 n.6 (quoting David W. Ewing, *Who Wants Corporate Democracy?*, HARV. BUS. REV., Sept.–Oct. 1971, at 12, 24–25).

74. *See* Sigler, *supra* note 6 (clarifying that the Business Roundtable recognizes that CEOs face responsibilities to not only shareholders, but also other groups like customers and employees).

75. Summers, *supra* note 67, at 187 n.4 (quoting Statement of Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporations*, 33 BUS. LAW. 2083, 2107 (1978)).

76. *See id.* at 155 (providing statements of labor leaders explaining why they rejected such proposals).

77. *Id.* at 158.

78. *Id.* The relevant portion of the NLRA states: "Representatives designated or selected for the purposes of collective bargaining by the majority of the employees in a unit appropriate for such purposes, shall be the exclusive representatives of all the employees in such unit for the purposes of collective bargaining in respect to rates of pay, wages, hours of employment, or other conditions of employment . . . ." 29 U.S.C. § 159 (1959).

79. BUREAU OF LABOR STATISTICS, USDL-19-0079, UNION MEMBERS—2018, at 1 (2019); *see* Fox, *supra* note 33 (criticizing the common rejection of codetermination in the U.S. in the late 1970s).

allowing employees to elect representatives to boards.[80] Some U.S. politicians have begun suggesting corporate reforms in line with this changing sentiment. Parallel to Senator Warren's proposal, U.S. Senator Tammy Baldwin of Wisconsin proposed the Reward Work Act in 2018.[81] The Act would limit corporations' ability to engage in stock buybacks and require a public company to allow its workers to elect one-third of the company's board of directors.[82] Furthermore, in May 2019, U.S. Senator Bernie Sanders of Vermont announced that his presidential campaign was "working on a plan to require large businesses to regularly contribute a portion of their stocks to a fund controlled by employees, which would pay out a regular dividend."[83] Sanders also stated that he would "introduce a plan to force corporations to give workers a share of the seats on their boards of directors." However, as Part III will discuss, ESG's more holistic approach may be better suited to protecting stakeholder interests than is the narrow focus on employee representation on boards. In order to see why that may be the case, the next section will address codetermination's theoretical and empirical impacts on the corporate enterprise.

C. *Impact of Codetermination*

Now that this note has discussed the concept and history of codetermination against the backdrop of the U.S. shareholder-centric corporate philosophy, this section will discuss in detail the academic work on codetermination. First, it will present the theoretical arguments both for and against a system of codetermination. Second, it will describe the findings of vari-

80. Dylan Matthews, *Workers Don't Have Much Say in Corporations. Why Not Give Them Seats on the Board?*, VOX (Apr. 6, 2018), https://www.vox.com/2018/4/6/17086720/poll-corporate-board-democracy-worker-council-codetermination-union-labor.

81. *See U.S. Senator Tammy Baldwin Introduces Legislation to Rein in Stock Buybacks and Give Workers a Seat at the Table*, U.S. SENATOR TAMMY BALDWIN WIS. (Mar. 22, 2018), https://www.baldwin.senate.gov/press-releases/reward-work-act ("The *Reward Work Act* improves disclosure of repurchases and requires public companies to give workers the right to directly elect one-third of their company's board of directors.").

82. *Id.*

83. Jeff Stein, *Bernie Sanders Backs 2 Policies to Dramatically Shift Corporate Power to U.S. Workers*, WASH. POST (May 28, 2019), https://www.washingtonpost.com/us-policy/2019/05/28/bernie-sanders-backs-policies-dramatically-shift-corporate-power-us-workers.

ous empirical studies on codetermination's economic impact on the firm.

1. *Theoretical Discussions*

Codetermination presents some clear theoretical benefits over the U.S. standard of shareholder primacy. Most immediately, it gives labor—one of the stakeholders most impacted by corporate decision making—significant monitoring authority over corporate conduct. Giving labor a "direct voice" allows them "both to protect their interests and to develop participatory decision making as an end in itself."[84] If shareholder primacy emphasizes short-term profits to the detriment of other stakeholder interests,[85] codetermination can "serve as an additional check on management, not only as far as labor interests are concerned, but more generally to suppress excessive risk-taking and other activities that are potentially disadvantageous to the enterprise and therefore to jobs."[86] Codetermination may alert the board to problems between labor and capital at an early stage, leading to faster resolution, increased productivity, and thus greater value for shareholders.[87] If enacted in the United States, labor representation—a form of what Robert Clark calls "high idealism"—could allow private parties, namely labor and management, to stand in for weak governmental regulatory regimes, which "suffer from informational problems, perverse agenda-setting processes, capture by vested interests, nonrepresentation of diffuse interests, [and] poor incentive structures."[88] According to Clark:

> High idealism holds that the business corporation's residual goal, and not just its specific, externally im-

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84. CLARK, *supra* note 1, at 691.

85. *See supra* p. 5.

86. Hopt, *supra* note 49, at 54; *see also* Wulf A. Kaal & Richard W. Painter, *Initial Reflections on an Evolving Standard: Constraints on Risk Taking by Directors and Officers in Germany and the United States*, 40 SETON HALL L. REV. 1433, 1456–57 (2010) ("Non-shareholder constituencies, such as employees and creditors, are often more adverse to risk than shareholders, particularly diversified shareholders who can afford to see some companies fail if others do spectacularly well.").

87. Hopt, *supra* note 49, at 54.

88. CLARK, *supra* note 1, at 691 (citing Elliott J. Weiss, *Social Regulation of Business Activity: Reforming the Corporate Governance System to Resolve an Institutional Impasse*, 28 UCLA L. REV. 343, 378–93 (1981)).

> posed legal obligations, should be defined to include a much wider set of interests than those of the shareholders. . . . The most common yet the most limited proposal of this sort is to have employee representation on the board of directors . . . .[89]

The entire system, by increasing worker satisfaction, participation, and thus productivity, could "lead to an improvement in social welfare."[90]

Codetermination also raises a number of theoretical problems. As Michael Jensen and William Meckling noted in 1979, while most Western nations allow for significant labor representation, including representation through workers councils or employee approval of major corporate decisions, firms rarely adopt this approach voluntarily.[91] That is because a company subject to codetermination remains in a difficult bind—it must reassure its shareholders that codetermination will not overly limit profitability, while also arguing that "codetermination bestows substantial benefits on labor."[92] As the ESG part of this note will discuss in more detail, firms do not have homogenous preferences.[93] Similarly, employees within a firm may have heterogenous interests.[94] This preference divergence and the fact that labor-managed firms rarely arise voluntarily "suggest[ ] that codetermination or industrial democracy is less efficient than the alternatives which grow up and survive in a competitive environment."[95] Because of this apparent lack of efficiency, Jensen and Meckling argued that codetermination "could survive in Germany by becoming irrelevant, as shareholder interests bypassed the employee members of the supervisory board (*Aufsichtsrat*) and dealt directly

89. *Id.* at 688–90.

90. Franziska Boneberg, *The Economic Consequences of One-Third Co-Determination in German Supervisory Boards: First Evidence for the Service Sector from a New Source of Enterprise Data* 15 (Univ. of Lüneburg Working Paper Series in Econ., Paper No. 177, 2010).

91. Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 J. BUS. 469, 472–73 (1979).

92. *Id.* at 474.

93. *See infra* Section III(A).

94. *See* Jensen & Meckling, *supra* note 91, at 488 ("No one has specified a well-defined set of procedures for solving the decision-making problem within the firm when the preferences of the workers are not all identical.").

95. *Id.* at 473.

with the executive (*Vorstand*). Alternatively, Germany's economy would grind to a halt like [that of] Marshall Tito's Yugoslavia."[96] In other words, codetermination could become a mere legal formality with no economic effect on the enterprise, or its current form could adversely impact the German economy. However, neither has happened thus far.

In line with the interest divergence Jensen and Meckling noted, stakeholder theory further clarifies the tension at the heart of German codetermination, namely that empowering one stakeholder may not advance the interests of stakeholders generally. In contrast with the American shareholder-centric model of corporate governance:

> Stakeholder theory is rooted in the ideal that "all parties work together for a common goal and obtain shared benefits" and therefore the corporate objective (and the duty of managers) is to create optimal value for all stakeholders[—]social actors who might be regarded as parties who can affect or are affected by a company's decisions.[97]

Stakeholders include shareholders, management, directors, and employees, "but also wider interests such as those of the government, local communities, state and even the environment."[98] While stakeholder theory notes the presence of these diverse interested parties, it "does not give any guidance on how to prioritise between stakeholders when their interests conflict."[99] As Part II(A) described, German codetermination affords explicit representation rights to labor. Accordingly, German codetermination is not "a vindication of stakeholder theory" writ large, but instead "privileges shareholders and labour by affording them control rights which could easily be

96. McGaughey, *supra* note 34, at 2 (citing Jensen & Meckling, *supra* note 91, at 503–04).

97. Hamilton, *supra* note 54, at 30 (quoting Andrew Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little?*, 22 EUR. BUS. L. REV. 1, 6–7 (2011)).

98. *Id.* at 30 (internal quotation omitted); *see also* Fink, *supra* note 29 ("Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.").

99. Hamilton, *supra* note 54, at 30 (citing Andrew Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value, and More: Much Ado About Little?*, 22 EUR. BUS. L. REV. 1, 8 (2011)).

extended to other interests groups."[100] And employee interests "may conflict seriously with those of consumers and governmental units"—other stakeholders a corporation impacts significantly.[101] Unless these stakeholders already have adequate control over a firm, while labor does not, privileging labor may be misguided.[102] However, this preference of employees over other stakeholders also presents one of the clear theoretical problems of German codetermination.

Allowing one particular stakeholder—in this case, labor—to have a say in board decisions presents its own problems. While the U.S.-style unitary board maintains "flexibility and responsiveness" in order to "institute change quickly and take painful measures such as restructuring . . . . [T]he codetermined board . . . is unable to pursue shareholder value with the same vigour and instead must engage in 'sub optimal compromises' and 'corporatist' decision-making by appeasing the labour representatives."[103] Instead, the "possibilities on the shareholder side are correspondingly weakened," and a decision making process which requires consensus between labor and capital, given their frequently divergent interest, is "more costly and slow."[104] The codetermined firm may "avoid painful measures such as redundancies, restructuring and plant clo-

100. *Id.* at 30.

101. CLARK, *supra* note 1, at 693.

102. *Id.* at 693–94 (stating: "For example, featherbedding may be desired by employees but may raise prices to consumers and result in lower profits, thus reducing corporate income tax revenues to certain governments. Unless there is some good reason to think that these latter groups already possess adequate controls on corporations, whereas labor does not," it may make sense to give these other groups a direct voice as well).

103. Hamilton, *supra* note 54, at 31 (first citing Thomas Clarke & Richard Bostock, *Governance in Germany: The Foundations of Corporate Structure?*, *in* CORPORATE GOVERNANCE: ECONOMIC, MANAGEMENT, AND FINANCIAL ISSUES 233, 244 (Kevin Keasey, Steve Thompson & Mike Wright eds., 1997); Horst Siebert, *Corporatist verses Market Approaches to Governance*, *in* CORPORATE GOVERNANCE IN CONTEXT 281, 290 (Klaus J. Hopt et al. eds., 2005); then quoting Wanjiru Njoya, *Employee Ownership and Efficiency: An Evolutionary Perspective*, 33 INDUS. L.J. 211, 233 (2004); and then citing Harald Baum, *Change of Governance in Historic Perspective: The German Experience*, *in* CORPORATE GOVERNANCE IN CONTEXT 3, 15 (Klaus J. Hopt et al. eds., 2005)).

104. Hopt, *supra* note 49, at 54; *see also* CLARK, *supra* note 1, at 692 ("Since corporate decision makers would not be assigned the task of maximizing a single, objective, easily monitored goal, it would be very difficult to keep them truly accountable to a vague statement of purposes.").

sure . . . due to the inherently conservative interests of labour members."[105] These conflicts could ultimately lead to a reduction in capital stock, increased unemployment, decreased incomes, and a general decrease in output and a country's prosperity.[106] The firm that "keeps a relatively inefficient plant in operation, for example, . . . may have to charge more than competitors, lose business, and eventually be forced to change its practices or seek a governmental bailout."[107]

Additionally, it is not as though the U.S. system lacks mechanisms for monitoring corporate conduct: takeover bids, shareholder derivative lawsuits, and greater market competition all constrain a unitary board's decisions.[108] There are, of course, even more fundamental monitoring mechanisms available in the U.S. system:

> The interests of nonshareholder groups like employees can be protected by contract, common law developments, and special legislation. Negative externalities like pollution can be corrected by tort law or pollution laws telling companies not to pollute or taxing them when they do. The production of public goods and the redistribution of wealth from rich to poor can be better accomplished by actual governments, which have a more legitimate claim to do these things. And corporate resources can still be diverted to these governmental activities, in small or great measure, as elected representatives see fit, because

105. Hamilton, *supra* note 54, at 31–32; *see also* CLARK, *supra* note 1, at 692 ("One main argument against high idealism is that, to the extent it would make a difference, it would have a very high cost in terms of decreased economic performance by corporations. It might impair overall allocational efficiency. For example, the corporation that quickly accedes to demands not to close an unsuccessful plant may be adding to immobility in the flow of resources to more productive uses; it may be merely putting a costly drag on changes that eventually ought to be made.").

106. Jörg-Richard Werner & Jochen Zimmermann, *Unternehmerische Mitbestimmung in Deutschland: Eine empirische Analyse der Auswirkungen von Gewerkschaftsmacht in Aufsichtsräten* [*Corporate Codetermination in Germany: An Empirical Analysis of the Effects of Union Power in Supervisory Boards*], 12 INDUSTRIELLE BEZIEHUNGEN 339, 341 (2005) (Ger.) (citing generally Jensen & Meckling, *supra* note 91).

107. CLARK, *supra* note 1, at 693.

108. *See id.* at 692 (describing "takeover bids, derivative lawsuits, and competition" as "present controls" within U.S. corporate law).

governments can tax both corporations and their shareholders.[109]

These mechanisms—contract, the common law, and regulation—do not require an overhaul of American corporate law and avoid the stakeholder interest problems inherent in codetermination. With the theoretical impacts of codetermination, as well as the system's current legal and economic status laid out, the next section will summarize relevant empirical findings on these points.

2. *Empirical Observations*

Thus far, empirical studies have come to mixed conclusions on codetermination's economic impact.[110] Most have simply found "there is no significantly positive effect of codetermination on share value."[111] The social welfare benefits to employees and other stakeholders derived from improved labor relations and cooperation are difficult to quantify.[112] Nonetheless, this section will summarize some key findings regarding codetermination's impact on a firm's success in the capital markets, worker productivity, and firm profitability, namely that benefits accrue to labor reducing overall profitability.

As some theoretical arguments have posited, codetermination allows workers to shape corporate decision making and to allocate resources to themselves more effectively than the purely shareholder-elected board:

> In reality, the presence of labour representatives allows employees to affect corporate policy, and reallocate corporate risk, in their favour. Therefore, labour is able to engage more effectively in rent seeking behaviour and will, as a result be more satisfied than in

109. *Id.* at 680.

110. McGaughey, *supra* note 34, at 3 (citing generally Felix R. FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 SCANDINAVIAN J. ECON. 365 (1993); Larry Fauver & Michael E. Fuerst, *Does Good Corporate Governance Include Employee Representation? Evidence from German Corporate Boards*, 82 J. FIN. ECON. 673 (2006)).

111. Lieder, *supra* note 59, at 147.

112. *See* Felix R. FitzRoy & Kornelius Kraft, *Economic Effects of Codetermination*, 95 SCANDINAVIAN J. ECON. 365, 374 (1993) (noting that social benefits have a real impact on employees and employers, but are normally discounted).

> [a shareholder-centric] firm which seeks to direct wealth exclusively to shareholders.[113]

Early on, this characteristic was seen as a positive economic development: "After post-war reconstruction and again in the 1970s and 1980s, the German model of stakeholder governance was revered for driving the country's robust business performance."[114] While the U.S. system of collective bargaining places labor and management on adversarial terms, potentially leading to conflicts that prevent effective decision making, the German Codetermination Commission (*Komission Mitbestimmung*) concluded that codetermination promoted economic modernization "by deepening trust between management and labor and improving information flow."[115]

In contrast to U.S. corporate governance, codetermination has also effectively limited "destructive shareholder primacy practices like executive stock options" and safeguarded German firms' "high-quality standards and deep commitment to long-term strategy."[116] For example, German CEOs receive far fewer stock options as a percentage of their pay packages than their American counterparts and earn far less on the whole, while at the same time focusing on "the importance of serving society and balancing the interests of shareholders and employees through the production of quality goods and services"[117]—echoing U.S. corporate strategy before the rise of shareholder primacy.[118]

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113. Hamilton, *supra* note 54, at 32 (first citing Horst Siebert, *Corporatist verses Market Approaches to Governance*, *in* CORPORATE GOVERNANCE IN CONTEXT 281, 289 (Klaus J. Hopt et al. eds., 2005); and then citing Mark J. Roe, *Modern Politics and Ownership Separation*, *in* CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE 252, 257–60 (Jeffrey N. Gordon & Mark J. Roe eds., 2004)).

114. HOLMBERG, *supra* note 47, at 5.

115. *Id.* at 19 (citing STEPHEN J. SILVIA, HOLDING THE SHOP TOGETHER: GERMAN INDUSTRIAL RELATIONS IN THE POSTWAR ERA (2013)).

116. *Id.* at 5.

117. *Id.* at 17. The studies that reflected these conclusions also found the following: while stock options comprise approximately sixty-three percent of American CEOs' pay, they make up only twenty-four percent of their German counterparts' pay; in 2015, the average German CEO made $5.6 million, while the average American CEO made $14. 9 million; and while American CEOs tend to follow "shareholder value thinking," German executives pay more attention to serving society. *Id.*

118. *See supra* Part I.

However, while codetermination creates more harmonious labor relations and maintains a company's long-term strategy, it comes at a high cost to the codetermined firm's shareholders.[119] For one, codetermination can have a detrimental effect on a firm's success in the capital markets due to the significant costs of negotiating with empowered labor representatives. The German system may make a firm's securities less attractive to the market, as "securities buyers will be unwilling to pay 'full' price for the stock because the buyers will have to deal either with a weak board or strong labor inside a strong board."[120] Accordingly, the firm's "founders may find it comparatively worthwhile to retain [their] block and induce the next generation in the family to enter and run the firm"—far from the robust initial public offering (IPO) market in the United States.[121] Instead, controlling block-holders will sell to other controlling block-holders who, unlike institutional investors in the United States, actively monitor the firm.[122] An IPO, on the other hand, would "decrease the power of equity to counterbalance labor in the boardroom."[123] Thus, "codetermination is sometimes considered to be one of the many structural obstacles to the development of a lively takeover market."[124] Some studies have even found codetermination to have a significant negative impact on German firm share price, with one finding "an average 31% stock market discount on firms with equal employee representation compared with one-third employee representation."[125]

While the division of power between labor and the board may decrease the attractiveness of a codetermined company's shares, does codetermination have a negative impact on the firm's productive output? Some scholars have theorized that labor's desire to employ workers even when market conditions require the firm to slim down will limit productivity, but stud-

119. Hamilton, *supra* note 54, at 32.

120. Mark J. Roe, *German Codetermination and German Securities Markets*, 1998 COLUM. BUS. L. REV. 167, 178 (1998).

121. *Id.* at 177–78.

122. *Id.* at 178–79.

123. *Id.* at 179.

124. Hopt, *supra* note 49, at 54.

125. Lieder, *supra* note 59, at 147 (citing generally Gary Gorton & Frank A. Schmid, *Capital, Labor, and the Firm: A Study of German Codetermination*, 2 J. EURO. ECON. ASS'N 863 (2004)).

ies on the subject have reached decidedly conflicting outcomes: some have identified positive relationships between codetermination and productivity, others negative relationships, and still others no impact at all.[126] However, existing studies on the economic impact of the German system is not only relatively limited in quantity, but also subject to critique on methodological grounds.[127] A 2010 study of firms with one-third employee representation on supervisory boards—required for companies with between 500 and 2,000 employees under the 2004 Codetermination Act[128]—found higher productivity per employee, but lower profitability.[129] The study places this result in line with earlier scholarship, which argues that "worker participation raises productivity as the employees put more effort into their work, but lowers profitability as highly productive workers exert more influence on the distribution of a company's rent."[130] In other words, codetermination leads to a mixed economic result: an increased share to labor with a correlated decreased share to shareholders.

Finally, "codetermination has not prevented major frauds and scandals, though shareholder-elected representatives [have not done] much better."[131] In fact, many analysts blamed the codetermined Volkswagen board for failing to diagnose its diesel emissions scandal proactively, claiming that

126. Boneberg, *supra* note 90, at 7.

127. *See id.* at 8 ("The varying results show that no clear conclusions on the impact of co-determination at the enterprise level can yet be drawn. Moreover, a direct comparison of the extant work is difficult to make because of the different methods and data used. . . . Taken together, the extant work on the subject makes it clear that, since the existing studies are neither numerous nor definite, the influence of co-determination cannot yet be assumed . . . [and] so far is not empirically resolved." (internal quotations and citations omitted)).

128. Drittelbeteiligungsgesetz [DrittelbG] [One-Third Participation Act], May 18, 2004, BGBL I at 974, last amended by Gesetz [G], Apr. 24, 2015, BGBL I at 642, § 1 (Ger.).

129. Boneberg, *supra* note 90, at 2, 13.

130. *Id.* at 13 (citing generally Richard B. Freeman & Edward P. Lazear, *An Economic Analysis of Works Councils*, *in* WORKS COUNCILS: CONSULTATION, REPRESENTATION, AND COOPERATION IN INDUSTRIAL RELATIONS 27 (Joel Rogers & Wolfgang Streeck eds., 1995)).

131. Hopt, *supra* note 49, at 54.

labor and management had grown too closely aligned.[132] However, there is no evidence that labor representatives were aware of the scandal before it became public, and "this accusation loses sight of the fact that the [U.S.] shareholder model has also led to a spate of scandals and crises, including its role in the global financial crisis" of 2008.[133] Instead, the failures of both systems to diagnose and address certain crises may demonstrate "that [problematic] corporate systems can get entrenched by power relationships, with or without workers serving on [boards]."[134] Recent reforms discussed earlier seek to remedy the information asymmetries that may have contributed to corporate crises by increasing the authority of the supervisory board and the amount of information the management board must share with its monitoring counterpart.[135]

This part has outlined the historical background, legal requirements, and theoretical and observed economic impacts of the German system of codetermination in order to provide an analog for Senator Warren's proposal in the United States. Codetermination may help ensure long-term profitability by checking excessive risk-taking and smoothing labor relations. At the same time, entrenching labor interests may negatively impact other corporate stakeholders and reduce the attractiveness of the firm's stock to investors. While Jensen and Meckling's worst fears have not been realized in the German case, empirical conclusions are not overwhelmingly positive either. The next part will present the private alternative that many major U.S. corporations have adopted to date in an attempt to foster long-term viability while maintaining economic efficiency.

III. The Rise of ESG

While government-imposed codetermination empowers employee stakeholders to combat the problems of a board focused on profit maximization, firms may be wary of burden-

132. Holmberg, *supra* note 47, at 16 (citing Guy Chazan, *Theresa May Looks to Germany for Board Reform*, Fin. Times (July 11, 2016), https://www.ft.com/content/3d70421e-4759-11e6-b387-64ab0a67014c).

133. *Id.*

134. *Id.*

135. *See* Lieder, *supra* note 59, at 148–49 (discussing legal reforms related to the transparency of the supervisory board).

some and potentially overbroad federal regulation and its attendant compliance costs. Accordingly, firms may attempt to preempt legal changes like Senator Warren's proposal through private ordering. ESG measures provide firms with such an opportunity. This part will describe the development of ESG, its levels of adoption, and its potential and actual economic and social impacts in order to analyze whether ESG provides a viable alternative within the U.S. system of unitary boards to the more drastic system of German-style codetermination. The issue at the heart of this analysis is whether private ordering around ESG provides an adequate alignment of incentives between directors and stakeholders without sacrificing the unitary board's advantage of flexibility.

A. *Development of ESG Measures*

As the introduction described, shareholder primacy and profit maximization did not always dictate the conduct of American corporate boards. Instead, "[f]or much of U.S. history . . . [c]orporations sought to succeed in the marketplace, but they also recognized their obligations to employees, customers and the community."[136] Engaging in socially beneficial practices and working to maximize profits are not always mutually exclusive. Robert Clark's "monist" view of corporate conduct contends that "many types of corporate activities that appear to be profit-reducing voluntary expenditures for the public good are really conducive to profit maximization in the long run."[137] Therefore, "there is some set of socially responsible corporate activities that it is good for corporations to foster, because doing so will eventually create a better climate or culture in which business can operate."[138] ESG, particularly in the context of institutional asset managers, guides responsible investing. It "cover[s] a wide spectrum of issues that traditionally are not part of financial analysis, yet may have financial relevance," and may include the following:

> [H]ow corporations respond to climate change, how good they are with water management, how effective their health and safety policies are in the protection against accidents, how they manage their supply

136. Warren, *supra* note 4.
137. CLARK, *supra* note 1, at 681.
138. *Id.* (internal quotation omitted).

> chains, how they treat their workers and whether they have a corporate culture that builds trust and fosters innovation.[139]

In 2000, U.N. Secretary-General Koffi Annan launched an international initiative called the Global Compact in order to bring companies, U.N. agencies, and social organizations together to promote human rights, better working conditions, environmental protections, and anti-corruption efforts.[140] A 2003 survey of CEOs by the World Economic Forum Global Corporate Citizenship Initiative found that seventy percent of companies surveyed "expected to see increased interest in corporate citizenship issues by mainstream investors in the future."[141] Continuing this trend, in 2004, Secretary-General Annan "wrote to over 50 CEOs of major financial institutions, inviting them to participate in a joint initiative under the auspices of the UN Global Compact" in order "to find ways to integrate ESG into capital markets."[142] Accordingly, global financial institutions, such as BNP Paribas, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, and Morgan Stanley, together holding over six trillion dollars in assets under management (AUM), developed guidelines for integrating ESG issues into finance on the premise that firms that do so "can increase shareholder value by, for example, properly managing risks, anticipating regulatory action or accessing new markets, while at the same time contributing to the sustainable de-

139. Georg Kell, *The Remarkable Rise of ESG*, FORBES (July 11, 2018), https://www.forbes.com/sites/georgkell/2018/07/11/the-remarkable-rise-of-esg/#77c10d401695.

140. *See* UNITED NATIONS GLOB. COMPACT, WHO CARES WINS: CONNECTING FINANCIAL MARKETS TO A CHANGING WORLD, at viii–ix (2004) (outlining the Global Compact principles, including: supporting international human rights, preventing human rights abuses, upholding freedom of association and collective bargaining, eliminating forced labor, abolishing child labor, eliminating employment discrimination, supporting environmental precautions, promoting environmental responsibility, encouraging the development and spread of environmentally friendly technologies, and working against corruption, such as extortion and bribery), https://www.unepfi.org/fileadmin/events/2004/stocks/who_cares_wins_global_compact_2004.pdf [hereinafter *Who Cares Wins*].

141. World Econ. Forum, *Values and Value: Communicating the Strategic Importance of Corporate Citizenship to Investors* 13 (Jan. 2004).

142. Kell, *supra* note 139.

velopment of the societies in which they operate."[143] The report tasked analysts, financial institutions, and companies with implementing ESG policies and reporting on their adoption more consistently.[144]

However, the World Economic Forum survey identified key obstacles to what would become known as ESG implementation, including, first and foremost, problems of definition.[145] Globally, as the survey noted, "[t]here is no single, commonly agreed definition to describe a company's overall role in society."[146] For one company the concept could mean "compliance and philanthropy," but for others it provides a "much more strategic framework, [for] looking at a company's overall impacts and relationships."[147] The potential impact of ESG strategies also varies greatly across industries and geographic regions.[148] Unlike codetermination, which elevates the power of particular stakeholders—employees—to combat the perceived over-concentration on profit maximization by corporate boards, ESG broadly calls for corporations to adopt measures regarding environmental, social, and governance issues, whether through board conduct or shareholder proxy initiatives. These might include reducing waste, managing reputational risks, and promoting environmentally friendly products; improving workplace health and safety, community relations, and human rights at the company, suppliers, and contractors; and reforming board structures to increase accountability, accounting and disclosure practices, and auditing procedures.[149] Given this breadth and malleability, ESG may struggle to influence directors concerned with maximizing profits and faced

143. *Who Cares Wins*, *supra* note 140, at i.

144. *Id.* at ii–iii.

145. *See* World Econ. Forum, *supra* note 141, at 13 (also identifying problems "of making and measuring the business case"; "with quality and quantity of information"; "of skills and competence"; and "of time horizon").

146. *Id.*

147. *Id.*; Bower & Paine, *supra* note 14, at 60 (describing shareholder-centric versus corporation-centric views of corporations).

148. *See Who Cares Wins*, *supra* note 140, at 6 ("ESG issues relevant to investment decisions differ across regions and sectors."); World Econ. Forum, *supra* note 141, at 13–14 (noting the differential impact of "[s]ocial or environmental challenges" across industry sectors).

149. *Who Cares Wins*, *supra* note 140, at 6.

with the threat of derivative suits or takeover attempts.[150] Part III(C) will address the difficulties that ESG's heterogeneity creates for measuring the system's economic and social impact.

In addition to the definitional problem, ESG, unlike codetermination, does not take an obvious shape in the boardroom. Broadly, the movement encourages directors of corporations to integrate ESG "into strategic and operational planning, budgeting, resource allocation and compensation structures . . . [and] communicate [the corporation's] policies on these subjects to investors."[151] Corporations should adapt to changing market conditions that favor "smarter, cleaner and healthier products and services, and . . . leave behind the dogmas of the industrial era when pollution was free, labor was just a cost factor and scale and scope was the dominant strategy."[152] ESG also emphasizes public disclosure by encouraging companies to share information with investors and by asking regulators, stock exchanges, and nongovernmental organiza-

150. See PEARLSTEIN, *supra* note 19, at 7, 9, which notes that, despite the lack of legal entrenchment of the principle of profit maximization:

> Beginning in the mid-1980s, however, a number of companies with lagging stock prices found themselves targets for hostile takeovers launched by rival companies or corporate raiders employing newfangled 'junk bonds' to finance unsolicited bids. Disappointed shareholders were only too willing to sell out to the raiders. And so it developed that the mere threat of a hostile takeover was sufficient to force executives and directors across the corporate landscape to embrace a focus on profits and share prices. Almost overnight they tossed aside their more complacent and paternalistic management style, and with it a host of old inhibitions against laying off workers, cutting wages and benefits, closing plants, spinning off divisions, taking on debt, moving production overseas. Some even joined in making hostile takeovers themselves.
>
> . . . .
>
> Reinforcing this mistaken belief are the shareholder lawsuits that are now routinely filed against public companies by class action lawyers any time the stock price takes a sudden dive. Most of these are frivolous and, particularly since passage of reform legislation in 1995, most are dismissed. But even those that are dismissed generate cost and hassle, while the few that go to trial risk exposing the company to significant embarrassment, damages and legal fees.

151. Martin Lipton, World Econ. Forum, *The New Paradigm: A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth* 8 (Sept. 2, 2016).

152. Kell, *supra* note 139.

tions to demand higher accountability standards.[153] In short, firms should move away from profit maximization to create a more sustainable business environment, echoing Robert Clark's discussion of "monism."[154] However, like the definitional problem related to ESG's ends, ESG also suffers from a definitional problem related to its means.

Before turning to ESG's impact, the next section will address the levels of adoption by major corporations, particularly in the United States.

B. *Levels of Adoption*

In a legal landscape where shareholder primacy and profit maximization dominate, firms are unlikely to adopt ESG measures that detract from the residual goal of benefiting shareholders. Robert Clark posited in 1986 that "[i]t seems unlikely that shareholders would often sacrifice their self-interest to the interest of other affected groups"—for example, employees or environmental neighbors.[155] Based on the 2003 World Economic Forum survey, not much had changed seventeen years later: The chief financial officer of Rio Tinto, a global mining company, replied that "[w]ith a few honourable exceptions, most mainstream investors ask little or nothing about social responsibility."[156] In fact, "[i]nstitutional investors were initially reluctant to embrace [ESG], arguing that their fiduciary duty was limited to the maximization of shareholder values irrespective of environmental or social impacts, or

153. *See Who Cares Wins*, *supra* note 140, at iii–iv (suggesting that companies share information with investors, and that regulators, stock exchanges, and nongovernmental organizations also contribute).

154. *See* CLARK, *supra* note 1, at 681 ("The monist viewpoint is that many types of corporate activities that appear to be profit-reducing voluntary expenditures for the public good are really conducive to profit maximization in the long run.").

155. *Id.* at 692.

156. World Econ. Forum, *supra* note 141, at 12. The study noted that instead, companies usually received questions about corporate citizenship "when there has been a crisis related to their industry or company, or around certain 'hot' topics such as climate change, diversity, obesity and HIV/AIDS. The head of investor relations at one company reflected the comments of many others, 'These issues never come up unless there is a problem—no one cares unless there's a financial risk or short-term exposure.'" World Econ. Forum, *supra* at 12.

broader governance issues such as corruption."[157] Widespread adoption of ESG measures seemed for a long time to be a laughable proposition.

However, the tide began to turn in the mid-2000s. Investors, financial professionals, and corporations began to see profit maximization and ESG concerns not as mutually exclusive, as they appear in Clark's "high idealism," but rather as intertwined and mutually reinforcing within a "monist" framework. A 2003 survey of European fund managers, analysts, and investor relations officers found that seventy-eight percent believed that "the management of environmental and social risk has a positive impact on a company's long-term market value."[158] In 2006, in response to the work under the auspices of the United Nations described above, one hundred institutional investors with approximately $6.5 trillion AUM signed on to the Principles for Responsible Investment (PRI) at the New York Stock Exchange, which is "the world's leading proponent of responsible investment."[159] By 2018, the PRI had grown to include over 1,600 members representing over seventy trillion dollars in AUM.[160] According to a 2017 report, fewer investors "believe that it is unclear whether nonfinancial disclosures are material."[161] Rather, they consider such disclosures to be material, with recent surveys indicating that investors consider ESG disclosures more carefully when evaluating investee companies, including disclosures regarding "corporate governance risks and those related to the treatment of employees worldwide."[162]

With investors increasingly concerned with a company's "exposure to climate risk, its efficiency and stewardship in using natural resources, the quality and safety of its products, the type of product claims it makes, and how it treats its workers,"

157. Kell, *supra* note 139.
158. *Who Cares Wins*, *supra* note 140, at 11.
159. Robert G. Eccles & Mirtha D. Kastrapeli, State Street, The Investing Enlightenment 5 (2017), https://arabesque.com/research/Final_The_Investing_Enlightenment.pdf.
160. Kell, *supra* note 139.
161. EY, Is Your Nonfinancial Performance Revealing the True Value of Your Business to Investors? 2 (2017), https://www.ey.com/Publication/vwLUAssets/EY_-_Nonfinancial_performance_may_influence_investors/$FILE/ey-nonfinancial-performance-may-influence-investors.pdf.
162. *Id.* at 6.

companies have responded to market demands.[163] Since the founding of the Global Reporting Initiative (GRI)—an independent international organization that developed the "first and most widely adopted global standards for sustainability reporting"[164]—in 2000, corporate disclosure on ESG has improved steadily.[165] In 2015, eighty-one percent of the Standard & Poor's 500 issued sustainability reports.[166] As of 2017, ninety-three percent of the world's largest corporations report on sustainability,[167] and "80% of the world's largest corporations use GRI standards."[168]

Perceptions of ESG have transformed dramatically since the early 2000s. Investor demand for reporting on ESG issues is no longer a laughable proposition, but instead a firmly entrenched market reality. Companies have responded by increasing disclosures of nonfinancial business practices and data. However, as with codetermination, questions remain regarding the impact of ESG. Namely, do companies—particularly in the United States, where shareholder primacy remains an entrenched philosophy—go beyond reporting to actually alter their practices in order to protect the environment and improve working conditions?

C. *Impact of ESG*

This section will address theoretical discussions of ESG within the broader framework of stakeholder representation

163. PwC Governance Insights Ctr., Investors, Corporates, and ESG: Bridging the Gap 3 (2016); *see* PwC Governance Insights Ctr., *supra* at 8 ("Half of investors want ESG information incorporated into SEC filings or some form of CEO or CFO certification to demonstrate quality . . . ."); *see also Who Cares Wins*, *supra* note 140, at 23 (describing initiatives by institutional investors on ESG issues, such as the Carbon Disclosure Project, which "call[s] on companies to provide investment-relevant information relating to green-house gas mitigation," and the Institutional Shareholders Committee Principles, which "call[ ] on fund managers to take a more active approach in relation to their engagement with companies, which should include ESG issues").

164. *About GRI*, Global Reporting Initiative, https://www.globalreporting.org/Information/about-gri/Pages/default.aspx (last visited Oct. 31, 2019).

165. Kell, *supra* note 139.

166. PwC Governance Insights Ctr., *supra* note 163, at 3.

167. *About GRI*, *supra* note 164.

168. Kell, *supra* note 139.

in corporate governance and empirical observations of ESG's impact, in order to analyze whether ESG provides a viable check on the perceived problems of U.S. corporate governance, particularly shareholder primacy.

1. *Theoretical Discussions*

While ESG clearly moves away from the strict profit maximization norm of *Dodge*, it does not necessarily involve the board's abandonment of shareholder centricity in favor of "high idealism," under which the residual goal of the corporation becomes one of social or environmental purpose.[169] Instead, managers adopt ESG strategies based on the "assumption that ESG factors have financial relevance"[170]—echoing Clark's description of "monism."[171] While there are clear advantages to allowing companies to follow market forces, a flexible system of ESG that relies on companies taking proactive steps suffers from a number of drawbacks.

Much as codetermination creates the potential for the firm to compromise on labor issues to the detriment of non-employee stakeholders,[172] allowing a corporation to deviate from shareholder primacy may let the board prioritize certain stakeholders over others. If directors are free to select which ESG measures the corporation adopts, then there is a risk that "these managerially chosen public goals . . . (1) [will not] have much to do with long-run profit maximization . . . , (2) [will not] reflect their shareholders' preferences, and (3) [will not] reflect the public policy preferences of citizens at large."[173] By extension, the board may also be ignoring preferences of important stakeholders, such as employees or customers. The board also faces difficult decisions when stakeholders' interests

169. *See* CLARK, *supra* note 1, at 688 ("High idealism holds that the business corporation's residual goal, and not just its specific, externally imposed legal obligations, should be defined to include a much wider set of interests than those of the shareholders.").

170. Kell, *supra* note 139.

171. *See* CLARK, *supra* note 1, at 681 ("The monist viewpoint is that many types of corporate activities that appear to be profit-reducing voluntary expenditures for the public good are really conducive to profit maximization in the long run.").

172. *See* discussion *supra* Section II(C)(i).

173. CLARK, *supra* note 1, at 684.

conflict.[174] While not perfect, shareholder primacy assigns to the board "a single, objective, easily monitored goal," which reduces monitoring costs.[175] Additionally, ESG-based conduct could function as a "façade for the illegitimate accumulation and exercise of managerial prerogatives."[176] Finally, with boards given so much flexibility to define policy goals, the risk arises that "overall public policy is likely to be even more incoherent and uncoordinated than it is now."[177] Of course, there is a strong counterargument in favor of ESG, namely that investors expect certain corporate practices regarding production and treatment of workers, among other social concerns.[178]

The most significant problem with ESG, whether enacted through proxy initiatives or increased disclosure, is that investors may not truly concern themselves with a company's engagement on social or environmental issues, rather than its profitability. Assuming most investors are socially neutral, the minority of socially conscious investors who pay a premium to own equity in a company with better ESG-related practices simply create an arbitrage opportunity for the majority:

> If there existed two companies, alike in all respects except that one produces socially-valuable goods and the other does not, any increase in the share price of the former will prompt socially-neutral investors to sell its shares and buy shares of the latter. This arbitrage process would continue until the stock prices of the two companies were identical, thereby eliminating any share price impact based on the socially-motivated trading, and therefore neutralizing any social value added.[179]

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174. *See id.* at 693 ("Consider, for example, the possible implications of a board composed of directors elected by shareholders and employees. The interests of these groups may conflict seriously with those of consumers and governmental units").

175. *Id.* at 692.

176. *Id.* at 684.

177. *Id.* at 694.

178. *See* discussion *supra* Sections III(A)–(B).

179. Paul Brest, Ronald J. Gilson & Mark A. Wolfson, *How Investors Can (and Can't) Create Social Value* 14 (Eur. Corp. Governance Inst., Law Working Paper No. 394/2018, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3150347; *see also* Brest, Gilson & Wolfson, *supra* at 20 n.42 (quoting Siew Hong Teoh, Ivo Welch & C. Paul Wazzan, *The Effect of Socially Activist*

However, if investors actually concern themselves with a company's ESG-related conduct, as recent surveys seem to suggest,[180] then a system that aligns investor interests with those of management has a number of clear theoretical advantages over a system of burdensome legal regulation. For one, if ESG factors do have financial relevance, particularly with respect to long-term profitability, then considering these factors in decision making does not radically depart from the current legal emphasis on a board's fiduciary duty to shareholders.[181] It also does not create the arbitrage opportunity for socially neutral investors. Instead, the majority of investors would view socially beneficial and profit maximizing conduct as interrelated and not mutually exclusive. Further, as better technology improves companies' disclosure capabilities and improves stakeholder access to ESG information, stakeholders may become more empowered in interacting with corporations.[182]

Finally, as discussed at length earlier, corporations have a number of significant stakeholders, not just management, shareholders, or labor. A system of private ordering that allows firms to tailor their approach to their particular stakeholders and to consider as many stakeholder interests as possible may

Investment Policies on Financial Markets: Evidence from the South African Boycott, 72 J. BUS. 35, 83 (1999)) ("In all, the evidence from both individual and legislative actions, taken together, suggests that the South African boycott had little valuation effect on the financial sector. Despite the prominence and publicity of the boycott and the multitude of divesting companies, the financial markets' valuations of targeted companies or even the South African financial markets themselves were not visibly affected. The sanctions may have been effective in raising the public moral standards or public awareness of South African repression, but it appears that financial markets managed to avoid the brunt of the sanctions.").

180. *See* PWC GOVERNANCE INSIGHTS CTR., *supra* note 163, at 3 (referring to a survey of Standard & Poor's 500 that indicates that investors are increasingly pressuring companies to issue sustainability reports).

181. *See* CLARK, *supra* note 1, at 682–83 (noting that if corporations embark on socially responsible activity carefully, i.e., in line with shareholder interests, then "it is almost impossible for shareholders to attack their actions successfully").

182. *See* Kell, *supra* note 139 ("Gathering and processing data will become ever easier and cheaper. Smart algorithms will increasingly allow for better interpretation of non-traditional financial information which seems to be doubling in volume every couple of years. . . . ESG investing allows [investors] to express their own values and to ensure that their savings and investments reflect their preferences, without compromising on returns.").

allow boards to maintain the flexibility normally seen as an advantage of the U.S. unitary board vis-à-vis the codetermined board, which entrenches labor interests above those of other stakeholders.[183] Even if in theory the majority of investors in the capital markets are not concerned with the investee firm's social as opposed to market value, non-shareholder stakeholders can and often do maintain significant leverage over a corporate board's decision making:

> [E]ach consumer who refuses to purchase apparel made under poor labor conditions detracts incrementally from the seller's bottom line. . . . [A] company that despoils the environment may be scrutinized by regulators who have immense power over its practices. From the perspective of these stakeholders, social performance and financial performance do not need double bottom line accounting—separate measures of the net financial and net social value created. The two are complementary.[184]

ESG may be the market-driven solution to the crisis of governance many see in corporate America.[185] However, there are a number of drawbacks of such a flexible philosophy: for example, the prioritizations of certain interests to the detriment of others and the concern for monitoring a more complicated goal. Still, stakeholders represent a significant market force. Boards should logically follow their demands for increased ESG-related measures if doing so will maximize long-term profitability. The next section will evaluate the impact ESG has had on corporate conduct to date.

2. *Empirical Observations*

It is difficult to make definitive statements about the empirical effects of ESG on corporate performance, given that ESG is still very much in its infancy,[186] particularly when compared with the long history of codetermination and holistic understanding of the corporation found in German law. Fur-

183. *See* discussion *supra* Section II(C)(i).
184. Brest, Gilson & Wolfson, *supra* note 179, at 19.
185. *See* Kell, *supra* note 139 ("And for policy makers, [ESG] should be a welcome market-led development that ensures that the common good does not get lost in short-term profit making at any cost").
186. *See supra* Section III(A).

thermore, in line with Clark's discussion of "monism," ESG is linked with long-term, as opposed to short-term, shareholder returns. Studies that have found a positive correlation between ESG and corporate financial performance show that benefits are typically realized in the range of six or seven years.[187] However, it is still possible to analogize to similar historical movements and to discuss some early empirical observations.

Boycotts, such as the movement to divest from apartheid-era South Africa, provide one analog. Even if investors as such can exert little power over a corporation's environmental and social decisions, "[t]here is evidence that consumer boycotts can influence company behavior, and that an important part of the success results from company-perceived reputational damage rather than only from the boycott's immediate financial impact."[188]

Early empirical evidence also suggests that long-term returns and social value do converge. For one, the widespread adoption of ESG disclosure and investing strategies implies that corporations, investment professionals, and stakeholders view ESG as an important part of financial success.[189] Currently, nearly one hundred third-party firms provide ESG ratings on companies.[190] Financial leaders like BlackRock's Larry Fink now recognize that "[s]ociety is demanding that companies, both public and private, serve a social purpose."[191] A 2015 meta-study by Oxford University and Arabesque Partners, an asset management firm "integrating ESG big data with quantitative investment strategies,"[192] found sustainability to be "one of the most significant trends in financial markets."[193]

187. ECCLES & KASTRAPELI, *supra* note 159, at 9 ("The same studies that show a positive relationship between ESG factors and corporate financial performance also show that the potential financial benefits from ESG take time to be realized—typically in the range of six or seven years.").

188. Brest, Gilson & Wolfson, *supra* note 179, at 20 (citing generally Mary-Hunter McDonnell & Brayden King, *Keeping Appearances: Reputational Threat and Impression Management After Social Movement Boycotts*, 58 ADMIN. SCI. Q. 387 (2013)).

189. *See supra* Section III(B).

190. EY, *supra* note 161, at 22.

191. Fink, *supra* note 29.

192. *About,* ARABESQUE PARTNERS, https://arabesque.com/about (last visited Oct. 31, 2019).

193. GORDON L. CLARK, ANDREAS FEINER & MICHAEL VIEHS, UNIV. OF OXFORD & ARABESQUE PARTNERS, FROM THE STOCKHOLDER TO THE STAKEHOLDER:

Ninety percent of the studies analyzed showed that "sound sustainability standards lower the cost of capital of companies," and eighty-eight percent of the studies analyzed determined that "solid ESG practices result in better operational performance."[194] ESG encourages corporations to analyze and manage their social and environmental risks, giving the "competitive advantage" of "pre-emptive insurance . . . for adverse ESG events."[195] Companies can identify specific risks and external costs; improve performance through process and product innovation; and boost their reputation among employees and consumers.[196] The latter is particularly significant, as "[i]t is not uncommon that intangible assets, including reputation and brands, represent over two-thirds of total market value of a listed company."[197] Corporations with strong governance mechanisms and environmental practices also benefit from reduced borrowing costs and improved credit ratings.[198] Other research has shown that "'high sustainability' companies significantly outperform their counterparts over the long term, both in terms of stock market as well as accounting performance measures."[199]

However, while there appears to be a growing academic and market consensus around the convergence of ESG factors and long-term profitability, others have criticized these findings based on the "likelihood that this information is already reflected in market price" and "the breadth and vagueness of the factors as a whole."[200] Additionally, the impact of ESG

HOW SUSTAINABILITY CAN DRIVE FINANCIAL OUTPERFORMANCE 9 (2015), https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf.

194. *Id.*

195. *Id.* at 12–13.

196. *Id.* at 13; *see also Who Cares Wins*, *supra* note 140, at 9 ("Companies with better ESG performance can increase shareholder value by better managing risks related to emerging ESG issues, by anticipating regulatory changes or consumer trends, and by accessing new markets or reducing costs. Instead of focusing on single issues, successful companies have learned to manage the entire range of ESG issues relevant to their business, thereby achieving the best results in terms of value creation. Moreover, ESG issues can have a strong impact on reputation and brands, an increasingly important part of company value.").

197. *Who Cares Wins*, *supra* note 140, at 9.

198. CLARK, FEINER & VIEHS, *supra* note 193, at 23–24.

199. EY, *supra* note 161, at 4.

200. Brest, Gilson & Wolfson, *supra* note 179, at 24.

measures, not governed by the same universal legal rules as German-style codetermination, is likely to differ markedly among corporations, if each adopts their own individualized ESG metrics, and thus is difficult to measure in the aggregate.

To summarize, ESG provides a market-driven solution to many of the issues of American capital markets, including its emphasis on shareholder primacy. It encourages corporations to consider their stakeholders, while allowing them to tailor their measures to their specific circumstances. The philosophy has expanded tremendously since the start of the 21st century. While the concept may suffer in theory from drawbacks related to its inherent malleability, research has already begun to show ESG's positive market impacts. But the question remains: Does ESG go far enough to assuage Senator Warren's concerns and to preempt an overhaul of U.S. corporate law?

IV. Conclusions and Predictions

Codetermination and ESG stem from different historical circumstances, but they share much in the way of underlying philosophy. In Germany, codetermination grew out of the nineteenth century welfare state's interest in taming labor unrest. It expanded greatly in the political and economic reorganization that followed World War II.[201] German law obligates firms of a certain size to maintain codetermined boards, giving a literal seat at the table to non-shareholder stakeholders—i.e., employee representatives.[202] ESG, on the other hand, results from contemporary conditions and debates on corporate engagement with labor, the environment, customers, and other stakeholders more broadly.[203] If codetermination developed out of the philosophical understanding of the corporation as a "social and economic" organization with long-term business purposes and ethical obligations,[204] then the rise of ESG represents a new, more holistic understanding of the corporation.

The ESG-conscious corporation responds to many of the criticisms that plague the shareholder model, such as short-termism and lack of respect for non-shareholder stakehold-

201. *See supra* Section II(A).
202. *See supra* Section II(A).
203. *See supra* Section III(A).
204. Bower & Paine, *supra* note 14, at 60.

ers.[205] But, importantly, corporate law does not mandate ESG policies and disclosures—at least, not yet. Instead, institutional and retail investors have begun to demand that boards ensure that their firms conduct business in line with this more holistic model of the corporation.[206]

Expansion of ESG, as opposed to enactment of Senator Warren's proposal, does not depart radically from U.S. corporate law, at least under a "monist" view, as long as ESG measures ensure the corporation's long-term viability and profitability.[207] While a Republican-majority Senate is unlikely to pass a proposal like Senator Warren's, any major reform of U.S. corporate regulation will likely involve intense debate with significant lobbying efforts from corporations whose compliance would be required.[208] However, ESG, by following market demands, avoids not only the ex ante problem of enacting legislation, but also the ex post issue of ensuring that corporations comply with a federal incorporation law mandating codetermination.

Of course, individual corporations, as well as their unions, could decide to adopt private measures similar to codetermination; granted, though, the prospect seems weak in light of the poor history of labor interest representation in U.S. corporations.[209] Recently, workers at a Volkswagen assembly plant in Chattanooga, Tennessee sought to establish the first German-style works council in the United States, but the union ultimately lost the plant workers' vote.[210] Thus, in terms of clearing initial legal hurdles, ESG seems more viable, at

205. *See supra* Section III(A).

206. *See supra* Section III(B).

207. *See supra* Section III(A).

208. *See* HOLMBERG, *supra* note 47, at 20 ("The biggest obstacle to adopting . . . co-determination in the U.S. is still employer resistance, particularly given that the American labor movement does not have the leverage of their German counterpart to push for this legislation.").

209. *See supra* Section II(B).

210. HOLMBERG, *supra* note 47, at 19–20; *see* Mike Pare, *Volkswagen, Labor Union Clash over Request Involving Chattanooga Plant*, CHATTANOOGA TIMES FREE PRESS (Dec. 22, 2017), https://www.timesfreepress.com/news/business/aroundregion/story/2017/dec/22/vw-uaw-clash-over-request-involving-chattanoo/459749 (noting that while the plant vote rejected the union, the UAW endorsed a smaller "micro-union" at the plant, leading to conflict between Volkswagen and the UAW and National Labor Relations Board over whether the corporation was required to bargain with the "micro-union").

least in the current climate, and a significant number of firms have begun adopting ESG measures and disclosing their compliance.[211]

Theoretically, codetermination and ESG provide a similar benefit, while suffering from inverse drawbacks. Both systems provide a check on short-termism and the resultant inclination to favor profits over ethical obligations to stakeholders.[212] Codetermination gives a particular stakeholder—labor—power to bargain with the rest of the board, who represent shareholder interests.[213] The ESG movement, on the other hand, pushes boards to consider stakeholders in their corporate policies, and its flexible nature allows boards to adapt to changing financial, social, and environmental conditions.[214]

Codetermination's enshrinement of labor interests, however, may limit the power of other relevant stakeholders, such as customers and environmental neighbors, whose interests may diverge significantly from those of employees.[215] For example, labor representatives could demand that a firm maintain a plant that imposes negative environmental externalities but also employs a large workforce. ESG, on the other hand, would not privilege labor's interests over those of other corporate stakeholders. However, ESG's inherent flexibility may not adequately signal to boards which stakeholders' interests it should consider when interests diverge.[216]

More fundamentally, ESG's private nature—and its corresponding lack of legal basis—may not adequately force boards to enact measures that safeguard labor, social, and environmental interests in line with societal expectations.[217] As the *New York Times* noted on the Business Roundtable's recent position change on profit-maximization, "[t]he Business Roundtable did not provide specifics on how it would carry out its newly stated ideals."[218] At least codetermination legally empowers one stakeholder, whereas, in a system where ESG dominates, investors must continue to demand corporate compli-

211. *See supra* Section III(B).
212. *See supra* pp. 16–18, 38–40.
213. *See supra* p. 11.
214. *See supra* Section III(A).
215. *See supra* Section II(C)(i).
216. *See supra* Section III(C)(i).
217. *See supra* Section III(C)(i).
218. Gelles & Yaffe-Bellany, *supra* note 31.

ance. Considering the different historical and theoretical contexts of U.S. and German corporate law, ESG seems to provide a valuable mechanism for maintaining a form of shareholder primacy, while also protecting long-term interests.

In terms of economic impact, the systems also diverge. Codetermination increases employee benefits, provides a check on executive compensation, and maintains relatively stable relations between workers and management.[219] However, codetermination also limits profitability and the attractiveness of the firm's securities, increasing ownership entrenchment and therefore decreasing mergers and acquisitions.[220] One of the most important benefits of ESG is that it aligns environmental and social interests with long-term profitability, a proposition that corporate leaders increasingly buy into and one that the empirical research has confirmed thus far.[221]

Despite these divergent conceptual and historical backdrops, as well as theoretical and observed economic effects, codetermination and ESG are not mutually exclusive governance mechanisms. A codetermined board, where legally allowed or obligated, can consider non-labor interests that favor long-term sustainability. While ESG may seem less necessary in countries with strong stakeholder protections, including legally required codetermination, German firms still tend to score higher in terms of ESG policies than their U.S. counterparts.[222]

Furthermore, the two do not provide the only potential solutions to the crises in U.S. corporate governance. For example, corporations could instead enact employee stock ownership plans (ESOPs), which give workers an ownership stake, or they could incorporate as cooperatives—"organizations owned and managed entirely by workers."[223] However, ESOPs also come with notable drawbacks. While "ESOPs may incentivize

219. *See supra* Section II(C)(i).

220. *See supra* Section II(C)(i).

221. *See supra* Section III(C)(i).

222. *See* Hao Liang & Luc Renneboog, *On the Foundations of Corporate Social Responsibility* 2–5 (Eur. Corp. Governance Inst., Finance Working Paper No. 394/2013, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360633 (stating that while the measures may be redundant, firms in the German system score higher, particularly in terms of environmental issues, than firms in common law systems).

223. HOLMBERG, *supra* note 47, at 20–21.

workers to be productive" because they stand to benefit in terms of increased equity value, they do not "necessarily give workers the right to vote their shares and may not offer enough of a countervailing weight to offset the outsized power of other stakeholders in, for example, a merger fight."[224] Cooperatives, on the other hand, place the onus on labor to found the business in the first instance and to run it themselves. But given U.S. corporations' reactions to previous attempts at codetermination and similar labor protections, neither ESOPs nor cooperatives seem destined to gain significant traction in the immediate future.

This note has presented two major mechanisms of controlling corporate decision making—German-style codetermination and the newer, market-driven system of ESG. It has described their historical and philosophical underpinnings, as well as their theoretical and empirical effects on corporate behavior and output. While codetermination may provide a clearer and more powerful enshrinement of stakeholder power, the recent history of shareholder primacy and significant political hurdles make its adoption in the United States unlikely. On the other hand, ESG provides U.S. boards with a flexible alternative that can morph with changing financial, social, and economic conditions, while simultaneously maintaining U.S. corporate law's dedication to profitability.

224. *Id.* at 20.